THE STATE OF SOUTH CAROLINA
In the Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable John D. McLeod
Administrative Law Judge

Opinion No. 27288 (Filed July 24, 2013)

Centex International, Inc. & Affiliates. . . . . Appellant,

v.

South Carolina Department of Revenue . . . . . .Respondent.

AMICUS CURIAE BRIEF ON BEHALF OF THE SOUTH CAROLINA MANUFACTURERS ALLIANCE ("SCMA")

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I. INTEREST OF THE AMICUS

The South Carolina Manufacturers Alliance (the "SCMA") is a non-profit, bipartisan organization that has been in existence for 109 years. It serves as the manufacturing industry's trade organization in South Carolina. The goal of the organization is to be the voice of manufacturers to the state's legislative and regulatory branches of government, as well as preserving and promoting South Carolina's widely respected business climate. It also provides a variety of educational forums.

Manufacturing employment (while down from historical figures) still constitutes 13% of total state employment in South Carolina,[1] and manufacturers pay 20.9% of all state wages. Manufacturers pay average annual wages of $47,073 versus the South Carolina state average of $37,752. Manufacturing wages range from $135,148 in aircraft manufacturing, $83,980 in nuclear power generation to $37,336 in textiles.[2] By contrast, retail trade pays an average wage of $23,862, with food services paying $14,357 and grocery stores $21,001.[3] Manufacturing directly creates and supports 256,000 jobs in South Carolina and indirectly another 328,000.[4]

Manufacturers also pay some 25% of all property taxes in South Carolina (including both traditional property taxes as well as fee-in-lieu).[5] In some counties manufacturers constitute more than 50% of the property tax base.

A recent study indicates that South Carolina's economy ranks 11th in the nation in being dependent on the manufacturing sector.[6]

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[1] Miley, Gallo & Associates, LLC, *The Economic Impact of Manufacturing in South Carolina* 3 (Dec. 2009), http://myscma.com/public_docs/ManufacturingReport_Final.pdf).
[2] *Id.* at 9, tbl. 7.
[3] *Id.* at 9, tbl. 7.
[4] *Id.* at 13.
[5] *Id.* at 11, tbl. 8.

The South Carolina tax system is characterized by extremes. For example, as the South Carolina Taxation Realignment Commission ("TRAC") reported, "The State has the highest property taxes in the Nation on manufacturers." TRAC quoted a study which contained a 50 state comparison of property taxes on small, medium and large manufacturers in both an urban (Columbia) and rural (Mullins) location. South Carolina had the highest property taxes in the Nation on all five categories cited in the report. Similarly, the Council on State Taxation's (COST) 2009 competitiveness study indicates that South Carolina has the highest property tax rate in the country on industrial machinery and equipment. For these reasons, the SCMA is critically interested in the construction and interpretation of the South Carolina tax incentive statutes and respectfully submits this Amicus Brief.

II. STATEMENT OF ISSUES UNDER APPEAL

I. "A" Taxpayer versus "The Taxpayer"

Did the Court err in holding that "the taxpayer" in the Infrastructure Tax Credit statute did not incorporate the statutory definition of "taxpayer"?

II. Entity that qualifies for a credit under the Pass-Through Statute

Did the Court err in holding that the statutory pass-through provision did not apply?

III. Entity and Aggregate Partnership Theories

Did the Court err in holding that the statutory partnership provision and case law did not apply?

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[6] G. Scott Thomas, *Indiana Leans More on Manufacturing than any Other State*, Charlotte Business Journal (July 18, 2011, 1:00 AM), http://www.bizjournals.com/bizjournals/on-numbers/scott-thomas/2011/07/indiana-leans-heavily-on-manufacturing.html.

III. ARGUMENT

A. General

The majority opinion is a very thorough and well-written Opinion. It provides a sound basis for its conclusions and thoughtfully rebuts the various arguments put forth by the taxpayer in a detailed fashion. Undoubtedly, many would agree with the Opinion. And it is just for those reasons that the SCMA urges the Court to reconsider its decision.

The Infrastructure Tax Credit statute is an economic development incentive. It was enacted as a result of the General Assembly's understanding that state (DOT) and local (county/city/Water and Sewer Districts) governments simply do not have the financial wherewithal to construct necessary road, water and sewer improvements. Accordingly, it provides a valuable tool whereby a real estate developer will make such improvements at its expense and take a tax credit for a (small) portion of its disbursements. Centex expended some $68 million for public infrastructure which resulted in a potential tax credit of $5 million.

B. "A Taxpayer" versus "The Taxpayer"

The Centex general partnerships were three corporations. If they had cut the checks for the $68 million in qualifying infrastructure expenditures, the credit would clearly be allowed. Instead, they opened a joint bank account in the name of a general partnership and funded it with $68 million. The joint partnership then cut the checks. The DOR argued that unless the checks were cut directly by the corporations, no credit is allowed. A majority of the Supreme Court agreed.

While SCMA members rarely use the Infrastructure Tax Credit, the majority's Opinion is deeply troubling. Does this cut the check rule apply to other tax incentives?

For example, the most common tax incentives used by SCMA members require a minimum capital investment. For example, the material handling sales tax exemption, 12-36-2120(51), states "To qualify for this [material handling] exemption, the taxpayer shall...invest at least thirty-five million dollars in real or personal property in this state..."

Do these expenditures have to be made by "the taxpayer?" For example, in the vast majority of projects, the capital investment is technically made by a bank. The bank cuts the checks for e.g. $35 million directly to the construction contractors who build the building and install the material handling equipment and the bank takes a first mortgage. Under a "cut the check" rule, the bank-not the manufacturer – made the capital investment. Is the manufacturer entitled to the incentive?

Take the simplest example:

A stockbroker takes a client to lunch and pays for it with his personal credit card. The broker is reimbursed by the stockbroker corporation which subsequently takes a deduction as an ordinary and necessary business expense. Under the *Centex* decision, no deduction is allowed. The corporation didn't pay for the lunch – the qualifying business expense. The corporation wrote a check to the broker, which is not deductible as a business expense.

Are the above examples absurd? Centex relied on an explicit statutory definition of "taxpayer" which includes partnerships! There is no statutory definition of "capital

investment" which includes bank loans. And there is no statutory definition of ordinary and necessary business expenses which includes reimbursements.

Of more relevance, many of the tax credit statutes use the term "the taxpayer." Are legions of lawyers and accountants now going to have to review every tax credit statute in light of the *Centex* decision and opine exactly how the capital investments are going to have to be made?

The majority's hyper-literal reading of the Infrastructure tax credit will lead to other tax credit issues. For example, Section 12-6-3470 reads:

> (A)(1) An employer who employs *a* person who received Family Independence payments within this State for three months immediately preceding the month *the* person becomes employed is eligible for an income tax credit of:
>
> (a) twenty percent of the wages paid to *the* employee....(emp added)

Does the statute limit the credit to hiring a single employee? Under *Centex*, the statute references "a person" and "the employee," and the credit is accordingly limited to hiring one person!

Similarly, Section 12-6-3350(A) states:

> (A) A taxpayer having a contract with this State who subcontracts with *a* socially and economically disadvantaged small business is eligible for an income tax credit equal to four percent of the payments to *that* subcontractor for work pursuant to the contract. *The* subcontractor must be certified as a socially and economically disadvantaged small business as defined in Section 11-35-5010 and regulations pursuant to it. (emp added)

Does this statute limit state contractors to subcontracting with a single small business? Under the *Centex* "*the*" rule, it may.

Even if the DOR never takes this position, employers may decline to utilize the

tax credit and hire recipients of Family Independence payments or subcontract with some businesses out of concern for this issue.

B. Statutory Ambiguity is Resolved Against the Government

Centex and the DOR no doubt argued that the Infrastructure Tax Credit statute was beautifully and clearly worded (and such wording supported their position.)

Everybody else would probably agree that the statute was ambiguous and could have been better written.

The DOR argued (and a majority of the Supreme Court agreed) that the statute actually reads as follows:

> A) A corporation may claim a credit for the construction or improvement of an infrastructure project against taxes due under Section 12-6-530 or Section 12-11-20 for:
>
> (1) expenses paid or accrued by the ~~taxpayer~~ *corporation*;

Centex no doubt argued that the statute read, "A corporation may claim a credit...for: (1) expenses paid or accrued by the taxpayer as defined in section 12-6-30."

Neither the DOR nor Centex wrote the statute – the General Assembly did. And the General Assembly wrote it to incentivize the construction of public sector improvements by the private sector.

Tax credits are strictly construed against the taxpayer. But ambiguities in tax credit statutes are resolved against the Government, see e.g. *SCANA Corp. v. SC Dep't of Revenue*, 384 S.C. 388, 394 n.3, 683 S.E.2d 468, 471 (2009) (Beatty J., dissenting.)

Both Centex, the DOR, the majority and dissenting opinions make excellent, even persuasive arguments. By definition therefore, the statute is ambiguous. Such ambiguity is resolved against the government. In simple terms, tie goes to the taxpayer.

C. "Entity that Qualifies for a Credit" under the Pass-through Statute

Many business entities are now structured as non-corporate entities. Many SCMA members have partnership and LLC subsidiaries. The General Assembly responded to this development by enacting section 12-6-3310(B)(1) which allows partnerships to pass-through economic development tax credits to their members (who, in many cases, are corporations.)

Perhaps because the section's only limitation is the words "Unless specifically prohibited," little attention has been paid to the exact wording of the statute, and the DOR – prior to *Centex* – and the business community have been in remarkable agreement regarding the pass-through of tax incentives.

An example of this is recent DOR PLR #11-6, which dealt with the bio-mass tax credit statute, section 12-6-3620. The Infrastructure Tax Credit and the bio-mass tax credit statutes are remarkably similar. Both are corporate tax credits and neither contain an explicit pass through provision.

The facts of the PLR and *Centex* are remarkably similar. The qualifying expenditures in both cases were not made by the corporation. Instead, the expenditures were made by a partnership (Centex) and an LLC (PLR #11-6.) The partners in *Centex* were C corporations and S corporations in PLR #11-6.

The DOR ruled in PLR #11-6 that the expenditures made by the LLC qualified for the credit which passed through to the S corporation members.

And the DOR relied on the general pass through provision as well as the definition of taxpayer found in section 12-6-30.

Prior to *Centex*, taxpayers have assumed the reasoning in PLR #11-6 was in fact the law in South Carolina.

PLR #11-6 is clearly wrong under the reasoning of the majority Opinion in *Centex*.

And legions of lawyers and accountants are going to have to attempt to reconcile the majority decision in *Centex* with their entity structure.

Also of significance is the majority's observation that the Infrastructure Tax Credit statute does not, unlike sections 12-6-3340, 12-6-3370 and 12-6-3560, contain an explicit pass-through provision. Tax practitioners have assumed after passage of section 12-6-3310, that such a provision was unnecessary. Now every corporate tax incentive provision is going to have to be carefully examined.

D. Entity and Aggregate Partnership Theories

Dalton v. SC Tax Commission, 295 S.C. 174, 367 S.E.2d 459 (Ct. App. 1988) and *Ellis v. SC Tax Commission*, 280 S.C. 65, 309 S.E.2d 761 (1983) found – in accordance with the general partnership law – that for tax purposes, expenditures are deemed to be made by partners, and not the partnership. This rule in both cases disallowed partners to take losses on their South Carolina individual income tax returns.

The rule in these two cases allows the Centex corporate partners to qualify for the Infrastructure Tax Credit as the partnership is ignored for tax purposes. Under the rule it is exactly as if the three corporation partners had cut the checks.

Why does the rule disallow losses – but not apply to credits? More importantly, has *Centex* overruled or limited *Ellis* and *Dalton*?

This is a very significant point! 2280 BNA TMP 2280 – 1st at section 2280.05 (attached Ex. A) states:

> Planning Point: Some publications have reported that South Carolina taxes resident individuals on their world-wide income. This statement appears to be based

> upon a negative inference from S.C. Code Ann. § 12-6-1720(1)(b), which provides that a non-resident individual is only taxed on his apportioned share of business conducted in South Carolina. *The authors suggest that it is incorrect to infer from this section that South Carolina residents are taxed on their worldwide income. South Carolinians are taxed on their worldwide personal service income, [FN285] but nothing has overruled the Seward and Ellis cases. The department has never attempted to tax South Carolina residents on their world-wide (non-personal service) business income.* (emp added.)

This TMP Portfolio was written by a former (Rick Handle) and current (Deanna West) employee of the DOR. It bears repeating, has *Centex* overruled *Dalton* and *Ellis*? Are South Carolinians now subject to tax on their worldwide income?!

IV. CONCLUSION

In order to rule that the taxpayer's $68 million in expenditures did not qualify for the credit, the majority had to find:

(1) that "taxpayer" did not mean "taxpayer" as defined by the General Assembly in 12-6-30;

(2) rely on a 1957 Colorado case which held that serving time in any jail but the Colorado State Penitentiary did not serve as the basis for removal from office, disbarment or divorce;

(3) disregard the pass-through statute although nothing in Infrastructure tax credit statute "specifically prohibited" it;

(4) rely on two cases, *Bell Atlantic Nynex Mobile, Inc. v. CIR*, 869 A2d 611 (Conn. 2005) and *L&W Constr. Co. v. Wisconsin Dept. of Revenue*, 439 N.W. 2d 619 (Wisc. Ct. App. 1989), even though the statutes in both cases (unlike the South Carolina

Infrastructure Tax Credit statute) explicitly limited the tax credit to the "corporation" which paid the expenditures (taxes);

(5) disregard section 12-6-600 and two South Carolina Supreme Court cases directly on point, *Dalton v. South Carolina Tax Commission*, 295 S.C. 174, 367 S.E.2d 459 (Ct. App. 1988) and *Ellis v. South Carolina Tax Commission*, 280 S.C. 65, 309 S.E. 2d 761 (1983); and

(6) ignore the DOR's own policy document, PLR #11-6 with remarkably similar facts and law!

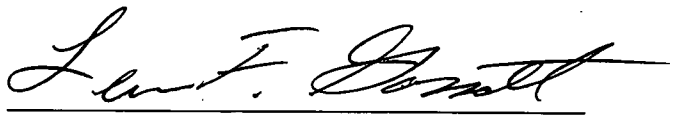
As a result of the majority opinion, the infrastructure expenditures incurred by the following types of entities qualify to "earn" an infrastructure credit:

- Corporation
- Individual shareholder of an S Corporation (via flow-through)
- Corporate shareholder (QSSS) of an S Corporation (via flow-through)
- Individual member of a Limited Liability Company taxed as partnership (via flow-through)
- Corporate member of a Limited Liability Company taxed as partnership (via flow-through)
- Limited Liability Company taxed as a corporation

According to the decision, this leaves only one other common type of entity that does not qualify for the infrastructure credit:

- An actual Partnership (taxed as a partnership)

The Supreme Court should reject this absurd result and hold that the Centex corporate partners qualified for the credit.



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CERTIFICATE OF COUNSEL

The undersigned certifies that this Amicus Curiae Brief filed by the South Carolina Manufacturers Alliance ("SCMA") complies with Rule 211(b), SCACR.

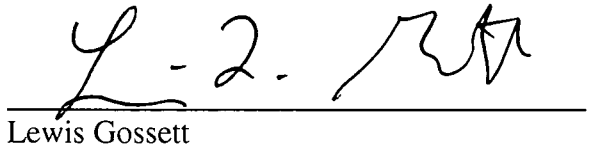

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Exhibit A

TMSTATEPORT No. 2280 s 05, TMSTATEPORT No. 2280 § 05, TMSTATEPORT No. 2280 § 05 (BNA), 20XX WL 4734429 (FEDERAL)

BNA Tax Management Portfolios
State Series
Specific States
2280-1st: South Carolina Corporate Income Tax

2280.05. Allocation and Apportionment

2280.05. Allocation and Apportionment

South Carolina and other states generally use allocation and apportionment to assure that they are taxing multistate and multinational corporations on an appropriate amount of income. National policy expressed through the Due Process and Commerce Clauses of the Constitution prevent states from over taxing multistate and out–of–state businesses. They do this by prohibiting states from taxing businesses that do not have Due Process and Commerce Clause nexus with the state; by prohibiting taxes which discriminate against multistate and out–of–state businesses; and by limiting states to taxing property, activities, or income earned within their geographical limits. State political considerations generally assure that states do not over tax in–state businesses compared with multistate and out–of–state businesses.

A taxpayer whose entire business is transacted or conducted in South Carolina is subject to income tax based on the entire taxable income of the busi-

the income apportionable to South Carolina than Avco reported in its returns. The court held that the net loss must be allocated. The actual receipt of dividends is not required before a related expense adjustment can be made.

Planning Point: S.C. Dept. of Rev., Revenue Ruling No. 98–14 (June 22, 1998), recognizes an argument that may be useful in appropriate cases for distinguishing *Avco* . This advisory opinion upholds the deduction of commissions paid to a subsidiary, a properly formed and operated foreign sales corporation (FSC). This advisory opinion distinguished *Lowenstein v. South Carolina Tax Comn.*, which denied the deduction of commissions paid to a domestic international sales corporation (DISC) because the DISC lacked economic substance. [FN280] To allow the deduction of the commission paid to the FSC, the advisory opinion reasoned that the payments were legitimate business expenses, and therefore, not expenses related to the generation of a dividend.

2. In *Seward v. South Carolina Tax Comn.*, the South Carolina Supreme Court held that the taxpayers could not claim deductions arising from operating losses incurred by the taxpayers in an out–of–state cattle operation. [FN281] They bought cattle for breeding purposes and hired a management company to run the business. The court ruled that the deductions could not be taken against South Carolina income because the deductions were expenditures incurred in connection with cattle having a situs outside of South Carolina, the sales of which would not be taxed in South Carolina. Secondly, under South Carolina apportionment statutes, income from an out–of–state business is not taxed by South Carolina and, conversely losses from such a business are not deductible.

3. *Ellis v. South Carolina Tax Comn.*, involved South Carolina residents who incurred losses as limited partners in an out–of–state oil and gas limited partnership. [FN282] The court held that since the losses in question were incurred by taxpayers from out–of–state limited partnership interests, those losses retained the character of out–of–state losses when distributed to taxpayers by reason of a statutory "pass through" provision. Therefore, the taxpayers could not deduct the losses on their South Carolina income tax returns. The court held that gains from a partnership that conducts no business in South Carolina would be passed through the partnership to the partner in South Carolina. Pursuant to South Carolina statutes, none of these gains are included in the base to which South Carolina income tax is applied. Therefore, if no gains are included in the base by reason of the statutes involved, then no losses would be included in the base. The court reasoned that partnerships and limited partnerships are not taxed on their income or losses. Although partnerships file information returns, the income or losses are passed through and distributed to the partners and reported in their income tax returns. [FN283]

The court made it clear that the "pass through" rule is equally applicable to limited partnerships. South Carolina does not distinguish between a general and limited partnerships or partners:

> By reason of the "pass through" rule, the character of any item of income, gain, loss, deduction or credit included in a partner's distributive share of gains and losses shall be the same as if such item was realized directly from the source from which realized or incurred by the partnership. In other words, each item of income, gain, loss, deduction or credit is treated as if it were realized or incurred by the partner directly from the source without ever having passed through the partnership...Since the losses in question were incurred by the taxpayer from out–of–state partnership interests, these losses retained the character of out–of–state losses when distributed to the taxpayer by reason of the "pass through" provision... [FN284]

Planning Point: Some publications have reported that South Carolina taxes resident individuals on their world–wide income. This statement appears to be based upon a negative inference from S.C. Code

Ann. § 12-6-1720(1)(b), which provides that a nonresident individual is only taxed on his apportioned share of business conducted in South Carolina. The authors suggest that it is incorrect to infer from this section that South Carolina residents are taxed on their worldwide income. South Carolinians are taxed on their worldwide personal service income, [FN285] but nothing has overruled the *Seward* and *Ellis* cases. The department has never attempted to tax South Carolina residents on their world–wide (non–personal service) business income.

4. In *Hercules v. South Carolina Tax Comn.*, [FN286] the court held that the matching principle can take precedence over the literal reading of a statute. When *Hercules* was decided, South Carolina's allocation statutes provided that gains and losses from the sale of real property located in South Carolina are allocable to South Carolina, and gains and losses from the sale of real property located outside South Carolina are allocated to the state in which the real property is located. [FN287] It did not matter whether or not the real property was connected with the taxpayer's trade or business.

The department argued that the Code provides that the gain or loss from sales of real estate located in South Carolina is allocated to South Carolina and that such income is not income that can be apportioned.

The court responded that this argument overlooked the fact that the department allowed Hercules to apportion depreciation of the real property for income tax purposes throughout the many states in which it did business. This caused South Carolina to receive greater income tax revenues from Hercules during this period of time than would have been received had all the depreciation been allocated to South Carolina. Further, the court reasoned, other states that allowed Hercules a tax deduction for this apportioned depreciation are entitled to recapture this depreciation upon the sale of the plant. The court said:

> If we were to hold that § 12–7–1120(4) [since amended and then recodified as S.C. Code Ann. § 12-6-2220(4)] allows South Carolina the sole benefit of recapturing all of the depreciation taken, one of two gross inequities would result. Either all other states which allowed depreciation would be denied the right to recapture or Hercules would be subjected to double taxation. It cannot be seriously argued that the legislature intended such a result. [FN288]

Therefore, if a taxpayer claims that some of its income is not apportionable to South Carolina because it is not connected with a business that is conducted or transacted in South Carolina, auditors will look to see whether any of the expenses incurred in that business were deducted against South Carolina apportionable income.

There is no statute, regulation, or formal department policy on how general expenses (interest expenses, salaries, etc.) should be allocated and/or apportioned between business and non–business income. The department will trace funds where possible and apportion expenses which cannot be traced. Generally, the department's auditors use the "DC Formula." [FN289] The DC Formula segregates expenses used to carry investment (nonbusiness) assets, the income from which is allocated, using the following formula: Related Expenses = Attributable Expenses x Investment Assets ÷ Total Assets

> **Related Expenses:** The interest and general and administrative expenses which will be associated with the investment assets and allocated to the state to which the income from the investment assets is allocated.
>
> **Attributable Expenses:** All interest and general and administrative expenses that cannot be directly traced to a business or nonbusiness activity.
>
> **Investment Assets:** The book value of investment assets, the income from which would be allocable or nontaxable.
>
> **Total Assets:** The book value of all assets of the corporation.

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PROOF OF SERVICE

I certify that I served the **Amicus Curiae Brief on Behalf of the South Carolina Manufacturers Alliance ("SCMA")** on the Appellant and Respondent by depositing copies of it in the United States Mail, postage prepaid, on August 19, 2013 addressed to their attorneys of record as follows:

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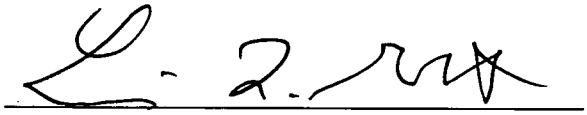

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