TALKING TAXES

"Nowhere Income" and the Throwback Rule

Every state that levies a corporate income tax must determine, for each corporation doing business within its borders, how much of the company's profit they can tax. One indicator that all states now use to achieve this is the percentage of the company's sales that can be attributed to the state. Ideally, all business sales would be taxed by exactly one state. But there are circumstances under which some corporate sales fall between the cracks, and cannot be taxed by any state. This phenomenon is called "nowhere income." This policy brief explains how the problem of "nowhere income" arises and discusses how a throwback rule can be used to ensure that all corporate sales are taxed by at least one state.

Dividing Corporate Profit Between the States

As states seek to determine which corporations are liable for their state income tax, the first question they must answer is what fraction of each corporation's business activities take place in the state. The most widely accepted approach to this is to look at three different measures of business activity—the total amount of sales a company makes, the total amount of property it owns, and its total amount of employee payroll—and determine what percentage of these three activities take place in any given state. Some states no longer factor in the property and payroll factors (for more information, see ITEP Policy Brief #11, *Corporate Income Tax Apportionment and the Single Sales Factor*), but all states still use the location of a corporation's total sales to help determine how much of the firm's profit they can tax. In other words, for each potentially taxable corporation, a state must figure out total in-state sales as a percentage of total overall sales. In-state sales are taxable by the state, and all other sales are left for other states to tax.

To calculate this percentage, each individual sale a corporation makes must be allocated to just one state. For sales of tangible personal property (that is, items with physical substance that can be touched, like a machine), most states do this using the "destination rule," which says that any sale should be assigned to the state to which the product sold is being delivered. For example, if a New York business manufactures a machine and sells it to a customer in Pennsylvania, this sale counts toward that firm's total Pennsylvania sales, but does not count toward its New York sales.

The Problem of "Nowhere Income"

Sometimes, however, sales allocated to other states using the destination rule end up not being taxed by those other states at all, because the destination state lacks the authority to tax the seller. When a destination state can't tax a specific corporation, it's either because that state does not levy a corporate income tax or because the corporation doesn't have a sufficient level of business activity in the state to be subject to tax. This minimal level of in-state activity that must be present before a state can tax a corporation is called nexus. Having property or payroll in a state is always sufficient to generate nexus, but having sales in a state is not always sufficient to create nexus. The reason for this is a federal law called Public Law 86-272. This law says that making sales into a state is not sufficient to generate nexus for corporate income tax purposes if the company's activities in the state are limited to soliciting sales of tangible personal prop-

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erty, if the orders for the company's sales are taken outside of the state, and if all such sales are delivered from outside of the state. When some of a corporation's sales that are made in other states are not taxable in those other states, because its sales activities do not meet the nexus criterion in those states, the result is "nowhere income"—corporate income that is not taxable by any state.

Companies aggressively pursuing "nowhere income" tax avoidance strategies can reduce their state tax bill far below what they ought to pay. The best remedy for this problem is enacting a "throwback rule."

A Simple Solution: The "Throwback Rule"

The best state remedy for the problem of "nowhere income" is enacting a "throwback rule," which simply says that any sales to other states or the federal government that are not taxable will be "thrown back" into the state of origin for tax purposes. In other words, the throwback rule is a backup for the destination rule: when the destination rule allocates a sale to a state that can't tax that sale, the sale is re-allocated back to the state that is the source of the sale. When legal reformers sought to create a uniform and fair system of state corporate taxation in the 1950s, they included the throwback rule in their set of recommended rules, known as the Uniform Division of Income for Tax Purposes Act (UDITPA). About half of the states with corporate income taxes have now created a throwback rule in keeping with the UDITPA recommendations—but half of the states have yet to enact this important reform.

Why Throwback Rules Are Necessary

The existence of states without a throwback rule creates a clear tax avoidance opportunity for multi-state corporations. These companies can reduce their state taxes by locating their property and payroll in states that don't have a throwback rule, and can reduce their taxes even further by making sales to customers in states in which the company does not have nexus. Companies aggressively pursuing this "nowhere income" tax avoidance strategy can reduce their state tax bill far below what they ought to pay—and far below the taxes paid by competing companies.

Allowing businesses to minimize their tax liability through these strategies distorts the economic incentives facing companies. The location and sales decisions of firms should depend strictly on market conditions, not on the existence of tax loopholes. Of course, economic research has generally shown no linkage between state tax breaks and the health of a state's economy—so it is more likely that the absence of a throwback rule simply gives some corporations tax breaks for activities they would have engaged in anyway.

The lack of a throwback rule also discriminates arbitrarily between corporations depending on which states they sell into. States without a throwback rule are giving a special tax reward to companies that sell into states in which they don't have nexus. No sensible policy goal is advanced through such discriminatory rules, and these arbitrary tax distinctions can reduce public confidence in the legitimacy and fairness of the corporate income tax.

Finally, the lack of a throwback rule means the loss of valuable tax revenues for state governments—an important consideration as states seek to dig themselves out from the recent economic slowdown. States that do not enact the throwback rule are allowing a potentially expensive tax break that could ultimately make state corporate income taxes even more loophole-ridden than they currently are.

To find out more about this issue, contact ITEP at (202) 626-3780