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REVENUE AND TAXATION

Income Taxes: Hold Service Providers to Three-Factor Tax Apportionment Standard Used by Manufacturers

CODE SECTIONS:	O.C.G.A. §§ 48-7-31, -141 (amended)
BILL NUMBER:	HB 50
ACT NUMBER:	353
GEORGIA LAWS:	1995 Ga. Laws 714
SUMMARY:	The Act clarifies how service companies are required to report net income attributable to Georgia. Service companies must allocate their income based on a three-factor formula, which is a similar method to that which nonservice companies have been required to use. The Act allows a service company to petition the Revenue Commissioner if use of this formula does not fairly represent the company's business activity in Georgia. Finally, the Act requires that local income taxes be apportioned in the same manner as state income taxes.
EFFECTIVE DATE:	April 18, 1995 ¹

History

Previously, the Georgia Tax Code included a corporate loophole for service companies, which provide services to the public rather than manufacture products for sale.² Because of this loophole, service companies were not required to apportion their income based on the three-factor formula³ that other companies were required to use.⁴ According to Michael O'Brien, the Georgia Department of Revenue's Income Tax Conferee, the Revenue Department (Department) has been aware of this loophole for a

1. The Act became effective upon approval by the Governor.

2. Jon McKenna, *Corporate Tax Law Springs Leak*, ATLANTA BUS. CHRON., Jan. 6-12, 1995, at 1A.

3. *Id.* The three-factor formula equally weighs property, payroll, and gross receipts. *Id.*

4. *Id.*

long time.⁵ The only attempt to address the problem was an unreported proposed regulation in the 1970s.⁶ However, Department officials realized a change was necessary when the Department lost three major court cases in 1993.⁷

Previously, Code section 48-7-31 only required that service companies apportion their net income "equitably" between the states in which they do business.⁸ Service companies could choose any tax method as long as it was reasonable.⁹ According to Mr. O'Brien, this vague standard caused inconsistent results.¹⁰ For example, some companies would not include a property factor or payroll factor in their apportionment formulas, claiming that all their factories or manufacturing plants were outside of Georgia and their small outlets in Georgia should not be factored into their income.¹¹ The problems caused by the statute's vagueness became apparent in a series of three superior court decisions in which the court ruled against the Department.¹²

In 1993, three prominent service companies used the loophole.¹³ BellSouth Advertising and Publishing Company (BAPCO) calculated its Georgia income tax liability based solely on its gross receipts, excluding both property and payroll, even though it had offices in Atlanta and Tucker.¹⁴ BAPCO prevailed in DeKalb County superior court.¹⁵ The judge ruled that

5. Interview with Michael O'Brien, Georgia Department of Revenue Corporate Income Tax Conferee, in Atlanta, Ga. (Apr. 4, 1995) [hereinafter O'Brien Interview].

6. *Id.*

7. McKenna, *supra* note 2; see *Bechtel Power Corp. v. Collins*, No. D-81178 (Fulton County Super. Ct. Mar. 11, 1994); *AT&T v. Collins*, No. D-90621 (Fulton County Super. Ct. Feb. 21, 1994); *BellSouth Advertising & Publishing Corp. v. Collins*, No. 92-6040-9 (DeKalb County Super. Ct. Dec. 10, 1993).

8. 1987 Ga. Laws 191, § 2 (formerly found at O.C.G.A. § 48-7-31(d)(3) (Supp. 1994)).

9. O'Brien Interview, *supra* note 5.

10. O'Brien Interview, *supra* note 5.

11. O'Brien Interview, *supra* note 5.

12. See *Bechtel*, No. D-81178 (Fulton County Super. Ct. Mar. 11, 1994); *AT&T*, No. D-90621 (Fulton County Super. Ct. Feb. 21, 1994); *BellSouth*, No. 92-6040-9 (DeKalb County Super. Ct. Dec. 10, 1993).

13. McKenna, *supra* note 2.

14. McKenna, *supra* note 2.

15. *Bellsouth*, No. 92-6040-9 (DeKalb County Super. Ct. Dec. 10, 1993).

“[a]mbiguous provisions in tax statutes must be construed liberally in favor of the taxpayer.”¹⁶ The court noted that the lack of clarifying language in the tax code concerning service companies could lead to arbitrary rulings by the Department.¹⁷

In 1994, a Fulton County superior court ruled in favor of Bechtel Power Corporation (Bechtel).¹⁸ Bechtel worked on two nuclear power plants in Georgia and paid taxes for work actually performed in the state.¹⁹ The Department argued that the company should pay taxes on any work associated with the two plants.²⁰ However, the judge ruled for Bechtel because the Department failed to show that Bechtel’s formula was inequitable.²¹

Finally, the biggest hit to the Department occurred when AT&T decided to use a “unitary” formula of apportionment and based its Georgia income tax liability on the parent company’s income attributable to Georgia, rather than on each subsidiary’s profit or loss.²² AT&T could use this method because Georgia was one of the only states that had such an ambiguous service company apportionment statute.²³ AT&T’s use of this formula has cost the Department approximately \$15 million in lost revenues so far.²⁴

HB 50

In an attempt to close the service company loophole in Code section 48-7-31, the Georgia Department of Revenue, with help from the Governor and prominent members of the House Ways and Means Committee, introduced HB 50.²⁵ The initial bill simply struck the ambiguous language granting service

16. *Id.*; McKenna, *supra* note 2.

17. McKenna, *supra* note 2. The Department estimated that it lost \$3.36 million in taxes as a result of the ruling. McKenna, *supra* note 2.

18. McKenna, *supra* note 2; *Bechtel*, No. D-81178 (Fulton County Super. Ct. Mar. 11, 1994).

19. McKenna, *supra* note 2.

20. McKenna, *supra* note 2.

21. *Bechtel*, No. D-81178 (Fulton County Super. Ct. Mar. 11, 1994).

22. *AT&T*, No. D-90621 (Fulton County Super. Ct. Feb. 21, 1994); McKenna, *supra* note 2.

23. O’Brien Interview, *supra* note 5.

24. O’Brien Interview, *supra* note 5.

25. Telephone Interview with Rep. Ronnie Culbreth, House District No. 132 (Aug. 4, 1995) [hereinafter Culbreth Interview].

companies the power to choose any equitable method of apportionment and added language prescribing the same three-factor formula used by nonservice companies.²⁶

However, the bill was controversial because large service companies opposed the measure.²⁷ The battle began in the House Ways and Means Committee.²⁸ First, due to the efforts of Delta Airlines, a subsection was added to the bill that provided a separate formula for airlines.²⁹ The gross receipts factor was then doubled to represent fifty percent of the three-factor equation with the payroll and property factors representing twenty-five percent each.³⁰ This was done to reflect the marketplace of these customer-oriented industries and to keep Georgia law consistent with that of other states using this formula, such as North Carolina and Florida.³¹ Finally, a taxpayer protection subsection was added, allowing a taxpayer to petition the Department if the three-factor formula did not accurately reflect the company's true income attributable to Georgia.³²

After further debate concerning the bill's uniformity, Representative Thomas B. Buck, III offered a floor amendment double-weighting the gross receipts factor for all companies.³³ This amendment would treat service and nonservice companies exactly the same in terms of income apportionment.³⁴ Representative Buck's floor amendment was approved by the House.³⁵ However, before the Senate could pass the bill, the airline provision was once again hotly contested.³⁶

Delta representatives argued that the airline industry is so different from most service industries that it is treated differently by most states and by the federal government.³⁷

26. HB 50, as introduced, 1995 Ga. Gen. Assem.

27. Culbreth Interview, *supra* note 25.

28. Culbreth Interview, *supra* note 25.

29. O'Brien Interview, *supra* note 5; HB 50 (HCS), 1995 Ga. Gen. Assem.

30. HB 50 (HCS), 1995 Ga. Gen. Assem.

31. O'Brien Interview, *supra* note 5.

32. HB 50 (HFA), 1995 Ga. Gen. Assem.

33. Culbreth Interview, *supra* note 25; HB 50 (HFA), 1995 Ga. Gen. Assem.

34. Culbreth Interview, *supra* note 25.

35. Final Composite Status Sheet, Mar. 17, 1995.

36. O'Brien Interview, *supra* note 5.

37. O'Brien Interview, *supra* note 5.

Without the airline provision, Delta would have the difficult task of petitioning the Department for the use of a special formula.³⁸ The Delta representatives claimed that obtaining industry-wide support for a special formula would be difficult since no other airline comes close to matching Delta's property or payroll factors in Georgia.³⁹

The Department responded by proposing a clause that would give it discretion to change the formula for certain companies, like Delta, that may be treated unfairly under the three-factor formula.⁴⁰ The Department argued that this provision would be consistent with the taxpayer's petitioning powers and would alleviate problems with industry-wide approval of different formulas.⁴¹ However, Delta demanded and received a separate formula for airlines that takes air miles and tons handled into account.⁴²

Although the Department would have preferred to maintain some discretion regarding whether to abandon the three-factor formula for some service companies, the absence of this power will lead to industry-wide negotiations concerning which apportionment formulas should be used for specific companies.⁴³ The Department was satisfied that the Act closed the loophole, which had been used by sophisticated companies to the detriment of the citizens of Georgia.⁴⁴

Brian Wiklendt

38. O'Brien Interview, *supra* note 5.

39. O'Brien Interview, *supra* note 5.

40. O'Brien Interview, *supra* note 5.

41. O'Brien Interview, *supra* note 5.

42. O'Brien Interview, *supra* note 5; see O.C.G.A. § 48-7-31(d)(3) (Supp. 1995).

43. O'Brien Interview, *supra* note 5.

44. O'Brien Interview, *supra* note 5.