Notes on "Throwback" Rule

The Case for "Throwback" Rules

The Corporate Income Tax Sheltering Working Group of the State Tax Compliance Initiative targeted the so-called "throwback" rule -- Reg. IV.16.(a). Sales Factor: Sales of Tangible Personal Property in This State[1] – for examination as a possible Uniformity Project. Uniformly applied "throwback" rules would minimize the ability of businesses to avoid income taxes by sourcing sales to states without such a rule when sales are made into states in which the business is not subject to tax. Professors William Fox, LeAnn Luna, and Matthew Murray[2] (FLM), argue that "throwback" rules serve two purposes, although they doubt the validity of these arguments:

1. The protection of PL 86–272 offers a tax planning opportunity that corporations can exploit by not establishing nexus in destination states. The destination state is precluded from taxing the income associated with the sale, and the origination state would normally not tax the income associated with the sale because the sale is sitused in the destination state.[3] As a result, businesses have an incentive to create corporate structures that allow

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[1] (6) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped.

(7) If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

(A) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.
(B) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

Example: The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state.

[2] William F. Fox, LeAnn Luna, and Matthew Murray, "How Should a Subnational Corporate Income Tax on Multistate Businesses be Structured?" ***National Tax Journal***, Vol. LVIII, No. 1, March 2005, pages 139-159.

[3] Combined reporting states that follow Finnigan would be able to tax the income if other parts of the combined group operate in the state.

them to sell tangible goods across state lines using corporations that do not rise to the standard that is protected by PL 86–272.

2. Throwback rules ensure that total business income is sourced to some state, even if the revenues go to the origin state rather than the destination state

Another aspect of "throwback" rules, often overlooked by public finance economists, is that "throwback:" rules allow states to capture some of the, in economists' jargon, locational "rents" they provide. For example, businesses that distribute tangible property may wish to locate in the Chicago metropolitan area because of the proximity to major highways, airports, rail lines, and water transport. The revenues "thrownback" to these governments as a result of "throwback" rules can be considered as compensation for past and present investments in the infrastructure that augments any natural locational advantage. One can argue that the property taxes, and other business taxes, imposed on these firms compensate state and local governments for their infrastructure investments. However, there is no reason why the state and local governments should be precluded from optimizing their revenues from all tax sources.

The Case Against "Throwback" Rules

As noted by Denen and Whitney, in their article in ***State Tax Notes***, throwback, double throwback, and throwout rules fail to achieve the objective of full taxation of 100 percent of a taxpayer's income; and, may incorrectly attribute business activity or income to a given state.[4] In addition, as shown by FLM, "throwback" rules violate the principle of economic neutrality in two related ways. The rules cause differential impacts on firms based on the location of the origination of the sales. The differential impacts may cause firms to base location decisions based on whether a state imposes a "throwback" rule.

The destination component of the tax should be the same on all firms (regardless of where they are situated) when selling into each other state.[5] The throwback rule distorts this objective because it imposes tax on home state firms selling into a state (based on the extent that the home state relies on the sales factor) The throwback rule converts at least part of the sales factor to an origin–based tax since the tax is imposed in the state from which transactions originate. Imposition of the throwback rule increases the incentive to move firms (or never locate them in the first place) that are selling tangible personal property into no–tax or non–throwback rule states.[6] Indeed, the throwback rule can impose a tax burden that is very large relative to the corporate profit that otherwise would be taxable in a state since it depends on the ratio of sales into PL 86–272 states to in–state sales.

"Throwout" Rule

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[4] Sylvia Denen and Christopher Whitney, "The Hidden Apportionment Factor**,"** ***State Tax Notes***, Tax Analysts Inc., Arlington, VA, September 12, 2005, p.802.

[5] The origin component of the corporate income tax results in different total tax burdens on firms selling into each state, depending on the origin state.

[6] See Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," ***New England Economic Review***, (March/April 1997); 37-52 for a summary of the effect of taxes on business location.

In contrast to the “throwback” rule which is seen by many as either a revenue grab by the state from which sales originate into states in which the company has no nexus, or in less inflammatory language, as rule which fosters economic non-neutrality, the “throwout” rule, if uniformly applied, promotes greater economic neutrality. Further, States into which sales are made by a firm from the originating state, may share in the increased apportioned net income. In order to implement a “throwout” rule, Reg. IV.16.(a). Sales Factor: Sales of Tangible Personal Property in This State could be worded in the following manner:

> (6) If the taxpayer is not taxable in the state of the purchaser, the sale is disregarded from the denominator of the ratio of sales in this state to total sales.
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> *Example:* The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer’s only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B will be disregarded from the denominator of the ratio of sales in this state to sales in other states.

Neutrality of a “Throwout” Rule Compared to a “Throwback” Rule

The differences between a ‘throwback” rule and a “throwout” rule is illustrated in the table below. Assume that a business in the originating state earns $1,000,000 in net income that must be apportioned to the originating state, other states in which the company has nexus, and still other states in which the company has no nexus. We further assume that the apportionment weights in all states are 50 percent sales, 25 percent property, and 25 percent payroll. The originating state has 10 percent of ***all*** sales, 45 percent of all property, and 65 percent of all payroll. The other states in which the company has nexus contain 85 percent of ***all*** sales, 55 percent of all property and 35 percent of all payroll. The states in which the company has no nexus 5 percent of ***all*** sales.

With neither a “throwback” rule nor a “throwout” rule, this company would apportion $325,000 of net income to the originating state, $650,000 to “nexus” states, and $25,000 to the non-nexus states. The latter figure is the so-called “nowhere” income. With a “throwback” rule, $350,000 of income is apportioned to the originating state and $650,000 is apportioned to the other nexus states. The ‘nowhere” income is eliminated. If only the originating state uses a “throwout” rule, $327,632 is apportioned to that state and $650,000 is apportioned to the nexus states; “nowhere’ income is reduced to $22,368.[7] With a uniformly applied “throwout” rule, $327,638 is apportioned to the originating state and $ 672,368 is apportioned to the nexus states.

With either a “throwback” rule or a uniformly applied “throwout” rule, “nowhere” income is eliminated in this simple example. However, under the uniform “throwout” rule, the apportioned income is more neutrally distributed, and the firm has no incentive to relocate its activities.

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[7] The principle of economic neutrality is violated because this firm, because of non uniform tax laws, has an incentive to relocate to one of the states that does not have a “throwout” rule.

Numerical Example of Apportioning the Net Income of a Multistate Business With "Throwback" and "Throwout" Rules"

	Apportioned Net Income			
	Total	Origination State	Other States[1]	Non-Nexus States
No Throw Back or Throw Out Rules	$1,000,000	$325,000	$650,000	$25,000
"Throwback" Rule	1,000,000	350,000	650,000	0
Throwout Rule[2]	1,000,000	327,632	650,000	22,368
Throwout Rule[3]	1,000,000	327,632	672,368	0

Assumptions:
Sales factor weight is 0.5, property and payroll factor weights are .25 respectively. Home state has 10 percent of sales, 45 percent of payroll, and 65 percent of property. Other states have 55 percent of payroll and 35 percent of property. Non-nexus states have 5 percent of total sales.

1. Firm has nexus in these states.
2. Other states do not adopt "throwout"" rule.
3. Other states adopt "throwout" rule.

MATHEMATICAL EXPOSITION of “Throwback” and “Throwout” Rules

The net income of multistate business (j) is apportioned to each state in which it conducts business according to the traditional three factor apportionment formula:

$$(1) \quad \Pi_{ij} = \Pi_J * \{(\alpha_i *(S_{ij}/S_J)) + (\beta_i * (L_{ij}/L_J) + (\gamma_i * (P_{ij}/P_J)\}$$

Where:

Π_{ij} is the net income of company (j) apportioned to State (i).

Π_J is the total net income of company (j).

α_i is the weight of the sales factor in state (i).

S_{ij}/S_J is the ratio of sales of company (j) in state (i) to the total sales of company (j).

β_i is the weight of the payroll factor in state (i).

L_{ij}/L_J is the ratio of payroll of company (j) in state (i) to total payroll of company (j).

γ_i is the weight of the property factor in state (i).

P_{ij}/P_J is the ratio of property of company (j) in state (i) to total property of company (j).

$\alpha_i + \beta_i + \gamma_i = 1$

We now characterize the operations of this company as doing business in its home state (h), other states in which it is taxable, regardless of whether a tax is imposed (k); and, state in which the company is not taxable (x); k ≠ h. For the sake of simplicity, we are assuming that company (j) has minimal levels of property and payroll in those states in which it is not taxable. The apportionment formula for the home state and for those states in which the company is taxable are identical to (1) with the appropriate subscripts. The income apportioned to those states in which the company is not taxable – “nowhere” income – can be written as:

$$(2) \quad \Pi_{jx} = \Pi_J * (S_{jx}/S_J)$$

$$(3) \quad \text{Let } S_X = \Sigma S_{jx}$$

If state (h) were to impose a “throwback” of sales to itself in order to eliminate “nowhere” income, the apportionment formula would be written as:

$$(4) \quad \Pi^*_{hj} = \Pi_J*\{(\alpha_h*((S_{hj} + S_X)/S_J) + \beta_h*(L_{hj}/L_J) + \gamma_h*(P_{hj}/P_J)\}$$

The apportionment formulas for those states in which the company is taxable do not change. Thus, all of the income apportioned to states in which the company is not taxable is “thrown” back to the home state. The additional income apportioned to the home state can be written as:

$$(5) \quad \Pi^*_{hj} - \Pi_{hj} = (\alpha_h*\Pi_J)*(S_X)/S_J)$$

If, instead of a "throwback" rule, the home state had adopted a "throwout" rule, the modified apportionment formula would be written as:

$$(6) \quad \Pi^{**}_{hj} = \Pi_J * \{\alpha_h*((S_{hj}/(S_J\text{-}S_X)) + \beta_h*(L_{hj}/L_J) + \gamma_h*(P_{hj}/P_J)\}$$

The additional income that is apportioned to the home state, after manipulating the like terms, can be written as:

$$(7) \quad \Pi^{**}_{hj} - \Pi_{hj} = ((\Pi_J*\alpha_h)*(S_{hj}/S_J)) *(S_X/(S_J\text{-}S_X))$$

Thus, the difference between the income apportioned to the home state under a "throwout" rule and without a "throwout" rule is equal to the income apportioned to the home state from the unmodified apportionment formula multiplied by the ratio of sales into states in which the company is not taxable to the difference between total sales and sales into states in which the company is not taxable.

The difference in the income apportioned to the home state under a "throwback" rule and the "throwout" rule, after manipulating the like terms, can be written as:

$$(8) \quad \Pi^{*}_{hj} - \Pi^{**}_{hj} = (\Pi_J*\alpha_h)*\{(S_X/S_J)*(1+(S_{hj}/(S_j - S_X)))\}$$

Thus, the difference in the income apportioned to the home state under a "throwback" rule and the "throwout" rule, after manipulating the like terms, is nearly identical to the difference between the income apportioned to home state under a "throwback" rule and the income apportioned to the home state without a "throwback" rule.

In contrast to a pure "throwback" rule, the income that would have been completely apportioned to the home state can also be apportioned to other states in which this company is taxable. These states, if they wish, can also increase the amount of income apportioned to them if they adopt the "throwout" rule. The apportionment formula for states in which this company is taxable can be written as:

$$(9) \quad \Pi^{**}_{kj} = \Pi_J * \{\alpha_k*((S_{kj}/(S_J\text{-}S_X)) + \beta_k*(L_{kj}/L_J) + \gamma_k*(P_{kj}/P_J)\}$$