THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No.: 2024-000013

Administrative Law Court Case No. 19-ALJ-17-0416-CC

Tractor Supply Company,..... Appellant,

v.

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

APPELLANT TRACTOR SUPPLY COMPANY'S FINAL OPENING BRIEF

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INTRODUCTION

This case should involve the use by the South Carolina Department of Revenue (the "Department") of its § 482 powers to adjust the price of an allegedly high transfer pricing payment to a related party. However, because the Department chose not to use these powers, the Administrative Law Court (the "ALC") improperly traveled down the inapplicable, erroneous, and complex path reflected in these proceedings in which the ALC misapplied the alternative apportionment statute at S.C. Code Ann. § 12-6-2320[1] (the "AA Statute") against Tractor Supply Company ("TSC").

South Carolina only seeks to tax the portion of a multistate taxpayer's total income derived from its business activity in this state. If 10% of a taxpayer's total business activity occurs here, then South Carolina seeks to tax only 10% of that taxpayer's total business income. Apportionment methods are designed to determine that fraction, which is then multiplied by the taxpayer's total business income to calculate the income apportioned to this state.

On the other hand, apportionment methods are *not* designed to determine or calculate the amount of a taxpayer's total business income. That is determined by a different set of rules, and in South Carolina, it starts with the taxpayer's federal taxable income ("FTI"). A taxpayer's total business income is its FTI, as modified by state law adjustments, less income (generally non-business income) that is first allocated to a particular state.

The required apportionment method for TSC is the sales factor (i.e., TSC's South Carolina sales divided by its everywhere sales), and its sales factor for the Audit Period is just shy of 3% because just under 3% of its total sales occurred in this state. If that sales factor did not properly measure the portion of TSC's everywhere business activity that occurred in this

[1] All code sections are from the South Carolina Code of Laws Annotated unless otherwise noted.

state, the AA Statute allows the Department to require a different method to accomplish what the sales factor was intended to but failed to accomplish. When an alternative method is required, restrictions are necessary to protect taxpayers from agency overreach, namely the method must be reasonable, equitable, and one that (like the sales factor) apportions a fraction of TSC's total business income to this state for taxation. *See* § 12-6-2320(A)(4).

To invoke the AA Statute, the Department must first prove TSC's sales factor did not fairly represent the portion of TSC's business activity that occurred in this state. However, the ALC applied the wrong legal standard and required the Department prove *separate reporting* (versus the sales factor) did not fairly represent the portion of TSC's business activity that occurred here. Separate reporting is not an apportionment method; it is a tax filing method, and unlike the sales factor, it is not intended nor designed to measure a taxpayer's South Carolina business activity. The ALC then found that wrong standard satisfied because of a business expense deduction taken by TSC for its payments to an affiliate, TSC of Texas, in exchange for the latter procuring inventory (among other things) for TSC to sell in its retail stores. The AA Statute was invoked based on the existence of this deduction (and no allegation of it being improperly high), and the ALC then found use of the AA Statute proper based on the ALC's belief the deduction was too high—a belief it reached not because the Department presented evidence showing the price paid to TSC of Texas was *not* an arm's length price but instead because the ALC determined *TSC* failed to prove the price *was* an arm's length price. That is improper burden shifting under any standard, including the wrong standard applied here. Moreover, while an improperly high deduction would reduce TSC's FTI below where it should be, the AA Statute is not intended to fix a problem with a taxpayer's FTI.

Furthermore, the ALC also erred by misconstruing the AA Statute to allow the

Department to require combined unitary reporting ("CUR") as the alternative "apportionment" method. CUR is an alternative tax filing method that combines the FTI of all members of a unitary group (including ones with no nexus to South Carolina) and then uses an apportionment method to apportion the combined income here. The ALC should have found the Department could not use the AA Statute this way as it is contrary to the plain language of the statute and its legislative intent.

In sum, the ALC's conclusions in this case are forcing a square peg into a round hole by applying the AA Statute in a context it was never intended to (and does not) apply. The ALC is, respectfully, not properly applying the AA Statute or the requirements of the Administrative Procedures Act (the "APA") and is failing to consider both the lack of evidence presented by the Department as well as the substantial evidence presented by TSC supporting its positions. Thus, the Order should, respectfully, be reversed.

STATEMENT OF THE ISSUES ON APPEAL

I. DID THE ALC ERR BY APPLYING THE WRONG LEGAL STANDARD FOR STEP ONE OF THE AA STATUTE?

II. DID THE ALC ERR BY FINDING CUR AUTHORIZED UNDER STEP TWO OF THE AA STATUTE IN THIS CASE?

III. DID THE ALC ERR IN FINDING THE DEPARTMENT MET ITS BURDEN OF PROOF UNDER THE WRONG STANDARD FOR STEP ONE OF THE AA STATUTE?

IV. DID THE ALC ERR IN CONCLUDING CUR IS REASONABLE AND EQUITABLE UNDER STEP TWO OF THE AA STATUTE?

V. DID THE ALC ERR IN CONCLUDING THAT THE APA WAS NOT VIOLATED?

STATEMENT OF THE CASE

This case involves a protest by TSC of an assessment of corporate income taxes by the Department for the tax years January 1, 2014 through December 31, 2016 (the "Audit Period").

TSC filed its tax returns for these years using the statutorily required apportionment method (the sales factor). The Department's assessment and audit, which the Determination affirmed, alleged that TSC's business activity was not fairly represented here, invoked the AA Statute to impose CUR, and assessed additional tax of $1,383,064 plus interest. TSC filed a request for contested case hearing with the ALC on December 11, 2019. The ALC held a five-day hearing from January 23 to 27, 2023 and issued a Final Order (the "Initial Order") on August 8, 2023. TSC filed a motion for reconsideration of that order on August 18, 2023. On August 21, 2023, the ALC entered an order rescinding its Initial Order pending disposition of TSC's motion. On December 4, 2023, the ALC entered two orders: a Reconsideration Order, which, while stating it granted TSC's motion, did not grant the relief requested and contained the same result as the prior order (albeit with additional bases/analysis), and an Amended Final Order (the "Order") (also with additional bases/analysis). TSC filed a second reconsideration motion on December 14, 2023. On January 3, 2024, TSC filed its notice of appeal. That same day, the ALC issued an order denying TSC's second reconsideration motion, and TSC filed an amended notice of appeal as to all three orders. The parties then filed a Joint Motion to recognize the inapplicability of the automatic stay to the ALC's Order on TSC's second reconsideration motion, which this Court granted.

STATEMENT OF FACTS

A. TSC Entities and Operations

TSC is a publicly traded parent corporation of an affiliated group of entities that operate retail farm and ranch stores in the United States, which offer an extensive mix of products necessary to care for home, land, pets, and animals. *See, e.g.,* R. 2890, 2014 TSC Annual Report and 10-K ("Annual Report"). TSC is headquartered in Brentwood, Tennessee (R. 449:15-19),

and it, along with TSC of Texas and TSC of Michigan (collectively, the "the TSC Group") had between 1,382 to 1,738 stores during the Audit Period. R. 2891, 2963, and 3041, Annual Rpts.

TSC owns and operates retail stores in all states except Texas and Michigan, which is approximately 80% of the total retail stores owned by the TSC Group. *See* R. 1245:3-8. TSC operated 32 to 42 retail stores in South Carolina during the Audit Period and is the only entity in the TSC Group with business activity in this state. *Id.* at 1246:11-14 and 1291:11-14; R. 2913, 2987, and 3066, Annual Rpts.

TSC of Texas owned and operated between 145 to 196 retail stores in Texas during the Audit Period. R. 2913, 2987, and 3066, Annual Rpts. TSC of Texas also (1) owns marketing-related intangibles used by the TSC Group; (2) procures inventory from third parties that is ultimately sold by the TSC Group's stores; and (3) develops private label goods manufactured on its behalf and sold by the TSC Group's stores. R. 1245:19-1246:3; 878:15-24; R. 3126, TSC Org. Structure. TSC of Michigan owned and operated between 77 to 81 retail stores in Michigan during the Audit Period. R. 1246:4-6; R. 2913, 2987, and 3066, Annual Rpts.

B. 2001 Restructuring

The current TSC Group structure has been in place since 2001. R. 1246:18-22. Prior to then, it existed as a single entity (only TSC). *Id.* In the mid-1990s, TSC went public and began trying to expand at a faster rate. *Id.* at 1247:11-859:14. It wanted to increase its purchasing power, grow the procurement function, and reduce the risk of reliance on distributors and vendors. *Id.* at 1249:15-1252:8. As a result of these and other goals, including tax efficiency, the current structure was implemented in the 2001 Restructure. *See id.* at 1254:14-1256:14; 1258:4-1259:6. The ALC correctly found tax planning is not wrongful and is often part of good business planning and tax advice. *See* R. 67, n. 5, Order. It correctly did not find TSC had no business

purpose for the 2001 Restructuring or that tax minimization was the only goal of the restructuring. *Id*.

C. Procurement and Licensing Activities

The procurement function performed by TSC of Texas is highly evolved and unique and includes identifying, sourcing, negotiating, and qualifying vendors and their products; inventory management; global sourcing; and developing private TSC-branded products with reliable supply chain availability, consistent high quality, and attractive pricing. *See generally* R. 1259:19-1268:14. TSC of Texas charged a 9.7% markup on the cost of inventory sold to TSC and TSC of Michigan. *See* R. 3826, Inventory Procurement Agr. TSC selected the price based on a transfer pricing study prepared by PwC Study. *See infra* Facts §D. TSC of Texas also licenses intellectual property ("IP") to TSC. R. 485:20-486:6. TSC's IP is a "valuable asset[]" of the business and has "significant value and is an important component of [its] merchandising and marketing strategies." *See, e.g.,* R. 2903, Annual Rpt; R. 4441, Licensing Agr. TSC of Texas did not charge for use of its IP during the Audit Period (and if it had, TSC would owe less tax to South Carolina), but a charge would have been justified.

D. PwC Transfer Pricing Study

TSC uses transfer pricing studies to price the procurement activities performed by TSC of Texas and has a study performed about every three years. R. 1278:3-8. PwC prepared the transfer pricing study (the "PwC Study") used during the Audit Period. R. 3762, PwC Study. Based on its results, TSC of Texas charging a 9.7% markup on the inventory it sold to TSC and TSC of Michigan was an arm's length price. *Id*. The PwC Study also determined the amount TSC of Texas could charge TSC and TSC of Michigan as a licensing fee for use of its IP and concluded an arm's length price to be between a 1.7% to 7.5% markup (in addition to the 9.7% markup for

procurement) on the inventory sold to TSC and TSC of Michigan. *Id.* at 3804-3806. TSC of Texas did not charge a licensing fee during the Audit Period to allow its affiliates to grow the brand and remain profitable. *Id.* at 3764; R. 486:7-24; R. 3823, TSC Memo re: 482 Study.

The Department ignores transfer pricing prior to litigation. *See infra* Facts §F. It does not evaluate whether a transfer pricing report is accurate during audits, and whether a price is an arm's length price is irrelevant to the decision of whether to require CUR. *Id.*; *see also* R. 2082:4-19. During this litigation (many years after TSC used the 9.7% procurement markup recommended by the PwC Study and years after the Department required CUR), TSC learned from its transfer pricing expert (Andrade) that the PwC Study did not use the most reliable transfer pricing method for pricing the procurement activities. Thus, more analysis was warranted to determine whether the 9.7% markup was an arm's length price, so Andrade performed his own transfer pricing analysis that confirmed it was. *See infra* Argument §III(B).

E. Tax Returns: As Filed (Separate Reporting) versus Audited (CUR)

For the Audit Period, TSC filed its South Carolina tax returns as required by law, and specifically (as is relevant here) it used separate reporting as its filing method and the sales factor as its apportionment method, which the Department agrees was correct. R. 3631-3698, TSC SC Tax Returns. TSC thus calculated its tax owed by starting with its FTI, followed by required state law modifications, and then a fraction of that amount is apportioned to this state using the sales factor. *Id.* The sales factor is used to measure the South Carolina portion of TSC's everywhere business activity—it is fraction, and the numerator is TSC's sales in South Carolina and the denominator is TSC's sales everywhere (i.e., in all states TSC conducts business). *Id.* TSC's

sales factor for the collective Audit Period was approximately 2.83%. *Id.*[2] Thus, TSC apportioned approximately 2.83% of its total income subject to apportionment to South Carolina during the Audit Period.[3] TSC's total income subject to apportionment for the collective Audit Period is $476,647,218,[4] its sales factor (approximately 2.83%) is used to apportion that amount to South Carolina, which was then taxed at the 5% corporate tax rate, ultimately causing TSC's tax due (and paid) to South Carolina for the Audit Period to be $675,135. *Id.*[5]

The Department audited TSC and required the use of CUR. *See* R. 3715, Audit Report. Mechanically, CUR calculates tax owed to South Carolina the same as described above except that CUR replaces "TSC" with the "TSC Group" until it is time to pay the tax, which TSC must pay. CUR starts with the TSC Group's FTI, followed by the same state law modifications, and then a fraction of that amount is apportioned to this state using the TSC Group's sales factor, which is the TSC Group's sales in South Carolina (but only TSC has sales here) divided by the TSC Group's sales everywhere. *See* R. 3700, Corporate Working Papers. For the collective Audit Period, the TSC Group's sales factor is approximately 2.32% (*id.*[6]), its total income subject to apportionment is $1,773,555,096,[7] approximately 2.32% of that amount was apportioned to South Carolina[8] and taxed at the 5% corporate tax rate, and the tax due under CUR (borne by TSC)

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[2] TSC's sales factor was approximately 2.79% for 2014, 2.82% for 2015, and 2.88% for 2016. *Id.* The sales factor for the collective Audit Period (2.83%) is calculated as total SC sales in 2014-16 divided by total everywhere sales. *Id.*

[3] More specifically, it apportioned 2.79% of its total income subject to apportionment to South Carolina in 2014, 2.82% in 2015, and 2.88% in 2016. *Id.*

[4] By year, it was $148,476,938 for 2014, $154,547,508 for 2015, and $173,622,722 for 2016. *Id.*

[5] TSC's tax due was $206,866 for 2014, $217,835 for 2015 and $250,434 for 2016. *Id.*

[6] The TSC Group's sales factor was approximately 2.28%% for 2014, 2.31% for 2015, and 2.37% for 2016. *Id.* The average TSC Group's sales factor for the collective Audit Period (2.32%) is calculated as total SC sales in 2014-16 divided by total everywhere sales. *Id.*

[7] By year, it was $569,699,814 for 2014, $593,633,362 for 2015, and $610,221,920 for 2016. *Id.*

[8] By year, the amount apportioned to South Carolina for taxation was $12,989,725 in 2014, $13,702,839 in 2015, and $14,471,413 in 2016. *Id.*

for the Audit Period was $2,058,199. *Id.*[9] The Department's Corporate Working Papers provide a useful comparison of TSC's tax returns as filed (Reported column) versus using CUR (Audited column):

Corporate Adjustments Summary for 2014

	Reported	Audited
1. Federal Taxable Income	$130,998,512	$552,221,388
2. Net Adjustment	$17,478,426	$17,478,426
3. Total Net Income as Reconciled	$148,476,938	$569,699,814
4. Total South Carolina Net Income	$4,137,310	$12,989,725
5. South Carolina Net Operating Loss Carryover	$0	$0
6. South Carolina Net Income Subject to Tax	$4,137,310	$12,989,725
7. Corporation Tax Due	$206,866	$649,486

See R. 3701. Line 1 is FTI, line 2 contains the state law modifications, line 3 is the income subject to apportionment, and the respective sales factor is applied to the amount on line 3 to arrive at line 4 (i.e., the income apportioned to this state), which is ultimately taxed at the 5% tax rate to reach the tax due on line 7. *Id.* Using 2014 as an example, the income subject to apportionment using CUR is $569,699,814, but only 26.1% of that is TSC's income ($148,476,938) with the remaining 73.9% coming from TSC of Texas and TSC of Michigan, neither of which are South Carolina taxpayers. Further, CUR apportioned $12,989,725 to South Carolina in 2014, which is 8.75% of TSC's total income subject to apportionment ($148,476,938) despite only 2.79% (TSC's 2014 sales factor) of TSC's total sales occurring in South Carolina. Similar outcomes occur for 2015 and 2016. When CUR is used for the Audit Period collectively, only 26.9% ($476,647,218) of the total income subject to apportionment under CUR ($1,773,555,096) is TSC's income, and the remaining 73.1% belongs to TSC of Texas and TSC of Michigan. In addition, despite only 2.83% of TSC's total sales occurring in South Carolina during the Audit Period, CUR apportioned $41,163,977 to this state, which is

[9] The tax due under CUR was $649,486 for 2014, $685,142 for 2015 and $723,571 for 2016. *Id.*

8.64% of TSC's total income subject to apportionment ($476,647,218).

F. S.C. Revenue Ruling 15-5, Department 30(b)(6) Witness, and the Audit

The Department issued S.C. Revenue Ruling 15-5 on June 12, 2015 (i.e., midway through the Audit Period). R. 3724 ("Rev. Rul. 15-5"). The Department did not consider promulgating it as a regulation. R. 2044:14-2045:21. Rev. Rul. 15-5 provides guidance on the Department's interpretation and application of the AA Statute and confirms the party seeking to use the AA Statute "must factually identify why the use of the standard statutory apportionment method [here, TSC's sales factor] does not fairly represent [TSC's] business activity in South Carolina." R. 3727. It also provides specific guidance for how the Department "analyz[es] whether the statutory formula [here, TSC's sales factor] fairly represents [TSC's] business activity in South Carolina" because it is a member of a unitary group. *Id.* at 3729. The guidance to both taxpayers and Department auditors consists of six vague factors that may be considered. *Id.* at 3729-30. It is unclear what the factors mean or how they will be applied, and none focus on the statutory formula (here, the sales factor) or attempt to analyze or measure South Carolina business activity. *Id.*[10] The Department acknowledges it has § 482 powers, which allow it to adjust incorrect transfer prices, but it chooses not to use these powers. R. 2082:4-2083:16. During audits, the Department does not evaluate whether a transfer pricing report is accurate, and whether the price is at arm's length is irrelevant to the decision of whether to require CUR. *Id.* at 2082:4-19.

The Department's Audit Report concluded TSC's business activities in South Carolina were not fairly represented because it found the TSC Group was a unitary business with

[10] The Department's witnesses do not understand what these factors mean or how to apply them. For example, the auditor testified factor 1 (amounts paid to related parties) means whether intercompany transactions exist (R. 691:5-11 and 692:4-303:9), but another Department witness said it means whether intercompany payments are paid via cash or recorded as journal entries. R. 2061:6-17. *See also* R. 2292,TSC's Proposed Order (for additional examples).

intercompany transactions. *See* R. 3715, Audit Report. The Department made no fact findings as to TSC's business activity in South Carolina, which it found irrelevant and instead only looked at the business activity of the entire TSC group before invoking the AA Statute and requiring CUR. *Id.* and R. 2096:9-19; 2098:7-2099:13.

STANDARD OF REVIEW

Appeals from the ALC are governed by the APA. § 1-23-310 *et seq*. Under the APA, this court may reverse, vacate. or modify the ALC's decision if TSC's substantive rights have been prejudiced because the ALC's findings, conclusion, or decision are: (a) in violation of constitutional or statutory provisions; (b) in excess of the statutory authority of the agency; (c) made upon unlawful procedure; (d) affected by other error of law; (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion. *Murphy v. S.C. Dep't of Health & Envtl. Control*, 396 S.C. 633, 639, 723 S.E.2d 191, 194 (2012); § 1-23-610(B).

Regarding the ALC's factual findings, judicial review "is limited to a determination whether the order is supported by substantial evidence." *MRI at Belfair, LLC v. S.C. Dep't of Health & Envtl. Control*, 379 S.C. 1, 6, 664 S.E.2d 471, 474 (2008). "Substantial evidence is evidence which, considering the record as a whole, would allow reasonable minds to reach the conclusion that the administrative agency reached." *Risher v. S.C. Dep't of Health & Env't Control*, 393 S.C. 198, 210, 712 S.E.2d 428, 434 (2011) (quotations and citations omitted); *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Rev.*, 411 S.C. 79, 90, 767 S.E.2d 195, 200 (2014) (finding Department failed to present substantial evidence on threshold issue and thus made insufficient showing as matter of law). However, the interpretation of a statute is a matter

of law that an appellate court may decide de novo. *CFRE, LLC v. Greenville Cnty. Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) ("Questions of statutory interpretation are questions of law, which we are free to decide without any deference to the court below.") (citations omitted).

ARGUMENT

The AA Statute "clearly evinces a two-part analysis[,]" and the Department bears the burden of proving each prong. *CarMax*, 411 S.C. at 88–90, 767 S.E.2d at 199-200 (2014). The first prong ("Step One") requires the Department to prove "the statutory formula does not fairly represent [TSC's] business activity in South Carolina[,]" and the second prong ("Step Two") requires it prove "the proposed alternative formula is reasonable" and effectuates an "equitable . . . apportionment of the taxpayer's income." *Id.* at 89, 767 S.E.2d at 200; § 12-6-2320(A)(4).

I. THE ALC APPLIED AN INCORRECT STANDARD FOR STEP ONE UNDER THE AA STATUTE.

Step One requires the Department show the "statutory formula" (here, the sales factor) does not fairly represent TSC's business activity in South Carolina. *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200. However, the ALC changed the standard in Step One and instead required the Department to prove *separate reporting* does not fairly represent TSC's business activity in South Carolina. *See, e.g.*, R. 121, Order (stating "the Department must provide specific evidence supporting its assertion that separate entity reporting does not fairly reflect TSC's business activity in South Carolina"). As explained below, applying the rules of statutory construction makes clear Step One requires exactly what the Supreme Court in *CarMax* held. Moreover, the ALC would have found the Department did not meet its burden for Step One had it applied the correct standard.

A. Applying the Rules of Statutory Construction Shows that the AA Statute Requires the Department to Show the Sales Factor Does Not Fairly Represent TSC's Business Activity in South Carolina.

"[W]ords of a statute must be read in their context and with a view to their place in the

overall statutory scheme." *Davis v. Mich. Dep't of Treas*, 489 U.S. 803, 809 (1989). The AA Statute can only be used "[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[.]" § 12-6-2320(A). When that phrase is read in context with the statutory scheme, it clearly requires that the Department prove TSC's sales factor does not fairly represent TSC's business activity in this state.

A corporate taxpayer's South Carolina taxable income is determined by starting with its FTI, followed by state modifications as provided in Article 9 of the Income Tax Act ("Article 9"), and then, for a multi-state taxpayer, this amount (FTI as modified by Article 9) is subject to the allocation and apportionment provisions in Article 17 of the Income Tax Act ("Article 17"). § 12-6-580 and § 12-6-2210(B); *see also CarMax*, 411 S.C. at 85–86, 767 S.E.2d at 198. Application of those provisions is a two-step process that distinguishes between non-business income, which is "allocated," and business income, which is "apportioned." A taxpayer's non-business income (if any) is first allocated to a particular state (*see* §§ 12-6-2220 and -2230), thus leaving only business income, and all income remaining after allocation is apportioned in accordance with § 12-6-2252 or one of the special apportionment formulas in §§ 12-6-2290 through 12-6-2310. § 12-6-2240; *Emerson Elec. Co. v. S.C. Dep't of Rev.*, 395 S.C. 481, 485, 719 S.E.2d 650, 652 (2011).

A taxpayer is required to apportion its business income using one of the apportionment methods in Article 17, which include the sales factor, the gross receipts method, or one of the methods in § 12-6-2310. *See* § 12-6-2240. The required method is dictated by the nature of the taxpayer's business in South Carolina. *See, e.g., DIRECTV, Inc. v. S.C. Dep't of Rev.*, 421 S.C. 59, 71, 804 S.E.2d 633, 639 (Ct. App. 2017). Manufacturers and those selling tangible personal

property (like TSC) must use the sales factor. *See* § 12-6-2252(A).[11] Each apportionment method is, and is specifically referred to as, "a fraction"[12] where the numerator is based on the taxpayer's business conducted within South Carolina, and the denominator is based on the taxpayer's business conducted everywhere. *See e.g.*, § 12-6-2280(A) ("[t]he sales factor is a fraction" that is "sales . . . in this State" over "sales . . . everywhere").[13]

Critically, the fundamental purpose of the Article 17 apportionment provisions is for a taxpayer's application thereof to result in a fraction that represents the portion of that taxpayer's total/everywhere business activity that took place in South Carolina—i.e., the fraction *is* the taxpayer's South Carolina business activity. *See, e.g., Duke Energy Corp. v. S.C. Dep't of Rev.*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (stating that "an apportionment formula

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[11] As to the remaining methods, taxpayers with specific lines of businesses not well suited for use of the sales factor or gross receipts method (e.g., transportation companies, telephone service companies, and others) must use one of the methods provided in § 12-6-2310, and everyone else (i.e., those not required to use the sales factor or a method in § 12-6-2310) must use the gross receipts method to apportion income to this state. *See* § 12-6-2290.

[12] There is one immaterial exception to this statement—the apportionment method in § 12-6-2310(6) (required for taxpayers operating shipping lines) refers to the method as a "ratio" (rather than a fraction) that functions the same as a fraction. The terms "apportionment method," "formula," "fraction," and "ratio" are synonymous in the statutory scheme. *See, e.g.*, § 12-6-2240 (requiring income that remains after allocation be apportioned per § 12-6-2252 or one of the special apportionment formulas in §§ 12-6-2290 to 12-6-2310); § 12-6-2310 (describing required apportionment methods for specific lines of business as "a fraction" or "ratio"). South Carolina courts have followed suit. *See, e.g.*, *CarMax*, 411 S.C. at 83-86, 767 S.E.2d at 197-198 (referring to gross receipts method in § 12-6-2290 as "the statutory apportionment method," "the gross receipts method," and "the statutory formula" and referring to Department's alternative apportionment method as a "formula"); *Rent-A-Ctr, v. S.C. Dep't of Rev.*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016) (referring to gross receipts method in § 12-6-2290 as "the statutory formula," "the statutory apportionment method," and "the standard apportionment method"); *Duke Energy Corp. v. S.C. Dep't of Rev.*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (an apportionment formula determines the fraction of business conducted in South Carolina and here is the multi-factor formula).

[13] *See also* § 12-6-2290 (referring to gross receipts method as "a fraction" that is "gross receipts from within this State" over "gross receipts from everywhere"); § 12-6-2310(1)-(5) (requiring certain companies "use a fraction" specific to the applicable line of business where the numerator is based on business in this State and the denominator is based on business everywhere).

determines the fraction of business conducted in South Carolina" and "'the statutory policy [of the apportionment statutes] is designed to apportion to South Carolina a fraction of the taxpayer's total income *reasonably attributable* to its business activity in this State.'" (citations omitted).[14] In addition, apportionment is an approximation, not an exact science. *See, e.g.*, *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66–67, 212 S.E.2d 574, 577–78 (1975) ("Although exactness in apportionment is desirable, all that is required is a reasonable approximation."); *DIRECTV, Inc.*, 421 S.C. at 76, 804 S.E.2d at 642 ("South Carolina law only requires a reasonable approximation for apportionment[.]").

The AA Statute is the final statute in Article 17 and starts by saying "[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[.]" § 12-6-2320(A). The "allocation and apportionment provisions of this chapter" are all in Article 17 (which is entitled "Allocation and Apportionment"), there are no allocation issues in this case (R. 103, n. 46, Order), and the "taxpayer" is TSC. The apportionment provisions are designed to generate a fraction that reasonably approximates (i.e., fairly represents the extent of) the taxpayer's business activity in this state. *Duke Energy*, 415 S.C. at 356, 782 S.E.2d at 592. Thus, when read in the context of the statutory framework, the AA Statute can be used only "[i]f . . . the apportionment provisions . . . do not" accomplish what those provisions are designed to accomplish. § 12-6-2320(A).

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[14] *See also Duke Energy Corp. v. S.C. Dep't of Rev.*, 410 S.C. 415, 417–18, 764 S.E.2d 712, 713–14 (Ct. App. 2014), *aff'd as modified*, 415 S.C. 351, 782 S.E.2d 590 (2016) ("A taxpayer's income is apportioned using a formula—a fraction—in which the numerator represents the business the taxpayer did in the applicable tax year in this state, and the denominator indicates the total business the taxpayer did in all states. . . . [T]he *business of the taxpayer in this state is converted to a fraction of its total business*[.]") (emphasis added); *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66–67, 212 S.E.2d 574, 577–78 (1975) ("The obvious purpose of the apportionment formula is the determination of income from business activities within this State[.]").

Here, the fraction generated by an application of the apportionment provisions is TSC's sales factor, and the legislative intent is for that sales factor to reasonably approximate (i.e., fairly represent the extent of) the portion of TSC's business activity that occurred in South Carolina. Step One of the AA Statute plainly requires the Department prove the apportionment provisions did not accomplish what those provisions are designed to accomplish, thus, Step One requires the Department show the sales factor failed to reasonably approximate the South Carolina portion of TSC's business activity. Stated differently, the Department must prove "the statutory formula [here, the sales factor] does not fairly represent [TSC's] business activity in South Carolina[.]" *CarMax*, 411 S.C. at 89S.E.2d at 200; *see also Rent-A-Ctr, v. S.C. Dep't of Rev.*, 418 S.C. 320, 332, 792 S.E.2d 260, 266 (Ct. App. 2016) (same).

B. The ALC Used the Wrong Standard Causing it to Ignore the Absence of Relevant Evidence and Instead Consider Irrelevant Evidence.

The ALC applied a different and completely incorrect standard for Step One. The ALC's standard, which ignored *CarMax* and re-wrote the plain language of the AA Statute, required the Department prove that *separate reporting* does not fairly represent TSC's business activity here, and the ALC found the Department met *that* standard. *See, e.g.*, R. 121, 123, and 127, Order. The apportionment provisions (and the "statutory formulas" contained therein) are designed to measure business activity, and more specifically, to generate a fraction that represents the portion of a taxpayer's total business activity that occurred in South Carolina. *See supra* Argument §I(A). Separate reporting (a/k/a "separate entity reporting"), on the other hand, is a filing method for tax returns—it is not designed to and does not measure South Carolina business activity. The ALC improperly applied a standard that is fundamentally contrary to the intent of the AA Statute.

The ALC's use of the wrong standard caused it to ignore the absence of relevant evidence and to consider evidence that was not relevant. The AA Statute can *only* be used in this case by

showing TSC's sales factor does not fairly represent its business activity in this state. *See supra* Argument §I(A). The Department never argued or presented evidence that the sales factor was not working properly, and the ALC never examined or considered whether the sales factor fairly represents the South Carolina portion of TSC's business activity. Instead, the ALC's use of the wrong standard caused it to find Step One satisfied without even looking at TSC's sales factor and based on evidence that is irrelevant when the correct standard is applied.

More specifically, the ALC found the Department met its burden by proving the procurement charge paid to TSC of Texas was above an arm's length price. *See infra* Argument §III. Assuming arguendo the procurement charge was above an arm's length price, that would mean TSC took an improperly high deduction, which (1) thus caused TSC's FTI to be improperly low, which (2) thus caused TSC's *income subject to apportionment* to be improperly low, which (3) thus caused TSC's income *apportioned to* South Carolina to be improperly low—but critically, that income would be improperly low *notwithstanding the apportionment provisions accomplishing what they were designed to accomplish*.

Showing that a taxpayer's *income subject to apportionment* is improperly low is not relevant evidence for the threshold issue when the AA Statute is applied correctly. The AA Statute applies "[i]f . . . the apportionment provisions . . . do not" accomplish what they are designed to accomplish, which is determine a reasonable approximation of the South Carolina portion of a taxpayer's business activity. *See supra* Argument §I(A); § 12-6-2320(A); *Davis*, 489 U.S. at 809. If 10% of a taxpayer's business activity took place in South Carolina, the legislative intent is for an application of the apportionment provisions to result in a fraction that is approximately 10%—that remains true regardless of what amount the taxpayer's income subject to apportionment *is or should be*. The AA Statute applies when that fraction is not reasonably

close to 10%, and a taxpayer's income subject to apportionment plays no role in determining the required apportionment method or its numerator or denominator. The AA Statute applies when the apportionment provisions do not work properly, and thus it does not apply when a taxpayer's income subject to apportionment is incorrect because the apportionment provisions are not designed to and do not calculate, determine, or otherwise ensure the accuracy of a taxpayer's income subject to apportionment. That amount is pre-determined and fixed; it is the taxpayer's FTI as modified by Article 9 less anything first allocated. *See* §§ 12-6-580 and -2240. The taxpayer then applies the apportionment provisions to determine the fraction used to apportion that sum to South Carolina.

The ALC's use of the wrong standard caused it to exclusively focus on irrelevant evidence and to ignore the absence of the only relevant evidence when the correct standard is applied—i.e., evidence related to whether the sales factor reasonably approximates the South Carolina portion of TSC's business activity. The ALC's standard was satisfied (1) notwithstanding the apportionment provisions accomplishing exactly what they are designed to accomplish; (2) without even looking at TSC's sales factor, which is the only thing that matters; and (3) by evidence of an alleged problem (i.e., the procurement charge TSC paid to TSC of Texas) that is entirely unrelated to the apportionment provisions in Article 17.

C. The ALC's Use of the Wrong Standard Caused it to Force a Construction of the AA Statute That Expands its Operation and Leads to Absurd Results.

The ALC's use of the wrong standard caused it to force a construction of the AA Statute that improperly expands its operation and leads to absurd results. Words in a statute must be construed in context, and a forced construction that expands the operation of a statute is prohibited. *Sparks v. Palmetto Hardwood, Inc.*, 406 S.C. 124, 128, 750 S.E.2d 61, 63 (2013) (citation omitted); *TNS Mills, Inc. v. S.C. Dep't of Rev.*, 331 S.C. 611, 624, 503 S.E.2d 471, 478 (1998).

The meaning of Step One is clear when the AA Statute is read in its context (*see supra* Argument §I(A)), but the ALC forcibly expanded the operation of the AA Statute by saying TSC's "income" (which appears to mean TSC's profits or FTI) comes from its retail sales, TSC retail sales is its business activity, thus, TSC's "income" from those retail sales is "a proxy" for TSC's South Carolina business activity. R. 122 and 125, Order.[15] That forced (and incorrect) construction allowed Step One to be satisfied if TSC's income subject to apportionment was improperly low (regardless of the reason and notwithstanding the apportionment provisions working properly), which the ALC found was satisfied because of an allegedly too high payment from TSC to TSC of Texas. *See, e.g., id.* at 125 (because of the procurement charge, "income is being shifted . . . [and] [b]ecause income is a proxy for retail sales in this case, this shift is distorting TSC's business activity in this state."). The ALC's forced construction was incorrect and prohibited as it greatly expanded the operation of the AA Statute far beyond the legislative intent. *TNS Mills,* 331 S.C. at 624, 503 S.E.2d at 478 ("[F]orced construction of statutory words for the purpose of expanding a statute's operation is prohibited.").

In addition, Step One must be construed and applied in a manner that considers the entire relevant statutory text and is in harmony with its purpose. *CFRE,* 395 S.C. at 74, 716 S.E.2d at 881 (court "should not concentrate on isolated phrases within the statute [and instead] read the statute as a whole and in a manner consonant and in harmony with its purpose"). When the correct standard is applied for Step One, then both Step One and Step Two work seamlessly and

[15] The ALC specifically recognizes that § 12-6-2320(A) "requires the Department to show the extent of TSC's 'business activity' in South Carolina is not fairly represented" and that "[b]usiness activity" is not defined for the purposes of that subsection. R. 117. Rather than attempting to ascertain and effectuate the legislative intent, the ALC instead determined TSC's business activity in South Carolina is retail sales—which is correct and also why the sales factor is required and appropriate when measuring that business activity—but the ALC then inexplicably decided, based on no authority of any kind, that because TSC's "income" comes from its retail sales, income is thus "a proxy" for TSC's South Carolina business activity. *Id.* at 118, 122, and 125.

in harmony with one another: if the apportionment provisions do not work as intended, then the AA Statute allows use of a different apportionment method (or separate accounting per § 12-6-2320(A)(1)) to accomplish that intent. § 12-6-2320(A)(1)-(4). That is by design, as seen in the statutory text: "[i]f . . . the apportionment provisions . . . *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" the options in subsections (A)(1)-(4). *Id.* (emphasis added). Step One envisions a problem with the apportionment provisions not working as intended, and that problem is then fixed by applying Step Two. *Id.*

However, when Step One is applied incorrectly, the statute no longer works seamlessly, and the harmony disappears when applying Step Two. When Step One is incorrectly satisfied because the taxpayer's income subject to apportionment is improperly low notwithstanding the apportionment provisions accomplishing their purpose, it causes at least two problems when Step Two is applied. First, whatever problem caused the income subject to apportionment to be improperly low is now being "fixed" with a power not meant to address that problem. And second, when the income subject to apportionment being low is the problem, that cannot be fixed using a different apportionment method because an apportionment method only divides the income subject to apportionment, it does not recalculate it, nor can it be used to increase that income.

Here, the ALC first forcibly expanded the AA Statute's reach by saying "income" is "a proxy" for TSC's South Carolina business activity, causing Step One to then be satisfied because TSC's income subject to apportionment was improperly low (due to a transfer pricing payment being too high). Then, when the Department required use of a different reporting method for Step Two that violates the plain language of the AA Statute, the ALC again forcibly construed the AA Statute for Step Two to again expand its operation beyond the legislative intent. *See infra*

Argument §II(A). Applying the wrong standard in Step One is the source of the problem—finding the threshold issue was satisfied because TSC's income subject to apportionment was improperly low, is what causes the need to forcibly construe Step Two to offset the error in Step One. Two wrongs clearly do not make a right. *TNS Mills,* 331 S.C. at 624, 503 S.E.2d at 478.

In addition, the AA Statute should not be construed or applied in a manner that leads to absurd results. *Duke Energy*, 415 S.C. at 355, 782 S.E.2d at 592. The ALC's wrong standard was met because a transfer price allegedly improperly reduced TSC's income subject to apportionment, but a single accounting error could do the same. It would be absurd to say Step One of the AA Statute can be satisfied because of an accounting error, and it is no less absurd because it is due to a transfer pricing payment. Here, the apportionment provisions accomplished exactly what they are designed to accomplish, yet the AA Statute was used based on an alleged transfer pricing issue, which was then "fixed" by a different reporting method—that too, is absurd, particularly given CUR does not "fix" the alleged problem, it grossly and punitively over-corrects it. *See infra* Argument §IV(A). The ALC erred in forcing this construction of the AA Statute, which leads to absurd results.

Finally, TSC submits that Step One of the AA Statute clearly and unambiguously requires the Department prove the sales factor does not fairly represent TSC's business activity in this state (*see supra* Argument §I(A)) and that the ALC's standard is clearly and unambiguously wrong as it completely disregards the plain language of the AA Statute and the context for which it applies, expands the operation of the AA Statute far beyond the legislative intent, and leads to absurd results. Nonetheless, even if the Court is not fully convinced TSC's interpretation is correct, TSC's interpretation is at least reasonable, and the AA Statute does not unambiguously show the ALC's standard is correct and that TSC's interpretation is incorrect. At

most the statute is ambiguous, and it is well settled that taxpayers receive the benefit of any doubt when construing tax statutes and thus ambiguities must be resolved in TSC's favor. *Alltel Commc'ns, Inc. v. S.C. Dep't of Rev.*, 399 S.C. 313, 321, 731 S.E.2d 869, 873 (2012) (citations omitted) (finding statutory language was not "absolutely clear," and thus case must be resolved in favor of taxpayer). It is certainly not "absolutely clear" the AA Statute can be used when "separate reporting" (rather than the sales factor) does not fairly represent TSC's business activity in this state, and thus, the AA Statute must be construed in TSC's favor.

D. If the ALC Had Applied the Correct Standard, it Would Have Concluded the Department Failed to Satisfy Step One.

Had the ALC applied the correct standard, it would have concluded the Department failed to satisfy Step One. The correct standard requires the Department to prove that "the statutory formula"—the sales factor—is not a reasonable approximation of TSC's South Carolina portion of its everywhere business activity. *See supra* Argument §I(A); *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200. The Department *never argued* that was true *nor presented any evidence proving* it true and, thus, it would have failed to satisfy its burden under the correct standard. Moreover, the Department would have been unable to prove the sales factor did not work as intended had it tried to do so. TSC's business activity in South Carolina is its retail stores, and the sales factor is not only reasonable but the obvious choice for measuring the business activity of a retailer. The apportionment provisions accomplished *exactly* what they are designed to accomplish, and the ALC would have found the Department failed to satisfy the correct standard had it been applied.[16]

[16] The ALC implicitly acknowledges this. The ALC found the Department satisfied the wrong standard by proving the procurement charge paid to TSC of Texas was above an arm's length price (*see infra* Argument §III), and the ALC acknowledged that but for the procurement charge issue, "I would conclude that separate reporting resulted in a fair representation of TSC's

II. THE ALC ERRED BY FINDING CUR AUTHORIZED UNDER STEP TWO OF THE AA STATUTE IN THIS CASE.

A. The AA Statute Does Not Authorize CUR in this Case.

The ALC also erred in concluding that subsection (A)(4) of the AA Statute grants the Department authority to require CUR in this case. As with other provisions of the AA Statute, a court must start with the text of the statute itself, must give words their plain and ordinary meaning and cannot re-write statutes where the language is clear. *See Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The plain language of subsection (A)(4) of the AA Statute allows the Department to require the use of "any other method" *provided* the method "effectuate[s] an equitable . . . apportionment of *the taxpayer's income*." § 12-6-2320(A)(4) (emphasis added).[17] The meaning of "the taxpayer's income" is clearly TSC's FTI as modified by Article 9. §§ 12-6-30(1), -580, and -2240; *supra* Argument §I(A)-(B). That amount is then subject to the Article 17 allocation and apportionment provisions, the latter of which are specifically "designed to apportion to South Carolina a fraction of the taxpayer's total income reasonably attributable to its business activity in this State." *Duke Energy*, 415 S.C. at 356, 782 S.E.2d at 592 (citation omitted). When the apportionment provisions do not work as intended, the AA Statute allows alternative methods of apportioning that same pre-determined income as seen in the plain language of subsection (A)(4) restricting methods to those that "apportion[] the taxpayer's income" and "the taxpayer's income" is TSC's FTI as modified by Article 9. CUR does not do that and instead apportions the combined income of affiliated entities. *See supra* Facts §E. Had

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business activity in this state." R. 126, Order. That means the apportionment provisions accomplished their purpose, thus the ALC would have found that the Department failed to satisfy the correct standard.

[17] The Legislature recently passed S. 298 (signed into law by the Governor on March 11, 2024), which amended subsection (A)(4) of the AA Statute and added a new subsection (B) related thereto. S.C. Code Ann. § 12-6-2320 (2024). As this amendment does not apply to cases at the ALC or the appellate courts, all cites to the AA Statute herein will be to the prior version.

the legislature intended for "apportionment of the taxpayer's income" to mean "apportionment of an affiliated group of entities' income," it would have said so as it did immediately below subsection (A)(4) in subsection (B).[18]

When faced with a similar argument alleging that Indiana's alternative apportionment statute (which was modeled after Section 18 of the Uniform Division of Income for Tax Purposes Act ("UDITPA") like South Carolina's)[19] allowed the state's taxing agency to first change the base of income subject to apportionment prior to apportioning a fraction of such income to the state, the Indiana Tax Court looked at the mechanics of calculating the tax due, which is identical to how South Carolina calculates tax due, and explained as follows:

> [T]he method by which a corporate taxpayer computes its Indiana [tax] liability also supports the conclusion that the concepts of allocation and apportionment under [the alternative apportionment statute] solely involve dividing the tax base among the states, not computing the tax base. As stated above, Indiana's [tax] liability calculation begins with federal taxable income ("FTI")[.] . . . The taxpayer then adjusts this starting point by making the applicable statutorily prescribed modifications to its FTI. . . . Only then can the taxpayer divide its Indiana net income *tax base* (court's emphasis) by applying the Standard Sourcing Rules. . . . Accordingly, the allocation and apportionment provisions under [the alternative apportionment statute] are distinct from the provisions that determine the Indiana tax base under Indiana Code § 6–3–1–3.5(b). ***Therefore, to conclude that [statute] authorizes the Department to make changes outside the context of allocation and apportionment would be like trying to pound a square peg into a round hole.***

Columbia Sportswear USA Corp. v. Indiana Dep't of State Rev., 45 N.E.3d 888, 895-896 (Ind. Tax Ct. 2015) (emphasis added).

The same is true in this case. The meaning of allocation and apportionment throughout Article 17 deals with dividing a pre-determined base of income—the taxpayer's FTI as adjusted

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[18] Subsection (B)(1) authorizes the Department to "enter into an agreement *with the taxpayer* establishing the allocation and *apportionment of the taxpayer's income*[,]" and subsection (B)(2) specifically expands the meaning of "taxpayer" for subsection (B) to include not only the taxpayer but also parties related to the taxpayer. § 12-6-2320(B)(1)-(2) (emphasis added).

[19] *See* R. 1469:5-6 and 1492:18-20.

by Article 9—among states, and subsection (A)(4) of the AA Statute restricts the Department to methods that "effectuate an equitable . . . apportionment of the taxpayer's income." The Department's use of CUR here does not apportion a fraction of "the taxpayer's income" to South Carolina, rather, it first recomputes the income subject to apportionment by combining the FTI of TSC with TSC of Texas and TSC of Michigan and then apportions a fraction of that *combined* income to South Carolina. *See supra* Facts §E. To interpret the AA Statute as authorizing the Department to make changes outside the context of allocation and apportionment such as recomputing "the taxpayer's income" by substantially increasing it prior to apportioning it to this state, would be contrary to the legislative intent of the entirety of Article 17. Thus, the use of CUR here is unlawful as it violates the restrictions placed on allowable methods seen in the plain language of subsection (A)(4).

Moreover, while TSC submits this statutory language is clear and unambiguous, even if the Court disagrees, TSC's interpretation is at least reasonable, and, therefore, the AA Statute must be construed in TSC's favor. *Alltel*, 399 S.C. at 321, 731 S.E.2d at 873. It is certainly not "absolutely clear" the AA Statute allows the Department to require use of a different reporting method that combines TSC's income with the income of numerous non-taxpayers, particularly when, as here, the apportionment provisions worked as intended.

B. Media General Does Not Say Otherwise.

The ALC erred by finding CUR is authorized in this case based on its incorrect interpretation of *Media General Commc'ns, Inc. v. S.C. Dep't of Rev.*, 388 S.C. 138, 694 S.E.2d 525 (2010). It first erred by misinterpreting the *Media General* holding, and even if correct, it erred by finding that holding authorizes the use of CUR in *this* case involving materially different facts and arguments. In *Media General*, the Court found the members of a unitary

business (which had requested CUR be used as an alternative method), all of which were South Carolina taxpayers,[20] could combine themselves for the purpose of determining the *ratio* that each entity would then use to apportion its *own income* to South Carolina. That method did not violate the plain language of § 12-6-2320(A)(4) restricting the Department to methods that apportion "the taxpayer's income" like the use of CUR plainly does in this case.

More specifically, the issue the parties raised before the ALC in *Media General* was whether § 12-6-2320(A)(4) allowed the use of CUR (which the parties referred to as the "combined entity apportionment method"). The ALC held it was authorized but *incorrectly described the mechanics* of the method the parties had requested on at least one occasion, saying the method involved the group of entities combining themselves solely for purposes of determining the apportionment ratio.[21] The Supreme Court adopted the ALC's *incorrect description* of the method (which is an actual apportionment method that would be allowed under subsection (A)(4)) and confirmed *that method* was authorized. Its description of this approved method is the following:

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[20] Each member was either filing tax returns in South Carolina (and thus admittedly a "taxpayer") or was not filing tax returns but had received a tax assessment from the Department (who was thus asserting nexus and claiming each such member was a "taxpayer" required to file returns). *See Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev.*, Docket No. 07-ALJ-17-0089-CC, and *Media Gen., Inc. v. S.C. Dep't of Rev.*, Docket No. 07-ALJ-17-0090-CC (S.C. Admin. Ct. May 4, 2009), at 2, 8 at ¶22, 9 at ¶ 26, 10 at ¶¶ 29-30, and 11 at ¶ 34.

[21] *See Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev.*, Docket No. 07-ALJ-17-0089-CC, and *Media Gen., Inc. v. S.C. Dep't of Rev.*, Docket No. 07-ALJ-17-0090-CC (S.C. Admin. Ct. May 4, 2009). In its Final Brief to the Supreme Court, the Department pointed to a specific portion of the ALC's Order that incorrectly described the method intended by the parties and explained that the ALC's description was wrong because it envisioned the members of the unitary business combining themselves for one purpose only, which was the determination of the ratio. Final Brief of Appellant at 20-21 (explaining that the ALC's description was wrong because it was "applying the combined apportionment factor to the individual entity's South Carolina incomes, rather than applying the factor to the unitary entities' income as a whole." (emphasis in original)). Despite mentioning this in its Final Brief, it appears the parties did not make clear what method they intended the Court address because it adopted the ALC's incorrect description and subsequently confirmed it was authorized by § 12-6-2320(A)(4).

> 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.

Id. at 147, 694 S.E.2d at 529 (emphasis added). The Court plainly says all related entities combine themselves solely for the purpose of determining the ratio (the fraction; here the sales factor), which is then used by each *individual entity* to apportion its income to South Carolina. *Id.* All analysis following this block quote addresses only the apportionment method (i.e., the ratio). *Id.*[22]

Further, even if *Media General* did approve CUR, the Court did not hold § 12-6-2320(A)(4) authorized the required use of CUR under these facts. The taxpayers requested the method allowed in *Media General*, and thus no concerns of agency overreach or inequities were present or argued. Here, the Department is forcing TSC to pay tax generated by income that is not its own. Almost 73.1% of the income apportioned to South Carolina is not “the taxpayer’s income.” *See supra* Facts §E. Regardless of the holding in *Media General*, the ALC erred by

[22] Moreover, not long after *Media General*, the Court in *CarMax* described its holding in *Media General* as approving use of an alternative *formula*. *See CarMax*, 411 S.C. at 89, 767 S.E.2d at 200 (“This argument is unavailing because it ignores the clear distinction between this case and *Media General.* There, both the Department and the taxpayer agreed that the statutory formula did not fairly represent the taxpayer's business in South Carolina. The taxpayer supplied an alternative formula, but the Department fell back on the statutory formula.”). A “formula” is a “fraction” which is a “ratio” which is an apportionment method, and that is what the Court approved in *Media General*. An application of the *Media General*-approved method here would be for TSC to apportion its own income to South Carolina using the combined sales factor of approximately 2.32% during the Audit Period, which would reduce its taxes owed here. That is a formula, and unlike CUR, it would not violate the plain language of § 12-6-2320(A)(4).

finding the Department established CUR is authorized here. The ALC should have applied rules of statutory construction to ascertain and effectuate the legislative intent regarding whether CUR is authorized in this case, which it admittedly did not do. *See* R. 107, Order (saying the ALC "does not need to engage in statutory construction" because the Court in *Media General* already decided this issue). Such an analysis would have revealed that CUR is not authorized here.

C. The ALC's Ruling Would Make South Carolina an Outlier and Negatively Impact the Business Community and Taxpayers' Reliance Interests.

South Carolina touts its use of separate reporting on its Commerce Department website, and it and other states view this as part of their economic development arsenal to attract and retain businesses like Volvo and BMW. R. 1458:2-1460:24; 1449:13-1450:8. The ALC's incorrect ruling condoning the Department's misapplication of the AA Statute will negatively impact South Carolina taxpayers' reliance interests and the business community generally not to mention violate separation of powers principles.[23] Moreover, Section 18 is a model statute in existence since the 1950s, but we have been unable to find any cases from other states with similar AA Statutes applying them this way, thus making South Carolina an outlier. South Carolina and other separate reporting states are not without recourse if they believe a transfer pricing problem exists. They have § 482 powers that allow them to make price adjustments. This simple mechanism is available to the Department, but it chose to instead embark on the inapplicable, erroneous, and complicated path reflected in these proceedings.

[23] *S.C. Pub. Int. Found. v. S.C. Transp. Infrastructure Bank*, 403 S.C. 640, 649, 744 S.E.2d 521, 526 (2013) (citations omitted) (stating that "[t]he legislative department makes the laws[,] the executive department carries the laws into effect, and the judicial department interprets and declares the laws."); R. 1458:4-25; 1464:3-20; 1473:16-1474:13 (TSC's tax policy expert Richard Pomp stating that once a state has made a policy decision to adopt separate reporting, whether for economic development or other reasons, then separation of powers considerations come into play and stating that taxpayers make investments in a state relying on the statutes in place (such as requiring separate reporting), and the rug should not be pulled out from under them "through the backdoor of alternative apportionment."

III. THE ALC ERRED IN FINDING THE DEPARTMENT MET ITS BURDEN OF PROOF UNDER THE WRONG STANDARD.

The ALC not only applied the wrong standard but also incorrectly found the Department satisfied that standard. *See, e.g.*, R. 121, Order. The ALC found the Department met its burden by proving the procurement charge failed to satisfy the Arm's Length Standard (*id*. at 93) combined with its rationale that TSC's "income" from retail sales is "a proxy" for South Carolina business activity. *Id*. at 121-128. However, even assuming the Department could meet its burden based on this rationale, the ALC's finding is not supported by substantial evidence and thus must be reversed.

A. The ALC's Conclusion that the Procurement Charge Failed to Satisfy the Arm's Length Standard is Not Supported by Substantial Evidence.

1. Internal Revenue Code § 482

Applying the wrong standard in this case necessitates delving into transfer pricing law. Internal Revenue Code Section 482 ("§ 482") grants the Internal Revenue Service (the "IRS") extensive powers, including the power to make an adjustment that reallocates income among related parties. *See* I.R.C. § 482. The final Treasury Regulations under § 482 (the "§ 482 Regulations") provide taxpayers guidance on pricing related-party transactions to help avoid the IRS exercising these powers. These regulations only apply to *non*-arm's length transactions, i.e., transactions between related parties, where a related-party is a "controlled taxpayer" and a related-party transaction is a "controlled transaction." *See generally* Treas. Reg. § 1.482-1(i)(3)-(8).

The key to the § 482 Regulations is the "Arm's Length Standard," which holds that "[a] controlled transaction [i.e., a transaction between related parties] meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled [i.e., unrelated] taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." Treas. Reg. § 1.482-1(b)(1). Thus, it analyzes the relevant

"controlled transaction" and determines the financial terms to which two unrelated parties would agree. *Id.* A range of results (and thus a range of prices used to obtain such results) will satisfy the Arm's Length Standard, and the IRS will not adjust a price that meets this standard. *See* Treas. Reg. § 1.482-1(e). The § 482 Regulations provide various transfer pricing methods and rules for selecting the most reliable method to reach the Arm's Length Standard; this "best method rule" holds that one should use the most reliable method based on the facts and circumstances. *See* Treas. Reg. §§ 1.482-1(b)(2) and (c). Nothing in the § 482 Regulations or elsewhere requires a taxpayer to have a transfer pricing study to support the price used in a related-party transaction. If the price satisfies the Arm's Length Standard, then nothing else matters, and the IRS will not adjust the price regardless of whether the taxpayer used a perfectly prepared transfer pricing study, a materially flawed transfer pricing study, or no study at all. However, if the price used is materially wrong and the IRS uses its § 482 powers to address it, then a taxpayer's reliance on an appropriately prepared transfer pricing study (that nonetheless reached a result the IRS rejected) provides the taxpayer penalty protections. *See* I.R.C. § 6662(e)(3). Thus, it is beneficial to have a transfer pricing study in case the IRS rejects the price used, but they are not required, and the only thing that matters is whether the price used satisfies the Arm's Length Standard.

2. Applicable Burden of Proof

All parties agree the Department bore the burden of proof. *See CarMax*, 411 S.C. at 89-90, 767 S.E.2d at 200 (the party invoking the AA Statute bears the burden of proof); *Rent-A-Center*, 418 S.C. at 332-33, 792 S.E.2d at 267 (same). While there is no bright-line test for determining if the taxpayer's business activity in this state is fairly represented, the party invoking the AA Statute must produce "specific evidence" that provides "a sound evidentiary

basis" to meet this element, and the appellate courts have given examples of what constitutes insufficient evidence. *CarMax*, 411 S.C. at 90-91, 767 S.E.2d at 200-201 (taxpayer's use of an east/west business structure often "linked with tax minimization strategies," fact that standard apportionment method yielded significantly lower tax than that of a related company, and bald assertions from Department witnesses that Step One was met deemed insufficient); *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267 (auditor testimony that management fee paid to related party was too high, yet auditor "did not point to any specific evidence the standard apportionment method did not fairly represent [the taxpayer's] business activities[,]" and bald assertions from Department witnesses that Step One was satisfied were deemed insufficient).[24]

Applying the correct standard in this case requires the Department prove the sales factor does not fairly represent TSC's business activity in this state, and TSC is not required to affirmatively prove the sales factor does, in fact, fairly represent its business activity because the sales factor, as the standard method, works as intended unless and until the Department proves it does not. *CarMax*, 411 S.C. at 89-91, 767 S.E.2d at 200-01; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. To satisfy its burden under the correct standard, the Department must identify and prove the specific reasons the sales factor fails to reasonably approximate TSC's South Carolina business activity. *Id.* The ALC's wrong standard essentially turned on whether the Department could prove the procurement charge was improper (as opposed to whether the sales factor

[24] Moreover, the AA Statute should be used sparingly. *CarMax*, 411 S.C. at 90-91, 767 S.E.2d at 200 (saying the Department bears the burden of proving both Step One and Step Two and citing *St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 385 A.2d 215, 217 (1978) (holding "an alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of showing that the alternative is appropriate") and *Donald M. Drake Co. v. Dep't of Rev.*, 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).

worked as intended). Assuming arguendo the Department can meet its burden using this rationale, the same rules would apply here, i.e., the standard method works until the Department proves it does not, which means the procurement charge satisfies the Arm's Length Standard unless and until the Department proves it does not. Finally, the Department cannot satisfy its burden absent providing specific evidence and a sound evidentiary basis for its positions, and bald, conclusory statements are insufficient. *Id.*

3. The Department Presented No Evidence of a Correct Arm's Length Standard or Range of Correct Transfer Prices and thus Failed to Meet its Burden.

The ALC's finding that "a preponderance of the evidence shows [the procurement charge] does not meet the [A]rm's [L]ength [S]tandard" (R. 93, Order) is not supported by substantial evidence. A "correct transfer price" is one that satisfies the Arm's Length Standard, the Arm's Length Standard is a range of results, and there are a range of "correct transfer prices" because a range of prices would satisfy that range of results. *See supra* Argument §III(A)(1). In addition, although perfection is desirable with apportionment, only a reasonable approximation is required. *See supra* Argument §I(A). In transfer pricing, prices will fail to satisfy the Arm's Length Standard and thus are not perfect but nonetheless are close enough to that standard to be a reasonable approximation. Thus, an Arm's Length Standard or a range of correct transfer prices is needed to know if the procurement charge failed to satisfy the Arm's Length Standard, and by how much.

The Department did not present evidence of a suggested correct Arm's Length Standard, range of transfer prices, or even a single transfer price—not even an estimate of any of the foregoing. *See, e.g.*, R. 81 (finding that "Dr. DeRamus did not . . . establish what the correct transfer price . . . should be in this case") and 127, n. 68 (stating that DeRamus did not provide a reliable transfer price). Thus, the ALC's finding that the Department proved the procurement

charge failed to satisfy the Arm's Length Standard is not supported by substantial evidence, and even if it had been, more (i.e., a range of prices) is required because perfection is not necessary.

4. The ALC Applied a Novel and Unsupported "Reasonableness" Test.

The ALC concluded that a transfer price must both satisfy the Arm's Length Standard *and* be "reasonable." *See, e.g.,* R. 79, 81, n. 23, and 124, n. 64, Order. However, there is no "reasonableness" requirement or test in the § 482 Regulations. A transfer price is correct if it satisfies the Arm's Length Standard; it is not then further checked for "reasonableness." Rather than ruling the Department failed to meet its burden, the ALC created and applied its own subjective "reasonableness" test, which it then used to incorrectly find the procurement charge failed to satisfy the Arm's Length Standard using what can only be described as the ALC's own materially flawed transfer pricing analysis based on what it deemed "reasonable" or "unreasonable."[25] *See generally id*. at 77-93 and 121-128.

The ALC has no transfer pricing expertise and, respectfully, should not be performing a transfer pricing analysis based on its subjective beliefs of what seems reasonable or unreasonable. Nonetheless, assuming arguendo the ALC could make a reliable finding using its test, it must be supported by *facts* along with some rational basis connecting those facts to the ALC's ruling. For example, if the Department presented evidence of several readily available companies TSC could hire to take over the procurement function performed by TSC of Texas, and those companies would charge substantially less than the 9.7% markup TSC of Texas charged, the ALC could rationally view those *facts* as evidence tending to support its finding that

[25] *See, e.g.,* R. 77, Order (procurement charge failed to satisfy the Arm's Length Standard because "the 9.7% markup resulted in a transfer of income from TSC . . . to Texas that is unreasonably large compared to the benefits received by TSC[.]"); *id.* at 81, 124, and 125 (same); *id*. at 126 ("[T]he unreasonable transfer price allowed [TSC] to take advantage of separate reporting[.]").

the procurement charge failed to satisfy the Arm's Length Standard. However, not a shred of evidence like that supports its finding.

In fact, the ALC inexplicably ignores the absence of this exact example of evidence that could rationally be viewed as factual support for its finding. A primary reason the ALC concluded the procurement charge failed to meet the Arm's Length Standard is its *assumption* TSC could find other companies to perform the procurement function that would charge less than TSC of Texas. *See, e.g.*, R. 84 and 92, Order. However, the Department presented no evidence that a single company exists with that capability and thus also presented no evidence of what that (non-existent) company would charge, but the ALC brushed aside the lack of evidence by saying "I do not find that degree of specificity was necessary to show TSC would find another realistic alternative." *Id*. at 92, n. 38. Respectfully, naming <u>one</u> company and alleging it could do what the ALC simply assumes is true is not asking for much specificity, and more importantly, the ALC correctly agreed that specificity is *exactly* what is required for the Department to meet its burden. *Id*. at 121 ("[I]t 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."). The ALC should not assume evidence exists that the Department failed to prove.

Moreover, when the ALC applied its "reasonableness" test, it failed to appropriately interpret and apply the § 482 Regulations. The ALC instead essentially accepted as true whatever the Department's transfer pricing expert (DeRamus) said was probative evidence even when it clearly was wrong and/or not probative. Some of the many examples of the ALC's flawed analysis, which is completely devoid of factual support, a rational basis for viewing alleged facts as probative evidence, or both, are the following:

- **Reliance on DeRamus testimony about the wrong "controlled transaction(s)" from the wrong time period**.

The key "controlled transaction" here is the one compensated by the procurement charge during the Audit Period. The ALC found the Department proved the procurement charge failed to satisfy the Arm's Length Standard (R. 93, Order) by relying on DeRamus testimony discussing different controlled transactions that occurred as part of the 2001 Restructuring. *See id.* at 18 (saying TSC transferred IP to TSC of Texas and "g[a]ve up a substantial amount of income" because TSC of Texas took over procurement and discussing "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"); *id.* at 84 (finding that "a company like TSC would not voluntarily give up millions of dollars of profit in return for someone taking over the procurement function[.]"). The ALC's analysis, which is consistent with DeRamus's testimony, is materially flawed because it is discussing multiple wrong "controlled transactions" from the wrong time period.[26] And even if they were discussing the correct controlled transaction (which they clearly are not), there is no factual basis or support for the statements.[27]

- **Reliance on evidence unrelated to transfer pricing and the Arm's Length Standard**.

The ALC found the procurement charge failed to satisfy the Arm's Length Standard based on evidence that has no probative value for analyzing that issue. Examples include the following:

[26] Any transaction between related parties is a "controlled transaction," and any restructuring is going to have at least one (and usually many). Transferring IP to Texas is one, transferring procurement to TSC of Texas is another one, etc., and they have no bearing on the Arm's Length Standard for the key "controlled transaction" in this case.

[27] For example, the ALC's statement that "there would likely be other reasonable alternatives that TSC would use" before paying what it paid TSC of Texas for procurement is an unsupported assumption, and the ALC's statement that TSC was paying "almost three quarters of its sales revenues" to TSC of Texas is incorrect and the origins of it are unknown. R. 84, Order.

- 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). R. 83 and 122-123.

Comparing tax owed to South Carolina to sales revenue in South Carolina shows absolutely nothing about the Arm's Length Standard for the procurement charge, and it is unclear why one would think otherwise.[28] Separately, no part of an appropriate transfer pricing analysis (i.e., one addressing the Arm's Length Standard) should rely on or analyze tax owed to a state as shown on a state tax return. The Arm's Length Standard is from the § 482 Regulations and thus based on I.R.C. § 482. Clearly when the IRS applies those regulations, it does not consider income apportioned to and taxed by states on state tax returns as part of its analysis.

- 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., id.* at 81-83 and 121-125.

TSC is a retailer purchasing billions of dollars of inventory from TSC of Texas each year, so clearly "before and after transfer pricing" comparisons of any kind of financial data will be materially different. That says nothing about whether the price meets the Arm's Length Standard.

- Statement that "almost 67% of TSC's income from its retail stores was shifted to Texas[.]" *Id.* at 122.

The origins and meaning of this statement are unclear. If it is based on TSC having $400 million in revenue in 2014 (*see id*. at 92, n. 37), then it is wrong because TSC had billions of

[28] The ALC appears to view this as probative evidence showing the procurement charge fails to satisfy the Arm's Length Standard because the delta between retail sales in South Carolina and the income apportioned to this state is more than $100 million. R. 122-123, n. 62, Order. But the same is true when CUR is used. Separate reporting apportions roughly $4-$5 million to South Carolina each year during the Audit Period, and CUR apportions roughly $13-$14 million to South Carolina each year. *See supra* Facts §E; R. 3700, Corporate Working Papers.

dollars of revenue in 2014.[29] Regardless, it is not probative evidence.

- **Reliance on DeRamus testimony excluding the cost of inventory to support the false statement that it only "costs $13 million" to perform procurement**.

The ALC believes that it only costs $13 million per year to perform the procurement function and views this "fact" as probative evidence. *See, e.g.*, R. 82, 84, 91, 92 at n. 38, and 123. That is incorrect, it is not supported by evidence, and the "costs" do not include at least the billions of dollars of inventory being purchased by TSC of Texas each year. Moreover, the ALC cites no authority to support that it is appropriate in a determination of the Arm's Length Standard under the § 482 Regulations for this transaction for either of the following: (1) that the costs of the procurement function—regardless of what that should be—is probative evidence to determine the Arm's Length Standard; or (2) if it is probative evidence, the proper way to determine the costs, and namely, whether the costs should include the billions of dollars of inventory being purchased as part of that function. The answers to those should be known and supported by authority—not decided based on what the ALC thinks is logical, which is how it was decided. R. 92, n. 38, Order.

The items described in the above bullet points capture essentially the entirety of evidence the Department presented as proof the procurement charge fails to satisfy the Arm's Length Standard. *See, e.g., id.* at 81-84 and 121-128. Half of the proof is addressing the wrong controlled transactions from more than a decade before the Audit Period, and the other half is either factually wrong or has no probative value, or both. *Id.* There is no factual (and certainly not substantial evidence), rational, or legal basis that supports the ALC's finding that the Department proved the procurement charge failed to satisfy the Arm's Length Standard.

The ALC also focused on the PwC Study and Andrade's testimony, both of which it

[29] For context, the sales factor for 2014 was 2.79% based on sales in South Carolina of $130,369,747 divided by sales everywhere of $4,678,600,286. R. 3636, 2014 SC Tax Return. TSC had almost $5 billion of sales revenue in 2014. *Id.*

rejected, but these findings do not show the procurement charge failed to satisfy the Arm's Length Standard. The Department criticized the PwC Study as being "unreliable," which simply means it did not use the best method (i.e., the method most likely to achieve the true Arm's Length Standard), something that TSC knew and readily agreed with at trial.[30] The PwC Study being unreliable, and similarly, the ALC finding Andrade's analysis was not persuasive, means neither the PwC Study nor Andrade proved the procurement charge did satisfy the Arm's Length Standard, but that is not evidence proving the charge did *not* satisfy the Arm's Length Standard. As the ALC properly found, a "flawed" or "unreliable" transfer pricing study does not mean the result of that study (or TSC's use thereof when selecting the price) is evidence showing the price did not satisfy the Arm's Length Standard. R. 81, Order. Thus, proof that either the PwC Study or Andrade's analysis is flawed is not proof that the price used by TSC failed to satisfy the Arm's Length Standard. Those findings could be viewed as a lack of evidence supporting that the price *does* satisfy the Arm's Length Standard, but neither is evidence the charge *does not* do so.

5. The ALC Focused on the Wrong Evidence Thus Shifting the Burden to TSC.

The ALC properly found the burden of proof rested on the Department (*see id*. at 56), but its application of the wrong standard led it to improperly shift the burden to TSC. The evidence that matters under the correct standard is the Department's reasons the sales factor *does not* fairly

[30] The ALC strongly implies (if not explicitly states) TSC was relying on the PwC Study as its defense at trial. *See, e.g.*, R. 123, Order ("In response to the evidence that . . . the 9.7% markup under the Procurement Agreement [was] not justified, Petitioner produced the PwC transfer pricing study. TSC argued that this study showed that the 9.7% markup . . . reflected the value of an arm's length transaction between the parties. However, DeRamus persuasively opined that the PwC transfer pricing study was unreliable."). However, this is not correct. TSC's defense was that the procurement charge satisfied the Arm's Length Standard; it knew and readily agreed the PwC Study did not use the best method, which is why its transfer pricing expert performed his own analysis. *See infra* Argument §III(B).

represent TSC's business activity, which here would be the Department's evidence proving the charge *did not satisfy* the Arm's Length Standard. Instead, the ALC focused on whether sufficient evidence proved the procurement charge *did satisfy* the Arm's Length Standard. This improperly shifted the burden of proof to TSC.

TSC has no burden to prove the sales factor does fairly represent its business activity in South Carolina when the correct standard is applied, yet here, when concluding the Department satisfied its burden, the ALC first evaluated whether the PwC Study proved the procurement charge did satisfy the Arm's Length Standard and rejected it as "flawed and unreliable," which served as the first of "two sub-findings" that the Department met its burden of proof. R. 77, Order. Based on that finding (which simply means the PwC Study did not use the best method and thus did not affirmatively prove the price satisfied the Arm's Length Standard), it essentially (at best) became an even playing field to see which transfer pricing expert the ALC found more "persuasive" instead of the burden remaining on the Department as required, and the ALC then chose the expert who "persuasively" talked about the wrong controlled transactions. *Id*. at 81-93. In the context of applying the correct standard, that would be like the ALC first requiring TSC to prove the sales factor *does* fairly represent its business activity and then finding TSC's evidence did not prove the sales factor worked. The sales factor works until the Department proves it does not. The ALC's focus on whether the PwC Study and/or Andrade could prove the procurement charge does satisfy the Arm's Length Standard rather than on evidence presented by the Department showing it did not (*id*. at 77-93) improperly shifted the burden of proof to TSC.

Moreover, the ALC states that unless TSC's transfer pricing expert could rebut the Department's alleged "proof," then the Department had met its burden. *Id*. at 123 (saying "Petitioner cannot simply rest upon its allegations or denials once the Department has met its

burden" and explaining how TSC then presented Andrade to prove its defense). However, the Department presented no *relevant* evidence (i.e., evidence the sales factor did not work as intended) nor any evidence showing the procurement charge failed to satisfy the Arm's Length Standard to rebut. On the latter, the Department presented no proposed Arm's Length Standard or correct transfer price (and thus no underlying supporting analysis), and no meaningful facts, such as evidence of one company alleged to be capable of doing what the ALC assumes is true—perform the procurement function and charge less than TSC of Texas. *See supra* Argument §III(A)(3)-(4). Thus, TSC had no evidence proving the transfer price failed to meet the Arm's Length Standard to rebut.

The ALC applied the wrong standard and effectively shifted the burden of proof to TSC to affirmatively prove the procurement charge did in fact satisfy the Arm's Length Standard prior to the Department presenting any evidence it did not. That is improper burden shifting.

B. The ALC's Finding that Andrade's Suggested Arm's Length Standard is Incorrect is Not Supported by Substantial Evidence.

The ALC improperly rejected Andrade's testimony based on conclusory statements and unfounded or immaterial criticisms, and its finding that the Arm's Length Standard suggested by Andrade is incorrect is not supported by substantial evidence.[31] Andrade examined the PwC Study and concluded it did not use the best method, so he was uncertain whether the Arm's Length Standard determined by that study was accurate. R. 1563:9-1568:15, 1582:7-25, and 1687:10-23. To find out, he performed his own transfer pricing analysis using the best method,

[31] Andrade has prepared approximately 300 to 500 transfer pricing reports in his career for approximately 200 different clients, including approximately 20 to 25 reports pricing activities like those addressed by the PwC Study. R. 1549:13-1551:16. This is in stark contrast to DeRamus, whose transfer pricing experience is largely unclear and who appears to have no experience working for retailers or pricing a procurement function. *See generally id*. at 1093:11-1103:22 (saying he has prepared "dozens" of reports, the majority of which were in 1993-1998); *id.* at 1103:23-1109:8 (little to no experience with retailers or procurement).

which confirmed the procurement charge satisfied the true Arm's Length Standard. *Id.*; R. 4017, Andrade Analysis. Andrade's analysis was reliable, it complied with the § 482 Regulations, and critically, it provided the *only* Arm's Length Standard for the procurement charge that was presented as evidence in this case. R. 81, Order ("Dr. Andrade presented a comprehensive transfer pric[ing] analysis that [provided the Arm's Length Standard.]"); R. 4017, Andrade Analysis; *see also* R. 2306-2314, TSC Proposed Order (providing detailed description of Andrade's analysis). The ALC nonetheless rejected his analysis because of one "fatal flaw," along with other immaterial and baseless criticisms.[32] R. 81, 85-93, Order.

The alleged "fatal flaw" was that Andrade failed to adequately explain why the profit split aspect of his analysis was 50/50 (50% to TSC of Texas and 50% to TSC). *Id.* at 89 and 122-123. However, it was supported by substantial evidence. The profit split relates to the six non-routine functions: (1) procurement; (2) product development; (3) merchandising; (4) corporate strategy; (5) data analytics; and (6) continuous process improvement. *Id.* at 85-86. The split is based on the value of those six functions and the entity responsible for the performance of each,

[32] The Court unjustifiably placed heavy reliance on DeRamus's criticisms of Andrade's analysis. *See, e.g.*, R. 86-88, Order. DeRamus's criticisms are merely unsupported conclusory statements—most of which the relevance is unclear—based on nothing other than his word and minimal experience. The ALC attempts to provide support for DeRamus's criticisms instead of acknowledging the criticisms are baseless. For example, the ALC cites Treas. Reg. § 1.482-6(c)(3)(iii) to support DeRamus, rather than seeing DeRamus's statements immediately before and after the cited "support" directly contradict one another, and the transaction Andrade is addressing is not remotely similar to the example in Treas. Reg. § 1.482-6(c)(3)(iii) being cited to support DeRamus's criticisms. *Id.* at 87. The ALC also highlights that § 1.482-6 envisions the allocation of operating profits rather than gross profits. *Id.* at 86-87. Using gross profits rather than operating profits for part of Andrade's analysis is simply a difference in timing and methodology of accounting for underlying costs that has an immaterial impact on the outcome of his analysis, it unquestionably is not a reason to entirely dismiss his work, and Andrade explained that he used gross profits because it was more reliable based on the data he had access to—i.e., he complied with the best method rule. Treas. Reg. § 1.482-1(c). Additionally, Andrade produced his entire file to the Department, and the ALC criticizes Andrade's analysis because the Department presented one document from the file (which he did not use as support) that a layperson could not understand. R. 89, n. 34. There are no actual, substantive criticisms of his work.

and TSC of Texas performs one and two, TSC performs four through six, and both entities jointly perform three (merchandising). *Id*. TSC of Texas thus performs 2.5 of the 6 functions and TSC performs 3.5 of the 6 functions, thus, if each function has the same value the split would be 42% to TSC of Texas and 58% to TSC,[33] but each does not have the same value. As the ALC acknowledged, Andrade concluded procurement was extremely valuable, and product development was not far behind. *See, e.g., id.* at 85, n. 29. Andrade did not arbitrarily decide on a 50/50 split, rather, based on his extensive experience and work in this case, he determined TSC of Texas should get more than 50% but conservatively backed that down to 50% thus causing the 50/50 split. *Id.* at 86.

Moreover, despite Andrade not convincing the ALC that procurement and product development were extremely valuable (R. at 90, Order), the ALC recognizes they unquestionably provide value. *See, e.g., id*. at 124, n. 65 (ALC is not convinced of the claimed value, but "[t]hat does not mean that . . . Texas[] is not very good at procuring products[.]"); *id*. at 130, n. 71 ("[T]he Court recognizes Texas's service[s] provide value[.]"). However, the ALC fails to recognize the profit being split comes from those six functions mentioned above and there is no evidence the functions TSC performed are more valuable than the procurement and product development functions performed by TSC of Texas. Andrade's analysis was reliable and supported, and the ALC erred in unreasonably rejecting it when substantial evidence did not support him doing so. When combined with the ALC's finding CUR was appropriate, the ALC effectively split the profits 0% to TSC of Texas and 100% to TSC, which finding is not supported by any evidence.[34] *See infra* Argument §IV(A). The ALC's findings rejecting

[33] Calculated as 2.5 / 6 = 42%, and 3.5 / 6 = 58%.

[34] The ALC cites *Eli Lilly & Co. v. United States*, 372 F.2d 990, 997 (Ct. Cl. 1967) to imply Andrade's 50/50 split was based on his subjective opinion and thus severely handicapped the

Andrade's opinions are not supported by substantial evidence and should be reversed.

IV. THE ALC ERRED IN CONCLUDING CUR IS REASONABLE AND EQUITABLE UNDER STEP TWO OF THE AA STATUTE.

The ALC's finding that CUR is reasonable and equitable here under Step Two of the AA Statute is likewise incorrect and not supported by substantial evidence. R. 128, Order. The plain language of the AA Statute requires at least four items be satisfied to support the ALC's finding: the alternative method must be (1) based on the reasons the taxpayer's business activity was not fairly represented; (2) reasonable; (3) equitable; and (4) apportioning the taxpayer's income. *See* § 12-6-2320(A)(1)-(4) ("If . . . the apportionment provisions . . . *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* . . . apportionment of *the taxpayer's income*.") (emphasis added).

The first requirement is effectively encompassed within the second requirement. To be reasonable, the alternative method must be based on the reasons the taxpayer's business activity was not fairly represented by the standard method. *Id.*; *Sparks*, 406 S.C. at 128, 750 S.E.2d at 63 ("Words in a statute must be construed in context."). Rev. Rul. 15-5 confirms the Department likewise views the "reasonable" requirement as necessitating the alternative method be one that (1) is based on the reasons the standard method failed to represent the taxpayer's business activity and (2) fairly represents that taxpayer's business activity. R. 3727-3728. The Department interprets the "reasonable" requirement as being satisfied only when the first and third

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party opposing it. R. 122-123, Order. Yet Andrade has extensive experience but was rejected so the ALC, with no transfer pricing experience, could subjectively decide the issue based on what the ALC deemed "reasonable" and "unreasonable." *See supra* Argument §III(A)(4). That is improper.

components are satisfied in the test set forth in *Twentieth Century-Fox Film Corp. v. Dep't of Rev.*, 299 Or. 220, 700 P.2d 1035 (1985). *See id.*; R. 2161:20-2162:19. The first and third components of that test require the following: (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; . . . and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in [South Carolina]. *Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1043. As seen in the first component of that test, there are two parts, the first of which (like the AA Statute) requires the alternative method to be one that does fairly represent business activity. *Id.*; *see also* R. 3727, Rev. Rul. 15-5 (stating that under the AA Statute "any alternative apportionment method should be determined in relation to the reasons the standard statutory method does not fairly represent the business activity in the state.").

The ALC's finding that CUR is reasonable and equitable in this case is not supported by substantial evidence because the use of CUR materially fails all requirements imposed by the plain language of the AA Statute and violates the Department's policy document.

A. The ALC Erred in Finding the Reasonable Requirement Met under Step Two.

The ALC states in conclusory fashion that both components of the *Twentieth Century-Fox* test for reasonableness in Step Two of the AA Statute are satisfied (R. 133-134, Order), but those findings are neither correct nor supported by substantial evidence. The test has two components but three total requirements. The first part of the first component requires the alternative method *fairly represent* the taxpayer's business activity in this State. *Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1043 (requiring "the division of income [accomplished by the method] fairly represents business activity"); § 12-6-2320(A) (when a taxpayer's business activity is not represented in this state, the Department may require "in

respect to all or any part of the taxpayer's business activity, if reasonable"). That requirement is not satisfied for the same reason the ALC should have found the Department failed to satisfy its burden of proof under the wrong standard—the Department did not present evidence of an Arm's Length Standard the procurement charge supposedly failed to meet. The ALC concluded TSC's South Carolina business activity was not fairly represented because the procurement charge failed to satisfy the Arm's Length Standard, so clearly, adjusting that charge to one that does satisfy the Arm's Length Standard is needed to meet that aspect of the "reasonable" requirement. Adjusting the price would also be consistent with the Department's statements to the public. R. 3728, Rev. Rul. 15-5 (stating that under the AA Statute "any alternative apportionment method should be determined in relation to the reasons the standard statutory method does not fairly represent the business activity in the state.").[35]

If the procurement charge failed to meet the Arm's Length Standard, the use of CUR does not correct that issue, it vastly over-corrects. The ALC acknowledges that CUR "eliminates the effect of intercompany transactions[.]" R. 130, Order.[36] That is correct and means that had the procurement charge been a **0%** markup on inventory (which is prohibited by the § 482 regulations) rather than 9.7%, then TSC's use of separate reporting during the Audit Period would cause the tax owed to South Carolina to be very similar to the tax owed to South Carolina

[35] TSC's accounting expert, Jack Small, explained that it would be simple to implement a price adjustment. For example, if the 9.7% markup on inventory should have been 7.0%, it would take him a couple of hours to determine the South Carolina tax due using the separate entity tax return using 7.0%. R. 1387:13-21 and 1391:25-1393:12.

[36] The ALC also suggests CUR nonetheless "still recogniz[es] the value" of those intercompany transactions that are eliminated. R. 130 and 132, Order. The meaning of this is unclear, but the way CUR "still recognizes the value" is by taking 100% of the value earned by TSC of Texas away from TSC of Texas and giving it to TSC which is then taxed by South Carolina.

using CUR.[37] The ALC oddly suggests it does not matter that CUR over-taxes TSC compared to its business activity in this state so long as the ALC specifically recognizes that is true. *Id.* at 130, n. 71 (emphasizing the ALC is not finding that the procurement charge should be 0% and that the procurement function is valuable). Acknowledging use of CUR is wrong does not make it right, reasonable, or equitable. The ALC in Step One found that separate reporting with the 9.7% markup fails to fairly represent TSC's business activity because the 9.7% markup is above the Arm's Length Standard, yet here in Step Two, the ALC found CUR *does* fairly represent TSC's business activity despite CUR being the same as separate reporting with a 0% procurement charge that is unquestionably below the Arm's Length Standard. They cannot both be correct, and here, neither are correct.

For the second part of the first component of the test for reasonableness, which requires that use of CUR "if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income[,]" the ALC makes no attempt to explain how this was satisfied here and it was not. CUR causes approximately 8.64% of TSC's income to be taxed when only 2.83% of TSC's business activity occurs in South Carolina (*see supra* Facts §E), and if all states assessed TSC in this manner, well more than 100% of TSC's income would be taxed. The Court incorrectly and summarily dismissed TSC's argument by stating it relies on the transfer price being correct. R. 132, Order. The Department must present evidence that proves the test was satisfied, not the other way around, and no evidence shows that it was satisfied. If TSC of Texas is deserving of any payment at all for its services or the use of its IP, which it undoubtedly is, the

[37] The primary reason the ALC finds CUR is reasonable is based the ALC's comparison of the tax owed using CUR to the ALC's "conservative" estimate of the tax that would be owed using separate reporting with an unspecified "modest" transfer price, which the ALC finds would make the tax owed to South Carolina *almost* as much as the tax owed using CUR. *Id.* at 129-134. That is because the ALC is being "conservative" and using some "modest" markup, rather than 0%.

use of CUR here fails Step One because, if applied uniformly, it would result in taxation of more than 100% of TSC's income.

The ALC also fails to explain how the third component of the test for reasonableness was satisfied, which requires "the division of income reflects the economic reality of the business activity engaged in by the taxpayer in [South Carolina]." The ALC merely states in conclusory fashion that it was met "for the reasons above" and because "income" is "a proxy" for business activity. R. at 134, Order. Neither the "reasons above" nor the "income" is "a proxy" statement constitute evidence that would satisfy this requirement.

In sum, the use of CUR fails all three requirements in the two components of the test the Department applies when determining whether an alternative method is reasonable under the AA Statute. TSC's business income comes from retail sales, only 2.83% of its sales occurred in South Carolina during the Audit Period, and there is no plausible basis for 8.64% of its total business income from that period to be apportioned to South Carolina like is done by CUR. *See supra* Facts §E. CUR does not fairly represent TSC's business activity in this state—it is the same as separate reporting while paying a 0% markup to TSC of Texas, which the ALC agrees would not be an arm's length price. The ALC makes no attempt to explain how CUR "if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income[,]" and CUR would not do so. And the ALC's conclusory statements provide no evidentiary support that the third component was satisfied. R. 134, Order.[38]

[38] The ALC's finding that the first and third components were satisfied is also neither correct nor supported by substantial evidence because the test *cannot* be satisfied in this case. The ALC applied the wrong standard for Step One and then forcibly construed Step Two to incorrectly find CUR is authorized here. *See supra* Argument §§I(C) and II. The *Twentieth Century-Fox* test is designed for a correct use of the AA Statute, and the components thus envision use of a different apportionment method (e.g., sales factor does not work, but gross receipts method does). The test must be satisfied in this case to be reasonable, but it is not nor can it be satisfied.

B. The ALC Erred in Ignoring the Heightened "Equitable" Standard under Step Two when (A)(4) is being Used and in Finding that Standard Met.

The ALC erred in ignoring the heightened "equitable" standard in (A)(4) by treating "reasonable" and "equitable" as one in the same (*see generally id*. at 128-134),[39] the apparent justification being that Black's Law Dictionary defines them similarly. *Id.* at 129, n. 70. But it does not—"reasonable" generally means fair or moderate whereas "equitable" means consistent with principles of justice. *Id.* The "equitable" requirement is a heightened standard imposed by the plain language, and when read in context as required, it must be equitable to TSC as the party contesting use of the AA Statute. *CFRE, LLC*, 395 S.C. at 74, 716 S.E.2d at 881 (statutes must be read so "that no word, clause, sentence, provision or part shall be rendered surplusage, or superfluous").

It is not equitable in this case to impose CUR on TSC. The Department required CUR because TSC was a unitary business with intercompany transactions and later searched for justification after TSC petitioned the ALC for relief. Even the Prehearing Statement fails to say the procurement charge is improperly high and/or fails to satisfy the Arm's Length Standard. *See* Dep't's Prehearing Statement. Yet more than three years after the Determination that upheld imposing CUR, the Department focused its attack at trial on the procurement charge as justification for its decision. Moreover, during litigation, the Department's transfer pricing expert DeRamus never provided the ALC with an opinion on the appropriate transfer price because he was not asked to do so. Thus, the ALC could not know whether this missing analysis would show that the Arm's Length Standard is not materially different than the procurement charge or would show that imposing CUR results in a vastly different amount of taxes owed to South Carolina than separate reporting with a correct Arm's Length Standard, or both. The AA Statute is a relief provision, and based on the foregoing, the principals of equity have not been met here.

[39] The Department likewise treats them as the same. R. 2144:15-2145:24.

V. THE ALC ERRED IN NOT FINDING DEPARTMENT'S FORCED USE OF CUR VIOLATES THE APA.

The Department's use of CUR against TSC violates the APA. As evidenced by Rev. Rul. 15-5's issuance and content and the facts here, the Department regularly targets a specific group of taxpayers and applies Step One of the AA Statute differently and incorrectly against them. R. 3729-30, Rev. Rul. 15-5. In addition, Rev. Rul. 15-5 makes policy decisions—i.e., making law, not just interpreting it—when describing how "South Carolina" applies CUR. *Id.* at 3730-34 (choosing waters edge approach, *Finnigan* over *Joyce,* etc.). States with similar statutes have found a taxing agency's intended regular use of an alternative apportionment method was tantamount to rulemaking that cannot be done absent promulgating a regulation under the state's APA. *See, e.g., CBS Inc. v. Comptroller of the Treas.*, 575 A.2d 324, 330 (Md. 1990); *Metromedia, Inc. v. Dir., Div. of Tax'n,* 478 A.2d 742, 754-755 (N.J. 1984).

Here, Rev. Rul. 15-5 shows the Department targets taxpayers that are members of a unitary business, and specifically ones with purchasing, management, and/or east/west companies, and misapplies Step One when examining those taxpayers. R. 3729-30. The AA Statute is intended for use only when the apportionment method/formula (here, the sales factor) does not work as intended, but the Department is deciding that question using six vague factors, and the *only* thing clear about those factors is they do not focus on the statutory formula. *Id.* Auditors are not evaluating TSC's sales factor and its South Carolina business activity because TSC has related parties. *Id.* Per the Audit Report, the AA Statute was invoked against TSC because it is a member of a unitary business that (as is typical) has intercompany transactions, with no indication the auditor thought TSC's sales factor was even relevant. R. 3715, Audit Report. And the Department (and now the ALC) continue to ignore TSC's sales factor. Rev. Rul. 15-5 encourages an incorrect application of the AA Statute against targeted taxpayers and invites

arbitrary and selective enforcement of the AA Statute against them. Moreover, for Step Two of the AA Statute when CUR is required for these taxpayers, Rev. Rul. 15-5 shows many policy choices made by the Department for how this state will apply CUR.

The necessity of a validly promulgated regulation before imposing CUR under the AA Statute is further evidenced by the statutory language that the Department *may* impose (versus *shall* impose) an alternative method when it concludes a taxpayer's business activity is not fairly represented here. *See Joseph v. S.C. Dep't of Lab., Licensing & Regul.*, 417 S.C. 436, 463-65, 790 S.E.2d 763, 777-78 (2016) (Justice Kittredge concurrence) (statute with discretionary language indicates agency should determine statute's parameters via the regulatory process, whereas mandatory language indicates agency need not formally promulgate a regulation). Finally, "when there is a close question whether a pronouncement is a policy statement or regulation, the [agency] should promulgate the ruling as a regulation in compliance with the APA." *Home Health Serv., Inc. v. S.C. Tax Comm'n*, 312 S.C. 324, 329, 440 S.E.2d 375, 378 (1994).

Rev. Rul. 15-5's guidance as to how the Department applies Step One to taxpayer's like TSC, and its guidance for when and how CUR and will be implemented are major policy decisions that cannot be made without promulgating a valid regulation under the APA that gives the Legislature a chance to reject them. As no regulation was promulgated, the Department's assessment is unlawful. At a minimum, CUR should not be required for tax years 2014 and 2015 as Rev. Rul. 15-5 did not exist until June 12, 2015, and should not be retroactively applied.

CONCLUSION

Based on the foregoing, the ALC's decision should be reversed.

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November 25, 2024

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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-000013
Administrative Law Court Case No. 19-ALJ-17-0416-CC

Tractor Supply Company,..... Appellant,

v.

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

CERTIFICATE OF COUNSEL

The undersigned certifies that the foregoing Final Opening Brief of Appellant Tractor Supply Company complies with Rule 211(b), SCACR.

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