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Exhibit A

(Petitioner's Motion to Reconsider, filed December 14, 2023)

STATE OF SOUTH CAROLINA

ADMINISTRATIVE LAW COURT

Tractor Supply Company, Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Civil Action No. 19-ALJ-17-0416-CC **TRACTOR SUPPLY COMPANY'S MOTION TO RECONSIDER AMENDED FINAL ORDER AND ORDER ON MOTION FOR RECONSIDERATION**

Pursuant to Rule 29(D) of the Rules of Procedure for the Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, Tractor Supply Company ("TSC" or "Petitioner") respectfully requests that this Court reconsider and modify its Amended Final Order (the "Amended Order") and its Order On Motion For Reconsideration (the "Reconsideration Order"), both dated December 4, 2023. Copies of these orders are attached hereto as **Exhibit A** and **Exhibit B** respectively. This motion is based upon the grounds that the Court has overlooked, misinterpreted, or failed to apply South Carolina law and/or overlooked or misunderstood certain evidence, points and arguments presented, which, when considered or reconsidered, necessitate modification of both the Amended Order and the Reconsideration Order in favor of TSC as set forth in more detail below. TSC further relies upon, hereby incorporates, and does not waive any and all prior points and arguments advanced supporting its position in prior submissions and otherwise at trial.

INTRODUCTION

Following a contested case hearing, this Court issued a Final Order on August 8, 2023, attached hereto as **Exhibit C**. TSC timely filed a motion for reconsideration of the Final Order on

August 18, 2023, detailing the arguments and points that were overlooked, or in error, and TSC requested that this Court reconsider its order and amend it to find in favor of TSC on all issues. On August 21, 2023, this Court entered an order, *ex mero motu*, which rescinded its Final Order pending disposition of TSC's reconsideration motion. On December 4, 2023, this Court entered two orders: 1) the Reconsideration Order, which, while stating it was granting TSC's motion, did not grant the relief requested by TSC but instead indicated that the Court was going to maintain the same result as in its prior Final Order; and 2) the Amended Final Order.

Under SCALC Rule 29(D), a party may move for reconsideration of a final decision of this Court subject to the grounds for relief set forth in Rule 59, SCRCP. *See Elam v. S.C. DOT*, 361 S.C. 9, 19, 602 S.E.2d 772, 777 (2004) ("It is proper to view a Rule 59(e) motion not only as a vehicle to request the trial court alter or amend the judgment, but also as a vehicle to seek reconsideration of issues and arguments.") "The purpose of Rule 59(e), SCRCP, to alter or amend the judgment[,] is to request the trial judge to 'reconsider matters properly encompassed in a decision on the merits.'" *Arnold v. State*, 309 S.C. 157, 172, 420 S.E.2d 834, 842 (1992) (citation omitted). A motion under SCALC Rule 29(D) and Rule 59(e), SCRCP is timely if it is served not later than 10 days after receipt of written notice of the entry of the order.

Here, TSC has three grounds that warrant reconsideration of this Court's December 4, 2023 Orders: (1) the Reconsideration Order erroneously applied principles of federal civil procedure to summarily disregard reconsideration of earlier made arguments at the contested merits hearing; (2) the Amended Order (as explained in the accompanying Reconsideration Order) substantively altered the application of the facts and law in this case; and (3) the Reconsideration Order also includes new and additional legal grounds and reasoning to sustain the Amended Order with respect to the underlying tax issues.

Regarding the first ground, TSC correctly seeks reconsideration of certain rulings contained in this Court's Reconsideration Order, specifically, the Court's summary refusal to reconsider arguments that TSC had previously made. *See* Reconsideration Order at 2 (citing a federal civil procedure treatise and explaining that the Order "briefly address[es]. . . the grounds of Petitioner's motion that [this Court] found were without merit *or were a reiteration of arguments made at the [merits] hearing.*" (emphasis added)). In South Carolina, a motion for reconsideration under Rule 59(e) may properly address issues that were previously raised at the hearing on the merits. *See Elam*, 361 S.C. at 21-26, 602 S.E.2d at 778-718 (A party is authorized to file an initial Rule 59(e) motion, regardless of whether the written Rule 59(e) motion may have revisited some issues and arguments raised at the merits hearing). Accordingly, this Rule 59(e) motion properly challenges this Court's overall application of South Carolina law to TSC's initial reconsideration motion as, respectfully, erroneous. This Court should not have been constrained to summarily reject TSC's reconsideration arguments merely because the Court felt that they had also been made during the earlier contested merits hearing.

Second, TSC seeks reconsideration based on the substantive alterations of the Amended Order. As our Supreme Court has explained, a second motion for reconsideration is proper "if the disposition of the first motion results in a judgment which is substantively altered[.]" *Elam*, 361 S.C. at 19, 602 S.E.2d at 777. TSC posits that such criteria are satisfied here. While the Amended Order arrived at the same overall result, it contains several new and additional legal grounds, facts, and reasoning to support the conclusions rendered. As examples, the Court: (1) cites numerous provisions in the § 482 Regulations to bolster DeRamus's testimony and/or to criticize Andrade's testimony; (2) expressly states it is not applying rules of statutory construction in response to TSC's argument that combined unitary reporting is not authorized by the plain language of the

statute used by the Department as authority for the tax assessment in this case; (3) introduces the doctrine of *stare decisis* and its potential application in this case; (4) clarifies its application of the heightened "equitable" standard and also claims it applied and satisfied the first and third components of the test for "reasonableness;" (5) explains why it ignored billions of dollars of inventory when determining the costs incurred to perform procurement; (6) determined "the preponderance of the evidence shows that the greatest effect of the [2001] restructuring was tax benefits" but does not explain its relevance to this case; and (7) explains its rationale for placing the burden of proof on TSC to affirmatively prove the procurement charge satisfied the arm's length standard as described in Treas. Reg. § 1.482-1(b)(1) ("the Arm's Length Standard"). Thus, TSC is correctly challenging these new and additional grounds and reasoning, with which TSC disagrees, via this motion. Under *Elam*, TSC's position is that this motion is not a "merely" successive motion to reconsider.

Third, this Rule 59(e) motion also correctly challenges the substantive alterations and additions to this Court's legal reasoning contained in the Reconsideration Order. To that end, sections 1(b), 1(c), 1(e), 2(c), 3(d), and 4 of the Reconsideration Order appear to include new and additional legal grounds to sustain the Amended Order. As with the challenges to new grounds in the Amended Order, TSC's challenges the substantive changes in the Reconsideration Order, argues they are error, and takes the position that this is not a "merely successive" motion to reconsider.

Hence, TSC respectfully requests that its motion for reconsideration of the Amended Order and Reconsideration Order be granted for the reasons that follow.

ARGUMENT

I. The Court is Improperly and Incorrectly Selectively Applying the Rules of Statutory Construction to Interpret S.C. Code Ann. § 12-6-2320(A).

A. The Court Failed to Apply the Rules of Statutory Construction and has Incorrectly Found Combined Unitary Reporting is Authorized in this Case.

The Court now expressly states that it is not applying the rules of statutory construction in its interpretation of S.C. Code Ann. § 12-6-2320(A) (the "the AA Statute") and specifically on the issue of whether subsection (A)(4) allows the use of combined unitary reporting ("CUR") in this case. *See* Am. Order at 41-42. That is improper for many reasons, including but not limited to, the following:

1. The Court's role and the cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature. *Id.* at 41-42 (citing *Hodges v. Rainey,* 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) and *Eagle Container Co., LLC v. Cnty. of Newberry,* 379 S.C. 564, 570, 666 S.E.2d 892, 895 (2008).).

2. Even under the Court's view that it only needs to engage in statutory construction for a statute that "has not previously been interpreted and/or its meaning becomes unclear in a particular application" (Am. Order at 41), it still must engage in statutory construction. For example:

    a. No South Carolina court has interpreted whether the Department can use § 12-6-2320(A)(4) as authority to *force* the use of CUR against a single taxpayer as it has done here (versus allow it where both parties agree).

    b. The Supreme Court in *Media General* did not rule the Department can force the use of CUR against a single, non-consenting taxpayer, nor did it address facts similar to those in the present case.

    c. TSC is not aware of any court interpreting a statute modeled after Section 18 of UDITPA (like the AA Statute) to allow a taxing agency to force the use of CUR against a single taxpayer as the Court has been done here.

    d. When the Department forces the use of CUR against a non-consenting taxpayer as it has done here, any ambiguity in the statutory text must be resolved in favor of Petitioner. *See* TSC Mot. to Reconsider at 4-5.

3. The Court's statements that it cannot engage in statutory construction because that would require it "to deviate from the Supreme Court's interpretation" in *Media General* of the AA Statute and that the doctrine of *stare decisis* would prevent the Court from doing so (*see* Am. Order at 45-46) are, respectfully, incorrect for many reasons, including, but not limited to the following:

    a. The Court ruling that the Department cannot force the use of CUR against Petitioner in this case would be contrary to nothing in *Media General* even viewing its holding as authorizing the use of CUR in that case. *Media General* supports that the Department may *allow* a group of taxpayers requesting CUR to use it.

    b. The cases cited by the Court are distinguishable. Am. Order at 45-46. Further, even if the *stare decisis* doctrine could be applicable here, the Court erred in finding "no 'internal evidence' or reasoning far stronger than our supreme court's that would require this [C]ourt to reinterpret the meaning" of whether CUR is authorized in this case. *See id.* at 46. For example, the briefings filed by the parties in *Media General* are internal evidence showing the Department's clear knowledge that the Supreme Court's view of the method it approved was not actually CUR, and the reasoning in *Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888 (Ind. T.C. 2015) is "far stronger than our supreme court's" possible application respecting whether § 12-6-2320(A)(4) authorizes the forced use of a method like CUR.

4. The Court also states, without explaining its significance, that the holding in *Media General* "did not reference nexus." Am. Order at 49. This is respectfully irrelevant. Each entity that was a member of the unitary business in that case appeared to have nexus,[1] and if any did not, they never argued that issue.

B. The Court's Failure to Apply the Rules of Statutory Construction Caused it to Err in Finding that an Incorrect Transfer Price is Evidence that Petitioner's Business Activity is Not Fairly Represented in South Carolina.

The Court misapplied the rules of statutory construction to incorrectly reject Petitioner's argument that an inaccurate transfer price is not evidence sufficient to establish step one of the AA Statute (*see* Am. Order at 60-63). The Court failed to consider legislative intent regarding the type of evidence that can serve as justification to invoke the AA Statute (i.e., evidence that shows or tends to show that "the allocation and apportionment provisions of this chapter do not fairly

[1] Each entity either already filed tax returns or were assessed tax / told by the Department they had to start filing tax returns. Each entity either admitted nexus or did not challenge the assertion of nexus by the Department.

represent the extent of the taxpayer's business activity in this State"). The AA Statute clearly envisions the necessary evidence as being evidence that shows statutory distortion, or stated differently, shows a causal link between the evidence and the alleged problem with the standard apportionment provisions. The sales factor is not causing the alleged problem here (and neither is the reporting method for that matter).[2] Thus, an inflated transfer price paid by a retailer is not itself evidence that the "taxpayer's business activity in this state" is unfairly represented within the meaning of the AA Statute.

II. The Court is Incorrect about the Holding and Significance of *Media General.*

The Court erred in its interpretation of both the holding in *Media General* and the significance of its holding for many reasons, including but not limited to the following:

1. The Court incorrectly refers to a quote from *Media General* as "the Supreme Court's own description of 'combined entity apportionment[.]'" Am. Order at 44. The quoted portion was the parties' stipulated description, and that description is also located in Section I of the *Media General* decision which was the parties' stipulated facts. *Media General*, 388 S.C. at 140-142, 694 S.E.2d at 526-527. For the Supreme Court's description, *see* Am. Order at 43.

2. The Court's focus on understanding what happened at the ALC level in *Media General* and its emphasis on the Supreme Court affirming the ALC's order "without modification[,]" does not support the Court's conclusion that the Supreme Court thus found § 12-6-2320(A)(4) allowed the use (in that case) of CUR. Am. Order at 44-45. Petitioner agrees that the parties intended for and requested that the ALC determine whether § 12-6-2320(A)(4) allowed the use of CUR in that case, that the ALC ruled it was allowed, and that the Supreme Court affirmed the ALC. However, the Supreme Court's description (as opposed to the parties' stipulated description) of the method it approved clearly related solely to the sales factor (in this case), and the Supreme Court's *analysis* used to affirm the ALC's order is based on the Supreme Court's view of the method as relating solely to the sales factor.[3]

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[2] *See also* TSC Mot. to Reconsider at 11-13.

[3] *See also* TSC Mot. to Reconsider at 5-7.

III. The Court Incorrectly Found the Department Satisfied the Necessary Burdens to Justify Use of the AA Statute.

A. The Court Applied the Wrong Test for Step One of the AA Statute.

To invoke the AA Statute, the Department must first show the standard method fails to "fairly represent the extent of the taxpayer's business activity in this State" ("Step One"), and the only "taxpayer" in this case is TSC. The Court (incorrectly) concluded the Department met its burden in Step One because it found that TSC's use of separate reporting failed to fairly represent its business activity in this state. *See, e.g.*, Am. Order at 60-63. However, for Step One, the Amended Order now plainly states the Court immediately evaluated the *TSC Group's* business activity in South Carolina because it was necessary to "capture the 'largely unquantifiable transfers of value that take place among the components of a single enterprise.'" Am. Order at 56-57. That is the wrong test and is language used by proponents of combined reporting, and the Court never examined the actual taxpayer's business activity in this state.

B. The Court Improperly and Unjustifiably Shifted the Burden of Proof to TSC.

The Court improperly shifted the burden of proof to Petitioner to affirmatively establish that the procurement charge satisfied the Arm's Length Standard. *See, e.g.*, Am. Order at 56-60. The Court now suggests this was appropriate because "the Department presented compelling evidence that the intercompany transactions failed to meet the arm's length standard" and thus, "[a]t that point, Petitioner had the burden . . . to provide evidence to rebut the fact that the Department had established its case." *See* Reconsideration Order at 5-6 and Am. Order at 58.[4] The

[4] The Court, at times, implies that TSC was at the hearing presenting the 2014 PwC Study as its proof the procurement charge satisfied the Arm's Length Standard, yet was then proven wrong by the Department, followed by TSC's

Court should reconsider this finding because the evidence it relied on to shift the burden to Petitioner proved nothing about whether the procurement charge failed to meet the Arm's Length Standard and the evidence it dismissed should have been more carefully considered. The evidence that should be reconsidered includes:

1. Items that have nothing to do with transfer pricing, the § 482 Regulations, or the Arm's Length Standard, such as the following:

    a. That "almost 67% of TSC's income from its retail stores was shifted to Texas[.]" Am. Order at 57.[5]

    b. Several "before and after transfer pricing" comparisons using financial data to show the impact of the 9.7% markup on inventory (as compared to using a 0% markup on inventory). *See, e.g.*, Am. Order at 56-60.

    c. A comparison of sales revenue in South Carolina (roughly $135-$160 million each year) to the ultimate taxable income apportioned to South Carolina (roughly $4 million to $5 million). Am. Order at 57-58. The Court deemed the delta of more than $100 million important (*id.* at 57-58, n. 62), but the same would be true using CUR which results in roughly $12 million to $13 million of taxable income apportioned to this state each year.

    d. Emphasis on the fact that the above evidence came from a transfer pricing expert. Am. Order at 58, n. 63. If any expert at all is needed to present and explain that evidence, which seems doubtful, it would be an accountant.

2. Testimony the Court deemed "logical" but that either (1) has no probative value under the § 482 Regulations, (2) is clearly contrary to the § 482 Regulations, or (3) is based on an incorrect understanding and application of the § 482 Regulations, and the Court's dismissal of the absence of critically important evidence needed to support the Court's findings. The Court essentially engaged in its own transfer pricing analysis, which, respectfully, was flawed, to incorrectly conclude the Department proved its case. *See, e.g.*, Am. Order at 16-28, and 56-60. Examples include the Court's reliance on the following:

    a. **DeRamus testimony excluding the cost of inventory to support the false statement that it only "costs $13 million" to perform procurement**. *See, e.g.*, Am. Order at 17, n. 24, and 27, n. 38. The Court justified excluding the inventory

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transfer pricing expert conceding that the 2014 PwC Study was unreliable. *See, e.g.,* Reconsideration Order at 5-6; *see also* Am. Order at 12 and 58. That, respectfully, is incorrect.

[5] The origins of this statement are unclear but may be from the Amended Order at 27, n. 37, which if true, is wrong because TSC had far greater than $400 million of revenue in 2014.

costs because "the transaction that is being valued is the service of procuring the goods, not the value of the goods themselves; therefore, it is logical that the cost of performing the service includes the cost of the procurement employees, etc., but not the cost of the goods purchased as a result of the service." Am. Order at 27, n. 38. Nothing in the § 482 Regulations supports this, and no evidence was presented to support it, such as (for example) any third party comparables. The Court's view that it "costs $13 million" was "evidence" used by the Court to conclude the procurement charge failed to meet the Arm's Length Standard. *See, e.g.*, Am. Order at 17, 26, and 58. The Court should not decide whether to include $13 million versus several billions of dollars as the costs of the procurement function based on what seems logical in a general sense, but rather should have based its analysis on the § 482 Regulations. *See also* TSC Mot. to Reconsider at 21-22, and TSC Resp. to Department's Proposed Order at 27-32.

b. **DeRamus testimony misapplying the concept of realistic alternatives**. The Court discusses the concept in relation to "whether TSC would agree to give up its IP and so much income for Texas's procurement services in an arm's length transaction," and the Court also says "a company like TSC would not voluntarily give up millions of dollars of profit in return for someone taking over the procurement function[.]" Am. Order at 18-19. The Court's analysis, which is consistent with DeRamus's testimony, is respectfully, materially flawed. The Court discusses the wrong "controlled transactions" from the wrong time period,[6] and the cited testimony of DeRamus lacks any factual basis[7] or support.

c. **Finding that lack of evidence regarding any third party companies that could perform the procurement function was not important**. *See* Am. Order at 27, n. 38. The Court brushed this lack of evidence aside by saying "I do not find that degree of specificity was necessary to show TSC would find another realistic alternative." Am. Order at 27, n. 38. A material basis of the Court's conclusion that the procurement charge failed to meet the Arm's Length Standard is the Court's belief that TSC could find other, cheaper companies to perform the functions performed by TSC of Texas. However, there is no evidence of this, and this lack of evidence cannot be deemed unimportant.[8]

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[6] The Court, consistent with DeRamus, is talking about "controlled transactions" back in 2001 that took place as part of the 2001 Restructuring and incorrectly believing they have relevance to "controlled transactions" taking place during the Audit Period (i.e., the procurement charge and use of IP). Further, the concept does not even apply to the transactions that occurred as part of the 2001 Restructuring (or to any restructuring), and it is nonsensical to think otherwise. For example, if the concept were attempted to be used for the 2001 Restructuring, one would merely argue TSC's reasonable alternative to contributing its IP to TSC of Texas would be to just keep its IP, and the same analysis would be applied to the procurement function. The concept does not apply to 2001 at all, and it certainly does not look back to 2001 to then determine the arm's length price for the procurement charge or use of IP during the Audit Period.

[7] In addition, it is unclear what factual basis supports the Court's statement that TSC paid "almost three-quarters of its sales revenues to Texas[.]" Am. Order at 19.

[8] *See also* TSC Mot. to Reconsider at 21 (explaining that there is no evidence that TSC has a single potential alternative option or what the price would be for any that may exist, and clearly no reasonable alternative for use of the IP owned by TSC of Texas).

d. **The Court's discussion and findings related to the relevance of the 2001 time period.** *See* Am. Order at 27, n. 39. The Court's lengthy discussion indicates its conclusion that the procurement charge failed to meet the Arm's Length Standard was influenced by both (1) the 2001 Restructuring and events from that time period, and (2) the Court's assumptions as to how the procurement function might have grown within TSC had the restructure not taken place. *Id.* Neither is relevant to determining the arm's length price of the procurement charge under the § 482 Regulations, and the latter of the two is a fundamentally incorrect approach to the concept of transfer pricing.

e. **The statement that "the preponderance of the evidence shows that the greatest effect of the restructuring was tax benefits."** *See* Am. Order at 27, n. 39. It is unclear what evidence the Court relies on for this statement as well as what it means, how the Court identifies and quantifies tax benefits, how the Court compares those benefits to other "effects" (i.e. using what standard or test?), the relevance of the Court's finding, and whether it influenced the Court's decision on something in this case. It is irrelevant to any issues in the case and has no bearing on the appropriate arm's length procurement charge during the Audit Period.

f. **Assumptions that all retailers are profitable and that the profits of apparently all other retailers (or perhaps all other retailers unless shown otherwise) are driven by retail sales.** *See* Am. Order at 25-26. The Court did not believe Andrade that the TSC Group's profits, "unlike other retailers," were driven by the procurement function or that this function was "driving the Group's income unlike other retailers that derived income from retail sales." No evidence supports these assumptions.

g. **The Court's conclusion that because the TSC Group "is in the retail business and not the procurement business" and because it holds itself out to the public as a retailer and not a procurement company, then its income and value must come from retail sales and not procurement.** *See, e.g.,* Am. Order at 19 and 59. This is error. Nothing in the § 482 Regulations supports this as being evidence of the value generated by the procurement function, nor does it support the conclusion the procurement charged failed to meet the Arm's Length Standard.

h. **Finding that TSC customers pay in cash and do so more frequently than customers of any other retailer.** *See* Am. Order at 25-26. No evidence supported this finding or any correlation between cash paying customers supporting the Court's findings in this case most specifically that the procurement charge failed to meet the Arm's Length Standard.

i. **Viewing the 2014 PwC Study not using the best method as evidence indicating the procurement charge failed to meet the Arm's Length Standard when it should have been viewed as irrelevant.** *See, e.g.,* Reconsideration Order at 5-6; *see also* Am. Order at 12-15 and 58-59. The Court views the "unreliability"

of the 2014 PwC Study as affirmative evidence that supports the conclusion that the procurement charge failed to meet the Arm's Length Standard, and once Andrade agreed the study did not use the best method, then the Court believed that the Department had proved its case absent Andrade convincing it otherwise. *Id.* However, the fact that the PwC Study did not use the best method had zero probative value as to whether the procurement charge failed to meet the Arm's Length Standard and did not establish the Department's case.

j. **Relying on DeRamus's testimony and Bruce Fort's testimony that if the procurement function were valuable then it would be marketed and sold as a product to other companies.** *See* Am. Order at 26-27. That is a materially flawed view of the concept of transfer pricing, and nothing in § 482 Regulations supports it as being probative evidence for determining the arm's length price of the procurement charge.

k. **The Court's Unsuccessful Attempts to Find Support in § 482 Regulations for DeRamus's Testimony.** *See, e.g.*, Am. Order at 18-19. The Court cites to Treas. Reg. § 1.482-1(f)(2)(ii) to bolster the credibility of DeRamus's testimony as being consistent with § 482. *Id.*; *see also id.* at 27. However, as explained above in § III(B)(2)(b), his application of the realistic alternatives concept is materially flawed, the Department has never cited this, and the Court should not grant relief based on DeRamus's unsupported (and unsupportable) testimony.[9]

The Court needs, but does not have, a range of prices to call a *potential* Arm's Length Standard which the procurement charge supposedly failed to meet in order to support its finding that the "preponderance of the evidence shows that Texas's 9.7% markup on inventory charged pursuant to the Procurement Agreement does not meet the arm's length standard." Am. Order at 28.[10] If it were that simple to know the procurement charged failed to meet the Arm's Length Standard, there would be no need for transfer pricing expertise in the first place, yet the Court acknowledges, correctly, that expert testimony is necessary in this case. Reconsideration Order

[9] *See also* TSC Mot. to Reconsider at 18-24 and 31-34 (for discussion of other things Court erroneously relied on to determine procurement charge failed to meet the Arm's Length Standard).

[10] That is particularly important in this case because apportionment is not a perfect science, and the Court needs to know not only whether the charge failed to meet the Arm's Length Standard but also, if it did not, whether the price was far enough outside of that standard to satisfy Step One of the AA Statute.

at 6. The Court's error may be due to its incorrect suggestion that the § 482 Regulations require a price to be consistent with the Arm's Length Standard *and* reasonable. *See, e.g.*, Am. Order at 16, n. 23 (suggesting a § 482 study is relevant evidence for whether "a transfer price is reasonable and arm's length" and also that general principles of the § 482 Regulations "can be utilized to determine the reasonableness and reliability of a transfer price"); *id.* at 59, n. 64 (saying a transfer pricing study is relevant to whether "a transfer price is a reasonable, arm's length price"); *id* at 14 ("From a transfer pricing perspective, the results must also be reasonable in order to be reliable and consistent with the arm's length standard."). The only thing that matters under the § 482 Regulations is the Arm's Length Standard—a price that meets that standard is not then checked for "reasonableness" nor can the Court conclude the procurement charge fails to meet that standard because it seems "unreasonable."

In addition, the Court asserts that Petitioner's argument that the Department did not present evidence that TSC's procurement charge failed to meet the Arm's Length Standard and thus failed to establish distortion "presupposes that the only way to show distortion is through expert testimony demonstrating the range of appropriate arm's length transfer prices under the 482 Regulations." Am. Order at 58, n. 63. The Court further explains that such evidence is only one type of evidence that it could consider, while other evidence such as disproportionality of revenue to taxable income is also relevant. *Id.*; *see also supra* § III(B) (for other evidence the Court improperly relied upon). Although evidence other than expert testimony of the correct arm's length price under § 482 might well be appropriate in some cases, it is not appropriate in a case like this where the only issue is whether one intercompany charge (here procurement) is distorting income because it is too high. In such a case, no other evidence is relevant to that issue

as all that matters is whether the taxpayer is paying the same amount that it would pay to a third party, in which case no income shifting or distortion would exist. None of the other evidence considered by the Court establishes statutory distortion. The Court appears to recognize that some of these "facts" do not establish distortion (*see id.* at 61), but to the extent other sections of the order appear to place weight on evidence other than whether the procurement charge meets the Arm's Length Standard under § 482, Petitioner would ask the Court to reconsider its reliance thereon.

C. The Court Improperly Rejected Andrade's Transfer Pricing Testimony.

The Court failed to consider all the evidence showing Andrade's testimony and conclusions were reliable, and its reasons for rejecting Andrade are, respectfully, materially flawed, including:

1. **The Court criticized Andrade for not *violating* the best method rule and for an immaterial issue**. *See* Am. Order at 20-24. The best method rule says to use the most reliable method based on the facts and circumstances, which includes the capabilities of the transfer pricing analyst and the available data. *See* Treas. Reg. § 1.482-1(c). Andrade said he was not applying "the RSPM" exactly as described in § 1.482-6, and specifically that he was using gross profits for part of his analysis rather than operating profits, and he did so because his method was better (i.e., more reliable). That is entirely permissible under the § 482 Regulations and consistent with the best method rule, and his following of "the RSPM" exactly as described in § 1.482-6 would be a violation of the best method rule.

   The Court now, in an apparent effort to bolster DeRamus's testimony criticizing Andrade, highlights that § 1.482-6 envisions the allocation of "operating profits" rather than gross profits. *See Am.* Order at 21-22. The Court's assertion that operating profits should have been used for the routine profit split is incorrect. *Id.* The CPM in Treas. Reg. § 1.482-5 is used for that step, which states that "the determination of an arm's length result is based on the amount of operating profit[,]" yet explains that operating profit is determined by using the appropriate profit level indicator and ultimately "applying the profit level indicator to the financial data related to the tested Party's" business activity. *See* Treas. Reg. 1.482-5(b)(1). In other words, use of the CPM also involves a comparison of operating profits, yet it involves an application of the profit level indicator to the relevant financial data and a reconciliation down to operating profit. *Id.* The Court also fails to recognize that had Andrade performed the non-routine profit split in his analysis at the operating profit level, the result of his work would have been substantially similar to the result of using gross profits. It is simply a difference in timing and methodology of accounting for costs, and not justification for dismissing his reliable work and findings.

2. **The Court's criticisms of the 50/50 profit split are also unjustified and flawed.** *See* Am. Order at 20-24. Andrade explained how he arrived at the 50/50 split, which was conservative, because he was comfortable TSC of Texas generated the majority of the non-routine profit. The Court rejected the 50/50 split based almost exclusively on the Court not being convinced that TSC of Texas contributed at least 50% of the non-routine profit, which was unjustified for many reasons such as:

    a. The Court's citations to Treas. Reg. § 1.482-6(c)(3)(ii)(B) and (D) do not support its conclusions that his analysis was unreliable. These citations acknowledge that the method usually cannot use external benchmarks, which is exactly why Andrade determined it was the best method because neither TSC of Texas nor TSC could be reliably benchmarked with a CPM analysis, which DeRamus agreed. Andrade followed "the RSPM" exactly as described in Treas. Reg. § 1.482-6 with the exception of the immaterial difference of using gross profits described above.

    b. The Court failed to recognize that some entity generated that non-routine profit—either TSC or TSC of Texas—and there is no evidence TSC generated more profit than TSC of Texas. Am. Order at 20-24. The profit split occurred after the routine profit—including profit from the retail stores—had already been accounted for. *Id.* The Court recognized the only non-routine functions TSC performed on its own were corporate strategy, data analytics, and continuous process improvement (Am. Order at 20-21) yet failed to recognize no evidence showed those functions are more valuable than the non-routine functions performed by TSC of Texas. Absent credible evidence (which was not presented) that TSC's non-routine functions were as valuable or more valuable than TSC of Texas's non-routine functions, the Court erred in rejecting Andrade's conclusion that TSC of Texas was responsible for a majority of the non-routine profit, which he conservatively backed down to 50%.

    c. The Court misunderstands and fails to account for the role of IP in Andrade's analysis. *See* Am. Order at 21. The Court first erroneously says Andrade opined the "IP was not significantly valuable" for purposes of his transfer pricing analysis. *Id.* The Court then says the opposite. *Id.* (saying Andrade considered trademarks, which are a form of IP, valuable and criticizing him for not quantifying that value). The Court also says Andrade's handling of the IP was a "fatal flaw" in his analysis. *Id.* at 24. The Court appears to misunderstand his testimony and the role of IP in his analysis, which was handled correctly and consistent with his analysis being conservative and reliable.[11]

    d. The Court fails to recognize that by rejecting Andrade's conclusion that TSC of Texas was responsible for a majority of the non-routine profit, the Court effectively concluded that TSC of Texas is responsible for 0% of the non-routine profit due to the manner that CUR calculates tax.

[11] *See* TSC Mot. to Reconsider at 33-34 (explaining Andrade's treatment of intangible property).

e. The Court places unjustified and unsupported reliance on DeRamus's criticisms of Andrade's analysis. Am. Order at 20-24.[12] The Court appears to be searching for § 482 Regulations to cite as "consistent" with what DeRamus says in an effort to support his testimony criticizing Andrade. *Id.* However, the added citations do not add any such support. *Id.* Other than the Court's attempts to find support, DeRamus's testimony (much of which is illogical) is supported by nothing other than his word.[13]

D. The Court Ignored the Heightened "Equitable" Standard in § 12-6-2320(A)(4).

The Court ignored the heightened "equitable" standard in (A)(4) by, like the Department, treating "reasonable" and "equitable" as one in the same. *See generally* Am. Order at 63-69. The Court's apparent justification is that the definitions of "reasonable" and "equitable" are similar (Am. Order at 64, n. 70), which is incorrect and violates the rules of statutory construction. *See* TSC Mot. to Reconsider at 26-27.

E. The Court Incorrectly Found CUR Satisfied the First and Third Components of the Test for Reasonableness.

The Court incorrectly concluded the use of CUR satisfied the first and third components of the test for reasonableness. *See* Am. Order at pgs. 63-64, and 68-69. For example:

1. The Court fails to explain how the use of CUR in this case "if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income" as required by the first component.

2. The Court incorrectly found the use of CUR fairly represents Petitioner's business activity in South Carolina, which is also required by the first component. Am. Order at

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[12] The Court should reconsider its complaints regarding certain portions of DeRamus's files being in an unreadable format (see Am. Order at 24, n. 34) as such files were not relied upon by Andrade or presented to the Court in support of his opinions. *See* TSC's Response to Department's Proposed Order at 36 (Criticism #4 and Petitioner's Response).

[13] For example, the Amended Order at 22 cites Treas. Reg. § 1.482-6(c)(3)(iii) to bolster DeRamus's testimony that the profit split is typically done based on costs, yet the very next sentence is DeRamus saying it is actually very complicated and thus the split cannot be reliable without a detailed supporting analysis. The Court should recognize the inconsistency in his testimony as both of those statements cannot be accurate. Also, the transaction being addressed in this case is not remotely similar to the example in Treas. Reg. § 1.482-6(c)(3)(iii) cited by the Court to support its misplaced reliance on DeRamus.

63-69. The Court misunderstands how separate reporting and CUR calculate tax and the relevance of transfer pricing and fails to recognize or appreciate that CUR assumes the arm's length price is one where TSC of Texas receives $0 for its procurement function and for the use of its IP. If TSC of Texas had charged nothing for use of its valuable IP and its valuable procurement function (i.e., charged only the costs of inventory thus a 0% markup on inventory), which is prohibited by the § 482 Regulations, then TSC's use of separate reporting would result in approximately the same tax owed to South Carolina as the tax due when CUR is used in this case.[14] The Court says the use of CUR "corrects the income shift" meaning it fixes the incorrect transfer price and also that CUR still "recogniz[es] the value" generated by TSC of Texas. *See* Am. Order at 63-67. However, if the procurement charge were too high, CUR does not correct it, rather, it over-corrects it by giving TSC of Texas, which already charged nothing for use of its valuable IP, nothing for the procurement function. The use of CUR also does not "recognize the value" of TSC of Texas's IP or procurement function, rather, it gives all the value, unjustifiably, to TSC, who then must pay tax on it.

The Court found (incorrectly) that proving the procurement charge failed to meet the Arm's Length Standard because the price was above that standard equates to proof that Petitioner's business activity is not fairly represented in South Carolina using separate reporting. Yet here, the Court found CUR does fairly represent Petitioner's business activity even though use of CUR as compared to separate reporting guarantees the procurement charge is less than the Arm's Length Standard (while also continuing to allow TSC's free use of the valuable IP). They cannot both be correct, and here, neither are correct.[15]

3. For the third component, no evidence or reasoning appears to support the Court's conclusory statement that it was met "for the reasons stated above." Am. Order at p. 69.

F. The Court Incorrectly Found CUR is Both Reasonable and Equitable.

[14] That is also why the Court's comparison of the tax owed using CUR to the Court's "conservative" estimate of the tax owed using separate reporting with the Court's estimated "modest" transfer price results in tax owed to South Carolina that is almost as much as tax due using CUR. *See* Am. Order at 64-69.

[15] The Court appears to recognize that TSC of Texas is excellent at procurement and that the procurement function is valuable. *See, e.g.*, Am. Order at 25, 26, and 59, n. 65. The Court nonetheless suggests it does not matter that CUR over-taxes TSC compared to its business activity in this state so long as the Court specifically recognizes that is true. *See, e.g.,* Reconsideration Order at 7, and Am. Order at 65, n. 71. Acknowledging it is wrong does not make it right, reasonable, or equitable. Further, TSC disagrees, respectfully, with the Court's suggestion that TSC of Texas not charging for IP "strengthens the Department's argument that income shifting (or lack thereof) distorted TSC's income during the audit years." Am. Order at 28, n. 40. The Department has no complaints about TSC's income being too high due to a lack of income shifting.

The Department failed to follow its own guidance set forth in Revenue Ruling 15-5 ("RR 15-5"), and its use of CUR is thus not reasonable or equitable. The Court appears to misunderstand Petitioner's argument on this issue (*see* Am. Order at 61-62, n. 66 and n. 67) causing it to err in its conclusions. Petitioner's argument is that RR 15-5 requires the Department to choose an alternative method after determining the standard method fails to represent a taxpayer's business activity in this state and that the alternative method must be chosen based on the reason the standard method fails. Thus, for example, if the procurement charge was too high, an adjustment to the price would be consistent with RR 15-5. The Court now responds to that argument by saying that Petitioner's position is that the AA Statute does not allow forced combination, RR 15-5 addresses how the Department should apply the AA Statute when forcing combination, therefore, Petitioner's position is inconsistent. However, Petitioner's arguments are not inconsistent but rather in the alternative, which is appropriate.

The Court states that the business community will not be negatively impacted by this ruling because RR 15-5 puts the public on notice as to how the Department is interpreting the AA Statute. Am. Order at 63, n. 69. This does not address any of Petitioner's arguments in its Motion to Reconsider, including that the Department is not following that guidance. *See* TSC's Mot. to Reconsider at 13-14 and 29-30. The Department ignored transfer pricing during the audit stage, then hired a transfer pricing expert years later after TSC was already before this Court, then instructed that expert not to provide the Court an opinion on what he deemed the Arm's Length Standard for the procurement charge to ensure that the Court could not adjust the price and instead must use CUR which pays TSC of Texas $0 and is a gross over-correction for a

problem that has not been shown to exist in the first place. The Court is rewarding that, which is not good for the entire business community, including TSC.

IV. The Court Incorrectly Found No Violation of the APA.

The Court erred in finding no violation of the APA for many reasons including, but not limited to, the following:

1. The Court appears to misunderstand Petitioner's argument on RR 15-5. *See* Am. Order at 71, n. 76. RR 15-5 is evidence that (1) CUR is regularly (not always) used at least enough to warrant its issuance; (2) when it is used, it is only applied to a specific category of taxpayers (those considered to be members of a unitary business); and (3) the Department is patently making law—choosing water's edge approach, choosing *Finnigan* over *Joyce*, and the many other policy choices that are seen throughout RR 15-5 and most particularly in pages 8-11. That is not merely interpreting the law, rather, those are policy choices made by the Department, which is improper legislation. The Department may arguably interpret the tax laws in *parts* of RR 15-5, but that does not somehow validate the Department making law elsewhere in RR 15-5.

2. The Court fails to address TSC's argument that at a minimum the Department should not be able to force CUR for tax years 2014-2015 because the supposed guidance in RR 15-5 was not issued until June 12, 2015. *See* TSC's Proposed Order at 58-60 and TSC's Mot. to Reconsid. at 38-40.

CONCLUSION

Based on the foregoing, TSC respectfully requests that this Court reconsider its Amended Order and Reconsideration Order and issue a new Order finding in favor of TSC on all issues.

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Charleston, South Carolina
December 14, 2023

CERTIFICATE OF SERVICE

I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for Tractor Supply Company, do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by e-mailing and mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

Pleadings:

TRACTOR SUPPLY COMPANY'S MOTION TO RECONSIDER AMENDED FINAL ORDER AND ORDER ON MOTION FOR RECONSIDERATION

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December 14, 2023

EXHIBIT A

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Tractor Supply Company, Petitioner, v. South Carolina Department of Revenue, Respondent.	)	Docket No. 19-ALJ-17-0416-CC **AMENDED FINAL ORDER**

This matter is before the South Carolina Administrative Law Court (ALC or Court) pursuant to a request for contested case filed by Tractor Supply Company (Petitioner) on December 11, 2019.[1] Petitioner contests the decision of the South Carolina Department of Revenue (Department) dated November 19, 2019, assessing corporate income taxes using an alternative apportionment method pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code (2014). As of December 12, 2019, the assessment totaled $1,605,002.45[2] for the time period of January 1, 2014, through December 31, 2016.

On January 6, 2023, Petitioner filed two motions—a Motion in Limine to Exclude Economic Substance or Other Similar Claim and Certain Expert Testimony Regarding the Same and a Motion in Limine to Limit Testimony of David DeRamus (Motions). The Court determined it would address Petitioner's Motions at trial.

The Court held a hearing on the merits at its offices in Columbia, South Carolina, on January 23, 2023, through January 27, 2023. The Motions in Limine were denied at the beginning of trial. On August 8, 2023, the Court issued a Final Order. Then, on August 18, 2023, Petitioner filed a Motion for Reconsideration (Motion). The Court rescinded its Final Order on August 21, 2023, to further consider the parties' pleadings and issues raised in Petitioner's Motion. Thereafter, on September 5, 2023, Respondent filed a response to the Motion. This Amended Order follows.

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[1] This case was originally assigned to the Honorable H. W. Funderburk but was reassigned to the undersigned on January 4, 2022.

[2] This amount does not include any interest or fines that have since accrued.

THE STATE OF SOUTH CAROLINA
FILED
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SC Admin. Law Court
ADMINISTRATIVE LAW COURT

Based upon my review of the testimony and the parties' arguments, I conclude the Department's decision must be affirmed.

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of proof and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence.

History and Structure of Tractor Supply Company

Tractor Supply Company (TSC) was founded in 1938. It was restructured in 2001 to create two affiliated subsidiaries of importance in this case: Tractor Supply Company of Michigan, LLC (Michigan) and Tractor Supply Company of Texas, LP (Texas).[3] As a result of the restructuring, Michigan is 100% owned by TSC. Interestingly, Texas is 99% owned by Michigan and 1% owned by TSC. TSC is the parent company of the affiliated group (Tractor Supply Group or the Group).

The restructuring took place after TSC consulted with the accounting firm PricewaterhouseCoopers (PwC) about its business goals. Petitioner asserts five reasons for the restructuring: growth, expansion, asset protection, procurement power, and tax minimization. However, outside of the Board minutes from 2001 setting forth the reasons for the restructuring, there are scant records explaining the reasons. TSC's Board simply referred to the re-organization of the company as the "Tax Restructuring" and noted it was undertaken as part of TSC's tax planning strategy for the reduction of state income tax expenses.[4] I thus find that tax minimization was a reason for the restructuring.[5]

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[3] Tractor Supply Company had a total of nine subsidiaries at the time this case was heard, but they are all disregarded for federal tax purposes except Texas and Michigan.

[4] The witness who testified to the five reasons for the restructuring was not an employee of TSC in 2001, and no one currently at TSC was present during the 2001 Board meeting when the "Tax Restructuring" strategy was discussed.

[5] I do not find this was the sole reason for the restructuring or otherwise imply that there was no business purpose outside of tax minimization for the restructuring. Moreover, I also recognize that tax minimization strategies are often part of good business and good tax advice.

Tractor Supply Company's Business

According to TCS's 2016 Annual Report,[6] TSC is "the largest retail store chain of rural lifestyle products in the United States." Its business is comprised of retail stores located in towns outlying major metropolitan markets and in rural communities. It seeks to be the "most dependable supplier of basic maintenance products for the lifestyle needs of recreational farmers and ranchers." Indeed, 99% of TSC's revenue is derived from its retail operations with the other 1% of revenue coming from interest and other miscellaneous income. It provides an assortment of "high quality, reputable brand name and exclusive brand products." It also places an emphasis on consumable, usable, and edible (CUE) products.

As of December 31, 2016, Tractor Supply Group operated almost 1,600 stores in forty-nine states and an e-commerce website, TractorSupply.com. In 2016, TSC had approximately $6,751,000,000 in sales, with each store averaging about $4,400,000 in sales.

Although Texas and Michigan run the stores in their states, the Group's stores are essentially uniform across all states. Except where geographic differences call for different products—for example, snowplows in northern stores and differences in signage based upon local sign ordinances—the stores are all a similar size, carry a similar array of products, the employees wear the same red aprons, and signage and labeling are the same as allowed. Purchases can be returned across state lines and gift cards can be used at any Tractor Supply store regardless of which TSC entity operates that store.

TSC's Role in the Business Structure

TSC is the taxpayer at issue in this case, and it operates retail stores in every state excluding Texas, Michigan, Utah, Hawaii, and Alaska. During the Audit Period, Tractor Supply had between 1,160 to 1,461 retail stores. Of those, it operated between thirty-two and forty-two retail stores in South Carolina during the audit period. TSC also operated seven distribution centers in several states.

TSC's headquarters are located in Brentwood, Tennessee, at a facility called the Store Support Center (SSC). At the SSC, TSC provides administrative services, including accounting, legal, human resources, data analysis, and other support services for the Group. Additionally, the

[6] TSC is the only entity that files an Annual Report or 10-K because it files the 10-K on behalf of the Group. The U.S. Securities and Exchange Commission requires publicly traded companies to file a 10-K annually.

entire C-suite of executives for the Group is employed by TSC. During the audit period, in addition to its retail stores and administrative roles, TSC also leased employees to Michigan. TSC, Texas, and Michigan have a highly integrated relationship that is recorded in several intercompany agreements that were executed as part of the 2001 restructuring. These intercompany agreements will be discussed in more detail below.

.Michigan's Role in the Business Structure

During the audit period, Michigan owned and operated between seventy-seven to eighty-one retail stores in Michigan, but it did not have any officers, executives, or directors.[7] Michigan leased all of its employees from TSC.

Texas's Role in the Business Structure

During the audit period, Texas operated between 145 to 196 Texas retail stores, one distribution center, and two mixing centers that functioned like smaller, more specialized distribution centers. The Texas distribution center also serviced retail stores outside of Texas. Texas also held the intellectual property/trademarks (IP) for TSC during the audit period. However, it did not charge the other Group entities for the use of these intangibles.

In addition to operating its retail stores, in the restructuring Texas was assigned the role of providing the procurement function for TSC and Michigan. The procurement function includes buying (inventory sourcing) and vendor management, inventory management (product selection, identifying trends, forecasting, product localization), and product development (including the development of exclusive brands like TSC's Dumor horse feed). Although Texas's procurement team develops products, the products it develops are generally the Group's own brand of existing products rather than novel products that require patents. Notably, before the 2001 restructuring, TSC performed the procurement function. TSC had approximately ten employees who worked in the merchandising/procurement area, including "buyers" who worked with third parties and wholesalers and undertook the procurement function for the business. These buyers were all located in Tennessee. After the restructuring, Texas was designated as the entity which performs the procurement function for the Group, and TSC's property (assets) associated with the merchandising operations were assigned to Texas. Nonetheless, the physical location and place of procurement operations remained at the SSC in Brentwood, and the delivery and vendor terms

[7] In the restructuring, Michigan received all the Michigan retail stores as assets.

did not change (with the exception of updating vendor agreements to reflect the new purchaser was Texas). The only change was the legal employer of the merchandising/procurement employees. As of December 31, 2016, Texas had approximately 130 individuals working in the procurement area.

Texas was also assigned the primary responsibility for setting prices for inventory, although pricing was a collaboration between Texas and TSC's own pricing team. Similarly, while Texas entered into the vendor contracts and incurred the expense for purchasing inventory, TSC actually disbursed the funds for the purchase of the inventory because it had the centralized cash management function for the Group. Additionally, the Chief Merchandising Officer, who oversaw Texas's procurement function, was an employee of TSC. Thus, the two entities collaborated extensively on procurement and merchandising during the audit period.

Intercompany Agreements

There are four intercompany agreements between TSC, Michigan, and Texas, that set forth how the entities function together: (1) the leasing agreement between TSC and Michigan; (2) the administrative and management services agreement between TSC, Texas, and Michigan; (3) the inventory procurement agreements between Texas and TSC and Texas and Michigan; and (4) the licensing of trademarks between Texas, TSC, and Michigan. Each agreement went into effect in September 2001 when the restructuring occurred. While some of these agreements include charges for services one entity provides to another, the "revenue" from these intercompany transactions is simply recorded as journal entries.[8] Indeed, Akash Deep Sehgal, whom the Court qualified as an expert in state income tax accounting (to include apportionment methods and multistate businesses), observed that 82% of Texas's income was generated from intercompany transactions where real revenue was never exchanged between the related entities.

Leasing Agreement

Michigan leased its employees from TSC during the audit period pursuant to an agreement entitled the Master Shared Services Agreement (Leasing Agreement). Pursuant to the Leasing Agreement, TSC provided "personnel management and employment services" to Michigan at cost plus a 10% markup. TSC also agreed to provide personnel, accounting, employee benefits,

[8] It is not uncommon for large companies like Tractor Supply Group to make intercompany payments and to record these transactions as journal entries as opposed to making actual cash/wire transfers.

administrative, and other personnel and payroll related services reasonably requested by Michigan. TSC does not have a 482 transfer pricing study[9] to support the 10% markup or a record of how the 10% markup was calculated. The Leasing Agreement was signed on Michigan's behalf by David Lewis, an officer of TSC.

Administrative Services Agreement

TSC, Texas, and Michigan executed an Administrative Services Agreement that was in effect during the audit period. The Administrative Services Agreement required TSC to provide support services for Texas and Michigan on a routine basis, to include, but not limited to: accounting and financial (audit and tax); financial (fiscal) and treasury services; legal; executive; human resources and benefits administration; field management and quality control; marketing and advertising; information systems management and data processing; and other services Texas and Michigan may have the occasion to require. Texas and Michigan pay TSC the costs of those services plus a markup they deem appropriate. The markup is not supported by a 482 transfer pricing study.

Licensing Agreement

Texas and TSC and Michigan executed a Licensing Agreement that was in effect during the audit period. Pursuant to the Licensing Agreement, Texas granted TSC and Michigan a non-exclusive license to use all trademarks owned by Texas. Texas does not charge TSC or Michigan for the licensing of the trademarks/intellectual property (IP) it holds. However, at one time, PwC developed a value (price) that Texas could charge for the use of its IP in a 482 transfer pricing study. Instead of monetary compensation for use of the IP, the Licensing Agreement provides that TSC and Michigan agree to engage Texas as their "sole and exclusive supplier of any and all merchandise inventory sold in TSC retail store locations."

Procurement Agreement

In September 2001, Texas, TSC, and Michigan executed Inventory Procurement Agreements (Procurement Agreements). Pursuant to the Procurement Agreements, Texas

[9] Transfer pricing is the method by which companies assign prices to intercompany transactions. Transfer pricing as a concept is derived from section 482 of the Internal Revenue Code, which is why a transfer pricing analysis under this section is often called a 482 transfer pricing study. 26 U.S.C.A. § 482 (Westlaw Edge through Pub. L. 118-3) ("Allocation of income and deductions among taxpayers").

provided inventory procurement services to TSC and Michigan at cost plus a 9.7% markup. The 9.7% markup was based upon a 482 transfer pricing study by PwC.

A significant focus of this case is on the effects of the Procurement Agreements, particularly the agreement between TSC and Texas. Pursuant to the Procurement Agreements, Texas was designated as the exclusive supplier of merchandise inventory for TSC and Michigan. Texas was to provide, to the best of its ability, a timely and uninterrupted flow of merchandise inventory; arrange shipment for the merchandise inventory; negotiate competitive merchandise inventory prices; and advise TSC and Michigan on appropriate inventory mixes and product trends. Texas did not provide procurement services for any company outside the Group during the audit period. The Procurement Agreement was signed on behalf of Texas by Cal Massmann, an executive of TSC.

Adoption of Transfer Prices During the Audit Years

PwC conducted a 482 transfer pricing study for TSC that was used to price the intercompany transactions during the audit years. For each tax year at issue during the audit, TSC recorded its transfer pricing decision in a brief memo. The 2014 memo provides, in part:

> The transfer pricing study prepared by PWC recommends that the markup on inventory sold by Tractor Supply Co. of Texas, LP (Texas) to Tractor Supply Company (TSC) and Tractor Supply Co. of Michigan (Michigan) be in the range of 3.9% to 12.0% before a charge for licensing the trademarks. The study also recommends that the company take into consideration the profitability of the TSC retail operation. The retailer profitability range in the study is 0.5% to 5.6%. Further, the study concluded that a markup on the licensing of the brand trademarks could range between 1.7% and 7.5%.
>
> The companies have reviewed the various profit scenarios in the study and have concluded that Texas will waive its right to compensation for the licensing of the trademarks for the current year 2014. Texas determined that this wavier will allow TSC and Michigan to continue to grow the brand and remain profitable. It has been determined that using the markup of 9.7% in the study will allow it to provide TSC and Michigan with the necessary procurement services and remain profitable with a retailer profitability margin of 3.1%.

The memos for 2015 and 2016 were the same as the 2014 memo in substance, including the adopted transfer prices.

TSC's Tax Returns During the Audit Years

During the audit years, TSC filed its South Carolina corporate income tax returns as a single entity using South Carolina's default method of separate entity reporting (Texas and

Michigan do not file in South Carolina).[10] Briefly, under separate entity reporting, a multistate taxpayer's South Carolina net taxable income is multiplied by a sales factor in which the numerator equals the taxpayer's South Carolina sales and the denominator equals the taxpayer's sales everywhere. In contrast, under combined unitary reporting, if the multistate taxpayer is part of a unitary group, then the South Carolina net taxable income of the unitary group[11] is multiplied by a sales factor in which the numerator equals the group's South Carolina sales and the denominator equals the group's sales everywhere.

During TSC's audit, the Department concluded separate entity reporting did not fairly represent TSC's business activity in South Carolina under subsection 12-6-2320(A) of the South Carolina Code. The Department's finding was based upon its conclusion that separate entity reporting allowed TSC to minimize its taxes in South Carolina by shifting income from its retail sales (including its South Carolina retail sales) to Texas through the 9.7% markup on inventory Texas charged pursuant to the Procurement Agreement. As a result, TSC's South Carolina net taxable income, against which the sales factor was applied, was artificially lowered. In other words, the Department concluded the intercompany charge (9.7% markup) pursuant to the Procurement Agreement created a distortion in South Carolina taxable income.[12]

The Department also concluded TSC, Texas, and Michigan operated as a unitary group because each entity was dependent upon the other for some necessary function. For example, Texas and Michigan were dependent upon TSC for payroll and human resources functions, etc., through the intercompany agreements. This functional dependence demonstrated operational interdependence.

As a result of these two conclusions, the Department determined combined unitary reporting was appropriate because it remedied the distortion and more fairly represented TSC's

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[10] In contrast, TSC filed consolidated federal returns for the whole Group during the audit years because all of the entities are owned, either directly or indirectly, by the parent company TSC. On federal consolidated returns, intercompany transactions are eliminated or zeroed out because the income for one company is being canceled out by the expense recognized by another. Also, in some other states, where required, TSC filed its returns using combined unitary reporting.

[11] The definition(s) and characteristics of a "unitary group" will be discussed later in this order. Essentially, a unitary group is a group of companies that are so dependent upon one another that they function as one entity.

[12] Prior to litigation, when the Department determined combined unitary reporting was fairer and more appropriate than separate entity reporting, it did not have the internal expertise to review and evaluate the reliability of the PwC 482 transfer pricing study that TSC used to defend the 9.7% markup. However, the Department acknowledged that if TSC was paying a third-party for inventory at an arm's length price (instead of paying Texas), then income shifting would not be implicated and separate entity reporting would be fair.

business activity in this state. As will be discussed more fully below, under combined unitary reporting, intercompany transactions like the 9.7% markup on inventory are eliminated, and therefore income shifting is eliminated, resulting in a return that includes all the income from TSC's retail stores. Therefore, the Department imposed combined unitary reporting as an alternate reporting method pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code.

Separate Entity Reporting in 2014

In tax year 2014, TSC's federal consolidated return showed a taxable income of $552,221,388. However, because TSC utilized separate entity reporting, its reported taxable income on South Carolina's return was $130,998,512, which represents its share of federal taxable income as a result of the intercompany agreements of the Group. Under separate entity reporting, the $130,998,512 was adjusted by $17,478,426 to arrive at South Carolina net taxable income of $148,476,938. South Carolina net taxable income was then multiplied by the sales factor in subsection 12-6-2280(A) of the South Carolina Code to calculate the taxable "base" upon which South Carolina's state income tax was calculated.[13] Additionally, under separate entity reporting, the sales factor is calculated with the numerator representing TSC's South Carolina sales and the denominator representing TSC's sales everywhere (not the Group's sales everywhere). In 2014, the sales factor was calculated to be 2.79%. Multiplying $148,476,938 by 0.0279 resulted in a taxable base of $4,137,310 to which South Carolina's corporate tax rate of 5% was applied to arrive at a corporate tax equal to $206,866 in 2014.

Combined Unitary Reporting in 2014

In contrast, when the Department applied combined unitary reporting in its audit of tax year 2014, it utilized the Group's income to calculate TSC's taxable income. Specifically, the Group's federal taxable income—$552,221,388—was adjusted to arrive at a South Carolina net

[13] For the purposes of this Order, "South Carolina net income" refers to the amount of taxable income calculated after South Carolina's modifications are made to federal taxable income and allocation but before the sales factor is applied to calculate the South Carolina "base" (the taxable income amount to which South Carolina's 5% corporate income tax is applied). *See* S.C. Code Ann. § 12-6-580 ("A corporation's South Carolina gross income, taxable income, and the unrelated business income of a corporation exempt from taxation under Internal Revenue Code Section 501 et seq., is computed as determined under the Internal Revenue Code with the modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter."); S.C. Code Ann. § 12-6-2210(B) ("If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State."); S.C. Code Ann. § 12-6-2252 ("Its income apportioned to this State is determined by multiplying the net income remaining after allocation pursuant to Sections 12-6-2220 and 12-6-2230 by the sales factor defined in Section 12-6-2280.").

taxable income for the Group of $569,699,814. Then, the sales factor was adjusted for combined unitary reporting. The numerator of the sales factor became the Group's South Carolina sales (in this case, only TSC had South Carolina sales), and the denominator became the Group's sales everywhere. In 2014, this resulted in a sales factor of 2.28%. Multiplying $569,699,814 by 0.0228 resulted in a taxable base of $12,989,725. This base was then multiplied by South Carolina's corporate tax rate of 5% to arrive at an audited corporate tax equal to $649,486 in 2014. Thus, the Department's application of combined unitary reporting resulted in larger net taxable income and a smaller sales factor; but overall, it resulted in the calculation of more tax due.[14]

Department Decision

TSC disagreed with the Department's decision to impose combined unitary reporting.[15,16] Following TSC's challenge of the staff decision, the Department issued a Department Determination on November 12, 2019. In its Determination, the Department concluded TSC's use of separate entity reporting during the audit period did not fairly represent the extent of TSC's business activity in South Carolina because Tractor Supply operates within the unitary business of the Tractor Supply Group, and separate entity reporting failed to use a reasonable base for representing the business activity of TSC in South Carolina. It also concluded the application of combined unitary reporting was a reasonable alternative apportionment method. It further found:

> Despite a single, vertically-integrated business, Tractor Supply files in South Carolina under separate entity reporting, a method creating a narrow and artificially drawn set of activities which improperly isolates and carves out "South Carolina activity" from an inseparable unitary-whole known as the Tractor Supply Group.

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[14] The above examples of how the reporting methods were applied to TSC's taxes in 2014 demonstrate how the reporting method impacts not just how much federal taxable income, and therefore South Carolina net taxable income, is utilized to apportion income to South Carolina. But they also demonstrate how the reporting method impacts the calculation of the sales factor to ultimately calculate the taxable base apportioned to South Carolina. If the net taxable income is based upon a separate, single entity, then so is the sales factor. Likewise, if the net taxable income is based upon a group of related entities, then so is the sales factor. A mathematical proportionality is maintained that ensures the sales factor ratio matches the net taxable income to which it is applied. However, under either reporting method, the result in the taxable income for a *single* taxpayer.

[15] TSC also initially disagreed with how the Department calculated its tax burden under combined unitary reporting; however, the Department revised its calculation and TSC agreed that the new calculation was correct under combined unitary reporting while still disputing its application.

[16] Notably, TSC was previously audited by the Department for tax years 2008 through 2010, and that review resulted in TSC using combined unitary reporting for its income tax return (only TSC and Texas were considered members for the unitary group; Michigan was excluded). There was an informal agreement with the Department that TSC would continue to file using combined unitary reporting going forward. However, after the South Carolina Supreme Court issued its decision in *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, 411 S.C. 79, 81, 767 S.E.2d 195, 196 (2014), TSC re-evaluated its tax reporting method, and, in 2013, filed using separate entity reporting because the Department had the burden to show this filing method was unfair.

> Specifically, Tractor Supply segregates certain activities through intercompany transactions between itself, TSC Texas, and TSC Michigan. As a result, Tractor Supply reduced its taxable income in South Carolina by intercompany expense deductions.
>
> Through these intercompany transactions, Tractor Supply significantly reduces its income by shifting income to TSC Texas, which does not source any income to South Carolina.

It also stated that "Tractor Supply's use of separate entity reporting fails to fairly capture the 'base which reasonably represents the proportion of the trade or business carried on within this State.'" TSC thereafter appealed the determination to this Court.

Traits of Unitary Businesses

There are generally three subjective tests for determining whether a business is unitary that are commonly used by tax professionals and accountants.[17] The first test is the unity of operations test. Unity of operations refers to companies having a common accounting system, common research and development, common marketing, and common characteristics of operations amongst the companies. TSC, Texas, and Michigan qualify as a unitary business under this test because they share a significant amount of operations; specifically, TSC provides accounting, marketing, and other back-office support to Texas and Michigan.

The second test is unity of use. Unity of use typically refers to the concept of centralized management, which may be evidenced by common executives between a group of companies. Tractor Supply Group is also a unitary business under this test because several TSC executives also acted as the executives of Texas and Michigan, as evidenced by TSC executives signing the intercompany agreements on behalf of Texas and Michigan. This shows overlapping, common, centralized management.

The third test is contribution and dependency, which refers to the amount of dependency between various companies. For instance, when a company heavily relies on services that are provided by another company, or one company generates a significant amount of revenue through related party transactions. Additionally, when companies are heavily integrated, they create

[17] Mr. Sehgal opined that the Group qualified as a unitary business under all three tests. Bruce J. Fort, who is a senior attorney with the Multistate Tax Commission (MTC) and was qualified as an expert in state and local tax policy considerations related to multistate taxation (including separate entity reporting, combined reporting, standard apportionment, alternative apportionment, and income shifting strategies, including transfer pricing), concurred with two of Mr. Sehgal's definitions for a unitary business: contribution and dependency and unity of operations as evidenced by common management, common control, and flow of value between them.

economies of scale together that contribute to functional dependency and other unitary characteristics. Here, the Group qualifies as a unitary business under this test because there is a significant amount of dependency between TSC, Texas, and Michigan. For example, Texas creates a significant amount of income by exclusively supplying TSC with inventory through the Procurement Agreement, and Texas, in return, receives a significant amount of administrative and back-office support through its Administrative Service Agreement with TSC. Both TSC and Texas are dependent upon each other for contributions to the business. Similarly, Michigan relies on Texas and TSC for all its needs except ownership of the Michigan retail stores.

Does The Markup on Inventory Represent an Arm's Length Transaction?

In response to the Department's allegation of income shifting, Petitioner presented the PwC 482 transfer pricing study to support its 9.7% markup on inventory (transfer price) because it is this markup that is primarily shifting income between Group members. A 482 transfer pricing study can show the income that was shifted through the 9.7% markup represented an arm's length transaction that was reasonable based upon the value Texas was providing to TSC and Michigan under the Procurement Agreements. However, I conclude that the 9.7% markup on inventory charged by Texas does not reflect an arm's length transaction. I reach this conclusion based upon two sub-findings. First, the PwC 482 transfer pricing study supporting the 9.7% markup was flawed and unreliable. Second, the 9.7% markup resulted in a transfer of income from TSC (and Michigan) to Texas that is unreasonably large compared to the benefits received by TSC (and Michigan) and does not reflect an arm's length transaction.

Transfer Pricing and the 482 Regulations

Transfer pricing is the method by which companies assign prices to intercompany transactions because these transactions do not take place in an open market. Thus, the goal of transfer pricing is to determine the price you would expect to see if the intercompany transaction was conducted by similar third-parties in an arm's length transaction on the open market. However, transfer pricing can be manipulated to shift income from one company to another. Taxing authorities therefore pay attention to transfer pricing because it can be a method by which companies artificially shift income from a higher tax jurisdiction to a lower tax jurisdiction to impermissibly reduce their tax liabilities. Accordingly, it is important to establish a correct transfer price to ensure that companies are not using intercompany transactions as a method of improper

tax avoidance or minimization.[18] When the price of an intercompany transaction is consistent with the price two third-parties would agree to on the open market (an arm's length transaction), it suggests that income is not being improperly shifted by the intercompany transaction to avoid or minimize taxes.

The transfer pricing concept is codified in section 482 of the Internal Revenue Code. 26 U.S.C.A. § 482 (Westlaw Edge through Pub. L. 118-3) ("Allocation of income and deductions among taxpayers"). Section 482 consists of one relatively short paragraph and essentially instructs that the Secretary can apportion or allocate income between two organizations owned by similar interests to prevent the evasion of taxes or to clearly reflect the income of any of the organizations.[19] *Id.* South Carolina has adopted section 482, and the Department has the authority, like the Secretary, to apportion or allocate income to prevent the evasion of taxes or to clearly reflect the income of an organization. *See* S.C. Code Ann. § 12-6-40 (adopting the Internal Revenue Code to state tax laws); S.C. Code Ann. § 12-54-155 (discussing the application of section 482 in the context of a "substantial valuation misstatement").

Because section 482 only consists of one paragraph, transfer pricing experts rely primarily on the "482 Regulations" for guidance on how to properly calculate and evaluate transfer prices in intercompany transactions. 26 C.F.R. § 1.482-0 to -9 (Westlaw Edge through 88 FR 30679). These regulations provide several principles or considerations that must be considered when analyzing a transaction, including the arm's length principle, the economic substance of the transaction, and the reasonableness and reliability of the overall results.

The arm's length principle refers to the principle that the intercompany transaction price should reflect what a price would be between two third-parties in an open market. *See* 26 C.F.R. § 1.482-1(b)(1) (Westlaw Edge through 88 FR 30679). There is usually a range of prices that will be consistent with an arm's length transaction. *See* 26 C.F.R. § 1.482-1(e)(1) (Westlaw Edge through 88 FR 30679). The economic substance principle in the 482 Regulations looks to the overall characterization of the transaction and whether the purported purpose of the transaction

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[18] Again, tax minimization strategies are not necessarily improper and are often part of good business and good tax advice.

[19] The intent to evade taxes is not a prerequisite to the application of section 482. 26 C.F.R. § 1.482-1(f)(1)(i) (Westlaw Edge through 88 FR 30679) ("In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.").

aligns with how the parties are actually behaving in the transaction. *See* 26 C.F.R. § 1.482-1(f)(2)(ii) (Westlaw Edge through 88 FR 30679) ("The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance."). In intercompany transactions, the companies themselves largely write the contractual terms, and these terms may create substantial deviation from how one party or both parties to the transaction actually act. Accordingly, when an intercompany transaction is analyzed under the 482 Regulations, the analyst should look at the substance of the transaction to see if it conforms to how the taxpayer has characterized the transaction. Finally, although a taxpayer or analyst may apply a series of what appears to be logical steps under the 482 Regulations to achieve a particular result, what matters most is whether the result actually comports with the arm's length standard. From a transfer pricing perspective, the results must also be reasonable in order to be reliable and consistent with the arm's length standard.

The 482 Regulations contain several different methods of accounting for intercompany transactions. 26 C.F.R. § 1.482-1(b)(2)(i) (Westlaw Edge through 88 FR 30679). Which method to apply to a given transaction is governed by the "best method rule." 26 C.F.R. § 1.482-1(c) (Westlaw Edge through 88 FR 30679). The best method rule generally states that a transfer pricing analysis should use whatever transfer pricing method is the most reliable method based on the facts and circumstances of the transaction. *Id.*

The 2014 PwC Transfer Study Supporting the 9.7% Markup

Both parties presented transfer pricing experts who testified about the PwC 482 transfer pricing study and the transfer pricing in this case. On behalf of the Department, Dr. David Watlington DeRamus testified as an expert witness in transfer pricing analysis, including economic principles. On behalf of Petitioner, Dr. David Fernando Andrade was qualified as an expert in economics, specifically in the sub-field of pricing valuation with a focus on transfer pricing.

The first step in any transfer pricing analysis under the 482 Regulations is to look at the companies involved in the transaction and ascertain what functions they are performing in the transaction, what assets they bring to the transaction, and what risks they are incurring. This is called a functional analysis, and based upon the functional analysis, the analyst determines which analytical method under the 482 Regulations is the best method to apply to the transaction at issue. This first step is crucial because the rest of the transfer pricing analysis is built upon, and flows from, the functional analysis. Both parties' experts agreed that PwC's functional analysis was

flawed, and PwC did not choose the best method for evaluating the appropriate transfer price under the 482 Regulations. *See* 26 C.F.R. § 1.482-1(c) (discussing the best method rule).

Dr. DeRamus's analysis of PwC's 482 study was especially well-articulated and persuasive. Ultimately, he concluded the study was unreliable for numerous reasons. First, he found PwC's functional analysis was flawed because it incorrectly characterized the functions, assets, and risks of the related parties (TSC and Texas). Next, he logically explained why PwC's chosen method, the comparable profits method (CPM),[20] was not the best method to benchmark a company like Texas. Third, he explained how PwC's set of comparables for Texas was flawed because it chose companies that performed a function that was not comparable to Texas's function.[21] *See* 26 C.F.R. § 1.482-1(d)(1) (Westlaw Edge through 88 FR 30679) ("In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result."). He also reasonably explained why the comparable companies PwC eventually chose to benchmark Texas against would skew the results towards higher profitability, thus the resulting percent markup on total costs (then converted to markup on inventory) would also skew high. Moreover, Tractor Supply Company's own expert witness, Dr. Andrade, found the PwC study did not use the best method for establishing a reliable transfer price under the 482 Regulations. Therefore, I conclude that PwC's 482 transfer pricing study is flawed and unreliable and does not support Texas's 9.7% markup on inventory as a reasonable markup in an arm's length transaction.[22]

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[20] The comparable profits method (CPM) is described in section 5 of the 482 Regulations and PwC used it to prospectively determine an arm's length range for the transfer price for Texas's procurement function under the Procurement Agreements. 26 C.F.R. § 1.482-5 (Westlaw Edge through 88 FR 30679). Generally speaking, under CPM, one of the parties to an intercompany transaction is chosen as the "tested party" and comparable companies to the tested party are identified. *See generally id*. The theory is that the profits earned by comparable companies can be used to benchmark the profits that should be earned by the tested party in an open market. These profits can, in turn, be translated into a transfer price or, as in this case, a markup on inventory.

[21] With respect to Texas's function, Dr. DeRamus opined that PwC incorrectly assumed Texas performs the wholesale distributor function. He also opined that PwC did not use a reasonable set of wholesale distributors to benchmark Texas' services. Specifically, by using maintenance repair and operations (MRO) companies, PwC used "a very narrow range" of distributors that "does not really reflect a broader wholesale distribution function." Thus, PwC's resulting range of markup on total costs (3.8% - 11.9%) is not consistent with markups typically obtained in benchmarking a wholesale distribution function.

[22] The calculation of the 9.7% markup did not include compensation for any value contributed by Texas through licensing its IP.

Does the 9.7% Markup in the Procurement Agreement Meet the Arm's Length Standard?

Simply because the PwC study is flawed and unreliable does not necessarily mean that the 9.7% markup on inventory adopted by Texas does not meet the arm's length standard. A flawed process can still produce a correct result. Both experts provided analyses regarding whether the 9.7% markup reflected an arm's length transaction. Although Dr. DeRamus did not conduct a comprehensive transfer price analysis to establish what the correct transfer price or markup on inventory should be in this case, he nevertheless demonstrated the 9.7% markup on inventory does not meet the arm's length standard.[23] In contrast, while Dr. Andrade presented a comprehensive transfer price analysis that purportedly calculated the markup on total costs associated with an arm's length transaction in this case, I found his analysis suffered from a fatal flaw that rendered it un-supported and unreliable. Based upon this fatal flaw, and other concerns regarding the presentation and development of Dr. Andrade's data, I found Dr. DeRamus's analyses to be more credible, supported, and well-reasoned than Dr. Andrade's analysis.

Dr. DeRamus's Analysis

a. Disproportionality and Distortion

Dr. DeRamus tested the 9.7% markup by examining how this markup shifted income between Texas, Michigan, and TSC, and whether the shift was reasonable. To do this, he reviewed, in part, the Procurement Agreements between Texas and TSC and Texas and Michigan. Specifically, Dr. DeRamus looked at the pretax income of Texas in the year 2015, that was around

[23] Dr. DeRamus was not contracted to conduct a comprehensive transfer pricing study to determine what the correct transfer price would be if the 9.7% markup was incorrect. Therefore, his testimony was generally limited to conducting an analysis of the transfer pricing in this case to show whether or not the 9.7% markup on inventory represented an arm's length transaction. Petitioner complains that without a comprehensive study showing the range of arm's length prices under the 482 Regulations, there is no evidence to show the 9.7% markup is inconsistent with the 482 Regulations or to show that it improperly shifts income. Petitioner's argument relies on the premise that no evidence, such as a general economic analysis, can be used to show that TSC's business activity was not being fairly represented in this state. Although a persuasive 482 study would be evidence a court could consider regarding whether a transfer price is reasonable and arm's length, it is not the only evidence that can illustrate whether business activity is being fairly represented in a state. *See Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888, 896 (Ind. T.C. 2015) ("A transfer pricing study done in accordance with IRC § 482 and its associated regulations provides evidence of a range of pricing for intercompany transactions between related entities that is similar to the pricing of comparable transactions between unrelated third parties (i.e., arm's-length pricing). This arm's length standard is relevant for evaluating whether intercompany transactions are inappropriate tax avoidance mechanisms that distort the true generation of income in various jurisdictions for both federal and state tax purposes." (internal citation omitted)). Moreover, the principles underlying the 482 Regulations can be utilized to determine the reasonableness and reliability of a transfer price even in the absence of a comprehensive study. Ultimately, what matters is whether the evidence demonstrates that TSC's business activity was not being fairly represented in this state under subsection 12-6-2320(A) of the South Carolina Code.

$439 million, and estimated the costs of the procurement function, which he found to be around $13 million.[24] The purpose of this assessment was to compare the income Texas received from the 9.7% markup on inventory to its costs incurred for the procurement function and evaluate whether that relationship was reasonable. In 2015, Texas received about $400 million dollars in procurement income through the inventory markup for the relatively small cost of $13 million, which showed income was being disproportionately shifted from TSC and Michigan to Texas. This disproportionality indicates the transaction was not arm's length.

Bruce J. Fort, Esq., who was qualified as an expert in tax policy, echoed Dr. DeRamus's analysis of the disproportionality of Texas's income to expenses and opined that it was evidence of income distortion.[25] Indeed, income should be aligned across geographic borders or divisional borders or entity borders. In this case, Texas had a much higher income compared to its number of sales than the other two entities (higher taxable income per unit of sales), which is indicative of distortion.

Next, using the Group's trial balances, Dr. DeRamus modeled how income shifted after transfer pricing was implemented. Before transfer pricing was implemented, TSC earned an expectedly large share of the Group's income because it owned and operated the majority of the Group's stores and accounts and it had approximately 80% of the Group's sales and 80% of the Group's inventory. In fact, the trial balances from 2014-2016 reflect TSC had income (before transfer pricing) of approximately $400-500 million per year while Texas and Michigan had incomes of approximately $100 million per year or less. However, after the transfer pricing was applied, TSC's taxable income dropped to a little over $100 million per year, Michigan's dropped to a negligible amount, and Texas's shot up to approximately $400 million per year. Thus, after transfer pricing, Texas, on average, accumulated about 71% of the entities' taxable income across

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[24] In arriving at this cost estimation, Dr. DeRamus reviewed the trial balances for 2015 provided in Dr. Andrade's data set. Dr. DeRamus totaled what he considered to be line items in the trial balance that were associated with the cost of the procurement service performed by Texas, to include $8.18 million dollars in cost for the salaries of employees in the procurement function and some third-party service fees. Dr. DeRamus did not include the cost of inventory to Texas in his calculation because TSC was ultimately cutting the checks for purchasing inventory and the cost of inventory does not represent the cost of the value of the **service** Texas was providing to TSC and Michigan. Specifically, Dr. DeRamus opined that TSC provides the cash management function on behalf of Texas and Michigan and "T[exas] can't even cut a check to somebody else without the parent company, since it relies on the treasury functions of the parent company." In contrast, PwC had estimated Texas's cost, including inventory, to be $2,803,040,409.

[25] The term distortion represents a normative rule that you want to align income with expenses.

the audit years even though TSC had approximately 80% of the sales. This shift fundamentally distorted TSC's operating income for all tax years at issue.[26]

Similarly, the implementation of the transfer pricing also resulted in a reduction in the amount of income TSC's South Carolina stores were apportioned for their retail sales. Over the audit years, retail sales at TSC's South Carolina stores totaled between $135 million to $160 million on an annual basis, but only about $4 million to $5 million in taxable income was apportioned to South Carolina after transfer pricing was implemented.

b. Commercial Effect of the Restructuring

Dr. DeRamus also considered whether the restructuring had a commercial or operational effect on the business. For example, if a taxpayer implements a restructuring, and as a result of that restructuring nothing really changes operationally, then you would expect the income of the taxpayer not to change significantly. If the income of the taxpayer does change significantly, it can imply that the transfer pricing that was utilized is inconsistent with the arm's length principles. Here, Dr. DeRamus opined that TSC's Tax Restructuring did not have an operational or commercial effect on the company, yet TSC consented "at arm's length" to (1) transfer a valuable asset (its IP) to Texas and (2) give up a substantial amount of income that it otherwise would have continued to earn absent that restructuring in return for Texas's procurement services.

c. Realistic Alternatives

In evaluating whether TSC would agree to give up its IP and so much income in exchange for Texas's procurement services in an arm's length transaction, the 482 Regulations are instructive. The regulations provide: "The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances." *See* 26 C.F.R. § 1.482-1(f)(2)(ii).[27] Considering this principle, Dr. DeRamus explained that

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[26] In terms of operating profits, Texas earned about $35 million from its retail sales at its Texas locations and approximately $350-400 million from its procurement services. However, while Texas's retail sales appear to be "somewhat greater" on a per store basis, the actual profit margins of Texas's retail stores as compared to TSC's and Michigan's retail stores are not distinguishable in any statistical sense.

[27] The 482 Regulations restate this principle again with reference to "unspecified methods":

> from a transfer pricing perspective, you simply would not expect a—at arm's length, a party like TSC to, just, to voluntarily say, here T—here Texas, feel free to pay the, the salary costs, the 13 million dollars of salary costs, and in return we're gonna forgo 300 million dollars of—or 350 million dollars of income. It's simply not consistent with the reasonable alternatives that [TSC] faced **at the time of the restructuring, or frankly, at any time since.**

(emphasis added). In other words, a company like TSC would not voluntarily give up millions of dollars of profit in return for someone taking over the procurement function, particularly when TSC had previously handled the procurement function itself before the restructuring. There would likely be other realistic alternatives that TSC would utilize before paying almost three-quarters of its sales revenue to Texas in exchange for its limited procurement function.

d. Summary of Dr. DeRamus's Conclusions

Dr. DeRamus convincingly opined that the income shifted from TSC and Michigan to Texas as a result of the 9.7% markup for the procurement function was disproportionate to the income each company brought to the Group from retail sales. Indeed, he explained that TSC is in the retail business and not the procurement business; therefore, it is expected that the largest share of TSC's income would come from retail sales and not be diverted to procurement through transfer pricing. Additionally, he explained that the amount of income Texas received for its procurement function through the 9.7% markup was disproportionate to its costs for that function. Further, the operational effects of the restructuring did not account for the enormous shift in income under the Procurement Agreements, and thus a company in TSC's position would not reasonably choose to enter into such an agreement with Texas. Overall, he found the 9.7% markup was inconsistent with an arm's length transaction.[28]

> Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by **considering the realistic alternatives** to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it.

26 C.F.R. § 1.482-9(h) (emphasis added).

[28] Dr. DeRamus also conducted several analyses that involved re-doing PwC's CPM analysis with more reliable comparables, but these analyses were of little value considering this method was already dismissed by both experts as a method that was not the best under the 482 Regulations and, therefore, would not produce the most reliable result. *See* 26 C.F.R. § 1.482-1(c)(2) (Westlaw Edge through 88 FR 30679) ("An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used.").

Dr. Andrade's Analysis

Dr. Andrade opined that the income reported by Texas during the audit years was consistent with a transaction between third parties at arm's length. Based upon his functional analysis, Dr. Andrade concluded the services provided by TSC and Texas were non-routine contributions that had significant value. In his opinion, the "highly unique" natures of TSC and Texas and their functions made it difficult to find comparable companies or activities to benchmark using CPM like PwC did. Accordingly, he chose a different method to analyze the transaction between the two entities: the residual profit split method (RPSM).

The RPSM envisions the two parties to a transaction operating as a joint venture and then separates the joint venture's total profits into two categories: (1) routine profit, and (1) non-routine profit. It then allocates the routine profit to the parties based on each party's appropriate contribution to the generation of the routine profit; then, finally, divides the non-routine profit (i.e., the profit split) between the parties based on each party's appropriate contribution to the generation of the non-routine profit. *See* 26 C.F.R. § 1.482-6(c)(3) (Westlaw Edge through 88 FR 74018) (describing the residual profit split method). Routine profit is first identified because it can be reliably determined using comparable evidence (i.e., comparable companies can be used as benchmarks, similar to a CPM analysis) and also because it, by default, identifies the total profit attributable to the non-routine functions (i.e., total profit less the routine profit equals the non-routine profit).

Dr. Andrade's analysis began with identifying the functions within Texas and TSC that he believed created value and sorted them into routine and non-routine functions. In this case, the routine functions he identified for all the Group members were distribution, retail operations, and centralized headquarters/administrative support services. Then, he identified the non-routine, or "premium" functions. For Texas, he determined the non-routine functions were procurement and product development along with some merchandising.[29] For TSC, he determined the non-routine functions were merchandising (which was shared with Texas) along with corporate strategy, data

[29] More specifically, Dr. Andrade believes Texas's procurement functions are much more complex and valuable than that of ordinary procurement companies. He found the manner in which Texas performs its procurement and product development functions to be extraordinary and based on a significant amount of built-up knowledge.

analytics, and continuous process improvement. Dr. Andrade concluded Michigan did not have non-routine functions.[30]

Once he determined the routine and non-routine functions, Dr. Andrade's application of the RPSM involved two parts. In Part 1, he performed the RPSM at the gross profit level because the data he received from the company (mostly SKU data) reflected gross profit data. During his calculations in Part 1, Dr. Andrade determined that the residual gross profits produced by TSC and Texas through their non-routine functions should be split (allocated) between the companies 50/50. In Dr. Andrade's opinion, Tractor Supply's IP was not significantly valuable in the context of the transfer pricing analysis. He thus simply split residual profit right down the middle between the TSC and Texas—50 percent for one, 50 percent for the other. In elaborating on how he came up with a 50% split, Dr. Andrade testified:

> So, at first, I thought I could go in and try to figure out an estimate that would be—you know, a calculation that would be higher than 50 percent. I was thinking that I would look at the total amount of activities and try to do some sort of ranking of those activities, and then weight them and try to do that calculation. And the more I thought about it, I said, you know, it's probably gonna come out in the favor of TSC Texas. But to be conservative, I'm just gonna back it down to half/half. So, that's how I went about the process of figuring out the 50 percent allocation of the [residual] profit.

However, Dr. Andrade's analysis did not adequately present quantitative data or analysis to back up his choice of the fifty percent split. For instance, he acknowledged that trademarks are valuable because they distinguish the company from other companies, assist with infringement activity, and help the market identify their unique goods. Yet, Dr. Andrade did not quantify the value although he testified it was imbedded in the profit split.

Moreover, Dr. DeRamus presented an excellent analysis of why Dr. Andrade's application of the RPSM was incorrect and unreliable.[31] He explained the 482 Regulations specify certain methods and principles for calculating the residual operating profit between two companies after routine profits have been deducted. First, Dr. DeRamus took issue with Dr. Andrade's use of gross profits to draw conclusions using the RPSM in Part 1. In his experience, under the 482

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[30] To form his opinion, Dr. Andrade significantly relied upon Tractor Supply's 10-K's, his discussions with three people supplied by the company, and stock keeping unit (SKU) data the company supplied to him. Dr. Andrade did not consider Tractor Supply's restructuring as part of his analysis because he did not find it relevant. Furthermore, in his opinion, earnings calls and analysts' summaries are not important sources for understanding a company for a transfer pricing analysis; rather, data from within the company itself it important.

[31] I find his criticisms to be persuasive.

Regulations, the RPSM is always analyzed at the operating profit level, and it was inappropriate for Dr. Andrade to use gross profits when defining his comparable companies to determine the routine profit split in Part 1. Dr. DeRamus explained that companies can differ greatly in their gross profit margins for many reasons that have nothing to do with the company that you are evaluating, which undermines the reliability of the analysis—things tend to wash out more when operating profits are calculated and companies are more reliably compared. A review of the RPSM under the 482 Regulations confirms that "operating profit" is the level of profit analyzed under this method. 26 C.F.R. § 1.482-6(3)(i) (Westlaw Edge through 88 FR 74018) ("Under this method, the combined **operating profit** or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this section" (emphasis added)).

Next, Dr. DeRamus explained that, typically, the profit split or allocation of the non-routine operating profits is based upon relative cost; for example, if one company spent $1 billion on product development and the other company spent $1 billion marketing it, then the allocation would be a 50/50 split. *See*, *e.g.*, 26 C.F.R. § 1.482-6(3)(iii) (providing an example application of the RPSM in which each companies' relative cost in developing valuable intangibles is used to allocate the residual profit). However, he further explained that, in practice, the allocation is more complicated, and the analysis should be supported by a fairly detailed analysis which did not occur in this case. Here, Dr. DeRamus could find no evidence for how or why Dr. Andrade came up with the 50/50 split of the residual gross profits between Texas and TSC other than simply his judgement. Since the split was unsupported by a quantitative analysis, Dr. DeRamus concluded it was entirely unreliable. Moreover, even removing the other flaws in Dr. Andrade's application of the RPSM method, Dr. DeRamus explained that the moment Dr. Andrade allocated the residual profits using an "ad hoc 50 percent number," it was a number devoid of any economic content. In his opinion, the profit split is extremely important because it can shift millions or billions of dollars, and, by choosing a number with no quantitative support, "you're, effectively, just assuming the conclusion."

Consistent with his opinion that the allocation should be a data-driven exercise under the 482 Regulations, Dr. DeRamus opined that Dr. Andrade did not provide enough evidence to back-up his conclusion that Tractor Supply Group is essentially so good at procurement and headquarters functions that it has created unusually valuable, non-routine intangibles out of

functions that are common to all retailers. He stressed that having data-driven evidence to back the conclusion that these functions were non-routine is even more important because these functions are usually described as routine functions. In his opinion, Dr. Andrade's reliance on SKU data and the three company interviews he conducted did not support his conclusion. Moreover, Dr. Andrade's reference to the Group's high profitability as a factor in determining the Group had a non-routine procurement function was simply assuming the conclusion.[32]

Dr. DeRamus further explained the kind of product development that leads to valuable intangibles is generally the development of products that are innovated and patent-protected or have other trade secrets embedded. In contrast, the products being developed and sold by Tractor Supply Group are similar to any other large retailer that has its generic brand of product manufactured for it to compete and undercut the same product manufactured by another national brand, similar to a grocery store selling knockoffs of national brand cereals under its store-brand name.

Dr. DeRamus's criticisms of Dr. Andrade's opinion echo some of the Court's own concerns regarding Dr. Andrade's testimony. Most concerning, during Part 1 of his analysis, Dr. Andrade did not adequately explain the basis of his decision to split the non-routine residual gross profits 50/50 between Texas and TSC. Indeed, the Court was left wondering how or why Dr. Andrade came up with the 50/50 split.[33] The 482 Regulations specifically recognize the allocation of the residual profit under the RPSM is susceptible to reliability issues based upon the quality of the data used to render the allocation of the non-routine (residual) operating profits. Specifically, subsection 1.482-6(3)(ii)(B) provides: "The second step of the residual profit split [allocating the residual profit], however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks." 26 C.F.R. § 1.482-6(3)(ii)(B) (Westlaw Edge through 88 FR 74018). Similarly, subsection 1.482-6(3)(ii)(D) addresses "[o]ther factors affecting reliability" under the RPSM and instructs that "to the extent the allocation of profits in the second

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[32] In contrast to Dr. Andrade, Dr. DeRamus explained he finds analyst reports and earnings calls helpful in his transfer pricing work. For instance, the reports may be helpful to learn third-party views as to what is driving the company's value in comparison with what the company says about itself, which can sometimes be biased to favor how the company wants to be perceived. He would expect a unique and incomparably valuable procurement department to be touted by the company in the earnings calls and discussed frequently in analyst reports.

[33] In Dr. DeRamus's words, he's seen profit splits "in documentation studies and audits, in litigation proceedings, in advanced pricing agreement, [but he's] never seen anybody just make up a number like that for a profit split."

step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks." 26 C.F.R. § 1.482-6(3)(ii)(D) (Westlaw Edge through 88 FR 74018). Because Dr. Andrade did not provide a quantitative analysis or external benchmarks upon which to base his allocation of the residual, non-routine profits, I find his determinations under the RPSM are unreliable.

Dr. Andrade also did not adequately explain how the result of his 50/50 split of residual, non-routine gross profits in Part 1 of his application of the RPSM was consistent with the arm's length standard. In other words, he did not sufficiently explain how applying his 50/50 residual profit split produced a result that indicated an arm's length transaction outside of simply stating as much. Thus, the Court was unable to sufficiently understand why a 50/50 split confirmed that the 9.7% markup on inventory charged by Texas was an arm's length transaction. Crucially, under the Court's understanding of this method, if the split was twenty or thirty percent to Texas, then this method could have indicated that Texas was reporting gross profits in excess of what would be expected. Therefore, the fifty percent split is essential to Dr. Andrade's method. Because I find Dr. Andrade's allocation of the residual gross profits was inadequately supported by his testimony, I do not find his method to reliably indicate an arm's length transaction between Texas and TSC.[34] Furthermore, Dr. Andrade's lack of data and quantitative support for his allocation, including the embedded allocation of the value of Texas's intellectual property, was a fatal flaw in his testimony.

Moreover, although Part 2 of Dr. Andrade's analysis resulted in a determination that the 9.7% markup fell within a profit range that an arm's length transaction would produce, his reconciliation of gross profits to operating profits suffered from the same flaw as his analysis in Part 1 because both Part 1 and Part 2 relied on Dr. Andrade's fifty-fifty allocation of the non-routine, residual profits, which I find to be unsupported and unreliable.

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[34] Additionally, some of the data Dr. Andrade provided to support other parts of his analysis was literally unreadable by the average person because it was produced in a file format that would need a programming expert or someone else familiar with computer code to read. Dr. Andrade conceded that some of the excel spreadsheets and data he produced needed a special text editor in order to see the code built into the documents and without the text editor, the documents would include some English and symbols that probably could not be deciphered by someone who is not a programmer or expert in that area. Further, although the specific comparable companies (farm retailers) Dr. Andrade used in his analysis were included in Joint Exhibit 42, he did not include the specific companies in his testimony or demonstrative exhibits to explain why they were reasonable comparables. In other words, much of Dr. Andrade's testimony and opinions were provided with veiled data that left the Court unable to verify the reasonableness of the application of his approach in this case.

Conclusion

Dr. Andrade chose the RPSM in part because he concluded that Texas's procurement function during the audit years was uniquely valuable and drove profits for the Group. Indeed, while Dr. Andrade admitted that selecting products to sell and merchandising them are functions consistent with all retailers, it was nevertheless his opinion that Tractor Supply Group did it significantly better than other retailers could hope to achieve, suggesting that, unlike other retailers, the Group's profits were driven by its procurement acumen. Thus, despite the parent company owning the vast majority of the retail stores and making the vast majority of the retail sales, Texas was much more profitable in Dr. Andrade's opinion than the parent, TSC. In Dr. Andrade's opinion, value was being created by Texas and TSC through their non-routine functions, which, in turn, drove demand and retail sales. In his words, retails sales picked up the revenue, but that was not the result of retail creating all the value. Dr. Andrade believes that it was the creation of the products, the decision about what products to stock, and how those products were put in store that drove the demand and value in the company.

I did not find Dr. Andrade's opinion that the Group derived its income primarily from Texas's procurement and product development functions to be compelling, reasonable, or persuasive. I find the Group is a retailer that derived its income from retail sales, and, like every retailer, its choice of products influenced its sales and created value, but I do not find it was the driving force during the audit years. As Dr. DeRamus pointed out, Texas may have engaged in product development, but this development was not geared toward patented or novel product development, but rather creating versions of existing products to brand as its own to undercut the price of national brands. This kind of product development does not create value in the same way that developing truly new products would.

Moreover, while Texas's procurement function was probably adept at picking good products during the audit years, and it had a robust system to ensure a constant, reliable supply of products, I found Dr. DeRamus's opinion about what drove the Group's success more persuasive. In Dr. DeRamus's opinion, Tractor Supply Group's success in the audit years is attributable to optimizing its business strategy of a monopolistic competition framework by locating itself in areas where it did not have competition from big box, low-price stores like Walmart or the little, higher-priced mom-and-pop feed stores. Similarly, Tractor Supply was somewhat insulated from competition from Amazon and other online retailers because its customers generally bought bulk

items with cash that do not translate easily to online ordering. Also, if Tractor Supply had developed such a unique product procurement process, you would expect to see Tractor Supply have significantly more online sales. Instead, the vast majority of the Group's sales took place at its brick-and-mortar stores where in-person customer demand was driving the sales. Additionally, if the procurement function was so valuable and driving so much of the company's earnings, then it would be expected that the company would have taken advantage of that value it created and sell its procurement service as a product to other companies.[35] I find his opinions logical, well-reasoned, and consistent with the evidence about how the Group functioned during the audit years.

Overall, I found Dr. DeRamus's testimony to be much more persuasive than Dr. Andrade's testimony.[36] Although Dr. DeRamus did not perform his own, comprehensive transfer pricing analysis to determine what an appropriate transfer price would be, the various analyses he conducted exposed the flaws in the 9.7% markup on inventory and demonstrated it does not meet the arm's length standard. I further find Dr. DeRamus's analysis of the 9.7% markup and its effect on income allocation compared to the cost of the procurement function at Texas to be highly persuasive. During the audit years, Texas, in combination with its back-office support at TSC, had a very successful procurement and product development function; however, I do not find that this function was so special or unique compared to other retailers that these functions were driving the Group's income unlike other retailers that derived their income from retail sales. In line with this reasoning, it is illogical that Texas would have costs of around $13 million for its procurement function and reap almost $400 million per year from those costs and not advertise and sell its lucrative procurement function as a product rather than engage in retail sales, which only earned

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[35] Mr. Fort agreed with Dr. DeRamus's reasoning concerning how a company would exploit what brings in value. As a tax policy expert, Mr. Fort explained that in the normative rules of taxation, you expect a business to invest few resources into a particularly inefficient operation; in contrast, if you have a particularly valuable activity, that is something you would expect the business to offer to provide for a third party to make more money off that valuable activity. Thus, if procurement was truly driving income for the Group, then you would expect it to not only invest in that function but sell it to third-parties.

[36] Although Tractor Supply challenged this determination in it Motion, this determination is properly within the province of the Court's factual determinations. *See Anderson v. Campbell Tile Co.*, 202 S.C. 54, 24 S.E.2d 104, 108 (1943) (holding "it is generally recognized that the relative weight and sufficiency of expert and opinion testimony is peculiarly within the province of the [fact-finder] to decide, considering the ability and character of the witness, his actions upon the witness stand, the weight and process of the reasoning by which he has supported his opinion, his possible bias in favor of the side for whom he testifies, the fact that he is a paid witness, the relative opportunities for study or observation of the matters about which he testifies, and any other matters which serve to illuminate his statements." (citation omitted)); *State v. Douglas*, 380 S.C. 499, 503, 671 S.E.2d 606, 609 (2009) ("As with any witness, the [fact-finder] is free to accept or reject the testimony of an expert witness.").

it around $35 million per year. Based upon the evidence in this case, it is also illogical that TSC, with 80% of the retails sales of the company, would agree to pay Texas what amounts to about 67%[37] of its income from those retail sales for Texas's procurement services. Rather, in an arm's length situation, a company like TSC would look at its reasonable alternatives to paying such a large amount for procurement and find a more reasonable to procure its goods for it,[38] especially considering it previously competently handled the procurement function in-house before the restructuring took place.[39] *See* 26 C.F.R. § 1.482-1(f)(2)(ii) ("The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."). I thus

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[37] This figure is based upon TSC's retail sales of approximately $400,000,000 in 2014 and TSC's taxable income of $130,998,512 in 2014. While retail sales and taxable income are not exactly the same, they still give a reasonable approximation of how much money TSC shifted to Texas, especially when the shift is so large.

[38] Although the Department did not present this court with evidence of a specific procurement company that charged less than Texas charged TSC, I do not find that degree of specificity was necessary to show TSC would find another realistic alternative. The testimony of Dr. DeRamus that it would be unsound business practice to give up $300-350 million dollars of income for a service that only costs $13 million was sufficiently persuasive. Furthermore, although Petitioner asserts that Texas actually has billions of dollars in cost because the cost of inventory should be included in its total costs, I found Dr. DeRamus's testimony that the cost of inventory should be excluded more persuasive. Specifically, the transaction that is being valued is the service of procuring the goods, not the value of the goods themselves; therefore, it is logical that the cost of performing the service includes the cost of the procurement employees, etc., but not the cost of the goods purchased as a result of the service.

[39] Although the restructuring took place in 2001, several years before the tax years in question, I find it is relevant. No further major restructuring has occurred since, at least none brought to this Court's attention, and while several of TSC's duties and assets from before the restructuring were transferred to either Michigan or Texas after the 2001 restructuring, the changes were mostly superficial as demonstrated by what did not change. Specifically, the physical location and place of operation for the procurement services did not change, and the delivery and vendor terms did not change (with the exception of updating vendor agreements to reflect the new purchaser as Texas). Thus, the primary change was the legal employer of the merchandising/procurement employees and the owner of the IP (both of which were transferred to Texas). The number of employees employed by TSC and Texas grew substantially between 2001 and the tax years in question; however, the number of employees at TSC performing procurement activities would have likely grown if TSC had not been restructured. Overall, an analysis of before and after the 2001 restructuring helps the court evaluate whether the new entity created in 2001—Texas—developed a new, robust, and exceptional procurement service by 2014-2106 as a result of the restructuring that TSC could not have accomplished if the restructuring had not taken place. Thus, the before-and-after analysis reflects the value that Texas brought to the Group after the restructuring, including in the audit years, and the reasonableness of the transfer price charged for Texas's services in the audit years. Moreover, while I decline to find that the restructuring had no commercial effect (although the commercial effect seems limited), I do find that the preponderance of the evidence shows that the greatest effect of the restructuring was tax benefits.

do not find that TSC would have entered into such an arrangement with a third-party in an arm's length transaction on the open market.[40]

Overall, I find a preponderance of the evidence shows that Texas's 9.7% markup on inventory charged pursuant to the Procurement Agreement does not meet the arm's length standard.

Tax Policy Considerations Related to the Reporting Method and Apportionment

Professor Richard D. Pomp[41] testified that separate entity reporting using the sales factor for apportionment developed, particularly in southern states, as a way to be economically competitive because it reduced the tax burden on companies who physically locate their businesses in the state compared to other states that used three-factor apportionment or combined reporting. For multi-entity companies with intercompany transactions, separate entity reporting generally requires the use of transfer pricing, and taxing authorities pay attention to transfer pricing because it can be a method by which companies shift income artificially from a higher tax jurisdiction to a lower one to reduce their tax liabilities.

In contrast to separate entity reporting, combined unitary reporting eliminates the need for transfer pricing, and, thus, eliminates the problem of inappropriate income shifting and tax havens. Indeed, from a tax policy perspective, Professor Pomp generally believes that "[b]y taking into account only the income and factors of the corporation having nexus with the taxing state, separate entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to the state." Combined unitary reporting avoids those failings of separate entity reporting by "automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities"

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[40] I also note that while both experts acknowledged Texas's IP had value, neither expert found that value was significant enough to meaningfully contribute to the 9.7% markup such that it would explain the enormous transfer in income from TSC and Michigan to Texas. And, as I already mentioned above, the value of the IP was not included in PwC's initial calculation of the 9.7% markup. Thus, I do not find the value of Texas's IP to be critical or determinative to the outcome of this case. Additionally, to the extent Petitioner contends this Court is not adequately accounting for the fact that Texas's IP had value and should have increased the markup on inventory further, the Court notes this contention amounts to an admission that the intercompany transactions were structured in such a way that they did not fairly represent the values exchanged between companies in the Group during the audit years (Texas should be paid for its IP but it is not being paid). Such an admission only further strengthens the Department's argument that income shifting (or the lack thereof) distorted TSC's income during the audit years.

[41] Professor Richard D. Pomp is a law professor at the University of Connecticut, and he is also an adjunct professor at New York University in its tax LLM program. He was qualified as an expert in tax law and tax policy.

and "helps to create a level playing field" and "improved equity . . . due to its superiority over separate reporting as a method of tax accounting."

Despite Professor Pomp's personal preference for combined unitary reporting as a reporting method, he asserted the legislature has the ultimate authority to prescribe the reporting method and should not be undercut by executive agencies simply because separate entity accounting results in understated revenues. Indeed, being a unitary business does not automatically mean that the standard reporting method cannot fairly represent a taxpayer's business activity in a state.

Nevertheless, the South Carolina legislature has clearly provided an alternative apportionment method when separate entity reporting does not fairly reflect a business's activities within the state. In regard to that alternative apportionment method, Professor Pomp opined that it was generally introduced in separate entity reporting states because one size does not fit all taxpayers and alternative apportionment functions as a safety valve. He explained the history of alternative apportionment goes back to the Uniform Division of Income for Tax Purposes Act (UDIPTA). Section 18 of UDIPTA includes an alternative apportionment provision that is almost identical to South Carolina's alternative apportionment statute, subsection 12-6-2320(A)(4) of the South Carolina Code.[42] Following the tenants of UDIPTA, Professor Pomp opined alternative apportionment should be used judiciously in unusual cases lest it swallow the standard reporting method in a state and, thus, render the standard no longer the default. Accordingly, Professor Pomp asserted that when a transfer price is incorrect, the transfer price should be corrected under the umbrella of separate entity reporting, and a taxing entity should not resort to alternative apportionment, which is a sweeping correction to a narrow problem. More broadly, he opined that resorting to alternative apportionment for an entire industry is a legislative issue, not an alternative apportionment issue.

Mr. Fort, who is a senior attorney with the Multistate Tax Commission (MTC),[43] agreed that the exception should not swallow the rule when it comes to the application of alternative apportionment. In his opinion, he would stick with the MTC's guidance on using alternative

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[42] Importantly, although Section 18 is almost identical to South Carolina's statute, South Carolina did not adopt UDIPTA and it is not a UPDITA state.

[43] Mr. Fort was qualified as an expert in state and local tax policy considerations related to multistate taxation, including separate entity reporting, combined reporting, standard apportionment, and alternative apportionment.

apportionment, which suggests it should be used in limited and specific circumstances that would otherwise produce incongruous results. Furthermore, both Mr. Small and Mr. Sehgal, in their expert capacity as accountants, testified that if a transfer price was corrected and the taxpayer's books were updated to reflect the corrected transfer price, then the taxes could be recalculated under separate entity reporting. Indeed, the Department also acknowledged it has the authority to make adjustments under separate entity reporting, like correcting an incorrect transfer price, so that separate entity reporting more fairly represents the taxpayer's business activities in the state. Accordingly, if the Department's auditor found the transfer price was too high, but could be corrected by lowering it, this would be an alternative solution to correcting the distortion in South Carolina income that would not require the Department to resort to an alternative reporting method like combined unitary reporting.

Finally, Dr. DeRamus opined that combined unitary reporting would achieve something very close to implementing a reasonable transfer price. Specifically, he stated that "the number you would get, the taxable income that you would derive by applying a reasonable transfer pricing method to the company's actual intercompany transactions, it would get you to a number very close to the number that you get through a combined entity apportionment method." He explained that if transfer prices were correct across the Group, then he would expect each entity to receive a modest markup for the services they provide—TSC would receive a modest markup for supplying employees to Michigan, TSC would receive a modest markup for its administrative services, and Texas would receive a modest markup for its procurement—and that these markups would effectively wash each other out and reach the same result as combined unitary reporting, which eliminates intercompany transactions.

ISSUES

1. Does the Department have the authority under subsection 12-6-2320(A)(4) of the South Carolina Code to require combined unitary reporting?

2. Does separate entity reporting fairly represent the extent of Petitioner's business activity in South Carolina?

3. Is the combined unitary reporting method a reasonable and equitable alternative appointment method?

4. Does the application of combined unitary reporting violate the Administrative Procedures Act?

CONCLUSIONS OF LAW

Standard of Review

This Court has jurisdiction over this case pursuant to section 12-60-460 of the South Carolina Code (2014) and section 1-23-600 of the South Carolina Code (Supp. 2023).

This is a contested case, and it is heard *de novo*. *Brown v. S.C. Dep't of Health & Envtl. Control*, 348 S.C. 507, 512, 560 S.E.2d 410, 413 (2002) (explaining that a contested case before the ALC is "in the nature of a de novo hearing with the presentation of evidence and testimony"). The standard of review is a preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2023); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998) ("Absent an allegation of fraud or a statu[t]e or a court rule requiring a higher standard, the standard of proof in administrative hearings is generally a preponderance of the evidence.").

Generally, the party asserting the affirmative issue has the burden of proof in contested cases. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017). However, in cases where the Department asserts an alternative apportionment method under section 12-6-2320 of the South Carolina Code, the Department bears the burden of proving the need to use an alternative method *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep't of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). Additionally, the burden of proof before this Court is a preponderance of the evidence. § 1-23-600(A)(5); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. at 375-78, 496 S.E.2d at 19-20. Therefore, the Department bears the burden of proving this case by a preponderance of the evidence.

History of the Unitary Business Principle and Combined Reporting

Before addressing the issues in this case, a review of the history and development of apportionment methods for multistate businesses is helpful. As early as the 1920s, tax authorities and courts wrestled with how to deal with multistate corporations whose business was hard to value for tax because the interconnected, "unitary" nature of the business made it difficult to pinpoint where the value was being generated for the purpose of apportionment. *See Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271 (1924); *Hans Rees' Sons v. State of N. Carolina ex rel. Maxwell*, 283 U.S.

123 (1931). "Because of the complications and uncertainties in allocating the income of multistate businesses to the several States," the "unitary business principle" was developed, which permitted "[s]tates to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State." *Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 778 (1992). As legal and tax theory progressed, several other principles were developed that guide the taxation of unitary businesses.

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) (*Container Corp.*), the U.S. Supreme Court held that "[u]nder both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, tax value earned outside its borders." 463 U.S. at 164 (internal quotation marks omitted). The Due Process Clause and the Commerce Clause also "do not allow a State to tax income arising out of interstate activities—even on a proportional basis—unless there is a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" *Container Corp.*, 463 U.S. at 165–66 (internal quotation marks and citation omitted). "A State may, however, tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a 'unitary business.'" *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 19 (2008).

The *Container* Court described two methods for apportioning the income of multistate taxpayers, while observing that, in the case of a unitary business, "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice." *Container Corp.*, 463 U.S. at 164. First, it described geographical or transactional accounting and the problems associated with it:

> One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting. The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.

Container Corp., 463 U.S. at 164–65. Similarly, in *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, the Court noted that when a unitary business is at issue, "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." 445 U.S. 425, 438, (1980). The *Mobil* Court further commented that

> [b]ecause these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Id. In a later decision, *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298, 305 (1994), the Court observed that "[s]eparate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability. To guard against such manipulation, transactions between affiliated corporations must be scrutinized to ensure that they are reported on an 'arm's-length' basis, i.e., at a price reflecting their true market value." Further, "[a]ssuming that all transactions are assigned their arm's-length values in the corporate accounts, a jurisdiction using separate accounting taxes corporations that operate within its borders only on the income those corporations recognize on their own books." *Barclays Bank PLC*, 512 U.S. 298, 305-06.

The *Container* Court contrasted separate accounting/geographical accounting with the "unitary business/formula apportionment method":

> The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints.

Container Corp., 463 U.S. at 165. "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." *Allied-Signal, Inc.*, 504 U.S. at 783 (internal quotation marks omitted).

Importantly, the unitary business method of formula apportionment may only be used when the business qualifies as a "unitary business," and whether a business is unitary is a very fact-based finding. On this issue, the Court has stated that "the unitary business concept . . . is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container Corp.*, 463 U.S. at 167. In

other words, there is no uniform set of facts that will always define a unitary business. *See Allied-Signal, Inc.*, 504 U.S. at 785 ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach . . . and also because the constitutional test is quite fact sensitive." (internal quotation marks and citation omitted)). Nevertheless, "where the asset in question is another business," the Court has described the "'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." *MeadWestvaco Corp.*, 553 U.S. at 30.

Once a state determines that a business is "unitary," it must then apply an apportionment formula that is "fair" under both the Due Process and Commerce Clauses. *Container Corp.*, 463 U.S. at 169. The Court has set forth several principles of fairness:

> The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

Container Corp., 463 U.S. at 169-70.

Thus, "[t]he 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principle.' If a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'" *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 223 (1980) (internal citation omitted). Accordingly, the application of unitary apportionment rests between two competing principles that must be balanced: "the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." *Allied-Signal, Inc.*, 504 U.S. at 780.

Combined Reporting in the States

With the development of the unitary business principle and formulary apportionment, states began to utilize a version of formulary apportionment known as combined reporting, or, as it has been referred to in this case, combined unitary reporting. The Supreme Court of Illinois

aptly provided this summary of the reasoning behind "combined reporting" as a method of apportionment:

> When a unitary business is carried on by an associated group of corporate entities, commonly referred to as a "unitary business group," resort to formula apportionment is also in order; a group of assets is used by the same overall entity for the generation of income through operation of a single, unitary business. If corporate forms were respected, State income taxation would be as artificially limited and open to manipulation as is the method of separate accounting. To prevent the triumph of corporate formality over economic substance, "combined reporting" is a necessary tool. . . . Combined reporting works to expand application of the unitary-business concept so that an associated group of corporations can be treated as though it constituted a single taxpayer carrying on a unitary business. The total income of a unitary business as carried on by the associated group is determined by combining the income of each corporation involved in that business, and an apportioning ratio is then applied to that total for determination of the taxable income of the corporate member operating in the taxing State.

Citizens Utilities Co. of Illinois v. Dep't of Revenue, 111 Ill. 2d 32, 40, 488 N.E.2d 984, 987 (1986).

Additionally, in an attempt to address the complexities surrounding this issue, a subset of states adopted the Uniform Division of Income for Tax Purposes Act (UDIPTA), including UDIPTA Section 18, which allows for alternative methods of allocation and apportionment.[44] Although not specifically adopted by South Carolina, UDIPTA Section 18 is almost identical to South Carolina's "alternative apportionment statute," subsection 12-6-2320(A)(4). Section 18 states:

> If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any one or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

[44] The National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDIPTA) in n 1957 to promote conformity among states and their income tax reporting structures. James S. Helms & Geoffrey J. Christian, *The Evolution of UDIPTA Section 18's Applicability and its Distortion Standard*, 38 J. Corp. Tax'n 3, 3, 2011 WL 2050897, 1.

UDIPTA § 18 (Westlaw Edge through 2021 Annual Meeting of the National Conference of Commissioners on Uniform State Laws).

Several states that adopted UDIPTA found that combined reporting was authorized under Section 18. *See Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). Nevertheless, the threshold necessary to show that relief should be granted under Section 18 has been much debated. The current official comment to Section 18 reads:

> Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in Section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

Id. While the comment vests the taxing authority with "broad authority," in practice tax authorities and courts have struggled with what the threshold is for proving that a state's standard apportionment method does not "fairly represent the extent of the taxpayer's business activity in this state." An early school of thought was advanced by Professor William Pierce, a drafter of UDIPTA, who commented that Section 18

> necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be **attacked successfully on constitutional grounds**. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, **departures from the basic formula should be avoided except where reasonableness requires**. Nonetheless, some alternative method must be available to handle the constitutional problem as well as **the unusual cases**, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 227, 700 P.2d 1035, 1039 (1985) (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957) (emphasis added)).

The constitutional threshold for attack referenced by Pierce was articulated by the *Container* Court, which held it would "strike down the application of an apportionment formula if

the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted in that State,' . . . or has 'led to a grossly distorted result." *Container Corp.*, 463 U.S. at 169-70.

However, while meeting the *Container* Court standard assures compliance when the constitutional threshold is at issue, some states have imposed a lesser threshold for determining when to impose an alternative method of allocating income. The Oregon Supreme Court delineated its threshold test as follows in *Twentieth Century-Fox Film Corporation v. Department of Revenue*:

> First, department must demonstrate that the statutory formula as a whole does not "fairly represent the extent of the taxpayer's business activity in this state." . . . It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state. *See Amoco Production Co. v. Armold, Director of Taxation*, 213 Kan. 636, 518 P.2d 453 (1974).
>
> Second, the party with the burden of proof must establish that its alternative method of allocating income is "reasonable." We believe that in the context of UDITPA, reasonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon.

299 Or. 220, 233–34, 700 P.2d 1035, 1042–43 (1985). Tennessee, which adopted UDIPTA, likewise adopted a similar test:

> Thus, to review the Commissioner's decision to impose a variance on Vodafone, the threshold inquiry under the variance statute is whether the standard statutory tax apportionment provisions "do not fairly represent the extent of the taxpayer's business activity in this state . . . ." Tenn. Code Ann. § 67–4–2014(a). If that threshold is met, we look at whether the alternate formula selected by the Commissioner in the variance is "reasonable."

Vodafone Americas Holdings, Inc. & Subsidiaries v. Roberts, 486 S.W.3d 496, 521 (Tenn. 2016).

Having now given some context on the unitary business principle, combined reporting, and UDIPTA Section 18 as these principles have been discussed nationally and within the states, I now turn to South Carolina law.

Does the Department Have the Authority Under Subsection 2320(A)(4) to Require Combined Unitary Reporting?

Corporate Taxation in South Carolina

South Carolina imposes an income tax of 5% on the "South Carolina taxable income" of every corporation "transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C. Code Ann. § 12-6-530 (2014). "South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter." S.C. Code Ann. § 12-6-580 (2014).

If, like TSC, a taxpayer[45] conducts business partly within and partly without South Carolina, then "the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). Additionally, if a taxpayer's principal business in South Carolina is "selling, distributing, or dealing in tangible personal property," then it "shall make returns and pay annually an income tax that includes its income apportioned to this State." S.C. Code Ann. § 12-6-2252(A) (2014). No one disputes that TSC is a retailer principally engaged in selling tangible personal property in this state, therefore, subsection 12-6-2252(A) applies.

Next, under subsection 12-6-2252(A), the taxpayer's "income apportioned to this State is determined by multiplying the net income remaining after allocation[46] . . . by the sales factor defined in Section 12-6-2280." *Id.* Pursuant to subsection 12-6-2280(A), "[t]he sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year." S.C. Code Ann. § 12-6-2280(A) (2014). This statutorily described method of multiplying a taxpayer's South Carolina net income by the sales factor is known as "standard apportionment." However, where this standard method of allocation and apportionment does not "fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for, **or** the

[45] The term "taxpayer" is defined to include "an individual, trust, estate, partnership, association, company, corporation, or any other entity subject to the tax imposed by this chapter or required to file a return." S.C. Code Ann. § 12-6-30(1) (2014).

[46] Allocation is not an issue in this case.

department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

> (1) separate accounting;
>
> (2) the exclusion of one or more of the factors;
>
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added).

At issue in this case is the Department's application of subsection 12-6-2320(A)(4) to impose combined unitary reporting on TSC after it concluded that separate entity reporting resulted in an allocation and apportionment that did not fairly represent the extent of TSC's business activity in South Carolina.

Statutory Construction of Subsection 12-6-2320(A)(4)

Petitioner argues the plain language of subsection 12-6-2320(A)(4) does not allow the application of combined unitary reporting because subsection 12-6-2320(A)(4) only authorizes the Department to employ an alternative **apportionment** method, not an alternative **reporting** method, like combined unitary reporting. Petitioner bases its argument upon the premise that apportionment only refers to the formula or ratio (under our law, the sales factor) that is used to estimate the amount of business attributable to the taxing jurisdiction whereas the reporting method controls the amount of net taxable income against which the apportionment factor is applied. Thus, Petitioner claims subsection 12-6-2320(A)(4) does not authorize the Department to change the net taxable income of the single taxpayer to the net taxable income of the Group consistent with combined unitary reporting. In support of its argument, Petitioner cites to *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010) (*Media General*), which it interprets to only authorize an alternative sales factor (apportionment) rather than an alternative South Carolina net taxable income (controlled by the reporting method).

Before I discuss *Media General*, a review of reporting methods is helpful. The parties agree that South Carolina is a separate entity reporting state.[47] This means that, unless otherwise

[47] "Separate entity reporting" is not the same as "separate accounting" for the purposes of apportionment. *See*, *e.g.*, *Am. Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 690 (Tenn. Ct. App. 1994) ("Tennessee's standard apportionment

provided, each corporation with a nexus to South Carolina is individually subject to tax in South Carolina and files an individual tax return, even if they are related entities that make up a "unitary business." S.C. Code Ann. § 12-6-4910(2) (2014) ("Income tax returns must be filed by the following: . . . (2) a corporation subject to tax under this chapter."); S.C. Code Ann. § 12-6-530 (2014) (Imposing an income tax on every corporation "transacting, conducting, or doing business within this State of having income within this State"). Because each separate corporation, even if they are part of a unitary business, files a separate tax return, only the modified federal taxable income of the single entity appears in the calculation of South Carolina income tax. § 12-6-580 ("South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.").[48]

The Supreme Court of Michigan adeptly summarized the difference between separate entity reporting and combined reporting and their relationship to "formulary apportionment."

> Our state has adopted formulary apportionment for individual taxpayers in the ITA [Michigan Income Tax Act]. Recognizing that Michigan is a formulary apportionment state, however, does not resolve the issue in this case because there are at least two different methods of applying the apportionment formula. First, a state may use separate-entity reporting, which requires each entity with a nexus to the taxing state to be considered as a separate and distinct entity, regardless of whether it could comprise a unitary business with other entities.
>
> Alternatively, a state may use combined reporting, which requires "each member of a group carrying on a unitary business [to] compute[ ] its individual taxable income attributable to activities in [the state] by taking a portion of the combined net income of the group through the utilization of combined apportionment factors."

Malpass v. Dep't of Treasury, 494 Mich. 237, 247, 833 N.W.2d 272, 277 (2013) (citation omitted). Notably, the Supreme Court of Michigan considered both separate entity reporting and combined

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formula, set forth in Tennessee Code Annotated § 67–4–811, may be referred to as requiring "separate entity reporting," however, that formula is not equivalent to separate accounting. The standard apportionment formula in Tennessee Code Annotated § 67–4–811 produces a ratio which is multiplied by the taxpayer's apportionable income.").

[48] Section 12-6-5020 of the South Carolina Code (2014) provides an exception to separate entity reporting and allows certain related corporations to file a single tax return called a consolidated income tax return. However, a consolidated return is not the equivalent of combined unitary reporting. A consolidated return taxes the income of the consolidated entities, whereas combined unitary reporting merely uses the group's net income to better calculate the tax upon a single taxpayer within the group, not the consolidated group as a whole. Additionally, only corporations that are subject to tax in South Carolina are allowed to be included in the consolidated return, and each corporation in the consolidated return must separately determine its South Carolina taxable income or loss. § 12-6-5020(B)-(D).

reporting to be methods of applying the **apportionment formula**. Thus, while the Supreme Court of Michigan recognized different types of reporting, it considered them to be underneath the umbrella of apportionment.[49] Although some courts have distinguished between reporting methods and apportionment methods,[50] in *Media General*, both the underlying ALC order and the South Carolina Supreme Court referred to combined unitary reporting (or simply combined reporting) as "combined entity apportionment." Essentially, the terminology used by the ALC and the supreme court combined the reporting method with apportionment and did not endeavor to distinguish them in any meaningful way. Moreover, in *Media General*, the supreme court held subsection 12-6-2320(A)(4) authorized the Department to apply combined unitary reporting. *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 694 S.E.2d 525 (2010). The clear implication is the South Carolina Supreme Court, like the Supreme Court of Michigan, found the reporting method to be under the umbrella of apportionment for the purpose of applying subsection 12-6-2320(A)(4).[51]

Next, although Petitioner argues this Court should engage in statutory construction to resolve this case, courts usually engage in statutory construction to interpret a statute when it has not previously been interpreted and/or its meaning becomes unclear in a particular application.

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[49] Other state courts have referred to combined reporting as a form of apportionment. *See Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 756, 684 P.2d 396, 406 (1984) ("The combined report method of allocation of income and expenses is wholly consistent with and a natural extension of the allocation and apportionment purpose of UDITPA and its three-factor formula rather than an exception thereto."); *Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691 (Tenn. Ct. App. 1994) (referring to combined reporting as a method of apportionment); *Hewlett-Packard Co. v. State, Dep't of Revenue*, 749 P.2d 400, 401 (Colo. 1988) ("The combined method, also known as unitary apportionment, is based on a recognition that an integrated business may operate through several separately incorporated entities.'"); *Coca Cola Co. v. Dep't of Revenue*, 271 Or. 517, 528, 533 P.2d 788, 793 (1975) ("The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method.").

[50] *See*, *e.g.*, *Cook v. Dep't of Revenue*, 23 Or. Tax 107, 114 (2018) ("The court is of the opinion that, notwithstanding some imprecise language in discussions of courts over the years, combined reporting is a concept and process separate and distinct from that of apportionment. Apportionment is the process by which a 'base' of business income is divided among two or more states. . . . However, apportionment of a 'base' is separate from determination of the 'base.'"); *Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888, 895 (Ind. T.C. 2015) ("Accordingly, the plain language of Indiana Code § 6–3–2–2(l), like that of Section 18 of UDITPA, 'deals only with the question of the fairness of the [allocation or apportionment] of income, not with the determination of the tax base itself.' "); *Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 295, 615 P.2d 16, 18 (1980) ("Section 39-22-303(5) provides that the department may distribute or allocate income and deductions, or may require returns on a consolidated basis. We conclude that it is that statutory provision for distribution and allocation of income and deductions which authorizes the department to require combined reports since a combined report does allocate or apportion income.").

[51] Petitioner nonetheless argues the description of the combined apportionment method in *Media General* shows our supreme court only approved an alternative sales factor to reflect a combined group and not alternative reporting of the taxpayer's net taxable income as the group's net taxable income. As I explain below, a thorough reading of the ALC's underlying order and the supreme court's order proves this conclusion is incorrect.

See Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) ("The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature."); *Eagle Container Co., LLC v. Cnty. of Newberry*, 379 S.C. 564, 570, 666 S.E.2d 892, 895 (2008) ("We proceed from the familiar premise that in the area of statutory construction, our role is limited to determining legislative intent and effectuating that intent."). In this case, the South Carolina Supreme Court has already interpreted the meaning of subsection 12-6-2320(A)(4) within the context of whether combined unitary reporting is authorized under that subsection. Therefore, this Court does not need to engage in statutory construction.

Media General

In 2010, the South Carolina Supreme Court issued an opinion in *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010) (*Media General*). In this opinion, our supreme court analyzed whether the Department could require a multistate taxpayer that was part of a unitary business to use "combined entity apportionment" instead of "separate entity apportionment" under subsection 12-6-2320(A)(4). *Id.* At 140-42, 694 S.C. at 526-27. The supreme court held the Department had the authority to utilize combined entity apportionment, which, as explained below, is the same as "combined unitary reporting." *Id.* at 151, 694 S.C. at 532. Accordingly, subsection 12-6-2320(A)(4) authorizes the Department to require combined unitary reporting.[52]

Petitioner nonetheless notes that the terminology used by the supreme court in *Media General* is not "combined unitary reporting," but rather "combined entity apportionment." Based upon this difference in terminology, Petitioner seeks to distinguish the method approved of in *Media General* from the Department's imposition of combined unitary reporting in this case. Specifically, Petitioner argues the "combined entity apportionment" described in *Media General* only alters the sales factor to apportion the combined group's sales but does not change the net

[52] Although combined unitary reporting is allowed, the Department must meet its burden under subsection 12-6-2320(A)(4). *See Media General*, 388 S.C. at 151, 694 S.C. at 532; *see also Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014) (holding where "the Department alone is arguing that the statutory formula does not fairly represent the taxpayer's business in South Carolina—the Department bears the burden to prove (1) that the statutory formula does not fairly represent [the taxpayer's] business activity in South Carolina and (2) that the proposed alternative formula is reasonable").

taxable income to which the sales factor is applied, whereas combined unitary reporting alters the sales factor and net taxable income.[53] I disagree.

In *Media General*, the supreme court quotes some of the findings from the ALC's underlying order, including a section of the order that describes how "separate entity apportionment" and "combined entity apportionment" are calculated. Specifically, the supreme court includes the following quotation about combined entity apportionment from the ALC's order that is slightly misleading:

> To determine the tax of a related entity or related entities of a multistate corporation in South Carolina by using the combined entity apportionment method, the individual entity or all related entities (if more than one taxpayer is transacting business in this state), must determine a ratio to apply against its/their taxable income to arrive at its/their net taxable income in South Carolina. The ratio is determined by dividing the gross receipts of all the related entities of the multistate corporation in South Carolina or all the related entities[']property, payroll, and sales from within South Carolina, by all the related entities[']gross receipts from everywhere or the related entities[']property, payroll, and sales from everywhere. **The taxpayer (individual entity) then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income.** The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

Media General, 388 S.C. at 146–47, 694 S.E.2d at 529 (emphasis added). Regrettably, the bolded language used here is not as precise as it could be. When viewed in isolation, specification of "the taxpayer (individual entity)" and "the entity's taxable income" in the bolded section could arguably lead Petitioner to conclude that only one entity's taxable income is applied against the combined sales factor instead of against the combined taxable income of the related entities. *Id*. However, when this quote is reviewed in the context of the ALC's original order from which it came, it becomes unquestionably clear that the combined sales factor is applied against the combined taxable income of the related entities (the group) and not against a single taxpayer's taxable income. *See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC at 26 n.39 (S.C. Admin. Ct. May 4, 2009). Indeed, a complete reading of the ALC's opinion leaves no doubt that when the ALC discussed "combined

[53] Although I do not agree with all of the arguments of Petitioner's counsel, I am nonetheless impressed by their keen effort.

entity apportionment," it was referring to "combined unitary reporting," and the two linguistic formulations of this "method" are interchangeable.[54]

Nevertheless, Petitioner argues the ALC's underlying order is irrelevant because "[i]t does not matter what the parties wanted the Supreme Court to approve, and it is the responsibility of the parties to ensure courts address the issues the parties intend be address. What matters is the method the Supreme Court did approve in *Media General*, which is not [combined unitary reporting]." Petitioner maintains the Supreme Court only approved modification of the sales factor in *Media General* and did not approve modification of the taxable income against which the sales factor is applied. However, the Supreme Court affirmed the ALC's order *without modification*. Therefore, the Supreme Court intended to approve the method approved by the ALC, which was combined unitary reporting. Furthermore, the Supreme Court's own description of "combined entity apportionment," confirms taxable income is altered to reflect the net taxable income of the group rather than the net taxable income of the single taxpayer:

> [Separate entity apportionment] is in contrast to the combined entity apportionment method, which the parties have stipulated is defined for this matter as an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking **a portion of the combined net income of the group** through the utilization of combined apportionment factors. **The combined income of the unitary group is not computed for the purpose of taxing such income**, but rather **as a basis** for determining **the portion of income from the entire unitary business attributable to sources within South Carolina that is derived by members of the group subject to South Carolina's taxing jurisdiction**. One of the purposes of this method is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.

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[54] *See*, *e.g.*, *Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC, at 12 ("The term 'combined apportionment methodology' means the following when used herein: an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a portion of the combined net income of the group through the utilization of combined apportionment factors."); *id.* at 12-13 ("The purpose of the combined apportionment methodology is to determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying the apportionment factors of the entire unitary business to the taxable net income of the unitary business and 2) to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise."); *id.* at 28 ("A state could select the combined report method [combined apportionment method] whereby the entire net incomes of several commonly owned unitary corporations . . . are included in the taxpayer's apportionable unitary net income base. . . . Any of these methods are permitted." (quoting the S.C. Tax Commission's SCTC Decision 94-1)).

Media General, 388 S.C. at 142, 694 S.E.2d at 527. The bolded portions of this quote from *Media General* show that the Supreme Court interpreted combined entity apportionment to effect a change in net taxable income so that "the portion of income from the entire unitary business attributable to sources within South Carolina that is derived by members of the group subject to South Carolina's taxing jurisdiction." *Id.*

Therefore, while an isolated reading of the section quoted from the ALC's order in *Media General* may lead one to infer that "combined entity apportionment" only impacts the calculation of the sales factor under section 12-6-2280, that inference would be incorrect—combined entity apportionment is the same as combined unitary reporting, which affects both the calculation of net taxable income and the sales factor.

To the extent Petitioner asks this Court to deviate from the Supreme Court's interpretation, the doctrine of stare decisis must be considered. Stare decisis exists to ensure certainty and stability. *State v. One Coin-Operated Video Game Mach.*, 321 S.C. 176, 181, 467 S.E.2d 443, 446 (1996). Stare decisis should be weighed more heavily when it reflects a "body of decisions as opposed to a single case standing alone." *McLeod v. Starnes*, 396 S.C. 647, 654, 723 S.E.2d 198, 203 (2012) "This is not to say that a single case garners no protection from stare decisis, for even in those circumstances we should hesitate to revisit and reverse our decisions without good cause to do so." *Id.* at 655, 723 S.E.2d at 203. "Stare decisis applies with full force with respect to questions of statutory interpretation because the legislature is free to correct us if we misinterpret its words." *Id.* at 655, 723 S.E.2d at 203; *see also Wigfall v. Tideland Utilities, Inc.*, 354 S.C. 100, 111, 580 S.E.2d 100, 105 (2003) ("The Legislature is presumed to be aware of this Court's interpretation of its statutes. When the Legislature fails over a forty-year period to alter a statute, its inaction is evidence the Legislature agrees with this Court's interpretation." (internal citation omitted)).

Nevertheless, "[w]hile adherence to precedent under the rubric of stare decisis is commendable and provides certainty and consistency within our judicial system, adherence to precedent that is wrong serves no such laudable purpose." *Joseph v. S.C. Dep't of Lab., Licensing & Regul.*, 417 S.C. 436, 451, 790 S.E.2d 763, 770 (2016). Thus, "[a] decision which is to overrule all former precedents and to establish a principle never before recognized should either contain some internal evidence that the prevailing law is to be overthrown, or else be founded upon reasoning far stronger than that comprehended in the previous decisions which by implication it

would set aside." *Coleman v. Page's Est.*, 202 S.C. 486, 25 S.E.2d 559, 560 (1943). This is a case of statutory construction, where stare decisis is at its strongest, and I find no "internal evidence" or reasoning far stronger than our supreme court's that would require this court to reinterpret the meaning of subsection 12-6-2320(A)(4) with regard to combined unitary reporting. *See McCleod*, 396 S.C. at 655, 723 S.E.2d at 203 ("Stare decisis applies with full force with respect to questions of statutory interpretation because the legislature is free to correct us if we misinterpret its words."); *Coleman*, 202 S.C. at 486, 25 S.E.2d at 560.[55]

Next, as discussed below, the holding in *Media General* resolves several of Petitioner's arguments in this case.

The Term "Taxpayer" Does Not Prohibit Combined Unitary Reporting

Petitioner argues the Department does not have authority to impose combined unitary reporting under subsection 12-6-2320(A)(4) because South Carolina's corporate income tax statutes specifically refer to "taxpayer" in the singular, leaving no room for a group of related entities to be taxed together because this would necessitate changing the language of the statutes to "taxpayers." *See* § 12-6-30(1) (defining "taxpayer" in the singular); § 12-6-2210(B) ("If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State."). Petitioner specifically refers to the language in subsection 12-6-2320(A)(4) providing that "any other method" may be used to effectuate equitable apportionment of "**the taxpayer's income**." (emphasis added). Petitioner contends this subsection

[55] Our supreme court's decision in *Media General* is a fair and reasonable interpretation of our statutory scheme, even if another state might interpret a similar scheme differently. *Compare Media General*, 388 S.C. 138, 146, 694 S.E.2d 525, 529, *with Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888 (Ind. T.C. 2015). Indeed, section 12-6-2320(A) provides for the alternative use of other methods of allocation and apportionment, "[i]f the allocation and apportionment provisions **of this chapter** do not fairly represent the extent of the taxpayer's business activity in this State." (emphasis added). One provision of import in Chapter 6 of Title 12 (governing allocation and apportionment) is subsection 12-6-2210(B), which instructs that "[i]f a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon **a base** which **reasonably represents the proportion of the trade or business carried on within this State**." (emphasis added). According to the Department's evaluation of Petitioner's tax returns during the audit period, the South Carolina income tax was imposed upon a **base** that does not "reasonably represent the proportion of the trade or business carried on within this State," contrary to subsection 12-6-2210(B). *See Duke Energy Corp. v. S.C. Dep't of Revenue*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (holding the primary thrust of South Carolina's apportionment statutes is "to apportion to South Carolina a fraction of the taxpayer's total income reasonably attributable to its business activity in this State.").

only authorizes the Department to require an alternative apportionment method against the single taxpayer's income and not the unitary group's income.

In *Media General*, and the Department argued that it could not impose combined entity apportionment because "taxpayer" was defined in the singular and required the Department to use separate entity apportionment. Our supreme court rejected this argument, citing with approval the decision of the Supreme Court of Oregon in *Coca Cola Co. v. Department of Revenue*, 271 Or. 517, 533 P.2d 788 (1975). *Media General*, 388 S.C. at 148-49, 694 S.E.2d at 530. In that case, the Supreme Court of Oregon held:

> The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method. While it is true, as plaintiff points out, that the statute speaks of taxpayer in the singular, this is no bar. We note that the prior statute also spoke in the singular. Yet in *Zale-Salem* we approved combined reporting.

Coca Cola, 271 Or. 517, 528, 533 P.2d 788, 793.[56]

It is also notable that under the unitary business principle, the companies that make up the unitary business are treated as functioning like one entity. Thus, Petitioner's argument fails to consider that once combined unitary reporting is applied, the unitary group, in a sense, becomes the "taxpayer." Therefore, while the language of the statute may remain singular, it now encompasses the group, which is a singular entity made up of several interrelated companies that function as a unified whole. However, "taxpayer" only becomes the group "in a sense," because ultimately combined unitary reporting seeks to tax only the singular taxpayer (or taxpayers within the group) with nexus to South Carolina. As our supreme court stated at the end of *Media General*,

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[56] Despite our supreme court's determination that "taxpayer" could be broadly interpreted to include a unitary group, Petitioner contends the supreme court's holding in *Media General* was based upon its limited review of the ALC's specific ruling that only included the "any other method" language in subsection (A)(4) and did not rely on the rest of the statute, which requires the method to be constrained to "apportioning **the taxpayer's income**." § 12-6-2320(A)94). (emphasis added). Petitioner thus argues the supreme court, in upholding the ALC's ruling in *Medial General*, likewise was focused on the "any other method" language without considering the statutory language as a whole. *Media General*, 388 S.C. at 146, 694 S.E.2d at 525. Petitioner's argument would have this Court believe the South Carolina Supreme Court did not review, analyze, or discern the full meaning of the statute before it when making its decision. Regardless of what portion of the statute the ALC quoted in its ruling, the supreme court has the authority under appellate review to review the ALC's ruling for errors of law, including the misinterpretation or misapplication of a statute. Therefore, I decline to believe the supreme court's appellate review was confined to a review of the specific language of the ALC's ruling and not the broader meaning and application of the statute at issue in that ruling. Moreover, it is clear from *Media General* that the supreme court reviewed the entire statute. *Media General*, 388 S.C. at 151, 694 S.E.2d at 531 (holding "the legislature enacted section 12-6-2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) clearly authorizes the department to use 'any other method' to effectuate an equitable apportionment of **the taxpayer's income**, including the combined entity apportionment method." (emphasis added)).

the "combined entity apportionment method is merely a mechanism for approximating the income attributable to the corporations that comprise the unified business, **but this does not change the fact that the entities will be reporting the taxes due for each entity**. *Media General*, 388 S.C. at 151-52, 694 S.E.2d at 532; *see also Container Corp.*, 463 U.S. at 165–66 ("The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities—even on a proportional basis—unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (citation omitted)). Thus, combined unitary reporting does not tax the unitary group; its function is to better reflect the value of a **single taxpayer** within the group, in keeping with the singular use the term "taxpayer" in our statutes.

Petitioner also cites to subsection 12-6-2320(B)(2) for the proposition that if the legislature intended the term "taxpayer" as used in subsection (A)(4) to be expanded to include a unitary group, then it would have explicitly done so as in subsection (B)(2). Subsection (B)(2) states: "For the purposes of this subsection the word 'taxpayer' includes any one of more of the members of a controlled group of corporations authorized to file a consolidated return under Section 12-6-5020. Also, the word 'taxpayer' includes a person who bears a relationship to the taxpayer as described in Section 267(b) of the Internal Revenue Code." § 12-6-2320(B)(2). However, Petitioner's interpretation is simply contrary to the supreme court's ruling in *Media General* that "taxpayer" can include a unitary group under combined entity apportionment. Moreover, subsection (B)(2) discusses consolidated returns, which contemplates the combination of two or more South Carolina corporate taxpayers' taxable income for the purposes of taxation and, unlike combined unitary reporting, does not ultimately seek to tax the consolidated entities separately. *See* S.C. Code Ann. § 12-6-5020 (2014). Therefore, there is a factual reason to distinguish taxpayer from taxpayers in the context of consolidated returns.

Next, Petitioner argues that if "taxpayer" is read to include "taxpayers," then this interpretation "could cause a South Carolina taxpayer with no income (or a loss, so negative income) to apportion 'the taxpayer's income' to South Carolina and owe corporate income tax to this state during years in which the taxpayer had no income in the first place." This argument is grounded in a misunderstanding of how combined unitary reporting works. As explained above, combined unitary reporting seeks to tax **individual taxpayers**, but it uses the combined income

and statistics of the unitary group to achieve a fair representation of business activity in a state. Petitioner's hypothetical is also unlikely to occur. For example, if a member of the unitary group outside of South Carolina (with no nexus to South Carolina) has income but the South Carolina group member does not have income or has a loss, then the numerator of the sales factor would remain zero and no tax would be attributed to the South Carolina member who had no income or a loss. Under another hypothetical, if both group members have South Carolina nexus and one member has South Carolina sales but the other does not, then the proportion of income subject to tax would be allocated to the South Carolina member with sales (and income). However, even if Petitioner's hypothetical did occur, then subsection 12-6-2320(A)(4) would be applicable and an alternative method of apportionment would be used to better reflect the taxpayer's business activity in this state.

Accordingly, under *Media General*, our supreme court determined that the definition of taxpayer as singular does not prevent the Department from requiring combined unitary reporting under subsection 12-6-2320(A)(4).

South Carolina Nexus

Finally, Petitioner argues that *Media General's* holding does not apply in this case because the taxpayers that made up the unitary group in *Media General* each had a nexus with South Carolina whereas only TSC has a South Carolina nexus in this case. However, only one member of the group in *Media General* filed a tax return in South Carolina before the Department's audit in that case. *See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC at 26 n.39 (S.C. Admin. Ct. May 4, 2009). Nonetheless, whether all the entities in the unitary business had South Carolina nexus was not a factor in the supreme court's holding. Indeed, the supreme court's holding is quite broad and did not reference nexus:

> We agree with the ALC that the legislature enacted section 12–6–2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) clearly authorizes the Department to use "any other method" to effectuate an equitable apportionment of the taxpayer's income, **including** the combined entity apportionment method.

Media General, 388 S.C. 138, 151, 694 S.E.2d 525, 531 (2010) (emphasis added). Moreover, the supreme court further held: "We emphasize that, as a general rule, the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an

alternative method that fairly measures the taxpayer's income in South Carolina." *Id.* at 151, 694 S.E.2d at 531-32. Thus, the supreme court's holding is not limited to approval to the combined entity apportionment method for unitary businesses in which all members of the unitary group have a nexus with South Carolina. Rather, the holding broadly determined that the Department has the authority to use alternative methods to equitably apportion the taxpayer's income under subsection 12-6-2320(A)(4) in a way that fairly measures the taxpayer's income in South Carolina.

Furthermore, this Court is unaware of any authority that has authorized combined reporting that has also rejected its application because a member of the group does not have a nexus with the taxing authority. The point of the unitary business principle is to recognize that income may be generated and flow across state/jurisdictional lines in unitary, multistate businesses, and states may reach across those jurisdictional lines when to do so better reflects the business activity generated in the taxing state. *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 94–95, 142 S.E.2d 445, 446 (1965) ("The purpose of this legislation, as declared in both acts, is to provide for the imposition of the South Carolina income tax, where the taxpayer is also subject to income tax in other states, 'upon a base which reasonably represents the proportion of the trade or business carried on within this State.'"); *Container Corp.*, 463 U.S. at 165 (observing that the "unitary business/formula apportionment method . . . rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the 'unitary business' **of which the taxed enterprise's activities in the taxing jurisdiction form one part**, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction" (emphasis added)). Indeed, the Department employs the two-step version of the *Finnigan*[57] method of combined unitary apportionment to split the taxable base income calculated under combined unitary reporting between two or more taxpayers in a unitary group that have nexus with South Carolina, which suggests that some members of the unitary group may not have nexus. Revenue Ruling #15-5 at 8-9.

[57] There are two standard methods of applying combined unitary apportionment: the *Joyce* method and the *Finnigan* method. For the purposes of this case, it is not necessary to define the difference between them, although the Department summarizes the difference in Revenue Ruling #15-5.

Does Separate Entity Reporting Fairly Represent the Extent of Petitioner's Business Activity in South Carolina?

Section 12-6-2320 provides that "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable: . . . (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." In cases where the Department asserts an alternative apportionment method under section 12-6-2320, our supreme court has held that the Department bears the burden of proving the need to use an alternative method. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. There are two steps in this process: the Department must prove (1) that the statutory formula does not fairly represent TSC's business activity in South Carolina and (2) that the proposed alternative formula is reasonable. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200.

TSC is Part of a Unitary Business

As a preliminary matter, I find both factually and legally that TSC, Texas, and Michigan are a unitary business. As the U.S. Supreme Court has recognized, there is no uniform set of facts that will always define a unitary business. *See Allied-Signal, Inc.*, 504 U.S. at 785 ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach . . . and also because the constitutional test is quite fact sensitive." (internal quotation marks and citation omitted)). Nevertheless, it has held that "where the asset in question is another business," the "hallmarks" of a unitary business are "functional integration, centralized management, and economies of scale." *MeadWestvaco Corp.*, 553 U.S. at 30. South Carolina has adopted similar hallmarks of a unitary group, including "unity of management, ownership, and control of operations resulting in unquantifiable flows of value among the related entities of the business." *Media General*, 388 S.C. at 141, 694 S.E.2d at 526 (2010); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 602, 258 S.E.2d 93, 97 (1979) ("The corporation possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of E & P, refining and marketing all contributed to and depended upon each other.").

The three hallmarks recognized by South Carolina align with the definitions to which the parties' witnesses testified. According to Mr. Sehgal, the three subjective tests for determining whether a business is unitary are the (1) unity of operations; (2) unity of use (or centralized management); and (3) contribution and dependency (functional integration). TSC, Texas, and Michigan meet each of three definitions for a unitary business. In fact, Mr. Small, Petitioner's witness, testified that TSC, Texas, and Michigan have the characteristics of a unitary group as commonly understood within the accounting field, including centralized management, functional integration, and common control of the entities. I therefore conclude the TSC, Texas, and Michigan are a unitary business under each of the three tests.

Specifically, under unity of operations, the Group shares a significant amount of operations; specifically, TSC provides accounting, legal, marketing, payroll, and other back-office support to Texas and Michigan. Additionally, through TSC providing these uniform functions across the Group and Texas providing procurement across the Group, the entire Group benefits from economies of scale.

Next, TSC, Texas, and Michigan have centralized management. The entire C-suite of executives is located in TSC, TSC's executives signed the intercompany agreements on behalf of Texas and Michigan, and Texas's Chief Merchandising Officer is a TSC executive. This shows overlapping, common, centralized management.

Lastly, TSC, Texas, and Michigan are very dependent upon each other to function as a result of the intercompany agreements. TSC relies on Texas for procurement, product development, and IP licensing. Texas and Michigan rely on TSC for management, accounting (including centralized payment), legal, and other back-office support activities, and Michigan relies on TSC and Texas for all aspects of its operation, including its employees. None of the three entities could function on their own.

Thus, based upon the highly integrated and dependent nature of the companies and their centralized management and control, I find TSC, Texas, and Michigan meet the definition of a unitary business.

Business Activity in South Carolina

Subsection 12-6-2320(A) requires the Department to show the extent of TSC's "business activity" in South Carolina is not fairly represented by standard apportionment pursuant to separate entity reporting. "Business activity" is not defined for the purposes of subsection 12-6-2320(A).

However, it is not so hard to discern in this case and it is readily admitted by Petitioner. Petitioner proclaims itself to be a retailer whose business activity in South Carolina is measured by its retail sales in South Carolina Nevertheless, Petitioner argues the Department cannot meet its burden in this case because "neither the Audit Report, the Determination, the Prehearing Statement, the Amended Prehearing Statement, nor any Department witness at the trial of this case attempted to address, measure, or otherwise quantify the extent of [Petitioner's] business activity in this state as the statute requires." I disagree.

In its Department Determination, the Department found TSC's business activity was not being fairly represented by separate entity reporting because TSC was utilizing intercompany transactions to shift income from its retail sales to Texas, thereby significantly reducing its South Carolina taxable income. While the Department may not have specifically stated that TSC's business activity in the state is represented by the income from its South Carolina retail sales, that finding is implicit throughout its Determination. And, while in some cases income may not reflect business activity, here, where 99% of TSC's income, and indeed the Group's income, comes from retail sales, I find that it does.[58] Furthermore, the evidence at the de novo hearing before this Court established that Petitioner's business activity in South Carolina is retail sales.[59] Moreover, the evidence introduced at the hearing quantified the retail sales and their relationship to income shifting in this case. For instance, Dr. DeRamus quantified TSC's sales and taxable income, its South Carolina sales, and the change in income reported by TSC before and after the intercompany transaction between TSC and Texas shifted the income from the sales from TSC to Texas. Therefore, I find the Department identified Petitioner's business activity in South Carolina as its retail sales.

Fairly Represented—Distortion

At what threshold does a method of apportionment stop fairly reflecting the extent of a taxpayer's business in a state? Pursuant to *Container Corp.*, a standard apportionment method offends the Constitution when it is shown by "clear and cogent evidence" that the apportioned

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[58] *Cf. Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1042–43 (1985) ("It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.").

[59] As noted above, Petitioner readily admits its business activity in this state is retail sales and this was a de novo hearing; therefore, the Court is mystified by Petitioner's continued pursuit of this issue.

income is "out of all appropriate proportion to the business" transacted in the state or "has led to a grossly distorted result." 463 U.S. at 169-70. While this constitutional threshold applies in all cases in which a party challenges the constitutionality of a state's method of apportionment, South Carolina has not inversely adopted it as its minimum threshold to establish unfairness in determining whether to utilize an alternative method apportionment. Furthermore, while South Carolina's alternative method apportionment codified in section 12-6-2320 is very similar to Section 18 of UDIPTA, South Carolina has not adopted UDIPTA. Thus, South Carolina is not bound by any commentary or construction of Section 18.

Although the ALC must determine the proper criteria for determining when separate entity reporting does not fairly represent a taxpayer's business activity in South Carolina, it is helpful to consider the analysis utilized by the Department. In Revenue Ruling #15-5, which sets forth the Department's policy on the application of alternative apportionment methods, the Department specifically notes that while some applications of alternative apportionment may involve "unusual or unique circumstances,"[60] it will not require such circumstances to be shown to apply alternative apportionment. S.C. Revenue Ruling #15-5 at 4. Rather, the Department's inquiry is focused on the statutory language of section 12-6-2320, which simply requires the party seeking an alternative method to "factually identify why the use of the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina." *Id.* I find the Department's interpretation to be reasonable and decline to impose any more stringent standard than the statutory language itself imposes.[61] *Kiawah Dev. Partners, II v. S.C. Dep't of Health & Env't Control*, 411 S.C. 16, 34, 766 S.E.2d 707, 718 (2014) ("[W]here an agency charged with administering a statute or regulation has interpreted the statute or regulation, courts, including the ALC, will defer to the agency's interpretation absent compelling reasons.").

Furthermore, in Revenue Ruling #15-5, the Department outlined "[s]ome of the facts" it may consider when determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina. Revenue Ruling #15-5 at 6. Those facts include:

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[60] This is most certainly in reference to Professor Pierce's widely quoted comment that UDIPTA Section 18 should be used to handle "the unusual cases." *Twentieth Century-Fox Film Corp.*, 299 Or. at 227, 700 P.2d at 1039 (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957) (emphasis added)).

[61] *Media General* did not adopt a standard because the parties in that case stipulated that separate entity apportionment created distortion and did not fairly represent the taxpayers' business activity in the state. *Media General*, 388 S.C. at 143, 694 S.E.2d at 527.

(1) amounts paid to related parties for good and services or goods and services provided without payment;

(2) profit margins associated with business activities;

(3) capital investments associated with business activities;

(4) whether goods and services are provided to both related and unrelated parties on similar terms;

(5) whether taxpayers in similar industries provide similar good and services to unrelated parties under similar terms; and

(6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other issues, the relinquishment of control over the business activity.

Revenue Ruling #15-5 at 6-7.

The Department also comments that a 482 transfer pricing study to support prices between related entities "is not determinative of whether South Carolina's statutory apportionment formula fairly represents the taxpayer's business activities in South Carolina." Revenue Ruling #15-5 at 7. It further states that it has required or approved combined unitary reporting "in situations involving the use of purchasing companies, management fee companies, and 'east/west' companies within a unitary group." Revenue Ruling #15-5 at 7 (footnotes omitted).

In addition to the guidance provided by the Department in Revenue Ruling #15-5, our supreme court has commented on the type of evidence that may satisfy (or not satisfy) the statutory threshold. In *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, the South Carolina Supreme Court found the evidence offered by the Department did not meet its burden to show the statutory formula did not fairly represent CarMax West's business activity in South Carolina. 411 S.C. 79, 90–91, 767 S.E.2d 195, 201 (2014). The insufficient evidence cited by the supreme court included (1) testimony from the Department's auditor that the "business structure of CarMax West and CBS is often 'linked with tax minimization strategies,'" (2) "the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East" in support of the Department's "determination that CarMax West's income was diluted," and (3) "bald assertions by [the Department's] witnesses that it satisfied this threshold question." *Id.* at 90-91, 767 S.E.2d at 201.

The South Carolina Court of Appeals likewise found the Department failed to meet its burden in *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). The court of appeals rejected the following Department

testimony as insufficient to show the statutory formula did not fairly represent Rent-A-Center's business activity in South Carolina: (1) Rent–A–Center was comprised of multiple entities and the Department auditor believed a management services fee was too high and (2) the Department expert indicated excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina" and "using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator." *Id.* The court of appeals specifically noted that the Department's auditor "did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities." *Id.*

Based upon these two cases, it is clear the Department must provide specific evidence supporting its assertion that separate entity reporting does not fairly reflect TSC's business activity in South Carolina. *See Carmax Auto Superstores W. Coast, Inc.*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. In other words, the Department cannot rely on business characteristics or business structures that "may" indicate a tax minimization scheme, bald assertions of unfairness or distortion, or a contention that standard apportionment results in less tax to this state. *See id.* Nevertheless, I find that the facts listed in Revenue Ruling #15-5 provide good guidance for determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina.

TSC's Business Activity in South Carolina is Not Fairly Represented

I conclude the Department has shown that TSC's business activity is not fairly represented under separate reporting. Specifically, it is not fairly represented under separate reporting because separate reporting allows the Group's business structure to dilute TSC's income and business activity in South Carolina by shifting income under the Procurement Agreement.

In coming to this conclusion, I first evaluate TSC's business activity in the context of a unitary business. As described in this Order, TSC, Texas, and Michigan were a unitary business during the audit years. They engaged in several intercompany transactions for services they provided to each other. These transactions shifted income between the companies, and, while this type of business structure is not inherently problematic, it can be used to disproportionately transfer income from one company to another in a manner that distorts the companies' respective incomes. Accordingly, individually examining TSC without relation to its unitary partners would not capture the "largely unquantifiable transfers of value that take place among the components of a single

enterprise." *Allied-Signal, Inc.*, 504 U.S. at 783 (internal quotation marks omitted); *see also Media General*, 388 S.C. at 141, 694 S.E.2d at 526 ("Unitary groups generally share a unity of management, ownership, and control of operations resulting in unquantifiable flows of value among the related entities of the business"). In this case, the transactions that predominantly shifted income between the companies were the transactions under the Procurement Agreement. Through the 9.7% markup on inventory (transfer price) implemented by the Procurement Agreement, almost 67% of TSC's income from its retail sales was shifted to Texas, a portion of which represents income shifted from TSC's South Carolina retail sales to Texas.

The expert opinion presented by Dr. DeRamus established that the shift in income from TSC to Texas through the Procurement Agreement resulted in a distortion of TSC's income, which also resulted in an unfair representation of TSC's business activity in South Carolina. Specifically, since TSC's business activity in South Carolina was its retail sales, and 99% of the Group's income was derived from retail sales, then income from retail sales is a proxy for business activity. Accordingly, a substantial shift in income from retail sales from TSC to Texas shows that TSC's business activity, including its business activity in South Carolina, was being substantially diluted by income shifting under the Procurement Agreement. Moreover, as I explain in the next section, separate reporting does not correct this shift, which means TSC's net taxable income and taxable base were diluted as well.

For instance, Dr. DeRamus used the Group's trial balances to show that from 2014-2016, TSC had income (almost exclusively from retail sales) of approximately $400-500 million per year while Texas and Michigan had income of approximately $100 million per year or less. After the transfer pricing was applied pursuant to the Procurement Agreement, TSC's taxable income dropped to a little over $100 million per year, Michigan's dropped to a negligible amount, and Texas's shot up to $400 million per year. Similarly, over the audit years, TSC's South Carolina stores had retail sales of approximately $135 million to $160 million on an annual basis, but only about $4 million to $5 million was apportioned to South Carolina as taxable income after transfer pricing was implemented. Although retail sales are not quite equivalent to taxable income, these revenue differences reflect a substantial reduction in income sourced to South Carolina.[62] Thus,

[62] The Court recognizes that retail income will be larger than taxable income. The Court was not presented with evidence detailing taxable income for South Carolina before and after transfer pricing was applied. While such a comparison may be useful, it was not necessary in this case to demonstrate the effect of income shifting in South Carolina. The alterations and deductions that take place to convert gross income from retail sales to taxable income

after transfer pricing, Texas, on average, accumulated about 71% of the entities' taxable income across the audit years even though TSC had approximately 80% of the retail sales. Moreover, Dr. DeRamus's testimony demonstrated that Texas's costs for its procurement functions were around $13 million, yet it was earning between $350-400 million for its procurement service. The enormous shift in income from TSC to Texas despite TSC having 80% of the Group's sales, and Texas's disproportionate earnings for its procurement function related to its costs, showed that TSC's income was being distorted.[63]

The Department also presented evidence that established the distortion caused by the income shifting under the Procurement Agreement was not justified. In response to the evidence that the Group's intercompany transactions, including the 9.7% markup under the Procurement Agreement, were not justified, Petitioner produced the PwC transfer pricing study. Petitioner argued that this study showed that the 9.7% markup did not disproportionately shift income in a way that distorted TSC's business activity; rather, the markup reflected the value of an arm's length transaction between the parties. However, Dr. DeRamus persuasively opined that the PwC transfer pricing study was unreliable. Indeed, **both parties'** experts concluded the PwC report was unreliable. Therefore, I do not find the PwC report supports Petitioner's contention that its 9.7% markup on inventory represented and arm's length transaction during the audit years.

Next, while the Department has the burden to show separate reporting does not fairly represent TSC's business activity, Petitioner cannot simply rest upon its allegations or denials once the Department has met its burden. Indeed, to further support its 9.7% markup as an arm's length price, Petitioner presented Dr. Andrade's transfer pricing study. Nevertheless, I concluded his opinion was not persuasive and, thus, that evidence did not support the 9.7% markup. For instance, the evidence did not support Dr. Andrade's 50/50 residual profit split. *See Eli Lilly & Co. v. United*

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are not so great as to amount to over $100 million to explain the discrepancy between the amount of South Carolina retail sales income and the amount of South Carolina taxable income, particularly in the context of the evidence in this case. Therefore, the difference between the retail income and taxable income in South Carolina is a reasonable demonstration of how the income shifting is taking place as it relates to South Carolina.

[63] Petitioner claims the Department provided no evidence to show its procurement charge failed to meet the arm's length standard. Petitioner's argument presupposes that the only way to show distortion is through expert testimony demonstrating the range of appropriate arm's length transfer prices under the 482 Regulations. However, evidence of reasonable and unreasonable transfer prices under the 482 Regulations is only one type of relevant evidence the Court can consider. For example, the above paragraph discusses evidence of distortion that is demonstrated by the disproportionality of revenue to taxable income. This evidence was presented by a transfer pricing expert and is persuasive evidence without an analysis of whether the transfer price under the procurement agreement falls within the arm's length standard under the 482 Regulations.

States, 372 F.2d 990, 997 (Ct. Cl. 1967) ("[H]ere is some merit to Eli Lilly's complaint in this respect, for it is apparent that a taxpayer subjected to a section 482 allocation will be severely handicapped in opposing any method of allocation where it contains a subjective element such as merely cutting a computed percentage as figure in half.").[64]

In the absence of a reliable transfer pricing study to support the 9.7% markup and the income shift from TSC to Texas, I examined whether other evidence presented in this case explained the distortion in TSC's income. I found it did not. Petitioner, through Dr. Andrade, attempted to argue that Tractor Supply Group, and in particular Texas, is so exceptional at procurement and product development that the 9.7% markup is reasonable to compensate Texas for this valuable function. I do not find this to be correct.[65] Tractor Supply Group represents itself as a retailer and it defines its business activity as retail sales, not procurement services. If this is true, it should earn most of its income from retail sales, not procurement. I found Dr. DeRamus's testimony concerning what drives Tractor Supply Group's healthy profitability to be more persuasive. Specifically, I find the Group's value is generated from its retail sales, and it benefits from stores that are positioned geographically in markets in which the Group has little competition, and which focus on supplying CUE items, like animal feed, that customers will need to repurchase frequently, in bulk, with cash. As Dr. DeRamus explained, if the procurement function's product selection was driving sales, then it would be expected that the Group's online sales would be substantial. However, online sales are a relatively small portion of the Group's sales; rather, the majority of the Group's sales take place at its brick-and-mortar retail stores. Because retail sales are the primary driver of income and value in the company, I find that it is unreasonable for TSC to agree to transfer so much of its income to Texas for the procurement service, particularly when TSC was previously performing this function successfully itself.

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[64] Petitioner argues that "nothing in the 482 regulations requires that a taxpayer have a transfer pricing study to support the price used for an intercompany transaction." Petitioner's argument implicitly presumes this Court required Petitioner to have a transfer pricing study to support the price it used. But here, the Court did not require a transfer pricing study from Petitioner. Instead, Petitioner offered its transfer pricing study, as a defense, to support its assertion that its intercompany transactions were conducted at arm's length prices. Quizzically, Petitioner also argues this Court cannot determine a transfer price is incorrect without an expert in section 482 completing a transfer study to show what the range of reasonable transfer prices would be. Thus, it is unclear whether Petitioner would have this Court utilize a transfer pricing study or not. Regardless, this Court finds that a transfer pricing study is relevant evidence as to whether a transfer price is a reasonable, arm's length price, but it is not the only relevant evidence as to whether a taxpayer's business in this state is fairly represented.

[65] That does not mean that Tractor Supply Group, and in particular Texas, is not very good at procuring products for its stores.

Therefore, the persuasive and reliable evidence before the Court indicates that an unreasonably large portion of TSC's South Carolina income is being shifted, unjustifiably, from TSC, an entity subject to South Carolina tax, to Texas, an entity that is not subject to South Carolina tax. Because income is a proxy for retail sales in this case, this shift is distorting TSC's business activity in this state.

Separate Reporting Does Not Fairly Reflect TSC's Business Activity in this State

Because separate reporting looks at each South Carolina taxpayer myopically, regardless of whether the taxpayer is part of a unitary business, separate reporting does not correct for income shifting between unitary businesses that unreasonably or inequitably distorts a taxpayer's income. Rather, to ensure an accurate reflection of tax where a unitary business is concerned, separate reporting relies on intercompany transactions being fairly priced at arm's length among the companies. In this case, the evidence established that the transfer price under the Procurement Agreement resulted in the unfair representation of TSC's business activity in this state during the audit years. The separate reporting utilized by TSC did not correct for this defect and, in fact, facilitated the unfair representation of income. Thus, separate reporting did not fairly represent TSC's business activity in this state during the audit years.

Petitioner nonetheless contends it is the transfer price, and not separate reporting, that is causing the distortion of TSC's business activity in this state. Petitioner interprets subsection 12-6-2320(A)(4) to only authorize an alternative apportionment method, like combined unitary reporting, when separate reporting ***causes or creates*** the unfair representation in business activity, in contrast to the ***application of*** separate reporting resulting in an unfair representation. Petitioner further contends that if the cause of the unfair representation is a flawed transfer price, then the solution is to fix the transfer price rather than impose combined unitary reporting under subsection 12-6-2320(A)(4).

The language of subsection 12-6-2320(A)(4) is not as specific as Petitioner interprets it to be. It provides that "[i]f the allocation and apportionment provisions of this chapter ***do not*** fairly represent the extent of the taxpayer's business activity in this State, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable: . . . (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (emphasis added). In particular, the statutory language does not require that the "allocation and apportionment provisions of this chapter" ***create or cause*** the unfair

representation of the taxpayer's business activity. *Id.* Rather, the statute merely says that if the "allocation and apportionment provisions of this chapter ***do not*** fairly represent . . . ." *Id.* (emphasis added). Therefore, the plain language of our statute does not support Petitioner's narrow interpretation that infers causation; rather, it is sufficient that application of the allocation and apportionment provisions result in an unfair representation. *See Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) ("Where the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning.").

In this case, I find the application of separate entity reporting resulted in the taxpayer's business activity being unfairly represented in this state. Importantly, I do not find that the corporate structure of the Group, the unitary nature of the Group, or the presence of intercompany transactions, on their own, indicate that TSC's business activity was not being fairly represented under separate reporting. *See Carmax*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. Indeed, if the transfer price/inventory markup were reasonable and supported by a reliable transfer pricing study, and the payment from TSC to Texas was more aligned with Texas's procurement costs, I would conclude that separate reporting resulted in a fair representation of TSC's business activity in this state. However, the transfer price, which is causing the distortion in this case, is a product of Petitioner's business structure and intercompany transactions; therefore, I cannot completely ignore the fact that the underlying corporate structure created an environment in which the transfer price was used to shift income. And here, the unreasonable transfer price allowed Petitioner to take advantage of separate reporting to substantially lower its tax burden in South Carolina by shifting income from TSC to Texas. Accordingly, the application of separate entity reporting during the audit years resulted in a taxable base that did not fairly reflect TSC's business activity in South Carolina. *See* § 12-6-2320(A); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State.").

Despite its responsibility in creating this dilemma, Petitioner maintains that if the transfer price is the issue, the Department must use its authority under the 482 Regulations to fix the unreasonable transfer price rather than resort to combined unitary reporting under subsection 12-

6-2320. As I have explained above, I do not agree with Petitioner's narrow interpretation of subsection 12-6-2320. Once the Department met its burden to show separate reporting does not fairly reflect Petitioner's business activity under subsection 12-6-2320; I do not find the Department had a further burden to produce a correct transfer price.[66] In this case, the Department had the discretion to either utilize 482 Regulations to correct the transfer price or to utilize subsection 12-6-2320(A)(4) to adopt an alternative apportionment method that more fairly represented Petitioner's business activity in South Carolina.[67] Moreover, Petitioner had the opportunity to produce a reasonable transfer price to utilize under separate reporting but did not. Specifically, Dr. Andrade's transfer pricing study was flawed and unreliable and did not produce a reliable and accurate transfer price to use to fix the artificial shift of income from TSC to Texas.[68]

Furthermore, although South Carolina's legislature has determined South Carolina is a separate reporting state, and separate reporting is the default reporting method used to apportion income to South Carolina, the relief under section 12-6-2320 is also an expression of the legislature's will and is applicable here. *See Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89–90, 767 S.E.2d 195, 200 (2014); *citing with approval Donald M. Drake Co. v. Dep't of Revenue*, 263 Or. 26, 500 P.2d 1041, 1044 (1972) (holding "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof). In fact, "[t]t is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme."" *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 809, 109 S.Ct. 1500 (1989). ; *see also*, *Pres. Soc'y of Charleston v. S.C. Dep't of Health & Env't Control*, 430 S.C. 200, 212, 845 S.E.2d 481, 487 (2020) ("Courts should consider not merely the language of the

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[66] Although the Department has the authority and power to challenge transfer prices under the § 482 Regulations, its employees do not have the training, capacity, or resources to evaluate transfer prices in an expert manner and must rely on other indicators of distortion prior to hiring a transfer pricing expert during litigation. These internal challenges do not excuse the Department from exercising its authority; however, I do not find that our statutory scheme requires the Department to utilize its § 482 powers instead of resorting to subsection 12-6-2320(A)(4) for relief.

[67] Petitioner claims the Department failed to follow its own guidance in Revenue Ruling 15-5 by failing to utilize its section 482 powers because Revenue Ruling 15-5 requires the Department to tailor the alternative method to the problem. *See* Revenue Ruling 15-5 at 5. However, the part of Revenue Ruling cited by Petitioner actually addresses how to select an alternative method under subsection 12-6-2320(A) whereas Petitioner is arguing the Department should have never reached the point of selecting an alternative method under subsection 12-6-2320(A). Therefore, Petitioner's argument does not support its position.

[68] Similarly, Dr. DeRamus did not conduct a comprehensive transfer pricing study in which he came up with a reliable transfer price or markup on inventory for the Procurement Agreement.

particular clause being construed, but the undefined word and its meaning in conjunction with the whole purpose of the statute and the policy of the law.").

Additionally, the case before the Court is very fact-driven, and it is not one that is likely to re-occur if a unitary company reasonably set forth its transfer prices. One would hope, at least, that the use of an unreliable transfer price is categorized as unusual. However, in this case, it is clear TSC is more than benignly taking advantage of a corporate structure and South Carolina's default reporting method—it is using a transfer price/markup on inventory to misrepresent its business activity in South Carolina and lower its tax burden without a reasonable and reliable justification from a transfer pricing or economic perspective. Thus, my finding in this case that separate reporting does not fairly represent TSC's business activity in this state is unlikely to unleash a torrent of alternative apportionment cases in this state and thus allow the exception to swallow the rule.[69] Next, I must determine whether the use combined unitary reporting as an alternative apportionment method for the audit period was "reasonable" and resulted in the "equitable allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4); *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 (holding the Department must prove that the proposed alternative formula is reasonable). I find that it did.

Is the Combined Unitary Reporting Method a Reasonable and Equitable Alternative Appointment Method?

I conclude combined unitary reporting is a reasonable and equitable alternative method of apportionment under subsection 12-6-2320(A)(4) because it (1) corrects the income shift from TSC to Texas as a result of the Procurement Agreement such that (2) it reasonably and equitably approximates the taxable net income attributable to TSC's business activity in South Carolina.

Pursuant to subsection 12-6-2320(A), "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if **reasonable** . . . (4) the employment of any other method to

[69] Similarly, I do not find that this outcome will negatively impact South Carolina taxpayer's interest in being able to rely on how the Department applies subsection 12-6-2320. Indeed, taxpayers are already on notice of the Department's position pursuant to Revenue Ruling 15-5 and my decision does not deviate from the interpretation of subsection 12-6-2320 expressed in that Ruling in any meaningful way.

effectuate an **equitable** allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4) (emphasis added).[70]

As noted in Revenue Ruling #15-5, the Oregon Supreme Court's discussion of "reasonableness" in *Twentieth Century-Fox Film Corporation v. Department of Revenue* offers insight into the determination of this issue. The court held:

> [R]easonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon.

299 Or. at 233–34, 700 P.2d at 1042–43.

Nevertheless, there is a notable distinction the Court must recognize. In Revenue Ruling #15-5, the Department correctly observes that the second element of the Oregon Supreme Court's test (the Oregon test) does not apply in South Carolina because South Carolina is not a UDIPTA jurisdiction. In addition, it is not reasonable to apply combined unitary reporting simply because a business is unitary in nature. *See Rent-A-Ctr. E., Inc.*, 42 N.E.3d at 1048–49 ("Regardless of a possibility of distortion, however, Indiana's AGIT statutory framework does not require a member of a unitary group to file a combined income tax return solely because there is a unitary relationship."). It is also not reasonable to impose combined unitary reporting because it will result in more tax than separate entity reporting. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."). Applying the statute and this guidance, I conclude the Department has met its burden to show the application of combined unitary reporting is reasonable and equitable.

First, combined unitary reporting fairly represents the business activity of TSC in South Carolina. The validity of that conclusion is reflected by comparing the results of combined unitary

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[70] The definitions of "reasonable" and "equitable" are very similar. Generally, "reasonable" means "fair, proper, or moderate under the circumstance," while "equitable" means "just; consistent with principles of justice and right." *See Reasonable,* Black's Law Dictionary (11th ed. 2019); *see also* Equitable Black's Law Dictionary (11th ed. 2019). Similarly, Merrium-Webster defines "equitable" as "dealing fairly and equally with all concerned" and "reasonable" as "moderate, fair." *See* http://www.merriam-webster.com/dictionary/equitable (last visited on August 31, 2023); *see also* http://www.merriam-webster.com/dictionary/reasonable (last visited on August 31, 2023).

reporting with separate reporting in the year 2014 where separate reporting is modified to correct the distortion created by the unreasonable transfer price. Specifically, if the transfer price is disregarded and separate reporting is applied, then TSC's taxable income reported to South Carolina in 2014 would have been, conservatively, approximately $400,000,000.[71] When this amount is modified by $17,478,426, TSC's South Carolina net taxable income would have been $417,478,426. The sales factor would have remained the same at 2.79%. Multiplying $417,478,426 by 0.0279% results in a taxable base of $11,647,648, five percent of which is $582,382. This number is close to the amount of tax the Department calculated for TSC in 2014 using combined unitary reporting, which was $649,486, especially when you consider that the above estimate is conservative. It makes sense that the numbers are close, but not exactly the same, based upon how combined unitary reporting is mathematically set up to eliminate intercompany transactions while still recognizing the value in those transactions.

Specifically, under combined unitary reporting, the net taxable income from the entire unitary group is applied to the sales factor ratio. This eliminates the effect of intercompany transactions while still recognizing the value shifting between companies (whereas the above estimate under separate entity reporting does not account for this value). As a result, the income that was shifted from TSC to Texas under the Procurement Agreement is returned to the net taxable income used to apportion income to this state. This does not merely correct the amount of taxable income for TSC, it adds in Texas's and Michigan's taxable income too, which is how the flow of values between the companies continues to be recognized. However, to compensate for this, the sales factor ratio is changed to align with the addition of the other members of the unitary group to the net taxable income. In this particular case, the numerator of the sales factor remains the same in either separate or combined reporting since only TSC has South Carolina sales, but the denominator changes to a larger number—the Group's sales everywhere—resulting in a smaller

[71] This $400,000,000 is based upon the elimination of the 9.7% inventory markup (transfer price) between TSC and Texas so that the shifted income is added back to TSC's net taxable income. In reality, the inventory markup would not be completely eliminated because some modest value would be attributed to Texas's services under the Procurement Agreement, but neither party established what transfer price/inventory markup would reflect that value. Therefore, while this estimate is reasonable for demonstrating how much the unreasonable transfer price affects the calculation of tax in this case, it is just that, an estimate. In other words, it does not carry sufficient specificity to justify using this approach as a means to modify the separate entity approach to resolve this case. Moreover, I emphasize that in using this estimate, the Court is not finding that Texas's procurement services are valued at $0; as mentioned above, the Court recognizes Texas's service provide value, but the evidence showed that value is more modest than a 9.7% markup on inventory.

sales factor ratio. Accordingly, the net taxable income is bigger under combined unitary reporting, but the sales factor ratio is smaller because the net taxable income and sales factor ratio are in proportion with each other. Because the net taxable income is in proportion to the sales factor, the result of combined reporting is a taxable base for the Group reasonably attributed to South Carolina retail sales. Moreover, because TSC is the only member of the Group to have South Carolina retail sales, the result is also a reasonable and equitable approximation of TSC's income attributable to South Carolina retail sales (its business activity). Even Petitioner's own witness, Professor Pomp, extolled the virtues of combined unitary reporting as a reasonable method and, in fact, a better method than separate reporting, for equitably apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

Moreover, if the differences between the tax calculations for TSC in 2014 are compared, it becomes apparent that not only is the tax calculated under combined unitary reporting reasonable, but it is much more reasonable and equitable than the result from separate entity reporting. Under the standard method of separate entity reporting, in 2014 TSC had $148,476,938 in South Carolina net taxable income. This amount was multiplied by a sales factor of 2.7%, which represents the amount of TSC's sales attributable to South Carolina, to arrive at a taxable base of $4,137,310. This resulted in a corporate income tax equal to $206,866. However, because TSC's South Carolina net taxable income was artificially diluted, TSC only paid taxes on approximately 1% of its net taxable income, even though 2.7% of its sales were attributable to South Carolina.[72] The difference in percent works out to be around $350,000 in tax.[73] Using combined reporting in 2014, TSC's income was not diluted because all of TSC's income was included in the Group's South Carolina net taxable income, and the taxable base was calculated based upon TSC having 2.28% of the Group's sales; therefore, TSC's taxable base was calculated to be 2.28% of the Group's net taxable income, or $12,989,725. This resulted in a corporate tax equal to $649,486, or a little over a $400,000 difference in tax compared to the corporate tax of $206,866 assessed in 2014. Because combined unitary reporting both corrects the distortion of the income shifting while also

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[72] TSC's taxable base of $4,137,310 in 2014 is approximately 1% of TSC's estimated corrected taxable income in 2014 of $417,478,426.

[73] When the estimated corrected net taxable income is utilized ($417,478,426), and the sales factor of 2.7% is applied, the resulting corporate tax is equal to approximately $563,600, or about a $350,000 difference compared to $206,866. Thus, although the change from 2.7% to 1% may seem small, it represents a 63% reduction in tax.

recognizing the value Texas (and TSC) contribute via the intercompany transactions, it is both reasonable and a more just (equitable) method of assessing tax in this case.

Nevertheless, Petitioner argues the use of combined unitary reporting is unreasonable and inequitable because it causes approximately 8.64% of the TSC's income to be taxed by South Carolina despite only 2.83% of its total business activity (sales) occurring in South Carolina. It argues this is distortion of approximately 205%, which means that TSC is paying 305% of the tax that it should pay based on its business activity here. It further argues that if all states uniformly applied combined unitary reporting to Tractor Supply like the Department has done here, the end result would cause Tractor Supply to pax tax on 305% of its income, not "no more or no less than 100% of the taxpayer's income" as required by the test for reasonableness under *Twentieth Century-Fox Film Corporation*.

However, Petitioner's calculation of this enormous 205% distortion relies on its theory that TSC's reported net taxable income of, for example, $130,998,512 in 2014 is correct and does not need to be adjusted. In other words, Petitioner is relying on the 9.7% markup as correct and not distorting TSC's net taxable income in South Carolina. If the 9.7% markup does not distort TSC's net taxable income, then Petitioner's contention that combined unitary reporting overtaxes TSC would be correct because the Department's taxable base that it calculated under combined entity reporting was $12,989,725, which is approximately 10% of $130,998,512. This would indicate that combined unitary reporting was taxing 10% of TSC's income and that 10% of TSC's sales were South Carolina retail sales when only 2.7% of its sales were South Carolina retail sales in 2014. Nevertheless, because Petitioner's argument is based on an unreasonable transfer price, its calculations are likewise unreasonable and unpersuasive.

Petitioner also argues combined unitary reporting is unreasonable and inequitable because it taxes income that is earned out of state by non-South Carolina taxpayers. It contends that for the tax years at issue, more than 73% of the income apportioned to South Carolina under the Department's use of combined unitary reporting is not TSC's income. Petitioner's argument again (1) relies on its premise that the 9.7% markup on inventory does not distort TSC's income and business activity in South Carolina, and (2) misinterprets the application of combined unitary reporting. Under combined unitary reporting, the unitary group's taxable income is used, which obviously includes the income of all group members, including members who have no nexus to South Carolina; however, the sales factor is adjusted to ensure that only the income attributable to

South Carolina, and those members with a nexus, is used to calculate the taxable base in South Carolina. Thus, Petitioner's argument that TSC is taxed for income generated outside of South Carolina is misplaced. Rather, combined unitary reporting captures the income that was generated in South Carolina but shifted to a different taxing jurisdiction, Texas.

Overall, I find Petitioner's arguments are not persuasive and that combined unitary reporting, by the very nature of how it is applied, reasonably carves out and fairly represents the income associated with TSC's business activity in this case: its South Carolina retail sales. Thus, combined unitary reporting does not distort the level of income and business activity that should be attributed to South Carolina and passes the first component of the Oregon test under Revenue Ruling #15-5. *See Twentieth Century-Fox Film Corp.*, 700 P.2d at 1043 (concluding that "reasonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon."). While no method of apportionment is perfect, I find that combined unitary reporting has the benefit of removing the unreliable transfer price(s) in this case while recognizing the value flowing between the Group and carving out only the income from retail sales associated with South Carolina (TSC's business activity). *See Media General*, 388 S.C. at 142, 694 S.E.2d at 527 ("One of the purposes of [combined entity apportionment] is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise."). My comparison of an estimated fix of the distortion using separate reporting supports this conclusion because it produced a tax that was very similar to the tax calculated by the Department under combined unitary reporting.

In fact, the Department's calculation of tax for TSC in 2014 under combined unitary reporting was only about 13% greater than the conservative estimate of tax under the corrected version of separate entity reporting.[74] This confirms that combined unitary reporting is a reasonable approximation for how much TSC would be taxed under separate entity reporting if the intercompany transaction between TSC and Texas was priced more modestly and reasonably. In

[74] $563,600 is approximately 87% of $649,486; stated differently, combined unitary reporting produced a tax that is 13% more than the estimated corrected tax in 2014 using separate reporting.

contrast, under the distorted version of separate entity reporting in 2014, TSC's calculated tax was only 37% of what I estimated (or a 63% decrease in tax).

Indeed, in *Container Corp.*, the U.S. Supreme Court noted that arriving at the correct amount tax for a unitary business through formulary apportionment is an imperfect undertaking, but a difference of 14% in two apportionment methods was not the kind of distortion that provoked it to reject an apportionment method:

> Of course, even the three-factor formula is necessarily imperfect. But we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant. Indeed, it would be difficult to come to such a conclusion on the basis of the figures in this case: for all of appellant's statistics showing allegedly enormous distortions caused by the three-factor formula, the tables we set out . . . reveal that the percentage increase in taxable income attributable to California between the methodology employed by appellant and the methodology employed by appellee comes to approximately 14%, a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.

463 U.S. at 183–84.

Finally, I conclude the division of income under combined unitary reporting reflects the economic reality of the business activity engaged in by TSC for the reasons stated above. *See Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. Indeed, as I have already stated, income is a proxy for retail sales in this case, which is TSC's business activity in South Carolina and combined unitary reporting reasonably carves out the income associated with TSC's retail sales in South Carolina, and thus fairly represents its business activity in this state. § 12-6-2320(A)(4). In sum, using combined unitary reporting as an alternative apportionment method in this case passes the reasonableness test from *Twentieth Century-Fox Film Corp.* 299 Or. 220, 700 P.2d 1035 (1985).

Because I find the Department has shown by a preponderance of the evidence that combined unitary reporting is reasonable and equitable, I find the Department had the authority to require TSC to file its taxes during the audit period using combined reporting pursuant to subsection 12-6-23209(A)(4).

Does the Application of Combined Unitary Reporting Violate the Administrative Procedures Act?

Petitioner argues the Department's use of combined unitary reporting against Tractor Supply violates the South Carolina Administrative Procedures Act (APA). In particular, Petitioner argues the Department's use of combined unitary reporting is so prevalent against a specific group of taxpayers—those the Department decides constitute a unitary business—that the Department issued Revenue Ruling #15-5, which sets forth numerous important policy decisions made by the Department on how it will implement its version of combined unitary reporting against taxpayers it decides constitute a unitary business. Petitioner contends that other states with alternative apportionment statutes have addressed analogous situations where the taxing agency intended for widespread use of a particular alternative apportionment method and those states found that the intended regular use was tantamount to rulemaking which cannot be done absent promulgating a regulation under the state's Administrative Procedure Act. *See, e.g., CBS Inc. v. Comptroller of the Treasury*, 319 Md. 687, 698, 575 A.2d 324, 330 (1990); *see also Metromedia, Inc. v. Dir., Div. of Tax'n*, 97 N.J. 313, 337-338, 478 A.2d 742, 754-755. (1984). In other words, Petitioner argues Revenue Ruling 15-5 should be promulgated as a regulation.

Pursuant to the APA, a "regulation" means "each agency statement of general public applicability that implements or prescribes law or policy or practice requirements of any agency. Policy guidance issued by an agency other than in a regulation does not have the force and effect of law." S.C. Code Ann. § 1-23-10(4) (2005). In *Home Health Service, Inc. v. South Carolina Tax Commission*, the South Carolina Supreme Court explained that determining an agency's statement amounts to a rule or a general policy statement depends upon whether the agency action establishes a "binding norm." *Home Health*, 312 S.C. 324, 328, 440 S.C.2d 375,378 (1994). The *Home Health* court cited to *Ryder Truck Lines, Inc. v. United States* to describe a "binding norm":

> The key inquiry, therefore, is the extent to which the challenged policy leaves the agency free to exercise its discretion to follow or not follow that general policy in an individual case, or on the other hand, whether the policy so fills out the statutory scheme that upon application one need only determine whether a given case is within the rule's criterion. As long as the agency remains free to consider the individual facts in the various cases that arise, then the agency action in question has not established a binding norm.

Ryder Truck Lines, 716 F.2d 1369, 1377 (11th Cir. 1983). Here, Revenue Ruling #15-5 is not a binding norm because the Department is free to exercise its discretion in applying the policy within it. *See id.*

Revenue #15-5 simply explains to the public the various factors and legal authority the Department will consider when evaluating, based on the facts of the case, whether an alternative apportionment method, like combined unitary reporting, is appropriate. Indeed, the determination of whether the method of calculation of a taxpayer's taxes fairly represents its business activity in this state is a factual determination, not a legal one requiring the promulgation of specific regulations. Under *Media General*, the South Carolina Supreme Court held that combined unitary reporting is allowed and sanctioned by the legislature under subsection 12-6-2320(A)(4). *Media General*, 388 S.C. at 151, 694 S.E.2d at 532. Therefore, in applying combined unitary apportionment in the appropriate factual situations, the Department is not legislating, it is applying the law.[75]

Finally, I do not find Petitioner established that the Department is using Revenue Ruling #15-5 to systematically target unitary businesses for combined unitary reporting without regard to the factual determination required to impose alternative apportionment. Rather, the Department's Revenue Ruling #15-5 informs taxpayers of its interpretation of subsection 12-6-2320(A) and how it applies to that highly fact-dependent statute.[76] Therefore, I do not find there "is a close question whether a pronouncement is a policy statement or regulation" such that "the [agency] should promulgate the ruling as a regulation in compliance with the APA." *Home Health*, 312 S.C. at 329, 440 S.E.2d at 378.

CONCLUSION

I conclude the Department has the authority to require combined unitary reporting under subsection 12-6-2320(A)(4). I further conclude that separate entity reporting does not fairly reflect Petitioner's business activity in this state during the audit years and the Department's decision to require combined unitary reporting was reasonable and equitable under subsection 12-6-2320(A)(4).

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[75] For this reason, I find Petitioner's citation to *Heyward v. South Carolina Tax Commission*, 240 S.C. 347, 126 S.E.2d 15 (1962) in support of its argument to be inapplicable and unpersuasive. *See Heyward*, 240 S.C. at 355-56, 126 S.E.2d at 20 ("The respondent was invested with rule-making power for the purpose of carrying out the legislative will expressed in statutory form; but it had no legal authority to enact new laws in the nature of regulations to satisfy its own theory as to the enforcement of the income tax laws of this State.").

[76] Moreover, I do not find the mere existence of Revenue Ruling #15-5 is evidence that combined unitary reporting is applied to all unitary businesses without the Department exercising discretion. This argument could be applied to invalidate any Revenue Ruling on the ground of improper legislating in which the Department presents its interpretation of the tax laws. Additionally, the Department's acknowledgement that a correct transfer price is not necessarily determinative in a case is not indicative that it does not exercise its discretion on a case-by-case basis.

ORDER

IT IS HEREBY ORDERED that the Department's application of an alternative apportionment method is upheld. TSC is required to use combined unitary reporting on its South Carolina corporate income tax returns for 2014-2016.

IT IS FURTHER ORDERED that TSC must pay, in full, the assessed tax of $1,383,064.00, and $221,938.45 in interest[77], with regard to its 2014 through 2016 South Carolina income tax and license fee obligations.

AND IT IS SO ORDERED.

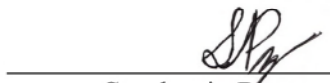
Ralph King Anderson, III
Chief Administrative Law Judge

December 4, 2023
Columbia, South Carolina

[77] Interest is accrued through December 12, 2019 (30 days from the date of the Department Determination). Pursuant to S.C. Code Ann. § 12-54-25(A), interest continues to accrue until the tax liability is paid in its entirety.

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

December 4, 2023
Columbia, South Carolina

EXHIBIT B

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Tractor Supply Company, Petitioner, v. South Carolina Department of Revenue, Respondent.	)	Docket No. 19-ALJ-17-0416-CC **ORDER ON MOTION FOR RECONSIDERATION**

This case is before the South Carolina Administrative Law Court (Court or ALC) pursuant to a Motion for Reconsideration (Motion) filed by Petitioner Tractor Supply Company (TSC) on August 18, 2023. Petitioner moves this Court pursuant to Rule 29(D) of the Rules of Procedures for the Administrative Law Court (SCALC Rules) and Rule 59(e) of the South Carolina Rules of Civil Procedure (SCRCP) to reconsider and amend its Final Order dated August 8, 2023. Petitioner contends this Court overlooked, misinterpreted, or failed to apply certain evidence and laws applicable in this case. On August 21, 2023, the Court rescinded its Final Order in consideration of Petitioner's Motion. On September 5, 2023, Respondent South Carolina Department of Revenue (Department) filed a Response to the Motion. After reviewing the Motion and Response, I grant the Motion for Reconsideration to amend my reasoning and issue an Amended Final Order. Nevertheless, after carefully considering the arguments made, I reach the same result overall.

Pursuant to SCALC Rule 29(D), a party may move for reconsideration of a final decision of this Court subject to the grounds for relief set forth in Rule 59, SCRCP. *See Elam v. S.C. Dep't of Transp.*, 361 S.C. 9, 21, 602 S.E.2d 772, 778 (2004) ("A motion under Rule 59(e) long has been viewed as 'motion for reconsideration' despite the absence of those words from the rule."). Petitioner moves this Court to reconsider its Final Order on the following seven grounds with attendant sub-issues:

1. The Court misinterpreted the AA statute [S.C. Code Ann. § 12-6-2320] in ruling that (A)(4) authorizes the use of CUR [Combined Unitary Reporting] in this case.
2. The Court's conclusion that "distortion" existed is incorrect and results from improper burden shifting and statutory interpretation as well as evidence being overlooked or misunderstood.

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3. The Court misinterpreted and misapplied the AA statute in finding that CUR is reasonable and equitable here.
4. The Court misunderstood certain facts, which led to erroneous factual findings and legal conclusions.
5. The Court appears to have ordered unrequested and improper relief in ordering TSC to use combined unitary reporting.
6. The Court misinterpreted S.C. Code Ann. § 12-6-2210(B) as support for the Department imposing CUR.
7. The Court erred in failing to conclude that the forced use of CUR violates the South Carolina Administrative Procedures Act (APA).

Ultimately, although review of Petitioner's grounds for this Motion caused me to rethink my reasoning on some issues in this case, I arrived at the same result. Therefore, although I grant the Motion and issue an Amended Final Order that better explains my application of the facts and the law in this case, I also briefly address in this Order the grounds of Petitioner's Motion that I found were without merit or were a reiteration of arguments made at the hearing. *See* CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2810.1 (2d ed. 1995) (observing that Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, but they "may not be used to relitigate old matters").

DISCUSSION

1. **Whether the AA statute [S.C. Code Ann. § 12-6-2320] authorizes the use of CUR in this case.**

    a. *Petitioner contends the Court should have applied the rules of statutory construction to the AA statute and applied that statute to the facts of this case and found that the forced use of combined unitary reporting is not authorized by § 12-6-2320(A)(4).*

The Court has addressed this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

    b. *Petitioner contends the Court erred in concluding that the supreme court in Media General*[1] *found combined unitary reporting was authorized by § 12-6-2320(A)(4).*

The Court does not find that it erred. Petitioner's Motion reiterates its argument that the terminology used by the supreme court in *Media General* is not "combined unitary reporting," but

[1] *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 694 S.E.2d 525 (2010).

rather "combined entity apportionment." Based upon this difference in terminology, Petitioner seeks to distinguish the method of apportionment approved of in *Media General* from the Department's imposition of combined unitary reporting in this case. To further support its assertions, Petitioner attached to its Motion the final brief of the Department that was filed in *Media General*. However, the Department's brief only further supports this Court's determination that when *Media General* is reviewed in the context of the ALC's original order, it is clear that the combined sales factor is applied against the combined net taxable income of the related entities (the unitary group) and not against a single taxpayer's net taxable income. *See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC at 26 n.39 (S.C. Admin. Ct. May 4, 2009). In fact, in its brief, the Department explained that "combined reporting seeks to apportion the entire unitary income of a business enterprise among the various states where it operates." Brief for Appellant at 20, *Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC (S.C. Admin. Ct. May 4, 2009). It further explained, in detail, the steps that are used in determining corporate income tax owed by a unitary group under combined entity apportionment, which were:

> a. Determine net taxable income of the unitary group taking into consideration corporate eliminations to arrive at taxable income;
>
> b. Determine apportionment formula: unitary entities' gross receipts from within the
>
> taxing state as compared to unitary entities' gross receipts from everywhere;
>
> c. Apply this ratio to net taxable income of the unitary group to arrive at the S.C. net
>
> taxable income;
>
> d. Multiply SC net taxable income by 5% corporate income tax.

Id.

Thus, a complete reading of the ALC's opinion, including the Department's final brief, leaves no doubt that when the ALC discussed "combined entity apportionment," it was referring to "combined unitary reporting," and the two linguistic formulations of this "method" are

interchangeable. Moreover, the South Carolina Supreme Court affirmed the ALC's order *without modification*. *See Media General*, 388 S.C. 138, 694 S.E.2d 525.

c. Petitioner contends the Court's ruling may be the first to allow a uniform statute enacted more than sixty years ago to serve as authority for the forced use of combined unitary reporting the way the Department has done in this case.

Petitioner asserts it cannot find any existing case law where a court has authorized a statute modeled after Section 18 of UDIPTA (like South Carolina's "AA statute") to authorize a state department of revenue to impose combined unitary reporting. More specifically, Petitioner claims the Court cited to two cases in its Final Order that do not actually support the proposition that other states "have found that combined reporting was authorized under Section 18." The two cases to which Petitioner refers are *Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996), and *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). The Court disagrees. These two cases support the proposition that "[s]everal states that adopted UDIPTA found that combined reporting was authorized under Section 18." Notably, Petitioner admitted in its Motion that in *Leathers*, "[t]he court, in *dicta*, said the state's statute modeled after Section 18 gave the taxing authority the **discretionary power to accept or require combined reporting**." *Id.* at 865, 935 S.W.2d at 256 (emphasis added). Furthermore, although the court in *Sears* ultimately found against the taxpayers, it nonetheless discussed combined reporting and determined that appellate cases in its state decided that "combined reporting **could be used** in appropriate circumstances." *Sears*, 561 A.2d 172, 174. Thus, this argument is without merit.

Petitioner also argues that an Indiana case, *Columbia Sportswear USA Corp. v. Indiana Department of State Revenue*, 45 N.E.3d 888, 896 (Ind. T.C. 2015), supports a finding that our appellate courts would interpret South Carolina's AA Statute in the same way that Indiana has to conclude our AA Statute does not allow the Department to impose combined unitary reporting. In addition to this case having no precedential value in South Carolina, it is distinguishable from the case at bar because the South Carolina Supreme Court, in its decision in *Media General*, has interpreted our AA Statute to allow combined unitary reporting. *See Media General*, 388 S.C. 138, 694 S.E.2d 525 (2010).

d. Petitioner contends the Court erred in concluding an incorrect transfer price is evidence that supports the finding that TSC's business activity is not fairly represented within the meaning of the AA statute.

The Court has addressed this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

e. *Petitioner contends the Court's conclusion that an incorrect transfer price is evidence that TSC's business activity is not fairly represented in South Carolina is contrary to the Department's own guidance and would make South Carolina an outlier and negatively impact the business community and corporate taxpayer's reliance interests.*

As explained in the Amended Final Order, I do not find my ruling is contrary to the Department's guidance in Revenue Ruling #15-5. Additionally, Petitioner argues that the Court's conclusion would "negatively impact the business community." However, Petitioner's own expert testified that combined reporting is good tax policy and an "effective method for fairly apportioning the tax base of the corporate income tax and for combating certain forms of aggressive tax avoidance."

2. **Whether the Court's conclusion that "distortion" existed is incorrect and results from improper shifting of burden of proof as well as evidence being overlooked or misunderstood.**

a. *Petitioner contends the Court incorrectly placed the burden of proof on TSC.*

I do not find the Court erred in this regard. The Court clearly stated in its Final Order that the Department bore the burden of proving the need to use an alternative apportionment method under section 12-6-2320 of the South Carolina Code.

b. *Petitioner contends the Department presented zero evidence to meet its burden to show by a preponderance of the evidence that the procurement charge failed to meet the arm's length standard.*

I disagree and do not find the Court erred or overlooked or misunderstood evidence.

c. *Petitioner contends that despite correctly finding that the Department presented zero evidence to meet its burden to show that the procurement charge failed to meet the arm's length standard, the Court improperly failed to dismiss the assessment and instead improperly shifted the burden of proof to TSC and improperly engaged in its own analysis of whether the procurement charge met the arm's length standard.*

I do not find that the Court erred. It appears Petitioner believes it had no obligation to introduce any evidence to support its claim that its procurement charge met the arm's length standard. However, even a party without the ultimate burden of proof must still offer evidence to substantiate its positions and assertions—particularly where those positions and assertions are raised as a defense, and the party with the burden of proof established its positions and assertions. RANDOLPH R. LOWELL, *The Contested Case Before the ALC, in* SOUTH CAROLINA ADMINISTRATIVE PRACTICE & PROCEDURE 191, 192 (Randolph R. Lowell ed., 2013).; 29 Am. Jur. 2d *Evidence* § 168.

Indeed, here, the Department asserted that Petitioner's business activity in South Carolina was not fairly represented using the standard reporting method. In response, Petitioner claimed these intercompany transactions were reasonable and arm's length transactions—and therefore not evidence of distortion—because they were based on a "competent IRC 482 transfer pricing study" (the PwC study). At the hearing, the Department presented compelling evidence that the intercompany transactions failed to meet the arm's length standard and did not fairly represent Petitioner's business activity in South Carolina, in part because of the way Petitioner utilized intercompany transactions to artificially shift income away from South Carolina. Importantly, Petitioner's own expert agreed that the PwC study used to support its assertion that its intercompany transactions were reasonable and indicative arm's length transactions was flawed. At that point, Petitioner had the burden, or the necessity, to provide evidence to rebut the fact that the Department established its case. Nevertheless, it failed to do so. Thus, the Court did not improperly shift the burden of proof.

Petitioner also contends this Court could not engage in an analysis of the transfer pricing evidence because only a transfer pricing expert can determine whether the arm's length standard was met. The Court agrees that, in this case, expert testimony was necessary to support an evidentiary finding that the transfer pricing was or was not comparable to an arm's length transaction. Yet, contrary to Petitioner's assertion, this Court **did** rely upon expert testimony in its analysis of whether the transfer pricing reflected an arm's length transaction in this case. Moreover, as I explain in the Amended Final Order, Petitioner's argument misses the forest for the trees. While a transfer pricing expert's opinion is, indeed, relevant and persuasive evidence regarding the transfer price used in a case like this, the ultimate question is whether the Department met its burden to show Petitioner's **business activity in this state was not being fairly represented by separate entity reporting**. Such a finding does not **require** a transfer pricing expert's opinion under the 482 Regulations, and a transfer pricing study, though relevant, is not necessarily determinative.

d. Petitioner contends that although it did not have the burden of proof, it provided the Court with an arm's length range of prices for the procurement charge, the Department did not rebut this evidence, and the Court misunderstood the evidence and improperly rejected it.

I did not find that Petitioner provided the Court with a reliable range of arm's length prices. Therefore, I do not find the Court erred, misunderstood evidence or improperly rejected evidence.

3. **Whether the Court misinterpreted and misapplied the AA statute in finding that CUR is reasonable and equitable here.**

    a. *Petitioner contends the Court ignored the heightened standard when (A)(4) is being used, namely, that it must be "equitable" in addition to reasonable.*

The Court has clarified its application of the equitable standard in its Amended Final Order.

    b. *Petitioner contends the Court failed to apply any legal test or standard when reaching its conclusion that CUR is "reasonable," including the test in Twentieth Century Fox-Film cited by the Department in Revenue Ruling 15-5.*

The Court has addressed this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

    c. *Petitioner contends the CUR cannot be reasonable or equitable because the Department is ignoring its own Revenue Ruling, and the Court should not reward the Department for instructing its transfer pricing expert to not provide the Court a transfer price.*

As explained in the Amended Final Order, the Court finds this argument to be without merit.

    d. *Petitioner contends the Court improperly granted relief based on arguments not asserted by the Department that are also circular, incorrect, and entirely based upon the erroneous assumption that the appropriate transfer price is one where Texas charges nothing for its procurement function and the use of its intellectual property.*

As explained more fully in the Amended Final Order, the Court did not grant relief based upon an assumption that the transfer price under the Procurement Agreement should be zero or that Texas's IP has no value. Indeed, the Court specifically recognized the correct transfer price would not be zero. Petitioner misunderstood the Court's analytical exercise in its order in which the Court eliminated the transfer price as a comparison tool, since the actual transfer price in this case, based upon the credible expert testimony, would be much more modest than to 9.7%. Furthermore, "the ALC is the ultimate fact finder in a contested case, and is not restricted by the findings of the administrative agency." *Kiawah Dev. Partners, II v. S.C. Dep'tof Health & Envtl. Control*, 411 S.C. 16, 66, 766 S.E.2d 707, 735 (2014). As a result, the Court may use any evidence in the record to conduct its analysis of the case.

4. **Whether the Court misunderstood certain facts, which led to erroneous factual findings and legal conclusions.**

The Court did not misunderstand the facts as articulated by Petitioner. Moreover, to the extent Petitioner argues the Court should not have relied on certain expert testimony, as the trier

of fact, the Court may give testimony, including an expert's testimony, the weight that he or she determines it deserves, *Florence County Department of Social Services v. Ward*, 310 S.C. 69, 72-73, 425 S.E.2d 61, 63 (Ct. App. 1992), and may accept the testimony of one expert over that of another, *South Carolina Cable Television Association v. South Bell Telegraph & Telephone Co.,* 308 S.C. 216, 417 S.E.2d 586 (1992). Indeed, "[t]he judging of the credibility of witnesses and the weighing of evidence in a law case are uniquely functions of the trial court." *Bivens v. Watkins*, 313 S.C. 228, 235, 437 S.E.2d 132, 136 (Ct. App. 1993). Further, the Court is "in a superior position to judge the witnesses' demeanor and veracity and, therefore, his findings should be given broad discretion." *Woodall v. Woodall*, 322 S.C. 7, 10, 471 S.E.2d 154, 157 (1996).

5. **Whether the Court ordered unrequested and improper relief in ordering TSC to use combined unitary reporting.**

The Court has addressed this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning. Moreover, the Court did not order that TSC use combined unitary reporting, but rather found that based upon the facts presented in this case, combined unitary reporting was a reasonable and equitable method of reflecting TSC's business activity in South Carolina.

6. **Whether the Court misinterpreted S.C. Code Ann. § 12-6-2210(B) as support for the Department imposing CUR.**

The Court has addressed this issue in its Amended Final Order to the extent the arguments in this section changed or informed this Court's reasoning.

7. **Whether the Court erred in failing to conclude that the forced use of CUR violates the South Carolina Administrative Procedures Act ("APA").**

I do not find the Court erred.

ORDER

IT IS THEREFORE ORDERED that Petitioner's Motion for Reconsideration is **GRANTED** and an Amended Final Decision is issued.

AND IT IS SO ORDERED.

Ralph King Anderson, III
Chief Administrative Law Judge

December 4, 2023
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

December 4, 2023
Columbia, South Carolina

EXHIBIT C

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Tractor Supply Company, Petitioner, v. South Carolina Department of Revenue, Respondent.	)	Docket No. 19-ALJ-17-0416-CC **FINAL ORDER**

This matter is before the South Carolina Administrative Law Court (ALC or Court) pursuant to a request for contested case filed by Tractor Supply Company (Petitioner) on December 11, 2019.[1] Petitioner contests the decision of the South Carolina Department of Revenue (Department) dated November 19, 2019, assessing corporate income taxes using an alternative apportionment method pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code (2014). As of December 12, 2019, the assessment totaled $1,605,002.45[2] for the time period of January 1, 2014, through December 31, 2016.

On January 6, 2023, Petitioner filed two motions—a Motion in Limine to Exclude Economic Substance or Other Similar Claim and Certain Expert Testimony Regarding the Same and a Motion in Limine to Limit Testimony of David DeRamus (Motions). The Court determined it would address Petitioner's Motions at trial.

The Court held a hearing on the merits at its offices in Columbia, South Carolina, on January 23, 2023, through January 27, 2023. The Motions in Limine were denied at the beginning of trial. Based upon my review of the testimony and the parties' arguments, I conclude the Department's decision must be affirmed.

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[1] This case was originally assigned to the Honorable H. W. Funderburk but was reassigned to the undersigned on January 4, 2022.

[2] This amount does not include any interest or fines that have since accrued.

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SC Admin. Law Court

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of proof and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence.

History and Structure of Tractor Supply Company

Tractor Supply Company (TSC) was founded in 1938. It was restructured in 2001 to create two affiliated subsidiaries of importance in this case: Tractor Supply Company of Michigan, LLC (Michigan) and Tractor Supply Company of Texas, LP (Texas).[3] As a result of the restructuring, Michigan is 100% owned by TSC. Interestingly, Texas is 99% owned by Michigan and 1% owned by TSC. TSC is the parent company of the affiliated group (Tractor Supply Group or the Group).

The restructuring took place after TSC consulted with the accounting firm PricewaterhouseCoopers (PwC) about its business goals. TSC asserts five reasons for the restructuring: growth, expansion, asset protection, procurement power, and tax minimization. However, outside of the Board minutes from 2001 setting forth the reasons for TSC's restructuring, there are scant records explaining the reasons. TSC's Board simply referred to the re-organization of the company as the "Tax Restructuring" and noted it was undertaken as part of TSC's tax planning strategy for the reduction of state income tax expenses.[4] I thus find that tax minimization was a reason for the restructuring.[5]

Tractor Supply Company's Business

According to TCS's 2016 Annual Report,[6] TSC is "the largest retail store chain of rural lifestyle products in the United States." Its business is comprised of retail stores located in towns outlying major metropolitan markets and in rural communities. It seeks to be the "most dependable supplier of basic maintenance products for the lifestyle needs of recreational farmers and

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[3] Tractor Supply Company had a total of nine subsidiaries at the time this case was heard, but they are all disregarded for federal tax purposes except Texas and Michigan.

[4] The witness who testified to the five reasons for the restructuring was not an employee of TSC in 2001, and no one currently at TSC was present during the 2001 Board meeting when the Tax Restructuring strategy was discussed.

[5] I do not find this was the sole reason for the restructuring or otherwise imply that there was no business purpose outside of tax minimization for the restructuring. Moreover, I also recognize that tax minimization strategies are often part of good business and good tax advice.

[6] TSC is the only entity that files a 10-K because it files the 10-K on behalf of the Group. The 10K is an annual report that the U.S. Securities and Exchange Commission requires publicly traded companies to file.

ranchers." Indeed, 99% of TSC's revenue is derived from its retail operations with the other 1% of revenue coming from interest and other miscellaneous income. It provides an assortment of "high quality, reputable brand name and exclusive brand products." It also places an emphasis on consumable, usable, and edible (CUE) products.

As of December 31, 2016, Tractor Supply Group operated almost 1,600 stores in forty-nine states and an e-commerce website, TractorSupply.com. In 2016, TSC had approximately $6,751,000,000 in sales, with each store averaging about $4,400,000 in sales.

Although Texas and Michigan run the stores in their states, the Group's stores are essentially uniform across all states. Except where geographic differences call for different products—for example, snowplows in northern stores and differences in signage based upon local sign ordinances—the stores are all a similar size, carry a similar array of products, the employees wear the same red aprons, and signage and labeling are the same as allowed. Purchases can be returned across states lines and gift cards can be used at any Tractor Supply store regardless of which TSC entity operates that store.

TSC's Role in the Business Structure

TSC is the taxpayer at issue in this case, and it operates retail stores in every state excluding Texas, Michigan, Utah, Hawaii, and Alaska. During the Audit Period, Tractor Supply had between 1,160 to 1,461 retail stores. Of those, it operated between thirty-two and forty-two retail stores in South Carolina during the audit period. TSC also operated seven distribution centers in several states.

TSC's headquarters are located in Brentwood, Tennessee, at a facility called the Store Support Center (SSC). At the SSC, TSC provides administrative services, including accounting, legal, human resources, data analysis, and other support services for the Group. Additionally, the entire C-suite of executives for the Group is employed by TSC. In addition to its retail stores and administrative roles, TSC also leased employees to Michigan during the audit period. TSC, Texas, and Michigan have a highly integrated relationship that is recorded in several intercompany agreements that were executed as part of the 2001 restructuring. These intercompany agreements will be discussed in more detail below.

.Michigan's Role in the Business Structure

During the audit period, Michigan owned and operated between seventy-seven to eighty-one retail stores in Michigan, but it did not have any officers, executives, or directors.[7] Michigan leased all of its employees from TSC.

Texas's Role in the Business Structure

During the audit period, Texas operated between 145 to 196 Texas retail stores, one distribution center, and two mixing centers that functioned like smaller, more specialized distributions centers. The Texas distribution center also serviced retail stores outside of Texas. Texas also held the intellectual property trademarks for TSC during the audit period. However, it did not charge the other TSC entities for the use of these intangibles.

In addition to operating its retail stores, Texas was assigned the role of providing the procurement function for TSC and Michigan in the reorganization. The procurement function included buying (inventory sourcing) and vendor management, inventory management (product selection, identifying trends, forecasting, product localization), and product development (including the development of exclusive brands like TSC's Dumor horse feed). Notably, before the 2001 restructuring, TSC performed the procurement function. TSC had approximately ten employees who worked in the merchandising/procurement area, including "buyers" who worked with third parties and wholesalers and undertook the procurement function for the business. These buyers were all located in Tennessee. After the restructuring, Texas was designated as the entity which performs the procurement function for the Group, and TSC's property (assets) associated with the merchandising operations were consigned to Texas. Nonetheless, the physical location and place of procurement operations remained at the SSC in Brentwood, and the delivery and vendor terms did not change (with the exception of updating vendor agreements to reflect the new purchaser was Texas). The only change was the legal employer of the merchandising/procurement employees. As of December 31, 2016, Texas had approximately 130 individuals working in the procurement area.

Texas was also designated as having the primary responsibility for setting prices for the inventory, although pricing was a collaboration between Texas and TSC's own pricing team. Similarly, while Texas entered into the vendor contracts and incurred the expense for purchasing

[7] In the restructuring, Michigan received all the Michigan retail stores as assets.

inventory, TSC actually disbursed the funds for the purchase of the inventory because it had the centralized cash management function for the Group. Additionally, the Chief Merchandising Officer, who oversaw Texas's procurement function, was an employee of TSC. Thus, the two entities collaborated extensively on procurement and merchandising.

Intercompany Agreements

There are four inter-company agreements between TSC, Michigan, and Texas, that set forth how the entities function together: (1) the leasing agreement between TSC and Michigan; (2) the administrative and management services agreement between TSC, Texas, and Michigan; (3) the inventory procurement agreements between Texas and TSC and Texas and Michigan; and (4) the licensing of trademarks between Texas, TSC, and Michigan. Each agreement went into effect in September 2001 when the restructuring occurred. While some of these agreements include charges for services one entity provides to another, the "revenue" from these intercompany transactions is simply recorded as journal entries.[8] Indeed, Akash Deep Sehgal, whom the Court qualified as an expert in state income tax accounting (to include apportionment methods and multistate businesses), observed that 82% of Texas's income was generated from intercompany transactions where real revenue was never exchanged between the related entities.

Leasing Agreement

Michigan leased its employees from TSC during the audit period pursuant to an agreement entitled the Master Shared Services Agreement (Leasing Agreement). Pursuant to the Leasing Agreement, TSC provided "personnel management and employment services" to Michigan at cost plus a 10% markup. TSC also agreed to provide personnel, accounting, employee benefits, administrative, and other personnel and payroll related services reasonably requested by Michigan. TSC does not have a 482 transfer pricing study[9] to support the 10% markup or a record of how the 10% markup was calculated. The Leasing Agreement was signed on Michigan's behalf by David Lewis, an officer of TSC.

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[8] It is not uncommon for large companies like the Tractor Supply Group to make intercompany payments and to record these transactions as journal entries as opposed to making actual cash/wire transfers.

[9] Transfer pricing is the method by which companies assign prices to intercompany transactions. Transfer pricing as a concept is derived from section 482 of the Internal Revenue Code, which is why a transfer pricing analysis under this section is often called a 482 transfer pricing study. 26 U.S.C.A. § 482 (Westlaw Edge through Pub. L. 118-3) ("Allocation of income and deductions among taxpayers").

Administrative Services Agreement

TSC, Texas and Michigan executed an Administrative Services Agreement that was in effect during the audit period. The Administrative Services Agreement required TSC to provide support services for Texas and Michigan on a routine basis, to include, but not limited to: accounting and financial (audit and tax); financial (fiscal) and treasury services; legal; executive; human resources and benefits administration; field management and quality control; marketing and advertising; information systems management and data processing; and other services Texas and Michigan may have the occasion to require. Texas and Michigan pay TSC the costs of those services plus a markup they deem appropriate. The markup is not supported by a 482 transfer pricing study.

Licensing Agreement

Texas and TSC and Michigan executed a Licensing Agreement that was in effect during the audit period. Pursuant to the Licensing Agreement, Texas granted TSC and Michigan a non-exclusive license to use all trademarks owned by Texas. Texas does not charge TSC or Michigan for the licensing of the trademarks/intellectual property (IP) it holds. However, at one time, PwC developed a value (price) that Texas could charge for the use of its IP in a 482 transfer pricing study. Instead of monetary compensation for use of the IP, the Licensing Agreement provides that TSC and Michigan agree to engage Texas as their "sole and exclusive supplier of any and all merchandise inventory sold in TSC retail store locations."

Procurement Agreement

In September 2001, Texas, TSC and Michigan executed Inventory Procurement Agreements (Procurement Agreements). Pursuant to the Procurement Agreements, Texas provided inventory procurement services for TSC and Michigan at cost plus a 9.7% markup. The 9.7% markup was based upon a 482 transfer pricing study by PwC.

A significant focus of this case is on the effects of the Procurement Agreements, particularly the agreement between TSC and Texas. Pursuant to the Procurement Agreements, Texas was designated as the exclusive supplier of merchandise inventory for TSC and Michigan. Texas was to provide, to the best of its ability, a timely and uninterrupted flow of merchandise inventory; arrange shipment for the merchandise inventory; negotiate competitive merchandise inventory prices; and advise TSC and Michigan on appropriate inventory mixes and product

trends. Texas did not provide procurement services for any company outside the Group. The Procurement Agreement was signed on behalf of Texas by Cal Massmann, an executive of TSC.

Adoption of Transfer Prices During the Audit Years

PwC conducted a 482 transfer pricing study for TSC that was used as a pricing basis for the intercompany transactions during the audit years. For each tax year at issue during the audit, TSC recorded its transfer pricing decision in a brief memo. The 2014 memo provides, in part:

> The transfer pricing study prepared by PWC recommends that the markup on inventory sold by Tractor Supply Co. of Texas, LP (Texas) to Tractor Supply Company (TSC) and Tractor Supply Co. of Michigan (Michigan) be in the range of 3.9% to 12.0% before a charge for licensing the trademarks. The study also recommends that the company take into consideration the profitability of the TSC retail operation. The retailer profitability range in the study is 0.5% to 5.6%. Further, the study concluded that a markup on the licensing of the brand trademarks could range between 1.7% and 7.5%.
>
> The companies have reviewed the various profit scenarios in the study and have concluded that Texas will waive its right to compensation for the licensing of the trademarks for the current year 2014. Texas determined that this wavier will allow TSC and Michigan to continue to grow the brand and remain profitable. It has been determined that using the markup of 9.7% in the study will allow it to provide TSC and Michigan with the necessary procurement services and remain profitable with a retailer profitability margin of 3.1%.

The memos for 2015 and 2016 were the same as the 2014 memo in substance, including the adopted transfer prices.

TSC's Tax Returns During the Audit Years

During the audit years, TSC filed its South Carolina corporate income tax returns as a single entity using South Carolina's default method of separate entity reporting (Texas and Michigan do not file in South Carolina).[10] Briefly, under separate entity reporting, a multistate taxpayer's South Carolina net income is multiplied by a sales factor in which the numerator equals the taxpayer's South Carolina sales, and the denominator equals the taxpayer's sales everywhere. In contrast, under combined unitary reporting, if the multistate taxpayer is part of a unitary group,

[10] In contrast, TSC filed consolidated federal returns for the whole Group during the audit years because all of the entities are owned, either directly or indirectly, by the parent company TSC. On federal consolidated returns, intercompany transactions are eliminated or zeroed out because the income for one company is being canceled out by the expense recognized by another. Also, in some other states, where required, TSC filed its returns using combined unitary reporting.

then the South Carolina net income of the unitary group[11] is multiplied by a sales factor in which the numerator equals the group's South Carolina sales and the denominator equals the group's sales everywhere.

During TSC's audit, the Department concluded separate entity reporting did not fairly represent TSC's business activity in South Carolina under subsection 12-6-2320(A) of the South Carolina Code. The Department's finding was based upon its conclusion that separate entity reporting allowed TSC to minimize its taxes in South Carolina by shifting income from its retail sales (including its South Carolina retail sales) to Texas through the 9.7% markup on inventory Texas charged pursuant to the Procurement Agreement. As a result, the South Carolina net income, against which the sales factor was applied, was artificially lowered. In other words, the Department concluded the intercompany charge (9.7% markup) charged by Texas pursuant to the Procurement Agreement created a distortion in South Carolina taxable income.[12]

The Department also concluded TSC, Texas, and Michigan operated as a unitary group because each entity was dependent upon the other for some necessary function. For example, Texas and Michigan were dependent upon TSC for payroll and human resources functions, etc., through the intercompany agreements. This functional dependence demonstrated operational interdependence.

As a result of these two conclusions, the Department determined combined unitary reporting was appropriate because it remedied the distortion and more fairly represented TSC's business activity in the State. As will be discussed more fully below, under combined unitary reporting, intercompany transactions like the 9.7% markup on inventory are eliminated, and therefore income shifting is eliminated, resulting in a return that includes all the income from TSC's retail stores. Therefore, the Department imposed combined unitary reporting as an alternate reporting method pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code.

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[11] The definition(s) and characteristics of a "unitary group" will be discussed later in this order. Essentially, a unitary group is a group of companies that are so dependent upon one another that they function as one entity.

[12] Prior to litigation, when the Department determined combined unitary reporting was fairer and more appropriate than separate entity reporting, it did not have the internal expertise to review and evaluate the reliability of the PwC 482 transfer pricing study that TSC used to support the 9.7% markup. However, the Department acknowledged that if TSC was paying a third-party for inventory at an arms' length price (instead of paying Texas), then income shifting would not be implicated and separate entity reporting would be fair.

Separate Entity Reporting in 2014

In tax year 2014, TSC's federal consolidated return showed a taxable income of $552,221,388. However, because TSC utilized separate entity reporting, it reported taxable income on South Carolina's return was $130,998,512, which represents its share of federal taxable income as a result of the intercompany agreements of the Group. Under separate entity reporting, the $130,998,512 was adjusted by $17,478,426 to arrive at South Carolina net taxable income of $148,476,938. South Carolina net taxable income was then multiplied by the sales factor in subsection 12-6-2280(A) of the South Carolina Code to calculate the taxable "base" upon which South Carolina's state income tax is calculated. Additionally, under separate entity reporting, the sales factor is calculated with the numerator representing TSC's South Carolina sales and the denominator representing TSC's sales everywhere (not the Group's sales everywhere). In 2014, the sales factor was calculated to be 2.79%. Multiplying $148,476,938 by 0.0279 resulted in a taxable base of $4,137,310 to which South Carolina's corporate tax rate of 5% was applied to arrive at a corporate tax equal to $206,866 in 2014.

Combined Unitary Reporting in 2014

In contrast, when the Department applied combined unitary reporting in its audit of tax year 2014, it effectively treated the Group as the taxpayer, not just TSC. Thus, the Group's federal taxable income—$552,221,388—was adjusted to arrive at a South Carolina net taxable income for the Group of $569,699,814. The application of combined unitary reporting also affected the sales factor. The numerator of the sales factor became the Group's South Carolina sales (in this case, only TSC had South Carolina sales), and the denominator became the Group's sales everywhere. In 2014, this resulted in a sales factor of 2.28%. Multiplying $569,699,814 by 0.0228 resulted in a taxable base of $12,989,725. This base was then multiplied by South Carolina's corporate tax rate of 5% to arrive at an audited corporate tax equal to $649,486 in 2014. Thus, the Department's application of combined unitary reporting resulted in larger taxable income and a smaller sales factor; but overall, it resulted in the calculation of more tax due.[13]

[13] The above examples of how the reporting methods were applied to TSC's taxes in 2014 demonstrate how the reporting method impacts not just how much federal taxable income, and therefore South Carolina taxable income, is utilized to apportion income to South Carolina, but also how the reporting method impacts the calculation of the sales factor to ultimately calculate the taxable base apportioned to South Carolina. If the taxable income is based upon a separate, single entity, then so is the sales factor. Likewise, if the taxable income is based upon a group of related

TSC disagreed with the Department's decision to impose combined unitary reporting.[14,15] Following TSC's challenge of the staff decision, the Department issued a Department Determination on November 12, 2019. In its Determination, the Department concluded TSC's use of separate entity reporting and the standard apportionment formula did not fairly represent the extent of TSC's business activity in South Carolina because Tractor Supply operates within the unitary business of the Tractor Supply Group, and separate entity reporting fails to use a reasonable base for representing the business activity of TSC in South Carolina. It also concluded the application of combined unitary reporting was a reasonable alternative apportionment method. It further found that

> Despite a single, vertically-integrated business, Tractor Supply files in South Carolina under separate entity reporting, a method creating a narrow and artificially drawn set of activities which improperly isolates and carves out "South Carolina activity" from an inseparable unitary-whole known as the Tractor Supply Group. Specifically, Tractor Supply segregates certain activities through intercompany transactions between itself, TSC Texas, and TSC Michigan. As a result, Tractor Supply reduced its taxable income in South Carolina by intercompany expense deductions.
>
> Through these intercompany transactions, Tractor Supply significantly reduces its income by shifting income to TSC Texas, which does not source any income to South Carolina.

It also stated that "Tractor Supply's use of separate entity reporting fails to fairly capture the 'base which reasonably represents the proportion of the trade or business carried on within this State.'" TSC thereafter appealed the determination to this Court.

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entities, then so is the sales factor. A mathematical proportionality is maintained that ensures the sales factor ratio matches the taxable income to which it is applied.

[14] TSC also initially disagreed with the way the Department calculated its tax burden under combined unitary reporting; however, the Department revised its calculation and TSC agreed that the new calculation was correct under combined unitary reporting while still disputing its application. Specifically, TSC does not dispute the Department's calculation of the sales factor under combined unitary reporting in this matter; but instead disputes the application of combined unitary reporting.

[15] Notably, TSC was previously audited by the Department for tax years 2008 through 2010, and that review resulted in TSC using combined unitary reporting for its income tax return (only TSC and Texas were considered members for the unitary group; Michigan was excluded). There was an informal agreement with the Department that TSC would continue to file using combined unitary reporting going forward. However, after the South Carolina Supreme Court issued its decision in *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, 411 S.C. 79, 81, 767 S.E.2d 195, 196 (2014), TSC re-evaluated its tax reporting method, and, in 2013, filed using separate entity reporting because the Department had the burden to show this filing method was unfair.

Traits of Unitary Businesses

There are generally three subjective tests for determining whether a business is unitary that are commonly used by tax professionals and accountants.[16] The first test is the unity of operations test. Unity of operations refers to companies having a common accounting system, common research and development, common marketing, and common characteristics of operations amongst the companies. TSC, Texas, and Michigan qualify as a unitary business under this test because they share a significant amount of operations; specifically, TSC provides accounting, marketing, and other back-office support to Texas and Michigan.

The second test is unity of use. Unity of use typically refers to the concept of centralized management, which may be evidenced by common executives between a group of companies. Tractor Supply Group is also a unitary business under this test because several TSC executives also acted as the executives of Texas and Michigan, as evidenced by TSC executives signing the intercompany agreements on behalf of Texas and Michigan. This shows overlapping, common, centralized management.

The third test is contribution and dependency, which refers to the amount of dependency between various companies. For instance, when a company heavily relies on services that are provided by another company, or one company generates a significant amount of revenue through related party transactions. Additionally, when companies are heavily integrated, they create economies of scale together which contributes to functional dependency and other unitary characteristics. Here, the Group qualifies as a unitary business under this test because there is a significant amount of dependency between TSC, Texas, and Michigan. For example, Texas creates a significant amount of income by exclusively supplying TSC with inventory through the Procurement Agreement, and Texas, in return, receives a significant amount of administrative and back-office support through its Administrative Service Agreement with TSC. Both TSC and Texas are dependent upon each other for contributions to the business. Similarly, Michigan relies on Texas and TSC for all its needs except ownership of the Michigan retail stores.

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[16] Mr. Sehgal opined that the Group met all three characteristics. Bruce J. Fort, who is a senior attorney with the Multistate Tax Commission (MTC) and was qualified as an expert in state and local tax policy considerations related to multistate taxation (including separate entity reporting, combined reporting, standard apportionment, alternative apportionment, and income shifting strategies, including transfer pricing), concurred with two of Mr. Sehgal's definitions for a unitary business: contribution and dependency and unity of operations as evidenced by common management, common control, and flow of value between them.

The Arm's Length Transaction of the Markup on Inventory

I conclude that the 9.7% markup on inventory charged by Texas does not reflect an arm's length transaction. I reach this conclusion based upon three sub-findings. First, the PwC 482 transfer pricing study supporting the 9.7% markup was flawed and unreliable. Second, the result of the 9.7% markup is a transfer of income from TSC (and Michigan) to Texas that is unreasonably large compared to the benefits received by TSC and Michigan and does not reflect an arm's length transaction. Third, and relatedly, neither party presented sufficient evidence to support a transfer price (or markup on inventory) that would correct the current deficiency of the 9.7% markup and reach an arm's length result.

Transfer Pricing and the 482 Regulations

Transfer pricing is the method by which companies assign prices to intercompany transactions because these transactions do not take place in an open market. Thus, the goal of transfer pricing is to determine the price you would expect to see if the intercompany transaction was conducted by similar third parties in an arm's length transaction on the open market. When the price of an intercompany transaction is consistent with the price two third parties would agree to on the open market (an arm's length transaction), it suggests that income is not being improperly shifted by the intercompany transaction to avoid or minimize taxes.

However, transfer pricing can be manipulated to shift income from one company to another, sometimes resulting in income being shifted from one taxing jurisdiction to another. Taxing authorities therefore pay attention to transfer pricing because it can be a method by which companies artificially shift income from a higher tax jurisdiction to a lower one to impermissibly reduce their tax liabilities. Accordingly, it is important to establish a correct transfer price to ensure that companies are not using intercompany transactions as a method of improper tax avoidance or minimization.[17]

Transfer pricing as a concept is derived from section 482 of the Internal Revenue Code. 26 U.S.C.A. § 482 (Westlaw Edge through Pub. L. 118-3) ("Allocation of income and deductions among taxpayers"). Section 482 consists of one relatively short paragraph and essentially instructs that the Secretary can apportion or allocate income between two organizations owned by similar

[17] Again, tax minimization strategies are not necessarily improper and often, are part of good business and good tax advice.

interests to prevent the evasion of taxes or to clearly to reflect the income of any the organizations. *Id*. Because section 482 only consists of one paragraph, transfer pricing experts rely primarily on the "482 Regulations" for guidance on how to properly calculate and evaluate transfer prices in intercompany transactions. 26 C.F.R. § 1.482-0 to -9 (Westlaw Edge through 88 FR 30679). There are several principles or considerations within the 482 Regulations that must be considered when analyzing a transaction, including the arm's length principle, the economic substance of the transaction, and reasonableness of the overall results.

The arm's length principle refers to the principle, discussed above, that the intercompany transaction price should reflect what a price would be between two third parties in an open market. Economic substance in the 482 Regulations looks to the overall characterization of the transaction and whether the purported purpose of the transaction aligns with how the parties are actually behaving in the transaction. In intercompany transactions, the companies themselves largely write the contractual terms, and these terms may create substantial deviation from how one party or both parties to the transaction actually act. Accordingly, when an intercompany transaction is analyzed under the 482 Regulations, the analyst should look at the substance of the transaction to see if that substance conforms to how the taxpayer has characterized the transaction. Finally, the resulting transfer price should be reasonable.

The 482 Regulations contain several different methods of accounting for intercompany transactions. However, even if a method appears to follow logical steps, if it produces a result that is not reliable in the particular circumstance, it will not pass the reasonableness test. Thus, it is important to pick a method under the 482 Regulations which meets the "best method rule." The best method rule generally states that a transfer pricing analysis should use whatever transfer pricing method is the most reliable method based on the facts and circumstances at hand. 26 C.F.R. § 1.482-1(c) (Westlaw Edge through 88 FR 30679).

The 2014 PwC Transfer Study Supporting the 9.7% Markup

Both parties engaged transfer pricing experts who testified about the PwC 482 study and the transfer pricing in this case. On behalf of the Department, Dr. David Watlington DeRamus testified as an expert witness in transfer pricing analysis, including economic principles. On behalf of Tractor Supply Company, Dr. David Fernando Andrade was qualified as an expert in economics, specifically in the sub-field of pricing valuation with a focus on transfer pricing. On the subject of the PwC transfer pricing study, both experts agreed that the study was flawed.

The first step in any transfer pricing analysis under the 482 Regulations is to look at the companies involved in the transaction and ascertain what functions they are performing in the transaction, what assets they bring to the transaction, and what risks they are incurring. This is called a functional analysis, and based upon the functional analysis, it can then be determined which analytical method under the 482 Regulations is the best method to apply to the transaction at issue. This first step is crucial because the rest of the transfer pricing analysis is built upon, and flows from, the functional analysis. Both parties' experts agreed that PwC's functional analysis was flawed, and PwC did not choose the best method for evaluating the appropriate transfer price under the 482 Regulations.

Dr. DeRamus's analysis of PwC's 482 study was especially well-articulated and persuasive. He logically explained why PwC's chosen method, the comparable profits method (CPM),[18] was not the best method to benchmark a company like Texas and how its set of comparables for Texas was flawed because it chose companies that performed a function that was not comparable to Texas's function. He also reasonably explained why the comparable companies PwC eventually chose to benchmark Texas against would skew the results towards higher profitability, thus the resulting percent markup on total costs (then converted to markup on inventory) would also skew high. Moreover, Tractor Supply Company's own expert witness, Dr. Andrade, found the PwC transfer pricing study did not use the best method for establishing a reliable transfer price under the 482 Regulations. Therefore, I conclude that PwC's 482 transfer pricing study is flawed and unreliable and does not support Texas's 9.7% markup on inventory as a reasonable markup in an arm's length transaction.[19]

The Procurement Agreement Does Not Meet the Arm's Length Standard

Simply because the PwC study is flawed and unreliable does not necessarily mean that the 9.7% markup on inventory adopted by Texas does not meet the arm's length standard. A flawed

[18] The comparable profits method (CPM) is described in section 5 of the 482 Regulations and PwC used it to prospectively determine an arm's length range for the transfer price for Texas's procurement function under the Procurement Agreement. 26 C.F.R. § 1.482-5 (Westlaw Edge through 88 FR 30679). Generally speaking, under CPM, one of the parties to an intercompany transaction is chosen as the "tested party" and comparable companies to the tested party are identified. *See generally id*. The theory is that the profits earned by comparable companies can be used to benchmark the profits that should be earned by the tested party in an open market. These profits can, in turn, be translated into a transfer price or, as in this case, a markup on inventory.

[19] The calculation of the 9.7% markup did not include compensation for any value contributed by Texas through licensing IP.

process can still produce a correct result. Both parties provided analyses from their experts regarding whether the 9.7% markup reflected an arm's length transaction. Although Dr. DeRamus did not conduct a comprehensive transfer price analysis to establish what the correct transfer price or markup on inventory should be in this case, I find he nevertheless demonstrated the 9.7% markup on inventory does not meet the arm's length standard.[20] In contrast, while Dr. Andrade presented a comprehensive transfer price analysis that purportedly calculated the markup on total costs associated with an arm's length transaction in this case, I found his analysis suffered from a fatal flaw that rendered it un-supported and unreliable. Based upon this fatal flaw, and other concerns regarding the presentation and development of Dr. Andrade's data, I found Dr. DeRamus's analyses to be more credible, supported, and well-reasoned than Dr. Andrade's analysis.

Dr. DeRamus's Analysis

a. Disproportionality and Distortion

Dr. DeRamus tested the 9.7% markup by examining how this markup shifted income between Texas, Michigan, and TSC, and whether the shift was reasonable. To do this, he reviewed, in part, the Procurement Agreements between Texas and TSC and Texas and Michigan. Specifically, Dr. DeRamus looked at the pretax income of Texas in the year 2015, which was around $439 million, and estimated the costs of the procurement function, which he found to be around $13 million. The purpose of this assessment was to compare the revenue Texas received from the 9.7% markup on inventory to its costs incurred for the procurement function and evaluate whether that relationship was reasonable. In this case, Texas received about $400 million dollars in procurement income through the inventory markup for the relatively small cost of $13 million, which showed income was being disproportionately shifted from TSC and Michigan to Texas. This disproportionality shows the transaction was not arm's length.

Bruce J. Fort, Esq., who was qualified as an expert in tax policy, echoed Dr. DeRamus's analysis of the disproportionality of Texas's income to expenses and opined that it was evidence

[20] Dr. DeRamus conducted a limited analyses of the transfer pricing in this case to show whether or not the 9.7% markup on inventory represented an arm's length transaction. However, Dr. DeRamus was not contracted to conduct a comprehensive transfer pricing study to determine what the correct transfer price would be if the 9.7% markup was incorrect.

of income distortion.[21] Indeed, income should be aligned across geographic borders or divisional borders or entity borders. In this case, Texas had a much higher income compared to its number of sales than the other two entities (higher taxable income per unit of sales), which is indicative of distortion.

Next, using the Group's trial balances, Dr. DeRamus modeled how income shifted after transfer pricing was implemented. Before transfer pricing was implemented, TSC earned an expectedly large share of the Group's income because it owned and operated the majority of the Group's stores and accounts and it had approximately 80% of the Group's sales and 80% of the Group's inventory. In fact, the trial balances from 2014-2016 reflect TSC had income (before transfer pricing) of approximately $400-500 million per year while Texas and Michigan had incomes of approximately $100 million per year or less. However, after the transfer pricing was applied, TSC's taxable income dropped to a little over $100 million per year, Michigan's dropped to a negligible amount, and Texas's shot up to approximately $400 million per year. Thus, after transfer pricing, Texas, on average, accumulated about 71% of the entities' taxable income across the audit years even though TSC had approximately 80% of the sales. This shift fundamentally distorts TSC's operating income.[22]

Similarly, the implementation of the transfer pricing also resulted in a reduction in the amount of income TSC's South Carolina stores were apportioned for their retail sales. Over the audit years, retail sales at TSC's South Carolina stores totaled between $135 million to $160 million on an annual basis, but only about $4 million to $5 million in taxable income was apportioned to South Carolina after transfer pricing was implemented.

b. Commercial Effect of the Restructuring

Dr. DeRamus also considered whether the restructuring had a commercial or operational effect on the business. For example, if a taxpayer implements a restructuring, and as a result of that restructuring nothing really changes operationally, then you would expect the income of the taxpayer not to change significantly. If the income of the taxpayer does change significantly, it

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[21] The term distortion represents a normative rule that you want to align income with expenses.

[22] In terms of operating profits, Texas earned about $35 million from its retail sales at its Texas locations and approximately $350-400 million from its procurement services. However, while Texas's retail sales appear to be "somewhat greater" on a per store basis, the actual profit margins of Texas's retail stores as compared to TSC's and Michigan's retail stores are not distinguishable in any statistical sense.

implies that the transfer pricing that was implemented is inconsistent with the arm's length principles. Here, TSC's Tax Restructuring did not have an operating impact or commercial effect on the company, yet TSC consented "at arm's length" to (1) transfer a valuable asset (its IP) to Texas and (2) give up a substantial amount of income that it otherwise would have continued to earn absent that restructuring in return for Texas's procurement services.

c. Realistic Alternatives

In evaluating whether TSC would agree to give up so much in an arm's length transaction in exchange for Texas's procurement services, one of the 482 Regulation guidelines states:

> Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by **considering the realistic alternatives** to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it.

Treas. Reg. § 1.482-9(h) (emphasis added). Based upon this principle, a company like TSC would not voluntarily give up millions of dollars of profit in return for someone taking over the procurement function, particularly when TSC had previously handled the procurement function itself before the restructuring. In other words, there would likely be other realistic alternatives that TSC would utilize before paying over almost three-quarters of its sales revenue to Texas in exchange for its limited procurement function. Dr. DeRamus explained that

> from a transfer pricing perspective, you simply would not expect a—at arm's length, a party like TSC to, just, to voluntarily say, here T—here Texas, feel free to pay the, the salary costs, the 13 million dollars of salary costs, and in return we're gonna forgo 300 million dollars of—or 350 million dollars of income. It's simply not consistent with the reasonable alternatives that [TSC] faced at the time of the restructuring, or frankly, at any time since.

d. Summary of Dr. DeRamus's Conclusions

The income shifted from TSC and Michigan to Texas as a result of the 9.7% markup for the procurement function was disproportionate to the income each company brought to the Group from retail sales. Indeed, TSC is in the retail business and not the procurement business; therefore, it is expected that the largest share of TSC's income would come from retail sales and not be diverted to procurement through transfer pricing. Therefore, the amount of income Texas received for its procurement function through the 9.7% markup was disproportionate to its costs for that function. Further, the operational effects of the restructuring did not account for the enormous

shift in income and thus a company in TSC's position would not reasonably choose to enter such an agreement with Texas.[23]

Dr. Andrade's Analysis

Dr. Andrade concluded the income reported by Texas during the audit years was consistent with a transaction between third parties at arm's length. Based upon his functional analysis, Dr. Andrade concluded the services provided by TSC and Texas in their transactions with each other had significant value and were non-routine functions. In contrast, he concluded Michigan only contributed routine functions.[24] In his opinion, the "highly unique" natures of TSC and Texas and their functions make it difficult to find comparable companies or activities to benchmark using CPM. Accordingly, he analyzed the transaction between the two entities using the residual profit split method (RPSM).[25] Dr. Andrade's application of RPSM involved two parts. In Part 1, he performed RPSM at the gross profit level because the data he received from the company (mostly SKU data) reflected gross profit data. During his calculations in Part 1, Dr. Andrade determined that the residual gross profits produced by TSC and Texas should be split between the companies 50/50. He explained his method of allocation as follows:

> I examined all the facts and all the data that I had access to, and I determined that a conservative estimate for the . . . [residual] profit for the Texas side would be 50 percent. So, I split it right down the middle between the parent [TSC] and Texas. 50 percent for one, 50 percent for the other.[26]

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[23] Dr. DeRamus also conducted several analyses that involved re-doing PwC's comparable profits analysis with more reliable comparables, but these analyses were of little value considering this method was already dismissed by both experts as a method that was not the best under the 482 Regulations and, therefore, would not produce the most reliable result.

[24] To form his opinion, Dr. Andrade significantly relied upon Tractor Supply's 10-K's, his discussions with approximately three people at the company, and stock keeping unit (SKU) data he received from the company. Dr. Andrade also explained Tractor Supply's restructuring was not a part of his analysis because he did not find it relevant, in part because it took place over twenty years ago. Furthermore, in his opinion, earnings calls and analysts' summaries are not important sources for understanding a company for a transfer pricing analysis; rather, data from within the company itself it important.

[25] RPSM visualizes the two parties to a transaction as a joint venture and then (1) breaks the joint venture's total profits into two categories: (a) routine profit, and (b) non-routine profit; then (2) allocates the routine profit to the parties based on each party's appropriate contribution to the generation of the routine profit; then, finally, (3) divides the non-routine profit (i.e., the "profit split") between the parties based on each party's appropriate contribution to the generation of the non-routine profit. Routine profit is first identified because it can be reliably determined using comparable evidence (i.e., comparable companies can be used as benchmarks, similar to a CPM analysis) and also because it, by default, identifies the total profit attributable to the non-routine functions (i.e., total profit less the routine profit equals the non-routine profit).

[26] In Dr. Andrade's opinion, Tractor Supply's IP was not significantly valuable in the context of the transfer pricing analysis. However, he explained that the value of Texas's IP was embedded in his 50% profit allocation. He conceded

He further explained that his estimate was conservative because there was evidence Texas could have a larger split—possibly up to 55% or 65%—but he did not explain what this "evidence" was because

> [w]hen I did that calculation based on 50/50, that [sic] the results were falling into place and I concluded, after this whole part of what we're calling part one, that the income reported by [Texas] was consistent with the arm's length standard. So, I was essentially done at this point with my inquiry.

In Part 2, he reconciled the gross profits to operating profits to ensure he was achieving an arm's length result.

Dr. DeRamus found Dr. Andrade's application of RPSM to be incorrect and unreliable.[27] He explained that the 482 Regulations specify certain methods and principles for calculating the residual operating profit between two companies after routine profits have been deducted. First, Dr. DeRamus took issue with Dr. Andrade's use of gross profits to draw conclusions using the RPSM in Part 1. In his experience, under the 482 guidelines, RPSM is always analyzed at the operating profit level, and it was inappropriate under the 482 Regulations for Dr. Andrade to use gross profit when defining his comparable companies to determine the routine profit split in Part 1. Dr. DeRamus explained that companies can have a lot of differences in their gross profit margins for many reasons that have nothing to do with the company that you are evaluating, which undermines the reliability of the analysis—things tend to wash out more when operating profits are calculated and companies are more reliably compared.

Next, typically, the profit split or allocation is based upon relative cost; for example, if one company spent $1 billion on product development and the other company spent $1 billion marketing it, then the allocation would be a 50/50 split. However, in practice, the allocation is more complicated, and the analysis should be supported by a fairly detailed analysis which did not occur in this case. Here, Dr. DeRamus could find no evidence for how or why Dr. Andrade came up with the 50/50 split of the residual gross profits between Texas and TSC other than simply his judgement. Since the split was unsupported by a quantitative analysis, it was entirely unreliable.

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that trademarks are valuable because they distinguish the company from other companies, assist with infringement activity, and help the market identify their unique goods, but he did not quantify that value and it was embedded in his profit split. I find Dr. Andrade's lack of data and quantitative support for his allocation, including this embedded allocation of the value of Texas's intellectual property, to be a fatal flaw in his testimony.

[27] I find his criticisms to be persuasive.

Moreover, even removing the other flaws in Dr. Andrade's application of the RPSM method, Dr. DeRamus explained that the moment Dr. Andrade allocated the residual profits using an "ad hoc 50 percent number," it was a number devoid of any economic content. In his opinion, the profit split is extremely important because it can shift millions or billions of dollars, and, by choosing a number with no quantitative support, "you're, effectively, just assuming the conclusion."

Consistent with his opinion that the allocation should be a data-driven exercise under the 482 Regulations, Dr. DeRamus opined that Dr. Andrade did not provide enough evidence to back-up his conclusion that Tractor Supply Group is essentially so good at procurement and headquarters functions that it has created unusually valuable, non-routine intangibles out of functions that are common to all retailers. He stressed that having data-driven evidence to back a conclusion that these functions were non-routine is even more important because these functions are usually described as routine functions. In his opinion, Dr. Andrade's reliance on SKU data and the three company interviews he conducted did not support his conclusion. Moreover, Dr. Andrade's reference to the Group's high profitability as a factor in determining the Group had a non-routine procurement function was simply assuming the conclusion.[28]

Dr. DeRamus further explained the kind of product development that leads to valuable intangibles is generally the development of products that are innovated and patent-protected or have other trade secrets imbedded. In contrast, the products being developed and sold by Tractor Supply Group are similar to any other large retailer that has its generic brand of product manufactured for it to compete and undercut the same product manufactured by another national brand, similar to a grocery store selling knockoffs of national brand cereals under its store-brand name.

Dr. DeRamus's criticisms of Dr. Andrade's opinion echo some of the Court's own concerns regarding Dr. Andrade's testimony. Most concerning, during Part 1 of his analysis, Dr. Andrade did not adequately explain the basis of his decision to split the non-routine residual gross profits

[28] In contrast to Dr. Andrade, Dr. DeRamus explained he finds analyst reports and earnings calls helpful in his transfer pricing work. For instance, the reports may be helpful to learn third party views as to what is driving the company's value in comparison with what the company says about itself, which can sometimes be biased to favor how the company wants to be perceived. He would expect a unique and incomparably valuable procurement department to be touted by the company in the earnings calls and discussed frequently in analyst reports.

50/50 between Texas and TSC. Indeed, the Court was left wondering how or why Dr. Andrade came up with the 50/50 split.[29] I thus found his determination was unreliable.

Dr. Andrade also did not adequately explain how the result of his 50/50 split of residual non-routine gross profits in Part 1 of his application of RPSM was consistent with the arm's length standard. In other words, he did not explain how applying his 50/50 residual profit split produced a result that indicated an arm's length transaction outside of simply stating as much. Thus, the Court was unable to sufficiently understand why a 50/50 split confirmed that the 9.7% markup on inventory charged by Texas was an arm's length transaction. Crucially, under the Court's understanding of this method, if the split was twenty or thirty percent to Texas, then this method could have indicated that Texas was reporting gross profits in excess of what would be expected. Therefore, the fifty percent split is essential to Dr. Andrade's method. Because I find Dr. Andrade's allocation of the residual gross profits was inadequately supported by his testimony, I do not find his method to reliably indicate an arm's length transaction between Texas and TSC.[30]

Moreover, although Part 2 of Dr. Andrade's analysis resulted in a determination that the 9.7% markup fell within a profit range that an arm's length transaction would produce, his reconciliation of gross profits to operating profits suffered from the same flaw as his analysis in Part 1 because both Part 1 and Part 2 relied on Dr. Andrade's fifty-fifty allocation of the non-routine, residual profits, which I find to be unsupported and unreliable.

Conclusion

I found Dr. DeRamus's opinion about what drives Tractor Supply Group's success more persuasive. In Dr. DeRamus's opinion, Tractor Supply Group's success is attributable to optimizing its business strategy of a monopolistic competition framework by locating itself in areas where it does not have competition from big box, low-price stores like Walmart or the little, higher-

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[29] In Dr. DeRamus's words, he's seen profit splits "in documentation studies and audits, in litigation proceedings, in advanced pricing agreement, [but he's] never seen anybody just make up a number like that for a profit split."

[30] Additionally, some of the data Dr. Andrade provided to support other parts of his analysis was literally unreadable by the average person because it was produced in a file format that would need a programming expert or someone else familiar with computer code to read. Dr. Andrade conceded that some of the excel spreadsheets and data he produced needed a special text editor in order to see the code built into the documents and without the text editor, the documents would include some English and symbols that probably could not be deciphered by someone who is not a programmer or expert in that area. Further, although the specific comparable companies (farm retailers) Dr. Andrade used in his analysis were included in Joint Exhibit 42, he did not include the specific companies in his testimony or demonstrative exhibits to explain why they were reasonable comparables. In other words, much of Dr. Andrade's testimony and opinions were provided with veiled data that left the court unable to verify the reasonableness of the application of his approach in this case.

priced mom-and-pop feed stores. Dr. DeRamus also noted that if Tractor Supply's procurement was the driving force of its success, you would expect to see Tractor Supply have significantly more online sales; instead, the vast majority of its sales take place at its brick-and-mortar stores where customer demand is driving the sales. Additionally, Dr. DeRamus opined that if the procurement function is so valuable and driving some much of the company's earnings, then he would expect the company to take advantage of the value it was creating and sell that procurement service as a product to other companies.[31]

Overall, I found Dr. DeRamus's testimony to be much more persuasive than Dr. Andrade's testimony. Although Dr. DeRamus did not perform his own, comprehensive transfer pricing analysis to determine what an appropriate transfer price would be, the various analyses he conducted exposed the flaws in why a 9.7% markup on inventory does not meet the arm's length standard. I further found Dr. DeRamus's analysis of the 9.7% markup and its effect on income allocation compared to the cost of the procurement function at Texas to be highly persuasive. Texas, in combination with its back-office support at TSC, has a very successful procurement and product development function; however, I do not find that this function is so special or unique compared to other retailers that these functions are driving the Group's income unlike other retailers that derive their income from retail sales. In line with this reasoning, it is illogical that Texas would have costs of around $13 million for its procurement function and reap almost $400 million per year from those costs and not advertise and sell such a lucrative function as its product rather than engage in retail sales. Based upon the evidence in this case, it is also illogical for TSC, with 80% of the retails sales of the company, to pay Texas what amounts to about 67%[32] of its income from those retail sales for Texas's procurement services. In an arm's length situation, a company like TSC would look at its reasonable alternatives to paying such a large amount for procurement and would undoubtedly find a cheaper company to procure its goods for it, especially

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[31] Mr. Fort agreed with Dr. DeRamus's reasoning concerning how a company would exploit what brings in value. As a tax policy expert, Mr. Fort explained that in the normative rules of taxation, you expect a business to invest few resources into a particularly inefficient operation; in contrast, if you have a particularly valuable activity, that is something you would expect the business to offer to provide for a third party to make more money off that valuable activity. Thus, if procurement was truly driving income for the Group, then you would expect it to not only invest in that function but sell it to third parties.

[32] This figure is based upon TSC's retail sales of approximately $400,000,000 in 2014 and TSC's taxable income of $130,998,512 in 2014. While retail sales and taxable income are not exactly the same, they still give a reasonable approximation of how much money TSC shifted to Texas, especially when the shift is so large.

considering it previously competently handled the procurement function in-house before the restructuring took place. I thus do not find that TSC would enter such an arrangement with a third-party in an arm's length transaction on the open market.[33]

Finally, I did not find Dr. Andrade's opinion that TSC derives its income primarily from its procurement and product development functions to be compelling, reasonable, or persuasive. I find TSC is a retailer that derives its income from retail sales, and, like every retailer, its choice of products may influence its sales, but is not the driving force. As Dr. DeRamus pointed out, Texas may engage in product development, but this development is not geared toward patented or novel product development, but rather creating versions of existing products to brand as its own to undercut the price of national brands. This kind of product development is not going to create value in the same way that developing truly new products would. Moreover, while Texas's procurement function is probably quite adept at picking good products and has a robust system to ensure a constant, reliable supply of products, Tractor Supply Company's locations and bulk-buying, cash-carrying customer base gives it a competitive advantage that drives the Group's sales and better than average profitability.

Overall, I find a preponderance of the evidence shows that Texas's 9.7% markup on inventory charged pursuant to the Procurement Agreement does not meet the arm's length standard and is not otherwise justified.

Tax Policy Considerations Related to the Reporting Method and Apportionment

Professor Richard D. Pomp[34] explained that separate entity reporting using the sales factor for apportionment developed, particularly in southern states, as a way to be economically competitive because it reduced the tax burden on companies who physically locate their businesses in the state compared to other states that used three-factor apportionment or combined reporting. For multi-entity companies with intercompany transactions, separate entity reporting generally requires the use of transfer pricing, and taxing authorities pay attention to transfer pricing because

[33] I also note that while both experts acknowledged Texas's IP had value, neither expert found that value was significant enough to meaningfully contribute to the 9.7% markup such that it would explain the enormous transfer in income from TSC and Michigan to Texas. And, as I already mentioned above, the value of the IP was not included in PwC's initial calculation of the 9.7% markup. Thus, I do not find the value of Texas's IP to be critical or determinative to the outcome of this case.

[34] Professor Richard D. Pomp is a law professor at the University of Connecticut, and he is also an adjunct professor at New York University in its tax LLM program. He was qualified as an expert in tax law and tax policy.

it can be a method by which companies shift income artificially from a higher tax jurisdiction to a lower one to reduce their tax liabilities.

In contrast to separate entity reporting, combined unitary reporting eliminates the need for transfer pricing, and, thus, eliminates the problem of inappropriate income shifting and tax havens. Indeed, from a tax policy perspective, Professor Pomp generally believes that "[b]y taking into account only the income and factors of the corporation having nexus with the taxing state, separate entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to the state." Combined unitary reporting avoids those failings of separate entity reporting by "automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities" and "helps to create a level playing field" and "improved equity . . . due to its superiority over separate reporting as a method of tax accounting."

Despite Professor Pomp's personal preference for combined unitary reporting as a reporting method, he asserted that the legislature's ultimate authority to prescribe the reporting method should not be undercut by executive agencies simply because separate entity accounting results in understated revenues. Indeed, being a unitary business does not automatically mean that the standard reporting method cannot fairly represent a taxpayer's business activity in a state.

Nevertheless, the South Carolina legislature has clearly provided an alternative apportionment method when separate entity reporting does not fairly reflect a business's activities within the state. In regard to that alternative apportionment method, Professor Pomp opined that it was generally introduced in separate entity reporting states because one size does not fit all taxpayers and alternative apportionment functions as a safety valve. He explained the history of alternative apportionment goes back to the Uniform Division of Income for Tax Purposes Act (UDIPTA). Section 18 of UDIPTA includes an alternative apportionment provision that is almost identical to South Carolina's alternative apportionment statute, subsection 12-6-2320(A)(4) of the South Carolina Code.[35] Following the tenants of UDIPTA, Professor Pomp opined alternative apportionment should be used judiciously in unusual cases lest it swallow the standard reporting method in a state and, thus, render the standard no longer the default. Accordingly, Professor

[35] Importantly, although Section 18 is almost identical to South Carolina's statute, South Carolina did not adopt UDIPTA and it is not a UPDITA state.

Pomp asserted that when a transfer price is incorrect, the transfer price should be corrected under the umbrella of separate entity reporting, and a taxing entity should not resort to alternative apportionment, which is a sweeping correction to a narrow problem. More broadly, he opined that resorting to alternative apportionment for an entire industry is a legislative issue, not an alternative apportionment issue.

Mr. Fort, who is a senior attorney with the Multistate Tax Commission (MTC),[36] agreed that the exception should not swallow the rule when it comes to the application of alternative apportionment. In his opinion, he would stick with the MTC's guidance on using alternative apportionment, which suggests it should be used in limited and specific circumstances that would otherwise produce incongruous results. Furthermore, both Mr. Small and Mr. Sehgal, in their expert capacity as accountants, testified that if a transfer price was corrected and the taxpayer's books were updated to reflect the corrected transfer price, then the taxes could be recalculated under separate entity reporting. Indeed, the Department also acknowledged it has the authority to make adjustments under separate entity reporting, like correcting an incorrect transfer price, so that separate entity reporting more fairly represents the taxpayer's business activities in the state. Accordingly, if the Department's auditor found the transfer price was too high, but could be corrected by lowering it, this would be an alternative solution to correcting the distortion in South Carolina income that would not require the Department to resort to an alternative reporting method like combined unitary reporting.

Sufficiency of the Evidence Presented to Support Separate Entity Reporting

Because I conclude Texas's 9.7% markup on inventory does not represent an arm's length transaction, it begs the question what markup would be reflective of an arm's length transaction so that the Court could utilize separate entity reporting? In this case, while Dr. DeRamus's analysis showed the 9.7% markup was not compatible with an arm's length transaction, he admittedly was not retained to determine what a correct transfer price would be in this case. While he formulated some estimates during his testimony, they were not data-driven in a way that this Court could rely upon. On the other hand, Dr. Andrade's analysis concluded the 9.7% markup was consistent with an arm's length transaction and, therefore, he concluded no adjustment to the transfer price was

[36] Mr. Fort was qualified as an expert in state and local tax policy considerations related to multistate taxation, including separate entity reporting, combined reporting, standard apportionment, and alternative apportionment.

necessary. However, since I determined Dr. Andrade's method was flawed and unreliable, the Court is left with a situation in which neither party presented sufficient evidence to reliably determine the correct transfer price for the intercompany transactions between Texas and TSC and Texas and Michigan should be in this case.

Turning to the evidence the Court found credible, Dr. DeRamus opined that combined unitary reporting would achieve something very close to implementing a reasonable transfer price. Specifically, he stated that "the number you would get, the taxable income that you would derive by applying a reasonable transfer pricing method to the company's actual intercompany transactions, it would get you to a number very close to the number that you get through a combined entity apportionment method." He explained that if transfer prices were correct across the Group, then he would expect each entity to receive a modest markup for the services they provide—TSC would receive a modest markup for supplying employees to Michigan, TSC would receive a modest markup for its administrative services, and Texas would receive a modest markup for its procurement, and that these markups would effectively wash each other out and reach the same result as combined unitary reporting, which eliminates intercompany transactions.

In sum, the evidence showed that combined unitary reporting could be used to fairly represent TSC's business activity in South Carolina. On the other hand, there was insufficient credible evidence to support the use of separate entity reporting to fairly represent TSC's business activity in this state. I thus find that the best method for reasonably and equitably calculating TSC's South Carolina revenue is combined unitary reporting.

ISSUES

1. Does the Department have the authority under subsection 12-6-2320(A)(4) of the South Carolina Code to require combined unitary reporting?

2. Does separate entity reporting fairly represent the extent of Petitioner's business activity in South Carolina?

3. Is the combined unitary reporting method a reasonable alternative appointment method?

4. Does the application of combined unitary reporting violate the Administrative Procedures Act?

CONCLUSIONS OF LAW

Standard of Review

This Court has jurisdiction over this case pursuant to section 12-60-460 of the South Carolina Code (2014) and section 1-23-600 of the South Carolina Code (Supp. 2022).

This is a contested case, and it is heard *de novo*. *Brown v. S.C. Dep't of Health & Envtl. Control*, 348 S.C. 507, 512, 560 S.E.2d 410, 413 (2002) (explaining that a contested case before the ALC is "in the nature of a de novo hearing with the presentation of evidence and testimony"). The standard of review is a preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2021); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998) ("Absent an allegation of fraud or a statu[t]e or a court rule requiring a higher standard, the standard of proof in administrative hearings is generally a preponderance of the evidence.").

Generally, the party asserting the affirmative issue has the burden of proof in contested cases. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017). However, in cases where the Department asserts an alternative apportionment method under section 12-6-2320 of the South Carolina Code, the Department bears the burden of proof. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014); *Rent-A-Ctr. W. Inc. v. S.C. Dep't of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). Additionally, the burden of proof before this Court is a preponderance of the evidence. § 1-23-600(A)(5); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. at 375-78, 496 S.E.2d at 19-20. Therefore, the Department bears the burden of proving this case by a preponderance of the evidence.

History and Development of the Unitary Business Principle and Combined Reporting

Before addressing the issues in this case, a review of the history and development of apportionment methods for multistate businesses is helpful. As early as the 1920s, tax authorities and courts wrestled with how to deal with multistate corporations whose business was hard to value for tax because the interconnected, "unitary" nature of the business made it difficult to pinpoint where the value was being generated for the purpose of apportionment. *See Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271 (1924); *Hans Rees' Sons v. State of N. Carolina ex rel. Maxwell*, 283 U.S.

123 (1931). "Because of the complications and uncertainties in allocating the income of multistate businesses to the several States," the "unitary business principle" was developed, which permitted "[s]tates to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State." *Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 778 (1992). As legal and tax theory progressed, several other principles were developed that guide the taxation of unitary businesses.

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983) (*Container Corp.*), the U.S. Supreme Court held that "[u]nder both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, tax value earned outside its borders." 463 U.S. at 164 (internal quotation marks omitted). The Due Process Clause and the Commerce Clause also "do not allow a State to tax income arising out of interstate activities—even on a proportional basis—unless there is a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Container Corp.*, 463 U.S. at 165–66 (internal quotation marks and citation omitted). "A State may, however, tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a 'unitary business.'" *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 19 (2008).

The *Container* Court described two methods for apportioning the income of multistate taxpayers, while observing that, in the case of a unitary business, "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice." *Container Corp.*, 463 U.S. at 164. First, it described geographical or transactional accounting and the problems associated with it:

> One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting. The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.

Container Corp., 463 U.S. at 164–65. Similarly, in *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, the Court noted that when a unitary business is at issue, "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for

contributions to income resulting from functional integration, centralization of management, and economies of scale." 445 U.S. 425, 438, (1980). The *Mobil* Court further commented that

> [b]ecause these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Id. In a later decision, *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298, 305 (1994), the Court observed that "[s]eparate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability. To guard against such manipulation, transactions between affiliated corporations must be scrutinized to ensure that they are reported on an 'arm's-length' basis, i.e., at a price reflecting their true market value." Further, "[a]ssuming that all transactions are assigned their arm's-length values in the corporate accounts, a jurisdiction using separate accounting taxes corporations that operate within its borders only on the income those corporations recognize on their own books." *Barclays Bank PLC*, 512 U.S. 298, 305-06.

The *Container* Court contrasted separate accounting/geographical accounting with the "unitary business/formula apportionment method":

> The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints.

Container Corp., 463 U.S. at 165. "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." *Allied-Signal, Inc.*, 504 U.S. at 783 (internal quotation marks omitted).

Importantly, the unitary business method of formula apportionment may only be used when the business qualifies as a "unitary business," and whether a business is unitary is a very fact-based

finding. On this issue, the Court has stated that "the unitary business concept . . . is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container Corp.*, 463 U.S. at 167. In other words, there is no uniform set of facts that will always define a unitary business. *See Allied-Signal, Inc.*, 504 U.S. at 785 ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach . . . and also because the constitutional test is quite fact sensitive." (internal quotation marks and citation omitted)). Nevertheless, "where the asset in question is another business," the Court has described the "'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." *MeadWestvaco Corp.*, 553 U.S. at 30.

Once a state determines that a business is "unitary," it must then apply an apportionment formula that is "fair" under both the Due Process and Commerce Clauses. *Container Corp.*, 463 U.S. at 169. The Court has set forth several principles of fairness:

> The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

Container Corp., 463 U.S. at 169-70.

Thus, "[t]he 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principle.' If a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'" *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 223 (1980) (internal citation omitted). Accordingly, the application of unitary apportionment rests between two competing principles that must be balanced: "the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." *Allied-Signal, Inc.*, 504 U.S. at 780.

Combined Reporting in the States

With the development of the unitary business principle and formulary apportionment, states began to utilize a version of formulary apportionment known as combined reporting, or, as it has been referred to in this case, combined unitary reporting. The Supreme Court of Illinois aptly provided this summary of the reasoning behind "combined reporting" as a method of apportionment:

> When a unitary business is carried on by an associated group of corporate entities, commonly referred to as a "unitary business group," resort to formula apportionment is also in order; a group of assets is used by the same overall entity for the generation of income through operation of a single, unitary business. If corporate forms were respected, State income taxation would be as artificially limited and open to manipulation as is the method of separate accounting. To prevent the triumph of corporate formality over economic substance, "combined reporting" is a necessary tool. . . . Combined reporting works to expand application of the unitary-business concept so that an associated group of corporations can be treated as though it constituted a single taxpayer carrying on a unitary business. The total income of a unitary business as carried on by the associated group is determined by combining the income of each corporation involved in that business, and an apportioning ratio is then applied to that total for determination of the taxable income of the corporate member operating in the taxing State.

Citizens Utilities Co. of Illinois v. Dep't of Revenue, 111 Ill. 2d 32, 40, 488 N.E.2d 984, 987 (1986).

Additionally, in an attempt to address the complexities surrounding this issue, a subset of states adopted the Uniform Division of Income for Tax Purposes Act (UDIPTA), including UDIPTA Section 18, which allows for alternative methods of allocation and apportionment.[37] Although not specifically adopted by South Carolina, UDIPTA Section 18 is almost identical to South Carolina's "alternative apportionment statute," subsection 12-6-2320(A)(4). Section 18 states:

> If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any one or more of the factors;

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[37] The National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDIPTA) in n 1957 to promote conformity among states and their income tax reporting structures. James S. Helms & Geoffrey J. Christian, *The Evolution of UDIPTA Section 18's Applicability and its Distortion Standard*, 38 J. Corp. Tax'n 3, 3, 2011 WL 2050897, 1.

> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

UDIPTA § 18 (Westlaw Edge through 2021 Annual Meeting of the National Conference of Commissioners on Uniform State Laws).

Several states that adopted UDIPTA found that combined reporting was authorized under Section 18. *See Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 935 S.W.2d 252 (1996); *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989). Nevertheless, the threshold necessary to show that relief should be granted under Section 18 has been much debated. The current official comment to Section 18 reads:

> Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in Section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

Id. While the comment vests the taxing authority with "broad authority," in practice tax authorities and courts have struggled with what the threshold is for proving that a State's standard apportionment method does not "fairly represent the extent of the taxpayer's business activity in this state." An early school of thought was advanced by Professor William Pierce, a drafter of UDIPTA, who commented that Section 18

> necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be **attacked successfully on constitutional grounds**. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, **departures from the basic formula should be avoided except where reasonableness requires**. Nonetheless, some alternative method must be available to handle the constitutional problem as well as **the unusual cases**, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 227, 700 P.2d 1035, 1039 (1985) (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957) (emphasis added)).

The constitutional threshold for attack referenced by Pierce was articulated by the *Container* Court, which held it would "strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted in that State,' . . . or has 'led to a grossly distorted result." *Container Corp.*, 463 U.S. at 169-70.

However, while meeting the *Container* Court standard assures compliance when the constitutional threshold is at issue, some states have imposed a lesser threshold for determining when to impose an alternative method of allocating income. The Oregon Supreme Court delineated its threshold test as follows in *Twentieth Century-Fox Film Corporation v. Department of Revenue*:

> First, department must demonstrate that the statutory formula as a whole does not "fairly represent the extent of the taxpayer's business activity in this state." . . . It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state. *See Amoco Production Co. v. Armold, Director of Taxation*, 213 Kan. 636, 518 P.2d 453 (1974).
>
> Second, the party with the burden of proof must establish that its alternative method of allocating income is "reasonable." We believe that in the context of UDITPA, reasonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon.

299 Or. 220, 233–34, 700 P.2d 1035, 1042–43 (1985). Tennessee, which adopted UDIPTA, likewise adopted a similar test:

> Thus, to review the Commissioner's decision to impose a variance on Vodafone, the threshold inquiry under the variance statute is whether the standard statutory tax apportionment provisions "do not fairly represent the extent of the taxpayer's business activity in this state . . . ." Tenn. Code Ann. § 67–4–2014(a). If that threshold is met, we look at whether the alternate formula selected by the Commissioner in the variance is "reasonable."

Vodafone Americas Holdings, Inc. & Subsidiaries v. Roberts, 486 S.W.3d 496, 521 (Tenn. 2016).

Having now given some context on the unitary business principle, combined reporting, and UDIPTA Section 18 as these principles have been discussed nationally and within the States, I now turn to South Carolina law.

Does the Department Have the Authority Under Subsection 2320(A)(4) to Require Combined Unitary Reporting?

Corporate Taxation in South Carolina

South Carolina imposes an income tax of 5% on the "South Carolina taxable income" of every corporation "transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C. Code Ann. § 12-6-530 (2014). "South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter." S.C. Code Ann. § 12-6-580 (2014).

If, like TSC, a taxpayer[38] conducts business partly within and partly without South Carolina, then "the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). Additionally, if a taxpayer's principal business in South Carolina is "selling, distributing, or dealing in tangible personal property," then it "shall make returns and pay annually an income tax that includes its income apportioned to this State." S.C. Code Ann. § 12-6-2252(A) (2014). No one disputes that TSC is a retailer principally engaged in selling tangible personal property in this State, therefore, subsection 12-6-2252(A) applies.

Next, under subsection 12-6-2252(A), the taxpayer's "income apportioned to this State is determined by multiplying the net income remaining after allocation[39] . . . by the sales factor defined in Section 12-6-2280." *Id.* Pursuant to subsection 12-6-2280(A), "[t]he sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable

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[38] The term "taxpayer" is defined to include "an individual, trust, estate, partnership, association, company, corporation, or any other entity subject to the tax imposed by this chapter or required to file a return." S.C. Code Ann. § 12-6-30(1) (2014).

[39] Allocation is not an issue in this case. Furthermore, for the purpose of this case and pursuant to subsection 12-6-2252(A), "South Carolina net income" will refer to the amount of calculated income that is multiplied by the sales factor. The result of multiplying the sales factor by South Carolina net income will be referred to as the "taxable base" upon which a corporation is taxed at the rate of 5%. *See* § 12-6-2210(B) (providing "the South Carolina income tax is imposed upon a **base** which reasonably represents the proportion of the trade or business carried on within this State" (emphasis added)).

year and the denominator is the total sales of the taxpayer everywhere during the taxable year." S.C. Code Ann. § 12-6-2280(A) (2014). This statutorily described method of multiplying a taxpayer's South Carolina net income by the sales factor is known as "standard apportionment." However, where this standard method of allocation and apportionment does not "fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for, **or** the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

> (1) separate accounting;
>
> (2) the exclusion of one or more of the factors;
>
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added). At issue in this case is the Department's application of subsection 12-6-2320(A)(4), to impose combined unitary reporting on TSC after it concluded that separate entity reporting resulted in an allocation and apportionment that did not fairly represent the extent of TSC's business activity in South Carolina. Petitioner argues the reporting method and the apportionment method are separate and distinct concepts, and subsection 12-6-2320(A)(4) only authorizes the Department to employ an alternative allocation or apportionment method, not an alternative reporting method.

Media General

In 2010, the South Carolina Supreme Court issued an opinion in *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010) (*Media General*). In this opinion, our supreme court analyzed whether the Department could require a multistate taxpayer that was part of a unitary business to use "combined entity apportionment" instead of "separate entity apportionment" under subsection 12-6-2320(A)(4). *Id.* At 140-42, 694 S.C. at 526-27. Accordingly, subsection 12-6-2320(A)(4) authorizes the Department to require combined unitary reporting as long as the Department meets its burden under subsection 12-6-2320(A)(4). *See id.; see also Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014) (holding where "the Department alone is arguing that the statutory formula does not fairly represent the taxpayer's

business in South Carolina—the Department bears the burden to prove (1) that the statutory formula does not fairly represent [the taxpayer's] business activity in South Carolina and (2) that the proposed alternative formula is reasonable").

Petitioner nonetheless notes that the terminology used by the supreme court in *Media General* is not "combined unitary reporting," but rather "combined entity apportionment." Based upon this difference in terminology, Petitioner seeks to distinguish the method approved of in *Media General* from the Department's imposition of combined unitary reporting in this case. Specifically, Petitioner argues the "combined entity apportionment" described in *Media General* only alters the sales factor to apportion the combined group's sales but retains the South Carolina taxable income of the individual South Carolina taxpayer and not the group's income.[40]

In *Media General*, the supreme court quotes some of the findings from the ALC's underlying order, including a section of the order that describes how "separate entity apportionment" and "combined entity apportionment" are calculated. Specifically, the supreme court includes the following quotation about combined entity apportionment from the ALC's order that is slightly misleading:

> To determine the tax of a related entity or related entities of a multistate corporation in South Carolina by using the combined entity apportionment method, the individual entity or all related entities (if more than one taxpayer is transacting business in this state), must determine a ratio to apply against its/their taxable income to arrive at its/their net taxable income in South Carolina. The ratio is determined by dividing the gross receipts of all the related entities of the multistate corporation in South Carolina or all the related entities[']property, payroll, and sales from within South Carolina, by all the related entities[']gross receipts from everywhere or the related entities[']property, payroll, and sales from everywhere. **The taxpayer (individual entity) then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income.** The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

Media General, 388 S.C. at 146–47, 694 S.E.2d at 529 (emphasis added). Regrettably, the bolded language used here is not as precise as it could be. When viewed in isolation, specification of "the taxpayer (individual entity)" and "the entity's taxable income" in the bolded section could arguably lead Petitioner to conclude that only one entity's taxable income is applied against the combined sales factor instead of against the combined income of the related entities. *Id*. However, when

[40] Although I do not agree with all of the arguments of Petitioner's counsel, I am nonetheless impressed by their keen effort.

this quote is reviewed in the context of the ALC's original order from which it came, it becomes unquestionably clear that the combined sales factor is applied against the combined taxable income of the related entities (the group) and not against a single taxpayer's taxable income. *See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC at 26 n.39 (S.C. Admin. Ct. May 4, 2009). Indeed, a complete reading of the ALC's opinion leaves no doubt that when the ALC discussed "combined entity apportionment," it was referring to "combined unitary reporting," and the two linguistic formulations of this "method" are interchangeable.[41]

Therefore, while a narrow reading of the quoted section from the ALC's order in *Media General* may lead one to infer that "combined entity apportionment" only impacts the calculation of the sales factor under section 12-6-2280, that inference would be incorrect—combined entity apportionment is the same as combined unitary reporting. With the terminology clarified, the significance of *Media General* becomes clearer and dismisses several of Petitioner's arguments in this case, which I discuss below.

Reporting Method and Apportionment Are Not Meaningfully Distinct Under Media General

Petitioner argues that since South Carolina is a separate reporting state, subsection 12-6-2320(A)(4) only authorizes the Department to employ an alternative *apportionment* method, not an alternative *reporting* method, like combined unitary reporting. Petitioner bases its argument upon the premise that apportionment only refers to the formula or ratio (under our law, the sales factor) that is used to estimate the amount of business attributable to the taxing jurisdiction whereas the reporting method controls the amount of net taxable income against which the apportionment factor is applied. Thus, Petitioner claims the Department does not have the authority to change

[41] *See*, *e.g.*, *id.* at 12 ("The term 'combined apportionment methodology' means the following when used herein: an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a portion of the combined net income of the group through the utilization of combined apportionment factors."); *id.* at 12-13 ("The purpose of the combined apportionment methodology is to determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying the apportionment factors of the entire unitary business to the taxable net income of the unitary business and 2) to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise."); *id.* at 28 ("A state could select the combined report method [combined apportionment method] whereby the entire net incomes of several commonly owned unitary corporations . . . are included in the taxpayer's apportionable unitary net income base. . . . Any of these methods are permitted." (quoting the S.C. Tax Commission's SCTC Decision 94-1)).

the net taxable income of the single taxpayer to the net taxable income of the Group consistent with combined unitary reporting. In support of its argument, Petitioner cites *Media General*, which it interprets to only authorize an alternative sales factor (apportionment) rather than an alternative South Carolina net income (controlled by the reporting method).

The parties agree that South Carolina is a separate entity reporting state.[42] This means that, unless otherwise provided, each corporation is individually subject to tax in South Carolina, even if they are related entities that make up a "unitary business," and each files a separate tax return. S.C. Code Ann. § 12-6-4910(2) (2014) ("Income tax returns must be filed by the following: . . . (2) a corporation subject to tax under this chapter."); S.C. Code Ann. § 12-6-530 (2014) (Imposing an income tax on every corporation "transacting, conducting, or doing business within this State of having income within this State"). Because each separate corporation, even if they are part of a unitary business, files a separate tax return, only the modified federal taxable income of the single entity appears in the calculation of South Carolina income tax. § 12-6-580 ("South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter."). Section 12-6-5020 of the South Carolina Code (2014) provides an exception to separate entity reporting and allows certain related corporations to file a single tax return called a consolidated income tax return.[43] However, a consolidated return is not the equivalent of combined unitary reporting. A consolidated return taxes the income of the consolidated entities, whereas combined unitary reporting merely uses the group's net income to better calculate the tax upon a single taxpayer within the group, not the consolidated group as a whole.[44]

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[42] "Separate entity reporting" is not the same as "separate accounting" for the purposes of apportionment. *See*, *e.g.*, *Am. Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 690 (Tenn. Ct. App. 1994) ("Tennessee's standard apportionment formula, set forth in Tennessee Code Annotated § 67–4–811, may be referred to as requiring "separate entity reporting," however, that formula is not equivalent to separate accounting. The standard apportionment formula in Tennessee Code Annotated § 67–4–811 produces a ratio which is multiplied by the taxpayer's apportionable income.").

[43] Only corporations that are subject to tax in South Carolina are allowed to be included in the consolidated return, and each corporation in the consolidated return must separately determine its South Carolina taxable income or loss. § 12-6-5020(B)-(D).

[44] *See*, *e.g.*, *Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 861, 935 S.W.2d 252, 254 (1996) ("In a combined report . . . the combined income of the affiliated group is not computed for the purpose of taxing such income, but rather as a basis for determining the portion of income from the entire unitary business attributable to sources within the state which is derived by members of the group subject to the state's jurisdiction." (quoting *Chesapeake Indus. v. Comptroller*, 59 Md.App. 370, 376, 475 A.2d 1224, 1227 (1984)).

The Supreme Court of Michigan adeptly summarized the difference between separate entity reporting and combined reporting and their relationship to "formulary apportionment."

> Our state has adopted formulary apportionment for individual taxpayers in the ITA [Michigan Income Tax Act]. Recognizing that Michigan is a formulary apportionment state, however, does not resolve the issue in this case because there are at least two different methods of applying the apportionment formula. First, a state may use separate-entity reporting, which requires each entity with a nexus to the taxing state to be considered as a separate and distinct entity, regardless of whether it could comprise a unitary business with other entities.
>
> Alternatively, a state may use combined reporting, which requires "each member of a group carrying on a unitary business [to] compute[ ] its individual taxable income attributable to activities in [the state] by taking a portion of the combined net income of the group through the utilization of combined apportionment factors."

Malpass v. Dep't of Treasury, 494 Mich. 237, 247, 833 N.W.2d 272, 277 (2013) (citation omitted). Notably, the Supreme Court of Michigan considered both separate entity reporting and combined reporting to be methods of applying the **apportionment formula**. Thus, while the Supreme Court of Michigan recognized different types of reporting, it considered them to underneath the umbrella of apportionment.[45] Although some courts have distinguished between reporting methods and apportionment methods,[46] in *Media General*, both the underlying ALC order and the South Carolina Supreme Court referred to combined unitary reporting (or simply combined reporting) as "combined entity apportionment." Essentially, the terminology they used combined the reporting method with apportionment and did not endeavor to distinguish them in any meaningful way. The

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[45] Several other state courts have referred to combined reporting as a form of apportionment. *See Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 756, 684 P.2d 396, 406 (1984) ("The combined report method of allocation of income and expenses is wholly consistent with and a natural extension of the allocation and apportionment purpose of UDITPA and its three-factor formula rather than an exception thereto."); *Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691 (Tenn. Ct. App. 1994) (referring to combined reporting as a method of apportionment); *Hewlett-Packard Co. v. State, Dep't of Revenue*, 749 P.2d 400, 401 (Colo. 1988) ("The combined method, also known as unitary apportionment, is based on a recognition that an integrated business may operate through several separately incorporated entities.'"); *Coca Cola Co. v. Dep't of Revenue*, 271 Or. 517, 528, 533 P.2d 788, 793 (1975) ("The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method.").

[46] *See*, *e.g.*, *Cook v. Dep't of Revenue*, 23 Or. Tax 107, 114 (2018) ("The court is of the opinion that, notwithstanding some imprecise language in discussions of courts over the years, combined reporting is a concept and process separate and distinct from that of apportionment. Apportionment is the process by which a 'base' of business income is divided among two or more states. . . . However, apportionment of a 'base' is separate from determination of the 'base.'"); *Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 295, 615 P.2d 16, 18 (1980) ("Section 39-22-303(5) provides that the department may distribute or allocate income and deductions, or may require returns on a consolidated basis. We conclude that it is that statutory provision for distribution and allocation of income and deductions which authorizes the department to require combined reports since a combined report does allocate or apportion income.").

clear implication is the South Carolina Supreme Court, like the Supreme Court of Michigan, found the reporting method to be under the umbrella of apportionment for the purpose of applying subsection 12-6-2320(A)(4).[47]

This conclusion is consistent with section 12-6-2320(A), which should not be read too narrowly. It provides for the alternative use of other methods of allocation and apportionment, "[i]f the **allocation and apportionment provisions of this chapter** do not fairly represent the extent of the taxpayer's business activity in this State." (emphasis added). In fact, in *Media General*, the supreme court agreed with the ALC that "the legislature enacted section 12-6-2320 as a relief mechanism, and [held] that the plain language of subsection (A)(4) clearly authorizes the department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income, including the combined entity apportionment method." *Media General*, 388 S.C. at 151, 694 S.E.2d at 531. The supreme court also appeared to agree with the ALC's determination that to find otherwise would "thwart legislative intent clearly expressed in **the general allocation and apportionment statutes**," i.e. subsection 12-6-2210(B). *Id.* Indeed, following Petitioner's logic, a taxpayer could utilize a corporate structure to patently circumvent fairly reporting their business activity in South Carolina and thus the revenue earned in this state, under the theory that their actions did not implicate the apportionment formula or ratio.

Furthermore, section 12-6-2320(A) must be read in context with the general statutory tax laws. Specifically, pursuant to the principles of statutory construction, statutes are to be read in harmony with each other whenever possible to give effect to each and achieve the legislative purpose. *See Sloan v. Hardee*, 371 S.C. 495, 499, 640 S.E.2d 457, 459 (2007) (holding "the statute must be read as a whole and sections which are a part of the same general statutory law must be construed together and each one given effect."). Thus, the Court must look at the provisions of all of Chapter 6 of Title 12 and determine whether, as a whole, the provisions of Chapter 6 result in a fair representation of the taxpayer's business activity in this State. *See TNS Mills, Inc. v. S.C. Dept. of Revenue*, 331 S.C. 611, 503 S.E.2d 471 (1998) ("In construing statutory language, the

[47] Petitioner nonetheless argues the description of the combined apportionment method in *Media General*, as discussed above, shows our supreme court only approved an alternative sales factor to reflect a combined group and not alternative reporting of the taxpayer's income as the group's income. As I have already explained, a reading of the ALC's underlying order proves this conclusion is incorrect.

statute must be read as a whole, and sections which are part of the same general statutory law must be construed together and each one given effect.").

One provision of import in Chapter six is subsection 12-6-2210(B) in Article 17, which instructs that "[i]f a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is **imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State**." (emphasis added). According to the Department's evaluation of Petitioner's tax returns during the audit period, the South Carolina income tax was imposed upon a taxable base that **does not** "reasonably represent the proportion of the trade or business carried on within this State" contrary to subsection 12-6-2210(B). Moreover, because it is TSC's taxable income that is causing the distortion, and not the sales factor, reading subsection 12-6-2320(A)(4) as not allowing the Department to use an alternative reporting method as a means of reapportioning the income more fairly would allow separate reporting to remain intact but would lead to a violation of subsection 12-6-2210(B). Thus, subsection 12-6-2210(B) is also a source of authority for the Department to impose combined unitary reporting.[48] *See Duke Energy Corp. v. S.C. Dep't of Revenue*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (holding the primary thrust of South Carolina's apportionment statutes is "to apportion to South Carolina a fraction of the taxpayer's total income reasonably attributable to its business activity in this State.").

In sum, since the reporting method is within the scope of apportionment, the Department has the authority under subsection 12-6-2320(A)(4) to modify both South Carolina net income and the sales factor to fairly reflect the business activity of the taxpayer in the State. Obviously, to determine whether a taxpayer's business activity is fairly represented, the Department may need to look at the taxpayer's group activity to discern whether the taxpayer is using its group activity to circumvent reporting its business activity. Otherwise, a taxpayer could shroud its diversion of income via a transfer pricing agreement.

The Term "Taxpayer" Does Not Prohibit Combined Unitary Reporting

Petitioner argues the Department does not have authority to impose combined unitary reporting under subsection 12-6-2320(A)(4) because South Carolina's corporate income tax

[48] Indeed, some other states have resorted to non-UDIPTA statutes like this to support the imposition of combined reporting where those courts have found a meaningful distinction between reporting method and apportionment. *See, e.g.*, *Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 297, 615 P.2d 16, 20 (1980).

statutes specifically refer to "taxpayer" in the singular, leaving no room for a group of related entities to be taxed together because this would necessitate changing the language of the statutes to "taxpayers." *See* § 12-6-30(1) (defining "taxpayer" in the singular); § 12-6-2210(B) ("If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State."). Petitioner specifically refers to the language in subsection 12-6-2320(A)(4) providing that "any other method" may be used to effectuate equitable apportionment of "**the taxpayer's income**." (emphasis added). Petitioner contends this subsection only authorizes the Department to require an alternative apportionment method against the single taxpayer's income and not the unitary group's income.

In *Media General*, and the Department argued that it could not impose combined entity apportionment because "taxpayer" was defined in the singular and required the Department to use separate entity apportionment. Our supreme court rejected this argument, citing with approval the decision of the Supreme Court of Oregon in *Coca Cola Co. v. Department of Revenue*, 271 Or. 517, 533 P.2d 788 (1975). *Media General*, 388 S.C. at 148-49, 694 S.E.2d at 530. In that case, the Supreme Court of Oregon held:

> The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method. While it is true, as plaintiff points out, that the statute speaks of taxpayer in the singular, this is no bar. We note that the prior statute also spoke in the singular. Yet in *Zale-Salem* we approved combined reporting.

Coca Cola, 271 Or. 517, 528, 533 P.2d 788, 793.[49]

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[49] Despite our supreme court's determination that "taxpayer" could be broadly interpreted to include a unitary group, Petitioner contends the supreme court's holding in *Media General* was based upon its limited review of the ALC's specific ruling that only included the "any other method" language in subsection (A)(4) and did not rely on the rest of the statute, which requires the method to be constrained to "apportioning **the taxpayer's income**." § 12-6-2320(A)94). (emphasis added). Petitioner thus argues the supreme court, in upholding the ALC's ruling in *Medial General*, likewise was focused on the "any other method" language without considering the statutory language as a whole. *Media General*, 388 S.C. at 146, 694 S.E.2d at 525. Petitioner's argument would have this court believe the South Carolina Supreme Court did not review, analyze, or discern the full meaning of the statute before it when making its decision. Regardless of what portion of the statute the ALC quoted in its ruling, the supreme court has the authority under appellate review to review the ALC's ruling for errors of law, including the misinterpretation or misapplication of a statute. Therefore, I decline to believe the supreme court's appellate review was confined to a review of the specific language of the ALC's ruling and not the broader meaning and application of the statute at issue in that ruling. Moreover, it is clear from *Media General* that the supreme court reviewed the entire statute. *Media General*, 388 S.C. at 151, 694 S.E.2d at 531 (holding "the legislature enacted section 12-6-2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) clearly authorizes the department to use 'any other method' to effectuate an

It is also notable that under the unitary business principle, the companies that make up the unitary business are treated as functioning like one entity. Thus, Petitioner's argument fails to consider that once combined unitary reporting is applied, the unitary group, in a sense, becomes the "taxpayer." Thus, while the language of the statute may remain singular, it now encompasses the group, which is a singular entity made up of several interrelated companies that function as a unified whole. However, "taxpayer" only becomes the group "in a sense," because ultimately combined unitary reporting seeks to tax only the singular taxpayer (or taxpayers within the group) with nexus to South Carolina. As our supreme court stated at the end of *Media General*, the "combined entity apportionment method is merely a mechanism for approximating the income attributable to the corporations that comprise the unified business, **but this does not change the fact that the entities will be reporting the taxes due for each entity**. *Media General*, 388 S.C. at 151-52, 694 S.E.2d at 532; *see also Container Corp.*, 463 U.S. at 165–66 ("The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities—even on a proportional basis—unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (citation omitted)). Thus, combined unitary reporting does not tax the unitary group; its function is to better reflect the value of a **single taxpayer** within the group, in keeping with the singular use the term "taxpayer" in our statutes.

Petitioner also cites to subsection 12-6-2320(B)(2) for the proposition that if the legislature intended the term "taxpayer" as used in subsection (A)(4) to be expanded to include a unitary group, then it would have explicitly done so as in subsection (B)(2). Subsection (B)(2) states: "For the purposes of this subsection the word 'taxpayer' includes any one of more of the members of a controlled group of corporations authorized to file a consolidated return under Section 12-6-5020. Also, the word 'taxpayer' includes a person who bears a relationship to the taxpayer as described in Section 267(b) of the Internal Revenue Code." § 12-6-2320(B)(2). However, Petitioner's interpretation is simply contrary to the supreme court's ruling in *Media General* that "taxpayer" can include a unitary group under combined entity apportionment. Moreover,

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equitable apportionment of **the taxpayer's income**, including the combined entity apportionment method." (emphasis added)).

subsection (B)(2) discusses consolidated returns, which contemplates the combination of two or more South Carolina corporate taxpayers' taxable income for the purposes of taxation and, unlike combined unitary reporting, does not ultimately seek to tax the consolidated entities separately. *See* S.C. Code Ann. § 12-6-5020 (2014). Thus, there is a factual reason to distinguish taxpayer from taxpayers in the context of consolidated returns.

Next, Petitioner argues that if "taxpayer" is read to include "taxpayers," then this interpretation "could cause a South Carolina taxpayer with no income (or a loss, so negative income) to apportion 'the taxpayer's income' to South Carolina and owe corporate income tax to this state during years in which the taxpayer had no income in the first place." This argument is grounded in a misunderstanding of how combined unitary reporting works. As explained above, combined unitary reporting seeks to tax **individual taxpayers**, but it uses the combined income and statistics of the unitary group to achieve a fair representation of business activity in a state. Petitioner's hypothetical is also unlikely to occur. For example, if a member of the unitary group outside of South Carolina (with no nexus to South Carolina) has income but the South Carolina group member does not have income or has a loss, then the numerator of the sales factor would remain zero and no tax would be attributed to the South Carolina member who had no income or a loss. Under another hypothetical, if both group members have South Carolina nexus and one member has South Carolina sales but the other does not, then the proportion of income subject to tax would be allocated to the South Carolina member with sales (and income). However, even if Petitioner's hypothetical did occur, then subsection 12-6-2320(A)(4) would be applicable and an alternative method of apportionment would be used to better reflect the taxpayer's business activity in this state.

Accordingly, under *Media General*, our supreme court determined that the definition of taxpayer as singular does not prevent the Department from requiring combined unitary reporting under subsection 12-6-2320(A)(4).

South Carolina Nexus

Finally, Petitioner argues that *Media General's* holding does not apply in this case because the taxpayers that made up the unitary group in *Media General* each had a nexus with South Carolina whereas only TSC has a South Carolina nexus in this case. However, only one member of the group in *Media General* filed a tax return in South Carolina before the Department's audit in that case. *See Media Gen. Commc'ns, Inc., and Media Gen. Broadcasting of S.C. holdings, Inc.*

v. S.C. Dep't of Revenue, Docket No. 07-ALJ-17-0089-CC, *and Media General, Inc. v. S.C. Dep't of Revenue*, Docket No. 07-ALJ-17-0090-CC at 26 n.39 (S.C. Admin. Ct. May 4, 2009). Nonetheless, whether all the entities in the unitary business had South Carolina nexus was not a factor in the supreme court's holding. Indeed, the supreme court's holding is quite broad:

> We agree with the ALC that the legislature enacted section 12–6–2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) clearly authorizes the Department to use "any other method" to effectuate an equitable apportionment of the taxpayer's income, **including** the combined entity apportionment method.

Media General, 388 S.C. 138, 151, 694 S.E.2d 525, 531 (2010) (emphasis added). Moreover, the supreme court further held: "We emphasize that, as a general rule, the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina." *Id.* at 151, 694 S.E.2d at 531-32. Thus, the supreme court's holding is not limited to approval to the combined entity apportionment method for unitary businesses in which all members of the unitary group have a nexus with South Carolina. Rather, the holding broadly determined that the Department has the authority to use alternative methods to equitably apportion the taxpayer's income under subsection 12-6-2320(A)(4) in a way that fairly measures the taxpayer's income in South Carolina.

Moreover, this Court is unaware of any authority that has authorized combined reporting that has also rejected its application because a member of the group does not have nexus with the taxing authority. The point of the unitary business principle is to recognize that income may be generated and flow across state/jurisdictional lines in unitary, multistate businesses, and states may reach across those jurisdictional lines when to do so better reflects the business activity generated in the taxing state. *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 94–95, 142 S.E.2d 445, 446 (1965) ("The purpose of this legislation, as declared in both acts, is to provide for the imposition of the South Carolina income tax, where the taxpayer is also subject to income tax in other states, 'upon a base which reasonably represents the proportion of the trade or business carried on within this State.'"); *Container Corp.*, 463 U.S. at 165 (observing that the "unitary business/formula apportionment method . . . rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the 'unitary business' **of which the taxed enterprise's activities in the taxing jurisdiction form one part**, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and

without the jurisdiction" (emphasis added)). Indeed, the Department employs the two-step version of the *Finnigan*[50] method of combined unitary apportionment to split the taxable base income calculated under combined unitary reporting between two or more taxpayers in a unitary group that have nexus with South Carolina, which suggests that some members of the unitary group may not have nexus. Revenue Ruling #15-5 at 8-9.

Does Separate Entity Reporting Fairly Represent the Extent of Petitioner's Business Activity in South Carolina?

Section 12-6-2320 provides that "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable: . . . (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." In cases where the Department asserts an alternative apportionment method under section 12-6-2320, our supreme court has held that the Department bears the burden of proof. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. There are two steps in this process: the Department must prove (1) that the statutory formula does not fairly represent TSC's business activity in South Carolina and (2) that the proposed alternative formula is reasonable. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200.

TSC is Part of a Unitary Business

As a preliminary matter, I find both factually and legally that TSC, Texas, and Michigan are a unitary business. As the U.S. Supreme Court has recognized, there is no uniform set of facts that will always define a unitary business. *See Allied-Signal, Inc.*, 504 U.S. at 785 ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach . . . and also because the constitutional test is quite fact sensitive." (internal quotation marks and citation omitted)). Nevertheless, it has held that "where the asset in question is another business," the "hallmarks" of a unitary business are "functional integration, centralized management, and economies of scale." *MeadWestvaco Corp.*, 553 U.S. at 30. South Carolina has adopted similar hallmarks of a unitary

[50] There are two standard methods of applying combined unitary apportionment: the *Joyce* method and the *Finnigan* method. For the purposes of this case, it is not necessary to define the difference between them, although the Department summarizes the difference in Revenue Ruling #15-5.

group, including "unity of management, ownership, and control of operations resulting in unquantifiable flows of value among the related entities of the business." *Media General*, 388 S.C. at 141, 694 S.E.2d at 526 (2010); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 602, 258 S.E.2d 93, 97 (1979) ("The corporation possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of E & P, refining and marketing all contributed to and depended upon each other.").

The three hallmarks recognized by South Carolina align with the definitions to which the parties' witnesses testified. According to Mr. Sehgal, the three subjective tests for determining whether a business is unitary are the (1) unity of operations test; (2) unity of use (or centralized management); and (3) contribution and dependency (functional integration). TSC, Texas, and Michigan meet each of three definitions for a unitary business. In fact, Mr. Small, Petitioner's witness, testified that TSC, Texas, and Michigan have the characteristics of a unitary group as commonly understood within the accounting field, including centralized management, functional integration, and common control of the entities. I therefore conclude the TSC, Texas, and Michigan are a unitary business under each of the three tests.

Specifically, under unity of operations, the Group shares a significant amount of operations; specifically, TSC provides accounting, legal, marketing, payroll, and other back-office support to Texas and Michigan. Additionally, through TSC providing these uniform functions across the Group and Texas providing procurement across the Group, the entire Group benefits from economies of scale.

Next, TSC, Texas, and Michigan have centralized management. The entire C-suite of executive is located in TSC, TSC's executives signed the intercompany agreements on behalf of Texas and Michigan, and Texas's Chief Merchandising Officer is a TSC executive. This shows overlapping, common, centralized management.

Lastly, TSC, Texas, and Michigan are very dependent upon each other to function as a result of the intercompany agreements. TSC relies on Texas for procurement, product development, and IP licensing. Texas and Michigan rely on TSC for management, accounting (including centralized payment), legal, and other back-office support activities, and Michigan relies on TSC and Texas for all aspects of its operation, including its employees. None of the three entities could function on their own.

Thus, based upon the highly integrated and dependent nature of the companies and their centralized management and control, I find TSC, Texas, and Michigan meet the definition of a unitary business.

Business Activity in South Carolina

Subsection 12-6-2320(A) requires the Department to show the extent of TSC's "business activity" in South Carolina is not fairly represented by standard apportionment pursuant to separate entity reporting. "Business activity" is not defined for the purposes of subsection 12-6-2320(A). However, it is not so hard to discern in this case and is readily admitted by Petitioner. Petitioner proclaims itself to be a retailer whose business activity in South Carolina is measured by its retail sales in South Carolina Nevertheless, Petitioner argues the Department cannot meet its burden in this case because "neither the Audit Report, the Determination, the Prehearing Statement, the Amended Prehearing Statement, nor any Department witness at the trial of this case attempted to address, measure, or otherwise quantify the extent of [Petitioner's] business activity in this state as the statute requires." I disagree.

In its Department Determination, the Department found TSC's business activity was not being fairly represented by separate entity reporting because TSC was utilizing intercompany transactions to shift income from its retail sales to Texas, thereby significantly reducing its South Carolina taxable income. While the Department may not have specifically stated that TSC's business activity in the state is represented by the income from its South Carolina retail sales, that finding is implicit throughout its Determination. And, while in some cases, income may not reflect business activity, here, 99% of TSC's income, and indeed the Group's income, comes from retail sales, I find that it does.[51] Furthermore, the evidence at the de novo hearing before this Court established that Petitioner's business activity in South Carolina. For instance, Dr. DeRamus quantified TSC's sales and taxable income, its South Carolina sales, and the change in income reported by TSC before and after the intercompany transaction between TSC and Texas shifted the income from the sales from TSC to Texas. Therefore, I find the Department identified Petitioner's business activity in South Carolina as its retail sales.

[51] *Cf. Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1042–43 (1985) ("It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.").

Fairly Represented—Distortion

At what threshold does a method of apportionment stop fairly reflecting the extent of a taxpayer's business in a state? Pursuant to *Container Corp.*, a standard apportionment method offends the Constitution when it is shown by "clear and cogent evidence" that the apportioned income is "out of all appropriate proportion to the business" transacted in the state or "has led to a grossly distorted result." 463 U.S. at 169-70. While this constitutional threshold applies in all cases in which a party challenges the constitutionality of a state's method of apportionment, South Carolina has not inversely adopted it as its minimum threshold to establish unfairness in determining whether to utilize an alternative method apportionment. Furthermore, while South Carolina's alternative method apportionment codified in section 12-6-2320 is very similar to Section 18 of UDIPTA, South Carolina has not adopted UDIPTA. Thus, South Carolina is not bound by any commentary or construction of Section 18.

Although the ALC must itself determine the proper criteria for determining when separate entity reporting does not fairly represent a taxpayer's business activity in South Carolina, it is helpful to consider the analysis utilized by the Department. In Revenue Ruling #15-5, which sets forth the Department's policy on the application of alternative apportionment methods, the Department specifically notes that while some applications of alternative apportionment may involve "unusual or unique circumstances,"[52] it will not require such circumstances to be shown to apply alternative apportionment. S.C. Revenue Ruling #15-5 at 4. Rather, the Department's inquiry is focused on the statutory language of section 12-6-2320, which simply requires the party seeking an alternative method to "factually identify why the use of the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina." *Id.* I find the Department's interpretation to be reasonable and decline to impose any more stringent standard than the statutory language itself imposes.[53] *Kiawah Dev. Partners, II v. S.C. Dep't of Health & Env't Control*, 411 S.C. 16, 34, 766 S.E.2d 707, 718 (2014) ("[W]here an

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[52] This is most certainly in reference to Professor Pierce's widely quoted comment that UDIPTA Section 18 should be used to handle "the unusual cases." *Twentieth Century-Fox Film Corp.*, 299 Or. at 227, 700 P.2d at 1039 (quoting William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957) (emphasis added)).

[53] *Media General* did not adopt a standard because the parties in that case stipulated that separate entity apportionment created distortion and did not fairly represent the taxpayers' business activity in the State. *Media General*, 388 S.C. at 143, 694 S.E.2d at 527.

agency charged with administering a statute or regulation has interpreted the statute or regulation, courts, including the ALC, will defer to the agency's interpretation absent compelling reasons.").

Furthermore, in Revenue Ruling #15-5, the Department outlined "[s]ome of the facts" it may consider when determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina. Revenue Ruling #15-5 at 6. Those facts include:

> (1) amounts paid to related partis for good and services or goods and services provided without payment;
>
> (2) profit margins associated with business activities;
>
> (3) capital investments associated with business activities;
>
> (4) whether goods and services are provided to both related and unrelated parties on similar terms;
>
> (5) whether taxpayers in similar industries provide similar good and services to unrelated parties under similar terms; and
>
> (6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other issues, the relinquishment of control over the business activity.

Revenue Ruling #15-5 at 6-7.

The Department also comments that a 482 transfer pricing study to support prices between related entities "is not determinative of whether South Carolina's statutory apportionment formula fairly represents the taxpayer's business activities in South Carolina." Revenue Ruling #15-5 at 7. It further states that it has required or approved combined unitary reporting "in situations involving the use of purchasing companies, management fee companies, and "east/west" companies within a unitary group." Revenue Ruling #15-5 at 7 (footnotes omitted).

In addition to the guidance provided by the Department in Revenue Ruling #15-5, our supreme court has commented on the type of evidence that may satisfy (or not satisfy) the statutory threshold. In *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, the South Carolina Supreme Court found the evidence offered by the Department did not meet its burden to show the statutory formula did not fairly represent CarMax West's business activity in South Carolina. 411 S.C. 79, 90–91, 767 S.E.2d 195, 201 (2014). The insufficient evidence cited by the supreme court included (1) testimony from the Department's auditor that the "business structure of CarMax West and CBS is often 'linked with tax minimization strategies,'" (2) "the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East" in support of the Department's "determination that CarMax West's income was

diluted," and (3) "bald assertions by [the Department's] witnesses that it satisfied this threshold question." *Id.* at 90-91, 767 S.E.2d at 201.

The South Carolina Court of Appeals likewise found the Department failed to meet its burden in *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). The court of appeals rejected the following Department testimony as insufficient to show the statutory formula did not fairly represent Rent-A-Center's business activity in South Carolina: (1) Rent–A–Center was comprised of multiple entities and the Department auditor believed a management services fee was too high and (2) the Department expert indicated excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina" and "using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator." *Id.* The court of appeals specifically noted that the Department's auditor "did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities." *Id.*

Based upon these two cases, it is clear the Department must provide specific evidence supporting its assertion that separate entity reporting does not fairly reflect TSC's business activity in South Carolina. *See Carmax Auto Superstores W. Coast, Inc.*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. In other words, the Department cannot rely on business characteristics or business structures that "may" indicate a tax minimization scheme, bald assertions of unfairness or distortion, or a contention that standard apportionment results in less tax to this State. *See id.* Nevertheless, I find that the facts listed in Revenue Ruling #15-5 provide good guidance for determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina.

TSC's Business Activity in South Carolina is Distorted

The determination of whether TSC's business activity in South Carolina is fairly represented requires the Court to evaluate TSC's business activity in the context of the unitary business. As described in this Order, TSC, Texas, and Michigan engage in several intercompany transactions for services they provide to each other. But the transactions that predominantly shifted income between the companies was via the Procurement Agreement. Through the 9.7% markup on inventory (transfer price) implemented by the Procurement Agreement, almost 67% of TSC's

income from its retail sales is shifted to Texas, a portion of which represents income shifted from TSC's South Carolina retail sales to Texas.

The evidence established that the shift in TSC's income to Texas through the Procurement Agreement results in a distortion of TSC's income, which also results in an unfair representation of TSC's business activity in South Carolina. For instance, the Group's trial balances show that from 2014-2016, TSC had income (almost exclusively from retail sales) of approximately $400-500 million per year while Texas and Michigan had income of approximately $100 million per year or less. After the transfer pricing is applied pursuant to the Procurement Agreement, TSC's taxable income drops to a little over $100 million per year, Michigan's drops to a negligible amount, and Texas's shoots up to $400 million per year. Similarly, over the audit years, TSC's South Carolina stores had retail sales of approximately $135 million to $160 million on an annual basis, but only about $4 million to $5 million was apportioned to South Carolina as taxable income after transfer pricing was implemented. Although retail sales are not quite equivalent to taxable income, these revenue differences reflect a substantial reduction in income sourced to South Carolina. Thus, after transfer pricing, Texas, on average, accumulated about 71% of the entities' taxable income across the audit years even though TSC had approximately 80% of the retail sales. Moreover, Dr. DeRamus' testimony demonstrated that Texas's costs for its procurement functions were around $13 million, yet it was earning between $350-400 million for its procurement service. The enormous shift in income from TSC to Texas despite TSC having 80% of the Group's sales, and Texas's disproportionate earnings for its procurement function related to its costs, showed that TSC's income is being distorted.

Further, since TSC's business activity in South Carolina is its retail sales, and 99% of the Group's income is derived from retail sales, income from retail sales is a proxy for business activity. Accordingly, the enormous shift in income from TSC to Texas shows that TSC's business activity, including its business activity in South Carolina, is being substantially diluted by income shifting under the Procurement Agreement. The income shift and its resulting dilution/distortion are not justified by Petitioner's explanations.

First, the distortion is not justified by the PwC transfer price study. Although the PwC transfer pricing study was initially used to support the 9.7% markup on inventory in the Procurement Agreement, it is flawed and unreliable. Indeed, **both parties'** experts came to this

conclusion about the PwC report. Therefore, I do not find the PwC report explains or otherwise justifies the distortion in income created by the 9.7% markup on inventory.

Also, Dr. Andrade's transfer pricing study did not support the 9.7% markup as a result of his conclusory and unsupported 50/50 residual profit split. *See Eli Lilly & Co. v. United States*, 372 F.2d 990, 997 (Ct. Cl. 1967) ("[H]ere is some merit to Eli Lilly's complaint in this respect, for it is apparent that a taxpayer subjected to a section 482 allocation will be severely handicapped in opposing any method of allocation where it contains a subjective element such as merely cutting a computed percentage as figure in half.").

Next, in the absence of a reliable transfer pricing study to support the 9.7% markup and the income shift from TSC to Texas, I examined whether the evidence presented in this case justified the distortion in TSC's income. I found it did not. Petitioner, through Dr. Andrade, attempted to argue that Tractor Supply Group, and in particular Texas, is so exceptional at procurement and product development that the 9.7% markup is justified to compensate Texas for this valuable function. I do not find this to be so.[54] Tractor Supply Group represents itself as a retailer and it defines its business activity as retail sales, not procurement services.

To the contrary, I found Dr. DeRamus's testimony concerning what drives Tractor Supply Group's healthy profitability to be more persuasive. Specifically, the Group's stores are positioned geographically in markets in which the Group has little competition and focuses on supplying CUE items, like animal feed, that customers will need to repurchase frequently, in bulk, with cash. As Dr. DeRamus explained, if the procurement function's product selection was driving sales, then it would be expected that the Group's online sales would be substantial. However, online sales are a relatively small portion of the Group's sales; rather, the majority of the Group's sales take place at its brick-and-mortar retail stores. Because retail sales are the primary driver of income and value in the company, I find that it is unreasonable for TSC to agree to transfer so much of its income to Texas for the procurement service, particularly when TSC was previously performing this function successfully itself.

Therefore, the persuasive and reliable evidence before the Court indicates that an unreasonably large portion of TSC's South Carolina income is being shifted, unjustifiably, from

[54] That does not mean that Tractor Supply Group, and in particular Texas, is not very good at procuring products for its stores.

TSC, an entity subject to South Carolina tax, to Texas, an entity that is not subject to South Carolina tax. Because income is a proxy for retail sales in this case, this shift is distorting TSC's business activity in this State.

Separate Reporting Does Not Fairly Reflect TSC's Business Activity in this State

Petitioner contends the solution to its transfer pricing flaws is to fix the transfer price rather than impose combined unitary reporting. Here, I agree with Professor Pomp and Mr. Fort that the exception to separate entity reporting under subsection 12-6-2320(A)(4) should not swallow the rule. The Department cannot choose an alternative method simply because separate reporting leads to lower taxes compared to combined unitary reporting or some other method. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."). As Professor Pomp stated, South Carolina's legislature has determined South Carolina is a separate reporting state and this is the default reporting method used to apportion income to South Carolina. The legislature's choice in this matter should not be lightly disregarded. *See Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89–90, 767 S.E.2d 195, 200 (2014); *citing with approval Donald M. Drake Co. v. Dep't of Revenue*, 263 Or. 26, 500 P.2d 1041, 1044 (1972) (holding "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof). Moreover, the Department has the authority and power under the 482 Regulations to adjust the transfer price if necessary. Therefore, although the income shifted from TSC to Texas distorts TSC's South Carolina business activity in this State, the standard reporting method should be used to correct the distortion if its use can reasonably represent TSC's business activity in this State.

Importantly, I do not find that the corporate structure of the Group, the unitary nature of the Group, or the presence of intercompany transactions on their own indicates that TSC's business activity was not being fairly reflected by separate entity reporting. *See Carmax*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. Indeed, if the transfer price/inventory markup were reasonable and supported by a reliable transfer pricing study, and the payment from TSC to Texas was more aligned with Texas's procurement costs, I would not conclude that separate reporting resulted in an unfair representation of TSC's business in this

state. Rather, it is the incorrect transfer price that is causing the unreasonable shift in income from TSC to Texas, which separate entity reporting allows to persist uncorrected.

In fact, separate reporting allowed TSC to take advantage of the distortion and substantially lower its tax burden in South Carolina. For example, in tax year 2014, TSC had approximately $400,000,000 in income. However, the use of separate entity reporting on TSC's South Carolina's 2014 return resulted in a federal taxable income of $130,998,512. The difference between $400,000,000 and $130,998,512 is a result of the income shifting from TSC to Texas pursuant to the Procurement Agreement; thus, approximately 67% of TSC income was shifted to Texas.

However, here, separate entity reporting cannot be used to correct the distortion because neither expert produced a corrected transfer price. In other words, the Court cannot simply adjust the transfer price and fix the issue. Dr. DeRamus did not conduct a comprehensive transfer pricing study in which he came up with a reliable transfer price or markup on inventory for the Procurement Agreement. Dr. Andrade's transfer pricing study was flawed and unreliable and, thus, likewise did not produce a reliable and accurate transfer price to use to fix the artificial shift of income from TSC to Texas. And, while the Department has the authority and power to challenge and correct transfer prices under the 482 Regulations, its employees do not have the training, capacity, or resources to evaluate transfer prices in an expert manner and must rely on other indicators of distortion prior to hiring a transfer pricing expert during litigation. Thus, there is no evidence to support what a corrected transfer price would be to allow separate entity reporting to fairly reflect TSC's business activity in this state.

Accordingly, while the reporting method is not the true problem in this case, the Court is constrained by the evidence before it and must deal with the fact that without a corrected transfer price, the application of separate entity reporting results in a taxable base that does not a fairly reflect TSC's business activity in South Carolina. *See* § 12-6-2320(A); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State."). As a result, I must look to subsection 12-6-2320(A)(4) as a method of relief; while it may not be the legislature's default method of apportionment, the relief under section 12-6-2320 is also an expression of the legislature's will.

In sum, application of relief under subsection 12-6-2320(A)(4) should be on a case-by-case basis and should reflect the specific facts of each case. The case before the Court is very fact-driven, and it is not one that is likely to reoccur if a unitary company reasonably set forth its transfer prices. One would hope, at least, that the use of an unreasonable transfer price is categorized as unusual. However, in this case, it is clear TSC is more than benignly taking advantage of a corporate structure and South Carolina's default reporting method—it is using a transfer price/markup on inventory to significantly misrepresent its business activity in South Carolina and lower its tax burden in South Carolina without reasonable and reliable justification from a transfer pricing or economic perspective. Thus, my finding in this case that separate reporting does not fairly represent TSC's business activity in this State is unlikely to unleash a torrent of alternative apportionment cases in this State and thus allow the exception to swallow the rule. And, if there was a way to fix the significant artificial dilution of TSC's business activity in South Carolina through fixing the transfer price and utilizing separate reporting, then I would rule in that direction. Since there is not, I must next determine whether the use combined unitary reporting as an alternative apportionment method for the audit period is "reasonable" and results in the "equitable allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4); *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 (holding the Department must prove that the proposed alternative formula is reasonable). I find that it did.

Is the Combined Unitary Reporting Method
a Reasonable Alternative Appointment Method?

Petitioner argues combined unitary reporting is unreasonable and inequitable because it is a gross over-correction of a discrete problem. Pursuant to subsection 12-6-2320(A), "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if **reasonable** . . . (4) the employment of any other method to effectuate an **equitable** allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4) (emphasis added); *See also Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 ("Accordingly, when a party seeks to deviate from a statutory formula under section 12-6-2320(A), the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that . . . (2) its alternative accounting method is reasonable."). In applying this test, I again recognize that it is not reasonable to apply combined unitary reporting

simply because a business is unitary in nature. *See Rent-A-Ctr. E., Inc.*, 42 N.E.3d at 1048–49 ("Regardless of a possibility of distortion, however, Indiana's AGIT statutory framework does not require a member of a unitary group to file a combined income tax return solely because there is a unitary relationship."). Moreover, it is not reasonable to impose combined unitary reporting because it will result in more tax than separate entity reporting. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."). Nevertheless, the Department has met its burden to show the application of combined unitary reporting is reasonable and equitable in this case under subsection 12-6-2320(A). Specifically, I conclude combined unitary reporting is a reasonable and equitable alternative method of apportionment under subsection 12-6-2320(A)(4) because it (1) corrects the income shift from TSC to Texas as a result of the Procurement Agreement such that (2) it reasonably and equitably approximates the taxable net income attributable to TSC's business activity in South Carolina.

First, combined unitary reporting fairly represents the business activity of TSC in South Carolina. For instance, if the transfer price is disregarded, then TSC's taxable income reported to South Carolina in 2014 under separate reporting should have been, conservatively, approximately $400,000,000.[55] When this amount is adjusted by $17,478,426, TSC's net South Carolina taxable income is $417,478,426. The sales factor would remain the same at 2.79%. Multiplying $417,478,426 by 0.0279% results in a taxable base of $11,647,648, 5% of which is $582,382. This number is close to the amount of tax the Department calculated for TSC in 2014 using combined entity reporting, which was $649,486, especially when you consider that the estimate is conservative. It also makes sense that the numbers are close based upon how combined unitary reporting is mathematically set up to eliminate intercompany transactions.

[55] This $400,000,000 is based upon the elimination of the 9.7% inventory markup (transfer price) between TSC and Texas so that the shifted income is added back to TSC's taxable income. In reality, some modest value would be attributed to Texas's services under the Procurement Agreement, but neither party established what transfer price would reflect that value. Therefore, while this estimate is reasonable for demonstrating how much the incorrect transfer price affects the calculation of tax in this case, it is just that, an estimate. In other words, it does not carry sufficient specificity to justify using this approach as a means to modify the separate entity approach.

Furthermore, under combined unitary reporting, the net taxable income from the entire unitary group is applied to the sales factor ratio. This eliminates the effect of intercompany transactions while still recognizing the value shifting between companies (whereas the above estimate under separate entity reporting does not account for this value). As a result, the income that was shifted from TSC to Texas under the Procurement Agreement is returned to the taxable income used to apportion income to this State. This does not merely correct the amount of taxable income for TSC, it adds in Texas's and Michigan's taxable income too, which is how the flow of values between the companies continues to be recognized. However, to compensate for this, the sales factor ratio is changed to align with the addition of the other members of the unitary group to the taxable income. In this particular case, the numerator of the sales factor remains the same in either separate or combined reporting since only TSC has South Carolina sales, but the denominator changes to a larger number—the Group's sales everywhere—resulting in a smaller sales factor ratio. Accordingly, the taxable income is bigger under combined unitary reporting, but the sales factor ratio is smaller because the taxable income and sales factor ratio are in proportion with each other. Because the taxable income is in proportion to the sales factor, the result of combined reporting is the taxable base income for the Group reasonably attributed to South Carolina retail sales. Moreover, because TSC is the only member of the Group to have South Carolina retail sales, the result is also a reasonable and equitable approximation of TSC's income attributable to South Carolina retail sales (its business activity). Even Petitioner's own witness, Professor Pomp, extolled the virtues of combined unitary reporting as a reasonable method and, in fact a better method than separate reporting, for equitably apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

Moreover, if the differences between the tax calculations for TSC in 2014 are compared, it becomes apparent that not only is the tax calculated under combined unitary reporting reasonable, it is much more reasonable than the result from separate entity reporting. Under the standard method of separate entity reporting, in 2014 TSC had $148,476,938 in South Carolina net taxable income and a taxable base of $4,137,310, which meant TSC paid tax on 2.7% of TSC's South Carolina net taxable income. The 2.7% represents the percent of TSC's sales attributable to South Carolina pursuant to the sales factor. However, because TSC's South Carolina income was artificially diluted, TSC only paid taxes on approximately 1% of its net taxable income, even

though 2.7% of its sales were attributable to South Carolina.[56] The difference in percent works out to be around $400,000 in tax. Under combined reporting, no correction is necessary because all of TSC's income was included in the Group's South Carolina net taxable income, and the taxable base was calculated based upon TSC having 2.28% of the Group's sales; therefore, TSC's taxable base was calculated to be 2.28% of the Group's net taxable income, or $12,989,725.

Nevertheless, Petitioner argues the use of combined unitary reporting is unreasonable and inequitable because it causes approximately 8.64% of the TSC's income to be taxed by South Carolina despite only 2.83% of its total business activity (sales) occurring in South Carolina. It argues this is distortion of approximately 205%, which means that TSC is paying 305% of the tax that it should pay based on its business activity here. It further argues that if all states uniformly applied combined unitary reporting to Tractor Supply like the Department has done here, the end result would cause Tractor Supply to pax tax on 305% of its income, not "no more or no less than 100% of the taxpayer's income" as required by the test for reasonableness under *Twentieth Century-Fox Film Corporation v. Department of Revenue*, 299 Or. 220, 233-34, 700 P.2d 1035, 1042-43 (1985) (referenced in the Department's Revenue Ruling #15-5 and holding "the division of income . . . if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income").

However, Petitioner's calculation of this enormous 205% distortion relies on its theory that TSC's reported taxable income of, for example, $130,998,512 in 2014 is correct and does not need to be adjusted. In other words, Petitioner is relying on the 9.7% markup as correct and not distorting TSC's taxable income in South Carolina. If the 9.7% markup does not distort TSC's taxable income, then Petitioner's contention that combined unitary reporting overtaxes TSC would be correct because the Department's taxable base that it calculated under combined entity reporting was $12,989,725, which is approximately 10% of $130,998,512. This would indicate that combined unitary reporting was taxing 10% of TSC's income and that 10% of TSC's sales were South Carolina retail sales when only 2.7% of its sales were South Carolina retail sales in 2014. Nevertheless, because Petitioner's argument is based on an incorrect conclusion that the transfer price is correct and does not create distortion, its calculations are likewise incorrect and

[56] TSC's taxable base of $4,137,310 in 2014 is approximately 1% of TSC's estimated corrected taxable income in 2014 of $417,478,426.

unpersuasive. Thus, combined unitary reporting does not distort the level of income and business activity that should be attributed to South Carolina.

Petitioner also argues combined unitary reporting is unreasonable and inequitable because it taxes income that is earned out of state by non-South Carolina taxpayers. It contends that for the tax years at issue, more than 73% of the income apportioned to South Carolina under the Department's use of combined unitary reporting is not TSC's income. Petitioner's argument again relies on its premise that the 9.7% markup on inventory does not distort TSC's income and business activity in South Carolina and misinterprets the application of combined unitary reporting. Under combined unitary reporting, the unitary group's taxable income is used, which obviously includes the income of all group members, including members who have no nexus to South Carolina; however, the sales factor is adjusted to ensure that only the income attributable to South Carolina, and those members with a nexus, is used as the taxable base in South Carolina. Thus, Petitioner's argument that TSC is taxed for income generated outside of South Carolina is misplaced. Rather, combined unitary reporting captures the income that was generated in South Carolina but shifted to a different taxing jurisdiction, Texas.

Overall, I find Petitioner's arguments are not persuasive and that combined unitary reporting, by the very nature of how it is applied, reasonably carves out and fairly represents the income associated with TSC's business activity in this case, its retail sales. While no method of apportionment is perfect, I find that combined unitary reporting has the benefit of removing the unreliable transfer price(s) in this case while recognizing the value flowing between the Group and carving out only the income from retail sales associated with South Carolina (TSC's business activity). *See Media General*, 388 S.C. at 142, 694 S.E.2d at 527 ("One of the purposes of [combined entity apportionment] is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise."). My comparison of an estimated fix of the distortion using separate reporting supports this conclusion because it produced a tax that was very similar to the tax calculated by the Department under combined unitary reporting.

In fact, the Department's calculation of tax for TSC in 2014 under combined unitary reporting was only about 12% greater than the conservative estimate of tax under the corrected version of separate entity reporting. This confirms that combined unitary reporting is a reasonable approximation for how much TSC would be taxed under separate entity reporting if the

intercompany transaction between TSC and Texas was priced more modestly and reasonably. In contrast, under the distorted version of separate entity reporting in 2014, TSC's calculated tax was only 35% of what I estimated (or a 65% decrease in tax).

Indeed, in *Container Corp.*, the U.S. Supreme Court noted that arriving at the correct amount tax for a unitary business through formulary apportionment is an imperfect undertaking, but a difference of 14% in two apportionment methods was not the kind of distortion that provoked it to reject an apportionment method:

> Of course, even the three-factor formula is necessarily imperfect. But we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant. Indeed, it would be difficult to come to such a conclusion on the basis of the figures in this case: for all of appellant's statistics showing allegedly enormous distortions caused by the three-factor formula, the tables we set out . . . reveal that the percentage increase in taxable income attributable to California between the methodology employed by appellant and the methodology employed by appellee comes to approximately 14%, a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.

463 U.S. at 183–84.

Finally, I conclude the division of income under combined unitary reporting reflects the economic reality of the business activity engaged in by TSC. *See Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. As I have already stated, income is a proxy for retail sales in this case, which is TSC's business activity in South Carolina and combined unitary reporting reasonably carves out the income associated with TSC's retail sales in South Carolina, and thus fairly represents its business activity in this State. § 12-6-2320(A)(4).

Because I find the Department has shown by a preponderance of the evidence that combined unitary reporting is reasonable and equitable, I find the Department had the authority to require TSC to file its taxes during the audit period using combined reporting pursuant to subsection 12-6-23209(A)(4).

Does the Application of Combined Unitary Reporting Violate the Administrative Procedures Act?

Petitioner argues the Department's use of combined unitary reporting against Tractor Supply violates the South Carolina Administrative Procedures Act (APA). In particular, Petitioner

argues the Department's use of combined unitary reporting is so prevalent against a specific group of taxpayers—those the Department decides constitute a unitary business—that the Department issued Revenue Ruling #15-5, which sets forth numerous important policy decisions made by the Department on how it will implement its version of combined unitary reporting against taxpayers it decides constitute a unitary business. Petitioner contends that other states with alternative apportionment statutes have addressed analogous situations where the taxing agency intended for widespread use of a particular alternative apportionment method and those states found that the intended regular use was tantamount to rulemaking which cannot be done absent promulgating a regulation under the state's Administrative Procedure Act. *See, e.g., CBS Inc. v. Comptroller of the Treasury*, 319 Md. 687, 698, 575 A.2d 324, 330 (1990); *see also Metromedia, Inc. v. Dir., Div. of Tax'n*, 97 N.J. 313, 337-338, 478 A.2d 742, 754-755. (1984). In other words, Petitioner argues Revenue Ruling 15-5 should be promulgated as a regulation.

Pursuant to the APA, a "regulation" means "each agency statement of general public applicability that implements or prescribes law or policy or practice requirements of any agency. Policy guidance issued by an agency other than in a regulation does not have the force and effect of law." S.C. Code Ann. § 1-23-10(4) (2005). In *Home Health Service, Inc. v. South Carolina Tax Commission*, the South Carolina Supreme Court explained that determining an agency's statement amounts to a rule or a general policy statement depends upon whether the agency action establishes a "binding norm." *Home Health*, 312 S.C. 324, 328, 440 S.C.2d 375,378 (1994). The *Home Health* court cited to *Ryder Truck Lines, Inc. v. United States* to describe a "binding norm":

> The key inquiry, therefore, is the extent to which the challenged policy leaves the agency free to exercise its discretion to follow or not follow that general policy in an individual case, or on the other hand, whether the policy so fills out the statutory scheme that upon application one need only determine whether a given case is within the rule's criterion. As long as the agency remains free to consider the individual facts in the various cases that arise, then the agency action in question has not established a binding norm.

Ryder Truck Lines, 716 F.2d 1369, 1377 (11th Cir. 1983). Here, Revenue Ruling #15-5 is not a binding norm because the Department is free to exercise its discretion in applying the policy within it. *See id.*

Revenue #15-5 simply explains to the public the various factors and legal authority the Department will consider when evaluating, based on the facts of the case, whether an alternative apportionment method, like combined unitary reporting, is appropriate. Indeed, the determination

of whether the method of calculation of a taxpayer's taxes fairly represents its business activity in this State is a factual determination, not a legal one requiring the promulgation of specific regulations. Under *Media General*, the South Carolina Supreme Court held that combined unitary reporting is allowed and sanctioned by the legislature under subsection 12-6-2320(A)(4). *Media General*, 388 S.C. at 151, 694 S.E.2d at 532. Therefore, in applying combined unitary apportionment in the appropriate factual situations, the Department is not legislating, it is applying the law.[57]

Finally, I do not find Petitioner established that the Department is using Revenue Ruling #15-5 to systematically target unitary businesses for combined unitary reporting without regard to the factual determination required to impose alternative apportionment. Rather, the Department's Revenue Ruling #15-5 informs taxpayers of its interpretation of subsection 12-6-2320(A) and how it applies that highly fact-dependent statute. Therefore, I do not find there "is a close question whether a pronouncement is a policy statement or regulation" such that "the [agency] should promulgate the ruling as a regulation in compliance with the APA." *Home Health*, 312 S.C. at 329, 440 S.E.2d at 378.

CONCLUSION

I conclude the Department has the authority to require combined unitary reporting under subsection 12-6-2320(A)(4). I further conclude that separate entity reporting does not fairly reflect Petitioner's business activity in this State during the audit years and the Department's decision to require combined unitary reporting was reasonable and equitable under subsection 12-6-2320(A)(4).

ORDER

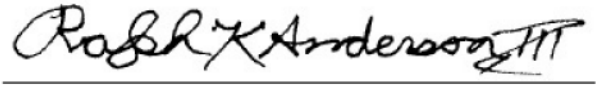
IT IS HEREBY ORDERED that TSC is required to use combined unitary reporting on its South Carolina corporate income tax returns.

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[57] For this reason, I find Petitioner's citation to *Heyward v. South Carolina Tax Commission*, 240 S.C. 347, 126 S.E.2d 15 (1962) in support of its argument to be inapplicable and unpersuasive. *See Heyward*, 240 S.C. at 355-56, 126 S.E.2d at 20 ("The respondent was invested with rule-making power for the purpose of carrying out the legislative will expressed in statutory form; but it had no legal authority to enact new laws in the nature of regulations to satisfy its own theory as to the enforcement of the income tax laws of this State.").

IT IS FURTHER ORDERED that TSC must pay, in full, the assessed tax of $1,383,064.00, and the legally required interest[58], with regard to its 2014 through 2016 South Carolina income tax and license fee obligations.

AND IT IS SO ORDERED.



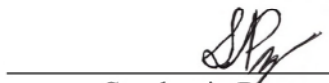
Ralph King Anderson, III
Chief Administrative Law Judge

August 8, 2023
Columbia, South Carolina

[58] Pursuant to S.C. Code Ann. § 12-54-25(A), interest continues to accrue until the tax liability is paid in its entirety.

CERTIFICATE OF SERVICE

I, Stephanie Perez, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Stephanie Perez
Judicial Law Clerk

August 8, 2023
Columbia, South Carolina