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Policy Brief

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"Nowhere Income" and the Throwback Rule

Every state that levies a corporate income tax must determine, for each company doing business within its borders, how much of the company's profits it can tax. One factor that all such states use to make this determination is the percentage of the company's nationwide sales that can be attributed to the state. Ideally, all of a company's sales would be attributed to the states in which it operates, but, due to differences among states' corporate income tax rules, this is not always the case. In some instances, a portion of a business' sales are not attributed to any state, which means that a corresponding portion of its profits go untaxed, a phenomenon often referred to as "nowhere income." This policy brief explains how this phenomenon arises and discusses how a throwback rule can be used to ensure that all corporate profits are subject to taxation.

Dividing Corporate Profits Among the States

Once a state has determined that a company is liable for its corporate income tax, it must then calculate how much of that company's nationwide profits can be taxed in that state, a process known as apportionment. The general aim of apportionment is to estimate how much of a company's activities occur in each state and to distribute its profits, for tax purposes, on that basis.

The most widely accepted approach to apportionment looks at three different activities — the total amount of sales a company makes, the total amount of property it owns, and the total amount it pays its employees — and calculates the percentage of those activities that took place in that state. Some states now ignore property and payroll in apportioning profits, but all states still use the location of a company's total sales in making these calculations. In other words, for each potentially taxable corporation, every state with a corporate income tax must figure out total in-state sales as a percentage of total overall sales. (For more on state apportionment rules, see ITEP's Policy Brief, **Corporate Income Tax Apportionment and the "Single Sales Factor"**).

To calculate this percentage — often called the "sales factor"— each individual sale a corporation makes must be assigned 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 assigns sales to the state into which the product sold is delivered. For example, if a New York business manufactures a machine and sells it to a customer in Pennsylvania, this sale counts toward that business' total Pennsylvania sales, but does not count toward its New York sales.

The Problem of "Nowhere Income"

Sometimes, however, sales assigned to other states by the destination rule end up not being included in those states' sales factors, because the destination state lacks the authority to tax the seller. When this happens, a portion of that company's profits go untaxed. That untaxed profit is known as "nowhere income" — and many large businesses are aware that they can set up their operations to maximize nowhere income and minimize the taxes they owe.

Nowhere income arises when a company is not subject to a corporate income tax in one of the states into which it makes sales, either because that state does not levy such a tax or because the company doesn't have a sufficient level of activity in the state to be subject to the tax, a concept known as "nexus". Having property or payroll in a state is always sufficient to constitute nexus, but making sales into a state is not. A little known federal statute, Public Law 86-272, stipulates that making sales into a state is not sufficient to generate nexus if:

(1) the company's activities in the state are limited to soliciting sales of tangible personal property;

(2) the orders for the company's sales are taken outside of the state, and;

(3) all such sales are delivered from outside of the state.

Given these restrictions, companies may be able to avoid establishing nexus in some of the states into which they make sales and thus generate nowhere income that is untaxed in any state.

A Simple Solution: "Throwback" or "Throwout" Rules

The best state remedy for the problem of nowhere income is enacting a "throwback rule," which mandates that sales into other states or to 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 assigns a sale to a state that can't tax that sale, the sale is re-assigned 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 recommendations, 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.

One alternative to the throwback rule is the "throwout rule" currently used by New Jersey and West Virginia. Rather than seeking to assign all sales to the states in which the company operates, the throwout rule simply excludes from overall sales any sales that are not assigned to any state.

Why Throwback and Throwout Rules Are Necessary

The existence of states without throwback rules 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 then 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 companies to minimize their tax liability through these strategies encourages them to engage in wasteful sham transactions with the sole purpose of avoiding tax, puts other businesses at a disadvantage, and drains away tax revenue that could be used to finance vitally important long-term public investments. Throwback and throwout rules can help to level the economic playing field among all businesses and to reduce state fiscal stress, just by simply ensuring that all of the profits companies earn are subject to taxation in the states in which they do business.