The Bridge to 'Nowhere Income'

by Brian Strahle

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In this article, Strahle explains how "nowhere income" is created and why state approaches to eliminate it should be changed. He uses Virginia as an example, summarizing a ruling from the tax commissioner to show how taxpayers could earn the right to apportion and exclude sales from the numerator of their apportionment factor. He points out that because Virginia does not have a throwback rule, a taxpayer's overall state income tax liability could decrease dramatically.

"Nowhere income" is the share of a company's income that goes untaxed by any state. That could happen for a variety of reasons, such as the interplay between the apportionment formulas of the states in which the company does business, differences in state tax base addbacks or subtractions, or credits and incentives.

A company's ability to earn the right to apportion and not pay tax on 100 percent of its income to its home state has been recognized for creating nowhere income. Once a company has nexus or is taxable in one other state, it generally has earned the right to apportion. Despite having nexus in another state, the company may have sales in numerous states without having nexus because of the protections of P.L. 86-272. When that occurs, if the origination state does not have a throwback rule, the sales into destination states where the company is protected by P.L. 86-272 are not included in the numerator of any state, but are included in the denominator of each state in which the company files a return. As a result, the apportionment factor is lower in the states in which the company files returns, resulting in less tax, or nowhere income.

A company with activities in only one state has not earned the right to apportion. Determining if a company has exceeded the threshold for nexus in another state to earn the right to apportion can be difficult. Does the company's home state require the business to have a regular place of business in the other state? Does the home state require the company to exceed the protections of P.L. 86-272? Does the home state require the company to file a tax return in the other state?

Under Virginia law, a corporation is presumed to be doing business entirely within Virginia if another state does not have jurisdiction to impose a net income tax, a franchise tax measured by net income, or a privilege tax measured by net income.[1] The actual imposition of a tax is not required, but the state must have jurisdiction to impose a tax measured by net income.[2] Virginia law provides that a corporation will be considered subject to tax in another state if it carries on sufficient business so that the other state has jurisdiction to impose taxes[3] (Virginia applies that same standard to foreign countries). Accordingly, a state or foreign country has sufficient jurisdiction over a corporation if the corporation's activities exceed the protection of P.L. 86-272, regardless of whether the tax is actually imposed or a treaty is in effect.[4] Thus, Virginia applies the P.L. 86-272 threshold to other states and foreign countries.

In Rulings of the Tax Commissioner 12-142, a manufacturer of equipment whose headquarters and sole production facility were located in Virginia requested a ruling on whether it could apportion its income for Virginia income tax purposes. Most of the taxpayer's sales were to the U.S. government and exported overseas under the government's direction. The U.S. government took title to the completed equipment at the taxpayer's production facility, before it was shipped overseas. In addition to shipping the product overseas, the taxpayer sent its employees to foreign countries to assist with the setup and installation of the equipment. The taxpayer owned and maintained structures and other tangible property in foreign countries for use while providing the services.

The commissioner did not rule on whether the taxpayer had nexus in the foreign country. He simply stated that if the taxpayer established it had nexus with a foreign country to which its products were shipped and its employees installed the equipment, it could be considered a multistate corporation eligible to apportion its income. The equipment shipped outside Virginia would not be included in the numerator of the taxpayer's sales factor.

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[1]Va. Code Ann. section 58.1-405.
[2]23 Va. Admin. Code section 10-120-120.
[3]VA P.D. 02-57.
[4]*Id.*

The commissioner based his conclusion on Virginia law, which provides that tangible property received in Virginia is not always considered a Virginia sale. The place at which the property is ultimately received after all transportation has been completed is considered the purchaser's place of receipt.[5] Because the taxpayer knew the ultimate destination of the equipment was outside Virginia, the sale was not a Virginia sale. The commissioner clarified that the mode of transportation did not have to be an independent carrier as long as the seller had knowledge that the ultimate destination of the property was outside Virginia.

The Virginia law and ruling show how taxpayers could earn the right to apportion and exclude sales from the numerator of their apportionment factor. The additional benefit to the taxpayer earning the right to apportion is the fact that Virginia does not have a throwback rule. In general, a throwback rule requires that any sale not included in the destination state's sales factor numerator must be thrown back to the state where the shipment of tangible property originated and be included in that state's sales numerator of the apportionment factor. Once a taxpayer earns the right to apportion, it can source its sales of tangible property by state of destination. In destination states where the taxpayer is protected by P.L. 86-272, the taxpayer would escape income taxation. The taxpayer would also not have to include those sales in the numerator of its Virginia apportionment factor because Virginia does not have a throwback rule. As a result, the taxpayer's overall state income tax liability could decrease dramatically. The Virginia apportionment factor would decrease by excluding the foreign sales, and the sales to destination states would be protected by P.L. 86-272. The taxpayer also would not pay any income tax to the destination states.

The Troll on the Bridge

Unlike Virginia, 22 states and the District of Columbia impose a throwback rule. Alabama, Maine, Michigan, and West Virginia impose a throwout rule, which removes sales from the denominator of the apportionment factor if the sales are not assigned to a particular state. The throwout rule has received scrutiny over the past few years, especially in New Jersey, where it was repealed as of July 1, 2010.

Alabama recently enacted a throwout rule to apply to tax years beginning on or after December 31, 2010. Maine repealed its throwback rule for tax years beginning on or after January 1, 2010, and replaced it with a throwout rule. The use of a throwback or throwout rule eliminates the benefits of earning the right to apportion and excluding foreign sales or destination sales protected by P.L. 86-272 — that is, nowhere income.

Many observers think the throwback rule is a necessary tax reform that all states should adopt. Proponents of the throwback and throwout rules argue that a state without a rule creates a tax avoidance opportunity for multistate corporations, encourages companies to engage in sham transactions, and puts other businesses at a disadvantage. They believe that throwback and throwout rules can "level the economic playing field among all businesses by ensuring that all of the profits companies earn are subject to taxation in the states in which they do business."[6]

Others argue that throwback and throwout rules require companies to pay tax in one state on income that another state has chosen not to tax or is legally unable to tax. According to the Council On State Taxation, "a company's tax liability in one state should not be measured by its tax in another state."[7]

Keep the Bridge Open

The throwback rule should be discontinued because it attempts to tax income earned outside the state. Thus, the rule implies the origination state has the right to tax income simply because another state chooses not to, or lacks the ability to do so. That is in direct contrast to other policies states have adopted such as market-based sourcing or economic nexus, which place more weight on the destination state for sourcing sales or taxing income. States should have a consistent approach in their policies to provide a better and more efficient system of compliance, reducing taxpayer error and litigation. That seesaw approach of placing more weight on destination versus origination (or vice versa) should be discontinued, and states should adopt one coherent philosophy.

Nowhere income is not always the result of an elaborate corporate tax avoidance scheme. Nowhere income may simply be the product of the application of state law to a taxpayer's facts and circumstances. Thus, what looks like tax planning may simply be tax compliance.

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Throwback and throwout rules have been litigated and upheld on several occasions, but that doesn't make them good tax policy. The purpose of apportionment is to provide states with the ability to determine what portion of a taxpayer's income it can tax. A state should not be able to tax income that was earned outside the state just because another state doesn't tax it. According to *Complete Auto Transit*

[5]Va. Code Ann. section 58.1-415.

[6]Institute on Taxation and Economic Policy, "'Nowhere Income' and the Throwback Rule," Policy Brief (Aug. 2011).

[7]COST, "Throwback, Throwout — Policy Position" **(Author: year??).**

v. Brady, 430 U.S. 274 (1977), a taxpayer has the constitutional right to have its income fairly apportioned among the taxing states. The amount of tax a company pays to each state will not be the same or result in 100 percent taxation, even if all states had the throwback or throwout rule. Each state has its own additions, subtractions, apportionment formula, tax rates, and credits or incentives that cause companies to pay different amounts of tax. Thus, trying to close one perceived loophole — nowhere income — by enacting a throwback or throwout rule is not the solution. ✰