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THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

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Appellate Case No. 2024-000013

Case No. 19-ALJ-17-0416-CC

Tractor Supply Company,..Appellant,

v.

South Carolina Department of Revenue,..Respondent.

RESPONDENT SOUTH CAROLINA DEPARTMENT OF REVENUE'S FINAL BRIEF

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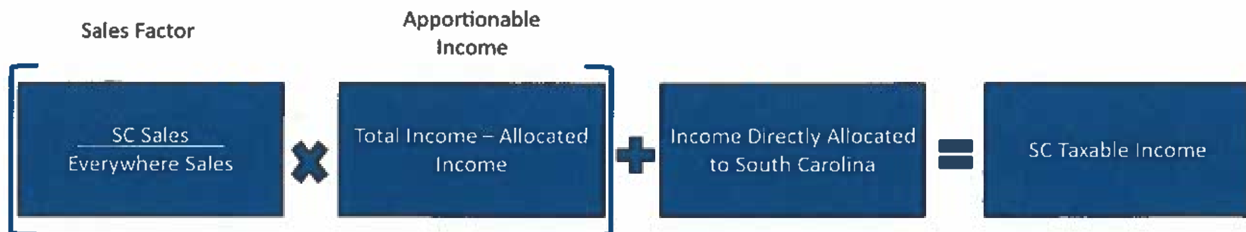
INTRODUCTION

This case is about whether the Department of Revenue (Department) rightly exercised its statutory authority to require Tractor Supply Company (TSC) to use an alternative apportionment method because the standard apportionment method does not fairly reflect TSC's business activity in South Carolina. The Legislature has explicitly authorized the Department to require alternative methods. The Supreme Court has previously approved the very method the Department used. The Department exercised its authority and required the alternative method in accordance with its own published guidance. And TSC's only defense to the Department's action was to rely on a study that TSC's own expert admitted was unreliable. The South Carolina Administrative Law Court's (ALC) final order and decision, which affirmed the Department's audit, properly applied relevant statutes and precedent and is supported by substantial record evidence. This Court should affirm.

The South Carolina Income Tax Act (Act), S.C. Code Ann. § 12-6-10 et seq., imposes a 5% corporate income tax on the taxable income of every corporation doing business in South Carolina. For multistate corporations, the tax is imposed on a base that reasonably represents the proportion of the corporation's business that is carried on within this State. The process for determining that proportion is apportionment; South Carolina's apportionment provisions are found in Article 17 of the Act. *See* S.C. Code Ann. § 12-6-2210 to -2320. For taxpayers who are principally in the business of retail sales, their South Carolina taxable income is calculated by multiplying their apportionable income by the sales factor (South Carolina sales divided by everywhere sales). *See* S.C. Code Ann. §§ 12-6-2252, -2280 (2014). The sales factor in South Carolina's apportionment formula is:



Although apportionment seeks to be as exact as possible, "all that is required is a reasonable approximation." *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66, 212 S.E.2d 574, 577 (1975). In South Carolina, the default apportionment method is separate entity reporting. Often, the default method achieves that reasonable approximation. But a one-size-fits-all approach rarely works every time, and the Legislature recognized the Department should have the flexibility to require an alternative method that effectuates an equitable approximation when the default method fails to do so. Section 12-6-2320(A)(4) gives the Department that discretion. *Media General*, 388 S.C. at 151, 694 S.E.2d at 531.[1] Combined unitary reporting is an accepted and judicially approved alternative apportionment method, particularly when the taxpayer operates within a unitary business group.[2] *Id.*

TSC is a retailer, so the default apportionment method it uses is separate entity reporting using a sales factor of TSC's retail sales in South Carolina divided by its retail sales everywhere. In 2001, TSC implemented a corporate restructuring: TSC created new entities, transferred valuable assets and functions to those entities at no cost, and created intercompany agreements in which TSC agreed to provide services (namely, procurement) to itself—for a fee. The intercompany transactions siphoned profits from TSC's South Carolina retail stores to a subsidiary in Texas, thus making TSC look a lot less profitable (on paper) in South Carolina that it actually is. As a result, when TSC used the default apportionment method to file its corporate tax returns, the income reported did not reflect the true

[1] During the pendency of this appeal, the Legislature amended this statute effective March 11, 2024. The portion quoted remains identical in the amended statute.

[2] A unitary business is one in which there is a 'high degree of interrelationship and interdependence among related entities so that the value of the business as a whole exceeds the sum of its individual elements." *Media General*, 388 S.C. at 141, 694 S.E.2d at 526. The characteristics of a unitary group include unity of ownership, management, and operation resulting in unquantifiable flows of value among related entities of the business; and whether the activities of the business in question contribute to or depend on the other activities of the business. *Id.*, *Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 258 S.E.2d 93 (1979).

economic and business activity of TSC in South Carolina. For example, in 2014 the TSC unitary group generated over $6 billion in gross sales (over $135 million from its South Carolina stores) and earned over $550 million in income but reported only $4.1 million in South Carolina income subject to tax.

Thus, the Department concluded that an alternative apportionment method—combined unitary reporting—appropriately disregarded TSC's artificial corporate form and properly captured the substance of its business activity in the state, including the many subtle and unquantifiable transfers of value taking place among the related companies within the single Tractor Supply business enterprise. *See Media General*, 388 S.C. at 142, 694 S.E.2d at 527. Combined unitary reporting cured the distortion caused by TSC's intercompany transactions and fairly reflected its business activity in the state. This method of filing was not new for TSC—it files combined unitary returns in many other states and had previously filed combined unitary returns in South Carolina.

The ALC did not err in finding that separate entity reporting did not fairly represent the extent of TSC's business activity in the state. Nor did it err in finding the Department had the authority to require combined unitary reporting under section 12-6-2320(A)(4), and that combined unitary reporting in this case was both reasonable and equitable. Because the ALC did not err, and its findings are supported by substantial evidence, the Department respectfully requests this Court affirm the ALC.

STATEMENT OF THE ISSUES ON APPEAL

I. DID THE ALC CORRECTLY HOLD THAT SECTION 12-6-2320(A)(4) AUTHORIZES THE DEPARTMENT TO REQUIRE COMBINED UNITARY REPORTING AS AN ALTERNATIVE APPORTIONMENT METHOD?

II. DOES SUBSTANTIAL EVIDENCE SUPPORT THE ALC'S FINDING THAT SEPARATE ENTITY REPORTING DOES NOT FAIRLY REPRESENT TSC'S BUSINESS ACTIVITY IN SOUTH CAROLINA?

III. DOES SUBSTANTIAL EVIDENCE SUPPORT THE ALC'S FINDING THAT COMBINED UNITARY REPORTING IS A REASONABLE AND EQUITABLE APPORTIONMENT OF TSC'S INCOME IN SOUTH CAROLINA?

IV. DID THE ALC CORRECTLY HOLD THE DEPARTMENT'S USE OF COMBINED UNITARY REPORTING DOES NOT VIOLATE THE SOUTH CAROLINA ADMINISTRATIVE PROCEDURES ACT?

STATEMENT OF THE CASE

The Department mailed TSC a Department Determination on November 8, 2019 concluding: (1) TSC's use of separate entity reporting in the standard apportionment formula does not fairly represent the extent of its business activity in South Carolina and (2) the Department's application of combined unitary reporting is a reasonable alternative apportionment method pursuant to section 12-6-2320(A)(4). *See* Department Determination (**R. pp. 2241–2258**). On December 11, 2019, TSC filed its request for a contested case hearing with the ALC challenging whether the Department could meet its burden to establish "(1) that the standard formula fails to fairly represent the extent of the taxpayer's business activity in the state, or (2) that the proposed alternative method of combination is reasonable." *See* Req. for Contested Case Hr'g (**R. pp. 154–160**).

The ALC held a contested case hearing from January 23–27, 2023. On August 8, 2023, the ALC issued a final order finding that the Department had met its burden and ruling in its favor. *See* Initial Order (**R. pp. 1–64**). On August 18, 2023, TSC filed a motion for reconsideration. *See* TSC's Initial Motion to Reconsider (**R. pp. 2531–2695**). On August 21, 2023, the ALC rescinded its Initial Order. *See* Rescission Order (**R. p. 65**). On December 4, 2023, the ALC issued an order granting

TSC's motion for reconsideration and an amended final order still finding that the Department had met its burden and ruling in its favor. *See* Order Granting TSC's Motion to Reconsider (**R. pp. 138–145**) and Amended Order (**R. pp. 66–137**). TSC filed another motion for reconsideration on December 14, 2023. *See* TSC's Second Motion to Reconsider (**R. pp. 2708–2874**). On January 3, 2024, TSC filed a Notice of Appeal; the ALC issued an order denying TSC's second motion for reconsideration and TSC filed an amended notice of appeal. *See* Order Denying TSC's Second Motion to Reconsider (**R. pp. 146–153**). On January 8, 2024, the parties filed a joint motion to recognize the inapplicability of the automatic stay to the ALC's Order on TSC's Second Motion to Reconsider, which this Court granted on January 18, 2024.

STATEMENT OF FACTS

1. The Tractor Supply Company: business operations and corporate structure

TSC and its subsidiaries (collectively, the "TSC Group") operate the largest retail store chain of rural lifestyle products in the United States. *See* Joint Ex. 3; Hr'g Tr. 51:3–7 (**R. pp. 3039–3123; 441**). The stores are operated under the name Tractor Supply Company and are located primarily in rural communities and towns outlying major metropolitan markets. *Id.* TSC seeks to be the "most dependable supplier of basic maintenance products for the lifestyle needs of recreational farmers and ranchers." *Id.* It describes its customers as "home, land, pet and animal owners that live a conservative and self-reliant lifestyle." *Id.*

TSC Group operates over 2,000 stores in every state except Alaska. *See* Hr'g Tr. 852:13–853:20; Joint Ex. 3 (**R. pp. 1242–1243; 3039–3123**). It also operates an e-commerce website, TractorSupply.com. TSC operates the vast majority of the company's retail stores, while other subsidiaries (discussed below) operate the stores in Texas, Michigan, Utah and Hawaii. *See* Hr'g Tr. 48:15–49:1 (**R. pp. 438–439**). Regardless of which entity operates a particular location, all Tractor Supply retail stores use the same signage and logos, have a nearly identical interior layout

(approximately 19,000 square feet), provide uniform display and product placement, offer a similar assortment of inventory, and require store employees to wear the same red aprons with name tags. *See* Hr'g Tr. 85:1–19, 919:12–14); Joint Ex. 3 (**R. pp. 475, 1309; 3039–3123**). Similarly, customers can purchase and use gift cards interchangeably with any Tractor Supply retail store and can purchase and return or exchange merchandise interchangeably at any retail store, regardless of which TSC Group entity operates the store. *See* Hr'g Tr. 86:8–87:5 (**R. pp. 476–477**). As of 2016, TSC operated 42 retail stores in South Carolina. *Id.*; Hr'g Tr. 60:19–22; Joint Ex. 3 (**R. pp 450; 3039–3123.**).

The TSC Group has approximately 26,000 employees: 98% work in the retail stores or distribution centers, while the remaining 2% work in TSC's corporate headquarters in Brentwood, Tennessee. *See* Hr'g Tr. 551: 6–25; 1544:1–5; Respondent's Ex. 33, slide 36 (**R. pp. 941, 1934; 4574**). The employees located in Brentwood include all the executives for the TSC Group, as well as those employees who provide a variety of administrative and support services for the TSC Group, including accounting, legal, human resources, data analysis, and procurement (this includes purchasing and merchandising).

TSC's growth and direction as a company is driven by customer demand for its retail products. *See* Hr'g Tr. 916:19–23 (**R. p. 1306**). Unsurprisingly, 99% of TSC's revenue is derived from its retail operations.[3] *See* Hr'g Tr. 60:8–11 (**R. p. 450**). Its operating profits increases with the number of stores. *See* Hr'g Tr. 485:23–486:12; Respondent's Ex. 33 (**R. pp. 875–876; 4538–4606**). In 2016, TSC generated approximately $6.761 billion in sales, with each retail store averaging $4.4 million in sales. Between 2014 to 2016, TSC's South Carolina stores generated over $135–160 million in sales revenues annually. *See* Hr'g Tr. 550:7–12 (**R. p. 940**).

[3] The remaining one percent (1%) is derived from interest, miscellaneous income (i.e., recycling pallets), and rental income. TSC agrees this income is "immaterial to the bigger piece." *See* Hr'g Tr. 60:12–18 (**R. p. 450**).

Every entity in the TSC Group is related through common ownership and control, with common officers and directors. *See* Hr'g Tr. 355:22–356:2; 361:8–19; 1585:20; Joint Ex. 5, 23; Respondent's Ex. 7–9 (**R. pp. 745–746, 751, 1975; 3129–3132; 3835–3850; 4423–4452**). TSC directly or indirectly owns 100% of all entities in the TSC Group. *See* Hr'g Tr. 84:3–8; Joint Ex. 4 (**R. pp. 474; 3124–3128**).

A. <u>Tractor Supply Company</u>

TSC is the parent holding company and the only entity in TSC Group that files a South Carolina income tax return. *See* Hr'g Tr. 49:16–18; Joint Ex. 4 at TSC_00004553; Hr'g Tr. 251:9–14; (**R. pp. 439; 3124; 641**). TSC has three main functions: (1) operates 84% of the Tractor Supply retail stores; (2) operates most of the distribution centers; and (3) provides administrative and management services for the TSC Group, including the TSC Group's centralized cash management function. *See* Hr'g Tr. 59:16–60:21; 461:12–13; 522:9–20; 855:6–18; 878:17–18; 883:18–884:2; Joint Ex. 19 at TSC_00000018–19) (**R. pp. 449–450, 851, 912, 1245, 1268, 1273–1274; 3747–3748**). TSC employs all the executives for the TSC Group, including the Chief Merchandising Officer who is responsible for overseeing TSC Group's procurement functions. *See* Hr'g Tr. 63:17–20, 887:14–19 (**R. pp. 453; 1277**).

B. <u>TSC of Michigan</u>

Tractor Supply of Michigan, LLC ("TSC of Michigan") was formed in 2001 and is owned 100% by TSC. *See* Joint Ex. 4 at TSC_00004553 (**R. p. 3124**). TSC of Michigan operates 81 retail stores only in Michigan. *See* Hr'g Tr. 61:11–18; Joint Ex. 1 at SCDOR_005735 (**R. pp. 451; 3066**). TSC of Michigan derives nearly 99% of its third-party revenue from its retail customers. *See* Hr'g Tr. 61:14–18 (**R. p. 451**). TSC of Michigan does not have its own company officers, executives, or directors, and it leases all its employees from TSC. *See* Hr'g Tr. 60:23–61:22; Respondent's Ex. 7) (**R. pp. 450–451; 4423–4431**).

C. TSC of Texas

Tractor Supply Company of Texas, LP ("TSC of Texas") is a limited partnership that was formed in 2001 and is owned 99% by TSC of Michigan and 1% by TSC. *See* Joint Ex. 4 at TSC_00004553; Hr'g Tr. 84:12–15 (**R. pp. 3124; 474**). TSC of Texas operates 196 retail stores, one distribution center, and several mixing centers only in Texas. *See* Hr'g Tr. 61:23–63:5, 154:22–155:20; Joint Ex. 3 at SCDOR_005723 (**R. pp. 451–453, 544–545; 3054**).

TSC of Texas owns the intellectual property for the TSC Group. *See* Hr'g Tr. 82:12–22; Respondent's Ex. 9 (**R. pp. 472; 4441–4452**). In addition, TSC of Texas employees physically located in TSC's Brentwood headquarters provide certain procurement and distribution services to the TSC Group. *See* Hr'g Tr. 884:6–8; Joint Ex. 23 (**R. pp. 1274; 3835–3850**).[4] During the Periods at Issue (2014–2016), approximately 100–120 TSC of Texas employees worked exclusively in inventory procurement. *See* Hr'g Tr. 881:15–16 (**R. p. 1271**). Although TSC of Texas is the entity that contracts with third party inventory vendors, it is TSC that pays those vendors and maintains insurance on the purchased inventory while it is in transit. *See* Hr'g Tr. 69:1–72:8, 883:12–20; Respondent's Exhibit 10 (**R. pp. 459–462, 1273; 4453–4455**).

2. TSC's 2001 Tax Restructuring

In 2001, after consulting with PricewaterhouseCoopers (PwC), TSC implemented a "strategy for reduction of state income tax expenses." *See* Hr'g Tr. 116:16–117:14, 142:13–144:5; Respondent's Ex. 12 (**R. pp. 506–507, 532–534; 4456–4467**). TSC referred to this strategy as the "Tax Restructuring," and the Board minutes and corporate documentation generated by TSC and PwC at the time of this Tax Restructuring do not identify any goal, intent, or reason for this strategy other

[4] TSC of Texas provides the procurement function for the Company except for Petsense, LLC. Petsense, LLC was acquired by TSC in the last quarter of 2016 (i.e., the last quarter of the Periods at Issue). *See* Hr'g Tr. 63:17–65:1 (**R. pp. 453–455**).

than tax minimization and a "Tax Restructuring" opportunity. *Id.*; *see also* Hr'g Tr. 925:11–929:6 (**R. pp. 1315–1319**). The strategy was "largely, if not entirely, a tax driven transaction." *See* Hr'g Tr. 641:16–18 (**R. p. 1031**).

TSC of Texas and TSC of Michigan were both formed as part of the 2001 Tax Restructuring.[5] *See* Hr'g Tr. 90:20–25, 100:24–101:3 (**R. pp. 480, 490–491**). In conjunction with their formation, TSC transferred all its procurement functions to TSC of Texas. *See* Hr'g Tr. 139:10–15, 153:23–25, 1543:1–6 (**R. pp. 529, 543, 1933**). TSC transferred all its retail store and distribution center operations and assets in the state of Texas to TSC of Texas and transferred all retail store operations and related assets in the state of Michigan to TSC of Michigan. *See* Respondent Ex. 12 (**R. pp. 4456–4467**). The Tax Restructuring also included the execution of several intercompany agreements between the TSC Group entities, discussed more below.

Importantly, TSC sought to accomplish the Tax Restructuring in a manner that would have "little or no impact on the day-to-day operations of Company personnel." *See* Hr'g Tr. 151:15–19 (**R. p. 541**). It succeeded. The Tax Restructuring had no operational change or commercial effects on the company. *See* Hr'g Tr. 464:14–19, 639:1–641:22 (**R. pp. 854, 1029–1031**). The physical location and place of operation for all procurement functions remained unaffected; the only meaningful change was the legal employer of the merchandising/procurement employees. *See* Hr'g Tr. 139:20–24 (**R. p. 529**). The delivery and vendor terms did not change (except to update vendor agreements to reflect TSC of Texas, rather than TSC, as the new purchaser). *See* Hr'g Tr. 139:16–140:9; 158:4–7 (**R. pp. 529–530, 548**). In fact, TSC did not even mention the Tax Restructuring or transfer of the

[5] TSC has a total of nine subsidiaries within its unitary group; except for TSC of Texas and TSC of Michigan, all of the subsidiary entities are single member limited liability companies (LLCs) whose activities are included with TSC's activities for purposes of tax filings. *See* Hr'g Tr. 931:17–932:18; Joint Ex. 4 (**R. pp. 1321–1322; 3124–3128)**

procurement functions in its 2000, 2001, or 2002 public filings with the Security Exchange Commission, which filings are intended to provide investors with a comprehensive overview of TSC's business and financial condition. *See* Respondent's Ex. 1, 2, and 3; Hr'g Tr. 937:10–939:12 (**R. pp. 4018–4422; 1327–1329**). Instead, TSC merely noted that its "merchandise purchasing is centrally managed." *See* Respondent's Ex. 1 at SCDOR_006495; Respondent's Ex. 2 at SCDOR_006661 (**R. pp. 4061; 4227**).

3. TSC's Intercompany Transactions

As part of the Tax Restructuring in 2001, TSC, TSC of Texas, and TSC of Michigan also entered into intercompany agreements that govern how these affiliated entities function together within the unitary business. TSC officers signed the agreements on behalf of TSC of Texas and TSC of Michigan. *See* Hr'g Tr. 92:10–17; Respondent's Ex. 7 at TSC_00004354; Respondent's Ex. 8 at TSC_00004366 (**R. pp. 482; 4431; 4440**). No money is exchanged or deposited into TSC's bank accounts for these transactions, which are simply documented in TSC's books and records as a journal entry.[6] *See* Hr'g Tr. 92:3–9, 95:7–14, 100:14–20, 1003:19–1004:9 (**R. pp. 482, 485, 490, 1393–1394**). No TSC entity provides these services to any entity outside the TSC Group. *See* Hr'g Tr. 91:11–92:2, 97:4–7, 100:10–13 (**R. pp. 481–482, 487, 490**).

A. <u>Master Shared Services Agreement: TSC of Michigan leases its employees from TSC</u>.

Under a Master Shared Services Agreement, TSC of Michigan leases all its employees from TSC at a rate of their cost plus a 10% markup. *See* Hr'g Tr. 89:12–92:2, 891:11–21); Respondent's Ex.

[6] When a company "pays" a related entity for a service or function via journal entries, the revenue/money stays within the unitary business and is available for use by the other related entities. *See* Hr'g Tr. 930:25–931:4 (**R. pp. 1320–1321**). But if that same payment for the same service or function is made to a third party, the revenue/money leaves the unitary business and is no longer available for use by any members of that unitary business. *See* Hr'g Tr. 930:13–24 (**R. p. 1320**).

7 (**R. pp. 479–482, 1281; 4423–4431**). TSC does not have a transfer pricing study related to this transaction or any idea how the fee or markup was determined. *Id.*

B. Administrative Services Agreement: TSC provides support services to TSC of Texas and TSC of Michigan.

Under an Administrative Services Agreement, TSC provides administrative/management services to TSC of Texas and TSC of Michigan, including accounting, financial, legal, executive, information technology, human resources, marketing and advertising, and quality control. *See* Hr'g Tr. 93:16–95:6; Respondent's Ex. 8 (**R. pp. 483-485; 4432–4440**). TSC has no transfer pricing study related to this transaction. *Id.* An officer of TSC signed the Administrative Services Agreement on behalf of TSC of Texas. *See* Respondent's Ex. 8 at TSC_00004366 (**R. pp. 4440**).

C. Inventory Procurement Agreements: TSC of Texas provides procurement services to TSC and TSC of Michigan.

Pursuant to Inventory Procurement Agreements, TSC of Texas purchases all inventory from third party vendors that will ultimately be sold to customers in all the Tractor Supply retail stores, including all inventory sold in South Carolina stores. *See* Hr'g Tr. 98:21–101:21; Joint Ex. 23 (**R. pp. 488–491; 3835–3850**). Upon purchasing the inventory, TSC of Texas immediately "sells" the inventory to TSC and TSC of Michigan at cost plus a 9.7% markup. *See* Hr'g Tr. 100:2–6; 157:14–158:3; Joint Ex. 20, 21, and 23 (**R. pp. 490, 547-548; 3762–3822; 3823–3825; 3835–3850**). TSC of Texas' decision to charge a 9.7% markup was based on a transfer pricing study provided by PwC and commissioned by TSC (not TSC of Texas). *See* Hr'g Tr. 100:2–9; Joint Ex. 20; Hr'g Tr. 929:25–930:5 (**R. pp. 490; 3762–3822; 1319–1320**).

TSC of Texas employees performing the procurement function for the TSC Group are physically located in Tennessee. *See* Hr'g Tr. 101:4–21 (**R. p. 491**). The procurement group/team does not physically hold the inventory; rather, once it is purchased from third party vendors it is shipped to and held by the TSC Group's distribution centers and retail stores. *Id.* A TSC officer signed the

Inventory Procurement Agreement on behalf of TSC of Texas. *See* Joint Ex. 23 at TSC_00006862 (**R. p. 3848**).

D. Licensing Agreement: TSC of Texas provides intellectual property to the TSC Group.

TSC of Texas owns the intellectual property for "Tractor Supply Company" but allows the TSC Group to use the intellectual property through a Licensing Agreement. *See* Hr'g Tr. 82:12–22; Respondent's Ex. 9; Hr'g Tr. 95:20–96:6; (**R. pp. 472; 4441–4452; 485–486**). Even though PwC analyzed and recommended an appropriate price to charge for use of the "TSC brand value," TSC of Texas chose to allow the TSC Group to use the trademarks for free. *See* Hr'g Tr. 96:7–24; Joint Ex. 20 at TSC_00004317) (**R. pp. 486; 3803**).

4. *Media General* and SC Revenue Ruling #15-5

In 2010, the South Carolina Supreme Court decided *Media General*, in which it held that combined unitary reporting (or combined entity apportionment) is a valid and proper "other method" of apportionment under section 12-6-2320(A)(4). *Media General*, 388 S.C. at 151, 694 S.E.2d at 531. On the heels of *Media General*, the South Carolina Taxation Realignment Commission (TRAC)[7] reported to the Legislature that the recent *Media General* ruling confirmed the Department has the authority to require "forced combinations" under section 12-6-2320(A)(4). *See Final Report of S.C. Taxation Realignment Commission*, Joint Exhibit 30 at p. 162, 170 (**R. pp. 3933, 3941**).[8]

[7] The TRAC was charged by the Legislature with conducting a thorough assessment of the State's current tax structure. S.C. Code Ann. § 12-3-10.

[8] The TRAC Report noted that although separate entity reporting is the standard method, combined reporting is "better equipped to handle the complexities of multi-state corporate structures, particularly when such structures impact the ability of the state to properly tax corporate income." *Id.* at 166 (**R. p. 3937**). The Report specifically noted that combined reporting "captures the true income of a multi-state corporate" and prevents the use of "tax loopholes linked to corporate structure" in which multi-state corporations utilize out-of-state subsidiaries to shift profits out of the state in order to avoid taxation on those profits. *Id.* at 163–64 (**R. pp. 3934–3935**).

In 2015, in response to *Media General* and corporate taxpayers requesting published guidance on how the Department would utilize combined unitary reporting, the Department issued SC Revenue Ruling #15-5.[9] *See* SC Revenue Ruling #15-5, Joint Ex. 17 (**R. pp. 3724–3736**). Among other things, Revenue Ruling #15-5 addresses how the Department will apply combined unitary reporting when it is used as an alternative apportionment method and explains some of the common situations in which the Department has required or approved combined unitary reporting (including the use of purchasing companies, management fee companies, and east/west companies within a unitary group). *Id.*

5. The Department's Audits of TSC

A. Prior Audit

The Department conducted two prior audits of TSC. *See* Hr'g Tr. 906:7–11 (**R. p. 1296**). In the audit covering tax years 2008–2010, the Department audited TSC's corporate income tax returns and determined that combined unitary reporting was an appropriate alternative apportionment method to fairly reflect TSC's business activity in South Carolina. *See* Hr'g Tr. 906:7–11, 243:22–244:3 (**R. pp. 1296, 633–634**); Respondent's Ex. 18 (**R. pp. 4470–4508**). Following this audit, TSC filed a unitary combined return in South Carolina for tax year 2012. *See* Hr'g Tr. 245:8–20 (**R. p. 635**). However, in tax year 2013, TSC reverted to filing under a separate entity reporting method in South Carolina. *Id.*

B. Current Audit

After discovering that TSC had stopped filing on a combined reporting basis, the Department audited TSC's corporate income tax returns for the Periods at Issue. *See* Hr'g Tr. 224:11–22; Joint Ex. 32 and 33 (**R. pp. 614; 3971–4009; 4010–4014**). During the Periods at Issue, the TSC Group filed consolidated federal income tax returns, which identified TSC, TSC of Texas, and TSC of Michigan

[9] Revenue Ruling #15-5 was drafted following a series of public meetings between the Department and tax professionals and representatives from businesses and business associations.

as a unitary group. *See* Hr'g Tr. 103:14–104:12, 237:14–21; Joint Ex. 6–8 (**R. pp. 493–494, 627; 3133–3630**). TSC Group filed a consolidated federal return because all the entities are owned 100% directly or indirectly by TSC. *Id.* All the intercompany transactions are eliminated on the federal consolidated returns because the expense for one member of TSC Group is cancelled out by corresponding income for another member of TSC Group. *Id.* However, TSC is the only filer for South Carolina purposes because it owns all the Tractor Supply retail stores in South Carolina. *See* Hr'g Tr. 237:25–238:8, 251:3–8, 263:8–15; Joint Ex. 9–11 (**R. pp. 627–628, 641, 653; 3631–3698**). On its returns, TSC apportioned its income to South Carolina using a separate entity or separate reporting apportionment method. *See* Hr'g Tr. 263:8–15 (**R. p. 653**). TSC of Texas and TSC of Michigan are not included on any corporate tax return filed in South Carolina. *See* Hr'g Tr. 251:9–14 (**R. p. 641**).[10]

During its audit, the Department determined that TSC operates within a unitary group—including TSC of Texas and TSC of Michigan—evidenced by the flow of value between the related TSC entities through functional integration; centralization of management; and economies of scale. *See* Hr'g Tr. 103:16–104:12; 172:13–19; 265:1–5; 975:14–976:6; Joint Ex. 17 at SCDOR_01297 (**R. pp. 493–494, 562, 655, 1365–1366; 3730**). The audit concluded that TSC is a retailer whose business activity is selling merchandise in its "rural lifestyle retail stores." *See* Hr'g Tr. 51:3–7; Joint Ex. 3 at SCDOR_005722 (**R. pp. 441; 3053**).[11]

The Department's audit conducted a qualitative analysis of the TSC Group's business operations and found the entities within the group completely rely upon each other for inventory

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[10] TSC of Texas and TSC of Michigan are included on the unitary returns filed in states that require combined unitary reporting as the default filing method. *See* Hr'g Tr. 104:13–22 (**R. pp.494**).

[11] Notably, the audit identified the management and purchasing companies within the TSC Group as the type of business structure or tax minimization strategy addressed in Revenue Ruling #15-5. *See* Joint Ex. 34, p. 7; Hr'g Tr. 273:7–13 (**R. pp. 4016; 663**).

purchases, distribution services, management services, employee leasing, trademark usage, and cash flow. Specifically, TSC retail entities are required to purchase all inventory from TSC Texas; TSC Michigan and TSC Texas rely on TSC to provide management and administrative services; TSC Michigan leases all its employees from TSC; TSC Texas holds the valuable trademarks for the TSC Group, and TSC performs the cash management function for the Company. *See* Hr'g Tr. 60:23–25, 63:17–22, 82:12–22, 94:2–24, 461:14–17 (**R. pp. 450, 453, 472, 484, 851**). By contrast, TSC Texas does not provide procurement services to any person or entity outside of the TSC Group; TSC does not provide employee leasing services to any entity outside of the TSC Group; TSC does not provide management services or any other services to any person or entity outside of the TSC Group; and TSC Texas relies on TSC's treasury function to purchase the inventory from third party vendors. *See* Hr'g Tr. 61:5–9, 65:13–16, 95:3–6, 461:14–17 (**R. pp. 451, 455, 485, 851**). Most significantly, 95–99% of the TSC Group's entire revenues are derived from its customers in the Tractor Supply retail stores. *See* Hr'g Tr. 60:8–61:18 (**R. p. 450**) The "revenue" the related entities receive from the intercompany transactions are merely journal entry reconciliations from other members in the TSC Group – it is not "real money." *See* Hr'g Tr. 92:3–9, 95:7–14, 100:14–20 (**R. pp. 482, 485, 490**) In other words, the entities providing those services do not receive any revenue from third parties for similar services or functions described in the above intercompany transactions.

The Department's audit determined that because of TSC's corporate structure and implementation of intercompany transactions, apportioning TSC's income under the default separate reporting method did not fairly represent the extent of TSC's business activity in this state. *See* Hr'g Tr. 237:5–9; Joint Ex. 13 and 14 (**R. pp. 627; 3700–3714; 3715–3717**). Instead, a significant portion of TSC's profits from its retail operations are shifted via intercompany transactions to TSC of Texas,

which does not file in South Carolina.[12] *See* Hr'g Tr. 251:9–11, 255:9–256:13 (**R. pp. 641, 645–646**). Because TSC operates within a unitary group and the members of the TSC Group significantly rely upon each other for core functions and services, the Department determined that requiring TSC to file a combined unitary return pursuant to § 12-6-2320(A)(4) fairly represented the extent of TSC's business activity within the State. *See* Hr'g Tr. 255:9–20; 261:17–263:15 (**R. pp. 645, 651–653**).

As a result of the audit findings, the Department recalculated TSC's taxable income for the Periods at Issue, using the method described in Revenue Ruling #15-5. *See* Hr'g Tr. 274:23–282:4; Respondent's Ex. 31. (**R. pp. 664–672; 4512–4522**). The result of those calculations is illustrated below:

2014		
	Reported	**Audited**
Federal Taxable Income	$130,998,512	$552,221,388
Total Net Income as Reconciled	$148,476,938	$569,699,814
Total South Carolina Net Income Subject to Tax	$4,137,310	$12,989,725
Corporate Tax Due	$206,866	$626,840

2015		
	Reported	**Audited**
Federal Taxable Income	$149,722,788	$588,808,642
Total Net Income as Reconciled	$154,547,508	$593,633,362
Total South Carolina Net Income Subject to Tax	$4,356,694	$13,702,839
Corporate Tax Due	$217,835	$685,142

2016		
	Reported	**Audited**
Federal Taxable Income	$138,467,788	$575,066,936
Total Net Income as Reconciled	$173,622,772	$610,221,920

[12] TSC's intercompany transactions have a significant impact on its South Carolina income tax returns under the separate reporting method because TSC's expenses paid to related entities are recognized while the related entities' "income" earned from that same transaction is not reported for South Carolina purposes. Under the Company's federal consolidated return or the combined unitary return filed in "unitary" states, those same intercompany transactions are zeroed out or eliminated. *See* Hr'g Tr. 104:5–8 (**R. p. 494**). As one accounting expert testified, for the financial statements to accurately reflect the income of a combined group of companies it is critical "**any intercompany transactions are eliminated so as not to create artificial income** from a financial standpoint." Hr'g Tr. 368:5–12, 378:18–380:1 (**R. pp. 758, 768–770**) (emphasis added).

Total South Carolina Net Income Subject to Tax	$5,008,670	$14,471,413
Corporate Tax Due	$250,434	$723,571

See Joint Ex. 13 (**R. pp. 3700–3714)**. During the audit and the contested case hearing, TSC did not dispute the Department's calculations of the combined unitary return, it only disagreed whether the Department could impose an alternative method in the first instance. *See* Hr'g Tr. 108:8–114:2 (**R. pp. 498–504**); Respondent's Ex. 17 (**R. pp. 4468–4469**).

STANDARD OF REVIEW

This Court may reverse the ALC's determination only if that decision was:

> (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.

S.C. Code Ann. § 1-23-610.

Judicial review of an ALC's findings of fact is limited to determining if the findings are 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, when considering the record as a whole, would allow reasonable minds to reach the conclusion that the [ALC] reached…." *Leventis v. Dep't of Health & Envtl. Control*, 340 S.C. 118, 130, 530 S.E.2d 643, 650 (Ct. App. 2000). This Court also "may not substitute its judgment for the judgment of the [ALC] as to the weight of the evidence on questions on fact." *Rent-A-Ctr. E., Inc. v. S.C. Dep't of Revenue*, 425 S.C. 582, 592, 824 S.E.2d 217, 222 (Ct. App. 2019) (substantial evidence supported the ALC's factual findings resulting in judgment for the Department). As explained below, the ALC's decision correctly followed the law and was based on reliable, probative, and substantial evidence.

ARGUMENT

I. THE ALC CORRECTLY HELD THAT SECTION 12-6-2320(A)(4) AUTHORIZES THE DEPARTMENT TO REQUIRE COMBINED UNITARY REPORTING AS AN ALTERNATIVE APPORTIONMENT METHOD.

A. The apportionment provisions of the South Carolina Income Tax Act are designed to tax the amount of a taxpayer's income that represents a fair approximation of its business activity in South Carolina.

To satisfy Constitutional requirements under the Due Process Clause and Commerce Clause, states may only tax the portion of a multi-state corporation's income that has a minimal connection and rational relationship (nexus) with the taxing state. *See Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 772 (1992); *Mobil Oil Corp. v. Comm'r of Taxes of Vermont,* 445 U.S. 425, 436–437 (1980). This does not mean the state has to isolate the intrastate business activities from the interstate activities; instead, the state "may tax an apportioned sum of the corporation's multistate business." *Allied-Signal*, 504 U.S. at 772. This approach, known as formulary apportionment,[13] attempts to calculate an apportionment percentage "that is based on the relative amount of a taxpayer's in-state activities or 'presence.'" *See* Richard D. Pomp, STATE AND LOCAL TAXATION at 10–18(8th ed. 2015). The "unitary business/formula apportionment method" is the "linchpin of apportionability in the field of state income taxation." *Mobil Oil Corp.*, 445 U.S. at 439; *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983).

States generally use one of two methods to apportion a multi-state corporation's income to the taxing state: separate entity reporting and combined unitary reporting. Separate entity reporting is the default method in South Carolina. *See Media General,* 388 S.C. at 142, 694 S.E.2d at 526–27; Amended Order at 62 (**R. p. 127**). The separate entity apportionment method treats each entity that

[13] The ALC's Amended Final Order contains a thorough and helpful history of formulary apportionment. *See* Amended Final Order at 31–37 (**R. pp. 96–102**).

has nexus with South Carolina as a separate and distinct entity, even if it is part of a unitary business. *Id.* By contrast, combined unitary reporting combines the income of unitary business group members and apportions that combined income among the states. *Media General*, 388 S.C. at 146, 694 S.E.2d at 529. Under combined reporting, each member of a unitary business group computes its individual taxable income by taking a portion of the combined net income of the group based on the unitary members' level of activity in the state as compared to the members' level of activity in all states. *See* Amended Order at 8; Joint Ex. 17 at 5 (**R. pp. 73; 3728**).[14] The purpose of combined reporting, among other things, is to "capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise." *Media General*, 388 S.C. at 142, 694 S.E.2d at 527.

As the entirety of Article 17 of the Act demonstrates, the goal of allocation and apportionment is to tax multistate corporations on a tax "base that reasonably represents the proportion of the [taxpayer's] trade or business carried on within this State." S.C. Code Ann § 12-6-2210(B); *see also Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 95, 142 S.E.2d 445, 446 (1995). Consistent with Constitutional considerations related to state taxation, the ultimate objective of apportioning a multistate taxpayer's income under the Act is <u>fairness</u>. *See Container Corp.*, 463 U.S. at 169 (the apportionment formula must "be fair"); *Duke Energy Corp. v. S.C. Dep't of Rev.*, 415 S.C. 351, 356 (2016) ("[T]he statutory policy is designed to apportion to South Carolina a fraction of the taxpayer's total income *reasonably attributable* to its business activity in this State." (citing *Emerson Elec. Co. v. S.C. Dep't of Rev.*, 395 S.C. 481, 485–86 (2011)).

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[14] Revenue Ruling #15-5 spells out in detail the step-by-step method for calculating combined unitary income in South Carolina. *See* Joint Ex. 17 at 9 (**R. p. 3732**).

B. **When the standard apportionment method does not fairly represent the taxpayer's business activity in South Carolina, the Legislature has explicitly authorized the Department to require an alternative apportionment method that does.**

Article 17 of the Act demonstrates the intent of the Legislature to implement a formulary apportionment scheme in South Carolina that is fair and reasonable—not arbitrary and unreasonable. Although the separate entity apportionment method is the standard apportionment method used in South Carolina, "standard" does not always mean "proper." *See Media General*, 388 S.C. at 142, 694 S.E.2d at 526–527. For that reason, the Legislature recognized that a "one size fits all" approach to apportionment will not always produce an outcome and consistent with the policy objective of ensuring a fair corporate income tax. Consequently, the Legislature expressly delegated authority to the Department to deviate from the standard apportionment method and instead require an alternative one where circumstances require.[15]

The Act explains how the Department may apportion a taxpayer's income when the standard apportionment provisions "unfairly represent a taxpayer's business activity." S.C. Code Ann. § 12-6-2320.[16] Specifically, section 12-6-2320 provides:

> If the apportionment provisions of [Chapter 6] do not fairly represent the extent of a taxpayer's business activity in the State . . . the department may require, in respect to all or any part of the taxpayer's business activity, if

[15] Section 12-6-2320 also permits the taxpayer to petition for the use of an alternative apportionment method. As the record demonstrates, the Department has granted numerous taxpayer petitions to use combined reporting as an alternative method for filing South Carolina returns. *See* Hr'g Tr. 284:14–285:18 (**R. pp. 674–675**). In fact, the Department's auditor testified to one occasion where, in his audit of a multistate retailer, he recommended using combined unitary reporting even though it resulted in the Department issuing a refund to the taxpayer. *Id.*

[16] In 1957, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDITPA), which was model legislation designed to facilitate uniformity across states with respect to taxation of multistate corporations. *See* Hr'g Tr. 1079:5–1080:2, 1378:23–1380:22 (**R. pp. 1469–1470, 1768–1770**). Although South Carolina is not a UDITPA compact member state, Section 12-6-2320(A) is nearly identical to Section 18 of UDITPA.

> reasonable . . . (4) the employment of any other method to effectuate an equitable[17] allocation and apportionment of the taxpayer's income.

S.C. Code Ann. § 12-6-2320(A)(4) (2014).[18] This "alternative apportionment" statute functions "like a safety value" that enables the Department to apply an alternative apportionment method if it finds that the standard formula is not working well "as applied to these facts under conditions set forth in the statute." *See* Hr'g Tr. 1078:3–18 (testimony of TSC's expert, Prof. Pomp) (**R. p. 1468**); *see also Media General*, 388 S.C. at 151, 694 S.E.2d at 531 ("We agree with the ALC that the legislature enacted section 12–6–2320 as a relief mechanism . . ."). Significantly, "the legislature has placed no explicit limitation on the alternative methods that may be used under § 12-6-2320(A)(4)." *Media General*, 388 S.C. at 152, 694 S.E.d2d at 532.

C. In *Media General*, the South Carolina Supreme Court confirmed that combined unitary reporting is a proper alternative apportionment method under section 12-6-2320(A)(4).

The ALC correctly held that combined unitary reporting is both "allowed and sanctioned by the legislature under subsection 12-6-2320(A)(4)." *See* Amended Order at 71 (**R. p. 136**). The ALC's holding is supported by the plain language of the statute, and it is consistent with the holding of South Carolina Supreme Court in *Media General*, which itself found that the "plain language of subsection

[17] The terms "alternative apportionment" and "equitable apportionment" are used interchangeably when referring to Section 18 of UDITPA. *See* Hellerstein, Hellerstein & Appleby, *State Taxation* (Thomson Reuters/Tax & Accounting, 3rd ed. 2001, with updates through December 2023) (online version accessed on Checkpoint (www.checkpoint.riag.com) May 29, 2024) at ¶9.20. Equitable means fair. *Equitable*, MERRIAM-WEBSTER'S ONLINE DICTIONARY, https://www.merriam-webster.com/dictionary/equitable (last visited May 15, 2024 at 2:39 PM) (having or exhibiting equity: dealing fairly and equally with all concerned); *see also equitable,* MERRIAM-WEBSTER'S ONLINE THESAURUS, https://www.merriam-webster.com/thesaurus/equitable (last visited May 15, 2024 at 2:44 PM) ("fair" listed as a synonym of equitable).

[18] The Legislature added this section in 1995. It was amended in 2024 to include a new subsection (B), which provides new procedural and other requirements specific to when the Department finds that a combined unitary return is required under the provisions of subsection (A).

(A)(4) clearly authorizes the Department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income, **including the combined entity apportionment method**." *Media General*, 388 S.C. at 151, 694 S.E.2d at 531 (emphasis added).[19] In *Media General*, the Court recognized that when a taxpayer operates a unitary business within South Carolina, all business activities of the unitary enterprise are attributable to South Carolina with no duty or requirement to place activities at a specific location or within a specific entity.[20]

TSC contends the ALC incorrectly interpreted section 12-6-2320(A)(4) and *Media General* to find the Department has authority to require combined unitary reporting in this case. *See* Appellant Br. at 23–25. Specifically, TSC claims that (1) *Media General* involved a unitary business where every member of the unitary business was a South Carolina taxpayer; (2) what the Court in *Media General* viewed as "combined entity apportionment" was an actual apportionment method, not combined unitary reporting, and thus only permits the combination of related entities for determining the sales factor ratio, not the tax base; and (3) section 12-6-2320(A) can only be used to apportion TSC's income (not the income of the TSC Group) because only TSC is the "taxpayer." *See* Appellant Br. at 23–28. The ALC rightly rejected these arguments.

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[19] As the ALC noted, some states that have adopted § 18 of UDITPA have found that subsection (A)(4) supports the imposition of combined reporting as a form of alternative apportionment. *See* Amended Order at 36 (**R. p. 101**); *see also Leathers v. Jacuzzi, Inc.*, 935 S.W.2d 252, 254 (Ark. 1996) ("[T]here is a discretionary provision in UDITPA upon which combined reporting can be allowed and, in fact, is allowed by a number of states.").

[20] The South Carolina Supreme Court is not alone in allowing combined reporting when it is not the default method. For example, the Supreme Court of Kansas held that the state's director of taxation had authority to require the combined report method for a unitary multicorporate business under Kansas' version of § 18 of UDITPA. *Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 684 P2d 396 (1984). Conversely, the Supreme Court of Kentucky held that a taxpayer was allowed to use combined reporting under § 18 of UDITPA. *GTE & Subsidiaries v. Revenue Cabinet*, 889 SW2d 788 (Ky. 1994). Even absent § 18 of UDITPA, some state courts allowed state tax administrators to require combined reporting. *See e.g. Edison California Stores v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947) and *Zale-Salem, Inc. v. State Tax Comm'n*, 237 Or. 261, 391 P2d 601 (1964).

First, the stipulated facts in the *Media General* case clearly establish that three of the four members of the unitary group had not filed South Carolina tax returns during the audit period; the only South Carolina taxpayer in the Media General unitary group that had filed South Carolina returns reported negative income and therefore paid no tax to the state. *See* Media General ALC Order on Motions for Summary Judgment (April 2, 2009), (**R. pp. 2489–2530**); *see also* Amended Order at 49–50 (**R. pp. 114–115**).

Second, in the *Media General* case, the Media General unitary group petitioned the Department for combined unitary reporting because it wanted to include the loss company to reduce the total tax liabilities of the remaining members of the group. In the ALC's order in *Media General*, it referred to this method as "combined apportionment methodology," but the mechanics of this method—as described by the ALC and *Media General* court—clearly refer to combined unitary reporting. *Id.* (describing the purpose of so-called "combined apportionment methodology" is to "determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business"); *see also Media General*, 388 S.C. at 142, 694 S.E.2d at 527 (describing combined entity apportionment method in which the members of a unitary group calculate their taxable income by taking a portion of the combined net income of the group). This is precisely how combined unitary reporting was imposed in this matter: the Department calculated the "income or other tax base" of TSC by looking to the unitary business of TSC and applied the South Carolina sales factor to the taxable income of the unitary business. *See* Hr'g Tr. 275:5–282:1; Joint Ex. 19 at TSC_00000024; Respondent's Ex. 31 (**R. pp. 665-672; 3753; 4512–4522**).

Third, as the ALC correctly noted, this Court has already rejected a version of TSC's "taxpayer is defined in the singular not plural" argument. *See Media General*, 388 S.C. at 148–49, 694 S.E.2d at 530. *Media General* quoted favorably to the Supreme Court of Oregon, which itself had rejected an argument that combined unitary reporting is separate and distinguishable from an "apportionment

method" and that the use of "taxpayer" in the singular prevented the tax agency from applying combined reporting. *Id.* (quoting *Coca Cola Co. v. Department of Revenue,* 271 Or. 517, 533 P.2d 788 (1975) ("The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method. While it is true . . . that the statute speaks of taxpayer in the singular, this is no bar [to approving combined reporting].").[21]

Although the *Media General* court used slightly different terminology from the terms used by the Department in Revenue Ruling #15-5 and the audit examination, those terms all refer to the same principle, and the reporting method applied in *Media General* (combined entity apportionment method) is identical to the reporting method applied in this matter (combined unitary reporting).[22] *Media General,* wholly relying on the 2009 Order, conclusively holds that a "taxpayer's" income includes the unitary business income, and combined unitary reporting is an appropriate alternative apportionment method under § 12-6-2320(A)(4).

Accordingly, in light of the overall intent of Article 17's apportionment provisions, the plain language of section 12-6-2320(A)(4), and the Supreme Court's clear holding in *Media General,* the ALC

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[21] *See also Covington Fabrics Corp. v. S.C. Tax Comm'n,* 264 S.C. 59, 68, 212 S.E.2d 574, 578 (1975) (holding "[if] the business is unitary in nature, therefore its income is attributable to all incidents of the business and not to any single activity."); *Exxon Corporation v. South Carolina Tax Commission,* 273 S.C. 594, 596–598, 258 S.E.2d 93, 94–95 (concluding taxpayer must include in the South Carolina tax base that portion of its corporate income assigned by the company to its exploration and production activities located in another state because those activities are a part of the company's single business operation which is unitary."); *Coca Cola Co. v. Department of Revenue,* 271 Or. 517, 526, 533 P.2d 788, 792 (1975) ("We must now decide whether the fact that Coca Cola and its wholly owned subsidiaries are organized as separate corporate entities precludes the Department of Revenue from combining their incomes to reflect the true character of their unitary business. We hold that it does not.").

[22] Notably, MGO (the SC filer with negative taxable income) was not a party to the *Media General* case despite the Court acknowledging the Media General entities (MGI, MGC, MGB, and MGO) operated a unitary business and concluding that the combined entity apportionment method was an appropriate alternative apportionment method. *Media General,* 388 S.C. at 141, n. 1, 694 S.E.2d at 526, n. 1.

correctly held the Department has the statutory authority to require combined unitary reporting as an alternative apportionment method.[23]

II. SUBSTANTIAL EVIDENCE SUPPORTS THE ALC'S FINDING THAT SEPARATE ENTITY REPORTING DOES NOT FAIRLY REPRESENT TSC'S BUSINESS ACTIVITY IN SOUTH CAROLINA.

The ALC's Final Order thoroughly examined the record evidence and correctly found that the standard apportionment method does not fairly reflect TSC's business activity in South Carolina. *See* Amended Final Order at 53–63 (**R. pp. 118–128**). This finding is supported by substantial evidence in the record.

A. TSC indisputably operates within a unitary group that is engaged in the business of retail sales.

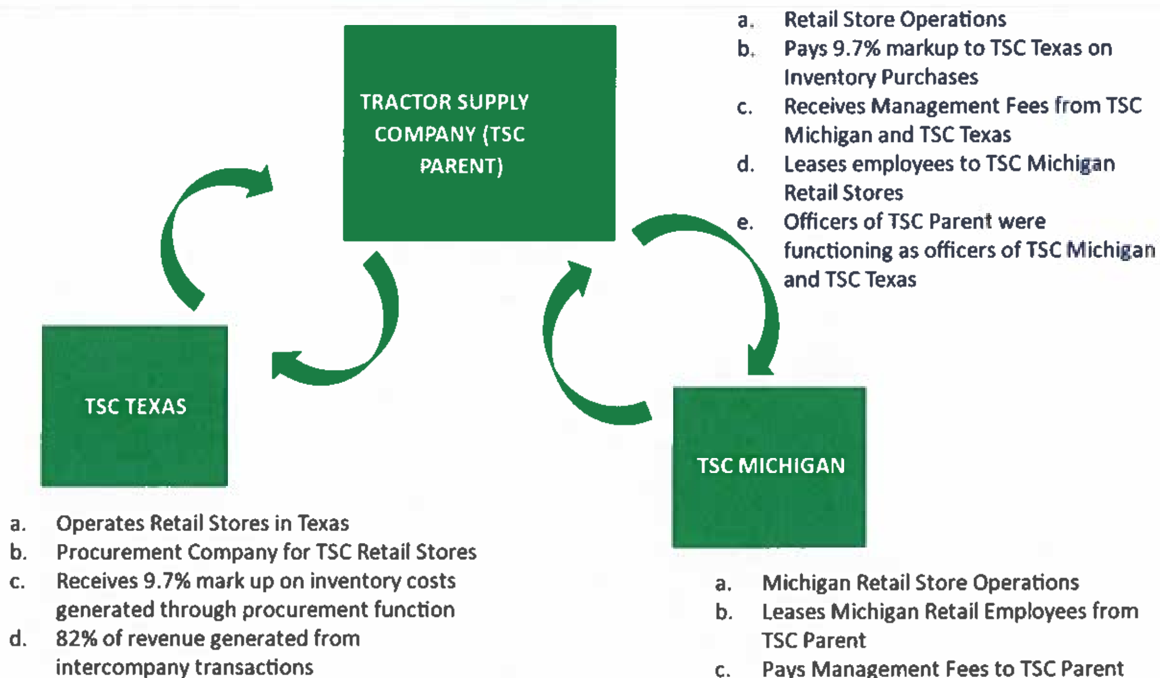
1. TSC meets the definitions of a "unitary business" offered by experts for both parties.

Both accounting expert witnesses conceded that TSC meets every recognized "unitary" test. *See* Hr'g Tr. 352:12–357:9; 1013:1–25 (**R. pp. 742–747, 1403**). The Department's tax policy expert opined that based on the facts presented in this matter and the general definition of unitary business in the tax policy field, "the common management, ownership, flows of value, unities of operation of [TSC, TSC of Texas, and TSC of Michigan] constitutes a unitary business under any recognized test." *See* Hr'g Tr. 1397:4–1400:3 (**R. pp. 1787–1790**). The TSC Group operates as a single unitary business in which the related entities completely rely upon each other for necessary business functions and

[23] Although TSC claims that section 12-6-2320(A)(4) does not authorize the Department's forced use of combined unitary reporting, this is a complete departure from the position it took throughout the audit, the Department's pre-hearing appeals process, and the bulk of the ALC litigation—a dispute that spanned over 4 years. In its written protest of the audit, its Request for a Contested Case Hearing, and its Prehearing Statement filed with the ALC, TSC repeatedly conceded that combined reporting was statutorily authorized—it merely argued that the Department had not met its burden to show that it was appropriate in this particular case. *See* TSC Protest at 4 (Nov. 13, 2018); TSC Request for a Contested Case Hearing at 3 (Dec. 11, 2019); TSC Pre-Hearing Statement at 3–4 (Jan. 27, 2020) (**R. pp. 3741; 157; 183–184**).

services. *See* Hr'g Tr. 466:19–467:13 (**R. pp. 856–857**). TSC provides the cash management function on behalf of TSC of Texas and TSC of Michigan. In fact, TSC of Texas "can't even cut a check to somebody else without the parent company, since it relies on the treasury functions of the parent company." *See* Hr'g Tr. 461:12–17 (**R. p. 851**).

The vast majority of TSC of Texas' income (82%) is derived from "intercompany transactions" where real revenue is never exchanged between the related entities (rather, accounting entries are made in the company's trial balances). *See* Hr'g Tr. 363:6–9; 100:14–20 (**R. pp. 753, 490**). These facts, when considering economic substance principles under the § 482 Regulations, *see infra* Argument § II.C., demonstrate that separate reporting cannot fairly represent the business activity of TSC because the Company cannot function without the circular flow of money from TSC to TSC of Texas and then back again to TSC. *See e.g., ConAgra Foods RDM, Inc. v. Comptroller of Treasury*, 241 Md.App. 547, 575, 211 A.3d 611, 627 (Md. Ct. Spec. App. 2019) (in determining whether a subsidiary lacks economic substance as a separate business entity, a court should consider whether there is a circular flow of money between the related entities); *Gore Enterprise Holdings, Inc. v. Comptroller of Treasury*, 437 Md. 492, 517, 87 A.3d 1263, 1277 (Md. 2014) (highlighting circular flow of money between subsidiaries and parent, and the subsidiaries' reliance on parent for core functions and services). This is illustrated below:



Respondent's Exhibit 32 at Slide 3 (**R. p. 4525**).

2. <u>TSC meets the definitions of a unitary business as defined in Revenue Ruling #15-5.</u>

The Department concluded that TSC operates within a unitary group, as defined in Revenue Ruling #15-5, because of a flow of value between the businesses through functional integration; centralization of management; and economies of scale. *See* Hr'g Tr. 172:13–19; 265:1–5; Joint Ex. 17 at SCDOR_01297 (**R. pp. 562, 655; 3730**). TSC acknowledges that all entities included on the federal consolidated return are part of TSC's unitary business and have at least 80% common ownership. *See* Hr'g Tr. 103:16–104:12, 975:14–976:6 (**R. pp. 493–494, 1365–1366**). Value flows between the TSC entities through functional integration because TSC of Texas purchases all inventory for the TSC Group, and the TSC retail operating entities are required to purchase its inventory from TSC of Texas. *See* Hr'g Tr. 63:17–22 (**R. pp. 453**). The TSC retail entities are the public-facing store fronts that sell to third party customers and bring in 95–99% of the TSC Group's annual revenue. *See* Hr'g Tr. 60:8–11; 61:14–18, 976:10–14 (**R. pp. 450, 451, 1366**) (TSC's accounting expert confirming that line 30 of federal consolidated return is "the federal taxable income of the group."). Finally, the TSC Group

entities are functionally integrated because specific entities are solely responsible for managing or providing services to other members of the TSC Group, including leasing of employees, managerial services, inventory procurement, and intangible ownership and development.

The TSC Group has centralization of management provided by TSC via the Store Support Center located at the corporate headquarters in Brentwood, Tennessee. *See* Hr'g Tr. 59:16–60:7; 94:2–95:6 (**R. pp. 449–450, 484–485**). The Store Support Center provides various management and administrative functions for the entities within the TSC Group but does not provide those same services for any entity outside the TSC Group. Moreover, every relevant intercompany agreement in this matter is signed by a TSC executive on behalf of TSC of Texas or TSC of Michigan – demonstrating duplication of management between the TSC entities. *See* Joint Ex. 23, Respondent's Ex. 7 and 9; Hr'g Tr. 92:10–17; 103:2–13 (**R. pp. 3835–3850; 4423–4431; 4441–4452; 482, 493)** (company witness acknowledging the same individuals signed the intercompany agreement on behalf of both parties to the contracts.).

Finally, economies of scale are present in the TSC Group: TSC of Texas purchases all the inventory for the TSC Group that is ultimately sold by the TSC retail entities. *See* Hr'g Tr. 483:2–19 (**R. pp. 873**) (Dr. DeRamus discussing why economies of scale are important to TSC's business); *See* Hr'g Tr. 462:19–463:2 (**R. pp. 852–853**) (TSC of Texas could not procure the Company's inventory at the prices it is able to procure without the $5–6 billion in sales.).

3. TSC is a retailer.

As the ALC correctly points out in its order at footnote 59, "[TSC] readily admits its business activity in this state is retail sales and this was a de novo hearing; therefore, the Court is mystified by Petitioner's continued pursuit of this issue." *See* Amended Final Order (**R. p. 118**). Yet TSC continues this argument in its brief. TSC is a retailer of rural lifestyle products. *See* Joint Ex. 3 at SCDOR_005722; Hr'g Tr. 51:3–7 (**R. pp. 3053; 441**). At least 95% of the TSC Group's revenue is derived solely from

retail sales in the retail stores. *See* Hr'g Tr. 390:18–23 (**R. p. 780**). TSC admits that 99% of its revenue is from its retail operations and any remaining income is "immaterial." *See* Hr'g Tr. 60:8–18 (**R. p. 450**). The ALC correctly found that TSC's business activity in South Carolina was retail sales based on substantial evidence. *See* Amended Final Order at p. 53 (**R. p. 118**).

B. The record contains specific evidence demonstrating that, as a result of TSC's Tax Restructuring and non-arm's length intercompany transactions, the standard apportionment method does fairly represent TSC's business activities in South Carolina.

TSC, TSC of Texas, and TSC of Michigan are highly interdependent entities. TSC makes all the payments on behalf of TSC of Texas and TSC of Michigan. *See* Hr'g Tr. 883:22–884:2 (**R. pp. 1273–1274**). TSC leases employees to TSC of Michigan. See Hr'g Tr. 89:14–17 (**R. p. 479**). TSC of Texas procures inventory for itself, TSC, and TSC of Michigan. *See* Hr'g Tr. 63:12–22 (**R. p. 453**). TSC's 2001 Tax Restructuring had no operational or commercial effects, other than some changes on paper. *See* Hr'g Tr. 464:14–25 (**R. p. 854**). Further, the restructure itself violated the arm's length principle because TSC transferred the procurement function with 14% of headquarters staff and its intellectual property to TSC of Texas for no compensation. *See* Hr'g Tr. 558:3–22; 730:15–732:4 (**R. pp. 948, 1120–1122**). However, it created a corporate structure that facilitates shifting income between entities through intercompany transactions.

Through those intercompany transactions, TSC's income is manipulated (on paper) in a manner that does represent its business activity in the state. TSC's own brief illustrates this point. After the intercompany transactions, 26.9% of the total income subject to apportionment is TSC's income and 73.1% belongs to TSC of Texas and TSC of Michigan. *See* Appellant Br. at p. 9. Also, compare the 8.75% of TSC income post-intercompany transactions to the 2.79% sales factor. *Id.* These percentages should be much closer because the results from reliable transfer pricing would approximate those from combined unitary reporting in this case. *See* Hr'g Tr. 1534:5–14 (**R. p. 1924**). This is also why income after the distortive intercompany transactions versus income under combined

unitary reporting—where intercompany transactions are eliminated—is an apples and oranges comparison. The ALC correctly recognized this and concluded that, as a result of TSC's intercompany transactions, the income reported on TSC's South Carolina tax returns does not fairly reflect TSC's economic activity in South Carolina.

Of particular significance, the 9.7% markup on inventory under the Procurement Agreement shifts income from TSC's retail sales to TSC of Texas. TSC of Texas charges a 9.7% markup on the inventory purchased by TSC for the South Carolina retail stores. TSC deducts this charge—for purchasing inventory from itself—as a deduction, thereby reducing TSC's income and increasing TSC of Texas' income. As a result, TSC Texas receives "hundreds of millions of dollars of procurement income through that 9.7% inventory markup [transfer pricing policy], that results in this huge disproportional shift of income" from both TSC and TSC Michigan to TSC Texas that "dwarfs" the "relatively modest amount of [the] expenditure" to perform the procurement services. *See* Hr'g Tr. 541:2–543:24 (**R. pp. 931–933**). This "disproportional shift of income" can be seen in TSC's trial balances with respect to the impact on TSC and TSC Michigan's income before and after the transfer pricing policies are implemented. *See* Hr'g Tr. 545:2–12; Respondent's Ex. 33, slides 30–31. (**R. pp. 935; 4568–4569**). This is distortive: TSC's income really reflects intercompany procurement charges/expenses, rather than its true business activity—retail sales.

The South Carolina stores had retail sales of approximately $135–160 million annually, but only $4–5 million taxable income. *See* Hr'g Tr. 550:9–12; Joint Exhibits 9–11 (**R. pp. 940; 3631–3698**). TSC has 80% of Group's retail sales, but TSC of Texas accumulated 71% of Group's taxable income. *See* Hr'g Tr. 547:4–12 (**R. p. 937**). Cost of procurement functions for TSC of Texas was $13 million, but it earned $400 million for those services. *See* Hr'g Tr. 543:5–24; 548:2–11 (**R. pp. 933, 938**). From a tax policy perspective, income and expenses should be aligned across divisional and jurisdictional lines (matching principle). *See* Hr'g Tr. 1425:4–21 (**R. p. 1815**) *see also Colonial Life & Acc. Ins. Co. v.*

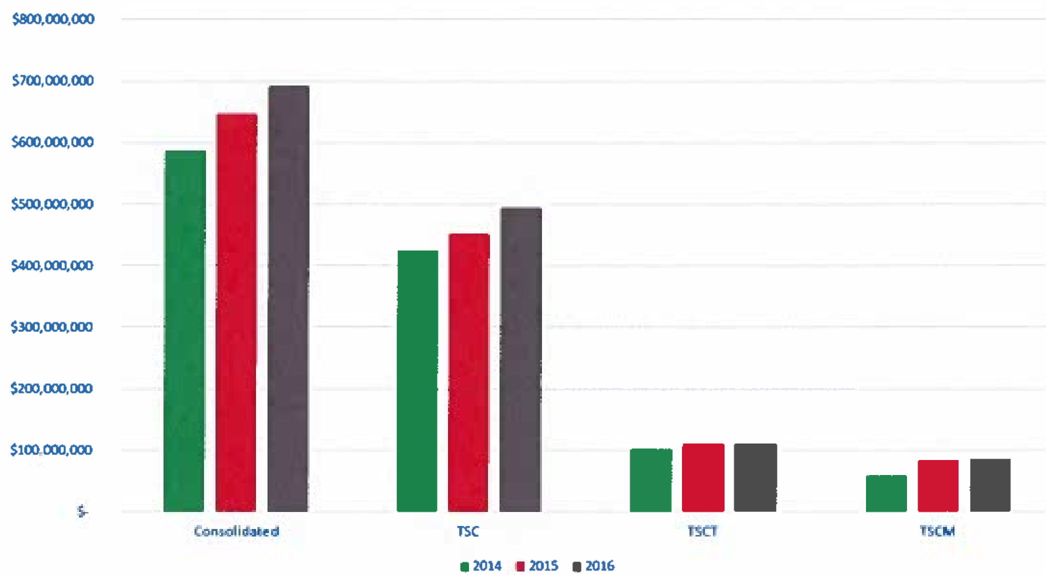
S.C. Tax Comm'n, 248 S.C. 334, 338–339; 149 S.E.2d 777, 780 (1966) (concluding that allowing taxpayers to claim deductions for income that is taxed outside of the state would be an unreasonable construction of the Legislature's intent). However, income from TSC of Texas' procurement function is grossly disproportionate to its expenses. *Id.* The procurement function is not a "special sauce." *See* Hr'g Tr. 513:13–514:18 (**R. pp. 903–904**). TSC of Texas does not have a competitive advantage over purchasers of similar volumes. *Id.* In other words, the procurement function is not unique and deserving of such a disproportionate ratio of income and expenses. The 9.7% markup is unreasonable and inconsistent with arms' length transactions. *See* Hr'g Tr. 587:24–589:10 (**R. pp. 977–979**).

Revenue is a reasonable proxy for business activity. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 76, 804 S.E.2d 633, 642 (Ct. App. 2017) ("we find that 0.85% of DIRECTV's total subscription revenue does not reasonably represent DIRECTV's business activity in South Carolina"). TSC produces approximately 80% of the TSC Group's retail sales revenue but through intercompany transactions receives only 24% of the taxable income. *See* Hr'g Tr. 545:13–19; Respondent's Ex. 33, slide 30 (**R. pp. 935; 4568**). The ALC correctly recognized the difference between retail sales income and South Carolina taxable income while appropriately considering this great discrepancy is evidence of income shifting. *See* Amended Final Order at n. 62 (**R. p. 122**). By considering revenue, the ALC could observe TSC's business activity unadulterated by intercompany transactions and appropriately judge that the business activity was not fairly represented.

Other states have considered disproportionate income versus receipts as evidence of distortion—i.e. that a taxpayer's business activity is not fairly represented. For example, in *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169, 39 Cal. 4th 750 (2006), the Supreme Court of California was tasked with determining how a taxpayer's income arising from the redemption of marketable securities should be apportioned to the State. In that case, the court ultimately concluded that a mismatch of the taxpayer's gross receipts "seriously distorts the standard formula's attribution of income to each

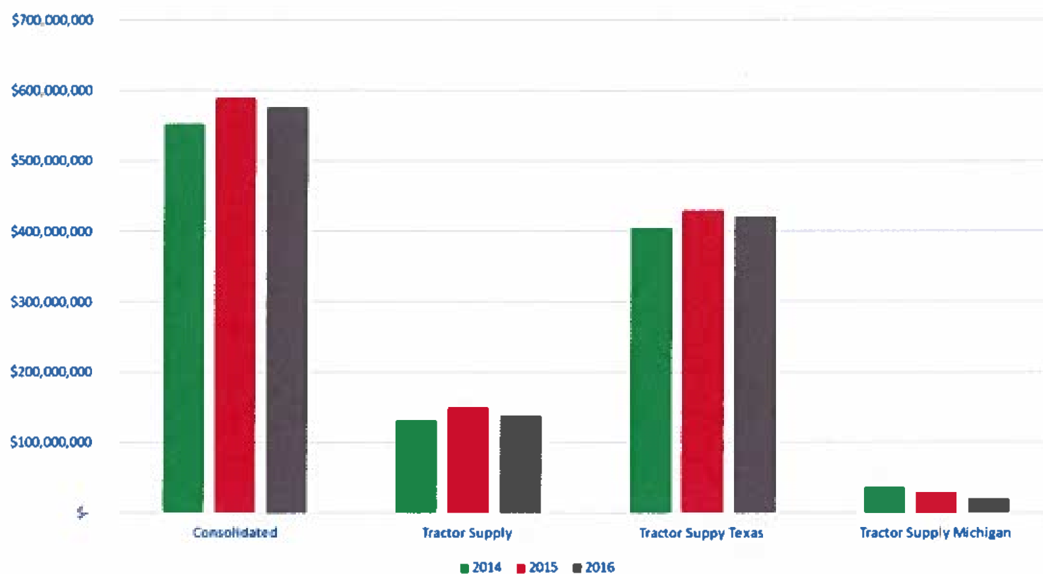
state." *Microsoft*, 139 P.3d at 1182. In reaching that conclusion, the court noted the "distortional impact is great here [compared to an earlier case]; Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts." *Id.* at 1183, fn. 17. Here, the record contains substantial evidence of distortion in the form of documents and testimony as illustrated below.

The following figure represents TSC's per entity income prior to transfer pricing:



Respondent's Exhibit 33 at slide 30 (**R. p. 4568**).

Compare the figure above to the figure below, which represents federal taxable income—the starting point for South Carolina taxable income—after transfer pricing:



Id. at Slide 31 (**R. p. 4569**). This demonstrates an almost complete reversal of the proportion of income between TSC and TSC of Texas.

1. <u>Revenue Ruling #15-5 identifies relevant facts to consider when the standard apportionment method may not fairly reflect a taxpayers business activity in South Carolina; those facts are present in this case.</u>

In Revenue Ruling #15-5, the Department provides a non-exhaustive list facts it may consider when evaluating whether the standard apportionment formula fairly represents a taxpayer's business activity in South Carolina. *See* Joint Ex. 17 (**R. pp. 3724–3736**). The ALC found that Revenue Ruling #15-5 was helpful guidance for making this determination, and ultimately concluded the Department had sufficiently shown that TSC's business activity was not fairly represented. *See* Amended Order at 56 (**R. p. 121**). Substantial evidence in the record to supports the ALC's finding regarding these factors.

a. Amounts paid to related parties for goods and services.

TSC has artificially segregated its necessary business functions, services, activities, and value within the Group. TSC of Texas allows all members of TSC Group to use its intellectual property for free, which was transferred for free from TSC during the 2001 Tax Restructuring and still developed by TSC. *See* Hr'g Tr. 571:2–24; 731:9–22; 1549:13–1553:8 (**R. pp. 961, 1121, 1939–1943**). This is likely

to avoid the Department from asserting nexus under *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993). *See* Hr'g Tr. 324:1–327.11 (**R. pp. 714–717**). However, most significantly, TSC of Texas charges member of TSC Group a 9.7% markup on inventory. As discussed above, this amount is disproportionately high and inconsistent with the market rate for such services.

b. Profit margins associated with business activities.

As a company, TSC has a particularly high operating margin for a retailer and is a highly profitable company. *See* Hr'g Tr. 477:9–25 (**R. p. 867**). TSC has "reasonably high" rates of either high operating margin, high markup on total costs, and a very high return on assets." *See* Hr'g Tr. 477:9–14; Respondent's Ex. 33, slides 2–7 (**R. pp. 867; 4540–4545**) (indicating high profitability ratios of TSC compared to other retailers). Because of the types of products it sells, TSC generally avoids direct competition with internet retailers like Amazon; its primary competition is mom-and-pop feed stores. *Id.* However, TSC's national footprint of retail stores allows it to purchase larger volumes at a cheaper price, which gives it a competitive advantage over its smaller competitors. *See* Hr'g Tr. 483:2–19 (**R. p. 873**). This drives its high profitability.

c. Capital investments associated with business activities.

As discussed above in Argument § II.A.1., TSC controls TSC Group's capital.

d. Whether goods and services are provided both to related and unrelated parties on similar terms.

None of the entities within TSC Group provide procurement, leasing of employees, or intellectual property to anyone outside the Group. *See* Hr'g Tr. 306:11–16 (**R. p. 696**).

e. Whether taxpayers in similar industries provide similar goods and services to unrelated parties under similar terms.

Even under accepted the unreliable method and comparables used by the 2014 Transfer Pricing Study, the procurement charge by TSC of Texas is outside the arm's length range. *See* Hr'g Tr. 597:9–18 (**R. p. 987**). Using the correct comparables, and assuming TSC of Texas performs a

wholesale function, the expert testimony established that TSC of Texas still earns far too much money relative to comparable companies. *See* Hr'g Tr. 600:4–23 (**R. p. 990**). Both from an economic and transfer pricing perspective, no third party would voluntarily enter this type of arrangement:

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

See Hr'g Tr. 544:13–24 (**R. p. 934**). This "disproportionate shift of income" can be seen in TSC's trial balances with respect to the impact on TSC and TSC of Michigan's income before and after the transfer pricing policies are implemented. *See* Hr'g Tr. 545:2–12; Respondent's Ex. 33, slides 30–31 (**R. pp. 935; 4568–4569**). Specifically, prior to the implementation of the transfer pricing policy, TSC's income accounts for approximately 80% of the Company's income on consolidated basis.[24] *See* Hr'g Tr. 545:13–19; Respondent's Ex. 33, slide 30 (**R. pp. 935; 4568**). The transfer pricing policy creates a significant "**reversal**" resulting in a "huge shift" of millions of dollars of income from TSC to TSC of Texas." *See* Hr'g Tr. 545:22–25; Respondent's Ex. 33, slide 31 (**R. pp. 935; 4569**) (demonstrating Tractor Supply taxable income, by entity, per Federal 1120s.). These are not small or even modest levels of compensation by TSC of Texas—these are "extreme" adjustments that "**fundamentally . . . distorts Tractor Supply's operating income**." *See* Hr'g Tr. 545:25–546:6 (**R. pp. 935–936**)

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[24] Although TSC accounts for approximately 80% of the Company's retail sales, it only accounts for 24% of the taxable income. In contrast, TSC of Texas accounts for approximately 13% of the Company's retail sales, but reports 71% of the Company's taxable income. The vast majority of TSC of Texas' "income" results from the 9.7% inventory markup to TSC and TSC of Michigan. *See* Hr'g Tr. 547:3–20; Respondent's Ex. 33, slide 31 (**R. pp. 937; 4569**). Further, TSC of Texas' retail store operations earn approximately 35 million dollars per year where as its procurement/purchasing function earns around 350 to 400 million per year. "So it's a huge disproportion of Texas' income is being driven by that purchasing function rather than by its actual retail operations." *See* Hr'g Tr. 547:21–548; Respondent's Ex. 33, slide 31 (**R. pp. 937–938; 4569**).

(emphasis added). This type of arrangement in a joint venture (true third-party transaction) is inconsistent with how third-parties would negotiate a split of profits and is contrary to basic transfer pricing principles. *See* Hr'g Tr. 548:12–550:6 (**R. pp. 938–940**). Simply put, taxpayers in similar industries do not provide similar goods and services to unrelated parties under similar terms.

> *f. Whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other things, the relinquishment of control over the business activity.*

As part of the Tax Restructuring, TSC agreed to transfer its intellectual property and related assets to TSC of Texas for no charge. Now, under the Licensing Agreement, TSC of Texas has agreed to license its trademark at no cost to TSC and TSC of Michigan. Undoubtedly, the Tractor Supply Company trademark and brand is a valuable asset to TSC of Texas and the TSC Group. As the Department's expert testified, it is inconsistent with basic economics and arms-length principles that a company would enter into a similar arrangement with an unrelated third party wherein the company would relinquish control over such a valuable asset as its trademarks. Again, the primary—if not only—reason that TSC and TSC of Texas would enter into this arrangement is to avoid nexus—and therefore tax—in South Carolina based on the *Geoffrey* case. Similarly, TSC would not give up such a lucrative procurement function to a third party and then pay such a high markup. It only costs TSC of Texas $13 million to provide the inventory services, but it earns upwards of $350 million a year from the inventory markup. *See* Hr'g Tr. 544:7–13 (**R. p. 934**). TSC would not willingly enter into such a disproportionate relationship with a third-party to outsource the procurement function where over $350 million a year leaves the TSC Group.

C. The ALC properly rejected TSC's transfer pricing study, which both experts agreed was flawed.

The 2014 Pricing Study was the only evidence TSC offered to suggest the standard apportionment method fairly reflected its business activity in South Carolina, and both experts agreed the study was flawed. *See* Hr'g Tr. 100:2–9; Joint Ex. 20 (**R. pp. 490; 3762–3822**). By way of

background, transfer pricing studies arose within the context of federal taxation of multinational taxpayers. In the case of taxpayers owned or controlled directly or indirectly by the same interests, 26 U.S.C. § 482 allows the Internal Revenue Service (IRS) to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."[25] When the IRS makes an adjustment under § 482, a taxpayer may be subject to a net adjustment penalty under 26 U.S.C. § 6662(e)(1)(B)(ii) unless it satisfies certain documentation requirements (i.e. a reliable transfer pricing study in existence at the time of filing the return) under 26 C.F.R. § 1.6662-6(e). Therefore, the purpose of a transfer pricing study is penalty protection in the event of a substantial or gross valuation misstatement, but even then, the study must be both reliable and in existence at the time of filing the return.

Of course, there are no penalties at issue in this case. Regardless, substantial evidence supported the ALC's rejection of TSC's transfer pricing study. The transfer pricing experts for both parties agreed that TSC's transfer pricing study was unreliable. *See* Hr'g Tr. 458:6–9, 1175:6–12, 1270:21–1271:9; Joint Ex. 20 (**R. pp. 848, 1565, 1660–1661; 3762–3822**). Further, TSC's implementation of the actual transfer prices do not reflect the economic reality of what the related parties are providing to each other and are inconsistent with the arm's length principles. *See* Hr'g Tr. 458:9–12 (**R. p. 848**).

Similarly, the ALC appropriately considered the 2001 Tax Restructuring under a § 482 analysis. This analysis is consistent with 26 U.S.C. § 482, which provides, "[i]n the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to

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[25] Through conformity, South Carolina has adopted 26 U.S.C. § 482.

such transfer or license shall be commensurate with the income attributable to the intangible." *See also* 26 C.F.R. § 1.482-1(f)(2)(ii) ("The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."). Specifically, the restructure was superficial, and the greatest effect was tax benefits. Economic substance is "part and parcel of the § 482 Guidelines" because under a related party contract, the company "can effectively structure it and write down the [ ] contractual terms however it wants to, but ultimately what should govern the actual pricing of that related party transaction is the economic substance of that transaction." *See* Hr'g Tr. 446:25–447:11 (**R. pp. 836–837**). Here, the 2001 Tax Restructuring was a tax avoidance scheme that lacked economic substance.

D. As the finder of fact, the ALC was in the best position to find the opinions of the Department's expert witness were more credible than the opinions of TSC's expert witness.

Determinations regarding the credibility of witnesses are properly within the discretion of the trial court, and appellate courts generally defer to those findings. "The judging of the credibility of witnesses and the weighing of evidence in a law case are uniquely functions of the trial court." *Bivens v. Watkins*, 313 S.C. 228, 235, 437 S.E.2d 132, 136 (Ct. App. 1993). Further, the Court is "in a superior position to judge the witnesses' demeanor and veracity and, therefore, his findings should be given broad discretion." *Woodall v. Woodall*, 322 S.C. 7, 10, 471 S.E.2d 154, 157 (1996). The ALC, as the fact finder, heard testimony and weighed all the evidence to correctly determine the facts in this case.

The ALC correctly found that TSC's transfer pricing expert arbitrarily chose a 50/50 residual profit split, which was an unpersuasive basis for a 9.7% markup on inventory procurement charge. TSC's transfer pricing expert acknowledged that his "50 percent profit split" analysis is "not exactly

what [the § 482 regulations] prescribe"; he is not aware if a court has allowed an expert to use the 50 percent figure to split residual profit the way he has; and he is not aware if a court also allowed this type of analysis without any accompanying quantitative support. *See* Hr'g Tr. 1311:9–20 (**R. p. 1701**). Weighing and judging the evidence, the ALC found a lack of data and quantitative support for TSC's transfer pricing expert's opinion that the 9.7% markup was an arm's length transaction.

Even in the context of a penalty abatement, which again is not at issue here, the analysis of TSC's expert falls short. Notably, his analysis occurred years after TSC filed its returns. Therefore, the only transfer pricing "documentation" that TSC professes to be reliable was not in existence at the time TSC filed its returns (a prerequisite for penalty abatement). Further, as supported by substantial evidence, the ALC found this later produced "documentation" to be unreliable.

III. SUBSTANTIAL EVIDENCE SUPPORTS THE ALC'S FINDING THAT COMBINED UNITARY REPORTING IS A REASONABLE AND EQUITABLE APPORTIONMENT OF TSC'S INCOME IN SOUTH CAROLINA.

A. No law requires the Department to make a transfer pricing adjustment; rather, this Court's precedent is clear the Department is free to select a reasonable alternative apportionment method of its choice.

At its core, TSC's chief complaint in this appeal is that the Department should have adjusted the transfer price in the Procurement Agreement to fix any alleged distortion. *See* Appellant Br. at 1, 44. In TSC's view, the use of combined reporting is both unreasonable and inequitable. Importantly, there is no law or legal requirement that the Department make a transfer pricing adjustment. Instead, the statutes and court precedent make it clear that the Department is free to select a reasonable alternative apportionment method of its choice. Section 12-6-2320(A)(4) represents the legislature's express delegation of <u>discretionary authority</u> to the Department to determine when an alternative apportionment method is warranted, and if so, which method is appropriate. *See Media General*, 388 S.C. at 151, 694 S.E.2d at 531–32. The Department's alternative method must be reasonable, but it need not be the most reasonable method. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*,

411 S.C. 79, 88, 767 S.E.2d 195, 199 (2014) ("we agree with the Department that the court of appeals misapplied *Media General* in holding the Department must prove that its alternate formula is 'more reasonable than any competing method'").

B. The ALC correctly held that combined reporting reasonably and equitably approximates TSC's business activity in South Carolina.

The ALC correctly found that, in light of the plain language of section 12-6-2320(A)(4) and the generally accepted considerations for whether an alternative apportionment method is reasonable, combined unitary reporting is reasonable and equitable in this matter.

As discussed above, courts have long recognized that combined unitary reporting "is wholly consistent with, and a natural extension of, the apportionment method." *Coca-Cola Company v. Department of Revenue*, 533 P.2d 788, 793, 271 Or. 517, 528 (Or. 1975). The U.S. Supreme Court has affirmed the constitutionality of combined reporting, and this Court has confirmed the Department's ability to require combined reporting as an alternative apportionment method under § 12-6-2320(A)(4). *See Container Corp. of America v. Franchise Tax Bd. of Cal.*, 463 U.S. 159, 184 (1983); *Media Gen. Comm'n, Inc. v. S.C. Dep't of Rev.*, 388 S.C. 138 (2010).

Moreover, in the Department's published guidance on alternative apportionment, it explained some of the factors courts have evaluated in determining whether an alternative apportionment method is reasonable. *See* Revenue Ruling #15-5 at 4 (**R. p. 2231**) (quoting *Twentieth Century-Fox Film Corp.*, 700 P.2d 1035, 1043 (Or. 1985). Specifically, Revenue Ruling #15-5 notes that a "reasonable" alternative apportionment method for South Carolina income tax purposes has at least two components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income; and (2) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in South Carolina. *Id.*

Here, the ALC found that combined unitary reporting fairly represents TSC's business activity in the state. TSC and its affiliates are highly interdependent entities that operate together as a single business enterprise that creates a seamless retail experience for TSC's customers. The substantial intercompany transactions evidence the circular flow of money, services, and value between TSC, TSC of Texas, and TSC of Michigan. The related entities all rely upon each other for necessary business functions and services. All the crucial components necessary for a retail business, such as purchasing, distribution services, management services, leasing employees, and use of trademarks are performed entirely by the TSC entities for each other. The headquarter functions for the TSC Group are all integrated at the same location in Tennessee. The executives and officers serve in dual-role capacities for both TSC and TSC of Texas. All the services that TSC of Texas provides the Group were previously performed by TSC before 2001.

In short, TSC's business activity (both in South Carolina and elsewhere) is effectively the same pre- and post-Tax Restructuring—there was no commercial effect or operational impact on the company. The only difference is the corporate structure, which TSC's Tax Restructuring designed specifically to exploit the tax ramifications in South Carolina (and other similar states) where separate reporting is the standard apportionment method. As a result of the Tax Restructuring, the income TSC reported under the standard apportionment method does not reflect the true economic activity of TSC in South Carolina. Despite being a highly profitable business enterprise compared to other retailers,[26] the implementation of the transfer pricing and Tax Restructuring strategy—with respect to

[26] TSC has grown significantly, from 300 nationwide stores in 2000 to well over 1800 stores in 2017. As a result, its operating profits have "increased substantially." *See* Hr'g Tr. 486:4–486:12 (**R. p. 876**); Respondent's Ex. 33, slide 8–9 (**R. pp. 4546–4547**). TSC Group consistently earned nearly $600 million annually during the Periods at Issue. *See* Hr'g Tr. 474:23–475:6; Respondent's Ex. 33, slide 1 (**R. pp. 864–865; 4539**). TSC also has high profitability ratios compared to other retailers. For example, TSC's average operating margin during the Periods at Issue was 10.7%; the median operating margin for other similar retailers (e.g. AutoZone, Inc.; Dollar General Corp.; Target Corp.; Walmart, Inc.; Lowe's Companies Inc.; and the Home Depot, Inc.) was 6.9%. *See* Hr'g Tr. 475:10–485:14;

TSC's tax filings—paint very different picture of the company's business activity, suggesting that TSC's income is a small fraction of what it actually is.

C. The ALC correctly held that combined unitary reporting reasonably and equitably corrects the distortion resulting from TSC artificially shifting its profits to TSC of Texas via the Procurement Agreement.

The ACL correctly found the "huge shift of income" (hundreds of millions of dollars) from TSC to TSC of Texas—primarily as a result of the 9.7% inventory markup—fundamentally distorts TSC's income. The ALC carefully and correctly explained how combined unitary reporting fixes this distortion by using an example calculation for tax year 2014. *See* Amended Order p. 65–69 (**R. pp. 130–134**).

In 2014, TSC's federal taxable income (which is the starting point for calculating its South Carolina taxable income) was $130,998,521. The ALC's example, which disregarded the transfer price but still used the standard apportionment method, assumed TSC's taxable income of $400,000,000. *See* Amended Order at 65 (**R. p. 130**). This was a "conservative" assumption (valuing the disregarded transfer price at approximately $270 million) in light of the undisputed evidence that the amount TSC of Texas earns annually for the procurement transfer price was between $300–400 million. *Id.*; Hr'g Tr. 544:2–13, 547–48 (**R. pp. 934, 937–938**). Using the same sales factor (2.79%) that TSC used in its South Carolina filing generates a tax base of $11,647,648. The ALC found the resulting tax due of $582,382 to be an appropriately close approximation of the tax due ($649,486) under the Department's combined reporting calculations.[27] *Id.* Notably, had the ALC's hypothetical included a less-

Respondent's Ex. 33, slides 2–7 (**R. pp. 865–875; 4540–4545**). TSC's markup on total costs was 11.5% during the Periods at Issues; the median for other retailers was 7.4%. *Id.* And TSC's return on operating assets was 31.8%, compared to the median 14.6% for other retailers. *Id.*

[27] In its calculation, the ALC added to the $400 million a net adjustment of $17,478,426 (per TSC's filed returns), *see* Joint Exhibit 13, p. 2 (**R. p. 3701**), and calculated the resulting tax base by the corporate tax rate of 5%. The ALC also noted that, under its 2014 example, TSC paid tax on approximately 1% of its net taxable income, even though 2.7% of its sales were attributable to South Carolina (per the sales factor). *See* Amended Order at 66 (**R. p. 131**).

conservative value ($300–400 million) for the transfer price, the resulting tax under this example would have been between $625,625 and $765,125.

The ALC's example calculation is consistent with the other record evidence relating to TSC's income relative to TSC Group. As discussed in Argument § II.A.3. above, TSC Group is in the business of retail sales and its retail stores bring in 95–99% of TSC Group's annual revenues. TSC represents 80% of TSC Group's total income generated from these sales. However, once the transfer pricing is implemented, TSC accounts for only 24% of TSC Group's taxable income. In 2014, TSC Group reported federal taxable income of $552,221,388. If TSC's contribution to the group's income is 80%, then 80% of the Group's combined income would represent approximately $441,777,101. If that amount is multiplied by the same sales factor (2.79%), it results in a South Carolina tax base of $12,325,581 and a tax due of $616,279. Again, this is a very close approximation to the tax due for 2014 under the combined unitary method ($649,486).

Thus, the ALC correctly concluded and its findings are supported by substantial evidence that combined unitary reporting is reasonable and equitable because it corrects the distortion of the income shifting while also recognizing the value TSC of Texas and TSC contribute to the unitary business.

D. The ALC was right to reject TSC's arguments when the experts for both parties unanimously agreed that combined unitary reporting is a reasonable and equitable method of apportioning income for a unitary business, and TSC files using combined unitary reporting in many other states and previously filed a combined unitary return in South Carolina.

As the ALC noted, TSC's own tax policy expert, Prof. Pomp, testified at length that combined reporting is often a better method for equitably apportioning all the income of a unitary business in the states where it has business activity. *See* Amended Order at 66 (**R. p. 131**).

Prof. Pomp's testimony demonstrates that combined reporting is reasonable and equitable—both in general, and here—for at least two reasons: first, separate entity states (like South Carolina) are "vulnerable to a panoply of common tax planning techniques" developed by big accounting firms

(like PwC) that make the corporate income tax for larger multistate corporations (like TSC) effectively "voluntary." *See* Hr'g Tr. 1114:9–15 (**R. p. 1504**). Prof. Pomp's examples of these "aggressive" tax minimization strategies include isolating the nexus-creating activities and property of a unitary business in one corporation, shifting income and deductions among states or creating intragroup expenses (i.e. management or procurement fees) that are payable to other members of the unitary group, or setting prices to charge for the provision of goods or services to a related entity within the unitary group that shifts income out of the taxing state (i.e. transfer pricing). *See* Hr'g Tr. 1114:9–1115:16, 1121:6–1127:1 (**R. pp. 1504–1505, 1511–1517**).

Second, Prof. Pomp opined that combined reporting is a "**reasonable** method for measuring the income of a unitary business" and a "safeguard against taxpayer manipulation," and it "**fairly**" responds to most of these common tax-avoiding techniques. *See* Hr'g Tr. 1110:5–14, 1125:15–1126:16 (**R. pp. 1500, 1515–1516**). He opined that as a matter of good tax policy, combined reporting is a reasonable and equitable method of apportionment because the substance—not the form—of a corporation's structure is the controlling consideration of the business activities (and tax liability) in a state. *See* Hr'g Tr. 1107:1–17 (**R. p. 1497**). Further, Prof. Pomp opined that combined reporting is particularly equitable in situations involving transfer pricing and related-entity transactions because it is "difficult—if not impossible" to determine the arm's length transfer price for intangible property like trademarks or unique management (or procurement) systems. *See* Hr'g Tr. 1128:2–1129:22 (**R. pp. 1518–1519**).

In addition, Bruce Fort, the Department's tax policy expert, also opined that combined unitary reporting is a reasonable apportionment method, both from the Department's and taxpayer's perspective. *See* Hr'g Tr. 1405:4–22; 1407:2–1409:1 (**R. pp. 1795, 1797–1799**). Mr. Fort's testimony was consistent with the principles enunciated in Revenue Ruling #15-5, that an alternative apportionment method is reasonable and consistent with good tax policy if every state in which the

taxpayer did business applied that method and no more than 100% of the taxpayer's income would be subject to tax. *See* Hr'g Tr. 1409:2–21 (**R. p. 1799**); *see also Twentieth Century-Fox*, 299 Or. at 233–43 (defining reasonableness in terms of an alternative apportionment method). Indeed, over 20 states have adopted combined unitary reporting as their standard apportionment method. *See* Hr'g Tr. 1461:17–1462:4 (**R. pp. 1851–1852**). Similarly, the Department's accounting expert opined that combined unitary reporting is a reasonable apportionment method because "it allows for a true reflection of the income of the group in a particular state without artificially creating tax benefits through intercompany transactions." *See* Hr'g Tr. 391:4–18 (**R. p. 781**).

With respect to TSC's filings in South Carolina, Dr. DeRamus opined that, from a transfer pricing perspective, apportioning TSC's income to South Carolina using combined unitary reporting **reasonably approximates** the same income and tax if TSC had implemented an arm's length transfer price. *See* Hr'g Tr. 653:10–656:14 (**R. pp. 1043–1046**).

Finally, despite TSC's argument that combined unitary reporting is unreasonable and inequitable, TSC files state income tax returns using a combined reporting method in other states. *See* Hr'g Tr. 104:13–16 (**R. pp. 494**). Moreover, TSC filed a unitary combined return in South Carolina for tax year 2012. *See* Hr'g Tr. 245:8–11 (**R. p. 635**). In light of this testimony and evidence, the ALC did not err in finding the combined unitary method is a reasonable method to effectuate an equitable apportionment of TSC's income.

IV. THE COURT CORRECTLY HELD THE DEPARTMENT'S USE OF COMBINED UNITARY REPORTING DOES NOT VIOLATE THE SOUTH CAROLINA ADMINISTRATIVE PROCEDURES ACT.

In years following *Media General*, and in response to numerous taxpayer inquiries, the Department issued an advisory opinion explaining generally the circumstances when the Department may require or a taxpayer may petition for use of combined reporting under the alternative apportionment statute. *See* Joint Exhibit 17; Hr'g Tr. 174:16–176:11 (**R. pp. 3724–3736; 564–566**).

Policy guidance is appropriate where the Department intends to inform the public how it plans to exercise its discretionary power in cases such as this. Revenue Ruling #15-5 "addresses some of the issues that may arise when South Carolina requires or a taxpayer requests an alternative allocation or apportionment method, including combined unitary reporting." *Id.* at 2. Importantly, the Department does not automatically require combined reporting for a unitary business and makes a case-by-case determination depending on the facts and circumstances of each case. *See* Hr'g Tr. 207:11–15, 271:19–272:6 (**R. pp. 597, 661–662**). Revenue Ruling #15-5 explains to taxpayers the factors that the Department will consider in exercising its statutory discretion under section 12-6-2320(A)(4).

The Administrative Procedures Act explicitly excludes advisory opinions from its definition of a regulation. S.C. Code Ann. § 1-23-10(4) ("'Regulation'…does not include…advisory opinions of agencies…"). By its very terms, Revenue Ruling #15-5 acknowledges the Department retains discretion as to whether and when to require an alternative apportionment method, depending on the specific facts and circumstances of each taxpayer. Revenue Ruling #15-5 declares: "The purpose of a Revenue Ruling is to provide guidance to the public. It is an **advisory opinion** issued to apply principles of tax law to a set of facts or general category of taxpayers." *See* Joint Exhibit 17 at p. 1 (**R. p. 3724**) (emphasis added).

When the Mississippi Department of Revenue faced a similar challenge by a taxpayer, the Mississippi Supreme Court held that the use of an alternative apportionment method was not a promulgation of new rule in violation of the APA. *Equifax, Inc. v. Mississippi Dep't of Rev.*, 125 So. 3d 36, 45 (Miss. 2013) ("Equifax presented no evidence that the Commission promulgated a new standard apportionment method for all service companies. Rather, the Commission required Equifax to use an alternative apportionment method under an existing rule, which provides that, '[i]f the [standard] allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business

activity in this state, ... the Commissioner may require ... [t]he employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.'").

Similarly, Revenue Ruling #15-5 is merely the Department's effort to educate taxpayers on how it will apply existing law. Revenue Ruling #15-5 advises taxpayers that the "Department **may** use combined unitary reporting as the alternative method when it determines that the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina for a company that is part of a unitary business group." *See* Joint Exhibit 17 at p. 6 (**R. p. 3729**) (emphasis added)). Here, the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina and taxpayer is part of a unitary business group. Therefore, the Department exercised its discretion and required combined unitary reporting as the alternative method.

Understanding that Revenue Ruling #15-5 is merely public guidance of an existing law reveals why TSC is misguided in arguing that application of combined unitary reporting to tax years 2014–2015 is improper retroactive application of Revenue Ruling #15-5 (which was issued in 2015). At the time of the audit, Section 12-6-2320(A)(4)'s authorization of alternative apportionment methods had been the law in South Carolina for nearly 20 years. *Media General*'s clarification of the application of combined reporting within section 12-6-2320(A)(4) was several years prior to the beginning of the audit period, and TSC had known since 2010 that the Department believe combined unitary reporting was necessary to fairly reflect the extent of TSC's business activity in South Carolina. *See* Hr'g Tr. pp. 243:8–245:15 (**R. pp. 633–635**). Perhaps most importantly, TSC cannot plausibly argue it did not know how and when a combined unitary return would be required in South Carolina until the Department issued its guidance in 2015, when TSC itself had filed a unitary combined return in South Carolina for tax year 2012—three years prior to the Department issuing Revenue Ruling #15-5.

Even if the Court were to find Revenue Ruling #15-5 violates the APA, the Department's use of combined unitary reporting in this case comports with the alternative apportionment statute and the *Media General* decision. Indeed, the Supreme Court blessed the use of combined unitary reporting with *Media General* in the absence of a regulation or advisory opinion from the Department.

CONCLUSION

As explained more fully above, this Court should affirm the ALC's decision as the decision was based on a plain reading of the language in the statutes at issue and the ALC did not make any errors of law that affected the decision. As supported by substantial evidence, the ALC correctly found that the allocation and apportionment provisions of the South Carolina Income Tax Act did not fairly represent the extent of TSC's business activity in this State and the employment of combined unitary reporting effectuated an equitable allocation and apportionment of TSC's income.

Respectfully Submitted,

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