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Change Up: The Potential Evolution of the Throwback Rule

By Tarra Curran, CPA, MST and Claudia Mullen, CPA, MBA

As states struggle to refine their taxation schemes to keep up with our increasingly technology-driven economy, traditional state tax concepts have been forced to evolve as well. States have been redefining the term "nexus" with the development of concepts such as economic nexus and factor presence nexus to tax businesses that have no physical presence in the state. This article provides an illustration of this trend with a discussion of a recent chief counsel ruling by the California Franchise Tax Board ("FTB") explaining how the state's traditional throwback rule will be applied in light of the state's adoption of factor presence nexus principles.

An Overview of Throwback

Generally, the receipts from the sale of tangible personal property are sourced for apportionment purposes to the numerator of the sales factor in the state of ultimate destination of the product. In order to prevent taxpayers from avoiding taxation by assigning sales to states where the taxpayer is not taxable, the Multistate Tax Commission created a "throwback rule" within the Uniform Division of Income for Tax Purposes Act ("UDITPA"). For states that have a throwback rule, the general rule provides that sales of tangible personal property are sourced to a particular state if the property is shipped from an office, store, warehouse, factory, or other place of storage within that state **and** either the purchaser is the United States government **or** the taxpayer is not taxable in the state of the purchaser. There are, however, exceptions to the standard rule - for example, Massachusetts' "sales office" rule.

Furthermore, UDITPA provides that a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does impose such a tax.

One of the consequences of the UDITPA's throwback provisions is that it allows the state of origin in a sale of tangible personal property to reassign the receipts from sales to other states where the state of destination is precluded from imposing a net income based tax due to Public Law 86-272 (P.L. 86-272) or some other federal constitutional restriction. As a result, when sales are thrown back to the state of origin, they are included in the numerator of the originating state's sales factor. Moreover, since the term "state" may include "any foreign country," the UDITPA throwback provision also applies to sales to customers located in foreign countries. Some jurisdictions, such as Massachusetts, provide exceptions to this rule of throwing back foreign sales. So, taxpayers should be sure to review each state in detail.

A slight majority of the states with corporate income tax adopt some sort of throwback rule, with the majority of those states following the UDITPA throwback rule. States such as Kentucky and Tennessee only apply the throwback rule to sales of tangible personal property to the U.S. government.

Alternatively, West Virginia and Maine have adopted "throwout rules" whereby receipts from sales destined to a state where the taxpayer is not subject to an income tax are thrown out of both the numerator and denominator of the sales factor. At one time, New Jersey also had a throwout rule. However, New Jersey's throwout rule was repealed in light of constitutional deficiencies.

The *Joyce* Approach vs. the *Finnigan* Approach to Combined Apportionment

Two California State Board of Equalization ("SBE") decisions have played an important role in defining the term "taxpayer" for purposes of computing the sales factor for unitary or combined filings. In *Appeal of Joyce, Inc. (No. 66-SBE-070, Nov. 23, 1966)*, the SBE held that the taxpayer was the specific member of the unitary group making the sale. On the other hand, in *Appeal of Finnigan Corporation (No. 85A-623-LB (88-SBE-022)*, Aug. 25, 1988), the SBE held that the taxpayer included any member of the unitary filing group. The distinction between *Joyce* and *Finnigan* is evident in the application of the throwback rule in states where taxpayers are required to file mandatory unitary combined returns. Under the *Joyce* rules, the throwback rule is applied separately to the sales of each member of the combined group. Meanwhile, the *Finnigan* rules provide that if any group member has nexus in another state, then all sales delivered to that state by the entire unitary group are sourced to that state. The general result is that the application of a *Finnigan* approach will likely result in fewer sales being thrown back.

Factor Presence Nexus and Chief Counsel Ruling 2012-03

Factor presence is dictated by the amount of property, payroll, or sales a business has within a state. In California's version of factor presence, substantial nexus is established if any of the following thresholds is exceeded during the tax period: $50,000 of property; $50,000 of payroll; or $500,000 of sales. See our June 2011 Alert for a comprehensive discussion on factor presence nexus.

In Chief Counsel Ruling 2012-03, the FTB addressed the application of California's throwback provisions to a unitary combined group where one member of the group manufactures and sells over $500,000 in tangible personal property from California to certain individual states and foreign countries ("Seller of TPP"). Meanwhile, another member of the unitary group (“Affiliate”) develops and sells over $500,000 of non-tangible personal property to customers located in certain individual states and foreign countries. The Affiliate does not have any other contacts outside of California, and therefore does not file in any other jurisdictions.

The FTB divided its analysis by examining the application of the throwback rule to foreign sales versus domestic sales. Since California adopted the UDITPA throwback rule, foreign sales would be subject to the throwback provision if the taxpayer's activity in the foreign country would be sufficient to impose a net income tax based on the Constitution and the statutes of the United States. After applying the factor presence nexus standards, the FTB determined that the Seller of TPP would be subject to tax in any foreign jurisdiction where it had over $500,000 in sales in any given year. Further, the FTB noted that P.L. 86-272 would not preclude a Seller of TPP from being subject to tax in a foreign country. As such, sales to any foreign jurisdiction where the taxpayer had more than $500,000 of sales were not required to be thrown back.

Similarly, the FTB also ruled that a seller should not throw back sales to California where its Affiliate made sales of other than tangible personal property to a particular state in excess of $500,000. Based on California's re-adoption of the *Finnigan* rule, the FTB held that sales of tangible personal property to another state are excluded from the California sales factor numerator if any member of the group is taxable in the state to which goods are shipped. As a result, sales of tangible personal property will not be thrown back to California if another member of the unitary group has greater than $500,000 in sales of other than tangible personal property, when applying California's market sourcing rules in that

particular state. In sum, since the Affiliate would be considered taxable in the other state, then the entire unitary group would be considered taxable in that state based on *Finnigan* principles.

Conclusion

This ruling provides relief to unitary filers who may no longer have to increase their sales factor in California due to sales being thrown back to the state because of the recent rule changes. While there is little doubt that taxpayers may apply the ruling to tax years beginning on or after January 1, 2011 when the factor presence and *Finnigan* rules were adopted, one has to wonder if such a position could be advocated for periods beginning prior to 2011. Further, it will be interesting to see if other states with similar rules to California will follow suit.

This ruling also illustrates how various aspects of a state's taxation scheme are synchronized with each other. Therefore, a change to one aspect of the taxing scheme may trigger changes in other areas. For instance, California's adoption of factor presence nexus also led to changes in the California sales factor through the use of factor presence nexus in the application of the throwback rule. As states are constantly refining their tax rules to keep up with the times, taxpayers should be vigilant as these changes may present opportunities to lower their tax liabilities.

For more information concerning state income tax issues, contact your CBIZ Tofias tax advisor, or you may reach Tarra Curran (TCurran@cbiztofias.com) at 401.626.3240 and Claudia Mullen (CMullen@cbiztofias.com) at 401.626.3241.

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