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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-001558

CarMax Auto Superstores, Inc., ... Appellant,

v.

South Carolina Department of Revenue, ... Respondent.

CARMAX AUTO SUPERSTORES, INC.'S INITIAL BRIEF

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INTRODUCTION

South Carolina only seeks to tax the portion of a multistate taxpayer's total income derived from its business activity in this state. For example, if 10% of the taxpayer's total business activity occurs here, then South Carolina seeks to impose tax on 10% of the taxpayer's total business income. The taxpayer determines its total business income by starting with its federal taxable income ("FTI"), followed by state law adjustments, less non-business income, thus leaving its total business income. An apportionment method—which is a fraction that generally compares the taxpayer's revenue in this state to its total revenue in all states—is then used to determine the percentage of the total business income that will be apportioned to and taxed by this state. For a taxpayer with 10% of its business activity occurring in South Carolina, the apportionment method is appropriate if it results in a fraction that is reasonably close to 10%. If the fraction is not reasonably close to 10%, there is a solution—application of the alternative apportionment statute (the "AA Statute") at § 12-6-2320(A).[1]

Here, the South Carolina Department of Revenue (the "Department") invoked the AA Statute against CarMax Auto Superstores, Inc. ("East") for Fiscal Years ("FY") 2016-2018 (the "Audit Period"). The Department bears the burden of proof to justify use of the AA Statute. That burden requires proof of two prongs in this case: (1) that the required apportionment method does not fairly represent the taxpayer's business activity in this state ("Step One"); and (2) the alternative method used is reasonable and equitable ("Step Two"). *See* § 12-6-2320(A).[2] Notably,

[1] All statutory references are to S.C. Code Annotated unless otherwise indicated.

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

the failure to prove Step One ends the analysis. Here, the ALC erred by finding the Department met Step One and thus did not need to even examine Step Two.

First, the ALC applied the wrong legal standard for Step One. East's required apportionment method (the sales factor), which was calculated as East's sales in South Carolina divided by its total sales in all states (with neither figure being challenged as wrong), resulted in a sales factor of approximately ("~") 3.49% during the Audit Period. Step One requires that the Department prove that East's sales factor did not fairly represent the South Carolina portion of East's total business activity. The Department did not attempt to prove this and presented no evidence to show it.

Second, the ALC also erred by finding its incorrect standard was met. The ALC found Step One met based on its belief that East's FTI was improperly low (or "artificially reduced"). Even assuming arguendo that the ALC's wrong standard for Step One was correct, the ALC erred in finding it was met because no evidence supports the ALC's belief that East's FTI was too low. The ALC supports its conclusion based on East being a participant in a permissible tax planning strategy the South Carolina Supreme Court has previously addressed. *See CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014). The other participants are CarMax Auto Superstores West Coast, Inc. ("West"), a South Carolina taxpayer, and CarMax Business Services, LLC ("CBS"), which is taxed as a partnership. Notwithstanding the ALC's descriptions of a supposedly nefarious strategy that helps the group allegedly pay less tax than the law requires, the facts are simple. Since 2004, East has owned 6.5% of CBS, and West has owned 93.5%. When CBS is profitable, 93.5% of its profits are included in West's FTI, whereas 6.5% are in East's FTI. Thus, when CBS is profitable, West's FTI can be higher than East's FTI. West has a smaller apportionment ratio than East's ~3.49% sales factor; thus, $1 in

West's FTI results in less tax paid to this state than $1 in East's FTI. These facts are the only clear evidence cited by the ALC to support its finding for Step One, and they do not prove it was met.

A few immaterial tweaks to the holding in the prior *CarMax* decision against West would result in it describing exactly what happened in this case as to East:

> In its order, the ALC [found] . . . that the business structure of [East,] CarMax West and CBS is often "linked with tax minimization strategies." Furthermore, the ALC relied on evidence . . . that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East, to support its determination that CarMax [East's] [taxable] income was diluted. This was the extent of the evidence offered by the Department to prove [Step One], other than bald assertions by its witnesses that it satisfied this threshold question.

CarMax, 411 S.C. at 90–91, 767 S.E.2d 195 at 201. In other words, the Supreme Court found the evidence used in the prior case was insufficient as a matter of law, yet the ALC and the Department are invoking the same evidence here and ultimately seeking the same conclusion. In the prior case, the Department used the AA Statute against West to increase its apportionment ratio so more of its FTI would be apportioned to this state for taxation. Here, the Department is using the AA Statute against East to require the use of a reporting method referred to as combined unitary reporting ("CUR") to achieve the same result—a larger apportionment ratio applied to West's FTI. The Department presented the same insufficient evidence in both cases to prove Step One.[3] The Department's actions in both CarMax cases (and as to other taxpayers) thwart our Legislature's goal of creating a fair and business-friendly tax environment and negatively impact corporate taxpayers' reliance interests.

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[3] To be clear, the Department's use of the AA Statute first against West and then against East is not the reason the ALC erred when it ruled in the Department's favor. The ALC erred by finding that the Department met Step One (and Step Two) because no evidence supports that conclusion.

The ALC also erred in finding the Department proved Step Two here, particularly where CUR is an egregious overcorrection of an unproven problem, and the Department has other remedies to address any actual problem. In sum, the Department's second attempt to reach West's FTI should fare no better than its first. Thus, the ALC's Order should, respectfully, be reversed.

STATEMENT OF THE ISSUES ON APPEAL

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

II. DID THE ALC ERR IN FINDING STEP ONE OF THE AA STATUTE MET?

III. DID THE ALC ERR IN FINDING STEP TWO OF THE AA STATUTE MET?

IV. DID THE ALC ERR IN ALLOWING AND RELYING UPON THE DEPARTMENT'S EXPERT'S TESTIMONY ON THE 2004 STUDY WHERE EAST HAD NO NOTICE THE STUDY WOULD BE CHALLENGED AND THE TESTIMONY WAS NOT RELIABLE OR RELEVANT?

V. DID THE ALC ERR IN SUA SPONTE FINDING THAT EAST SHOULD GET CREDIT FOR WEST'S CONTRIBUTION OF ASSETS TO CBS IN 2004?

STATEMENT OF THE CASE

This case involves a protest by East of an assessment of corporate income taxes by the Department for the Audit Period. East filed its tax returns for these years using the statutorily required apportionment method (the sales factor). (R. pp.) The Department's assessment (R. pp.) and audit (R. pp.), which East protested (R. pp.), and which the Determination affirmed (R. pp.), alleged that East's business activity was not fairly represented in South Carolina, invoked the AA Statute to impose CUR, and assessed $2,224,389.00 in additional tax and $372,318.97 in interest as of June 14, 2021, for a total of $2,596,707.97.

East filed a request for contested case hearing with the ALC on June 8, 2021. (R. pp.) The ALC held a five-day hearing from May 22 to 26, 2023. (R. pp.) Thereafter, it issued a Remand

Order, which although remanding the case to the Department, appeared to be the ALC's final order, on July 12, 2024. (R. pp.) East filed a motion for reconsideration of that order on July 22, 2024. (R. pp.) On July 29, 2024, the ALC entered an order, ex mero motu, rescinding its Remand Order pending disposition of East's motion. (R. pp.) On August 15, 2024, the ALC entered two orders: (1) an Amended Final Order (the "Order") (R. pp.); and (2) an Order Granting Motion for Reconsideration (the "Reconsideration Order") (R. pp.). In these orders, the ALC substantially stood by its original result in ruling adversely to East but added additional legal grounds and reasoning to support its ruling and made other changes.

East felt compelled to move to reconsider the two new orders to preserve all issues for appeal and filed a Motion to Reconsider Amended Final Order and Reconsideration Order (the "Second Reconsideration Motion") on August 26, 2024. (R. pp.) On September 18, 2024, East filed its notice of appeal as to the Remand Order, the Reconsideration Order, and the Order. (R. pp.) On September 20, 2024, the ALC issued an order denying East's Second Reconsideration Motion (the "Second Reconsideration Order"). (R. pp.) On October 2, 2024, East filed a consent motion to recognize the inapplicability of the automatic stay to the ALC's Second Reconsideration Order (R. pp.), which this Court granted. (R. pp.) East filed a notice of appeal as to the Second Reconsideration Order on October 18, 2024. (R. pp.) On October 23, 2024, the Court consolidated the two notices of appeal. (R. pp.)

STATEMENT OF THE FACTS

A. Relevant Entities; Ownership Structure; and Taxation

The relevant entities (collectively, "the Group"), their organizational structure, and how each one operates, is the same as the prior 2014 case involving the Department and a CarMax entity. *CarMax*, 411 S.C. at 81-82, 767 S.E.2d at 196. The Group consists of East, West, and CBS.

Id. East owns 100% of West and 6.5% of CBS. *Id*. West owns the other 93.5% of CBS. *Id.* East and West are taxed as (and are) corporations, and CBS is taxed as a partnership. *Id.* East and West are taxed on CBS's net income (or net loss) based on each's ownership thereof (i.e., East at 6.5% and West at 93.5%). *Id.* This structure has been in place since 2004. *See supra* Facts § L.

B. East and West Business Operations

East and West own and operate retail stores that primarily sell used vehicles. East's stores are mainly in eastern states, and West's stores are mainly in western states. At the end of the Audit Period, the Group owned 188 stores—East owned 141 stores (75%), and West owned 47 stores (25%). Tr. 748:23-749:13 and 750:11-18. During the Audit Period, the Group sold ~2,000,000 vehicles—East sold ~1,500,000 vehicles (~75%), and West sold ~500,000 vehicles (~25%). *Id.*

C. CBS Business Operations

CBS has two lines of business (and thus two revenue sources). Each is discussed below.

1. Financing. CarMax Auto Finance ("CAF") is a division of CBS with ~500 employees performing financing services.[4] Joint Ex. 33, CarMax Org. Chart (R. pp.); Tr. 786:12-14. CAF and third-party banks/lenders[5] offer loans to customers buying vehicles from the Group's stores. Tr. 780:23-782:16. A customer may complete a credit application at a store, which is then shared with the lenders (including CAF). *Id.* at 781:2-784:16. The customer then receives financing options from the lenders[6] and can select a loan and execute loan documents at the store.

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[4] Although immaterial here, the ALC mistakenly says CAF is a subsidiary (versus a division) of CBS. Order at 9. (R. pp.); Joint Ex. 33, CarMax Org. Chart (R. pp.). Also immaterial, CAF leases employees (who are outside this state) from a related party not relevant here. Tr. 746:15-21.

[5] The Group has contractual arrangements with several financial institutions that offer financing options to store customers. *See* Joint Ex. 8, 2015 TP Study, at CarMax_001159. (R. pp.)

[6] The stores have no input on credit decisions, loan terms, etc., that CAF and third-party lenders offer. Tr. 784:17-785:1.

Id. CAF services its loans (payments, collection issues, customer service, etc.) for the life of the loan (typically ~60 months), including loans that are securitized. *Id.*; *see also id.* at 785:2-787:15.

2. Management Fee Services. CBS performed various managerial and related services for the East and West stores and allowed use of CBS's intellectual property ("IP"). These licenses/functions/services can be described as (i) use of CBS's intangible assets and intellectual property, including trademarks and tradenames ("IP"); (ii) general management and administrative support (e.g., accounting, human resources, IT, etc.); (iii) advertising and marketing; (iv) real estate services; and (v) strategic analysis and data analytics. *See* Joint Ex. 34- 36 (R. pp.- pp.); East Prop. Order at 8-12 (R. pp.) (providing detailed description of these functions/services).

D. Management Fees

1. Management Fee Price. East and West paid CBS "management"[7] fees for the services (and use of IP) described immediately above. The management fees were made on a per-vehicle sold basis, and the price was $1,107/vehicle in FY2016 and $1,192/vehicle in FY2017 and FY2018.[8] *See* Tr. 790:20-25 and Joint Ex. 37, Management Fee Breakout FY2016-18 (R. pp.). The management fee prices were based on transfer pricing studies prepared by E&Y. *See* Joint Ex. 7-8, E&Y TP Report FYE 2/29/12 (the "2012 TP Study") (R. pp.) and E&Y TP Report FYE 2/28/15 (the "2015 TP Study") (R. pp).[9] The 2015 TP Study[10] priced the management fee as five

[7] The fees compensated CBS for more than just "management services," but East will refer to them as "management fees" unless the context warrants more specificity.
[8] In other words (and as an example), in FY2016 East paid CBS a fee of $1,107 for each car sold at an East retail store, and West did the same. The price was $1,192 per car sold in the final two years of the Audit Period (FY2017 and FY2018).
[9] The management fee price of $1,107 (FY2016) was based on the 2012 TP Study, and the price of $1,192 (FY2017-2018) was based on the 2015 TP Study. *See* Joint Ex. 7-8 (R. pp.- pp.).
[10] The 2012 TP Study is substantially the same as the 2015 TP Study. East will generally discuss the 2015 TP Study unless the context warrants otherwise.

separate transactions and the determined the arm's length standard for each transaction. Joint Ex. 8, 2015 TP Study (R. pp.). A conservative price within the applicable range was selected for each transaction, and the five collective prices make up the $1,192 total price. Order at 28 (R. pp.).[11]

2. Management Fee Costs. CBS incurred substantial costs to provide the services compensated by the management fees. In fact, most of the management fee payments only covered the underlying costs. The average costs incurred by CBS during the Audit Period (on a per-car sold basis) to provide the management services were ~$701 per vehicle sold. Tr. 776:11-16 and 800:19-803:9; Joint Ex. 81-83, FY2016-2018 CAF v. Non-CAF Legal P&Ls (R. pp.- pp.). In other words, had the management fee price been $701/vehicle for the Audit Period (versus the prices used of $1,107/vehicle in FY2016 and $1,192/vehicle in FY2017-2018), CBS would have earned ~$0 of net income (i.e., no profit) from the management fees.

3. Management Fee Payments (Revenues). East and West paid CBS a total of ~$2.37 billion in management fees during the Audit Period. Joint Ex. 26, Audit Report at SCDOR_0159. East paid ~$1.76 billion (~74.4%), and West paid ~$606 million (~25.6%). *Id*.

4. CBS Net Income (Profits) from Management Fees.The management fees generated ~$1.05 billion of net income for CBS (~50% of CBS's total net income of ~$2.1 billion) during the Audit Period. *Infra* Facts § E. Of that ~$1.05 billion, East's payments generated ~$781 million (~74.4%). Of that ~$781 million, ~$730 million (93.5%) was ultimately included in West's FTI. West's payments generated ~$269 million (~25.6% of ~$1.05 billion) of CBS's net income

[11] East is providing only a brief discussion of the 2015 TP Study (and 2012 TP Study) because the Department did not prove the management fee price failed to satisfy the arm's length standard, and the appropriateness of the price was not relevant to the ALC's rulings. *See infra* § II(B). For a detailed discussion of the 2015 TP Study and the reasons the management fee price satisfied the arm's length standard, see East Prop. Order at 8-13 and 46-55. (R. pp.- pp.)

from the management fees. Of that ~$269 million, ~$17 million (6.5%) was ultimately included in East's FTI.

E. CBS Profitability and Impact on FTI of East and West

CBS was profitable. *See* Joint Ex. 12-14, CBS Forms 1065 FY2016-FY2018 (R. pp.- pp.).[12] Despite incurring over $2 billion of costs, CBS's total net income[13] for the Audit Period was ~$2.1 billion. *See id.* (~$626 million in FY2016, ~$732 million in FY2017, and ~$759 million in FY2018).[14] Notably, CBS's net income during the Audit Period was equally derived from the financing activities (CAF) and the management fee payments (i.e., each generated ~50% of CBS's net income). Tr. 751:9-14; Joint Ex. 12-14 (R. pp.- pp.); Order at 10 (R. pp.).

CBS's net income was ultimately included in East's FTI and West's FTI in proportion to each's CBS ownership. For the Audit Period, East's FTI was ~$502 million, and West's FTI was ~$2.09 billion. *See* Joint Ex. 16-21, East and West SC returns FY2016-FY2018 (R. pp.- pp.) (see Line 1 of each return). CBS's net income caused West's FTI to exceed East's FTI.[15]

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[12] CBS's Form 1065s labeled 2015-2017 correspond to FY2016-FY2018. CBS, East, and West filed amended returns for FY2016, which (as the governing returns that year) are referred to herein as the FY2016 returns.

[13] Because CBS is taxed as a partnership (and not taxed directly), it does not have FTI. Rather, CBS had net income (or loss) found on Line 22 of its federal returns. Joint Ex. 12-14 (R. pp). CBS's net income was ultimately included in the FTI of East and West based on ownership.

[14] For additional details, see Line 8 (total income before deductions), Line 21 (total deductions), and Line 22 (ordinary business income (i.e., here, net income)), of CBS's Forms 1065. Joint Ex. 12 at CarMax_003244 (R. pp.), Joint Ex. 13 at CarMax_003279 (R. pp.), and Joint Ex. 14 at CarMax_003310 (R. pp.). For the Audit Period, CBS's total income exceeded $4.6 billion, and its deductions exceeded $2.5 billion to arrive at ~$2.1 billion of net income. *Id.*

[15] Excluding CBS's net income from the FTI of East and West indicates East and West are similar. Regarding CBS's ~$2.1 billion of net income, East's FTI included ~$140 million (6.5%) and West's FTI included ~$1.96 billion (93.5%). Excluding CBS's net income from East's FTI (~$502 million) and West's FTI (~$2.09 billion) leaves East with ~$362 million and West with ~$130 million. East and West are both profitable in each's own right, and East sold ~3 times as many vehicles as West (hence East's profits being ~3 times greater than West's).

F. South Carolina Business Operations

Only East and CBS had nexus creating activities in this state. East owned three stores in South Carolina for most of the Audit Period (a fourth opened at the end of FY2018). Order at 13 (R. pp.). CBS had no physical presence here, but it licensed IP to East and had financing income (CAF) from South Carolina customers.[16] *Id.*; *see also* Tr. 751:15-20 and 785:2-786:6. West had no business activity here, but it files South Carolina returns due to its 93.5% ownership of CBS. *See, e.g.*, Tr. 750:19-22; *see also* Order at 13 (R. pp.).

G. East's South Carolina Tax Returns

East filed income tax returns as required by South Carolina law. *See* Joint Ex. 16-18, East SC Returns FY2016-2018 (R. pp- pp.); Order at 13 (R. pp.); *see also infra* pp. 19-20 (explaining process of calculating South Carolina tax). The returns begin with East's FTI, followed by state law modifications, and then use of the mandated apportionment method (the sales factor)[17] to measure its South Carolina business activity. *Infra* pp. 19-20. The sales factor is a fraction—South Carolina sales divided by total (everywhere) sales.[18] The sales factor provides the percentage used to determine the portion of East's total income taxed by South Carolina at the 5% tax rate. *Id.*[19]

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[16] In accordance with a prior settlement agreement with the Department, 100% of CBS's finance receipts from South Carolina are accounted for in the collective returns filed by East and West.

[17] The apportionment method is technically a combination of the sales factor (for East's business activity) and gross receipts factor (for 6.5% of CBS's business activity included in East's returns). The parties (and ALC) have referred to East's apportionment method as the sales factor, and East will continue that practice herein.

[18] The numerator contains East's retail sales and 6.5% of CBS's royalty and finance receipts from South Carolina, and the denominator contains East's retail sales and 6.5% of CBS's royalty and finance receipts from everywhere.

[19] Using FY2016 as an example, East's FTI was $159,609,689; its income subject to apportionment was $208,904,788; its sales factor was 3.35%; the income apportioned to this state was $7,010,427 (i.e., 3.35% of $208,904,788); and the tax due was $350,521 (i.e., 5% of $7,010,427). *See* Joint Ex. 16 (R. pp.). The results for FY2017 and FY2018 are similar. Joint Ex. 17-18 (R. pp.- pp.).

For the Audit Period collectively, East's average sales factor was 3.49%,[20] and it reported (and paid) $1,052,454 of tax. *See* Joint Ex. 16-18 (R. pp.- pp.); *see also* East Prop. Order at 15-18 (R. pp.) (providing additional details regarding calculations of East's tax liability).

H. Requirements for East's Returns to Result in its Tax Liability Being as High as the Tax It Must Pay Under CUR.

1. <u>$1.3 Billion Increase to East's FTI Is Needed to Reach CUR Result.</u>

The use of CUR in this case requires East to pay tax (in addition to the $1,052,454 already paid) of $2,224,389. For East's returns as filed to result in as great of a tax owed to this state as under CUR, East's FTI would need to increase by $1,274,721,490 during the Audit Period. This approximation is calculated as $1,274,721,490 multiplied by East's average sales factor of 3.49%, multiplied by the 5% tax rate, which is $2,224,389. East will refer to this $1,274,721,490 as ~$1.3 billion herein. Increasing East's FTI by ~$1.3 billion during the Audit Period would result in East paying as much tax is it must pay under CUR.

2. <u>Management Fee Payments – Impact on East's Tax Returns.</u>

During the Audit Period, East's total management fee payments generated ~$730 million of CBS net income that was included in West's FTI. *Supra* Facts § D(4). If East's FTI was increased by ~$730 million during the Audit Period, it would have resulted in East owing additional tax to South Carolina of ~$1.27 million (based on $730 million, multiplied by 3.49%, multiplied by 5%).

Further, if the management fee price was reduced to an amount that caused CBS to have $0 of net income (rather than ~$1.05 billion) from the management fee payments during the Audit

[20] The sales factor was 3.35%, 3.49%, and 3.65%, for FY2016-2018, respectively. Joint Ex. 16-18. (R. pp.- pp.). The average (3.49%) is based on total South Carolina sales in FY2016-2018 divided by total everywhere sales during that period.

Period, East's FTI would have increased by ~$713 million because East would have retained the ~$730 million that was in West's FTI but would not have received the ~$17 million of CBS's net income generated by West's management fee payments. *Supra* Facts § D(4). Increasing East's FTI by ~$713 million during the Audit Period would have resulted in East owing additional tax to South Carolina of ~$1.24 million (based on $713 million, multiplied by 3.49%, multiplied by 5%).

I. West's South Carolina Tax Returns

West also filed income tax returns as required by South Carolina law, using the same process as East described immediately above. *See* Joint Ex. 19-21 (R. pp.- pp.); Order at 13-14 (R. pp.- pp.). For the Audit Period collectively, West's average apportionment factor (gross receipts) was 0.33%,[21] and West reported (and paid) $369,104 of tax. *Id.*; East Prop. Order at 16 (R. pp.). The Department audited West, but it ultimately accepted West's tax payments and returns as filed. Order at 14 (R. pp.), n. 27.

J. Combined Unitary Reporting

The Department's use of CUR requires East pay additional tax (i.e., on top of $1,052,454 already paid) of $2,224,389, plus interest. Order at 14-15 (R. pp.- pp.). The substantial increase to East's tax liability is caused by the initial step of CUR, which combines the FTI of East and West. *See* East Prop. Order at 17-20 (R. pp.- pp.) (describing calculation of tax owed under CUR compared to East's filed returns); Order at 16 (R. pp.) (FY2016 chart comparing East's filed return to CUR).[22] The use of CUR requires East pay tax that greatly exceeds the extent of its South

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[21] The numerator contains West's South Carolina retail sales ($0) and 93.5% of CBS's royalty and finance receipts from South Carolina, and the denominator contains West's retail sales and 93.5% of CBS's royalty and finance receipts from everywhere.

[22] The Department calculated East's additional tax by: (1) combining East's and West's FTI, followed by state modifications; then (2) apportioning the combined income here using a combined sales factor (i.e., numerator is the Group's South Carolina sales, and denominator is the Group's

Carolina business activity.[23] For the Audit Period collectively, CUR apportioned to South Carolina ~12.09% of East's total apportionable income (and ~10.86% when accounting for the credit West's tax payments) despite only ~3.49% of East's total business activity occurring in South Carolina. *See* Joint Ex. 16-21 (R. pp.- pp.), 24 (R. pp.), and 26 at SCDOR_0155 (R. pp.- pp.); *see also* East's Prop. Order at 18-20 (R. pp.- pp.) (details on CUR over-taxing East compared to its business activity here). For the Audit Period collectively, CUR used $2,827,737,254 as the total apportionable income, but only $603,226,332 (21.3%) was East's income; the rest (78.7%) was West's income. *Id.*

K. Relevant Procedural History

From July 1, 2019 through March 8, 2023, the Department used the AA Statute to issue fifty-three (53) proposed assessments requiring the use of CUR. Tr. 111:4-11.[24] One of those 53 assessments requiring CUR was issued to East in September 2019 and required East pay additional tax of $2,224,389 (plus interest). *See* Joint Ex. 23, Proposed Assessment. The Department's

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everywhere sales)); then (3) applying the 5% tax rate to the income apportioned here in the prior steps; then (4) requiring East pay the resulting tax (totaling $3,645,948) less the tax already paid by East ($1,052,454) and West ($369,104). Order at 15-16 (R. pp.- pp.); Joint Ex. 26, Audit Report, at SCDOR_0155-0157 (R. pp.- pp.); Joint Ex. 24, Corporate Working Papers (R. pp.- pp.). The Department did not apply intrastate apportionment (i.e., the process of dividing the total tax owed to South Carolina between all taxpayers (East and West)), which Revenue Ruling 15-5 requires. *See* Joint Ex. 28, Rev. Rul. 15-5 at 9-10 (R. pp.- pp.); *see also* Dep. of Dep't at 78:2-79:11.

[23] For example, the use of CUR in FY2016 apportioned to South Carolina ~10.84% of East's total business (apportionable) income despite only 3.36% of East's total business activity occurring in South Carolina that year. *See* Order at 16 (R. pp.- pp.) (calculated at $22,652,851 (Line 4 of CUR column) divided by $208,904,788 (Line 3 of East's FY2016 return)). When accounting for East getting credit for West's tax payment ($109,407 for FY2016), CUR still apportions to South Carolina ~9.80% of East's total income subject to apportionment. The results of FY2017 and FY2018 are similar. *See* East's Proposed Order at 19-20 (R. pp.- pp.) (showing CUR over-taxing East compared to its business activity here).

[24] When the Department uses the AA Statute, the second most common alternative method (after CUR) has been used only three or four times since 2018. Dep. of Dep't at 23:14-25:2.

reasons for invoking the AA Statute against East are unclear. *See, e.g.*, Joint Ex. 27, Determination (R. pp.- pp.); Dep't Pre-Hearing Statement (R. pp.); Order at 14-15 (R. pp.- pp.).

Discovery in this case ended on March 17, 2023 (the "Discovery Deadline"), which is also the date that audit supervisor Orville Sharpe ("Sharpe") testified as the Department's designated 30(b)(6) witness. Order on Mot. re: Expert Deps. (R. pp.); Dep. of Dep't at 1 and 4 (R. pp.). The Department viewed the profit portion of the management fee payment as the reason the AA Statute was warranted. *See, e.g.*, Dep. of Dep't at 143:6-144:8 and 130:8-132:5. Through at least the Discovery Deadline, the Department incorrectly believed virtually all of CBS's net income was from the management fees. *See*, *e.g.*, *id.* at 142:19-22, 138:5-138:13, and 135:20-137:16. CAF's financing activities appear to have played no role in the decision to use the AA Statute, the Department ignored these activities for the entire case (until the eve of trial), and the record contains virtually no evidence related to these activities. Tr. 789:2-10 (Eileen Yost testimony that the Department did not request any information about CAF during the audit and "none or very little" during litigation); *see also* East Prop. Order at 26-27 (R. pp.- pp.). The accuracy of the 2004 Study likewise played no role in the Department's decisions in this case, but it was challenged on the eve of trial. *See infra* Facts § L.

L. The 2004 Restructuring

The organizational structure of the Group during the Audit Period resulted from a restructuring that occurred on December 1, 2004 (the "2004 Restructuring"). Tr. 813:25-814:18. There were many business reasons for the 2004 Restructuring including tax savings, and it was effectuated through various steps after much planning. *See generally* Order at 4-6; *see also* Tr. 814:19-820:25; Joint Ex. 43 (R. pp.- pp.); Joint Ex. 54 at CarMax_001805-1811 (R. pp.- pp.). The ownership of CBS (6.5% East and 93.5% West) was based on the value of the assets East and

West, respectively, contributed to CBS on December 1, 2004. Tr. 823:1-13. East contributed ~$120 million of assets to CBS, and West contributed ~$2 billion of assets to CBS. Order at 16-17 (R. pp.- pp.); *see also* Joint Ex. 55, 2004 E&Y Valuation Study (the "2004 Study") (R. pp.). The 2004 Study solely determined the FMV of assets West contributed to CBS. *Id.*

Prior to the 2004 Restructuring, East contributed certain business process intangible assets (the "2004 BPI") to West. Although this transfer of assets was never an issue in the case or mentioned before trial, the ALC made a sua sponte ruling in its Order related thereto. *See infra* § V; Order at 25 (R. pp.). At the time of the transfer, West already owned valuable intangible assets (the "2004 IP"), and East owned 100% of West. *Id.* During the 2004 Restructuring, West contributed the 2004 BPI and 2004 IP (collectively, the "Car-Related IP") to CBS. Ex. 55, 2004 Study (R. pp.); Order at 17 and 22 (R. pp. and pp.). The 2004 Study solely determined that the FMV of the Car-Related IP was ~$2 billion; it did not individually value the 2004 IP or 2004 BPI, nor does it indicate one is more valuable than the other. Ex. 55, 2004 Study (R. pp.- pp.).

Little evidence is in the record about the 2004 IP and the 2004 BPI. Ex. 55, 2004 Study at CarMax_001605 (describing the Car-Related IP as "certain intangibles, among which are processes, know-how, trademarks, brand names, and other similar items[.]" The available evidence indicates the 2004 IP includes general intangible assets including trademarks and tradenames. Ex. 55, 2004 Study (R. pp.); Ex. 52, 05/31/2005 E&Y Memo at CarMax_001702. The 2004 BPI is known only to include general types of assets such as proprietary systems and trade secrets. Order at 5, n. 13. The only evidence related to the value of the assets that make up the 2004 BPI and 2004 IP is that collectively they were worth ~$2 billion. Ex. 55, 2004 Study (R. pp.)

DeRamus revealed in his deposition that he had formed an opinion that the 2004 Study was wrong. Mot. in Limine at 3 (R. p.) At that time, he did not know East had transferred the 2004 BPI

to West. Tr. 689:16-20, 1274:15-1276:5, and 692:20-693:22. He incorrectly believed that West contributed only the 2004 IP to CBS, and thus believed the 2004 Study only valued the 2004 IP when it concluded that West's assets were worth ~$2 billion.[25] *Id.* At trial, DeRamus discussed East transferring the 2004 BPI to West, which is the first instance any Department witness had indicated knowledge of this fact.

STANDARD OF REVIEW

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

The interpretation of a statute is a matter of law that an appellate court may decide de novo (i.e., without deference to the trial court). *CFRE, LLC v. Greenville Cnty. Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) ("Questions of statutory interpretation are questions of law, which we are free to decide without any deference to the court below.") (citations omitted). On the other hand, judicial review of the ALC's factual findings "is limited to a determination of whether the order is supported by substantial evidence." *MRI at Belfair, LLC v. S.C. Dep't of Health & Envtl.*

[25] East's motion in limine highlighted this error as one of many reasons to exclude his testimony attacking the 2004 Study. Mot. in Limine at 10 (R. pp.).

Control, 379 S.C. 1, 6, 664 S.E.2d 471, 474 (2008). Substantial evidence is evidence that would allow reasonable minds to reach the conclusion that the trial court reached. *See Risher v. S.C. Dep't of Health & Env't Control*, 393 S.C. 198, 210, 712 S.E.2d 428, 434 (2011); *CarMax*, 411 S.C. at 90, 767 S.E.2d at 200 (finding Department failed to present substantial evidence on threshold issue and thus made insufficient showing as matter of law).

LAW

STATUTORY INTERPRETATION

"The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature." *Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). "What a legislature says in the text of a statute is considered the best evidence of the legislative intent[.]" *Id.* (citation omitted). "[W]ords of a statute must be read in their context and with a view to their place in the overall statutory scheme." *Davis v. Mich. Dep't of Treas*, 489 U.S. 803, 809 (1989). "Where the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." *Hodges*, 341 S.C. at 85, 533 S.E.2d at 581. In addition, the words in a statute must be construed in context, and a forced construction that expands the operation of a statute is prohibited. *Sparks v. Palmetto Hardwood, Inc.*, 406 S.C. 124, 128, 750 S.E.2d 61, 63 (2013) (citation omitted); *TNS Mills, Inc. v. S.C. Dep't of Rev.*, 331 S.C. 611, 624, 503 S.E.2d 471, 478 (1998) ("[F]orced construction of statutory words for the purpose of expanding a statute's operation is prohibited.").

TRANSFER PRICING

Internal Revenue Code Section 482 ("§ 482") grants the Internal Revenue Service (the "IRS") the power to reallocate income among related parties in limited circumstances. *See* I.R.C. § 482. The final Treasury Regulations under § 482 (the "§ 482 Regulations") provide taxpayers

guidance on pricing related-party transactions. The key to the § 482 Regulations is the arm's length standard (the "ALS"). Treas. Reg. § 1.482-1(b)(1). A range of results (and thus a range of prices used to obtain such results) will satisfy the ALS, and the IRS will not adjust a price that meets this standard. *See* Treas. Reg. § 1.482-1(e). The § 482 Regulations provide various transfer pricing methods and rules for selecting the most reliable method to reach the ALS; this "best method rule" holds that one should use the most reliable method based on the facts and circumstances. *See* Treas. Reg. §§ 1.482-1(b)(2) and (c). However, if the price used satisfies the ALS, then nothing else matters, and the IRS will not adjust the price.[26]

SOUTH CAROLINA CORPORATE INCOME TAX

Determination of Tax. A multi-state taxpayer determines its South Carolina corporate income tax liability by starting with its FTI, followed by state modifications as provided in Article 9 of the Income Tax Act ("Article 9"), and then this amount (FTI as modified by Article 9) is subject to the allocation and apportionment provisions in Article 17 of the Income Tax Act ("Article 17"). § 12-6-580 and § 12-6-2210(B); *see also CarMax*, 411 S.C. at 85–86, 767 S.E.2d at 198. Applying the Article 17 provisions is a two-step process: (1) non-business income (if any) is first allocated to a particular state(s) (which is not at issue here); and (2) the remaining income (i.e., total income less allocated income), which is business income, is apportioned to South Carolina using an apportionment method. *See* §§ 12-6-2220, -2230, and -2240; *Emerson Elec. Co. v. S.C. Dep't of Rev.*, 395 S.C. 481, 485, 719 S.E.2d 650, 652 (2011). This process results in a fraction of the total income (i.e., FTI as modified by Article 9) being attributed to this state as the South Carolina taxable income, which is then taxed at the 5% tax rate. *See, e.g.*, *Duke Energy*

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[26] A transfer pricing study can provide a taxpayer protection from penalties when an inappropriate price is used. *See* I.R.C. § 6662(e)(3).

Corp. v. S.C. Dep't of Rev., 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016).

Apportionment. An apportionment method is a formula used to measure a taxpayer's South Carolina business activity. *Id.* ("an apportionment formula determines the fraction of business conducted in South Carolina"). Apportionment is an approximation, not an exact science. *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66–67, 212 S.E.2d 574, 577–78 (1975); *DIRECTV, Inc. v. S.C. Dep't of Rev.*, 421 S.C. 59, 76, 804 S.E.2d 633, 642 (Ct. App. 2017).

Article 17 contains numerous apportionment methods. *See* §§ 12-6-2252, -2280, -2290, and -2310. A taxpayer cannot choose its desired apportionment method; rather, the nature of the taxpayer's business dictates the required method. *See, e.g.*, *DIRECTV,* 421 S.C. at 71, 804 S.E.2d at 639.[27] All Article 17 apportionment methods function in a similar manner; each one is a fraction where the numerator is based on the taxpayer's business conducted within South Carolina, and the denominator is based on the taxpayer's business conducted everywhere. *See* §§ 12-6-2280(A) (fraction for the sales factor is "sales . . . in this State" over "sales . . . everywhere"); 12-6-2290 (fraction for gross receipts method is "gross receipts from within this State" over "gross receipts from everywhere"); 12-6-2310(1)-(6) (same concept for six additional methods). These apportionment methods all have the same, self-evident purpose of determining the South Carolina portion (reflected in the numerator) of the taxpayer's total business activity (reflected in the denominator). *Id.*; *see also Duke*, 415 S.C. at 356, 782 S.E.2d at 592. The formula is a fraction that represents the fraction of the taxpayer's total business activity that occurred in this state. *Id.*

Alternative Apportionment. The AA Statute exists to address situations where the

[27] Manufacturers and those selling tangible personal property must use the sales factor. *See* § 12-6-2252(A). Unique businesses such as transportation companies, shipping lines, telephone services providers, and others, must use specially tailored apportionment methods. *See* § 12-6-2310. All others use the gross receipts method. *See* § 12-6-2290.

allocation and apportionment provisions (all of which are in Article 17) do not accomplish their purpose. *See* § 12-6-2320(A) ("If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State," one may seek an alternative option). It is a relief valve at the end of Article 17 made available to both taxpayers and the Department. *Id.*

Burden of Proof. The Department, as the party seeking to use the AA Statute, bears the burden of proof. *CarMax*, 411 S.C. at 88–90, 767 S.E.2d at 199-200 (2014). It is a two-part analysis, and the Department must prove each prong. *Id.* The first prong ("Step One") requires proof that "the statutory formula does not fairly represent [the taxpayer's] business activity in South Carolina[,]" and the second prong ("Step Two") requires proof that "the proposed alternative formula is reasonable" and effectuates an "equitable . . . apportionment of the taxpayer's income." *Id.* at 89, 767 S.E.2d at 200; § 12-6-2320(A)(4). Step Two need not be examined unless and until Step One is met. *Id.* at 88-90, 767 S.E.2d at 199-200.

The standard (i.e., required) apportionment method is presumed to work (*see* Hellerstein & Hellerstein, State Taxation § 9.20[5] (3d ed. 2022)), and use of the AA Statute is the exception. *CarMax*, 411 S.C. at 89-90, 767 S.E.2d at 200 (citing *St. Johnsbury Trucking Co. v. State,* 118 N.H. 209, 385 A.2d 215, 217 (1978) and *Donald M. Drake Co. v. Dep't of Rev.,* 263 Or. 26, 500 P.2d 1041, 1044 (1972)). The burden of proof cannot be satisfied absent providing specific evidence and a sound evidentiary basis. *See CarMax*, 411 S.C. at 89-90, 767 S.E.2d at 200; *Rent-A-Center W. Inc. v. S.C. Dep't of Rev.*, 418 S.C. 320, 332-33, 792 S.E.2d 260, 267 (Ct. App. 2016).

ARGUMENT

The ALC erred in finding that the Department satisfied its burden of proof required by the AA Statute. The ALC applied an incorrect legal standard for Step One and then erred again in

finding the Department met that standard. The ALC also erred in finding Step Two met and made other errors as discussed below.

I. THE ALC APPLIED THE WRONG LEGAL STANDARD FOR STEP ONE OF THE AA STATUTE.

The correct legal standard for Step One requires the Department to prove that East's sales factor does not fairly represent its South Carolina business activity. However, the ALC failed to apply that standard contrary to caselaw, the relevant statutory text of the AA Statute, the purpose of apportionment, Article 17, and the Income Tax Act. While East believes the AA Statute is clear on the correct legal standard for Step One, to the extent this Court is not convinced, the statute is at a minimum ambiguous, and ambiguities in a tax statute must be resolved in the taxpayer's favor.

A. The Correct Legal Standard for Step One Requires the Department to Prove East's Sales Factor Does Not Fairly Represent its South Carolina Business Activity.

In *CarMax*, the applicable apportionment method was the gross receipts formula found in § 12-6-2290. *Id.* at 83, 767 S.E.2d at 197. For Step One, the Court unequivocally held:

> [W]hen a party seeks to deviate from a statutory formula under section 12–6–2320(A), the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that: (1) ***<u>the</u>*** *statutory formula* does not fairly represent the taxpayer's business activity in South Carolina[.]

Id. at 89, 767 S.E.2d at 200 (emphasis added). The "statutory formula" means the applicable apportionment method Article 17 requires the taxpayer use. *Id.* Thus, here, Step One requires the Department prove "the statutory formula does not fairly represent [East's] business activity in South Carolina[.]" *Id.*; *see also Rent-A-Ctr.*, 418 S.C. at 333, 792 S.E.2d at 267 (same); § 12-6-2320(A). The "statutory formula" here means East's sales factor. *Id.*[28]

[28] The terms "apportionment method," "formula," and "fraction" are synonymous in the statutory scheme and caselaw. *See, e.g.*, §§ 12-6-2240, 12-6-2290, and 12-6-2310; *CarMax*, 411 S.C. at 83-

The standard for Step One is established, clear, and sound. *Id.* It is consistent with the Income Tax Act, Article 17, the purpose of apportionment, and the relevant statutory text of the AA Statute. *Supra* at pp. 20-21.[29] Article 17 contains many "statutory formulas" (i.e., apportionment methods) each of which is designed to measure the fraction of a multi-state taxpayer's business conducted in this state. *Id.* To deviate from that required statutory formula requires proof that it does not fairly represent the taxpayer's business activity in this state. *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200.

East's sales factor here is ~3.49% for the Audit Period. *Supra* Facts § G. Thus, Step One requires the Department prove that ~3.49% does not fairly represent East's South Carolina business activity. *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200; § 12-6-2320(A).

B. The ALC Failed to Apply the Correct Legal Standard.

The ALC failed to apply the correct legal standard for Step One. *See* Order at 59-63 (R. pp.- pp.). While the exact standard applied is unclear and its origins are unknown, the ALC's standard can be satisfied by merely proving a taxpayer's FTI is improperly low, as evidenced by how the Department allegedly proved Step One here. *See, e.g.*, *id*. at 63 (finding Step One met because "this ratio [East's sales factor] is applied against a federal taxable income that is artificially reduced . . . As a result, standard apportionment does not produce a result that fairly represents

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86, 767 S.E.2d at 197-198; *Rent-A-Ctr,* 418 S.C. at 333, 792 S.E.2d at 267; *Duke*, 415 S.C. at 356, 782 S.E.2d at 592.

[29] Ascertaining and effectuating the Legislature's intent begins with the statutory text, and the words must be viewed in their context within the statutory scheme. *Hodges*, 341 S.C. at 85, 533 S.E.2d at 581; *Davis*, 489 U.S. at 809. The AA Statute starts by saying "If the . . . apportionment provisions of [Article 17] do not fairly represent the extent of the taxpayer's business activity in this State[.]" § 12-6-2320(A). Thus, the AA Statute is meant to apply when the apportionment method ("statutory formula") required by Article 17 does not accomplish its purpose of fairly representing the fraction of the taxpayer's total business that occurred in this state.

business activity[.]"); *id.* (Step One met because the "apportionment factor is applied against a much smaller starting number [East's FTI] that then produces" too little tax.).[30] The ALC's standard is incorrect because it is (1) not the same as the standard established in *CarMax*; (2) contrary to the legislative intent of the AA Statute; and (3) one that leads to absurd results.

First, the standard for Step One established in *CarMax* requires proof that East's sales factor does not fairly represent its South Carolina business activity. *Supra* § I(A). That standard is sound and consistent with the legislative intent of the AA Statute. *Id.* The ALC did not apply that standard. The ALC did not even exam whether East's ~3.49% sales factor fairly represented its business activity in South Carolina.[31]

Second, the ALC's standard is contrary to the legislative intent of the AA Statute. The AA Statute is plainly meant to apply when the applicable apportionment method (the "statutory formula") required by Article 17 does not accomplish its purpose of fairly representing the fraction of the taxpayer's total business that occurred in this state. *Supra* § I(A) and pp. 18-20. However, the ALC's standard, which can be met by merely showing a taxpayer's FTI is too low, is a forced construction of Step One that expands the AA Statute's reach far beyond the legislative intent and would allow the AA Statute to address issues it is not intended to address. The Article 17 provisions

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[30] The ALC regularly identifies other items (besides East's FTI) as being improperly low as the evidence for Step One, but each one is the direct consequence of the FTI being allegedly improperly low. *See, e.g.*, Order at 60 (discussion of how the "shifted income" and the partnership allegedly cause East to have an improperly low: "taxable income," "South Carolina tax," "taxable income apportioned to South Carolina," and "taxable income in this state"); *id* at 59.

[31] The ALC does not clearly explain its justification for applying a different Step One standard than *CarMax*, nor does it attempt to analyze the relevant statutory text of the AA Statute to ascertain and effectuate the legislative intent. The ALC's only apparent justification is a statement that because "all of CarMax East's business activity results in revenue, I find that [taxable] income is a proxy for CarMax East's business activity in this state." Order at 57. It is difficult to envision any multistate taxpayer with business activity in South Carolina where this would not be true. This reasoning appears to render meaningless the entirety of Article 17.

apply to a fixed, pre-determined income—FTI as modified by Article 9. *Supra* at pp. 18-20. If FTI is incorrect, then FTI as modified by Article 9 will also be incorrect, but the Article 17 provisions are not seeking or designed to fix that problem. If FTI is too low, then FTI as modified by Article 9 will be too low, the income apportioned to South Carolina for taxation at the 5% rate will be too low, and the tax liability will also be too low. *Id.* But critically, an incorrect FTI (and the direct consequences of that on South Carolina taxable income and tax liability) is not evidence that proves Step One. Even if the Department had proven that East's FTI was "artificially reduced" (which it did not), that would not justify applying a different, incorrect, legally unsupported standard for Step One.

Finally, the ALC's standard is one that leads to absurd results and thus cannot be consistent with the legislative intent of the AA Statute. Any improper business expense deduction, or even an accounting error, could cause a taxpayer's FTI to be improperly low. It would be absurd for those to satisfy Step One of the AA Statute, yet under the ALC's standard, they would.

In sum, the ALC's standard incorrectly conflated taxable income with business activity and thus incorrectly focused on East's FTI as opposed to the sales factor, which is contrary to *CarMax,* the relevant statutory text of the AA Statute, the purpose of apportionment, Article 17, and the Income Tax Act, and it is a forced construction that would lead to absurd results.

C. The AA Statute is at Least Ambiguous and thus Must be Construed in the Taxpayer's Favor.

East submits the AA Statute clearly requires the Department prove its sales factor does not fairly represent East's South Carolina business activity. However, to the extent the Court is not convinced, the statute is at a minimum ambiguous, and ambiguities in a tax statute must be resolved in the taxpayer's favor. *Alltel Commc'ns, Inc. v. S.C. Dep't of Rev.*, 399 S.C. 313, 321, 731 S.E.2d

869, 873 (2012) (holding that if a tax statute is "reasonably susceptible of an interpretation that will exclude [a taxpayer], then [the taxpayer] will be excluded, any substantial doubt being resolved in his favor.").

The statute at issue in *Alltel* provided that "every … telephone company" was required to pay an increased license fee. S.C. Code Ann. § 12-20-100(A); *Alltel*, 399 S.C. at 317, 731 S.E.2d at 871. The issue was whether Alltel's business of providing cell phone service could reasonably be excluded from the meaning of "telephone company," with the taxpayer arguing that "telephone company" should be understood to apply only to companies that use landlines, rather than radio waves, to transmit communications. *See id.* Because the statute was "reasonably susceptible of an interpretation that [would] exclude [Alltel]," the Court found in the taxpayer's favor. *Id.* at 873.

Thus, if there is any need to resort to statutory interpretation as to the legal standard for Step One, East's reasonable interpretation, as opposed to the Department's strained interpretation, should prevail.

II. THE ALC ERRED IN FINDING STEP ONE OF THE AA STATUTE MET.

A. The Department Did Not Satisfy Step One under the Correct Legal Standard.

Step One, when correctly applied, requires the Department prove the sales factor is not a reasonable approximation of East's South Carolina portion of its everywhere business activity. *See supra* § I(A). The Department never argued nor presented any evidence proving this; thus, the ALC should have concluded the Department failed to satisfy Step One.[32]

[32] The ALC acknowledged, and did not disagree with, East's argument that its sales factor correctly measured its South Carolina business activity during the Audit Period. Order at 62-63, n. 70 (R. pp.- pp.). The ALC viewed the accuracy of the sales factor as irrelevant because East's FTI was too low. *Id.* ("Petitioner repeatedly argues that the sales factor measures 'business activity' under section 12-6-2320, and because this ratio was correct during the audit years, the Department cannot show that CarMax East's business activity was not fairly represented. However, because of the

B. The Department Did Not Satisfy Step One even under the ALC's Wrong Legal Standard.

The ALC's basis for finding the Department proved Step One is that East's FTI was improperly low. *See generally* Order at 59-63 (R. pp.- pp.). However, the Department failed to prove each of its arguments that could arguably support that East's FTI was too low, the ALC's theory based on the management fee payments and partnership distributions "working together" does not support it, and the remaining evidence relied on by the ALC does not support it.

1. <u>The Department failed to prove East's FTI was improperly low.</u>

At trial, the Department set forth three arguments—one related to the management fees, one related to CAF, and one related to the CBS ownership—that, if proven, conceivably could be viewed as evidence that East's FTI was improperly low. None were proven.

First, the Department failed to prove the management fee price was above the ALS. *See, e.g.*, Order at 43-44 (R. pp.- pp.) (numerous statements indicating ALC could not determine whether management fee payments satisfied the ALS); *id.* at 60 (same). The Department (via its expert) also tried to provide a suggested price, but he failed to provide a credible one, and the ALC rejected it. Order at 43 (R. pp.) ("[No] expert provided a reliable, arm's length transfer price[.]"); *id*. at 60.[33]

The Department also argued CBS should have paid substantial loan origination fees to East for loans CAF made to customers who purchased a vehicle from an East retail store. However, the ALC properly rejected this argument. Order at 28, n. 44 (R. pp.).[34]

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artificial reduction in federal taxable income, the sales factor does not produce a fair representation of CarMax East's income.").

[33] For the reasons the ALC correctly rejected it, see East Prop. Order at 41-43 (R. pp.- pp.).

[34] For the reasons the ALC correctly rejected this argument, see East Prop. Order at 35-36, 68 (R. pp.- pp.). Further, had the Department proven that loan origination fees of some amount were warranted, that alone would not necessarily support a finding that East's FTI was improperly low. Additional facts would need to be known/proven to determine whether additional revenue for East

Finally, the Department argued East should have received more than 6.5% of CBS during the 2004 Restructuring because the 2004 Study was incorrect. However, the ALC also properly rejected this argument. Order at 24 (R. pp.) ("I conclude the Department's evidence was insufficient to establish whether the Valuation Study was accurate."); *id*. at 25 (same).[35] In sum, the Department failed to prove each argument that conceivably could support the ALC's finding that East's FTI was improperly low.

2. The management fee payments and partnership distributions "working together" does not support that East's FTI was improperly low.

After having already ruled that the Department failed to prove both (1) the management fee price was incorrect, and (2) the partnership distributions were incorrect (*supra* § II(B) (1)), the ALC found these same items *still* proved East's FTI was improperly low. Order at 60-61. (R. pp.) Specifically, the ALC held that it does not matter if both are correct because they are impermissibly "working together" in an east-west structure. *Id.* at 60-62. The ALC deemed the relationship inappropriate and held that its "effect" proved Step One. *Id.* The ALC appears to view the partnership as making the Group a unique, impermissible east-west structure that is siphoning FTI from East (via CBS net income earned on East's management fee payments) and using "disproportionate" partnership distributions to wrongfully send FTI to West. *Id.* at 60-61.

However, the ALC misunderstands the implications of there being a partnership / pass through entity in the Group's east-west structure, which actually renders it less (not more) effective

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(via loan origination fee payments) would increase East's FTI. However, the record contains virtually no evidence about this topic. *See supra* Facts § K.

[35] The ALC also sua sponte said that East "should have received credit" for West's contribution of the 2004 BPI to CBS in the 2004 Restructuring. Order at 25 (R. pp.). The ALC does not expressly use this finding to support its ruling that the Department proved Step One. *See generally id.* at 59-63. Nonetheless, the finding is incorrect. *See infra* § V.

than a pure east-west structure. As the ALC correctly notes, "an east-west structure is not illegal." *Id.* at 60. In fact, it is a well-known and permissible "strategy" used by two (or more) related parties to help the group not pay more tax than is required.[36] In an "east-west structure" an east-entity pays a west-entity (both taxed as corporations), and the east-entity deducts the payment (thus reducing its taxable income), while the west-entity may earn a profit, which can help the group avoid paying more tax than is required. *See* Joint Ex. 28, Rev. Rul. 15-5, at 7, n. 15 (R. pp.); East Prop. Order at 14-15 (R. pp.- pp.). For example, if east-entity pays $1,000 to west-entity for services costing west-entity $900 to perform, then east-entity deducts $1,000 and west-entity has a $100 profit. Critically, west-entity's $100 profit stays in west-entity—0% of it "flows through" or goes back to east-entity.[37]

The difference for the Group (compared to the above example) is that west-entity's profit is only $93.50 (rather than $100) because $6.50 goes back to east-entity. Thus, the Group's structure has *less* profit flowing from the east-entity to the west-entity as compared to the standard, legally permissible, east-west structure because 6.5% is sent back to East, rather than nothing. The partnership is not a "siphon" or otherwise something that renders the Group an impermissible east-west structure. It merely prevents the Group from achieving the full tax benefits that could be realized were it operating as a pure east-west structure. Nothing about having a less than fully efficient east-west structure supports a conclusion that East's FTI is too low or that Step One has

[36] An east-west structure is commonly referred to as a "tax strategy." It is wrong to view a "tax strategy," including an east-west structure, as tax *avoidance* (much less a "scheme"). An east-west structure "reduces" the group's tax by not *overpaying* tax (i.e., paying more than is required). It does not "reduce" the group's tax by avoiding tax.

[37] This is distinctly different than a situation where the arm's length price for east-entity's $1,000 payment to west-entity was shown to be only $970. In that instance Petitioner agrees one could argue east-entity's FTI is improperly low by $30, but the FTI is low because of the inflated deduction—not because 0% of west-entity's profit "flows though" to east-entity.

been met. And the ALC's conclusion to the contrary is incompatible with its correct statements that "[a] management fee, when appropriately priced . . . should be respected" and that "an east-west structure is [permissible]." Order at 60 (R. pp.). Thus, the management fee and partnership distributions "working together" in an east-west structure does not prove Step One.

3. The ALC's primary evidence the Department proved Step One is West's South Carolina business activity.

Here, the ALC identifies the 93.5% CBS partnership distribution as the key reason that East's business activity is not fairly represented in this state. Order at 44 and 60-61(R. pp.). That 93.5% distribution is West's South Carolina business activity, not East's. The only entities in the Group that conduct business in this state are East and CBS, not West. *Supra* Facts § F. In the prior case where the Department argued "West's business activity" is not fairly represented in this state, that was an argument that CBS's business activity (and specifically the 93.5% of CBS that West owns) was not fairly represented in this state. *See CarMax*, 411 S.C. at 83, 767 S.E.2d at 197.[38]

Here, the 93.5% partnership distribution driving the ALC's conclusion for Step One is West's South Carolina business activity, which is essentially the same challenge rejected by the Court in the prior case, and the ALC is using the same "tax minimization strategy" allegations that previously failed. Making the same allegations, again about West's South Carolina business activity, does not support the ALC's finding that Department proved Step One against East.

4. The remaining evidence relied on by the ALC does not support that East's FTI is improperly low.

The ALC's four remaining reasons do not support the conclusion that the Department proved Step One. *Id.* at 59-63. First, the ALC claims that "[t]hrough these intercompany

[38] The Department failed to prove that argument, but the argument was framed correctly and was against the right party. *Id.* at 90–91, 767 S.E.2d at 201.

transactions, CarMax East reduced its federal taxable income by $1.6 billion for the audit period while CarMax West increased its federal taxable income by $1.4 billion." *Id.* at 60; *id*. at 15 (same). This is not accurate.[39] The ALC derived the $1.6 billion figure based on East's total management fee payments (~$1.76 billion) less 6.5% of CBS's total net income (~$140 million).[40] There is no basis for viewing that as supporting that East's FTI was reduced by $1.6 billion. The main errors include that the analysis ignores all costs incurred by CBS, and its logic is incorrect (meaning even considering all costs, it would still be incorrect to characterize the result as East's "reduced FTI"). East's ~$1.76 billion of management fee payments only generated ~$781 million of CBS net income, and only ~$730 million of that net income was in West's FTI. *Supra* Facts § H(2).[41]

Second, the ALC states that East's South Carolina stores had ~$90,000,000 of operating profit but only ~$21,000,000 of "taxable income apportioned to South Carolina[.]" Order at 61; *see also id*. at 8 and 63 (R. pp.) (same). This is incorrect as the South Carolina stores had nowhere close to $90 million of operating profit.[42] *See* Second Reconsid. Mot. at 16-17 (R. pp.- pp.). This alleged "operating profit" *has not* accounted for (at least) the management fee payments, which is then compared to South Carolina taxable income that *has* accounted for those payments. It is

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[39] The statement has a clear red flag—it is describing a tax "scheme" where FTI is shifted from East to West, yet East's FTI is reduced by $200 million more than the increase to West's FTI. Order at 60 (R. pp.). If the statement was supportable, the numbers would be the same. The delta between these two values is clear evidence the analysis used to support the statement is flawed.

[40] The statement is based on Audit Report calculations and/or Sharpe discussing those calculations. *See* Joint Ex. at 26, at SCDOR_0159 (R. pp.) (calculations suggesting East reduced FTI by $1,623,917,479 and West increased FTI by $1,356,151,515); Tr. 73:1-10 (Sharpe testimony).

[41] The same rationale was used to support the statement West increased FTI by $1.4 billion.

[42] The South Carolina stores represented between 2%-3% of East's total stores during the Audit Period, all stores are substantially the same, and $90 million is more than 13% of East's total operating profit (~$674.6 million) for the Audit Period. *See* Second Reconsid. Mot. at 16-17 (R. pp.- pp.). A reasonable approximation of the South Carolina stores' operating profit is between 2%-3% of $674.6 million (i.e., between ~$13.5 million and ~$20.2 million). *Id.*

unclear how comparing the actual operating profit of the South Carolina stores to South Carolina taxable income has any probative value for proving Step One, much less how this arbitrary comparison that treats material expenses inconsistently supports the ALC's ruling.

Third, the ALC compares East's revenues (~75%), management fee payments (~75%), and FTI (~20%) to West's revenues (~25%), management fee payments (~25%), and FTI (~80%). Order at 60-61. These comparisons have no relevance and prove nothing. West's FTI is greater than East's FTI because West's FTI includes 93.5% of CBS's net income. Tax is not imposed on revenue, and high revenue does not necessarily mean high tax liability for any business—countless items must be accounted for to get from revenue to taxable income.[43] The ALC's comparisons do not support the conclusion Step One was met.

Fourth, the ALC relied on a "distortion ratio," created by Sharpe which the Department refers to as Taxable Income over Total Income. Order at 61 and 61, n. 66 (R. pp.- pp.). The ALC says that East's ratio should be similar to West's ratio and that the ratios being dissimilar is evidence that supports finding the Department proved Step One. *See id.* at 61, n. 66 (final two sentences). This ratio is essentially FTI divided by revenue with the difference between those values being largely deductions for normal business expenses. *See* East Prop. Order at 25-26 (R. pp.- pp.). East's ratio is calculated based on East plus 6.5% of CBS, and West's ratio is calculated based on West plus 93.5% of CBS. The Department agrees it would not expect three entities—one selling cars, one providing management services, and one providing financing services (as the Group does)—to have similar ratios. Tr. 134:11-136:11. West's ratio contains 93.5% of the

[43] Most retailers have small profit margins; high revenues but high costs are typical. There also is no support for assuming profit margins for a financing company and management company would be similar to profit margins for a retailer.

management and finance businesses. Thus, East and West having different ratios is to be expected and proves nothing related to Step One. *See* East Prop. Order at 25-26 and 65 (R. pp.- pp.).[44]

5. Conclusion.

There is no evidence here that *any* FTI was improperly "shifted" from East to West. Moreover, during the Audit Period, East's management fee payments only generated ~$730 million of FTI for West, but East would need to have improperly shifted ~$1.3 billion of FTI to West to make true the ALC's finding that CUR "corrects" the income shifting that it found proved Step One. Order at 65 (R. pp.); *supra* Facts § H(2). Specific evidence and a sound evidentiary basis are required to support a finding the Department proved Step One. *See CarMax*, 411 S.C. at 89-90, 767 S.E.2d at 200. The Department did not satisfy that burden.

C. The ALC Failed to Correctly Apply the Burden of Proof for Step One.

The ALC failed to correctly apply the burden of proof. In the 70-page Order, it is unclear what specific evidence supports finding that the Department supposedly proved Step One. Order at 1-70 (R. pp.- pp.). The Department failed to: (a) prove the management fee did not satisfy the ALS (*supra* § II(B)(1)); (b) provide a credible appropriate management fee price (*id.*); (c) prove that substantial loan originations fees were owed to East (*id.*); (d) prove the 2004 Valuation Study was wrong (*id.*); and (e) prove East's sales factor failed to represent its South Carolina business

[44] The Order contains statements where it may not be readily apparent that the values discussed were derived using this distortion ratio, including: "East had a net taxable income return of $10.54 for every $100 of income it produced" (Order at 61, n. 66 (R. pp.- pp.)), is East's FTI (including 6.5% of CBS net income) divided by East's revenues (including 6.5% of CBS revenues), which is 10.54%; "West had a net taxable income return of $57.00 for every $100 of income it produced" (*id.*), is West's FTI (including 93.5% of CBS net income) divided by West's revenues (including 93.5% of CBS revenues), which is 57.00%.; and "West's income produced 541% more federal taxable income than CarMax East" (*id.* at 61), is 10.54% divided by 57.00%, which is 541%. For additional details, see East's Prop. Order at 25-26 and 65. (R. pp.- pp.)

activity (*supra* § II(A)). And the ALC failed to support its own sua sponte argument. *Infra* § V.

The ALC also erred by incorrectly finding that East did not prove the management fee price does satisfy the ALS. *See, e.g.*, Order at 43 (finding the management price was "not reliable" because "the methodologies for Transaction 1, 3, and 5 are not reliable" and concluding the 2015 TP Study does not "reliably support the price . . . [or] justify the amount of income being shifted" from East to West.). The ALC suggests that East bears the burden to prove the price does satisfy the ALS to "justify" shifted income, but East bears no such burden.[45] And the ALC's reasons for finding the price was "unreliable" are not valid and do not support that conclusion.[46]

Here, the Department merely identified that East sells more cars and (thus) pays more management fees than West and that West has more FTI than East. Order at 1-70 (R. pp.- pp.). Beyond that, the Department alleged "income shifting," described how the Group operates, and complained that the 93.5% owner of CBS is taxed on 93.5% of CBS's net income. *Id*.[47]

More must be required of the party that bears the burden of proof. If the Department seeks to meet its burden based on the argument that the management fee is not an arm's length price or

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[45] The Department presented no evidence that warrants the ALC effectively shifting the burden to East to prove the price satisfied the ALS. And while not East's burden to prove, Brian Cody (East's expert witness) nonetheless provided sufficient testimony demonstrating the price was appropriate, reliable, and satisfied the ALS. *See, e.g.*, Tr. 1025:1-1028:7, 1047:2-1051:9, 1057:5-1058:6, and 1066:11-1081:6; East's Prop. Order at 46-55 (R. pp.).

[46] For Transaction 1 and 3, the ALC merely found that the 2015 TP Study did not use the best transfer pricing methods, yet it does not identify better methods. Order at 34 (Transaction 1) and 37 (Transaction 3). Even if the best method was not used, the result can still be correct and reliable as numerous reliable methods can exist for a transaction. The ALC found Transaction 5 was unreliable solely based on the absence of evidence (internal data and underlying calculations) that was used when determining the price. *See, e.g.*, Order at 43. The ALC's inability to review such data or calculations does not indicate or prove the price is incorrect or unreliable, and the absence of evidence should not be used against the party that does not bear the burden of proof.

[47] The ALC suggests the Department made a prima facie case that it proved Step One such that the burden then shifted to East to rebut the Department's evidence. Order at 62, n. 69 (R. pp.). But the evidence proving Step One is non-existent—there is nothing for East to rebut.

that the 2004 Study was wrong, the Department must be required to prove these arguments. If these fundamental principles are not required, the burden of proof is meaningless.

III. THE ALC ERRED IN FINDING STEP TWO OF THE AA STATUTE MET.

For Step Two, the Department must first prove it satisfied the AA Statute's requirement that the alternative method be "reasonable" and "equitable." §12-6-2320(A). The Department failed to present sufficient evidence to meet this burden. *See generally* Order at 63-68 (R. pp.-pp.). And here, CUR is not reasonable or equitable.

A. The Department did Not Present Substantial Evidence that CUR Meets the Twentieth Century-Fox Test or is Otherwise Reasonable and Equitable.

The AA Statute does not define the "reasonable" or "equitable" requirements that an alternative method must meet. However, the Department interprets the statutory mandate regarding "reasonable" as being satisfied only when the alternative method passes the first and third components of the test set forth in *Twentieth Century-Fox Film Corp. v. Dep't of Rev.,* 700 P.2d 1035 (Or. 1985); Joint Ex. 28, Rev. Rul. 15-5 at 4-5 (R. pp.- pp.); Dep. of Dep't at 29:6-31:11. The first and third components of that test (collectively, the "Reasonableness Test") require:

> (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 (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in [South Carolina]."

Id. The Department agrees the use of CUR here is not reasonable if it fails to satisfy either component. Dep. of Dep't at 29:6-31:11. The ALC also agrees CUR must pass the Reasonableness Test. Order at 64 (R. pp.).

However, the Department did not present sufficient evidence to support the ALC's conclusion that the Reasonableness Test was met. *Id.* at 65. The ALC merely (1) describes how CUR calculates tax (by combining the FTI of East and West, which is then apportioned using a

combined sales factor); and (2) describes how the Department did not follow Revenue Ruling 15-5 (requiring intrastate apportionment) and instead gave East credit for tax West already paid. *Id.*[48] Neither shows the Reasonableness Test is met, and the ALC is rubber-stamping CUR as passing the test whenever used against a unitary business. *Id.* The AA Statute clearly requires more.

B. The ALC Failed to Correctly Apply the Burden of Proof for Step Two.

The Department must prove CUR *is* reasonable and *is* equitable. Here, the Department and ALC claim to apply the Reasonableness Test to decide whether CUR passes the "reasonable" requirement in the AA Statute, but no evidence shows how CUR satisfied that test. *Supra* § III(A). To satisfy the "reasonable" requirement in the AA Statute, the Department must *at least* be required to show that CUR passes the Reasonableness Test. Anything less would render the burden of proof for Step Two meaningless.

The ALC misapplied the burden of proof on Step Two by prematurely focusing its attention on responding to East's arguments showing that CUR is *not* reasonable or equitable. Order at 66-68. But East does not bear the burden of proving that. Ample evidence shows the many reasons that CUR is not reasonable or equitable (*infra* §III(C)), but until the Department presents sufficient evidence to show that CUR *is* reasonable and equitable, the ALC should not be looking at East to prove otherwise. No evidence shows CUR *is* reasonable or equitable (*supra* §III(A)), thus, the ALC misapplied the burden of proof by prematurely requiring East to show CUR is not

[48] Beyond that, the ALC makes blanket, unproven statements such as CUR "corrects the shift" of East's FTI to West (which is not accurate (*infra* § III(C)(2))). The ALC also references a comparison of East's South Carolina sales of $90 million to East's "taxable business activity," which is neither accurate nor supporting evidence for Step Two (or Step One). Order at 65. In FY2018 alone, East had well over $400 million of South Carolina sales. *See, e.g.,* Joint Ex. 18, at CarMax_001064 (Schedule H-1, showing $470,911,270 as the numerator of East's sales factor). If the ALC intended to say $90 million of operating profit, that is also incorrect. *Supra* § II(B)(4).

reasonable or equitable.

C. The Evidence Shows that CUR is not Reasonable or Equitable.

Here, CUR fails both components of the Reasonableness Test and is otherwise not reasonable or equitable because it overtaxes East based on its business activity in South Carolina and for other reasons discussed below.

1. <u>CUR does Not Pass the Reasonableness Test.</u>

CUR fails both components of the Reasonableness Test. The initial part of the first component requires the alternative method (which is "dividing" business income)[49] to fairly represent East's South Carolina business activity.[50] No aspect of CUR is based on East, much less based on East's South Carolina business activity. The business income being apportioned (or "divided") to South Carolina is the Group's income (and mostly West's income), and the sales factor used to apportion (or divide) that income is also based on the Group. As one would expect, the result of that process is not going to fairly represent East's South Carolina business activity. CUR is not even trying to reach that result. Thus, CUR fails the initial part of the first component.

The use of CUR likewise fails the latter part of the first component, which requires that the alternative method "if applied uniformly [i.e., by all states] would result in taxation of no more or no less than 100% of the taxpayer's income." During the Audit Period, ~3.49% of East's business

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[49] Regarding the "division of income" in the Reasonableness Test, allocation and apportionment is often described as dividing a multi-state taxpayer's income among states. *See, e.g.*, *Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888, 895 (Ind. T.C. 2015) (concluding "the concepts of allocation and apportionment . . . solely involve dividing the tax base among the states, not computing the tax base."). In South Carolina, a taxpayer's FTI (as modified by Article 9) is "divided" by the Article 17 provisions to determine the portion taxed here.

[50] This is exactly what the AA Statute envisions. *See* §12-6-2320(A) (saying if East's sales factor "do[es] *not fairly represent* the extent of the taxpayer's *business activity in this State*, . . . the department may require, *in respect to all or any part of the taxpayer's business activity*, if reasonable" an alternative method (emphasis added)).

activity took place in South Carolina, yet CUR results in ~10.86% of East's total apportionable income being taxed by this state. *See* s*upra* Facts § G and J. If all states uniformly applied CUR against East as the Department did here, East would be taxed on more than 300% of its apportionable income. Thus, CUR does not pass the latter part of the first component.

Finally, CUR also fails the third component. The "economic reality of the business activity engaged in by [East] in [South Carolina]" is already reflected by East's sales factor. The entirety of CUR is based on the Group—not on East—and CUR does not coincidentally happen to reflect the economic reality of anything for East, including its business activity in this state.

The Reasonableness Test is consistent with the AA Statute; the Department agrees CUR is inappropriate if CUR does not pass it; and the ALC agrees. *Supra* § III(A). Failing either component means the Reasonable Test is not met, and CUR fails both components here. The Reasonableness Test is working exactly as intended—only ~3.49% of East's total business activity occurred in this state, East's business activity here is the same as its business activity in every state where it conducts business, and there is no plausible reason why ~10.86% of East's total business income should be taxed by South Carolina.

2. <u>CUR Grossly Over-Taxes East Compared to its South Carolina Business Activity.</u>

The evidence demonstrates that the amount of tax East may pay under CUR is not justified compared to its business activity in this state. The ALC's reasons Step One was met do not support the tax East must pay under CUR; the result of CUR cannot be achieved using appropriate transfer prices; and to the extent any income was shifted (despite no evidence that any was), CUR is not "correcting" it but is instead egregiously over-stating it.

a. The ALC's reasons Step One was met do not justify CUR.

The ALC found Step One met because FTI was "shifted" from East to West via East's management fees to CBS coupled with 93.5% of CBS's net income earned from those fees being in West's FTI. Order at 59-63 (R. pp.- pp.). East's management fee payments during the Audit Period only generated ~$730 million that was included in West's FTI. *Supra* Facts § D(4) and H(2). Adding all ~$730 million to East's FTI during the Audit Period would result in East owing only ~$1.27 million of additional tax to South Carolina. *Supra* Facts § H(2). However, CUR results in East owing additional tax of $2,224,389.

b. The result of CUR cannot be achieved using arm's length prices.

East's FTI needs to be increased by ~$1.3 billion during the Audit Period to reach the tax owed by CUR. *Supra* Facts § H(1). That result cannot be achieved using appropriate transfer prices. Reducing the management fee price to an amount that covers the underlying costs (and thus eliminates CBS's management fee profits), which is prohibited by the § 482 Regulations as an impermissibly low price,[51] would increase East's FTI by only ~$713 million. *Supra* Facts § H(2). Thus, even using a forbidden transfer price for the management fees still leaves East needing almost $600 million more FTI to reach $1.3 billion, and CBS would only have ~$1.05 billion of net income (from CAF) left. The Department's expert tried to create a new intercompany transaction by arguing that enormous loan origination fee payments to East (and West) were warranted in an effort to move more FTI to East, but the ALC appropriately rejected that argument. *Supra* § II(B)(1). And no argument would allow East to acquire 60% or more ownership of CBS

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[51] The ALC recognized, correctly, that the § 482 Regulations prohibit a price that only covers the underlying costs. Order at 35, n. 50 (R. pp.) (discussing service cost method (SCM)).

to move another $600 million.[52] Abusive transfer prices are required to move the ~$1.3 billion of FTI to East that is needed to reach the result of CUR.

c. CUR is a gross over-"correction" of unproven allegations.

The ALC states that CUR is reasonable and equitable here because it "corrects the shift in income that distorts CarMax East's federal taxable income[.]" Order at 65. However, the Department did not prove that any FTI was improperly "shifted" from East to West. *Supra* § II(B)(1). It is unclear what "income shifting" the ALC believes is corrected by CUR, but if any income is shifted (despite no evidence of it), the facts plainly show that CUR is not correcting it but is grossly over-stating it.

3. East is Being Taxed on West's Business Income After West's South Carolina Business Activity was Evidence of Step One.

The ALC found (incorrectly) that West's South Carolina business activity proved Step One, so that CUR could be used in Step Two to impose tax on West's business income—but the tax bill is against East. *Supra* § II(B)(3). The problem here is not merely that the Department targeted West in *CarMax* and now has chosen to target East (Order at 66-67)—the Department is again targeting West but calling it East. West's South Carolina business activity was the proof of Step One so that CUR could reach West's business income by combining the FTI of East and West and making East pay the tax. Under CUR, nearly 79% of the income apportioned to and taxed by this state is West's income. *Supra* Facts § J. This renders CUR neither reasonable nor equitable.

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[52] It is a moot point since the Department did not prove the 2004 Study was wrong (and there is no actionable claim even had it done so), but to conclude the 2004 Study was so off base such that East should have received ~60% is unrealistic. East only contributed ~$120M to CBS. Order at 16-17. That means the assets West contributed to CBS would have needed to be only about ~$80 million, not $2 billion as found by the 2004 Study.

4. Approving CUR Here Thwarts the Legislature's Intent and Harms the Business Community that Relies on the Tax Laws Being Fairly Enforced.

The ALC erred in upholding the Department's misuse of the AA Statute in a way that is contrary to the Legislature's intentions and harms the business community. East received one of fifty-three proposed assessments requiring CUR that the Department issued in less than a four-year period. *Supra* Facts § K. The ALC describes the reasons the Department required CUR here: (1) East shifted FTI to West via a partnership with CBS; (2) *existence* of a management fee; (3) *existence* of an east-west business structure; (4) description of the Group's east-west structure; (5) incorrect statement that East reduced its FTI by $1.6 billion while West increased its FTI by $1.4 billion; and (6) use of a "distortion ratio" created by Sharpe. Order at 14-15. After East was forced through litigation, those are the only clear reasons the ALC ruled in the Department's favor. And the Supreme Court nearly a decade ago *already found* that same evidence, for the same business structure, failed to prove Step One as a matter of law. *CarMax*, 411 S.C. at 90–91, 767 S.E.2d at 201. CUR was required based on nothing, and years later, the ALC upheld it, still based on nothing.

That is not what the Legislature intends. The Legislature has attempted to create a fair and business-friendly tax environment to further the state's economic development goals; to that end, it has chosen separate reporting as the required filing method (versus CUR) and the sales factor as the required apportionment method.[53] The AA Statute is a part of this overall statutory scheme and is intended to apply where the Article 17 provisions do not fulfill their purpose, which is not to

[53] *See generally* Tr. 869:8-871:1; 891:1-13; 897:3-18; 886:14-890:3; 911:11-914:5 (Pomp explaining that: states view separate reporting as part of their economic development arsenal to attract/retain businesses like Volvo, BMW, Boeing and Mercedes; combining separate reporting with the sales factor is an attractive tax climate; the South Carolina Department of Commerce touts these attributes on its website; and good tax policy dictates that the AA Statute not be interpreted so broadly that it swallows up the standard method but instead should be used judiciously such that the default method is predominantly used and taxpayers' reliance interests are protected).

determine FTI or fix an incorrect amount of FTI—other remedies exist for that.[54] *See Supra* III(C)(2)(c). The Department's actions, which the ALC erroneously approved, thwart the Legislature's intent and negatively impact corporate taxpayers who rely on the tax laws being fairly enforced.

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

CUR is not lawful based on the facts of this case.[55] Here, the ALC erred in concluding the AA Statute grants the Department authority to require CUR. Order at 50-56. The plain language of subsection (A)(4) only allows methods that (among other requirements) "effectuate[s] an equitable . . . apportionment of *the taxpayer's income*." § 12-6-2320(A)(4) (emphasis added). The meaning of "the taxpayer's income" in (A)(4) is East's FTI as modified by Article 9. *Supra* p. 18-19; § 12-6-30(1). When the Article 17 provisions do not work as intended, the AA Statute allows alternative methods of apportioning that income. CUR does not apportion "the taxpayer's income" as required by (A)(4) because it first combines the FTI of East and West[56] and then apportions it. *See supra* Facts § J.[57] To interpret the AA Statute as authorizing the Department to make changes outside the context of allocation and apportionment such as recomputing "the taxpayer's income"

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[54] If there is an issue with something such as the management fee price, the Department can adjust it, and the AA Statute is not the appropriate remedy. *See* Tr. 924:8-925:22 (testimony of tax policy expert Professor Richard Pomp ("Pomp") explaining that problems with transfer prices are not questions of apportionment or alternative apportionment, and auditors can adjust a transfer price just as they would for any improper deduction such as travel or entertainment).

[55] The ALC misunderstand East's argument. Order at 50-51. East is not arguing that no fact pattern exists that would allow the Department to require CUR but is only arguing that CUR is not authorized by the AA Statute under the facts of this case.

[56] But for an oversight, the Department also would have added the FTI of another related party that is not a South Carolina taxpayer and has no nexus here. *See* East Prop. Order at 76, n.118.

[57] Had the legislature intended for "apportionment of the taxpayer's income" to mean "apportionment of an affiliated group of entities' income," it would have expanded the meaning of "taxpayer" like it did in subsection (B). § 12-6-2320(B)(1)-(2).

by substantially increasing it prior to apportioning it would be contrary to the legislative intent of the Income Tax Act and Article 17.[58]

The ALC should have applied the rules of statutory construction to determine whether CUR is authorized under the facts of this case, but it did not. Order at 52-53, n. 61. The ALC is incorrect when it suggests the Court in *Media General Commc'ns, Inc. v. S.C. Dep't of Rev.*, 388 S.C. 138, 694 S.E.2d 525 (2010) already decided this issue. *Id.* In *Media General*, the method approved by the Court was not even CUR.[59] But even if *Media General* did approve the use of CUR in that case, the ALC erred by interpreting that to mean the issue of whether CUR is allowed in this case has already been decided. There are materially different facts and arguments in this case that were not present in *Media General*. *See* East Prop. Order at 78-79. (R. pp.).

In addition, the standard the ALC applied for Step One is a forced construction of the AA Statute that expands its reach far beyond the legislative intent and leads to absurd results. By disregarding the statutory text in Step One and finding it met because of FTI being allegedly too low, the ALC also had to disregard the statutory text of (A)(4) in Step Two that plainly restricts

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[58] As aptly described by the Indiana Tax Court discussing a similar statutory scheme and alternative apportionment statute, interpreting (A)(4) as allowing the Department to make changes outside the context of allocation and apportionment, such as recomputing the income to be apportioned as CUR does here "would be like trying to pound a square peg into a round hole." *Columbia Sportswear USA Corp.*, 45 N.E.3d at 895-896.

[59] In *Media General*, the Court allowed members of a unitary business (which had requested an alternative method) to combine themselves for the purpose of determining the ratio that each entity would then use to apportion its own income to South Carolina. *Id.* at 147, 694 S.E.2d at 529 (describing method it approved as one where "[t]he taxpayer (individual entity) then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income."). That method did not violate the plain language of § 12-6-2320(A)(4) restricting the Department to methods that apportion "the taxpayer's income" like the use of CUR plainly does here. Also, each member of the unitary business was either filing South Carolina returns or had received a tax assessment from the Department. *See Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev.,* Docket No. 07-ALJ-17-0089-CC and *Media Gen., Inc. v. S.C. Dep't of Rev.,* Docket No. 07-ALJ-17-0090-CC (S.C. Admin. Ct. May 4, 2009) at 2, 8 at ¶22, 9 at ¶ 26, 10 at ¶¶ 29-30, and 11 at ¶ 34.

the Department to a method that, unlike CUR, apportions "the taxpayer's income." Step One and Step Two work seamlessly when the AA Statute is applied correctly; when Step One applies the wrong standard as the ALC did here, the harmony disappears.

East submits that the statutory language is clear and that CUR is not authorized based on the facts of this case. If the Court disagrees, the AA Statute is at least ambiguous on this issue, and East's interpretation is reasonable; thus, the AA Statute must be construed in East's favor. *Alltel*, 399 S.C. at 321, 731 S.E.2d at 873. It is certainly not "absolutely clear" the AA Statute allows the Department to require use of CUR under these facts. *Id.*

6. <u>The Department has Not Proven Step One or Step Two Against West.</u>

CUR is a single tax return that encompasses multiple entities, thus, requiring that East use CUR is the same as requiring its use by West. The AA Statute must be interpreted as requiring the Department prove (1) Step One for both East and West, and (2) Step Two for both East and West, to require CUR here. Any other rule allows the Department to select one of multiple South Carolina taxpayers in a unitary group so it can use CUR to pursue the income of other taxpayers in the group notwithstanding those taxpayers' South Carolina business activity being fairly represented here.[60]

Moreover, West is not a party in this case, CUR directly impacts its rights, and West has never consented to its use. West filed its returns and paid its tax due for the Audit Period and later years. Requiring the use of CUR, which includes non-party West, without first proving Step One and Step Two against West is unreasonable, not equitable, and a violation of West's due process rights. *See infra* § V(A) (regarding law on due process rights).

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[60] The Department interprets the AA Statute as allowing it to choose one of multiple South Carolina taxpayers in a unitary group, prove Step One for that chosen taxpayer, and then require the use of CUR for all other taxpayers even if the standard method fairly represents the South Carolina business activity of the other taxpayers. *See* Dep. of Dep't at 96:20-97:16 and 86:19-93:6.

IV. THE ALC ERRED IN ALLOWING AND RELYING UPON THE DEPARTMENT'S EXPERT TO PROVIDE TESTIMONY ON THE ACCURACY OF THE 2004 STUDY.

The ALC should have granted East's motion in limine to exclude expert testimony challenging the 2004 Study. *See* East's Mot. in Limine (as to pre-trial motion); Tr. 182:18-188:17 (as to renewed motion at trial); and *see e.g.*, *id.* at 495:25-498:20; 499:25-501:1; 512:14-513:6; 531:9-13 (as to objections at trial). The ALC erred in allowing this testimony because: (1) East had no notice the Study would be challenged and was prejudiced by the testimony; (2) the testimony was not reliable; (3) the testimony was not relevant; and (4) East did not "open the door" to the 2004 Study being challenged by allowing it into evidence.

A. East did Not Have Any Notice or Reason to Anticipate Any Testimony, Including Expert Testimony, Challenging the 2004 Study.

The 2004 Study solely determined the Car-Related IP that West contributed to CBS had a FMV of ~$2 billion. *Supra* Facts at § L. There are many ways the Department could have provided East notice that it or its expert intended to challenge the conclusion of that study, but the Department failed to provide any such notice. And the Department's expert disclosure does not give notice DeRamus would challenge the accuracy of the 2004 Study. *See* Dept.'s Discl. (R. pp.); *see also* Mot. in Limine at 5-7 and n. 7 (R. pp.); *see also* Order at 2 (R. pp.). The Department also never asserted any legal claim that challenges the 2004 Study.[61] Nothing in the audit report, Determination, Pre-Hearing Statement, or elsewhere alleges or otherwise argues the 2004 Study is incorrect.[62] The Department (like East) also did not conduct any discovery focused on the accuracy

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[61] The only apparent reason to challenge the 2004 Study would be to increase East's CBS ownership, which requires decreasing West's ownership. However, doing so when West is not a party to this case would violate West's due process rights. *See supra* § V(A).

[62] East is not suggesting an unreasonably strict standard should apply for the Department to have provided adequate notice. Anything that gives East reason to know the accuracy of the 2004 Study

of the 2004 Study. *See* East Prop. Order at 30 (R. pp.). And it is still unclear what a successful challenge to the 2004 Study would have even accomplished in this case. *Infra* § IV(C). East had no reason to expect this undisclosed expert testimony that relates to no claim asserted in the case.

The Department's failure to provide notice that it or its expert would challenge the 2004 Valuation violated East's due process rights. *Olson v. S.C. Dep't of Health & Env't Control*, 379 S.C. 57, 69, 663 S.E.2d 497, 503 (Ct. App. 2008) ("Due process requires (1) adequate notice; (2) adequate opportunity for a hearing; (3) the right to introduce evidence; and (4) the right to confront and cross-examine witnesses."); *id*. at 69, 663 S.E.2d at 504 ("The fundamental requirement of due process is the opportunity to be heard at a meaningful time and in a meaningful manner."); *Bryan v. Bryan*, 282 S.C. 506, 508, 319 S.E.2d 360, 360 (Ct. App. 1984) ("Due process requires that litigants be placed on notice of the issues which a court is to consider."). East had no notice of the issue and so was unable to properly cross-examine DeRamus in his deposition. His deposition testimony was unhelpful in preparing for his trial testimony because at the deposition he thought the 2004 Study only valued the 2004 IP. *Supra* Facts § L. East also could not name its own expert on this issue, conduct discovery thereon, and otherwise prepare a defense. Mot. in Limine at 4-7 (R. pp.- pp.). The ALC declined to allow East more time such that the prejudice could be alleviated. Order at 3 (R. pp.- pp.). Because the Department never provided notice of a challenge to the 2004 Study, the ALC should have excluded the testimony and not relied thereon.

B. DeRamus's Testimony on the 2004 Study was Not Reliable.

The ALC should also have excluded DeRamus's testimony because it was unreliable. *See*

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may be challenged would suffice (e.g., the 2004 Study is wrong or inaccurate; the 2004 Study overvalued West's assets; the assets West contributed to CBS were not worth $2 billion; an expert disclosure that mentions the 2004 Study or West's contribution to CBS or the formation of CBS as a subject of expected testimony, etc.).

Graves v. CAS Med. Sys., Inc., 401 S.C. 63, 74, 735 S.E.2d 650, 655 (2012) (citation omitted). No evidence indicates what specific assets the 2004 Study valued—just the vague category of Car-Related IP, which is the combined vague categories of the 2004 IP and 2004 BPI. *Supra* Facts § L. Thus, even after learning (after his deposition) that the Car-Related IP included the 2004 BPI, DeRamus still did not know at trial what assets the 2004 Study valued. Tr. 701:2-10. The 2004 Study references an enormous amount of information used ~20 years ago to reach its conclusion. *See* Ex. 55, 2004 Study (R. pp.). But the record contains little evidence on this subject, and DeRamus thus had no knowledge about the entire factual underpinnings of the 2004 Study. Thus, the Court should have excluded his testimony on the 2004 Valuation as unreliable. *Graves*, 401 S.C. at 74, 735 S.E.2d at 655.

C. DeRamus's Testimony on the 2004 Study was Not Relevant.

DeRamus's testimony also should have been excluded because it was not relevant. Rule 402, SCRE (only relevant evidence admissible). Relevant evidence is "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Rule 401, SCRE. The accuracy of the 2004 Study is not relevant to anything in this case. The Department did not prove the 2004 Study was wrong (Order at 24 (R. pp.)), but if it had—to what end? The Department asserted no legal claim that could empower the ALC to take CBS ownership from West, a non-party, and give it to East. Because the accuracy of the 2004 Valuation Study had no bearing on the issues before the ALC,[63] DeRamus's testimony challenging it should have been deemed

[63] The ALC criticizes East for continuing to argue this (Order at 62 (R. pp.)), but the ALC does not ever explain how the accuracy of the 2004 Study is relevant. It is not even clear that the ALC believes the accuracy of the 2004 Study is relevant. *See, e.g., id.* at 17.

inadmissible. Rules 401-402, SCRE.[64]

D. Agreeing for the 2004 Study to be a Joint Exhibit does Not "Open the Door."

Despite correctly acknowledging that the Department never challenged the 2004 Study in any pleading or gave notice that DeRamus would challenge it, the ALC allowed DeRamus to provide the undisclosed expert testimony challenging the accuracy of the conclusion reached by the 2004 Study because it believed East "opened the door" by allowing the 2004 Study into evidence. *See* Order at 2-3 (R. pp.). The ALC erred in finding this "opened the door." If this were the case, expert disclosures would not be needed so long as an issue on which an expert wished to speak was related to a document that was agreed to be admissible.

V. THE ALC ERRED IN SUA SPONTE FINDING THAT EAST SHOULD GET CREDIT FOR WEST'S CONTRIBUTION OF ASSETS TO CBS.

The ALC did not find the 2004 Study was wrong, but then sua sponte found (1) the 2004 BPI represented the majority of the ~$2 billion value of the Car-Related IP; and (2) East should have received credit for West's contribution of the 2004 BPI to CBS and "a commensurate portion of the CBS partnership" for that contribution. *Id.* at 25.[65] The ALC made similar findings in its Remand Order, where it served as the key evidence for finding the Department proved Step One. *See, e.g.*, Remand Order at 24-25 and 61-62.[66] The ALC largely removed those findings when it issued the Order, yet still erroneously concludes East *deserved* credit and thus *should have received* credit for West's contribution of the 2004 BPI to CBS. Order at 25-26. The Order does not clearly

[64] Even if DeRamus's testimony was tangentially or potentially relevant to something, it should nonetheless have been excluded under Rule 403 because its probative value was substantially outweighed by the danger of unfair prejudice and confusion of the issues. Rule 403, SCRE.
[65] The ALC also says West's contribution of the 2004 BPI to CBS "facilitated a huge shift in income from CarMax East to CarMax West that appears to be a scheme to minimize CarMax East's taxable income." Order at 26.
[66] East addressed these erroneous findings. *See* Mot. to Recon. at 17-21 (R. pp.-pp.).

include these findings as supporting evidence of Step One like the similar rulings were used in the Remand Order, yet the ALC still found Step One met without substituting any material new supporting evidence in place of the removed support that was in the Remand Order. East was prejudiced by these findings because they appear to have still influenced the ALC's ruling the Department proved Step One and Step Two as no other evidence justified finding Step One met, and CUR effectively gave East the credit for West's contribution the ALC believed East deserved. Order at 25-26.

A. The ALC's Sua Sponte Decision East Should Get Credit for West's Contribution of Assets to CBS is Improper and Violates East's and West's Due Process Rights.

The Department has never asserted or even argued that East should get credit for West's contribution of any assets to CBS.[67] And this finding directly impacts West, who is not a party here. The ALC should not sua sponte rule on issues not raised by the parties as this violates their due process rights. *Bryan*, 282 S.C. at 508, 319 S.E.2d at 360 ("Due process requires that litigants be placed on notice of the issues which a court is to consider."); *Olson*, 379 S.C. 57, 69, 663 S.E.2d 497, 503 (Due process requires adequate notice and opportunity for a hearing, the right to introduce evidence, and the right to confront and cross-examine witnesses); *id.* at 69, 663 S.E.2d at 504 ("The fundamental requirement of due process is the opportunity to be heard at a meaningful time and in a meaningful manner."); *United Transp. Union v. State Bar of Mich.*, 401 U.S. 576, 581 (1971).[68] Making findings and ordering relief on grounds the Department never asserted also

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[67] The ALC's statement that "[t]he parties dispute whether CarMax West or CarMax East should have been credited with [West's] contribution [to CBS]" is not correct. Order at 1, n. 3 (R. pp.). This was never an issue in the case.

[68] In addition, the ALC's basis for its finding that East should get credit for West's contribution of the 2004 BPI to CBS is centered on the transfer of the 2004 BPI from East to West. Order at 25-26 (R. pp.). Prior to DeRamus's testimony at trial, neither the Department nor any of its witnesses

violates East and West's due process rights under the Due Process Clause in Article I, § 3 of the South Carolina Constitution and the Due Process Clause of the United States Constitution because, *inter alia*, they had no notice the ALC would rule on this issue and thus no meaningful opportunity to prepare for or defend against this claim raised by the ALC for the first time in its Remand Order.

B. The ALC Made Incorrect Findings to Support the Issue it Sua Sponte Raised.

The ALC made numerous erroneous statements to the effect that the 2004 BPI represented the majority of the ~$2 billion value of the Car-Related IP. *See, e.g.*, Order at 7 (R. pp.) (saying West owns 93.5% "primarily due to its contribution of [the 2004 BPI]"); *id.*, 23 n. 38 (saying "the [2004] IP represents a small fraction of the $1.996 billion" and that most of that value is from the 2004 BPI); *see also id*. at 25. East also disputes these findings because no evidence supports them.[69] In addition, these findings violate East's and West's due process rights as neither had any meaningful opportunity to prepare for or defend against these unsupported findings, which then served as support for the erroneous and improper finding that East should get credit for the 2004 BPI that West contributed to CBS. *Supra* §V(A) (as to due process law).

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had indicated knowledge of the fact that East transferred the 2004 BPI to West, so the Department clearly had not alleged or argued East should get credit for West's contribution of the 2004 BPI because of the transfer from East to West. East is not suggesting (and does not know whether) the Department was unaware of the fact that East transferred the 2004 BPI to West. East only knows that the Department said nothing indicating knowledge of it. The Department, like East, may have deemed it an irrelevant and unimportant fact.

[69] The 2004 Study did not determine the value of the 2004 BPI versus the value of 2004 IP. *See* Facts § L; Joint Ex. 55, 2004 Study (R. pp.); Order at 23, n. 38. (R. pp.). No evidence indicates what assets make up the 2004 BPI, much less shows the value of the 2004 BPI and how it compares to the value of the 2004 IP. The ALC unjustifiably assumes that because Transaction 5 in the 2015 TP Study is based on some business process intangibles that existed during the Audit Period, that means the unknown 2004 BPI was more valuable than the 2004 IP. Order at 25; *id*. at 23, n. 38 (R. pp.). Despite being unknown, the 2004 BPI is undoubtedly extinct, while trademarks and tradenames generate value for as long as CarMax exists.

C. The ALC's Sua Sponte Ruling East Should Get Credit for West's Contribution is an Unsupported and Incorrect Legal Conclusion.

The ALC's sua sponte ruling that East should get credit for West's contribution of the 2004 BPI to CBS is a legal conclusion, yet it is supported by no law and is unrelated to any claim in the case. It also is unsupported by (and, in fact, contrary to) the evidence, which shows that West, not East, contributed the 2004 BPI to CBS. The ALC appears to support its ruling based on the ALC's finding that East's transfer of the 2004 BPI to West was for "zero compensation" and thus violates the ALS. Order at 25 (R. pp.). However, this finding is wrong and contains numerous errors. This transfer would not violate the ALS—East owned 100% of West, and therefore, East's contribution of the 2004 BPI to its wholly owned subsidiary West is an exchange of equal value in the form of increased value of shares. Tr. 1109:21-1110:18 (testimony of expert Cody).[70] Also, a violation of the ALS allows a taxing agency to use its § 482 powers to make a price adjustment; it does not allow what the ALC suggests. The ALC is disregarding transactions that took place and making rulings that West is not the rightful owner of its 93.5% ownership of CBS. Order at 25-26. (R, pp.). No legal basis or claim in this case allows that result.

CONCLUSION

Based on the foregoing, the ALC's decision should be reversed and the proposed assessment against East dismissed.

[70] The ALC's logic that the contribution of BPI to West violates the ALS is at odds with ubiquitously used provisions like I.R.C. § 351 ("§351"), which South Carolina follows, which not only allows but encourages this transfer of BPI from a parent (here, East) to its subsidiary (here, West) by treating it as a tax-free nonrecognition event. In fact, East confirmed before implementing the 2004 Restructuring that both (1) the contribution of BPI to West would qualify under § 351, and (2) South Carolina had adopted § 351. *See* Joint Ex. 54 at CarMax_001827-001828 (confirming § 351 treatment) and CarMax_001832 (confirming South Carolina follows § 351).

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