POLICY MEMORANDUM

Fiscal Research Center

Andrew Young School of Policy Studies

Georgia State University

SUBJECT: Tax Issues for Possible Consideration by Tax Reform Council

Analysis Prepared by: David L. Sjoquist

Contact Information: Sjoquist (404) 413-0246; Sjoquist@gsu.edu

August 25, 2010

This document is an attempt to identify tax provisions or structures that are associated with each of the state taxes that the Tax Reform Council may want to consider addressing. The list was generated from issues raised from many sources, but is undoubtedly incomplete. The ordering is meaningless. These tax provisions are issues because they appear to conflict with one or more of the principles of a good tax system or are not in harmony with the economic structure.

I first describe the issue, providing some background; the description is not the analysis that needs to be done before any recommendations are made. I then list questions that I hope provides a better idea of what the issue is about and what the purpose of any analysis might be. I list all of the taxes, but for two of them I do not list any issues. The three figures referred to can be found at the end of the memo.

Overarching Issues

Our task is to consider the tax system. While we will do that by separately considering each tax, it is important to keep the tax system in mind. We need the pieces to fit together; making changes piecemeal is the reason we have been asked to review the tax code. We consider the tax system because there are trade-offs between taxes. Obviously, it we reduce or eliminate the revenue from one tax, we need to find that revenue elsewhere. The equity of the tax system depends on the mix of taxes; making one tax more regressive can be offset by increasing progressivity in another tax, so that for the system we have the desired level of equity.

Another point to keep in mind is that taxes and tax changes differ in how well they conform to the tax principles; some taxes do better on one score than another. For example, the flatter the income tax rate, the less the tax affects behaviors (efficiency), but the less progressive it is (equity). Creating more equity or fairness will generally require more complexity in the tax structure. What we want to do is to create a tax portfolio that best meets our objectives, but rather than the risk and return factors that drive decision for a financial portfolio, we have equity/fairness, economic efficiency, growth in revenue, stability of revenue, tax complexity, etc. that we trade off.

Before discussing the individual taxes, I list three overarching issues that Council might consider.

1. Is the distribution of tax burdens appropriate or acceptable? The presentation at the first Council showed that Georgia's tax system is regressive, i.e., taxes as a share of income is higher for lower income households. In making this decision, we need to consider the cost in terms of reduced incentives for economic growth, tax complexity, etc.

2. Should Georgia retain all of its current taxes? Do any of the taxes violate the principles of a good tax to such a degree that the tax should be eliminated? In the past few years there have been suggestions for eliminating the personal income tax, the corporate income tax, the net worth tax, and the property tax. Do we not want any of these in our tax portfolio?

3. Should Georgia adopt taxes that are fundamentally different from those taxes it currently uses, for example, a gross receipts tax, a value added tax, or a consumption tax? Doing so would change the Georgia tax system in a fundamental way. Are these taxes we want in our tax portfolio, either in addition to existing taxes or as substitutes?

Personal Income Tax

1. Issue: The income tax rate schedule is rather flat, as can be seen in Figure 1. The top marginal tax rate is reached at a taxable income of $10,000 for a joint return. The effective tax rate (tax liability divided by Federal AGI) is progressive, i.e., increases with income, as can be seen in Figure 2. The current rate structure was set in 1937, except that in 1955 the 7 percent rate on incomes over $20,000 was eliminated. A flatter tax rate structure would decrease the progressivity of the tax system but reduce disincentives to work, save and invest. It may increase stability but reduce the growth. Adding a 7 percent bracket would increase revenue.

Questions: Is the rate structure too flat, not flat enough? Is the effective tax rate structure too progressive or not progressive enough? Should the 7 percent bracket be re-imposed?

2. Issue: The current value of personal exemptions has been in place since at least 1995. The values of these exemptions differ from the personal exemptions allowed under the Federal income tax. The exemption for filers is $2,700 and for dependents it is $3,000. The principle reason for allowing personal exemptions is to increase the progressivity of the income tax system. Because of inflation the real value of the personal exemptions has decreased.

   Question: Are the current values of the personal exemption the appropriate values? Should the personal exemption be indexed for inflation?

3. Issue: Georgia is phasing in a 100 percent deduction for retirement income. This means that the elderly are treated differently than the non-elderly. This policy would seem to violate the equal treatment of equals principle (horizontal equity) in that household with equal income would be taxed differently.

   Question: Should Georgia provide for this differential tax treatment based on age?

4. Issue: Georgia piggybacks on the Federal personal income tax, adopting most but not all of the changes that Congress makes to the IRS code each year. In each session the General Assembly passes a conformity bill. This also applies to the corporate income tax. Conformity reduces the burden of filing a Georgia tax return for most individuals but it puts Georgia somewhat at the mercy of tax changes the Federal government adopts. The conformity legislation is approved about April, so a fourth of the year has elapsed before taxpayers know what rules will apply for this tax year; this affects the ability to do tax planning.

   Question: Should the state continue to define its personal income tax in terms of the Federal income tax? Is there a better way of conforming than annual legislation?

5. Issue: The calculation of Georgia income tax starts with Federal AGI. To get to Georgia AGI, there 9 adjustments that must be added to Federal AGI and 19 adjustments that are subtracted from Federal AGI. On net, these adjustments reduce AGI by about 20 percent. They add to the complexity of the income tax.

   Question: Should Georgia retain all of these adjustments?

6. Issue: Georgia has a low income tax credit that up until this year was refundable. The maximum credit is $26 per person for households with a federal AGI of $6,000 or less. The credit phases out at an income of $20,000. It increases the progressivity of the tax system and reported was added to offset the sales tax on groceries. The credit is not index for inflation so that its value decreases over time.

   Question: Should this credit be eliminated? Should the refundable nature of the credit be reinstated? Should the credit be indexed for inflation?

7. Issue: Georgia has 9 personal income tax credits that do not depend on income. These credits reward certain types of behavior, which violates the principle of an efficient tax system. There is no known evidence as to the effect or effectiveness of these credits. Of course these credits reduce income tax revenue, thus requiring higher tax rates, either for the income tax or other taxes.

   Question: Should any of these credits be eliminated? Should any of them be restructured?

8. Issue: The Federal government has an earned income tax credit (EITC), as do several states. The credit is a percentage of wage and salary income for low wage workers. The credit phases out as income increases. The federal EITC is refundable. Such a credit provides an incentive (and additional income) to low-wage workers to work more. An EITC does increase the progressivity of the income tax but violates economic efficiency in that it rewards certain behaviors beyond what the market provides.

   Question: Should Georgia consider adding an EITC?

9. Issue: For calculating business income, the state specifies the allowable depreciation rates. The state has not always adopted the special depreciation schedules that the Federal government allows. For example, the state has not adopted the bonus depreciation allowances that the Federal government has adopted. (Bonus depreciation allows the firm to depreciate the asset faster for tax purposes.) If allowable depreciation rates are too low, then firms may under invest in plant and equipment; if the rates are too generous, then firms will over invest.

   Question: Is the allowable depreciation schedule appropriate?

10. Issue: The state includes income taxes paid to the state to be included as an itemized deduction. This is not a common practice in other state income tax systems. There appears to be no economic justification for such an exemption.

Question: Should state income taxes paid in one year be deductable in computing state income tax for the following year?

11. Issue: Income of nonresidents and part-year residents is taxed differently than out-of-state income of Georgia residents. In particular, the full/part-year resident credit for taxes paid to other states while a Georgia resident is less favorable than the non-resident/part-year resident calculation of tax on Georgia income.

    Questions: Should Georgia change its credit for income taxes paid to other states on out-of-state income?

Retail Sales and Use Tax

The base of the sales tax has decreased as a share of the state's economy (Figure 3). This raises several issues.

1. Issue: The sales tax applies mainly to the purchase and lease of tangible personal property. Services are generally excluded. Services have increased as a share of the economy, so a smaller share of consumption is being taxed under the sales tax. The Federation of Tax Administrators identified 166 services that at least one state taxed; Georgia taxes 36 of those. Not taxing services means that the tax base is narrow, requiring a higher tax rate to obtain the same revenue, and provides an incentive to purchase services rather than tangible personal property, all of which violates the economic efficiency principle.

    Question: Should services be included in the sales tax base? If so, which services?

2. Issue: There are over 110 exemptions from the sales tax. The number of exemptions granted has increased at an increasing rate over the past three decades. The total revenue loss from the exemptions is about $10 billion. The exemptions can be classified into those for purchases by government and governmental agencies, by agriculture businesses, by health providers and consumers of health products, by other industries and specific firms, by nonprofits, and by households. Examples of the exemptions include purchases by the federal government, raw materials used in manufacturing, goods purchased for resale, casual sales including the purchase of cars other than through a dealer, and food for home consumption.

Question: Should any of these exemptions be eliminated? Are there exemptions that should be added?

3. Issue: The sales tax applies to purchases made by business. Purchases by business are estimated to be 36 percent of the sales tax base. This results in tax pyramiding, i.e., a tax levied on a tax, as the product goes through the production channels. To the extent the tax at each stage is included in the price the effective tax rate on the final product will differ across products depending on the number of times the sales tax was applied in the production/distribution process.

   Question: Should Georgia exempt all or most business-to-business purchases?

4. Issue: The state cannot require most remote vendors to collect sales tax on purchases made in Georgia (the result of a U.S. Supreme Court ruling in a case referred to as Quill) and collecting the use tax is not considered administratively feasible. The estimated revenue loss from e-commerce is $310 million.

   Question: Is there anything the state should do that might increase collection of the taxes that are due on these purchases? Should Georgia adopt an "Amazon" law? (New York enacted an innovative law that effectively deems a retailer to have a physical presence within the state when it has independent "affiliate" Web sites in the state promoting sales on its behalf. Physical presence is a legal necessity if a state is to be able to require an out of state Internet retailer to collect sales or use tax. New York's law has been dubbed the "Amazon" law because Amazon is the largest Internet retailer potentially affected by it. North Carolina and Rhode Island have enacted similar laws. Amazon is fighting these laws in court but to date has been unsuccessful.)

5. Issue: The state passed legislation that would allow it to join the Streamline Sales Tax Project (SSTP). The SSTP is an effort to promote uniformity in sales taxes across states, for example, by having common definitions of products such as food, so as to simplify compliance by remote vendors. The goal is to get Congress or the Supreme Court to allow state to require remote vendors to collect sales taxes. However, the state has adopted partial sales tax exemptions on certain products that may put Georgia out of conformity with the SSTP master agreement. States that have joined the SSTP have found that remote vendors have voluntarily collected sales taxes.

   Question: Should Georgia change these exemptions?

6. Issue: Georgia allows vendors to retain a small percentage of sales tax revenue collected as compensation for collecting the sales tax. The percentage decreases with the amount

of sales tax revenue collected. However, there is no cap on the total compensation paid to a vendor.

Question: Does the compensation cover the cost of collection? Should there be a cap on the compensation?

Corporate Income Tax

The revenue from the corporate income tax is very cyclical and has been declining relative to the size of the state's economy. There are many reasons for this decline, including the shift from C-corps to S-corps and LLCs, increased credits, and increased tax planning.

1. Issue: The corporate income tax applies only to C-corps. The profits of S-corps, LLCs, and other pass through firms are taxed only as personal income. Thus, the tax a firm pays differs by the nature of their organizational structure.

   Question: Should firms be treated the same regardless of their organizational structure? Do differences in organizational structure sufficient to warrant differential tax treatment?

2. Issue: The profits of multi-state firms are apportioned to Georgia based on the percentage of total U.S. sales the firm made in Georgia. Multi-state firms account for 80 percent of the corporate income tax revenue. When Georgia adopted the 100 percent sales factor, it reduced corporate income tax revenue and shifted the burden of the tax between firms. Until a few years ago, most states used a three-factor apportionment formula, with the firm's share of employment, property, and sales in a state were equally weighted. That is still the most common method, but many states have moved to a 100 percent sales formula. The argument for not including employment or property in the formula is that this reduces the disincentive for firms to locate in the state.

   States do differ in how sales are measured. For example, about 25 states have a throwback rule. Georgia, North Carolina, Florida, Tennessee, South Carolina, and Virginia do not but Alabama does. Under a throwback rule, out-of- state sales are treated as if they were made within the state of origin if the corporation has no nexus in the destination state. States differ in their sourcing rule, which specifies whether the apportionment formula is based on the state in which their products or services are sold or where production takes place. In Georgia corporations profits are apportioned based on the state in which their products are sold. This rule applies to the sale of tangible property. For apportionment of services Georgia employs a market-based sourcing rule. At the present, there is no consensus between the states on how to define a "market" for the purpose of implementing this rule but in general it means that services will be taxed based on the state in which they are performed. The rule is meant to apply a consistent destination-based treatment to services when compared to tangible goods.

Question: Should Georgia continue to use the sales factor to apportion income? Should the state consider redefining what is included in sales, adding a throwback rule, and reconsider its sourcing rule?

3. Issue: Corporations have established what are called “Delaware holding companies” in order to avoid state corporate income tax. The firm creates a subsidiary in Delaware, sells its intangible asset (for example a trademark) to the Delaware company and then leases the intangible asset. The lease payment is deducted from the Georgia company, but the income from intangibles is not taxed in Delaware. Georgia passed legislation to restrict the deduction of lease payments for intangibles in an attempt to close this loophole. Other states have required combined reporting of income to address the issue. (Combined reporting means that the corporate income tax would apply to the state’s share of the profit of all subsidiaries of the firm.)

   Question: Does the current provision work to prevent the use of this loophole? Should Georgia consider combined reporting?

4. Issue: Georgia has adopted 33 income tax credits, several of them being adopted in the past couple of years. (These credits are available for any business, not just corporations, although they are commonly thought of a corporate income tax credits.) For tax year 2006, the 20 credits which DOR has tracked reduced tax revenue by $95 million, with carry forward credits of $245 million. There is little information regarding the effects of the credits.

   Question: Should any of these credit programs be eliminated or restructured?

5. Issue: The state levies a franchise (net worth) tax. The rates were set in 1931; the minimum tax is $10 (which probably doesn’t cover the cost of filing and collecting). It applies only to C-Corps and S-Corps.

   Question: Should the tax be eliminated? Should the tax be imposed on businesses organized as LLCs, etc.? Should the rate structure be changed? Should the minimum payment be increased?

Insurance Premium Tax

1. Issue: The insurance premium tax is a tax on premiums received on policies written in Georgia; it is essentially a gross receipts tax. Georgia is one of the few states with both a local and state insurance premium tax. The combined rate makes the rate one of the highest in the country; for non-life companies the combined tax rate is more than double the average U.S. insurance premium tax rate. Because Georgia-based insurance firms that write policies in other states pay the higher of the Georgia or the other state's tax rate, there is a strong disincentive for locating in Georgia.

   Question: Should the state and/or local insurance premium tax be reduced?

2. Issue: The state provides a tax abatement to any insurance firm that invests at least one-fourth of its portfolio in qualified Georgia assets. Only smaller firms can take advantage of this tax abatement since it would be imprudent for large firms to invest such a large percentage of its assets in Georgia.

   Question: Should the state drop or modify these special provisions?

3. Issue: Insurance companies can be required to make payments to cover unpaid claims of a bankrupt insurance company. Life insurance companies can deduct these payments against its premium tax but property-casualty firms cannot.

   Question: Should the life insurance companies be allowed to deduct these payments? Should all insurance firms be treated the same in their ability to deduct these payments?

Financial Institution Tax

Financial institutions are taxed at the rate of 0.25 percent on adjusted gross receipts. Local governments are authorized to levy an additional tax of up to 0.25 percent. The revenue from the tax is credited against corporate income tax liability.

Motor Fuel Tax

1. Issue: Highways and bridges are financed by fuel taxes, i.e., user taxes in which those who use (benefit from) the road more pay more. There are two fuel taxes, a 7.5 cents per gallon tax and a 3 percent tax on fuel, called the "prepaid fuel tax". The 7.5 cent tax was set in 1971. The 3 percent tax was carved out of the sales tax in 1989; the revenue replaced General Fund revenue about dollar for dollar. Revenue from these two taxes per vehicle mile traveled in inflation adjusted terms decreased until gas prices rose, which increased the revenue from the 3 percent "prepaid fuel tax." Gas prices have moderated

some, but vehicle miles traveled have also declined. On a per gallon basis, the combined fuel tax is the fourth lowest in the county. Because of differences in fuel economy, drivers who travel the same distance pay difference amounts of fuel taxes.

Question: Should Georgia increase its fuel tax rates? Should the per-gallon tax be indexed for inflation? Should Georgia consider replacing the fuel tax with a vehicle miles traveled (VMT) tax?

Inheritance Tax

1. Issue: The state's inheritance tax equals the credit for state inheritance tax allowed under the Federal inheritance tax. However, as part of the tax cuts made by the federal government in 2002, the allowable credit was set at zero, and thus the state inheritance tax is zero.

   Question: Should the state change its inheritance tax so it does not depend on the federal credit?

Severance Tax

1. Issue: A severance tax is a tax on raw materials extracted from the land. Georgia imposes a "mining fee" of $1 per ton of phosphate rock that is mined. Georgia does not have oil, gas, coal, copper, etc, but it does have large deposits of kaolin. In addition there appears to be some interest in off-shoring drilling off Georgia's coast.

   Question: Should Georgia impose a severance tax on the extraction of kaolin?

Tobacco Tax

1. Issue: Georgia has one of the lowest taxes on tobacco products. Smoking results in health care expenses borne by others, either through the payment of part of the cost of health care expenses of smokers or because they suffer health issues due to second hand smoke.

Question: Are Georgia's taxes on cigarette at the level that accounts for the damages and cost that smokers impose on others? If not, should tobacco taxes be changed accordingly?

Alcoholic Beverage Taxes

Georgia imposes relatively high taxes on beer, wine and spirits.

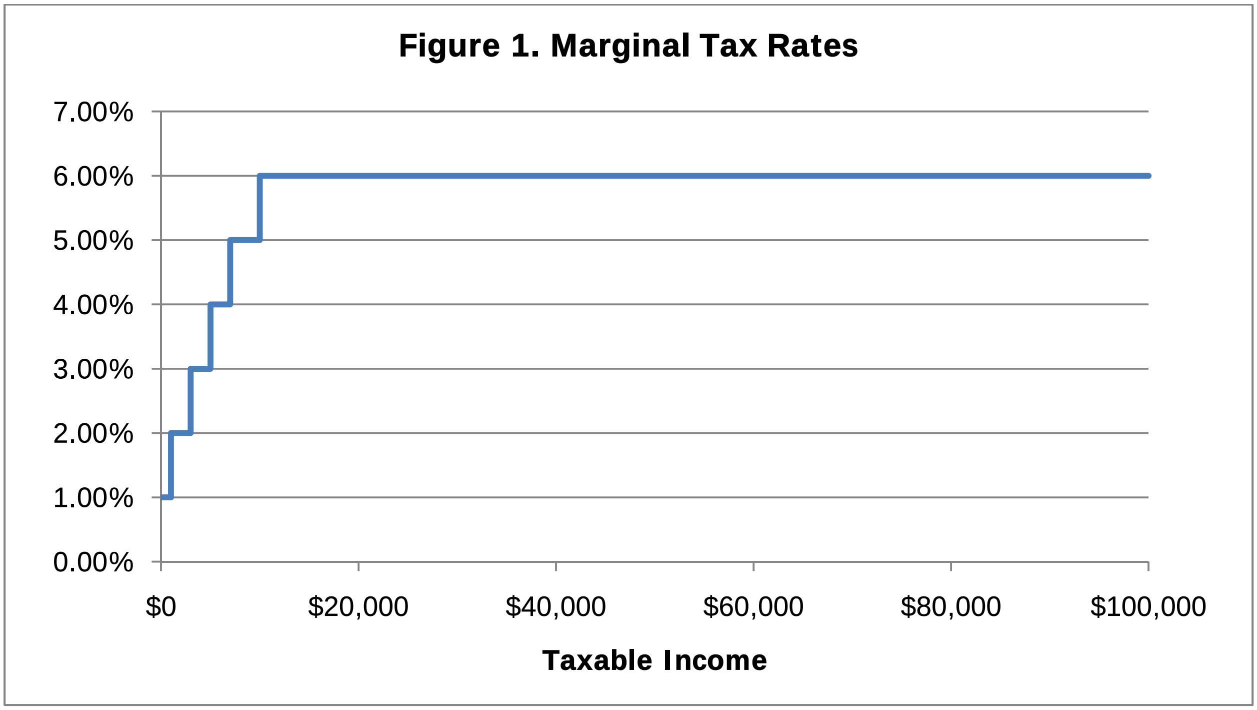
Figure 1. Marginal Tax Rates
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
$0
$20,000
$40,000
$60,000
$80,000
$100,000
Taxable Income

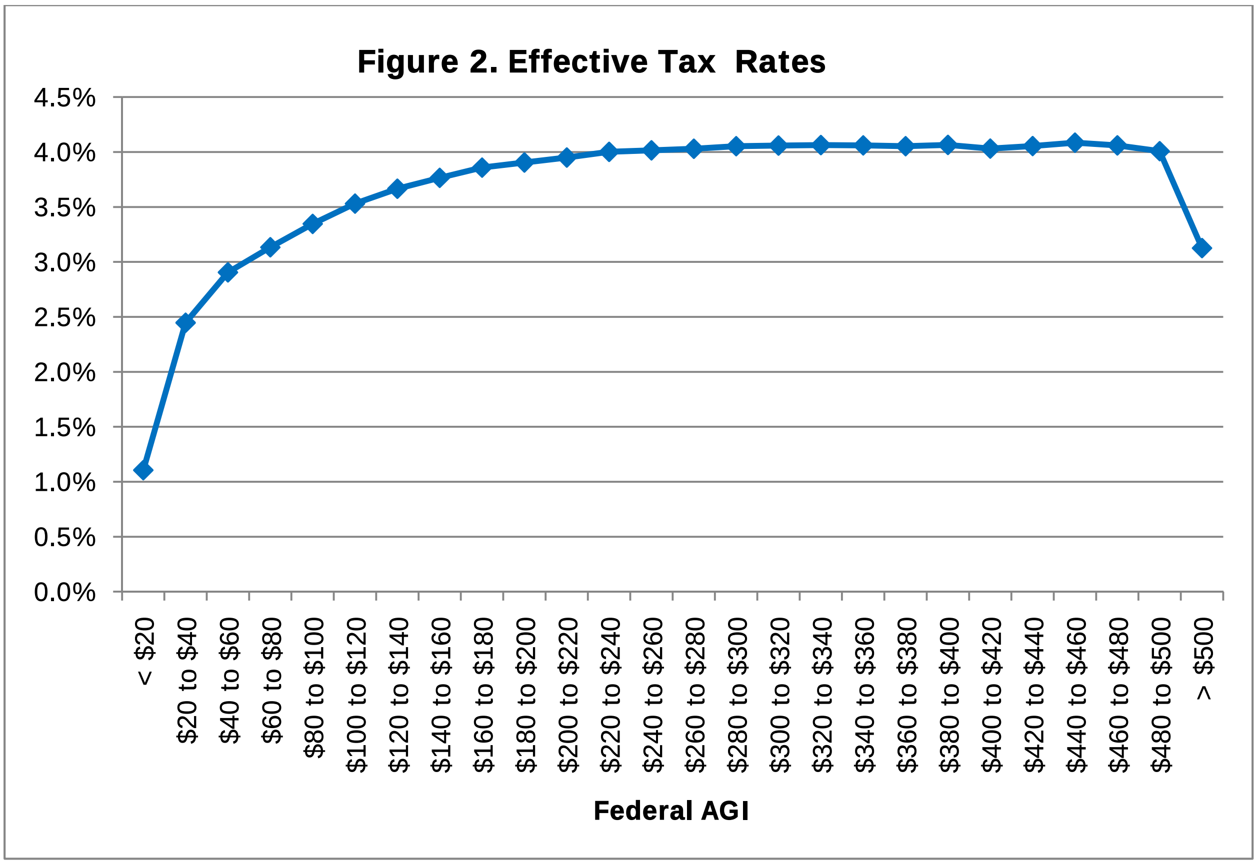
Figure 2. Effective Tax Rates
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
< $20
$20 to $40
$40 to $60
$60 to $80
$80 to $100
$100 to $120
$120 to $140
$140 to $160
$160 to $180
$180 to $200
$200 to $220
$220 to $240
$240 to $260
$260 to $280
$280 to $300
$300 to $320
$320 to $340
$340 to $360
$360 to $380
$380 to $400
$400 to $420
$420 to $440
$440 to $460
$460 to $480
$480 to $500
> $500
Federal AGI

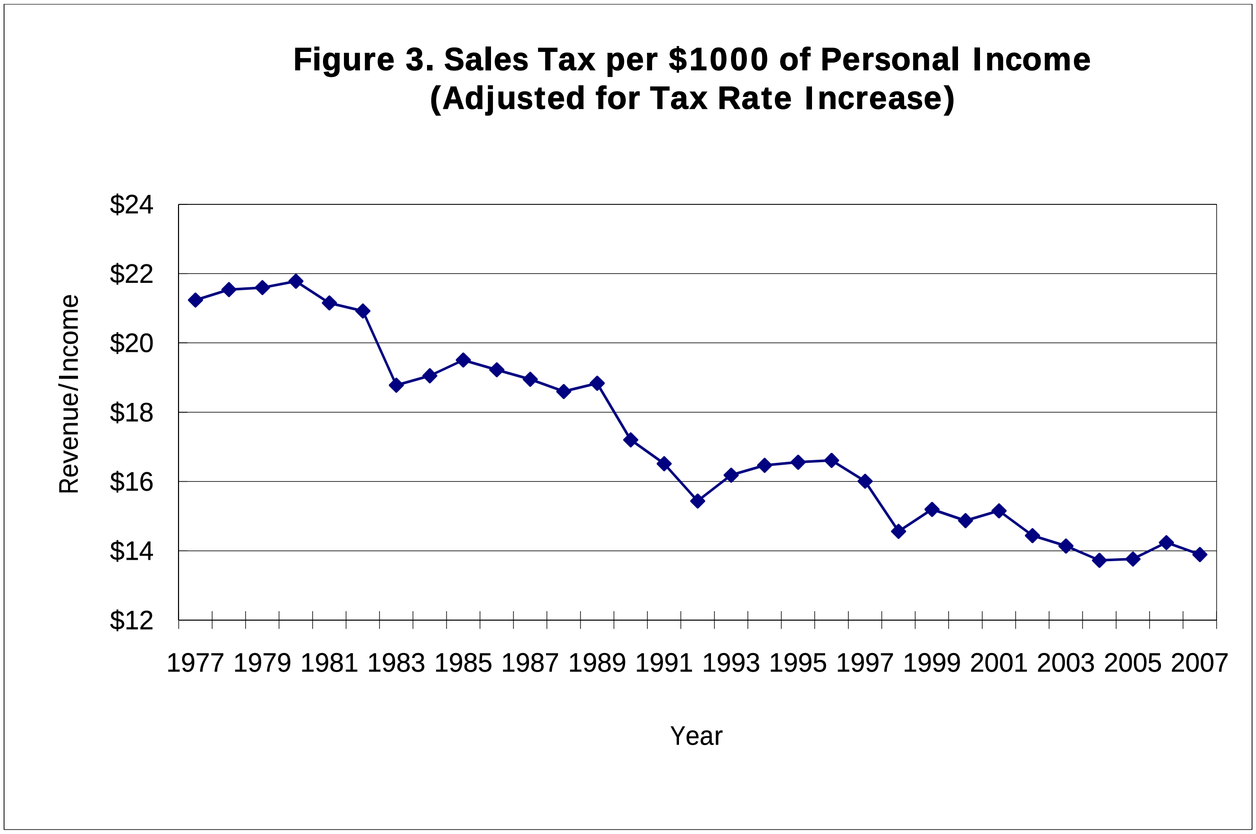
Figure 3. Sales Tax per $1000 of Personal Income
(Adjusted for Tax Rate Increase)
Revenue/Income
$24
$22
$20
$18
$16
$14
$12
1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007
Year