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April 3, 2017

Oregon State Legislature
Senate Committee on Finance and Revenue

Via E-mail

Re: COST Opposes the "Throwout" Provision in the -4 and -6 Amendments to S.B. 28

Dear Chairman Hass and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing to oppose the "throwout" provision included in the -4 and -6 amendments to S.B.28. These proposed amendments to S.B. 28 would repeal Oregon's current cost-of-performance method for sourcing of services and intangibles and adopt market-based sourcing for such sales. Although COST does not take a position regarding cost-of-performance versus market-based sourcing, COST is opposed to the throwout provision in the proposed -4 and -6 amendments to that legislation.

COST is a nonprofit trade association consisting of approximately 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

The "Throwout" Provision Should Be Removed from H.B. 2274

The COST Board of Directors has adopted a formal policy statement against both throwback and throwout provisions.[1] That policy statement position is:

> *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 Such rules must not be adopted and must be repealed where they presently exist.*

[1] COST's Policy Statements are available at: http://cost.org/Page.aspx?id=3140. In general, a throwback provision is used for sales of tangible personal property; under throwback, a sale to a "destination" state in which the taxpayer is not taxable is thrown back to the "origin" state's sales factor numerator. A throwout provision is used with sales of services and/or intangibles; those sales are excluded from both the numerator and denominator of the sales factor.

Subpart (6) of Section 2 of the -4 amendment and subpart (5) of Section 2 of the -6 amendment to S.B. 28, which contains the throwout provision COST opposes, states the following

> If the taxpayer is not taxable in a state to which a receipt is assigned under subsections (1) to (5) of this section, or if the state of assignment cannot be determined under subsections (1) to (4) of this section or reasonably approximated under subsection (5) of this section, the receipt shall be excluded from the denominator of the sales factor.

"Throwout" Provision Contradicts Move to Market-Based Sourcing

Many states have moved to market-based sourcing to export their tax burden. In other words, instead of sourcing receipts to the location where the cost to perform a service occurs (origin location), receipts are sourced to the location of the customer (market location). Thus, in general, the tax liability of a service provider in Oregon with the majority of its customers located outside of the State will be reduced if the State switches to market-based sourcing. In contrast, tax liability will increase for an out-of-state service business with the majority of its income producing activities outside of Oregon but its customers in the State. By including a throwout provision in a market-based sourcing statute, sales not taxable in another state or which cannot be assigned are excluded or "thrown out" of both the numerator and the denominator. Although COST does not take a position on whether a state should use cost-of-performance sourcing or market-based sourcing, sales that are "thrown out" will likely increase an Oregon based business's sales factor to the State. Accordingly, by including a throwout provision, Oregon would essentially be negating the general rationale behind adopting market-based sourcing.

"Throwout" Provision Is Constitutionally Suspect

As noted above, the proposed throwout provision will generally require a business, when calculating its tax in Oregon, to exclude sales made to customers in another state if the other state chooses not to tax that income or is prohibited from taxing that income by the U.S. Constitution or by a federal law. This violates principles of sound tax policy. A business's correct measure of tax in a state should be determined without reference to the taxes a business pays in other states. It is also inconsistent with the basic premise of fair apportionment.[2] Throwout must be limited to survive a constitutional challenge. Two cases in New Jersey that addressed New Jersey's throwout provision, which was subsequently repealed, held: (1) only receipts where another state lacks the legal authority to impose an income tax can be subject to throwout and (2) to be "internally consistent" for purposes of the U.S. Constitution's Commerce Clause, the taxing state's position on what constitutes "substantial nexus" must be used to determine the legal authority to impose a tax, not the other states' legal positions.[3] Thus, based on the Oregon

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[2] *See* COST's Policy Statements are available at: http://cost.org/Page.aspx?id=3140, citing Final Report, New Jersey Corporation Business Tax Study Commission, June 29, 2004, pp. 8-9.

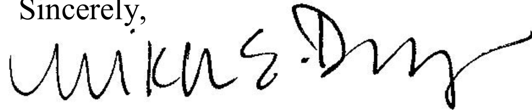
[3] *See Whirlpool Properties, Inc. v. Director, Div. of Taxation*, 208 N.J. 141 (N.J. 2011) and *Lorillard Licensing Co., LLC v. Director, Div. of Taxation*, Superior Court, App. Div. (Dec. 4, 2015), review denied, N.J. (June 17, 2016). The New Jersey legislature repealed its throwout provision effective July 1, 2010. To be internally consistent, a

Department of Revenue's position that it can impose the State's income tax against businesses with no physical presence in the State (*i.e.,* merely having an economic presence in the State), the Department will be hard pressed to throw out any sales.[4]

Conclusion

COST strongly encourages this Committee to recommend that throwout provisions be excluded from any Oregon market-based sourcing proposal.

Sincerely,



Nikki E. Dobay

cc: COST Board of Directors
Douglas L. Lindholm, President & Executive Director, COST

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state's tax, if theoretically imposed by every other state, would not result in duplicative taxation. See *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787, 1802 (2015).

[4] *See* Or. Admin. R. 150-317.010(2) stating substantial nexus may be established through a significant economic presence in the State.