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Throwback Sales (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2009-11 Budget Summary: Page 261, #13]

CURRENT LAW

In general, a single sales factor apportionment formula is used to apportion the income of a multistate corporation to Wisconsin. (The income of certain types of corporations, such as public utilities, is apportioned using different apportionment formulas). The sales factor is the ratio of the total sales of the taxpayer in the state to total sales everywhere. Sales of tangible personal property are typically considered to be in Wisconsin if the property is delivered or shipped to a purchaser within Wisconsin. In general, sales of tangible personal property shipped from the state to the federal government, or shipped by an office or from a location in the state to a destination where the taxpayer is not subject to income or franchise taxes are treated as throwback sales, and 50% of such sales are included as Wisconsin sales in the apportionment formula.

GOVERNOR

Require that throwback sales be included 100%, rather than 50%, in the numerator of the sales factor of the apportionment formula for allocating income to Wisconsin. The Department of Revenue would deem as timely paid the estimated tax payments attributable to the difference between a person's tax liability under the revised throwback provisions and the tax liabilities under current law for installments that became due during the period beginning on January 1, 2009, and ending on the bill's effective date, if such estimated tax payments were paid by the next installment due date that follows in sequence following the effective date. However, if the next installment due date that follows in sequence following the bill's effective date was less than 45 days after the effective date, such estimated tax payments, in addition to the payment due less than 45 days after the effective date, would be deemed timely paid if paid by the next subsequent installment due date. At the time the bill was introduced, the administration estimated that these provisions would increase state income and franchise tax revenues by $57,700,000 in 2009-10 and $37,500,000 in 2010-11.

DISCUSSION POINTS

1. When the states tax the income of corporations generated by activities carried on across state lines, they are required under the strictures of the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. In order to meet this constitutional obligation, Wisconsin generally employs one of three methods of assigning income to the state--separate accounting, formula apportionment, or specific allocation.

Under the formula apportionment method of assigning corporate income, a formula is employed for dividing the income of a multistate corporation among the states in which its business is conducted. States have developed apportionment formulas as a rough means of attributing a reasonable share of the income tax base of a multistate unitary business to the taxing state. A principal reason for using formula apportionment is that many corporations cannot explicitly attribute the income generated by multistate activities or businesses to a particular state.

2. Under Wisconsin law, formula apportionment is used if a corporation's Wisconsin activities are an integral part of a unitary business which operates both within and outside of the state. In these cases, the corporation adds its total gross income from its in-state and out-of-state unitary activities, subtracts its deductions, and multiplies the amount of net income by its apportionment ratio as determined by the Wisconsin apportionment formula. The apportionment ratio is used to approximate how much of a corporation's total net income is generated by activities in Wisconsin.

The apportionment ratio is the end result of the application of the Wisconsin apportionment formula to a particular corporation. Historically, for most corporations, the apportionment ratio or fraction was based on three factors: property, payroll, and sales. Specifically, the apportionment ratio was determined by adding three fractions--the corporation's property value in Wisconsin divided by its total property value, the corporation's payroll in Wisconsin divided by its total payroll, and the corporation's sales in Wisconsin divided by its total sales -- double weighting the sales factor, and dividing the aggregate sum by four.

Under provisions included in 2003 Wisconsin Act 37, enacted in July, 2003, use of a single sales factor apportionment formula for most multistate corporations was phased-in over three years, from 2006 to 2008. As a result, most corporations, insurance companies, nonresident individuals, estates, and trusts apportion income to Wisconsin using a single sales factor apportionment formula. Interstate air carriers, motor carriers, railroads, pipeline companies, and telecommunications companies are required to use different apportionment formulas to determine Wisconsin net taxable income.

3. The sales factor is the ratio of the total sales of the taxpayer in the state to total sales everywhere. Sales are generally all gross receipts from the course of the taxpayer's regular trade or business operations which produce apportionable business income. For the sales factor, sales of tangible personal property are generally considered to be in Wisconsin if the property is delivered or shipped to a purchaser (including the federal government) within Wisconsin. These sales are included in both the numerator and the denominator of the apportionment ratio. In addition, the following sales are considered to be in Wisconsin:

a. Sales of tangible personal property that is shipped from an office, store or warehouse, factory, or other place of storage in Wisconsin, and delivered to the federal government outside the state, and the taxpayer is not within the jurisdiction, for income tax purposes, of the destination state.

b. Sales of tangible personal property that is shipped from an office, store, warehouse, factory, or other place of storage in Wisconsin to a purchaser, other than the federal government, and the taxpayer is not within the jurisdiction, for income tax purposes, of the destination state.

c. Sales of tangible personal property by an office in Wisconsin to a purchaser in another state, that are not shipped or delivered from Wisconsin if the taxpayer is not within the jurisdiction, for income tax purposes, of either the state from which the property is delivered or shipped, or of the destination state.

These latter types of sales (a. through c.) are considered "throwbacks" and 50% of such sales are included the numerator of the of the apportionment ratio.

4. Under the provisions of Assembly Bill 75, 100% of "throwback" sales would be included in the numerator of the apportionment formula.

5. Prior to 1979, the sales factor in the Wisconsin apportionment formula included: (a) sales of tangible personal property delivered to a purchaser in Wisconsin; (b) sales of tangible personal property shipped from Wisconsin to the federal government; and (c) sales of tangible personal property shipped from Wisconsin and delivered to an out-of-state purchaser, if the taxpayer was not subject to taxation in the purchaser's state. Untaxed sales to out-of-state purchasers were considered throwbacks, and were 100% included in the apportionment formula. Under the provisions of Chapter 1, Laws of 1979, throwback sales were 50% included in the numerator of the apportionment formula. (Since the sales factor was double-weighted in the three-factor [property, payroll, and sales], throwbacks were actually single-weighted.) This provision was recommended by the 1978 Tax Reform Commission, as a compromise to lessen the impact of throwbacks on businesses in the state. Treating, as throwbacks, sales by an office from a location outside Wisconsin to a destination outside the state was adopted in 1983 Wisconsin Act 27 (the 1983-85 biennial budget act). The current treatment of sales to the federal government as throwbacks was adopted in 1989 Wisconsin Act 31 (the 1989-91 biennial budget act).

6. The apportionment formula does not imply that a business that sells goods and services into a state owes income/franchise taxes to the state. A state can impose income/franchise

taxes on a businesses only if the business has nexus in the state. There are two circumstances which give Wisconsin taxing jurisdiction over corporations. First, corporations which are created and authorized to act in a corporate capacity (incorporated) under Wisconsin law or foreign corporations which are licensed to transact business in the state are subject to the Wisconsin corporate income tax. Second, corporations which are organized under the laws of other states or foreign nations are generally subject to the Wisconsin corporate income tax if they exercise a franchise, conduct business, or own property within the state. There are specific statutory provisions and administrative rules that describe the type of business activities that are required to establish nexus with out-of-state businesses, while certain activities are excluded.

In addition, federal Public Law (PL) 86-272 provides that a state may not impose its income tax upon a corporation that is organized under the laws of other states and that sells tangible personal property, if the corporation's only activities in the state are:

b. Solicitation, by employees, of orders for tangible personal property which are sent out-of-state for approval or rejection. (The orders must be filled from a delivery point outside the state.)

a. Solicitation of sales by nonemployee independent contractors conducted through their own offices or businesses located in the state.

7. The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model act drafted and adopted by the Commissioners on Uniform State laws and the American Bar Association. The act was designed to set uniform rules and procedures for the allocation and apportionment of income to the state. The goal of UDITPA, assuming it was adopted in every state, would be to ensure that exactly 100% of a multistate corporation's income will be subject to state taxation in the states in which it operates. Some states, through the Multistate Tax Compact (MTC), have voluntarily adopted UDITPA rules and procedures. Also, many states that have not formally adopted uniform UDITPA standards, such as Wisconsin, adhere to many of those standards. However, due to differences between state apportionment formulas, nexus rules, and Public Law 86-272, corporations can be taxed on more or less than 100% of their income.

8. The Supreme Court has generally, accepted variations in methods of formulary apportionment because of "the difficulty of identifying the geographic source of the income of a multistate enterprise" (Trinova Corp., 498 U.S. at 373, citing Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120-121 [1920]). When the Court contemplated invalidating the Iowa single sales factor apportionment formula in 1978, the Court determined that the Commerce Clause did not flatly prohibit "any overlap in the computation of taxable income by the States." The Court acknowledged that unless all of the states in which a corporation did business followed identical apportionment rules, there would always be some risk of duplicative taxation. However, the Court found that if the freedom of each state to choose its own independent apportionment formula rules was ever to have to yield to "an overriding national interest in uniformity," the determination of which apportionment should govern all states "should be determined only after due consideration is given to interests of all affected states" (Moorman Manufacturing Co. v. Bair, 437 U.S. 267,278

[1978]). The Supreme Court refused to make a policy decision, and left it up to Congress. To date, Congress has declined to address the matter (Wilson, 2005).

9. The "throwback rule" is an example of a mechanism provided under UDITPA to that is intended promote uniformity and to insure that 100% of a corporation's income is subject to taxation by the various states in which it operates. Under the throwback rule, if a corporation is not taxable in the state of destination, the sale is "thrown back" to the state of origin, and included in that state's apportionment calculation. The throwback rule attempts to insure that 100% of a multistate corporation's sales are assigned to a state that has jurisdiction to tax the corporation. The lack of uniformity among state apportionment formulas and nexus rules, and PL 86-272 means that making sales in a state may not be sufficient activity for imposing the state corporate income tax. Without a throwback rule, sales made by a multistate corporation to destination states in which the corporation is not subject to tax are not included in the numerator of the sales factor for any state. These sales become "nowhere income." The overall result is that the sum of the apportionment factors for the states in which the corporation files returns is less than 100%. The more weight that is assigned to the sales factor in a state apportionment formula, the greater the potential for producing "nowhere income." Throwbacks provide a fallback provision for state corporate tax laws to deal with conflicting nexus and apportionment provisions. When a sale is made in a state that can't impose a tax on the transaction, the sale is reallocated and taxed in the state that is the source of the sale. Without throwbacks a significant portion of corporate profits may not be subject to taxation.

10. The existence of states without throwback provisions and PL 86-272 create a potential tax avoidance opportunity for multi-state corporations. Companies can reduce state taxes by locating their physical operations in states that don't have throwback rules and the sell their products in states that cannot tax the sales under PL 86-272. Allowing companies to minimize their tax liabilities through such strategies can distort investment decisions by such firms, and places small businesses that can only sell in-state at a competitive disadvantage.

11. Table 1, which is based on Commerce Clearing House (CCH) surveys of state tax or revenue departments, shows the states that have throwback rules for apportionment purposes. The table shows that 24 of 46 states with a corporate income tax have throwback rules. Wisconsin is the only state where throwback sales are 50% included in the apportionment factor. Of the surrounding states, Michigan, Minnesota, and Iowa do not have throwback rules, while Illinois does. Based on information from the 2005 corporate income/franchise tax sample, approximately 1,600 corporations (3% of all corporations in the sample) reported throwback sales, and 24% of those corporations had a tax liability.

TABLE 1

States with Throwback Rules
2009

State	Throwback Rules
Alabama	Yes, state goods shipped from.
Alaska	Yes
Arizona	No
Arkansas	Yes, state goods shipped from.
California	Yes, state goods shipped from.
Colorado	Yes (3-factor only, not under 2-factor), state goods shipped from.
Connecticut	No
Delaware	No
Florida	No
Georgia	No
Hawaii	Yes, state goods shipped from.
Idaho	Yes, state goods shipped from.
Illinois	Yes, state goods shipped from.
Indiana	Yes, state goods shipped from.
Iowa	No
Kansas	Yes, state goods shipped from.
Kentucky	No
Louisiana	No
Maine	Yes, state goods shipped from.
Maryland	No
Massachusetts	Yes, state where order was processed.
Michigan	No, assuming nexus somewhere other than Michigan.
Minnesota	No
Mississippi	Yes, state goods shipped from.
Missouri	Yes, state goods shipped from.
Montana	Yes, state goods shipped from.
Nebraska	No
New Hampshire	Yes, state goods shipped from.
New Jersey	No
New Mexico	Yes, state goods shipped from.
New York	No
North Carolina	No
North Dakota	Yes, state goods shipped from.
Ohio	No, no throwback provisions; destination and cost of performance are the primary considerations. Ohio uses the MTC as guidelines.
Oklahoma	Yes, state goods shipped from.
Oregon	Yes, state goods shipped from.
Pennsylvania	No
Rhode Island	No
South Carolina	No
Tennessee	No
Texas	Yes, state goods shipped from.
Utah	Yes, state goods shipped from.
Vermont	Yes, state goods shipped from.
Virginia	No
West Virginia	No
Wisconsin	Yes, but not for foreign sales; state goods shipped from.

Source: Commerce Clearing House

12. Throwback rules can be neutral tax policy as part of a system where all states impose corporate income taxes at the same rate and where the federal government imposes PL 86-272, since these provisions would not distort locational decisions. However, in the current environment, where some states choose not to impose a corporate income tax, some states choose not to have throwback rules, and states tax at different rates, throwback rules are not neutral in their impact (Fox, Murray, and Luna, 2005). All firms producing and selling in the home state should be taxed the same on their in-state sales. This will be the result if situsing (allocation of sales to a particular location) operates properly, and the throwback rule is not necessary for this outcome. Similarly, the destination component should be the same for all firms when selling into other states, regardless of where those firms are situated. The throwback rule distorts this objective by imposing a tax on home-state firms that sell into states with no corporate income tax. This places these firms at a disadvantage on their out-of-state sales, compared to firms in non-throwback rule states. In addition, the tax base that results from imposition of the throwback rule is inconsistent with the intended tax base. The throwback income is taxed, not because the state has determined that the income was earned in the state, but because another state is unwilling or unable to tax that income. Finally, the throwback rule can impose a tax burden that is very large relative to the corporate profit that otherwise would be taxable in the state, since the allocation of income to the state includes all sales into PL 86-272 states.

13. Throwback rules are unlikely to result in the taxation of all corporate income since companies can plan to reduce tax liability due to the existence of non-corporate income tax or non-throwback states. For example, Klassen and Shakelford (1999) found that companies appeared to structure their shipments strategically in order to reduce sales in states that applied a higher weight on the sales factor of the apportionment formula. Moreover, the economic climate of a throwback state is potentially disadvantaged. Firms can be discouraged from locating in the state since the throwback rule can increase the company's tax burden. Absence of a throwback rule can encourage firms to locate in that state, if the company has direct sales to out-of-state customers (Swenson, 2005).

14. In a 2003 regression study of state level data from 1983 to 1996, Gupta and Hofmann examined whether states with lower income tax burdens on property, measured as a combination of statutory corporate income tax rates and apportionment formula factor weights, experienced a higher level of new capital spending by corporations. The authors found that throwback rules had statistically significant negative impact on capital investment. However, the economic magnitude of the effects was modest. Similarly, Swenson used a firm location decision model (2005) and found that absence of a sales throwback rule was an effective incentive in firm location decisions, but resulted in negative externalities for other states. Bruce and Deskins conducted study for the U.S. Small Business Administration (SBA) using regression analysis and state level data from 1989 through 2001 to isolate the impact of tax policy on entrepreneurship. The authors found that states with combined reporting and throwback rules tended to have higher levels of entrepreneurship. Finally, using aggregate state-level data from 1982 to 2002, Gramlich, Gupta, Hofmann, and Moore found that state adoption of a throwback rule had a generally positive and significant association with state corporate income tax collections.

15. On May 11, 2009, this office provided revised estimates of general fund tax revenues that projected a reduction in tax revenues for fiscal years 2008-09 through 2010-11 of $1,382 million in individual income taxes and $282 million in corporate income and franchise taxes. As a result, the estimates of the additional revenues that would result from increasing from, 50% to 100%, throwback sales that are included in the numerator of the sales factor of the apportionment formula have also been revised. Specifically, the additional revenues generated by this provision are reestimated to be $44,500,000 in 2009-10 and $36,000,000 in 2010-11. These estimates are lower by $13,200,000 in 2009-10 and $1,500,000 in 2010-11 than the amounts included in the bill.

ALTERNATIVES

1. Adopt the Governor's recommendation to require that throwback sales be included 100%, rather than 50%, in the numerator of the sales factor of the apportionment formula for allocating income to Wisconsin. Reestimate the increase in corporate income and franchise tax revenues to be $44,500,000 in 2009-10 and $36,000,000 in 2010-11.

ALT 1	**Change to Bill** Revenue
GPR	**-** $14,700,000

2. Delete the Governor's recommendation.

ALT 2	**Change to Bill** Revenue
GPR	**-** $95,200,000

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