THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

APPEAL FROM THE S.C. ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-001558
Administrative Law Court Case No. 21-ALJ-17-0182-CC

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

v.

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

SOUTH CAROLINA DEPARTMENT OF REVENUE'S FINAL BRIEF

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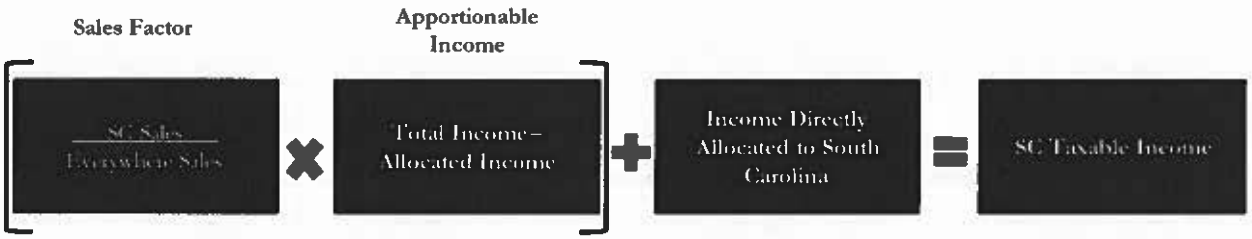
INTRODUCTION

This case is about whether the Department of Revenue (Department) rightly exercised its statutory authority to require CarMax Auto Superstores, Inc. (CarMax East) to use an alternative apportionment method because the standard apportionment method does not fairly reflect CarMax East's business activity in South Carolina. The South Carolina Administrative Law Court's (ALC) amended final order, which affirmed the Department's audit, properly applied relevant statutes and precedent and is supported by substantial record evidence. This Court should affirm.

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



Although apportionment seeks to be as exact as possible, "all that is required is a reasonable approximation." *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66, 212 S.E.2d 574, 577 (1975). In South Carolina, the default apportionment method is separate entity reporting. Often, the default method achieves that reasonable approximation. But a one-size-fits-all approach rarely works every

time, and the Legislature recognized the Department should have the flexibility to require an alternative method that effectuates an equitable approximation when the default method fails to do so. Section 12-6-2320(A)(4) gives the Department that discretion. *Media General*, 388 S.C. at 151, 694 S.E.2d at 531.[1] Combined unitary reporting is an accepted and judicially approved alternative apportionment method, particularly when the taxpayer operates within a unitary business group.[2] *Id.*

CarMax East is a retailer, so the default apportionment method it uses is separate entity reporting using a sales factor of CarMax East's retail sales in South Carolina divided by its retail sales everywhere. CarMax East directly operates retail stores in primarily eastern states, including South Carolina, and indirectly operates retail stores in primarily western states, through CarMax Auto Superstores West Coast, Inc. (CarMax West), which CarMax East owns 100%.

In 2004, CarMax created a partnership entity CarMax Business Services, LLC (CBS), into which CarMax East and CarMax West moved assets and in return received ownership interests of 6.5% and 93.5%, respectively. The ownership interests did not account for the valuable business process intangibles and financing function that CarMax East contributed to CBS. The ownership interests also did not account for the fact that CarMax East assigned trademarks to CarMax West for no consideration immediately prior to CarMax West contributing the trademarks for almost a $2 billion value. CarMax East and CarMax West pay CBS management fees, and CBS distributes its

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

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

profits to CarMax East and CarMax West consistent with their ownership percentages. The purpose and effect of these intercompany transactions is to siphon profits from CarMax East's South Carolina retail stores to CarMax West, which has a significantly lower apportionment ratio because it operates primarily outside of South Carolina, thus making CarMax East look a lot less profitable (on paper) in South Carolina than it actually is. As a result, when CarMax East used the default apportionment method to file its corporate tax returns, the income reported did not reflect the true economic and business activity of CarMax East in South Carolina.[3] For example, during the three-year audit period, CarMax East owned 75% of the retail stores, generated about 75% of the CarMax Group's revenues, and contributed about 75% of the income CBS earned from the management fees. Nevertheless, CarMax East received only 6.5% of the profit from CBS and was only attributed with approximately 20% of the CarMax Group's taxable income. The rest of the revenues were shifted to CarMax West.

This income shifting had real world tax impacts. Despite CarMax East's South Carolina stores having a total operating profit of approximately $90 million during the Audit Period, its taxable income apportioned to South Carolina was only approximately $21 million. This reduction of nearly $70 million in apportioned income was the direct result of the CarMax Group's shifting of income from CarMax East to CBS, using the management fee, with the majority of CBS's income then flowing back to CarMax West under the partnership distributions.

Thus, the Department concluded that an alternative apportionment method—combined unitary reporting—appropriately disregarded CarMax East's artificial corporate form and properly captured the substance of its business activity in the state, including the many subtle and unquantifiable transfers of value taking place among the related companies within the single CarMax business enterprise. *See Media General*, 388 S.C. at 142, 694 S.E.2d at 527. Combined unitary reporting cured the

[3] The "objective economic realities of a transaction," rather than "the particular form the parties employed," will determine tax consequences. *Frank Lyon Co. v. United States*, 435 U.S. 561, 573.

distortion caused by CarMax East's intercompany transactions and fairly reflected its business activity in the state. This method of filing was not new for CarMax East—it files combined unitary returns in many other states.

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

STATEMENT OF THE ISSUES ON APPEAL

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

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

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

STATEMENT OF THE CASE

The Department audited CarMax for the corporate income tax periods ending March 1, 2015 through February 28, 2018 (Audit Period). In its final Determination dated May 14, 2021, the Department concluded: (1) CarMax's use of separate entity reporting in the standard apportionment formula does not fairly represent the extent of its business activity in South Carolina and (2) the Department's application of combined unitary reporting is a reasonable alternative apportionment method pursuant to section 12-6-2320(A)(4). *See* Department Determination (**R. pp. 3762–3774**). On June 8, 2021, CarMax requested a contested case hearing with the ALC challenging whether the

Department could meet its burden to establish "(1) that the standard formula fails to fairly represent the extent of the taxpayer's business activity in the state, or (2) that the proposed alternative method of combination is reasonable." *See* Req. for Contested Case Hr'g (**R. pp. 156–167**).

The ALC held a contested case hearing from May 23-26, 2023. On July 12, 2024, the ALC issued a final order finding that the Department had met its burden and ruling in its favor. *See* Initial Order (**R. pp. 3–72**). On July 22, 2024, CarMax filed a motion for reconsideration. *See* CarMax's Initial Motion to Reconsider (**R. pp. 518–551**). On July 29, 2024, the ALC rescinded its Initial Order. *See* Rescission Order (**R. p. 73**). On August 15, 2024, the ALC issued an order granting CarMax's motion for reconsideration and an amended final order still finding that the Department had met its burden and ruling in its favor. *See* Order Granting CarMax's Motion to Reconsider (**R. pp. 74–83**) and Amended Order (**R. pp. 84–152**). CarMax filed another motion for reconsideration on August 26, 2024. *See* CarMax's Second Motion to Reconsider (**R. pp. 566–590**). On September 13, 2024, CarMax filed a Notice of Appeal. On September 20, 2024, the ALC issued an order denying CarMax's second motion for reconsideration. *See* Order Denying CarMax's Second Motion to Reconsider (**R. pp. 153–154**). On October 2, 2024, CarMax filed a consent motion to recognize the inapplicability of the automatic stay to the ALC's Order on CarMax's Second Motion to Reconsider, which this Court granted on October 21, 2024.

STATEMENT OF FACTS

1. History and Structure of CarMax

CarMax, Inc. was formed in 1993 as a subsidiary of Circuit City and spun off in 2002. *See* Hr'g Tr. 738:22-24; 813:25-814:1 (**R. pp. 1343; 1418–1419**). CarMax, Inc. is organized under the laws of the state of Virginia and has its headquarters in Richmond, Virginia. *See* Joint Ex. 27 (**R. pp. 3762–3774**). CarMax, Inc. is the parent company of the affiliated group (the CarMax Group) and directly owned CarMax East and CarMax West. *See* Hr'g Tr. 813:8-15 (**R. p. 1418**). CarMax East primarily operates

retail stores in eastern states, and CarMax West primarily operates retail stores in western states.[4] *See* Hr'g Tr. 217:7-23 (**R. p. 822**).

In 2004, CarMax, Inc. retained the accounting firm Ernst & Young (E&Y) to assist it in the process of restructuring its business to "realize greater operational, legal, and tax advantages than were being realized under the current structure." *See* Joint Ex. 44 at 8 (**R. p. 3984**); *see also* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 167:12–168:16 (**R. pp. 4726–4727**). As the result of the restructure, CarMax, Inc. remained the parent company and directly owned CarMax East. However, CarMax East now owned 100% of CarMax West, which owned 100% of the newly created CarMax Auto Superstores California, LLC. Another important result of the restructure was the creation of CBS. *See* Hr'g Tr. 821:15-24; Joint Ex. 39 (**R. pp. 1426; 3909**). The restructure moved business process intangibles and other assets from CarMax East to CBS, and intellectual property from CarMax West to CBS. *See* Hr'g Tr. 824:2-7 (**R. p. 1429**). Originally, CarMax East was responsible for all the advertising for the CarMax Group, but immediately prior to the restructure, CarMax East assigned the trademark rights to CarMax West. *See* Hr'g Tr. 366:10-22 (**R. p. 971**). Prior to the restructuring, the financing business was owned by CarMax East. *See* Hr'g Tr. 518:21-519:8 (**R. pp. 1123–1124**). After the restructure, CBS—through wholly owned CarMax Auto Finance (CAF)—held the financing business. *See* Hr'g Tr. 226:18-22 and Joint Ex. 33 (**R. pp. 831; 3805**). Post restructure, CarMax East owned 93.5% of CBS, and CarMax West owned 6.5% of CBS. *See* Hr'g Tr. 823:1-5; Joint Ex. 39 (**R. pp. 1428; 3909**). After the 2004 restructure, the CarMax Group had the following structure and ownership interests:

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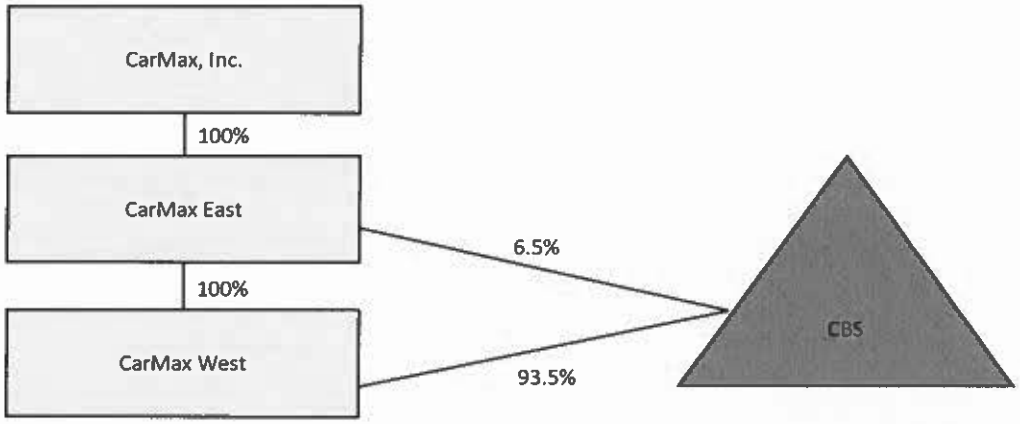
[4] CarMax West does not operate any stores in separate entity states. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 39:13-15 (**R. p. 4598**). Separate entity states are concentrated in the southeast—e.g. Louisiana, Alabama, Tennessee, Georgia, South Carolina, North Carolina, etc. *See* Hr'g Tr. 867:9–25 (**R. p. 1472**).



CarMax admits that a primary reason for its formation of CBS was to reduce state income taxes. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 150:21-151:4 (**R. p. 4709–4710**).

a. CarMax's Business

According to CarMax's 2018 Annual Report,[5] it "sells used vehicles, purchases used vehicles from customers and other sources, sells related products and services, and arranges financing options for customers." The CarMax Group makes its nationwide inventory of approximately 70,000 vehicles available on CarMax.com and its mobile app and will transfer virtually any used vehicle in its inventory to a local store. *See* Joint Ex. 6—2018 CarMax Annual Report and 10-K at 5 (**R. p. 2490**). During the Audit Period, the CarMax Group's total retail stores grew from 144 to 188 *See* Hr'g Tr. 749:2-7 (**R. p. 1354**); *see also* Joint Ex. 6—2018 CarMax Annual Report and 10-K at 5 (**R. p. 2490**). The CarMax Group operates retail stores in every state except for Vermont, West Virginia, and Arkansas. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 37:11-17 (**R. p. 4596**).

The CarMax Group's stores sell used consumer vehicles from zero to ten years old. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 46:11-47:14 (**R. pp. 4605–4606**). At the request of customers, CarMax transfers vehicles between its retail stores. *See* Hr'g Tr. 827:17-20; Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 164:20-165:2 (**R. pp. 1432; 4723–4724**). When CarMax transfers inventory

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

between stores, no cash changes hands between the stores. *See* Hr'g Tr. 828:4-6; Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 106:18-108:16 (**R. pp. 1433; 4665–4667**). CarMax East, CarMax West, and CBS commingle their cash. *See* Hr'g Tr. 828:7-10 (**R. p. 1433**).

b. CarMax East's Role in the Business Structure

CarMax East owned approximately 75% of the retail stores during the Audit Period. *See* Ex. 85—CarMax 30(b)(6) Depo Tr. 35:6-17 (**R. p. 4594**). CarMax East produced 75.5% of the income for the CarMax Group. *See* Hr'g Tr. 48:4-12 (**R. p. 653**). CarMax East operated three stores in South Carolina during all three years of the Audit Period and added a fourth store in the last quarter of the last year of the Audit Period. *See* Hr'g Tr. 749:20-750:2 (**R. pp. 1354–1355**). CarMax East sold, purchased, and reconditioned vehicles and offered financing and extended purchase plans through its retail stores in South Carolina. *See* Hr'g Tr. 748:10-22, 749:14-19 (**R. pp. 1353; 1354**).

c. CarMax West's Role in the Business Structure

CarMax West owned 47 retail stores at the end of the Audit Period. Hr'g Tr. 750:11-14 (**R. p. 1355**). CarMax West receives flow-through income from CBS. Hr'g Tr. 57:4-17 (**R. p. 662**).

d. CBS' Role in the Business Structure

CBS has no employees, but rather leases employees from CarMax Auto Superstores Services, Inc. (CASS), which it wholly owns. *See* Hr'g Tr. 320:3-9 and 746:15-21; Joint Ex. 33 (**R. pp. 925; 1351; 3805**). CBS creates strategies executed by the CarMax Group's retail stores. *See* Hr'g Tr. 744:17-745:2 (**R. pp. 1349–1350**). CBS owns trademarks and trade names that are used in South Carolina. *See* Hr'g Tr. 751:15-20 (**R. p. 1356**). CBS finances vehicles sold in South Carolina. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 101:1-104:15 (**R. pp. 4660-4663**).

e. Intercompany Transactions

CBS licenses trademarks and provides management services to the operating entities. *See* Hr'g Tr. 219:3-7 (**R. p. 824**). CarMax East pays approximately 74.5% of the management fees to CBS and receives 6.5% of CBS' income. *See* Hr'g Tr. 824:21-825:1 (**R. pp. 1429–1430**). CarMax West pays approximately 25.5% of the management fees to CBS and receives 93.5% of CBS' income. *See* Hr'g Tr. 825:2-7 (**R. p. 1430**). The management fee derives from five intercompany transactions. First, CBS licenses trademarks to members of the CarMax Group. *See* Hr'g Tr. 329:6-12; Joint Ex. 36—License Agreement (**R. pp. 934; 3846–3856**). Second, CBS provides back-office services like accounting for the CarMax Group. *See* Hr'g Tr. 338:22 (**R. p. 943**). Third, CBS provides advertising for the CarMax Group. Fourth, CBS provides real estate services for the CarMax Group. *See* Hr'g Tr. 335:9-19 (**R. p. 940**). Fifth, CBS provides analytical/business services for the CarMax Group. *See* Hr'g Tr. 335:21-24 (**R. p. 940**).

2. Transfer Pricing Studies

CarMax East relied on three studies, based on § 482 analyses, to support its claim that the CarMax Group's intercompany transactions were consistent with arms-length principles: the 2004 Valuation Study, 2012 Transfer Pricing Study, and 2014 Transfer Pricing Study. *See* Joint Ex. 55; Joint Ex. 7; and Joint Ex. 8 (**R. pp. 4227–4272; 2613–2852; 2853–2984**). By way of background, transfer pricing studies arose within the context of federal taxation of multinational taxpayers. In the case of taxpayers owned or controlled directly or indirectly by the same interests, 26 U.S.C. § 482 allows the

Internal Revenue Service (IRS) to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."[6] When the IRS makes an adjustment under § 482, a taxpayer may be subject to a net adjustment penalty under 26 U.S.C. § 6662(e)(1)(B)(ii) unless it satisfies certain documentation requirements (i.e. a reliable transfer pricing study in existence at the time of filing the return) under 26 C.F.R. § 1.6662-6(e). Therefore, the purpose of a transfer pricing study is penalty protection in the event of a substantial or gross valuation misstatement.

a. 2004 Valuation

Ernst and Young (E&Y) completed a valuation of car-related intellectual property on March 15, 2005 based on § 482 principles.[7] *See* Joint Ex. 55 (**R. pp. 4227–4272**). Critically, the valuation gave no consideration to the fact that just prior to the 2004 restructuring CarMax East had transferred its intellectual property to CarMax West for zero dollars ($0.00). When CarMax West contributed that same intellectual property to CBS, the study valued it at nearly $2 billion. *Id.* Additionally, the study failed to value the financing intangibles that CarMax East contributed to CBS. *See* Hr'g Tr. 233:16-234:14 (**R. pp. 838–839**). In other words, CarMax East received no remuneration for its role in developing and maintaining the CarMax intellectual property or contributing the financing functions to CBS. Yet, CarMax East paid CBS for providing the intellectual property and financing function during the Audit Period.

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

[7] Although dated March 15, 2005, this study is referred to as the 2004 Valuation Study.

b. Adoption of Transfer Prices During the Audit Period

E&Y conducted § 482 transfer pricing studies for CarMax on August 22, 2012 and April 21, 2016 that were used as a pricing basis for the intercompany transactions during the Audit Period. *See* 2012 Transfer Pricing Study-Joint Ex. 7 (**R. pp. 2613–2852**) and 2015 Transfer Pricing Study-Joint Ex. 8 (**R. pp. 2853–2984**). The studies recommended the following prices for five intercompany transactions:

August 22, 2012 Study Summary					
	Transaction 1	Transaction 2	Transaction 3	Transaction 4	Transaction 5
	Trademark Royalty: % of sales	Back Office Services: % markup on costs	Advertising Fee: % of sales	Real Estate Services: % markup on costs	Analytical/Business Services: $ per vehicle
25th Percentile	0.5%	3.9%	2.0%	5.1%	$396.50
Median	1.0%	7.9%	2.0%	10.3%	
75th Percentile	1.25%	16.0%	5.0%	10.9%	$475.80
Method	Comparable Uncontrolled Transaction Method (CUT)	Comparable Profit Method (CPM)	CUT	CPM	Unspecified

April 21, 2016 Study Summary					
	Transaction 1	Transaction 2	Transaction 3	Transaction 4	Transaction 5
	Trademark Royalty: % of sales	Back Office Services: % markup on costs	Advertising Fee: % of sales	Real Estate Services: % markup on costs	Analytical/Business Services: $ per vehicle
25th Percentile	0.5%	4.4%	2.0%	8.0%	$491.00
Median	0.6%	7.9%	2.0%	10.4%	
75th Percentile	1.3%	12.5%	5.0%	11.9%	$736.50
Method	Comparable Uncontrolled	Comparable Profit	CUT	CPM	Unspecified

	Transaction Method (CUT)	Method (CPM)			

3. CarMax's Tax Returns During the Audit Period

During the Audit Period, CarMax East and CarMax West filed their South Carolina corporate income tax returns using South Carolina's default method of separate entity reporting.[8] During its audit, the Department concluded separate entity reporting did not fairly represent CarMax's business activity in South Carolina under subsection 12-6-2320(A) of the South Carolina Code. The Department concluded the use of separate entity reporting allowed CarMax to distort its tax obligations in South Carolina by shifting income from CarMax East's retail sales (including its South Carolina retail sales) to CarMax West, through fees paid to CBS who disproportionately distributes its net income to CarMax West, which has a significantly lower apportionment ratio. As a result, the South Carolina net income, against which the sales factor was applied, was artificially lowered. The Department concluded the intercompany charges by CBS in conjunction with its artificial distributive shares created a distortion in South Carolina taxable income.

The Department also concluded CarMax East, CarMax West, CBS, and CarMax, Inc. operated as a unitary group because each entity was dependent upon the other for necessary functions. *See* Hr'g Tr. 52:10–22 (**R. p. 657**). For example, CarMax East and CarMax West were dependent upon CBS for management services, finance operations, and intellectual property through the intercompany agreements. *See* Hr'g Tr. 56:18-24 (**R. p. 661**). This functional dependence

[8] In contrast, CarMax filed consolidated federal returns for the CarMax Group during the Audit Period (with the exception of the payroll company CarMax Auto Superstores Services, Inc.) because all of the entities are owned, either directly or indirectly, by the parent company. On federal consolidated returns, intercompany transactions are eliminated or zeroed out because the income for one company is being canceled out by the expense recognized by another. Also, in some other states, where required, CarMax filed its returns using combined unitary reporting.

demonstrated operational interdependence, a fact CarMax West conceded when it previously told the Supreme Court that it had formed a unitary business with CBS. *See CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014); *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, Docket No. 09-ALJ-17-0160-CC (S.C. Admin. Ct. April 22, 2010).

As a result of these conclusions, the Department determined combined unitary reporting was appropriate because it remedied the distortion and more fairly represented CarMax's business activity in the State. As will be discussed more fully below, under combined unitary reporting intercompany transactions, like the five priced transactions in the tables above and distributions from the CBS partnership, are disregarded. As a result, the artificial income shifting is eliminated, and the income returned from CarMax's retail stores more fairly and accurately reflects the income that CarMax East earned in South Carolina. For this reason, the Department imposed combined unitary reporting as an alternate reporting method pursuant to subsection 12-6-2320(A)(4) of the South Carolina Code.

STANDARD OF REVIEW

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

> (a) in violation of constitutional or statutory provisions;
> (b) in excess of the statutory authority of the agency;
> (c) made upon unlawful procedure;
> (d) affected by other error of law;
> (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or
> (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

S.C. Code Ann. § 1-23-610.

Judicial review of an ALC's findings of fact is limited to determining if the findings are supported by "substantial evidence." *MRI at Belfair, LLC v. S.C. Dep't of Health & Envtl. Control*, 379 S.C. 1, 6, 664 S.E.2d 471, 474 (2008). "Substantial evidence is...evidence which, when considering the record as a whole, would allow reasonable minds to reach the conclusion that the [ALC] reached...."

Leventis v. Dep't of Health & Envtl. Control, 340 S.C. 118, 130, 530 S.E.2d 643, 650 (Ct. App. 2000). This Court also "may not substitute its judgment for the judgment of the [ALC] as to the weight of the evidence on questions on fact." *Rent-A-Ctr. E., Inc. v. S.C. Dep't of Revenue*, 425 S.C. 582, 592, 824 S.E.2d 217, 222 (Ct. App. 2019) (substantial evidence supported the ALC's factual findings resulting in judgment for the Department). As explained below, the ALC's decision correctly followed the law and was based on reliable, probative, and substantial evidence.

ARGUMENT

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

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

To satisfy Constitutional requirements under the Due Process Clause and Commerce Clause, states may only tax the portion of a multi-state corporation's income that has a minimal connection and rational relationship (nexus) with the taxing state. *See Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 772 (1992); *Mobil Oil Corp. v. Comm'r of Taxes of Vermont,* 445 U.S. 425, 436–437 (1980). This does not mean the state has to isolate the intrastate business activities from the interstate activities; instead, the state "may tax an apportioned sum of the corporation's multistate business." *Allied-Signal*, 504 U.S. at 772. This approach, known as formulary apportionment,[9] attempts to calculate an apportionment percentage "that is based on the relative amount of a taxpayer's in-state activities or 'presence.'" *See* Richard D. Pomp, *State and Local Taxation* at 10–18 (8th ed. 2015). The "unitary business/formula apportionment method" is the "linchpin of apportionability in the field of state

[9] The ALC's Amended Final Order contains a more detailed history of formulary apportionment. *See* Amended Final Order at 46–49 (**R. pp. 129–132**).

income taxation." *Mobil Oil Corp.*, 445 U.S. at 439; *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983).

States generally use one of two methods to apportion a multi-state corporation's income to the taxing state: separate entity reporting and combined unitary reporting. Separate entity reporting is the default method in South Carolina. *See Media General*, 388 S.C. at 142, 694 S.E.2d at 526–27; Amended Order at 50 (**R. p. 133**). The separate entity apportionment method treats each entity that has nexus with South Carolina as a separate and distinct entity, even if it is part of a unitary business. *Id.* By contrast, combined unitary reporting combines the income of unitary business group members and apportions that combined income among the states. *Media General*, 388 S.C. at 146, 694 S.E.2d at 529. Under combined reporting, each member of a unitary business group computes its individual taxable income by taking a portion of the combined net income of the group based on the unitary members' level of activity in the state as compared to the members' level of activity in all states. *See* Amended Order at 51 (**R. p. 134**).[10] The purpose of combined reporting, among other things, is to "capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise." *Media General*, 388 S.C. at 142, 694 S.E.2d at 527.

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

[10] Revenue Ruling #15-5 spells out in detail the step-by-step method for calculating combined unitary income in South Carolina. *See* Joint Ex. 28 at 9 (**R. p. 3783**).

designed to apportion to South Carolina a fraction of the taxpayer's total income *reasonably attributable* to its business activity in this State." (citing *Emerson Elec. Co. v. S.C. Dep't of Rev.*, 395 S.C. 481, 485–86 (2011)).

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

Article 17 of the Act demonstrates the intent of the Legislature to implement a formulary apportionment scheme in South Carolina that is fair and reasonable—not arbitrary and unreasonable. Although the separate entity apportionment method is the standard apportionment method used in South Carolina, "standard" does not always mean "proper." *See Media General*, 388 S.C. at 142, 694 S.E.2d at 526–527. For that reason, the Legislature recognized that a "one size fits all" approach to apportionment will not always produce an outcome and consistent with the policy objective of ensuring a fair corporate income tax. Consequently, the Legislature expressly delegated authority to the Department to deviate from the standard apportionment method and instead require an alternative one where circumstances require.[11]

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

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[11] Section 12-6-2320 also permits the taxpayer to petition for the use of an alternative apportionment method. As the record demonstrates, the Department has granted taxpayer petitions to use combined reporting as an alternative method for filing South Carolina returns. *See* Hr'g Tr. 85:9–22 (**R. p. 690**).

[12] In 1957, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDITPA), which was model legislation designed to facilitate uniformity across states with respect to taxation of multistate corporations. Although South Carolina is not a UDITPA compact member state, Section 12-6-2320(A) is nearly identical to Section 18 of UDITPA.

> If the apportionment provisions of this chapter do not fairly represent the extent of a taxpayer's business activity in the State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable . . . (4) the employment of any other method to effectuate an equitable[13] allocation and apportionment of the taxpayer's income.

S.C. Code Ann. § 12-6-2320(A)(4) (2014).[14] This statute functions as a relief mechanism that enables the Department to apply an alternative apportionment method when the standard apportionment formulas provided by statute do not fairly represent the taxpayer's business activity in South Carolina. *See Media General*, 388 S.C. at 151, 694 S.E.2d at 531 ("We agree with the ALC that the legislature enacted section 12–6–2320 as a relief mechanism . . .").

CarMax seeks to strike the language of "if the allocation and apportionment provisions of this chapter" and replace it with "sales factor." Under CarMax's edit, an unfair representation of a taxpayer's business activity is fine so long as that distortion is not caused by the sales factor.[15] Indeed, CarMax East could shift all its income out of South Carolina through non-arm's length priced

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

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

[15] Appellant argues that an accounting error could meet the alternative apportionment standard recognized by the ALC. However, an error, whether intentional or not, that affects federal taxable income would not be a failure of "the allocation and apportionment provisions of this chapter" to represent the taxpayer's business activity in South Carolina. Instead, it is a failure of the filer. Here, neither the parties nor the ALC claimed there was an error.

intercompany transactions irrespective of the amount of its business activity in South Carolina. Certainly, the Legislature did not intend such an absurd result. Instead, "the legislature has placed no explicit limitation on the alternative methods that may be used under § 12-6-2320(A)(4)." *Media General*, 388 S.C. at 152, 694 S.E.d2d at 532.

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

The ALC correctly held that "the Department acted within its authority to require an alternate method—[combined unitary reporting]—under subsection 12-6-2320(A)." *See* Amended Order at 68 (**R. p. 151**). The ALC correctly explained that "*Media General* stands for the principle that subsection 12-6-2320(A)(4) is broad enough to encompass an adjustment to the reporting method." *Id.* at 52 (**R. p. 135**). The ALC's holding is supported by the plain language of the statute, and it is consistent with the holding of South Carolina Supreme Court in *Media General*, which itself found that the "plain language of subsection (A)(4) clearly authorizes the Department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income, **including the combined entity apportionment method**." *Media General*, 388 S.C. at 151, 694 S.E.2d at 531 (emphasis added).[16] In *Media General*, the Court recognized that when a taxpayer operates a unitary business within South Carolina, all business activities of the unitary enterprise are attributable to South Carolina with no duty or requirement to place activities at a specific location or within a specific entity.[17]

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[16] As the ALC noted, some states that have adopted § 18 of UDITPA have found that subsection (A)(4) supports the imposition of combined reporting as a form of alternative apportionment. *See* Amended Order at 48 (**R. p. 131**); *see also Leathers v. Jacuzzi, Inc.*, 935 S.W.2d 252, 254 (Ark. 1996) ("[T]here is a discretionary provision in UDITPA upon which combined reporting can be allowed and, in fact, is allowed by a number of states.").

[17] The South Carolina Supreme Court is not alone in allowing combined reporting when it is not the default method. For example, the Supreme Court of Kansas held that the state's director of taxation had authority to require the combined report method for a unitary multicorporate business under Kansas' version of § 18 of UDITPA. *Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 684 P2d 396

CarMax contends the ALC incorrectly interpreted section 12-6-2320(A)(4) and *Media General* to find the Department has authority to require combined unitary reporting in this case. *See* Appellant Br. at 41-43. Specifically, CarMax claims that (1) what the Court in *Media General* viewed as "combined entity apportionment" was an actual apportionment method, not combined unitary reporting, and thus only permits the combination of related entities for determining the sales factor ratio, not the tax base and (2) section 12-6-2320(A) can only be used to apportion CarMax East's income (not the income of the CarMax Group) because only CarMax East is the "taxpayer." *See* Appellant Br. at 42-43. The ALC rightly rejected these arguments.

First, in the *Media General* case, the Media General unitary group petitioned the Department for combined unitary reporting because it wanted to include the loss company to reduce the total tax liabilities of the remaining members of the group. In the ALC's order in *Media General*, it referred to this method as "combined apportionment methodology," but the mechanics of this method—as described by the ALC and *Media General* court—clearly refer to combined unitary reporting. *Id.* (describing the purpose of so-called "combined apportionment methodology" is to "determine the income or other tax base of the in-state taxpayer by viewing the taxpayer as part of the unitary business"); *see also Media General*, 388 S.C. at 142, 694 S.E.2d at 527 (describing combined entity apportionment method in which the members of a unitary group calculate their taxable income by taking a portion of the combined net income of the group). This is precisely how combined unitary reporting was imposed in this matter: the Department calculated the "income or other tax base" of CarMax East by looking to the unitary business of CarMax East and applied the South Carolina sales

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(1984). Conversely, the Supreme Court of Kentucky held that a taxpayer was allowed to use combined reporting under § 18 of UDITPA. *GTE & Subsidiaries v. Revenue Cabinet*, 889 SW2d 788 (Ky. 1994). Even absent § 18 of UDITPA, some state courts allowed state tax administrators to require combined reporting. *See e.g. Edison California Stores v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947) and *Zale-Salem, Inc. v. State Tax Comm'n*, 237 Or. 261, 391 P2d 601 (1964).

factor to the taxable income of the unitary business. *See* Hr'g Tr. 60:8–63:8; Respondent's Demonstrative Ex. 1 (**R. pp. 665–668; 4773**).

Second, this Court has already rejected a version of CarMax's "taxpayer is defined in the singular not plural" argument. *See Media General*, 388 S.C. at 148–49, 694 S.E.2d at 530. *Media General* quoted favorably to the Supreme Court of Oregon, which itself had rejected an argument that combined unitary reporting is separate and distinguishable from an "apportionment method" and that the use of "taxpayer" in the singular prevented the tax agency from applying combined reporting. *Id.* (quoting *Coca Cola Co. v. Department of Revenue,* 271 Or. 517, 533 P.2d 788 (1975) ("The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method. While it is true . . . that the statute speaks of taxpayer in the singular, this is no bar [to approving combined reporting].").[18]

Although the *Media General* court used slightly different terminology from the terms used by the Department in Revenue Ruling #15-5 and the audit examination, those terms all refer to the same principle, and the reporting method applied in *Media General* (combined entity apportionment method) is identical to the reporting method applied in this matter (combined unitary reporting).[19] *Media*

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

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

General, wholly relying on the 2009 Order, conclusively holds that a "taxpayer's" income includes the unitary business income, and combined unitary reporting is an appropriate alternative apportionment method under § 12-6-2320(A)(4).

Accordingly, in light of the overall intent of Article 17's apportionment provisions, the plain language of section 12-6-2320(A)(4), and the Supreme Court's clear holding in *Media General*, the ALC correctly held the Department has the statutory authority to require combined unitary reporting as an alternative apportionment method.[20]

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

The ALC's Final Order thoroughly examined the record evidence and correctly found that the standard apportionment method does not fairly reflect CarMax East's business activity in South Carolina. *See* Amended Final Order at 56–68 (**R. pp. 139–151**). This finding is supported by substantial evidence in the record.

[20] Although Appellant claims that section 12-6-2320(A)(4) does not authorize the Department's forced use of combined unitary reporting, this is a complete departure from the position it took throughout the audit, the Department's pre-hearing appeals process, and the bulk of the ALC litigation—a dispute that spanned over four years. In its written protest of the audit, its Request for a Contested Case Hearing, and its Prehearing Statement filed with the ALC, Appellant repeatedly conceded that combined reporting was statutorily authorized—it merely argued that the Department had not met its burden to show that it was appropriate in this particular case. *See* Appellant's Protest at 6 (Nov. 14, 2019); Appellant's Request for a Contested Case Hearing at 3 (June 8, 2021); Appellant's Pre-Hearing Statement at 2-5 (August 2, 2021) (**R. pp. 3799; 157; 169–172**).

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

1. CarMax East, CarMax West, and CBS meet the definition of a "unitary business."

There are generally three subjective tests for determining whether a business is unitary that are commonly used by tax professionals, accountants, and courts.[21] A unitary group is one in which the members of the group all contribute to income through functional integration, centralization of management, and economies of scale. *See* Joint Ex. 28 (**R. pp. 3775–3787**). CarMax East, CarMax West, and CBS qualify as a unitary business under this three-part test.

The first test is the unity of operations test. Unity of operations refers to companies having a common accounting system, common research and development, common marketing, and common characteristics of operations amongst the companies. Specifically, CBS provides corporate business management services (finance and accounting, legal, human resources, information technology, marketing, etc.) to CarMax East and CarMax West. *See* Hr'g Tr. 751:21-752:18 (**R. pp. 1356–1357**). Therefore, the CarMax Group meets the unity of operations test.

The second test is unity of use. Unity of use typically refers to the concept of centralized management, which may be evidenced by common executives between a group of companies. CarMax admits that CarMax East, CarMax West, and CBS have centralized management. *See* Hr'g Tr. 828:14-23 (**R. p. 1433**). CarMax has a single executive team for the entirety of the domestic business. *See* Hr'g Tr. 478:2-4; 1066:15-19 (**R. pp. 1083; 1671**). CBS is the "brains of the operation" and provides the strategy for CarMax East and CarMax West. *See* Hr'g Tr. 1017:9-25 (**R. p. 1622**). The directors and

[21] Appellant files a combined unitary report in unitary states. *See* Joint Ex. 85-CarMax 30(b)(6) Depo Tr. 61:13-62:4 (**R. pp. 4620–4621**). Further, West argued it was a unitary business with CBS in *Carmax Auto Superstores West Coast, Inc. v. S.C. Dep't of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014)—the operations of Appellant and West are the same except they operate in different states and their operations have not changed since the *CarMax* case. *See* Hr'g Tr. 79:8-80:10 (**R. p. 684–685**).

officers for CarMax East, CarMax West, and CBS are identical. *See* Joint Ex. 49 (**R. pp. 4047–4074**). The entire C-suite of executives is located in CBS, CBS' executives signed the intercompany agreements on behalf of both CarMax East and CarMax West, as well as CBS. *See* Joint Ex. 34-36; Hr'g Tr. 828:24–830:7 (**R. pp. 3806–3856; 1433–1435**); *see also* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 70:11-25 (**R. p. 4629**). CarMax East, CarMax West, and CBS have centralized cash management and commingle their funds. *See* Hr'g Tr. 828:7-10 (**R. p. 1433**). Also, CarMax East and CarMax West share inventory. *See* Hr'g Tr. 827:17-20 (**R. p. 1432**); *see also* Joint Ex. 85-CarMax 30(b)(6) Depo Tr. 46:7-10 (**R. p. 4605**). Therefore, the CarMax Group meets the test of unity of use.

The third test is contribution and dependency, which refers to the amount of dependency between various companies. For instance, when a company heavily relies on services that are provided by another company, or one company generates a significant amount of revenue through related party transactions. Additionally, when companies are heavily integrated, they create economies of scale together that contribute to functional dependency and other unitary characteristics. CarMax East, CarMax West, and CBS are highly integrated entities. *See* Hr'g Tr. 226:9-230:6 (**R. pp. 831–835**). CarMax East and CarMax West rely on CBS to develop and manage trademarks and trade names, corporate business management services (finance and accounting, legal, human resources, information technology, marketing, etc.), business strategy, and data analytics. *See* Hr'g Tr. 56:18-24; 751:21-752:18 (**R. pp. 661; 1356**). CBS in turn depends completely on entities within the CarMax Group for income because it receives no income from outside the CarMax Group. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 55:3-6 (**R. p. 4614**).

By CBS providing these uniform functions across the CarMax Group, the entire CarMax Group benefits from economies of scale. *See* Hr'g Tr. 832:17-833:2 (**R. pp. 1437–1438**). CBS creates the business strategy, and the stores execute it. *See* Hr'g Tr. 744:20-745:19 (**R. pp. 1349–1350**). CarMax's inventory of vehicles is a collective activity of all the stores together. *See* Hr'g Tr. 229:9-

230:6 (**R. pp. 834–835**). As such, the CarMax Group enjoys economies of scale by spreading their central costs over a greater volume of units (one salesperson can make a sale to a customer over thousands of vehicles; the same mechanic who reconditions cars can appraise cars to be purchased; and the data analytic function can gather information from a broad range of wholesale and retail sales to make pricing decisions). *See* Hr'g Tr. 264:15-266:3; 1231:10-1233:6 (**R. pp. 869–871; 1836–1838**). None of the three entities could function on their own. Therefore, the CarMax Group meets the test of contribution and dependency.

Consistent with Revenue Ruling #15-5 and the above tests, the Department concluded that CarMax East operates within a unitary group. *See* Hr'g Tr. 52:10-22 (**R. p. 657**). The same attorneys and fact witness for CarMax East argued that CarMax West formed a unitary business with CBS in *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014); *see also CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, Docket No. 09-ALJ-17-0160-CC (S.C. Admin. Ct. April 22, 2010). The only difference between CarMax East and CarMax West is that they operate in different states. *See* Hr'g Tr. 79:8-80:10 (**R. pp. 684–685**). CarMax's organizational structure has not changed materially since it argued that CarMax West and CBS were unitary in the previous *CarMax* trial and appeals. *See* Hr'g Tr. 825:8-15 (**R. p. 1430**). As the ALC noted, CarMax East, CarMax West, and CBS are the CarMax entities primarily at issue and the parities do not dispute that they make up a unitary group. *See* Amended Order at 7, fn. 14 (**R. p. 90**).

2. CarMax East is a retailer.

CarMax East's principal business in South Carolina is selling used cars at retail. *See* Hr'g Tr. 50:4-7 (**R. p. 655**). As the ALC noted, "During the audit years, CarMax held itself out as the largest retailer of used cars in the United States." *See* Amended Final Order at 8 (**R. p. 91**). CarMax admits in its brief that "East and West own and operate retail stores that primarily sell used vehicles." *See* Appellant's Brief at 6. CarMax East also admitted through its 30(b)(6) designee that its business activity

in South Carolina is vehicle retail operations. *See* Appellant's 30(b)(6) Depo. Tr. 24:4-14 (**R. p. 4583**). CarMax's own expert testified that the "lion's share" of its business activities in South Carolina is the sale of cars. *See* Hr'g Tr. 922:7-10 (**R. p. 1527**). Undisputedly, CarMax East is a retailer.

B. The record contains specific evidence demonstrating that, as a result of CarMax's restructuring and non-arm's length intercompany transactions, the standard apportionment method does not fairly represent CarMax East's business activities in South Carolina.

CarMax's restructuring created an artificial structure that did not match the economic reality of its business activity. This led to the standard apportionment method failing to capture the extent of CarMax East's business activities in South Carolina. The restructure did not have an operating impact or commercial effect on the company, yet CarMax East consented "at arm's length" to (1) transfer a valuable asset (its business process intangibles and financing function) to CBS and (2) give up a substantial amount of income that it otherwise would have continued to earn absent that restructuring. This was a tax restructuring. *See* Hr'g Tr. 471:14–473:10 (**R. pp. 1076–1078**).

CarMax asserted four business purposes for its restructure: 1) re-align the business function to avoid duplicative functions in the CarMax East and CarMax West, 2) isolate value created through supply chain activities, 3) focus management attention on most profitable activities, and 4) tax planning. *See* Joint Ex. 52 (**R. pp. 4078–4099**). However, the record contradicts the first three asserted business purposes and shows that state income tax benefits was the real purpose of the restructure. First, the restructuring had no operational effect. *See* Hr'g Tr. 477:11-19 (**R. p. 1082**). Second, the supply chain consists of customers bringing cars into the local stores rather than a centralized procurement function. *See* Hr'g Tr. 479:3-481:4 (**R. pp. 1084–1086**). Further, CarMax's documentation regarding the restructure makes an economically absurd statement that profits are realized prior to delivery of the product to the retail location. *See* Hr'g Tr. 480:8-481:4; Joint Ex. 52 at 3, fn 3 (**R. pp. 1085–1086; 4080**). Third, CarMax has a single executive team for the entirety of its business. *See* Hr'g Tr. 477:22-478:4 (**R. pp. 1082–1083**). The use of transfer prices to shift income through non-arms-

length ways distorts the management metrics. *See* Hr'g Tr. 478:12-16 (**R. p. 1083**). In its Annual Reports and 10-Ks, CarMax describes the business as a whole and does not discuss CBS as performing a function deserving of more profits than the operating companies. *See* Hr'g Tr. 478:16-479:2; Joint Ex. 1-6 (**R. pp. 1083–1084; 2165–2612**). Therefore, CarMax has no reasonable business purpose for the restructure other than the creation of state income tax benefits.

The true purpose of the restructure was tax planning by implementing a structure (partnership that receives licensing and management fees from the operating entities and disproportionately distributing its income to the West company) to lower CarMax's taxes. *See* Hr'g Tr. 477:1-11 (**R. p. 1082**). This is effectively the East-West and management fee strategies mentioned in Revenue Ruling #15-5. *See* Joint Ex. 28 (**R. pp. 3775–3787**); *see also* Richard I. Simons, *Fair Representation in the South Carolina Corporate Income Tax: Combined Reporting As Equitable Apportionment After Media General Communications, Inc. v. South Carolina Department of Revenue*, 62 S.C. L. REV. 743, 759 (2011) (discussing CarMax's use of the "East-West tax avoidance scheme"). Further, the restructure itself violated the arm's length principle because CarMax East transferred the business process intangibles and financing function to CBS for no compensation. *See* Hr'g Tr. 410:10-20. (**R. p. 1015**). A company like CarMax East would not voluntarily give up its business process intangibles and financing function and then pay a fee for those services. *See* Hr'g Tr. 1238:16-1241:17 (**R. pp. 1843–1846**). In reality, CarMax created a corporate structure that facilitates shifting income between entities through intercompany transactions.

Through those intercompany transactions, CarMax East's income is manipulated (on paper) in a manner that does not fairly represent its business activity in the state. The transfer pricing siphons off approximately 70% of the operating profits from the operating companies to CBS. *See* Hr'g Tr. 218:4-14 (**R. p. 823**). The 2012 and 2015 transfer pricing studies have trademarks and business process intangibles at about 20% and 80% respectively for the value of the intangibles. *See* Hr'g Tr. 549:4-24

(**R. p. 1154**). However, when CarMax West contributed the trademarks and CarMax East contributed the business process intangibles, CarMax West received 93.5% ownership interest and CarMax East a 6.5% ownership interest. *See* Hr'g Tr. 494:14–495:18; 550:1-18 (**R. p. 1099–1100; 1155**). This is in addition to CarMax East giving the trademarks that it developed to CarMax West immediately prior to the restructure for free. *See* Hr'g Tr. 365:12–368:15 (**R. pp. 970–973**). The Department's expert economist opined that "you can almost set aside the transfer pricing study because any amount of profit being allocated to CBS in the first instance gets you, in my view, to this non-arm's-length result based on these—this 93.5 versus 6.5 percent share." *See* Hr'g Tr. 1247:5-10 (**R. p. 1852**). This is also why income after the distortive intercompany transactions versus income under combined unitary reporting—where intercompany transactions are eliminated—is an apples and oranges comparison. The ALC correctly recognized this and concluded that, as a result of CarMax East's intercompany transactions and partnership distributions, the income reported on CarMax East's South Carolina tax returns does not fairly reflect CarMax East's economic activity in South Carolina.

As an illustration of the disconnect between its business activity and tax returns, CarMax East's South Carolina stores had retail sales of approximately $400-470 million annually, but only $6.4–7.6 million of South Carolina taxable income. *See* Hr'g Tr. 921:16-922:3; Joint Ex. 16-18 at Line 6 (**R. pp. 1526–1527; 3637; 3650; 3661**). Although CarMax East and CarMax West both operate CarMax's retail stores only in different states, CarMax East ends up with $10.54 of taxable income for every $100 it produces while CarMax West ends up with $57 of taxable income for every $100 it produces. *See* Hr'g Tr. 68:5-70:22 (**R. pp. 673–675**). This difference indicates income distortion and a mismatching of expenses paid and income received through the CBS partnership. *See* Hr'g Tr. 136:17-137:8 (**R. pp. 741–742**). From a tax policy perspective, income and expenses should be aligned across divisional and jurisdictional lines (matching principle). *See Colonial Life & Acc. Ins. Co. v. S.C. Tax Comm'n*, 248 S.C. 334, 338–339; 149 S.E.2d 777, 780 (1966) (concluding that allowing taxpayers to claim deductions for

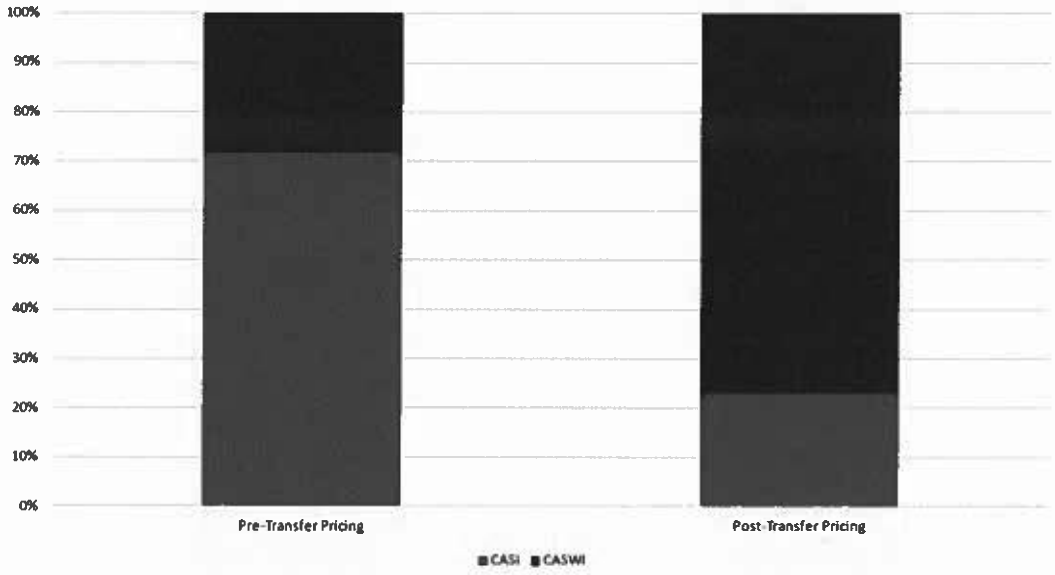
income that is taxed outside of the state would be an unreasonable construction of the Legislature's intent). However, income CarMax East receives is grossly disproportionate to its expenses. *Id.* The unreliable intercompany transactions and CBS distributions leads to results that are unreasonable and inconsistent with arms' length principles. *See* Hr'g Tr. 218:4-221:25 (**R. pp. 823–826**).

Further, revenue is a reasonable proxy for business activity. *DIRECTV, Inc. & Subsidiaries v. S.C. Dep't of Revenue*, 421 S.C. 59, 76, 804 S.E.2d 633, 642 (Ct. App. 2017) ("we find that 0.85% of DIRECTV's total subscription revenue does not reasonably represent DIRECTV's business activity in South Carolina"). CarMax East accounts for approximately 75% of the CarMax Group's retail sales revenue but through intercompany transactions receives only 20% of the taxable income with CarMax West accounting for the remainder. *See* Hr'g Tr. 320:21-321:10; Respondent's Demonstrative Ex. 2, slides 32-33 (**R. pp. 925–926; 4806–4807**). The ALC correctly recognized the difference between retail sales income and South Carolina taxable income while appropriately considering this great discrepancy is evidence of income shifting. *See* Amended Final Order at 13 n. 25 (**R. p. 96**). By considering revenue, the ALC could observe CarMax East's business activity unadulterated by intercompany transactions and appropriately judge that the business activity was not fairly represented.

Other states have considered disproportionate income versus receipts as evidence of distortion—i.e. that a taxpayer's business activity is not fairly represented. For example, in *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169, 39 Cal. 4th 750 (2006), the Supreme Court of California was tasked with determining how a taxpayer's income arising from the redemption of marketable securities should be apportioned to the State. In that case, the court ultimately concluded that a mismatch of the taxpayer's gross receipts "seriously distorts the standard formula's attribution of income to each state." *Microsoft*, 139 P.3d at 1182. In reaching that conclusion, the court noted the "distortional impact is great here [compared to an earlier case]; Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts." *Id.* at 1183, fn. 17. Here, the

record contains substantial evidence of distortion in the form of documents and testimony as illustrated below.

The following figure represents CarMax East's (green) and CarMax West's (blue) share of taxable profits before and after pass-through of CBS income:



Respondent's Demonstrative Ex. 2 at slide 45 (**R. p. 4819**). This demonstrates an almost complete reversal of the proportion of taxable income between CarMax East and CarMax West. In sum, CarMax East's taxable income does not align with the economic reality of its business activity.

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

In Revenue Ruling #15-5, the Department identified a non-exhaustive list of factors it may consider when evaluating whether the standard apportionment formula fairly represents a taxpayer's business activity in South Carolina. *See* Joint Ex. 28 (**R. pp. 3775–3787**). The ALC found that Revenue Ruling #15-5 was helpful guidance for making this determination, and ultimately concluded the Department had sufficiently shown that CarMax East's business activity was not fairly represented.

See Final Order at 59 (**R. p. 142**). Substantial evidence in the record supports the ALC's findings regarding these factors.

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

CarMax has artificially segregated its necessary business functions, services, activities, and value within the CarMax Group. CarMax East transferred trademark and business process intangibles for free to CarMax West who then contributed them to CBS during the 2004 restructuring in exchange for a 93.5% ownership share. *See* Hr'g Tr. 464:19-470:19 (**R. pp. 1069–1075**). CarMax East also contributed its financing function to CBS for no compensation. *See* Hr'g Tr. 463:8-464:17 (**R. pp. 1068–1069**). CarMax East then pays CBS a management fee for the use of these intangibles that CarMax East gave for zero compensation. *Id.* As discussed above, this amount is disproportionately high and inconsistent with the market rate for such services and with the partnership distributions creates a non-arms-length result.

b. Profit margins associated with business activities.

As a company, CarMax has a high operating margin for automotive retailers and is a highly profitable company. *See* Hr'g Tr. 244:22-247:11; Respondent's Demonstrative Ex. 2 at slide 8 (**R. pp. 849–852; 4782**). CarMax is the largest retailer of used cars in the United States and sells mostly newer, lower mileage used cars, which gives it a competitive advantage over its smaller competitors and retailers of new or older, higher mileage vehicles. *See* Hr'g Tr. 245:2-247:11 (**R. pp. 850–852**). With its large size, CarMax benefits extensively from economies of scale. *See* Hr'g Tr. 259:3-268:22 (**R. pp. 864–873**). This drives its high profitability. No single entity within CarMax can claim the benefit of economies of scale for itself through intercompany transactions. *See* Hr'g Tr. 273:3-276:8 (**R. pp. 878–881**).

c. Capital investments associated with business activities.

As mentioned above, CarMax East, CarMax West, and CBS have centralized cash management and commingle their funds. *See* Hr'g Tr. 828:7-10 (**R. p. 1433**).

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

CBS does not provide intellectual property or any services to entities outside the CarMax Group. *See* Hr'g Tr. 79:4-7 (**R. p. 684**).

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

The transfer pricing studies address five transactions: 1) trademarks, 2) back-office services, 3) advertising, 4) real estate, and 5) data/business analytics/strategy. *See* Hr'g Tr. 218:17-25 (**R. p. 823**); *see also supra* §2.b of the Statement of Facts. As explained by Dr. DeRamus, the transfer pricing studies are inconsistent with arms-length standards for several of the transactions. For transaction one, trademarks for retailers do not have the same value as a consumer product company, so usually that value is zero. *See* Hr'g Tr. 355:9-21 (**R. p. 960**). For transaction five, the markup for CBS's data analysis function is orders of magnitude larger than the median markup for similar companies. *See* Hr'g Tr. 429:20-430:12; Respondent's Demonstrative Ex. 2 at slide 73 (**R. pp. 1034–1035; 4847**). Both from an economic and transfer pricing perspective, no third party would voluntarily enter this type of arrangement. A taxpayer would not voluntarily give up a stream of profits to an unrelated party where the taxpayer would be worse off as a result. *See* Hr'g Tr. 1238:16-1239:11 (**R. pp. 1843–1844**). Simply put, taxpayers in similar industries do not provide similar goods and services to unrelated parties under similar terms to what the entities within the CarMax Group agreed.

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

For transaction three, advertising accounts for about 1% of sales, so CarMax would not willingly enter into a similar arrangement to pay 2% of sales to an unrelated third party for advertising services. *See* Hr'g Tr. 375:7-379:4; Respondent's Demonstrative Ex. 2 at slide 58 (**R. pp. 980–984; 4832**). As part of the restructuring, CarMax East contributed its business process intangibles and financing function for no compensation to CBS. *See* Hr'g Tr. 464:19-470:19 (**R. pp. 1069–1075**). CarMax East accounted for nearly 80% of operating profit for the CarMax Group prior to the transfer pricing and pass-through income compared to about 23% afterwards. *See* Hr'g Tr. 344:25-348:1; Respondent's Demonstrative Ex. 2 at slide 44 (**R. pp. 949–953; 4818**). CarMax East would not willingly enter into a similar agreement with an unrelated third party that shifted its profits to the extent that it did so with CarMax West. *See* Hr'g Tr. 348:2-18; Respondent's Demonstrative Ex. 2 at slide 45 (**R. pp. 953; 4819**).

C. The ALC properly rejected CarMax's transfer pricing studies for Transactions One, Three, and Five and looked skeptically at the Valuation Study.

As mentioned, the purpose of transfer pricing studies is penalty abatement in cases where the IRS—or, through conformity, the Department—makes a transfer pricing adjustment. However, no penalties are at issue in this case. Further, the ALC correctly held "this is **not** a transfer pricing case." Order Granting Motion for Reconsideration at 8 (**R. p. 81**) (emphasis in original). Regardless, substantial evidence supported the ALC's finding CarMax's transfer pricing studies to be unreliable as to transaction one, three, and five. *See* Amended Order at 43-44 (**R. pp. 126–127**). The record is replete with evidence as to the unreliability of the methods and their flawed application in arriving at a transfer price. *See e.g.* Hr'g Tr. 348:19-368:15; 375:7-391:4; 396:4-430:21; 1214:25-1218:7; 1219:21-1226:13; Respondent's Demonstrative Ex. 2 at slides 46-53, 58-64, 69-73 (**R. pp. 953–973; 980–996; 1001–1035; 1819–1823; 1824–1831; 4820–4827; 4832–4838; 4843–4847**).

Similarly, the ALC appropriately considered the 2004 restructuring under a § 482 analysis. This analysis is consistent with 26 U.S.C. § 482, which provides, "[i]n the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." *See also* 26 C.F.R. § 1.482-1(f)(2)(ii) ("The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."). Under such an analysis, the restructure was superficial, and the greatest effect was tax benefits. Both parties' expert economists agree on the importance of evaluating the economic substance of transactions within the § 482 context. *See* Hr'g Tr. 1210:14-1213:10 (**R. pp. 1815–1818**). Further, CarMax's policy expert relied on the accuracy of the ownership percentages to form his opinion. *See* Hr'g Tr. 950:6-952:12 (**R. pp. 1555–1557**).

The mechanism by which income moves from CarMax East to CarMax West via the CBS partnership is distribution based on respective ownership percentages. CarMax purportedly based those ownership percentages on the value of assets contributed by CarMax East and CarMax West to CBS.[22] Specifically, CarMax East contributed corporate management service and financing, and CarMax West contributed intangible trademarks and trade names. *See* Hr'g Tr. 823:1-13 (**R. p. 1428**). CarMax provided the 2004 Valuation Study as support for only the value of intellectual property contributed by CarMax West to CBS. The 2004 Valuation Study states, that the "applicable taxation regulatory framework for this analysis is guided largely by §482 of the Internal Revenue Code ('IRC

[22] The organizational structure has not changed materially since the 2004 reorganization. *See* Hr'g Tr. 825:12-15 (**R. p. 1430**).

§482') and the final §udi Treasury Regulations (published on July 8, 1994)." *See* Joint Ex. 55 at 5 (**R. p. 4232**).

However, these intercompany transactions that resulted in the 93.5% ownership by CarMax West and 6.5% ownership by CarMax East fail the arms-length standard due to three fatal flaws. First, CarMax West was only the nominal owner of CarMax's trademarks and trade names. CarMax decided to initially assign legal ownership of the trademarks and trade names to CarMax West, and bare legal ownership could not generate the $2 billion dollar valuation. *See* Hr'g Tr. 1154:14-1156:1; 519:19-522:13 (**R. pp. 1759–1761; 1124–1127**). As the headquarters entity, CarMax East was responsible for defending and developing the trademarks through marketing and advertising prior to the creation of CBS. *See* Hr'g Tr. 232:12-235:5; 474:1-20; 1211:19-1213:10 (**R. pp. 837–840; 1079; 1816–1818**). Further, the retail stores drive the value of CarMax's trade names. *See* Hr'g Tr. 1212:11-1213:10 (**R. pp. 1817–1818**). Second, CarMax East was responsible for what it argues are high-value analytic functions prior to transferring this to CBS. *See* Hr'g Tr. 474:21-475:1 (**R. pp. 1079–1080**). Third, CarMax East had the finance business before transferring it to CBS. *See* Hr'g Tr. 475:1-5 (**R. p. 1080**). CarMax East did not receive remuneration for contribution of the business process and financing intangibles. *See* Hr'g Tr. 410:10-20; 463:8-11 (**R. pp. 1015; 1068**). This violates § 482 principles because CarMax would not have gifted away those valuable assets to a third party. *See* Hr'g Tr. 231:13-17; 1238:16-1241:17 (**R. pp. 836; 1843–1846**). Further, in assessing the transfer pricing for intangibles, it is important to look at how those intangibles were developed. *See* Hr'g Tr. 466:3-470:19 (**R. pp. 1071–1075**).

Here, the 2004 restructuring was a tax avoidance scheme that lacked economic substance.

D. As the finder of fact, the ALC was in the best position to weigh the evidence, and its findings of fact are based on substantial evidence.

Determinations regarding the credibility of witnesses and weight of evidence are properly within the discretion of the trial court, and appellate courts generally defer to those findings. "The

judging of the credibility of witnesses and the weighing of evidence in a law case are uniquely functions of the trial court." *Bivens v. Watkins*, 313 S.C. 228, 235, 437 S.E.2d 132, 136 (Ct. App. 1993). Further, the Court is "in a superior position to judge the witnesses' demeanor and veracity and, therefore, his findings should be given broad discretion." *Woodall v. Woodall*, 322 S.C. 7, 10, 471 S.E.2d 154, 157 (1996). The ALC, as the fact finder, heard testimony and weighed all the evidence to correctly determine the facts in this case. Just because CarMax disagrees with the ALC's findings, that does not mean those findings are wrong. As discussed above, substantial evidence supports the ALC's findings.

The ALC found explanations of several intercompany transactions by CarMax's expert to be not "rigorous or convincing." *See* Amended Order at 21 (**R. p. 104**). Regarding transaction one, the ALC found testimony of the Department's expert to be persuasive and "supported by the 482 Regulations." *See* Amended Order at 32-34 (**R. pp. 115–117**). The ALC properly found the testimony of CarMax's expert "unpersuasive" and that the effect of the CBS distributions mattered more than the whether the ownership shares are proper. *See* Amended Order at 25-26. The ALC again found the Department's expert persuasive and agreed that the method used for transaction three was unreliable. *See* Amended Order at 37-38 (**R. pp. 120–121**). The ALC correctly noted that CarMax is not a franchise and found "advertising under a franchise agreement is not sufficiently similar to CBS's provision of advertising services." *Id.* For transaction five, the ALC once more found the Department's expert's opinion more persuasive and found the undefined method unreliable. *See* Amended Order at 40-43 (**R. pp. 123–126**). The ALC did not blindly accept testimony by the Department's expert and reject testimony by CarMax's expert. Instead, the ALC carefully weighed and considered both. Ultimately, the ALC correctly found "the Management Fee, as a whole, is not reliable." *See* Amended Order at 43-44 (**R. pp. 126–127**).

Pairing the management fee with the distributive shares distorts the representation of CarMax East business activity. CarMax chose what assets to assign to its subsidiaries prior to the 2004

restructure. The unreliable nature of the 2004 Valuation Study is demonstrated by the fact that immediately prior to the 2004 restructure, CarMax East transferred business process intangibles to CarMax West for zero compensation. *See* Hr'g Tr. 482:23-485:12, Respondent's Demonstrative Ex. 2 at 85 (**R. pp. 1087–1090; 4859**). The ALC found "based upon the evidence, the **reliability** of the study is diminished." *See* Amended Order at 25 (**R. p. 108**) (emphasis in original).[23] Regardless of whether the ownership percentages are proportionate to the value of the assets contributed at formation of the partnership, those percentages are unrelated to CarMax East and CarMax West's respective business activity in South Carolina. The CarMax Group chose what assets CarMax East and CarMax West held. *See* Joint Ex. 27 (**R. pp. 3762–3774**). In the end, what matters is the effect. The ALC correctly found that "regardless of whether the Valuation Study is accurate or correct, the resulting shifts in income between the CarMax Group result in CarMax East's business activity in South Carolina to not be fairly represented." *See* Amended Order at 17 (**R. p. 100**).

The ALC was also right to find that "the local stores, through the actual sales of cars and the employees' input as to the condition of the cars purchased, created the most revenue for CarMax." *See* Amended Order at 30 (**R. p. 113**). Yet, as discussed above, CarMax East's business activity in South Carolina is not fairly represented when the default apportionment method is applied to CarMax East. The ALC in its position as fact finder and hearing the testimony first-hand found that:

> CarMax was more than benignly taking advantage of a corporate structure and South Carolina's default reporting method. Indeed, it was using intercompany transfer pricing and a partnership with an east-west structure to significantly distort CarMax East's business activity in South Carolina and artificially lower its tax burden in South Carolina without reasonable and reliable justification.

[23] The ALC correctly rejected CarMax's "disingenuous" argument that it was unfairly prejudiced by the Department challenging the 2004 Valuation. *See* Amended Order at 1-3 (**R. pp. 84–86**); *see also* Department's Response to CarMax's Motion to Reconsider at 5-8 (**R. pp. 556–559**).

See Amended Order at 68-69 (**R. pp. 151–152**). Based on substantial evidence in the record, the ALC correctly found CarMax East's business activity in South Carolina was not fairly represented. *See* Amended Order at 69 (**R. p. 152**).

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

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

As the ALC correctly found, the crux of CarMax's argument is that the Department should make a transfer pricing adjustment. *See* Amended Order at 67 (**R. p. 150**). In CarMax's view, the use of combined reporting is both unreasonable and inequitable.[24] The ALC correctly found that:

> utilizing Section 482 power is a complicated and fraught venture that takes enormous time and resources to ostensibly arrive at the same result as CUR achieves in this case: a fair representation of the taxable business activity in this state for a single taxpayer.

Amended Order at 68 (**R. p. 151**). Importantly, there is no law or legal requirement that the Department make a transfer pricing adjustment. Instead, the statutes and court precedent make it clear that the Department is free to select a reasonable alternative apportionment method of its choice. Section 12-6-2320(A)(4) represents the Legislature's express delegation of discretionary authority to the Department to determine when an alternative apportionment method is warranted, and if so, which method is appropriate. *See Media General*, 388 S.C. at 151, 694 S.E.2d at 531–32. The

[24] Appellant also misplaces its reliance on the holding in *Alltel Commc'ns, Inc. v. S.C. Dep't of Rev.*, 399 S.C. 313, 731 S.E.2d 869 (2012). Significantly, the SC Supreme Court held that: "[W]here the language relied upon **to bring a particular person within a tax law** is ambiguous **or is reasonably susceptible of an interpretation that will exclude such person**, then the person will be excluded, any substantial doubt being resolved in his favor." (emphasis added). In other words, this holding applies to whether a person is subject to a tax—i.e. falls under a tax imposition statute. Here, no party disputes that Appellant is subject to South Carolina corporate income tax.

Department's alternative method must be reasonable, but it need not be the most reasonable method. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 88, 767 S.E.2d 195, 199 (2014) ("we agree with the Department that the court of appeals misapplied *Media General* in holding the Department must prove that its alternate formula is 'more reasonable than any competing method'").[25]

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

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

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

Moreover, in the Department's published guidance on alternative apportionment, it explained some of the factors courts have evaluated in determining whether an alternative apportionment method is reasonable. *See* Revenue Ruling #15-5 at 4 (**R. p. 3778**) (quoting *Twentieth Century-Fox Film Corp.*, 700 P.2d 1035, 1043 (Or. 1985). Specifically, Revenue Ruling #15-5 notes that a "reasonable"

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[25] Under the subsequent amendment to Section 12-6-2320, the Legislature explicitly granted the Department authority to require a taxpayer file a return that reflect the net income on a combined basis of all members of the unitary business if adjusting intercompany transactions are not adequate to redetermine state net income. Appellant concedes the result of combined unitary reporting cannot be achieved using appropriate transfer prices. *See* Appellant's Brief at 38. Therefore, even under the new law combined unitary reporting would be appropriate.

alternative apportionment method for South Carolina income tax purposes has at least two components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100% of taxpayer's income; and (2) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in South Carolina. *Id.*

The ALC correctly found that combined unitary reporting met these reasonableness factors. *See* Amended Order at 65 (**R. p. 148**) The ALC correctly explained that combined unitary reporting utilizes an apples-to-apples approach that increases the starting point of taxable income but reduces the sales factor by the proper proportion. *Id.* However, CarMax argues that combined unitary reporting fails to meet these reasonableness factors. CarMax relies on an apples and oranges comparison by comparing CarMax East's distorted income—post management fee and distributive share—to its income under combined unitary reporting, which eliminates intercompany transactions. Applied uniformly, combined unitary reporting results in taxation of 100% of CarMax East's income. Simply put, the books balance. Income allocated to one state is subtracted from the other states. The apportionable income is apportioned by the sales factor based on CarMax East's sales in the respective states. Adding the sales factors of every state equals one—i.e. 100%. Therefore, combined reporting taxes no more or no less than 100% of CarMax East's income.

Here, the ALC found that combined unitary reporting fairly represents CarMax East's business activity in the state. CarMax and its affiliates are highly interdependent entities that operate together as a single business enterprise that creates a seamless retail experience for CarMax's customers. The substantial intercompany transactions evidence the circular flow of money, services, and value between CarMax East, CarMax West, and CBS. The related entities all rely upon each other for necessary business functions and services. All the crucial components necessary for a retail business, such as inventory, management services, and use of trademarks are performed entirely by the related

entities for each other. The same executives and officers serve in the same capacities for CarMax East, CarMax West, and CBS.

In short, CarMax East's business activity (both in South Carolina and elsewhere) is effectively the same pre- and post- restructuring—there was no commercial effect or operational impact on the company. The only difference is the corporate structure, which CarMax's restructuring designed specifically to exploit the tax ramifications in South Carolina (and other similar states) where separate reporting is the standard apportionment method. As a result of the restructuring, the income CarMax East reported under the standard apportionment method does not reflect the true economic activity of CarMax East in South Carolina. Despite being a highly profitable business enterprise compared to other automotive retailers,[26] the implementation of the transfer pricing and CBS partnership resulting from the restructure—with respect to CarMax East's tax filings—paint very different picture of the company's business activity, suggesting that CarMax East's income is a small fraction of what it actually is. However, combined reporting reflects the economic reality of the business activity engaged in by the CarMax East in South Carolina.

Therefore, combined reporting reasonably and equitably approximates CarMax East's business activity in South Carolina.

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[26] CarMax's operating profits increased as the number of CarMax stores increased. *See* Hr'g Tr. 266:9-271:5; Respondent's Demonstrative Ex. 2, slide 17-20 (**R. pp. 871–876; 4791–4794**). The CarMax Group consistently earned between $800 and $900 million annually during the Periods at Issue. *See* Hr'g Tr. 236:16-237:10; Respondent's Demonstrative Ex. 2, slide 8 (**R. pp. 841–842; 4782**). Appellant also has high profitability ratios compared to other automotive retailers. For example, CarMax's average operating margin during the Periods at Issue was 6.8%; the median operating margin for other similar retailers was 4.0%. *See* Hr'g Tr. 244:22-247:11; Respondent's Demonstrative Ex. 2, slides 2–7 (**R. pp. 849–852; 4776–4781**). CarMax's markup on total costs was 7.3% during the Periods at Issues; the median for other retailers was 4.1%. *See* Hr'g Tr. 247:16-22; Respondent's Demonstrative Ex. 2, slide 9 (**R. pp. 852; 4783**).

C. The ALC correctly held that combined unitary reporting reasonably and equitably corrects the distortion resulting from CarMax East artificially shifting its profits to CarMax West through CBS via the management fee and distributive shares.

Having found the management fee and CBS partnership distributions distorted CarMax East's income, the ALC correctly found combined unitary reporting fixes this distortion. *See* Amended Order p. 65 (**R. p. 148**). Based on substantial evidence, the ALC concluded that the default apportionment provisions did not reflect the economic reality of CarMax East's business activity in South Carolina. *Id.* For example, CarMax East earned a gross operating profit of approximately $90 million from its South Carolina stores while the default apportionment provisions resulted in only $21 million attributed to South Carolina. *See* Hr'g Tr. 322:17–324:3; Respondent's Demonstrative Ex. 2 at slides 35-36 (**R. pp. 927–929; 4809–4810**). From an economic perspective, South Carolina's share of CarMax's total sales would reliably reflect CarMax East's operations in South Carolina. *See* Hr'g Tr. 324:4–325:4 (**R. pp. 929–930**). Combined unitary reporting accomplishes this and produces a result that reasonably reflects CarMax East's economic activity in South Carolina. *See* Hr'g Tr. 552:18–22 (**R. p. 1157**). Further, combined unitary reporting reasonably approximates arm's length transfer pricing. *See* Hr'g Tr. 554:19–556:7 (**R. pp. 1159–1161**).

The below example of tax year 2015 illustrates the mechanics of separate entity reporting versus combined unitary reporting on the tax returns:

1. Separate Entity Reporting in 2015

In tax year 2015, CarMax's amended federal consolidated return showed a taxable income of $159,609,689 for CarMax East. *See* Joint Ex. 9 at 77 (**R. p. 3165**). Under separate entity reporting, the $159,609,689 was adjusted by $49,295,099 to arrive at South Carolina net taxable income of $208,904,788. *See* Joint Ex. 16 at 1 (**R. p. 3637**). South Carolina net taxable income was then multiplied by the sales factor in subsection 12-6-2280(A) of the South Carolina Code to calculate the taxable

"base" upon which South Carolina's state income tax was calculated.[27] Additionally, under separate entity reporting, the sales factor is calculated with the numerator representing CarMax East's South Carolina sales and the denominator representing CarMax East's sales everywhere (not the CarMax Group's sales everywhere). In 2015, the sales factor was calculated to be 3.35%. Multiplying $208,904,788 by 0.0336 resulted in a taxable base of $7,010,427 to which South Carolina's corporate tax rate of 5% was applied to arrive at a corporate tax equal to $350,521 in 2015.

2. Combined Unitary Reporting in 2015

In contrast, when the Department applied combined unitary reporting in its audit of tax year 2015, it looked at the CarMax Group, not just CarMax East and CarMax West. Thus, the CarMax Group's federal taxable income—$835,068,258—was adjusted to arrive at a South Carolina net taxable income for the CarMax Group of $903,584,022. *See* Joint Ex. 26 at 3 (**R. p. 3747**). Then, the sales factor was adjusted for combined unitary reporting. The numerator of the sales factor became the CarMax Group's South Carolina sales, and the denominator became the CarMax Group's sales everywhere. In 2015, this resulted in a sales factor of 2.507% for CarMax East. *Id.* at 5. (**R. p. 3749**). It is important to note that this apportionment ratio under combined unitary reporting is less than the 3.35% under separate entity reporting. Multiplying $903,584,022 by 0.02507 resulted in a taxable base

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

of $22,652,851. *Id.* This base was then multiplied by South Carolina's corporate tax rate of 5% to arrive at an audited corporate tax equal to $1,132,643 in 2015. *Id.* at 3 (**R. p. 3747**). Thus, the Department's application of combined unitary reporting resulted in larger net taxable income and a smaller sales factor; but overall, it resulted in the calculation of more tax due.[28]

Thus, the ALC correctly concluded and its findings are supported by substantial evidence that combined unitary reporting is reasonable and equitable because it corrects the distortion of the income shifting.

D. The ALC properly addressed CarMax West in its rulings.

CarMax makes much ado about nothing regarding the ALC's consideration of CarMax West. Paradoxically, CarMax claims that the Department is pursuing income from CarMax West although combined unitary reporting results in a refund for CarMax West. *See* Hr'g Tr. 62:14–18 (**R. p. 667**). As discussed above, CarMax East directly and wholly owns CarMax West, and the two entities share directors and executives. CarMax's 30(b)(6) designee Ms. Yost testified for CarMax West in the prior *CarMax* case and testified for CarMax East in the instant case. If CarMax West had a legitimate concern over its rights, it could have moved to intervene in the contested case hearing. *See* Rule 20, SCALC. Despite the same people (attorneys and witness) representing CarMax East and CarMax West, no motion to intervene was filed. Instead, CarMax concedes in its Protest that "Taxpayer (collectively) consists of the following corporations which are relevant to the Audit: CarMax, Inc.,

[28] The above examples of how the reporting methods were applied to CarMax's taxes in 2015 demonstrate how the reporting method impacts not just how much federal taxable income, and therefore South Carolina taxable income, is utilized to apportion income to South Carolina, but also how the reporting method impacts the calculation of the sales factor to ultimately calculate the taxable base apportioned to South Carolina. If the taxable income is based upon a separate, single entity, then so is the sales factor. Likewise, if the taxable income is based upon a group of related entities, then so is the sales factor. A mathematical proportionality is maintained that ensures the sales factor ratio matches the taxable income to which it is applied.

[CarMax East], and [CarMax West]." *See* Joint Ex. 32 at 1 (**R. p. 3794**). Ironically, CarMax West argued in the previous *CarMax* case that the ALC erred in: "failing to consider that CarMax West operates a unitary business and permitting the Department to use separate accounting procedures when calculating tax liability of a unitary business." *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 84, 767 S.E.2d 195, 197 (2014).

The ALC properly addressed CarMax's arguments regarding CarMax West in its Amended Final Order and did not order relief that directly affects CarMax West. *See* Amended Final Order and Order Granting Motion for Reconsideration (**R. pp. 84–152; 74–83**). The Department's audit covered both CarMax East and CarMax West. *See* Joint Ex. 26 Report of Field Audit (**R. pp. 3745–3761**). The Report of Field Audit identifies the taxpayer as "CarMax Auto Superstores, Inc. & Affiliates." *Id.* Further, the Report of Field Audit separately accounts for CarMax East and CarMax West in its calculations and analysis. Notably, CarMax's 30(b)(6) witness testified that, if combined unitary reporting was an appropriate methodology, then she did not disagree with the Department's calculations under that method. *See* Joint Ex. 85—CarMax 30(b)(6) Depo Tr. 21:4-16 (**R. p. 4580**); *see also* Hr'g Tr. 832:9-16 (**R. p. 1437**). Combined unitary reporting combines the income of unitary business group members and apportions that combined income among the states. *Media General*, 388 S.C. at 146, 694 S.E.2d at 529.

Under combined unitary reporting, CarMax East's tax liability increased while CarMax West's tax liability decreased. *See* Hr'g Tr. 62:14–18 (**R. p. 667**). For administrative efficiency and consistent with Department practice, the Department issued a single net assessment to CarMax East. *See* Hr'g. Tr. 60:8–22 (**R. p. 665**). The amount of the assessment sent to CarMax East is its additional tax owed minus the refund owed to CarMax West. *See* Hr'g. Tr. 62:19–63:4 (**R. pp. 667–668**); *see also* Respondent's Demonstrative 1 (**R. p. 4773**). The Department would have separated the liability/refund if CarMax had requested separate assessments—but CarMax never made such a

request. *See* Hr'g. Tr. 63:5–8 (**R. p. 668**). This is unsurprising because, as discussed above, the CarMax Group commingles its funds. Ultimately, CarMax East was properly credited with taxes paid by its wholly owned subsidiary CarMax West, and the ALC correctly found combined unitary reporting to be a reasonable equitable apportionment method.

CONCLUSION

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

Respectfully Submitted,

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September 15, 2025

THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

APPEAL FROM THE S.C. ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-001558
Administrative Law Court Case No. 21-ALJ-17-0182-CC

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

v.

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

PROOF OF SERVICE

I, the undersigned Paralegal with the South Carolina Department of Revenue, attorneys for the Respondent, hereby certify that I have served all counsel listed below with South Carolina Department of Revenue's Final Brief via electronic mail:

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VIA ELECTRONIC MAIL to ctappfilings@sccourts.org
The Honorable Jenny Abbott Kitchings
SC Court of Appeals
Clerk of Court
1220 Senate Street
Columbia, SC 29201

Re: CarMax Auto Superstores, Inc. v. South Carolina Department of Revenue
Appellate Case No. 2024-001558

Dear Ms. Kitchings:

Attached please find South Carolina Department of Revenue's Final Brief in the above referenced matter which we are filing electronically. Additionally, I have included a Proof of Service for the same.

By copy of this letter, we are serving counsel of record with a copy of the same.

Sincerely,

Marcus D. Antley, III

MDA/jdg

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