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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-001558

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

v.

South Carolina Department of Revenue, ... Respondent.

RECORD ON APPEAL
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[2] The last page for both Joint Exhibit 7 and 8 was filed under seal.
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[5] Respondent's Demonstrative Exhibits 1, 2, and 3 were filed under seal. Additionally, Respondent's Demonstrative Exhibit 1 is an electronic document submitted to the Court via a thumb drive.

[6] The bulk of the remaining exhibits in this deposition are duplicates of items already included in the Record on Appeal, so the placeholder for each will refer to the page where each exhibit was previously included.

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of the trade or business carried on within this State." S.C. Code Ann. § 12-6- 2210(B) (2014). Additionally, if a taxpayer's principal business in South Carolina is "selling, distributing, or dealing in tangible personal property," then it "shall make returns and pay annually an income tax that includes its income apportioned to this State." S.C. Code Ann. § 12-6-2252(A) (2014). No one disputes that CarMax is a retailer principally engaged in selling tangible personal property in this State, therefore, subsection 12-6-2252(A) applies.

Next, under subsection 12-6-2252(A), the taxpayer's "income apportioned to this State is determined by multiplying the net income remaining after allocation[28] . . . by the sales factor defined in Section 12-6-2280." *Id.* Pursuant to subsection 12-6-2280(A), "[t]he sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year." S.C. Code Ann. § 12-6-2280(A) (2014). This statutorily described method of multiplying a taxpayer's South Carolina net income by the sales factor is known as "standard apportionment." However, where this standard method of allocation and apportionment does not "fairly represent the extent of the 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:

> (1) separate accounting;
>
> (2) the exclusion of one or more of the factors;
>
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added). At issue in this case is the Department's application of subsection 12-6-2320(A)(4), to impose combined unitary reporting on CarMax after it concluded that separate entity reporting resulted in an allocation and apportionment that did not fairly represent the extent of CarMax's business activity in South Carolina.

Media General

In 2010, the South Carolina Supreme Court issued an opinion in *Media General Communications,*

[28] Allocation is not an issue in this case. Furthermore, for the purpose of this case and pursuant to subsection 12-6- 2252(A), "South Carolina net income" will refer to the amount of calculated income that is multiplied by the sales factor. The result of multiplying the sales factor by South Carolina net income will be referred to as the "taxable base" upon which a corporation is taxed at the rate of 5%. *See* § 12-6-2210(B) (providing "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" (emphasis added)).

Inc. v. South Carolina Department of Revenue, 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010) (*Media General*). In this opinion, our supreme court analyzed whether the Department could require a multistate taxpayer that was part of a unitary business to use "combined entity apportionment" instead of "separate entity apportionment" under subsection 12- 6-2320(A)(4). *Id.* At 140-42, 694 S.C. at 526-27. The supreme court held the Department had the authority to utilize combined entity apportionment, which, as explained below, is the same as "combined unitary reporting." *Id.* at 151, 694 S.C. at 532. Accordingly, subsection 12-6-2320(A)(4) authorizes the Department to require combined unitary reporting.[29]

Reporting Method and Apportionment Are Not Meaningfully Distinct Under Media General

The parties agree that separate entity reporting is the default method in South Carolina.[30] This means that, unless otherwise provided, each corporation is individually subject to tax in South Carolina, even if they are related entities that make up a "unitary business," and each files a separate tax return. S.C. Code Ann. § 12-6-4910(2) (2014) ("Income tax returns must be filed by the following: . . . (2) a corporation subject to tax under this chapter."); S.C. Code Ann. § 12-6-530 (2014) (Imposing an income tax on every corporation "transacting, conducting, or doing business within this State of having income within this State"). Because each separate corporation, even if they are part of a unitary business, files a separate tax return, only the modified federal taxable income of the single entity appears in the calculation of South Carolina income tax. § 12-6-580 ("South Carolina taxable income" is "computed . . . under the Internal Revenue Code with modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter."). Section 12-6-5020 of the South Carolina Code (2014) provides an exception to separate entity reporting and allows certain related corporations to file a single tax return called a consolidated income tax return.[31] However, a

---

[29] Although combined unitary reporting is allowed, the Department must meet its burden under subsection 12-6-2320(A)(4). *See Media General*, 388 S.C. at 151, 694 S.C. at 532; *see also Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014) (holding where "the Department alone is arguing that the statutory formula does not fairly represent the taxpayer's business in South Carolina—the Department bears the burden to prove (1) that the statutory formula does not fairly represent [the taxpayer's] business activity in South Carolina and (2) that the proposed alternative formula is reasonable").

[30] "Separate entity reporting" is not the same as "separate accounting" for the purposes of apportionment. *See, e.g., Am. Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 690 (Tenn. Ct. App. 1994) ("Tennessee's standard apportionment formula, set forth in Tennessee Code Annotated § 67–4–811, may be referred to as requiring "separate entity reporting," however, that formula is not equivalent to separate accounting. The standard apportionment formula in Tennessee Code Annotated § 67–4–811 produces a ratio which is multiplied by the taxpayer's apportionable income.").

[31] Only corporations that are subject to tax in South Carolina are allowed to be included in the consolidated return, and each corporation in the consolidated return must separately determine its South Carolina taxable income or loss. § 12-6-5020(B)-(D).

consolidated return is not the equivalent of combined unitary reporting. A consolidated return taxes the income of the consolidated entities, whereas combined unitary reporting merely uses the group's net income to better calculate the tax upon a single taxpayer within the group, not the consolidated group as a whole.[32]

The Supreme Court of Michigan adeptly summarized the difference between separate entity reporting and combined reporting and their relationship to "formulary apportionment."

> Our state has adopted formulary apportionment for individual taxpayers in the ITA [Michigan Income Tax Act]. Recognizing that Michigan is a formulary apportionment state, however, does not resolve the issue in this case because there are at least two different methods of applying the apportionment formula. First, a state may use separate-entity reporting, which requires each entity with a nexus to the taxing state to be considered as a separate and distinct entity, regardless of whether it could comprise a unitary business with other entities.
>
> Alternatively, a state may use combined reporting, which requires "each member of a group carrying on a unitary business [to] compute[ ] its individual taxable income attributable to activities in [the state] by taking a portion of the combined net income of the group through the utilization of combined apportionment factors."

Malpass v. Dep't of Treasury, 494 Mich. 237, 247, 833 N.W.2d 272, 277 (2013) (citation omitted). Notably, the Supreme Court of Michigan considered both separate entity reporting and combined reporting to be methods of applying the **apportionment formula**. Thus, while the Supreme Court of Michigan recognized different types of reporting, it considered them to underneath the umbrella of apportionment.[33] Although some courts have distinguished between reporting methods and

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[32] *See, e.g., Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 861, 935 S.W.2d 252, 254 (1996) ("In a combined report . . . the combined income of the affiliated group is not computed for the purpose of taxing such income, but rather as a basis for determining the portion of income from the entire unitary business attributable to sources within the state which is derived by members of the group subject to the state's jurisdiction." (quoting *Chesapeake Indus. v. Comptroller*, 59 Md.App. 370, 376, 475 A.2d 1224, 1227 (1984)).

[33] Several other state courts have referred to combined reporting as a form of apportionment. *See Pioneer Container Corp. v. Beshears*, 235 Kan. 745, 756, 684 P.2d 396, 406 (1984) ("The combined report method of allocation of income and expenses is wholly consistent with and a natural extension of the allocation and apportionment purpose of UDITPA and its three-factor formula rather than an exception thereto."); *Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691 (Tenn. Ct. App. 1994) (referring to combined reporting as a method of apportionment); *Hewlett-Packard Co. v. State, Dep't of Revenue*, 749 P.2d 400, 401 (Colo. 1988) ("The combined method, also known as unitary apportionment, is based on a recognition that an integrated business may operate through several separately incorporated entities.'"); *Coca Cola Co. v. Dep't of Revenue*, 271 Or. 517, 528, 533 P.2d 788, 793 (1975) ("The combined method of apportionment reporting is wholly consistent with, and a natural extension of, the apportionment method.").

apportionment methods,[34] in *Media General*, both the underlying ALC order and the South Carolina Supreme Court referred to combined unitary reporting (or simply combined reporting) as "combined entity apportionment." Essentially, the terminology they used combined the reporting method with apportionment and did not endeavor to distinguish them in any meaningful way. The clear implication is the South Carolina Supreme Court, like the Supreme Court of Michigan, found the reporting method to be under the umbrella of apportionment for the purpose of applying subsection 12-6-2320(A)(4).

This conclusion is consistent with section 12-6-2320(A), which should not be read too narrowly. It provides for the alternative use of other methods of allocation and apportionment, "[i]f the **allocation and apportionment provisions of this chapter** do not fairly represent the extent of the taxpayer's business activity in this State." (emphasis added). In fact, in *Media General*, the supreme court agreed with the ALC that "the legislature enacted section 12-6-2320 as a relief mechanism, and [held] 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. The supreme court also appeared to agree with the ALC's determination that to find otherwise would "thwart legislative intent clearly expressed in **the general allocation and apportionment statutes**," i.e. subsection 12-6-2210(B). *Id.* This prevents a taxpayer from utilizing a corporate structure to patently circumvent fairly reporting their business activity in South Carolina and thus the revenue earned in this state, under the theory that their actions did not implicate the apportionment formula or ratio.

Furthermore, section 12-6-2320(A) must be read in context with the general statutory tax laws. Specifically, pursuant to the principles of statutory construction, statutes are to be read in harmony with each other whenever possible to give effect to each and achieve the legislative purpose. *See Sloan v. Hardee*, 371 S.C. 495, 499, 640 S.E.2d 457, 459 (2007) (holding "the statute must be read as a whole and sections which are a part of the same general statutory law must be construed together and each one given effect."). Thus, the Court must look at the provisions of all of Chapter 6 of Title 12 and determine

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[34] *See, e.g., Cook v. Dep't of Revenue*, 23 Or. Tax 107, 114 (2018) ("The court is of the opinion that, notwithstanding some imprecise language in discussions of courts over the years, combined reporting is a concept and process separate and distinct from that of apportionment. Apportionment is the process by which a 'base' of business income is divided among two or more states However, apportionment of a 'base' is separate from determination of the 'base.'");
Joslin Dry Goods Co. v. Dolan, 200 Colo. 291, 295, 615 P.2d 16, 18 (1980) ("Section 39-22-303(5) provides that the department may distribute or allocate income and deductions, or may require returns on a consolidated basis. We conclude that it is that statutory provision for distribution and allocation of income and deductions which authorizes the department to require combined reports since a combined report does allocate or apportion income.").

whether, as a whole, the provisions of Chapter 6 result in a fair representation of the taxpayer's business activity in this State. *See TNS Mills, Inc. v. S.C. Dept. of Revenue*, 331 S.C. 611, 503 S.E.2d 471 (1998) ("In construing statutory language, the statute must be read as a whole, and sections which are part of the same general statutory law must be construed together and each one given effect.").

One provision of import in Chapter six is subsection 12-6-2210(B) in Article 17, which instructs that "[i]f 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**." (emphasis added). According to the Department's evaluation of Petitioner's tax returns during the audit period, the South Carolina income tax was imposed upon a taxable base that **does not** "reasonably represent the proportion of the trade or business carried on within this State" contrary to subsection 12-6- 2210(B). Moreover, because it is CarMax's taxable income that is causing the distortion, and not the sales factor, reading subsection 12-6-2320(A)(4) as not allowing the Department to use an alternative reporting method as a means of reapportioning the income more fairly would allow separate reporting to remain intact but would lead to a violation of subsection 12-6-2210(B). Thus, subsection 12-6-2210(B) is also a source of authority for the Department to impose combined unitary reporting.[35] *See Duke Energy Corp. v. S.C. Dep't of Revenue*, 415 S.C. 351, 356, 782 S.E.2d 590, 592 (2016) (holding the primary thrust of South Carolina's apportionment statutes is "to apportion to South Carolina a fraction of the taxpayer's total income reasonably attributable to its business activity in this State.").

In sum, since the reporting method is within the scope of apportionment, the Department has the authority under subsection 12-6-2320(A)(4) to modify both South Carolina net income and the sales factor to fairly reflect the business activity of the taxpayer in the State. Obviously, to determine whether a taxpayer's business activity is fairly represented, the Department may need to look at the taxpayer's group activity to discern whether the taxpayer is using its group activity to circumvent reporting its business activity. Otherwise, a taxpayer could shroud its diversion of income via a transfer pricing agreement.

Does Separate Entity Reporting Fairly Represent the Extent of Petitioner's Business Activity in South Carolina?

Section 12-6-2320 provides that "[i]f the allocation and apportionment provisions of this

[35] Indeed, some other states have resorted to non-UDIPTA statutes like this to support the imposition of combined reporting where those courts have found a meaningful distinction between reporting method and apportionment. *See, e.g., Joslin Dry Goods Co. v. Dolan*, 200 Colo. 291, 297, 615 P.2d 16, 20 (1980).

chapter do not fairly represent the extent of the taxpayer's business activity in this State, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable: . . . (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." In cases where the Department asserts an alternative apportionment method under section 12-6-2320, our supreme court has held that the Department bears the burden of proof. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200; *Rent-A-Center*, 418 S.C. at 333, 792 S.E.2d at 267. There are two steps in this process: the Department must prove (1) that the statutory formula does not fairly represent CarMax's business activity in South Carolina and (2) that the proposed alternative formula is reasonable. *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200.

CarMax is Part of a Unitary Business

As a preliminary matter, I find both factually and legally that CarMax East, CarMax West, and CBS are a unitary business. As the U.S. Supreme Court has recognized, there is no uniform set of facts that will always define a unitary business. *See Allied-Signal, Inc.*, 504 U.S. at 785 ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach . . . and also because the constitutional test is quite fact sensitive." (internal quotation marks and citation omitted)). Nevertheless, it has held that "where the asset in question is another business," the "hallmarks" of a unitary business are "functional integration, centralized management, and economies of scale." *MeadWestvaco Corp.*, 553 U.S. at 30. South Carolina has adopted similar hallmarks of a unitary group, including "unity of management, ownership, and control of operations resulting in unquantifiable flows of value among the related entities of the business." *Media General*, 388 S.C. at 141, 694 S.E.2d at 526 (2010); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 602, 258 S.E.2d 93, 97 (1979) ("The corporation possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of E & P, refining and marketing all contributed to and depended upon each other.").

The three hallmarks recognized by South Carolina align with the definitions to which the parties' witnesses testified. The three subjective tests for determining whether a business is unitary are the (1) unity of operations; (2) unity of use (or centralized management); and (3) contribution and dependency (functional integration). CarMax East, CarMax West, and CBS meet each of three definitions for a unitary business. I therefore conclude the CarMax East, CarMax West, and CBS are a unitary business under each of the three tests.[36]

[36] CarMax's organizational structure has not changed materially since it argued that CarMax West and

Specifically, under unity of operations, the Group shares a significant amount of operations; specifically, CBS provides accounting, legal, marketing, payroll, and other back-office support to CarMax East and West. Additionally, through CBS providing these uniform functions across the Group, the entire Group benefits from economies of scale. Hr'g Tr. 832:17-833:2. CarMax's inventory of vehicles is a collective activity of all the stores together. Hr'g Tr. 229:9-230:6.

CarMax admits that CarMax East, CarMax West, and CBS have centralized management. Hr'g Tr. 828:14-23. The entire C-suite of executives is located in CBS, CBS' executives signed the intercompany agreements on behalf of CarMax East, CarMax West, and CBS. Joint Exhibits 34-36; Hr'g Tr. 829:28-30:7

Lastly, CarMax East, CarMax West, and CBS are very dependent upon each other to function as a result of the intercompany agreements. CarMax East and West rely on CBS to develop and manage trademarks and trade name, corporate business management services (finance and accounting, legal, human resources, information technology, marketing, etc.), business strategy, and data analytics. Hr'g Tr. 751:21-18. None of the three entities could function on their own. CarMax East, CarMax West, and CBS are highly integrated. Hr'g Tr. 226:9-230:6.

Thus, based upon the highly integrated and dependent nature of the companies and their centralized management and control, I find CarMax East, CarMax West, and CBS meet the definition of a unitary business.

Business Activity in South Carolina

Subsection 12-6-2320(A) requires the Department to show the extent of CarMax's "business activity" in South Carolina is not fairly represented by standard apportionment pursuant to separate entity reporting. "Business activity" is not defined for the purposes of subsection 12-6-2320(A). However, it is not so hard to discern in this case, and it is readily admitted by Petitioner. Petitioner proclaims itself to be a retailer whose business activity in South Carolina is measured by its retail sales in South Carolina. CarMax East's business activity in South Carolina is selling used cars, financing, and extended service plans. Hr'g Tr. 58:2-11. CarMax West's business activity is the flow-through income it receives from the CBS partnership. Hr'g Tr. 57:9-17.

In its Department Determination, the Department found CarMax's business activity was not being fairly represented by separate entity reporting because CarMax East was utilizing intercompany transactions to shift income from its retail sales to CarMax West via the CBS partnership, thereby

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CBS were unitary in the previous *CarMax* trial and appeals. Hr'g Tr. 825:8-15.

significantly reducing its South Carolina taxable income. While the Department may not have specifically stated that CarMax's business activity in the state is represented by the income from its South Carolina retail sales, that finding is implicit throughout its Determination. And, while in some cases, income may not reflect business activity, where most of CarMax's income, and indeed the Group's income, comes from retail sales, I find that it does.[37] Furthermore, the evidence at the de novo hearing before this Court established that Petitioner's business activity in South Carolina. For instance, Dr. DeRamus quantified CarMax's sales and taxable income, its South Carolina sales, and the change in income reported by CarMax before and after the intercompany transaction between CarMax East and West and CBS shifted the income from the sales from CarMax East to CarMax West. Hr'g Tr. 323:2-324:3. Therefore, I find the Department identified Petitioner's business activity in South Carolina as its retail sales.

Fairly Represented—Distortion

At what threshold does a method of apportionment stop fairly reflecting the extent of a taxpayer's business in a state? Pursuant to *Container Corp.*, a standard apportionment method offends the Constitution when it is shown by "clear and cogent evidence" that the apportioned income is "out of all appropriate proportion to the business" transacted in the state or "has led to a grossly distorted result." 463 U.S. at 169-70. While this constitutional threshold applies in all cases in which a party challenges the constitutionality of a state's method of apportionment, South Carolina has not inversely adopted it as its minimum threshold to establish unfairness in determining whether to utilize an alternative method apportionment. Furthermore, while South Carolina's alternative method apportionment codified in section 12-6-2320 is very similar to Section 18 of UDIPTA, South Carolina has not adopted UDIPTA. Thus, South Carolina is not bound by any commentary or construction of Section 18.

Although the ALC must itself determine the proper criteria for determining when separate entity reporting does not fairly represent a taxpayer's business activity in South Carolina, it is helpful to consider the analysis utilized by the Department. In Revenue Ruling #15-5, which sets forth the Department's policy on the application of alternative apportionment methods, the Department specifically notes that while some applications of alternative apportionment may involve "unusual or unique circumstances," it will not require such circumstances to be shown to apply alternative

[37] *Cf. Twentieth Century-Fox Film Corp.*, 299 Or. at 233–34, 700 P.2d at 1042–43 (1985) ("It is also important to note that it must be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.").

apportionment. S.C. Revenue Ruling #15-5 at 4. Rather, the Department's inquiry is focused on the statutory language of section 12-6-2320, which simply requires the party seeking an alternative method to "factually identify why the use of the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina." *Id.* I find the Department's interpretation to be reasonable and decline to impose any more stringent standard than the statutory language itself imposes.[38] *Kiawah Dev. Partners, II v. S.C. Dep't of Health & Env't Control*, 411 S.C. 16, 34, 766 S.E.2d 707, 718 (2014) ("[W]here an agency charged with administering a statute or regulation has interpreted the statute or regulation, courts, including the ALC, will defer to the agency's interpretation absent compelling reasons.").

Furthermore, in Revenue Ruling #15-5, the Department outlined "[s]ome of the facts" it may consider when determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina. Revenue Ruling #15-5 at 6. Those facts include:

> (1) amounts paid to related parties for good and services or goods and services provided without payment;
> (2) profit margins associated with business activities;
> (3) capital investments associated with business activities;
> (4) whether goods and services are provided to both related and unrelated parties on similar terms;
> (5) whether taxpayers in similar industries provide similar good and services to unrelated parties under similar terms; and
> (6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated third party considering, among other issues, the relinquishment of control over the business activity.

Revenue Ruling #15-5 at 6-7.

The Department also comments that a 482 transfer pricing study to support prices between related entities "is not determinative of whether South Carolina's statutory apportionment formula fairly represents the taxpayer's business activities in South Carolina." Revenue Ruling #15-5 at 7. It further states that it has required or approved combined unitary reporting "in situations involving the use of purchasing companies, management fee companies, and "east/west" companies within a unitary group." Revenue Ruling #15-5 at 7 (footnotes omitted).

In addition to the guidance provided by the Department in Revenue Ruling #15-5, our supreme court has commented on the type of evidence that may satisfy (or not satisfy) the statutory threshold. In *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, the South

[38] *Media General* did not adopt a standard because the parties in that case stipulated that separate entity apportionment created distortion and did not fairly represent the taxpayers' business activity in the State. *Media General*, 388 S.C. at 143, 694 S.E.2d at 527.

Carolina Supreme Court found the evidence offered by the Department did not meet its burden to show the statutory formula did not fairly represent CarMax West's business activity in South Carolina. 411 S.C. 79, 90–91, 767 S.E.2d 195, 201 (2014). The insufficient evidence cited by the supreme court included (1) testimony from the Department's auditor that the "business structure of CarMax West and CBS is often 'linked with tax minimization strategies,'" (2) "the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East" in support of the Department's "determination that CarMax West's income was diluted," and (3) "bald assertions by [the Department's] witnesses that it satisfied this threshold question." *Id.* at 90-91, 767 S.E.2d at 201.

The South Carolina Court of Appeals likewise found the Department failed to meet its burden in *Rent-A-Center West Inc. v. South Carolina Department of Revenue*, 418 S.C. 320, 333, 792 S.E.2d 260, 267 (Ct. App. 2016). The court of appeals rejected the following Department testimony as insufficient to show the statutory formula did not fairly represent Rent-A-Center's business activity in South Carolina: (1) Rent–A–Center was comprised of multiple entities and the Department auditor believed a management services fee was too high and (2) the Department expert indicated excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina" and "using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator." *Id.* The court of appeals specifically noted that the Department's auditor "did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities." *Id.*

Based upon these two cases, it is clear the Department must provide specific evidence supporting its assertion that separate entity reporting does not fairly reflect CarMax's business activity in South Carolina. *See Carmax Auto Superstores W. Coast, Inc.*, 411 S.C. at 90-91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. In other words, the Department cannot rely on business characteristics or business structures that "may" indicate a tax minimization scheme, bald assertions of unfairness or distortion, or a contention that standard apportionment results in less tax to this State. *See id.* Nevertheless, I find that the facts listed in Revenue Ruling #15-5 provide good guidance for determining if the standard apportionment method fairly represents a taxpayer's business in South Carolina.

CarMax's Business Activity in South Carolina is Distorted

The determination of whether CarMax's business activity in South Carolina is fairly represented requires the Court to evaluate CarMax's business activity in the context of the unitary

business. As described in this Order, CarMax East, CarMax West, and CBS engage in several intercompany transactions for services they provide to each other. CarMax East pays roughly 74.5% of the management fees to CBS yet receives only 6.5% of CBS' net income. Hr'g Tr. 824:21-825:1. On the other, CarMax West pays roughly 25.5% of the management fees to CBS yet receives 93.5% of CBS' net income. Hr'g Tr. 825:2-7. A portion of this represents income shifted from CarMax East's South Carolina retail sales to CarMax West.

The evidence established that the shift in CarMax East's income to CarMax West through the management fees paid to CBS results in a distortion of CarMax's income, which also results in an unfair representation of CarMax's business activity in South Carolina.

Further, since CarMax's business activity in South Carolina is its retail sales, income from retail sales is a proxy for business activity. Accordingly, the enormous shift in income from CarMax East to CarMax West shows that CarMax East's business activity, including its business activity in South Carolina, is being substantially diluted by income shifting through the management fee and CBS partnership distributions. The income shift and its resulting dilution/distortion are not justified by Petitioner's explanations.

First, the distortion is not justified by the E&Y transfer price studies. Although the E&Y transfer pricing studies were used to support management fee, it is flawed and unreliable. Therefore, I do not find the E&Y reports explain or otherwise justify the distortion in income created by the management fee.

Even if the transfer pricing was accurate, the disproportionate distributive shares of CBS would lead to distortion.

Alternatively, if the distributive shares must be taken as a given, the cost would need to be split in the same proportion, which would drastically reduce the management fee paid by CarMax East to CBS. Hr'g Tr. 1241:18-12244:1. Further, it is well-established in South Carolina that courts impose the "matching principle," and CarMax Group's intercompany transaction violates the 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 General Assembly's intent); *see also In the Matter of the Petition of InterAudi Bank f/k/a Bank Audi (USA)*, 2011 WL 1537402 (N.Y.Tax App.Trib.) (Apr. 14, 2011). Under separate reporting, CarMax's artificial income shifting violates the matching principle by failing to match income shifted outside of South Carolina (and thus income non-taxable by South Carolina) with the expenses incurred (and deducted in South Carolina) by CarMax East in

producing that income.

Therefore, the persuasive and reliable evidence before the Court indicates that an unreasonably large portion of CarMax's South Carolina income is being shifted, unjustifiably, from CarMax East, an entity with a significantly higher South Carolina apportionment ratio, to CarMax West, an entity with a significantly lower South Carolina apportionment ratio. Because income is a proxy for retail sales in this case, this shift is distorting CarMax's business activity in this State.

Separate Reporting Does Not Fairly Reflect CarMax's Business Activity in this State

The Department cannot choose an alternative method simply because separate reporting leads to lower taxes compared to combined unitary reporting or some other method. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."). South Carolina's legislature has determined separate reporting is the default reporting method used to apportion income to South Carolina. The TRAC report suggests South Carolina is a "Forced Combined Reporting" state. *See* Joint Exhibit 56 at p. 161-162. Nonetheless, the default method should not be lightly disregarded. *See Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 89–90, 767 S.E.2d 195, 200 (2014); *citing with approval Donald M. Drake Co. v. Dep't of Revenue*, 263 Or. 26, 500 P.2d 1041, 1044 (1972) (holding "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof). Moreover, the Department has the authority and power under the 482 Regulations to adjust the transfer price if necessary. Therefore, although the income shifted from CarMax East to CarMax West distorts CarMax East's South Carolina business activity in this State, the standard reporting method should be used to correct the distortion if its use can reasonably represent CarMax's business activity in this State.

In this case, I find the application of separate entity reporting resulted in the taxpayer's business activity being unfairly represented in this state. Importantly, I do not find that the corporate structure of the Group, the unitary nature of the Group, or the presence of intercompany transactions on their own indicates that CarMax's business activity was not being fairly reflected by separate entity reporting. *See Carmax*, 411 S.C. at 90- 91, 767 S.E.2d at 201; *Rent-A-Ctr. W. Inc.*, 418 S.C. at 333, 792 S.E.2d at 267. Indeed, if the transfer prices were reasonable and supported by a reliable transfer pricing study and not disproportionately distributed by the CBS partnership, I would not conclude that separate reporting resulted in an unfair representation of CarMax's business in this state. However, the transfer price and

distributive shares, which are causing the distortion in this case, is a product of Petitioner's business structure and intercompany transactions; therefore, I cannot completely ignore the fact that the underlying corporate structure created an environment in which the transfer price was used to shift income. And here, the unreasonable transfer price allowed Petitioner to take advantage of separate reporting to substantially lower its tax burden in South Carolina by shifting income from CarMax East to CBS. Accordingly, the application of separate entity reporting during the audit years resulted in a taxable base that did not fairly reflect CarMax's business activity in South Carolina.

In fact, separate reporting allowed CarMax to take advantage of the distortion and substantially lower its tax burden in South Carolina. Through these distortive intercompany transactions, CarMax East reduces its taxable income by $1.6 billion for the audit period while CarMax West increases its income by $1.4 billion. Hr'g Tr. 59:7-25. The CarMax Group produce $30.99 of taxable for every $100 of income it produces. Hr'g Tr. 68:18-69:5. CarMax East has $10.54 of taxable income for every $100 of income it produces while CarMax West has $57.00 for every $100 of income it produces. Hr'g Tr. 70:8-22. In other words, CarMax West's Income produces 541% more federal taxable income than CarMax East's Income produces.

However, here, separate entity reporting cannot be used to correct the distortion because neither expert produced a corrected transfer price. In other words, the Court cannot simply adjust the transfer price and fix the issue. Similarly, the Court cannot simply adjust the ownership percentages of CBS and fix the issue. Dr. DeRamus did not conduct a comprehensive transfer pricing study in which he came up with a reliable transfer price or appropriate distributive shares. Dr. Cody did not complete his own study. Instead, he simply relied on the flawed and unreliable transfer pricing studies and accepted the ownership percentages of CBS as given. Thus, likewise, he did not produce a reliable and accurate transfer price and ownership percentages to use to fix the artificial shift of income from CarMax East to CarMax West. And, while the Department has the authority and power to challenge and correct transfer prices under the 482 Regulations, its employees do not have the training, capacity, or resources to evaluate transfer prices in an expert manner and must rely on other indicators of distortion prior to hiring a transfer pricing expert during litigation. The transfer pricing issues are further complicated by the disproportionate distributive shares of CBS. Thus, there is no evidence to support what a corrected transfer price would be to allow separate entity reporting to fairly reflect CarMax's business activity in this state and transfer pricing adjustments alone would not remedy the distortive distributive shares.

Accordingly, while the reporting method is not the true problem in this case, the Court is

constrained by the evidence before it and must deal with the fact that without a corrected transfer price or distributive shares, the application of separate entity reporting results in a taxable base that does not a fairly reflect CarMax's business activity in South Carolina. *See* § 12-6-2320(A); *see also Exxon Corp. v. S.C. Tax Comm'n*, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State."). As a result, I must look to subsection 12-6-2320(A)(4) as a method of relief; while it may not be the legislature's default method of apportionment, the relief under section 12-6-2320 is also an expression of the legislature's will.

In sum, application of relief under subsection 12-6-2320(A)(4) should be on a case-by-case basis and should reflect the specific facts of each case. The case before the Court is very fact- driven, and it is not one that is likely to reoccur if a unitary company reasonably set forth its transfer prices. One would hope, at least, that the use of an unreasonable transfer price is categorized as unusual. However, in this case, it is clear CarMax is more than benignly taking advantage of a corporate structure and South Carolina's default reporting method—it is using a transfer price and partnership structure to significantly misrepresent its business activity in South Carolina and lower its tax burden in South Carolina without reasonable and reliable justification from a transfer pricing or economic perspective. Thus, my finding in this case that separate reporting does not fairly represent CarMax's business activity in this State is unlikely to unleash a torrent of alternative apportionment cases in this State and thus allow the exception to swallow the rule. And, if there was a way to fix the significant artificial dilution of CarMax's business activity in South Carolina through fixing the transfer price and distributive shares while utilizing separate reporting, then I would rule in that direction. Since there is not, I must next determine whether the use combined unitary reporting as an alternative apportionment method for the audit period is "reasonable" and results in the "equitable allocation and apportionment of the taxpayer's income." § 12-6-2320(A)(4); *Carmax*, 411 S.C. at 89, 767 S.E.2d at 200 (holding the Department must prove that the proposed alternative formula is reasonable). I find that it did.

Is the Combined Unitary Reporting Method a Reasonable Alternative Appointment Method?

Pursuant to subsection 12-6-2320(A), "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, 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 allocation

and apportionment of the taxpayer's income." § 12-6-2320(A)(4).[39] In applying this test, I again recognize that it is not reasonable to apply combined unitary reporting simply because a business is unitary in nature. *See Rent-A-Ctr. E., Inc.*, 42 N.E.3d at 1048–49 ("Regardless of a possibility of distortion, however, Indiana's AGIT statutory framework does not require a member of a unitary group to file a combined income tax return solely because there is a unitary relationship."). Moreover, it is not reasonable to impose combined unitary reporting because it will result in more tax than separate entity reporting. *See Carmax*, 411 S.C. at 91, 767 S.E.2d at 201 *citing with approval St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (1978) ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."). Nevertheless, the Department has met its burden to show the application of combined unitary reporting is reasonable and equitable in this case under subsection 12-6-2320(A). Specifically, I conclude combined unitary reporting is a reasonable and equitable alternative method of apportionment under subsection 12-6-2320(A)(4) because it (1) corrects the income shift from CarMax East to CarMax West as a result of the management fee and CBS partnership distributions such that (2) it reasonably and equitably approximates the taxable net income attributable to CarMax's business activity in South Carolina.

First, combined unitary reporting fairly represents the business activity of CarMax in South Carolina. Furthermore, under combined unitary reporting, the net taxable income from the entire unitary group is applied to the sales factor ratio. This eliminates the effect of intercompany transactions while still recognizing the value shifting between companies (whereas the above estimate under separate entity reporting does not account for this value). As a result, the income that was shifted from CarMax East to CarMax West under the management fee and CBS partnership structure is returned to the taxable income used to apportion income to this State. This does not merely correct the amount of taxable income for CarMax East, it adds in CarMax West's taxable income too, which is how the flow of values between the companies continues to be recognized. However, to compensate for this, the sales factor ratio is changed to align with the addition of the other members of the unitary group to the

[39] The definitions of "reasonable" and "equitable" are very similar. Generally, "reasonable" means "fair, proper, or moderate under the circumstance," while "equitable" means "just; consistent with principles of justice and right." *See Reasonable,* Black's Law Dictionary (11th ed. 2019); *see also* Equitable Black's Law Dictionary (11th ed. 2019). Similarly, Merrium-Webster defines "equitable" as "dealing fairly and equally with all concerned" and "reasonable" as "moderate, fair." *See* http://www.merriam-webster.com/dictionary/equitable (last visited on January 26, 2024); *see also* http://www.merriam-webster.com/dictionary/reasonable (last visited on January 26, 2024). Merrium-Webster's definition of "equitable" lists "reasonable" as a synonym.

taxable income. In this particular case, the numerator of the sales factor remains the same in either separate or combined reporting since only CarMax has South Carolina sales, but the denominator changes to a larger number—the Group's sales everywhere—resulting in a smaller sales factor ratio. Accordingly, the taxable income is bigger under combined unitary reporting, but the sales factor ratio is smaller because the taxable income and sales factor ratio are in proportion with each other. While CarMax's overall tax liability increases, CarMax East's tax liability increases and CarMax West decreases. Because the taxable income is in proportion to the sales factor, the result of combined reporting is the taxable base income for the Group reasonably attributed to South Carolina retail sales. Even Petitioner's own witness, Professor Pomp, extolled the virtues of combined unitary reporting as a reasonable method and, in fact a better method than separate reporting, for equitably apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

Overall, I find combined unitary reporting, by the very nature of how it is applied, reasonably carves out and fairly represents the income associated with CarMax's business activity in this case, its retail sales. While no method of apportionment is perfect, I find that combined unitary reporting has the benefit of removing the unreliable transfer prices and distortive distributive shares in this case while recognizing the value flowing between the Group and carving out only the income from retail sales associated with South Carolina (CarMax's business activity). *See Media General*, 388 S.C. at 142, 694 S.E.2d at 527 ("One of the purposes of [combined entity apportionment] is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.").

Finally, I conclude the division of income under combined unitary reporting reflects the economic reality of the business activity engaged in by CarMax. *See Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43. As I have already stated, income is a proxy for retail sales in this case, which is CarMax's business activity in South Carolina and combined unitary reporting reasonably carves out the income associated with CarMax's retail sales in South Carolina, and thus fairly represents its business activity in this State. § 12-6-2320(A)(4).

Because I find the Department has shown by a preponderance of the evidence that combined unitary reporting is reasonable and equitable, I find the Department had the authority to require CarMax to file its taxes during the audit period using combined reporting pursuant to subsection 12-6-23209(A)(4).

CONCLUSION

I conclude the Department has the authority to require combined unitary reporting under subsection 12-6-2320(A)(4). I further conclude that separate entity reporting does not fairly reflect Petitioner's business activity in this State during the audit years and the Department's decision to require combined unitary reporting was reasonable and equitable under subsection 12-6- 2320(A)(4).

ORDER

IT IS HEREBY ORDERED that Petitioner is required to use combined unitary reporting on its South Carolina corporate income tax returns March 1, 2015 through February 28, 2018.

IT IS FURTHER ORDERED that Petitioner must pay, in full, the assessed tax of $2,596,707.97, and the legally required interest,[40] with regard to its 2016 through 2018 South Carolina income tax and license fee obligations.

AND IT IS SO ORDERED.

_____
Ralph King Anderson, III
Chief Administrative Law Judge

_____, 2024
Columbia, South Carolina

[40] Pursuant to S.C. Code Ann. § 12-54-25(A), interest continues to accrue until the tax liability is paid in its entirety.

STATE OF SOUTH CAROLINA

ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc., Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 21-ALJ-17-0182-CC **CARMAX AUTO SUPERSTORES, INC.'S MOTION TO RECONSIDER**

Pursuant to Rule 29(D) of the Rules of Procedure for the Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, CarMax Auto Superstores, Inc. ("CarMax East") respectfully requests that this Court reconsider and amend its Final Order dated July 12, 2024 (the "Order"), a copy of which is attached hereto as **Exhibit A**. This motion is based upon the grounds that the Court has overlooked, misinterpreted, or failed to apply South Carolina law and/or overlooked or misunderstood certain evidence and arguments presented, which, when considered, necessitate reconsidering and amending the Order.[1]

LEGAL ARGUMENT

I. THE COURT ERRED IN REMANDING THIS CASE AND ORDERING THE APPLICATION OF THE *FINNIGAN* METHOD.

The Court's Order remands this matter to the Department "to divide the South Carolina taxable income under CUR between CarMax East and CarMax West during the audit period pursuant to the *Finnegan* (sic) method as described in Revenue Ruling #15-5." Order at 70. The

[1] In support of this motion, CarMax East further relies upon, hereby incorporates, and does not waive, all prior arguments advanced supporting its positions in prior submissions and otherwise at trial.

Order further states that [t]he Department will then issue amended assessments to CarMax East and CarMax West for the audit period." *Id.*

The Court should reconsider and reverse its Order on this issue. No party requested or argued that the Court remand the case to the Department for the *Finnigan* method to be applied or for the Department to issue new assessments against CarMax East and CarMax West, the latter of which is not a party.[2] The Court should not sua sponte raise issues and order relief not raised, argued, or requested by any party. *See Bryan v. Bryan*, 282 S.C. 506, 508, 319 S.E.2d 360, 360 (Ct. App. 1984) ("Due process requires that litigants be placed on notice of the issues which a court is to consider."); *Crocker v. Crocker*, 281 S.C. 154, 158, 314 S.E.2d 343, 346 (Ct. App. 1984) ("A judgment or decree, whether in law or equity, must accord with and be warranted by the pleadings of the party in whose favor it is rendered. If it is not supported by the theory of action on which the pleadings were framed, it is fatally defective."); *United Transp. Union v. State Bar of Mich.*, 401 U.S. 576, 581 (1971) ("A decree must relate specifically and exclusively to the pleadings and proof. If not so related, the provision, because of its vagueness, will jeopardize the exercise of protected freedoms."). Ordering relief on grounds never asserted by the Department would violate CarMax East and CarMax West's due process rights under the Due Process Clause contained in Article I, Section 3 of the South Carolina Constitution and the Due Process Clause of the United States Constitution because, *inter alia*, they had no notice that the Court would be ruling on this issue and thus were denied the opportunity to present a defense thereon.

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[2] In addition, were the Court's order for remand and issuance of the new assessments carried out, upon information and belief, the total tax and interest collectively owed by CarMax East and CarMax West would be greater than the total tax and interest collectively owed by CarMax East and CarMax West were the Court to uphold the assessment against CarMax East at issue in this case.

The Court also should not make rulings regarding CarMax West for the reasons in § II below. Therefore, if the Court does not reverse the Order on the grounds requested by CarMax East herein, the Court should at least amend the Order such that it does not remand the case to the Department for application of the *Finnigan* method and the issuance of new assessments but instead is a final order.

In the alternative, because it is not clear from the Order what happens after the Department issues new assessments, the Court should clarify that after the Department applies the *Finnigan* method and issues new assessments, the Court's Order becomes a final order and incorporates the amounts of the assessments into this final order.

II. THE COURT ERRED IN ISSUING RULINGS THAT DIRECTLY AND INDIRECTLY IMPACT CARMAX WEST, WHICH IS NOT A PARTY IN THIS CASE.

The Court's Order contains many rulings that directly and indirectly materially impact the rights of CarMax West, a non-party, in violation of its due process rights. CarMax West is not a party to this proceeding; the Department has asserted no claims against CarMax West; and neither a party nor the Court has even asserted, much less proven, that the separate corporate form of CarMax East and CarMax West should be disregarded. Accordingly, the Court lacks personal jurisdiction over CarMax West and lacks the authority or ability to Order any relief pertaining to or implicating the rights of CarMax West. *See Ex Parte Hart*, 190 S.C. 4732 S.E.2d 52, 54-55 (1939) (holding the lower court's order "was invalid because of lack of jurisdiction of the county of Greenville, which was not a party to the proceeding in which that order was rendered"); *Hornsby v. Hornsby*, 187 S.C. 463 (1938) ("[A]s the company was not a party to the action and was served with no process of any kind, it is clear that the court was without authority to issue or to enforce the mandate contained in its order."); *James v. Graham*, 114 S.C. 107, 78 S.E. 82, 83 (1913) ("'It

seems to us clear, both upon principle and authority, that there was error in the order appealed from, in so far as it affected the appellant [], because he was not a party to either of the actions[.]'" (quoting *Ex parte Jenkins*, 48 S. C. 332, 26 S.E. 689 (1897)).

Because the Court lacks jurisdiction over CarMax West, and because any relief awarded against a non-party is violative of due process, the Court should reconsider and reverse all findings, rulings, and dicta in its Order that directly or indirectly impact the rights of CarMax West, including the following:

- Remanding the case to the Department and requiring use of *Finnigan* and issuance of new tax assessments against CarMax East and CarMax West.

- Finding that the Department can require the use of CUR solely based on the Department proving CarMax East's business activity is not fairly represented in this state without proving the same as to CarMax West.

    - The Department has never proved CarMax West's business activity is not fairly represented in this state or otherwise shown that it is entitled to invoke the AA Statute against CarMax West. Thus, CarMax West is entitled and required to file its returns using separate reporting and the statutorily mandated apportionment method. As previously explained, the Department's interpretation of the AA Statute is such that it can selectively choose one of multiple South Carolina taxpayers that are members of a unitary group and force CUR on the entire group by proving one South Carolina taxpayer's business activity is not fairly represented in this state. *See* CarMax East Proposed Order at 22. That is incorrect. The Court cannot require CarMax West, or its income, to be included in a tax return filed by CarMax East when CarMax West has already filed its return, paid its taxes owed, is not a party in this case, and has never consented to such action. That is particularly true in this case where the Court's Order is largely based on a finding that CarMax West does not get credit for assets it contributed to CBS and other direct and indirect attacks on its ownership of CBS. The Court's findings all throughout the Order directly impact CarMax West and are a violation of CarMax West's due process rights.

    - CUR is also taxing the same income twice. *See* CarMax East Proposed Order at 20. CarMax West's total income subject to apportionment has already been apportioned to and taxed by this state, and CarMax West has paid its tax due. CUR is taking that same income and again apportioning it to this state to determine CarMax East's tax liability here. *Id.*

- Findings directly or indirectly stating or suggesting that CarMax West is not, or should not be viewed as, the legitimate bona fide owner of its 93.5% interest in CBS since December

1, 2004. This includes at least the following, which are legal conclusions and not findings of fact, for which CarMax West has a material interest:

- "However, based upon the evidence before me, I conclude CarMax West should not have received credit for their contribution to CBS." Order at 24.

- "Because I find the transfer of the intangibles from CarMax East to CarMax West was not an arm's length transaction, I further find the valuable contribution of the business process intangibles to CBS should be re-allocated [from CarMax West] to CarMax East." Order at 25.

- "Specifically, the evidence established that CarMax West's assigned 93.5% interest in the CBS partnership, which caused so much of CarMax East's income to be shifted to CarMax West, was unsupported by [CarMax West's] contributions to the partnership." Order at 61.

- "Because CarMax West did not pay CarMax East for the business process intangibles, CarMax West's distributional share of the partnership should not have been valued based on its contribution of these intangibles. Rather, CarMax East should have received credit for contributing the business process intangibles to the partnership." Order at 61.

- "Moreover, Petitioner failed to justify why CarMax West was entitled to credit for contributing the business process intangibles to CBS other than the legal reality that CarMax West technically owned them at the time of their contribution." Order at 62.

III. THE COURT ERRED IN DENYING CARMAX EAST'S MOTION IN LIMINE AND IN ALLOWING THE DEPARTMENT'S EXPERT TO PROVIDE TESTIMONY ON THE ACCURACY OF THE E&Y 2004 VALUATION AT TRIAL.

The Court erred in denying CarMax East's Motion in Limine and in allowing David DeRamus ("DeRamus"), the Department's expert economist, to provide expert testimony opining on the accuracy of the E&Y 2004 Valuation Study ("2004 Valuation") at trial. CarMax East respectfully requests that the Court reconsider the following issues and arguments regarding this ruling:

- The Department never disclosed to CarMax East that DeRamus's expert testimony would challenge the accuracy of the 2004 Valuation nor did the Department previously assert any such allegation, issue, or claim, and thus, CarMax East was not able to properly cross-examine DeRamus in his deposition or rely on the existing deposition testimony when

preparing for trial because DeRamus was unaware during his deposition of a fact that should materially change his testimony at trial (namely, that business process intangibles previously owned by CarMax East were transferred to CarMax West and thus included in the assets that were valued by that study (*see* CarMax East's Proposed Order at 33-35)); name its own expert on this topic; and otherwise prepare a defense against this. The Court should have not allowed this testimony or, in the alternative, should have granted CarMax East's request to mitigate the prejudice caused as a result of this late-raised issue (by, at a minimum, giving CarMax East additional time to prepare a defense to this issue, allowing it to depose DeRamus on this issue, and allowing it to name its own expert thereon). *See* 04/21/2023 CarMax East Mot. in Limine; CarMax East Proposed Order at 27-30. More specifically, the Department's position for the duration of the case prior to DeRamus's deposition was that the CBS ownership percentages should be based on each owner's business activity in South Carolina during the audit period, not that the 2004 Valuation was incorrect or unreliable. *See e.g.,* CarMax East Proposed Order at 27-30; Joint Ex. 27, Determination at CarMax_000541-542; and Order at 14 (acknowledging same). CarMax East's defense was and is that no legal or other authority supports the position that ownership interests should be based on each partner's level of business activity in a state at all and certainly not based on such activity each tax year. Instead, CarMax East based the ownership percentages on the 2004 Valuation, which it properly cited. While the Department could have conducted discovery on the 2004 Valuation, identified an expert that would challenge the 2004 Valuation (as it did for the E&Y Transfer Pricing Studies), and added a claim (with the Court's permission) in its Pre-Hearing Statement (if it could show it was not time-barred) that challenged the 2004 Valuation (or the accuracy thereof), it never did so.

- DeRamus's testimony regarding the accuracy of the 2004 Valuation was not reliable because it had an insufficient factual basis. *See* Mot. in Limine at 8-10. There was insufficient factual information available related to the creation of the 2004 Valuation because no claim attacked it and thus no discovery was conducted that focused on the issue. *Id.* DeRamus also did not know what assets the study valued and incorrectly thought CarMax East contributed valuable business process intangibles to CBS that were actually contributed by CarMax West. *Id.* at 10. In addition, he lacked the proper knowledge, experience, and credentials to address this issue. *Id.* at 8-10; *see also* CarMax East Proposed Order at 32-35.

- Expert testimony about a document is not permissible merely because the document is a joint exhibit. *See* Order at 2-3. Agreeing a document is a joint exhibit should not open the door for undisclosed expert opinions attacking the accuracy of the 2004 Valuation, particularly where, as here, the Department has never argued, until the eve of trial and after discovery in this case was over, that the 2004 Valuation was incorrect or that anything done back in the 2004 time period related to the accuracy of the establishment of the ownership in CBS was done incorrectly. CarMax East has always cited to the 2004 Valuation (*see supra* bullet point #1), and the Valuation also contains information that is at least tangentially relevant to the issues in the case (like many other documents on the joint exhibit list that are unrelated to issues upon which expert opinions were disclosed and

provided), such as background historical information about the CarMax Group.[3] The accuracy of the 2004 Valuation (and thus DeRamus's testimony challenging its accuracy) was not relevant to any claim in this case. *See* Mot. in Limine at 7-8 and 10-12. The Department never challenged it or otherwise asserted a claim alleging it was inaccurate, and it was not relevant to the issues before the Court. *Id.* The 2004 Valuation also was not relevant to the accuracy of the Transfer Pricing Studies, and it had no bearing on the arm's length price of the transactions addressed by those Transfer Pricing Studies. *Id.*; *see also* CarMax East Proposed Order at 28-38 and 68-70.

IV. THE COURT ERRED IN MAKING CERTAIN RULINGS REGARDING THE 2004 VALUATION.

After the Court allowed the Department to attack the 2004 Valuation, the Court then made rulings regarding the 2004 Valuation that CarMax East also respectfully requests it reconsider, including the following:

- The Court's finding that the study was unreliable and its reliance on DeRamus's testimony as support for the same is incorrect and unsupported by any credible evidence. Order at 23-24. As previously explained, reliance on DeRamus's opinions on this subject is improper and unsupported for many reasons. *See* CarMax East Proposed Order at 31-35.

- There is virtually no evidence on which the Court can rely regarding this event from 20 years ago that the Department did not attempt to attack until the eve of trial and on which no party conducted any discovery. DeRamus does not know the actual assets that were valued—only that it included unspecified business process intangibles and other intangible assets—and neither does this Court. *See* CarMax East Proposed Order at 32-35. The absence of evidentiary support for the Court's findings falls on the Department as the party with the burden of proof. That is particularly true here where the 2004 Restructuring took place squarely in the middle of the tax years at issue in the prior case against CarMax West. *See* CarMax East Order at 73. If the Department had an issue with the 2004 Restructuring, it should have addressed it 15 years ago and conducted discovery on the subject matter, not wait until now and decide on the eve of or during trial to attack it without any notice to CarMax East and without evidentiary support.

- The Court's rulings that CarMax East failed to prove the partnership distributions were justified, arm's length, and based on the valuable contributions of the parties to CBS is incorrect, unsupported by evidence, and the product of improper burden shifting. CarMax East need not prove the 2004 Valuation is correct or justify the CBS ownership percentages, which are presumed correct by the burden of proof being on the Department

[3] For example, although CarMax East does not agree with the Court's reliance on such, the Order cites information from the 2004 Valuation as being relevant to issues during the audit period that are unrelated to the accuracy of the study. *See, e.g.*, Order at 27, n. 42 (discussing $314 value as being related to origination fee); *id.* at 30 (discussing rejection of the CUT method in the 2004 Valuation as evidence that the CUT method was unreliable for transaction one in the 2015 E&Y Transfer Pricing Study).

in a case such as this. The Court should have found the Department failed to meet its burden on this issue rather than blaming CarMax East for not proving the CBS ownership and distributions were justified. *See, e.g.*, Order at 61-62.

- The Court states: "In response to the Department Determination, CarMax submitted evidence to support CBS's partnership distributions." Order at 16. This is not an accurate statement and is also improper burden shifting.

- The Court's findings that the partnership distributions were not arm's length because of the CBS ownership percentages is unsupported by any evidence. Order at 59-62. The partnership distributions do not "distort" income or "shift" CarMax East's income to CarMax West and are irrelevant evidence when the proper standard is applied under the AA Statute for Step One, which in this case did not occur. CarMax East made payments for necessary business expenses, and separately, for years when CBS is profitable, its income flows to its owners based on their percentage ownership, and thus money is actually coming back to CarMax East as opposed to had CBS not been a pass-through entity. Calling a deduction taken for an ordinary business expense (which was not even proven to be a non-arm's length price) derogatory names with no meaning like "distortion" and "income shifting" and "artificial" does not turn it into something wrongful nor serve as proof that the Department satisfied its burdens in this case, and the Court's findings to the contrary are incorrect. Order at 59-63.

- The Court is, respectfully, incorrect when it states: "I note that partnership interests can be reallocated under the § 482 Regulations." Order at 68, n. 71. When § 482 powers are used, which in this case they were not, they can allow allocation of income, deductions, tax credits, etc., not take ownership (which is property) from one owner and give it to a different owner. And regardless of what, in theory, can be achieved using § 482 powers, it is unclear why the Court finds this relevant as the Department never sought to use such powers. The Court should have found the 2004 Restructuring and the 2004 Valuation are not relevant to the issues before this Court, and that even had they been, the Department failed to prove the 2004 Valuation is incorrect or that the CBS ownership percentages are not justified. *See* CarMax East Proposed Order at 28-35 and 63-70.

V. THE COURT APPLIED THE WRONG LEGAL STANDARD FOR STEP ONE UNDER THE AA STATUTE.

Step One requires the Department show the "statutory formula" (here, the sales factor) does not fairly represent CarMax East's business activity in South Carolina. *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200. While the Court acknowledged that was the correct standard (Order at 55), it did not apply it. CarMax East respectfully requests that the Court reconsider the arguments below

as to the proper legal standard and why the Department has not met its burden to show Step One is satisfied.

A. The ALC's Legal Standard is Incorrect.

The Court should reconsider the following arguments as to why the legal standard it applied is incorrect:

- The AA Statute can only be used "[i]f the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State[.]" § 12-6-2320(A). The Court should ascertain and effectuate the legislative intent regarding the meaning of that phrase to know the type of evidence that is relevant to the issue at hand and what must be shown by the Department to meet its burden of proof for Step One. The Court has not done that. The Court should do so by applying the rules of statutory construction, including that words in a statute should be read in their context. There are no allocation issues in this case, and the apportionment provisions, all which are in Article 17, are designed for the purpose of generating a fraction that reasonably approximates the fraction of CarMax East's total business activity that occurs in this state. When the words used in Step One of the AA Statute are read in context with the statutory scheme, it means the AA Statute can be used if the apportionment provisions do not accomplish what they are designed to accomplish, which here requires the Department prove CarMax East's sales factor does not reasonably approximate (i.e., fairly represent the extent of) the fraction of CarMax East's total business activity that occurs in this state, which is also consistent with the legislative purpose of the apportionment provisions. *See also CarMax*, 411 S.C. at 89, 767 S.E.2d at 200 (stating that the Department must show that the *statutory formula* does not fairly represent the taxpayer's business activity in South Carolina). The Court has not applied the standard set forth in *CarMax* or examined CarMax East's sales factor,[4] and the Department has not argued that the sales factor, which is approximately 3.5% for the audit period, does not reasonably approximate the fraction of CarMax East's total business activity that occurs in this state. Instead, both the Department and the Court improperly focus on CarMax East's federal taxable income ("FTI") and its income subject to apportionment (despite the Department having proper avenues to address any problems with the same).

- The South Carolina Supreme Court already provided the standard for Step One. *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200 (stating that the Department must show that the *statutory formula* does not fairly represent the taxpayer's business activity in South Carolina). The standard meant the apportionment method (i.e., the fraction) in that case, and it means the

[4] The Court states that "'[b]usiness activity' is not defined for the purposes of subsection 12-6-2320(A)" yet makes no further inquiry to determine its meaning within the context of the AA Statute. Order at 56. Statutes should be read in context, and when done here, its meaning is clear. Business activity means the sales factor, which is based on CarMax East's business activity (sales) and designed to represent the fraction of its total business activity that takes place in this state.

same here. The ALC has provided no explanation for deviating from this standard in this case. The "statutory formula" means the apportionment method (i.e., the fraction). It does not mean the entire tax return, nor does proof that tax due to South Carolina is lower than it should be mean that Step One is met. Step One in this case requires proof the sales factor did not accomplish what it is designed to accomplish.

- If the Court does not find that the AA Statute here clearly can only be used by the Department upon proving that the apportionment method (here, the sales factor) does not fairly represent the portion of CarMax East's total business activity that occurs in this state, then the statute is at least ambiguous, and any ambiguity (particularly where the AA Statute is being invoked by the Department and not the taxpayer) must be resolved in favor of the taxpayer in this case. *Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue*, 399 S.C. 313, 321, 731 S.E.2d 869, 873 (2012); *see also Mead v. Beaufort Cnty. Assessor*, 419 S.C. 125, 139-140, 796 S.E.2d 165, 173 (Ct. App. 2016).

- Although stated in a variety of different ways throughout the Order, the standard the Court is applying for Step One is whether *separate reporting* fairly represents CarMax East's business activity in this state. That is the wrong standard. The apportionment provisions (and the "statutory formulas" therein) are designed to measure business activity, and more specifically, to generate a fraction that represents the portion of a taxpayer's total business activity that occurred in South Carolina. Separate reporting, on the other hand, is a filing method for tax returns—it is not designed to and does not measure South Carolina business activity. This Court clearly recognizes the difference between reporting methods and apportionment methods (*see, e.g.*, Order at 44, 50, 63, and 69), yet it appears to have mistakenly combined them together as, in totality, "standard apportionment." Order at 49.[5] This may have caused the Court to confuse "taxable income" with "business activity" and thus incorrectly find that proving taxable income is too low is proof of Step One. A taxpayer with substantial business activity in South Carolina can have a loss year and thus no taxable income. The Court appears to be confusing the two, applying the wrong standard, and thus focusing on evidence that is not relevant when the correct standard is applied. The Court may also be misinterpreting the meaning and significance of S.C. Code Ann. § 12-6-2210(B). Order at 55.

- The Court says that "here, where all of CarMax East's business activity results in revenue, I find that income is a proxy for CarMax East's business activity in this state." Order at 56. While that is partly correct in that CarMax East's business activity does result in revenue, it is largely incorrect because "business activity" means the sales factor, which is based on that same revenue. Revenue from sales in this state is in the numerator, and revenue from sales everywhere is in the denominator. By saying "income" is "a proxy" for business activity, the Court imposed a forced construction of Step One that incorrectly expanded the

[5] It is unclear what has caused the Court to apply the wrong standard. The Court may be misinterpreting § 12-6-2252(A), and specifically, the portion cited on page 49 saying taxpayers in the business of selling tangible property "shall make returns and pay annually an income tax that includes its income apportioned to this state." Order at 49. That phrase does not mean the entire tax return is standard apportionment or otherwise mean that proof that taxable income is too low is proof of Step One.

scope of evidence that may satisfy Step One beyond the legislative intent of the AA Statute and in a manner that leads to absurd results.

- The AA Statute is a relief provision that should be used sparingly. *CarMax*, 411 S.C. at 89–90, 767 S.E.2d at 200 (citing *St. Johnsbury Trucking Co. v. State,* 118 N.H. 209, 385 A.2d 215, 217 (1978) and *Donald M. Drake Co. v. Dep't of Revenue,* 263 Or. 26, 500 P.2d 1041, 1044 (1972)). The Department's policy document, as seen by the six vague factors considered by the Department to decide Step One for a taxpayer that is a member of a unitary business, is applying Step One differently and incorrectly for such taxpayers, as none of those factors focus on the apportionment method, which here is the sales factor. Order at 57-58 (citing Revenue Ruling 15-5 and discussing factors). The Department, and now this Court, are applying the wrong standard for Step One in a way that greatly expands its reach far beyond the legislative intent. That is why the Department has used the AA Statute to issue 53 proposed assessments requiring CUR in less than a four year period, whereas the second most common alternative method required by the Department has been used, at most, four times since 2018. *See* CarMax East Proposed Order at 21. The Department is incorrectly applying Step One of the AA Statute, and this Court is doing the same. CarMax East uses separate reporting in approximately 20 states, and no separate reporting state besides this one has ever invoked the AA Statute to require the use of CUR despite many having tax laws similar to this state. *Id.* at 20.

- As explained below, (A)(4) does not authorize the use of CUR under the specific facts of this case as the plain language of the AA Statute makes clear. The only way to make (A)(4) seem to authorize CUR in this case, which it does not, is by ignoring the plain language of (A)(4) and thus forcing it to work. The problem is Step One, not Step Two. The forced, incorrect construction of Step One is why another forced and incorrect construction is needed for Step Two. Step One and Step Two work seamlessly and in harmony when the AA Statute is applied correctly. If the sales factor does not generate a fraction that fairly represents the portion of CarMax East's total business activity that occurs in this state, then the Department can try another fraction that does, such as property or payroll. The harmony disappears when incorrectly viewing Step One as being satisfied based on FTI or income subject to apportionment being too low notwithstanding the apportionment provisions working as designed.

- Had the Court applied the correct standard it would have concluded the Department failed to satisfy Step One. Approximately 3.5% of CarMax East's total business activity occurs in this state which is why that is the amount of its sales factor and the amount of its income subject to apportionment that is apportioned to and taxed by this state.

B. The Department has Not Met its Burden to Show Step One is Satisfied.

The Court says that the Department met its burden to establish Step One by showing CarMax East "shifted income" to CarMax West via (initially) the Management Fee payments to CBS (and a lack of origination fees paid to CarMax East), followed by CBS's profits

"disproportionately" flowing to CarMax West as the 93.5% owner of CBS, which the Court found had not been proven justified. Order at 58-63. However, none of these is sufficient evidence to satisfy Step One, and CarMax East respectfully requests that the Court reconsider the following arguments on this ruling:

- The Court correctly states that the burden of proof is on the Department, but then it does not apply it that way and looks to CarMax East to prove various issues discussed below. This is improper burden shifting.

- The standard method is presumed to work. *See* Hellerstein & Hellerstein, State Taxation § 9.20[5] (3d ed. 2022) (stating that "[i]t is only in those unusual circumstances where the standard 'allocation and apportionment provisions. . . do *not* fairly represent the extent of the taxpayer's business activity in this state' that an alternative apportionment method may be employed," and, thus, the party seeking the exception should bear the burden of showing that the "presumptively fair standard is unfair under the particular circumstances. Otherwise, the exception would threaten to swallow the rule.'") (emphasis in original). If the Department is trying to prove the standard method fails because the Management Fee or the origination fee is not an arm's length price, then each is an arm's length price until the Department proves it is not. And the Department failed to prove the Management Fee did not satisfy the Arm's Length Standard[6] and failed to prove CarMax East was entitled to origination fees or what price would satisfy the Arm's Length Standard for either such fee. The Department also failed to present evidence that charging an arm's length price origination fee would even generate a profit for CarMax East. *See supra* §VI. Thus, the Court has no basis upon which to find any income was improperly shifted by these fees or lack thereof.

- The Department's attacks and the Court's findings fail to recognize they are focused on the wrong subject matter. The only entities conducting business in South Carolina are CarMax East and CBS. The Court's incorrect findings are largely driven by the partnership distributions and thus based on CBS's business activity, 93.5% of which belongs to CarMax West. Assuming arguendo that the Court's implicit finding that CBS's business activity in this state is not fairly represented was correct, that finding would relate to CarMax West as the 93.5% owner thereof (who is not a party in this case) not CarMax East. Such findings do not support the conclusion that CarMax East's business activity is not fairly represented in this state.

- A flawed transfer price is the equivalent of an improperly high deduction and is not relevant evidence for Step One, which is only seeking to determine the fraction of business activity that takes place in South Carolina. *See* CarMax East Proposed Order at 79-80. Even if the Department had shown that either the management fee was inaccurate or that the lack of

[6] The "Arm's Length Standard" herein refers to the standard set forth in Treas. Reg. § 1.482-(b)(1).

an origination fee shifted any income, such problems could be fixed with a simple accounting adjustment.

- The Court's lengthy descriptions of how money flows within the CarMax Group, and its comparison of various values like CarMax East's revenue compared to its portion of the CarMax Group's total FTI, prove nothing about whether Step One has been met, nor are they considering the only thing that matters for Step One, which is the sales factor. Order at 59-61. It is obvious that comparing hand-picked financial attributes of CarMax East to CarMax West will look different from one another, as they should, given one entity owns 93.5% of CBS and the other does not. *Id.* The Court has not provided a plausible explanation for why their financial attributes should look similar to one another.

- The transfer of business process intangibles ("BPI") from CarMax East to CarMax West is also not a basis for finding Step One met. The Department never raised any claim regarding this transfer, never argued much less met its burden of proof to establish that the transfer was improper, it, in fact, was not improper, and even if it had been improper, it is not relevant evidence as to Step One.

- The Court says the CBS partnership structure was not justified and the only purpose could be tax minimization. (Order at 62). This is contrary to the evidence regarding the many business purposes of the restructure generally and the business purposes of CBS specifically. Additionally, the Department never asserted any claim to challenge the partnership interests or formation, and even if it had, it presented no evidence as to what the proper partnership percentages should be and thus would not have met its burden of proof had it made a proper claim. *See* CarMax East Proposed Order at 28-35.

- The Court supports its finding with distortion ratios created by the Department that compare the financial data of one related entity to another (such as a comparison of CarMax East's and West's revenues to taxable income), which are arbitrary and not probative evidence. *See* Order at 60-61 and n. 66. These ratios should be very different from one another based on the different revenue streams each entity has, and it is unclear why one would think otherwise. And they show nothing about the South Carolina business activity of any CarMax entity. *See* CarMax East Proposed Order at 65. The use of these distortion ratios also discriminates against South Carolina taxpayers that have related parties and/or have chosen to conduct business using multiple entities in violation of CarMax East's rights protected by the South Carolina Constitution and the U.S. Constitution.

VI. THE COURT SHOULD RECONSIDER ITS RULINGS THAT ORIGINATION FEES WERE OWED TO CARMAX EAST.

The Court erred in its rulings that CarMax East should have been paid origination fees for loans originating at its stores that were serviced by CAF and should reconsider such rulings for the reasons set forth in CarMax East's Proposed Order as well as the following:

A. The Department Never Raised the Issue of Origination Fees.

The Court sua sponte raised this issue and ruled in the Department's favor based on arguments the Department has never made.[7] The Department has never, including in its Proposed Order, argued that origination fees should be paid to CarMax East.[8]

The Court should reconsider these rulings because the Court may only grant relief on issues raised by the parties. *See Bryan,* 282 S.C. at 508, 319 S.E.2d at 360 ("Due process requires that litigants be placed on notice of the issues which a court is to consider."); *Crocker*, 281 S.C. at 158, 314 S.E.2d at 346 ("A judgment or decree, whether in law or equity, must accord with and be warranted by the pleadings of the party in whose favor it is rendered. If it is not supported by the theory of action on which the pleadings were framed, it is fatally defective."); *United Transp.*, 401 U.S. at 581 ("A decree must relate specifically and exclusively to the pleadings and proof. If not so related, the provision, because of its vagueness, will jeopardize the exercise of protected freedoms.). Ordering relief on grounds never asserted by the Department would violate CarMax East's due process rights under the Due Process Clause contained in Article I, Section 8 of the South Carolina Constitution and the Due Process Clause of the United States Constitution because, *inter alia*, it had no notice that the Court would be ruling on the aforementioned issues and thus was denied the opportunity to go through the administrative process and defend itself (i.e., the Department issues an assessment to CarMax East, CarMax East files a protest, the Department files a Determination, the parties participate in the administrative appeals process, and CarMax East files a request for contested case hearing, which would allow discovery and the presentation

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[7] The Department never raised any of these issues in any written filing. *See* Joint Ex. 26, Audit Report; Joint Ex. 27, Determination; Dep't's Prehearing Statement; and Dep't's Proposed Order.

[8] The Department's attacks on the Management Fee are not arguments that origination fees were warranted. *See supra* § VI(B).

of evidence and expert testimony to the Court on those years). Thus, the Court's rulings on these issues should be reversed.

B. The Court's Ruling is in Error and Unsupported by Evidence.

The Court's ruling that origination fees were owed to CarMax East contains several errors that should be reconsidered, including the following:

i) Origination Fees would be Unrelated to the Management Fee.

The Court suggests that origination fees allegedly owed to CarMax East should have reduced CarMax East's management fee payments to CBS and thus found that the Management Fee was too high. *See* Order at 27-28, n. 42; *id.* at 59. That is not correct, and no evidence supports it. The Management Fee compensates CBS pursuant to contractual agreements for services performed by CBS and for licensing use of intangible assets and is paid to CBS on a per-car sold basis. If origination fees were owed to CarMax East for loans it originated, those would be payments flowing in the opposite direction (i.e., from CBS to CarMax East), and they would not be on a per-car sold basis because not all customers finance using CAF. Origination fee payments also would have nothing to do with the Management Fee payments. The CAF Function is performed by its own division within CBS that is separate from those performing services compensation by the Management Fee. There is no plausible reason to assume, and no evidence supports the assumption that, any origination fees paid to CarMax East would take the form of reduced Management Fee payments from CarMax East.

ii) No Evidence Supports the Amount of an Origination Fee or the Court's Assumption that CarMax East's Taxable Income Would Increase Had Origination Fees Been Paid.

There is virtually no evidence in the record related to the entire subject matter of CAF, including whether origination fees were warranted and, if so, the arm's length price thereof.[9] Because the Department bore the burden of proof, it failed to meet its burden on these issues.[10] Moreover, no evidence supports the Court's finding that CarMax East's taxable income would be higher had it been paid origination fees at an arm's length price. *See, e.g.*, Order at 28, n. 42 (saying that as a result of no origination fees, "CarMax East's taxable income was also reduced."); *id.* at 59. Payment of origination fees results in revenue (and even that amount is unknown because there is no evidence of an arm's length price), but much more information is needed to know the impact that revenue has on taxable income.[11] There is no evidence of how costs are currently handled related to this function or how they would be handled if origination fees were paid. As DeRamus testified at trial, the evidence he saw indicated that in the exact same transaction at issue here that exists between the retail stores and third-party banks, the retail stores were not making a profit. *See* CarMax East Proposed Order at 36.[12] Thus, no evidence supports the assumption that

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[9] The reason for the absence of evidence is that the Department ignored the entire subject matter of CAF and origination fees for the entire case and never asserted any claims related to same. *See* CarMax East Proposed Order at 26-27.

[10] The Department's Proposed Order also fails to address origination fees much less state an amount that should have been paid as such.

[11] The Court references DeRamus's testimony that he saw $314 listed in the 2004 Valuation as an origination fee that was used by CarMax many years ago. Order at 27, n. 42. His testimony on this was not accurate. One cannot tell from the 2004 Valuation or from other evidence in the record what the $314 referenced in the 2004 Valuation represented.

[12] Perhaps that is why no origination fees are paid in the first place. There is no evidence from CarMax's perspective about this topic because as explained above, the entire subject matter was ignored by the party with the burden of proof.

origination fees paid to CarMax East at an arm's length price would lead to an increase in CarMax East's taxable income.

VII. THE COURT SHOULD RECONSIDER ITS RULING THAT CARMAX EAST SHOULD GET CREDIT FOR ASSETS CARMAX WEST CONTRIBUTED TO CBS IN THE 2004 RESTRUCTURING

The Court's ruling that CarMax East should have received credit for any assets, including business process intangibles ("BPI"), that CarMax West contributed to CBS in the 2004 Restructuring is improper, incorrect, and should be reconsidered for the reasons in CarMax East's Proposed Order as well as the following:

A. The Department Never Raised the Issue of Giving CarMax East Credit for Assets CarMax West Contributed to CBS.

The Court sua sponte raised as an issue in the case the question of whether CarMax East should get credit for assets that CarMax West contributed to CBS in the 2004 Restructuring. *See* Order at 16, 24; *see also id.* at 1, n. 3. The Court also sua sponte ruled on that issue, finding that CarMax East should get credit for the BPI CarMax West contributed to CBS because CarMax East's transfer of the BPI to CarMax West prior to CarMax West contributing the BPI to CBS violated the Arm's Length Standard. *Id.* at 24-25 and 61-62. That has never been an issue in this case, the transfer of BPI from CarMax East to CarMax West has never been a relevant fact in this case, and the Court's reasoning is one the Department has never argued in this case. DeRamus's testimony at trial is the first instance that any Department representative has ever even indicated knowledge of the fact that CarMax East transferred BPI to CarMax West.[13] The Department never

[13] In fact, neither the Department nor DeRamus was even aware of the transfer of BPI from CarMax East to CarMax West until the eve of trial. *See* CarMax East Proposed Order at 35 and Hr'g Tr. at 689:16-20, 1274:15-1276:5, and 692:20-693:22 (regarding DeRamus admission at trial that he did not know this fact at his deposition); *see also* 04/21/2023 CarMax East Mot. in Limine at 10 (highlighting this fact, of which DeRamus was not aware, as one of the many reasons he should not be allowed to testify about the accuracy of the 2004 Valuation).

asserted any claim related to this fact in any pleading in this case, nor argued anywhere, including in its Proposed Order, that CarMax East should get credit for the BPI because of the transfer of the BPI to CarMax West prior to the Restructuring.

The Court should not rule on issues not raised by the parties, and such a ruling violates CarMax East's due process rights. *See supra* §§ I and VI (as to the legal authority supporting same). CarMax East has conducted no discovery on the issue raised by the Court, the transfer of BPI from CarMax East to CarMax West, or any arguments stemming therefrom as it had no notice of any such claim and was never provided an opportunity to prepare a defense thereto. CarMax East has not even had an opportunity to brief the issue.[14] That should not happen in any case, particularly one where the Department bears the burden of proof, which can only be satisfied by providing specific reasons and a sound evidentiary basis for its decision from years ago when it concluded CarMax East's business activity was not fairly represented in this state.[15]

B. CarMax East Did Not Open the Door to the Court Raising this Issue Sua Sponte.

The Court's ruling that CarMax East "opened the door" to the Department challenging the 2004 Valuation does not mean CarMax East also opened the door for the Court sua sponte raising the issue of who should get credit for the contribution of the assets that the study was valuing. The purpose of the 2004 Valuation, and the only thing it did, was determine the value of the assets that were the subject of that study. It did not address who should receive credit for the assets being valued. Opening the door to challenge the 2004 Valuation's determination that the assets it valued

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[14] The brief discussion about this fact at trial, which was the first time the Department had mentioned it and was unrelated to any legal claim, and thus CarMax had no reason to address it in its Proposed Order, and the Court did not allow the parties to prepare a response to the Proposed Orders.

[15] The Court's expectation that CarMax East should have proven the purpose of this fact or otherwise proven CarMax West should get credit for the BPI is puzzling and should be reconsidered. *See, e.g.,* Order at 62.

were approximately $2 billion does not open the door for a materially different issue that has never been argued by the Department, on which no discovery was ever conducted, of which CarMax East was never put on notice such that it could prepare a defense thereto, and that the Court decided based on a fact that CarMax East heard testimony on for the first time at trial. This is improper as the Court should only rule on issues raised by the parties, and this is a violation of CarMax East's due process rights. *See supra* §§ I and VI (regarding legal authority).

C. The Court Erred in Making Incorrect and Irrelevant Rulings.

The Court should reconsider its rulings that are incorrect and irrelevant to anything in the case besides providing support for the improperly raised issue (which is not an issue) of who gets credit for the BPI CarMax West contributed to CBS, including the following:

- The Court's statement that "because the business process intangibles had already been transferred from CarMax East to CarMax West by the date on which the valuation was requested, E&Y did not consider this transfer in their valuation." Order at 21, n. 32. This statement is not supported by evidence, is incorrect, and should be removed or materially clarified. The statement suggests that both (1) CarMax did not request E&Y do the 2004 Valuation until after the restructuring was already completed; and (2) that because of #1, E&Y did not consider the transfer of BPI from CarMax East to CarMax West in the 2004 Valuation. Neither of those are true. The study was finalized in 2005. The 2004 Restructuring was planned for the majority of 2004 and implemented in December of 2004, and deciding to obtain a valuation of the assets contributed to CBS was not an afterthought, nor was it the reason the valuation did not consider the transfer of BPI from CarMax East to CarMax West.

- The Court's ruling that the BPI transferred from CarMax East to CarMax West represents the substantial majority of the $1.996 million figure reached by the 2004 Valuation is improper and flawed. Order at 22, n. 36; *id.* at 24. The ruling is irrelevant to the accuracy of the 2004 Study, and one that the Court, respectfully, is not qualified to make. No evidence shows what BPI existed then, much less the value of it. Also, because BPI that existed in the Audit Period is valuable does not mean the BPI that existed in 2004 comprised the substantial majority of the $1.996 million value. Unlike the IP CarMax West contributed to CBS, BPI has a short lifespan. *See, e.g.*, Order at 12 (ninth or tenth version of ACR during the audit period); *see also* CarMax East Proposed Order at 12, n. 24 (same for ASRP). An asset that generates $20 profit/year forever is worth exponentially more than an asset that generates $100 profit/year for two years.

D. The Court's Arguments and Findings on the Issue are Incorrect.

The Court's rulings on this issue are also incorrect and should be reconsidered for the reasons in CarMax East's Proposed Order and the following:

- The Court is incorrect in finding that CarMax East's transfer of BPI to CarMax West violates the Arm's Length Standard. CarMax East was the sole shareholder (i.e., the 100% owner) of CarMax West when CarMax East transferred its BPI to CarMax West. If the sole owner of a corporation puts $100 into that corporation, the value of his shares increases by $100. A contribution of assets by the sole owner of corporation to the corporation does not violate the Arm's Length Standard. The transaction also qualified as a tax-free non-recognition event under I.R.C. § 351, which South Carolina recognizes, thus meaning the transaction is encouraged—not a violation of the Arm's Length Standard.[16]

- Similarly, the Court's view that CarMax East gave away its BPI for free is incorrect. CarMax East's contribution of BPI to CarMax West causes the value of CarMax East's ownership in CarMax West to increase by the value of the BPI. As CarMax East's transfer pricing expert Brian Cody testified, a contribution of assets owned by CarMax East to CarMax West is not a gift because there is an exchange of equal value in the form of the increased value of shares. Hr'g Tr. at 1109:21-1110:18.

- The Court's ruling suggests that had it known the exact value of the BPI, it would have redetermined or re-calculated the ownership of CBS, or relatedly, that CarMax East could be given "credit" for contributing the BPI to CBS. *See, e.g.*, Order at 24-25; id. at 68, n. 71. These rulings are incorrect, and the Court has no such authority in this case even had it known the value of the BPI. The 2004 Restructuring occurred almost 20 years ago, CarMax West is not a party to this case, any claim that requested such relief would unquestionably be time-barred, and most importantly, the Department has asserted no claim that could empower this Court to provide such relief. The Department has made no attempt to use § 482 powers in this case, much less for transactions that occurred in 2004, but even had it tried to do so, § 482 powers do not allow the result the Court is suggesting could be achieved (nor does anything in Treas. Reg. § 1.704-1).[17]

- The Court also misunderstands the role of considering reasonable alternatives under the § 482 Regulations and should reconsider its rulings that are based on that concept. Order at 25. The concept considers the controlled transaction at issue, considers alternative available options for the related parties in that controlled transaction, and uses any relevant evidence of alternative options for the purpose of making price adjustments. *See* Treas.

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[16] To be clear, the transaction does not violate the Arm's Length Standard irrespective of whether it qualified as a tax-free transfer under I.R.C. § 351 or whether South Carolina had adopted I.R.C. § 351.

[17] See also the testimony of Brian Cody explaining that no economic principle allows one to disregard the transfer of BPI from CarMax East to CarMax West and that nothing in the § 482 Regulations allows one to set aside or disregard the transfer of BPI from CarMax East to CarMax West. Hr'g Tr. at 1110:19 – 1111:3.

Reg. § 1.482-1(f)(2)(ii)(A). It does not allow the IRS (or the Department or Court) to restructure the controlled transaction as though the alternative option (here, based on the Court's argument, CarMax East keeping the BPI or selling it rather than gifting it to CarMax West) had been adopted by CarMax East. *Id.*

- The Court also should reconsider its findings and rulings related to the 2004 Restructuring, including those addressed immediately above, because they are not relevant to the issue before the Court. *See* CarMax East Proposed Order at 68-70.

VIII. THE COURT IS CONFUSING "ECONOMIC SUBSTANCE" IN § 482 REGULATIONS WITH AND IMPROPERLY USING THE ECONOMIC SUBSTANCE DOCTRINE AND RELATED LEGAL DOCTRINES.

The Court is making rulings that are not findings of fact but are instead legal conclusions, such as finding that CarMax West should not have received credit for contributing the BPI to CBS, or conversely, that CarMax East should have received credit for contributing the BPI contributed by CarMax West. The Court is using its legal conclusions as evidence the Department met its burdens of proof required by the AA Statute. *See, e.g.*, Order at 61-62. But the Court is both conflating "economic substance" as used in the § 482 Regulations with legal doctrines that have not even been alleged to apply in the case, while also providing no legal support for its findings, all of which prevent CarMax East from defending itself against these findings in violation of its due process rights. *See* §§ I and VI (as to the legal authority supporting same). The Court should reconsider the following issues and amend its ruling to allow CarMax East to understand the basis and support of the Court's findings:

- The Court makes key rulings using language as though it is applying well-known common law legal tax avoidance doctrines, such as the substance over form doctrine or the business purpose doctrine. *See, e.g.*, *Frank Lyon Co. v. United States*, 435 U.S. 561, 573, 98 S. Ct. 1291, 1298, 55 L. Ed. 2d 550 (1978) (applying common law substance over form doctrine). The Court also uses language as though it is applying the closely related economic substance doctrine, which was a common law doctrine but is now codified in I.R.C. § 7701(o). The Court also, respectfully, misunderstands or misapplies the phrase "economic substance" in the Order, which has a significantly different meaning under the § 482 Regulations than its meaning when used for legal doctrines like those mentioned immediately above. "Economic substance" in the § 482 Regulations does not empower the IRS, and thus cannot empower the Department or the Court, to disregard transactions, to

disregard entire business structures, and to give CarMax East credit for the BPI that CarMax West transferred to CBS nearly twenty years ago.

- The Department has not asserted claims based on any legal doctrines in this case, nor has the Department attempted to use its § 482 powers for anything including attacking the 2004 Valuation and events from the 2004 Restructuring, yet the Order contains many statements that suggest otherwise and that are used to support key rulings in this case. The statements listed below appear to impact the Court's rulings in this case, but the Court provides no legal authority supporting them, thus making them impossible to defend against given the nature of these amorphous terms and the significant differences between the meaning of "economic substance" or "substance" in the § 482 Regulations versus the meaning of those terms as used in legal doctrines, such as the economic substance and substance over form doctrines. CarMax East respectfully requests the Court amend the ruling to provide the specific legal authority supporting the following statements and/or clarify the nature of its rulings (as noted below):

    - "Economic substance refers to whether the purported purpose of the transaction aligns with how the parties are actually behaving in the transaction—whether substance matches form." Order at 18. Please provide the specific authority relied on for this statement so that CarMax East can defend against this viewpoint, which the Court suggests is in the § 482 Regulations.

    - "How the parties represent themselves legally and contractually will be respected unless there is no economic substance to the transaction. 26 C.F.R. § 1.482-1(d)(3)(ii)." Order at 18. The Court's citation to § 1.482-1(d)(3)(ii) spans many pages of material, none of which CarMax East can tell supports the belief expressed in the Court's statement, and therefore, CarMax East respectfully requests the Court cite the specific authority supporting this statement so that CarMax East can defend against this viewpoint that underlies the Court's findings.

    - "Indeed, it is acceptable to take advantage of different states' tax regimes, *as long as the movement of income from east to west has a legitimate business purpose with substance*." Order at 59 (emphasis added). CarMax East respectfully requests the Court clarify the meaning of this statement and cite the specific authority supporting this statement so that CarMax East can defend against this viewpoint that underlies the Court's findings.

    - "In this case, however, the evidence established the Management Fee and the partnership distributions work together to shift a substantial amount of income from CarMax East to CarMax West, in an east-west structure, *for no discernable business reason* other than tax minimization." Order at 59 (emphasis added). Many business reasons existed for the 2004 Restructuring and for CarMax East paying CBS during the audit years for the performance of functions that are necessary for CarMax East to conduct business, thus rendering the Court's statement unclear. CarMax East respectfully requests the Court provide the legal authority supporting

this ruling and clarify what the Court is suggesting has been violated here so that CarMax East can defend against this finding.

- "Rather, CarMax East should have received credit for contributing the business process intangibles to the partnership. Therefore, the distributional shares of the partnership do not reflect the partners' valuable contributions. *To put it succinctly, the form of the transaction(s) creating CBS did not match the substance*." Order at 61 (emphasis added). CarMax East respectfully requests the Court provide the legal authority supporting this statement, clarify which "transaction(s)" the Court is referencing, and clarify what the Court is suggesting has been violated here so that CarMax East can defend against this finding.

- "Moreover, Petitioner failed to justify why CarMax West was entitled to credit for contributing the business process intangibles to CBS other than the legal reality that CarMax West technically owned them at the time of their contribution. In other words, *Petitioner failed to show how the economic substance of the transaction supported its legal form*." Order at 62 (emphasis added). CarMax East respectfully requests the Court provide the legal authority supporting this ruling and clarify what the Court is suggesting has been violated here so that CarMax East can defend against this finding.

- "If there is evidence that the partnership percentages reflect the valuable contributions of the parties, *and substance matches form*, Petitioner should have presented it." Order at 62 (emphasis added). CarMax East respectfully requests the Court provide the legal authority supporting this ruling and clarify what the Court is suggesting has been violated here so that CarMax East can defend against this finding.

IX. THE COURT ERRED IN MAKING CERTAIN TRANSFER PRICING RULINGS.

The Court should reconsider the following arguments regarding its findings on the E&Y Transfer Pricing Study[18] in this matter, including the following:

- The Court cannot find that the Transfer Pricing Study failed to use the best method for Transactions 1, 3, and 5, without identifying a method that is better than the one used (and supporting it with the reasons why it is better).

- The failure to use the best method simply means a more reliable transfer pricing method exists. It says nothing about whether the results reached by the method actually used are correct.

[18] Consistent with its Proposed Order and the Court's Order, CarMax East will refer to the 2015 E&Y Transfer Pricing Study unless the stated otherwise or implied otherwise by context.

- The Court's findings that the Transfer Pricing Study was unreliable based on a lack of information such as the franchise agreements used for transaction one and three[19] and detailed underlying data for transaction five, thus rendering the Court and/or DeRamus unable to verify something about the study's conclusions are unfounded and should be reconsidered. Order at 30-43. First, the burden of proof is on the Department, and thus any rulings based on the Court or DeRamus lacking information fall on the Department, not CarMax East. Second, the Court's finding implies certain standards, or requirements, apply to transfer pricing studies for those studies to be appropriate and/or reliable—that is incorrect. Hr'g Tr. at 982:1-984:25 (Cody explaining there are no documentation requirements in the § 482 Regulations). Nothing requires CarMax East to have a transfer pricing study in the first place, and a price used that is not derived based on the use of transfer pricing study can certainly satisfy the Arm's Length Standard. Nothing in the § 482 Regulations requires a taxpayer have a transfer pricing study; instead, a properly prepared transfer pricing study simply provides taxpayers with protection from penalties in situations where the price used does not satisfy the Arm's Length Standard. *See* I.R.C. § 6662(e). There is no evidence that the Management Fee does not satisfy the Arm's Length Standard, and even had it not, no penalties are at issue in this case. The Transfer Pricing Study is extensive and would most certainly provide penalty protection as it satisfies the necessary requirements to do so were that ever at issue. *Id.* The Court's expectation that more information should be in the Transfer Pricing Study is unfounded.

- The Court is relying on DeRamus's calculations as supporting the Court's findings. *See, e.g.*, Order at 36, n. 50; *id.* at 37 (comparing transaction three costs to amount of charge); *id.* at 40 (same for transaction five). As explained in detail below, DeRamus calculations are materially wrong and should not be relied on. *See infra* § XII.

- The Court should not assume that E&Y not using the CUT method for 2004 contradicts E&Y using the CUT method for Transaction 1. Those are factually completely different controlled transactions, and they are a decade apart.

- The Court should clarify its final sentence for this transaction on page 34 saying "Therefore, CBSs compensation for the IP should be modest" and provide the basis of the clarification. The arm's length range was 0.5% to 1.3%, and CarMax used 0.5%. When the Court says it should have been "modest," how does that compare to this range and selected price? The price used is already "modest" (but arm's length), and 100% of this payment is sourced to and taxed by South Carolina on the collective returns filed by CarMax East and CarMax West.

- The Court questions why Horizon Media was not used as an uncontrolled transaction under the CUSP method. *See* Order at 37, n. 51. However, CarMax East fully explained how this would not be proper in its Proposed Order, and regardless, the Department bore the burden

[19] The burden of proof is on the Department, yet the Court criticizes CarMax East for not providing franchise agreements, which were publicly available and which DeRamus never tried to find and never mentioned in his deposition that he wanted. *See* CarMax East Proposed Order at 38, n. 87.

of proof and any failings in the evidence presented belong to it. *See* CarMax East Proposed Order at 40-41.

- The Court should reconsider its findings on transactions three and five. DeRamus has no experience in this industry, no factual knowledge of these transactions, and no evidence supporting his opinions. *See* CarMax East Proposed Order at 31, 38-43. On the other hand, Brian Cody has substantial experience in this industry, obtained factual information needed to support his opinions, and provided ample testimony explaining the value attributable to these functions. *Id.* at 46-51 and 54-55. The Court also did not give adequate weight to the importance of Cody's testimony in which he explained the inherent reliability of the data that was used for the pricing of transaction five. *Id.* at 49-50.

X. THE COURT MISINTERPRETED AND MISAPPLIED THE AA STATUTE IN FINDING THAT CUR IS REASONABLE AND EQUITABLE HERE.

The Court respectfully misinterprets or misapplies the AA Statute in finding that CUR is reasonable and equitable in this case. It also appears to have misunderstood CarMax East's arguments on this issue. CarMax East respectfully requests that the Court reconsider the following issues:

- The Court appears to believe that CarMax East is arguing that CUR can never be allowed under the AA Statute. *See e.g.*, Order at 50-52; *see also id.* at 52, n. 61 (saying the Court will not engage in statutory construction because *Media General* already found that CUR can be allowed under (A)(4)). CarMax East is not arguing that CUR is forbidden by (A)(4) in all cases, nor is it arguing that CUR can never be used under (A)(4). It is only arguing that it is not allowed in this case. *See* CarMax East Proposed Order at 76-78 (arguing that Court should apply rules of statutory construction to the AA Statute and then apply that to the facts of this case). The Court should ascertain and effectuate the legislative intent as expressed in the statute's plain language. *Hodges v. Rainey,* 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000) ("The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature.").

- The plain language of the AA Statute shows that CUR is not authorized in this case. The meaning of "the taxpayer's income" in (A)(4) is CarMax East's income subject to apportionment, which here is FTI as modified by Article 9 of the South Carolina Income Tax Act. The terms "allocation and apportionment" in the context of taxing a business operating in multiple states addresses allocation and apportionment of a taxpayer's income *to states*, not from one entity to another entity—that is what § 482 powers are for. Allocation and apportionment divide a tax base that is already set by separate law; allocation and apportionment does not determine, recalculate, or modify a tax base. When the standard method of dividing that tax does not work as intended, the AA Statute allows alternative methods of dividing that same tax base, and such methods are restricted to those that equitably apportion "the taxpayer's income." *Hodges v. Rainey*, 341 S.C. 79, 85, 533

S.E.2d 578, 581 (2000) ("Under the plain meaning rule, it is not the court's place to change the meaning of a clear and unambiguous statute."). CUR in this case did not apportion "the taxpayer's income" as required by (A)(4). It apportioned the collective income of CarMax East and CarMax West, and but for an oversight by the Department, it also would have apportioned the income of CASS, which is not a South Carolina taxpayer and has no nexus with this state.

- If the Court does not find that the AA Statute clearly does not authorize CUR in this case, then the statute is at least ambiguous, and any ambiguity (particularly where the AA Statute is being invoked by the Department and not the taxpayer) must be resolved in favor of the taxpayer in this case. *Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue*, 399 S.C. 313, 321, 731 S.E.2d 869, 873 (2012); *see also Mead v. Beaufort Cnty. Assessor*, 419 S.C. 125, 139-140, 796 S.E.2d 165, 173 (Ct. App. 2016).

- The Court's finding that (A)(4) of the AA Statute authorizes CUR in this case was based, in large part, on its mistaken belief that *Media General* interpreted (A)(4) in this way. However, *Media General* did not approve of CUR in a situation like this case, and even if *dicta* therein could arguably be interpreted in that way, the facts and arguments in this case are materially different than those in *Media General*. The taxpayers requested the alternative method in that case, and thus, no concerns of agency overreach or inequities were present or argued. The Court's reference to the applicability of stare decisis is also incorrect due to the different facts and issues in *Media General* versus this case.

- The Order also incorrectly concludes that the Supreme Court in *Media General* meant to approve the use of CUR even though the Supreme Court actually *said* it was approving only the use of a combined apportionment factor (which description the ALC had also used). Order at 52-55. *See also* CarMax East's Proposed Order at 78-79.

- The Court erred in failing to recognize the heightened standard that must be met when (A)(4) is used as required by the plain language of the AA Statute. It discusses that these words have similar definitions and then treats them as one in the same. *See* Order at 64. However, statutes should be construed in a manner that gives effect to every word rather than adopting an interpretation that renders any word meaningless. *Florence Cnty. Democratic Party v. Florence Cnty. Republican Party*, 398 S.C. 124, 128, 727 S.E.2d 418, 420 (2012) (citing *Hinton v. S.C. Dep't of Probation, Parole and Pardon Servs.*, 357 S.C. 327, 592 S.E.2d 335 (Ct. App. 2004)).

- The Court should reconsider its finding in light of the Department's failure to follow Revenue Ruling 15-5 as well as the specific harm such failures caused in this case. *See* CarMax East Proposed Order at 75-76.

- As the Court correctly found, the Department did not apply the *Finnigan* method of dividing income between CarMax East and CarMax West, which is required by Revenue Ruling 15-5. The Court also finds that CUR *would be* reasonable and equitable *if* the Department used *Finnigan*. That means CUR is not reasonable or equitable in this case.

CarMax West is not a party in this case, and the Court cannot order relief that changes CarMax West's tax liability from back in 2016-2018.

- The Order errs in finding CUR reasonable when the Department did not follow its own revenue ruling, and it does not pass the *Twentieth-Century Fox* reasonableness test. *See* CarMax East Proposed Order at 71-72 and 75-76. The Court merely states in conclusory fashion that the *Twentieth-Century Fox* reasonableness test was satisfied with no explanation as to how that is true. Order at 66.

- CUR is also not reasonable or equitable because it rewards the Department for failing to provide an arm's length range of prices for the Management Fee or an origination fee, failing to assert a claim as to an origination fee or the partnership, failing to provide an appropriate partnership percentage, and failing to make any claim regarding the transfer of BPI from CarMax West to CarMax East.

- The Court appears to think that CUR is reasonable because correcting transfer prices can be complicated and take much time and resources, and CUR ostensibly reaches the same result. *See* Order at 69. However, that is not correct in this case. The only way the same result would be reached in this case is if (1) CBS had no profit, either from the Management Fee or from CAF; or (2) CarMax East owned about 75% of CBS rather than the 6.5% it actually owns. The Department failed to establish #1, and the Department asserted no claim that would enable the Court to revalue or change CarMax East's ownership of CBS, and thus, #2 fails as well. *See* CarMax East Proposed Order at 45. In addition, as explained above, even under the Court's conclusion that CarMax East should have received credit for the BPI that CarMax West contributed, no evidence supports the Court's finding that the BPI was more valuable than the IP. Thus, even under that logic, which effectively decides that CarMax East "should have" received more of CBS back in 2004 (which the Court then uses to support its finding that the Department proved Step One under the AA Statute), there is no basis for suggesting CarMax East should have received anywhere close to 75% of CBS even had it been given "credit" for the BPI.

XI. THE COURT'S RULING WILL MAKE SOUTH CAROLINA AN OUTLIER AND NEGATIVELY IMPACT TAXPAYERS' RELIANCE INTERESTS.

The Court's ruling will make South Carolina an outlier and negatively impact taxpayers' reliance interests. CarMax East respectfully requests that the Court reconsider the following arguments:

- Notwithstanding the many states that have adopted a statute based on Section 18 of UDITPA, to which South Carolina's AA Statute is identical, we have been unable to find any decision (other than a similar one from this Court several months ago) where a court has found that (A)(4) authorizes the forced use of CUR against a taxpayer like the

Department has done in this case.[20] In addition, this Court rejected as persuasive authority an Indiana tax court case[21] that addresses this same issue and correctly concludes that (A)(4) does not authorize alternative methods that alter the tax base (that will then be apportioned) of a non-consenting taxpayer, which is exactly what CUR is doing here, based on the Court not being bound by other jurisdictions and its mistaken belief that other states had reached the opposite conclusion. *See* Order at 51. Respectfully, the Indiana case is highly instructive and based on the same statute as South Carolina's, and perhaps the Court would have given it more weight had it understood that other states have not reached the opposite conclusion. *See* CarMax East Proposed Order at 77 (for full discussion of Indiana case). The Court's ruling will make South Carolina an outlier.

- The Court's ruling that an improper transfer price can justify the use of the AA statute is contrary to the Department's own guidance in Revenue Ruling 15-5, which requires the Department to tailor the alternative method to the problem. *See* S.C. Rev. Rul. 15-5 at p. 5.[22]

- Additionally, South Carolina touts its use of separate entity reporting in combination with the single sales factor on its Commerce Department website. *See* CarMax East Proposed Order at 56. South Carolina and other states use such statutes as part of their economic development arsenal to try to attract and retain businesses like Volvo, BMW, Boeing and Mercedes. *Id.* The Department's misinterpretation and misapplication of the AA Statute and its deviation from its own guidance to taxpayers on how it will interpret/apply the statute, which the Order is now approving, will negatively impact South Carolina taxpayers' reliance interests and the business community generally.

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[20] A small handful of cases could be misconstrued as a court finding that in a statute modeled after Section 18 of UDITPA, subsection (A)(4) authorized a taxing agency to require CUR, including the two cited by the Court to support its statement that other states "have found that combined reporting was authorized under Section 18." Order at 32 (citing *Leathers v. Jacuzzi, Inc.*, 935 S.W.2d 252 (Ark. 1996) and *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989)). However, these cases do not actually support that proposition. *See Sears*, 561 A.2d at 174 (wherein the court held that the taxing agency failed to show the standard method did not fairly represent that taxpayer's business activity in the state but did not even address whether the statute modeled after Section 18 authorized the forced use of combined unitary reporting); *Leathers,* 935 S.W.2d at 253 and 256 (wherein two related entities, both of which filed Arkansas state corporate income tax returns on a separate entity basis as required by Arkansas law as the standard method, unilaterally decided to start filing combined unitary tax returns (and filed amended returns for earlier years seeking refunds) without ever requesting or receiving permission to do so and the court, in *dicta*, said the state's statute modeled after Section 18 gave the taxing authority the discretionary power to accept or require combined reporting, but the case was decided against the taxpayers because they never requested permission in the first place).

[21] *See Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888 (Ind. T.C. 2015).

[22] South Carolina and other separate reporting states are not without recourse if transfer pricing problems arise. States can use their § 482 powers to adjust transfer prices, which directly addresses the problem instead of attacking a discrete problem with a bludgeon.

XII. THE COURT SHOULD NOT REWARD TRIAL BY AMBUSH.

The Court should not reward the Department's trial by ambush, as it is neither reasonable nor equitable, and it violates CarMax East's rights to notice, a fair trial, and additional due process rights. The Court should reconsider its ruling in light of the Department having the burden of proof and the following:

- The audit concluded in 2019, the Department filed its Pre-Hearing Statement on July 29, 2021, and it never filed an amended Pre-Hearing Statement. The Department never challenged the accuracy of the 2004 Valuation or disclosed it as the subject of expert testimony, and the Department ignored the entire subject matter of CAF (including, but not limited to, whether an origination fee should be charged). Discovery in this case ended on March 17, 2023 (the "Discovery Deadline"), and the Department's 30(b)(6) witness testified on that date. As of that time, the Department's reasons Step One was satisfied were limited to "distortion ratios," the profit-portion of the Management Fee, and a flawed view of the matching-principle that was nonetheless still based on facts taking place during the audit period. *See* CarMax Proposed Order at 23-27. Thus, as of the Discovery Deadline, there was no indication the accuracy of the 2004 Valuation or the entire subject matter of CAF would be discussed at trial.

- DeRamus began working on this case shortly before the Discovery Deadline and requested his deposition be postponed because he lacked materials relevant to his opinions. *Id.* at 32. CarMax East accommodated that request. *Id.* DeRamus revealed in his deposition (which occurred on March 29, 2023, after the Discovery Deadline by agreement of the parties and permission from this Court) that he had formed an opinion the 2004 Valuation was egregiously wrong and that he had opinions about CAF. DeRamus never mentioned each of the following in his deposition (1) Horizon Media; (2) that he wanted the franchise agreements used by the Transfer Pricing Studies for transactions one or three; (3) the $314 figure that is in the 2004 Valuation upon which he had already formed an opinion and which he discussed extensively at trial as being evidence related to origination fees; or (4) the transfer of BPI from CarMax East to CarMax West because he was unaware of that fact. *See* 04/21/2023 CarMax East Mot. in Limine, Ex. C. The Court's Order uses each one of those against CarMax East, none of which were mentioned by any Department representative before trial. The Court also suggests CarMax East is to blame for the absence of evidence and for not proving things the Department has never argued were a problem or a reason Step One was met. DeRamus's testimony at trial attacking the 2004 Valuation was also new because he did not know the BPI was owned by CarMax West and addressed by the study during his deposition.[23] DeRamus's opinions at trial on the 2004 Valuation, CAF, and the Transfer Pricing Studies had little to no evidence supporting them and were not

[23] CarMax East also had to file a motion to exclude the Department's accounting expert because she had not formed any opinions as of her deposition date and had to argue to keep out more than 1,000 pages of materials the Department added to its proposed exhibit list after the deadline to do so that related to DeRamus's opinions.

credible. *Id.* at 33-43. DeRamus also provided no suggested Management Fee price in his deposition, then suggested a price in the Department's case in chief, and then presented a materially different suggested price in the Department's rebuttal case (*id.* at 41-43), which CarMax East likewise spent substantial trial time defending against. The Court also did not grant CarMax East's request to exclude DeRamus's testimony attacking the 2004 Valuation or its alternative request to postpone trial to determine how the severe prejudice could be alleviated were he allowed to proceed with such testimony.

XIII. THE COURT MISUNDERSTOOD CERTAIN FACTS, WHICH LED TO ERRONEOUS FACTUAL FINDINGS AND LEGAL CONCLUSIONS.

The Court appears to have misunderstood certain facts, which led to erroneous fact findings and legal conclusions. The material factual errors (in addition to those already discussed above) include, but are not limited to, the following:

- The Order relies on calculations that, upon information and belief, are based on DeRamus's testimony during the Department's case in chief. The Court should not rely on such testimony because it is materially incorrect. DeRamus's preparation for this case was clearly rushed. As one of many examples, he had no suggested arm's length price for the Management Fee at his deposition, he testified it was $528 during the Department's case in chief, and then he stated it was $712 in the Department's rebuttal case after Eileen Yost provided testimony making clear his original price was materially wrong. CarMax East Proposed Order at 41-42. Numerous calculations provided during the case in chief that this Court appears to have adopted are also wrong. One example is the Order's statement that CarMax East South Carolina stores had approximately $90,000,000 of operating profit. Order at 7, 60, and 63; *see also id.* at 66 (same, but saying $90,000,000 in sales rather than operating profit). The basis of this is unclear, and CarMax East's South Carolina stores did not have an operating profit of anywhere close to $90,000,000 during the audit period (nor $90,000,000 in sales). The Court should remove these errors or alternatively use correct information and cite to evidence in the record on which the Court is relying, so the Court's ruling is clear. In addition, DeRamus's testimony about the costs associated with transaction three and five is also clearly wrong. *See* Order at 37 and 40. As Eileen Yost testified, the costs incurred by CBS underlying the Management Fee was an average of $701 per car sold. The Order, at page 27, contains a breakdown of the transactions for one year of the audit period. The costs for transactions two and four can be determined to be about $168. If $101 of costs is assigned to transaction one, which is substantially higher than the actual costs, that leaves $432 of the original $701 that are attributable to transactions three and five. It is unclear how DeRamus calculated the costs he associates with transactions three and five, which the Court relies on in its Order, but whatever he did is materially wrong because no matter how that $432—which is very conservative—is divided between transactions three and five, it comes nowhere close to his conclusions. The Court should reconsider relying on any calculations that are based on DeRamus's testimony.

- The Court incorrectly states that the parties presented expert testimony to assist the Court "in evaluating the related party transactions at issue in this case, including the transfers

underpinning the formation of CBS. . . ." Order at 20. It is unclear what the Court is referring to when it says, "related party transactions at issue," but this statement is correct as to only the transfer pricing of the management fee. While DeRamus did attempt to provide testimony regarding other transactions and the formation of CBS, this was done over CarMax East's strenuous objections, and the Court erroneously failed to allow CarMax East more time such that it could retain an expert to combat these late-raised assertions that had never been pled. *See supra* §III.

- All monetary amounts discussed in footnote 36 on page 22 and the first paragraph of page 23 of the Order should be billions not millions.

The Court should reconsider the above factual findings in light of the evidence presented by CarMax East and the lack of evidence presented by the Department.[24]

XIV. ADDITIONAL REQUESTS FOR CLARIFICATION

CarMax East respectfully requests that the Court clarify the following statements in the Order that are unclear.

- The Court's Order states that "[u]nder the facts of this case, I find the 'distortion ratios' used by the Department demonstrate that income *is not flowing between the companies in the manner one would expect, which signals distortion* if not otherwise justified. (Emphasis added). Order at 60, n. 66. Please clarify what the Court would expect these ratios to be (i.e., should they be the same?) and the Court's reasoning for its expectation such that CarMax East can defend itself on this point.

- The Court's Order states that "the discrepancy between how much income CarMax East earns and how much taxable income it produces is evidence of distortion in this case." Order at 60, n. 67. Please clarify the meaning of this phrase (e.g., what is the "income CarMax East earns" and what is the "taxable income it produces" referring to), and the Court's reasoning to view this as evidence supporting its ruling so CarMax can defend itself on this point.

- The Court's Order states: "Again, an uncontrolled party in CarMax's East's position would not engage in this kind of behavior, and the transfer was not arm's length." Order at 61. Please clarify "the transfer" referred to here as violating the Arm's Length Standard.

[24] CarMax East would note that the Order could contain additional errors of fact as many "facts" stated in the Order have no cite to the record and CarMax East has not had adequate time to fact-check every single statement in this 70-page Order.

CONCLUSION

Based on the foregoing, CarMax East respectfully requests that this Court reconsider its Order and amend it to find in favor of CarMax East on all of the above issues.

[*signature on following page*]

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Attorneys for CarMax Auto Superstores, Inc.

Charleston, South Carolina
Dated: July 22, 2024

Exhibit A

Remand Order (July 12, 2024)

See R. 3

STATE OF SOUTH CAROLINA

ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc., Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 21-ALJ-17-0182-CC **RESPONSE TO CARMAX AUTO SUPERSTORES, INC.'S MOTION TO RECONSIDER**

The Court issued an Order of Remand (Order) in this contested case on July 12, 2024. On July 22, 2024, Petitioner CarMax Auto Superstores, Inc. (CarMax East) filed a motion for reconsideration (Motion) of the Order. On July 29, 2024, the Court issued an order rescinding the Order of Remand. Pursuant to SCALC Rule 29(D), Respondent South Carolina Department of Revenue (the Department) responds to CarMax's Motion, and for the following reasons respectfully requests the Court deny the Motion with the limited exception of remanding the matter to the Department for the issuance of amended assessments.

ARGUMENT

SCALC Rule 29(D) limits a motion for reconsideration to the grounds for relief set forth in Rule 59, SCRCP. The purpose of a Rule 59(e), SCRCP, is to preserve an issue or argument that has been raised, but not ruled on, for appellate review. *See Home Med. Sys., Inc. v. S.C. Dep't of Revenue*, 382 S.C. 556, 562, 677 S.E.2d 582, 586 (2009). Rule 59(e), SCRCP allows "a party one final chance not only to call the court's attention to a possible misapprehension of an earlier argument, but also to revisit a previously raised argument" *Id.*; *see also* CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2810.1 (2d

ed. 1995) (observing that Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, but they "may not be used to relitigate old matters"). "A party cannot use Rule 59(e) to present to the court an issue the party could have raised prior to judgment but did not." *Hickman v. Hickman*, 301 S.C. 455, 456, 392 S.E.2d 481, 482 (Ct. App. 1990).

The Department incorporates by reference the arguments and issues it raised in trial and its Proposed Final Order dated January 31, 2024. Nevertheless, the Department briefly responds to several issues raised by CarMax in its Motion.

The Department disagrees with CarMax's reasoning but agrees that a remand is unnecessary.

CarMax raised the issue of *Finnigan* apportionment through the designation of the Department's 30(b)(6) deposition. *See* DOR 30(b)(6) Depo. Tr. 33:14–34:16; 36:7–12; 37:21–38:17; 77:18–79:11. The question of using the *Finnigan* versus *Joyce* method arises in the context where a member of the unitary group does not have nexus (i.e. is subject to tax) with the taxing state. *See id.* 78:2–10. The *Joyce* method does not consider the sales factor numerator of those members of the unitary group that do not have nexus. On the other hand, the *Finnigan* method uses all sales numerators of members of the combined group to apportion income to a state, regardless of whether each member has nexus. *Finnigan* affords the taxpayer the advantage of claiming net operating losses and credits from entities that do not have nexus. The Department applies the *Finnigan* method. *See* Joint Exhibit 28 Rev. Rul. #15-5 at 8–9. Here, CarMax East and CarMax West both have nexus with South Carolina, so *Joyce* versus *Finnigan* is a nonissue.

Regardless, the Department understands the Order to require the Department to issue two separate assessments: one for CarMax East and one for CarMax West. The Department would have separated the liability/refund if CarMax had requested separate assessments, and the

Department is prepared to comply with the Order. *See* Hr'g. Tr. 63:5–8. The Department's audit covered both CarMax East and CarMax West. *See* Joint Exhibit 26 Report of Field Audit.[1] Combined unitary reporting (CUR) 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. The Court correctly found that CarMax East, CarMax West, and CBS make up a unitary group. *See* Order at n. 12. For administrative efficiency and consistent with Department practice, the Department issued a single net assessment to CarMax East. Hr'g. Tr. 60:8–22. Notably, CarMax East owns 100% of CarMax West. *See* Order at 6. Under combined unitary reporting, CarMax East's tax liability increased while CarMax West's tax liability decreased. Hr'g Tr. 62:14–18. The amount of the assessment sent to CarMax East is its additional tax owed minus the refund owed to CarMax West. Hr'g. Tr. 62:19–63:4; *see also* Respondent's Demonstrative 1. In its proposed order, CarMax recognized that the assessment included a "credit" for CarMax West. *See* CarMax Proposed Order at p. 18–20; n. 48–49, 115. Thus, in terms of the mechanics of applying this directive in the Court's Order, the Department will assess CarMax East the increased amount and refund CarMax West a proportionate amount.

In its Motion, CarMax argues the Order violates due process because CarMax West is not a party. However, this misunderstands how combined unitary reporting works.[2] The United States Supreme Court "long ago upheld the constitutionality of the unitary business/formula

[1] The Report of Field Audit identifies the taxpayer as "CarMax Auto Superstores, Inc. & Affiliates." Further, the Report of Field Audit separately accounts for CarMax East and CarMax West in its calculations and analysis.

[2] CarMax even uses the argument rejected in *Media General* about taxpayer being used in the singular. *See* Motion at 25. *Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue*, 388 S.C. 138, 149, 694 S.E.2d 525, 530 (2010) ("the use of 'taxpayer' in the singular did not prevent the Department of Revenue from applying combined reporting").

apportionment method" Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 165, 103 S. Ct. 2933, 2940, 77 L. Ed. 2d 545 (1983). In the *Container Corp.* case, upheld combined unitary reporting even as applied to a multinational enterprise. *See also Allied-Signal, Inc. v. Dir., Div. of Tax'n*, 504 U.S. 768, 778 (1992) ("unitary business principle" permits "[s]tates to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State.") and *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 19 (2008) ("A State may, however, tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a 'unitary business.'"). Even ignoring the unitary business principle, CarMax West suffers no harm from receiving a refund. On the other hand, CarMax East's tax liability would increase without CarMax West receiving a proportionate refund under CarMax's argument. This seems to contradict the ultimate objective of apportioning a multistate taxpayer's income is fairness. *See Container Corp.*, 463 U.S. at 169 (the apportionment formula must "be fair"). Separate assessments under the rescinded Order or a combined net assessment as the Department initially provided both achieve the goal of fairness. However, the Department's original combined net assessment accomplishes this goal while alleviating CarMax's procedural and due process concerns. Therefore, the Department joins CarMax's request that this matter not be remanded.

The hearing before the Court was *de novo*.

Throughout its Motion, CarMax claims that the Department did not raise specific issues, and the Court made sua sponte rulings. This argument misunderstands that this is a de novo hearing. The Court "is not sitting in an appellate capacity and is not restricted to a review of the decision below. Instead, the proceeding before the ALJ is in the nature of a *de novo* hearing." *Reliance Ins. Co. v. Smith*, 327 S.C. 528, 534, 489 S.E.2d 674, 677 (Ct. App. 1997). CarMax

frames the issues before the Court in its prehearing statement as whether the statutory apportionment method fairly represents CarMax's business activities in South Carolina and whether the Department's alternative method is reasonable. This is a broad framing of the issues and the Court's decision in this case falls squarely within those issues and is supported by substantial evidence in the record.

The Court properly considered, weighed, and ruled upon evidence in the record.

Throughout its Motion, CarMax also claims that the Court erred in making certain factual findings. Rather than erring, the Court simply gave the evidence in the record the appropriate weight. The Court is not bound to weigh evidence and arrive at the conclusion according to CarMax's preference. "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). Thus, the Court properly considered and weighed the evidence in the record to arrive at its ruling.

Through the CBS partnership and intercompany transactions, CarMax shifts income among its unitary business to the point that the allocation and apportionment provisions of the South Carolina Income Tax Act[3] do not fairly represent the business activity of the South Carolina taxpayers. The Court's findings in this regard are based on substantial evidence in the record.

The Court correctly allowed a qualified expert to opine on an admitted joint exhibit.

Despite CarMax's curious assertions of surprise, the Department challenged the Valuation Study (Joint Exhibit 55) beginning in the Audit at issue.

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[3] Chapter 6 of Title 12 of the South Carolina Code of Laws

> The major tax shifting strategy is demonstrated below. CBSLLC is performing management services for both CASI and CASWC and the taxpayer has structured the partnership so that CASI (owns retail locations in mostly separate entity states) owns 6.5% of the partnership while CASWC (owns retail locations in mostly unitary states) owns 93.5% of CBSLLC. Obviously, this was planned by the taxpayer to shift income away from separate entity states to unitary states and is the classic east/west strategy that taxpayers utilize to shift income from separate entity states to unitary states.

Joint Exhibit 26 Report of Field Audit.

On November 14, 2019, CarMax raised the issue in its protest of the Department's assessment when it argued: "CASWC owns 93.5%, and CASI owns 6.5% of CBS. These ownership percentages were established in 2004 when the members transferred assets to the LLC. The assets were independently appraised at that time to establish the ownership percentage interest of each of the member corporations." Protest Letter pp. 1-2 (Joint Exhibit 32). Notably, CarMax included the Valuation Study on its own Exhibit List filed on April 21, 2023.

In its Motion to Exclude, CarMax even cites to a portion of the Department Determination questioning the Valuation study. The Department provides the full paragraph for context:

> The Taxpayer *alleges* that CarMax Group assigned ownership percentages of CBS based on the value of the assets transferred to CBS by CarMax East and CarMax West, respectively. 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.* CarMax Group chose what assets CarMax East and CarMax West held. For example, CarMax Group decided initially to put the CarMax intellectual property in CarMax West. However, *the retail stores are what makes the intellectual property valuable*—the better the stores do, the more valuable the intellectual property. Because the shifting is not based on the extent of CarMax East's business activity, the result is not a fair representation of the Taxpayer's business activity in South Carolina.

Department Determination at pp. 4-5 (emphasis added) (Joint Exhibit 27).

Prior to Dr. DeRamus' deposition, CarMax's expert witness testified in his deposition he would be qualified to value the intellectual property that was contributed to CBS. Hr'g Tr. 1119:15–1120:13. Only after CarMax attempted to exclude Dr. DeRamus' testimony did CarMax's expert contradict his prior testimony to claim he was unqualified.

From the beginning of his deposition, Dr. DeRamus explained the relevance of the Valuation Study—which was CarMax's document offered in defense of CBS' ownership percentages/distributive shares—to his opinions regarding the reliability of the 482 Studies, whether separate reporting reasonably reflects CarMax's business activity in South Carolina, and whether combined reporting more reasonably reflects CarMax's economic activity in South Carolina:

> **Q. And so with that clarification, does this description accurately reflect the opinions that you intend to give in this case?**
> A. In broad brush, yes, but there's certainly more specifics. I have been provided a wide range of documents, and I have reviewed those documents. Some of those documents include, for example, studies preceding the period at issue, i.e. there is an Ernst & Young 2004/2005 valuation study that I reviewed, so I would consider part of my opinions to extend to that as well, because that ultimately informs my opinion as to an appropriate transfer pricing analysis during the years at issue…

DeRamus Dep. Tr. 8:7-19 (Exhibit C to CarMax's Motion to Exclude). Dr. DeRamus provided further explanation of the relation of the Valuation Study to his opinion in his deposition and at trial. CarMax cannot offer the 2004 Valuation Study as a defense and then cry foul when the Department challenges that defense.[4] The Court properly allowed Dr. DeRamus–a Ph.D.

[4] CarMax implies the existence of statute of limitation for challenging the 2004 Valuation Study yet points to no authority in support. Under CarMax's argument, a taxpayer could restructure for the sole purpose of avoiding tax, create an unreliable valuation study that gives it the desired ownership percentages, wait an undefined number of years before subjecting itself to nexus, and then use the study as an unchallengeable defense based on the age of the study.

economist with extensive experience in § 482 transfer pricing and valuations–to opine on a valuation study (that was admitted as a joint exhibit) based on § 482 principles. Therefore, CarMax's argument to exclude his testimony was and is without merit.

Further, the Court properly considered and ruled upon the evidence in the record regarding CarMax's ownership shares and CarMax's defense of those ownership shares with the Valuation Study. 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.").

As the Department argued, the 2004 Valuation is intimately connected to CarMax's transfer pricing studies. *See* Hr'g Tr. 187:19–21. For example, CBS charges management fees to CarMax East for use of the business process intangibles that CarMax East transferred to CarMax West for zero consideration. *See* Hr'g Tr. 232:18–235:5; 349:17–352:2; 464:19–470:19; 482:23–485:6; 490:5–493:19. CarMax West contributed those business process intangibles to CBS in exchange for a 93.5% ownership in CBS. *Id.* The management fees and disproportionate shares of the CBS partnership are how CarMax siphons income from CarMax East. Yet, CarMax argues no one can challenge those fees or how the shares of CBS were established. The Court appropriately weighed evidence in the record related to CarMax's structure and intercompany transactions and ruled based on substantial evidence.

CarMax asks this Court to rewrite the unambiguous alternative apportionment statute.

CarMax edits S.C. Code Ann. § 12-6-2320(A) to read: "if the ~~allocation and apportionment provisions of this chapter do~~ sales factor does not fairly represent the tent of the taxpayer's business activity in this State...." In other words, an unfair representation of a taxpayer's business activity is fine so long as that distortion is not caused by the sales factor. This inappropriately narrows a statute that our Supreme Court held to be plain and unambiguous in *Media General*. While inclusive of the sales factor, the allocation and apportionment provisions of South Carolina Income Tax Act are not limited to the sales factor. The integrity of the sales factor is dependent upon the apportionable base to which it is applied. 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). CarMax's rewriting of the alternative apportionment statute contradicts its very purpose of remedying unfair representation of a taxpayer's business activity. *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 . . ."). Significantly, "the legislature has placed no explicit limitation on the alternative methods that may be used under § 12-6-2320(A)(4)." *Media General*, 388 S.C. at 152, 694 S.E.d2d at 532. Moreover, CarMax's proposed revision of section 12-6-2320(A) is unfair to the taxpayers who petition the Department to use combined unitary reporting as a method to effectuate an equitable apportionment of their income. *See* Hr'g Tr. 85:9–22 (Mr. Sharpe discussing taxpayers' petitions for combined reporting as an alternative method). Therefore, the Court applied the correct legal standard to find that separate reporting did not fairly

represent CarMax's business activity in South Carolina. Additionally, substantial evidence in the record supports the Court's finding that the allocation and apportionment provisions of chapter 6 do not fairly represent CarMax's business activity in this State.

CUR is a reasonable alternative method to effectuate an equitable apportionment.

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 Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina."). The Department's alternative method must be reasonable, but it need not be the most reasonable method. *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 88, 767 S.E.2d 195, 199 (2014) ("we agree with the Department that the court of appeals misapplied *Media General* in holding the Department must prove that its alternate formula is 'more reasonable than any competing method'").

Substantial evidence supports the Court's rulings related to origination fees, CAF, and economic substance.

The Department discussed the origination fees in its case in chief. *See* Hr'g Tr. 216:1-14; 451:13–455:4; 538:1–540:14; 542:6–14; 640:14–642:15; 657:15–659:3. This evidence in the record supports the position that CarMax is shifting income to the point that its business activity in this State is not fairly represented under the default apportionment method. This also supports the use of combined unitary reporting as an alternative apportionment method because it eliminates the intercompany transactions that are causing the distortion. Relatedly, CarMax asserts that "There is virtually no evidence in the record related to the entire subject matter of CAF…" See Motion at p. 16. A simple word search or review of the hearing transcript index reveals the "CAF"

was mentioned approximately 190 times. *See also* Joint Exhibits 81-83 (Excel files related to CAF financials). Similarly, the phrase "economic substance" appears in the hearing transcript alone over 50 times. The Court properly made findings of fact based on substantial evidence regarding the lack of economic substance behind CarMax's structure and intercompany transactions. The Court has no obligation to point CarMax to all evidence in the voluminous record that supports its findings.

CarMax's transfer pricing studies defense was unpersuasive.

Contrary to CarMax's assertion, neither the Department nor the Court has an obligation to accept CarMax's transfer pricing studies or conduct its own transfer pricing studies. The Department and the Court are free to reject all or parts of the transfer pricing studies. The Court properly weighed the evidence related to CarMax's proffered defense of the transfer pricing studies. 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."[5] When the IRS makes an adjustment under § 482, a taxpayer may be subject to a net adjustment penalty under 26 U.S.C. § 6662€(1)(B)(ii) unless it satisfies certain documentation requirements (i.e. it has a reliable transfer pricing study that was in existence at the time of filing the return) under 26 C.F.R. § 1.6662-6€. Therefore, the purpose of a transfer pricing study is penalty protection in the event of a substantial or gross valuation

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

misstatement, but even then, the study must be both reliable and in existence at the time of filing the return. Of course, there are no penalties at issue in this case. Regardless, substantial evidence supported the Court's rulings criticized by CarMax regarding CarMax's transfer pricing studies.

The Court correctly applied section 12-6-2320 as written.

The Legislature added enacted section 12-6-2320 in 1995. In 2010, the South Carolina Taxation Realignment Commission (TRAC)[6] reported to the Legislature that the *Media General* ruling confirmed the Department has the authority to require "forced combinations" under section 12-6-2320(A)(4). *See Final Report of S.C. Taxation Realignment Commission*, Joint Exhibit 56 at p. 162. In 2024, the Legislature amended section 12-6-2320(A)(4) 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). If South Carolina is an outlier as CarMax argues, it is not because of this Court's ruling. It is because the Legislature has chosen to adopt the statutory scheme that the Department and this Court properly followed.[7]

The Court gave CarMax a fair trial, but the facts and law were not in its favor.

In response to CarMax's claims of ambush, CarMax seems to fundamentally misunderstand the purpose of discovery. When a party obtains information via a request for production, interrogatory, admission, or deposition, that is not an ambush or unfairly prejudicial. The purpose of discovery is to obtain that information in preparation for trial. CarMax is the gatekeeper of documents in its possession or control. If it plans to offer documents into evidence, it should be prepared to answer questions about those documents. It cannot put its head in the sand

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

[7] Notwithstanding, from a tax policy standpoint, even CarMax's expert recommends combined reporting. Hr'g Tr. 896:15-25.

and claim surprise. CarMax also mispresents the postponement of Dr. DeRamus' deposition. The undersigned offered to delay Dr. DeRamus' deposition to allow him time to review and be prepared to answer CarMax's questions regarding documents—specifically, documents that CarMax had not yet produced in response to the Department's requests for production. Simply because evidence is harmful to CarMax's case does not make it unfairly prejudicial. Similarly, the discovery of harmful evidence is not ambush. One can hardly blame CarMax's strategy. When the facts are against them and the opposing party has the burden, attempts to exclude evidence and procedural attacks may be the best approach. However, its arguments were without merit, and the Court was not fooled.

The Court provided extensive analysis supported by substantial evidence.

The Court considered, weighed, and ruled based upon the substantial evidence in the record. Before the Court were five days of live testimony in addition to deposition designations and thousands (if not tens or hundreds of thousands) of pages of documentary evidence. CarMax is not entitled to a chapter and verse recitation of every single piece of evidence that supports each sentence in the Order. While CarMax claims it does not have "adequate time to fact check every single statement in this 70-page Order," CarMax asks the Court to do this work on its behalf. Motion at n. 24. The Court provided more than sufficient analysis for its conclusions and CarMax's requests exceed what judicial economy allows.

CONCLUSION

CarMax is rolling back the odometer and telling the Court that no one is allowed to kick the tires or look under the hood. However, neither the Department nor this Court is obligated to buy CarMax's arguments and defenses "as is." If the standard allocation and apportionment provisions do not fairly represent a taxpayer's business activity (the mileage on odometer is off),

our Legislature allows alternative methods to arrive at a fair representation. Accordingly, the Court correctly found that CarMax's business activity in South Carolina is not fairly represented and combined unitary reporting is a reasonable method to effectuate an equitable apportionment. Therefore, the Department respectfully asks the Court to deny CarMax's Motion with the limited exception of the remand issue discussed above.

Respectfully submitted,

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Columbia, South Carolina
August 2, 2024

STATE OF SOUTH CAROLINA

ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc., Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 21-ALJ-17-0182-CC **PETITIONER'S MOTION TO RECONSIDER AMENDED FINAL ORDER AND ORDER GRANTING MOTION FOR RECONSIDERATION**

Pursuant to Rule 29(D) of the Rules of Procedure for the Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, CarMax Auto Superstores, Inc. ("CarMax East" or "Petitioner") respectfully requests that this Court reconsider and modify its Amended Final Order (the "Amended Order") and its Order Granting Motion for Reconsideration (the "Reconsideration Order"), both dated August 15, 2024. Copies of these orders are attached hereto as **Exhibit A** and **Exhibit B** respectively. This motion is based upon the grounds that the Court has overlooked, misinterpreted, or failed to apply South Carolina law and/or overlooked or misunderstood certain evidence, points, and arguments presented, which, when considered or reconsidered, necessitate modification of both the Amended Order and the Reconsideration Order in favor of CarMax East as set forth in more detail below. CarMax East further relies upon, hereby incorporates, and does not waive any and all prior points and arguments advanced supporting its position in prior submissions and otherwise at trial.

INTRODUCTION

Following a contested case hearing, this Court issued an Order of Remand ("Remand Order") on July 12, 2024, attached hereto as **Exhibit C**. While the Remand Order remanded the case to the Department to address one issue, it also contained the Court's fact findings and legal conclusions on all issues and, thus, in effect, was a final order. CarMax East timely filed a motion for reconsideration of the Remand Order on July 22, 2024 ("Motion to Reconsider"), detailing the arguments and points that were overlooked, or in error, and requested that this Court reconsider its order and amend it to find in favor of CarMax East on all issues. On July 29, 2024, this Court entered an order, *ex mero motu*, which rescinded its Remand Order pending disposition of CarMax East's reconsideration motion. On August 15, 2024, this Court entered two orders: (1) the Reconsideration Order, which, while stating it was granting CarMax East's motion, granted only a small portion of the relief requested by CarMax East and instead indicated that while the motion caused the Court "to rethink its reasoning on some issues in the case," the Court reached "the same result" as in its prior Remand Order; and (2) the Amended Order.

Under SCALC Rule 29(D), a party must move for reconsideration of a final decision of the ALC (subject to the grounds for relief set forth in SCRCP Rule 59) prior to appealing such a decision. *See* SCALC Rule 29(D); *Elam v. S.C. DOT*, 361 S.C. 9, 19, 602 S.E.2d 772, 777 (2004) ("It is proper to view a Rule 59(e) motion not only as a vehicle to request the trial court alter or amend the judgment, but also as a vehicle to seek reconsideration of issues and arguments.") "The purpose of Rule 59(e), SCRCP, to alter or amend the judgment[,] is to request the trial judge to 'reconsider matters properly encompassed in a decision on the merits.'" *Arnold v. State*, 309 S.C. 157, 172, 420 S.E.2d 834, 842 (1992) (citation omitted).

Here, in addition to all grounds raised in its Motion to Reconsider, which is incorporated herein in full by reference, CarMax East has three grounds that warrant reconsideration of this Court's August 15, 2024 Orders: (1) the Reconsideration Order erroneously applied principles of federal civil procedure, and it is unclear whether that error led the Court to disregard reconsideration of earlier-made arguments at the contested merits hearing; (2) the Amended Order (as explained in the accompanying Reconsideration Order) substantively altered its reasoning and/or the application of the facts and law in this case; and (3) the Reconsideration Order also includes new and additional legal grounds and reasoning to sustain the Amended Order with respect to the underlying tax issues.

Regarding the first ground, it is unclear whether the Court declined to reconsider arguments that CarMax East had previously made based on its belief that a party should not raise issues that had previously been raised and ruled upon. *See* Reconsideration Order at 1 (citing a federal civil procedure treatise and stating that Rule 59(e) motions may be used to preserve an issue for appellate review or request the court rule on an issue raised but not ruled upon but "may not be used to relitigate old matters"); *see also id.* at 5, ¶ 3 (citing same treatise and stating court will address the issue to the extent clarification is needed) and 8, ¶ 10 (citing same treatise and stating to the extent changes made or informed Court's reasoning, court will address the issue raised). In South Carolina, a motion for reconsideration under Rule 59(e) may properly address issues that were previously raised. *See Elam*, 361 S.C. at 21-26, 602 S.E.2d at 778-718 (A party is authorized to file an initial Rule 59(e) motion, regardless of whether the written Rule 59(e) motion may have revisited some issues and arguments raised at the merits hearing). Accordingly, to the extent this Court rejected any reconsideration arguments because it felt that they had also

been made during the earlier contested merits hearing, this Court should not have been so constrained and should reconsider such arguments.

Second, CarMax East seeks reconsideration based on the substantive alterations of the Amended Order. As our Supreme Court has explained, a second motion for reconsideration is proper "if the disposition of the first motion results in a judgment which is substantively altered[.]" *Elam*, 361 S.C. at 19, 602 S.E.2d at 777. CarMax East posits that such criteria are satisfied here. While the Amended Order arrived at substantially the same overall result, it contains several new and additional legal grounds, facts, and reasoning to support the conclusions rendered. As examples, the Court: has provided new arguments to support its finding that CarMax East should have received credit for assets CarMax West contributed to CBS; determined the effect of the partnership distributions results in satisfaction of Step One of the AA Statute regardless of whether the partnership distributions were appropriately established; found that the Department established a prima facie case and added supporting authority; and changed its rationale with respect to its finding that combined unitary reporting ("CUR") is reasonable and equitable in this case, among other changes. Thus, CarMax East is correctly challenging these new and additional grounds and reasoning, with which it disagrees, via this motion. Under *Elam*, CarMax East's position is that this motion is not a "merely successive" motion to reconsider.

Third, this motion also properly challenges the substantive alterations and additions to this Court's legal reasoning contained in the Reconsideration Order. To that end, sections 1, 2, 7, 8, 12, and 13 of the Reconsideration Order appear to reference or include new and additional grounds to sustain the Amended Order. As with the challenges to new grounds in the Amended Order, CarMax East challenges the substantive changes to the Court's reasoning in the

Reconsideration Order, argues they are in error, and takes the position that this is not a "merely successive" motion to reconsider.

CarMax East respectfully requests that its motion for reconsideration of the Amended Order and Reconsideration Order be granted for the reasons that follow.

ARGUMENT

I. THE COURT ERRED IN FINDING THE DEPARTMENT CAN REQUIRE COMBINED UNITARY REPORTING WITHOUT PROVING STEP ONE FOR CARMAX WEST AND IN FINDING THE FAILURE TO NAME CARMAX WEST AS A PARTY IS NOT FATAL IN THIS CASE.

The Amended Order now states "Petitioner [CarMax East] is required to use combined unitary reporting on its South Carolina corporate income tax returns for fiscal years 2016-2018." Am. Order at 69. CUR involves a single tax return that encompasses multiple entities. In other words, if South Carolina adopted CUR as the required reporting method as other states have done, the CarMax Group would file only one tax return here, not two returns as CarMax East and CarMax West have done for many years, including during and after the audit period. CarMax West has already filed its tax returns for the audit period and been assessed tax, it already paid its taxes owed to this state, it is not a party to this case, and it has never consented to this.

Even if the Department could prove Step One solely for CarMax East (but not CarMax West)[1] and require CUR that includes both CarMax East and CarMax West, the Court incorrectly found the Department's failure to name CarMax West as a party to this action is not fatal to its case. Reconsideration Order at 4, n. 2. The Court correctly recognizes that it cannot order relief that directly affects CarMax West's rights. *Id.* at 4-5. Here, requiring the use of CUR

[1] The Department cannot require CUR that includes both CarMax East and CarMax West (or CarMax West's income) when the Department has not proven Step One under the AA Statute for CarMax West. *See* Mot. to Reconsider at 4, and Proposed Order at 22. That would remain true even had the Department named CarMax West as a party in this case, and it certainly is true here where the Department did not name CarMax West as a party.

directly affects CarMax West's rights both during and after the audit period. The Court impliedly recognizes this. *Id.* at 4, n. 2 (saying "it certainly appears the better practice would be to include" CarMax West as a party in this case). CUR is a single tax return for multiple entities and requiring that CarMax East use CUR is the same as requiring its use by both CarMax East and CarMax West. The Department has never proven that CarMax West must use CUR, and CarMax West has never consented to its use.[2]

CarMax West has already filed its tax returns for years after the audit period, and thus the Amended Order also appears to directly impact CarMax West's rights for those years. The Court has now ruled that CarMax East is required to use CUR for 2016-2018 for reasons that are unclear yet appear to be based on the ownership of CBS, and thus, those reasons would likely continue to apply as long as CBS is in existence.[3] CarMax West should be entitled to file its tax returns using separate reporting and the standard apportionment method unless proven otherwise or agreed otherwise, neither of which have occurred, and South Carolina law requires it to file its tax returns that way. The Court has ordered relief that directly impacts CarMax West's rights both during and after the audit period, in violation of CarMax West's due process rights. *See* Mot. to Reconsider at 3-5.

[2] The Court says, "the Department assessed taxes for the group through CarMax East" and suggests that is permissible because both taxpayers were audited. Reconsideration Order at 3. The Court also says CarMax East did not object to the Department giving it credit for the taxes CarMax West had already paid. *Id.* Nothing authorizes the Department to assess tax for the group through CarMax East, and CarMax East's acceptance of a tax credit that reduced the assessment of additional taxes against CarMax East does not equate to CarMax West consenting to the use of CUR.

[3] For example, an adjustment to the Management Fee—which has not even been shown to be a non-arm's length price—does not appear to be a circumstance that would change the Court's conclusion.

II. THE COURT'S CONCLUSION REGARDING WHO GETS CREDIT FOR BUSINESS PROCESS INTANGIBLES TRANSFERRED TO CBS IS FLAWED AND INCORRECT, AND ITS IMPACT ON THE COURT'S OVERALL RULING IS UNCLEAR.

Even though the Court appears to say that whether the partnership interests are appropriate or justified does not matter (*see infra* § III), it still finds (as it did in the Remand Order) that CarMax East should get credit for CarMax West's contribution of business process intangibles ("BPI") to CBS in 2004. Am. Order at 25. However, due to changes in the Amended Order, it is unclear what impact, if any, this finding now has on the Court's ultimate ruling, and the new reasons provided to justify the Court's conclusion are, respectfully, flawed and incorrect. The following are new additions to the Court's reasoning and CarMax East's responses to same:

A. Both the Amended Order and the Reconsideration Order discuss for the first time Cody's testimony on this issue. Am. Order at 24-26; Reconsideration Order at 6-7. Particularly in the Reconsideration Order, the Court implies that CarMax East was expecting the issue of who gets credit for the BPI and/or had adequate notice and opportunity to be heard on it as seen by CarMax East presenting evidence about it (via Cody) at trial. *Id.* The Court also suggests CarMax East should have anticipated the Court ruling that CarMax East should get credit for the BPI that CarMax West contributed to CBS as a potential outcome and thus been prepared to defend against it. Reconsideration Order at 7.

CarMax East Response: CarMax East transferred the BPI to CarMax West in 2004. The Department never mentioned that fact or otherwise indicated it was aware of it prior to trial, and the Department's sole expert witness (DeRamus) was not aware of it at his deposition, which occurred after the close of discovery and less than two months before trial. Mot. to Reconsider at 17, n. 13.[4] Neither the Determination nor the Department's Pre-Hearing Statement mention this fact much less indicate it was improper, nor assert any argument or theory that would lead CarMax East to anticipate this fact being relevant, much less important. The

[4] In its Motion to Reconsider at 17, n. 13, CarMax East mistakenly said the Department was not aware of this fact and seeks to clarify that statement here. CarMax East does not know whether the Department was aware of this fact. CarMax East knows only that the Department has never mentioned it or said anything indicating knowledge of it and that DeRamus did not know of this fact at the time of his deposition. The Department may have known of this fact because it was clearly stated in documents produced in discovery early in the case or otherwise learned of it. The Department may have known the fact but (like CarMax East) correctly deemed it irrelevant or unimportant.

fact also is not relevant to the accuracy of the 2004 Valuation Study.[5] To be clear, CarMax East is not criticizing the Department for possibly not knowing this fact or for failing to expressly make arguments related to it, because it is not an important or relevant fact. DeRamus's testimony about this fact at trial is the first instance the Department indicated knowledge of this fact, and thus the first instance CarMax East learned the Department's position on its significance in this case, and even then, it was minimal. CarMax East responded to the testimony the best it could upon hearing it for the first time at trial, and its expert briefly explained that it is incorrect to say CarMax East "gave away" the BPI it contributed to its wholly owned corporation, CarMax West.

The Court's belief that CarMax East should have anticipated and defended against the Court ruling that the transfer of BPI to CarMax West violated the Arm's Length Standard, and consequently, that CarMax East should have received credit for CarMax West's contribution of the BPI to CBS in 2004, respectfully, is not reasonable. Both parties viewed the fact as virtually irrelevant (even after trial), the Department has never argued the rationale used by the Court that is centered on this fact (including in its Proposed Order), and CarMax East in its Proposed Order likewise did not attempt to combat anything related to such a rationale, including the Court's *sua sponte* findings that (1) the fact that BPI was transferred to CarMax West is meaningful; (2) an issue in this case is whether CarMax East can or should get credit for CarMax West's contribution of the BPI to CBS; or (3) CarMax East should get credit for that contribution by CarMax West. Nothing about CarMax East's expert providing testimony in response to new testimony from DeRamus at trial justifies or supports the Court's belief that CarMax East should have anticipated or defended against this issue and/or that CarMax East had adequate notice and opportunity to be heard on this issue, and the Court's *sua sponte* findings on this issue violate CarMax East's due process rights.

B. The following three consecutive sentences in the Amended Order are new:

(1) "While the parties quibbled about how valuable the business process intangibles were for the purpose of the Management Fee, they both agreed they were valuable assets."

(2) "Therefore, whoever contributed these assets to CBS deserved credit for them."

(3) "Regarding the partnership distributions more generally, I conclude the evidence shows that CarMax East should have received credit for the contribution

[5] The 2004 Valuation Study determined the value of certain assets owned by CarMax West, which included the BPI. The transfer of BPI could be a relevant fact to one trying to determine the assets valued by the study, but the transfer of BPI is not relevant to the accuracy of the study. Thus, even when CarMax East learned right before trial the Department intended to attack the accuracy of the 2004 Valuation Study, that did not give notice the transfer of BPI now may be relevant in this case.

of the business process intangibles to CBS and should have received a commensurate portion of the CBS partnership."

CarMax East Response: These new sentences are problematic for many reasons, including the following:

- Regarding #1, the Court is still unjustifiably concluding that because the BPI that existed during the audit period was valuable as evidenced by the arm's length price for the use of the BPI related to the Management Fee, that means whatever BPI CarMax West contributed to CBS in 2004 (which is both unknown and undoubtedly extinct prior to the BPI used during the audit years) was the majority of the value of the assets CarMax West contributed to CBS. *See* Mot. to Reconsider at 19 (as to why Court should not reach this conclusion).

- The first sentence, whether true or not, and whether discussing the value of BPI in 2004 or the audit period, does not lead to the conclusion in sentence #2. The Court suggests there is a cause and effect between #1 and #2, but there is none.

- Regarding #2, CarMax West, not CarMax East, contributed the BPI, thus the Court should have concluded that CarMax West should get the credit.

- Regarding #3, its meaning is unclear, particularly given that the sentence immediately before it says CarMax West deserves the credit.

C. The Court provides new reasons supporting its finding that CarMax East should have received credit (and corresponding ownership of CBS) for the contribution of BPI in 2004. *See* Am. Order at 25-26.

CarMax East Response: The new reasons are, respectfully, flawed and/or incorrect for many reasons including the following:

- The Court's rejection of Cody's testimony on this issue is flawed. Am. Order at 25-26. If a person deposits money into his own bank account, he has not given away that money. It is no different here. CarMax East owned 100% of CarMax West, and the contribution of BPI was an exchange of equal value because the CarMax West stock shares owned by CarMax East increased by the same value as the BPI. That contribution does not violate the Arm's Length Standard, and the Court incorrectly rejected Cody's testimony for reasons that are entirely irrelevant here. *Id.* It does not matter that CarMax West is not publicly traded on the stock market or that no new shares of stock were issued in the transaction, and neither of those are evidence that the contribution of BPI to CarMax West violates the Arm's Length Standard. Am. Order at 25-26. The Court's arguments here and its implied suggestion that Cody should have but

failed to explain the relevance of CarMax West not being publicly traded and not issuing new shares of stock in this transfer also illustrate the problem of the Court *sua sponte* raising this issue that was never raised by the parties, was not focused on at trial, and thus was not ever briefed.

- The Court's logic that the contribution of BPI to CarMax West violates the Arm's Length Standard and could result in CarMax East getting credit for CarMax West's subsequent contribution of those assets to CBS is at odds with ubiquitously used provisions in the Internal Revenue Code and adopted by South Carolina including I.R.C. § 351, which encourages this transfer of BPI by treating it as a tax-free nonrecognition event. In addition, here, CarMax East confirmed before implementing the 2004 Restructuring that both (1) the contribution of BPI to CarMax West would qualify as a tax-free non-recognition event under I.R.C. § 351, and (2) South Carolina encourages and allows this transaction by its adoption of I.R.C. § 351. *See* Joint Ex. 54 at CarMax_001827-001828 (confirming § 351 treatment); *id.* at CarMax_001832 (confirming South Carolina follows I.R.C. § 351). Thus, South Carolina encouraged and allowed CarMax East's transfer of BPI to CarMax West, and CarMax East confirmed this before making the transfer. *Id*. South Carolina would not encourage/allow this transfer only to have this Court 20 years later unravel it based on the premise that it violates § 482.

- The Court is also misapplying § 482 principles by failing to identify the specific "controlled transaction" that is the subject of the Arm's Length Standard and failing to differentiate between different "controlled transactions" in its § 482 analysis. Each of the following is a distinct controlled transaction: (1) CarMax East's transfer of BPI to CarMax West; (2) CarMax West's transfer of BPI to CBS; and (3) CarMax East's payment to CBS for the use of BPI as part of the Management Fee in the 2004-2005 time period. The Court, for example, says #1 is "a non-arm's length transaction" because CarMax East gave away the BPI for free (which is not accurate) and agreed to pay for the use of the BPI (i.e., #3). Am. Order at 25. The Court may be simultaneously discussing #1, #2, and #3, and perhaps even a fourth controlled transaction if discussing the Management Fee payment in the audit period to reach its unclear conclusion. *Id.* at 26. This is a flawed application of § 482 principles.[6]

[6] The Court is also misapplying § 482 principles by determining whether the transfer is or is not "an arm's length transaction," rather than taking the transaction as given and determining the price that satisfies the Arm's Length Standard for it. Am. Order at 25-26. A § 482 analysis is only used for non-arm's length transactions (i.e., transactions between related parties). The Court appears to be deciding whether two unrelated parties would have been in the transaction, whether CarMax East would ever transfer assets to an unrelated party, or whether it is possible for two unrelated parties to partake in the transaction, as opposed to taking the transaction as given and determining the value exchanged therein to see if it satisfied the Arm's Length Standard. *Id.*

D. The final concluding paragraph (Amended Order at 26, final full paragraph immediately before the next section entitled "Management Fee") of this section is new, incorrect, and entirely unclear. Am. Order at 26.

CarMax East Response: It is unclear whether the Court found the ownership of CBS and/or partnership distributions were appropriate or inappropriate. *Id.* (saying "whether the partnership distributions are proper or not does not matter" and "Even if the partnership percentages are correct, I would still find . . ."). If the Court found they are incorrect or inappropriate, the legal and factual basis and the rationale used for such finding(s) are unclear. *Id.* It is also unclear how, if at all, the Court's unclear finding(s) impacted any of its ultimate rulings in this case. *Id.* To the extent the Court's findings here had any impact on any rulings in this case, even if only as supporting evidence, the findings and impact of those findings should be reconsidered, or at least clarified, for the reasons expressed herein.

III. THE COURT'S NEW CONCLUSION THAT STEP ONE HAS BEEN MET BASED SIMPLY ON THE OPERATION OF THE OWNERSHIP INTERESTS IN CBS IS IMPROPER.

The Amended Order appears to conclude that even if the ownership interests were justified, Step One has been satisfied based simply on the operation of the ownership interests in CBS. For example, the Court states that it ". . . found, similar to the Department, that regardless of whether the ownership percentages were justified, the partnership caused income to be shifted from CarMax East to CarMax West with the result that the extent of CarMax East's taxable income was not fairly represented by standard apportionment." Am. Order at 3, n. 5.[7] Thus, the Court appears to conclude that accepting the existing ownership of CBS as given, and accepting as true that the ownership of CBS was correctly established, the Court nonetheless found that (1)

[7] *See also id.* at 17 ("Similar to the Department, I ultimately find 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."); *Id.* at 26 ("However, whether the partnership distributions are proper or not does not matter nearly as much as the **effect** of the partnership ownership interests on taxable income. Even if the partnership percentages are correct, I would still find that standard apportionment does not fairly reflect the extent of CarMax East's business activity in this state because the partnership distributions effectively distorted CarMax East's taxable income under standard apportionment.") (emphasis in original); *Id.* at 61 ("Thus, regardless of whether the underlying partnership distributions are proper or not, the Department showed that their effect is to distort CarMax East's taxable income in this state.").

the Department proved Step One of the AA Statute by showing CarMax East's taxable income in this state was too low compared to its business activity (which the Court seems to refer to as "distortion"), and (2) the cause of #1 is because of the "effect" of the CBS ownership, meaning that 93.5% of CBS's net income (or loss) flows to CarMax West and only 6.5% to CarMax East. Although CarMax East agrees with the Court's apparent finding that it is appropriate to accept the ownership of CBS as given regardless of whether appropriately established in 2004, the Court's subsequent findings that Step One was met and the reasons it was met are, respectfully, flawed and mistaken for many reasons, including the following:

- The Court is applying the wrong standard in Step One and conflating taxable income with "business activity" within the meaning of that phrase in the AA Statute. *See* Mot. to Reconsider at 9-11.

- The evidence the Court relies on does not support its conclusion that Step One was satisfied. Am. Order at 60-63. The Court is merely describing the partnership structure and then comparing financial data related to CarMax East and CarMax West, which, of course, is affected by the partnership distributions. *Id.*

- The Court appears to have it reversed when it finds that the partnership distributions are causing the "distortion" of CarMax East's business activity by "siphoning" CarMax East's taxable income *away* and improperly giving it to CarMax West. The Court discusses the Management Fee and partnership distributions "working together" to result in the finding that Step One was satisfied in this case. Am Order at 60-63. However, CarMax East is paying CBS for the Management Fee, and then a portion of CBS's profits (including from that fee) is coming *back* to CarMax East, which is then reflected on its tax returns filed here. That only occurs because CBS is taxed as a partnership. CBS could elect to be taxed as a corporation, and then nothing would flow back to CarMax East, and CarMax East's tax returns would have shown less tax due than its returns as filed. Similarly, if the CarMax Group had decided to structure themselves such that CarMax West performed all functions of CBS (both Management Fee services and CAF), and thus CarMax East operated exactly as it did in the audit period yet paid the Management Fee directly to CarMax West, then CarMax East's tax returns in the audit period would look the same as they do as filed but with even less taxable income as no profit from the Management Fee or CAF would flow back to CarMax East (like it does here with CBS and CarMax's East's 6.5% ownership thereof). If CarMax East's federal taxable income is too low thus resulting in its South Carolina taxable income being too low as this Court has found, that is not caused by the partnership distributions, and they are not "siphoning" CarMax East's taxable income away from this state.

- Organizational/business structures, and the distinct legal entities and ownerships thereof, should be respected by a Court unless a proper claim is made to justify disrespecting them (such as a veil piercing action or a lack of economic substance claim). The Department made no such claims in this case.

- Taxpayers are entitled to structure their businesses as they see fit, and tax minimization strategies are not unlawful.

- If the partnership distributions are proper, then it is unclear on what basis the Court is finding that CarMax East's business activity in South Carolina is not fairly represented.

The Court should reconsider its overall conclusions in light of the above reasons.

IV. THE MOTION IN LIMINE SECTION OF THE AMENDED ORDER CONTAINS SEVERAL ITEMS THAT SHOULD BE RECONSIDERED.

The following are new statements in the section of the Amended Order addressing CarMax East's Motion in Limine that warrant reconsideration and CarMax East's responses thereto:

- The Court states that "whether the partnership distributions distorted CarMax East's taxable income is a central issue in this case." *See* Am. Order at 2, n. 3. While the statement's meaning is not clear, it is, in any event, incorrect because: (a) whatever it means, it was not a central issue; and (b) it incorrectly focuses on CarMax East's taxable income and conflates it with "business activity" within the meaning of Step One of the AA Statute because the Court applied the wrong standard for Step One. *Id.; see also id*. at n. 4 and 5 (where the Amended Order also appears to conflate "taxable income" and "business activity"); *see also* Mot. to Reconsider at 9-11 (describing application of incorrect legal standard).

- The new statements at page 2, n. 4 are also both incorrect and unclear. The Court suggests that any event or fact, no matter how many years or decades before the audit period in which that fact or event occurred, that "affected how money shifted between" related parties in the audit period should be known to be relevant in this case. *Id.* Under that logic, had the 2004 Restructuring occurred 100 years earlier and was supported by a 1904 Valuation Study, CarMax East should have expected the accuracy of that study to be relevant in the case, and had CarMax East mentioned the study in response to complaints about CarMax West receiving 93.5% of CBS's profits, then CarMax East should have expected undisclosed expert testimony challenging the accuracy of it, all of which is not reasonable. The Court also says it is "relevant in an analysis of whether income shifting is distorting taxable income." *Id.* The meaning of that statement is unclear, but it is incorrect because the analysis that

should be applied is whether the "statutory formula," here, the sales factor, fairly represents South Carolina business activity.

- The new addition to the Amended Order at page 2, n. 5 is flawed and unclear. The Court quotes the Determination's statement that essentially says the Department does not care whether the 2004 Valuation Study is accurate and then (although unclear) suggests that CarMax East argues this is proof the Department did not challenge it or otherwise give CarMax East notice of its intent to challenge the accuracy of that study. *Id.* If that is the intent, it is incorrect. The proof the Department did not provide notice that the accuracy of the 2004 Study would be challenged is that nothing (such as the Determination, the Department's Pre-Hearing Statement, or the Department's Expert Disclosure) says the study was not accurate or that it would be challenged nor is a legal claim asserted challenging it. Even if the Department had alleged a claim to challenge the 2004 Valuation, it would still also need to provide notice that its expert intended to give opinions on that issue such that discovery could be conducted on the issue and CarMax East could adequately prepare to depose him and engage its own expert on that issue. If a party must anticipate an expert giving an opinion on any issue the other side could conceivably raise in the case, then expert disclosures would be worthless.

- The Court then indicates CarMax East is both responsible for the 2004 Valuation being challenged and on notice it would be challenged because CarMax East mentioned the study in response to allegations of "income shifting" and the Department's complaints about CarMax West's profits received from its 93.5% CBS ownership. *Id*. Thus, because CarMax East was prudent and had a study prepared and then cited it in response to the Department's complaints, the Court suggests that CarMax East should have known and anticipated non-disclosed expert testimony, after the close of discovery where no discovery was conducted on the issue, challenging the accuracy of a study prepared nearly 20 years ago. The Court's view causes that result, which is not reasonable.

- The Court also appears to be saying that CarMax East suffered minimal prejudice from the Court's decision not to allow CarMax East additional time to prepare its case due to the undisclosed expert opinion because any prejudice "was minimal" as "the accuracy of the Valuation Study was not the keystone in this case…" (Am. Order at 3, n. 5). What role the Valuation Study played in the Court's reasoning and analysis is unclear in the Amended Order. To the extent it played any role (including, but not limited to, as support for Step One or as opening the door to the issue of who gets credit for BPI to CBS), CarMax East has suffered prejudice.

- Finally, to the extent that the Court continues to view the accuracy of the 2004 Valuation as relevant (which as previously stated is unclear), it would appear to be because the Court is applying the wrong standard for Step One. *See* Mot. to Reconsider at 9-11.

V. THE COURT INCORRECTLY FOUND THAT THE DEPARTMENT MET ITS BURDEN OF PROOF AND THUS SHIFTED THE BURDEN TO CARMAX EAST.

The Court now states that "[o]nce the Department met its burden to show that CarMax East's business activity was not fairly represented, the burden switched to Petitioner to show why the Department was incorrect." Am. Order at 62, n. 69 (citing *Daisy Outdoor Adver. Co., Inc. v. S.C. Dep't of Transp.*, 352 S.C. 113, 118, 572 S.E.2d 462, 465 (Ct. App. 2002)). This is a misapplication of South Carolina law and is not supported by the evidence.

The *Daisy* decision does not support the Court's conclusion. The issue in that case involved a permit for an outdoor commercial advertising sign. By statute, such signs could be in unzoned, commercial or industrial areas so long as the commercial/industrial activity in such area is not a sham. *Daisy*, 352 S.C. at 118, 572 S.E.2d at 465. The statute specifically provides that if the commercial/industrial activity ceases to exist within one year after the sign permit is issued that "shall be prima facie evidence that the activity was a sham." *Id.* The business at issue had ceased business activity prior to one year following the permit's issuance, and thus the Court properly shifted the burden of proof to Daisy to show that the business was not a sham. *Daisy*, 352 S.C. at 118-19, 572 S.E.2d at 465-66.

Unlike in *Daisy*, no statute in this case defines what would constitute prima facie evidence the Department proved Step One. Black's Law Dictionary defines a "prima facie case" as "[t]he establishment of a legally required rebuttable presumption" and "[a] party's production of enough evidence to allow the fact-trier to infer the fact at issue and rule in the party's favor." Black's Law Dictionary (12th ed. 2024). No such evidence was presented here. *See, e.g.*, Mot. to Reconsider at 11-13 (discussing the evidence presented by the Department and how it is insufficient to prove Step One is met or to justify a burden shift).

VI. THE COURT'S COMPARISON OF CARMAX EAST'S OPERATING PROFIT TO TAXABLE INCOME IS INCORRECT FACTUALLY AND CONCEPTUALLY, AND THE COURT RELIES ON ADDITIONAL INCORRECT TESTIMONY.

The Court clarified the origins of its belief that South Carolina retail stores had approximately $90 million of operating profits during the audit period and further suggests CarMax East should not take issue with the Court's reliance on DeRamus's calculations that are factually incorrect because CarMax East did not provide this Court the correct calculations to fix the errors. Reconsideration Order at 10. As explained below, the Court has adequate evidence to know the testimony relied upon is incorrect.

The Court states several times that South Carolina retail stores had an operating profit of approximately $90,000,000 during the audit period and then compares it to the approximately $21,000,000 of CarMax East's taxable income apportioned to South Carolina during that period. Am. Final Order at 8, 61, and 63. That is materially incorrect both factually and conceptually for at least the following reasons:

- First, the South Carolina retail stores had nowhere close to $90 million of operating profit during the audit period. The Court relies on DeRamus's testimony regarding the $90 million, and DeRamus relies on Joint Ex. 70.[8] Reconsideration Order at 10, n. 5. However, one must account for expenses to derive operating profit, and here, the $90 million has not accounted for *at least* the Management Fee payment for each car sold by those South Carolina retail stores along with additional expenses.[9] CarMax East's operating profit for the audit period was approximately $676.4 million. *See* Joint Ex. 70.[10] Less than 3% of CarMax East's total retail stores during the audit

[8] In Joint Ex. 70, for 2016, see tab FY16, Column AI, Row 434 ($26,565,148); for 2017, see tab FY17, Column AK, Row 454 ($30,070,697); and for 2018, see tab FY18, Column AK, Row 449 ($33,137,115). The total for the audit period is $89,772,960, thus, approximately $90,000,000.

[9] *See also* Hr'g Tr. at 323:3-6 (DeRamus stating that the $90 Million does not account for the Management Fee payment.).

[10] For 2016, see tab FY16, Column AX, Row 434 ($235,012,673); for 2017, see tab FY17, Column AZ, Row 454 ($225,690,120); and for 2018, see tab FY18, Column AZ, Row 449 ($215,653,529). The total for the audit period is $676,356,322.

period were in South Carolina (and closer to 2% until the fourth store opened at the end of the audit period). It is implausible to suggest that less than 3% of CarMax East's retail stores (i.e., the stores in South Carolina) generated more than 13% of CarMax East's operating profits during the audit period. Thus, the statement that South Carolina retail stores had $90 million of operating profit during the audit period is clearly materially incorrect.[11]

- Second, the Court is comparing "operating profit" that has not accounted for the Management Fee payment (and other expenses) to taxable income that has accounted for the Management Fee payment (and other expenses), and then suggesting the delta between those values is probative evidence. Assuming arguendo that comparing operating profit to taxable income is relevant evidence that supports finding Step One was met, the Court should either include the Management Fee in both or exclude it from both. The delta between "operating profit" and taxable income would be small if both accounted for the Management Fee payment or both did not account for it.[12]

- Third, the Court's focus on the profitability of the South Carolina retail stores compared to the South Carolina taxable income is fundamentally at odds with South Carolina corporate income taxation and formulary apportionment on multiple fronts. In short, the intent is that if all of CarMax East's retail stores were in South Carolina and North Carolina, 50% of CarMax East's total sales occurred in each state, and the South Carolina stores had a $500 loss but the North Carolina stores had a $3,500 profit, then the result would be that CarMax East has $3,000 profit with 50% of that being apportioned to and taxed by South Carolina notwithstanding the poor performance of the South Carolina retail stores. On the flip side, if instead the North Carolina stores had the $500 loss and the South Carolina stores had the $3,500 profit, then the tax owed to this state is the same. That is the concept of formulary apportionment in the context of state corporate income taxation (including in this state). The individual South Carolina retail stores do play a critically important role in the process—the 50%, i.e., the sales factor—which the Court continues not to consider. The Court's focus on the profitability of the individual South Carolina retail stores as supporting evidence that the Department proved Step One is thus, respectfully, misguided.

[11] The Court also states that "under separate reporting and standard apportionment, the economic reality that CarMax East had around $90,000,000 in South Carolina sales was distorted by the partnership distributions to reflect only $21,000,000 worth of taxable business activity." Am. Order at 65. The Court's intent here is unclear, but the statement contains factual inaccuracies. CarMax East had substantially more than $90,000,000 of sales in South Carolina as seen by the numerator of its sales factor, and to the extent the Court intended to say $90,000,000 of operating profit, that would also be incorrect. The statement is also confusing "business activity" with taxable income.

[12] Comparing operating profit to taxable income is not relevant evidence, and certainly not probative evidence, that Step One is met. It is an arbitrary comparison, and it is not clear what it should show.

In addition, the Court states that, "[t]hrough these intercompany transactions, CarMax East reduced its federal taxable income by $1.6 billion for the audit period while CarMax West increased its federal taxable income by $1.4 billion." Am. Order at 60. This statement is, respectfully, materially incorrect. The Court is presumably relying on the calculations in the Audit Report and/or testimony from the Department's witness Orville Sharpe that is based on those calculations. *See* Joint Ex. at 26, at SCDOR_0159 (calculations suggesting CarMax East reduced taxable income by $1,623,917,479 and CarMax West increased taxable income by $1,356,151,515); Hr'g Tr. at 73:1-10 (Sharpe testimony discussing Audit Report). The Audit Report calculations arrive at the supposed $1.6 billion reduction of CarMax East's taxable income by taking the approximately $1.8 billion of management fees that CarMax East paid to CBS and subtracting the net income CarMax East received from CBS. *See* Joint Ex. at 26, at SCDOR_0159. Those calculations ignore the substantial costs incurred to perform the management services. The majority of the $1.8 billion management fee payments only covered the underlying costs of those services, and the profit portion (which may ultimately become taxable income) of those $1.8 billion of fees is only approximately $720 million.[13] CarMax East submits that none of its taxable income was "shifted" or improperly lowered, because the Management Fee payments were at an arm's length price. Nonetheless, given that the profit portion of the $1.8 billion of management fees CarMax East paid to CBS was only around $720 million, it is materially incorrect to say CarMax East reduced its taxable income by $1.6 billion

[13] This is merely an approximation for the purpose of showing the statement that CarMax East reduced its taxable income by $1.6 billion is materially incorrect. The approximation is based on an average management fee during the audit period of $1,164 (derived by using $1,107 for year 1, and $1,192 for years 2 and 3) and the average cost per car sold of $701, which leaves $463 profit per car sold. The $463 profit is approximately 40% of the average $1,164 management fee, and 40% of $1.8 billion is $720 million.

because of its $1.8 billion of management fee payments less the net income received from CBS.[14]

Finally, Petitioner has never claimed the Court adopted any of DeRamus's multiple suggested Management Fee prices. *See* Reconsideration Order at 9. Regarding the Management Fee Payment and the Court's evaluation of the E&Y Transfer Pricing Studies used to derive the price, the Court is relying on DeRamus's testimony attacking Transaction Three by comparing his calculations of the underlying costs to the price (Am. Order at 37), and the Court is doing the same for Transaction Five (*id*. at 41). As previously explained, DeRamus suggested using $512 per car sold as an appropriate Management Fee in the Department's case in chief, then Eileen Yost provided testimony related to the costs of performing the functions underlying the Management Fee, and then DeRamus's suggested Management Fee shot up to $712 in the Department's rebuttal case because of Ms. Yost's testimony. *See* Mot. to Reconsider at 30; CarMax East Proposed Order at 41-42. The point (among others) is that DeRamus's testimony regarding his calculations should be viewed with caution, particularly testimony during the Department's case in chief and especially calculations that relate to the costs of functions underlying the Management Fee. *Id.* Moreover, as previously explained, a simple and conservative math exercise using known values makes clear that DeRamus's testimony on which the Court relies is materially incorrect. Mot. to Reconsider at 30; Am. Order at 37 and 41.

VII. THE COURT INCORRECTLY FOUND CUR IS REASONABLE AND EQUITABLE.

The following are the Court's additional reasons for finding CUR is reasonable and equitable in this case, which should be reconsidered, as well as CarMax East's responses thereto:

[14] In addition, even had CarMax East reduced its federal taxable income by $1.6 billion while CarMax West increased its federal taxable income by $1.4 billion, $200 million is unaccounted for, which does not make sense. This is additional evidence that the underlying calculations are not correct, because they should at least match.

A. The Court describes the mechanics of how CUR calculates tax, states the result of CUR is a taxable base for the Group based on the Group's business activity in the state, and then states that, "When this process is applied uniformly, it does not result in taxation of more or less than 100% of the taxpayer's income." Am. Order at 65 (citing *Twentieth Century-Fox*, 299 Or. at 233–34, 700 P.2d at 1042–43).

CarMax East Response: The Court does not explain how the above-quoted statement is true, and it is, respectfully, incorrect. The "taxpayer" is CarMax East, and if all states uniformly did what the Department has done here, substantially more than 100% of CarMax East's taxable income would be taxed. The Court also states that "the use of CUR resulted in a taxable income for the group[.]" *Id.* It is unclear how the Court has or could bifurcate that collective Group income that is supposedly based on the Group's business activity in the state, which is necessary to support its statement that exactly 100% of CarMax East's income would be taxed if all states did what the Department has done here.

B. The Amended Order also now states the following: "Next, because the use of CUR resulted in a taxable income for the group, in this case, the Department credited CarMax East with the taxes already paid by CarMax West during the audit years. The resulting assessment corrected for the artificial reduction of CarMax East's federal taxable income by eliminating the intercompany shifting of income. As a result, CUR produced a taxable income apportioned to CarMax East that better reflects the economic reality of CarMax East's business activity in this state." Am. Order at 65.

CarMax East Response: These statements are, respectfully, conclusory, incorrect and unclear. As the Court previously noted (see point A above), CUR purports to be based on the CarMax Group's business activity in the state, and as noted here, CUR results in a taxable income apportioned to this state for the Group. It is unclear how giving CarMax East a credit for the tax CarMax West paid results in the conclusion reached here. The only legal entities conducting business in this state are CarMax East and CBS, and the Court's issues in this case are almost entirely focused on CBS, 93.5% of which is owned by CarMax West. Assuming arguendo the Court were correct about the ownership of CBS and corresponding partnership distributions causing "distortion" in this case, the Court's issue is with CarMax West, not CarMax East.

VIII. ADDITIONAL ISSUES THE COURT SHOULD RECONSIDER.

CarMax East respectfully requests the following additional issues be reconsidered:

- The Court adds a statement that because CarMax East and CarMax West are in the same business with similar expenses and costs, their "distortion ratios" should be the same. Am. Order at 61, n. 66. This is, respectfully, incorrect as it fails to take into account the

very different ownership interests the parties have in CBS. One would not expect their ratios to be similar if that is considered. *See* CarMax East Proposed Order at 25-26, 65.

- In both the Remand Order and the Amended Order, the Court finds that: "[t]he evidence established the Management Fee and the partnership distributions work together to shift a substantial amount of income from CarMax East to CarMax West, in an east-west structure, for no discernable business reason other than tax minimization." Am. Order at 60; Remand Order at 59. However, the Amended Order adds the following statement: "In making this finding, the Court is not concluding that the formation of CBS had no purpose except tax minimization; rather this finding is narrowly tailored to how CBS shifts money from CarMax East to CarMax West." Am. Order at 60. The Court's finding and new caveat are both unclear and appear to be imposing an additional requirement on top of the requirement that CBS have a business purpose without clarifying what that requirement is and the legal basis for the same.

- The Amended Order at 62, n. 70, is new and unclear. The new footnote is added to a sentence that was also in the Remand Order where the Court states that, "Normally, this ratio [the sales factor] is a perfectly rational way to apportion income to a taxpayer." Am. Order at 62; Remand Order at 63. The sales factor is used to apportion a taxpayer's apportionable income (i.e., the taxpayer's FTI as modified by state adjustments) to a state. It is not used to apportion income to a taxpayer or to apportion income among related parties. Petitioner initially presumed this was an oversight, but the new footnote appears to suggest something similar, which is thus also incorrect. Am. Order at 62, n. 70 (saying "because of the artificial reduction in federal taxable income, the sales factor does not produce a fair representation of CarMax East's income."). The sales factor is supposed to represent the portion of CarMax East's total business activity that occurs in South Carolina—it is not intended nor designed to apportion income to or among entities nor to "produce a fair representation of CarMax East's income."

- The Court deleted a footnote from the Remand Order in its Amended Order that stated: "Indeed, if the Management Fee was reliable and the partnership distributions were arm's length, I would likely conclude that standard allocation and apportionment fairly represented CarMax's business in this state." Remand Order at 69, n. 72. This statement helps clarify the Court's analysis and reasoning, and it is unclear why it was deleted and if the Court no longer believes that statement to be accurate.

CONCLUSION

Based on the foregoing, CarMax East respectfully requests that this Court reconsider its Amended Order and Reconsideration Order and issue a new Order finding in favor of CarMax East on all issues.

Respectfully submitted,

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Charleston, South Carolina
August 26, 2024

Exhibit A

Amended Final Order (August 15, 2024)

See R. 84

Exhibit B

Order Granting Motion for Reconsideration (August 15, 2024)

See R. 74

Exhibit C

Remand Order (July 12, 2024)

See R. 3

STATE OF SOUTH CAROLINA

ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc., Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 21-ALJ-17-0182-CC **RESPONSE TO CARMAX AUTO SUPERSTORES, INC.'S SECOND MOTION TO RECONSIDER**

The Court issued an Order of Remand in this contested case on July 12, 2024. On July 22, 2024, Petitioner CarMax Auto Superstores, Inc. (CarMax East or CarMax) filed a motion for reconsideration (First Motion) of the Order. On July 29, 2024, the Court issued an order rescinding the Order of Remand. On August 15, 2024, the Court issued an order granting CarMax's First Motion and an Amended Final Order. On August 26, 2024, CarMax filed a second motion for reconsideration (Second Motion) this time for the Amended Final Order. Pursuant to SCALC Rule 29(D), Respondent South Carolina Department of Revenue (the Department) responds to CarMax's Second Motion, and for the following reasons respectfully requests the Court deny the Second Motion.

ARGUMENT

Despite encouraging the Court to consider the Federal Rules of Civil Procedure regarding the exchange of demonstratives in a telephone conference with the Court[1], CarMax now says the Court should ignore "principles of federal civil procedure." During the telephone conference,

[1] The telephone conference with the Court related to CarMax Auto Superstores, Inc.'s Motion to Set Deadline for Parties to Exchange Demonstrative Exhibits filed on May 5, 2023.

CarMax offered Fed.R.Civ.P. 26 in support of its position although the South Carolina Rules of Procedure contain no similar rule. Contrast that with the Notes for Rule 59, SCRCP, which provide that "This Rule 59 is substantially the Federal Rule." *See also*, *Elam v. S.C. Dep't of Transp.*, 361 S.C. 9, 22, 602 S.E.2d 772, 779 (2004) ("Rule 59(e) in the South Carolina and federal rules of civil procedure is practically identical."). Thus, "[s]ince our Rules of Procedure are based on the Federal Rules, where there is no South Carolina law, we look to the construction placed on the Federal Rules of Civil Procedure." *Gardner v. Newsome Chevrolet-Buick, Inc.*, 304 S.C. 328, 330, 404 S.E.2d 200, 201 (1991).

Nevertheless, CarMax admits that its First Motion asked the Court to reconsider issues raised and ruled upon. *See* Second Motion at 3 ("it is unclear whether the Court declined to reconsider arguments that CarMax East had previously made based on its belief that a party should not raise issues that had previously been raised and ruled upon."). In its Second Motion, CarMax raises and asks the Court to rule upon those same issues a third time. However, the Court ruled correctly the first and second times.

Further, CarMax admits that "the Amended Order arrived at substantially the same overall result." Second Motion at 4. The main change was granting CarMax's request not to remand the matter to the Department. Otherwise, the Court's ruling does not result in a substantial alteration.

CarMax seems to envision an endless cycle of orders and motions to reconsider. Until both parties agree with the order (i.e. reach a settlement), each would be forced to move for reconsideration prior to appealing. Such a cycle overly complicates the deadline for filing an appeal and supplants legal process with attrition. In its Second Motion, CarMax makes this point by asking the Court to reconsider its order granting CarMax's First Motion. The Court expressly ruled upon the fourteen issues enumerated in CarMax's First Motion. Because the Court has

already properly ruled based on the substantial evidence in the record, the Court should deny CarMax's Second Motion.

Due to the duplicative nature of the Second Motion, the Department incorporates by reference the arguments and issues it raised in trial, its Proposed Final Order dated January 31, 2024, and Response to CarMax's First Motion. Additionally, the Department briefly responds to several issues raised by CarMax in its Motion.

I. The Court properly found based on substantial evidence in the record that the Department can require combined unitary reporting.

CarMax simultaneously argues that Carmax Auto Superstores West Coast, Inc. (CarMax West) must be kept out of this matter because it was not a named party and that CarMax West business activity must be considered. Specifically, CarMax East seems to suggest that it should not receive a credit, and CarMax West should not receive a refund under combined unitary reporting (CUR) because it was not a party. However, this would result in an unfair over-representation of CarMax's business activity in this State and higher tax liability. For that reason, CarMax presumably wants to create such a fact scenario to argue CUR is unreasonable. Then, CarMax could keep the default unfair underrepresentation of its business activity in this State and lower tax liability. However, those are not the facts, and the Court properly ruled based on the substantial evidence in the record.

Constitutionally, CUR can include members of a unitary group that do not individually have nexus, so including a member with nexus raises no constitutional concerns. Here, CarMax East directly owns 100% of CarMax West. *See* Joint Exhibit 39. In addition to the fact that CarMax East, CarMax West, and CBS are part of a unitary business, the same attorneys and 30(b)(6) witnesses are involved here as in the case with CarMax West. *See CarMax Auto Superstores West Coast, Inc. v. SC Dep't of Rev.*, Docket # 09-ALJ-17-0160-CC (April 22, 2010); *Carmax Auto*

Superstores West Coast, Inc. v. South Carolina..., 397 S.C. 604, 725 S.E.2d 711 (2012); *Carmax Auto Superstores West Coast, Inc. v. South Carolina...*, 411 S.C. 79, 767 S.E.2d 195 (2014); Hr'g Tr. 830:8–13. If CarMax West interests were affected and not adequately represented by the existing parties, it could have moved to intervene under SCALC Rule 20. However, CarMax East appears to be more than adequately advocating on behalf of its wholly owned subsidiary CarMax West.

II. The Court's findings of fact regarding the business process intangibles are correct based on the substantial evidence in the record.

CarMax's disagreement with the Court's factual conclusions around CBS's distributive shares and the business process intangibles does not mean the Court erred. To the contrary, the Court's findings are based on substantial evidence in the record. CarMax repeats its feigned surprise regarding the Valuation Study. Likely, this was a strategic decision to restrict evidence because the Department carried its burden of proof. However, CarMax seems to argue it should receive an exhaustive script in advance of trial and the Department and its witnesses are prohibited from reacting or elaborating. This is a fundamental misunderstanding of the purpose of a *de novo* hearing. Inevitably, uncertainties arise during a trial, but a party's failure to prepare for or react to those uncertainties does not indicate unfair prejudice. The Court has properly addressed CarMax's complaints multiple times already. The Court has a firm grasp of the evidence and made correct findings of fact regarding the business process intangibles and their role in establishing ownership percentages of CBS.

III. The Court properly considered the role of CBS's distributive shares in distorting CarMax's income.

Contrary to CarMax's assertions, what matters is the result and not the means. CarMax's strategically focuses attention on how it arrived at the CBS ownership shares and transfer prices,

but what matters is whether, at the end of the day, CarMax's business activity is fairly reflected. The issues with establishing the CBS ownership shares and transfer prices demonstrate the artificiality of CarMax's structure. Further, this explains how income is shifted amongst the members of the unitary group with the result of distorting CarMax's business activity in this State. Therefore, the Court properly looked beyond CarMax's paper manipulation of income.

The absurdity of CarMax's argument is shown by its emphasis that a portion of CBS's profits is coming back to CarMax East. CarMax East pays approximately 74.5% of the management fees to CBS and receives 6.5% of CBS' income. Hr'g Tr. 824:21-825:1. This disproportion is why a transfer pricing adjustment alone is insufficient to remedy the income distortion. If CBS was taxed as a corporation, it would be directly subject to South Carolina income tax instead of its partners. If CarMax East paid the management fee directly to CarMax West, perhaps a transfer pricing adjustment could remedy the income distortion. In any event, these are mere hypotheticals, and the facts before the Court resulted in income distortion, which CUR cured.

Undisputedly, a taxpayer may choose its structure. The issue is that CarMax chose a business structure that caused the standard South Carolina allocation and apportionment provisions to not fairly represent CarMax's business activity in this State. As a result, the statute authorizes the Department to employ *any other method* to effectuate an equitable apportionment. Here, CarMax can keep its structure and enjoy all the purported business purposes for it. The Court's order has no operational effect on CarMax. However, for tax purposes, CUR cures the unfair representation of CarMax's business activity to effectuate an equitable apportionment in South Carolina.

IV. The Court has repeatedly ruled on CarMax's Motion in Limine based on the substantial evidence in the record.

CarMax continues to quibble with the framing of the issues. How to categorize sub-issues is irrelevant. The issues are: (1) Does Petitioner's use of separate reporting in the standard apportionment formula fairly represent the extent of Petitioner's business activity in South Carolina, and (2) is the Department's application of combined unitary reporting a reasonable alternative apportionment method pursuant to § 12-6-2320(A)(4)? Starting at the audit stage, the CBS partnership's distributive shares paired with the transfer prices were central to CarMax's income distortion. The Department disclosed that Dr. DeRamus was expected to provide testimony regarding transfer-pricing analysis and provide testimony from an economic perspective regarding the extent of Petitioner's business activity in South Carolina. In his deposition, Dr. DeRamus explained his opinion from a transfer pricing perspective on the Valuation Study—which according to the study itself was based on a § 482 analysis. He can hardly be described as an undisclosed expert.

CarMax then repeats its "statute of limitations" argument regarding the Valuation Study while conveniently not pointing to any actual statute of limitations. CarMax also does not say how recent the study must be before its accuracy becomes irrelevant. Regardless, the Court does not have to address a fictious 1904 study. CarMax cannot simultaneously say that its ownership shares are justified by a 2004 Valuation Study and assert that study is unchallengeable based solely on the passage of time. Paradoxically, CarMax argues that a *joint* exhibit is not relevant. Therefore, the Court should again reject CarMax's argument.

V. The Court correctly found that the Department met its burden of proof.

Once more, CarMax makes its burden shifting argument. However, by citing the Black's Law Dictionary definition of prima facie case (a "party's production of enough evidence to allow

the fact-trier to infer the fact at issue and rule in the party's favor"), CarMax actually proves the Court's finding. That is what happened here. The Court found the Department met its burden of proof. At that point, CarMax had the burden to show otherwise, which it failed to do. Therefore, the Court's findings were correct.

VI. The Court properly considered and made factual findings based on substantial evidence in the record regarding operating profits and taxable income.

Again, CarMax simply disagrees with the Court's conclusions based on its weighing of the evidence. CarMax's disagreement does not indicate an error by the Court. Profitability compared to South Carolina taxable income shows the disconnect between the standard apportionment provisions and a taxpayer's business activity. Here, no evidence showed that profitability varied drastically like in CarMax's hypothetical. To the contrary, the evidence showed the stores were similar. *See* CarMax 30(b)(6) Depo. Tr. 61:21–62:4. CarMax had profitable business activity in South Carolina (before intercompany transactions) and that should be reflected in its South Carolina taxable income. Rather than making bald assertions about the inaccuracy of numbers in a Second Motion for Reconsideration, CarMax should have presented evidence of a contrary number or challenged the witness during the contested case hearing. Ultimately, the Court is the fact finder and can make its factual conclusions based on evidence in the record. Here, the Court did just that and properly considered and weighed the evidence in the record to arrive at its conclusions.

VII. The Court correctly found CUR to be a reasonable method to effectuate an equitable apportionment of CarMax's income.

CarMax makes the conclusory statement—without any evidence—that CUR would result in double taxation. This statement is incorrect. As discussed in the Department Response to CarMax's First Motion, the United States Supreme Court "long ago upheld the constitutionality of the unitary business/formula apportionment method" *Container Corp. of Am. v. Franchise Tax*

Bd., 463 U.S. 159, 165, 103 S. Ct. 2933, 2940, 77 L. Ed. 2d 545 (1983) (also noting that there is no "absolute prohibition on state-induced double taxation"). The Court can make conclusions based on the evidence in the record. This is within its purview and entirely appropriate.

VIII. The Court properly considered the "additional" issues CarMax asked it to reconsider.

CarMax raises redundant issues that the Court has previously properly ruled upon.

- The different ownership interests and the intercompany transactions are why CarMax East's and CarMax West's distortion ratios are different. As already discussed, the intercompany transactions and disparate distributive shares is what causes the unfair representation of CarMax's business activities.
- CarMax admits that it is asking for reconsideration of an issue ruled upon in both the initial remand order and the amended order with a clarifying statement. Because of the distortion of the apportionable base, the sales factor does not and cannot fairly represent CarMax's business activity in South Carolina.
- CarMax's unnecessarily criticizes the Court's use of "income" versus "business activity." Despite the initial reference to a taxpayer's business activity, Section 12-6-2320(A) later uses language similar to the Court's: "an equitable allocation and apportionment of the taxpayer's **income**." (emphasis added).
- In an ontological exercise, CarMax asks the Court to reconsider an absent footnote. If a second motion to reconsider is necessary, it must be as if the initial order did not exist. Therefore, no way exists to reconsider a deleted footnote. Notwithstanding, the inclusion or exclusion of the footnote is immaterial. The substantive expression of the Court's order can be accomplished in a myriad of ways, and the Court is free to choose what suits it best.

The Court afforded the proper consideration and ruled upon these issues based on substantial evidence in the record.

CONCLUSION

Supported by substantial evidence in the record, the Court correctly found that CarMax's business activity in South Carolina is not fairly represented and combined unitary reporting is a reasonable method to effectuate an equitable apportionment. Therefore, the Department respectfully asks the Court to deny CarMax's Second Motion.

Respectfully submitted,

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Columbia, South Carolina
September 10, 2024

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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2024-001558

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

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

v.

South Carolina Department of Revenue, ... Respondent.

CONSENT MOTION TO RECOGNIZE INAPPLICABILITY OF AUTOMATIC STAY TO ALC'S ORDER DENYING SECOND MOTION FOR RECONSIDERATION, OR, ALTERNATIVELY, FOR LIMITED REMAND TO ALLOW THAT ORDER TO BE RE-FILED

Appellant CarMax Auto Superstores, Inc. ("CarMax East" or "Appellant") with consent of Respondent South Carolina Department of Revenue (the "Department" or "Respondent") (collectively, the "Parties") makes this motion requesting that the Court recognize the inapplicability of the automatic stay to the Order Denying Motion for Reconsideration (the "Second Reconsideration Order") issued by the Administrative Law Court (the "ALC") on September 20, 2024. *See* Exhibit A, Second Reconsideration Order. In the alternative, Appellant with Respondent's consent moves for a limited remand order permitting the ALC to re-file the Second Reconsideration Order.

Following a contested case hearing, the Honorable Ralph King Anderson, III issued a Remand Order (the "Original Order") on July 12, 2024.[1] On July 22, 2024, CarMax East filed a Motion to Reconsider the Remand Order ("Motion to Reconsider"). On July 29, 2024, *ex mero motu*, the ALC rescinded the Original Order while it deliberated on the Motion to Reconsider. On August 15, 2024, the ALC issued ***two*** new orders: (1) an Amended Final Order (the "Amended Order"); and (2) an Order Granting Motion for Reconsideration (the "Reconsideration Order"). In these two new orders, the ALC substantially stood by its original result in ruling adversely to CarMax East.

However, CarMax East felt compelled to move to reconsider the two new orders to preserve all issues for appeal and thus filed a motion on August 26, 2024. *See* Exhibit B, Mot. to Reconsider Am. Final Order and Reconsideration Order (the "Second Reconsideration Motion"). The Parties dispute the appropriateness of CarMax's Second Reconsideration Motion.

As a result of these circumstances and to avoid any claim that its appeal was untimely, CarMax East filed and served the Notice of Appeal on September 13, 2024.[2] On September 20, 2024, CarMax East received the Second Reconsideration Order of the ALC.

Because the Notice of Appeal was filed before the issuance of the ALC's Second Reconsideration Order, the latter could be viewed as having been issued by the ALC while the automatic stay (created by the appeal notice) was in place. However, under these circumstances, the Court should determine that there is no need to consider that the Notice of Appeal created an

---

[1] The orders and motions referenced herein are voluminous. CarMax East is happy to provide copies of any of these documents should the Court request them. For the sake of brevity, only the most relevant are attached hereto.

[2] Pursuant to Rule 203(b)(6), SCACR, the Notice of Appeal was timely filed within 30 days of receipt of the orders dated August 15, 2024.

automatic stay that precluded the ALC from ruling on CarMax East's Second Reconsideration Motion. Accordingly, Appellant with Respondent's consent moves that this Court issue an order recognizing that the ALC was empowered to enter its Second Reconsideration Order.

In the alternative, if the Court believes that the automatic stay must be recognized here such that the ALC was not empowered to enter the Second Reconsideration Order, then Appellant with Respondent's consent moves that this Court issue an order granting a limited remand to the ALC for the sole purpose of the ALC re-filing its same Second Reconsideration Order (which is entitled Order Denying Motion for Reconsideration).

Respectfully submitted,

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October 2, 2024

Exhibit A

Order Denying Motion for Reconsideration
(September 20, 2024)

See R. 153

Exhibit B

CarMax East's Motion to Reconsider Amended Final Order and Reconsideration Order (August 26, 2024)

See R. 566

OF SOUTH CAROLI
ADMINISTRATIVE LAW COURT DIVISION
Docket No. 21-ALJ-17-0182-CC

CarMax Superstores, Inc.	)	
	)	
Petitioner,	)	
	)	**VOLUME I**
v.	)	**CORRECTED**
	)	**ORIGINAL**
South Carolina Department of Revenue,	)	
	)	
Respondent.	)	
	)	

HEARING

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Monday, May 22, 2023
10:05 a.m. - 3:03 p.m.
Tuesday, May 23, 2023
10:02 a.m. - 4:49 p.m.
Wednesday, May 24, 2023
9:32 a.m. - 5:12 p.m.
Thursday, May 25, 2023
9:32 a.m. - 5:22 p.m.
Friday, May 26, 2023
9:30 a.m. - 4:50 p.m.

The hearing before the Honorable Ralph K. Anderson was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 22nd, 23rd, 24th, 25th and 26th day of May, 2023 before M. Sean Cary, Court Reporter and Notary Public in and for the State of South Carolina.

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Kristin Pawlowski, Staff Attorney
Daniel Bloor
Richard Pomp, witness
Brian Cody, witness
Eileen Yost, witness
Dr. Brian J. Cody, Witness
Dr. David DeRamus, Witness

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EXHIBITS

(Joint Exhibit Numbers 1 through 80 were admitted into evidence on page 43. Joint Exhibit Numbers 81 through 85 were admitted into evidence on page 182. Respondent's Demonstrative Exhibits 1 through 3 were marked and referenced as noted above. All Exhibits were provided electronically to The Court.)

(The Court's Exhibit Inventory and list of Exhibits from the parties are attached and incorporated herein by reference.)

STIPULATIONS

It is stipulated and agreed that this hearing is being taken pursuant to the rules of the Administrative Law Court and the South Carolina Rules of Civil Procedure.

DAY 1 - MONDAY, APRIL 22, 2023

CALL TO ORDER:

THE COURT: This is the hearing in the matter of CarMax Auto Superstores, Inc., Petitioner, versus South Carolina Department of Revenue. The Docket Number is 21-ALJ-17-0182-CC. Are there any additional motions and stipulations parties wish to make before we proceed?

PRELIMINARY MATTERS

EXHIBIT AGREEMENT:

MR. ANTLEY: Your Honor, we had, we had agreed on some Joint Exhibits that we would offer.

THE COURT: All right. That would meet the stipulation category.

MR. ANTLEY: Yes, Your Honor. And our intention is to, is to work as much we can with electronic copies, and so there are a few more that we had some last minute additions to this morning that we would like to add to the USB drive before we actually present it to the Court, the electronic copy, but we would like to offer as joint exhibits.

THE COURT: All right. So you're offering Joint Exhibits that will be modified into?

MR. ANTLEY: We will add, we will add a, a few more

to them, yes, Your Honor.

THE COURT: Well, that's modification.

MR. ANTLEY: Yes, Your Honor.

THE COURT: Okay. All right. Mr. Von Lehe, Mr. Geer -- Ms. Geer?

MS. GEER: There's one issue which I thought I was gonna be able to say succinctly, but now there appears to be a problem with a document. I'll just put on the record that we submitted a ---

THE COURT: Are you saying you thought it was going to be simpler and now it's gonna be more complicated?

MS. GEER: Yeah, and, and it's my fault. So when you were talking about mistakes, I've made one already this morning. So ---

THE COURT: Well, basically that's just a part of my life right now.

MS. GEER: Yeah. Well, I'm sorry to contribute to it.

THE COURT: That's all right.

MS. GEER: So, Mr. Antley and I had negotiated a consent protective order, CarMax found some documents that were potentially responsive to some discovery requests. We sent it in to

the Court, but apparently the hard copy may have not made it in the mail.

THE COURT: Yeah.

MS. GEER: And so I -- we, we had just signed one, but now I've noticed there's some sort of pagination weird issue, but I'll try to get that corrected and we will submit that to you. Neither party I don't think is trying to get any -- use any of these documents at trial, it's merely us trying to comply with discovery obligations. So anyway, we'll -- if you get the, the full one today in today's mail and could execute it so that we could provide the documents to 'em or we will get this corrected. I thought it was corrected, but there's ---

THE COURT: Well, I'll sign it as soon as ---

MS. GEER: Okay.

THE COURT: And both sides were aware of the protective order? Y'all, y'all were aware of it?

MR. ANTLEY: Yes, Your Honor. We ---

THE COURT: All right. So ---

MR. ANTLEY: --- we executed it.

THE COURT: --- even though I haven't signed it,

I'll just, you know, I'll order the ---

MS. GEER: Consider it entered?

THE COURT: I'll consider it entered and hereby order that it be complied with. How about that?

MS. GEER: Okay. Excellent.

MR. ANTLEY: Thank you.

THE COURT: All right. Okay.

MS. GEER: Thank you, Your Honor.

THE COURT: Anything else? All right. Opening statements. I guess y'all are going first because you got the burden.

OPENING STATEMENTS

OPENING STATEMENT BY MR. ANTLEY:

MR. ANTLEY: Yes, Your Honor. Good morning, Your Honor. Marcus Antley the third, counsel for the Department. This is a case where Petitioner's arguing form, and the Department is arguing substance. It is undisputed that Petitioner filed using the standard apportionment method. However, under Section 12-6-2320(A) the General Assembly provided that if the standard apportionment method does not fairly represent the taxpayer's business activity in this state, in other words, the

form does not match the substance, the Department may require the employment of any other method which our Supreme Court has explicitly held to include combined unitary reporting.

THE COURT: All right. So y'all are arguing form, but they're ar- -- no, y'all are arguing substance and they're arguing form?

MR. ANTLEY: That's correct, Your Honor. And the alternative ---

THE COURT: But to get to the substance you have to go through the form.

MR. ANTLEY: That's, that's correct. So the -- in, in some ways the alternative apportionment statute is a form.

THE COURT: Yeah.

MR. ANTLEY: But it, it -- in my example, the form is the standard. The -- when we get to the substance through alternative apportionment.

THE COURT: You just go ahead. Go ahead.

MR. ANTLEY: Petitioner argues South Carolina is a separate entity state and cannot use combined reporting as an alternative method. And that is the same position that the Department took in the Media General case which the Supreme

Court rejected 13 years ago. As Petitioner points out in its pre-hearing statement, this is the second time the Department has sought to impose alternative apportionment on CarMax. That the first time the burden was incorrectly placed on Car- -- on CarMax, and the Department required separate accounting. The Department did not meet its burden because it had -- did not realize it had its -- had the burden. In that case, CarMax argued that separate reporting was not a reasonable alternative because it was a unitary business. This time the Department recognizes and intends to meet its burden, and the Department agrees that CarMax is a unitary business. The Court has two issues before it. First, does Petitioner's use of separate reporting in the standard apportionment formula fairly represent the extent of its business activity in South Carolina? And second, is the Department's application of combined unitary reporting a reasonable alternative apportionment method pursuant to Section 12-6-2320(A)? The Department will put forth evidence supporting

its determination that Petitioner's use of separate reporting in the standard apportionment formula does not fairly represent the extent of its business activity in South Carolina, and the Department's application of combined unitary reporting is a reasonable alternative apportionment method pursuant to 12-6-2320 subsection (A). Specifically, CarMax uses a -- an intercompany management fee, East West companies and a partnership to shift income from South Carolina to the extent that its business activity is not fairly represented under the standard method as a remedy to this highly -- -

THE COURT: I don't wanna throw you off too much. Will you -- just keep where you are with it.

MR. ANTLEY: Yes.

THE COURT: When you say they're shifting income, I read that the CarMax East and CarMax West both were, were taxed in South Carolina. Unless it's something I didn't understand, CarMax West is taxed South Carolina. Don't you eventually get sufficient tax revenues out of both? And why would you need to do the

unitary approach? Is it because of the CBS?

MR. ANTLEY: Yeah, the ---

THE COURT: That being the -- I can't remember what CBS stands for, it's an acronym.

MR. ANTLEY: CarMax Business Services.

THE COURT: Yeah.

MR. ANTLEY: Yes, Your Honor. CBS is the partnership in -- and you're right, they are both, CarMax East and CarMax West, are filers in South Carolina. The, the issue is that CarMax West has a much smaller apportionment ratio so, so the, the effective tax rate of CarMax West is substantially smaller than that of CarMax East. So, it's advantageous from the taxpayers point of view to shift income and put it on the lower tax entity instead of the CarMax East which has the higher apportionment ratio.

THE COURT: All right. While I'm asking you questions. About the ownership, there was a statement of CarMax, a prehearing statement that the Department does not dispute that those percentages are accurate based on the value of the assets contributed, but believes the ownership percentages of the LLC should

not be based on the contributions of the LLC members. It goes on, but, you know -- but rather, but my question, and I emphasize the word, not, the Department does not dispute those percentages are accurate? Do you know what I'm talking about and do y'all dispute this percentages? I'm just wanting to clear that up in my mind.

MR. ANTLEY: We dispute the valuation that led to those percentages that -- on paper that is correct, that is the ownership percentage. So if that ---

THE COURT: Oh, okay.

MR. ANTLEY: --- if the question is whether or not the ownership is 93.5 percent and 6.5 percent between CarMax West and CarMax East ---

THE COURT: Let me rephrase it then. When you tell me you dispute the values that led to the percentages, that you're -- what you're telling me now is you don't dis- -- you don't dispute the, the percentages that exist now, but you're disputing the accuracy of those percentages? Because if you don't -- if you dispute the value that led to the percentages, and I'm not putting words in

your mouth, I'm trying to figure this out.

MR. ANTLEY: Yes, Your Honor.

THE COURT: I would assume that you're saying that you dispute those values, if those values are inaccurate, the subsequent percentages that would result from those values would be inaccurate?

MR. ANTLEY: Yes, Your Honor. So -- maybe two points. So first, CarMax, Inc., the CarMax group, decided where to put, where, where to put assets to begin with. So whether it was in East or West ---

THE COURT: Where to put what now?

MR. ANTLEY: Yes, Your Honor. So, it's all -- it's when ---

THE COURT: They're not really -- all right. So I'm ---

MR. ANTLEY: Yes, sir.

THE COURT: When you say put them, you mean put them under CarMax East or West, or to apportion them through a perfor- -- a performance or ---

MR. ANTLEY: Oh, that -- so what I'm talking about is the valuate- -- the, the valuation that led to the different ownership percentages was

based on assets contributed by CarMax West and CarMax East. CarMax, the group decided to put those assets initially in CarMax East or CarMax West.

THE COURT: Okay. All right.

MR. ANTLEY: So that's that's, that's, that's the first issue. And then the second issue, even if, even if that was appropriate, then the, the resulting -- or the valuations of those contributed assets, it's not, it's not an accurate evaluation. So it's onto us ---

THE COURT: Find your place and keep going, if you wish.

MR. ANTLEY: Yes, Your Honor. So, as a remedy to this highly artificial form the Department required the combined unitary reporting method as a reasonable alternative method that appropriately represents the substance of CarMax's business activity in this state. And the Department asks that the Court uphold its determination.

THE COURT: One of the issues was the matching principle, and you referenced that there are assets that are nontaxable in South Carolina. I'll assume that's part of your shifting

analysis. What assets are -- or what income is nontaxable in South Carolina? That should be taxed, I assume. If you follow that.

MR. ANTLEY: I'm sorry, Your Honor. Can you repeat ---

THE COURT: Well you're obvous- -- I'll get to that later then.

MR. ANTLEY: Okay.

THE COURT: That may be something a little deeper than I wanna get into right now.

MR. ANTLEY: Thank you.

THE COURT: All right. Okay. Mr. Von Lehe.

OPENING STATEMENT BY MR. VON LEHE:

MR. VON LEHE: May it please the Court?

THE COURT: Yes, sir.

MR. VON LEHE: I'm glad to be here again. You, of course, know Ms. Geer and Bobby Streisel also I believe, who was with me last time I was here.

THE COURT: I see you got your side kick.

MR. VON LEHE: Yes.

THE COURT: Professor Pomp back there.

MR. VON LEHE: Yes, he's also very much here.

THE COURT: Yes.

MR. VON LEHE: Thank you. Like most cases, this is

one of statutory interpretation, most tax cases, that is. The statute is 12-6-2320(A)(4) al- -- also known as the alternative apportionment statute. Before getting to that though I'd like to give the Court a little context, which it probably doesn't need considering the amount of this that you've already been through in the past. But by providing a little bit of background as to how our multi-state business is taxed in South Carolina. States have primarily adopted one of two different types of taxing methods, the -- and those methods are the separate entity reporting method, which is the one that I hope everybody in the courtroom would agree is South Carolina's method. Then the other one is the combined unitary reporting method. And we begin with the separate entity reporting method, which is our, our standard statutory reporting method. And one doesn't go to some alternate method, including the combination method, unless the standard method isn't working. If the standard method is not working, then you do seek an alternative, but if the standard

method is working, which this one is, it's not our burden to prove that it is, it's their burden, as you well know, to prove that it is not. But nevertheless, we have, we have arguments, etcetera, to show that the standard method is in fact working. There's no need to go to some alternative method like this. And you're certainly ---

THE COURT: That may ultimately come down to what we consider working or not, because if working is, is defined as collecting taxes, then it's working.

MR. VON LEHE: That's, that's quite true, Your Honor, that's quite true, and CarMax once said that a while back some time, some time ago, did make that point. But both methods use apportionment factors. First of all, you have to determine the base; that is to say, what are we going to apportion? Are we going to apportion the income of this taxpayer, CarMax East? Are we going to apportion the income of CarMax East and all other entities that are subsidiaries of it no matter whether or not they file in South Carolina or not? In other words, entities under the combination

method, enti- -- entities which have no connection with the taxing state are still brought in in order to determine the base of the tax as long as the, the only rule being it has to be of a unitary nature. That is to say if you have that system, which we don't. South Carolina is -- has not adopted this combination system. It was -- you know, it's, it's more famous or infamous deciding on what side of the fence you're on, called the California system. We just don't have that system. We'll have witnesses that'll testify, they will to. combination system's a good system. There's nothing really wrong with a combination system except that it shouldn't be imposed on this taxpayer because combination is what our legislature has considered, but has not adopted. So we are a separate return state, whether that's appealing or not for revenue raising, that's not the issue. It's a separate return state, and, and the question's gonna have to be, does this work in the sense of are the taxpayer's business activities in South Carolina being properly reflected by this

formula, and we believe they are. They have to show that they're not. But we, we, we plan to show that they are in any case.

THE COURT: I think I would give you a little more latitude on that. It's not whether they're properly, it's whether it's fairly.

MR. VON LEHE: Yes, Your Honor. Their statute says as you pointed out, the wording of the statute is, If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer’s business activities in this 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, the employment of any other method to effectuate equitable apportionment. There is a question as to whether or not the Department of Revenue does have authority to impose this. I know that they depend on the Media General case for that authority, it was mentioned a moment ago by Mr. Antley. I know that they depend on Media General for that authority. But when you read the Med- -- Media General case, it doesn't say that.

What the Media General case says is, you still start with a separate taxpayer's income, and then you use an apportionment formula composed of the sales of all the entities. But if Media General had said combination is what we seek to follow as an alternative it would have said, take all the income of all the entities, the base would have been all entities, take that and then apply the combined apportionment formula. Instead, they applied the combined apporti- -- apportionment formula to each single entity. So, in any case, be that as it may ---

THE COURT: So where I can understand. When -- if we determine that it's not being fairly apportioned based on the separate entity apportionment ---

MR. VON LEHE: Yes, sir.

THE COURT: --- then what -- if I don't use the combined unitary approach, what approach would be allowed under the statute? There are about three or four separate ones stated in there. One of them is separate accounting, seldom used these days, but it's still mentioned.

THE COURT: All right. So I'm going to kick that baby out.

MR. VON LEHE: Additional factors, you can add other factors other than the sales factor to get to it. Additional factors, don't happen to have the statute in front of me, but there are a couple of others. And then it says, and any other method. And that method -- it doesn't say combination, it says, and any other method. And Media General did this -- did develop another method, but it's just not the combination method that they're applying. Media General took each individual entity and multiplied it by a combined a apportionment factor. If you were applying a combination method like they want to apply to this taxpayer, you would take the total income of all entities, you wouldn't take each one separately, and then you would apply the combined sales tax apportionment formula to that. It's a little bit quirky, but that's what happened. So, Media General does not say yes, you can apply the standard combined apportionment formula to a taxpayer, it just doesn't say that.

THE COURT: Doesn't say you can't though either, does it?

MR. VON LEHE: Doesn't say you can't, but it doesn't say you can.

THE COURT: Okay.

MR. VON LEHE: So we don't think it's been authorized, but nevertheless. So we get down to this question of are the business activities of the taxpayer, are they being fairly represented by the standard formula, this is the issue. This is the ultimate issue in this case just as it was in CarMax One as an ultimate question before you go to a, a -- an alternative formula. We haven't seen anything this far -- thus far that says anything about this taxpayer's business activities in South Carolina. It's almost as though the Department of Revenue does not see that as the central question, they will answer that, of course. But they are looking at the combined income and want, and want to apportion that. And they're emphasizing the fact that this is a unitary business and so, therefore, it is, is not possible for the separate entity method to be used because

it's a unitary business. We disagree with that. It's used all the time. I don't have any statistics to show you along this. But I know enough about it to say this, there are an awful lot of taxpayers that have subsidiaries and related entities that file in this state and they're all, except for those that the Department of Revenue seeks to audit and change, they're all filing under the separate return system, and they are unitary, they're multiple unitary entities. This is the way things are done here and been -- have been done this way for a long, long time ever since this statute was adopted. So there's no question in our mind anyhow, and I believe there -- that the witnesses this week will testify that yes, a unitary business can use separate return reporting. They do it all the time. It -- this -- so we believe we can ---

THE COURT: I think I would go further ---

MR. VON LEHE: --- we hope that, that you will have clear testimony on that saying that yes, it can be done. What do we have here, we have three retail stores. Okay. Paid a lot of

taxes. I don't have the numbers in front of me right now, somewhere in a range of a million dollars, paid a lot of taxes, reported a lot of income for each of these years, significant income for each of these years, which will be in the record. This is not a question of a taxpayer not paying his fair share. This taxpayer is paying a lot of money to South Carolina, we just don't want to doubled or tripled is what it's going to be. We don't want that because it doesn't represent -- we don't have to prove this, but their combined method does not represent the extent of this taxpayers business activities in South Carolina. It represents everybody put together and then apportioned to South Carolina. There was a fourth store by the way in the last in the last year. You mentioned ---

THE COURT: So at the time it was three but now it's four?

MR. VON LEHE: Yeah.

THE COURT: But that four doesn't apply to this case?

MR. VON LEHE: That's corre- -- well, the last year

it was four.

THE COURT: Oh, the last year.

MR. VON LEHE: The last year it was four.

THE COURT: Okay. Didn't know if you meant this last year or the last year of ---

MR. VON LEHE: In the audit report.

THE COURT: Okay. I get it.

MR. VON LEHE: You, you asked about the other entity, CarMax West. And you said, that reports in South Carolina, which it does. Mr. Antley correctly said that CarMax West has a small apportionment ratio. Well, that's what the law says. They don't have any sales of cars in South Carolina so they're not going to have much except some royalties in the numerator of their receipts apportionment formula. They don't have any sales here. Since they don't have any sales here and we are a sales factor state, surely one would anticipate it would have a small formula. It wouldn't have it any formula in South Carolina except for the royalties that it, that it collects through this other entity, CBS. But, you asked about the matching principle. Every payment that is

made from CarMax East that goes -- it goes into a partnership or LLC, but taxed as a partnership, and then it comes out to West and East and it is matched up. Income is perfectly matched up, there is no, there's no violation of the matching principle. All of the income and all of the expenses are matched up against each other. The problem, as I believe they see it, is with the apportionment ratio that West has. If it had an identical apportionment ratio then the picture would be a lot different. But it doesn't of course, it doesn't have any car sales here. But that's what our law does. That is one reason so many people come to this state is because of this single sales factor. A manufacturer wouldn't come here or it'd be less likely -- it would be much less likely to come here if we had the old three factor formula, property, payroll and savings. It's been whittled down over the years to all it is is sales now. That's what our legislature wants, that's what our law says, that's what we applied. And yes, it resulted in CarMax West having a low apportionment

ratio, but it certainly did not result in CarMax East having a low apportionment ratio. Your Honor, I'm coming towards the end of this opening statement, but I also want to mention this transfer pricing which will be discussed some length today. And then the question there is whenever you have related entities, and if they have intercompany transactions, which I would venture to say most entities that file in South Carolina have intercompany transactions, transfer pricing is used to make sure that the amount that one entity charges the other is accurate. And so you will hear transfer pricing testimony today with regard to the accuracy. However, should it turn out that after looking at the record and your decision is that well, I don't think the transfer pricing is accurate. We -- we, we, we believe that the way to fix that is just follow whatever transfer pricing has been put before the Court, change the transfer price to what the Court finds to be the correct transfer price, and that solves the problem. You don't have to go to combined -- a

combined method of reporting in order to change a transfer price, all you do is change the price.

THE COURT: Will you give me -- were y'all gonna offer evidence ---

MR. VON LEHE: Yes, sir.

THE COURT: --- that ---

MR. VON LEHE: Excuse me.

THE COURT: --- that if I don't -- if I do find that it's not fair that -- and I went to another transfer price, what transfer price I should find to be appropriate?

MR. VON LEHE: Yes. We are going to give you evidence as to a transfer price.

THE COURT: All right.

MR. VON LEHE: Your Honor, the question of the valuation study was, I believe questioned by you a few moments ago and answered by Mr. Antley, that they plan to challenge the, the valuation back in 2004 when this CBS, which is the LLC owned by the two parties, they plan to challenge that study. I believe you have already ruled that that study is not -- that criticizing that study is not admissible evidence. This is my understanding of your

ruling, but I, I didn't make the motion before, I was ---

THE COURT: I think I said ---

MR. VON LEHE: --- listening. But ---

THE COURT: I think my ruling was -- let's see, if I could go back, it was Price Waterhouse that did the ---

MS. GEER: Ernst and Young.

MR. VON LEHE: Ernst and Young.

THE COURT: Price Waterhouse isn't in this case. Okay. Ernst and Young. I think they couldn't criticize Ernst and Young's study itself, but that they could do their analysis of what the proper valuation would be without going into whether Ernst and Young's valuation was proper.

MR. VON LEHE: All right, sir.

THE COURT: Well, we'll see. That's still all up for debate and objections, so we'll cross that bridge when we come to it.

MR. VON LEHE: Understood and thank you, Your Honor.

THE COURT: All right. Call your first witness.

RESPONDENT'S CASE IN CHIEF

MR. ANTLEY: Your Honor, the Department calls

Orville Sharpe.

COURT REPORTER: Do you solemnly swear or affirm the testimony you're about to give will be the truth, the whole truth and nothing but the truth so help you God?

MR. SHARPE: I do.

COURT REPORTER: Would you please state your full name for the record?

MR. SHARPE: Orville Sharpe.

COURT REPORTER: Thank you, Mr. Sharpe.

MR. ANTLEY: And, Your Honor, there may be moments where we would like to project from -- on the screens from our computer. But I -- I ---

MS. GEER: You'll let me know?

MR. ANTLEY: Yeah.

THE COURT: There may be moments that I would like to project thoughts.

MR. SHARPE - DIRECT EXAMINATION BY MR. ANTLEY:

Q: Good morning, Mr. Sharpe.

A: Good morning.

Q: Where are you currently employed?

A: South Carolina Department of Revenue.

Q: And how long have you been employed by the Department?

A: 45 years.

Q: And if you could -- you know, it's a lot, but if you can briefly run through the positions you've had with the Department, and how long you were at each of those positions.
A: I started in 1978 and I was a Sales and Use Tax Auditor and I think I did that up until '95 or '96. And then I became a Multi-State Corporate Income Tax Auditor. And then in October 2018, became a Foreign Audit Supervisor.
Q: And is that your current position?
A: Yes, it is.
Q: Okay. What are the job duties or responsibilities of an audit supervisor?
A: I help select the audits. So we, we have a group that actually provides leads, and we look at those leads and determine if they're promising and then I assign the leads to the auditors. And I review their work, I approve their reports and various other administrative functions. And currently there are five people reporting to me, one just was assigned to a different supervisor.
Q: Do you have any professional licenses?
A: Yes, I'm a CPA.

Q: Are you familiar with the taxpayer in this matter?
A: Yes.
Q: And what is the, what was the nature of your involvement with the taxpayer in this matter?
A: With this current cycle?
Q: Yes.
A: I was the audit supervisor.
Q: What years did the audit cover?
A: It was the audit years ended 2/28/16 through 2/28/18.
Q: Where did the Department conduct the audit of the taxpayer?
A: I think it was in -- outside of Richmond, in Henrico, Virginia. I'm not quite sure if I pronounced that right.
Q: And who is the auditor involved in this audit examination?
A: There were actually two auditors, one has since left. Annette Palmer was one of the auditors and she's left the Department, and the other auditor was Jamie Kolenc.
Q: Okay. Did you supervise them during this audit?
A: Yes, I did.

Q: Does Ms. Kolenc, does she report directly to you?
A: Yes.
Q: And she did during the audit too?
A: Yes.
Q: All right.
MR. ANTLEY: So I'm just gonna -- these, these would -- have been offered and, and I believe admitted as Joint Exhibits, but I'm just going to pull them up so that you can just tell the court what they are. So if we could go to ---
THE COURT: How about if I could be clear what y'all offered because you said you -- I used another phrase, I said modified the Joint Exhibit, but what does the Joint Exhibit consist of?
MR. ANTLEY: The, the Joint Exhibits I -- I'm ---
MS. GEER: It's like 80 exhibits right now, but we have a few more that we have agreed on this morning.
THE COURT: Will it be -- all right. So will it be Petitioner's 1 through 80 or ---
MS. GEER: No. It'd be Joint Exhibit's 1 through 80.

THE COURT: Okay. So Joint Exhibit 1 through 80. And offered into evidence?

MR. ANTLEY: Yes, Your Honor.

THE COURT: Any objection?

MS. GEER: No objection.

THE COURT: It's admitted. I think that will make the record a little cleaner.

(Joint Exhibits Numbers 1 through 80 were admitted into evidence.)

MS. GEER: Thanks, Your Honor.

MR. ANTLEY: Thank you, Your Honor.

THE COURT: And then if we wish to offer more, I'll address that at that time. All right. Oh, yippie, aye, yay, let's go.

MR. ANTLEY: If you, if you could pull up Joint Exhibit Number 29.

(Joint Exhibit Number 29 was referenced at this time.)

Q: All right. Do you recognize this, Mr. Sharpe?

A: Yes. This looks like the initial audit appointment letter, and initialed IDR.

Q: If you could just scroll down so the Court can see the whole document.

THE COURT: What's the IDR?

A: Information Document Request.
THE COURT: Oh, okay.
MR. ANTLEY: And since the, the Court asked, could you also pull up Joint Exhibit Number 30.
(Joint Exhibit Number 30 was referenced at this time.)
Q: Okay. Do you recognize this?
A: Yes. This looks like a, a response from the taxpayer regarding -- I don't know if it was the initial IDR or an additional IDR, but this is a response from the taxpayer providing some of the requested information.
Q: Okay.
MR. ANTLEY: And then if you could pull up Joint Exhibit 31.
(Joint Exhibit Number 31 was referenced at this time.)
Q: Okay. Do you recognize this?
A: Yeah. That's where we were requesting. This is a IDR too, an additional IDR request where we were requesting more information from the taxpayer. For example, the, the transfer pricing analysis and other items.
Q: Okay. All right.
MR. ANTLEY: So if we can now look at Joint Exhibit

Number 24.

(Joint Exhibit Number 24 was referenced at this time.)

A: This ---

Q: What's this?

A: This looks like the -- what we call our doorway work papers by our reporting periods. So it, it shows the, the tax penalty and interest due by each period within the audit.

MR. ANTLEY: Now, if you could pull up Joint Exhibit Number 23.

(Joint Exhibit Number 23 was referenced at this time.)

THE COURT: That's faster.

A: And this is the proposed assessment letter which shows the, the tax, the penalty, and the interest and the total, of course there was no penalty in this case. And it indicates that -- when the taxpayer has to pay, or if they don't pay they have to provide a protest by a certain date.

Q: All right.

MR. ANTLEY: And then if you can now pull up Joint Exhibit 26.

(Joint Exhibit Number 26 was referenced at this

time.)

Q: What is this?

A: This is our -- really we start our audit on an Excel file and so -- because our doorway schedules don't work that good. We, we have to back into our doorway schedules from our Excel file. But this is a -- an Excel file converted to PDF, and it, it basically shows the, the amount due for the audit period. It, it also provides the various audit schedules, the distortion, quantitative and qualitative. And it, it shows the computation -- recomputation of the net income and tax due for each year and an explanation of the adjustments and why we made the, the adjustments.

MR. ANTLEY: And if you could just leave that up.

THE COURT: What do you mean by distortion?

A: The distortion is, is something that we use, although we're not required to. We use certain ratios to show the differences between an entity that's filing in South Carolina or an entity that's not filing in South Carolina in the federal consolidated return. And the two that we feel were the net taxable income

return on income, and the net taxable income return on payroll. And if you look at the, the, the apportionment ratios for these, the net taxable income return on income and the net taxable income return on payroll is substantially lower than, than the ratio for, for the West. And that to us shows distortion because our entities are in -- that are in the same business should have basically the same ratio. And in this case all the money is shifted to, to, to West. So they have a substantially higher ratio than the, than the East has.

THE COURT: So when you say distortion from a taxing standpoint, are you saying that that reflects fairness or is that another phraseology that I'm not ---

A: It, it -- right, it's a way of determining fair -- in our opinion, fairness. If, if they -- if one entity is earning all the money, you can, you can show that, that they're earning all the money through these distortion ratios. And here, all the ---

THE COURT: When you say earning all the money for the distortion ratios, in my mind, distortion

ratio reflect the fairness, but you seem ---
A: Right, right.
THE COURT: They're offering a different analysis.
A: Well, no, I'm just look -- we're, we're showing that, that there's distortion. And the reason there's distortion is because of the shifting strategy where all the income is shifted from the, the, ent- -- the entity that produces 75.5 percent of the income for the whole CarMax enterprise. Most of the income is shifted through -- to West. Distortion ratios in my opinion support that.
MR. ANTLEY: Your Honor, if it's helpful, I, I do plan on going through this distortion ratio with him later on.
THE COURT: Okay. All right.
MR. ANTLEY: So it might help clarify.
THE COURT: Okay.
Q: So just to make sure we got this question answered, to -- generally what are the findings of the audit?
A: That the taxpayers statutory reporting merit -- method did not fairly reflect that their activity in South Carolina, and that an alternative proportionate method was proposed,

a unitary commi- -- combined filing method because it's reasonable. 29 states have adopted unitary combination, and it more fairly reflects the taxpayer's -- the realities of the taxpayer's business activity in South Carolina than the, the standard reporting method.

Q: Okay. So just to be clear what, what, what is the alternative apportionment method?

A: Unitary combined reporting.

Q: Okay. And what is unitary combined reporting?

A: Unitary combined reporting is a method that state's have adopted. And the starting point for unitary combined return -- or, or the base, you take all of the taxable income for all of the, the unitary combined entities, and that amount is less any intercompany income or, or expenses, and then you multiply that by the uni- -- unitary combined sales ratio. And in the numerator and the denominator, any intercompany receipts are eliminated from the intercompany -- from the numerator and the denominator. And you multiply the base by the combined

apportionment ratio. And then -- and then that's how you arrive at the income -- the apportionable income to South Carolina.

Q: What is CarMax's principal business in South Carolina?

A: The principal business is they, they sell retail -- used retail cars, and they also sell -- they also have some wholesale sales. And they also provide financing to some of the customers of the vehicles that they sell. Most of that's provided through CBS, but they do take the application for the financing so they get the finance customer for, for CBS.

Q: Why is it necessary to determine a taxpayers principal business in South Carolina?

A: You need to know that so you can determine what method to use. Do you use -- for sourcing, do you use the sales methods or do you use the gross receipts method? And also you gotta know what their business activity is. So, so if you're using an alternative apportionment and -- you need to know if, if, if they properly reported their business activities in South Carolina to determine whether their -- they should be on, on an

alternative apportionment method.
Q: What is an apportionment formula?
A: Apportionment formula is a way to apportion the apportionable base to South Carolina or any other state.
Q: Okay. And what is the sales factor?
A: The sales factor is the South Carolina sales divided by the everywhere sales.
Q: Is that formula provided by statute?
A: Yes. It's 12 -- I think it's 12-6-2280.
Q: And are you familiar with the type of taxpayer who utilizes the sales factor?
A: Yes. Taxpayers and -- who are, are dealing in manufacture or tangible personal property use this factor pursuant to 12-6-2255 -- I'm sorry, 12-6-2252.
Q: Is that the factor that was applied to the taxpayer in this case?
A: Yes.
Q: In your experience, what are the two basic methods states use to determine the amount of income that will be apportioned to that particular state?
A: It's either single unitary combined reporting or separate reporting.

Q: Now, I'd like to get more into the specifics of this audit. How does CarMax file its federal income tax returns?
A: They file on a consolidated return on all but one entity.
Q: Okay. What entities are included in the consolidated return?
A: CarMax, Inc., CarMax West, CarMax East and Gleen -- Glenn Allen Insurance, Ltd.
Q: Okay. What did the Department determine was the unitary group in this case?
A: We determined that the unitary ---
Q: Per the ---
A: You mean per the audit?
Q: Per the audit.
A: Per the audit we took -- determined that East, West, and the partnership CBS were part of the unit- -- unitary group along with CarMax, Inc. We didn't include the insurance company because there is no corporate income tax on insurance companies, but they pay a premium tax to the Department of Insurance.
Q: In preparation for this hearing, did you confirm that those were in fact the correct entities to be included in a unitary group?

A: I confirmed that we were wrong.
Q: So ---
THE COURT: You confirmed they're what?
A: I confirmed that we were wrong.
THE COURT: Oh.
Q: So, so what is the right answer?
A: The right answer is that we should have included -- also included CarMax Auto Superstores Services, Inc.
Q: Okay. Did you rerun the numbers with CarMac audits -- CarMax Auto Superstores, Inc. included in the unitary group?
A: Yes. If, if we had included them -- properly included them in the interior group, based on my estimations the amount of the tax due in the unitary combi- -- combination for the audit years would be includ- -- increased by about $23,000.
Q: Okay. So that -- was that in CarMax's favor?
A: Yes.
Q: Okay. And do you know why we, why we missed Car Max ---
A: Because I ---
Q: --- Auto Superstores and Services, Inc.?
A: For retailers I don't -- I can on- -- can't

recall ever seeing a retailer not include an entity in their federal consolidated return except unless it was a REIT. I mean, a foreign corporation, there, there are a lot of times -- there, there are several federal consolidated groups, but I, I -- we didn't, we didn't realize that they've had -- separately filed a federal return for CarMax Auto Superstore Services, which it's just -- it's the payroll company. They have the payroll for late -- for all the officers and for CBS. They -- in fact, they, they lease the employees to CBS.

Q: Who -- thank you. Who is the parent company for the unitary group as filed in federal returns?

A: CarMax Inc.

Q: Okay.

A: All right.

MR. ANTLEY: If you could pull up Joint Exhibit Number 33.

(Joint Exhibit Number 33 was referenced at this time.)

THE COURT: Do y'all need any help with my computer people in order to facilitate what you're ---

MR. ANTLEY: I think we're, we're fine, Your Honor. We're trying to unplug it before we pull it up, because we don't want to show any other taxpayer's information or anything.

THE COURT: Oh, that's why you're doing that.

MR. ANTLEY: Yes, yes, Your Honor.

THE COURT: I noticed you unplugging it, plugging it back.

MR. ANTLEY: Very protective.

THE COURT: I'm not gonna say what was in my mind, but it was -- I was wondering what that was.

MR. ANTLEY: Yes, Your Honor.

Q: Okay. So did the Department receive an organization chart from the taxpayer?

A: Yes, we did.

Q: Is this that chart or a -- what is this?

A: I think it is.

Q: Okay. So what did these charts -- or what does this chart demonstrate?

A: It shows who owns who.

Q: Okay. Who owns CarMax West?

A: CarMax West? CarMax West is owned by CarMax East.

Q: Okay. And maybe just so we're all clear on definitions since we haven't -- I don't think

we've set up these definitions first. When we- -- when we're referring to CarMax West, what's the full name of that entity?

A: CarMax Autos Stu- -- Auto Superstores West Coast, Inc.

Q: Okay. And when we refer to CarMax East, what entity is that?

A: CarMax Auto Superstores, Inc.

Q: Okay. And when we refer to CBS, what entity is that?

A: CarMax Business Services LLC.

Q: I don't think you said this one, but who wants CarMax East?

A: CarMax East is owned by CarMax, Inc.

Q: Okay. And who owns CBS?

A: CBS is owned 6.5 percent by CarMax East and 93.5 percent by CarMax West.

Q: What is CBS?

A: CBS is the, the, the business that provides the management services for CarMax East and CarMax West through five different type services they provide for them. And they also provide the finance operations for East and West.

Q: Which CarMax entities filed corporate income

tax returns in South Carolina for the audit period?

A: CarMax East and CarMax West.

Q: Why did CarMax West have a filing obligation in South Carolina?

A: Because -- why did who?

Q: CarMax West.

A: Because of the flow-through income from CBS.

Q: What is CarMax West business activity in South Carolina?

A: Same as CarMax East except they don't sell any cars in South Carolina. CarMax West -- all those stores are located in unitary states and they have no activity in South Carolina. They would have, they would have no activity except for the flow-through from CBS.

Q: What did -- or I'm sorry, why did CarMax East have a filing obligation in South Carolina?

A: Because they have retail used car lots in South Carolina. They have three during most of the audit period, Columbia, Charleston, and Greenville, the three city- -- cities where you would expect. And toward the end of the, the last audit year they opened a location

also in, in Myrtle Beach.
Q: And what it's CarMax East business activity in South Carolina.
A: East they, they sell used cars at those car lats -- lots located in South Carolina, and they also provide financing through their -- through the partnership CBS, and they also sell extended service plans, and they also provide some vehi- -- vehicle services and other miscellaneous income they received from South Carolina customers.
Q: All right. Understanding the taxpayer's business operations in this state, does separate entity reporting fairly re- -- reflect the taxpayer's business operations in this state?
A: No.
Q: And why not?
A: Because it's -- because of the structure set-up and the, the required intercompany transactions. For example, CarMax East pays 74.5 percent of the management fees that CBS receives and, and, and yet they only receive 6.5 percent of the flow-through income from, from CBS. So that's a violation of the

matching principle because they're not receiving the full amount of income that is produced from the payment that they make on, on the, the management fees that they pay and the income that's produced from those management fees.

Q: You, you just spoke about CarMax East. What -- roughly what percentage of the management fee does CarMax West pay?

A: Well CarMax West is paying 25.5 percent of the management fee that, that a CBS receives, yet they received 93.5 percent of the net income produced from the management fee that they paid to CBS. So here, the management -- the matching principle is violated again because they're receiving too much money from the, from the income that they paid CBS. And if you look at all these transactions in totally -- in totality from East to West and back from CBS, it, it results in a gross distortion because CarMax East, their taxable income is reduced by $1.6 billion for the for the audit years whereas CarMax West income is increased by $1.4 billion. So that's -- you can see the distortion right there.

Q: So based on these intercompany transactions what proposed adjustments did the Department make to the taxpayer's return?
A: We required a unitary combination.
Q: Did that result in the proposed assessment that we mentioned earlier?
A: Yes.
Q: Okay. Did the Department assess the accounts for CarMax East and CarMax West in our, in our system?
A: No. Our system only allows us -- when you have a unitary combined you have to put all the money under one account. So everything was, was put under this situation. We called CarMax East the lead corporation, and all the money was applied to that one corporation because of our, our system. We count a unitary combination -- a unitary combined entity, our South Carolina style consolidated return, as one entity as opposed to the number of entities that are included in those groups.
Q: Okay. In preparation for this hearing did you calculate what the liabilities are for CarMax East and CarMax West separately?

A: Yes, we did.
MR. ANTLEY: If you could pull up -- and pull out the cord, please.
THE COURT: The Department of Revenue is cutting the cord?
A: We've done it a lot of years ago. We used to keep all these hard copies, but we don't anymore. Everything's on the computer now.
THE COURT: Everybody that's from South Carolina knows why y'all started cutting the cord.
Q: Do you recognize this Excel? And you can -- we can scroll if we need to scroll.
A: Yes. I think this is the -- I'd have to see the breakout, but oh, yeah, it looks like it's -- we'd have to go to this common- -- the, the tab called 10 -- 2-2816. It looks like the one that we did.
Q: That pink tab?
A: Yes, the pink tab.
MR. ANTLEY: If you could click on that pink tab, please.
A: Right.
MR. ANTLEY: Okay. If you could scroll through that.
Q: Okay. Are these your calculations?

A: Mine and Jamie's.
Q: Okay. So if you could, as we're looking at this document, if you could just explain what affect did the Department's adjustments have a CarMax's -- CarMax West tax liability for the audit period?
A: Well, first of all, the liability didn't, didn't change. But -- so basically all you're doing is allocating the liability to East and West. But if you're looking at East, their liability increased, and if you're looking at West, they li- -- their liability decreased so that they had a refund due.
Q: Okay. So making sure I understood that. So West liability would have gone down resulting in the refund, East went up so then it would have an additional tax due?
A: Right.
Q: So it -- was the amount of the refund greater than the -- due to West greater than the additional tax due to East -- or due from East.
A: No. The amount of refund was less than the, the tax due by East.
Q: Okay.

A: But the, the bottom line is that if you sum the two amounts, they both come up with what, what the amount would be on a unitary combined basis.

Q: If a taxpayer requests to have it separated like this they'll -- different liabilities -- or is the Department able to do that?

A: Sure.

Q: All right.

MR. ANTLEY: Your Honor, this would be a Joint Exhibit. I ha- -- it's the 30(b)(6) designee from CarMax -- it's from CarMax. I don't, I don't think that is one that's on the hard drive. I have the deposition in a hard copy if that's helpful, or we can discuss it, and then the electronic copy could come in tomorrow?

MR. STREISEL: What, what is this? You said 30(b)(6) ---

MR. ANTLEY: That's Yost 30(b)(6), the deposition. So it's -- we talked about it being a joint exhibit, but it's ---

MS. GEER: Are you saying this is part of that?

MR. ANTLEY: My question will, will draw from that. So that's, that's ---

THE COURT: You can draw your question from wherever and we can deal with that, but when you're talking about putting it up on the screen and defending it?

MR. ANTLEY: No, Your Honor. I just wanted it to be clear that this is a Joint Exhibit, we just don't have the electronic copy ready to be provided to the Court.

THE COURT: Okay. That is clear.

MR. ANTLEY: Thank you.

Q: Okay. Did you read the, the 30(b)(6) deposition of CarMax, Ms. Eileen Yost?

A: Yes.

Q: Did you read where she stated that the Department apportions almost 12 percent of sales to South Carolina despite 3.5 percent of sales taking place in South Carolina?

A: Yes.

Q: Okay. Were you able to see where she got 12 percent?

A: No. We tri- -- we played around with it, we couldn't figure it out.

Q: Okay. Did the Department apportion 12 percent of CarMax sales to South Carolina?

A: No. Unitary combined, the apportionment ratio

actually goes down from 3.5 to around 2.5 percent. So the apportionment ratio didn't go up, it went down. The thing that changed was the apportionable base increase, which ...

Q: Okay.

MR. ANTLEY: If you could pull up Exhibit -- and Your Honor, I would offer as a demonstrative exhibit only not as substantive evidence, Department's Demonstrative 1, it's the Excel file that he was discussing.

THE COURT: So that's not in the Joint Exhibits?

MR. ANTLEY: No, Your Honor.

THE COURT: All right.

MR. STREISEL: You -- what was the request? Sorry.

MR. ANTLEY: I- -- I'm offering this as demon- -- respe- -- Respondents Demonstrative 1, so not substantive evidence.

THE COURT: Hold on. Is it demonstrative? So you're offering it as -- I didn't know you offer demonstrative exhibits.

MR. ANTLEY: No.

THE COURT: You just use demonstrative.

MR. ANTLEY: Yes, Your Honor, but if you're -- in order for you to be able to take it back and consult it, if you -- to help understand his

testimony.

THE COURT: Well, you can just put that in the flash drive.

MR. ANTLEY: Okay.

THE COURT: That'll be fine with me. Just label it as demonstrative exhibit.

MR. ANTLEY: Yes, Your Honor.

THE COURT: Is there any problem with that?

MR. STREISEL: No objection.

THE COURT: All right.

(Respondent's Demonstrative Exhibit 1 was entered into the record.)

MR. ANTLEY: Okay. So now if you could pull up Joint Exhibit 26.

(Joint Exhibit Number 26 was referenced at this time.)

Q: This is the, the audit report, I think you said that was converted from an Excel. What type of analysis does the Department use to reach the conclusion in the audit report?

A: We did a quantitative and qualitative distortion analysis.

Q: Okay. So let's start with the quantitative analysis.

MR. ANTLEY: If you could scroll down.

Q: And you can -- just whenever you see it gets, it gets to that portion of the report if you could just let us know.
A: We're talking about the quantitative, quantitative?
Q: Quantitative.
A: Okay. Keep going. Go to about Page 15.
THE COURT: Yeah, that's a quicker approach.
Q: And if we need to zoom in, we can ---
A: Go up a little bit more. Go up one more. One more. Okay, there's good.
Q: Okay. All right. So, are we now at the quantitative analysis portion of the report?
A: Right.
Q: Okay. So what is the quantitative analysis based on?
A: It's based on ---
THE COURT: Can you take that sidebar off? Just hit the arrow button on the sidebar part. No, no, no.
MR. ANTLEY: No, no, no, no, no.
MS. GEER: Right here.
THE COURT: There ya go.
A: All right.
MR. ANTLEY: And if you could maybe scroll, scroll

a little bit so he can see more of the page. Scroll down a little bit. Okay. That's it.

A: Okay. The- -- these are, are -- do you just want me to explain it?

Q: Yeah. What is, what is the quantitative analysis based on?

A: The quantitative analysis that we utilized was the taxable income return, total income concerning the -- comparing the consolidated to CarMax Inc. to CarMax Auto Superstores to CarMax Auto Superstores West. And we also did a taxable income return to total payroll for the consolidated CarMax, Inc.'s, CarMax Auto Superstores, Inc., CarMax Auto Superstores West, and then we compared the, the total income and the total payroll for each entity to the consolidated amount.

Q: And the Court had some questions about these distortion ratios. So, I just wanna make sure we -- you really explain this clearly. So, how is the ratio related to the return on total income calculated?

A: Okay. You take the taxable income reported on Line 30 of either the consolidated return or the US 1120 pro forma return, and you

divide that by the total income reflected on all on Line 11 of the federal return. And you can see that the -- on a consolidated basis, the -- they produced a 30.9917 percent taxable income return on total income. CarMax, Inc. is basically -- it's a true holding company, they basically have no activity so there was no computation. CarMax Auto Superstores, Incorporated, they had a 10.5.2.0 net taxable, taxable income return on total income, and West had a 57.008 percent taxable income return on income. And if you look at the percentages, CarMax Auto Superstores, for every $10.54 perce- -- percent in the -- for every $100 of income that they, they -- of income they produce, they only produce $10.54 in taxable income. Well, Auto ---

THE COURT: You say they only produced?

A: Right.

THE COURT: I thought it was only apportioned. What do you mean by produced?

A: Okay. You have an income, they generate X amount of income. We're looking at the federal consolidated per -- the federal pro

forma return. They have, what, 4.7 million in, in total income and 500 million in taxable income. They only -- of that income that they produce ---

THE COURT: Okay.

A: Okay. So, so for here ---

THE COURT: I get it now.

A: Okay. You get it. So for every $100 in income they produ- -- produce they get $10.54 in taxable income. Whereas -- where all the money is being shifted to CarMax Auto Superstores West, for every $100 of income they produce they get $57 in income. So you can see the distortion there. And then you can also see it on, on, on the consolidated that the entity is filing mostly in South Carolina is getting very little return on the income that they were produced. And the same with the, the payroll, you can see the percentages are, are very low for superstores compared to CarMax Auto Superstores West and consolidated.

Q: So you just walked through the two distortion ratios.

A: Right.

Q: So what is -- what do these distortion ratios demonstrate?
A: Well, I think they demonstrate that CarMax West is more efficiently utilizing their income and their employees to produce taxable income. And we believe the reason they are -- they're doing that is because of the structure of CBS and, and the way taxable income has been shifted from superstores to West via the partnership CBS. 'Cause normally entities who are in the same type business, these ratios should be as close to the -- to the same. They're not going to be exact, but they should be close to the same, not the drastic distortion that we see here.
Q: Okay. So is that the full extent of the quantitative analysis for this audit?
A: Yes, that's most of it. There's a little more which is to the right. But there was a little bit that was actually included in the qualitative analysis under the, under the explanation of the recomputation of the tax, which I think that was on Page 1 or 2.
Q: Okay. If we could go there and then you can point that out.

A: Okay.
Q: And you said 1 or 2?
A: I think it's Page 1 or 2 of this.
MR. ANTLEY: Go to Page 1 and we can scroll down if that's not right.
Q: It's on Page 2?
A: Yeah, it might be 3.
Q: Okay.
A: Or 4.
Q: We'll find it. Is that too fast?
A: No, keep going.
Q: Okay.
A: You'll see numbers, and when you see the numbers, stop. Oh, wow, I didn't realize it was this far down. Keep going. Oh, here it is.
MR. ANTLEY: If you could go back up.
A: Oh, no, that- -- that's ---
Q: Oh.
A: Keep going.
Q: Keep going down?
A: Yes, sir. Keep going down. There it is.
Q: All right. So you said this was part of the quantitative analysis?
A: Right.

Q: Okay. And what does this quantitative analysis show?

A: It shows that, that basically, as I indicated before, based on these intercompany transactions and the flow-through back from CBS to East and West, East has taken a hit to their taxable income of 1.6 billion, but -- billion dollars for the audit period, whereas West is increasing their taxable income by $1.356 billion for the audit years. And you can co- -- go down a little bit for -- more. And you can see here, we computed the amount of the total management fee that CBS receives from East and West, and East is paying 74.5 percent of the management fee, but yet they're only getting back 6.5 percent of the net income that CBS earns on that management fee that East pays to CBS. And so that's, as we indicated, a violation of the match- -- matching principle because they're paying 74.5 percent of the matching expenses to CBS, and they're only getting 6.5 percent of the net income that's produced from the management income that East pays to CBS.

MR. ANTLEY: If you can just scroll down just

enough ---

THE COURT: I'm sorry. Just do me a favor 'cause I don't know how long you're going to use this. I'm speaking to the computer guy. Go up to the highlighting pencil in the top of the page on the right. Click on that and switch it off for that. Right there. Every time -- I think every time he touches the screen it's making it red. Don't worry about it. I can show her how to fix it, but I'd have to do it myself. Don't worry about it.

MR. ANTLEY: So I was just gonna see if you can scroll down the bottom to show that Bates label so we -- where's the record clear what page we're on since we've moved around.

Q: Okay. What- -- what's the -- that -- is that South Carolin- -- or SCDOR0159, Is that the page you were just discussing, Mr. Sharpe?

A: Yes. And it, it might have started on the page above, but I think it was -- most of it was all -- was on that page.

Q: Okay. All right. Is that the full -- the, the extent of the quantitative analysis?

A: Yes. That's basically the quantitative analysis.

Q: All right. And you -- I think you mentioned there's also a qualitative analysis?
A: Right.
Q: Okay. Is that also contained in this report?
A: Yes.
Q: Okay.
MR. ANTLEY: If, if you could go to the portion of this report.
Q: Is it -- would it be towards the end?
A: Yes.
MR. ANTLEY: If you could go towards the end of this ---
A: Part of it's on this schedule, too. So you might want to go on this schedule.
Q: Okay. Let's start here then. Let's see, we're, we're still on SCDOR0159?
A: Go up, go up.
MR. ANTLEY: Go up.
A: Okay. Here- -- here's -- it starts -- go up one more, I believe. Okay. No, no, go down. I'm sorry. I know it's confusing. Usually we had -- we had binders before, but that -- I could just flip to it.
Q: Lesson learned.
A: Okay. Here -- this is part of the

qualitative discussion, which mainly we describe the entities, we describe the intercompany transactions, we- -- we've described what's going on and, and why we feel apportionment is, is needed.

Q: Okay.

MR. ANTLEY: What pa- -- what's the Bates Label on this page? If you scroll down on that so the records clear.

Q: So this is SCDOR0158, is that right? Is that the page you're talking ---

A: Yeah. Come on down, it might be some more.

Q: And it continues beyond that?

A: I think so. Yes. This -- to this right there. Okay.

Q: Okay. So what is a qualitative analysis?

A: Basically, as I said, it describes the, the entities that are involved in the intercompany transactions, and what the charges are for the intercompany transaction. How that this dilutes or distorts the South Carolina net income reported to South Carolina, and why we feel that the alternative apportionment method that we proposed is a reasonable method to reflect the activity which is not fairly

reflected from the standard reporting method.
Q: As part of the qualitative analysis, did the Department rely on certain facts regarding the CarMax Group's business operations?
A: Yes.
Q: Okay. So how does CarMax rely on its related entities for necessary business functions and services?
A: Well, CBS relies on -- for rega- -- with regard to the finance operations that -- East and West generates all the leads for the, for the finance contracts to the, to the customers because they take the applications from the customers when they're at the store. I think, as I remember, it seems like they actually finance around 40 percent of the total retail automobiles. So they take -- East and West takes the applications, and also East and West pays management fees to CBS, and that enables West -- I mean CBS to perform all these management services for East and West.
Q: Okay. So you said CBS performs these management services for East and West so how, how do the related entities in the CarMax

group rely on CBS for services or income?
A: Okay. Like I said, CBS provides the finance, they actually issues the notes to the, to the, to the customers, the loans to the customers, and they also provide those five management services. Which the first service is the -- they license the trademarks and CBS works to East and West. And they also provide administrative support functions to East and West. And this is normally called back office services. And they also provide advertising and marketing to East and West. And they also provide real estate services to East and West. And they also provides strategic management to East and West, and East and West has to pay them a total management services fee of -- I think it's 1,000 -- approximately 1,111 per retail vehicle. So for the first audit period, and the last two audit years it's 1,200 -- approximately $1,200 for each retail vehicle sold. And of the, the total amount that they pay for the management services are $100 for each -- approximately $100 for each year, represents the amount that they charge --

that CBS charges East and West for the use of the trademarks and CBS works they license to East and West.

Q: Based on the audit, does CBS provide any services to unrelated entities, in other words, entities outside the CarMax group?

A: No.

Q: You testified earlier that the taxpayer is part of the unitary group. What guidance are you relying on to define a unitary business?

A: Part of the guid- -- guidance is from what the taxpayer said in the -- of the, the prior Car- -- CarMax West case. They basically said that our -- their constitutional rights were violated because we were requiring separate accounting on a unitary group. So they agree that these entities are part of the unitary group, and the taxpayers experts said that Ms. Yost in her deposition that there's been no significant changes to their operations since the prior court case or when the -- I think the partnership was initially set up in 2004. But they -- the economies of scale and -- are present through the management services company providing all

these services for the other businesses. And centralization of man- -- management is also present because all the officers are, are located in one affiliate, which is CarMax Auto Superservices -- Superstore Services. And as I indicated previously, they lease these employees to CBS. And there's flow of value, everything is flowing from East to CBS, and back from CBS the East and West. So I feel like they're definitely unitary.

MR. ANTLEY: If you could pull up Joint Exhibit 28.

THE COURT: How much longer are you gonna be on this witness?

MR. ANTLEY: I really don't have that much more. I think I've probably ---

THE COURT: I'm just trying to decide whether to take a break now or not.

MR. ANTLEY: Yes, Your Honor. I have to have two of eight -- I have total eight pages of questions. I have two pages remaining.

THE COURT: We can take a break. Percentage wise I'm going it's a good time. Let's just take a ten minute break.

(Off the record from 11:35 a.m until 11:52 a.m.)

THE COURT: Go ahead, Mr. Antley.

MR. ANTLEY: If you could pull up Joint Exhibit 28.

(Joint Exhibit Number 28 was referenced at this time.)

Q: Do you recognize this, Mr. Sharp?

A: Yes. It's South Carolina Revenue Ruling 15-5.

Q: Okay. When you were testifying earlier about what constitutes a unitary group, is this -- do you use this or is this what you were referring to?

A: Yes.

Q: Okay. And you stated earlier that the proposed adjustment to taxpayer's returns was to impose combined unitary reporting, is that correct?

A: Yes.

Q: What authority does the Department rely upon to impose an alternative method in this case?

A: We use 12-6-2320(a) and this Revenue Ruling 15-5 and of course the Media General court case.

Q: What percentage of the taxpayer's income from these sources would be subject to tax if every state in which the taxpayer did business like combined unitary reporting?

A: One hundred percent.
Q: Okay. This Document 15-5 discusses some business structures or strategies that may create tax -- state tax benefits, what common features or structures from 15-5 were present in this case?
A: They have a management company, and they're using the East West tax shifting structure.
Q: Okay. And what's the significance of those two structures?
A: Well, the, the management company is, of course, CBS, and we indicated that they received a bunch of money from East and West. And so that's one way you can shift income. The other way is that the, the money ultimately comes back, most of the money through the shifting strategy to -- and the structure of the partnership to West. And West only has entities that operate in unitary states. The only own entities that operate in unitary states. So how will you shift the money back and forth, it doesn't matter for a unitary entity because they're gonna be reporting on a unitary combined basis. Whereas if the money is shifted to,

in this case, West away from East, which has all -- most of them -- produces most of the income for the whole enterprise. But because all their money's been shifted away to West, since we have a very low enforcement ratio in East, that's kind of where the distortion occurs.

Q: So you said West only operates in uni- -- unitary states. When you say operates, do you mean operate retail locations? Is that what ---

A: Right.

Q: --- you're saying? Okay. In your experience as an auditor and supervisor, does the Department propose combined unitary reporting as an alternative method for every taxpayer that's part of a unitary group?

A: Of course not.

Q: Why not?

A: Well, first of all, you got -- most of the entities are -- that are unitary are reporting the, the standard method fairly reflect their activity in South Carolina. Usually it's, it's only when there's gross distortion, which is the case here, do we

apply a unitary combination.

Q: And is the Department's position on this in Revenue Ruling 15-5?

A: Yes.

Q: Does Revenue Ruling 15-5 provide any guidance related to a taxpayer’s reliance on IRC Section 482?

A: Yes. It says, that whether they have a 482 transfer pricing or not, it's not determinative of whether an alternative apportionment method including a unitary combination will be applied. It talks about we have to prove as our -- if we're advocating an alternative method it’s, it's our burden to prove that the standard reporting method does not fairly reflect the taxpayers business activity in South Carolina, and too, the proposed alternative rollout method has to be reasonable.

A: Does Revenue Ruling 15-5 provide any guidance to auditors in how to calculate the combined unitary income?

A: Yes, it does.

Q: Okay. Did the Department follow that approach in this case?

A: Yes, I believe we did.
Q: And I remind you again ---
A: Except for one thing, we didn't include -- and so we, we mentioned that. Just now remembered that we didn't include the Auto Superstores or CarMax Auto Superstores Services, we didn't include that one in the two combined reporting, and we should have.
Q: Reminding you about the prohibition under Section 24-54-240, we can't talk about specific taxpayers. In, in your experience, has a taxpayer ever petitioned the Department to use combined reporting as an alternative method for filing its South Carolina income tax returns.
A: Yes.
Q: Did the Department grant the petition?
A: First of all, I'm not the one that makes that approval so I'm not aware of all of them, but I am aware of four of them. And of the four, we approved three, and, and we, we did not prove -- approve one.
Q: In your experience, does the Department impose combined unitary reporting on every South Carolina retailer that operates within a

unitary group?
A: Of course not.
Q: In your experiences, does the Department impose combined unitary reporting on taxpayers that operate industries other than the retail industry?
A: Yes, we have.
Q: All right. And I'm gonna ask you about penalties, interest, license fees. Were there any penalties assessed against CarMax during the audit period?
A: No penalties were assessed because pursuant to 15-5, unless we have a prior settlement that requires the taxpayer to report on alternative apportionment method and they didn't, whenever we propose an alternative apportionment no penalties will apply.
Q: Was interest added to the assessment?
A: Yes, it's statutorily required pursuant to 12-5425.
Q: Were any license fees included as part of the Department's assessment?
A: No.
Q: Did, did the taxpayer challenge the Department's assessment related to license

fees?

A: No.

MR. ANTLEY: I beg the Court's indulgence. No further questions from the Department.

THE COURT: Who's up?

MR. SHARPE - CROSS-EXAMINATION BY MR. STREISEL:

Q: Morning, Mr. Sharpe.

A: How are you?

Q: Good, how are you?

A: Hanging in there.

Q: And is it -- should I call you Orville or Mr. Sharpe?

A: Orville.

Q: Orville? All right. All right. Orville, so the alternative apportionment statute, do you know what I'm talking about when I refer to that?

A: Yes, sir.

Q: Okay. And no, sir, please.

A: Okay.

Q: You agree that it can only be used when the taxpayer's business activity is not fairly reflected in the state, correct?

A: When, when the standard mayor -- method does not fairly reflect the taxpayer's business

activity in the state, correct.

Q: Okay. And do you also agree that proving a South Carolina taxpayer is a member of a unitary business is not proof that the taxpayer's business activity is not fairly represented in South Carolina?

A: I'm sorry, I didn't understand that question.

THE COURT: Yeah. I think you need to do that for me too.

Q: Solely showing that the taxpayer is a member of a unitary business is not enough evidence to justify the use of the alternative apportionment statute, correct?

A: Correct.

Q: And the Department in this case, did they -- so the Department determined that CarMax East business activity is not fairly represented in South Carolina, right?

A: Right. CarMax East and CarMax West, both of their businesses are not fairly reflected in South Carolina.

Q: Okay. So it, it independently determined that CarMax East business activity is not fairly reflected, and also independently determined that CarMax West business activity

is not fairly reflected, is that right?
A: Correct.
Q: Okay. So let's start with CarMax West. They have no retail stores in South Carolina, right?
A: Correct.
Q: So, during the audit years, what was CarMax's business activity in South Carolina -- excuse me, what was CarMax West's business activity in South Carolina?
A: They received flow-through income from CBS and they sourced financing receipts and royalty receipts to South Carolina.
Q: Okay. And you, you are familiar with the prior South Carolina case against CarMax West, right?
A: Yes.
Q: Did you have any involvement in that case?
A: Yes, I was the auditor.
Q: Okay. Do you know what tax years were at issue in that case?
A: Yes.
Q: What were they?
A: I'm pretty sure it was 12 -- I mean, 2/28/202 through 2/28/207.

Q: Okay. So 2002 to 2007, February of 2002 through February of 2007, is that right?
A: Yeah, 2/28. Period's ended 2/28/02 through 2/28/07.
Q: Okay. And do you agree that nothing factually has changed about CarMax West's business activity in South Carolina since the tax years that were at issue in that prior CarMax case?
A: Nothing major. According to Michelle Yost, it's basically the same operation.
Q: Okay. So, so you're not aware of anything of significance that has changed factually about CarMax West business activity in South Carolina since those tax years at issue in the prior case?
A: Like, not -- I'm not aware of anything.
Q: Okay. And so still focused on CarMax West here. Without talking about CarMax East can you tell me any specific reason that the Department concluded CarMax West business activity is not fairly represented in South Carolina?
A: The main reason is they're getting too much of the, of the income from CBS. Most of it

should be going to -- from CBS to East because they pay 25.5 percent of the, the management fee that CBS receives. But yet they received 93.5 percent of the net income produced on the management fee that West pays to CBS.

Q: Okay. And so you were discussing CarMax East there as part of your answer. And without talking about CarMax East, can you tell me the specific reasons the Department concluded that CarMax West ---

A: I thought I said West, I said East?

Q: Part of your answer referenced East, and I want to know without talking about CarMax East, can you tell me the specific reasons the Department concluded that CarMax West business activity is not fairly represented in South Carolina?

A: Well, the reason is that East paid only 20.-- 24.5 percent of the management fee that CBS receives, but yet they get back 93.5 percent of the net income produced on the management fee that they pay to CBS. And I didn't -- don't think I used East.

Q: I think ---

A: But I think you have to include them all together. They all work together.
Q: Well, you, I believe, were talking about West but said East ---
A: Oh, I meant, I meant ---
Q: --- you said that East pays twenty-four and a half percent ---
A: Well, I meant West.
Q: Yes. So ---
A: You want me to repeat it again?
Q: Well, let me, let me just start over and I'll ask the question again.
A: Okay.
Q: Without talking about CarMax East, can you tell me the specific reasons the Department concluded that CarMax West business activity is not fairly represented in South Carolina?
A: CarMax West pays 25.5 percent of the management fee that CBS receives. That management fee produces net income. That net income that flows back to West is 93.5 percent. And that, that violates the matching principle that we discussed earlier.
Q: Okay. And so it pays 25 percent of the management fee that CBS receives, CarMax East

pays the other 75 percent roughly, right?
A: 74.5 percent.
Q: Okay. And isn't it true that CarMax West pays 25 percent of the management fees because it has about 25 percent of the total stores that CarMax East has?
A: Yes.
Q: Okay. And so you said CarMax West pays 25 percent of the management fee to CBS and gets back 93.5 percent, and that's why the Department concluded CarMax West business activity is not fairly represented in South Carolina, right?
A: Right. And also, I think our for 482 expert will get into this. I think that there were some -- the amount that they pay for the, the management services fees is not correct.
Q: Okay. And so are you saying the management fee was too high?
A: Well, I'm saying that I don't think it's correct, but, but our 482 expert will address that.
Q: Okay. And so CarMax West, they pay 25 percent of the management fee and they get back 93 and a half percent of the net income

from CBS, and that, you said, shows that West's business activity is not fairly represented in South Carolina?

A: Correct.

Q: Okay. The 93 and a half percent that it gets back from CBS, that's just based on its ownership of CBS, right?

A: Correct.

Q: And so, what we're discussing right now, the reasons that CarMax the West business activity is not fairly represented in South Carolina, are you actually looking at West's business, business activities in South Carolina as part of that analysis?

A: I'm looking at the busi- -- you have to look at the business activity and you also have to look at the flow-through, you're, you're looking at both of them. I mean they're paying sixteenths -- 24.5 and they're getting 93.5. That's a disconnect. They should be getting something around 24.5 percent. So, I'm looking at both of them.

A: All right. If they're paying 24.5 percent and they own 93 and a half percent of the partnership, doesn't it make sense that

they're going to get back 93 and a half percent of the partnership from that income?

A: If they own 93.5, but, but, but the structure we think is, is -- wasn't set up properly. We think that the, the, the amount that really produces -- the amount that produces the income for CBS is actually based on the, the number of vehicles that are sold.

Q: Okay. And so ---

A: So, so the percentage should be more in line with -- the flow-through percentages should be more in line with, with the percentage or the amount of the business for, for CBS which is 20.5 percent, and East -- can I say East, 74.5 percent.

Q: All right. And so are you actually looking at CarMax West business activities in South Carolina as part of this analysis?

A: Yeah, I'm looking at, I know what their business activity is, there was recipient of flow-through income from CBS, and the amounts that were sourced to South Carolina where the royalties and financing. And they, they have no stores -- West has no stores in South Carolina so there's no sales of automobiles.

I know what their activity is, but you can't look at it in a vacuum, you gotta look at it the whole transaction, the flow -- the flow to and the flow back.

Q: Did you quantify West's business activity in South Carolina in any way?

A: Quantify it?

Q: Yes. How are you measuring CarMax West business activity in South Carolina in order to know that that business activity is not fairly represented in the state?

A: Well, I, I just told you the reason because of the flow-through from CBS. So that's -- so I guess I did quantify it by, by -- I know what their business activity is 'cause they provided the amount of the receipts from South Carolina and, and we know what, what West paid CBS, and we know what the flow back from CBS was. So yes, it was quantified.

Q: And so CarMax West, they have a pretty small apportionment ratio, right?

A: Right.

Q: What, what is it generally speaking for the audit period, about .3 percent or so?

A: I don't remember.

Q: Okay. Well, doesn't it make sense that their apportionment ratio is small given that they don't have any retail stores here?
A: The apportionment -- well, that's part of the issue too is that it, it should really be lower because most of the income that they receive should be reflected on the books of West. So they -- the apportionment ratio in South Carolina, if you're looking at on separate entities, is overstated because of the flow-through. I mean, the ratio is gonna be -- no, the ratio is gonna be the same, but the, the apportionable base will be less.
Q: And ---
A: I -- well -- and the ratio will be less too because the flow, flow-through receipts won't be included in the denominator.
Q: So you concluded that West's South Carolina business activity is not fairly reflected when it filed its tax returns as required by South Carolina law, right?
A: Yes, sir.
Q: So, what are you comparing its tax return to in order to conclude that its tax returns as filed are not a fair reflection of its

business activity in the state?

A: What am I comparing it to?

Q: Yes.

A: I'm comparing it with ---

THE COURT: You're talking about CarMax West?

MR. STREISEL: West.

A: I'm comparing it to the amount of, of receipts that are, are flowing to from CBS. And I'm saying that the amount should -- that should flow from CBS is -- not receipts, but net income that should flow from CBS to West, it should be in the neighborhood of 24.5 percent, not 93.5 percent. That's what I'm comparing it to.

Q: So what is the basis of saying that because CarMax West pays 24 and a half percent of the management fee it should only get back 24 and a half percent of CBS' net income?

A: Because, because CBS produces 24.5 percent. They only produce 25 -- 24.5 percent of the management fee, and I would, I would also say, the finance receipts that CBS receives. It doesn't -- it's not a lot rational for them to receive -- although they on- -- they only have to pay the small amount and they

get this huge amount back. That's not logical or rational.

Q: Well, if the next year CarMa- -- CarMax West pays 40 percent of the total management fee, does that mean they're supposed to get 40 percent of the income from CBS last year?

A: That would be more logical and rational. If, if that's what -- if, if it's based on the -- did they change the method that they determine the amount that they pay from East and West to CBS, or is it the same thing based on the retail sale of vehicles?

Q: If you were the one hundred percent owner of a partnership, and I've made a payment to you, and that's your sole source of income for the year, should I get it all back because I am your sole source of income for the year?

A: There's no such thing as one hundred percent own- -- partnership by one entity.

Q: Let me start that over.

THE COURT: Hence the phrase, partnership.

MR. STREISEL: Yes.

Q: If you and your friend owned a partnership, and you owned 70 percent of it, he owned 30

percent of it ---

A: Right.

Q: --- and I was your only customer that year, should I get back a hundred percent of the partnership's income because I'm the source of your revenue.

A: Should you get back a hundred percent?

Q: Yes. Because I'm the sole source of revenue for your partnership.

A: Well, are you paying management fees? Or who's, who's the individual? Are you paying management fees? Is there ---

Q: Yeah. We'll start over. You and your friend have a partnership and you own 70 percent and he owns 30 percent. You are a -- provide management services. I'm your only customer, hundred percent of your revenue comes from me. Am I supposed to get a hundred percent of the net income of the partnership?

THE COURT: I'm trying to make a distinction between the derivation of income from the 30 percent owner versus the 70 percent owner. Because didn't you say ---

MR. STREISEL: I was just setting up a partnership.

THE COURT: Coming from you.

MR. STREISEL: Yeah.

THE COURT: I mean, who's you is my problem.

MR. STREISEL: Me.

THE COURT: Go ahead.

Q: Well, we'll move on, we'll move on from this. All right. Let's talk about the CarMax East business activity. So you said that the Department independently found that CarMax East business activity is not fairly reflected in South Carolina as well, right?

A: Correct.

Q: Okay. And what was CarMax East business activity in South Carolina during the audit years?

A: CarMax business activity, they sold retail used cars, and I think they also wholesale -- sell cars at wholesale, and they also sell extended service protection plans, and they also are the people who get the customers by taking the financing applications for the finance entities, and they also service vehicles. And there's probably miscellaneous things that they, they provide here in South Carolina at the car lots.

Q: Okay. And so CarMax East, they had three

retail stores and they added a fourth during the audit period, is that right?

A: Correct.

Q: And is CarMax East business activity in South Carolina similar to its business activity everywhere else it conducts business?

A: Yes, basically. I mean, there's no -- from the 10K it doesn't make any difference -- differ in -- there's no differences though indicated in the 10K.

Q: So for CarMax West, would you agree that its business activity in South Carolina is not the same as its business activity everywhere else it conducts business?

A: Can you repeat that question?

Q: For CarMax West, would you agree that its business activity In South Carolina is not the same as its business activity everywhere else it conducts business because it has retail stores in those other states?

A: Oh, yes. Of cour- -- yes.

Q: Okay. Now switching it up here. Without talking about CarMax West, can you tell me specifically why CarMax East business activities are not fairly represented in South

Carolina when it filed its tax returns as required by law?

A: It's basically the same reason. They have to pay 74.5 percent of the management fee that CBS receives, and yet they only receive back 6.5 percent of the net income on that management fee. And then there could also be an issue with the, the proper pricing on the management service fees, the five different management service fees, which -- that they pay.

Q: Okay. And so that last part, you're saying that there might be a problem with the amount of the management fee payment, meaning it is too high?

A: Yes. I think that's what our expert's gonna say.

Q: Okay. And any other specific reasons why CarMax East's business activities are not fairly represented in South Carolina other than what you just listed?

A: No.

Q: Now, would you agree that you're not actually looking at CarMax East business activities in South Carolina as part of your analysis of

concluding that its business activity is not fairly represented in this state?

A: No, I would not agree.

Q: Okay. And so, explain to me what you are looking at in -- as to its South Carolina business activities as part in your analysis?

A: Well, we already know what the South Carolina business activity is in South Carolina because I just told you what it was. They sell retail vehicles, and they sell some wholesale sales, and they sell services to the vehicle owners. And they also get the customers for the finance business by taking the application, and from other miscellaneous services. So that's part of their business that they, they get. And then they, they, they pay intercompany -- they make intercompany payments to CBS. And so that's their business acti- -- part of their business activity because CBS performs those five different management services that we, we -- so we're, so we're looking at that complete picture. So of course we're looking at their business activity, and making a decision on whether it fairly reflects their

activity in South Carolina. You know, it's not rational that somebody like East, who produces 74.5 percent of the total annual income for the whole enterprises, is receiving such a small amount of a taxable income. And the reason is -- but -- as I mentioned earlier, is because 1.6 billion, not million, 1.6 billion of their taxable income has been shifted to West via CBS.

Q: When you say income is shifted to West, does that means something different than a business deduction for a business expense?

A: A business deduction? What I'm saying -- the net effect is that East is paying a net amount. So yes, they're paying a net amount of 1.6 -- their taxable income is reduced by 1.6 billion. So that means that their in- -- they're expenses are increased by 1.6 billion.

Q: Yeah, sure. So $1.6 billion business deduction, you know, paying for management services, right?

A: Right.

Q: Okay. And I was just asking, so -- never mind. Did you quantify East business activity in South Carolina as part of your

analysis of finding that it's not fairly represented in this state?

A: Did I quantify it? We did the, the distortion analysis, is that what you're talking about?

Q: No. I was asking if there's anything else -- if there's a particularly -- particular way that you quantified the amount of East business activity in South Carolina in order to determine that that amount is to low?

A: Yes. I think you, I think you can look at the -- our car or -- it all relates, I think, to the distortion analysis that we've, that we've showed where -- I think we brought up that earlier where, where 1.6 billion taxable income is reduced for East, and one point -- about -- approximately 1.35 billion is increased for West. And you look at their business activity, both of these entities are in the same type of business so they should be producing about the same amount of taxable income. So to me that is quantifying it.

Q: But are you quantifying its business activity in South Carolina? Like, for example, if 3 percent of CarMax East sales occur in South

Carolina, sales factor's 3 percent, right?
A: Right.
Q: So are you quantifying CarMax East business activity in South Carolina in any way?
A: I, I just explained to how we -- I think that we quantified it, but you don't -- on a, on a multi-state corporation you, you apply a portion of that ratio. So you, so you applied on a, on a, on a federal return basis, but we know what their activity is in South Carolina based on their receipts in South Carolina. So these receipts should generate a certain return, and they don't because of the tax shifting to West via CBS.
Q: All right. And so the management fee payment that both East and West make to CBS, that price is determined using a transfer pricing study, correct?
A: Correct.
Q: And are you aware that there are two relevant transfer pricing studies in this case that cover the three year period?
A: Initially I wasn't, but then later after the deposition I was aware of another one.
Q: Okay. So during the audit stage, would you

agree that the transfer pricing studies, other than gaining factual information are errelevant in your analysis of whether CarMax East business activity is fairly represented in South Carolina?

A: Did you say he errelevant or irrelevant?

Q: No.

THE COURT: I think that you switched the I to E, but I don't think that ---

MR. STREISEL: I might, I might have. We'll try it, we'll try it again.

Q: Other than gaining a factual understanding of what the company is doing, would you agree that the transfer pricing studies used with a management fee are errel- -- irrelevant in your analysis of whether CarMax East business activities are fairly represented in South Carolina?

A: No. We use the 482 studies, we don't, we don't render an opinion on whether they're correct or not. But there's a ton of information in there that we use and look at, but we don't render an opinion on a 482 study because we don't have anybody in the Department that can answer that equi- -- that

question. But if, if -- once it goes to appeals our, our legal litigation and our appeals will make a decision on whether we'll hire an expert, and we've hired an expert in this case. So those type questions are probably going to be -- I know you're probably gonna direct those to our expert. Hopefully, you're not going to direct them to me because I can't answer them. But because, you know, it's very expensive. I think the experts that we have make about 20 times an hourly rate that I make. So I'm kinda low on the pole so to speak.

Q: All right. So you gain factual information from the transfer pricing studies during the audit, right?

A: Oh, yes, sir.

Q: Okay.

A: Yes, not sir.

Q: But, but you're not challenging whether or not the price is an arm's-length price, correct?

A: Right.

Q: And you said you don't have a transfer pricing expert on staff?

A: Correct.
Q: Did you use a transfer pricing expert during the audit in this case?
A: No, we don't -- at the audit level we, we never have, have used one. And I'm aware of one time, maybe two times it was used at the appeals level, mostly it's handled at the litigation section. I guess somehow they can get the funding for that, we can't get it at the audit level.
Q: And you're not aware of the Department ever using a transfer pricing expert to assist during an audit, right? The audit stage.
A: No. I should say one time, I remember there was one time.
Q: One time at the audit or one time at appeals?
A: It was kind of like in between the appeals and audit. I would say more at the appeals level than more of the audit. But I actually worked on some of that, but I was actually directed by the expert. But it was kind of in between, it was kind of making its way to appeals.
Q: So why was there a transfer pricing expert used in that case at that stage but that's

the only one that you know of?
A: I don't know, I didn't make the decision to hire the expert.
Q: And I believe you said since July 1st, 2019 the Department has issued 53 proposed assessments requiring combined unitary reporting, is that correct?
A: I, I think it went to 3/8/2023. Right. So we haven't updated since then.
Q: Okay. So you're saying ---
A: So we've done 53, yes.
Q: Okay. And at most, maybe one of those involved a transfer pricing expert at the audit or appeal stage -- yeah, audit or appeal stage?
A: Right. There may have been another one at the appeal stage, but I'm not sure about that one.
Q: Okay. And so the transfer pricing studies in this case, they implemented it on a per vehicle charge, right?
A: Retail -- per retail vehicle.
Q: Okay. And so just to be clear, so CarMax East sells a car, they pay CBS a fixed fee, right?

A: Right.
Q: And CarMax West, same thing, right?
A: Right.
Q: Okay. And do you know what the amount of that per vehicle charge was for the years during the audit?
A: Yes.
Q: What is it?
A: For the first year it was approximately $1,100, and for the last two years it was approximately $1,200. And of those amounts that were paid for management services, one hundred, approximately $100 were representing the licensing of the trademarks and the CBS works to East and West.
Q: Okay. So about $1,100 in the first year of the audit and about $1,200 in the second and third year of the audit, right?
A: Yes, sir. Yes.
Q: Okay. So let's -- can we just use $1,200 per vehicle for a round number, is that fair?
A: That's fair.
Q: Okay. And so, during the audit, do you assume that $1,200 per vehicle management fee payment is an arm's-length price?

A: We didn't make an assumption whether it was arm's-length or not.
Q: Do you assume that it's the same amount that a third party would charge to provide the same services that CBS is providing?
A: We didn't assume that or make a decision about that.
Q: So it sounds like you don't assume that it was too high, you don't assume it was too low, and you also don't assume it was just right, correct?
A: Right. Because Revenue Ruling 15-5 says that whether we utilize an alternative apportionment, including unitary combinations, is not determinative of, of whether an alternative apportionment method will be used. So pursuant 15-5 we don't have to disprove or prove a transfer pricing study.
Q: Okay.
THE COURT: And the logic of that is if you combine all three he just simply doesn't assume.
MR. STREISEL: Okay.
Q: So let's ignore that, right? I mean if you don't think it's too high, too low or just right, I don't know any other options other

than you ignore it.

A: No. I -- and you, and you mentioned that too earlier, there's a lot of good information in there and we use that information in there. It describes the various businesses and what they do, and, and there's a lot of good information in there that we use. We us- -- I, I scan them. I- -- I'll go to page -- like usually its for -- like the first 25 pages there's a lot of good information in there, but then when it talks about inner quantum -- quartile ranges and all that kind of stuff and it shows mathematical computations and all that kind of stuff, that's above my pay level. Like I said, we -- my pay is like 1/20th of what these experts make, and most of them have PhDs and years and years of experience.

Q: You got through 25 Pages, that's further than I got. So congrats. All right. And so did you say that you, I guess, don't make any assumptions about whether or not the price is arm's-length because Revenue Ruling 15-5 says you don't have to.

A: It, it, it says that whether you have a

transfer pricing study is not determinative of whether you will use alternative apportionment. And then it cites the two things we have to -- the person advocating the alternative apportionment method has to prove that the statutory filing method does not fairly reflect the taxpayer's business activity. And that the second thing we have to prove is that our alternative method is reasonable and it more fair- -- fairly reflects the taxpayer's business activity in South Carolina.

Q: And so whether or not the transfer pricing study is accurate, it doesn't matter during the audit stage because Revenue Ruling 15-5 says it's not determinative, right?

A: It doesn't matter at the audit stage, but if it goes to court it does matter because we bring in experts. Or if it goes to the appeals, we'll bring in an expert.

Q: And you've only brought an expert one, maybe two times at appeals, right?

A: One or two. And then when it goes to -- every time I've been to court on, on this, we've had an expert on unitary combination.

MR. STREISEL: Let's go to Joint Exhibit 26. This is the audit report that we were discussing.

(Joint Exhibit Number 26 was referenced at this time.)

Q: So, Joint Exhibit 26, this is, this is the audit report you were discussing earlier, right?

A: Yes, sir. Yes.

Q: And as the audit supervisor, you approved this before it was finalized, right?

A: Yes.

Q: So, let's talk about -- here we're on Page 7, Bates Label SCDOR0159. I'm looking at the third set of calculations down there, the management fee expenses paid to CBS.

A: Right.

Q: See where I am?

A: Yes, sir. Yes.

Q: Okay. And, and that's, that's showing, you know, 2016, the total management fee paid by CarMax East versus CarMax West and the same thing for the next two years, right?

A: Right.

Q: And that's where you get the 74.5 percent.

A: Yes.

Q: So over the audit period, 74 and a half percent of the total fees paid by East?
A: Yes.
Q: Okay. So let's use 2017. Just get some round numbers there, it looks like CarMax East paid 600 million and CarMax West paid 200 million of the management fee, right?
A: Yes.
Q: Okay. And you agree CBS is providing services to both CarMax East and West, right?
A: Yes.
Q: And do you agree CBS should be compensated for its services?
A: Not necessarily. A lot of times people just charge out the cost of, of something that doesn't really produce income. This is just cost for the CarMax Enterprises. So, so no. I don't agree that it should be making a -- necessarily making a profit. A lot of companies just charge out the costs, because they make no money on this in- -- these intercompany transactions. These are just book entries where they actually -- journal entries. They, they probably pay these amounts, but the enterprise CarMax makes zero

money on this management fee.

Q: So you're saying CBS should not be compensated for the services is providing?

A: What, what I'm saying is that a lot of the entities I've audited, just charge out the cost. So they should at least be, be compensated for the costs. But, but it's not -- I don't think it -- they have to charge a markup, if they don't -- the CarMax enterprises doesn't earn any money from these intercompany transactions.

Q: So because they don't have to charge a markup, they shouldn't earn anything on their services?

A: I'm saying there's no reason. There's no rational reason. I mean, they can char- -- charge, whatever -- I mean as long as our expert says it's okay, but there's no reason for them to charge it. They don't earn any extra money at the CarMax, this is just play money. I call it play money. Nobody really earns -- is earning anything. They're not making any third-party sales. It doesn't increase their 10k income. It doesn't increase the, the income that they report on

their federal consolidated return, or the taxes that they pay on the -- it's just a kind of a wash, back and forth wash.

Q: So if we all agree that the management fee payment to CBS is an arm's-length price, would the Department's still concluded that CarMax East South Carolina business activity is not fairly represented when it filed tax returns as required by law?

A: Yes. If we -- if we've proved, proved the two points before, that doesn't adequately reflect the taxpayers business activity in South Carolina utilizing the statutory apportionment method. And, and we've proposed a reasonable method to, to cure the distortion created, yes.

Q: All right. I'm not sure I followed your answer so I'm gonna try asking a different way. If everyone agreed on what the arm's-length price was, what the service is that CBS is providing, and that arm's-length price was used, would the Department concluded that CarMax East South Carolina business activity is fairly represented in South Carolina?

A: And nothing else changed in the audit?

Q: Yes.
A: No. We -- because we've already -- we think that we supported our position that the standard apportionment method doesn't fairly reflect their business activity in South Carolina. And the alternative proportionate method we proposed is reasonable unitary combination, something that 29 states use to report, you know, their income.
Q: Okay. So even if an arm's-length price is used, you're saying that invoking the alternative apportionment statute is still justified?
A: Yes. Because as we indicated before, pursuant to 15-5, the 482 study is not determinative of whether we'll utilize an alternative apportionment method.
Q: The Department wrote 15.5, right?
A: Yes, sir.
Q: Okay. And so I asked for East, I assume the answer is gonna be the same for West. So if an arm's-length price was used for the management fee payment, would the Department still conclude the CarMax West business activity is not fairly represented in South

Carolina?
A: Yes. For the, the, the reasons I've previously indicated for East.
Q: Okay. And those reasons are just that, for example, East is paying 74 and a half percent for the fee, but only getting back 6 and a half percent of the net income?
A: Right.
Q: So 2017, $600 million dollars was paid by CarMax East roughly, right. management fee payment?
A: You, you're at the first one? Right.
Q: It's like the third set of numbers, CarMax East, just over $600 million in 2017?
A: Yes.
Q: Okay. So CarMax East in 2017 paid about $600 million to CBS for the management fee services?
A: Yes.
Q: Okay. If CarMax East had paid that exact same amount to a third party for the same services, would the Department conclude the CarMax East business activity is not fairly represented in South Carolina?
A: Well, that's a big if, because I don't think

they would pay that much to a third party. But if they did, we don't normally look at the third party transactions, so we would probably accept it, but whether they would actually pay that is a big if. I don't think they would.

Q: But if they paid that same exact amount to a third party, are you saying that you would conclude CarMax East business activities are fairly represented in South Carolina?

A: Right. Because we don't look at third -- we don't look at third part- -- if it was a legitimate expense paid to a third party we would accept that.

Q: Okay. So CarMax West paid $200 million in 2017, right?

A: Okay. Yes. Down, the next row, okay, yes.. 200,000,000, 199, is that what you're talking about? 199 million?

Q: Yes.

A: Okay.

Q: So is it fair that your issue with West is not that it's paying too much of a management fee?

A: My issue with West ---

Q: I mean the problem with West it sounds like as if they have too much income, right?
A: Yes.
Q: Okay. So if that's -- I'm going back to East now. The $600 million payment in 2017, if that's an arm's-length price, would the Department conclude that a CarMax West business activity is fairly represented in South Carolina?
A: You said that if it was third party, before. I said if it's to a third party we would accept it, but not to an intercompany transaction, because there's no way to know whether that's arm's-length or not even if -- even if you have a 482 study, whatever the price you charge is, is really fiction if you're guessing what the price is. But are you saying this is the third party or are you saying -- using the term arm's-length?
Q: All right. We'll do it this way. So if CarMax East paid $600 million dollars in 2017 to a third party, the Department would conclude that CarMax West business activity is fairly represented in South Carolina, correct?
A: Yes. If they were paying it through a third

party we wouldn't look at the transaction. I mean, if it was paid to -- it was a legitimate business expense paid to a third party, we wouldn't we wouldn't look at the transaction.

Q: Okay. And so if that $600 million payment is an arm's-length price, meaning it's the price that a third party would charge for the same services, the Department would conclude that CarMax West business activity in South Carolina is not fairly represented?

A: So, so what, so what you're saying is that this was an intercompany transaction, right?

Q: Yes, at an arm's-length price.

A: At an arm's-length price? Well, first of all the -- we're saying it -- what I said is that whenever you determine the arm's-length prices, we think that price is fiction because you don't even know what -- you're making an assumption of what the arm's-length price is based on, on your transfer pricing study. Well, I'm saying that we wouldn't -- we would look at that transaction, but we wouldn't make a decision on whether it was arm's-length or not. We would determine

whether their standard reporting method fairly reflected their activity in, in South Carolina. If it, if it did not, then we would propose an alternative of apportionment that was reasonable, and more fairly reflected their activity in South Carolina.

Q: So CBS is incurring costs when it provides these management services, right?

A: Right.

Q: Do you at least agree that the management fee payment to CBS should be enough to cover the costs that CBS incurs providing those services?

A: Yes.

Q: So if CarMax East paid CBS only what it costs CBS to provide the services, meaning CBS is earning no profit from CarMax East on these management fee payments, is it still true that you would conclude CarMax East business activity is fairly represented in South Carolina when it filed its tax returns as required by law?

A: I'll have to think that through because -- so they're paying it -- they're still paying it, so, so the cost goes out and goes in. So

there's no flow back, there wouldn't be any flow-through from the net income, there wouldn’t be a net income on the management. I think we would still have an issue with the, the, the finance if they were still paying. I think the finance receipt should flow back to East at 74.5 percent -- or you're not paying anything to them. But they still should flow back at 74.5 percent because East is the one that produces the finance income for CBS because they take the applications.

Q: So you're saying that if CarMax East only paid CBS costs, that you would still conclude its business activity is not fairly represented in South Carolina?

A: Not because of the management fee, but because of the finance receipts, finance receipts.

Q: All right. Let's go to Page 13 of this, the distortion ratios. I think it's SCDOR0165. And so the Department views these distortion ratios as evidence that CarMax East business activity is not fairly represented in South Carolina, right?

A: As part of the support we provided, yes.
Q: So it's evidence that indicates East business activity is not fairly represented?
A: It- -- it's support that we provided.
Q: Okay. And do you view these distortion ratios as evidence that supports the conclusion that West business activity is not fairly represented?
A: I don't know whether evidence or not, I just call them support. Additional support to support our, our position. When you say evidence, what do you mean by evidence?
Q: I think support's fair. You think it supports your ---
A: Right.
Q: --- conclusion, right?
A: Yes.
Q: Okay. And so where, where do these distortion ratios come from?
A: Well, these are -- I think over time we developed at the Department of Revenue, but the payroll is, is one of the ratios that South Carolina used to have. So payroll is -- especially for a brick and mortar company, payroll is a driver of, of income, or taxable

income for brick -- especially for a brick and mortar company like CarMax. So that's -- so the more people you hire, naturally the more income you're, you're going to make. That's what people expect. And the same with taxable income, that's kind of like the gross receipts. And the gross receipts used to be one of the apportionment ratios -- well, it still is, gross receipts or sales is the, is the only ratio that we have in South Carolina. So, that's a driver of taxable income. So these -- both total income and payroll are drivers of income.

Q: Okay. So earlier you're talking about transfer pricing experts are very expensive, PhDs, all that stuff, right?

A: Yes, sir.

Q: Okay. And because of that they cost a lot more, right?

A: (Nods head.)

Q: Yes?

A: Yes, I'm sorry.

Q: Okay. And so if CBS have people that are doing sophisticated things, doesn't it make sense to pay them more than a retail store

employee?
A: Well, I just think if it's part of their core business, but it's not part of their core business. I mean, you know, they make money down -- they don't make money from these things that you're talking about except for that they define in these transfer pricing studies. They don't make any money that they show to their investors or they report to the Internal Revenue Service on federal consolidated return.
Q: Okay. So taxable income over total income, this first distortion ratio.
A: Right.
Q: This is for the three year period collectively, right?
A: Yes, it's overall for the three year.
Q: Okay. And Line 30 and Line 11, that matches up to the consolidated return, is that correct?
A: Yes.
Q: Okay. Generally speaking, do you agree that taxable income is total income less deductions?
A: Yes.

Q: Okay. So this 10.54 percent for East, without saying anything about CarMax West, what does this number have to be in order for you to conclude East business activity is fairly represented?
A: Well, I think it should be in line with what they make on a consolidated basis, 30.9917. So if it was 30.9917, we would probably be happy.
Q: Okay. And CarMax West, are they also supposed to be at 30.99 percent?
A: Yes.
Q: Okay. And why would you expect them to be the same? Why would that make you happy?
A: Well, because they're doing the same -- they're in the same business, they're doing the same thing.
Q: Okay. So taxpayers, this distortion ratio, if they're not pretty close to each other then they might be subject to combined reporting, is that right?
A: Yes.
Q: Okay. Taxable income over total payroll, is it the same, meaning you expect both East and West, their distortion ratios to be similar

to one another and similar to the consolidated value?

A: Yes.

Q: Okay. So that taxable income over total income for CarMax East, 10.54 percent, what does that have to do with CarMax East South Carolina business activity?

A: What is the 10.542 percent?

Q: The 10.54 percent for CarMax East and the first distortion ratio of taxable income over total income.

A: Right. Okay. Well, CarMax Auto Superstores is the entity that, that reports all the retail sales of vehicles in, in South Carolina. So, so that's the entity that has all the activity in South Carolina. Is that the question you were asking?

Q: I was just wondering, what does that percentage tell you about South Carolina business activity?

A: Well, it tells you that for every $100 of income that CarMax Auto Superstores, Inc. generates, they only produced $10.54 in income -- I mean in taxable income. So, and you compare it to West and it's, it's

substantially higher, meaning that CarMax Auto Superstores West is the entity getting all the money. So, I'm not sure if I answered the question or not.

MR. STREISEL: Let's take a five minute break or possibly a lunch break. I have a little bit left and ...

THE COURT: You want to take a lunch break?

MS. GEER: Yes.

MR. ANTLEY: Yes.

THE COURT: Okay. How long?

THE COURT: 12:59, 2:00 o'clock? Is that ---

MR. ANTLEY: I can do shorter too if you need more time.

THE COURT: Okay, 2:00 it is.

(Off the record from 1:00 p.m. until 2:02 p.m.)

Q: Orville, we spent -- or we were talking about distortion ratios before the lunch break, correct?

A: Yes.

Q: Okay. And you came up with the distortion ratios that are used by the department, right?

A: I think I came up with those two and then there are other ones that other people came -

- came, come up with that we, that we use the term gross profit margin, net taxable return receipts, net taxable return on assets, net taxable return on equity.

Q: Okay. And were auditors required to use distortion ratios during the audit period? Excuse me, during the audit in this case, were auditors required to use distortion ratios?

A: Yes.

Q: Okay. And when did the Department start requiring auditors to distortion ratios?

A: I always used them when I when I was an auditor, but when I became a supervisor in October of 2018 I required them on all my audits. I don't think the other foreign audit supervisor necessarily required on all her audits.

Q: Okay. And so when you're the supervisor they're required, but when someone else is a supervisor, they're optional, is that what you're saying?

A: I'm thinking that they may have been, but I-- I'm not sure. I think everybody uses them now, but I don't think they -- she required

it. Actually, Rob was the supervisor at that point, I don't know if he required them.

Q: And in Revenue Ruling 15-5, it doesn't say anything about distortion ratios, right?

A: No.

Q: Okay. And you're not aware of distortion ratios being published anywhere as being evidence of distortion under the alternative enforcement statute, right?

A: No.

Q: Okay. So with these distortions, let's say you have three businesses, all unrelated parties, one sells cars, one does financing, and one provides management services. Would you expect their distortion ratios to all be the same?

A: Three, three different businesses?

Q: Yes. One sells cars, one does financing, and one provides management services. Would you expect the distortion ratios for each of them to be the same?

A: And they're in different- -- they're, they're independent businesses is what you're saying, right? They're all separate businesses, they're not related.

Q: Yes.
A: Not necessarily, but in this situation where you have like one group, which is CarMax Inc., you would think that the distortion, distortion ratios would be the same because they're in the same business and they're managed the same way.
Q: So how come third parties with different lines of businesses, you assume their distortion ratios would not be the same, but if there's related entities with multiple lines of business, you expect the related entities to all have the same distortion ratio?
A: No. These entities in this case all have the same lines of business.
Q: Okay. And what lines of business is that?
A: CarMax and -- East and CarMax West, both do the same thing. They're -- they still used cars, and at retail, and they also sell wholesale cars, and then they also sell extended service plans, and they also provide vehicle servicing, and they also both receive flow-through income -- the same type of flow-through income, management services income and

finance income.
Q: Okay. And so the management income and the finance income, that's run by CBS, right?
A: Right.
Q: Okay. And 93 and a half percent of that is attributed with -- is attributed to CarMax West, right?
A: Right.
Q: Okay. So six and a half percent is from CarMax East, right?
A: Correct.
Q: And so East and West both sell cars, CarMax West is 93.5. percent of the financing and management business activity of the group. Why would you expect CarMax East and CarMax West to have the same distortion ratio?
A: Why would I expect them have the same distortion ratio?
Q: Yes.
A: Because they're in the same line of business, and as I indicated before the -- part of the issue is with, with, with the matching adjustment, the expenses that East and West pay to CBS, and the, and the flow-through net income that flows back to East and West, they

don't match, there -- they violate the matching principle. But I'm saying that they- -- shou- -- they shouldn't be matching -- they shouldn't be violating that principle. And the distortion ratios show that, that, that the, the matching principle is violated and the income is, is shipped -- are all sent to -- most of it is sent to West via CBS.

Q: So West pay is about 25 percent of the management fee because it sells about 25 percent of the total cars sold by the group, right?

A: Exactly.

Q: And East pays about 75 percent of the management fee, because it sells 75 percent of the cars, correct?

A: Yes.

Q: And then West gets 93.5 percent of CBS's net income because it owns 93 and a half percent of CBS, right?

A: Right.

Q: And East gets six and a half percent of CBS net income because it owns six and a half percent of CBS?

A: Right.

Q: Okay. And you as a CPA, wouldn't you agree that that's just how partnerships work?
A: Well, the -- they -- this -- the partnership is basically wholly owned by CBS, and if whoever is the partner, whatever percentage they own it flows through on a percentage -- based on the percentage they own. But in this case, it's -- the partnership is wholly owned ultimately by CarMax. They could have set it up any way they wanted to. And I think the more appropriate way to set it up was, was to be based on the, the sales because that's what the, the, the -- that's really the finance income and the management fee income is based on the sales of East and West. It's not fair to the separate entity states like South Carolina, the fact that East pay 7- -- 74.5 percent of the management fee, and they only receive back 6.5 percent.
Q: Yeah, but that's just because they own six and a half percent of the partnership and that's how partnerships work, right?
A: That's how partnerships work, but I'm saying that it -- in this case we don't think it should have worked that way because it's --

it, it seems like the, the, the income would have been associated with the gross -- the retail sales because that's what's generating the income for the, for the CBS.

Q: Okay. And so as a partnership ownership percentage supposed to be based on the amount of the management fee payment coming in from each party every year?

A: I think it should have been in this case.

Q: Why?

A: Because that's -- to me that's the more, the, the, the more -- to me it seems like the fair way to, to account for the ownership of the partnership because that's what really -- produces the income for the partnership, is the sales of the, the -- by East and West.

Q: You agree though, that that's not how partnerships work? What you're saying is fair?

A: I agree that that's not how partnerships work. Well, I think we, we have to look farther, it's like -- and I think that's something our 482 expert is going to do about the valuation. We think the valuation was probably off.

Q: Okay. So the management function performed by CBS, would you agree that everybody performing that function is doing it outside out of South Carolina?
A: Except for the, the intangibles, they are actually used in South Carolina.
Q: But the, the people who are performing the management function in CBS, they're not in South Carolina, right?
A: I don't think there was any. I think there might have been a -- one or two employees located for a portion of the audit periods or maybe prior to the audit periods. I remember looking at our system, but basically I would say no.
Q: Okay. And the financing function performed by CBS, do you know how much revenue CBS earned from the financing function during the audit years?
A: How much revenue they earned from the ---
Q: Approximately.
A: I think it was around 600 million, but I don't know if that was a net income or if that was the gross amount that they earned.
Q: Okay. All right. For the audit period, the

revenue was over $2 billion.

A: Right, but that was the revenue -- not the net revenue, right?

Q: Right. Yes. So revenue for the financing function was more than $2 billion during the audit period?

A: Right.

Q: And other than people at a South Carolina store accepting an application from a customer, do you agree that all of the financing functions performed by CBS occurs outside of South Carolina?

A: No.

Q: Okay. Well, what else -- what occurs in South Carolina, other than the acceptance of an application for a customer?

Q: They, they -- if they have to repossess a vehicle I'm sure that takes place in South Carolina, and because CBS continues, or CarMax finance continues to manage the receivables after, after their securitized. So, so if they have to repossess the vehicle, somebody, I don't know if third party or if it's one of the disregarded entities of CBS repossessed the, the fees. But we sourced those

intangibles, like our license fees -- I mean not license fees, interest on those receivables to the location of where the intangible is used for the production of the income. So those intangible loans should be sourced to South Carolina.

Q: Okay. Do you know how many cars they repossessed in South Carolina during the audit years?

A: I don't know. But I looked at the pa- -- pa- -- prospectus, and that's part of their normal business operation. So I wouldn't say yes, obviously, I don't know for sure, but I mean in or- -- they -- if the, if the loan goes bad, somebody's going to have to repossess the vehicle. And we could bring up a pro- -- prospectus if you wanted to, but it talks about that.

Q: Okay. And so other than someone at a store accepting an application and maybe someone from CBS repossessing a car in South Carolina, do you agree that all of the finance and function of CBS occurs outside of South Carolina?

A: Finance -- financing function occurs outside

of South Carolina. And then the fact that the intangible that -- the loan receivable has a South Carolina side, so that -- any interest that's generated on that loan receivable would be sourced to South Carolina. But I don't know when you consider the fact that there's a property located in South Carolina, and ---

Q: I'm talking about people doing things ---

A: Oh, people doing things?

Q: --- not in South Carolina?

A: No. I don't, I don't -- the only thing I can think of is the, the stores get the customers for the finance entities by taking the application. And there's -- I'm sure I would be almost, would almost say a hundred percent there was some vehicles repossessed in South Carolina during this audit period.

Q: Okay. And so during the audit, would you agree that the Department did not do much of any investigation into CBS's financing activity?

A: Did we in- -- investig- -- I did look at -- I don't remember, I did look at their prospectuses, so I did look at some of those,

but I don't think they did it in the audit. But I did look at how they securitized their receivables.

Q: The Department, they didn't even request CBS's federal tax returns for the audit period, right?

A: Well, they should have filed one with -- one with South Carolina they didn't file returns with South Carolina. You're required to file a 1065 -- an SC 1065 with South Carolina if the entities that are reporting in South Carolina have nexus. So there should have been an SC 1065 in our system, and, and the taxpayers failed to file the SC 1065 for the partnerships. But I, I could not find any partnership returns for this period, but I did find them for the prior period. So I think that we, we may have failed to ref- -- request those, but they should have filed them -- they should have been in our system and they weren't because they -- CarMax failed to file the SC 1065.

Q: Okay. And so I was just asking, do you agree that the Department did not ask CarMax to provide ---

A: I don't know whether they ---
Q: --- federal ---
A: --- asked them.
Q: --- taxes ---
A: I know that we don't have them.
Q: Okay.
A: But I, I think that they were requested in discovery, but I'm not sure.
Q: Okay. And so you were the deposed a couple months ago or so, right?
A: Yes, sir.
Q: Okay. And at that time your expectation was that CBS, the majority of its net income was from the management fee as opposed to from the finance function, correct?
A: Yes. I, I, and I think that, that was an incorrect assumption on my part.
Q: So the -- I'm gonna switch gears a little bit here. So the matching principle you've been discussing, doesn't that apply to one taxpayer meaning taxpayer's income should match the taxpayer's expenses?
A: That's not my understanding of it based on the DD that, they issued. I think that if, if this, if this in- -- the expenses that,

that East takes are like 20 -- or 75.5 percent, and the flow-through income should come back at -- no, I'm sorry, the expenses that East takes for the management fee, 74.5 percent of the management fee that CBS, the, the income generated on those management fees should come back at 74.5, based on the matching. That's my understanding of the matching principle.

Q: Okay. And I think we talked about in your deposition, you commonly see East, West structures without a partnership in the middle, meaning just two companies, one's in the East and one's in the West?

A: Right.

Q: Yes?

A: Yes.

Q: Okay. And so, for example in this case, if CarMax West purchased six and a half percent from CarMax East, in that situation CarMax West owns one hundred percent of CBS, right?

A: Talking about following -- oh, 6.6 ...

Q: CarMax West, say it purchased six and a half percent interest from East, therefore CarMax West now owns a hundred percent of CBS. Do

you follow me?
A: Right.
Q: Okay. And so -- and that's a simple East/West structure, right?
A: Right.
Q: Okay. I'm gonna get a visual here. All right. See, see that with CarMax West the hundred percent owner of CBS?
A: Right.
Q: Okay. That's just a simple East/West structure, right?
A: So CarMax East -- so CarMax West owns a hundred percent. Well, that wouldn't be a partnership so ---
Q: Right.
A: All right. So it wouldn’t be in the triangle.
Q: My bad, the triangle, you're right. Well, you get the picture, right?
A: Yes, I get the picture.
Q: It's a little East/West structure.
A: Yes.
Q: Okay. That situation, CarMax East will be paying a hundred percent of the management fee, correct?

A: Right.
Q: Okay. And in that situation, zero percent of the net income would flow back to CarMax East, correct?
A: Zero the net income would flow back, right.
Q: Okay. And what's wrong with that?
A: Well, what's wrong with it is -- it's -- it -- well it'd probably be -- we'll probably do -- if they're paying the same thing, we -- we would definitely be shifting income when we do a unitary combination.
Q: And so ---
A: Because CarMax East is paying one hundred percent of the management fee, shouldn't they be getting something for the management fee that they pay? Well, they are, I guess they're getting the services.
Q: So you believe that -- and wha- -- in the actual structure, CarMax East should get 74 and a half percent of the flow-through net income because it makes 74 and a half percent of the management fee payments, right?
A: Right. And it makes 74.5 percent, I believe, of the total taxable income for the whole CarMax Enterprises. But it reports

substantially less than that because of the, the intercompany transactions between West and East to CBS and the flow-through back from CBS to East and West.

Q: Right. And so under that same rationale, it seems like you would say that CarMax East should get hundred percent of the net income of CarMax West in a regular East/West structure, are you not?

A: What I'm saying is that we're saying this based on a unitary combination. It makes sense that that's what's happened here. We would do a -- I'm sure we would do a unitary combination if the shifting was as great as it was here, and re- -- and require the, the CarMax expenses and, and receipt to go away. Because it would definitely be unfair that, that CarMax West is reporting one hundred percent of the finance and the, the -- well, you -- it would be a separate corporation, right? It wouldn't -- and you said that they bought them, but they didn't merge into them so it'd be -- it would still be, be CBS corporation. So yeah, it would make sense to me, we would definitely do a unitary

combination in that situation or another alternative apportionment method.

Q: So why wouldn't you just deny part of the management fee that you thought was too high?

A: Deny the management fee?

Q: Yeah.

A: We'd have to, we'd have to -- in order to deny the management fee we'd have to prove that the transaction didn't have any economic substance. And I'm not sure how we would do that. We'd have to review it in detail. But obviously, they are performing some services.

Q: So under the alternative apportionment statute, you agree that any alternative method chosen must be reasonable, right?

A: Yes, yes.

Q: Okay. And the Department, they're using Subsection (a)(4), correct?

A: Right.

Q: And that also requires an alternative method to be equitable, right?

A: Right.

Q: Okay. The Department, they just view reasonable and equitable as synonymous meaning if it's reasonable it's also equitable, right?

A: Yes.
Q: Okay. And do you agree that combined unitary reporting is not automatically a reasonable alternative for a taxpayer that's a member of unitary business?
A: It's not, it's not necessarily automatically, but I would think that if there's a bunch of intercompany transactions it's probably the best method because it eliminates the intercompany transactions that cause distortion. So I would say a unitary combination would probably be the best method, not always, but generally, yes. And, and because it's recognized by 29 states as a fair and appropriate method.
Q: I mean some states have three factor apportionment in their separate reporting states, right.
A: Some states have what now?
Q: Three factor apportionment, you know, payroll, sales, property?
A: Right.
Q: Okay. And South Carolina used to do that, right? South Carolina used to do that, right?

A: Right. They phased in to single sales or single gross receipts factor, I think it was 2011.
Q: I mean, why does the fact that other states choose to have combined reporting mean that it's going to be reasonable as alternative methods?
A: Well, I think that the other, other states recognize that it's a good method where you have a lot of intercompany transactions because it eliminates the intercompany transactions. When you have like me selling to myself, you know, it's hard to determine that the taxpayers really having a valid transaction or if it's just -- they're just trying to save money on taxes. So that's what purpose of the unitary combination is, is to, to more fairly reflect the business activity in those unitary states.
Q: So, this picture we're looking at, simple East/West structure, one transaction management fee payment. You said several times that combined unitary reporting would be used here in this East/West structure, right?
A: If you -- based on the, the fact that you

indicated that the, the, the amount of the transactions were the same such that all of CarMax is -- most of CarMax's East income is going to be shifted to West or -- and I guess another separate entity which is owned by West. But you're saying that Wes- -- was it merged into West or is it a separate entity because it makes a difference? Was it merged into West?

Q: I mean, the hypothetical I gave was that West purchased a 6.5 percent interest from the East, but East could also contribute into West as a wholly owned corporation. So there's various ways to get to that situation.

Q: Well, it makes a difference, because if, if CBS was purchased, and, and became part of CBS West it's a disregarded entity, then I'm assuming that CB West -- CarMax West is not going to be playing -- paying any, any of the management fee. If they did, it's going to be an in and out transaction, so it'd be a wash. So -- but if CBS as a separate corporation is a separate entity that is owned by West, then West is still gonna be

paying the management fee to East and West.
Q: So an alternative method under the alternative apportionment statute, it's supposed to be selected based on the source of the problem meaning that selected based on the reason the standard method did not fairly represent the taxpayer's business activity, correct?
A: Correct.
Q: And Revenue Ruling 15-5 says I'm right?
A: Yes.
Q: Okay. And so if the source of the problem was just an inaccurate transfer pricing study for an intercompany transaction, isn't that the method that was most closely related to the problem and thus would be reasonable method?
A: I think that's a method we could use. But I -- the law don't allow does not preclude us from using a unitary combination.
Q: But it requires you to be like a reasonable one and that reasonable method is one that is tailored to the source of the problem, right?
A: Well, there -- I think there's two problems in this in this situation and it's the structure of CBS and the payment of the

intercompany transactions. The bigger problem, I think, is the structure of CBS. So I don't think that a 482 would have, would have cured the distortion because you still have the issue with the structure of the East/West. I mean, not the East/West -- the flow-through from CBS to East and West.

Q: CarMax and Rent-A-Center cases, I know you're familiar with the prior CarMax case, but you're also familiar with Rent-A-Center, right?

A: Yes.

Q: And so outside of the burden of proof, what did -- how did those cases impact your analysis in this case?

A: Of CarMax West and CarMax East? Let's see, CarMax -- the prior CarMax case was a -- we used separate accounting. Basically we required the flow-through partnership income to be basically the taxable income. And in the numerator we included the finance and the, the royalties in the denominator. It was all other receipts of CBS. That's how we taxed it. But in the case they said that -- well, we won at, at the first level, ALC, and

we lost at the, at the Appeals Court, and then we also lost at the, at the Supreme Court. So, I kinda lost -- what was your question again? I know I ---

Q: I was asking you, the prior CarMax case and Rent-A-Center, how does it impact your analysis in this case outside of you knowing where the burden of proof stands?

A: Yeah. Well we, well we, know where the burden of proof is and we also know that, that we also have to come up with a reasonable method. And we know that our separate ac- -- they -- well, the method we selected was actually -- was approved. They said that our method was reasonable. They just said that we didn't prove that the statutory filing method did not fairly reflect our business activity. And in fact, the CarMax -- the appeals case wanted to send the court case back to the ALC and one of the courts of the -- one of the Judges on the Supreme Court wanted to send the case back to the ALC, give us a chance to meet our burden to prove that the alternative apportionment did not meet our -- did not fairly reflect

their activity in South Carolina. But it shows -- well, the method we selected would not be an appropriate method because it only partially, partially cured the distortion. It didn't cure the distortion from, from the, from the, from this partnership flow-through, it only cured the distortion of the amount that would flow, flow-through to, to West where, where the, the -- those rece- -- receipts really should have been reported -- South Carolina receipts should have been recorded on East if we'd had the appropriate flow-through from the partnership. So the -- so your question was, how does it impact us. Well it impact us because we know we're not going to -- separate accounting would not work, and any -- if even if we use separate accounting, it was the wrong method because it did not fully cure the distortion, which the unitary combination does.

Q: All right. So switching gears now, you agree that CarMax cooperated during the audit and provided whatever materials were requested?

A: Yes.

Q: Let me take one minute, please.

MR. STREISEL: No further questions.

THE COURT: Re-Direct?

MR. ANTLEY: Yes, Your Honor, briefly.

MR. SHARPE - RE-DIRECT EXAMINATION BY MR. ANTLEY:

Q: You were asked questions about the different hypotheticals with the partnership, the CBS partnership. The facts we have in this actual case, the -- are the partners of CBS, are they related parties?

A: Yes.

Q: Okay. You were asked a question about an extensive deduct- -- deduction, how this was similar to taking a expense deduction, the payment of the management fees.

A: Right.

Q: Where does that income go after it's -- we know it's been deducted from one entity, where does, where does ---

A: It goes to CBS.

Q: Okay. And then after CBS where does it go?

A: It comes back to East and West.

Q: Okay. So does that expense ever leave the CarMax group?

A: No.

Q: Is that the same, is that the same thing that

happens if this expense was to an unrelated party?

A: No.

Q: I think you were asked a question and your, and your testimony was that your problem with West is that they have too much income or I think that was the question, your response was, yes. What -- could you elaborate, what, what did you mean by, by that?

A: Well, they have too much income because CarMax East is, is the predominant entity in the CarMax enterprise. They produce about 74.5 percent of the taxable income that's reflected in the 10k and, and the US 1120 Federal Consolidated Return, that's filing -- filed. But based on the flow-through from East to West, of the expenses from East to West management expenses to CBS and then the flow-through back, as I indicated, East taxable income is reduced by 1.6 billion, not million, 1.6 billion for the audit years. And West's taxable income is increased by, by 1.4 billion. So basically East -- West is getting all the, all the taxable income. And to me it's not fair to South Carolina and

other separate entity states.
Q: You're were asked a question, I think it was in the context of salary and you were asked a question about CBS employees requiring more, higher paid than the retail store employees. Does CBS even have employees or are they leased?
A: They're leased.
Q: Okay. And who are they leased from?
A: From CarMax Auto Superstores Services, Incorporated.
Q: Okay. And then you had some testimony about CarMax East versus CarMax West, and I just -- I think there might have been moments when you might have had the, the two in -- reversed so I just want to clarify. With the apportionment ratio, could you tell me what they were for CarMax East as filed?
A: As filed as I think it was around 3.5 percent.
Q: Okay. And what was the apportionment ratio for CarMax East still after the audit as -- after ---
A: 2. -- around 2.5 percent.
Q: Okay. And for Car- -- we're gonna do the

same thing for CarMax West. So what was the apportionment ratio as filed for CarMax West?

A: I don't remember, but I think it was around .30, but I might be wrong.

Q: And what was the apportionment ratio for CarMax West post audit, so what did y'all -- Department thought it should have been?

A: I think it went down to point -- around point .1136. But I'd have to look at the, the recap to make sure.

Q: Okay. All right. And then you were asked some questions about the alternative apportionment and if that first element, I guess, is met. Does the Department get to choose any reasonable method as an alternative or does it have to choose a method that the taxpayer suggests?

A: We can -- we -- any, any method which is reasonable, what we don't choose the, the method that they suggest unless we feel it's reasonable.

MR. ANTLEY: No further questions, Your Honor.

THE COURT: Okay. I'm just curious. If every state was a unified state, combined unified reporting, would there ever be need for

transfer pricing?

A: There will still be transfer pricing, but it would be, and this is the big thing that a lot of states are talking about now, is that even if you do a unitary combination you still have a world -- that -- they still shift income to offshore affiliates. So that -- so the best way to do it is for the states to have a worldwide combination. And the drug companies are particularly good at shifting their income to offshore entities. And I think recently Minnesota was trying to go worldwide combination, but there was such an uproar they had to back down from that. But worldwide combination is really the best way for everybody to go because it's, you know, there's no shifting between anybody. It's all cured.

THE COURT: Any follow-up questions on what I asked?

MR. ANTLEY: None from the Department.

THE COURT: You may step down.

MR. SHARPE: Thank you.

THE COURT: Any further witnesses?

MR. ANTLEY: The Department does have another

witness. I believe, Your Honor, I mentioned 3:00 o'clock as being a close time if ---

THE COURT: Yeah.

MR. ANTLEY: It's an expert witness, we could, we could try to get through his qualifications.

THE COURT: Okay. We'll do that.

MR. ANTLEY: So at this time, the Department will call Dr. David DeRamus.

COURT REPORTER: Dr. DeRamus, do you solemnly swear or affirm the testimony you're about to give will be the truth, the whole truth, and nothing but the truth so help you God?

MR. DeRAMUS: I do.

COURT REPORTER: Would you please state your name for the record?

MR. DeRAMUS: David Watlington DeRamus.

COURT REPORTER: Thank you, Dr. DeRamus.

MR. DeRAMUS - DIRECT EXAMINATION BY MR. ANTLEY:

Q: Dr. DeRamus, what do you do for a living?

A: I'm an economist and a partner with the economic consulting firm of Bates White, LLC.

Q: And the Department of Revenue has hired you as an ex- -- to serve as an expert witness in this dispute with CarMax, is that right?

A: That's correct.

Q: Okay. And what were you asked to do?
A: I was asked to address basically four broad issues. First, whether the -- whether CarMax's transfer pricing studies and the policies that it implemented, were consistent with the -- were reliable and consistent with the arm's-length principle, as articulated in the Section 482 guidelines, promulgated by the Internal Revenue Service. Second, I was asked to assess whether the Company's use of separate entity reporting, and particularly the way it applied its transfer pricing policies resulted in income in South Carolina that from an economic perspective, reasonably reflect the economic activity of the company of the state. Third, I was asked to evaluate whether a combined entity apportionment method would more likely produce a, a more reliable reflection of the, of CarMax's income than its use of separate entity reporting. And fourth, whether the application of combined entity reporting would reasonably approximate the result that one would get if the company had actually implemented transfer pricing policies that we're reflective of the arm's-

length standard.

Q: And before we get to ---

MS. GEER: Your Honor, just one quick question. If we could slow down just a tiny bit with the talking, it would be very much appreciated.

THE COURT: What -- I've never had that request before. I mean, I've had it from the court reporter, but do you object to that at all?

MR. ANTLEY: No, Your Honor.

THE COURT: If you could slow down but still stay within your natural train of thought. I'm not asking you to throw yourself off, okay?

MR. DeRAMUS: Certainly. Thank you, Your Honor.

Q: Before we tell the Court your opinions, before you get into your opinions, I'd like to review your qualifications. So, could you please describe your educational background?

A: Yes, I received an Undergraduate from Duke University, and a PhD in Economics from the University of Massachusetts at Amherst.

Q: Did you have any particular areas of specialization in this?

A: Yes, in the, in my PhD in Economics, my areas of specialization were international economics and industrial organization. Industrial

organization is often referred to as the applied theory of price. It's where market struc- -- economists analyze market structure and the impact of market structure on prices. It's also the area of economics where you will find some of the transfer pricing literature developed as well.

Q: If, if you could also describe your relevant work experience.

A: Certainly. So for instance, 1999, I've been a partner with the economic consulting firm of Bates White. I've worked on a wide range of litigation matters, including transfer pricing matters since that time period. Before that I was with the, the management consulting firm of A.T. Kearney, where I engaged in similar type of activities, as well as general management consulting work. And then prior to that I was at KPMG Peat Marwick for approximately five years, where most of my work was related to transfer pricing, although I also worked on some litigation matters unrelated to transfer pricing at that time as well. So in all I would say I've spent approximately 30 years

working on transfer pricing, approximate -- across, kind of a broad range of different types of transfers, transfer pricing engagements out there, namely, both -- what's called documentation studies, audits I've worked on, something called Advanced Pricing Agreements, agreements between the taxpayer and a sovereign, either United States or Foreign Sovereign. And I've worked on, yeah, other kinds of planning studies as well. So pretty much the whole gamut.

Q: Have you been qualified to testify on economic and transfer pricing issues in court proceedings?

A: Yes, I have.

Q: Are you familiar with IRS Section 482 regulations?

A: Yes, I frequently consult the IRS's Section 482 regulations as well as the OECD guidelines in my work, and I've done so since approximately 1993.

Q: What is transfer pricing?

A: So, transfer pricing is the way in which internal prices are set within a company. They are not market mediated prices the way

normal prices are, but instead they are administratively determined prices.

Q: And in your experience, why are taxing authorities interested or concerned about transfer pricing?

A: Because, because transfer prices are administratively set by company, a company can set the prices that its various subsidiaries or other entities charged each other at non-arm's-length rates in order to shift income from one jurisdiction to another and therefore avoid paying taxes in certain jurisdictions. So, it's, maybe, just by way of example, a company that is a manufacturer with a distributor affiliate can the, if the company wants to take more profit in the, the geography where the manufacturing facility's located, it may charge the, the, it may undercharged the distributor or leave the distributor with too low of a profit, and then pool, to pool more of the profit into the manufacturing geography or vice versa, it might undercompensate the manufacturer for the manufacturing activity it's performing and pool more money into the distribution

location. You can also do the same thing with a headquarters surfaces as well, where for example, it might try to overcompensate the headquarters for a procurement service, for example, or any range of other administrative services, and therefore, pool, effectively shift income from the income generating affiliate and move it into the headquarters location.

Q: Can a company engage in a restructuring for a similar purpose?

A: Yes. So that, that actually has been part of a, a substantial amount of my work on behalf of the US Government has been analyzing the extent to which companies have restructured their operations or their ownership of certain assets in order to shift income from one location to another. So one way you can do so is for a company to take what is previously an integrated company, and then split that company up into different pieces, and then move certain assets or functions among those pieces in order to effectively shift income as well. It can also do that by charging prices that are of non-arm's-length

prices in those transactions. And it can also assign ownership shares that are also inconsistent with arm's-length dealings.

Q: And was that part of your prior testimony in Federal Court on behalf of the Department of Justice in the Perrigo matter?

A: Yes, it was.

Q: And were you asked to provide your opinion in that matter as an economist of whether the asset transfer or restructuring had any commercial effect on the taxpayer?

A: Yes.

Q: And what does that have to do with transfer pricing?

A: Well, it has quite a bit. So first, if you have a situation where, where there is a restructuring, and you have a compensation that is being earned by a taxpayer prior to the restructuring, and if there is no real substantive operational effect of the restructuring, you wouldn't expect the income that the taxpayer earns after the restructuring to be substantially different, unless there's some broader external factor. But the, the nature of the, of the

intercompany transactions in this kind of A versus B kind of scenario, where you've had or a time T minus one versus time T plus one, you shouldn't expect to observe a big change in that, in the compensation of, of a related party solely as a result of a restructuring if that restructuring had no significant commercial impact on the business. So that would be the biggest thing. The other thing, particularly in any kind of intangible related transaction is that the federal authorities are, are concerned about the extent to which intangible assets may be transferred from one part- -- one related party to another at non-arm's-length party at non-arm's-length prices in an earlier time period, and those may be used, those earlier transfers may be used to try and justify non-arm's-length pricing during the years it issued. So even though the transfer might have occu- -- might have occurred, the restructuring might have occurred in a closed year, as it happened in the Perrigo matter, the implicate that, that restructuring can have enormous implications for a transfer pricing analysis and for the

taxing authority as to what are the actual arm's-length prices during the tax -- during the open tax years, the few years at issue in a litigated proceeding?

Q: What do you consider your expertise as it is relevant to this dispute with CarMax?

A: Well, primarily, it's the economics of transfer pricing. But I would say it's also more broadly and of my expertise as I con- -- I consider myself to be an applied micro economist. So I studied a wide range of industries and a wide range of companies and assessed the way in which the, the factors that lead to some companies being high profit or low profit companies, or having high profits or low profits. So I think there is a fair amount of that expertise that is relevant here as well, particularly in assessing the extent to which CarMax's activities in the state of South Carolina, give rise to a certain amount of economic value here in the state and that should be appropriately subject to taxation.

Q: As part of your work in the area of transfer pricing, do you general, generally analyze the

extent to which activities performed by different related parties contribute to the firm's overall profitability?

A: Yes, I do.

Q: And have you done that analysis in this case as well?

A: Yes.

Q: As part of your work in the area of transfer pricing, do you routinely analyze taxpayers tax returns?

A: Yes, I do.

Q: Did you analyze CarMax's tax returns in this case?

A: I did.

Q: As part of your work in the area of transfer pricing, do you routinely analyze the allocation or apportionment cost or income among related parties?

A: Yes, although I should say the notion of, of the apportionment of income in a state proceeding is, has its own kind of nuances and very, it's very specific to the state tax issue. But I would say across the board in transfer pricing analysis, the issue of both cost allocation and either income, typically,

I would think of it as an allocation, but it could also be considered an apportionment using the tax, the language of the tax statute. So those issues come up, it's simply applied in a different analytical framework.

Q: Are you familiar with how the Department of Revenue has implemented its alternative combined unitary apportionment method?

A: Yes, I am.

Q: And have you previously analyzed the extent to which a company's operations across different related parties are interdependent?

A: Yes, I have.

Q: And do your opinions regarding the reliability of the taxpayers transfer pricing policies have implications for your opinion as to whether CarMax's use of separate entity recording reflects from an economic perspective, the activity of the company in South Carolina?

A: Yes.

Q: And you, you said earlier that you've previously analyzed the extent to which activities performed by different related

parties contribute to the firm's overall profitability. Have you done that analysis in this case?

A: Yes, I have.

Q: And does that analysis have implications for your opinion as to whether CarMax's use of separate entity reporting reflects from an economic perspective the activity of the company in South Carolina?

A: Yes, it does.

Q: And has the Department asked you to redo the taxpayers transfer pricing analysis and calculate a precise proposed income adjustment based on that analysis?

A: No, it has not.

Q: Do you have an opinion of the result that you would obtain to a reasonable degree of approximation if you were to redo the taxpayer’s transfer pricing analysis and calculate the income adjustment on that basis?

A: Yes.

Q: Are you able to compare that approximate result to what the taxpayer has actually implemented through the use of separate reporting?

A: Yes.
Q: Are you able to compare the approximate result to what the Department has proposed based on combined entity apportionment?
A: Yes.
Q: Do you have a current CV?
A: I do.
MR. ANTLEY: I beg the Court's indulgence.
Q: This is what's been admitted as Joint Exhibit Number 61.
(Exhibit Number 61 was referenced at this time.)
Q: Is this the CV that you just mentioned?
A: Yes, it is. I believe I produced an updated one at some point. So I'm not quite sure if this is the updated one or this is the original one that I submitted, but it is accurate.
Q: Okay. So let's discuss the process that you had, you used to formulate your analysis in this case. First, did anyone in the Department tell you what your opinion should be?
A: No.
Q: Did anyone in the Department limit your ability to research or analyze the matters at

issue in this case?
A: No.
Q: What were you asked to do in this matter?
A: Well, I was asked to review the various information produced in the, in this case, including the Department determination, the, the taxpayers transfer pricing, reports, and other information produced in discovery and also to conduct my own research. And then to provide my opinion on the four matters, or the four issues I address, or I, I noted earlier on, namely, with regard to the -- first, with regard to the whether the transfer pricing study in policies were reasonable and reliable from a transfer pricing perspective, or from a 482/arm's-length perspective. Second, whether the taxpayers economic activity in the state of South Carolina is reasonably reflected in their use, or in CarMax's use of separate entity reporting, and particularly the way it is implemented its transfer pricing policies. Third, whether combined entity reporting would produce a result that's more reliable and more accurately reflect the company's

economic, economic activity in South Carolina than its use of separate entity reporting. And then fourth, whether the use of combined entity reporting, or a combined entity reporting method would produce a result that was reasonably approximate to what you would get had the taxpayer actually implemented a reliable transfer pricing policy.

Q: And could you briefly summarize the types of information you considered in arriving at your opinions?

A: Sure. So first and foremost, would have been the two transfer pricing studies that E&Y provided that are relevant to the time period, namely one in 2012, and one in 2015. Those were used to -- as part of the documentation for and used to set the prices, transfer prices for 2016, and 2012 was used for 2016, and the 2015 study was used for the 2017 and 2018 years. These are fiscal years, so year ending February of that year. I was asked to review the -- or I reviewed the, the E&Y 2004/2005 study and the other, some other documents related to the restructuring. So that would include kind of the E&Y valuation

report that accompanied that, of the intangible that was used in determining the 93.5 percent ownership share for CarMax West, and a six and a half percent share for CarMax East. I reviewed a broader range of, of documents including financials, some of which were provided as part of Dr. Cody's work papers. And again, my -- also have some, some of my own independent research I conducted looking at both 10K's, not only for the company, but for other competitors using information in commercially available databases like Capital IQ. So I've done a fair amount of research using those resources as well.

Q: Did you review the deposition transcript of Ms. Eileen Yost, the 30(b)(6) witness?

A: Yes, I did. Thank you.

MOTION TO ADMIT AS EXPERT:

Q: Okay, at this time, the, the Court would ask that -- oh, I'm sorry, the Department would ask that the Court recognize Dr. DeRamus as an expert witness in the area of transfer pricing analysis, including economic principles.

THE COURT: Any objections?

MS. GEER: One second. Your Honor, we do not have any objection to his, his qualifications as -- just make sure I got it right, transfer pricing analysis, including economic principles.

THE COURT: All right. And so qualified.

MR. ANTLEY: It's, it's -- I think we're at 3:02, if this is an appropriate time to break.

THE COURT: Okay. We'll take a break then.

(Day 1 of the hearing adjourned at 3:03 p.m. on Monday, May 22, 2023.)

DAY 2 - TUESDAY, MAY 23, 2023

CALL TO ORDER:

THE COURT: We are back up. You are still under oath.

PRELIMINARY MATTERS

EXHIBITS AGREEMENT:

MS. GEER: Your Honor, we had a couple of quick housekeeping items.

THE COURT: Well.

MS. GEER: So, joint exhibits, we have agreed to add some additional joint exhibits. But some technical difficulties have prevented them from getting put on the thumb drive yet. So

I'm just going to put into the record what they are. They are Exhibits 81, is an original return from 2016 of CarMax West. It's CarMax Bates Label 704 to 713. Then Number 82 through 84, are CAF, C-A-F, versus Non-CAF P&Ls. And those are CarMax 3645 through 3647. And then Number 85 is going to be a 30(b)(6) designation of Eileen Yost, which the Department has designated into the record. So we'll fix our technical difficulties and get thumb drives with all of those joint exhibits. And we've also discussed if it's possible there's another one to be added. So we may just wait till everything's added if that suits the Court. Or do you want ---

THE COURT: So, is it just offered for information purposes or do you want me to say that you off- ---

MS. GEER: No, we'd like to move those ---

THE COURT: --- 81 through 85 ---

MS. GEER: --- those into the record. Yes.

THE COURT: --- are offered and admitted without objection?

MR. ANTLEY: Yes, Your Honor. They're -- they'd be

joint exhibits.

THE COURT: They're admitted.

(Joint Exhibits Numbers 81 through 85 were admitted into evidence.)

MS. GEER: Okay.

THE COURT: Now what is CAF?

MS. GEER: It's, it's CarMax Auto Finance.

THE COURT: Okay. And what was the other, the ---

MS. GEER: And then non ---

THE COURT: --- there, there was two ---

MS. GEER: --- non-CAF. Non-CAF is Non-CarMax Auto Finance.

THE COURT: And then there was another acronym after that, wasn't it? PE?

MS. GEER: P and L, sorry. Profit and Loss.

THE COURT: All right.

MOTION IN LIMINE:

MS. GEER: And then the -- then the other matter is that we would like to renew our Motion in Limine that we had filed prior to the case as to excluding Dr. DeRamus from testifying about the accuracy of the 2004 valuation. For the record, I think I'm required to, to renew that now so that that was preliminary.

THE COURT: Uh-huh.

MS. GEER: And so if Your Honor's willing to hear that now, I'd like to put that on the record.

THE COURT: Go ahead.

MS. GEER: Okay. So as the Court may recall, we filed a Motion in Limine a few weeks ago on these grounds. We had a hearing with Your Honor. Our, our basis was -- the primary grounds were that the Department had not alleged that the valuation is inaccurate in any of the relevant pleadings, including the audit, the determination, the pre-hearing statement, that the expert disclosure had stated that he would testify regarding a transfer pricing report, which the Department had later clarified was intended to refer only to the transfer pricing reports regarding the intercompany transactions dated 2012 and 2015. And did not mention at all the 2004 valuation study, that we believe that the testimony was not relevant to the case or reliable, and that CarMax was prejudiced by this addition to his expert testimony. At that time we had asked that the Court continue the case to allow CarMax to cure the prejudice that was -- that we believe

resulted from if he was allowed to testify on that topic, including that we wanted to procure documents related to that study, which had never been requested or sought. As ---

THE COURT: And how many days have passed since you first were on notice of his evaluation of that opinion, I guess, or study?

MS. GEER: So his deposition was March 17th -- 29th, March 29th.

THE COURT: Okay.

MS. GEER: And the other thing that we wanted to be able to do was to hire an expert economist that had the requisite credentials to be speaking to that topic. So those were our grounds at the time. I, I -- since we don't have a written order, I'm gonna attempt to say what I thought the Court's ruling was at that time. But I, of course, defer to your recollection of that.

THE COURT: Give it a shot.

MS. GEER: I understood that you were making a preliminary, giving us your preliminary thoughts on the matter. And then ---

THE COURT: Right.

MS. GEER: --- at that time, your thoughts on the

matter was that Dr. DeRamus would not be able to speak to the accuracy of the valuation study unless CarMax opens the door for that to be -- to be attacked directly.

THE COURT: He couldn't impeach -- it wasn't Price Waterhouse, it was ---

MS. GEER: Ernst and Young.

THE COURT: --- Ernst and Young's, their evaluation -- when I say evaluation, I mean the opinions that they gave, but that if there was evidence of just analyzing the circumstances of -- that existed in this case, he could give an opinion on that, but he can't attack Ernst and Young's opinions because you weren't on notice regarding that. That's how I ruled.

MS. GEER: I'm sorry. Let, let me make sure I understand the distinction you're making. So can't attack the Ernst and Young, but what can he do?

THE COURT: He can just look at the percentages of allocations of ownership, and give an opinion about whether that's proper based on his own analysis of the evidence. All right. So how would that be improper? So that's my ruling,

let's ---

MS. GEER: Yeah.

THE COURT: --- let's ---

MS. GEER: So, so ---

THE COURT: --- attack or address my opinion.

MS. GEER: Right. So our opinion would be that that is still attacking the conclusions of the Ernst and Young study. I mean, if he is saying, Okay, I won't, I won't say what they did is wrong, but here's how I would do it right. I mean, to me, that's, that's a direct attack on the valuation that Ernst and Young did. And it would be fine if he wanted to do that, for him to say so in an expert disclosure, or for the Department to say so in an expert disclosure and say, other side, he's going to speak to his conclusions on what the correct price would be under the 2004 study.

THE COURT: Well, you could not anticipate the fact that he would come in and say as a transfer pricing expert that, that the, the ownership percentages that were established were not -- were not proper?

MS. GEER: I -- the, the argument that we

anticipated was the one that the Department has made in their pleadings, which is whether or not those were the assets that were contributed were properly valued, and thus the percentages properly established, is irrelevant in this case because the Department's position is that partnership flow-through distribution interests should be based on the partner's business activities in the state. That was the argument that was -- has been made from day one on their side. So we anticipated that argument. We believed that was the argument they were -- would make. We believe DeRamus might, might speak to that as support for whatever other opinions he was giving, but not that they were going to attack the specific study and the specific prices determined.

MR. ANTLEY: Your Honor, the, the valuation study itself is intimately connected to the Transfer Pricing Study. The valuation itself is Joint Exhibit Number 55. The valuation study itself says that it is based on a transfer pricing analysis, and before it -- the 482 regulations. Dr. DeRamus testified about his

opinion related to that valuation study two months ago. Their, their own expert in his deposition testified that he was able and an expert in, in valuations. So it's within the scope of his expert disclosure, he is qualified as an expert to talk about that. And his opinion on the matter will help the Court understand the facts at issue in this case. Thank you, Your Honor.

THE COURT: Well, I'll respectfully deny your motion. Let's stick with our previous ruling.

MS. GEER: I just want to make sure that I put all the points that I would want in the record --

THE COURT: Okay.

MS. GEER: --- for appeals.

THE COURT: That's fine.

MS. GEER: I'm sorry, give me one second.

THE COURT: You mean you may appeal me?

MS. GEER: I hope not. But my track record in your Court is not great. Let's see.

THE COURT: Were y'all in Farmers?

MS. GEER: Yes.

THE COURT: In the original case?

MS. GEER: Yes.

THE COURT: Okay.

MS. GEER: Were you glad to see those be put to bed?

THE COURT: Well, the thing is, I -- maybe I should just do that more often, write a 100 page order that nobody wins. And so when you say your track record, I mean you won in that case, you lost int hat case.

MS. GEER: That's true, that's true. That is a good point, Your Honor.

THE COURT: And same for the Department. I don't know what y'all ever was -- resolution y'all came up with but maybe that's the approach I should take in the future. Now ---

MS. GEER: Settlements are where everyone goes away, no one's happy, no one's mad. Everybody ---

THE COURT: Your track record may not be good with me, but Dr. Pomp's track record's pretty good.

MS. GEER: So, Your Honor, if I could get, the only other thing that I have not covered is that if that testimony is -- if you're going to allow that in, then we would object that

there has not been put into the record sufficient evidence to establish his qualifications to speak to a valuation study. It's our position that valuing the price of intercompany transactions for a, a service transaction, service functions, is a very different matter from valuing intellectual property in the context of value partnership interest; That those are two very different areas within the, you know, economics in transfer pricing fields. And so we would ask that, that the other side lay the foundation for his expertise in that, and then we'd be allowed to Voir Dire him on that.

THE COURT: Okay. Any response to that?

MR. ANTLEY: The study itself says that it's based on transfer pri- -- the transfer pricing analysis and the 482 regulations.

THE COURT: The study itself?

MR. ANTLEY: Yes, Your Honor. And, and I'm happy to pull it up. It's Joint Exhibit Number 55.

(Joint Exhibit 55 was referenced at this time.)

THE COURT: And she said he hasn't testified specifically regarding his ability to analyze ownership versus, I think she said

intellectual property. Is that what you said?

MS. GEER: Yeah. I said, valuation of intangibles.

THE COURT: Intangibles.

MS. GEER: And also valuation of intangibles in the context of valuing partnership interest.

THE COURT: I think you're expanding a little bit now, but.

MS. GEER: That is -- that's what I originally said.

THE COURT: Okay.

MS. GEER: Yeah.

MR. ANTLEY: But if, if, if Your Honor thinks that, or if it's -- if the Court decides that the, the fact that the study itself says it's based on transfer pricing analysis and 482 --

THE COURT: Well, I mean it -- I think you could offer me further clarity in this area regarding it.

MR. ANTLEY: And I'd, I'd be happy to ask Dr. DeRamus his qualifications regarding valuations.

THE COURT: Well then if you would be happy to, I would not want to stand in the way of that.

Go ahead.

MR. DeRAMUS - DIRECT EXAMINATION CONTINUED BY MR. ANTLEY:

Q: Dr. DeRamus, could you -- did, did you hear the discussion earlier about Joint Exhibit 55, the valuation study?

A: I did.

Q: Did, did you review that study?

A: I did.

Q: Okay. Could you tell the Court your relevant experience and expertise in valuation studies?

A: Sure. I would say I've done valuation analyses for asset transfers and particularly for internet -- for intangible assets pretty much over the entire course of my 30 year career in transfer pricing. In fact, most of the dispute issues, the thornier issues in transfer pricing, all relate to transfer -- to, to intangible property. The, the pricing of headquarter services is actually a fairly routine function. The analysis required to appropriately benchmark headquarter services is fairly routine, again, from a transfer pricing perspective. So the, the intellectual property that I've analyzed in the past has

involved transit -- has involved asset transfers. In fact, I mentioned earlier, kind of the Perrigo litigation where I testified on behalf of the government where I was qualified to testify in that matter that was very much all about intangible property, and the transfer of that intangible property from one related party to another, and specifically the value that was ascribed for that trans- -- that asset transfer. I provided the opinion in Court that that was vastly undervalued. And I provided my analysis of a range of, of different alternative values for that, that property based on the evidence available to me to perform that analysis. I would say that's -- I'm pretty much bookending my, my work in transfer pricing on intangible assets because I've done similar analyses back in the early 2000s and the late 1900s -- 1900s. Sounds kinda weird, doesn't it?

THE COURT: Maybe you need to really doctor that photo.

DR. DeRAMUS: Put in some more wrinkles.

Q: So the -- I've also worked on intangible

asset valuation issues more broadly in my other litigation work. I've testified on intellectual property issues for patent infringement cases, for example, in regard to, I mean with regard to damages, and also infringement issues. I've also testified on valuation issues which included intangible property for -- in disputes related to ownership interest in a particular enterprise, shareholder interest in a particular enterprise. Several -- happy to point you to several different parts of my CV where I describe that experience.

MR. ANTLEY: If you don't mind pulling up his CV. It's Joint Exhibit 61. If you could scroll down.

(Joint Exhibit 61 was referenced at this time.)

THE COURT: Actually, just ---

Q: Which page would it be on?

A: Let's start with the first page, please.

MR. ANTLEY: If you could scroll up a little bit.

A: So right there at the top, Western Digital Corporation.

MR. VON LEHE: What's the ---

MR. ANTLEY: We're in the section Selected Transfer

Pricing and Tax Experience of Dr. DeRamus' CV.

A: So the very first bullet involving Western Digital Corporation, as you can see references that I analyzed the development and value of hard disk drive technology, that was very much central -- a central issue in that case. And that also involved a transfer of, of the responsibility for that technology, and ultimately similar issues in terms of royalty payments, etcetera. The Perrigo matter, the second bullet, was also one in which, as I mentioned before, I analyzed the value and I came up with a value of the technology, of the asserted patent rights that were transferred from -- or I should say broader intellectual property rights transfer from one party to another. In the Purdue Pharma case, I extensively analyzed royalties, and in transfers of certain rates between the entities. Although I did not come up with a valuation, as I don't recall doing a, kind of a broader valuation in the same way of saying, here is the value of a patent estate, or the value of a particular asset the way I

did to the other ones. But nonetheless, it was very much all about -- or centrally about intellectual property. Go on down below. Well, Tractor Supply was about a transfer of certain functions. I don't recall if there were intellectual property issues there, but there were in AutoZone. There was more about valuation of the trademarks, but not so much in a asset transfer context. It was more about the royalty. I've -- on this bullet about the transfer pricing documentation for a large multinational pharmaceutical company, that was the value of, of an acquired intangible asset, effectively a portfolio of patents intellectual property. I'm happy to keep going through that. They're the numbers -- there, there are a large number of similar other types of engagements, including the intellectual property type litigation and other third-party disputes.

Q: So would you describe this area of expertise in the valuation of intangibles? Is that how you would describe it or how would you describe it?

A: Yes, I would say it’s valuation more broadly.

But valuation of intangibles tends to be where the area of dispute comes up more clinically, but as I said, I testified recently on a -- in a matter involving a dispute about the value of a company, so it's a valuation writ large, and that valued company included to have a wide range of different kinds of assets. But the same general approaches, or often the same general approaches are used whether you're valuating a company as an entirety or kind of a narrow piece of that company in terms of intellectual property.

EXPANDED MOTION TO ADMIT AS EXPERT:

MR. ANTLEY: At this time, the Department would offer to expand Dr. DeRamus' qualifications as an expert also in valuation.

THE COURT: Valuation of?

MR. ANTLEY: In the broader sense.

THE COURT: Okay.

MR. ANTLEY: Including valuation of intangibles.

THE COURT: All right. Voir dire?

DR. DeRAMUS - VOIR DIRE BY MS. GEER:

Q: Morning, Dr. DeRamus.

A: Good morning.

Q: So are the certifications that you believe would qualify you to conduct valuation analysis your PhD in Economics and your experience?
A: Yes.
Q: And do you have any specific other certifications that are specific to valuation?
A: No.
Q: To business valuations?
A: That would be encompassed within my PhD and my relevant training and experience as an economist.
Q: Any specific certifications regarding the valuation of intangibles?
A: No.
Q: Any specific certifications to financial analysis more generally?
A: No. And when you say -- I mean other than my PhD.
Q: Are you a member of the American Society of Appraisers, the ASA?
A: No.
Q: Are you aware of what this organation -- organization does or its purpose?
A: Yes. Generally.

Q: Would you agree that it sets the standards for all types of valuations including business valuations and tangible valuations and the market value of businesses and business interests?
A: That's generally my understanding of what it -- what it does. These are generally organizations that are often applied to folks with a -- maybe an MBA or a, an accounting background. So they are folks who may decide to specialize in valuation, who come out of that at background and specialize in valuation and seek that kind of certification.
Q: What about do you have a Business Valuation, called a BV?
A: No.
Q: Accreditation, sorry. What about -- and I think that's also known as an ABV, an Accredited Business Value -- or do you have that certification?
A: No.
Q: Are you aware of the requirements to obtain a business valuation accreditation?
A: No.
Q: Do you have the CEIB designation, which

stands for Certified in Entity and Intangible Valuations?

A: No.

Q: Are you a CBV, which stands for Chartered Business Valuer?

A: No.

Q: Do you have an IA, which stands for Intangible Asset Appraisal specialty designation?

A: No.

Q: Are you a CFA, which stands for a Chartered Financial Analyst?

A: No.

Q: Are you aware that the IRS requires for a valuation to be considered a qualified appraisal?

A: I would have to know the specific context. I work extensively for the IRS, including in various litigation matters, including the two that I mentioned on the screen and those involved with valuation analyses. So I don't know what specific requirements they would -- what they, they have for other types of valuations offered in different kinds of context.

Q: Okay.
A: But in, in expert witness testimony, that has never been a requirement for me.
Q: Okay. Are you aware of what the requirements of the uniform standards of professional appraisal practice are?
A: No.
Q: Are you aware of the professional and experience and qualifications required by the IRS for an individual to be accepted as a qualified appraiser or a valuation specialist?
A: No.
Q: And I assume you're not qualified by the IRS as a qualified appraiser or a valuation specialist?
A: Not so far as I've heard those names, called out specifically, but like I said, I have been offered by the IRS as a witness to testify on valuation matters. So I'll leave it to you to draw what inference, inferences you may -- you may about that in terms of their perception of my qualifications and ability to testify on very complex valuation issues.
Q: You indicated that you conducted valuations,

including valuations of intangibles. Approximately how many valuation studies have you done on intangibles?

A: On intangibles? I can't recall, it's a very large number.

Q: Can you give me a ballpark?

A: Over the course of my career, maybe 20 to 30? I just don't -- I don't recall with any increased specificity.

Q: And can you describe the, the general type of transactions that were involved?

A: In would range from studies of principally, it'll be technology. That's where most of the intellectual property disputes arise, and internet -- in a transfer pricing context it often involves the transfer of the -- or I should say the disputes often arise when there's a transfer of technology related intangibles from one geographic location to another in terms of the cost responsibility for those functions. I have worked extensively on trademarks as well, both in a litigation and non-litigation context. And I'm trying to think if there's been other cases that have been more kind of catch-all,

kind of a broader range of intangibles that might encom- -- that might encompass things that are not easily classifiable as trademark versus, versus patent, for example. So actually, trade secrets would be in there as part, part of the -- some of the work that I've done before.

Q: Have you ever performed a valuation study regarding an intangible of a retailer?

A: Of a retailer? I don't think in the sense that you think it me- -- or I -- but I -- if you're talking about the specific intangibles of like a trademark, or a specific asserted trade secret, no, but there are -- but I have worked on valuing the ability of a retailer to generate a stream of interest income from issuing of credits. And I think there are -- there may be ways in which one could describe that as an intangible generating activity, to the extent that is a -- of a long term property or long term ability of the company to generate value that is not otherwise captured in a value of its tangible assets. So I have done that.

Q: But no studies on the valuation of trademarks

and trade names owned by a retailer?
A: I have evaluated trademarks and royalty rates, but not ---
Q: Sorry, I want to make sure you understood my question.
A: Sure.
Q: Not just valuation analysis, performed a valuation study?
A: I have analyzed -- I think to make sure I understand or I'm responsive to the ---
Q: Yes.
A: --- substance of your question. Oftentimes, when I think of valuation, I do you think of price in terms of how much a intangible asset is worth and therefore it should be priced and paid for an a curring -- on a current basis. So for example, in a royalty rate calculation, and in that, I believe I have, yes, studied and analyzed royalties paid by retailers in other environments. But I have not done, to my recollection, a -- an analysis of a, what is the current value, i.e. the net present value of that future stream of royalties discounted to the present, I have not been asked to do that calculation

to my recollection for a retailer.

Q: Have you valued intangibles or other business interests in the context of valuing partnership shares?

A: I have analyzed issues related to partnership shares and valuation issues that arise in, in partnership agreements.

Q: And again, back to my question, it's not just analyzed, but performed a valuation study?

A: It was, yes I should say -- I'm sorry, it was a valuation study to determine the appropriate allocation of the sale proceeds of a business. So a business was sold, and there was a dispute between the partners as to who should get what from the sales proceed, and so part of my analysis was to establish the value and especially the relative value that should be assigned to each of the partners. So that, that is a issue that kind of comes -- that and it was relatively recent, so it sticks in my mind. I would say a lot of the transfer pricing issues that I've worked with in the past where there has been a transfer of, of an asset, an intangible asset, there is often kind of a Byzantine set of ownership

relationships and ownership percentages where I've had to kind of trace through those ownership percentages. But it wasn't in the context of the most recent example that I mentioned in terms of literally defining what is the ownership share. So I've analyzed the, the implications of partnership, partnership interests in a value of an intangible, but the one that kinda sticks in my mind most readily is this other engagement that was fairly recent.

Q: And you -- what intangible were you evaluating in that?

A: In the -- in the one that I meant -- the most recent one?

Q: Yes.

A: That would have been kinda the entirety of the business. So then that's kind of the broader -- the excess of the val- -- of the value of the future cash flows of the business relative to the tangible property associated with the business. So to some extent, you can think of that as almost a locational type intangible. Or it could be one of a, kind of -- the value of the

contract that it had to estab- -- to establish a retail location. Actually, it was retailer. I should have said, I'm sorry. It was a -- it was in the retail industry. I don't know why I just forgot about that. So, so it was a business that had effectively an operating franchise to operate in a particular location. And, and so it was evaluating the, the profitability and the excess profitability associated with that, effectively that franchise.

Q: And you came up with a valuation of the trademarks and trade names of that retailer?

A: Well again, it wasn't the -- my charge wasn't to define it as narrowly as that. My charge was to define what is an appropriate allocation of the value of this business, retail business, between the various partnerships.

Q: Okay.

A: The, the various partners, based on the effect of the assets and capabilities that each of the partners brought together -- brought to the business, as well as taking into consideration the partnership agreements

that existed between, between the parties. So the, the intangibles effectively being valued is really the intangibles associated with the entirety of the business and not with one specific intangible versus another.

Q: But no individual valuation of the specific price of the trademarks and trade names of that retailer?

A: Not of the trademarks and trade names as an explicit line item in my testimony, no.

Q: Have you ever published anything on the valuation of intangible assets in the context of valuing partnership assets?

A: No.

Q: What about just either of those components separately? Have you ever published anything on valuation of intangible assets?

A: No.

Q: And have you ever -- I assume that means you have also never published anything on valuing partnership interests?

A: Well, I'm sorry, I sh- -- when I said -- I said no maybe a little too quickly. I, I -- part of my dissertation was on valuing of intangible assets and the -- effectively the

extent to which trade names and advertising contributed to the value of long-term assets for a company. But I -- I've -- I interpreted your question to mean have I ever published something in a journal.

Q: That's what ---

A: So, no I've not published anything in a journal on one of those topics.

Q: Have you ever taught any seminars or given any presentations about the valuation of intangible assets in the context of valuing partnership assets?

A: Not in the context of partnership assets, but in a broader context, yes.

MS. GEER: So, Your Honor, it's our opinion that --

THE COURT: Let's just -- do you have any responsive questions?

MS. GEER: Okay.

MR. ANTLEY: No questions.

THE COURT: All right. Can I ask this?

MS. GEER: Please.

THE COURT: Ms. Geer went through a variety of credentials like of certified appraiser, a -- was it BAB or BBA?

MS. GEER: There was a BB and I think there might of been a BBA as well.

THE COURT: Okay. And those types credentials. Are you -- why would you be able to give your opinion in this case, even though you don't have any of those credentials?

DR. DeRAMUS: I think the -- a lot of those credentials, I think, evolved out of a specialized need within the accounting professions or folks that have a Master's in Business Administration to demonstrate that they've mastered the skills associated with valuation. I think a lot of it actually historically probably arose out of the valuation of tangible assets, where there's probably a much greater volume of this kind of work being done. Over the years, I would say, not just the 30 -- in the 30 years that I've been in this business but even prior to that, I've come across experts, basically valuation experts, they come in two flavors: one, generally PhD economist, and two, generally folks with an MA, a master's, or an MBA or an accounting background that have gone through these certification processes.

Ultimately, the principles of valuation are based in economics. And so to some extent, I think the Courts have probably recognized that, by dint of a PhD economist's training and experience, they have the requisite tools to reliably provide an opinion about valuation issues. This is particularly the case for intangible property, which as I mentioned earlier, is one of the harder issues to quantify with any kind of the reliability. It's also the one where I think cookie cutter kind of approaches to valuation are often un-- entirely unreliable. So most valuation, the valuation profession, I think, is probably focused a lot on things like comparables. And, you think about selling a house where you have a set of comparable houses so that -- comparable sales that have occurred to determine the value of property. Whereas intangibles, particularly like trademarks or, or patents require very in-depth analysis of the actual contribution of that intellectual property to the broader revenue generating and profit generating capability of the company. And also just to distinguish the contribution

of that particular asset versus other kinds of assets that the company might have. Those are deeply economic questions there, but -- at their heart. It's what is -- what makes a company tick? What is it that is required to drive profitability in a particular company? How is the company able to exercise pricing power in a market? Those are fundamental about -- to my profession of economics, and also within my field of specialization, industrial organization. And that's why I think over time, if you see the, the witnesses who testify on valuation of intellectual property in, for example, patent infringement cases, you see an increasing number of economists testifying on those issues. And the same thing on transfer pricing issues. I think all -- virtually all of the expert witnesses I know of who have testified on major transfer pricing disputes involving the valuation of intangible property, those have all been PhD economists. So, I think it is a, a difference in terms of economists and accountants come up through the ranks as it were through different ways, but

at the end of the day it's up to the Court and or the person who hires you to decide whether you have the training and experience necessary to reliably measure a, a piece of intangible property.

THE COURT: I'll hear from you now.

MS. GEER: So it's, it's our position that those certifications are -- do have meaning and, and are necessary in the context of valuing an intangible, particularly in the context of the added issue of the partnership interest shares. And it -- it's to me, if you don't have those certifications, it's hard to, to say that you've got the expertise to give the -- give the opinions on the -- on those valuations.

THE COURT: Any response?

MR. ANTLEY: Yes, Your Honor. So under South Carolina Rules of Evidence 702, the only requirements to be qualified as an expert is to have knowledge, skill, experience, training or education. Dr. DeRamus has all those. You don't have to have all of them, just one of them would be sufficient. Doesn't mention anything about certifications. It'd be

similar if -- to, to excluding Professor Pomp because he doesn't have an LLM in tax. He -- you can demonstrate expertise through other, other methods besides just a certification.

THE COURT: All right. I, I qualify him as a specifically, you said an expert in valuation, but the question is expert, whether he has expertise in valuing -- I called it intellectual property at first but y'all using the phrase intangibles. So -- but it appears to me he certainly has knowledge in that area, and has skill in that area, and he has experience in that area. Training, I don't' know about the training. I don't know what training would be, but he has education in that area. So as far as he -- regarding the credentials that you have set forth, that would go to the weight of his testimony of which I will consider throughout this case, especially after I hear your expert's ---

MS. GEER: Understood.

THE COURT: --- response in this area.

MS. GEER: Thank you.

DR. DeRAMUS - DIRECT EXAMINATION CONTINUED BY MR. ANTLEY:

Q: What is your overall opinion regarding the reliability of the taxpayers two transfer pricing studies, in other words the Ernst and Young transfer pricing analysis for CarMax for the fiscal years ending 2012 and 2015?

THE COURT: I just said earlier that I'm not going to allow him to attack Ernst and Young's specific study, because they don't have Ernst and Young here to respond. So I would allow him to go into this area of the valu- -- the current valuation that exists. And you can respond to that right now if you wish, but right out the chute you're going against what I ruled.

MR. ANTLEY: Your Honor, I referenced the, the transfer pricing studies, not the valuation that would -- that was ---

THE COURT: Okay.

MR. ANTLEY: --- that we ---

THE COURT: Okay. I'm sorry.

MR. ANTLEY: Sorry if that -- if that wasn't clear. So ---

THE COURT: I might just be too sensitive, I'm sorry. All right. I've got him over here. Okay.

Q: So in ---

THE COURT: Go ahead.

Q: --- reference to the transfer pricing studies from 2012 and 2015, what is your overall opinion regarding the reliability?

A: I, I consider them to be wholly unreliable from an economic perspectim -- perspectives. They are also in- -- inconsistent with my understanding and experience in applying the requirements of the IRS Section 482 regulations. And they are also incomplete as they fail to address a very large amount of activity by the retail stores, namely the origination of the finance contracts.

Q: Are the two studies similar in their approach discussions, methods and conclusions?

A: Yes, they're highly similar in their analytical approaches. Although there are some differences in the specific, comparable companies they use, or comparable transactions for some of the transactions. And they update their analyses with more recent financial data in the 2015 study compared to the 2012 study, but they are very similar in all of the regards.

Q: And, and just to make sure we're consistent within -- and clear about which entities we're relate -- we're referring to. Could you tell me your understanding of the functions of the various CarMax related parties?

A: Sure. So CarMax Inc. is the parent company. The operations of the -- of the company are performed by CarMax Auto Superstores, Inc., and CarMax Auto Superstores West Coast Inc. CASI is I often refer to as either CarMax East or just East, because it has responsibility for the operation of the retail stores in the Eastern US as well as a number of other western states like Texas that are nominally -- that are in the West, but they're under the East umbrella. And whereas CarMax West is primarily comprised of California, that's the larg- -- it's the largest state in which it operates, but it also has operations in other western states like Oregon and Utah and Washington state for example. The management functions are currently performed by CarMax Business Services, LLLC, CBS. And that was created as

a result of this 2004 restructuring, December 2004 restructuring. And it's also where the CarMax Auto Finance or CAF business resides.

Q: Could you please explain or, or summarize why you concluded that the Ernst and Young transfer pricing studies were unreliable?

A: Sure. The big picture is that they apply unreliable methods or they apply methods that are inappropriate to the paper transactions. And they apply them in an unreliable way to in effect siphon off a substantial fraction, approximately 70 percent of the operating profits of the operating companies to CBS, the, the management company affiliate. So, the company does so -- I'm sorry, the studies do so in a couple of different ways. So first, it divides up the transactions into five distinct transactions. The first one is a trademark transaction. The second one is a business, I think of it as a back office services transaction. The third is an advertising services transaction. The fourth is a real estate services transaction. And the fifth is a data/business analytics/strategy service. So it uses a

different method to price each of these different transactions even though effectively, sim- -- we only have two different intercompany contracts. We've got a license associated with a trademark, and then we have a management services contract between CBS and the operating companies. So my primary concern is with regards to transactions one, three, and five, the trademark, the advertising and the so called data analysis, business analytics function. Those are the ones where I think it applies an inappropriate method or it applies it in an unreliable way. And it is the way in which it shifts the vast majority of it's profits from the operating companies over to CBS. The other two, while I don't think that they are necessarily the most reliable way of doing it within the broader context of the structure, the operating structure, nonetheless, they applied a method of the comparable profits method, the CPM, which I consider to be a reasonable method, and they applied it in a generally reasonable way even if I would have applied it differently with

different sets of comparables. One of the biggest concerns I have with the Transfer Pricing Study is it fails to consider the, the effects of the, the disproportion ownership interest that CBS -- that West has in CBS. So West owns a 93.5 percent ownership share of CBS, whereas East only owns a six and a half percent ownership interest. So ultimately, in transfer pricing, it's all about -- it is about how you get to a number, but at the end of the day you're evaluating the reasonableness or the arm's-length nature of that end number, the number effectively that shows up on the tax return. So it -- the -- even though the transfer pricing report mentions the ownership interest percentages, it doesn't look to see whether those ownership interests are established consistent with arms-length principles such that -- and if they aren't, it means that the income, all of the profits that are flowing over to CBS as they kind of go through the waterfall for the ownership interest, that the net result income will be -- will be a non-arm's-length result if those percentages are

inconsistent with arm's-length principles. So that is my other criticism is -- of the study is that they fail to take that additional step and, and analyze the arm's-length nature of those, those ownership percentages. And last, the, I guess the bigger criticism, I'm not quite sure how much of its criticism of the studies themselves or CarMax, but Car- -- but the studies do not address at all the finance business, which in the studies they state that it's effectively outside the scope of what they do. But it just leaves a very large piece of revenue generated by the -- by the, the retail stores in the first instance, from customers that come into the stores, it just leaves that hanging as a substantial flow of income where there's zero documentation about whether the, the resulting allocation of income between the two entities associated with that -- or between CBS on the one hand, the owner of the CAF business after the restructuring and the operating entities, there's nothing to -- that the companies provided to establish that that is an arm's-length result.

THE COURT: You said the last one, it's not so much a criticism of the study, but of format. But it sounds to me like that if that information is not in the study, then you're telling me that it's -- I'm not a proper -- or you can't reach a proper evaluation.

A: Well ---

THE COURT: So, I ---

A: Certainly. So what I -- I think the issue is -- well, it's one of the reasons why when I talk about what is my opinion about a company's transfer pricing. I have an opinion both about the studies themselves and the policies as they were implemented. And so as a -- typically in a transfer pricing exercise, one -- an analyst will get a Transfer Pricing Study that covers all of the tran- -- all of the related parties at issue. All the -- sorry. All the related party transactions at issue. Here, there's just this big gap with regard to the finance business. So, to that regard, there's not -- the company has not even provided what I think is the minimal amount of information necessary to even begin to us to assess

whether the compensation received ---

THE COURT: I, I get the distinction.

A: Okay.

Q: Could you please summarize your opinion regarding whether the company's tax returns based on separate entity reporting fairly reflect the economic activity of CarMax in South Carolina?

A: Sure. So I, I do not consider that the, the, the company's use of separate reporting, particularly the way they've implemented the transfer pricing policies, I don't think that it represents, fairly represents from an economic perspective the economic activity of the company in South Carolina. There are a broad number of reasons for that. First and foremaste -- foremost, this is a retail business, a brick and mortar retail business. The whole reason for being for the business is to sell to retail customers. And therefore, you'd -- all of the revenue that is generated by the company is generated at that retail location. So there is -- that's the first reason why as an economist, I would expect the vast majority of the value

generated be attributable to that brick and mortar function, and those brick and mortar locations. Here, this is also, as I've analyzed their -- the company's 10k's and other industry reports, there's an integration of the, kind of the broader finance business and the retail business. It's not like these are se- -- they're separable in some general analytical sense, but not in a -- from a -- an economic perspective. The only reason CarMax makes any auto loans is because it's selling cars to customers. It's because if I'm a customer, I walk into the store, and I buy a, buy a car, at that point then I'm going to turn to the salesperson, if I need financing, and acquire financing from CarMax. I don't go to CarMax because I bought a car from a, a Toyota dealer down the street. So there's that kind of a -- in the broader integral nature of the, both the finance and the -- and the retail business makes it such that all of that -- again, all that revenue is attributable to that retail location. It is not the case where you might have different kinds of companies, for example a

conglomerate, that has a, like a windmill business in one company, in one area, and a small retail location in another state, in which case that separation might fairly reflect the economic value of the entity where if the -- if you're looking at the retail location, for example, versus the windmill business, that's not what we have here. We don't have a conglomerate kind of operation, nor do we have kind of a, a type of business that is easily separable between things like R&D like you would in a -- for a pharmaceutical or a high tech product, where a lot of the value generation is going to be in the product design function that might reside in a different geographic location or a different geo- -- or a different entity -- in a different legal entity. And that legal entity may have incurred substantial costs and substantial risks associated with developing those intangible assets. Here you have, again, this integrated business that is focused on one thing, and it does very well, which is selling used cars at retail. And therefore that's where I consider the, based

on the sum total of everything I reviewed is that, that separate reporting the company's implemented, particularly with this -- these disproportionate ownership shares of CBS, that that results in a non-arm's-length result and -- I'm sorry, and it's the -- where the result is also inconsistent with the economic activity being performed in the state.

Q: In your analysis, did you consider whether CarMax East, CarMax West and CBS were interdependent businesses?

A: Yes, I did. I should say the -- I think I've described kind of my overall conclusions in my prior answer to that, but I do consider them to be highly integrated. First and foremost, the -- I said -- I described the interrelated nature of the finance and the -- and the automotive business. And so the finance business nominally sits with CAF, which, which sits under CBS, but nonetheless that is an integral part what happens at the retail level. More importantly, these broader headquarters functions are also fundamental interdependent with the operations. So it's not like you have a -- an independent

consulting business that, that CarMax runs, an independent data analysis consulting business that it's -- that it -- where it provides services to any company out there for whatever purpose. The only reason it has this data analytic function is the only reason -- is, is because it has retail stores, and that those retail stores are providing -- are, are selling cars. The same thing goes with more mundane activities, the, the headquarters activities. You don't have an accounting function independently of having an operating -- operations to provide those accounting services or strategy services too. More broadly, I think CBS, I'm sorry, CarMax East and CarMax West are inde- -- interdependent. This is an unusual business for a retailer insofar as where the inventory comes from. I think other types of retailers that folks may have experience with before, the headquarters is responsible for entering into contracts, the suppliers of that inventory. Well, how does a business like CarMax get its inventory? CarMax is not -- it has a very small new car business, but the

vast, vast majority is from used car sales. And it gets those -- the u- -- the used cars that it sells are in fact cars it purchases from customers. So who does that purchasing function of inventory? That's the retail stores. A customer walks into the store, and the customer will often want to be trading, either trading up to a car, to, to a different car, or they want to dispose of a car that they have. Car- -- CarMax will ha- -- will issue an appraval -- appraisal and then offer to buy the, the person's car if it is a car that meets the type of specifications that the company has for putting the cars on the -- on, on, on the, the showroom. Typically it focuses on late model cars, relatively low mileage under 60,000 miles. It will take that car, recondition it, fix whatever's wrong with it, make it look nice, fix all the cosmetic problems, and, and sell it to other customers. At the same time, it then turns around, hopefully, and sells that same customer a, a new car. It doesn't condition the purchase of inventory on the sale of a --

of another car to that -- to that customer. Or it may dispose of that car, that -- the, the retailer may dispose of that car in a wholesale auction. You know, if it's an older car, if it doesn't me- -- if it's like a 100,000 mile car, it -- and they just see kinda greater value in terms of disposing it at wholesale versus offering it at, at retail. So that integrated nature of that business, that, that source of, of inventory, is really a collective activity of the -- of all the stores together. Approximately 30 percent of the cars that are sold at any given location actually come from different locations. So, for example, if you buy a car here in South -- you walk into a CarMax sto- -- store and you want a light blue Toyota Corolla, there's not one there in that store and there happens to be one in North Carolina or Missouri or some place farther west, you can get that car delivered to you and, and the local store will make that sale. But it's procuring that inventory and taking advantage of that kind of broader nationwide footprint of its inventory to make that sale.

And that's one of its important competitive advantages. In that regard, that's why I think it's, it's, from an economic perspective, I think there is an integration of that kind of US-wide business because of that integration of inventory.

Q: Did you analyze the 2004 restructuring that created CBS and the trade flows at issue?

A: Yes, I did.

Q: Why did you analyze the restructuring in 2004?

A: Well, I'd say there's two principal reasons. One, one is completely independent of the ownership shares. And that is, whenever there is an asserted intangible asset from a transfer price, and, and whenever there's a significant payment for those intangibles, as there -- as there is here, it's important to assess which entity develops that particular intangible whether there was a change in terms of the, the nominal legal ownership of the -- of the intangible as part of a restructuring. And because ultimately, there is a, as I, I think I said maybe yesterday, that there's almost an A versus B analysis.

Like there's a -- if there was a restructuring and there was a -- an intangible being used in the business at a particular time, and if there were change in the way that, that intangible was -- but the assignment was, was moved from one party to another, and I observed a very different compensation. The results from that, it, it requires a big question as to why that happened. There, there is -- one would not exp- -- the regs have a -- the 482 regulations have a long or frequent references to the company's available alternatives. So a company that has a valuable asset at arms-length, somebody doesn't transfer it to another third party without being remunerated for that asset.

OBJECTION:

MS. GEER: Your Honor, I would just object. I didn't realize from the question that what all was going to come after, and I just for the -- for the record purposes would like to continue to object to him providing testimony that is a direct attack on the valuation of those assets, just for record preservation

purposes.

THE COURT: An evaluation of what assets?

MS. GEER: Of the assets that were transferred in the 2004 transaction.

THE COURT: Okay.

MR. ANTLEY: Our, our response is that that ---

THE COURT: Well, objection is noted is what ---

MR. ANTLEY: Oh, thank you.

Q: And I don't know if you -- if you got cut off so let just ---

A: Yes.

Q: --- ask this question to be sure. Could you describe your conclusions regarding or, or about the restructuring as it ---

THE COURT: Had you finished answering?

A: Not quite, no.

THE COURT: Okay.

A: So I said there were kind of two different components to why I look at the 2004 restructuring, one is because there is compensation that is -- there, there are char- -- intercompany charges being made during the years at issue for the trademark and for something generally referred to as business process intangibles, which primarily

reflects the data analytic function. And there wa- -- those are functions that were performed by East, by CarMax East, prior to the restructuring. And those are fun- -- and even with regard to the advertising, the advertising was a function performed by CarMax East, not CarMax West. CarMax West, all it did was operate stores. It had no other ---

THE COURT: All it did was what?

A: Operate stores.

THE COURT: Stores.

A: Right. So the entirety of all of the -- of the functions associated with the headquarters functions were part and parcel, indistinguishable, from the, the, from -- in CarMax East is not separated out into CBS. CBS was only created in 2004. It, it also -- East, also, was responsible for the entirety of the finance function. So all of that CAF business, the Consumer Auto Finance, the, the CarMax Auto Finance business, that was all subsumed within CarMax East. And so now when I observed on the -- in the tra- -- during the years at issue, I observed substantial payments being made by CarMax East to CBS and

effectively to CB- -- to CarMax West via that ownership interest, it's a compensation of a very large amounts for a function that CarMax East in fact previously performed. And for -- if there are any intangibles associated with that, these are intangibles that CarMax East would have been instrumental in developing because it was the only entity at the time, at the time of the restructuring that was actually performing these functions. So that is kinda -- that does fundamentally go to the issue of how do you price the transactions during the current time period independently of the ownership shares. The ownership shares -- the restructuring is important, because it is where the ownership shares, the 93 and a half and 6 and a half percent were established. So this has -- this case has an unusual fact pattern in that you have some of this flow-through of the income that CBS earns from its two operating -- from the two operating companies back to the operating companies in what I consider to be a non-arm's-length matter. The 93.5 percent and the 6 and a half percent

ownership shares, or the distribution shares as it were, of those, means that the profits that, that CBS is earning from East are kinda flowing through over to West in a way that does not reflect arm's-length dealings.

Q: Can you please summarize your opinion from an economic perspective as to why combined entity apportionment would reasonably reflect CarMax's economic activity in the state of South Car- -- of South Carolina?

A: Sure. Well, again, from a big picture perspective, I -- because I consider the broader business to be appropriately considered as a -- as a -- an integrated basis that a allocating or apportioning the income of, of the entirety of the company to South Carolin- -- Carolina I think would provide a reasonable reflection of the economic activity that the company engages in in the state. The, the headquarters function that -- ultimately it would have the same effect as if one were to allocate the costs of the headquarters function in its -- on the transfer pricing side at cost to the various entities, or it would have -- you could then

get to the same results if the -- if the ownership interest or the distribution of the CBS profits were being ultimately flo- -- flowed down to the partners in a -- in a more of a -- on percentage terms that were reflective of arm's-length dealings. So I think either way to think about it, either in terms of it's the -- it's a result that is consistent with an allacu- -- simple allocation of costs of the -- of the -- of the headquarter's function, and it's also consistent with the unique issues we have here. It's a good -- it's a way of resolving that unique issue of having these non-arm's-length ownership interests of CBS.

Q: As, as part of your assignment, have you analyzed CarMax's overall consolidated level of profitability?

A: I have.

MR. ANTLEY: If you could go to Slide 1 please? Okay.

(Slide Number 1 was referenced at this time.)

Q: Does this figure show CarMax's consolidated profits over time as reflected in its federal tax return?

A: Yes. And, and I, I think it's always helpful to start with some of the top line numbers and the aggregate numbers to get a sense of the overall amount of profits at issue and the overall level of -- the degree to which the taxpayer is profitable, or maybe even unprofitable. And so overall, the company earns between 800 thousand and 900 thousand -- I'm sorry, 800 million and $900 million of taxable income each year.

MR. ANTLEY: Can we go to the next slide, please.

(Slide Number 2 was referenced at this time.)

Q: Does this figure show the profitability ratios of CarMax on a consolidated basis over time?

A: Yes. And I've provided three different alternative measures of profitability and transfer pricing jargon, these are often referred to as profit level indicators, or PLIs. So one might use an operating margin or markup on total cost or return on assets in different ways in a transfer pricing analysis, depending on the specific taxpayer. I often find it very helpful to review these as well as other profit level indicators to make sure I understand from a holistic

perspective, the profitability of the company. These generally show, from a -- from my perspective, working with -- on, particularly on retailers, a very healthy operating margin over the, the, not only over the audit years but even over a broader historical time period of around 6.8 percent or nearly 7 percent. And a markup on total costs of 7.3 percent on average, and a return on assets of 7.4 percent. Again, I consider these to be very healthy levels of profitability for a retailer, and in fact, on the higher side.

Q: I, I think you've mentioned operating margin, markup on total cost and return on operating assets?

A: That's correct.

Q: And why, why might you focus on one measure versus the other?

A: Well, it depends on how you kind of slice -- well, it depends on the type of business first. So a manufacturer, you typically look on -- you focus on a return on assets, because the manufacturer is typically heavy in terms of the capital that's required, or capital intensive is the nature of the

business. So you tend to expect kind of a convergence of, of a return on assets across different kinds of manufacturers in a -- in a similar industry. The operating margin is something you probably focus more -- or I would focus more in -- for a, for a retailer or for a distributor for example. But also as you kind of go through the different -- as you're slicing up a company's activities into different pieces and different entities and they're trans- -- related party transactions. That's where you may focus on one PLI versus another as a way to establish an arm's-length return for that function. So, for example, for headquarter services cost, you might look to a markup on total cost is the way to, to draw -- to, to benchmark that particular -- it's a PLI you would use to benchmark that particular function.

Q: As an economist, do you consider CarMax's consolidated profitability to be particularly high?

A: I consider it to be not at the high -- I've seen significantly higher margins, for example, with some specialty retailers, but

they are consistently higher than a lot of other large volume retailers that might be selling kinda low -- relatively lower value goods, like a grocery store for example. So it's still considered to be on the high side and on the -- on the healthy side of, of profitability, but not at the extreme end that I've seen in some other segments of the retail industry.

Q: And it sounds like you said this, but so you've compared CarMax's profitability to that of other retailers?

A: Yes, I have.

MR. ANTLEY: If you could go to Slide 7 -- 3.

(Slide Number 3 was referenced at this time.)

Q: What -- are these some of those other retailers or what, what is this that we're looking at?

A: Yes. I saw this, and on the next slide is just a -- provides you with kind of a general sense of the range of, of profit margins that one observes for retailers more generally. And I, I find it again helpful as a -- as a way of setting context to understand what's driving the profitability of a -- of a

taxpayer. So if it's hel- -- to begin with, it's helpful to assess where they stack up relative to other types of retailers to then try and tease out what is it that will lead to a taxpayer having relatively low or high profitability. So, apparel is one area where you have a fairly broad range of, of prof- -- of profitability depending on the strength of the company's brand name for example. The automotive retail -- actually, the automotive retail should be automotive parts retailers. So this would be companies like AutoZone, O'Reilly, Genuine Parts Company. Those are the -- some of the companies that have substantially higher operating margins as retailers. Then you have department stores -- if you want to flip the next -- to the next, next one.

MR. ANTLEY: All right. So we're on slide -- that was Slide 3.

Q: We're now going to Slide 4?

A: Right.

(Slide Number 4 was referenced at this time.)

A: And, and that's where you'll see like food retailers are generally the ones that tend to

be on the lower end of the margin range, grocery stores for example. And then other general mech- -- merchandise stores or specialty stores really will depend on the specific niche that they're targeting. And so you could have even some, some companies that operate a, out of a low price point type operation like Dollarama, having kind of a very high property margin. And so kind of, but then you have companies like Costco with a, a 3 percent margin as, as well. So it really kind of depends on the specific area that the retailers are serving.

Q: And, and are these from what's Joint Exhibit 65, the-- the retailer's side?

(Joint Exhibit 65 was referenced at this time.)

A: Yes. And if there's -- there's one more slide as well, but then summarizes ---

MR. ANTLEY: Go to Slide 5, please.

(Slide Number 5 was referenced at this time.)

A: Yeah. So then, here's where some of the specialty stores crop up. So for example, you see Tractor Supply there at the bottom, and then other kinds of retailers. Not all specialty stores are highly profitable.

Barnes and Noble, for example, in this time period is very low margins. A lot of this goes to the impact of Amazon and online ordering. I think that's one of the big things to tease out in a lot of -- with a lot of retailers is to what extent is a -- the, the local brick and mortar presence really of continued value to the company relative to the ability for companies to purchase a product online. Books, for example, it's not particularly important. All in you see CarMax's profitability, it looks like a little bit -- a little bit above the median of, of the comparable. So that's why it's not one of these surprisingly high profit companies. But nonetheless, because of the nature of the product that it's selling in car dealers, it is none -- I nonetheless consider it to be a relatively high profit company.

MR. ANTLEY: If you could go to Slide 6.

(Slide Number 6 was referenced at this time.)

A: So I've done a similar kind of calculation just for completeness to have these -- the PLIs for the -- sorry, the profit level indicators for these other retailers for

comparison, but you come to the same conclusion if you look at the markup on total cost here. This is a summary for those companies we just reviewed before.

Q: Okay. That's Slide 6 that you're talking through -- describing?

A: Yes. And the same applies to, if you look at a return on assets as well.

MR. ANTLEY: If you could go to Slide 7.

(Slide Number 7 was referenced at this time.)

A: So this is Slide 7, yes.

Q: This is Slide 7?

A: Yes. And so the return on assets is a little bit lower here than some of these other companies. I think a lot of this is because CarMax does have the auto loans as an asset, so it's got a fin- -- this big finance receivable sitting on its balance sheet. So I think that pulls down the, the ROA calculated, but nonetheless, I still consider it to be a, a high profit company.

Q: Have you compared CarMax's profitability to that other automotive retailers?

A: Yes, I have.

MR. ANTLEY: Can you go to Slide 8.

(Slide Number 8 was referenced at this time.)

A: And so, so here I, I've compared to a broad number of other automotive retailers. Again, this is more for context, to really assi- -- to assess whether the, the -- how profitable the company is relative to its peers. And if it is profitable, or even more profitable, what is driving the profitability. And in fact, we do observe it is higher -- has higher margins than a number of its other competitors. So I've done a fair -- so you can see here it's got a 6.8 percent operating margin on average over the time period where the 75th percentile of the -- of the -- the upper end of the quartile range is 4.6 percent. Again, there are other companies here like Camping World Holdings, for example. It’s not an automotive company, but still a distributor of, I think these are probably more RV type, type products. So still very high levels of profitability overall. But -- so one of things I did once I observed this, this relatively high profit margins at CarMax was to evaluate how that -- what was really appear to be driving that. And some of that

appears to be the specific product mix that CarMax is offering. There are two things the CarMax has, it's got -- it's offering these one -- I should start with the size. CarMax is the biggest retailer of used car in the country. There are other auto retailers out there that rival it in size, like AutoNation. But AutoNation also sells a substantial amount of new cars. Surprisingly, or maybe not, I don't know, the margins that, that a, a car retailer earns are higher for certain types of new cars, than they are for use -- I'm sorry, for type of used cars than for new cars. So CarMax's margin will tend to be higher than au- -- than AutoNation on an overall basis because CarMax's selling a greater proportion of its sales are comprised of used cars, and particularly used cars at this, what I'll call, the sweet spot of, of used cars. These are below 60,000 miles, relatively new, I believe it's five -- within the past fI've years. Those the predo- -- 90, 90 percent of the, the vehicles on a CarMax lot are those kind of vehicles. So they tend to have still a lot of value

associated with them. They're priced at a discount relative to what a new car costs. But the net result is there is a significant wedge that CarMax and other retailers who focus on selling those cars can, can earn relative to the typical used lot you might be thinking that's selling cars with 100,000 miles or they may be 10 years old, where those margins and the dol- -- both the percentage margins, the dollar margins are much smaller.

Q: And, and this data, is this from Joint Exhibit 62, the, the car dealer side?

(Joint Exhibit 62 was referenced at this time.)

A: Yes.

MR. ANTLEY: If you could keep going, Slide 9.

(Slide Number 9 was referenced at this time.)

A: Yeah. And just, just again, for completeness I provided -- I, I analyzed the markup on total cost and the ROAs. The markup on total cost shows a very similar view as the operating margin. And if you'll turn to ---

MR. ANTLEY: Next slide, Slide 10.

(Slide Number 10 was referenced at this time.)

A: Ten, yes. The, the ROA is a little bit on

the low. So there's -- this is where it's helpful, I think to see a different ratios. So here, the average return on asset -- or the period return on asset for CarMax of 7.4 percent is actually below the median of its comparables. And a lot of that appears to be driven by the volume of the car loans that CarMax is originating. Even though the other businesses, car businesses, also have substantial finance businesses, it's a difference. It's not as vertically integrated finance business the way CarMax, CarMax's business is.

Q: Have you analyzed the composition of CarMax's assets?

A: Yes.

MR. ANTLEY: If you'll go to Slide 11.

(Slide Number 11 was referenced at this time.)

A: So this slide shows again, kind of what you would expect. One, or maybe part of it, shows what you might not expect. The, the finance loans leases comprise a fairly substantial fraction of the company's operating assets. Aside from that, it is wh-- I think it is what you would expect that a

car business is -- the assets are mostly con-
-- consist of the inventory, i.e. the cars that are sitting on the lot. And then property, plant and equipment, namely kinda either the, the, brick and mortar locations, the concrete, the parking garages, those -- and those -- so that's going to be PP&E line. So those are the two major operating assets that really -- that the company depends on.

Q: Have you analyzed the composition of CarMax's sales?

A: Yes.

MR. ANTLEY: Can you go to Slide 12, please.

(Slide Number 12 was referenced at this time.)

A: So, so CarMax has, I would say on the, the auto side of, of the business, there's two distinguishable segments to that. One is the, the used vehicle -- the used vehicle retail sales, that's the green part here. They comprise a substantial majority of the revenues and the number of vehicles that the company sells. So that's where you walk onto a -- you and I will walk onto a lot, a dealer lot, a CarMax retail lot, we'll buy a car. So then we pop up in the green bars where the

sale is. They're also wholesale auctions, that's the, the gray bar on top. So these are significant sales in -- remember these are -- so this is USD millions of sales. So these are still billions of dollars of sales annually of -- at, at auction. So this is where a customer will come in with a 10 year old vehicle with 70,000 miles, or it might be in a condition that the company makes the assessment that you can't, they can't or don't want to resell it on their lot. So they will re- -- have -- they run an auction for other dealers and they'll sell that to another used car dealer who would then put that one -- that vehicle on their lot. So they still make a substantial amount of margin in the process since they've sourced that particular vehicle from a customer that walked into the CarMax dealership in order to get an appraisal and, and hopefully for that and the -- for the customer, an offer to purchase the, the vehicle from the company. It had -- does have these other two components that I think are really going to be increasingly important the more we talk

about profits, even though they look like they're a relatively minor share of revenues. And that is the finance business, so that's the orange bar at the top. So there is a significant amount of finance revenue that the company earns. This is from interest expenses that they're, they're earning from a -- from customer loans. And these other sales revenues, and those will include things like I think they call it the EPP program, Extended -- I'm sorry, I'll forget all the acronyms. Some will be Extended Service Plans, ESP. So a customer walks in, buys a used car and it's, it's out of warranty. And so the customer says I want a five year warranty on the vehicle, and, and CarMax will sell them that warranty and earn a commission on that. Those are generally provided by third parties, CarMax contracts with a third party to provide that service. But, but CarMax takes a cut out of that, and the gre- -- the, the orange will include that. It's not just an extended service plan ---

THE COURT: Orange includes that or the blue?

A: I'm sorry, the blue. Thank you for the

correction. It also includes things like what's called a GAP, Guarantee Asset Protection. So, again, it's almost like an insurance product. So if you're insured during an auto accident, and your, and your, your car's completely totaled, and you still owe, you know, 15, you owe $15,000 on the car, the insurance company only gives you $10,000, this GAP policy will cover the, the remaining $5,000. So, a CarMax salesperson will offer to sell that policy to a customer who walks into the store. A significant fraction of customers buy these policies, and then CarMax earns a commission on the sale of that product. CarMax also, because it has extensive mechanics on sites that are doing the, the evaluation of the -- of the appraisal, as the car comes in, they want to see how much they're willing to offer a customer for it. They're all -- they also are able to effectively repurpose that mechanic function to offer -- to offer service. And that's actually, in fact most dealers, like a new car dealer will make a substantial fraction of its share of -- a, a

fraction of its income through the sale of -- from the provision of service to customers, even more so than what they earned in the initial -- from, from the initial sale of a vehicle to the customer. So those are kind of the different components to think about in terms of the sources of revenue for the company.

MR. ANTLEY: Let me get a drink of water.

Q: Have you analyzed the composition of CarMax's gross profits?

A: Yes.

MR. ANTLEY: If you could go Slide 13, please.

(Slide Number 13 was referenced at this time.)

A: So here's where you see there's that -- those small little slivers in revenue come out -- come to be actually bigger in terms of when it -- when it com- -- when it comes to gross profits. And actually for, particularly for the finance business, it's even larger for the -- in terms of an operating profit level. So here are the finance that -- I'm sorry, I switched colors on you here, finance here is gray, it's about 25 or 20, 23 percent of the -- actually, on average, probably about 25

percent of the company's gross margin. So before you consider a lot of operating expenses, before the -- any overhead expenses, on a operating profit level it's closer to 40 percent of the company's business is attributable to the finance business. On this, this ESP, the, the Extended Service Plan, the GAP and these other types of products. Again, those comprise al- -- you know, nearly 18, nearly 20 percent of the company's gross profit. And then service is a -- is a smaller fraction, but still in dollar terms, it's significant.

Q: Did CarMax's 10k's provide additional insight into the profitability of its finance business?

A: Yes.

MR. ANTLEY: If you could go to Slide 14.

(Slide Number 14 was referenced at this time.)

A: So here's where you see the -- so this is a, a separate part of the 10k where they describe its CAF, it's CarMax Auto Finance business and some selected financials. I think the important -- a couple of important data points here are circled in red. So you

see it's earning about, in 2018, $857 million of interest income. But the, the -- ultimately the cost of that to the -- in terms of the amount that CarMax actually has to pay to -- for its interest cost associated with each of those loans, leaves it with a margin of about $421 million. So it's a highly -- high profit margin, high profit dollars as well. And then again, this is back to the -- really the very first slide we started with, about a billion dollars, 800, $900 million of total taxable income, $400 million is a big chunk of that total taxable income. We also see down below the net penetration rate, the one that the other piece that's circled, that -- that's 43 percent of the customers that walk into a car dealership to buy customer -- to buy a vehicle actually finance their vehicle through CarMax, which is a substantial fraction. So that's, that's one of the reasons why I consider this to be kind of an integral part of that, of the finance and the -- and the car sales process to be integral, because that's the only reason they're making this

high fraction, this high volume of sales, that $856 million, or $857 million of, of interest income that they're earning is only a function of those customers walking in and 42 percent of them signing on the line to get them -- get a loan from, from CarMax.

Q: Have you reviewed whether other automotive, retailers similarly have finance businesses?

A: Yes, I have.

MR. ANTLEY: If you could go to Slide Number 15.

(Slide Number 15 was referenced at this time.)

A: So here this shows, most of the, the other automotive, purely automotive companies that were in my -- the dealer set that we talked about earlier, this is their finance revenue. Actually, this -- the title says, finance revenues as a share of gross profits. It should be finance revenue as a share of revenue over the audit time period. I think there is a -- so you can see CarMax's share of revenue has a little bit higher fraction, but these other companies have a substantial finance business as well. So they're all earning a significant amount of finance revenue. These revenues actually, I think,

underestimates this percentage, underestimates the importance of the finance business to these other ones, because it's expressed as a percentage of revenue and not as -- not a percentage of their, their operating profits. Every company has its own -- has structured its company -- it's business -- finance business a little bit differently. So a lot of these other companies are really doing under contract with third parties. CarMax, they have -- they have enough -- I'll consider it a -- call it a dual model. So on the one hand, for subprime lenders, if you walk in and you're -- into a car store and you want to buy a car, and your credit score is below a certain number, call it 500, and in order to finance that vehicle purchase, the company will, will outsource the credit decision and the credit itself to another company. So it has relationships with Capital One and other kind of large automotive finance lenders who specialize in subprime lend- -- lending. And they will earn -- and, and CarMax will earn a commission on a type of sale. Maybe

structured slightly differently, sometimes it's -- they'll, they'll sell the contract at a discount, sometimes it'll earn a commission. But generally that's the idea, is the financing is provided by third party. So CarMax -- but then there are other ones particularly for the prime borrowers. So somebody comes in with a credit score of about 700, for sake of argument, buys a vehicle, then CarMax will generally provide the financing for that. The customer's free to decline it. But like we saw in the earlier statistics, 43 percent of the cu- -- of the customers are still financing their purchase with the company. So bottom line is, from an industry perspective, finance really is an integral fu- -- function. Companies do it in different ways, but it's still part and parcel of the car sales process.

Q: Have you analyzed other factors that lead to CarMax's high level of profits in addition to its finance income?

A: Yes, I did.

Q: And is that routinely part of your analysis

of the company's transfer prices?

A: Yes, it is.

Q: Based on your research and experience, what do you consider is the reason for CarMax's high level of profitability?

MR. ANTLEY: And if you could go to Slide 16.

(Slide Number 16 was referenced at this time.)

A: Well I, I -- there are -- some companies it's like there's one factor you could point to. I think with CarMax it's really a constellation of factors. The first one and the most obvious one is its economies of scale. I think every analyst who talks about the company, everything that I've read, is consistent with the notion that it's CarMax for a reason. The max is because it's big, it's got big stores, lots of inventory and sells lots of cars around the United States, and that can provide it with enormous economies of scale. So over in 2015 it had 582,000 used vehicles and then 376,000 wholesale vehicles. This where you see the small number of new vehicles. I believe they've since shut down that part of the business. So it did have a small number --

small number of stores that had new, new car franchises. But as a minor portion of the business. To think about your typical used car dealership, right? And that's generally gonna be a small company or usually an individual owned lot. And CarMax has -- just has a scale that's far beyond what you'd observed for the many thousands of small individually owned car lots. Even with regard to -- its principal competitors are surprisingly not those -- your typical used car lot, they're actually the new car franchisees who also sell used cars. And that's because of the specific make and -- types of makes and models that CarMax sells. These five year old, under 60,000 mile car, those -- those are the cars you will also find on your local Toyota or Honda or Ford dealership lots where they sell new cars and they'll have an accompanying used car lot. But CarMax, unlike these other franchise dealers, they have this big, broad national network. So, you have a kind of much broader selection. If you really want that baby blue Toyota Corolla, with a, you know, a certain

kind of feature associated with it, you're much more likely to be able to get that from the CarMax dealership than from a used car lot of the Toyota dealership simply because of that nationwide reach that CarMax has. So obviously that's the first and foremost thing is its economies of scale that I think it provides. I'm -- I -- I'm happy to go on to some other things to -- that jump to mind. The other one would be this broad vehicle selection. It's not just having a certain number of units on hand, it's having that breadth of product selection, because oftentimes people come in thinking they want one vehicle and end up walking out of the dealership with a different vehicle. So that breadth of vehicles in a given storeroom provides a -- an additional sales opportunity that the -- that other -- its competitors often don't have. It was also innovative in terms of it's -- was, I think, one of the first to offer this no-haggle pricing, kind of low, low sales pressure environment, it didn't -- doesn't condition. So the no-haggle prices, here's the price and that's

it, makes it for a much lower stress level for the -- for, for the buyer coming into the process and into the dealership. So I think that generates a lot of goodwill for the, for the customer. That positive experience at the retail is going -- level is going to encourage that, that customer then to come back in the future or to recommend the CarMax dealership to other people. So there's -- it also has its -- the economies of scale function also at the purchasing level. So because it's selling so many cars, it's also out there buying a whole lot of cars. So all you -- all these people coming into the dealership provides it with a effectively inventory advantage. So if you are a -- if I'm a small dealership on the -- that has a small lot, I'm not getting in the people, the number of people coming into my dealership that are willing to sell me the cars the same way the CarMax dealership is. That provides it also with an informational advantage. So that says to CarMax, hey, I, I know what the prices are because I'm working on big scale. I know the price that customers are willing

to pay for, are what they pay for pri- -- for a car I want to sell. I know how much they're willing to, to sell me their cars for because I have many observations that I'm collecting from all over the country. And I also know what inventory is selling, and is the hottest selling inventory, and I can actually move inventory between locations. Now these are all this informational advantage that the company has, I think it's very valuable, but it is a function of that retail location.

Q: Does it have any advantages over online auto shopping?

A: It does. And I think that's one of the reasons -- in face every time I look at a retailer it's the first thing they ask is why are -- if you see persistent high margins, why are they still there in the world of online retailing where you would expect the competitive process to chip away at those margins. And one of the reasons -- and you -- we -- and, and even in car retailing we've seen the new purely online companies like Carvana, for example. But at the end of the

day, customers buying such a high-priced item are typically still want to go into a dealership. That's why cus- -- the CarMax's volumes and, and revenues have continued to increase over this time period. There's something about that car purchasing experience that requires that local brick and mortar presence: kick the tires, talk to a salesperson, explain the functions, go for the features and go for a test drive. And the online sear- -- the, the purely online companies have not been able to displace CarMax from that basic function that customer's value.

Q: On the topic of economies of scale, is CarMax having any advantages as far as procurement or fixed cost?

A: On, on economies of scale, certainly. I think I mentioned earlier that the, the size -- that it's the, the sheer size of the company in terms of how many vehicles it's selling, gives it a sourcing advantage. So it's able to get more inventory in the pipeline because of that size. And, and it has that informational advantage as well. On

the terms of the, the economies of scale kind of operate at two levels. One is gonna be obvious one, just has fixed costs. So if you've got a dealership, a warrant or you've got your headquarters costs and you want to amortize those costs over a greater volume of sales. So that's a competitive advantage for a company, to be able to grow by scale so that it can -- it's able to offer better prices to customers, attract more people in there because it's got a better cost structure than its smaller competitors. But here I think it's also operating at the store level as well, because those stores -- again, this is a big box kind of framework. This grew out of Circuit City. This was originally a Circuit City -- part of the Circuit City business, and that's, that was the model, grow and develop very large footprint stores with a lot of inventory and you'll be able to get a lot of economies of scale for your local sales staff. You have one salesperson, able to offer customers a much broader, a larger number of, of inventory, you can spread out the cost of

that location across this greater volume of sales even before you get to things like the operating expenses of the headquarters.

Q: Has the company been able to achieve economies of scale by increasing the number of physical locations with brick and mortar stores, as in South Carolina?

A: Yes.

MR. ANTLEY: And if you could go to Slide Number 17.

(Slide Number 17 was referenced at this time.)

A: So this is similar to a slide you'll see with a lot of -- I'd say similar to the data you would see with a lot of retailers. And retailers generally grow their business through what I'll call an extensive strategy. It -- you -- it makes sense when you think about it, it's a un- -- there are some, some companies grow their business by investing in R&D, other companies invest to grow their business by investing in a brand, retailers generally grow their business by investing in new brick and mortar locations. And here, the, the orange bar or the orange line, is the number of stores. And you can see the

operating profits earned by the company have pretty much grown consistently over that time period. And with two exceptions, the 2009 Great Recession, and then more recently in the COVID era there was a drop. But still quite substantial levels of profitability even in those, those downtime periods. And that, ultimately, from those greater number of locations then provides it with a, a greater ability to spread its costs across a large number of units.

Q: Has the company's increased sales and store locations allowed it to increase its profit margins over time?

A: Yes.

MR. ANTLEY: And if you could go to Slide 18, please.

(Slide Number 18 was referenced at this time.)

A: So here, I think the story here is one of -- yeah, they were ab- -- from the, almost right out of the gate -- so this begins -- my slide here begins in 2000, 2001, so after a number of years after it's been op- -- in operation. But even by then it's able to achieve relatively substantial operating margins and

gross margins of 4 percent, 4 percent operating margin, 14 percent gross margins. Again, very healthy for a retailer. And the one thing that's gonna be notable from my perspective is the relative consistency of these over time. And then in 2009, and there's after the 2009 recession, there's actually a bump up. So there's a level up in terms of the operating margins and the -- and the gross margins. So over this entire time period it's growing in size, it's incre- -- the inventory, the amount of inventory being carried in a store is increasing, and there are also other things that it's doing to improve the operations of the retail stores that then accounts for this bump. But I think ultimately, there's a big economies of scale component to this. It would never have achieved these levels of profitability, nor been able to maintain this level of profitability, absent significant economies of scale.

Q: Has the amount of its profits per store changed over time?

A: Yes.

MR. ANTLEY: If you could go to Slide 19, please.

(Slide Number 19 was referenced at this time.)

A: So similar to that, when we saw on the operating margin levels. So this is on a per store basis. So on average the stores, again, in the earlier time period before 2001 you see kind of a time period when you -- when you had lower levels of profit per, per store, but by 2001, 2002 they're up to a very healthy $4 million per store in operating profit and $12 million dollars in gross profits. And again, there's this up, the shift up after the Great Recession. Again, I -- there's -- I think there are various factors that explain that but -- and I've seen references in from the analysts reports to, to different factors. I think some of it is going to reflect the specific mix of products that they're selling. These higher margin, late model cars, low mileage cars, and also some of the, the analysts always talk about the, the ability to lower the reconditioning costs. So one of the big factors of cost that a -- that a used car dealer will occur is somebody sells them a

car, and they got to fix it up. So that can be repaired, there can be repair cost, they got to buy different parts to repair it and fix the cosmetic damage. That actually can be a significant amount of money. And there was some indication that there was a -- an upshift in the, or I would say a reduction in the cost per vehicle of that, that reconditioning process during this time period as well. I think that also helps to contribute to that uplift that we see after the Great Recession.

MR. ANTLEY: Can you go to Slide 20, please.

(Slide Number 20 was referenced at this time.)

A: So the other thing is on, on the inventory side, we al- -- we also see kind of increase in the amount of inventory. I think some of that increase in value, I haven't been able to tease out how much of that increase in inventory is literally an increase in the number of vehicles or an increase in the value of vehicles. I think it's probably a little bit more of the latter based on the overall rev- -- some of the other statistics I've seen about the stores. But the bottom

line is the -- over time, just having that greater volume of inventory available in the store, at store level in turn allows each store to sell more cars and earn greater profits on a per store basis.

Q: From a transfer pricing perspective, can any single entity within a company claim the benefit of economies of scale to itself via the transfer prices that one related party charges another?

THE COURT: Read that question again.

OBJECTION:

MS. GEER: I will object to leading on that question, Your Honor.

THE COURT: Well, I was going to tell him to read it again but, you know, because I didn't catch it quite, but -- so you can read it again or rephrase it. I just want to hear it.

MR. ANTLEY: I'll go slowly.

Q: So, from a ---

THE COURT: All right. So you're gonna read it again?

MR. ANTLEY: Yes, Your Honor.

THE COURT: Okay.

MR. ANTLEY: I don't -- I don't think the answer is implying.

THE COURT: Well.

Q: From a transfer pricing perspective, can any single entity within a company claim the benefit of economies of scale to itself via the transfer prices that one related party charges another?

OBJECTION:

MS. GEER: I'll object to leading. I mean, I think it suggesting. It's a yes, no, question and I think it's leading.

THE COURT: Any response?

MR. ANTLEY: Yes or no is not a leading question. That's -- those are options. Or he could elaborate.

THE COURT: Unless -- yes or no may not -- potentially may not be a leading question is what you're getting at.

MR. ANTLEY: Yes, Your -- if, if an answer is either yes or no ---

THE COURT: It is often a leading question.

MR. ANTLEY: --- then it's -- there's ----

THE COURT: I'm going to overrule that. That question is convoluted enough where it is not

leading. I'm gonna create a new exception for that.

A: So I, I would say the short answer is that it would be inconsistent with transfer pricing principles and particularly the arm's-length standard to have one related party effectively take advantage -- say claim for itself the, the benefits the company obtain simply because of the economies of scale that the company as a whole enjoys. So for example, it's an issue that often comes up in purchasing entities, where a purchasing entity will be able to buy something at a -- at a lower price because of the sales, the overall sales that the compan- -- the company makes. So it's get a discount relative to somebody who's buying a product in a onesies, twosies kind of way. But then it'll -- turns around -- it may try and turn around and sell that very inventory at bottom low price because the company enjoys this high level of sales to another company -- to a related party at a much higher price at the onesie, twosie price. It's all -- that's something that a transfer pricing authorities in a national

perspective have long been concerned about, that that is a way in which a company can try and shift profits by effectively taking advan-- putting all this scale economies advantage in the purchasing entity. I think there are lots of other ways in which companies try and do this where there -- it's one of the reasons why you go through the trouble of trying to figure out what is it that really drives the profitability of the company, is because at the end of the day, a lot of big companies that earn significant margins, they're doing so because of economies of scale. But then the transfer pricing advisors or the tax department tries to assert that those high profit margins attributable to something else, it's not economies of scale, it's something else. So if it -- ultimately, if it's a factual matter, that -- there is a, effectively a stripping off of these high margins that are coming from economies of scale through whether you call it a purchasing contract or a headquarters agreement or anything else of that ilk, those -- that's inconsistent with

arm's-length dealings. Actually ---

Q: And ---

A: I'm sorry. The one thing should elaborate on and one of the reasons why I think this slide in particular is informative is because unlike that, that purchasing entity, that purchasing strategy that I talked about a minute ago where companies try and use that as the hook to, to, to move profits from one related party to another, here, all that inventory the inventory is an important issue. All that inventory procurement and the holding of that inventory is not that -- that inventory's not procured in the first instance by CBS, it's not -- it's procured by the stores themselves. It's not held in a distribution affiliate, and so there's no kind of asset holding, inventory holding function and breakbulk function of a distributor that you see embedded sometimes in a -- in other types of retailers. Here, all that inventory, it's very much localized inventory. It's locally sourced, locally held, and then loc- -- and locally s- -- well, either locally sold or then sold throughout the, the

BAR network. But that is a really important differentiator about CarMax relative to other retailers, and I think it adds additional important fact to my analysis at least as to why I think the economic -- the, the taxable income of the taxpayer should reflect that local activity which includes this important sourcing activity.

THE COURT: All right, Ms. Geer, that answer either indicates that my ruling was correct or that Dr. DeRamus can take a leading question and make a non-leading one.

MS. GEER: I don't know which one, Your Honor.

Q: In your research, did you review statements by the company regarding the reasons for CarMax's high level of profitability?

A: Yes, I did.

Q: All right.

MR. ANTLEY: If you could go to Slide Number 21.

(Slide Number 21 was referenced at this time.)

A: So, this is probably one of the things you see repeatedly in just about every discussion of CarMax, both by the com- -- the company officials and analysts, is this focus on the specific pricing policy. So it has no-haggle

prices, that was differentiator at the time, more companies have adopted that, but that provides for a certain, a transparent process. And there are other parts of the car buying process that the company chose to revise relative to what was standard practice at the time when it started business back in the, in the mid 90's. It also talks about these four core equities in the, the last slide. That is something that I, I see, a reference to other core customer benefits that I think are part and parcel of that formula.

MR. ANTLEY: If you can go to Slide Number 22.

(Slide Number 22 was referenced at this time.)

Q: Is this -- is this what you were just referring to, the four ---

A: Yes. So I, again, I -- that particular investor presentation didn't have a whole lot of elaboration on what the executive meant with that, but I've seen -- this is from their, from the, the write-up of one of the transfer pricing studies. This is the 2012 study, I believe. And it talks about the four customer benefits. Keep in mind, I believe CarMax itself, based on Ms. Yost's

deposition, that CarMax is the one that's wrote up a lot of that functional analysis. So I believe these, to some extent, these are the company's words is more -- as much E&Y's words. They talk about these four customer benefits being low, no-haggle prices, number one. Second, this broad selection of high quality, a broad selection of vehicles. Third, I'm sorry, high quality vehicles. I'm having a hard time seeing where the, the, that red circle is, overcomes the -- there's a semicolon between selection and high quality vehicles. So the high quality vehicles, the fact they focus on these under 60,000 mile vehicles and its customer friendly sales process. Again, these are very localized benefits associated with a customer ---

THE COURT: Hold on.

MS. GEER: Your Honor, I, I have an objection. And I, I just need to ask a question to make sure I understand where this document is, is coming from. Is this, this is not one of the joint exhibits? What is it from, that's what I'm really looking for.

THE COURT: It sounds like it was in a Transfer

Pricing Study by someone, but that CarMax provided the information is what I understood.

MS. GEER: So is it from within one of the transfer pricing studies that's already into the record?

MR. ANTLEY: I think that was his testimony, but give me a second and ---

MS. GEER: Yeah.

MR. ANTLEY: --- I'll tell you which -- I can point you to the joint exhibit. So as, as the slide indicates at the bottom, it says it's CarMax30 -- 001360. That is Joint Exhibit Number 7.

(Joint Exhibit 7 was referenced at this time.)

MS. GEER: So you said it is from one of the joint exhibits?

MR. ANTLEY: It's Joint Exhibit Number 7.

MS. GEER: Okay. And so then my question is just, now that I know the source, what the foundation is for these being CarMax's words versus E&Y's words.

MR. ANTLEY: I think he just test- -- testified to that, but.

THE COURT: I think I'll let you cross him on that.

MS. GEER: Okay.

THE COURT: But he did just testify to it. I will say whoever wrote it, the no-haggle price and the customer friendly proc- -- sales process are logic ---

MS. GEER: They are nice words.

THE COURT: Huh?

MS. GEER: They are nice words.

THE COURT: Well they -- they're also logically the same, so. But, go ahead.

A: I guess the, the -- ultimately the import of this is really the fact that it focuses very much on this customer experience in the retail store. And that's what really is driving the growth of the business.

THE COURT: All right, so now you're saying that the four things were really the final thing.

A: I'm sorry, the four things are related to the what?

THE COURT: You said ultimately, it's the customer friendly sales process. So, so now the four things have become the final thing.

A: I should have said the, the, it's the four customer benefits that ultimately ---

THE COURT: Oh, okay.

A: I don't know if you would like me to clarify

that, but I ---

THE COURT: No, no.

A: Okay.

Q: Are there any statements in the company's transfer pricing documentation that describe the customer benefits that CarMax provides to its customers?

A: Yes.

MR. ANTLEY: If you can go to Slide Number 23.

(Slide Number 23 was referenced at this time.)

A: So, there was an extensive discussion in the 2012 Transfer Pricing Study on what they consider to be the principal competitive advantages. Again, the statement says CarMax believes, so I think these are -- I interpret that to mean these are statements by CarMax as opposed to E&Y, but it appears to be an E&Y document, so. But nonetheless, it is the, the, the principle compativ- -- competitive advantage identified here are similar to those that I've seen referenced elsewhere. Namely, this low, no-haggle -- competitively low, no-haggle prices, customer friendly sales process, selection of models, quality vehicles. It does reference -- then

there's in the middle, you see this competitive sourcing advantage. That's that inventory procurement advantage that I think the company has, as a result of its scale economies. And then down below it talks about the ability to transfer the used vehicles. There are a couple of things that I think are worth at least kind of raising. It talks about proprietary information systems. That's one where I don't consider that to be necessarily a competitive advantage. That the information systems that CarMax has, those are probably very similar to the inves- -- information systems that any similarly large dealership or large retailer is going to have. On the next slide, there's reference to some additional competitive advantages as well. But ---

Q: Before you get ---

A: Sure.

Q: --- to the next slide, just for the record this, this is from Joint Exhibit Number Seven as well, the, the Ernst and Young study from 2012?

(Joint Exhibit 7 was referenced at this time.)

A: Yes.

Q: All right.

MR. ANTLEY: So if you could go to the next slide, now.

(Slide Number 24 was referenced at this time.)

MS. GEER: May I ask if I could have a copy of the demonstrative that you're using? And if you want to give it to me just as your ---

THE COURT: Is this a demonstrative or is this in evidence?

MR. ANTLEY: This is a demonstrative.

MS. GEER: Demonstrative.

THE COURT: Okay.

MR. ANTLEY: The underlining ---

THE COURT: So it's in evidence, but the demonstrative has the circles?

MR. ANTLEY: Exactly. That's right.

MS. GEER: Say that again, I'm sorry.

THE COURT: The demonstrative has, I called it the circles, yeah, that red. You could call it highlighting, but it appears to be highlighting in a configuration of a circle. Well, not a circle, but an ellipse if you want get technical here from a geometry standpoint.

MS. GEER: I would just like a copy if I can have one. So that I can ...

MR. ANTLEY: Yeah, after we go through it?

(No audible response heard.)

MR. ANTLEY: Yeah, I'll give you ---

THE COURT: You want it ---

MS. GEER: I mean, I would like it now.

MR. ANTLEY: It's being ---

MS. GEER: I think I'm technically ---

MR. ANTLEY: --- published, and if, if you'd asked for advanced slides ---

MS. GEER: I, I don't need the advanced ones just what you've done.

MR. ANTLEY: The current ones?

MS. GEER: What you've done so far.

MR. ANTLEY: Okay.

THE COURT: How about the slides with just the, the red highlighted, that color, that she just referenced? The circles.

MR. ANTLEY: Yes, Your Honor.

THE COURT: Give her copies of that.

MR. ANTLEY: Just, just give her the slides with it real quick?

THE COURT: Vignettes.

MS. GEER: Basically, I'm just asking for any that

are different than the joint exhibits that are already in. So if they're marked differently than the joint exhibits or if it's not a joint exhibit.

THE COURT: Why are you looking at me, sir?

MR. ANTLEY: I just wanna make sure I follow your instructions, not hers. So, you would ---

THE COURT: Well, she's expanding it, but her expansion is anticipating other exhibits that may be marked differently is what I would assume, because mine referenced exhibits where you are -- have already highlighted various words, and I think you're anticipating future highlighted areas.

MR. ANTLEY: I'm fine with providing slides up to this point. I think that's what you're requesting?

MS. GEER: Yeah, that’s fine.

MR. ANTLEY: Okay. I'll, I'll provide.

THE COURT: Okay. If y'all are in agreement, then...

MR. ANTLEY: And at the end I can provide an electronic copy for the Court ---

THE COURT: Okay.

MR. ANTLEY: --- and for Respondants.

MS. GEER: That, that -- thank you.

THE COURT: I would like an electronic copy of the demonstrative exhibit. Are you okay with that?

MS. GEER: Yes, sir.

THE COURT: All right.

MR. ANTLEY: Okay, if we could go ---

Q: Looks like we're already there. Slide 24. I'm sorry, if -- I don't know, I'm not sure where we left off. But have you spoken to this slide?

A: Well, this was a really continuation of the information that was presented on the prior slide. So it was a long section, or longish section I guess, in the transfer pricing report. So it just describes additional factors that, that the company, or E&Y, considered to be the company's competitive advantages. So it in- -- I just highlighted them just to save time on reading it. Highlighted things that were most notable to me. So it talks about the ability to offer customer financing. One thing that I do see in the analyst reports and in the data is that, you make -- you will make fewer sales

if you don't have a financing function to offer. So if your lenders start tightening their credit requirements, your sales will go down, because certain customers come in and they can't complete a transaction because they can't afford the car. Similarly, there -- this comprehensively competitively priced ESP and GAP products, those are significant fraction of the profits that the company earns is from these, these add-on sales. It' a, it's a great way for the company to earn at the margin, significant dollars, because, because the customer's already there buying a car, and it's like, Hey, would you like to buy these additional things on which we as a company are going to make a significant margin. I'm gonna skip over the proprietaries stuff, the second paragraph ---

THE COURT: ESP ---

A: --- til I go to ---

THE COURT: ESP is Extended Service Plan?

A: Indeed, Extended Service Plan, yes. So I'm going to jump to the one in the third paragraph, the sales consultants. Again, this is a very, -- you want the whole purpose of

this -- of the -- of the company was to make that use car sale process different. And as you'd expect, and that means you have to have sales consultants, have to have retail brick and mortar store who are engaging with customers in that customer friendly way, in that low pressure, kind of -- kind of way. So they -- they call that out as a competitive advantage is that they have good sales consultants who are -- who are doing that at the retail level. The one thing they, they, they call out here that, again, is refer- -- similar to what was referenced in the earlier side about proprietary information systems. Here, this proprietary inventory management and pricing system, we're going to come back that in when I talk about transaction five, because the company is asserting that that is a significant business process intangible. Again, I, as a -- as an economist, and as someone who's -- I've dealt a lot with these kinds of models, these pricing models where you have, where any kind of econometric model where you get lots and lots of data input, and then you, you have a,

a statistical model that then tries to get a particular out -- that gives an particular output and a prediction based on the inputs that you've provided. Those models are only as good as the information that are being generated, that, that, that information set. The bigger that information set is, the better your model is going to be. The model itself is based on standard statistical techniques that are widely available that anybody of any training and experience can develop. So the real -- if there's any value in these proprietary inventory management and pricing systems, it is in the data generated by the retail brick and mortar stores. By the people coming in and buying products, that's additional data point. There's a sale that happened to this particular price point. And by the -- by the, the purchase when, when a customer says yes, when the customers -- when the -- when the company offers to buy their com- -- their car at a particular price point. As well as the systems ---

THE COURT: Well, so I can understand that.

A: Sure.

THE COURT: Does that reference the fact that they gain information about the value of the cars?

A: Yes. I mean ---

THE COURT: Is that what you're talking about?

A: To gain value about the value -- information about the value of these cars ---

THE COURT: I mean, in part.

A: Sorry?

THE COURT: In part, I know it's a ---

A: Yeah, actually I would say a substantial amount. So the -- so the problem or the -- I don't want to say a problem, but a, a basic function that the company must do every day is determine the prices that all of the -- all the stores are going to sell their cars at. So if a car has this -- this store has a whole bunch of different cars, a lot of different makes and models, lots in different condition, and it's setting the prices. And so the question's what price to set that light blue Toyota Corolla with the nice air conditioning system. So it's collecting information on a real time basis, both from its others -- all of its nat- -- for its entire national headquarter, national

operations. It's collecting data from its, its wholesale auction business. It's also, I expect based on my work with others, it's also collecting information from third-party sources to try and figure out what is that price I need to sell that particular car in that location for. So it's, and it's constantly updating those prices. So if inventory is not moving, so that cars being sold for $25,000, and it's not moving, so they might kind of bump it down another couple $100 to try and motivate a sale. So, but these are all systems. People often talk about systems as being proprietary valuable. These kinds of systems are proprietary and value- -- and valuable only because of this vast quantity of data that these hundreds of thousands of sales and purchases are feeding up into that algorithm. These are algorithms the same way there's a Facebook algorithm, the same way there's a gazillion -- a credit card fraud detection algorithm every time you swipe your credit card. Those are some things I've worked on specifically. And so those have value, but they only have value

because of, of that data that they're collecting and then using to make a pu- -- a decision.

Q: And just for the record, to make sure we're clear, this is from Joint Exhibit Number 7, and this is Slide 24.

A: Yes.

Q: All right.

MR. ANTLEY: So if we can go to Slide 25.

(Slide Number 25 was referenced at this time.)

A: So this is a statement from -- by a company from one -- from an investor presentation about the selection of vehicles. Again, this -- I've said this several times about the size, but it also talks about the website. So it's got -- so you walk into a location, the customer is benefitting not only from the cars in that retail store, but from these 40 -- these 41,000 cars that are available on their website for, for sale nationwide. And the company kind of often does, 30 percent of the time, can have a, a car transferred to that location. So again, back to this integrated nature of that inventory and that -- the National inventory, the importance of

that.

Q: What is your understanding of the role of CarMax's internet presence to its business?

A: So I think you mentioned ---

MR. ANTLEY: If you could you go to Slide 26.

(Slide Number 26 was referenced at this time.)

Q: I'm sorry.

A: I think I'm -- I mentioned before that the internet, the internet and e-commerce has not kind of chipped away significantly at the CarMax business, at least not in terms of its top-line sales and, and margins, even though you have more competitors in there -- out there now, like Carvana for example. And generally it's because customers, as I said before, still value the in-store buying experience for, for the most part. And the customers actually do use the CarMax website. They're using it primarily for research. So you go -- a customer is looking for a, a Toyota, it goes through and looks at the se- -- at the selection available on the online store. It identifies five or six different models or maybe a Toyota Corolla and a Ford Escort, whatever, and says -- identifies those

on the website, and then goes into the webstore -- into the physical store, and that helps the cus- -- the salesperson to complete the transaction quicker because the com- -- the person has already done that research. It was a helpful tool, but the internet is not replacing the importance of the brick and mortar location. And I think this is a lesson that we've seen across a lot of other types of retailers that have a thriving brick and mortar business, and how they in, in- -- integrate the internet in a way that's actually helpful for their business without effectively breaching the competitive moat, as it were, such that Amazon comes in and takes away their business. This is one where there still is a pretty substantial protective moat around the retail car business.

Q: In your research, did you review the financial analyst reports assessing the reasons for CarMax's high level of profitability?

A: Yes.

MR. ANTLEY: And if you can go to Slide Number 27.

(Slide Number 27 was referenced at this time.)

Q: What conclusions, if any, did you draw from your review of the analyst reports?

A: They -- they're pretty broad and every analyst has their own take on things, but they're all pretty much referencing very similar types of factors. Sometimes they highlight some- -- something new that I hadn't seen in other sources of information. So for example, two analysts reports talked about reconditioning as a competitive advantage. And that's where I was trying to understand why there's this bump in the -- in CarMax's profitability after the great recession. And it looks like there was this kind of reduction in their per unit reconditioning costs. Again, why do I focus on reconditioning? Reconditioning's important as it is a locally performed activity, it's performed by the stores themselves. So -- and that lower -- and really because of the sheer volume of, of the sales that it makes, those add up to quite significant dollars over the, the company as a whole. But I also observed similar kinds of comments about the importance of product selection and volume of

the business and reports of the financing business as part parcel of those investor analyst reports.

MS. GEER: Your Honor, I, I'm sorry, I -- this one I don't see a source on so I'm not sure.

MR. STREISEL: It's, it's under the graph.

MS. GEER: Okay. And are these in the joint exhibits or not?

MR. ANTLEY: These are not joint exhibits.

MS. GEER: And so ---

THE COURT: So you're kind of publishing a demonstrative exhibit?

MR. ANTLEY: Yes, Your Honor. This is a demonstrative. And, and I'm happy to -- I think -- I think he talked about the relevance of analysts reports, but I'm happy to ask him if those are -- if that's information that experts in his field rely on.

THE COURT: Well I was just -- I asked him about that. I mean you have a demonstrative exhibit, an out-of-court statement that he publishes, you really need to get it introduced before we can publish it, but ---

OBJECTION:

MS. GEER: That's my objection. And also that I, I believe this is part of a group of documents that were provided after the exhibit disclosure deadline. And that I believe he's using these all as saying he testified that these were -- formed the basis of his opinion. And we had obviously asked for, in discovery, all documents that form the basis that support his opinion. So we didn't see them before his deposition, and we didn't see him before the exhibit deadline, so we'd object on hearsay and lateness.

THE COURT: All right. She called it hearsay and lateness, so she did explain what lateness meant before she utilized that term. And so?

MR. ANTLEY: The exhibit, as far as lateness, the exhibit was produced, or the document was produced I think within four days of the exhibit, exhibit list deadline. The only delay -- it was listed but the document was provided later once it was Bates labeled. Part of those four days included two weekends, so Saturday and Sunday. But the documents ---

THE COURT: All right, so ---

MR. ANTLEY: --- not ---

THE COURT: --- provided within the timeframe.

MS. GEER: Sorry, I didn't understand ---

THE COURT: It was provided within the timeframe for disclosing exhibits is what he's telling me, so ---

MR. ANTLEY: It was listed, Your Honor.

THE COURT: Oh ---

MR. ANTLEY: The doc -- the document ---

THE COURT: --- it was listed.

MR. ANTLEY: --- itself -- the actual documents. So the -- like the source document was provided, or the, the name of the document was provided. The hardcopy wasn't provided until it was Bates labeled. It was received by the Department the day of the disclosure -- the exhibit list disclosure deadline, which was a Friday. It -- so ---

THE COURT: It was received by the Department?

MR. ANTLEY: Yes, Your Honor. To be able to produce in response to discovery. So we, we produced it within four days of receiving it. That -- two of those days were the weekend, and then the other two were the time it took to review it and Bates label it.

THE COURT: I don't really -- I mean what does it matter when it was received by you? It matters when it was given to her. Isn't that the issue? You can explain it, that's ---

MR. ANTLEY: Yeah, well, my, my understanding was that, that we had not provided it with enough anticipation. We provided since we had it is, is, is my point. In as far as the exhibit itself, experts are ---

THE COURT: So now the exception to providing documents is that you can provide documents belatedly as long as you provide them soon as you have it? Because that's what -- sounds like what you're saying.

MR. ANTLEY: I can't -- we cannot provide them sooner than then we have them.

THE COURT: I agree with that.

MR. ANTLEY: And as far as the document itself, it doesn't have to be admissible. We're not offering it as an exhibit. Experts can rely on inadmissable evidence for -- in forming of their opinion.

THE COURT: That's true.

MS. GEER: A, I don't think it should be published if that's the case, and B, I also still

object that, that we have asked for anything that supported his opinions to be provided to us prior to his deposition so that we can understand the underlying support for his opinions and examine him on that. And so, I mean, I'm, I'm reading between the lines that he provided it to the Department ---

THE COURT: After ---

MS. GEER: --- late, but I mean, in my mind, he should have provided that too. So, I'm not blaming the Department for that. I think he should have provided it to the Department prior to his deposition if he intended to rely on it.

MR. ANTLEY: Your Honor, in response to the publishing issue, I think -- I think that's, that's a concern if we had a jury. I have full faith that this Court understands that this is not evidence in itself, and that it's only his testimony that is in fact evidence.

THE COURT: All right. So now you're providing him something to supposedly refresh his recollection. You know, he's reading it, he's looking at it. So I -- I'll -- I don't think that's needed unless you establish that

he cannot recall this evidence. You're giving it to him, for him to follow the, the testimony. So, I'm gonna sustain the objection at this point regarding this out -- you can ask about every bit of this. Well, you can still object you didn't know about it, but if it's a component of -- I'm not even sure about that. Let me just take a quick break.

MS. GEER: Your Honor, can I just add one more, one more piece of information for Your Honor to consider. So when it was identified on the ex- -- on the exhibit list, it was identified somewhat generically like CarMax analyst report. There's a, a number of them ---

THE COURT: Okay. So it was identified.

MS. GEER: Well, it was identified generically, but like we didn't have the opportunity to, to see what that was at that point is, is one issue. And the other issue is that it was about, I -- I'm not -- I don't have the exact number, but like a thousand pages of documents. So about thousands pages of documents that we didn't get to see before his deposition, that he's now coming to Court

saying, these form the basis of an opinion, he's relying upon it. And so that's the other, other basis of our objection as far as the -- not just the lateness, but the quantity that we would, A, have to go through on eve of trial, and B, not have had a chance to explore with him in his deposition.

THE COURT: All right. Do you wish to respond?

MR. ANTLEY: The alternative is, is we could not provide it and it could just be part of what he's relied on. Experts, what -- what they rely on reaching their opinion, it can involve voluminous documents as far as their education, their experience. And so to err on the side of providing them with -- the, the Petitioner with more rather than less, we provided this documentation to them so they would have it and have time to, to do what they needed to do with it. The, the, the expert disc- -- the exhibit disclosure deadline, I think the point of that deadline was so they would have time to, to file objections. They filed objections. They're still filing objections now. So I, I don't think they've been harmed in that -- in that

aspect.

THE COURT: This exhibit though, if I can be clear, was not provided at the deadline, the list was provided.

MR. ANTLEY: The list, yes, Your Honor.

THE COURT: Okay. All right.

MR. ANTLEY: Your Honor, since today was the day that we talked about a longer lunch break ---

THE COURT: Yeah, let's just go ahead and break for lunch.

MS. GEER: Okay. And one last thing is I also can't tell, because this doesn't have a Bates label on it, if this one actually was on the list or not.

MR. ANTLEY: Yeah, it, it was. But I, I can, I ---

THE COURT: You said as an officer of the Court that it was on the list.

MS. GEER: Yeah, I just -- I'm more just asking can we have the Bates label so that I actually know what, what this document came from is, is my main point. I, I agree he's an officer of Court, I'm not suggesting at all that he would say anything that is not accurate.

THE COURT: All right. Can you provide her that?

MR. ANTLEY: If, if I -- if I have time to do it I,

I will.

THE COURT: Okay.

MR. ANTLEY: Just as long as I have sufficient time, I don't mind doing that.

THE COURT: Okay. Well, let's just take a lunch break.

(Off the record from 12:13 p.m. until 2:33 p.m.)

THE COURT: You know, I didn't think about your argument over lunch, but I should have. I'll just give -- I didn't think about your argument over lunch. I should have devoted more thought to it, but I'm going to give a shot at it now. In the -- I just wanna make sure I'm clear on the chronology of events. So there was a listing of exhibits. Or first of all, Dr. DeRamus?

MR. DeRAMUS: Yes, sir?

THE COURT: The list that you've relied upon, what's the phrase group you're, you're challenging now? The documents?

MS. GEER: Yes.

THE COURT: What are they?

MS. GEER: Well, the one that at issue is, the one that we start -- started on is Slide 27, which contains excerpts from two documents

that were provided ---

THE COURT: What did you call those documents?

DR. DeRAMUS: Analyst reports, Your Honor.

THE COURT: There you go. That's what I was ---

MS. GEER: Analysts reports.

THE COURT: Analyst reports.

MS. GEER: Yes.

THE COURT: So it was listed that he relied upon analysts reports.

MS. GEER: Not, not prior to his deposition.

THE COURT: Not prior to his deposition?

MS. GEER: No. So ---

THE COURT: Okay.

MS. GEER: -- in, in the initial exhibit list, there was a I think ---

THE COURT: And this is following deposition ---

MS. GEER: Following deposition.

THE COURT: --- pre-trial?

MS. GEER: Pre-trial, the day that -- in time for the deadline for exhibit lists to be filed. So on that initial exhibit list that they filed there is a, a line item that says CarMax analyst reports, and then it just says TBD for the Bates labels.

THE COURT: Okay.

MS. GEER: So it's not clear ---

THE COURT: To be determined.

MS. GEER: --- how many or where from or you know, how to get to it. And then when they filed an amended exhibit list -- hold on one second.

THE COURT: So the analyst reports were not questioned at all in the deposition?

MS. GEER: Correct.

THE COURT: Okay. Go ahead then.

MS. GEER: I'm sorry.

THE COURT: Go ahead.

MS. GEER: Okay, okay. I just wanna make sure I heard you. Okay, so then the -- then they did an amended exhibit list that then -- that still said analyst reports, but it had a Bates range. And then they did provide the Bates range. There were two, two productions post filing of the exhibit. One was, I think ---

THE COURT: Exhibit or exhibit list?

MS. GEER: Exhibit list. Thank you.

THE COURT: Okay.

MS. GEER: I think, and Trey, please correct me if I'm wrong, but I think there was a bit -- a

larger production that was maybe three days after, and then a little bit smaller production that was maybe five days after?

THE COURT: And that was both of you doing -- both sides were doing the production?

MS. GEER: No, these are -- I'm talking about his right now.

THE COURT: I know but you were doing the same thing?

MR. ANTLEY: They did.

MS. GEER: We, we produced -- yes. We produced one production that had three Excel files.

MR. ANTLEY: Yeah.

THE COURT: After the exhibit list is what I'm getting at.

MS. GEER: Yes, Your Honor,

MR. ANTLEY: And after our productions as well.

THE COURT: Okay.

MS. GEER: I mean, he's welcome to object to that on the same basis. I can't ---

THE COURT: Yeah.

MS. GEER: I would, I would ---

THE COURT: I'm just thinking through this.

MS. GEER: Yeah. So I think it was like 190 pages of documents that he is relying upon that he

did not disclose prior to the deposition. And these are pieces pulled out of those documents. So I think that's the factual underpinnings that you were asking about.

THE COURT: All right. And you have been given copies of all those demonstrative evidence over lunch, correct? Or not?

MS. GEER: All the ones that have been used thus far. Yes, sir.

MR. ANTLEY: That's correct.

THE COURT: Have you -- and have you given her copies of the ones you -- any further ones you're intending to use?

MR. ANTLEY: I haven't given additional copies of demonstratives. Just, just up to the point where we stopped.

THE COURT: Do you intend to use more?

MR. ANTLEY: Demonsta- -- yes, Your Honor.

THE COURT: That are pre-marked like this? Well here's what I would like to do now. I want you to provide Ms. Geer every demonstrative evidence that you intend to use. Well, it's already been provided to her, it's just now you've marked them up. Is that correct?

MR. ANTLEY: So I, I want to make sure we're clear.

So all of the underlying documents that might be referred to or excerpts of, in the demonstrative that we're using today have been produced ---

THE COURT: Yeah.

MS. ANTLEY: --- to ---

THE COURT: The only issue is, now you have some of the ellipses around the wording, correct?

MR. ANTLEY: Or highlighting I think ---

THE COURT: Yeah, highlighting.

MR. ANTLEY: Some, some may just be -- just a, a screen -- a clip of a portion of one of those.

THE COURT: And you intend -- so you've got the highlighting and then you've got the actual language that this is -- of the analysts reports was it?

MR. ANTLEY: So as far as the analyst reports, it's my understand that's what's at issue, I think that the only demonstrative that has highlighting and quotes is the one that we stopped at.

THE COURT: Okay. So I -- so we're -- she objected halfway through that one. So I'm, I'm really dealing with the objection of, of exhibits

going forward because you've already referred to that one a good bit. Then Ms. Geer brought the objection up. So I'm taking from that point on, we're moving forward. So are there demonstrative exhibits going forward that have statements that were not produced in a disclosure before the deadline?

MR. ANTLEY: I -- if it's helpful to the Court, I, I can provide those, I think there are only three additional slides, and they, they include some graphs, but those graphs are cut directly from the, the documents that were produced.

THE COURT: So we're not -- we're not gonna be dealing with quotes?

MR. ANTLEY: It, it would not be a quote like the last slide that, that we were discussing.

THE COURT: All right.

MR. ANTLEY: It's, it's not that.

THE COURT: Let's just move forward. And if you object, object out -- on the outset and I'll address the issue from now on.

MS. GEER: Okay. And Your Honor, just to be clear, since -- so that Trey is clear as well. My objection is not that, you know, I had a

document before, but it wasn't highlighted, or I had a document before, but it -- I didn't see this exact excerpt. That, that's not our objection. So just to make sure everybody's clear.

THE COURT: Your objection is for the, the quotes themselves?

MS. GEER: No. The objection ---

THE COURT: Okay. Well, I missed it.

MS. GEER: Yeah. Okay. The objection is that the, the, the documents that have now become demonstratives, in either excerpts or, or highlighted or marked up or whatever, that we didn't have what these came from, not only did we not have these, we didn't have the sources that these came from until after the exhibit disclosure deadline. So didn't have them in time for that, for -- and didn't have them before the exhibit disclosure deadline, and, and there are things that DeRamus is saying, or the support for his opinions that he had in his file, I don't know when they got in his file, but they didn't get to the Department until after his deposition. It's just that I, I ---

THE COURT: All right. Now I'm thinking through --
-

MS. GEER: --- this is an issue.

THE COURT: What is -- so if it was a quote, I can understand the prejudice. So let's just -- what is the prejudice to you?

MS. GEER: So the prejudice is that, you know, the expert disclosure deadline is April 21st.

THE COURT: Well that's the deadline ---

MS. GEER: Sorry. Expert -- exhibit list deadline is April 21st, and then trial is four weeks later, right?

THE COURT: Correct.

MS. GEER: Okay. So we're attempting to prepare for trial and we, we have already deposed the experts, and we get an exhibit list which says, analyst reports, but no way for us to know what those are or how to look them up or how to preview them.

THE COURT: Okay.

MS. GEER: And then within a few days after that we do actually get them, but we're now almost three weeks from trial with a thousand, I think it's about a thousand pages of new documents that we have to review, absorb and

think about DeRamus is relying on them, but we don't get to depose him again.

THE COURT: Okay.

MS. GEER: It's just a lot to, to do in the weeks before trial when you're trying to do everything else. And I think that's the reason for all of those deadlines.

THE COURT: You did previously say that. I said you did previously say that.

MS. GEER: Okay, good.

THE COURT: Go forward.

Q: And I think we've been speaking about analyst reports. Did any of the analyst reports you rely on assess the impact of competitors on CarMax?

A: Yes, they did.

THE COURT: Well, I'm gonna allow you to go into the analysts reports that you put up that were not objected to, but any other analysts reports I'm gonna sustain the objection.

MR. ANTLEY: And just so I understand, Your Honor. Is, is it the report itself that can come in, or any of his analysis related to that report?

THE COURT: He referred to them, his analysis

relating to them, I'm -- that's okay. We've moved that far along into evidence before there was an objection. But now Ms. Geer has made an objection. So if there's anything new that you intend to offer, I'm going to sustain the objection. So I just -- I don't know where you are or what you're, you're about to offer. If you're -- if you're questioning him about that, which you've already done ---

MR. ANTLEY: Yes, sir.

THE COURT: --- I'm going to allow you to go into it. If you're questioning about anything you're about to do that is new, a new demonstrative evidence for which she did not receive notice before the deadline, then I'm going to sustain the objection as to the statements. Now when you get to graphs and all that, that may be a different story, because the -- then we're getting into the 10 -- the 1006 summaries that we discussed in the conference call and that's a different issue.

Q: I think you heard, heard the Court's ruling there. So only speaking about analysts

reports that, that we've already discussed, what impact if any, did they have -- I'm sorry. What assessment, if any, did they have on the impact of competitors on CarMax?

A: In one of my previous answers, I described the general conclusions I took from my review of the analyst reports in their totality. Since I'm having a hard time remembering specifically which ones had different references in them relative to the spe- -- there's only one specific analyst report, or there were two specific analyst reports that were up on that slide. But there were others that were also in that broader constellation, and I just wanna make sure I'm permitted to continue to explain the, the conclusions I came to in one of my prior answers. It would be a continuation of that earlier answer.

MR. ANTLEY: If, if it's -- if it's helpful for the Court, we, we could just talk about how his rel- -- his reliance on the analyst reports without showing any demonstratives?

THE COURT: Yeah.

MR. ANTLEY: If that -- if that's ---

MS. GEER: I would say it can rely on any of the

analysts reports that have already come in.

THE COURT: Yeah, that's where I was.

MS. GEER: But not any additional, which that was what I understood his question to be is that he was not sure he could distinguish between ---

THE COURT: My problem is ---

MS. GEER: --- first or ---

THE COURT: --- where I could be -- I mean ---

MS. GEER: Yeah.

THE COURT: --- we're beating this to death. I almost want to ---

MS. GEER: I know. I ---

THE COURT: But I'm gonna stick with making a proper ruling. It's my understanding that the analyst reports, there was no notice prior to the deposition about the analysts reports. And therefore, it's not just the demonstrative aspect that she's objecting to, it's that she did not receive any notice to question him about said analysts reports, and therefore the testimony about the analysts reports at this point in time, for matters that have not yet come in prior to her objection, would be improper because she

didn't have a sufficient chance to question him and examine that, that evidence.

MR. ANTLEY: And Your Honor, I, I think I, I think I understand. That ---

THE COURT: Is that ---

MS. GEER: Yes. Thank you, Your Honor. That's fair.

THE COURT: Fair or correct?

MS. GEER: I think it's fair and correct.

THE COURT: Okay.

Q: How important, if at all, is advertising to CarMax's retail business?

A: I would say it's relatively modest. It accounts for about 1 percent of sales. The car retailing business is not like a branded consumer product business. So you don't see the level of advertising that you would for Nike, for example, or soft drinks, branded soft drinks for example. So in aggregate, the total amount of dollars is about $125 million a year is what they spend on advertising. A lot of that is directed at general brand awareness, with some of this advertising on TV, and local circulars, newspapers. But it is not a -- what I would

consider an advertising driven business the way it is in other types of industries. It's also a, a function that CarMax, during the time period, appears to have outsourced a significant amount of the management of that function to a company called Horizon Media. I don't have exact numbers in terms of the amount of spend that Horizon Media was responsible for. But effectively, as I understand it, Horizon Media would be in the nature of a management consulting or an advertising consulting company whose responsibility it was to place a lot of the advertising dollars.

Q: What conclusions do you draw as an economist from the research you have done on the determinants of profitability of CarMax's business?

A: I, I concluded it's, again, as you would expect with a retail business, and that, that it is the profitability is driven substantially by the brick and mortar locations of that business. And that goes all the way from kind of the, the generation of the inventory that the company had offers

to sell to other customers, all the way to the sales themselves, both of the cars, the retail cars, the wholesale cars, and then a broader range of, of, of financing and other associated services like the extended protection service plans. So this is a very highly localized activity and dri- -- and driven very much by that brick and mortar consider- -- that, that brick and mortar business.

MR. ANTLEY: If you could pull up Slide Number 31.

(Slide Number 31 was referenced at this time.)

Q: Dr. DeRamus, can you describe your understanding of CarMax's corporate structure in the US?

A: Sure. So it's ---

MS. GEER: Hey Trey, it's not up if you're looking for that.

A: Sure, we, we touched on this somewhat earlier I think in my testimony, is that at the top we have CarMax, Inc. Below CarMax, Inc. you have on the left of the demonstrative the two, or three if you include the California as a separate entity, the three operating companies, Cal- -- CarMax East, CarMax West

and, and CarMax California. And then aside from an insurance entity, on the right, we have the CBS, the CarMax Business Services LLC, below which sits CarMax Auto Supers- -- Auto Superstores Services, which is the entity that actually houses all the employees of Car- -- of CBS. So CB- -- CBS itself does not have any employees. It contracts with CAS for all those employees. But there are other employees, you can see by the number, the, the headcounts in the -- in the slide, the number of employees in East and West and California.

A: Okay. How much of the company's total sales is CarMax East responsible for?

MR. ANTLEY: And if you could go to Slide Number 32.

(Slide Number 32 was referenced at this time.)

A: On average, it's about 74 or 75 percent over the -- over the time period.

Q: Does the fraction of CarMax Inc.'s taxable income earned by East and West correspond to their respective shares of retail sales?

MR. ANTLEY: And if you could go to Slide Number 33.

(Slide Number 33 was referenced at this time.)

A: No, not at all. And you can see kind of by the shift in the green bars in these two demonstratives. Green is East, so while Green const- -- while East constitutes approximately 75 percent of the company's sales, it'll only constitute the -- the East accounts for only about 20 percent of the company's taxable income with the remainder being accounted for by West.

Q: What is causing this result?

A: A combination of the non-arm's-length transfer pricing for the management services provided by CBS, the way in which the -- all of the benefits of the financing business are accrued at CBS rather than at the operating company level. And then because of the, in my view, non-arm's-length, disproportionate share of CBS that is owned by West as opposed to East.

OBJECTION:

MS. GEER: Your Honor, just objection to just to preserve the record on him testifying as to the ---

THE COURT: Overruled.

MS. GEER: Thank you.

Q: Did you finish your answer?
A: I did.
Q: Have you prepared a chart comparing the taxable income by entity?
MR. ANTLEY: And if you could go to Slide Number 34.
(Slide Number 34 was referenced at this time.)
A: Yes. So this puts in dollar terms I think what we saw on the other, on the previous slide. So the green bars represent kind of CarMax's consolidated taxable income, they -- they're relatively low. Blue bar is CarMax East. The company accounts for 75 percent of the company's sales, whereas the larger or much larger gray bars are the profits -- or the taxable income of CarMax West.
Q: Has CarMax produced financial information that would allow you to analyze the amount of revenues and operating profit earned in South Carolina prior to the transfer pricing payments by CarMax East to CBS for headquarters services?
MR. ANTLEY: And if you could ---
A: Yes.
MR. ANTLEY: --- if you could go to Slide Number

35.

(Slide Number 35 was referenced at this time.)

A: Yes. So the figures on here provide the revenue attributable to the South Carolina locations, as well as the operating profit before the management fee charges to CBS. I should also note that this does not include any assignment of -- or any allocation of income associated with the, the finance business. So this is the operating profit as recorded on the financial statements for the implementation of the management fee.

Q: And what was the actual taxable income apportioned to South Carolina by CarMax through the use of its transfer pricing policies and separate entity reporting?

MR. ANTLEY: And if you could go to Slide Number 36.

(Slide Number 36 was referenced at this time.)

A: Well, you'll see that while the, the prior -- the prior slide had about $89 point, I believe it was eight million in total operating profits over the audit period, by the time you go through the actual use of separate entity reporting the taxable income,

apportioned of South Carolina was $21 million. So that delta is a function of the transfer pricing mechanism effectively.

Q: From an economic perspective, if CarMax, Inc.'s total taxable income were apportioned to South Carolina based on South Carolina's share of the company's total sales, would the resulting apportionment reliably reflect the underlying profitability of the car- -- of CarMax East retail operations in South Carolina?

OBJECTION:

MS. GEER: I would object to the form unless that's from an economic perspective.

MR. ANTLEY: That's how I prefaced my question.

MS. GEER: I, I didn't -- I didn't hear that ---

THE COURT: He said ---

MS. GEER: --- then, I apologize.

THE COURT: There was a prepositional phrase ---

MS. GEER: Yeah. Okay good ---

THE COURT: --- at the ---

MS. GEER: --- I just ---

THE COURT: --- beginning of that ---

MS. GEER: --- missed ---

THE COURT: --- question.

MS. GEER: --- it. I'm, I'm sorry.

THE COURT: It started with, from.

MS. GEER: Good, good, good.

A: Yes, it would.

Q: Okay. And does your analysis of the determinants of CarMax's profitability and the relative profitability inform your opinion as to whether CarMax's use of separate entity apportionment fairly reflects its economic activity in South Carolina?

A: Yes. That analysis does inform that opinion. I would say my overall opinion on that is that the company's use of separate entity reporting and particularly in the way it's implied its transfer pricing policies is that the, the taxable income does not fairly reflect the economic activity in the state.

Q: And before we start discussing the company's transfer pricing policies in detail, what analytical framework did you use in carrying out your analysis of CarMax's transfer pricing?

A: So in transfer pricing analysis, the, the general standard is often referred to as the arm's-length standard, namely how -- what are

-- what are the prices that would obtain between related parties if in fact those transactions had occurred at arm's-length, i.e., between independent parties that had no common ownership. It's consis- -- also consistent with my understanding of the Section 482 regulations, that which describe at length the arm's-length's standard and reference it constant.

Q: Do the 482 regulations require analysis of the functions, assets and risk of the related parties?

A: Yes, they do.

Q: And have you performed such an analysis for CBS CarMax East and CarMax West?

A: I have.

Q: Do the 482 regulations reference the need to consider the economic substance of the transactions and not just the legal form that the taxpayer uses?

A: Yes. They refer to that in several different locations. At, at the end of the day, the job of the economist is to analyze the prices that would be consistent with the economic substance of the transactions that occur.

And there are times particularly in a related party transaction where the economic substance can deviate substantially from the way the related parties have set up their transactions. So that can occur both in terms of thinking how -- about the, the, the contracts themselves, where the contracts can say one thing and the conduct can be different. Or it can also refer to kind of the broader structure that the taxpayer has, has put in place that could have one legal structure, but the operational -- the operations of the company could be very different. At the end of the day, my job as an economist is to price the substantive transactions even if there's a con- -- a difference between the substance and the legal form of those transactions.

Q: In your experience, do the 482 regulations also require you to assess the reasonableness of the overall results of the transfer pricing methodology applied?

A: Yes. There is a, I often think of it as almost like a two pronged analysis. There are -- a significant portion of a transfer

pricing analysis goes through the methodology and, and walks through the re- -- the methodology to ensure that it's an appropriate methodology and reasonably done. But at the end of the day, the bottom line number is the ta- -- that, that I'm being asked to assess is the reasonableness of the actual intercompany charge, that transfer price itself. So there is an o- -- that's one of the reasons why the, the regs frequently refer to the need to evaluate the, the reasonableness and the arms-length nature of that overall result independently of how the parties came to that particular result.

Q: That -- I'd like to get to a little more detail of the transfer pricing studies. So I'm, I'm going to refer to Ernst and Young's transfer pricing analysis for CarMax for 2012, and 2015. Those are -- 2012 is Joint Exhibit Number 7, 2015 is Joint Exhibit Number 8.

(Joint Exhibits 7 and 8 were referenced at this time.)

Q: Are you familiar with those studies?

A: Yes, I am.

Q: What is your opinion regarding the reliability

of the taxpayer's transfer pricing studies?

A: It's my opinion that neither of them are reliable, and they are inconsistent with my understanding of the requirements of the 482 regulations.

Q: How many separate transactions between CBS, CarMax East and CarMax West does E- -- E&Y, or Ernst and Young evaluate?

A: They evaluate five transactions.

Q: Do you know what those five are?

A: Yes. So the first one is a trademark licensing agreement. The second one is the -- what, what they assert is a business services transaction or a back office services. It's, I think it's sometimes referred to as that. The third one is an advertising services charge. And the fourth one is a real estate services charge, while a fifth one is a business/data analytics services charge. Those latter four all relate to the services provided by CBS to CarMax East and West under the management services aren- -- agreements, whereas the first one refers to the lic- -- the, the trademark refers to the license.

Q: Are all of these services provided by employees of CBS or employees of a different entity?

A: They're employed by a -- by CASS. That's employee -- the employee's of a different legal entity.

Q: Is CarMax use of ---

THE COURT: You said CASS?

A: CASS, C-A-S-S. CarMax, CarMax Auto Superstores Services.

THE COURT: Okay. It's a separate entity, but is it -- is it under the Car- -- the CarMax, Inc. umbrella?

A: It is. It's under the -- actually it's, I believe it's underneath the, the CBS umbrella. CBS LLC owns CASS, and CASS is where all the employees reside.

THE COURT: Okay.

Q: Is CarMax's use of separate -- of the separate employee company for the functions performed by CBS central to your criticism?

A: I would say it's irrelevant, simply because it is a -- it wouldn't be that, that big an issue for me if the, at the end of the day, the company were charging a reasonable markup

on the costs or the -- just the actual costs of the employees to the operating companies. But it is a, from an economic perspective, it's a very odd result, to see a related party transaction where the employees performing a -- this particular function or this other entity, and yet CBS as an entity is charging a, you know a, a very large amount of fees to the -- to the operating companies that's unmoored with those, those cost of those services. So CBS pay- -- compensates the, the, the service comp- -- the employee company at a cost plus, I believe, 2 percent. And yet CBS, the taxpayer has asserted that CBS is providing these func- -- that these functions being performed by these individuals are extraordinarily valuable and warrant the payment of these premium payments back from the operating companies to CBS. That, to me, is inconsistent. Mythologically it, it's inconsistent, and it's inconsistent what I -- with what I would expect under arm's-length dealings.

MR. ANTLEY: If you could go to Slide Number 37.

(Slide Number 37 was referenced at this time.)

Q: Can you give us a summary of these five transactions?

A: Sure. So we'll start with transaction one, it's probably the easiest one to follow, the trademark royalty. It's easiest because it's fairly discreet and trademarks come up in other contexts as well. So they -- this is the summary of the results from Ernst and Young's 2015 Transfer Pricing Study. So they applied a methodology called comparable uncontrolled transaction methodology, or CUT, and you'll see that in the bottom row versus methodology. And they basically attempt to identify agreements, third-party agreements that they say are comparable to the use of this -- of a -- of a license in this context, or of a trademark writ largely, and I can come back to that in a minute. But they, they come up with a, a royalty of between 1.3 and 0.5 percent, with a median of 0.6 percent. Transaction two, the back office services, they apply the comparable profits method. It's a method where one goes out and finds companies, benchmark companies that

perform similar services. They then identify the markup earned by these third parties, and then apply that markup to the tested party. So in this case, the -- that's where CPM, in that section -- second column, applies to the back office services, and the -- with the percentages you observe, there are the results of the, the third-party companies that they've identified for that transaction. Transaction three is something they call the comparable uncontrolled services price, CUSP, which is a bit of a mouth full. But basically has a corollary to something called a comparable uncontrolled price. So -- except it's in a service con- -- context. So a CUP, or a com- -- uncontrolled price is kind of analogous to what I've described before in terms of a comparable uncontrolled transaction, or a CUT in the context of a royalty. A CUP or a CUSP would be, in the event, in a -- typically, the easiest one to think about is if I am selling -- I, I produce engines, and I sell engines to a related party and an unrelated party, and it's the exact same engine, that's a comparable uncontrolled price, it's

identical product, so I know exact- -- I know I have a very good reliable benchmark of the price in which I should be charging my related party since I'm charging an unrelated party the identical price. A CUSP, comparable uncontrolled service price, the idea it was that it -- in the regs it's that it would arise in situations where a company where it was providing a service to both related parties and unrelated parties. So if I'm providing accounting services to an unrelated party and accounting services to a -- to a relate -- to, to a related party, and I'm charging $100 an hour to the unrelated party, then the related party charge should also be $100 an hour. Fairly straightforward type of idea. I, I have a broader criticism of how they've applied it because I do not think how they've applied it comports in any way with the regulations and the guidance in the regulations, but nonetheless, that's what the -- that's the method that they assert to have applied in this instance. And they come up with an advertising fee as a percentage of sales of between two and five percent with a

median of two percent. Keep in mind these percentages are applied in different ways. So that 2 percent is applied to sales. The, the transaction two, that 7.9 percent, that's applied to the cost base, the cost of providing the services. And the transaction one, the royalty, is also applied as a percentage of sales. Transaction four is a real estate services markup. Think of four as very similar to two. It's a -- it is a -- the application of the comparable profits method in which they've identified third-party companies, identified a markup from these third-party companies, these are the ranges of the markups they've applied, and they apply it to the cost basis for that particular function provided by CBS. So here's a bunch of real estate c- -- real estate costs associated with employees in CBS, and I'll mark those up by the amount of that markup, that 10.4 percent you do markup. Fifth, and the one that takes maybe a little longer to understand, is this charge for analytical/business services. They implement on a per vehicle basis. So the, the study

comes up with a range of between $491 to $736.50 per vehicle that the study asserts is the value attributable to these services. Now the method, I have an unspecified method there, because it is literally called an unspecified method, even in the documentation. So Ernst and Young says, says -- goes through and talks about the different methods that one might use, and concludes that in it's judgment the most appropriate method to apply is this unspecified method that effectively, the company has, has derived.

MR. ANTLEY: If you could go to Slide Number 38.

(Slide Number 38 was referenced at this time.)

Q: Has Car- -- how has CarMax used these results to develop the actual transfer prices paid to CBS by CarMax East?

A: So this, I think hopefully a helpful example of just how all these numbers are turned into the final transfer price. So the final prices that, that, that how -- in terms of the implementation of the policies, they're applied on a per vehicle basis. And so that's a -- there's a column that says per car invoice rates. So that is the number

that's being derived by the company taking the inputs, the, the analy- -- the analysis that E&Y provides them. So for example, maybe I'll start with the easier ones. They, they typically start doing this on -- appears to be being done on a forecast basis. So here, the company -- this is for 2017. For FY 2017, the company has projected sales of $13.8 billion. So it applies a 2 percent, effectively I consider it more of a royalty, they call it an advertising services fee, that's 2 percent times that projected, projected revenue to get that charge of $275 million -- $275.7 million. They divide that by the projected number of, of retail sales. You'll see that towards the bottom left 600 and -- my eyes, sorry my eyes are a little bit blurry, 682,294 to get to the per vehicle basis of $404 for the advertising -- I'm sorry, it was 682,294 protected units, to get to a per unit charge of $404 for the advertising services fee. They do a similar calculation for the trademark royalty where they're applying another 0.5 percent. With regard to the -- this big charge, this $506

charge for -- this is transaction five, remember the range that was established in those early -- that earlier slide, CarMax, I'm not quite sure how they pick 506 versus 403 or 400- -- or 512. It's still somewhere within that range, but they applied $506 on a per unit basis. So there's no need to convert that one. The markup on the cost of services you see down below. We've applied this -- the 7.9 percent is applied to several different categories of costs of, of CBS, and basically everything other than finance and accounting services. So finance -- I'm sorry, other than the real estate services. The real estate services fee is that 10.4 percent median markup, and the, the other ones get the 7.9 percent. And I should say his not sh- -- I said a minute ago, this applied to all the cost, this is actually a subset of the costs, the only -- those costs associated with that specific function. So think of back office services like accounting, they'll mark up the cost of those by 7.9 percent to get a total projected charge. And then they'll also divided those numbers by

the number of units to get per unit to, to add up to $1,192 per unit for that particular year.

Q: And, and just for the record, this is Slide Number 38. And this information is from Joint Exhibit 37, the management fee breakout?

(Joint Exhibit 37 was referenced at this time.)

A: Yes.

Q: If you go the next slide, please.

A: So, so the company develops these per unit charges and per service charge -- per services charges and they apply -- so they change a little bit on a year by year basis as they update these numbers. So here you can see what they come out to for -- this is for FY 2016, ranging from $100 for the trademark royalty, $192 for the back office services considered collectively. You'll note in the footnote it's really kind of a collection of these different services. 399 for the advertising, etcetera. And then -- to add up to $1,100 for 2016. It increases in 2017 and 18. I think the one important takeaway in this is also think about the percentages and to see what fraction of these

char- -- of this total, in this case $1,100 charge, is attributable to each of the transactions. So the real big dollar ones are going to be this transaction five, the Analytical Business Services, which accounts for 37 percent; the advertising fee, which accounts for 36 percent of that; and then if you add on a trademark royalty, I put that also in kind of the same group of, of more -- of high, high profit activities that the company is, is asserting relative to the back office services and real estate services, which are really being simply compensated on cost plus. So even though that $192 for back office services is a relatively sizable amount, the vast majority of that is going to cover the cost as opposed to the profit element, which is really what's in the, the other three components.

Q: And again, just for the record, this is Slide Number 39, and this data comes from Joint Exhibit 37, the management fee breakout?

(Slide Number 39 was referenced at this time.)

A: Yes.

Q: If you can go to the next slide, please.

A: And so just for completeness, a similar -- this is a, a similar schedule for 2017 and FY 2018, you'll see the changes in the numbers here to 1,192. This is actually consistent with that earlier demonstrative we went through to show the derivation of the numbers. That one applies to this specific schedule. And then there's another one, a -- a different schedule that was prepared for 2018. The 1192 was the same number in total, but the numbers changed a little bit with regard to components. The trademark royalty changed a little bit and back office services. So even though the total stays the same, the individual elements have some changes.

Q: Okay, and this is Slide Number 40, and this also comes from Joint Exhibit Number 37, the management fee breakout?

A: Yes.

(Slide Number 40 was referenced at this time.)

MR. ANTLEY: If you can go to the next slide, please.

Q: This is Slide Number 41.

(Slide Number 41 was referenced at this time.)

Q: And I'll go ahead and say this at the beginning, does this also comes from Joint Exhibit Number 37, the management fee breakout?

A: Yes.

MR. ANTLEY: If you could go to Slide Number 42.

(Slide Number 42 was referenced at this time.)

A: So ---

Q: Can -- I'll have to ---

A: Yes.

Q: Can, can you explain how the company applies this policy to, to retail sales by the South Carolina's stores?

A: Sure. So ---

MS. GEER: Trey, I apologize, could you -- that one's really small. Would you mind handing me that one?

MR. ANTLEY: I don’t know if this will make it better, but.

MS. GEER: Thank you.

A: Sure, so I think it's just helpful to see the, the line by line implementation of the -- of the charge. It's not simply one charge, charged in aggregate, but here we have separate line items for each of the South

Carolina stores, in Greenville and Columbia, and it has a record of the number of units being sold. There's a timing issue with regard to forecast versus budgeted, but they're -- it appears that the company does a true-up to each one of the changes are appropriately reflect the number of vehicles sold. The ---

THE COURT: What?

A: I'm sorry?

THE COURT: You said true-up?

A: A true-up, yes. Because there's a, I think there's a tend- -- there's you'll, you'll see there's a budgeted units column and an actual units column. So I believe there is some attempt to, to reconcile their charges that are made in a given month that need to be trued up based on the actual sales that occurred. The charges across the top row you'll see it as a, a -- these are the per unit charges. They're broken out by these very separate or more detailed functions like the general management and administration support, all the way to the intellectual property charge at the end. But those'll add

up, you'll see the far right column, the $1,100 per unit. But these are how the charges are actually invoiced to CBS.

Q: And, and for the record, this is Slide Number 42. And this comes from Joint Exhibit 38, the 2016 sample South Carolina invoices?

A: Yes.

(Joint Exhibit 38 was referenced at this time.)

MR. ANTLEY: If you could go to Slide Number 43.

(Slide Number 43 was referenced at this time.)

Q: How much in total are the management fees paid to CBS?

A: Well, as you can see from the demonstrative, that even though they talk about 1100 or $1,200 per unit, because of the sheer number of units, these are quite substantial. So, depending on the year, it's between 700 million and close to $900 million, of, of which the vast majority is paid by CarMax East.

Q: What impact does the payment of the management fee have on the relative share of operating profits by the various CarMax entities? And before you answer.

MR. ANTLEY: If we can go to Slide Number 44.

(Slide Number 44 was referenced at this time.)

A: So sim- -- simply because of the way in which the company is structured, CBS and the, kind of the flow-through of income with CBS, I think it's helpful to kind of step through it on a piece by piece basis. So before the transfer pricing, which is what we see in the far -- the far left-hand column, see East has nearly 80 percent of the operating profits. The, the numbers are actually greater than 100 percent here because the -- you'll see that white box at the bottom, that's the, the operating profit of CBS. It's before the transfer pricing mechanism is actually in a loss position before you consider the payment and the fees, because it actually does incur some costs, significant costs, associated with that headquarters function. So, the operating profit initially, I think I had an earlier slide that showed the al- -- the allocation be- -- between East and West, but the predominant share of the operating profits, pre-transpor- -- transfer pricing are in East, a mu- -- a much smaller share as in West. As a result of the transfer pricing, 70 percent

of those profits get moved over to, to CBS. So that's why the white box all of a sudden goes from that negative number to a very, very large positive number and -- that big box at the top. So that's where I said it accounts for about 70 percent of the operating profits at that point.

Q: Okay.

A: Now those won't include the operating profits, both from the, what I consider the non-arm's-length management fee as well as the profits from the, the finance business. The -- so before the distribution of the income of CBS, you'll see kind of a much reduced profits of East and West. But those prob- -- those proportions are still proportionate to the in- -- the operating income that the -- that they were hurting before the transfer pricing mechanism, simply because there's not yet been the flow-through of the CBS income, and because West is also being charged a similar price as for the admin fee -- fees has East. And then you go to the last column, that's where you see the effect of the flow-through of CBS. So because the -- that white box

flows through to 93.5 percent to West and only 6.5 percent to East, then that's where you see the, there's a little, relatively small green, light green shaded bar that 2 for the, the third box up from the bottom, that's the 6.5 percent share of CBS profit that's going -- that's being passed through to East as a result of the LLC pass-through structure. But that very, very large, light blue share is the -- is the amount that's going through to West. So that's how you get the combination of that, that, that large share of the light blue and the dark blue, that's where you have a disproportionate share of the profits, effectively 75 percent of the profits, being shifted over to West through this combination of the transfer pricing mechanism and this disproportion in the shares of ownership of CBS.

Q: And, and this source data for Slide Number 44 is Joint Exhibit Number 70.

(Joint Exhibit 70 was referenced at this time.)

Q: It's an Excel spreadsheet of the, I think the legal balance sheets, and I think that was from Dr. Cody's file?

A: That's correct.

MR. ANTLEY: If you could go to Slide Number 45, please.

(Slide Number 45 was referenced at this time.)

A: So, so this -- this is a -- effectively takes that prior slide and just kind of simplifies it a little bit to say, here's the pre-transfer pricing result, where you have about, a little over 70 percent of the pro- -- operating profits in the -- in East relative to West prior to the transfer pricing, but through the magic of the transfer pricing and the ownership shares, then those are -- I believe it's 23 percent of the taxable income relative to West.

Q: And the source data, again, would be Joint Exhibit Number 70?

A: Yes.

Q: All right. Okay. I'd like to review the Ernst and Young report for each of the five transactions in more detail. So let's start with transaction one, the trademark royalty.

A: Okay.

MR. ANTLEY: If you could go to Slide Number 46.

(Slide Number 46 was referenced at this time.)

Q: What does the license agreement between CBS and CarMax East cover?

A: So the license agreement appears to cover the trademarks themselves and the trademarks and trade names.

Q: Let me just make sure for the record, we have the source data for this. This is from the, the license agreement, is that correct?

A: Correct.

Q: And that -- so that would be Joint Exhibit Number 36?

A: Yes.

(Joint Exhibit 36 was referenced at this time.)

MR. ANTLEY: If you could go to Slide Number 47, please.

(Slide Number 47 was referenced at this time.)

Q: Okay. In its transfer pricing analysis, what does Ernst and Young assume that the license agreement covers?

A: This is where the, the documentation gets a little confusing, because -- so I go to the li- -- the fir- -- my first task as an -- as a transfer pricing economist is to look at the license agreement. It's very clear, in my view, that it is a trademark license, and

yet the moment I started reading the tran- -- the transfer pricing report, Ernst and Young appears to be imputing the -- a, a license to a broader range of business process intangibles. And so it's effectively, it's folding in these additional intangibles into that trademark license, and it is -- it claims to be evaluating kind of a, a license for the totality of the -- of those very separab- -- separate transactions.

THE COURT: By folding in, you mean adding in?

A: Yes, effectively. It, it is, it ---

THE COURT: What's the difference then, if you say effectively?

A: It is because, and this is the part where I find it, the whole presentation of the report confusing, because there -- it is not additive in the sense that CBS as an entity does provide business process intangible. I'm sorry, it does provide these data analytic services, that's what's supposed -- is was -- it is assertively being covered in transaction five. I think I talked about that per unit number of $400 per vehicle for data analytic business services. But then now I see it

folded, and there's a piece of that, that appears to be folded into transaction one under the cov- -- the rubric of a business process intangible. So that's where I see it as -- it is a -- the -- a -- the whole notion of the -- of the data anac- -- analytics services, they are a service that, that, that is a service that's being provided by CBS. So it's not necessarily additive to the broader framework of services being provided, but it's being folded into the trademark transaction one even though you look at the structure the way E&Y has, has set it up, and you say, Why isn't that covered under transaction five? Now, E&Y tries to do some, I, I think some mental gymnastics to try and reconcile the fact that it has included these business process intangibles in transaction one with the analysis in doing a transaction five, but ultimately conclude that it's, it's failing to do so in a reasonable way. But it's also I think, there's a big disconnect between what transaction one is, it is a license, it is a license for a trademark, and what the, the -- these additional, broader

scope, that E&Y is imputing to it in order to, in my view, come up with a higher value.

Q: The information we see on Slide 47, where's, where's that from?

A: So this is from the 2015 Ernst and Young transfer pricing report.

Q: Okay, so Joint Exhibit Number 8. Would that be Joint Exhibit Number 8?

A: Yes, it is.

(Joint Exhibit 8 was referenced at this time.)

MR. ANTLEY: If you could go to Slide Number 48.

(Slide Number 48 was referenced at this time.)

Q: What exactly are these business process intangibles according to Ernst and Young?

A: Well, how they, they describe them in, actually in a prior slide, it's the -- it's these algorithms and the pricing algorithms and the inventory algorithms, things that are being -- I don't know if the wor- -- right word is either developed or implemented by this data analytics group. But they -- so they, they fold that into the, the trademark and then say, okay, now let me figure out how to price this combined intangible trademark plus data analytic services.

Q: So, so which legal entity initially developed these systems?

A: So, this -- the business analytic systems were originally all developed by CarMax East. East was responsible for all the headquarters function, anything related to headquarters was originally developed by East, not by West, not by -- and they were, they were transferred to CBS as a result of restructuring.

Q: And, and what conclusions do you draw about the transfer pricing analysis from the fact that Ernst and Young is including these business process intangibles in transaction one?

A: It makes the, the, their entire analysis of transaction one unreliable. They should -- if they were trying to establish the value of a trademark, they should have evaluated it independently because it's process intangibles. And if they're going to apply the method that they say they're applying, a CUT method, then they should have tried to find royalty rates associated with that with the use of those trademarks. I think there

are broader conceptual problems with even implementing that approach based on the facts of the taxpayer and the -- and the facts and circumstances, but just from a pure methodological approach, that's how they should have applied it in a more reasonable way. Instead, they go to this use of, we call these franchise agreements. And franchise agreements are very, very different from a trademark license agreement. It's a very different economic concept and -- but they -- that's the hook that Ernst and Young uses to say, Ah, now that I've put these business process intangibles, come into the trademark, then that provides them with what I see as more of an analytical hook to say, Okay, I can't find trademark, comparable trademark agreements, but I can find something called a franchise agreement. And franchises often, franchisees often license a broader business system in addition to trademarks. So therefore, they use that as a way to motivate the analysis they're doing here, even though I think it's ultimately applied in a completely unreliable way and inconsistent

with the guidance of the 482 regulations.

Q: So in, in, in your view, why did Ernst and Young include business process intangibles in transaction one instead of leaving them in transaction five?

A: I think it's because as retailers you rarely find observations, reliable observations of trademark licenses in re- -- retail setting. Trademarks, they don't have the same kind of value for a retailer that they might have for a consumer product company, which is why -- that's why they're -- the, the fact that we don't observe those observations means that in most scenarios the value is zero. There's not really a value people want to pay for the use of that particular trademark. So because they have no way of -- other way of deriving a trademark royalty, they then pull in -- fold in the business process intangibles to try and bootstrap this other very different approach using these franchise agreements.

MR. ANTLEY: If you could actually get back one slide, to 47.

Q: What method did -- I'm sorry. What method did Ernst and Young use to develop a royalty

rate for transaction one?

A: So it's, it's that CUT method, Comparable Uncontrolled Transaction method.

MR. ANTLEY: All right, we can go back to Slide 48.

Q: So how did Ernst and Young develop a set of asserted comparable transactions?

A: So it looked for these franchise agreements in some -- in industries that were broadly related to automotive type things. So for example, Jiffy Lube, you see kind of the -- through the -- through the, the range of, of agreements here, Big O Tire dealers, Mr. Tire Service Centers, Incorporated. So it loo- -- in the first instance it says that Ernst and Young goes out to it's databases, to find instances where East has a summary of these agreements, to then say, Okay, here's an end where it specifies a franchise fee, you'll notice Franchise Fee, (Royalty). So I'm not quite sure if that means it was literally called a royalty or whether it was called a franchise fee in that particular one. But nonetheless, he uses that franchise fee as the basis, as the beginning point for his calculations.

Q: And Slide Number 48, is that from Joint Exhibit Number 8, the, the 2015 Transfer Pricing Study?

A: Yes.

(Joint Exhibit 8 was referenced at this time.)

A: And there's a number of, of -- in subsequent slides, there some -- it shows the other asserted comparable ---

MR. ANTLEY: If you could advance ---

Q: I'm sorry.

MR. ANTLEY: If you could advance please to the next slide.

Q: Is this Slide 49?

A: Yes.

(Slide Number 49 was referenced at this time.)

A: And so you'll see -- I believe there's a total of 11 transactions ---

Q: Okay.

A: --- or 11 franchise agreements that they used in the 2015 study. There might -- I think there were a little bit larger number in the earlier study, some of which they cut in the, in the later study. Some of them you'll notice are the same company, just different agreements. Like Jiffy Lube has a couple

different observations, same thing with Big O Tires, Incorporated. And some of them actually aren't even actual agreements between third parties. They're what's called a basic agreement. And that basic agreement, I, I don't have the underlying documents, but I'm assuming that it is a basic, a kind of plain form agreement that may or may not be negotiate -- well the terms might may or may not be negotiated to be different when somebody comes to them with a particular franchise opportunity.

Q: Okay. So this is Slide Number 49. This is from Joint Exhibit Number 8, the 2015 transfer pricing?

A: Yes.

Q: If you could go to the next slide. I think you've discussed it when you mentioned 11. Is this Slide Number 50, is this also from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Correct.

(Slide Number 50 was referenced at this time.)

A: And here you'll see even different companies like this Biker's Dream Company that it threw

in there. It is a, a company like -- the best I can tell, it's a defunct company. At some point, it had a, some kind of storefront where it was selling motorcycles and de- -- motorcycle detailing, could be modifications to, to motorcycles. So I'm not even quite sure how long it was even in operation, but certainly by this time it doesn't appear to have been even operating.

Q: Okay. Did CarMax provide the actual franchise agreements that Ernst and Young used in its analysis?

A: No.

Q: Does Ernst and Young try to factor into its analysis the fact that it's third-party franchise agreements are broader in scope than the CBS License Agreement?

A: It tries to, yes.

MR. ANTLEY: And if you could go to Slide Number 51.

(Slide Number 51 was referenced at this time.)

A: So -- and this is, this is pretty much the extent of the information that Ernst and Young provides, it provides a summary table like this. And it says in effect, we have a

franchise fee, the franchise fee may cover more than just the trademark and the business process intangible that we, Ernst and Young, are tying to benchmark. So let's see if we can kind of disentangle a piece of the -- of all the, the other stuff embedded in the franchise fee. And so they claim that they have certain master franchise agreements, which are -- where there's a -- they're the franchisor, and will contract the fran- -- with a master franchisor, who in turn contracts with the franchisee, and is only a fraction of the -- so the ma- -- the master franchisor takes a large -- turns out, from their comparables, a fairly large fraction of the franchise fees paid by the franchise -- the franchisees. It retains that for whatever services the master franchisor's providing, the local business development or whatever, and then it remits a, a fraction up to the, the, the actual franchise owner. Which -- so here they have a set of seven franchise arrangements. Again, just the observations. This is all the detail that I observed in the documentation. And they

assert that -- it shows that about 25 percent of the total franchise fee paid by an individual franchisee is paid up to the master franchisor. So they're trying to analogize Car- -- CBS as effectively the mast- -- as, I'm sorry, is effectively the franchisor. And looking at that fee that, that CBS should receive as the franchisor from the total franchise fee paid by the operating companies which it is -- which E&Y is analogizing as -- as a franchi- -- as a franchisee. Which I think from a transfer pricing perspective, I think is totally inappropriate. Inappropriate and inconsistent with a very clear guidance in the 482 regulations that say, when you apply this kind of method, this comparable uncontrolled transaction method, you better be sure that you have a reasonably good comparable that you -- you can have a lot of hand waving associated with a -- something that is very, very different. It's highly unlikely to come, come up with a reliable result. So if they had wanted to go down this route, they being Ernst and Young, of, of trying to price

the trademark using a comparables approach, you should have just done what every other trademark license transaction I've seen in transfer pricing, where people go to comparable uncontrolled transac- -- actual royalty agreements for the use of the trademark.

Q: The information we see in Slide Number 51, is that also from Joint Exhibit Number 8, the transfer pricing site for 2015?

A: Yes.

(Joint Exhibit 8 was referenced at this time.)

MR. ANTLEY: If you could go to Slide Number 52.

(Slide Number 52 was referenced at this time.)

Q: So what, what does Ernst and Young do with its information on master franchise agreements?

A: So, so here's where you can see, in column A is these base range of royalty rates that it derives from that, that first step where it identifies these other franchise agreements, or these -- that, that group of 11. It then applies this 25 percent adjustment factor based on the master franchise agreements, and then it applies that 25 percent to those

other -- that column B to column A, to derive it's ultimate adjusted royalty rate of between 0.5 and 1.3 percent.

Q: Do you consider these master franchisee agreements to be comparable to anything related to CBS's license agreement?

A: No. It's far different in scope, it requires this leap of faith in terms of the applicability of that kind of economic arrangement to kind of the operations of the indus- -- integrated business. And it's just far beyond what I would consider to be a reliable application of the method.

Q: Has CarMax provided copies of the master franchise agreements that Ernst and Young uses in its calculations?

A: No. And I would say that's a major deficiency. Not a -- not even -- they don't -- they didn't even provide the summaries to really understand the scope of those -- of those agreements. Recall that this, this notion of a division of profits between different entities really depends enormously on the specific functions being performed, what's -- what is being contributed by each

of the parties involved; and we have zero vil- -- visibility into what lies behind those.

Q: Does this application of the CUT method comport with your understanding of the requirement for the CUT methods specified in the 482 regulations?

A: Not at all.

MR. ANTLEY: If you could go to Slide Number 53.

(Slide Number 53 was referenced at this time.)

Q: Has Ernst and Young previously considered and rejected the use of the CUT method to value the same bundle of intangible that it -- intangibles that it purports to be pricing with transaction one?

A: Yes. So this is a statement that Ernst and Young made in its 2005 intangible valuation analysis, when it was evaluating the alternative ways of valuing the intangibles that were be- -- that were assertally being transferred at the time. And so this is the same type of asserted bundle of trademark, trade names, business process intangibles, and it says it comes up with the -- with the conclusion that given the highly specific and

unique character of CarMax's relevant intangibles, it is difficult, if not impossible, to identify external comparables which could serve as the basis for this analysis. So it is, apparently at that time, it considered and rejected that, that very approach.

Q: And Slide Number 53, is -- this from Joint Exhibit Number 55?

A: Yes.

(Joint Exhibit 55 was referenced at this time.)

Q: Conceptually, even aside from your criticism of the inclusion of the business process intangibles and the royalty rate, do you consider it to be consistent with arm's-length principles for CBS to charge CarMax East a trademark royalty?

A: No, I don't. The -- and that's the important thing to transfer pricing analysis is to take a step back, and again, look at the history of the development of any asserted intangibles that are being priced. There is a, a something generally referred to as the owner developer rule, or its -- or I thinks it's maybe better referred to as the owner

developer principle, which is the notion that because a company can arbitrarily assign legal ownership of an intangible, any entity it wants to, that what the economist needs to do is to look at what entity is actually responsible for the development of an intangible. So here, what do we know about advertising or the value of the trademarks, and, and the legal ownership associated with them, we know, all the -- up until 2004, East, CarMax East, was responsible for all of the advertising associated with the company. Not CarMax West, it was all on CarMax East. And that was before the formation of CBS. And also there -- from the get go, i.e., as I understand from Ms. Yost's deposition, the company assigned the trademark rights to West. Trademark, it didn't, does not appear from my review of the evidence that, that, that West ever did have any employees to, to, to -- that were engaged to protect that trademark or to further develop that trademark. So the fact that, that, that because of the restructuring, all of a sudden East would start paying a royalty for intangible that it

developed is -- I, I would say it -- there, there may be a certain set of fact finders where that might come about but it's, it's highly unusual, and it's certainly not something that I would expect. The, the other part is that the, the -- where, where you might expect the payment of a royalty is if CBS were entirely responsible for the advertising function going forward. And bore the risks of tho- -- of substantial advertising expenses. But in fact going forward, from 2004 forward, E- -- both East and West are bearing the cost of the advertising function and then some. They're paying a lot for that. So there's no risk bearing activity that E- -- that, that CBS is performing with regard to develop of those trademarks that would warrant a payment of a -- of a trademark royalty by East to CBS. And lastly, it does beg the question of what is the value of a trademark and where does it come from in a retail store situation? A lot of -- my opinion as an economist is a lot of the value of that trademark is a function of the customer experience at the retail store

level. Advertising plays some role, but it's not like a con- -- it's not like Nike, it's not like Air Jordans. This is a very different kind of trademark, that has value because of the, the customer knowledge of the pro- -- that there is a retail store in close proximity to them, they're friendly salespeople, and I can buy a car with a minimal hassle, and they have a good selection of stores. If that's the case, then really the value -- that, that -- what's really being priced is the value customer goodwill, and I don't think there should be a payment to CBS for the goodwill that's being created by the stores themselves.

Q: Now I'd like to move to transaction two, the charge by CBS for back office services.

A: Yes.

Q: What method did Ernst and Young apply there?

A: So this is the comparable profits method, the easiest of all the methods to understand because we see it a lot. Where you go and you identify a tested party, usually this, the more simpler -- the simpler of, of the test -- of the related parties, you identify

comparable companies that perform very similar functions. You derive a profit level indicator and then you will apply that to your tested party.

Q: Is, is that one of the specified methods in the IRS 482 regulations?

A: Yes.

Q: I think you just described the comparables for that profits method. Did Ernst and Young generally follow this guidance as you understand it?

A: Yes, they did. And, and with regard to transaction two, Yes.

Q: In what specific section of the 482 regulations does Ernst and Young use to evaluate this transaction?

A: This is the so called Dash 9, 482-9 regulations, which apply to services. And I think this is pretty much consistently the section of the regulations that the -- they apply to transactions two through five.

Q: And do you agree that the 482 services regulations are the appropriate section of the regulations to apply to the headk- -- headquarters services provided by CBS in

transaction two?

A: Yes. And I also think they're the appropriate one to apply to all the transactions, two through five.

Q: From a conceptual level, do you generally agree with Ernst and Young's application of the CPM to transaction two?

A: Methodologically I agree that they've applied it in a reasonable way. And in general, I would say it is a reasonable method that I would expect to apply in the normal context of a services transaction. And even here I would say, I, I agree that it would be -- it is a reasonable approach to apply with one important caveat, and that's that any prop- -- because of the ownership shares and because I've concluded that the -- those ownership shares of CBS are non-arm's-length, in effect, any ---

OBJECTION:

MS. GEER: Your Honor, just objection to the form of that particular comment for -- to keep my objection on the record.

THE COURT: Overruled.

A: In this particular context, any profit

allocation to CBS no matter how modest is going to disproportionately flow to CarMax West. So even the ap- -- the application of a -- what I consider to be a generally reasonable method, like a CPM, it's going to produce some markup on cost for the service, that the -- because CBS -- because East is paying the, the majority of those costs, and the majority of those -- and majority of that markup, and the majority of that markup is flowing over to West, it's still going to have a non-arm's-length result. That's why I think in this particular context, the most reliable method would actually be something called the Service's Cost Method as specified in the regs. Which is simply taking all the costs, and allocating them out to East and West based on either the revenues or profits.

Q: Okay. And, and we can come back to those, those prior reservations later on.

MR. ANTLEY: If you could go to Slide Number 54.

(Slide Number 54 was referenced at this time.)

Q: Are these the industries Ernst and Young used to find comparable companies for transaction two?

A: Yes.
Q: And does this also come from Joint Exhibit Number 8, the 2015 transfer pricing site?
(Joint Exhibit 8 was referenced at this time.)
A: Yes, it does.
Q: Okay.
MR. ANTLEY: If you could go to Slide 55.
(Slide Number 55 was referenced at this time.)
Q: Are these the business services companies that Ernst and Young uses to benchmark CBS's return and the cost plus markups that they earned in these years?
A: Yes, it is.
Q: Okay. In Slide 55, is, is this from the -- from Joint Exhibit Number 8, as well?
A: Yes, it is.
Q: 2015 study?
A: Yes.
Q: Do you consider this to be a reasonable result for benchmarking the back office services function?
A: Again, setting aside my reservation about the ownership shares, yes, it's an o- -- on -- it -- in the broad scheme of things it's a reasonable implementation. While at the end

of the day, I, I would have implemented the, the search criteria slightly differently, and I, I believe the 7.9 percent is a little bit high for what I consider to be true back office services, but nonetheless, the appro- -- and, and because this has really being applied to cost, that the profit element is not that lar- -- the delta between the way I would apply it and the way they app- -- way H&M applied is not all that large. My, my biggest reservation is the fact that they didn't apply the same method, the CPM approach, to all the, the four transactions, transactions two through five, at issue here.

Q: Have you identified an alternative set of back office services companies?

A: Yes, I have.

Q: Okay.

MR. ANTLEY: If you could go to Slide Number 56.

(Slide Number 56 was referenced at this time.)

Q: And is Slide Number 56, is this from the Joint Exhibit Number 63, the back office set?

(Joint Exhibit 63 was referenced at this time.)

A: Yes, it is. There's this and there are some additional companies on the following slide I

believe.

Q: Okay.

MR. ANTLEY: If you could go to the next slide.

(Slide Number 57 was referenced at this time.)

Q: So Slide 57 is also from that same Joint Exhibit Number 63, the back office set?

A: Correct. And you'll, you'll see that the, the, the results that I obtained are probably more consistent with what I would have expected going in. You have kind of returns, a markup on total cost of around 4 percent as a median over this time period. It actually has some relevance for the application of the 482 services regs. It's often what's called kind of a low-value added services. Companies often can, can apply that services cost method, i.e., apply a 0 percent markup and just allocate costs for services that are general -- have a -- generally have a low markup, which is below 7 percent. So the 7.9 percent or the 6.7 percent that the taxpayer comes -- has come up with or that Ernst and Young has come up with, is a little bit higher in, in some of the years in particular than the numbers that, that I have. But

generally within that -- in that ballparkish range. That's why I said the 7 percent, 7.9 percent that I observed Ernst and Young applying is not an unreasonable number in and of itself, even if it's -- I consider it a bit high.

Q: Moving to transaction three, the charge by CBS for advertising services. What method did Ernst and Young apply here?

MR. ANTLEY: And if you could go to Slide Number 58.

(Slide Number 58 was referenced at this time.)

A: So this is the, the -- that mouth full, full, the comparable uncontrolled services price. Ultimately, it's still a fancy way of saying a, a comparable uncontrolled transaction, a CUT. They're -- Ernst and Young is using that very same set of franchise agreements, and it's using a subset of those agreements that have specified advertising fee, and it says, so, and it, it purports to be the, the, that is a reliable way of deriving the, the payment to CBS for the advertising services that it applies. So it comes up with this inter-quartile range of between 5 and 2

percent of -- for a advertising fee that -- the subset of franchise -- franchisees pay, the franchisor, or master franchisor as the case may be, and then it applies that 2 percent median as effectively -- I consider it more for akin to a royalty because it's applied to sales.

Q: And what we're seeing on Slide Number 58, is that from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Yes.

(Joint Exhibit 8 was referenced at this time.)

Q: Is one of the specified meth- -- sorry. Is CUSP, the method you were just discussing, is that one of the specified methods in IRS regulations, the 482 regulations?

A: Yes, it is.

Q: Is, is -- how Ernst and Young applied the CUSP methond here, is that consistent with the 482 regulations?

A: Not at all. And, and the, the -- this 482 regulations, when they talk about the CUSP method, there's -- that's probably the one -- the area where there's the kind of greatest particularity in terms of the need for very,

very close comparability. I don't know if you remember my earlier analogy about the engine being sold between two parties. So if I'm selling you a Corolla engine versus a Ford F150 engine, the price of those engines are going to be very different. So you can't use one to set the price of a different one. So the same thing applies in spades in a -- this -- a comparable uncontrolled service price method. If you're going to price a service that I -- that -- using this method, then the service being provided to the related and the unrelated party have to be very close, if not identical. Here, these are based on advertising fees, advertising fees charged to franchisees in some other types of industries for some specific kinds of franchise arrangements. The -- what the problems by using these kinds of arrangements is that franchise fees that the -- the advertising that a company may spend is gonna be -- depend very heavily on the type of business it's involved in, how much in advertising is required. So one thing, I don't know if I said this early on when you

asked me my -- the, the role of advertising, but it accounts for about 1 percent of sales. So the advertising expenses of CarMax is about 1 percent of sales. So it's a relatively low level of advertising expense. So why would I expect the arm's-length to observe a 2 percent advertising fee? Again, this is a fee, this is the -- the royalty is suppose to be compensating the use of the trademark separately. So there is this du-- -- this one use of an inappropriate method using these franchise agreements to benchmark to apply the CUSP in a way that it's not at all envisioned by regs. Two, it comes up to a result that even on its face is patently unreasonable. A 2 percent fee for a service that only costs 1 percent to provide. And furthermore, a duplicative nature of a payment because you already had the trademark fee being paid first. And typically a trademark owner is charging a trademark royalty in part to compensate itself for the ongoing maintenance and development of that particular trademark.

Q: This may be inferred from your, your previous

answer, but do you consider this to be a reliable application of the comparable uncontrolled service price method?

A: Not at all.

Q: Okay. And could you explain exactly how Ernst and Young selected it's assertedly comparable advertising agreements?

A: So, actually it describes it in that first paragraph. It identifies these eight agreements that it used in its prior trademark agreement.

Q: And would that -- the first paragraph, we're on Slides 58, still? Is that ---

A: Correct.

Q: Okay.

MR. ANTLEY: And if you could go to Slide Number 59.

(Slide Number 59 was referenced at this time.)

Q: And, and which specific franchise agreements did Ernst and Young use for the advertising fee?

A: So you can see on the licensor name, a column that says specialized licensor, it's Grease Monkey, Mr. Tire services, Jiffy Lube, Big O Tires. Again, some of these are actual

agreements, or appear to be actual agreements, because it specifies a licensee. Other ones are so called basic agreements, so it's unclear. It's just a framework agreement. And then there are three additional ones, I believe, included as well in the following slides.

MR. ANTLEY: If you go to the next slide, please.

A: Yes. So, and again, here's this company called Biker's Dream that pops up that also has a 2 percent contribution to advertising fund.

Q: And so what we saw on Slide Number 59 and now Slide 60, is that from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Yes, it is.

(Slide Number 60 was referenced at this time.)

(Joint Exhibit 8 was referenced at this time.)

Q: Earlier in discussing transaction one, you provide your opinion as to why you consider these franchise agreements and the others included in that said, were not -- were not comparable to the License Agreement at issue. Are your reasons for rejecting these as comparables the same as your earlier reasons

or different?

A: Pretty much the same in terms of the lack of close comparability, the fact that it's one, I don't have any information about the underlying agreements, but also more broadly, even just looking at the results. There -- that result of this 2 percent advertising fee for something that only cost the company 1 percent to do, to perform is something that I think on its face is patently unreasonable. There are some other more specific ones as well that I think Ernst and Young failed to delve into. For example, you'll notice the circle around advertising fund. So in my -- I have analyzed franchise agreements before, franchise arrangements, and generally sometimes they'll set up, they'll call it an advertising fund or a cooperative funds. And these are largely set up in order to have contributions by various franchisees to a central pool of money that the company then deploys to engage in broader advertising that benefits all the franchisees. So there's not really a whole lot of visibility here, whether that 2 percent was set in order to

effectively have a pot of money that would all be spent, or whether there was some intention by the franchisor in these arrangements to have some kind of markup on that particular function. But generally what I've seen in this cooperative advertising arrangements, it's largely a cost recovery kind of exercise.

Q: Okay. Do most of these agreements appear to reference the fee as being applied to an advertising fund, cooperative -- advertising, is that you're discussing?

A: Correct.

Q: Okay. Could you explain those and how those relate to your analysis?

A: Well, that's I think what I was referring to a minute ago in terms of how, how, how it undermines the reasonableness and the reliability of them in purpo- -- for this purpose.

Q: Okay. And again, again, did Ernst and Young provide the actual franchise agreements as part of its studies or has CarMax provided them as part of this litigation?

A: No.

Q: Does CBS pay any third parties for advertising services?

MR. ANTLEY: And if you could go to Slide Number 61.

(Slide Number 61 was referenced at this time.)

A: Yes. And that's where it's interesting that this is where I think Ernst and Young ignores the elephant in the room. If it wants to find a comparable uncontrolled transaction or a conc- -- comparable, uncontrolled services price, it had some data to work with by the company itself. So in 2016, on the advertising side, it could -- the company contracted with a third-party provider, Horizon Media. They paid some -- Horizon Media some price in order to place the, at least some portion of, of the marketing's Department's $126 million budget. I don't know if -- I don't think Horizon Media was paid $126 million, it was paid some subset of that. So if they wanted to apply this, this method, they could simply charge the operating companies what the company is paying Horizon Media. Effectively, that was -- would result in a pass through of those costs. Or if

Horizon Media is charging some kind of markup, I, I wouldn't expect the company to apply another markup on top of that markup. But at least that begins to give you a sense of the amount of money that they should be paying for -- that the operating company should be paying for the services, not what amounts to a 2 percent royalty on the company's actual sales. I should also note that the same thing applies on the franchise agreement issue. So the company actually doe- -- is a franchisor, for it sells new, new cars. So I assume they sell, they're a small amount, but it sells some or has sold in the past. So I assume it has a franchise agreement with a man- -- with some new, new car manufacturers. Now my understanding of those franchise agreements that I've seen in other contexts, they're very -- structured very differently than the type of franchise agreements that the -- that Ernst and Young use for transaction one or transaction four in that regard. They generally don't provide an obligation for the company to contri- -- the, the franchisee to contribute anything to

an advertise- -- to, to advertising, it's really an obligation to sell the, the -- and promote the company's products and basically be a good representative of the national brand. So the, the Ernst and Young, I think, not only ignored, not, not only chose a -- an inappropriate method, but even in applying that, they ignored a lot of other data points that they could have used to provide ultimately a more reliable result.

Q: And Slide 61, is this from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Yes.

(Joint Exhibit 8 was referenced at this time.)

MR. ANTLEY: You can go to Slide Number 62.

(Slide Number 62 was referenced at this time.)

Q: Have you reviewed the way this company has recorded its advertising expenses and its accounting systems?

A: Yes, I have. And so the -- that's where I -- oh, I found it somewhat confusing in that the way that transfer pricing documentation is written, it would suggest that all of the advertising expenses are incurred by CBS in the first instance. And I -- as I go through

the different lines, you -- you'll observe CBS, the middle column there, CBS LLC, and you'll see certain expense items popping up under that column. But also, confusingly, you see a lot of other expenses that, that appear to be allocated to this -- to East and West respectively, in columns effectively, I guess it's called three and four. In the first instance, and those are substantial, so the -- and if you add up that entire column down at the bottom, you'll see the $96.6 million for, effectively, East, for that third column. Now there is a, a cross charge that happens down below, you see that line that's not highlighted there, it's circled. So a substantial fraction of, or if not the vast majority of those expenses are then picked back up by CBS. But to me, it is inconsistent with the, the way the documentation describes it to, to observe these expenses being incurred in the first instance by East and West as part of the operating companies.

Q: And what we're seeing on Slide Number 62, is this taken directly from Joint Exhibit Number

70, the Excel spreadsheet that was part of the Dr. Cody's file?

A: Yes.

(Joint Exhibit 70 was referenced at this time.)

Q: Is there an alternative method that Ernst and Young should have used instead of the best method? Or sorry, instead as the best method?

A: Yes. It could have used the comparable profits method just like it used for the profit -- for the back office services, which I would consider a reasonable approach. Personally, I think that because of this disproportion in the ownership shares, the services cost method and allocation of costs is more reasonable given those -- that ownership structure. But the CPM would have been a much more direct and reliable method to apply, and more consistent with the guidance of the 482 regulations.

MR. ANTLEY: If you could get to Slide Number 63.

(Slide Number 63 was referenced at this time.)

Q: Have you analyzed the effective markup on CarMax's advertising cost that East and West paid to CBS as a result of the 2 percent of

revenue advertising services fee?

A: Yes. And as I mentioned before, because CarMax East is paying a 2 percent advertising fee for a function that only costs the company 1 percent to actually perform, you'd expect a markup of a hundred, approximately 100 percent. But nonetheless, going through the, the data that the company provided in terms of the financial data to see the actual advertising fees paid, that's the $303 million you observe in FY 2016. I compared it to the advertising expenses. You'll notice there's an asterisk on that, because the company is not provided out -- this is the -- it could be the direct expenses associated with advertising, i.e., primarily those things we were seeing on the, the, the prior demonstrative. So I don't have a way of breaking out the marketing staff, but it's not going to be were -- wouldn't change these conclusions that much. But ultimately, I get to a profit from advertising, that CBS is earning, of $161 million in that first year. So for $516 million over the entire audit period, which is a markup on cost of about

115 or 116 percent.

Q: So on Slide 63, the source data for that, is that Joint Exhibit Number 70, that spreadsheet you can keep referencing?

A: Yes, it is.

(Joint Exhibit 70 was referenced at this time.)

Q: If you could go to Slide Number 64.

(Slide Number 64 was referenced at this time.)

Q: Have you developed this -- developed a set of comparable companies that could be used to apply the CPM to this transaction?

A: Yes. And I would say this is a standard way of doing a, a CPM analysis for services like advertising. The regs even call out having at least one example that I know of, maybe multiple examples, of applying the CPM to a -- a advertising services function performed by a headquarters. So I've identified a number of companies that perform your advertising services or other services that are analogous to advertising. And as you'd expect they've earned a markup, or as I would expect, a markup little bit less than 10 percent, but in that range of around -- so on average, or the median, is 8.3 percent over the time

period, which is obviously an order of magnitude less than what the company earned.

Q: Slide Number 64, that -- the source data for that is Joint Exhibit Number 63, the back office set and as well as Joint Exhibit Number 70, that spreadsheet, the Excel spreadsheet we were referring to?

A: Yes.

(Joint Exhibit 63 and 70 were referenced at this time.)

Q: Okay. So earlier you described how East and West pay for the company's advertising, both in the first instance as we saw with the accounting information, and then again, through the 2 percent advertising fee that you've been discussing here. Did these facts have any implication on -- for your analysis of transaction one, the trademark license fee?

A: To some extent, yes, it just shows the circular nature of a lot of these transactions where costs appear to be incurred in first instance by the operating companies, then they're reimbursed by the -- with those costs reimbursed by CBS, but then that -- the -- there's a 2 percent charge paid again. So

then there's ultimately this, this big siphoning of profits from the operating companies into CBS that ultimately flows o- - - the vast majority which flows over to West.

Q: And now moving on to transaction four, the charge by CBS real estate services. I think we saw earlier that you showed an amount at issue in transaction four that that was pretty small. Is that ---

A: That's correct.

Q: Okay.

MR. Antley: If you could to Slide 65.

(Slide Number 65 was referenced at this time.)

Q: All right. What method did Ernst and Young apply here?

A: So like with transaction two, they also apply the comparable products, the same method that I said they should have applied to transaction three.

Q: And did Ernst and Young generally follow the IRS's guidance for applying the CPM to transaction four as you understand that?

A: Yes, they did. I disagreed with some of the specifics and how they implemented it, but generally, they chose CBS as the tested

party. The -- they -- so they did the right thing in terms of identifying the tested party, and then choosing a set of, at least in the first instance, a set of comparables that appeared to be broadly reasonable.

Q: Okay. But you said you disagreed. How, how do you disagree?

A: Well, the -- they chose -- in addition to providing some identifying companies with real estate comp- -- real estate services, they threw in a couple of additional companies that provide management consulting services. These are also companies that popped up in their transaction two set as well, or at least some, I believe some subset of them did, rather than just sticking with the real estate services company. So that was the part that where there's a little bit of disconnect, in terms of how they did it and how I thought it would be more reasonable. But at the end of the day, this is a relatively modest markup being applied to a very small number, so it doesn't move the needle all that much.

Q: Are these industries we see in Slide Number

65, are these the industries Ernst and Young selected in its search for comparable companies for transaction four?

A: Yes, that was in their step one.

Q: Okay. Is, is this, what we see on Slide 65, is that from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Yes, it is.

(Joint Exhibit 8 was referenced at this time.)

MR. ANTLEY: If you could go to Slide Number 67.

(Slide Number 66 was referenced at this time.)

Q: Are these the real estate services companies that Ernst and Young identified as comparables?

A: Yes. And then you'll see in that second paragraph below that it -- because it was only able to identify three comparable, it went more broadly and decided to put some general management services companies.

Q: And is this source -- or is this information we see on Slide Number 67, is that also from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

(Joint Exhibit 8 was referenced at this time.)

A: Yes, it is.

MR. ANTLEY: If you could go to Slide Number 67.

(Slide Number 67 was referenced at this time.)

Q: Is this the resulting set of comparable firms that they obtained?

A: Yes, it is. And you'll see the, the inner-quartile range of 8 percent to 11.9 percent in that far right column. Those are the numbers they used to then set the transfer price for the real estate function, where the 10.4 percent is.

Q: And what we see up there, is that from Joint Exhibit Number 8, the 2015 Transfer Pricing Study?

A: Yes, it is.

(Joint Exhibit 8 was referenced at this time.)

Q: All right. So do you consider this to be a reasonable result for benchmarking the back office services function?

A: Well in, in general, I think it's close to being reasonable, you know with this big asterisk about any profit being allocated to CBS flowing through disproportionately to, to, to West, but in, in general it think that the approach is, is broadly reasonable. I would have selected different comparables and I

wouldn't have followed the approach they used here, but I think the, the general approach is reasonable.

MR. ANTLEY: If you could go to Slide Number 68.

(Slide Number 68 was referenced at this time.)

Q: Have you developed a set of comparable companies that could be used to apply the CT-- CPM to this transaction?

A: Yes, I have. It's -- so the, the companies here, I re-ran the, the search process, and ident- -- identified six companies that I thought were reasonable comparables. And they showed a, a period median of 7.3 percent cost plus markup compared to the number, you know, in between 8.9 and 10.4 percent that the company used. Again, this is not going to move a lot of dollars because it's applied to a pretty small base.

Q: And is what we see on Slide Number 68, is, is the source data from that Joint Exhibit Number 60 -- I'm sorry, yes, Joint Exhibit Number 64, the Real Estate Services set?

A: Yes.

(Joint Exhibit 64 was referenced at this time.)

Q: As well as the, the Joint Exhibit Number 37,