Throwback/Throwout

Policy Position

Position: *Throwback and throwout laws seek to require companies to pay tax in one state on income that another state has chosen not to tax or is legally unable to tax. A company's tax liability in one state should not be measured by its tax in another state. Throwback and throwout rules also discourage investment in a state. Such rules must not be adopted and must be repealed where they presently exist.*

Explanation: Although throwback and throwout laws are different in their mechanical operation, the motivation for them and their flaws are similar. Generally speaking, throwback and throwout laws require a company, when calculating its tax in a state, to add income earned in another state if that other state chooses not to tax that income or is prohibited from taxing that income by the U.S. Constitution or by federal law.

A recent paper[1] by three leading state tax economists addressed the case for and against these laws. They cite two frequent claims made in favor of such policies but note that "the validity of each is questionable." The first claim proponents make is that throwback and throwout laws discourage tax planning. The authors conclude, however, that such laws fail to accomplish this goal and are in fact potentially damaging to the state's economic climate "because firms are discouraged from locating in throwback states." It should also be noted that "tax planning" is not only legal but the only responsible course of action for tax professionals. Failing to plan for the tax consequences of business activity is a breach of a tax professional's fiduciary responsibility to employees, consumers and shareholders, all of whom would ultimately bear the burden if the business paid more in tax than was legally due.

The second claim proponents of throwback and throwout laws make is that such laws ensure that all corporate income is taxable in some state. The authors of the recent paper note that again these laws do not accomplish this goal and argue that there is "little practical reason why any state's tax policy should be based on ensuring that out of state activity is properly included in some state's tax base". A corporation's correct measure tax in a state is determinable without reference to the tax a corporation pays in other states. Throwback and throwout laws tax income that is, by definition, earned outside of the state, and such laws tax that income at the wrong rate and direct the resulting revenue to the wrong state.

In 2002, New Jersey became the first state in many years to adopt a throwback or throwout law. The New Jersey law also created a study commission to review the new provisions and evaluate them based on several principles of sound tax policy. The commission's final report recommended repealing the law, saying that it "…does not more fairly measure a corporation's business activities in a state." The commission further concluded that the law "…is inconsistent with the basic premise of fair apportionment which requires each factor of the apportionment formula to reflect how the income of a corporation is earned."[2]

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[1] Fox, Luna and Murray, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?", *National Tax Journal*, March, 2005, pp. 153-5.
[2] Final Report, New Jersey Corporation Business Tax Study Commission, June 29, 2004, pp. 8-9.

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