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GEORGIA ADOPTS ADVANTAGEOUS INCOME TAX TREATMENT FOR MANUFACTURING, SALES & SERVICE COMPANIES

House Bill 191, passed during Georgia's 2005 legislative session and recently signed into law by Governor Perdue, significantly reduces the effective rate of Georgia income taxation of Georgia-based manufacturing, sales and service companies with substantial sales to customers outside Georgia. House Bill 191 amends Section 48-7-31 of the Georgia Code.

For all tax years beginning on or after January 1, 2008, manufacturing, sales and service companies doing business in Georgia are to use a "Single Factor Gross Receipts" apportionment formula. This new method of apportionment results in a substantial reduction of Georgia income taxes for companies that manufacture products within the state of Georgia, sell goods from a Georgia base or render services from a Georgia base, but sell those products or services to customers in other states. This change was designed to encourage manufacturing, distribution and service companies to invest or expand in Georgia.

The "Single Factor Gross Receipts" apportionment formula benefits manufacturing, distribution and service companies which conduct business in a number of states from a Georgia base in the following manner. Georgia only taxes a portion of the total income of a company that conducts its business in a number of different states. Under former law, a manufacturing or sales company's total taxable income was "apportioned" to Georgia by multiplying that income by a fraction, computed as follows:

$$\frac{\dfrac{\text{Property Owned in Georgia}}{\text{Total Property Owned}} + \dfrac{\text{Payroll in Georgia}}{\text{Total Payroll}} + 2\text{x}\ \dfrac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}}{4}$$

Another way to calculate the part of total income apportioned to Georgia was to add the following three factors:

Property Factor	.25	x	$\dfrac{\text{Property in Georgia}}{\text{Total Property}}$
Payroll Factor	.25	x	$\dfrac{\text{Payroll in Georgia}}{\text{Total Payroll}}$
Sales Factor	.50	x	$\dfrac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}$

As indicated, under the old formula, each of the Property and Payroll factors had equal weight and the Gross Receipts factor had double weight in determining the portion of a manufacturing or sales company's income that was apportioned to, and therefore taxed by, the state of Georgia.

Under Georgia law prior to 1995, the income of a service company was required to "equitably" apportion their income to Georgia, but such companies were not required to use a particular formula to accomplish this apportionment. However, after 1995, service companies were and are still required to apportion their income to Georgia in the same manner as manufacturing or sales companies, unless such an apportionment "does not fairly represent the extent of the [service company's] business activity in Georgia." In such case, a service company can petition the Commissioner of Revenue to use a different formula.

Under the new apportionment formula, the Gross Receipts or sales element will be the only factor used in determining the apportionment of a company's income to Georgia for tax years beginning on or after January 1, 2008. The appropriate apportionment fraction will then be computed as follows:

$$\frac{\textbf{Georgia Gross Receipts}}{\textbf{Total Gross Receipts}}$$

For 2006 and 2007, the Gross Receipts Factor will represent 80% and 90%, respectively, of the apportionment fraction.

As indicated by its name, the new "Single Factor Gross Receipts" formula will, by 2008, treat a company's Gross Receipts or sales factor as the only relevant factor in determining the portion of that company's income that is subject to Georgia income tax. It will, for the 2008 tax year and thereafter, ignore Georgia Property and Payroll.

The net result of this change is that, beginning with the 2006 tax year, companies with significant Georgia assets and Georgia payroll but substantial sales of goods or services to customers outside Georgia, will bear a proportionately smaller Georgia state income tax burden on manufacturing, sales and service income under the new formula than under Georgia's old three-factor apportionment formula. <u>Beginning in 2006, Georgia will have a significantly lower effective rate of income tax for Georgia-based manufacturing, distribution or service companies</u> which sell goods or services to customers outside Georgia. An example will illustrate these advantages.

Example: Assume that, for the 2008 tax year, In-State Manufacturing Co., Inc. has the following total overall taxable income and the following percentages of Gross Receipts, Property, and Payroll within the state of Georgia:

Taxable Income:	$100 million
Percent of Property in Georgia:	100%
Percent of Payroll in Georgia:	100%
Percent of Gross Receipts in Georgia:	13%

Under the old formula, the following portion of In-State Manufacturing Co., Inc.'s income would be apportioned to Georgia:

Property Factor	.25	x	1	.25
Payroll Factor	.25	x	1	.25
Sales Factor	.5	x	.13	.065
Total				.565

Accordingly, $56.5 million (.565 x $100 million) of In-State Manufacturing Co., Inc.'s income would have been subject to Georgia income tax under the old formula.

Under the new formula, the following portion of In-State Manufacturing Co., Inc.'s income would be apportioned to Georgia:

$$\frac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}} = .13$$

Accordingly, in 2008, only $13 million (.13 x $100 million) of In-State Manufacturing Co., Inc.'s income would be subject to Georgia income tax under the new Single Factor Gross Receipts formula.

Thus, in this example, the new formula results in $43.5 million less of In-State Manufacturing Co., Inc.'s income being subject to Georgia income tax.

<u>Under Georgia's new law, the result will be the same for a manufacturing, distribution or service company</u>.

This result is available under the new apportionment formula because, first, under long standing Georgia law, gross receipts are "sourced" by where the product or service will be used, or by the so-called "Marketplace" source rule. That is, if the customer will sell or use a product or service outside Georgia, the gross receipts from the sale of goods or services to that customer is not treated as a Georgia gross receipt in the allocation formula. Second, Georgia does not generally use the so-called "Throw Back Rule," under which many states tax income from sales of goods or services to out of state customers if the customer's state does not. Georgia does not generally tax such income. Accordingly, if the state in which the goods or services are used does not tax the income attributable to those goods or services, that income will escape state income tax.

To illustrate the Throw Back Rule, assume a Service Company ("SERCO") based in State A (a state other than Georgia) sells services to a customer in State B and that State B does not attempt to tax SERCO on its income from sales in State B. Unfortunately, State A applies the Throw Back Rule to tax the income from sales of services in State B because State B did not do so. On the same facts, if Georgia were State A, Georgia would generally not tax income from sales of services to customers in State B even if State B does not tax income from such sales.

As described above, this change to a Single Factor Gross Receipts formula will be phased in beginning with the 2006 tax year. For 2006, the Property and Payroll factors will each represent 10% of the fraction, and the Gross Receipts Factor will represent 80% of the fraction. For 2007, the Property and Payroll Factors will each represent 5% of the fraction, and the Gross Receipts Factor will represent 90% of the fraction.

The apportionment formula (simplified) for the 2006 tax year will be:

$$\text{Property Factor} \quad .1 \quad \text{x} \quad \frac{\text{Georgia Property}}{\text{Total Property}}$$

$$\text{Payroll Factor} \quad .1 \quad \text{x} \quad \frac{\text{Georgia Payroll}}{\text{Total Payroll}}$$

$$\text{Sales Factor} \quad .8 \quad \text{x} \quad \frac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}$$

The apportionment formula (simplified) for the 2007 tax year will be:

Property Factor	.05	x	$\frac{\text{Georgia Property}}{\text{Total Property}}$
Payroll Factor	.05	x	$\frac{\text{Georgia Payroll}}{\text{Total Payroll}}$
Sales Factor	.9	x	$\frac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}$

To summarize:

1. **Georgia's new Single Factor Gross Receipts apportionment formula will greatly reduce Georgia income tax on Georgia-based manufacturing, distribution and service companies that have out-of-Georgia sales. Beginning with the 2006 tax year, the phased in application of this new formula will significantly reduce Georgia's effective rate of income tax on Georgia companies that have sales outside Georgia.**

2. **Georgia is the first southeastern state to adopt the Since Factor Gross Receipts formula.**

3. **Other states may also adopt the Single Factor Gross Receipts formula for apportionment; however, if their source rules for Gross Receipts are more expansive than Georgia's, or if they use the Throw Back Rule, as described above, they will not offer income tax savings as large as those available under newly enacted Georgia House Bill 191.**

If you have any questions about the matters discussed in this memorandum, please call John Gornall at (404) 873-8650 or Mark Salsbury at (404) 873-8182.

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