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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

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

v.

South Carolina Department of Revenue, ... Respondent.

**RECORD ON APPEAL
VOLUME III of IX**

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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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1 the Management Fee Breakout?

2 A: Correct.

3 **(Joint Exhibit 37 was referenced at this time.)**

4 Q: Okay. Moving to transaction five, the charge
5 by CBS for analytical and business development
6 services. I think from the earlier
7 demonstrative, you showed that the amount in
8 transaction five is, is quite large?

9 A: Yes.

10 Q: Okay.

11 **MR. ANTLEY:** If you could go to Slide Number 69,
12 please.

13 **(Slide Number 69 was referenced at this time.)**

14 Q: And, and what exactly do these analytical and
15 business services entail?

16 A: There's not that much detail provided in the
17 documentation. There's -- it's generally
18 referred, I think it really seems to be
19 trying to encompass the functions performed by
20 a specific group called the quantitative and
21 analytics group. I'd have no idea how big
22 that group is. I just know that they
23 referenced it as a group -- that E&Y
24 references it as a group of the company.
25 They -- in the documentation is referenced as



1 a unique and proprietary service. And -- but
2 it, it appears to be primarily regarding
3 folks that work on this pricing and inventory
4 management software, and implementation of
5 those -- that software and those strategies
6 across the, the broader group. I also note
7 that in the documentation, it described it as
8 this group as having been doing this since
9 CarMax's creation, which implies that the
10 initial -- that this was -- if there's any
11 intangibles associated with this function
12 those it wouldn't -- would have been created
13 by East, not by West, and not even by CBS.
14 They would -- in the first instance, they
15 would have been created by East itself. I'm
16 sorry.

17 Q: You, you can go on, but just, for the record,
18 so we're clear, this is what we're seeing on
19 Slide Number 69. This is from the Joint
20 Exhibit Number 8, the 2015 Transfer Pricing
21 Study, the, the information that's on this
22 Slide?

23 A: Correct.

24 **(Joint Exhibit 8 was referenced at this time.)**

25 A: It's just a, a summary of the -- of the



1 information it described in that particular
2 section.

3 Q: And you can finish your answer if I ---

4 A: No, no, that's -- I think I was done.

5 Q: I think you might have hinted on this earlier
6 or a little bit, but in your broader work in
7 economic consulting, have you developed a
8 general understanding of how such pricing
9 algorithms work?

10 A: Yes, I have.

11 Q: And based on your research, is CarMax the
12 only company that employs a data analysis
13 team to determine pricing and inventory
14 levels, including using algorithms?

15 A: No, not at all. This is a, I think a common
16 function, and that is I think spread
17 throughout most sophisticated, large
18 companies, ranging -- whether you're talking
19 about a -- the automotive manufacturers, as
20 I've done a substantial amount of work for
21 automotive manufacturers, and I know there's a
22 substantial data analysis group in that area.
23 I've also worked on things related to online
24 car retailing, and I know there's a
25 substantial data analysis function associated



1 with that business as well. And, and I've
2 worked on similar issues, in fact, the
3 development of algorithmic tools to be used
4 for actual business purposes on for credit
5 card fraud detection, or for pharmaceutical
6 pricing, and acro- -- and, and other things
7 as well. So there's a kind of a, I don't
8 know how much others have exposure to those
9 kinds of, of techniques, but ultimately, they
10 are tools that rely on standard statistical
11 or artificial neural network type constructs.
12 These are taught all the time in economics
13 departments, physics departments, computer
14 science departments. And so they're built on
15 formula that are derived based on statistical
16 principles, some economic principles, and they
17 are fed with data. And every company out
18 there tries to get as much data as it can to
19 then optimize the prices that it charges
20 consumers for a particular product, or even
21 so far as the specification of, of a vehicle.
22 I worked on a vehicle development project
23 when I was at A.T. Kearney where a part of
24 our work was to figure out what are the at- -
25 - vehicle attributes that customers desire.



1 And that algorithm was fed with data on terms
2 of -- come from survey data in terms of the
3 types of attributes that customers want, or,
4 or they valued for the -- to then guide the
5 company's decision about whether to make a
6 delivery van tall and skinny or short and
7 wide. And also how much to charge for that
8 particular feature. So these are well
9 established protocols, for lack of a better
10 word, or well established systems. Every
11 company is going to have its own flavor of
12 how it implements it, but they're also then
13 the value of those protocols are really only
14 as good as the data inputs. So I think
15 earlier I described, I think the primary
16 value here is derived from the fact that,
17 that the company has so many data points
18 coming in from the retail store locations.
19 So it has a very good sense of these prices
20 that which comp- -- customers are willing to
21 sell cars for when they come into the store
22 with a car to sell, or how much they're
23 willing to buy a car for, and what specific
24 vehicles are in hot demand. And also whether
25 there's a, a dislocation or differential in



1 pricing or demand between different regions
2 that would then say, you know what, even if
3 that inventory isn't moving in South Carolina,
4 there's a store -- there's a store in
5 Kentucky, where that particular vehicle is in
6 high demand. So you don't want to sell it
7 for a lower price in South Carolina if a
8 customer over in Kentucky's willing to pay a
9 higher price for that vehicle. So these are
10 ways these information systems are kind of
11 integrated on a national level for -- that
12 ultimately are beneficial for companies as a
13 whole.

14 Q: What method did Ernst and Young apply here?

15 A: It's an unspecified method. And when I say
16 unspecified, by that I mean, I don't mean
17 that they didn't specify, it's just the word
18 unspecified method is a term of art in the
19 482 regulations. So in the dash nine
20 services regulations, the 482-9 regulations,
21 they go through the various specified methods,
22 and then there's a catch all where they say
23 unspecified methods. There's no indication of
24 what is a reasonable unspecified method. So
25 Ernst and Young goes through and it



1 eliminates all the other methods and says,
2 Okay, we're gonna apply this unspecified
3 method.

4 Q: Okay. According to your understanding the
5 482 regulations, when should a taxpayer apply
6 an unspecified method to a related party
7 transaction?

8 A: Only when it provides the most reliable
9 estimate or the most reliable results where -
10 - effectively it comes up when -- if you, you
11 -- if you really don't have the data to
12 implement these other specified methods, and
13 you do have the data to implement something
14 different and that really does give you a
15 more reliable result, yes, that's the time
16 when you go to that specific, and you use
17 that method, but you need to justify that
18 particular method. And I should also say
19 there's a strong emphasis in -- throughout
20 the regs that says, Be careful not to rely
21 heavily on a method that is entirely
22 dependent on a company's own data. And which
23 makes a lot of sense, because the tax
24 authorities don't have a way of, of really
25 fly specking a data point that company just



1 asserts. So there's a strong preference for
2 methodologies that rely on external
3 information, third party information, or
4 information that can be fully reviewed and
5 verified by an external party, could be by a
6 tax authority.

7 Q: Were you surprised that Ernst and Young used
8 an unset- -- unspecified method here for
9 transaction five?

10 A: Yes, I was. The -- and probably about two
11 counts. One, we've gone through multiple
12 instances in which Ernst and Young has
13 already applied the, the comparable profits
14 method, the CPM to transactions two and four.
15 There's no reason it couldn't have applied
16 that to method -- to transaction five as
17 well. And, and particularly because this
18 data analytical function is something that a
19 lot of the comparables that he was using it
20 his other, both of those other transactions,
21 those other companies actually performed them.
22 And these are companies that are competitors
23 of mine, Charles River Associate, FTI
24 Consulting, believe there's another CRA,
25 Charles River Associates. These are companies



1 that have a very sophisticated data analytic
2 capability and have the ability to provide
3 these kinds of services to their clients. So
4 I was -- so and that's an instance in which
5 there are third party data available, the
6 tried and true method. And particularly
7 because it's asserted that it's effectively
8 already taking the intangible portion of this
9 function, this -- he calls it a unique and
10 proprietary service, but remember, when I
11 started talking about transaction one, it said
12 there was these business pros intang- --
13 business processes intangibles that it was
14 inserting into the trademark agreement in
15 transaction one. Well if it's already taken
16 out the intangible associated properties of
17 this service, then it should be just
18 compensating the straightforward service that
19 the people are providing the same way they
20 would do for transaction two and four.

21 Q: So how did Ernst and Young apply the
22 unspecified method here?

23 A: It is not clear at all. I mean, I have the
24 numbers, but it's not clear at all where
25 these numbers come from. Or I should say,



1 it's -- from the description, it's, it's
2 pretty -- in the documentation, it's pretty
3 clear that it's coming from the company, but
4 there's no underlying data to allow me to
5 ascertain how they calculated these numbers.
6 So the company that CarMax's has, has
7 asserted that the total value of strategies
8 and systems is \$1,526.50 per vehicle. So if
9 that's in the 2015 study, I believe it's the
10 same number in the earlier study as well. So
11 again, it's just a number that's asserted,
12 it's not clear to me necessarily even how
13 those -- that value pertains to this rela- --
14 what I would assume to be a relatively small
15 group within the broader CBS function. CBS
16 is providing a wide range of, of services,
17 HR, MIS, etcetera. And particularly when
18 you're talking about systems, systems start to
19 sound like MIS sounds, starts sounds, sounds,
20 sounds like IT services. So it's the
21 infrastructure, the data infrastructure you
22 have, the communication protocol, which often
23 is a big investment. So it's unclear to me
24 how much of these -- of this asserted \$1,526
25 of benefit is being provided from the small



1 group or from the more broader range, but it
2 is a number that they assert.

3 Q: Can you walk us through how Ernst and Young
4 describes the derrivut- -- the derivation of
5 this number?

6 A: Sure, and I, I -- some of it I've had to kind
7 of infer based on the way to describe it
8 because I say the description is not
9 particularly clean in terms of it doesn't
10 provide a ability to walk through each of the
11 calculations step by step and source all of
12 the data the same way they did in -- with
13 some of the other transactions where you can
14 see how they come up with a number. So they,
15 they appear to try to make a distinction
16 between systems and strategies. And so I
17 think the, the conceptual notion that Ernst
18 and Young is trying to go after, is to say,
19 Hey, you know what, anything systems related,
20 business systems, that sounds like a franchise
21 agreement, that's kind of what we were trying
22 to do -- deal with in, in transaction one.
23 So let's take this \$1,526 number, and let's
24 try and bifurcate it between what is systems,
25 and we're going to set that aside, because



1 that's been presumably compensated as part of
2 the 0.5 percent trademark royalty,
3 trademark/business systems royalty. And then
4 everything else, we're going to effectively
5 associate with strategy, which is, to me, is
6 a little bit odd because I -- there's a, I
7 think, a separate strategy group, I would
8 assume there to be strategy is something
9 that's been set by the CEO and the CFO of the
10 company, not necessarily by the quantitative
11 and analytics group, but. But nonetheless,
12 that's why they first attract this \$299.
13 Again, it's a very specific number the
14 company has calculated. I have no idea how.
15 If it -- they subtract that from the 1526 to
16 get us \$1227.50, but they say, Okay, this is
17 still -- we got our systems only piece out of
18 the way, now I'm left with this bundle of
19 dol- -- cost savings or revenue contributions
20 or some other number. And I -- that's,
21 that's some combination of strategy and
22 systems. We don't really know how to divvy
23 it up with any degree of precision, so we
24 think it's somewhere between 40 and 60
25 percent strategy. So they take 40 percent



1 and multiply it -- they take 40 percent
2 multiply it by 1227.50, that gets you the
3 \$491 low end of the range. They take the 60
4 percent and apply that to the same number,
5 and they get the 736.60. So that gives them
6 -- that's the -- that range then is the basis
7 for the company to choose some number within
8 that range. And they happen to pick 413 to
9 \$508 a vehicle.

10 Q: Has Ernst and Young or CarMax provided any
11 additional information describing how either
12 the 1526 number or the 299 per unit is
13 derived?

14 A: Not with any degree of specificity that would
15 allow me to understand that calculation.
16 There is a -- an appendix to the report that,
17 that provides a table that has a few more of
18 those numbers spelled out one by one. But
19 they haven't provided the underlying analysis
20 that did the, the -- working files that would
21 allow me to say, how did they come up with
22 this 1500 number. And to me it's, based on
23 all of my research, that number just screams
24 out as being unreliable. The company as a
25 whole earns about \$2,156 in gross profit



1 before subtracting all its operating expenses.
2 That's what it earns, when it sells a new car
3 at retail. So the comps of this -- the
4 company would have us believe that something
5 that 70 percent, 70 plus percent of that
6 total gross margin is attributable to this
7 very small group, and to them alone, and not
8 to kind of whatever contributions that the
9 company, that the other staff makes. And
10 that to me, on its face, is an absurd
11 assertion.

12 **THE COURT:** What -- what did they pay for this
13 service before reorganization in the company?

14 A: I, I don't know, is the short answer. You
15 mean in terms of the intercompany pricing?

16 **THE COURT:** CarMax must have paid for -- you said
17 CarMax East provided this service?

18 A: Correct.

19 **THE COURT:** It must have provided the service at
20 some cost?

21 A: So there, there is a co- -- I tried to
22 estimate the cost that they, that a, of
23 providing service, i.e., the salaries
24 associated with that. It's a very modest
25 amount. I don't know how they implemented



1 the transfer pricing before the restructuring.
2 So whether West's -- before the restructuring,
3 it was just East and West. So I would have
4 expected West to have compensated East for,
5 for the cost. Maybe it was a cost plus
6 percent, I just don't know. But -- so that's
7 a -- that, to me is, at this point, we don't
8 have that pre 2004 transfer pricing analysis
9 other than the valuation for the trans- --
10 for, for the transfer. But it was a function
11 provided by East. And I should say, the one
12 thing we know is that East received zero
13 compensation for that in the ownership share.
14 So in establishing CBS, even though this is
15 an asserted, high value function developed
16 initially by CarMax East as part of the
17 headquarters, in establishing those ownership
18 shares, the amount attributable to the -- to
19 the development of that for -- to East was
20 zero. All of that value ---

21 **OBJECTION:**

22 **MS. GEER:** Your Honor ---

23 A: --- was ascribed over to West.

24 **MS. GEER:** --- I just want to interject my original
25 objection to -- just talk about the,



1 attacking the valuation study.

2 **THE COURT:** Okay. Proceed.

3 Q: Have you compared CarMax's asserted \$1,526 per
4 vehicle value, this function, to the total
5 gross margin CarMax earns on its vehicles?

6 A: Yes, that was actually what I think I, I
7 referenced in my earlier ---

8 Q: Okay.

9 A: --- transaction. I'm sorry, in my earlier
10 response.

11 Q: And can you explain what a, a, a Passive
12 Association benefit is from a transfer pricing
13 perspective, and how such Passive Association
14 benefits are generally treated in transfer
15 pricing analysis?

16 A: Yes. I, I think I referred to it before in
17 the sense of a, like a purchasing entity that
18 might take advantage -- that might have the
19 advantage of the economies of scale. That
20 economies of scale is what's referred to as a
21 Passive Association Benefit. And it's
22 inconsistent with transfer pricing principles
23 to apply the benefits for one party, could be
24 a purchasing entity, to claim all the
25 benefits on that -- of, of the economies of



1 scale, because that would be effectively them
2 appropriating passive associated benefit to
3 itself.

4 Q: And in its report, Ernst and Young states
5 that the benefits from this function are not
6 the result of a Passive Association Benefit.
7 Do you agree with that assessment?

8 A: I, I, I agree with the statement says this is
9 an actual function of the quantitative analy-
10 -- analysis group, provide a service, and
11 that is a service that frankly should be
12 reimbursed, the cost of that service should
13 be reimbursed. But the way -- and I disagree
14 with that statement in so far as the number
15 that they have actually derived for that to
16 compen- -- the amount of compensation, I
17 believe is real- -- what they're really doing
18 is providing this -- the entity with a
19 Passive Association Benefits. But there is
20 some complex bundle of things of attributes
21 associated with this business that allows the
22 company to earn a substantial amount of
23 profits. And it is trying to assert that
24 they're subdivide -- with these numbers to
25 assert that this is really all attributable



1 to a specific function, when in fact, I think
2 it's those benefits, if there are these kind
3 large -- there's an additional gross margin
4 being earned, this is really a Passive
5 Association Benefit.

6 Q: Setting aside the lack of documentation for
7 the starting point of CarMax's transfer
8 pricing calculation for transaction five, what
9 is the next step in Ernst and Young's or
10 CarMax's calculation?

11 A: So I think we went through before in terms of
12 taking the 40 to 60 percent of applying that
13 to the 120- -- the \$1,227, and that gets you
14 that final charge.

15 MR. ANTLEY: If you could go to Slide Number 70.

16 (Slide Number 70 was referenced at this time.)

17 THE COURT: So are you moving away from transaction
18 five?

19 MR. ANTLEY: I, I think we're still in transaction
20 five.

21 THE COURT: Okay. I wasn't sure in your question.
22 Well, I -- go ahead.

23 MR. ANTLEY: Yes, sir.

24 Q: So you said that you -- you mentioned the 40
25 to 60 percent?



1 A: Yes.

2 Q: Previously. Okay. And what -- this is Slide
3 Number 70. And, and where is this
4 information from? Is this from Joint
5 Exhibit 8, the 2015 Transfer Pricing Study?

6 A: Yes.

7 **(Joint Exhibit 8 was referenced at this time.)**

8 A: So this is the appendix, it is the entirety
9 of the appendix that deals with this
10 particular covered transaction. So in, you
11 know, my other work, if there was -- if a, a
12 taxpayer or even a accounting firm were
13 preparing documentation, and it provided kind
14 of a -- particularly one that moves so much
15 money, I would've expected a voluminous amount
16 of information to be able to understand the
17 derivation of those numbers. The only thing
18 they provided was this summary table, which
19 appears to have been prepared by the company
20 itself. And not -- none of the underlying
21 documents. And that is something that is, I
22 think, completely -- it's completely unusual
23 in my experience. In the 30 years I've been
24 doing this, I've never seen a taxpayer put
25 forward or pay a -- an advisor put forward a



1 number that was entirely ---

2 **OBJECTION:**

3 **MS. GEER:** Your Honor, I just want to insert an
4 objection to foundation that he said he
5 doesn't think this was prepared. I think he
6 said by the company but I, I don't know that
7 any foundation's been laid as to who, who
8 prepared this and how he would know that.

9 **THE COURT:** Response?

10 **MR. ANTLEY:** So this, this is from the transfer
11 pricing report, so I'm not sure if I
12 understand the objection.

13 **THE COURT:** The objection is that he said, her
14 analysis that Dr. DeRamus said that this was
15 not prepared by the company.

16 **MS. GEER:** I think he said he said it was prepared.

17 **THE COURT:** Was prepared.

18 **MS. GEER:** Was prepared by the company but I, I'm
19 not sure any foundation has been laid as to
20 how he would know who prepared this.

21 **THE COURT:** Okay.

22 **Q:** Is there -- is there any reason that you
23 think this was or why you think you know who
24 prepared this or didn't prepare this?

25 **A:** Well, you'll see in the footnote it talks



1 about the evaluation by CarMax. It says
2 CarMax re-evaluated the car savings. So I
3 think it's right there in the -- in the
4 should be the demonstrative, but even in
5 their report itself, Ernst and Young makes it
6 very clear that the calculations were
7 performed by CarMax, not by Ernst and Young.
8 There's not an independent analysis that Ernst
9 and Young did.

10 Q: Okay. And just for the record Slide Number
11 70 is from Joint Exhibit Number 8, which is
12 the 2015 Transfer Pricing Study, and that
13 includes that footnote that you just
14 referenced?

15 A: That's correct.

16 Q: Okay.

17 **THE COURT:** Correct.

18 Q: Is this consistent, consistent with the
19 guidance provided in the 482 regulations?

20 A: Not at all. Again, if you're going to do --
21 if you're going to offer an unspecified
22 method, you need to provide all the data and
23 assumptions underlying that. And I also
24 think, just in -- from out, out of the gate,
25 they ignore the elephant in the room, which



1 was simply just to apply comparable profits
2 method, which is by far and away the more
3 reliable method that relied on ext- -- you
4 could -- where you could use external
5 information and -- but and, and it certainly
6 wouldn't expect to have just an analysis
7 performed by the taxpayer and then have an
8 advisor say, this is consistent with the
9 arm's-length standard, you didn't do the
10 calculations.

11 Q: Have you calculated the markup on the CBS's
12 cost associated with this function as a
13 result of CarMax's 400 to \$500 per unit
14 charge for transaction five?

15 A: I have, at least to the best of my ability
16 based on the available information.

17 Q: And we're at Slide Number 71 now?

18 A: Correct.

19 **(Slide Number 71 was referenced at this time.)**

20 A: So I could cut to the chase and just say it's
21 a very, very large percentage markup, but
22 then I could take you through the painful
23 exercise of walking through the calculations.
24 And it's only painful because the company did
25 not provide a breakout of their expenses



1 associated with this particular function. So
2 I had to basically estimate that, that cost
3 based on the data, data that are available to
4 me. So I have two different data sources.
5 One is that very first demonstrative or the
6 schedule that we looked at, the earlier
7 demonstrative showed the derivation, the way
8 the company derives all of the individual
9 cost per vehicle of the -- for, I believe it
10 was related to FY 2017. So ---

11 Q: Is that Joint Exhibit Number 37, the
12 management fee breakout?

13 A: Yes, it is.

14 **(Joint Exhibit 37 was referenced at this time.)**

15 Q: Okay.

16 A: And so that, that provides effectively, the -
17 - it's done on a forecast basis. If you
18 recall, it was a forecast of sales and a
19 forecast of various cost items for different
20 departments. So I, because I -- those are
21 the elements I start with, so that -- you'll
22 see that first row is the transaction five
23 revenue on a forecast basis. So I take the
24 implied revenue, multiplying it per feet, per
25 unit of value for transaction five by the



1 forecast number of units in each of those
2 years, that gives you the top row. So that's
3 the revenue they expected to earn, CBS
4 expected to earn from transaction five. I
5 then added up all of the payroll and fringes
6 cost. Here's I have a total number that from
7 the actuals I go to the actual financial
8 statements and pull up all of CBS's payroll
9 and fringes costs, that's the second line.
10 And then when I deduct from that the amount
11 that they've identified in that other
12 schedule, in that schedule where they develop
13 the cost plus for HR, for MIS. MIS is gonna
14 -- the information system's function is gonna
15 be the big driver of a lot of costs.

16 **THE COURT:** Say that again.

17 A: MIS, Management Information Systems, the IT
18 Department. So in that schedule where I
19 originally walked through how the company
20 derives that per unit charge for each of
21 these individual administrative functions,
22 they'd broken out separately, they reported
23 the amount of the fee -- I'm sorry, the cost
24 associated with that function because they're
25 gonna apply a 10.7 percent markup to that



1 cost for example.

2 **THE COURT:** And that costs was attributable to
3 what? In other words I've seen personnel
4 costs, payroll, fringe, so what is it?

5 A: So, as I understand the way they develop that
6 cost plus markup in compensating transactions
7 two and four. So the general back office
8 services and the real estate services, they
9 identified the payroll costs associated with
10 providing a function and they mark that up at
11 either a 10 percent or a 7 percent markup
12 based on their CPM analysis. So I have a
13 schedule that has the forecasts of the frac-
14 -- of the portion of those CBS costs that
15 they have associated with these other
16 functions. The thing I'm trying to derive is
17 how much does it cost to provide this
18 transaction five? Was the cost -- the
19 payroll cost associated with this quantitative
20 and data analy- -- data analytical function?
21 Because they haven't provided it to me. So I
22 have to estimate it based on the other little
23 data points that I have. That's why I said
24 it's a little bit of a painful process. So I
25 have the starting -- I have total cost and



1 actual costs, that's \$145 million number in
2 that eon- -- in 2016, in the second row. I
3 have what I estimate to be the, the costs
4 associated with these other functions
5 unrelated, so this gonna be HR, finance,
6 management, information systems, accounting,
7 etc. I have that for this other schedule
8 where they derive the per unit charges. That
9 comes up -- but it is done on a forecast
10 basis. So I have an actual and a forecast
11 number, assuming that though, that the
12 forecast was reasonably accurate and these are
13 being updated on an annual basis. I think
14 that's a reasonable assumption. That leaves
15 me with a delta of about \$25 million. That's
16 the most that could be ascribed to this
17 quantitative data ana- -- data analysis
18 function. Now I think it's a vast
19 overestimate of the amount of charges because
20 there are other costs that are not
21 encompassed in that 119 figure, that 119.9
22 that's in the third row. But nonetheless,
23 just as an order of magnitude, because
24 ultimately here, I'm just interested in order
25 of magnitude calculations, because I know the



1 markup's gonna be enormous. So if I take the
2 \$270 million in 2016 and then I subtract out
3 the maximum amount of the, the admin fee
4 associated, I get a profit of about \$245
5 million. Again, I think it's a vast -- it's
6 an underestimate of the amount that they're
7 actually earning. That's a 964 percent
8 markup over the actual cost of providing that
9 function. Even if -- even if my estimation
10 process here is way off, even relative to the
11 total headquarters payroll, that amount is 186
12 percent, that amount of profit that they're
13 earning, that plus is 186 percent of that
14 total.

15 Q: And you mentioned one source for this Slide
16 Number 71. But it's, it's another source,
17 Joint Exhibit Number 70, that, that
18 spreadsheet that was from Dr. Cody's file?

19 A: Yes.

20 (Joint Exhibit 70 was referenced at this time.)

21 **QUESTIONS BY THE COURT:**

22 **THE COURT:** And while we're on this subject, and
23 back to before we organization.

24 A: Yes.

25 **THE COURT:** The analytical and business development



1 was developed before 2004, correct?

2 A: You're asking was it developed prior to 19- -
3 - 2004?

4 **THE COURT:** Yeah.

5 A: Yes, it was.

6 **THE COURT:** Did that function that existed after
7 its development have value?

8 A: So I think it has value in the sense that it
9 should be compensated to the taxpayer ---

10 **THE COURT:** No, I mean there was an analytical
11 computer framework, I assume?

12 A: Yes.

13 **THE COURT:** And it's got algorithms that have been
14 developed and ---

15 A: Correct.

16 **THE COURT:** --- all that. So after 2004,
17 individuals are simply applying those
18 algorithms that have been developed and
19 updating those algorithms.

20 A: Correct. I think there is a, probably a
21 broader process of constantly revisiting those
22 algorithms and trying to improve them, maybe
23 even applying them in areas that had not
24 previously been applied or maybe were
25 insufficiently explored. But this is a, a



1 process -- I, I would assume any company is
2 constantly trying to improve its processes.
3 And it's -- particularly in the way it's
4 collecting data and what it's doing with that
5 data.

6 **THE COURT:** Well during reorganization, or
7 following, when you start reorg- --
8 reorganizing, then did this function have a
9 value that ---

10 A: So in the organization ---

11 **THE COURT:** --- should be considered, is what I,
12 that's what I'm trying to figure out here.

13 A: So in, in the organization, there was no real
14 change in this function. It's still being
15 performed by the same people.

16 **THE COURT:** Okay.

17 A: It's still -- they just -- there's different
18 change of hats. They were now called ---

19 **THE COURT:** It was moved ---

20 A: --- employees ---

21 **THE COURT:** --- it was moved from Car- -- CarMax
22 East to CBS?

23 A: To CBS, correct. So all it was was a change
24 in the nominal -- legal entity under which
25 they fell.



1 **THE COURT:** Okay.

2 A: And so the people are still doing the same
3 thing they were doing time t- -- T minus one
4 versus time T plus one. So in terms of does
5 it have value, I do think this provides
6 value, but I think the same way provides
7 value that the broader strategic direction of
8 the firm has value, that is no different than
9 the broader headquarter's function that every
10 company -- every other company provides.
11 Ultimately, I think this is a service that
12 should be compensated on the cost plus basis.
13 The part where there is a major disconnect,
14 in terms of your question of, does it have
15 value, is the way that the company has
16 asserted that in the, the transfer pricing
17 policies that it implemented after the
18 transaction, it's bas- -- it's asserted this
19 is a very, very valuable function, and it
20 deserves this incredible, incredibly large
21 charge that CBS should be paid. And it -- be
22 should -- that you should extract this very
23 large amount of profits from the operating
24 companies for this, this particular service.
25 And yet, it's -- if this was that valuable an



1 intangible developed by CBS -- by East, by
2 CarMax East, why would CarMax East ever agree
3 to give up a function that was that valuable
4 in return for an obligation to make a very,
5 very large payment. And this is where --

6 **THE COURT:** That's part of what I was asking.

7 A: Correct. That's, that's where there's a --
8 that's why the 482 regulations talk about
9 this notion of a -- that the analyst needs to
10 look at the reasonable alternatives available
11 to the, the parties at the time. And so, at
12 the time, would a third party, if they had a
13 super valuable function like this that
14 deserved lots and lots of compensation, that
15 they could foresee earning a lot of money
16 from -- and that -- and back in the day, if
17 they applied it to West, they should be
18 earning a lot of money from West, and they
19 should be keeping all the money that they're
20 earning in from the operations of East, why
21 would they say, I'll tell you what, we just
22 give it to you for free, we'll give it to
23 CarMax East for free -- I'm sorry, to CarMax
24 West for free, and then we'll have CarMax
25 West contribute it to CBS. And oh, by the



1 way, that will then balloon up CarMax West's
2 ownership share, because all of a sudden it's
3 assertively contributed a super valuable
4 intangible, so now all of a sudden it gets
5 93.5 percent of the -- of the income. So
6 that's where a -- earned by CBS. That's
7 where the whole nature of that structure,
8 that restructure and those percentages, why
9 they fail a basic test of reasonableness from
10 a arm's-length perspective. You would not
11 see that in arm's-length's dealing.

12 **OBJECTION:**

13 **MS. GEER:** Your Honor, I just want to interject
14 that it's didn't start off that way, but it's
15 gotten into the valuation study attack again.
16 So just to preserve my objection for the
17 record.

18 **THE COURT:** All right. I mean, I guess you're
19 objecting to my question maybe. All right.
20 Proceed. Sorry for interrupting.

21 **MR. ANTLEY:** Thank you, Your Honor.

22 **THE COURT:** Yeah, I thought you were about to move
23 on from there, so.

24 **MR. ANTLEY:** If you could go to Slide Number 72.
25 **(Slide Number 72 was referenced at this time.)**



1 Q: So we were earlier talking about the, the --
2 certain calculations. If you don't recall,
3 we can -- we can revisit that earlier
4 question. But have you updated those
5 calculations based on additional information
6 provided by CarMax more recently?

7 A: Yes. Last week, I received some information
8 about the headquarters costs of CBS associated
9 with the finance business. So I was not
10 previously able to exclude the, the payroll
11 costs of CAF from that calculation that I
12 just walked you through. So here -- and
13 that's why -- it's one of the reasons I
14 thought that the costs associated with this
15 function in the prior demonstrative were
16 significantly overestimated. Here, I've
17 subtracted out the additional COFF -- I'm
18 sorry, the additional CAF headquarters staff
19 costs from those calculations, which we've
20 reduced that line, that, that line two, which
21 in turn significantly reduces the estimate of
22 the cost for the data analysis function. One
23 thing I would call out is there's a negative
24 number in 2016 for a differential between
25 those values. It's just the way the numbers



1 work out. So you get a non-meaningful, but -
2 - because I expect there -- there are -- I
3 know there are costs associated with that
4 function, but I -- but the, the numbers are
5 kind of swamped by that con- -- that CAF
6 adjustment. So I would probably focus more
7 on the figures for 2017 and 2018, as a
8 reasonable estimate of the cost that function.
9 So all that doesn't qualitatively change the
10 conclusion, it just says this is a very, very
11 large markup. Is it 5000 percent, is it a
12 1000 percent? I don't have a way of knowing
13 further without getting more detailed,
14 granular information from, from the -- from
15 the -- from CarMax. But nonetheless, it's
16 more than sufficient to establish that it's
17 far, far above an arm's-length charge.

18 **MR. ANTLEY:** If you could go to Slide Number 73.

19 **(Slide Number 73 was referenced at this time.)**

20 **Q:** Have you applied the comparable profits method
21 to assess the reasonableness of Ernst and
22 Young and CarMax his approach to pricing
23 transaction five?

24 **A:** Yes, I have. So I've gone through and
25 identified kind of a range of management



1 services companies that I think are reasonable
2 benchmarks for the cost plus markup that the
3 company should earn for these functions. And
4 I, I derive a median of about 9.2 percent
5 over the period for the cost plus markup.
6 And when you compare that to the actual
7 markup that CBS earned for that function, and
8 it's different by orders of magnitude.

9 Q: And, and the source data for Slide Number 73,
10 is that Joint Exhibit Number 63, the back
11 office set, is that what that's from?

12 A: That's correct.

13 **(Joint Exhibit 63 was referenced at this time.)**

14 A: So I call -- it's called the back office set
15 but it is the manag- -- within that it's a
16 bit of a misnomer because there are three
17 different sets within there. What I call
18 really back office services used for
19 transaction two, the advertising services, for
20 transaction three, and then this particular
21 function for transaction five.

22 **THE COURT:** How much longer.

23 **MR. ANTLEY:** I was trying to gauge that. I, I
24 think we are 75 to 80 percent through.

25 **THE COURT:** How much longer we gonna be on



1 transaction five?

2 **MR. ANTLEY:** Oh, transaction five?

3 **THE COURT:** Because I don't think you're going to
4 reach your 100 percent. May just make it
5 transaction five.

6 **MR. ANTLEY:** That, that might be a good stopping
7 point. I think, I think it might be an
8 additional seven slides.

9 **THE COURT:** All right. Transaction five it is.

10 Q: So in, in summary, what method do you think
11 Ernst and Young should have used to set the
12 transfer prices for the functions performed by
13 CBS?

14 A: Well, I would say this is moving beyond
15 transaction five ---

16 Q: I just ---

17 **THE COURT:** Oh, well then ...

18 (Laughter.)

19 A: I, I can give you the answer to the question
20 and then you can decide how you want to
21 proceed. So I, I think that they -- the
22 company should have applied either the
23 comparable profits method to all of the
24 services provided by the headquarters, or I
25 think given this disproportionate ownership



share of, of the -- of CBS, it should have applied the services cost method, i.e, it should have allocated out the cost of that function, of the headquarter's function, to East and West based on their relative sales.

Q: And, and I think -- I think that's right. I think now that I'm looking at it close, more closely. It looks like we're -- this is more of a -- the broad. So I think we have -- will be wrapping up the specifics on transaction five, if the Court would like to.

THE COURT: I therefore think we're done for the day.

MR. ANTLEY: Yes, sir.

THE COURT: Since I make the call, we're done for the day.

(Day 2 of the hearing adjourned at 4:49 p.m. on Tuesday, May 23, 2023.)

DAY 3 - WEDNESDAY, MAY 24, 2023

CALL TO ORDER:

COURT REPORTER: All rise.

THE COURT: Y'all be seated, thank you. Sounded like you said hello.

COURT REPORTER: Did it sound like I said hello?

THE COURT: From outside. Y'all ready at 9:28.



1 MS. PEREZ: Mine says 9:36.

2 THE COURT: Oh, yours says 9:36? What do y'all's?

3 MS. GEER: Mine says 9:32.

4 THE COURT: Yours, 9:32?

5 MS. GEER: We got a bunch of different times.

6 MR. ANTLEY: 9:32.

7 THE COURT: Okay. Well, my -- according to my
8 computer I'm early, according to y'all I'm
9 late. Well, Dr. DeRamus, for a second time,
10 you're still under oath.

11 DR. DeRAMUS: Yes, indeed, sir. Thank you.

12 DR. DeRAMUS - DIRECT EXAMINATION BY MR. ANTLEY:

13 Q: Here right before we, we broke, I just want
14 to make sure we're -- we get back on track.
15 So in summary, what method do you think Ernst
16 and Young should've used to set the transfer
17 prices for the functions performed by CBS?

18 A: So given the disproportionate ownership shares
19 in CBS, i.e., the 93.5 percent interest owned
20 by West, it's my opinion that they should've
21 used the services cost method which would
22 effectively have allocated the cost between
23 the parties -- between the operating
24 companies, East and West, based on their
25 proportional share of revenues. But setting



1 aside the issue of the ownership of CBS, they
2 should've applied the comparable profits
3 method; and this is the same method that they
4 used for transactions two and four, but did
5 not use for transactions three and five.

6 Q: Have you performed that calculation?

7 A: I have.

8 Q: Okay.

9 **MR. ANTLEY:** If, if you could go to Slide Number
10 74?

11 **(Slide Number 74 was referenced at this time.)**

12 **THE COURT:** Is this in evidence or demonstrative?

13 **MR. ANTLEY:** This is the demonstrative, Your Honor.

14 A: So ---

15 **MS. GEER:** I, I apologize. Is it ---

16 **MR. ANTLEY:** Is it not matching up?

17 **MS. GEER:** Okay. Yeah, sorry. Apologies.

18 Q: You can, you can continue.

19 A: Yes. So the, the top block provides a
20 summary of the comparable companies that
21 identified in the -- in my previous responses
22 for each of -- to each of the transactions.
23 So I described how I developed an alternative
24 set of back office comparables, an alternative
25 set of advertising comparables, alternative



1 set of strategic comparables and real estate
2 comparables. So those would've corresponded
3 to that -- in that first column, that's
4 transa- -- the comparables I developed for
5 transaction two. Advertising comparables
6 would be for the ones that I talked about in
7 -- with tra- -- transaction three. The
8 strategic comparables would be the ones I, I
9 referenced in the transaction five. So,
10 sorry, I'm skipping. I'm doing this out of
11 order. And then real estate transactions
12 would be for transaction four. So I don't
13 have the -- you know, typically you would
14 apply these different sets of comparables to
15 the cost, the headquarter's cost, that
16 corresponded to each of these functions. I
17 don't have that. Didn't -- the, the tax
18 payer did not provide that breakdown in the
19 level of detail that I would need to apply
20 that. So here I simply took the, the average
21 of the results of these sets, and I'm taking
22 the median at 7.2 percent across the fa- --
23 that I've averaged across the four sets, and
24 then I would apply that -- and I have applied
25 that to CBS's total headquarters cost, or



1 rather a subset thereof. I, I also note in
2 that bottom section -- it's a different --
3 another way to evaluate the extent to which
4 CBS is outside the range, i.e., outside an
5 arms-length range. That the profits -- the
6 cost plus the -- if you consider CBS's
7 functions as a whole and you try an ascer- --
8 ascertain -- and, and the costs as a whole,
9 you try and ascertain what is the markup that
10 CBS earned on that, they earned -- depending
11 on whether you include or you ex- -- you
12 exclude the finance functions and costs, you,
13 you get a markup of somewhere between 83
14 percent and 135 percent and either of those
15 numbers is far outside of an, an arms-length
16 range. So this is similar to the
17 calculations that I did before on a function-
18 by-function basis, and now I'm simply
19 consolidating all of the CBS functions in
20 that bottom -- and, and costs in that bottom
21 section.

22 Q: Okay. And, and the source data for this is
23 Slide Number 74, that would be Joint Exhibit
24 62 through 65. The car dealer set, the back
25 office set, the real estate services set, and



1 the retailers set?

2 **(Joint Exhibits 62-65 were referenced at this**
3 **time.)**

4 A: That's correct.

5 Q: It, it would also be Joint Exhibit Number 70,
6 the Excel spreadsheet that came from Dr.
7 Cody's file?

8 A: That's right.

9 **(Joint Exhibit 70 was referenced at this time.)**

10 **MR. ANTLEY:** If you could go to Slide Number 75.

11 **(Slide Number 75 was referenced at this time.)**

12 Q: Have you calculated the dollar impact on the
13 operating profit for East, West and CBS of
14 applying the comparable profits method to
15 CBS's headquarters functions before
16 considering the pass-through of CBS's income
17 to its owners?

18 A: Yes. And so this is where, as I said before,
19 I take the 7.2 percent markup, I go to the
20 cost data that we're provided in Dr. Cody's
21 backup files, i.e., it provides a P&L, a
22 profit and loss statement for the various
23 entities. And there I have identified the,
24 the portion of those costs. Some of those
25 costs I, I consi- -- I consider to be more



1 appropriately treated as pass-through
2 expenses. So for example, the TV, and the --
3 some of the -- primarily it's gonna be in the
4 marketing department. So these are expenses
5 of the company, of the headquarters, that
6 they're paying to third parties. And so a
7 television network is already charging its own
8 markup for that service, so. And there's
9 already probably a markup built into some of
10 the fees that are being paid to this company,
11 Horizon Media, which is this third-party
12 provider of advertising services that fai- --
13 the marketing department is already using.
14 So I've, I've done the calculations both
15 ways, i.e., applying the markup to alls -- to
16 all, all of the costs and versus a subset of
17 the costs. I believe appro- -- appropriately
18 dividing up the costs into these pass- --
19 appropriate pass-through costs versus costs
20 that should be marked up is the right way to
21 go. And then the -- then I allocate the CBS
22 costs so then I have a -- the total cost of
23 CBS, I have a markup that I applied on those
24 costs, and I take that total cost plus markup
25 and then I allocate that between East and



1 West based on their rev- -- their revenues.

2 Q: Okay.

3 **MR. ANTLEY:** If you could go to Slide Number 76.

4 **(Slide Number 76 was referenced at this time.)**

5 Q: What is the result of that calculation?

6 A: Sure. Maybe I'll start with the -- kind of
7 the bottom line number for East, and that's -
8 - would be under the CASI column, so the
9 second column at the far bottom that the --
10 applying the procedure that I described versus
11 what the company applied would result in an
12 increase in operating income for East of
13 \$833,000,000. And now maybe I'll just kind
14 of walk you through quickly how I got to that
15 number. So you'll start up at the top row.
16 You see that's the operating profit before
17 transfer pricing of \$2.3 billion for East.
18 This is before the management fee is deducted
19 from that. So then we see the management fee
20 as reported to get to the operating profit
21 that's coming off of the financials that were
22 in Dr. Cody's files. So to get the
23 \$570,000,000 number for East is a net of
24 those, those two numbers. So I've gone back,
25 and that's where I've identified the, the two



1 different components of cost. The so-called
2 -- what I -- what I'll call through pass-
3 through -- inter-company pass-through costs,
4 which are -- they're inter-company pass-
5 through costs, but ultimately they're third-
6 party costs, which is why I don't think they
7 should be charged a markup -- or they
8 wouldn't be charged a markup at arms-length.
9 So I separate those out, I -- the
10 \$780,000,000 includes the 7.2 percent markup
11 on all the other costs that are appropriately
12 assigned a markup. So this would be the
13 staff costs, other kinds of, of out of pocket
14 costs for, for the headquarters that -- all,
15 all of which related to the broader
16 headquarter's functions. This gets me the
17 total management fee of \$921,000,000. I used
18 that instead of the 1.754 billion dollar
19 number in that first line to get to a revised
20 operating profit of \$1.4 billion, and that
21 833 is the delta between the operating profit
22 as reported and, and the 1.4 billion dollar
23 number.

24 Q: Okay. And you said this, this information on
25 -- or the source data for this information in



1 Slide Number 76 was from Dr. Cody's Excel
2 spreadsheet? Was that ---

3 A: Yes.

4 Q: And that's Joint Exhibit Number 70, is that
5 correct, that spreadsheet?

6 A: That's correct.

7 **(Joint Exhibit 70 was referenced at this time.)**

8 A: And he's -- I, I didn't walk through the, the
9 impact on the other, on the other entities,
10 but you see the change in West's income that
11 would result, and then CBS -- the, the change
12 in CBS income as well.

13 Q: If you could go to Slide Number 70 ---

14 **THE COURT:** When you're doing ---

15 Q: --- is that ---

16 **THE COURT:** --- all of this ---

17 **MR. ANTLEY:** Wait. Go back.

18 **THE COURT:** --- when you're making all these
19 adjustments.

20 A: Yes.

21 **THE COURT:** Is that under the -- and I think that
22 the answer's obvious, but I'm go ahead and
23 ask it. Is it a separate accounting
24 approach, or is that part of the combined
25 unitary ---



1 A: It's under the separate accounting approach.

2 **THE COURT:** Okay.

3 A: So it -- the -- we're -- I'm still ---

4 **THE COURT:** You're ---

5 A: --- keeping the separate entities ---

6 **THE COURT:** --- just modifying ---

7 A: Corre- ---

8 **THE COURT:** --- the separate accounting?

9 A: Correct. And I, I would say what I'm
10 modifying is just the transfer prices.

11 **THE COURT:** Okay.

12 A: So I respect the, the separation of these
13 entities, and all I'm modifying is the inter-
14 company charges associated with these
15 functions to get to that specific adjustment.

16 **THE COURT:** Okay.

17 **MR. ANTLEY:** If you could go to Slide Number 77.

18 **(Slide Number 77 was referenced at this time.)**

19 Q: Have you updated those calculations based on
20 additional information provided by CarMax more
21 recently?

22 A: Yes. And as I believe I stated yesterday, I
23 only received the CAF portion of the
24 headquarter's costs sometime last week, so the
25 previous calculation, I used the entirety of



1 CBS's headquarter's cost, but what we're
2 really trying to get at here is the, the
3 charge for the management fee. And the
4 management fee is supposed to be distinct and
5 separate from all -- everything that goes on
6 with the auto finance business, the, the CAF
7 business of the headquarters. That's a
8 separate business where -- or the company
9 treats it as effectively a separate business
10 and it keeps all the profits of that in CBS
11 which ultimately flows through to West, 93.5
12 percent at least. So now that I have the CBS
13 headquarter's costs, I deduct those from the
14 aggregate amount of this -- I'm sorry, now
15 that I have the CAF, the finance related
16 headquarter's costs, I deduct those from the
17 CBS total headquarters costs and that's what
18 you see in that -- down the -- one to the
19 fourth, the fourth row where you see
20 \$651,000,000 under the CASI cost. That's a
21 reduction relative to the number you saw
22 previously, because here I've excluded the CAF
23 portion of the headquarter's cost. But the
24 calculations ultimately work the same way to
25 get to a change in operating profit, this



1 time now of \$968,000,000 versus the 800 and
2 something million dollars number we saw in
3 the previous slide.

4 Q: And, and so the source data for this, this is
5 Slide 77, is that -- again, that Joint
6 Exhibit 70 of Dr. Cody's spreadsheet, in
7 addition to the additional Joint Exhibits.
8 I, I don't recall the, the numbers, but
9 there's -- the, the more recently provided
10 spreadsheets of -- I think they're Joint
11 Exhibits somewhere between 80 or 85, does
12 that sound ---

13 A: That's ---

14 Q: --- about right?

15 A: That's correct.

16 Q: Okay.

17 **MR. ANTLEY:** If you could go to Slide Number 78.

18 **(Slide Number 78 was referenced at this time.)**

19 Q: Have you calculated your alternative CBS
20 management fee on per uni- -- on a per unit
21 basis to compare with the amount that was
22 charged to CarMax East on a per unit basis?

23 A: Yes, I have. So here I, I took the total
24 retail units that the company sold during the
25 audit period, about 2,000,000 units, the



1 actual management fee -- the fees paid over
2 that time period, approximately \$2.4 billion,
3 divide the dollars by the number of units to
4 get a per unit price of \$1,169. Pretty close
5 to what we've seen for, but again, this is an
6 average over the three years. So then at
7 year four -- I took the -- this alternative
8 cost plus -- the CBS headquarter's cost plus
9 markup and then -- to get the, the total
10 alternative management fee of \$1,000,000,000
11 number, the number that I calculated prev- --
12 in the prior slides.

13 **THE COURT:** Oh, I didn't quite follow that. Say
14 that again.

15 A: Sure. So I have the, the second block below
16 ---

17 **THE COURT:** I see the numbers.

18 A: Okay. So I -- in that second block below
19 this is simply reporting those numbers that I
20 used in that previous slide that we just went
21 through.

22 **THE COURT:** Okay.

23 A: This is the alternative -- the redoing the
24 transfer prices for the management fee using
25 the cost plus markup that I derived, and then



1 I divided this into these two components, the
2 first one are the costs that have the markup,
3 and the second one are, are the costs -- are
4 the -- just the pass-through costs, and that
5 gets you the, the \$1,000,000,000 alternative
6 management fee instead of the 2.4 billion
7 dollar actual management fee, that's redoing
8 the transfer price. What does that come out
9 on a per, per unit basis? That comes out --
10 if you divide the one billion by the two
11 million units, you get the \$528 per unit is
12 the alternative.

13 Q: Did you finish your explanation of your
14 calculations on this slide?

15 A: Yes, I did.

16 Q: Okay. And is, is the source data for this
17 Slide Number 78, is it the same as the
18 previous Slide 77?

19 A: Yes, it is.

20 **MR. ANTLEY:** If you could go to Slide Number 79.

21 **(Slide Number 79 was referenced at this time.)**

22 Q: Have you also calculated the resulting share
23 of CarMax's operating profits that would have
24 been earned by CarMax East and CarMax West
25 using your alt- -- your alternative CBS



1 management fee?

2 A: Yes.

3 Q: Is, is that what we're seeing here on Slide
4 Number 79?

5 A: Yes. And there's a lot of columns and boxes,
6 so I think it's helpful to walk through them,
7 but I've tried to keep it similar to the, the
8 presentation of the information previously.
9 So again, we start with -- in the, the very
10 first column shows this pre-transfer pricing
11 operating profit. So -- and that's why there
12 is the -- you've got this loss, this loss --
13 the little white box down below the zero
14 percent axis, that's the -- effectively the,
15 the -- before the transfer prices you've got
16 the -- all, all the costs -- the
17 headquarter's costs, CB- -- sitting in CBS
18 without having been allocated out yet, but
19 you do see the relative proportions of the,
20 of the shares of, of profits of, of East and
21 West. The green bar is East, the blue bar is
22 West. And then as you walk through it, then
23 you see the as reported number, this is where
24 we saw the vast -- the, the -- that 70
25 percent of the profits go into that white



1 box. That's all CBS. So before the pass-
2 through happens, all the white -- the CBS has
3 70 percent of the operating profits, the, the
4 green bar -- the -- West has about twen- --
5 I'm sorry, East has about 20 percent, and
6 then West has about 10 percent, that's the
7 blue bar. Then through ma- -- then under the
8 alternative man- -- management fee, the one
9 that I just calculated, that's when you go to
10 the third bar. So what happens there? There
11 I've shrunk that white bar, that white box, a
12 sig- -- by a significant amount, and you see
13 kind of the relative sizes of the, the -- of
14 East and West, that -- those -- the gre- --
15 the green and the blue bars haven't really
16 changed much as I'm going through here 'cause
17 I haven't yet accounted for the, the pass-
18 through of the CBS income. So there's still
19 is this substantially greater amount of, of
20 income in, in East and West as a result of,
21 of the reduction in the management fee, but
22 there's still a substantial amount of white -
23 - of profit let at the headquarter's level,
24 and a sm- -- very small amount of that is
25 going to be the markup that I've just



1 assigned through this 7.2 percent, applying it
2 to a fairly sizeable cost base. So it's a
3 som- -- 10s of millions of dollars of profit,
4 but the vast majority of that is going to be
5 the profits from the finance business, all of
6 which are effectively being accrued to this
7 CBS headquarter's entity and not to the
8 originating operating companies. And then the
9 last bar, again, goes through the waterfall.
10 So the -- that white box, that's the CBS
11 income, gets allocated to the members in
12 proportion to their ownership interests, so
13 you have 93.5 percent of that going to this
14 light blue box on the top. That's all going
15 to West. So West gets both the light blue
16 and the dark blue boxes, and East gets that -
17 - gets the, the dark green and that very
18 small light green sliver, that's -- it's 6.5
19 percent proportionate interest -- or
20 membership interest in CBS.

21 Q: So in your calculations of an alternative CBS
22 management fee, are you still showing that
23 operating profits between 800 million and 1
24 billion in total for CBS?

25 A: Correct. That's -- those are the numbers



1 that correspond to primarily the -- they're
2 the profits from the finance function, but
3 there's gonna be a little bit in there that
4 would be attributable to the, to the markup
5 on the management fee that I just calculated.

6 Q: Okay. Do you consider the income earned by
7 CBS over the audit period different from the,
8 the financing func- -- or, sorry, from the
9 financing function to be an arms-length
10 result? Sorry. I can rephrase the question.

11 **THE COURT:** I'm just going to hold on to the
12 question in my head. Go ahead.

13 A: Go ahead. Can ---

14 **THE COURT:** You can answer.

15 A: So the short answer is no, I don't consider
16 the income earned by CBS from the financing
17 inco- -- from the financing business to be an
18 arms-length result. I think at arms-length
19 there would be a substantial amount of that
20 income would be attribut- -- attributable to
21 the operating -- to the stores themselves.
22 We see that even in the relationship between
23 the stores and third parties. So when the
24 stores originate a sub-prime loan for example,
25 the customer comes in with a credit core --



1 score of call it 580 or something, the, the
2 company generally does not finance that
3 particular loan. It has arrangements with
4 third-party financeers -- financiers like
5 Capital One for example or other companies,
6 and that, that third-party financier pays the
7 company either a commission or else they'll
8 actually execute the con- -- the company
9 might execute the contract and sell the
10 contract at a discount. But regardless,
11 there is a pro- -- there's a fee that the
12 company receives from the, the stores receive
13 from making that sa- -- that sale. You can
14 think of it as an origination fee in that
15 regard. I think of it a little bit
16 differently because I think the whole --
17 because of this intertwined nature of the,
18 the car sale and the financing I think is
19 much more an inherent inter-relationship
20 that's different than somebody -- a sales
21 person might get from originating like an
22 insurance contract for example. Setting that
23 aside, we have these third-party payments that
24 actually make, and those -- for those, the --
25 actually the stores keep them in the first



1 instance, but there's a tremendous amount of
2 additional costs. I can't figure out where
3 those costs come from, such that on net the
4 stores lose money. I don't know why the
5 stores are losing money on that financing
6 fun- -- function, even though they're getting
7 a little bit of finance income from the
8 origination of these sub- -- effectively these
9 sub-prime loans. But the bottom line is
10 where all the money is really being made in
11 the -- for -- in the -- for it from the
12 finance business, it's -- all of it is
13 accruing that entirety of the -- yesterday,
14 I, I referenced 440 million dollars of annual
15 operating profit from the finance business.
16 From the, from the financials that Dr., Dr.
17 Cody's files, it's clear that all those
18 profits and effect- -- and then some, there's
19 a little bit of additional delta on top of
20 that, is being earned by CBS. So at arms-
21 length, we, we see how arms-length parties
22 are already -- how are already interacting
23 with a company. They're paying -- there's a
24 finance that these third-party finance
25 companies that pay the company an origination



1 fee, but we don't see that with regard to the
2 related parties. That to me is fundamentally
3 a non-arms-length result. I -- my -- it's my
4 own opinion based on having reviewed this
5 that a substantial majority if not the
6 entirety of the income but for a small marku-
7 -- or a -- I should say a modest markup on
8 the cost of the -- of administering the
9 program, actually those profits should really
10 be with the operating companies and not with
11 CBS. And one of the reasons is because what,
12 what you're talking about, these are not
13 simply consumer loans, these are auto
14 financing vehicles -- these are auto -- this
15 is your auto financed loans. The vehicle is
16 securing the -- that -- that's being sold by
17 the store is the security interest in that
18 particular loan. So there is that -- that's
19 that fundamentally different kind of, of
20 relationship then some other kind of banking
21 relationship where somebody -- you might have
22 a sales person out there originating a loan
23 but then there's some other part of the
24 organization that -- where the primary banking
25 function is occurring. Here, the origination



1 and the sale of the product that's backing
2 the, the loan itself, all is happening at the
3 store-level. But the -- at the end of the
4 day, there has not -- the company's provided
5 zero documentation of even why that result
6 should apply. I would say I have alm- -- I,
7 I have found one reference to a -- to, to a
8 transfer price in the Ernst and Young --
9 transfer price for the financing function in
10 the Ernst and Young 2005 valuation study that
11 -- where they attribute a 304 -- they say
12 that the -- oh, I'm sorry. The -- according
13 to the report ---

14 **OBJECTION:**

15 **MS. GEER:** Your Honor?

16 A: --- the ---

17 **MS. GEER:** I just want to keep my running objection
18 to this attacking the E&Y report from 2004.

19 **THE COURT:** Noted.

20 A: According to this report there's a statement
21 that the -- that according to the company
22 that the finance comp- -- that the operating
23 companies should receive \$314 per vehicle
24 financed from the finance company. So --
25 there's a statement out there, it's like \$314



1 is used in that analysis, I've seen no
2 evidence to suggest that the company has ever
3 implemented that in the transfer prices in
4 the time period after the, the restructuring.

5 **MR. ANTLEY:** If you go to Slide 80.

6 **(Slide Number 80 was referenced at this time.)**

7 Q: Has CarMax implemented any adjustment in its
8 South Carolina tax filings to address the
9 finance revenue associated with the retail
10 stores in South Carolina?

11 A: Yes. So this is a schedule that was produced
12 in discovery and it shows the, the way in
13 which the, the apportionment ratio was
14 calculated for West. So you'll at the top
15 this is CarMax Auto Superstore's West Coast
16 Inc., and that's why the South Carolina
17 column is zero until you get to the very
18 bottom. And there you'll see it's got --
19 there's two entries, one for the partnership
20 shared services fees. I understand that --
21 the -- that 1.5 million dollars to be the
22 royalty, so I think this is part of the, the
23 way in which the, the reason West Coast is
24 filing a tax return is because there's a --
25 because there are royalty payments by East to



1 CBS, and that the beneficial interest in, in
2 CBS is going fully through to West. So it's
3 effectively that royalty income by West that
4 is being included in these -- in this
5 apportionment ratio pursuant to what I
6 understand to be the Geoffrey's approach to
7 dealing with royalty pay- -- outbound royalty
8 payments. So it -- my understand- -- the bo-
9 -- below that, you'll see this \$15,000,000
10 partnership financing amount. So that's my
11 understanding of how the company is applying
12 -- is incu- -- is u- -- is, is taking -- is
13 effectively the fi- -- the, the South
14 Carolina portion to the financing income and
15 it's applying, applying -- developed as
16 apportionment ratio of 0.31 percent pursuant
17 to what I -- from the, from the documents
18 produced it appears -- the statements by the
19 company, they're doing this pursuant to a
20 prior settlement of, of an audit period --
21 of, I'm sorry -- it was prio- -- a settlement
22 of a prior audit.

23 Q: And, and the source for what we're seeing
24 here, I think you said it was produced by
25 dis- -- CarMax, but is this also from a Joint



1 Exhibit, this ---

2 A: Yes.

3 Q: Okay. Have you evaluated to a reasonable
4 degree of approximation whether the way in
5 which CarMax has implemented this adjustment
6 would provide the same result that would --
7 that it would've attained for the finance
8 business if we're -- one were to apply
9 combined entity apportionment method?

10 A: Yes, I have done that analysis.

11 Q: And what did you conclude from that analysis?

12 A: So I, I concluded that one, the combined
13 entity analysis is more -- much more of a
14 permanent fix. This appears to me more of a
15 voluntary attempt at a partial fix, but the,
16 the num- -- even there, there, the numbers
17 are, are very different than if you were to
18 include all the income -- all the finance
19 income under a combined entity approach, and
20 the reason is just a basic math issue. Is
21 that you've got a -- the apportionment ratio
22 is that finance income, largely, the -- plus
23 a little bit of the, of the smaller amount
24 of, of royalty income, divided by the
25 revenues of the company -- re- -- of, of



1 West. That gives you the apportionment
2 ratio. And then you apply that to the income
3 earned by the, by the -- by West. Well, that
4 income -- the, the finance revenue is
5 actually hi- -- very high margin business.
6 And where as the -- I still think as a, as a
7 retailer, the, the car business is -- I
8 consider it a healthy margin, but it's vastly
9 different in those -- in the -- kind of in
10 the, in the returns. So the amount of profit
11 that is ultimate- -- or the amount of income
12 that's being allocated back to -- for the
13 financing business that's being allocated back
14 to, to South Carolina as a result of this
15 approach is gonna be much lower than if you
16 were to simply have all of the finance income
17 and all of the com- -- and all of the car
18 business income on a consolidated ba- --
19 consolidated basis apportioned to, to South
20 Carolina based on a single apportionment
21 ratio.

22 Q: And just to, just to be clear. So if, if one
23 were to apply combined entity apportionment
24 method, from a transfer pricing perspective,
25 is it your opinion that this would address



1 any distortion of income resulting from both
2 CarMax's implementation of the management fee
3 and the way it treats the, the CAF finance
4 income?

5 A: Yes. I would say effectively all --
6 actually, all three issues. It would address
7 the, the distortion caused by the non-arms-
8 length management fee, it would address the
9 distortion cost by the non-arms-length
10 allocation of profits the company does with
11 regard to the finance business, and it would
12 also address the distortion caused by what I
13 consider be -- to be the non-arms-length
14 distribution of profits of CBS to -- in that
15 93.5 percent share.

16 **OBJECTION:**

17 **MS. GEER:** Your Honor, my running objection to the
18 last part of that answer on the attack to the
19 valuation of the percentage interest. He
20 said non-market -- I'm just trying to
21 preserve my objection ---

22 **THE COURT:** Yeah, I know but ---

23 **MS. GEER:** --- for the record.

24 **THE COURT:** --- I didn't quite get where there is
25 was a problem on that one, but I'll note it.



1 **MS. GEER:** Thank you.

2 **A:** I, I would say that effectively the, the
3 combined entity apportionment method I think
4 is particularly appropriate from econ- --
5 economic perspective in terms of how do you
6 get to the right arms-length number. Because
7 ultimately that's what the whole -- this
8 whole process of, I mean, these very detailed
9 calculations, these approach of different
10 methods, the whole point is to get to the
11 arms-length result. The arms-length result
12 really is referring to the taxable income
13 that is -- that -- on which taxes are
14 assessed by, by the tax payer. So some, some
15 companies may have a very messy way of
16 getting there, they may even have gotten,
17 gotten to a number the wrong way, but as long
18 as that number is the -- is an arms-length
19 result, that's really all that matters. And
20 here because of this unique fact pattern we
21 have with this dis- -- and again, in my
22 opinion, non-arms-length ownership shares of
23 CBS between East and ---

24 **MS. GEER:** Your Honor?

25 **A:** --- West.



OBJECTION:

MS. GEER: My objection to that one as well.

A: Given that distortion and that non-arms-length -- arms-length result, the, the most effective way of getting to that -- to, to that result, and frankly because we don't have any way of -- there's no transfer pricing study even offered by the, by the tax payer for the finance business itself. The -- really the only way to reliably get to an arms-length result is through this combined entity apportionment method.

THE COURT: You say the only reliable way to get there is combined entity reporting. But then you've made adjustments in the -- in your prior testimony that got us there through the separate accounting approach, did you not?

A: I, I got you most of the way -- well, I'd say a good portion of the way there, but I couldn't get all the way there. And I ---

THE COURT: All right.

A: --- part -- and that -- I can't get all the way there because of the financing issue.

THE COURT: Okay. I got you.

A: So the financing is just the big -- that,



1 that was that big white space ---

2 **THE COURT:** Yeah.

3 A: --- left at -- in, in CBS as going out to
4 the, the -- to see C- -- East and West in
5 these, in these proportions that I consider
6 to be non-arms-length. Ev- -- even any kind
7 of allocation of profit, even aside from the
8 finances, say I had the right -- the arms-
9 length result in the first instance, in the
10 transaction between East and CBS, both for
11 the financing and the management fee, any
12 profit that's going into CBS, the on- -- if
13 you -- if, if it's still going out into the -
14 - into East and West in this 93 and a half, 6
15 and a half percent percentages, that next --
16 net result in terms of the taxable income in
17 South Carolina is still gonna be a non-arms-
18 length result. It's just the -- your --
19 we're just kind of squeezing down the -- kind
20 of the, the amount of the distortion, but
21 that distortion is still going to be there.
22 That's why I think for the most efficient way
23 is, is going to be to, to do it with combined
24 entity reporting, that will get you an arms-
25 length result in my opinion. Yeah, I'll,



1 I'll leave it at that.

2 **THE COURT:** Well, I didn't mean to cut you off.

3 A: Well, I -- here -- maybe I'll, I'll posit a,
4 posit a different way. Assume, for example,
5 the com- -- the company wan- -- had the --
6 that, that you left alone what I consider to
7 be these wildly distorted transfer prices.
8 So we have no payment by the, the company for
9 -- no compensation that East receives for its
10 financing function, it's paying these inflated
11 management fees. If the shares in CBS were
12 73/27 -- 73 percent East, 27 percent for
13 West, i.e., in proportion to the, to the
14 revenues, what happens to all its income
15 sitting in C- -- in C- -- that, that goes
16 into CBS? So the finance income that stays
17 in CBS in the first instance, these inflated
18 management fees that go -- that are paid into
19 CBS by East, when these -- when those go
20 through the waterfall, 70- -- if 73 percent
21 of those were to come back into, into East,
22 then you'd get the combined entity result.
23 It's basically all the money that East has
24 paid -- and that East, East has paid for the
25 management fee, all those premium profits that



1 are being paid would come back, all the, all
2 the finance income that's attributable to the
3 73 percent of the sales being made in East,
4 even though they never showed up in East to
5 begin with, they would flow through to East
6 via the on- -- via, via the ownership shares.
7 So that's where I, I think the -- given the
8 fact that you've got the -- kind of the
9 elephant in the room being these -- the, the
10 ownership shares of, of CBS, a very efficient
11 way to do -- to, to come to what I consider
12 to be an arms-length result is simply to, to
13 use combined of the apportionment, which gets
14 you to that same result had these percentages
15 been, been assigned in what I consider to be
16 more an arms-length matter in the first
17 place.

18 **THE COURT:** All right.

19 Q: Have you reviewed the information on the
20 Company's 2004 restructuring that led to the
21 creation of CBS?

22 A: I have.

23 Q: Is that relevant to the analysis, the
24 transfer prices at issue in the -- in, in the
25 years at issue, fiscal year 2016 to 2018?



1 A: Yes, it is, very much.

2 Q: Okay. And why is that?

3 A: Well, two reasons. Again, I think I said
4 this maybe earlier when we talked about the -
5 - or at least touched on this issue, that
6 there is -- there's an assertion that there
7 are intangibles being provided by the Company,
8 by CBS, and that CBS deserves significant
9 compensation for those intangibles. So I'll
10 consider those the -- put it in the bucket of
11 trademark/ -- they, they describe it as
12 trademark and business process intangibles.
13 It's baked into this notion of this -- these
14 data, data analysis -- this data analysis
15 function. It's a high profit intangible-
16 generating activity that's in there as well.
17 I think it's broader than that trademark
18 royalty. I, I mentioned earlier I thought
19 the advertising fee really should be thought
20 of as part of a royalty for the trademark.
21 So I -- actually I think of the trademark
22 royalty as a two and a half percent royalty.
23 So you have a significant value in the
24 marketing intangible being asserted by the
25 client, and you have a significant value in



1 these other business process intangible -- I'm
2 sorry, being asserted by CarMax. I said the
3 client, I meant, I meant CarMax. Given that,
4 from a transfer pricing perspective it's
5 important to understand how those functions
6 were developed, who invested in the
7 development of those, and if there was
8 restructuring and they were put from one
9 entity to an- -- into another entity, it's
10 important to assess that. Even if it
11 happened a long time in the past, because
12 those restructurings have important
13 implications for the prices, the tran- -- the
14 appropriate transfer prices, the arms-length
15 transfer prices that should be paid today.
16 So I need to -- yeah, independent of the
17 whole ownership issues, I need to look at the
18 ownership that -- the ownership interests in
19 CBS simply because we're talking about
20 intangibles. I need to go back in time and
21 look and see who developed those, those --
22 the -- those, those intangibles, both at the
23 time of the restructuring and in every year
24 since the restructuring, who's contributed to
25 investing and who -- who's been paying for



1 the advertising. So, that's a, that's a
2 relevant question. Has there been an
3 investment by CBS of the advertising in a
4 brand intangible from between 2004 and the
5 present, or has that all been funded by the
6 operating companies? My view, it's the
7 latter. So that's why you need to first
8 always look at that restructuring the moment
9 you start talking about intangibles. In a,
10 in a federal context, the -- so this has come
11 up in federal cases before. I had mentioned
12 my Perrigo case had a same fact pattern,
13 transfer of an intangible prior to the years
14 at issues. I need to evaluate the, the comp-
15 -- the monies paid in that time period
16 because it had important ramifications for
17 what the appropriate division or the
18 appropriate allocation in the federal words of
19 the income wa- -- would be during the years
20 at issue among the different related parties.
21 That was a big issue. What happened and
22 should there -- was, was that valuation done
23 appropriately, and what does that have --
24 what implications does, does that have for
25 the transfer prices. And if there's a need



1 to change those transfer prices, one way to
2 get there is to go back and adjust that
3 valuation. Not to make an adjustment in the
4 earlier closed year, but in order to
5 determine the right amount of income that the
6 parties should earn during the current time
7 period. In the -- in a federal area, there's
8 also something called 367-D intangibles. So
9 this is where a -- when the -- I think this
10 was passed in the 60's because multinationals
11 were transferring out valuable intangibles to
12 -- for no compensation to, to foreign-related
13 parties and Congress saw that effectively as
14 a -- you don't -- at arms-length you
15 certainly don't have a transfer -- somebody
16 doesn't give up the crown jewels for nothing.
17 And the reason they were doing that was to
18 effectively assign profits to a foreign entity
19 and not to the US, even though the investment
20 in those intangibles, the R&D for if the
21 patented technology or the advertising for a
22 brand, even those investments that were, were
23 made in the United States and the deductions
24 to their U.S. income as those investments
25 were being made were done in the sta- -- in



1 the United States, but then there were simply
2 assigned to a foreign-related party. So
3 Congress comes in and says this doesn't look
4 right, let's -- they passed this 367-D
5 portion of the Statute, and that basically
6 allows the Commissioner or the I- -- the IRS
7 to come in and effectively impute a -- they
8 call it a -- it's like a elm- -- almost an
9 installment sale. It says yeah, you might've
10 transferred this intangible, but if it's
11 valuable, you're gonna owe income for
12 effectively an installment sale of that
13 particular asset over the life of the, of the
14 transferred intangible. So what that means
15 is if you have a tra- -- an intangible
16 transfer in, in an international context in
17 2000 for zer- -- and it's a valuable
18 intangible, for zero consideration, there
19 still can be payments due even in 2015, '16,
20 '17, '18 until all the way to 2020 and maybe
21 even beyond, depending on the useful life of
22 that intangible. So all of these reasons
23 from a transfer pricing perspective tells me
24 that I definitely need to look at that,
25 particularly because here we have something I



1 think is -- that is analogous to that 367-D-
2 type intangible where you have a transfer of
3 what the company asserts, these are valuable
4 intangibles, namely the trademark and the --
5 and these business process intangibles, and
6 they use that -- those -- and some of these
7 tran- -- these intangibles were explicitly
8 transferred from East to West, and then from
9 West to CBS, and the -- with no compensation,
10 these were kind of back to back almost
11 instantane- -- effectively instantaneous
12 transfers, and with no compensation back.
13 And as a result, all of a sudden East is now
14 obligated to make these very, very large
15 payments to, to CBS in the first instance,
16 and then to C- -- and then the 93 and a half
17 percent share of those profits to CBS get
18 funneled over to West, all because of the
19 transfer of these intangibles.

20 **MR. ANTLEY:** If you could go to Slide Number 81.

21 **(Slide Number 81 was referenced at this time.)**

22 Q: What has the Company stated about the purpose
23 of the restructuring?

24 A: Well, the, the -- there are different
25 documents that make different statements, but



1 there is a general reference -- like there --
2 like in this document to an efficiency need,
3 that there's some, some other references that
4 talk about a duplication of, of ex- -- of
5 expenditures. So I've seen kind of various
6 other, other statements that talk about
7 appropriate recognition of where the value is
8 created.

9 Q: And, and the source for the information we're
10 seeing in Slide 81, that's CarMax's response
11 to the Department's first request for
12 production?

13 A: That's correct.

14 Q: Based on your analysis from an economic
15 perspective, do you consider these reasons to
16 be consistent with your understanding of the
17 performance of these functions?

18 A: No. Effectively in the time -- again, I get
19 this -- I keep using this time T minus 1
20 versus the T plus 1. Before the transaction,
21 so December 31st -- I'm sorry November 30 --
22 30th, 2004, the day before kind of the
23 contribution of the assets to CBS. Who's
24 performing these functions? The same people
25 that are performing them on December 1st and



1 December 2nd. The -- these are functions,
2 all of the management functions, the
3 headquarter's functions, they're the same --
4 we're talking about the same facilities, the
5 same people, the same functions, and
6 effectively if they're -- if these intangibles
7 have any value, they have the same value on
8 November 30th as they do on December 1st or
9 December 2nd. So that -- I from an
10 operational perspective this is a -- I, I
11 consider this more of a tax restructuring.
12 It's not an operational restructuring that's
13 meant to kind of drive efficiencies that you
14 might observe in a different context. In an
15 international context you might have a
16 duplication. You'd have a foreign subsidiary
17 in Brazil, and you have a U.S. subsidiary
18 and, and a German subsidiary, and each of
19 them may have a purchasing function. And you
20 might say, hey, this is -- this makes zero
21 sense, we're buying all of our inventory from
22 a single global -- from, you know, these sin-
23 -- single, single sources that are supplying
24 all of us, so let's just centralize the pur-
25 -- the purchasing function in one



1 headquarters. Put the headquarter's function,
2 or that global purchasing function in the
3 United States or put it in Germany, or put it
4 in Brazil. Wherever you're putting it, it
5 has that efficiency operational comp- -- real
6 operational consequences because a company --
7 like centralizing some of these functions, it
8 can achieve efficiencies. Here all we have
9 is basically a changing of the hats and
10 redrawing of some, some lines for org charts.

11 **MR. ANTLEY:** If you could go to Slide Number 82.

12 **(Slide Number 82 was referenced at this time.)**

13 Q: Can you, can you explain your understanding
14 of the functions performed by the entities
15 prior to the restructuring?

16 A: Sure. So, so this is -- describes as it --
17 as I understand this -- the setup up until
18 call it November 30th, 2004. So West is
19 operating the -- its primary function -- it's
20 rea- -- only real operational function is
21 running the stores in the West, and this is
22 primarily California. I think Nevada was
23 also part of West at the time. I think this
24 is before they'd opened some stores in some
25 other West Coast locations. It was also the



1 legal owner of the trademarks. According to
2 Ms. Yost's deposition, that was the way
3 Circuit City set it -- set this up from the
4 get go. Not because there was any rhyme or
5 reason -- or at least I, I didn't see any
6 rhyme or reason to it in her description of
7 it, and there's certainly -- from an economic
8 perspective, it seemed very odd to have the
9 legal owner of the trademark not be the
10 entity -- the headquarters entity that is
11 responsible for defending the trademark, for
12 developing the trademark through advertising
13 and marketing and so forth. So all of the
14 headquarter's function, including the
15 advertising, which I think is a really
16 important fact here, that you have even the
17 legal ownership of the trademark sitting in
18 West, all of the development of the
19 advertising is really going on at CB- -- at -
20 - I'm sorry, in East on November 30th, 2004.
21 And as well as this is where all these
22 supposedly high-value data analytic functions
23 are, are happening. This is where the
24 algorithms for the pricing and the inventory
25 management are all happening. These are all



1 a part of East. East also in charge of the
2 finance business. They still call it CAF, or
3 they're calling it CAF in this earlier time
4 period, but that's where the finance business
5 is housed. In addition, East also has all
6 the stores for the, the entirety of the rest
7 of the United States. Again, primarily East,
8 but bleeding into other states west of the
9 Mississippi like Texas, and so that was the -
10 - kind of the structure in time, you know, T
11 minus 1, Dec- -- Nov- -- November 30th, 2004.
12 After the, the ownersh- -- the -- after the
13 restructuring on December 1st, 2004, one day
14 after the restructuring, all of a sudden you
15 see 93 and a half percent of the ownership of
16 CBS when they're moving all of these asse- --
17 these intangibles and these functions, these
18 supposedly high valued functions into CBS's
19 new entity, the ownership shares are suddenly
20 93 and a half percent of this valuable
21 headquarter's operation is now being assigned
22 to West and only 6 and a half percent to
23 East.

24 **MR. ANTLEY:** If you could go to Slide Number 83.

25 **(Slide Number 83 was referenced at this time.)**



1 Q: Have you reviewed any documents associated
2 with the restructuring?

3 A: Yes.

4 Q: Is what we're seeing on Slide Number 83, is
5 that one of those documents, and before you
6 answer just for the record, this is -- is
7 this from Joint Exhibit Number 52, the Ernst
8 and Young memo to CarMax regarding the
9 treatment of advanced payments following
10 restructuring?

11 A: Yes. It's a -- an Ernst and Young
12 restructure. I call it the -- or I refer to
13 it as the restructuring memo. It -- dated
14 May 31st, 2005, so shortly after the
15 restructuring. In similar analyses and
16 documents by Ernst and Young produced in
17 discovery basically starting in early 2004
18 through 2005 it described the -- both the
19 plans for the restructuring and then the
20 implementation of the restructuring and
21 providing certain -- asserted reasons behind
22 the restructuring. I think this one is
23 particularly informative because it provides
24 for asserted reasons for the restructuring,
25 none of which, other than maybe the last one



1 -- the last one, it talks about to reflect
2 the appropriate state tax liabilities. I, I
3 interpret that to mean the -- Ernst and Young
4 thought there was an opportunity -- tax
5 planning opportunity to reduce the Company's
6 taxes as a result of the restructuring. I
7 think that's probably an accurate statement.
8 There's a -- if you implement an East-West
9 structure, which ultimately I see this as
10 being, then there's an opportunity to lower
11 the, the tax rate of the Company. The other
12 ones are really there -- that are in -- to
13 assert that there is a need to, for example,
14 this realigning the comp- -- the business on
15 a functional basis. It's not like they would
16 -- the Company had -- there was no
17 operational affect of the restructuring, so
18 there was no need to -- for some kind of
19 functional realignment. The, the thir- --
20 I'll go to the third one before I go to the
21 second one, 'cause that -- the second one
22 deserves a little bit more attention. To
23 focus management attention on the most
24 profitable activities, I also think is, again,
25 there's no diversion of attention of



1 management. There's no -- to -- from on
2 activity one or activity two. There's a
3 single executive team for the entirety of the
4 domestic business. It's not like you've got,
5 like, a different -- in a -- an international
6 context you have somebody who might be
7 running a -- kind of a local affil- -- you
8 know, local subsidiary in, in Brazil and the
9 North American business. You may have a very
10 distinct need to focus them on a particular
11 activity. That fact pattern does not apply
12 here. And in fact, I think the, the use of
13 transfer prices to shift income from one
14 entity to another through non-arms-length ways
15 distorts all your management metrics, it
16 doesn't facilitate them in anyway. And
17 typically they're often ignored by management
18 when you are looking at the results, and I
19 see that in the 10Ks. The 10Ks talk about
20 the results of the business as a whole, they
21 don't talk about CBS as being this incredible
22 function that deserves all these profits.
23 It's really attributable not to this -- the
24 activities in the stores, but to this
25 wonderful thing called CBS. So you don't



1 observe that in the comp- -- way the Company
2 describes the performance of the business.
3 But sec- -- I'll go back to that, that second
4 point, because I think that's helpful, because
5 it does help to, I think, unpack a little bit
6 the way in which, I think, the advisors or
7 the -- they are pitching this as an idea.
8 The notion that it's a way of -- a need to
9 isolate the value created through supply chain
10 activities. So what is a supply chain?
11 Supply chain's typically every other context
12 I've seen before, it's about inventory, it's
13 about procurement, so. And I think in a
14 typical retailer structure, the play would be,
15 hey, let's figure out how to ascribe a lot of
16 value to this procurement, procurement
17 function, buys a lot of stuff, we have a lot
18 of smart people working really hard to get
19 low prices, let's figure a way to put more
20 value in there. Because even if they, they -
21 - even if they thought that the -- that that
22 was a high value activity and that, that was,
23 that was appropriate, that's what supply chain
24 means, right, is that inventory procurement.
25 What do we have here in the situation with



1 the supply chain for CarMax? The supply
2 chain are the cars that customers bring into
3 the local stores. You don't have this
4 centralized procurement function the way you
5 have it with other kinds of retailers. So
6 even from the get go it seems like I, I take
7 it -- I interpret this as almost a -- kind of
8 boiler plate explanation. But you look at
9 the further in the footnote three, again, it
10 goes to this notion that somehow the supply
11 chain -- managing the supply chain is the key
12 value driver in retail business. Look at the
13 part that's circled in red. In well esta- --
14 well managed retail establishments, profits
15 are now effectively realized prior to delivery
16 of the goods at the retail locations. So
17 pause for a minute and just think about what
18 they're, what they're implying. The profits
19 earned by the Company are earned before the
20 goods that the retailers are selling or even
21 delivered to the location? For me -- for --
22 as an economist, it's one of those kind of
23 mind-exploding or head-exploding kind of
24 sentences, is the -- I think it's on, on its
25 face it's patently absurd. So there's an



1 attempt to kind of provide a little bit of
2 gloss of, of business purpose around the
3 restructuring that I think from an economic
4 perspective actually makes zero sense.

5 **MR. ANTLEY:** If you could go to Slide Number se- --
6 84.

7 **(Slide Number 84 was referenced at this time.)**

8 Q: Does the Ernst and Young memo explain exactly
9 which functions and assets are to be
10 contributed by East and West to the form- --
11 in the formation of CBS?

12 A: Yes. And I'd say this is a consistent
13 description with how the planning happened.
14 So it's the 2000 -- early 2004, before the,
15 before the restructuring, all the way through
16 the completion, and then this memo after the
17 fact. So they describe about how all the
18 management functions are now going to -- and
19 including the CAF financing, the real estate
20 support services, the advertising and
21 marketing, those functions, again, previously
22 performed by East, are gonna be contributed
23 over to, to CBS. It also talks about the
24 intangibles, and it -- then it makes -- it's
25 very explicit in separating out the trademarks



1 and trade names on the one hand, versus these
2 business process intangibles on the other
3 hand, and it kind -- and I think in a lot of
4 the documentation, both in the transfer
5 pricing documentation of the current period
6 and in the documents around the restructuring,
7 there's a lot of references to this highly
8 valuable trade secret, referring explicitly to
9 the business process intangibles. Again, the
10 -- if these are an intangible, if they are
11 highly valuable trade -- trade secrets, on
12 November 30th, 2004, those are owned entirely
13 by East, not by West.

14 Q: And again, the -- for the record, so this is
15 Slide 84, the source from this is the Joint
16 Exhibit 52, the Ernst and Young restructuring
17 memo that, that we were referring to in the
18 previous slide?

19 **(Joint Exhibit 52 was referenced at this time.)**

20 A: Yes.

21 **MR. ANTLEY:** If you could go to Slide Number 85.

22 **(Slide Number 85 was referenced at this time.)**

23 Q: How are the business process intangibles
24 transferred to CBS?

25 A: So this was a bit of a mystery to me. And so



1 how, how the Company could possibly
2 characterize the business intangibles as being
3 contribution from West to CBS when those were
4 clearly owned by East, and they were even
5 identified as being an intangible and a
6 valuable intangible prior to the
7 restructuring. So then you kind of walk
8 through the seq- -- the, the sequence of
9 events and it kind of makes sense -- or it
10 makes sense at least from a -- I, I can see
11 it as a sequence of events ---

12 **MS. GEER:** Your Honor?

13 A: --- for me to understand ---

14 **OBJECTION:**

15 **MS. GEER:** I apologize, but I would like to
16 interpose my objection to attack, attack on
17 the E&Y restructuring memo for the record.

18 **THE COURT:** Attack on the E&Y memo? Can you
19 explain that. I mean, is this the -- your
20 renewed objection, or is this a different
21 one?

22 **MS. GEER:** No, not, not leading. Never mind, Your
23 Honor. I'll withdraw that.

24 **THE COURT:** Thank you. Because I was gonna have to
25 think too much.



1 A: So on the -- in a document on the -- or the
2 Demonstrative, there's a couple of, of circled
3 -- red circles around what I think are the --
4 kind of the sequence of interest. So on
5 December 1st, CASI, i.e., CarMax East,
6 contributes the business process intangibles
7 and some other assets, tangible assets, this
8 West Coast -- West Creek land to West. These
9 are done November 30th, these are valuable
10 in- -- assets owned by East. On December 1st
11 the Company has East, assigned them to -- or,
12 or contributes those to, to West. On the --
13 that -- down under -- or rui- -- the number
14 4-A, West in turn contributes the business
15 process intangibles and the West Creek land
16 received in step three and the CBS trademarks
17 and trade names immediat- -- and so that
18 immediately after the transfer West now has
19 this 93 and a half percent membership
20 interest in CBS. So effectively you have --
21 and then I should say even down below, East
22 is -- on that section B of four, so West is
23 not only contributing its assets, but it's
24 also contributing these assertively very
25 valuable business functions. So it's a, so



1 it's a read- -- and so it, it provides these
2 very valuable business functions to CBS, and
3 what does it get in return? It gets in
4 return a six and a half percent interest in,
5 in CE- -- in CBS. East gets that six and a
6 half percent interest. Not real- -- and if
7 compensation is ra- -- really for those
8 functions, it's for the tangible assets and
9 the -- primarily the tangible assets that the
10 comp- -- that the Company is actually ---

11 **MS. GEER:** Your Honor?

12 A: --- and other assets.

13 **OBJECTION:**

14 **MS. GEER:** I think now we're getting into him
15 criticizing the 2004 study and saying that
16 it's conclusions aren't correct based on what
17 he's reading here. So I -- just for the
18 record, I want to interpose my objection.
19 Thank you.

20 **THE COURT:** Any response?

21 **MR. ANTLEY:** Your Honor, this is from Joint Exhibit
22 52. It's an Ernst and Young restructuring
23 memo. It's -- I, I think he's ex- --
24 explained how it's relevant to his opinion on
25 the transfer pricing studies in the future.



1 It, it ---

2 **THE COURT:** Are you -- In your analysis, are you
3 challenging the Ernst and Young memo or the
4 results of what occurred based on the
5 transactions by CarMax?

6 A: Much more to the latter. And I, I would say
7 ---

8 **THE COURT:** Well the ---

9 A: As -- I'm, I'm -- I am doing this as an
10 economist. I'm not challenging in the sense
11 of trying to undo what was done. I'm chall-
12 -- I, I am analyzing what they did to try and
13 understand the -- A, the basis of this 93 and
14 a half percent, 6 and a half percent split,
15 how did that come about. It's a relevant
16 fact for me because it affects taxable income
17 and it is a related party transaction and
18 therefore it is a transfer price. So, first
19 and foremost, I'm trying to understand that.
20 Ultimately I do have an opinion as to whether
21 that transfer is consistent with the arms-
22 length standard, and those ownership interests
23 are consistent with those sta- -- the arms-
24 length standard. So part of this is trying
25 to tease-out where is it they were abl- --



1 where do I see a disconnect between what the
2 Company has done even before you get to the
3 study, before you get to the E&Y 2005 study
4 itself, this is what this goes to.

5 **THE COURT:** I would ask that you, in giving your
6 opinions, 'cause you said it was more the
7 latter, just went through the two
8 possibilities, that your opinions be based on
9 only what occurred and not upon any opinions
10 or analysis that Ernst and Young gave. Do
11 you follow that distinction? I mean, I don't
12 even know if they gave any opinions or
13 analysis, 'cause I don't -- I haven't read
14 the memo myself. I want to stick with the
15 facts of the case and what has occurred and
16 what has been laid before us and the analysis
17 of that.

18 A: So I, I think I understand, but maybe just so
19 I want to be clear, because one of the facts
20 in this case is a 93 and a half percent
21 versus 6 and a half percent ownership
22 interest.

23 **THE COURT:** You can analyze that.

24 A: Okay. So that's -- with all of this, that's
25 all -- that really is all I'm doing is trying



1 to ---

2 **THE COURT:** All right.

3 A: --- analyze ---

4 **MS. GEER:** Thank you.

5 A: --- those percentages.

6 **MS. GEER:** Well, Your Honor, I would submit that
7 the, the most recent testimony as it just
8 came in was basically criticizing the, the
9 analysis and conclusions based on the E&Y
10 report, and so I'd ask that that portion be
11 stricken.

12 **THE COURT:** Well, I will just say that I'm --
13 anything regarding his analysis and criticism
14 of the E&Y report, I will not consider.

15 **MS. GEER:** And just so we're clear for the record,
16 the E&Y 2004 valuation study.

17 **THE COURT:** All right.

18 **MS. GEER:** Since we have multiple E&Y ---

19 **THE COURT:** Okay.

20 **MS. GEER:** --- documents.

21 **THE COURT:** Okay.

22 **MS. GEER:** Thank you, Your Honor.

23 **THE COURT:** All right.

24 **MR. ANTLEY:** I might need to be sure I understand
25 too. So the, the -- what we're, what we're



1 talking about here is not the valuation
2 study. This is an Ernst and Young
3 restructuring memo, it is a Joint Exhibit.
4 Is ---

5 **THE COURT:** You're just talking about a Joint
6 Exhibit?

7 **MR. ANTLEY:** Yes. And, and the valuation study
8 itself is a Joint Exhibit.

9 **MS. GEER:** Yeah.

10 **THE COURT:** And it's in evidence.

11 **MR. ANTLEY:** And it's been -- yes, Your Honor.

12 **MS. GEER:** It is in evidence, but you're -- the
13 issue was that ---

14 **THE COURT:** Yeah.

15 **MS. GEER:** --- the expert disclosure part and him
16 not being -- us given notice that he would be
17 attacking valuation study. Yes, this is a
18 memo. It's related to that valuation
19 analysis, and my understanding of the Ruling
20 is, he can talk about the facts of this case
21 and his own analysis ---

22 **THE COURT:** Yeah.

23 **MS. GEER:** --- but he cannot critique E&Y's.

24 **THE COURT:** I think he can accomplish his goals by
25 staying within my parameters. And if not,



1 then he can't.

2 Q: And I -- I'm sorry, I don't know if we -- if
3 he had finished speaking to -- an- --
4 answering your -- the last question I asked.

5 A: I, I believe I had, yes. And I think part of
6 the issue for me is, as an economist, trying
7 to understand the -- what would be the arms-
8 length percentages for a membership in a
9 partnership interest. And I've testified on
10 this issues in other disputes where I had
11 partners involved in a dispute over the
12 distribution -- the appropriate distribution
13 of the shares, so I have some experience in,
14 in seeing how partners actually assign
15 ownership interests in a joint enterprise.
16 And so typically you'll have -- in third-
17 party arrangements you'll have it based on
18 the, the assets contributed, right? So if I
19 contribute something very valuable and you
20 have something less valuable, then I get a
21 disproportionate share of the enterprise,
22 that's number one. Another one could be also
23 on the obligations of the ---

24 **THE COURT:** You said you'd get a disapportionment,
25 or you'd get a ---



1 A: A disproportionate ---

2 **THE COURT:** --- a proportionate, yeah.

3 A: Well, proportionate to the value that I'm
4 receiving. So if I ---

5 **THE COURT:** Should get that?

6 A: Correct. I should get a -- something
7 proportionate to the value that I'm -- of the
8 assets that I'm contributing rela- -- if
9 you're contributing a lesser amount of assets.
10 A different way of doing that is based on the
11 cash required for the operation. If I commit
12 to, to funding 90 percent of the cash
13 requirements and you only commit to funding
14 10 percent of the cash requirements of, of
15 the ongoing operation, a 90/10 percent -- 90
16 versus 10 partnership interest is a -- these
17 are kind of reasonable, and what, what I
18 observe in arms-length transactions the, the
19 parties actually contributing. In tra- -- in
20 transfer pricing analysis, this often comes up
21 in something called cost-sharing arrangements.
22 So a cost-sharing arrangement, not necessarily
23 a partnership, but it's nonetheless a -- an
24 arrangement that's set up in order for two
25 different related -- or multiple related



1 parties to share in the costs of -- in the
2 development of -- to be -- usually
3 intangibles. So if there's an R&D center
4 that's setup, then if -- then -- and there
5 are costs associated with running that R&D
6 center, then the, the cost share participants
7 will agree to share in the costs of that and
8 -- that -- of, of that cost center
9 proportionate to the benefits they expect to
10 receive. But you'll, you'll get the sense
11 that ultimately these arm- -- that that's
12 intended to mirror the -- these -- what we
13 observe in arms-length dealings. That it is
14 one of kind of a issue of what do you
15 contribute, because if a cost-sharing
16 participant contributes a pre-existing
17 intangible, a very valuable intangible to that
18 cost-sharing arrangement, it gets compensated
19 for that. It's not just a nothing, it's a
20 very significant portion -- or part of these
21 cost-sharing exercises to recognize when one
22 of the parties is contributing valuable assets
23 to that. But those are kind of -- those are
24 set up based on arms-length principles based
25 on what we observed in joint venture



1 arrangements or partnership arrange- --
2 arrangements every day between unrelated
3 parties. So that's why for, for -- as, as an
4 economist, my first conundrum to wrestle with
5 is that if the business process intangibles
6 are so valuable, if it -- they would -- and
7 they were asserted to be very valuable at the
8 time of the transaction, why isn't the
9 ownership interest of, of West -- I'm sorry,
10 of East, much, much higher? So -- and that's
11 part of this -- the, the -- this document
12 here is really showing me the step-through
13 process, because it was transferred for an
14 instantaneous moment on December 1st from West
15 to -- I'm sorry, from East to West to CBS.
16 And so it counted as a contribution not by
17 East, but it counted as a contribution by, by
18 West in, in a way that I think is completely
19 inconsistent with arms-length principles.

20 **THE COURT:** So that was one -- an epiphany today
21 that economists actually grapple with logic.

22 **MR. ANTLEY:** And, Your Honor, based on your, your
23 ruling, it might be helpful if, if we take a
24 five to 10 minute break. I think it could
25 help streamline my questions, my even



1 eliminate some if, if that would be okay?

2 **MS. GEER:** 10 or 15 is fine with me if you want to.

3 **MR. ANTLEY:** Yeah. 10 ---

4 **THE COURT:** 10 or 30 depending on how many
5 questions you eliminate. All right. All
6 right. 10?

7 **MR. ANTLEY:** That's fine.

8 **THE COURT:** All right.

9 **MR. ANTLEY:** Thank you, Your Honor.

10 (Off the record 10:36 a.m until 10:56 a.m.)

11 **THE COURT:** All right, y'all. Be seated.

12 **MR. ANTLEY:** If you could go to Slide Number 86.

13 (Slide Number 86 was referenced at this time.)

14 Q: Can you describe your understanding of how
15 the ownership shares of CBS were allocated
16 between East and West?

17 A: Yes. So it's my understanding that the
18 contribution by West was based on the value
19 of the, the -- both the tangible and the
20 intangible assets that West contributed to
21 CBS. And this was based -- the, the value of
22 the intangible assets was based on this 2004
23 intangibles valuation study by Ernst and
24 Young. It wa- -- the standard that was
25 applied was the fair market value as opposed



1 to the book value of the assets, and so the
2 number that was used was \$2,000,000,000 for
3 the contribution -- the value of the
4 contribution by West. For East, the
5 valuation was based solely on the value of
6 the tangible assets contributed. Those are
7 the tangible assets attri- -- associated with
8 the headquarters function primarily, including
9 the tangible assets associated with the, the
10 CAF -- the finance business as well. It was
11 also based on just the book value of the
12 headquarter's assets and the finance business,
13 not based on the fair market value of those
14 assets. And the value of that contribution
15 by East was asserted to be \$120,000,000. And
16 so those proportions with some adjustments are
17 then used to derive the 6.5 percent and the
18 93.5 percent shares.

19 **MR. ANTLEY:** If you could go to Slide Number 87.

20 **(Slide Number 87 was referenced at this time.)**

21 Q: Have you reviewed the calculations underlining
22 these -- underlying these ownership shares?

23 A: Yes, I have.

24 **OBJECTION:**

25 **MS. GEER:** Your, Your Honor, I, I would object to



1 this as well for the record. I know Your
2 Honor's ruling is that he is not allowed to
3 give testimony as to his analysis of the E&Y
4 report, but we also think that he should not
5 be able to give his own analysis because that
6 wasn't disclosed in the expert report either.
7 So it didn't say he was going to contest the
8 valuation study, it didn't say he was gonna
9 give his own value. So on that basis, we
10 would object to this line of questioning as
11 well.

12 **THE COURT:** But based on what I have heard about
13 the -- well, here, I'll let you respond to
14 that. Just go ahead.

15 **MR. ANTLEY:** All right. To the, to the valuation?
16 Yes, Your Hon- ---

17 **THE COURT:** No, to the objection.

18 **MR. ANTLEY:** To the objection? So he -- he's been
19 qualified as an expert in valuations. I've -
20 - he's only talking about Joint Exhibits ---

21 **THE COURT:** He's talking about the disclosures.

22 **MR. ANTLEY:** Oh.

23 **THE COURT:** I think she's speaking of the
24 disclosure before the deposition ---

25 **MS. GEER:** Correct.



1 **THE COURT:** --- or regarding the deposition.

2 **MR. ANTLEY:** So, Your Honor, I'd be happy to pull
3 up that disclosure, but it says that he is --
4 if, if you don't mind, if you could -- could
5 plug it and pull that up?

6 **THE COURT:** Well, I remember us discussing it.
7 Maybe I need it into the record though. Do
8 y'all want me to read it 'cause you're all
9 having trouble finding it?

10 **MS. GEER:** We've got it, Your Honor.

11 **THE COURT:** You've got it?

12 **MS. GEER:** Thank you.

13 **MR. ANTLEY:** Thank you.

14 **MS. GEER:** Yes, Your Honor. Thank you.

15 **THE COURT:** We found it faster than y'all did.

16 **MR. ANTLEY:** Okay. If you could scroll down.
17 Okay. So just for the record, the disclosure
18 says Dr. DeRamus is expected to provide
19 testimony regarding transfer pricing analysis
20 including Petitioner's transfer pricing
21 report, that's a typographical error that
22 we've discussed, prepared by Ernst and Young
23 LLP. Dr. DeRamus is also expected to provide
24 testimony from an economic perspective
25 regarding the extent of Petitioner's business



1 activity in South Carolina.

2 **THE COURT:** Okay. Based upon that, I'll overrule
3 your objection.

4 **OBJECTION:**

5 **MS. GEER:** All right. Your Honor, just so I have
6 my full ground on the record, that in
7 response to what Mr. Antley said. If he was
8 intending to give his own analysis of what
9 the correct valuation should have been, we
10 should be entitled to see -- explore that
11 opinion in his deposition, find out what it's
12 based on, see these -- whatever calculations
13 he's getting ready to give, whatever his
14 analysis is as to why this study is
15 incorrect, and why his opinion is correct.
16 And so I basically would like to incorporate
17 for the record all of the objections that I
18 made on my -- in my motion in limine, which
19 is on file with the Court and would apply to
20 this issue as well for preservation purposes.

21 **MR. ANTLEY:** And, and Your Honor, he was actually
22 deposed on these issues. They asked him
23 questions on those issues and I'm happy to
24 publish ---

25 **THE COURT:** Well, if ---



1 **MR. ANTLEY:** --- that deposition.

2 **THE COURT:** That's -- this sets forth what he was
3 expected to testify about. If someone is
4 given this Notice and doesn't sufficiently
5 explore the, the possibilities of testimony,
6 then that's not -- that doesn't affect my
7 ruling. I mean, that -- you've got to do --
8 in my opinion, this gave you sufficient
9 notice, and that -- you know, I mean, we may
10 disagree on that, but on this one, I'm -- I
11 think you're a very fine lawyer by the way,
12 Ms. Geer, but you know what, on this one,
13 I'll just have to disagree with you on it.

14 **MS. GEER:** I understand, Your Honor. Thank you.

15 **THE COURT:** Do you understand my ruling or ---

16 **MS. GEER:** I un- ---

17 **THE COURT:** --- understand that I think you're a
18 very fine lawyer?

19 (Laughter.)

20 **MS. GEER:** Well, I think that's true as well. I
21 appreciate the kind words.

22 **MR. ANTLEY:** Okay. If we can go back.

23 Q: We were on -- I think we were on Slide 87.

24 **OBJECTION:**

25 **MS. GEER:** Your Honor, I apologize. Would it be



1 possible -- I know this whole section I'm
2 guessing that Trey is going through will be
3 addressing this particular issue. If I could
4 have a running objection until Trey as- -- I
5 mean, I don't want to have stand up ---

6 **THE COURT:** That's fine.

7 **MS. GEER:** --- every question he asks. Is that --
8 a running ---

9 **THE COURT:** That's fine.

10 **MS. GEER:** --- objection? And Trey, could you just
11 let us know when you move to a different
12 topic?

13 **MR. ANTLEY:** When I finish?

14 **MS. GEER:** I, I don't under -- have a ---

15 **MR. ANTLEY:** You just have to follow along. I ---

16 **MS. GEER:** I ---

17 **MR. ANTLEY:** --- I don't...

18 **MS. GEER:** Okay.

19 **THE COURT:** I will allow your objection to be a
20 running objection.

21 **MS. GEER:** Thank you, Your Honor.

22 **THE COURT:** That running objection can keep right
23 on running until we go off a cliff at the end
24 of the case.

25 **MS. GEER:** I appreciate that, Your Honor. Thank



1 you.

2 Q: Okay. So I -- I'm not sure if I got this
3 question out, so ---

4 **THE COURT:** You haven't gotten it out yet.

5 **MR. ANTLEY:** Okay.

6 (Laughter.)

7 Q: Have you reviewed the calculations underlying
8 these ownership shares?

9 A: Yes, I have.

10 Q: Okay. And is that -- is, is that what we're
11 looking at now, Slide 87? Is, is that
12 relevant?

13 A: Yes, that's the, the spreadsheet that was
14 produced in discovery that provided the, the
15 numeric calculations to derive the 93 and a
16 half, 6 and a half percent ownership shares.
17 So across the top you'll see CAS, i.e., East,
18 at the top of that -- actually the fourth
19 column in. And then CASWC, that's circled in
20 red th- -- three columns over. So West -- so
21 you have East in that initial column and then
22 West in the far column, and then along the
23 rows you see various assets that are being
24 listed. The first bucket of assets are these
25 corporate department assets, that's the



1 headquarter's function. And so for East,
2 that's where all of the corporate department
3 assets actually are located. The -- I think
4 it's a little bit of a misnomer as it's
5 applied to West. West is contributing some
6 intan- -- some tangible assets I can talk to
7 in a minute, but the corporate department is
8 really -- as I understood it to be the, the
9 headquarters, which is really reflective of,
10 of East. So there you see kind of the type
11 of assets you'd expect, the cash, the
12 accounts receivable. The PP&E, you'll see
13 that, it's the physi- -- the, the property,
14 plant and equipment, that was worth about
15 23.4 million dollars. That's the
16 headquarter's -- the tangible assets at the
17 headquarters that was owned by, by East and
18 contributed to the -- to, to CBS, and then
19 various other feat- -- values down below.
20 You'll notice there's a zero under the
21 intangibles line for the corporate department
22 for the contribution by East, so it's --
23 there's no number there. It's below that 24
24 million dollars, below that cash funding that
25 you'll see in that fourth column. So that



1 gets the total -- or at least the subtotal
2 for the corporate department for East is 50.7
3 -- or 50.8 million dollars, and then below
4 that, the next group is the finance business,
5 and a similar notion of cash. A lot of these
6 -- a lot of that is actually the -- these
7 other receivables is about 96 million dollars
8 of other receivables in there from the
9 finance business, for a subtotal for the
10 contribution of the CAF business of 90.6
11 million dollars. Again, these are still
12 East's contribution. Now, against this there
13 are some liabilities down below that are
14 subtracted from the, from the assets. So you
15 see that -- again, approximately \$16,000,000 -
16 - or 16.8 million dollars of liabilities from
17 the headquarters, and \$4,000,000 for the
18 finance function, so you have a net
19 contribution for the assets of 120.5 million
20 dollars for, for East. So what has East
21 contributed? Cash, the CAF business and the,
22 and the, the tangible -- effectively the
23 tangible assets of the corporate headquarters.
24 Now, let's go over to the West column, so
25 what is West contributing.



1 **THE COURT:** When you say what have they

2 contributed, according to this document?

3 **A:** Correct. According to this document they are
4 contributing those particular functions. And
5 in terms of -- also in terms of thinking
6 about the restructuring, that's how the
7 restructuring was posited by the tax payer,
8 is that CBS was going to takeover the
9 headquarter's functions and headquarter's
10 assets and the finance business. So this is
11 just the enum- -- the enumeration or the
12 quantification of those specific contributions
13 for, for East. You'll notice there is two
14 columns, both under the -- on the East side
15 of the ledger, one labeled NBV, Net Book
16 Value, and the other one that I circled in
17 red, FMV, Fair Market Value. And you'll
18 notice how the numbers are identical in those
19 two columns for, for East. If you scoot over
20 a couple columns over, then you get to the
21 West side of the ledger to see how they did
22 it. So there you'll see -- maybe I'll start
23 in the Net Book Value side. So the Net Book
24 Value, there's \$10,000 worth of cash and 11.3
25 million dollars of PP&E. That was a bit of a



1 head-scratcher to me because all of the
2 corporate headquarters was really -- these
3 were assets of East, not of West. I believe
4 that that pertains to the West. There's some
5 West land, I think we saw that in the prior
6 memo, it's a relatively modest amount of
7 tangible assets that were contributed by, by
8 East to West on December 1st, and then
9 contributed down from West to, to CBS. So
10 that ultimately it appears that that 11.3
11 million dollars ultimately derived from East,
12 at least from on the day before the, the
13 restructuring. But you'll notice there's no
14 other en- -- entry on any of the other line
15 items under the NBV or the Net Book Value
16 column. So then you scr- -- go over though
17 to the FMV, the Fair Market Value column, and
18 you'll see the only difference between those
19 two columns is the fact that there's a
20 \$1,996,000,000 number, you know, that's
21 entered into the intangibles line. And it's
22 my understanding that that is intended to
23 represent the value of the intangible assets
24 contributed by West, which is on this -- at
25 this point in time is being asserted to



1 include not just the trademarks, not just
2 the, the -- what I consider the bare legal
3 ownership of the trademarks, but also these
4 broader business process intangibles.

5 **THE COURT:** And those were the assets that were
6 transferred from East to West prior to this?

7 A: The, the business process intangibles were.
8 I think there's a outstanding question about
9 the value of the trademark ---

10 **THE COURT:** Well ---

11 A: --- intangibles.

12 **THE COURT:** Trade- -- trademark's is what I'm
13 saying.

14 A: Right. So the trademarks were in -- were
15 always in West.

16 **THE COURT:** Yeah.

17 A: I think there's a question about -- from a
18 transfer pricing perspective and an economic
19 perspective of did those have value,
20 appropriate to assign value to West for that
21 legal ownership share since they didn't
22 develop those particular assets. But from a
23 -- just a legal structure, that is where
24 those trademark assets were residing on
25 November 30th, whereas the business process



1 intangibles, these intangibles they assert to
2 be much more valuable, were sitting on the
3 East side ---

4 **THE COURT:** All right.

5 A: --- as of November 30th of 2004.

6 Q: And Slide Number 87, what we're seeing there,
7 is that from Joint Exhibit Number 40, the
8 CarMax East and West initial contributions to
9 CAS dated 12/1/04?

10 A: Yes, it is.

11 **(Joint Exhibit 40 was referenced at this time.)**

12 A: And I'm sorry, I probably also should've
13 focused on the -- do you see the percentages
14 down at the bottom line, the ownership
15 percentages? Those are based on that -- tho-
16 -- that -- those two relative amounts, the
17 \$2,000,000,000 number that's popping up into
18 the We- -- on the West side on the left-hand
19 side relative to the \$120,000,000 number that
20 is the, the asserted contribution of East on
21 the right side of that ledger.

22 **MR. ANTLEY:** If you could go to Slide Number 88.

23 **(Slide Number 88 was referenced at this time.)**

24 Q: And based on your analysis, was that cash
25 infusion imported -- an important part of the



1 restructuring plan?

2 A: Yes, it was. And with any kind of new
3 venture or establishing a new company, there
4 is just a basic question of how do you get
5 fun- -- how do you get cash into the entity
6 in order for it to be able to pay its
7 expenses. So the headquarter's function, it's
8 in a fairly sizeable operation. There's a
9 lot of people working there. They need to be
10 paid on a current basis. Actually here these
11 people are being paid in ca- -- they're in
12 CAS, the actual people, so the salaries are
13 being in- -- the salary expenses are all
14 being incurred by CAS. But nonetheless, CBS
15 on day one needs to have cash in order to pay
16 those -- tho- -- those, those employees, and
17 I, and I mean its broader expenses. So for
18 me as an economist, the first thing I look to
19 is where is the cash coming from and in what
20 proportion. Well, effectively here, almost
21 all the cash but for that \$10,000 number, is
22 coming from, from the -- on the get go, on
23 the formation of it, all of it's coming from
24 the East side of the business, primarily from
25 the CAF business. That's where the -- in



1 that finance business, that's the one that's
2 generating and holding more of the cash and -
3 - or it's getting a lot of receivables, so
4 cash is coming in associated with the -- with
5 that business. But ultimately it's coming
6 from there, and also from the management fee.
7 So there's a pre-payment of the management
8 fee. Who's paying the management fee and
9 what proportion? Well, based on sales --
10 it's based on the number of units that are
11 sold. So approximately 73 -- so let's call
12 it 75 percent just for the sake of argument
13 for you -- the ease of the calculations, 75
14 percent of the management fees are coming in
15 from, from East, 25 percent are coming in
16 from West. So on day one, the minor- -- 6
17 and a half percent minority owner is
18 contributing 75 percent of the ongoing cash
19 required to pay all CBS expenses and all the
20 cash that's gon- -- that's already on the
21 balance sheet effectively of the headquarter's
22 function as of tha- -- as, as of that, that
23 day, and that to me is inconsistent with --
24 on any kind of arms-length notion of that 6
25 and a half percent ownership share.



1 **MR. ANTLEY:** If you could go to Slide Number 89.

2 **(Slide Number 89 was referenced at this time.)**

3 Q: Okay. Have you reviewed Ernst and Young's
4 valuation study of the intangibles dated March
5 15th, 2005?

6 A: Yes, I have. And -- but I -- even before you
7 start talking about this, I want to be
8 cognizant of the Judge's ruling. I, I have
9 come to my own views as to what would be an
10 arms-length allocation of the income through
11 CBS, independent of that particular report.
12 So even before getting into the details of
13 that, I think everything that I've reviewed
14 up to this point provides me a sufficient
15 factual basis to provide an opinion on that,
16 that ---

17 **THE COURT:** Well ---

18 A: --- arms-length percentage.

19 **THE COURT:** Okay. I recognize my ruling on this
20 Ernst & Young thing, it made a lot of sense
21 at first. The functionality of it is -- I'm
22 starting to question, but I'm gonna stick
23 with it. Although my sticking with it goes
24 in your favor. I'm just not so sure about
25 it, but -- so. Go ahead.



1 MR. ANTLEY: Okay. So ---

2 THE COURT: That was a diatribe that ---

3 MR. ANTLEY: Okay.

4 THE COURT: Yeah.

5 MR. ANTLEY: I'll keep going.

6 A: He, he -- I'm, I'm sorry, Your Honor. I know
7 it's somewhat unusual because I'm -- there's
8 a -- there was a question about it and I was
9 trying -- I'm trying to be responsive to your
10 earlier questions and statements.

11 THE COURT: Let's just stick with what -- like I
12 told you earlier. Give us a lit- -- it was
13 maybe splitting hairs, but my original ruling
14 is that I just don't want you attacking the -
15 - anything that was -- Ernst and Young gave
16 their opinion on.

17 A: Correct.

18 THE COURT: But the facts of where we are in this
19 case and the results of Ernst and Young did,
20 that's all on the table, so.

21 A: Okay.

22 THE COURT: But go ahead, proceed. And you're,
23 you're ---

24 MR. ANTLEY: And, and -- I'm sorry. I thought, I
25 thought I was following you. So, the



1 opinions of Ernst and Young cannot be
2 attacked, but the study itself can be? Is
3 that it?

4 **THE COURT:** Well, the results of it ---

5 **MR. ANTLEY:** The results?

6 **THE COURT:** --- yeah.

7 **MR. ANTLEY:** Okay. Okay. Well, I'll keep going
8 then.

9 Q: Did -- and you said -- were you in the middle
10 of an answer ---

11 **THE COURT:** Whoa, whoa, whoa.

12 **MS. GEER:** Yeah.

13 **THE COURT:** She doesn't like ---

14 **MS. GEER:** Your Honor, just for the record, I'm,
15 I'm not clear myself on whether I -- I, I
16 know with the last objection we were
17 discussing I was objecting to him giving his
18 own analysis, and you said I could have a
19 running objection on that.

20 **THE COURT:** Yeah.

21 **OBJECTION:**

22 **MS. GEER:** I would also like a running objection on
23 my objection that he not be able to attack
24 the valuation study.

25 **THE COURT:** Well, if you want to have a running



1 objection on your objection, then I'll ---

2 **MS. GEER:** Well, I ---

3 **THE COURT:** I'll allow you to do that.

4 **MS. GEER:** Thank, thank you, Your Honor.

5 **THE COURT:** 'Cause I probably would agree with
6 that.

7 **MR. ANTLEY:** Your Honor, if I could just respond
8 for the record then to ---

9 **THE COURT:** To the running objection of ---

10 **MR. ANTLEY:** To her running ---

11 **THE COURT:** --- her running objections?

12 **MR. ANTLEY:** The ...

13 **THE COURT:** Go ahead.

14 **MR. ANTLEY:** To the running objection that I
15 believe was just made.

16 **THE COURT:** Okay.

17 **MR. ANTLEY:** So it -- just to make it clear, I --
18 Dr. DeRamus is qualified to talk about the
19 valuation.

20 **THE COURT:** I agree with all of that.

21 **MR. ANTLEY:** Okay.

22 **MS. GEER:** Are -- you're not objecting to me having
23 a running objection? Is that ...

24 **MR. ANTLEY:** I'm not.

25 **THE COURT:** I feel like we're getting to the point



1 of ---

2 **MS. GEER:** I'm just gonna object ---

3 **THE COURT:** --- who's on first ---

4 **MS. GEER:** --- to every question.

5 **THE COURT:** --- right now?

6 **MR. ANTLEY:** Okay.

7 **THE COURT:** I would, I would like to hear a
8 question.

9 **MR. ANTLEY:** Okay.

10 Q: I, I think you were answering a question
11 earlier, is that correct?

12 A: Yes. And I was ---

13 Q: Could you finish your ---

14 A: --- trying -- I ---

15 Q: --- answer?

16 A: And I, I guess I was trying to maybe expand
17 on the quest- -- expand my answer that you
18 had -- that -- to the question that you
19 posed, to first provide my, my own
20 independent opinion as to what I think an
21 arms-length appr- -- percentage ownership
22 would be for East based on the facts as I
23 understand them, even before I get into the
24 details of the Ernst and Young report. So
25 setting that aside and first going to what



1 would that number be. Because as, as I
2 understand it, to the Court's direction, that
3 would be consistent with the Court's allowing
4 me to, to talk about that. It's also what I
5 dis- -- discussed in -- during my deposition.
6 So as I mentioned a few minutes earlier, or
7 maybe this is more than a few minutes
8 earlier, there are several different ways in
9 which third parties typically will value
10 percentage ownership interests, whether it's
11 in a partnership or a joint venture based on
12 the assets contributed or the cash they
13 expect to provide. So here I think given the
14 -- there are a couple of different ways in
15 which I would expect that at arms-length that
16 the ownership shares to be derived. One
17 would be based on -- if you were just to do
18 it based on the cash contribution approach,
19 which -- almost like a cost-sharing approach.
20 Here's a headquarter's function, which of the
21 entities that are expected to, to actually
22 bear the costs and then what proportion are
23 they expected to bear the cost of that
24 entity, then the ownership shares could be
25 based on those expected cost-sharing



1 percentages. Those cost-sharing percentages
2 generally, in a transfer pricing context, are
3 derived on a revenue basis. So this is where
4 I would've expected a 75 percent, 25 percent
5 kind of structure, 75 percent to East,
6 because 70- -- goes back -- East accounts for
7 75 percent of the Company's revenues, 25
8 percent to West. And then if there's any
9 profits associated with the headquarter's
10 function or the finance business, those
11 profits will then flow through to the, the
12 owners in that 75/25 percentage basis. An
13 alternative principle that I called out, I
14 think we observe in third-party negotiations,
15 is assets. So first we talk about the enhan-
16 -- so how -- what kind of asset base are you
17 going to use that on. Well, one could be
18 based on the -- or even before -- I should
19 sa- -- well, I said cash earlier, so let me
20 just stick with the other cash. There's the
21 forward-looking cash and then there's the
22 current cash. So how much had the current
23 cash on day one is East contributing versus
24 West. Well there, West is only contributing
25 \$10,000, and East is contributing everything



1 else. And mo- -- mon- -- several million
2 dollars, primarily again generated from the
3 CAF business. So there the proportionate
4 interest in East would be far higher than its
5 revenue share. It wouldn't be 75 percent, it
6 would be well north for that, in a 90-some-
7 odd percentage. 90 -- probably 99 percent
8 interest. A different way to do it would be
9 to do it based on the tangible assets that
10 are contributed. What are the tangible
11 assets being contributed? As of November
12 30th, all of the sa- -- those tangible assets
13 are coming from, from East. So again, you
14 get this hundred -- nearly 100 percent or
15 effectively 100 percent based on the ta- --
16 value of the tangible assets on November
17 30th, but if you effectively give West credit
18 for these tangible assets that were
19 transferred on December 1st from East to
20 West, you're still going, going to get
21 something that was like an \$11,000,000 number.
22 You're still gonna get approximately 90
23 million dol- -- you're gonna get north of 90
24 percent ownership interest based on tangible
25 assets being allocated to East. We saw that



1 \$120,000,000 was the value of effectively the
2 tangible -- the net value of the tangible
3 assets being contributed by East on that
4 prior slide. There was an \$11,000,000 number
5 on that slide for the tangible assets
6 contributed by West, so you're gonna get
7 north of 90 percent ownership interest on
8 that basis going over to East. Then you move
9 to the thorny issue of the intangible assets.
10 November 30th, where, where -- what are the -
11 - where are the tangibles? The, the -- on
12 November 30th, the, the business process
13 intangibles are sitting on the side of East.
14 The cha- -- the legal ownership, the bare
15 legal ownership of the trademark intangibles
16 are sitting on the side of, of West. So how
17 do you apportion the intangible value in that
18 context? Actually there this would be part
19 of -- more of -- using that spreadsheet
20 framework, you'd be using fair market value
21 for both entities. You say, what's the fair
22 market value of the CAF busi- -- of both the
23 intangible assets that, that East is
24 contributing as well as the fair market value
25 of the CAF business? Remember, CAF is being



1 contributed by East. CAF is a highly
2 profitable business. CAF con- -- the finance
3 business constitutes -- comprises
4 approximately 40 percent of the operating
5 profits of the Company. That is a, that is a
6 substi- -- substantial amount of future
7 revenues far in excess of the tangible book
8 value of the assets to that business. So on
9 the -- what would be on the, on the side of
10 East letter -- ledger, if you did it on
11 November 30th you'd have the business process
12 intangibles, the CAF intangibles, and then
13 sitting over here on the West side you'd have
14 this bare legal ownership of the trademark
15 intangibles. What would be a -- where -- how
16 would I think would be the -- kind of the,
17 the most that you would ascribe to the --
18 kind of the relative values of those
19 intangibles? I -- so there -- I, I -- my own
20 opinion is that bare legal ownership of the,
21 of the trademark intangibles was worth very,
22 very little, because that did not -- from a
23 transfer pricing perspective or an arms-length
24 perspective, that did not provide them with a
25 economic entitlement if you were -- if you



1 will, to a stream of substantial royalty
2 income associated with that bare legal
3 ownership, because all of the intangible
4 generating functions are really happening
5 either by the, by the advertising done by the
6 headquarter's or down below by each of the
7 operating companies that are developing all
8 the goodwill that occurs -- the good -- at,
9 at the customer, at the customer store. So
10 that bare legal ownership of the trademark
11 doesn't really have much value. But let's
12 just set aside my opinions and go to what
13 the, the tax payer has asserted. So the tax
14 payer in their transfer pricing, in the years
15 at issue have asserted the trademark should
16 be compensated at about \$100 per unit. And
17 the business -- the -- at, at least part of
18 the business process intangibles are really
19 imbedded in this \$400 per unit in transaction
20 five. That's the data analytical function
21 and that's the algor- -- the development of
22 the algorithms and everything else. Now,
23 technically that \$100 and the trademark,
24 they've actually said that comprises both the
25 trademark and a little bit of business in- --



1 process intangibles. So you've got -- so I
2 think that \$100 overestimates the val- -- the
3 relative value of the trademark even in the
4 calculations that E&Y has presented. But
5 just take th- -- those two as relative
6 factors for proportion for the value of those
7 intangibles. That would suggest that the
8 business process intangibles comprise
9 approximately 80 percent, so 400 divided by 5
10 -- so if the total value of the intangibles,
11 if you sum up those two numbers, 400 and 100,
12 that's \$500 in -- for those two. The value
13 of the business process intangibles, and the
14 way they've structured it, or they way
15 they've done their analysis, would imply an
16 80 percent of that going to the business and
17 process int- -- to, to the owner of business
18 process intangibles. Who's the owner in
19 proce- -- process intangibles as of November
20 30th, that would be East. So however you do
21 the numbers, you get numbers that are North
22 of the 73 -- 70 -- the 75 percent revenue
23 share for East that otherwise I would have
24 expected going in -- going into this is only
25 because of the transfer of the intan- -- of



1 the business process intangible from East to
2 West on December 1st, and then on that same
3 day from West down the CBS. And all of a
4 sudden magically appears this \$2 billion
5 number over on the on the West side of the
6 ledger. Now, I have additional criticisms
7 for how that \$2 billion number was derived,
8 it's a very large number. So -- and that
9 goes -- that number, it was ultimately
10 derived by the report that's on the screen
11 right now, this March 2005 valuation study.
12 But I've seen that number approximately
13 referenced earlier as well.

14 **MS. GEER:** Your Honor, just for the record. I
15 thought we had decided he wasn't going to
16 attack the valuation study directly.

17 **MR. ANTLEY:** Your Honor, if I'm able, I'd like to
18 respond at least for the record of how he
19 should be able to attack the valuation study.

20 **THE COURT:** Go ahead.

21 **MR. ANTLEY:** Okay. So first, he is qualified to
22 talk about valuation. It's a Joint Exhibit
23 so it's in evidence. It's a Joint, so it's
24 not just an exhibit that the Department has
25 to offered. It's an, it's an exhibit by the



1 Petitioner as well.

2 **THE COURT:** So it's addressing an exhibit that's in
3 evidence.

4 **MR. ANTLEY:** Yes, Your Honor.

5 **THE COURT:** Proceed.

6 **MR. ANTLEY:** Okay. If, if you could go to Slide
7 90.

8 **(Slide Number 90 was referenced at this time.)**

9 Q: Okay.

10 A: Even before you go to the slide there was a
11 question about an earlier slide, and this has
12 an excerpt that introduction is actually a
13 pasted excerpt. That's not the -- the cover
14 page is just that black portion. There's --
15 from the -- there's a paragraph inserted from
16 the introduction that describes the regulatory
17 framework used for the, for the analysis, and
18 the study makes it clear that it's, it's a
19 482 study. So it's being done similar to
20 what I observed when I was at KPMG, it would
21 have been done -- similar studies may have
22 been done by my colleagues in the transfer
23 pricing group there using 482 principles to
24 value intangibles. It appears that E&Y
25 applied kind of similar principles, I expect



1 it's coming from similar folks sitting in
2 their transfer pricing practice.

3 Q: For the record, we're looking at Slide 89 and
4 this is an excerpt from Joint Exhibit Number
5 55, is that correct?

6 **(Joint Exhibit Number 55 was referenced at this**
7 **time.)**

8 A: That's correct.

9 Q: Okay. If you can now go to Slide Number 90.
10 What method did Ernst & Young apply this
11 study?

12 A: Something they call the discount- --
13 discounted residual free cash flow method.
14 Now, ear- -- earlier in the report Ernst &
15 Young goes through the alternative methods
16 that are specified in the regulation, when it
17 comes to analysis of intangibles. I think
18 earlier in my testimony I referenced how they
19 considered using the comparable and controlled
20 transaction method, i.e, identifying third
21 party comparable royalty arrangements or even
22 franchise agreements. And, and he concluded
23 that they were not reliable. So they then
24 come up with this -- an unspecified method,
25 according to the regulations. But it



1 effectively is similar approach to what a lot
2 of valuation analyses, if you're valuing a
3 business in its entirety, it's generally the
4 approach that we -- that you would do in
5 terms of the discounted free cash flow
6 method, i.e., you project the future cash fl-
7 -- free cash flows of the company, it's not
8 just the operating profits, but you're really
9 interested in the cash. So you don't care
10 about depreciation, which is a non-cash
11 expense, you do care about capital expen- --
12 expenditures. So you add back in the
13 depreciation and you subtract out the, the
14 capital expenditures because what you care
15 about is what's the cash that the company is
16 throwing -- that the businesses expected throw
17 off. I mean, discount that down to the
18 present, so you go all the way out to
19 perpetu- -- up in to perpetuity, although the
20 values for the -- beyond 20 years are very,
21 very small, because you're applying a present
22 value factor to all those future cash flows
23 to get to a present value of -- that's why
24 the discounted portion of the free cash flow
25 that that refers to. The residual is a



1 little bit of the innovation here because
2 what they're trying to do is not value the
3 entirety of the business, by they I mean
4 Ernst & Young, but they're trying to value --
5 but ultimately, they're trying to value
6 intangibles, the whole purpose of this is
7 this bundle of intangibles that the company
8 has. So the cu- -- so the approach Ernst &
9 Young has used here is to separate out the
10 CAF business, the finance business, from the
11 rest of the business, and also then account
12 for the value of the tangible assets that are
13 sitting over here on the East side. So all
14 they really care about is what's the residual
15 free cash flow that they're going to
16 attribute on, a hundred percent, to the
17 business pricing tangibles and the, and the
18 trademark collectively, that are now being
19 contributed by West on December the 1st.

20 Q: And so this is Slide Number 90 and this is
21 also from Joint Exhibit 55?

22 **(Joint Exhibit Number 55 was referenced at this**
23 **time.)**

24 A: Yes.

25 **MR. ANTLEY:** If you can go to Slide Number 91.



1 Q: So how did how did Ernst & Young apply this
2 method?

3 A: Well, first -- so for a discounted free cash
4 flow method you have, you have to have a
5 forecast of the effectively the profits of
6 the company going forward. So they've
7 develop- -- I un- -- as I understand it, they
8 took internal projections from CarMax, Ernst &
9 Young didn't independently develop their own
10 forecast. They -- I don't know if these are
11 management forecasts or who they were prepared
12 by, but the company prepared these forecasts.
13 Keep in mind that a value of a company will -
14 - is obviously depending entirely on the
15 magnitude of those future forecasts and future
16 profits. So the greater the growth in those
17 profits, the, the, you know, the lower your
18 assumed costs, the higher your assumed
19 revenues, the greater value you're going to
20 calculate. So they had -- they made certain
21 assumptions, growth assumptions in different
22 time periods and th- -- until they reach ---

23 **THE COURT:** And this is in the Ernst & Young's 2005
24 valuation study?

25 A: That's correct.



1 **THE COURT:** Not 2004?

2 A: Cor- -- I think we've maybe, maybe used these
3 -- this term interchangeably.

4 **THE COURT:** Okay.

5 A: It's the 2000 -- the date of the report is
6 2005. The number derived in this 2000
7 businesses report dated March 2005 is the
8 number that appears in determining ownership
9 interest as of December 1st, 2004.
10 Oftentimes with -- so it's the -- you would -
11 - if the dating sounds a little bit strange,
12 sometimes in transfer pricing, because these
13 are related party transactions, companies
14 might actually document something or finish
15 the documentation a little bit after the
16 transaction occurs, even if the results --
17 the -- because the numbers are so exact, they
18 match identically, it -- I, I can, maybe
19 inference, that the study must have been
20 completed prior to the preparation of that
21 earlier sheet. I just don't know at the end
22 of the day when there was a pa- -- piece of
23 paper written down that said 93.5 percent. I
24 saw earlier memos, you know, like November of
25 2004 that talked -- so before the transaction



1 date, that talked about a 95 percent, 5
2 percent split, 95 percent West, 5 percent
3 East. So -- but then the first time I see
4 that in very precise number is in the -- that
5 earlier spreadsheet we saw, and then I
6 observe it in this study, and the study for
7 that number corresponds to the number we saw
8 earlier, that \$1,996,000,000 we saw on the
9 spreadsheet.

10 **MS. GEER:** Your Honor, for the record, I'm
11 concerned that the Court's earlier ruling was
12 based on the fact that this says E&Y 2005
13 valuation study ---

14 **THE COURT:** Your original motion in limine he was
15 based only on the E&Y 2004 valuation study.

16 **MS. GEER:** They're the, they're the same thing.

17 **THE COURT:** Well, that's why I was asking.

18 **MR. ANTLEY:** And for they're record, what we're
19 looking at -- this is on Slide 91. This is
20 Joint Exhibit Number 55.

21 **(Joint Exhibit Number 55 was referenced at this**
22 **time.)**

23 **MS. GEER:** So, Your Hon- -- Your Honor, for the
24 record, we understood your prior ruling to
25 mean that he could not directly attack the



1 E&Y 2004 study, which is sometimes
2 represented the 2005 study, but he could do
3 his own analysis. And so that's why I made
4 the object- -- objection a, a few questions
5 ago. And so to the extent, Your Honor, I was
6 thinking that these are two separate reports,
7 I wanted to make sure that that is clear now
8 and ...

9 **THE COURT:** Thank you for that. I think he
10 explained it. But -- so that I'm clear on
11 now. My ruling has been fluid because now
12 I'm dealing with evidence that's in the
13 record, and I'm allowing him to testify about
14 that which is in the record.

15 **MS. GEER:** All right. Well ---

16 **THE COURT:** Various ways to open the doors, and
17 this is in the evidence. He can certainly
18 testify about that which is in evidence.

19 **MS. GEER:** I know I -- for the record, I don't
20 think I opened the door to an expert speaking
21 to an opinion that he never provided notice
22 of just because items related to what he
23 might have been able to opine upon are in the
24 record. I don't think that opens the door.

25 **MR. ANTLEY:** Your Honor, I -- she had notice of



1 that, and I, and I can run through how she
2 had notice. But this -- if we have to go to
3 that point, but this is evidence in the
4 record. This is a Joint Exhibit he's
5 speaking about, but I'm happy to go through
6 the notice.

7 **THE COURT:** Proceed.

8 **OBJECTION:**

9 **MS. GEER:** Okay. And just -- I would like a
10 running objection on that -- either 2004 or
11 2005 reference to the E&Y study, attacking
12 it directly, or attacking it indirectly by
13 giving his own analysis as to that opinion.

14 **THE COURT:** I don't think he's given any analysis
15 as to an opinion.

16 **MS. GEER:** Correct, right now. I was just trying
17 to, for the record, make ---

18 **THE COURT:** Oh, okay.

19 **MS. GEER:** --- clear what my running objection is.

20 **THE COURT:** Okey-doke.

21 Q: I know we had -- we'd stopped a little bit
22 there. Did -- were you finished speaking to
23 this slide?

24 A: Pretty much. I guess the, the main -- the
25 other thing to, to note is that this is an



1 unspecified method and the, the -- even
2 though there's no strict priority of methods
3 in the 482 regulations that E&Y is
4 purportedly following here, there is a concern
5 about using a method that relies entirely on
6 internal company data. Again, I mentioned
7 this earlier in respect to the use of this
8 CUSP, the, the adver- -- getting that two
9 percent advertising fee. So if you're going
10 to use internal data, you need to have a lot
11 of visibility into how it's prepared. So
12 this is prepared based on a forecast basis.
13 The value will depend entirely -- well, the -
14 - a large part on that, that forecast as well
15 as the other assumptions that the analyst
16 makes. And there's no way to trust -- to, to
17 understand the reasonableness in those
18 forecasts based on, on the four corners of
19 what was presented in the document. I just
20 note that there were verily -- fairly high
21 growth rates applied to those, which will in
22 turn increase the value of the intangibles.
23 But it's just -- as a methodological issue,
24 here's something that they -- that the 482
25 regulations cautioned strongly against. If



1 there's another method, doesn't rely on
2 internal company data, go with the other
3 method. Particularly as it is more -- if it
4 is more likely to get you a more reliable
5 number.

6 Q: Okay.

7 **MR. ANTLEY:** If you could go to Slide Number 92.

8 **(Slide Number 92 was referenced at this time.)**

9 Q: What are the results of this method?

10 A: So, this shows that the bottom, the
11 highlighted portion, that \$1,996,000,000
12 number that we saw on that earlier
13 spreadsheet. So that's the results of the
14 entire study and you see that, just for
15 completeness, you see how the -- they start
16 with this present value and they call it the
17 non-CAF cash flows. Keep in mind, I think
18 there are some, some profits associated with
19 the CAF business with the financing business
20 embedded in them. But nonetheless, that's
21 what they start with, and then subtract out
22 the net book value of, of the business, some
23 of which is being effectively accounted for
24 on the, on the East side of ledger. So this
25 is -- they're just trying to get the



1 residual. And what is the 1-9-9-6, it is
2 just a residual, right? It's just -- it's a
3 whole bunch of cash flows. There's a whole
4 bunch of cash coming -- expected to come into
5 the company from 75 percent generated by
6 East, 25 percent generated by West. You kind
7 of run through their various calculations to
8 get from operating profit down to net cash
9 flows. And they're attributing the entirety,
10 100 percent of that, to this bundle of
11 intangibles, these two intangibles that
12 they've identified, trademark and the business
13 process intangibles. So if not looked at any
14 other -- whether there may be any other
15 intangibles that are gener- -- that are
16 helping to generate this number. Why is it,
17 you know, they've not looked at -- what are
18 the reasons why the company is expecting to
19 earn these high levels of profit? How much
20 of it might be attributable to economies of
21 scale? Why should that be attributable to a
22 business process intangible and trademark --
23 or trademark or collectively, business process
24 and trademark intangible versus some other
25 intangible? So it's just a big one single



1 number, all residual, a hundred percent of
2 this residual profits associated with the car
3 business is going into value, what? It's
4 going to value West's share of CBS. That's
5 the only way you can get that 96 point --
6 that -- the 93.5 percent.

7 Q: And, and this may be inferred from your
8 answer, but do you consider this to be a
9 reliable method or reasonable result applied
10 to value the asserted intangibles?

11 A: No. And I, I would say at the outset that
12 sometimes you will see from a variant of this
13 approach used in transfer pricing and
14 international context, when you actually are
15 trying to figure out and, and measure a
16 payment made between one party and another.
17 So for example, if this were in international
18 context and the, the business process
19 intangibles were being transferred from United
20 States over to France, for example, somebody
21 might go through this exercise and say, hey
22 France, you got to pay -- you have -- the
23 French entity needs to make a payment of
24 \$1.996 billion to the US for the transfer of
25 that intangible. Generally you'd only do



1 that when effectively, you've already gone
2 through the analysis to ascertain that it
3 really is the -- this broader bundle of
4 intangibles that you're -- it's pai- -- it's
5 effectively saying, it's the whole enchilada
6 that you're transferring, all the profits
7 you're transferring from this entity to
8 another entity. And the -- because you --
9 they're -- you're not distinguishing between
10 different types of intangibles that might be
11 contributing to that. So it's just a all-in
12 number, there's a big payment coming in from
13 France to the United States at \$1.996
14 billion. So, for example, if East -- I'm
15 sorry, if West compensated East for the
16 contribution of the business process
17 intangibles, this is kind of the, the
18 exercise that you would see. You would see--
19 okay, wait a second, I should see \$1.96
20 billion paid by West to East for the transfer
21 of the intangibles, here, we don't see any
22 dollars being transferred. In international
23 context that generates taxable income in the,
24 the transf- -- the transferor or transferor
25 country. So United States is -- if the



1 company is shifting an intangible from the
2 United States overseas, that means that income
3 comes in, and that it, that it's subject to
4 current taxation. Or it could be based on an
5 installment, there are different ways of
6 structuring it. But the bottom line, it
7 becomes real dollars that the related party
8 has to pay to the other one. Here, it's
9 simply kind of a bookkeeping entry to try and
10 -- to establish the ownership share. I
11 shouldn't say to try to establish, in order
12 to establish the ownership share of, of East
13 -- I'm sorry, of West, that, that entire 1-9-
14 9-6 goes on to West. It includes cash flows,
15 a lot of cash flow is being generated by
16 East, and I think in a way that is entirely
17 inconsistent with the guidance provided in the
18 482 regulations, and inconsistent with the
19 arm's-length standard.

20 Q: In Slide Number 92, this is from Joint
21 Exhibit Number 55, as well?

22 **(Joint Exhibit Number 55 was referenced at this**
23 **time.)**

24 A: Yes.

25 **MR. ANTLEY:** Can you go to Slide Number 93.



1 Q: In Ernst & Young's March 2005 valuation, how
2 are the CAF revenues factored into the
3 analysis?

4 A: Well, this is what required diving into the,
5 the -- both the text and the, and the
6 appendices in a little bit more detail to
7 understand what they did. Because a, a
8 question for me is if you're going to
9 discount the cash flows of the company,
10 there's the CAF count -- accounts for 40
11 percent of the property profits of the
12 company. Why isn't the -- on the -- there
13 isn't -- why isn't there a similar intangible
14 asset of a similar size on the, on the East
15 side of the ledger, because CAF has never
16 contributed to West. CASS was -- CAF, the
17 finance business, was contributed directly by
18 East to CBS. So why am I not seeing a big
19 number, a big nut associated with the CAF
20 income? Well, first, then I go into the
21 detail here, and the first thing I see is the
22 fact that there is a -- an assumed
23 intercompany charge of \$314 per unit paid by
24 the CAF entity over to the, the car business
25 as a group. So this is an assumed transfer



1 price. This is not an arm's-length price,
2 this is an assumed transfer price. You'll
3 see it -- that it says, and I mentioned this
4 earlier in my testimony, according to the
5 company, the cost to acquire a loan is either
6 \$250 for Value Max cars, or 325 for new and
7 used car units at CarMax. They derive a
8 weighted average of \$314. The Value Max cars
9 are simply slightly higher mileage, older
10 cars, so they, they call them something
11 differently relative to 90 percent of their
12 vehicles, which are these newer ones. So
13 this is simply an asserted fee that they're
14 incorporating into the analysis. It's not a
15 fee that was ever paid during the, during the
16 years at issue. I have never seen any of the
17 documentation after 2004. I don't -- I have
18 no idea whether it was paid prior to that
19 time. I ---

20 **THE COURT:** You said you have- -- haven't seen any
21 of the documentation after 2004 or before
22 2004?

23 A: I, I haven't seen any evidence in the
24 documentation after 2004 that this \$314 ---

25 **THE COURT:** Oh, it's -- okay.



1 A: --- per unit was paid ---

2 **THE COURT:** I get it.

3 A: --- from the finance at the CAF, which is now
4 in CBS ---

5 **THE COURT:** Right.

6 A: --- back to the oppor- -- to East and West on
7 a per unit basis.

8 **THE COURT:** Okay.

9 A: So typically you would think it might be a --
10 so that, that \$1,200 management fee, you
11 might have seen a credit of \$314 to offset
12 for this payment for the -- effectively an
13 origination fee, I don't see that in any of
14 the documents. I would, I would be surprised
15 if it had been paid even prior to this time
16 period because effectively CAF at that point
17 was in the East entity. So you'd have a West
18 entity shifting the \$314 into ---

19 **OBJECTION:**

20 **MS. GEER:** Your Honor, I would object based on
21 speculation.

22 **THE COURT:** Yeah, I'll sustain that.

23 A: Okay.

24 **THE COURT:** Well, I'll let you respond to that
25 because he can have opinions.



1 **MR. ANTLEY:** Yes, Your Honor. He can, he can give
2 expert opinions.

3 **THE COURT:** Well, you ---

4 **MS. GEER:** It's gotta be based on fact. He says,
5 he's, he's -- he would be surprised if that
6 fee was paid.

7 **THE COURT:** I'll sustain it just because I'd like
8 to move along.

9 Q: Okay. So just to be clear, so after the
10 restructuring did CBS pay East and West for
11 the auto loans that they generated?

12 A: No.

13 Q: All right. If you'd go to Slide Number 94.

14 **(Slide Number 94 was referenced at this time.)**

15 A: I'm sorry, you said did he -- did East -- CBS
16 did not pay East or West for the auto loans
17 that they generated. That's true.

18 **OBJECTION:**

19 **MS. GEER:** I would just object based on foundation.

20 **THE COURT:** Well, can I get it?

21 Q: Did you see any evidence that CBS paid East
22 or West for the auto loans that they
23 generated?

24 A: No. And I would have seen that in the
25 accounting records that were produced in, in



1 Dr. Cody's files that had the P&Ls, the
2 profit and loss statements, for the -- each
3 of the entities, and I see no such payment.

4 **MR. ANTLEY:** If, if you could go to Slide Number
5 94.

6 Q: Okay. Have you analyzed the impact of Ernst
7 & Young's March 2005 valuation of this
8 assumption of a payment from CAF to the
9 retail stores for a loan origination?

10 A: Yes, I have. And what's on the demonstrative
11 is from the appendix of the E&Y 2005
12 valuation report.

13 Q: Is that Joint Exhibit 55?

14 A: Yes, it is.

15 Q: And was the correct -- previous slide, Slide
16 93, was that also from Joint Exhibit 55?

17 **(Joint Exhibit Number 55 was referenced at this**
18 **time.)**

19 A: Yes, it was.

20 Q: All right.

21 A: So you'll see -- this is the, the cash flows
22 -- the projected of the free cash flows.
23 Again, this is -- you add back in
24 depreciation, you subtract out the capital
25 expenditures, that's why you have -- and



1 there's a change also in working capital that
2 you have to account for. That's why you see
3 some negative numbers in the earlier year --
4 in 2007 and 2008, even though on an operating
5 profit basis the company was projected to be
6 very profitable throughout the time period.
7 But in any event, you've got this entire
8 company forecast of free cash flows, you'll
9 see the CAF column and then the residual CAR.
10 So the residual CAR column is what Ernst &
11 Young is discounting to the present or
12 discounting to December 1st, 2004 to value
13 the intangibles. So the CAF numbers to me is
14 a surprising thing because I know CAF is 40
15 percent of the operating profit. Why do I
16 see numbers -- the ones that are easiest to
17 see may be down below, under the last line,
18 2020, or the years at issue, 20- -- I picked
19 2016, why is CAF only generating \$21.5
20 million of free cash flow, whereas the
21 residual CAR is gener- -- generating \$220
22 million. So why is CAF only 10 percent
23 instead of 40 percent. And that's because
24 they've moved -- Ernst & Young has moved \$314
25 per vehicle sold from the CAF line over to



1 the residual car lines that reduces the CAF
2 number, and it pops up the, the residual car
3 valued by a substantial amount.

4 **MR. ANTLEY:** If you could go to Slide Number 95.

5 **(Slide Number 95 was referenced at this time.)**

6 Q: Is this also from Joint Exhibit Number 55?

7 **(Joint Exhibit Number 55 was referenced at this**
8 **time.)**

9 A: Yes, it is.

10 Q: Okay. And if, if you have trouble seeing
11 this, if anyone has trouble seeing this, we
12 can pull up Joint Exhibit 55. And I think
13 you can -- if you're able to ---

14 A: Sure, I think it just provides additional
15 detail. We saw that -- we've seen the
16 underlying numbers earlier. But just to give
17 you a sense of, you know, just mechanically
18 where does this adjustment for the CAF --
19 assumed CAF payment come in? You see on this
20 -- I've circled the numbers off to the far,
21 the far right. I'm just picking 2020 for
22 ease of comparison. And you see CAF net
23 income, I've circled -- I've done the circle
24 on the far left so you can see which lines
25 they refer to. So CAF net income is about



1 \$489 million whereas the operating profit,
2 consolidated operating profit is projected to
3 be about a billion dollars. So that's back
4 to this 40 to 50 percent share of operating
5 profit that I expect from the finance
6 business. So that's how you start, and then
7 down below this is the calculation of the
8 cash flows. And then you ca- -- so as you
9 run through the calculations at the bottom
10 you get the CAF FCF, that's the auto finance
11 free cash flows, and then the car free cash
12 flows down below. And their, oops, I just
13 marked on that exhibit, you'll see that the
14 numbers are, on a free cash flow basis, it's
15 26 million I believe for the, for the CAF --
16 it's for the finance business relative to
17 \$459 million for the car business. So
18 magically that 40 percent ratio that we
19 observed on an operating margin basis comes
20 to -- all of a sudden CAF only accounts for
21 about 6 percent of the free cash flows, which
22 is once again shifting the, the val- -- the,
23 the values that they're deriving to increase
24 substantially the value of the car business.

25 Q: Okay.



1 **MR. ANTLEY:** If you can go to Slide Number 96.

2 **(Slide Number 96 was referenced at this time.)**

3 **Q:** Is this also from Joint Exhibit Number 55.

4 **(Joint Exhibit Number 55 was referenced at this**
5 **time.)**

6 **A:** Yes. This provides -- it maybe a little bit
7 easier to see way of the -- this is a bit of
8 a backup for that, this is -- it's Exhibit
9 4.1. It's a backup to their calculations in
10 that other spreadsheet and some other
11 spreadsheets that are a little bit harder to
12 follow.

13 **(Joint Exhibit Number 4.1 was referenced at this**
14 **time.)**

15 **A:** But nonetheless, it's maybe a little bit more
16 explicit here where you see down at the very
17 bottom this wa- -- weighted average cost to
18 acquire the loans of \$314 per vehicle.
19 They're multiplying it by -- so they have the
20 -- kind of the total units that first block
21 above like for 212,000 units in 2003,
22 actually we picked the first year of the
23 forecast 2005 of 265,000 units. And then
24 they have a an estimate of a CAF, the
25 financed share. So they have down that



1 bottom section they say -- under assumptions
2 that first assumption is the CAF percent of
3 total units 43 percent, which is actually
4 pretty consistent with what I've observed in
5 their -- from the -- that -- what we saw from
6 their 10k earl- -- yesterday. They, they are
7 able to consistently finance about 43 percent
8 or in that order of magnitude of the, the
9 vehicles that they sell. So they apply 314
10 times 43 percent times the 265,000 units gets
11 you a payment of -- in 2005, an assumed
12 payment of \$36 million that goes -- the
13 transfer -- I assume transfer price from CAF
14 to the operating companies that then increases
15 those cash flows.

16 Q: Okay. And how does this affect Ernst &
17 Young's two billion dollar overall valuation
18 of the car related intangibles?

19 A: Well, as you'd expect, it substantially
20 increases the value. And not just -- well,
21 we, we saw it before in terms of -- I, I
22 would have expected like this 40 percent
23 share of the CAF business relative to the car
24 business. And yet they come with this very -
25 - this much more disproportionate share in



1 the car business has resulted this.

2 Q: And how does that affect CarMax's allocation
3 of CBS, its ownership shares between CarMax
4 East and CarMax West?

5 A: It significantly increases the value of this
6 asserted process intangible. That 1-9-9-6
7 number goes up a lot as a result of that
8 number. If I recall they've done it --
9 there's two different things that they're
10 doing. One is they're pumping up the value
11 of the 1-9-9-6, and the other thing is
12 they're not even accounting for the fair mar-
13 -- the discounted present value of those CAF
14 -- those remaining CAF cash flows. So
15 there's no credit -- you remember that
16 earlier spreadsheet that we walked through,
17 there's no credit for the fair market value
18 of the cash -- of the CAF business the way
19 they're doing for the, the car business that
20 they're ascribing in its entirety to West.

21 Q: Do Ernst & Young's 2012 and 2015 transfer
22 pricing reports and the separate values
23 derived therein for the trademark royalty and
24 the data analysis payment have any relevance
25 in evaluating the reliability of Ernst &



1 Young's valuation study?

2 A: Yeah. I'm sorry, could you ask that one more
3 time?

4 Q: Sure, it's a long question. Did Ernst &
5 Young's, the 2012 and 2015 transfer pricing
6 reports, in, in the values that derive
7 therein for the, for the trademark royalty
8 and the data analysis payment, did those have
9 any relevance in evaluating the reliability of
10 Ernst & Young's 2004 valuation study or 2005
11 -- for the record to be clear, Joint Exhibit
12 55?

13 **(Joint Exhibit Number 55 was referenced at this**
14 **time.)**

15 A: Yes. And that goes back to -- I think I, I
16 may have talked about this earlier. The
17 notion that they've, they've developed in
18 their current transfer pricing reports or
19 their 2012 and 2015 study they have the value
20 of these intangibles benchmarked about where
21 the trademark is about 20 percent of the
22 value of the, of the assets in the business
23 process intangibles are about 80 percent of
24 those of those intangibles. That's kind of
25 back where I thought that -- from an economic



1 perspective I thought that really should
2 have been a tr- -- 80 percent of this really
3 should be on -- if this is the right
4 calculation, then 80 percent of that 1.996
5 really should be attributable to West because
6 -- I'm sorry to East because that is -- East
7 contributed those business process
8 intangibles. So if, if those are all
9 consistent numbers across the board, these are
10 all kind of reliable derivations and you, and
11 you use one that -- to set your transfer
12 prices then you need to go back and revisit
13 those shares in which case if you get
14 effectively 80 percent ownership of CBS, then
15 you will get more income in South Carolina
16 through the waterfall of CBS, then under
17 combined entity apportionment even if you
18 don't even touch the management fee.

19 Q: How, if at all, does your analysis of the
20 restructuring and the supporting documents
21 impact your opinions regarding the arm's-
22 length nature of the intercompany prices
23 during the audit period? If you haven't
24 already addressed that.

25 A: Well, it -- just to be clear, I think I've



1 said I have an independent opinion about what
2 I think the arm's-length proportions should be
3 for the, for the CBS business, independent of
4 the study. But I would sa- -- and those are
5 at least 73 percent East and 27 percent West
6 and probably more than that. This basically
7 just confirms that there -- I, I -- one of
8 the reasons nobody wanted to go to the study
9 was to see whether I missed anything.

10 Whether there was something in the analysis
11 that they had done that would suggest that
12 they're -- that there was something of
13 greater value contributed by West than I was
14 otherwise aware of. And as I've gone through
15 it, I've seen nothing in there and all I've
16 seen is a, a methodology that is one, I don't
17 think is the right methodology; two, I think
18 it's applied in an inappropriate way; and
19 three, there's a -- the entire inconsistency
20 in the entire framework, not just within the
21 -- this \$314 per unit number here that pops
22 up on the, on the transfer, on the transfer
23 pricing analysis for the ownership shares,
24 which was never implemented in the actual
25 transfer prices in the post-2005 time period.



1 But also inconsistency with the relative
2 values of those -- of the intangibles being
3 asserted in the current documentation relative
4 to the asset that the intangibles that were
5 owned by the entities on November 30 -- on
6 the day bef -- 2004, the day before the
7 restructuring occurs.

8 Q: So just wrapping up and getting to your
9 ultimate opinions. So based on everything
10 you have reviewed including the transfer
11 pricing study, as well as the overall
12 economics of the CarMax business, what is
13 your opinion regarding the reliability of the
14 taxpayers use of separate entity reporting in
15 this instance?

16 A: I consider it to be unreliable and
17 inconsistent with arm's-length principles.

18 Q: And from an economic perspective, would a
19 combined entity apportionment method produce a
20 result that reasonably reflects an econo- --
21 reflects economic activity in South Carolina?

22 A: Yes, it would.

23 Q: And as an expert on transfer pricing issues,
24 do you consider combined entity apportionment
25 meant to provide a more reasonable result in



1 terms of South Carolina taxable income than
2 the taxpayer's use of separate entity
3 reporting in associated transfer prices?

4 A: Yes, I do.

5 Q: As a trans- -- as a transfer pricing
6 economist, do you consider it to be
7 particularly burdensome and time sensitive for
8 the South Carolina Department of Revenue to
9 derive an alternative apportionment method by
10 adjusting the transfer prices used to derive
11 taxpayer separate entity results?

12 **OBJECTION:**

13 **MS. GEER:** Objection, leading.

14 **THE COURT:** I'll overrule that one.

15 A: So yes, I would consider it exceptionally
16 cumbersome and time consuming. And really in
17 this instance because one, the, the tax --
18 the tax authority -- the Department of
19 Revenue would need a lot of detail on the
20 costs being expended, and those were not
21 provided as part of even the transfer pricing
22 documentation. Second, there's a lot of
23 analysis that needs to go in to derive an
24 optimal markup, which I've kind of gone
25 through already. But third, you also have



1 the finance function, so it's a substantial
2 amount of money that the taxpayer's not even
3 provided any amount of information in order
4 to, to go through that transfer pricing
5 exercise with any kind of detail and rigor.
6 And then fourth -- the -- I'm on fourth or
7 fifth, I'm not quite sure. Lastly, the fact
8 that you have this unique set of
9 circumstances here where CBS has these -- has
10 their ownership percentages of CBS that
11 result in my view, non-arm's-length
12 distribution of the income that's -- that CBS
13 is earning however you set the transfer
14 prices in the first instance, such that the
15 overall result is going to be non-arm's-length
16 if there's any profit going in to CBS and
17 those profits are distributed in those
18 ownership shares.

19 Q: Would the use of combined entity apportionment
20 reasonably approximate the results that one
21 would obtain if the taxpayer had implemented
22 arm's-length transfer pricing -- prices?

23 A: Yes. It's -- it effectively would get you
24 the same result as if you had effi- --
25 applied something called this -- the services



1 cost method to all of the headquarter's
2 functions. So, both on the CAF side and on
3 the non CAF headquarters just allocate all
4 those costs proportionate to the sales that
5 will give you effectively the same result.
6 Even if you have worked to allocate the -- a
7 profit element on the, the -- to the
8 headquarters function like a 7.2 percent
9 markup that I mentioned before that'll get
10 you -- even before you start touching the --
11 as long as you address the financing income.
12 He -- so attrib- -- if you attribute a
13 substantial fraction of the finance income
14 back to where it's originated -- where it is
15 originating from, namely South Carolina,
16 you'll get that same result with a little bit
17 of a difference, but that 7.2 percent, if
18 that 7.2 percent or any markup go -- is
19 funneled over to West through the current
20 ownership shares. But if you were to fix
21 those to what I consider to be arm's-length
22 percentages, even if you kept the ownership
23 interest the same but you simply impute a
24 distribution to your, to your income from one
25 to the other based on arm's-length shares



1 , you'll get to a similar result as under
2 arm's-length dealings. I would note that
3 this is similar to the way I have seen and
4 would expect the IRS to apply kind of
5 imputation of income principles when you're
6 trying to figure out what is, at the end of
7 the day, what is the arm's-length result.

8 Q: And are your opinions that you- -- you've
9 testified here to, are they the same as the
10 opinions that you testified to in your
11 deposition?

12 A: Yes, they are.

13 Q: Okay.

14 **MR. ANTLEY:** Beg the Court's indulgence. No
15 further questions, Your Honor.

16 **THE COURT:** That's good 'cause if y'all are gonna -
17 - if -- Ms. Wooten was gonna suggest anymore
18 questions I was gonna hold her in contempt.
19 All right. We gonna take a break for lunch
20 now, or?

21 **MS. GEER:** That's good with us, Your Honor.

22 **THE COURT:** Okay. It's 12:01, it's -- I, I mean
23 normally I think a hour's pushing it for
24 y'all to go back and get -- go and get back
25 here in time, but is that okay now, or?



1 **MS. GEER:** Can we do 1:20?

2 **THE COURT:** Okay.

3 **MR. ANTLEY:** That's fine with the Department, Your
4 Honor.

5 **THE COURT:** We'll be back at 1:21.

6 (Off the record from 12:01 until 1:20)

7 **COURT REPORTER:** All rise.

8 **THE COURT:** Y'all be seated. Thank you. Time for
9 you to have a lovely interaction with Ms.
10 Geer.

11 **DR. DeRAMUS:** Yes, indeed.

12 **MS. GEER:** He promised me that no answer would
13 exceed thirty seconds before we got on.

14 **THE COURT:** Yeah. You were sleeping when that
15 occurred.

16 **MS. GEER:** Oh, it's my dream. All right. Dr.
17 DeRamus, we meet again.

18 **DR. DeRAMUS:** Indeed.

19 **DR. DeRAMUS - CROSS-EXAMINATION BY MS. GEER:**

20 Q: I'm gonna start with your work for the
21 Department. You've worked for the Department
22 on other matters besides this case, correct?

23 A: That's correct.

24 Q: And when did the Department hire you for the
25 first time?



1 A: I feel like I've been asked this question
2 before, and trying to remember. It was
3 several years ago, I just, I can't recall the
4 exact year.

5 Q: More than three years ago?

6 A: Yes, I think so.

7 Q: More than four years ago.

8 A: Maybe it was, four years ago sounds like
9 about right.

10 Q: Okay. And you've been retained by the
11 Department for at least seven cases, correct?

12 A: In terms of my retentions, yes, at least
13 seven.

14 Q: Is it more than that now, or?

15 A: It may be eight by now.

16 Q: And is that eight including this case?

17 A: Yes. And I'm saying these are approximate
18 numbers, because it's a significant number I
19 kind of lose track

20 Q: So approximately eight?

21 A: That's correct.

22 Q: Have you ever declined to serve as an expert
23 when asked by the Department?

24 A: No.

25 Q: And did all -- and just assume for the



1 purposes of the rest of my questions that
2 when I say eight, I mean the approximately
3 eight. I'm not ---

4 A: Yes.

5 Q: Okay. Did every one of those other eight
6 cases involve the Department's use of the
7 alternative apportionment statute against a
8 taxpayer?

9 A: I don't know if all eight do, I know a
10 substantial fraction of them involved that.
11 There are some cases where I've been retained
12 where I haven't had time to review a lot of
13 the documents. And I know there are, there's
14 at least one matter, I think, that did not
15 involve -- well, I'm not quite sure. It was
16 a little bit different than the others. Let
17 me just leave it at that.

18 Q: Okay. So one is slightly different. Of the
19 ones that you have reviewed information, those
20 all, besides the one that may be a little bit
21 different, all the ones where you've reviewed
22 the file materials, you, do those cases all
23 involve alternative apportionment?

24 A: Yes, they do.

25 Q: And then how many cases do you have where you



1 have been retained by the Department, but you
2 have not yet reviewed the file materials?

3 A: I would need to review the engagement letters
4 to see which ones would have actually been
5 retained. But I would say it's several.
6 More than two, maybe three or four.

7 Q: Okay. So maybe three or four where you've
8 been retained by the Department, but you have
9 not reviewed the file materials sufficiently
10 to determine whether the alternative
11 apportionment statute is being invoked?

12 A: That's correct.

13 Q: All right. Of those eight cases, how many
14 involve retailers with subsidiaries?

15 A: I would say the vast majority. Not, not all
16 of them, but the vast majority. I'm sorry,
17 did you -- I was focusing on the first part
18 where you said retailers -- you said
19 retailers that have subsidiaries?

20 Q: Yes.

21 A: So some of them I don't know, because I
22 haven't reviewed the files.

23 Q: Okay.

24 A: But the vast majority are retailers.

25 Q: And all the ones where you've reviewed the



1 file materials are retailers with
2 subsidiaries?

3 A: That's correct.

4 Q: Okay. And of those eight cases, how many
5 involve the existence of intercompany
6 transactions?

7 A: Well, I would say of all the ones where I've
8 reviewed the files, they all, they all
9 involve intercompany transactions.

10 Q: Of all the ones where you've reviewed the
11 file, how many involve a related entity
12 providing management services for the group?

13 A: I think there are different ways in which
14 different taxpayers have characterized what it
15 is that they're providing, so that might be a
16 kind of difference of opinion. My opinion is
17 largely that a lot of them do involve the
18 provision of management services.

19 Q: Okay.

20 A: But some of them may be in the form of an
21 inventory charge, for example. So it may be
22 asserted that there is a markup on the
23 inventory as a sale of a good, a tangible
24 transaction as opposed to a service
25 transaction.



1 Q: Okay.

2 A: So that would depend on the particular
3 taxpayer and the matter.

4 Q: And of those eight cases, how many involve an
5 entity leasing employees to a member of the
6 group for a charge?

7 A: I would say at least two, including this one,
8 and possibly three. I just don't recall how
9 many have that specific feature.

10 Q: Two to three?

11 A: Correct.

12 Q: And of the eight cases, how many involve the
13 use of a transfer pricing study?

14 A: Of the ones that I have reviewed, they all
15 had transfer pricing studies.

16 Q: And of the ones that you reviewed, that
17 involve transfer pricing studies, are there
18 any way you have concluded that the transfer
19 pricing study was appropriate? And by that,
20 I mean to satisfy the arm's-length principle?

21 A: Not of the ones that I reviewed?

22 Q: So the answer is none?

23 A: None, none to date of the ones that I've
24 reviewed.

25 Q: Okay. So of the work you've done with the



1 Department of Revenue, all of the files that
2 you have reviewed, you have not yet come
3 across the transfer pricing study that you
4 would conclude satisfies the arm's-length
5 standard

6 A: That's correct.

7 Q: All right. And you are not a CPA, correct?

8 A: That's correct.

9 Q: And you don't have a law degree?

10 A: No, I don't.

11 Q: And you've never prepared any type of tax
12 return state or federal for a client?

13 A: No, I haven't. I'm sorry, did you say the
14 tax return or correspondence?

15 Q: I'll repeat it. You've never prepared any
16 type of tax return, state or federal, for a
17 client?

18 A: That's correct. Some of the calculations
19 I've done have gone into tax assessments or
20 tax filings, but I've never been the one to
21 prepare the tax return.

22 Q: Okay. You've never published anything
23 discussing the use of combined reporting or
24 separate reporting have you?

25 A: No.



1 Q: What about publishing anything related to
2 allocation or apportionment of income among
3 states or alternative apportionment?

4 A: No.

5 Q: What about any state income tax issue?

6 A: No.

7 Q: And similar question, but have you ever
8 taught any seminars or given any presentations
9 about separate reporting, combined reporting,
10 allocation apportionment of income or
11 alternative apportionment?

12 A: Not in that sense I think you mean, in terms
13 as they pertain to specifically state
14 taxation.

15 Q: Yes.

16 A: But in regard to general issues of allocation
17 of income, to this that those issues come up
18 at transfer pricing, there are presentations
19 I've given on that matter, on those broader
20 matters.

21 Q: What about any seminars or presentations, have
22 you ever -- I'm sorry, have you ever taught
23 any seminars or given any presentations on
24 any state income tax issue?

25 A: No.



1 Q: And other than your recent testimony in South
2 Carolina, while serving as an expert for the
3 Department, you've never testified in any
4 court cases involving any state tax issues,
5 correct?

6 A: That's correct.

7 Q: And other than your work for the South
8 Carolina Department of Revenue, you've never
9 worked for a state taxing agency on any state
10 corporate income tax issues, correct?

11 A: Correct.

12 Q: And my understanding is that other than some
13 general, I think you might have used the word
14 not in depth, consulting work that you did
15 with some colleagues while at KPMG in the
16 '90s, that you have not ever assisted a
17 client with any state corporate income tax
18 issue. Is that correct?

19 A: That's correct.

20 Q: Okay. And would you agree that you did not
21 become aware of the alternative apportionment
22 statute in South Carolina until you were
23 hired by the Department a few years ago?

24 A: That's correct.

25 Q: Would you agree that you had never looked at



1 any state's alternative apportionment statute
2 before that time?

3 A: Correct.

4 Q: How many transfer pricing reports have you
5 prepared in your career?

6 A: A large number. I don't know how to
7 benchmark it with any level of precision.
8 When I was at KPMG, there were a fair number
9 of what I would consider bread and butter
10 type documentation reports that we would
11 prepare. So these are annual compliance
12 reports that the clients needed to have on
13 file. So I did a large number of those in
14 the five years that I was there. I also
15 worked on some litigation matters, some
16 transfer pricing, some non-transfer pricing,
17 so that would have taken up some of my time
18 away from the report writing. So, and I
19 would say that continued when I was at -- at
20 A.T. Kearney, it was maybe less focused on
21 documentation studies and more, there was some
22 planning studies that I was working on as
23 well as some other tax related issues
24 unrelated to transfer pricing. But then
25 since, since that time, since we started



1 Bates White in 1989, I've prepared transfer
2 pricing reports pretty consistently every year
3 for certain clients.

4 Q: Okay. So let me make sure that I'm
5 understanding your terminology. When I refer
6 to a transfer pricing, study or report, I
7 don't know how your, how that matches with
8 your term documentation studies.

9 A: Sure. And I'm sorry, I pro- -- probably
10 should -- I talk about documentation studies
11 because these are done on a relatively
12 frequent basis, every year companies have to
13 have documentation that's filed in case the
14 IRS asks for it for the transfer pricing. So
15 I would work on annual updates to those or
16 maybe you might even be the first, the first
17 study, and I would update it annually. When
18 I was at KPMG, for example, there are ---

19 Q: Can I just make sure I understand? So would
20 you say that what you just described, is that
21 equivalent to or different from a transfer
22 pricing study like we've been looking at
23 today, that the 2012, 2015, is that -- are
24 you saying that was equivalent or not?

25 A: It is generally equivalent. Sometimes it's



1 some, this one, I don't believe they call it
2 a, I don't know if they call it a memo, per
3 se. Sometimes there's a, the ones that I've
4 seen in the state proceedings have been
5 periodic ones instead of annual updates. And
6 there's, sometimes there's been a little bit
7 of some cagey language, in terms of what it
8 actually represents. In the federal context,
9 it's pretty, it's a little bit more clear.
10 These are reports that are prepared for
11 what's called 6662 penalty protection. So
12 they're done on an annual basis, and there's
13 usually fairly explicit language that says
14 that's why the report has been prepared. So
15 here we don't have that application in the
16 state context. So, I can't remember the, if
17 there were any caveats associated with that,
18 that was done here. But I would say
19 generally, the framework, the, the layout, the
20 types of methods that are used are very
21 similar. This was done, the update here was
22 done 2012 and 2015, instead of done annually.
23 Whereas the documentation studies that I've
24 typically been referring to here have been
25 annual. There have been planning studies



1 that have been forward looking that I've done
2 in the past, or advanced pricing agreements
3 that are done on the schedule of those
4 agreements, which may be every three years
5 or five years.

6 Q: All right, so let me ask in a different way.
7 Using the 2012 and 2015 reports as our, as,
8 as what we're considering a transfer pricing
9 study for purposes of this question, how many
10 of those type studies have you prepared?

11 A: My answer would be the same that I just gave
12 you.

13 Q: Okay.

14 A: Because I, I consider some of the, the
15 studies that are done for advanced pricing
16 agreements, for example, to be, encompass what
17 you observe in these kinds of studies. It
18 might be a little bit different in terms of
19 how it's structured, but I've done some of
20 those as well. But on a regular basis, every
21 year, I would say, with the exception of a
22 time period I was at A.T. Kearney for that
23 one year time period, since 1993, I would
24 say, I think I've been doing documentation,
25 in wo- -- some type of transfer pricing study



1 during that entire time period. There might
2 have been one year when I was at KT -- when I
3 was at KPMG, when I was doing other
4 litigation matters that I might not have had
5 time to do a documentation, but it's been a
6 consistent part of my practice.

7 Q: Okay. And I know you said that you couldn't
8 -- you didn't know the exact number, but can
9 you give us a ballpark? More than 50?

10 A: I would say so, because I've been doing at
11 least three a year for one client every year
12 since maybe 1999, 2000.

13 Q: How many clients? So you said you've done
14 three a year for one client. How many
15 clients are involved in that universe of
16 reports?

17 A: Well, the one I was just calling out to try
18 and benchmark a number was because I have a
19 clear recollection of the timeline for the,
20 for this one particular client. The -- so
21 again, I'd probably divide up the time period
22 my career. At KPMG, it was many clients,
23 many different clients. The, since -- at
24 A.T. Kearney was for one client.

25 Q: Okay.



1 A: That was prim- -- primarily a planning study.
2 And then, since 1999, it has been primarily
3 for -- in terms of the documentation type
4 studies, or the advanced pricing agreement
5 studies, it's been primarily for two clients.

6 Q: Okay.

7 A: Although there, I have done it for other
8 clients periodically. So ---

9 Q: And the ---

10 A: --- there's a third client in there, and then
11 other clients unrelated to documentation where
12 I've done transfer pricing work.

13 Q: All right. So let me make sure I'm have my
14 timing right. Can you remind me when you
15 left KPMG?

16 A: I believe it was 1998.

17 Q: And you were there for how many years?

18 A: Five.

19 Q: Okay. So during that five year period -- I
20 didn't catch it, you said a number?

21 A: I didn't say a number.

22 Q: Okay.

23 A: It would have been, it would have been a lot.
24 I think, consistent with anyone you talk to
25 who's coming out of an accounting firm, it's



1 a pretty high volume business associated with
2 the, the transfer pricing work, particularly
3 the documentation side, simply because so many
4 companies need to have those reports filed
5 for compliance ---

6 Q: Okay.

7 A: --- and an international perspective.

8 Q: So it would have been north of 20?

9 A: It's been a long time, so I'm having a hard
10 time remembering. I think that's probably a
11 fair number all in. But I, I, again, some of
12 those may have been on the planning side
13 versus the documentation, the pure, what I
14 call these docu- -- pure documentations.

15 Q: So it could be less than that, somewhere
16 between 10 and 20 would be fair?

17 A: Sure.

18 Q: Okay. And for how many clients would that
19 have been?

20 A: I would hesitate to hazard an estimate on
21 that. But I would say, off the top of my
22 head, maybe 10 clients. It just depends how
23 I calculate out, how I think about the
24 transfer pricing work that I did for
25 companies that were in litigation.



1 Q: So possibly 10 to 20 reports, or possibly --
2 or did you have some repeat clients?

3 A: Yes.

4 Q: Okay. So if it ends up that you fell on the
5 10 side of the range versus the 20, it might
6 be more, might be less than 10 clients?

7 A: Yes. That's why I think it's probably north
8 of that number. I think I underest- -- I'm
9 underestimating.

10 Q: All right. And then, I'm sorry, what was the
11 name of the place you went after KPMG?

12 A: A.T. Kearney.

13 Q: A.T. Kearney. And you said one client there?

14 A: One transfer pricing client.

15 Q: Okay. And then two clients since then?

16 A: Well, two primary clients while at the
17 transfer pricing clients where I've been asked
18 to do documentation or similar types of
19 studies, like for advanced pricing agreements.

20 Q: Yes.

21 A: And, and there was a third one as well.

22 Q: The third one is for the advanced pricing.
23 Is that what you're saying?

24 A: No. The third one was also a documentation
25 study. But it was not -- I don't put it in



1 the same bucket ---

2 Q: Okay.

3 A: --- as the, the recurring ones that I've been
4 doing for these other two clients.

5 Q: Okay.

6 A: And they -- different -- for one of those
7 clients I've been doing those consistently
8 over the entire time period. Another of
9 those clients, another of the two that I
10 mentioned, was a client that for whom I
11 started working sometime in the past, I want
12 to say seven or eight years maybe, maybe
13 eight years.

14 Q: Okay. So, let's take KPMG out of the
15 picture, so just the A.T. Kearney period and
16 after. Maybe somewhere in the neighborhood
17 of three to four clients for documentation
18 transfer pricing studies?

19 A: At, at KPMG? Or you mean since?

20 Q: No, since. Since then.

21 A: Yes.

22 Q: Okay. And what industry, what type of
23 business without giving me a name of the
24 business?

25 A: Generally, the ones I've done the most for



1 since I started Bates White would have been
2 the automotive industry. But it, they would
3 have encompassed a broad range of studies
4 related to tangible goods, transaction
5 services, intangibles, distribution, you name
6 it.

7 Q: Am I correct that you've only done transfer
8 pricing work for one retailer in your career?

9 A: I'm sorry, let me think back. As I recall,
10 yes. It was a fairly vague recollection ---

11 Q: Yeah.

12 A: --- but it's, it would have been back in the
13 time period, probably when I was at KPMG.

14 Q: Okay. Yeah ---

15 A: In terms of transfer pricing work, I've done
16 other tax related work ---

17 Q: Right.

18 A: --- for retailers.

19 Q: And I think that one did not include a
20 transfer pricing study. Is that your memory?

21 A: The one that when I was at KPMG?

22 Q: Yeah. The one retailer.

23 A: You know, that's the one where this, the
24 subject of procurement comparables comes up.
25 And, so I reviewed that particular -- so I



1 know about that issue. That's where I think
2 I must have been doing something related to
3 the transfer pricing study at the time, I
4 just don't recall exactly the metes and
5 bounds of my responsibilities.

6 Q: You were not the, the sole person doing a
7 transfer pricing study in that case, if the
8 transfer pricing study was done is what
9 you're saying?

10 A: I don't think so. Correct.

11 Q: And how many transfer pricing studies have
12 you done that involve companies performing
13 functions like the ones at issue in this
14 case?

15 A: Well, an analysis of administrative services
16 and headquarters services comes up quite a
17 bit.

18 Q: Okay.

19 A: So for one of those clients that I mentioned,
20 where I've been doing their work on an annual
21 basis, that has been the subject of both
22 increase of controversy. So that's actually
23 been a fairly consistent time period, as the
24 controversy arose, this is an international
25 context. I would say I, I've looked at



1 headquarters services even back when I was at
2 KPMG. And they just come up on a fairly
3 routine basis.

4 Q: Okay.

5 A: I would also say it comes up somewhat in, in
6 some of the other litigation cases I've been
7 involved in as well.

8 Q: And how many cases have you done transfer --
9 performed a transfer pricing study that
10 involved an advertising or marketing function?

11 A: A fair amount. So that would span
12 documentation and going into planning as well
13 as controversy litigation. So I've, again,
14 I'm hazard -- hesitant to hazard a guess, but
15 it's a, a significant number.

16 Q: What about financing?

17 A: Financing, relatively fewer studies.
18 Financing comes up, again, as more on the
19 edges of the transactions that I come across.
20 Sometimes it's been central to a litigated
21 proceeding, but it hasn't been central to the
22 documentation that I've done. So for
23 example, I haven't done a -- this will often
24 come up in, for a bank, so I have not had a
25 banking transfer pricing client.



1 Q: So your transfer pricing testimony in this
2 case is based on the 482 Regulations,
3 correct?

4 A: That's correct.

5 Q: Okay. And you've concluded that the E&Y
6 transfer pricing studies from 2012 and 2015
7 failed to meet the arm's-length standard with
8 respect to the management functions that are
9 performed by CBS, correct?

10 A: Correct.

11 Q: All right. So to make sure we're on the same
12 page here, I've put up on the screen Treasury
13 Regulation 1.482-1 regarding the arm's-length
14 standard. So is this what you're referring
15 to when you were talking about the arm's-
16 length standard under 482 regs?

17 A: Yes.

18 Q: Do you agree that it, it says that in
19 determining the true taxable income of a
20 control taxpayer, the standard to be implied
21 in every case is that of a taxpayer dealing
22 at arm's-length with an uncontrolled taxpayer?

23 A: Correct.

24 Q: And a controlled taxpayer generally means a
25 related party, right?



1 A: Correct.

2 Q: And an uncontrolled taxpayer essentially means
3 an unrelated third party, right?

4 A: That's correct.

5 Q: And then the next thing it says, a controlled
6 transaction meets the arm's-length standard if
7 the results of the transaction are consistent
8 with the results that would have been
9 realized if the uncontrolled taxpayers had
10 engaged in the same transaction under the
11 same circumstances?

12 A: Correct.

13 Q: Okay. And a controlled transaction is
14 between related parties?

15 A: Correct.

16 Q: What are the control transactions, as you
17 view it, that are addressed by the E&Y
18 transfer pricing studies?

19 A: Well, I would say before I look at the E&Y
20 study, I look at the related party contracts
21 and I see a license agreement to the
22 trademark and trade means, and I see the
23 management services agreement. I know that
24 there's a separate leasing agreement for the
25 -- to lease the employees between CAS and



1 NCBS, but my focus was on the, the license
2 and the management services agreement. I
3 think earlier in my testimony, I described
4 how Ernst & Young separates out the, their
5 report to address five distinct transactions,
6 where it's calling transaction one, not a
7 trademark and license -- not, not an
8 evaluation of the trademark and licensed loan,
9 but a trademark and trade name license loan.
10 But that's where they fold in this business
11 process intangible, and then they have these
12 four other ones.

13 Q: Right. I wanna know what yours are. What
14 are you, what are you, what are you saying
15 the transactions that are being priced are?

16 A: Well ---

17 Q: You may agree with how they've divvied it up,
18 or you may not, and I want you to tell me
19 what your answer is to that.

20 A: So. So, if I had never seen the study, I
21 would have looked at the Headquarter's
22 function as it performed those services in
23 their entirety. And I may have made a
24 distinction between them, if there are -- I
25 wouldn't call them different transactions, I



1 would still say there's, there's one
2 Headquarter's Service being provided to the,
3 to the, to East and West. But as a matter of
4 convenience, you might break that up into
5 different pieces in order to derive a mark --
6 a different markup associated with different
7 costs, for example. So they, Ernst & Young,
8 called it a separate transaction. So I think
9 ultimately you're still getting to the same
10 end result as long as you're covering kind of
11 the scope of the Headquarter Services. So in
12 a lot of my analysis and my critique of their
13 analysis, that's why I went through the
14 transactions as they did the analysis on each
15 of these four separate groups.

16 Q: Okay. So, the controlled transactions
17 addressed by the transfer pricing studies at
18 issue, when you were viewing them, you viewed
19 them as they set them out in the transfer
20 pricing study?

21 A: Yes, with the exception of the, the finance
22 issues that are sitting off here, off to the
23 side that they did not address.

24 Q: And would you agree that a related party
25 transaction meets the arm's-length standard,



1 if the results of the transaction are
2 consistent with the results that would have
3 been realized by unrelated third parties
4 engaged in the same transaction under the
5 same circumstances?

6 A: Yes.

7 Q: Would you agree that the arm's-length standard
8 is not determined by looking at the income
9 recorded on a state corporate income tax
10 return?

11 A: Well, ultimately, that's where the the
12 question is, what do you mean terms of quote,
13 unquote, results? So I think if there are
14 instances in which there is some kind of
15 intervening related party transaction, as
16 there is I think here with the CVS ownership
17 distribution shares, I think that does require
18 a, a proper analysis that transfer pricing
19 does require considering how that all flows
20 through to the ultimate taxable income of the
21 company. So for example, I think I said
22 earlier that you could have a non-arm's-length
23 pricing structure implemented at the first
24 instance, but then if the result of all that
25 non-arm's-length prices flows back through,



1 through the ownership interest, the
2 distribution of the ownership interest of the
3 LLC, or an arm's-length -- resulted in an
4 arm's-length allocation of that profit, it's
5 effectively all coming back. So as to the
6 results, that's where I focus very much on
7 the word result that's in here in the
8 language you're pointing here. The end
9 results will then still be arm's-length at
10 the end of the process, even if the first
11 step was to have an arm's-length, was to have
12 a non-arm's-length transfer price. So again,
13 I think it's important ---

14 Q: I don't ---

15 A: --- to look at that

16 Q: --- yeah ---

17 A: --- by step.

18 Q: --- I think I asked a bad question. Let me
19 ask you again, because that's not -- I
20 understand what you're saying, but it's not
21 exactly what I was asking. We're looking at
22 1.482-1(b) arm's-length standard. Do you
23 agree that under that regulation that we have
24 up there, that the arm's-length standard is
25 not determined by looking at the income



1 recorded on a state corporate income tax
2 return?

3 A: I would say not in isolation. You would need
4 to consider other factors. It's an important
5 input into that, but it's not something you
6 can tell just from looking at the tax return
7 only.

8 Q: Okay. And are you agreeing with me that that
9 regulation does not say to look at the income
10 reported on state corporate income tax return?

11 A: Well, first, this is a regulation about
12 federal taxation. In all of the transfer
13 pricing work I've done, the number reported
14 on the federal tax return is very much at
15 issue, but it's probably kind of downstream
16 where a lot of the, the action occurs in
17 terms of the determination of the, the arm's-
18 length prices. Ultimately, when I'm asked to
19 provide an opinion about an adjustment to
20 income, to -- for that -- resulting from a, a
21 non-arm's-length price, if I come up with
22 what I think is the correct arm's-length
23 price, that's ultimately going through down to
24 the taxable income of the taxpayer.

25 Q: And I understand what you're looking at, but



1 I'm just trying to get like a yes or no. Yes
2 or no, does this regulation give you any
3 support, or tell you at all, to determine the
4 arm's-length standard by looking at the income
5 as reported on a state corporate income tax
6 return?

7 A: I would say the fact that it talks about the
8 results, does lend support to the need to
9 consider the company's taxable income.

10 Q: Would you agree that it's not in the language
11 of the regulation?

12 A: I would agree ---

13 Q: In your interpretation ---

14 A: --- that the only, that the language of the
15 regulations is, it is what it is. It says
16 results. So it's a question of how, how you
17 interpret that. I can only tell you what has
18 been my practice in my 30 years of doing
19 transfer pricing analysis.

20 Q: Okay. All right, ear- -- earlier, you said
21 that the ownership percentages of CBS impact
22 the arm's-length price for the transfer
23 pricing in this case, is that correct?

24 A: That's correct.

25 Q: Okay. And you agree that CarMax East owns



1 6.5 percent of CBS, correct?

2 A: That's correct, as a factual matter, yes.

3 Q: Okay. And would you agree that East, as a
4 6.5 percent owner of CBS, receives 6.5
5 percent of CBS's net income, correct?

6 A: That is my understanding of how the company
7 has implemented the distribution, yes.

8 Q: For the management fee payment from East to
9 CBS during the audit period, you agree that
10 there is a price that exists out there that
11 would meet the arm's-length standard in this
12 regulation, correct?

13 A: Correct.

14 Q: Okay. For purposes of this question, let's
15 just assume that we all agree that the arm's-
16 length price is 800 per vehicle sold.

17 A: Okay.

18 Q: Okay. So CarMax East owns six and a half
19 percent of CBS, and we all agree that 800 is
20 the correct arm's-length price for vehicle
21 sold. Yes, or no, if CarMax East owned zero
22 percent of CBS, rather than six and a half
23 percent, under the arm's-length standard and
24 this regulation, would the arm's-length price
25 still be \$800?



1 A: The, the result, the arm's-length results
2 would not be -- would -- the result would not
3 be an arm's-length result. So if the --
4 that's where I said this is a unique fact
5 pattern where you may have an arm's-length
6 price in the first instance. So let's think
7 of that as transaction one. But because of
8 the, the ownership interests are themselves a
9 related party transaction, are the result of
10 a related party transaction, and if those
11 ownership interest do not reflect arm's-length
12 dealings, then the income flowing through if
13 that, if the income in fact is a portion
14 based on, or allocated based on the ownership
15 shares, that six and a half percent or that
16 zero percent ownership share, then the net
17 results would be a, a non-arm's-length result.

18 Q: So are you saying that the arm's-length price
19 can shift based on what you determine the
20 correct ownership percentages should be?

21 A: I would say the arm's-length result is what
22 it is, in that you need to -- it is that
23 final number. And I said before, you can get
24 there in a very messy way or you can get
25 there in a very clean way as long as that



1 result is consistent with the arm's-length
2 standard. So, and here, because we have
3 multiple related party transactions, the one -
4 - the two asserted by the trans- -- the two
5 or five, however you wanna do the math or
6 however you want to count them, asserted by
7 the taxpayer, to meaning the license and then
8 the management fee, five if you divvy up the
9 management fee into four, its four constituent
10 components the way E&Y has done. In my view,
11 there's a another one that's outside the
12 scope, which is the financing fee, or the
13 financing business. And then there's yet
14 another one, which is the, effectively the
15 allocation of ownership interest in CBS or
16 the distribution of the CBS profits to the
17 members, which was a -- the result of a
18 related party transaction.

19 Q: So isn't it true that under the 482 regs,
20 ownership is only taken into account for the
21 purpose of determining whether 482 applies?
22 In other words, defining the control group?

23 A: I, I would say that's the first and most
24 obvious place that you start with. I have
25 been involved in other cases where the way in



1 which a taxpayer set up its foreign
2 affiliates very much mattered to the transfer
3 pricing analysis. So for example, in setting
4 up offshore affiliates that are, the purpose
5 of which are to shield the company from U.S.
6 taxation or to shift profits overseas to a
7 tax haven, how those are set up and the
8 ownership interests of those are very much an
9 issue in my transfer pricing analysis, and,
10 and in the litigation cases.

11 Q: Okay. So, so earlier you pointed to what you
12 thought was support in this reg was the term,
13 arm's-length result, was what you said
14 supported being able to look at the ownership
15 percentages in order to determine the arm's-
16 length price. Did I understand that
17 correctly?

18 A: Well, so far, if you want to start with the
19 language of the regs, yes.

20 Q: Yes, that is where I wanna start.

21 A: But I would state my approach was to look at
22 it the way, as an economist, I always look at
23 these things, which is to say, what are all
24 of the arm -- of the related party
25 transactions that give rise to a certain



1 allocation of income or apportionment of
2 income at the end of the day.

3 Q: And ---

4 A: And so that's where the related party
5 transaction involved in establishing CBS is
6 still very much part of the analysis that I
7 need to do today, or that I think anybody
8 should do, I think Ernst & Young should have
9 done, at the time that it did its 2012 and
10 2015 report.

11 Q: All right. I understand what you're saying.
12 And you're relying on some of your general
13 practices and economic experience and training
14 to do this. I want to stay in 482 regs. And
15 what I'm asking is, I want whatever
16 regulation language either here or elsewhere
17 you say supports that in determining the
18 arm's-length price, that you need to look at
19 the ownership.

20 A: Okay. Well, I appreciate the fact that you
21 first prefaced it by recognizing that it's
22 primarily based on my training and experience
23 as an economist, because I think that's
24 always what I bring primarily. I'm not a, a
25 legal expert, I don't instruct the court in



1 terms of how they should interpret the regs.
2 I provide my own opinion as to how I've
3 interpreted the regs and how I've used them
4 in my work. I would say as a general matter,
5 that the -- it is consistent -- there are
6 probably two different areas of the regs that
7 you gen- -- I generally look to in thinking
8 about broader structuring. And one is, well,
9 certainly the result issue will be an
10 important one. Has a company, has a taxpayer
11 implemented a particular structure in order to
12 get to a non-arm's-length result through
13 probably or perhaps innovative or aggressive
14 tax planning strategy. That will be number
15 one. But the other part is the regs are
16 replete with references to the economic
17 substance. And so the transfer pricing
18 economist is bound to look at the economic
19 substance of the transaction to see at the
20 end of the day, what actually is occurring.
21 You can have interposed lots of different
22 legal organizations and create legal fictions
23 that would require one analytically to kind
24 of connect the dots through a long winding
25 chain before you got to the result, or you



1 can say, step back and say, what is actually
2 substantively going on here, who is providing
3 services who's getting compensation, even if
4 at the end of the day that compensation
5 arises through rather circuitous means. And
6 I say economic substance because I think
7 there's sometimes a misunderstanding by some
8 folks in terms of the breadth of that term,
9 because there are economic substance issues
10 that come up in sham transaction type
11 theories, but there's also ---

12 Q: Outside of the regs, are you talking about?

13 A: Where the sham -- if the sham transaction
14 theory is brought under a different statute.
15 Yes, outside the regs. But then there's the,
16 what I'll call the economic substance issue
17 that's -- it is within 482 ---

18 Q: Okay.

19 A: --- type concept.

20 Q: That's what I wanna ask you about. So the
21 economic substance concept that's within the
22 regs, doesn't it deal with, what are the
23 parties doing and what do the parties'
24 contracts say they're doing?

25 A: That's, that's part of it. But I think it's,



1 it's a pretty broad statement, but that's,
2 that is a big part of it, yes.

3 Q: I mean, isn't that the main part of it?

4 A: I would say it's the main part insofar as
5 the, the issues that come up on a regular
6 basis. So you can have a related party
7 transaction that says anything. You can
8 have a license agreement between anybody that
9 says anything, you can have a supply
10 agreement. These are just documents created
11 by the tax staff. And so the economist needs
12 to look at the substance. And I would say
13 the same thing goes for the structure. So
14 typically a structure will follow. There'll
15 be contracts associated with the particular
16 structure. Here, I assume, you could think
17 of the, the, the organizational document of
18 CBS or the formation of CBS as being kind of
19 one of those similar contracts, but that it's
20 still ultimately a related party transaction.

21 Q: But, and I, I heard you talk about, but in
22 your experience, prior to that, I want to get
23 back to the 482 regs. Under the 482 regs,
24 isn't the economic substance comp- -- sorry.
25 Under the 482 regs, isn't the economic



1 substance concept limited to, are the parties
2 performing the activities that their contracts
3 say they are?

4 A: I think it's broader than you're interpreting.
5 Based on my experience, and based on, it
6 could be based on the work that I did in
7 Perrigo, but also the work that I've done in
8 other cases ---

9 Q: Why ---

10 A: --- I think it's broader than that.

11 Q: Okay. Why don't you tell me which regulation
12 are you relying on to say that it's broader
13 than that?

14 A: Well, in terms of, I'm describing it based on
15 my experience working on behalf of the US
16 Department of Justice and the Internal Revenue
17 Service and dealing with this issue of
18 economic substance. It's not a narrow
19 provision the way I think you are trying to
20 portray it. It's a fairly broad provision
21 that, that it is the economist's job to look
22 past the form and the formalism to say what
23 actually is occurring, and then price the
24 transactions consistent with the economic
25 substance of the, of the conduct of the



1 parties, the assets, and the, also their
2 historical contributions.

3 Q: All right, so you're saying I have an overly
4 narrow interpretation and that you have an
5 overly -- that you have, sorry, that you have
6 a more broad interpretation. And I'm trying
7 to figure out, what are you interpreting?
8 What are you saying gives you, what 482 reg
9 are you saying that you're interpreting
10 broadly?

11 A: So I am referring to the language in the 482
12 regs where it talks about economic substance.
13 I am also referring to my experience working
14 on these issues at the federal level. And
15 I've, I'm just telling you, this is how I've
16 approached this or similar issues in other
17 types of situations where I've had to deal
18 with entities, effectively paper entities
19 created in order to funnel income outside of
20 the scope of U.S. taxation.

21 Q: Do you, do you know, or do you not know which
22 regulation you're referring to?

23 A: It would be the, the substance of the, the
24 substance of the economic substance that I'm
25 referring to is all the -- the words are in



1 the 482 Regulations.

2 Q: I know, but like, which one? Which
3 regulations?

4 A: Oh, 482 regulations is pretty broad. There's
5 nine different subsections. So I would have
6 to -- if you do a word search on economic
7 substance, it comes up in a couple different
8 spots.

9 Q: All right. So as we're sitting here right
10 now, you don't know which specific
11 regulations?

12 A: I don't know within the 482 regulations,
13 which specific subsection it appears. I know
14 it appears in multiple parts. I believe it
15 at least appears in dash one. But I know, I
16 think it also comes up in other sections of
17 the regs.

18 Q: All right. (The question was stricken.) I
19 went further in my outline than I thought. I
20 mean, isn't the fundamental purpose of the
21 482 regs to take ownership out of the
22 question and to treat the parties to the
23 transaction as if they're unrelated, and then
24 determine the term -- determine the terms at
25 which those two parties would transact?



1 A: That's correct. And here -- so for example,
2 here, that's one of the reasons why you'd say
3 if they were unrelated parties, how would
4 East and West divvy up the profits of CBS,
5 right? That's where -- I think that's a
6 fundamental question, a fundamental issue of
7 applying the arm's-length standard in this
8 particular case.

9 Q: Are you -- I think I understood you to say
10 this, but correct me if I've got this wrong.
11 Were you saying earlier that the distributive
12 share of CarMax East should be about, I think
13 you said, 73 percent?

14 A: Correct. I was using that as, based on my
15 recollection of East's share of the company's
16 U.S. income, U.S. revenue.

17 Q: And is that primarily because approximately
18 that percent of the management fees are paid
19 by East to CBS?

20 A: No, but I think the reasons are probably
21 highly correlated. It's because I think at
22 the get go, if the distributive shares had
23 been determined based on the relative
24 expectations of the extent to which each
25 party would bear the costs associated with



1 CBS, it would have been based on a 73/27
2 split, or call it 75/25 just for the sake of
3 argument. But I would also say it was, I
4 think I said at least that amount, because if
5 you did it based on the assets contributed,
6 it would have been well north of that. So
7 you have a disproportionate share, or a
8 greater than 75 percent share of CBS owned by
9 East based on the value of the assets that
10 are contributed since at the time it was
11 owned -- East was the only entity that was
12 doing anything related to headquarters
13 functions, and it had all the CAF business as
14 well. And it had, if there were any
15 intangibles of any value at the time, I think
16 they were put up -- they would have been
17 owned by East, not West.

18 Q: All right. Here's part of your opinion that
19 I'm not sure I understand. So I'm gonna set
20 out two things and ask you to tell me where,
21 if I'm wrong. So are you saying -- you said
22 it's part of it, it's so the, so the, I'm
23 gonna call it the, the activities, business
24 activities that are being performed, you said
25 that's correlated?



1 A: Yes.

2 Q: That's why you think it should be 73 percent?

3 A: Correct.

4 Q: And then beyond that, is it based on the, the
5 valuation of the assets contributed?

6 A: Well, that's why I said, if you do it on an
7 asset basis ---

8 Q: Okay.

9 A: --- then you're gonna get a greater than 75
10 percent share in East. Because ---

11 Q: So there's two things you're looking at.
12 You're looking at both what assets were
13 contributed, and you're looking at what that
14 business activity is.

15 A: Correct. And maybe just for ease of
16 clarifying the record, when I say correlated,
17 what I meant was, the issue was -- I was
18 analogizing to what's called a cost share
19 arrangement, where ---

20 Q: I'm sorry. What did you, what ---

21 A: A cost share arrangement.

22 Q: Oh, okay. Yeah.

23 A: It comes up frequently in international
24 transfer pricing contexts. Where two related
25 parties will agree to split the costs of a



1 particular entity or a particular function, in
2 proportion to their, their expected benefits
3 or their relative expected benefits. So if
4 you were to approach this similar as a kind
5 of a cost sharing type structure, then you
6 would generally expect to split it based on
7 either revenues or profits so that at the end
8 of the day there is highly correlated then
9 with the company's actual revenues or profits.
10 It just all depends on the specific math that
11 you use to come up with it. But if you'd use
12 profits or revenues, you're still going to
13 come up with a kind of very similar, similar
14 results in terms of the shares.

15 Q: All right, let's assume that you ended up
16 determining that the assets that were
17 contributed were perfectly valued. Okay? So
18 assets were perfectly valued, and what the
19 dis- -- distributive shares are correct, just
20 assume that. But, assume that the activities
21 are 73 and 27 percent. Does that impact your
22 decision?

23 A: I'm sorry. Are you asking me to assume that
24 the \$1,996,000,000 was an arm's-length price?

25 Q: Yes.



1 A: Or an arm's-length valuation ---

2 Q: Yes.

3 A: --- rather?

4 Q: Yes.

5 A: And that the, the way in which the company
6 relied entirely on the book value of the
7 assets for the East contribution?

8 Q: We're just taking that out of the picture.

9 A: Well, it's a question of taking out of the
10 picture whether I have to assu- -- you're
11 asking me to assume that those are -- were
12 all done consistent with the arm's-length
13 standard ---

14 Q: Yes.

15 A: --- so that the net result, the 93 and a half
16 percent and the six and a half percent, is in
17 fact an arm's-length percentage?

18 Q: Yes, I'm asking you to assume that.

19 A: If those, if those are, in fact, arm's-length
20 percentages, then, then the only issue would
21 be determining in that first step what is
22 the, the right arm's-length price for the
23 payment of the management services and the
24 payment for the financing function.

25 Q: Right.



1 A: Yeah, you'd be done at that point.

2 Q: What, well so what I'm asking is, let's
3 assume that the ownership percentages are
4 correct, but you've still got East paying 70,
5 let's just use 75 for even numbers, paying 75
6 ---

7 **THE COURT:** While ago you missed a percent.

8 **MS. GEER:** Did I?

9 **THE COURT:** In your math.

10 **MS. GEER:** My math, sorry. I'm glad you're there
11 to catch me on that.

12 Q: All right. So let's assume that we've got
13 the ownership percentages are correct as they
14 are, but East is still paying 75 percent of
15 that management fee into CBS.

16 A: Well, I want to make a distinction when you
17 say correct. I assume what you really mean
18 is they are consistent with the arm's-length
19 standard?

20 Q: Yeah.

21 A: Because I think there's a correctness, one
22 can do correct calculations that are
23 mathematically correct or might have a
24 different logic, but they're not consistent
25 with the arm's-length standard.



1 Q: And I wanna, I wanna, I wanna start my
2 question over again, because I didn't mean to
3 use 75 percent. All right. So the assets
4 are valued correctly, but CBS is receiving --
5 well, yeah, let's just use 75 percent. So
6 the activity is just as it is today, the
7 assets are correct. Does the fact that, that
8 East is contributing more in management fees
9 impact your decision at all as to whether an
10 arm's-length result is reached?

11 A: Well, again, if I can just slightly tweak it,
12 because you keep saying correct, and I keep
13 wanting to say arm's-length ---

14 Q: Arm's length is good.

15 A: --- because those are two different ---

16 Q: I'm good with arm's-length.

17 A: Okay, thank you. So if the distributive
18 shares are consistent with the arm's-length
19 standard ---

20 Q: Yes.

21 A: --- then the, the fact that East -- I'm
22 sorry, that East provided 75 percent of the
23 management fee would be probably neither here
24 nor there ---

25 Q: Okay.



1 A: --- in re- -- because you have already
2 defined that issue -- taken care of that
3 issue with the distributive shares. I would
4 say it would be a moment of cognitive
5 dissonance for me to have that result to have
6 this extreme disproportion. But the only way
7 you could justify it, or hypothetically you
8 could justify it if in fact there was
9 something weird about East that I, again, a
10 fact that I didn't know when I said that 93
11 and a half percent was an arm's-length
12 result.

13 Q: But if the, if the assets are at an arm's-
14 length price, then it doesn't matter how much
15 either entity is contributing to CBS in terms
16 of management fees paid?

17 A: In terms of the relative proportion I think I
18 agree with you. Yes.

19 Q: Okay. Thank you. I think I heard you use
20 this terminology earlier, do you agree that
21 intangibles can be the crown jewel of a
22 company?

23 A: Yes. It depends very much on the specific
24 company and the industry.

25 Q: And do you agree that currently, CBS, and



1 during the audit period, CBS was the legal
2 owner of the CarMax intangible assets,
3 correct?

4 A: I agree it is the legal owner of the
5 trademark and trade names. I don't know the
6 extent to which the company has ever
7 registered. I don't think it's filed any
8 patents associated with al- -- with its
9 algorithms. So I think it is structured as
10 if CBS owns some asserted business process
11 intangibles, but I just don't recall seeing
12 that in any kind of concrete document ---

13 Q: Okay.

14 A: --- other than the transfer pricing studies.

15 Q: So you're agreeing as to the trademarks and
16 trade names, and you're not sure about the
17 business process intangibles, is that you're
18 saying?

19 A: Correct. Insofar as I don't recall seeing
20 that is -- that is not a term in a lic- -- in
21 the trademark license agreement. I just
22 don't recall what is in the management
23 services agreement.

24 Q: Okay.

25 A: I, I believe there is a -- and I think I've



1 been through that before in terms of the
2 structure, there seems to have been a
3 contribution of business process intangibles.
4 I just haven't seen the underlying contracts.
5 You said legal owner, that's the part that
6 kind of threw me.

7 Q: Okay. Okay.

8 A: So I see that the party has structured its
9 transactions with the business process
10 intangibles effectively owned by CBS. I just
11 don't know about the legal nature ---

12 Q: The legal part you agree as to the trademarks
13 and trade names, correct?

14 A: Correct.

15 Q: Okay. And ---

16 A: Because I believe those are actually
17 registered intellectual property.

18 Q: Okay. And you agree that CarMax East's
19 ability to use trademarks and trade names and
20 the CarMax brand at their retail stores
21 provides value to CarMaxes, correct?

22 A: Correct.

23 Q: But you say that the arm's-length price under
24 482 regulations for this valuable use of the
25 trademarks and trade names is zero, right?



1 A: In this instance, given the facts and
2 circumstances, yes.

3 Q: Okay. And a few months ago in another case
4 you likewise said in that case that the -- in
5 the Tractor Supply case, that the arm's-length
6 price for the use of the Tractor Supply
7 trademarks and trade names is also zero,
8 correct?

9 A: I defer to the Court in terms of whether it's
10 appropriate for me to mention testimony given
11 about another matter. If that was a matter
12 of public record and if I'm free to answer
13 that, I'm happy to do so, but I'm always
14 cautious about talking about other cases.

15 **THE COURT:** Your lawyer's sittin' right there and
16 hasn't objected, so.

17 A: Okay. So, I believe the answer is yes.

18 Q: So if CBS, which is the entity that owns the
19 trademarks and trade names, would offer to
20 sell those trademarks and trade names to you
21 for, I don't know \$1, \$5, you're saying that
22 that would be, that would be too much for
23 those trademarks and trade names?

24 A: No. I think I said the issue is whether a,
25 at arm's-length, given the facts and



1 circumstances here, whether one would expect
2 East to be paying CBS a trademark royalty of
3 anything greater than zero. And here we have
4 the fact that East originally was responsible
5 for the entirety of the ad- -- the entirety
6 of the advertising function, and we have the
7 fact that even since 2004, has been paying
8 for all of the advertising effectively
9 associated with what's going on in the East
10 through this 2 percent advertising fee. It's
11 actually been paying not only for all the
12 advertising costs, it's paid for -- and
13 marketing costs, it's paying double those
14 costs. So it went from paying for all the
15 costs when it was responsible for the, for
16 the headquarters function prior to 2004, to
17 paying double those costs after 2004. From
18 an arm's-length perspective, or from applying
19 the arm's-length standard, it's this notion of
20 the legal owner versus developer.

21 Q: Okay.

22 A: You need to see who's responsible for
23 developing those intangibles.

24 Q: So you're not saying ---

25 A: The other ---



1 Q: I'm sorry.

2 A: --- if I can just finish the thought.

3 Q: Yep.

4 A: So this also assumes that the trademarks have
5 value because of advertising. I think that
6 in the retail business a lot of the value of
7 the trademarks are there because it identifies
8 to a customer, if there is a store in this
9 location, that it's carrying a certain kind
10 of inventory that they may want. So there's
11 a lot of local customer goodwill simply by
12 having the name of the retailer sitting there
13 so that when the customer drives by every day
14 they know that's the place that they can go
15 to, to provide that particular kind of
16 product. So in the retail industry, I think
17 it's a combination in terms of -- where's the
18 value of that trademark, I think a lot of
19 this develops by the local retail brick and
20 mortar presence, and some of it may be
21 generated through advertising. And in this
22 case, East has been responsible for the
23 development of that local goodwill, for, and
24 for advertising, and then advertising plus, as
25 well as all the other headquarters expenses



1 that it's funded since 2004 and before.

2 Q: So you're not saying that the trademarks and
3 trade names aren't very valuable?

4 A: I'm saying the, they would not -- correct.
5 I'm saying that they would not warrant
6 payment by, by East to CBS under the, under
7 the facts and circumstances before us today.

8 Q: Okay.

9 A: And I'd also say that a lot of my analysis is
10 going to whether Ernst and Young provided a
11 reasonable basis on which to establish a
12 trademark royalty. And that's where I
13 concluded that their analysis was inconsistent
14 with the requirements of the 482 regulations.

15 Q: Would you agree that it would be very harmful
16 or detrimental to the CarMax retail stores
17 that they could no longer use the CarMax
18 trademarks and trade names and other
19 businesses and intangibles?

20 A: Yes.

21 Q: Okay. Would you agree that if a third party
22 owned those trademarks, trade names and
23 business process intangibles, that it would
24 not allow the CarMax retail stores to use
25 them for \$0?



1 A: You, well sorry, you folded in the business
2 process intangibles because I think we started
3 off on trademark and trade names.

4 Q: Yeah.

5 A: So I would say it would be highly disruptive
6 to a local CarMax store if somebody else were
7 to somehow acquire the rights and forbid the
8 local stores to put the CarMax name on their
9 stores. With regard to the business process
10 intangibles, I do think ultimately these --
11 I'm adopting them in a language that the
12 taxpayer is offering. I think a lot of what
13 they are asserting to be intangibles are in
14 fact broader capabilities that competitors
15 throughout the industry are using, and not
16 just this industry but other industries. I
17 talked about the use of which, the extent to
18 which companies use sophisticated data
19 analytical techniques, and I think it's,
20 they're very widespread at this point. So I
21 think the real value associated with what the
22 taxpayer is asserting, are business process
23 intangibles, is really driven by the data
24 collected by the stores. And so if, if today
25 they had a very specific formula that there's



1 a, there's an econometric formula, or a, or a
2 statistical formula or an artificial neural
3 network that they were precluded from using,
4 I think they could probably develop an
5 alternative one on relatively short order and
6 populate that alternative formula with the
7 data being generated by the stores on a
8 consistent basis such that it would provide
9 similar types of indications as, as to what
10 level of prices they should charge and the
11 amount of inventory that the companies --
12 that the stores should hold. So I put the
13 trademark and trade name in a very different
14 bucket ---

15 Q: All right.

16 A: --- from the business process intangibles.

17 Q: Let's talk about that for a second.

18 Trademarks and trade names, do you agree that
19 if a third party owned those that it would --
20 let me ask it this way. If an unrelated
21 third party owns those CarMax trademarks and
22 trade names, don't you think CarMax would be
23 willing to pay something to that third party
24 for the rights to use them moving forward?

25 A: Yes, to avoid customer confusion.



1 Q: Right.

2 A: I certainly think so. You'd want to put
3 CarMax on the store and you don't want to put
4 CarMix or CarBig or whatever they would do
5 instead.

6 Q: And you've, you've talked a lot about the
7 importance of the store, and the atmosphere
8 that the store creates and that value that is
9 created within the stores versus in CBS.

10 A: Correct.

11 Q: Okay. Wouldn't you expect any successful
12 retailer to have store employees who would do
13 a good job of executing the business's
14 strategy in making the retail store provide a
15 good customer experience?

16 A: I, I would expect a company's employees to do
17 a competent job and to do the job that
18 they're instructed to perform.

19 Q: Okay.

20 A: Yes, but I would not thereby relegate that to
21 some kind of lesser functionality or some
22 lesser role, simply because they are, if they
23 provide a friendly, low stress, kind of
24 positive customer experience. I still think
25 that that positive customer experience that



1 the customer walks away from, based on that
2 interaction, can redound considerably to the
3 value of the company, because that's going to
4 hopefully provide that, a repeat customer.
5 And even perhaps a word of mouth affects,
6 Yelp reviews and things like that ---

7 Q: Right.

8 A: --- for get -- to get other customers into
9 that store.

10 Q: But aren't the employees, and at CarMax, at -
11 - sorry. Aren't the employees at CBS the
12 ones that are developing the store strategy,
13 trying to figure out what price to purchase
14 cars for, what price to sell cars for, what
15 mix of cars to have, how to control costs,
16 where to open new stores, all those things
17 that the, that the store employees are then
18 in the store carrying out what a cashier and
19 other employees would do? All that's how --
20 all that other high-level strategy stuff is
21 happening at CBS, right?

22 A: Well, I would start by maybe pushing back on
23 your characterization ---

24 Q: Can ---

25 A: --- of a store employee as an automaton who's



1 simply responding blindly, and that even the
2 stores writ largely has effectively simply
3 been kind of passive participants in the
4 entire business. There is a centralization,
5 a substantial centralization of the management
6 functions at CBS. There is some autonomy for
7 management that occurs at the store levels.
8 It's -- from the documentation it was unclear
9 where that dividing line is, but it looks
10 like, like you look at the counts, the number
11 of employees have at CBS, at CBS, and you see
12 a large number of people there, relatively
13 speaking. It's still small, it's I think
14 it's 7 percent of the overall employees, but
15 it's still a significant number in total.
16 Now backing away from this notion of the
17 automaton, or the, you know, the purely
18 passive function at the retail level, which I
19 think mischaracterizes how the stores actually
20 operate, step back, historically. We're --
21 let's first look, because you've, you've
22 layered in a couple of different concepts in
23 your, in your argument or your question.
24 First off, where and who developed the
25 strategy of low-haggle pricing? Well, that



1 was pre-2004. That was developed by East.
2 That wasn't developed by CBS. There was
3 also, there's a lot of the things you
4 describe there, in terms of kind of this
5 broader responsibility for strategy, they
6 apply, just like I talked about before for
7 these business data analytics and the, the
8 asserted intangible associated with that
9 function, those were all developed pre-2004.
10 They may have been subsequently refined or
11 modified, or tweaked as you go forward, but
12 the original development is back by East in
13 2004. So it raises a big question about
14 whether now, East should be paying a premium
15 price for the continued develop of that when
16 it used to have responsibility, it had the
17 responsibility to develop those in the first
18 place. And now it's, and there was a change
19 in the ownership, and now all of a sudden,
20 it's, for example, back to the advertising
21 function, now it's paying twice what it was
22 paying before on a percentage basis. Used to
23 be paying 1 percent of sales, now it's paying
24 2 percent of sales. So, there is a kind of a
25 disconnect in the ultimate price that's paid



1 in this in looking at the before and after
2 analysis. I would say that more broadly, I
3 think the question goes to, in general,
4 because I think this applies to every company
5 out there, is how much profits generated by
6 the company should want to ascribe to the
7 headquarters function. It applies to --
8 every single company has the same issue.
9 You've got a CEO, you've got smart pricing
10 people, you've got inventory people, you know,
11 the hard, they work hard, they get paid a lot
12 more money, probably on average, than the
13 folks working at -- if it's a manufacturer,
14 then the people on the shop floor somewhere.
15 Maybe not as much as the R&D folks, or the
16 R&D folks may get paid a little bit higher
17 price point, but you're having, you're still
18 asking the broader question of how much value
19 should be sucked out of the operations of the
20 company into the headquarters location. In
21 all of my experience and transfer pricing and
22 international context, all those cases
23 involved ones in which headquarters employees
24 were always compensated on a cost basis or a
25 cost plus basis like I've done in my



1 alternative calculations. And where countries
2 and tax affor- -- and tax authorities have
3 pushed back on that, it's not -- the ones
4 that I've been involved in have not been
5 where the, the taxpayer has asserted some
6 large additional payment compensation for that
7 function, like a super compensation for the
8 strategy for example, the push-back that I've
9 seen and the controversy I've been involved
10 in, has been where the foreign tax
11 authorities simply say you haven't identified
12 the costs. You haven't identified the costs,
13 that those costs have no business being
14 allocated out. So that's -- gets down to a
15 much lower level of, of granularity and much
16 less of a big picture issue in terms of where
17 the profits of the company ultimately should
18 be generated. I haven't been in any prior
19 case in international context where somebody
20 asserted that simply because the headquarters
21 was in location X, that you should therefore
22 siphon up all the profits to that location.

23 Q: All right. I certainly was not asking you
24 about all of your ultimate opinions here. I
25 just wanted to understand whether you agreed



1 or disagreed that CBS employees were the ones
2 that were performing the, some of the
3 strategic, strategic planning, and that the
4 retail stores were not doing that, they were
5 implementing what CBS was ---

6 A: So to some extent, that's, that is consistent
7 with my understanding. I think there's some
8 flexibility at the store level, but there is
9 one senior management team for the entirety
10 of the company. And it's my understanding
11 that they have responsibility for the
12 strategic management of the company as a
13 whole.

14 Q: Thank you. All right. And yesterday, you
15 put a bunch of slides up, or your counsel
16 did, that had different types of companies
17 that you had collected. There were some
18 retailers and back office comparables, some
19 real estate comparables, do you recall those?

20 A: Yes, I do.

21 Q: Okay. And I think you said that CarMax did
22 not provide you the franchise agreements that
23 the E&Y studies identified as being used for
24 the transaction?

25 A: Correct. With regard to there were the



1 franchise agreements that it used for
2 transaction one. And it used two different
3 types of franchise agreements. You know, the
4 basic franchise agreements and then these so-
5 called master franchise agreements. It
6 provided a summary of the fran- -- of these,
7 I'll say step one, year transaction one ---

8 Q: My question is just did you say you didn't
9 have the franchise agreements?

10 A: Oh, I'm sorry, yes ---

11 Q: Okay. Thank you.

12 A: --- I did. I said, I did say that, and I do
13 not have them.

14 Q: All right. And don't you have access to
15 those agreements through Capital IQ or the
16 other sources where you pulled all these
17 other agreements from?

18 A: Well, let's start with the -- to be honest, I
19 don't, I don't know. I haven't looked to see
20 whether the -- I haven't looked for Ca- --
21 for franchise agreements before in that
22 context. I've seen -- so for the 2012 study
23 they used something called FRANdata, which a
24 database I've never heard of, and I don't
25 sub- -- my company does not describe,



1 subscribe to. So that was the source for
2 some number that were used in the 2012 study.
3 Those were dropped in the 2015 study. They
4 didn't go into the whys and wherefores. So I
5 just, I remember, I'd have to go back and
6 look at the documentation to see how they
7 described the source for those franchise
8 agreements, but they're not part of the
9 royal- -- like the source for, for trademark
10 license agreements that I typically use.

11 Q: They're obtainable?

12 A: I don't know. To be honest, they could be
13 obtained if I, if I were to -- some of them
14 may be obtained if I were to subscribe to
15 that FRAN database, although some of the
16 large consulting firms, the large accounting
17 firms maintain their own databases that they
18 derive. Some of them appeared -- remember, I
19 don't know if you recall the master franchise
20 agreements that they refer to, what they used
21 in transaction one. Those, there was no
22 source or no summary even there. It almost
23 appears as if these were agreements that the
24 author had previously come across in other
25 work. So I had no way of finding what they



1 were talking about in those. I think I might
2 have mentioned that I did look to see what
3 are standard terms in, in automotive franchise
4 agreements. I came across one that had very
5 different types of instructions, very
6 differently than the type, than the one, the
7 ones used by Ernst & Young.

8 Q: All right. So I think your answer is that
9 you're not sure, but you did not make an
10 attempt to find them yourself.

11 A: That's correct. And there were some that I
12 assumed would not be available to me based on
13 the resources that I have.

14 Q: Yesterday you said the services cost method
15 under regulation 1.482-9(b) should be used for
16 this transaction, correct?

17 A: I considered it. At the end of the day, if I
18 were asked to determine, given the facts and
19 circumstances what would be the best method,
20 and given the fact of this, what I consider
21 to be the non-arm's-length ownership shares of
22 CBS, yes, I consider that to be the method
23 that should be used.

24 Q: All right.

25 A: If there were no issue with the ownership



1 shares, then I would have probably said that
2 the, the CPM was the right way to go.

3 Q: All right. In your work for the IRS, has the
4 IRS ever required a taxpayer to use the
5 services cost method?

6 A: To my knowledge, no. It is, it's defined in
7 the regs as simply a method. I think in
8 practice, a lot of taxpayers have approached
9 it as almost an elective. And I say almost
10 because in the document in Ernst and Young's
11 documentation here, they describe it as an
12 elective. I don't generally see language
13 about it really being an elective, it's
14 simply one of a enumerated number of methods.
15 But as I understand it, based on my
16 involvement in the field, that's how taxpayers
17 have generally approached it. Namely, if you
18 can benchmark something reliably, and you come
19 up with a, a, a markup of 4 percent or 5
20 percent or 8 percent, you'd go ahead and
21 apply that markup. It's just that the to,
22 the to those costs, but the, there is a
23 specified method called the services cost
24 method that the IRS has promulgated, and that
25 allows one, and it doesn't, it doesn't



1 specify require versus elective, it just says
2 here's a method and you can charge off the
3 costs for certain types of activities under
4 certain conditions. Certain ones you're not
5 supposed to do it, other ones you can do it.
6 And as a, as a, just as a matter of
7 implementation, given the way some of the
8 international disputes have arisen between
9 taxpayers, I've often seen taxpayers simply
10 approach the problem of allocation of
11 headquarters cost as applying what is
12 effectively a services cost method without a
13 markup, even in instances where the regs
14 otherwise would say you should apply a markup
15 simply in order to deal with conflicts
16 between US tax authorities and foreign tax
17 authorities.

18 Q: So you've never seen the IRS force a taxpayer
19 to use the services cost method? Right?

20 A: Correct.

21 Q: But you think that it might be allowed?

22 A: Well, I know it's allowed. It's in the, it
23 is a specified method ---

24 Q: I'm sorry. I didn't do a good question.

25 Not, not allowed generally. You think that



1 it's a, that the IRS is entitled to require a
2 taxpayer to use the services cost method?

3 A: I would say at the end of the day, if that
4 were the, the best method, then I would say
5 the service would apply, but in all case,
6 apply the method that it determined was the
7 best method. It would just require a certain
8 set of circumstances that I think don't come
9 up that often. I think would be the rare
10 circumstance, but occasionally would come up.

11 Q: Okay.

12 A: Or could come up.

13 Q: Do you agree that a taxpayer is only allowed
14 to use the services cost method for a limited
15 number of low value functions?

16 A: It is -- I think it's implied by what I said
17 before. Yes, that there is a certain
18 threshold that the IRS specifies, and there's
19 certain types of functions that the IRS says
20 you can't apply it to, like manufacturing and
21 things like that, distribution, so it has an
22 enumerated list of functions that says thou
23 shalt not apply the services cost method to.
24 And then it does, talks about, does talk
25 about the notion of relatively low value.



1 Effectively, we've been talking about the back
2 office services, a lot of those would fall
3 under the rubric of low value services as I
4 understand the regs.

5 Q: Great. So your answer is yes?

6 A: Yes.

7 Q: Yes. I think, I believe you also said that
8 you have no meaningful criticisms of the
9 transfer pricing method or the price used for
10 -- sorry, this transaction being transaction
11 2, the corporate services support?

12 A: Well, I think I said I, I believe that they
13 imp- -- that Ernst and Young implemented the,
14 the CPM, the Comparable Profits Method in a
15 reasonable way. They chose a reasonable set
16 of companies. They ended up coming up with a
17 number that was a little bit higher than the
18 number that I would have expected for that.
19 And so I think there may be differences of
20 approach we might have in terms of the
21 comparables we selected, but if you're gonna
22 go and apply the comparable profits method to
23 transaction two, I believe they did it in a
24 reasonable way.

25 Q: Okay.



1 A: I don't think it's the best method in this
2 instance, because, again, on this
3 disproportionate ownership share.

4 Q: Okay. All right, let's talk about the
5 advertising marketing transaction. Do you
6 agree that under 1.482-9(b), the advertising
7 and marketing services would not qualify for
8 the services cost method?

9 A: Correct.

10 Q: Are you aware that CBS performs the following
11 functions: they determine the overall
12 marketing advertising strategy, they determine
13 all media buying and create and manage a
14 strategy for using third-party marketing and
15 ad agencies for broadcast and creative work,
16 they manage the CarMax.com website and public
17 relations, and they provide market research
18 and related strategy and assist in real
19 estate acquisition analysis and expansion
20 planning.

21 A: I would say that's consistent with my
22 understanding of reading the documentation. I
23 would just add the, another significant note
24 that they also engage a third-party, Horizon
25 Media, to do a substantial range of



1 advertising functions, at least it was
2 substantial enough for it to be noted in the
3 2015 transfer pricing study.

4 Q: Okay. So you're talking about a separate
5 function. Of the functions I listed, do you
6 agree with me that CBS is providing this?

7 A: Well, that's where it was unclear to me in
8 the 2015 study what fraction of those action
9 -- activities you just described might now be
10 performed, or then performed, by Horizon
11 Media, the third party, versus the staff of
12 CBS.

13 Q: Okay.

14 A: So the expenses are all kind of popping up
15 under CBS with this caveat of, I don't know
16 if you recall the demonstrative that had some
17 expenses, a significant amount of expenses
18 popping up in the first instance, under the
19 East and West columns. So that's the part
20 where I found it somewhat confusing to see
21 who's responsible for the costs. But in
22 general, from a functional analysis, I think
23 all the people responsible for the high-level
24 advertising are either sitting within CBS or
25 else they are third parties contracted ---



1 Q: Okay.

2 A: --- with whom CBS contracts.

3 Q: All right. Do you think the stores would be
4 negatively impacted if no one was providing
5 those functions?

6 A: Yes.

7 Q: Do you agree that if a third party was
8 providing all those functions or services to
9 CarMax East and West that it would charge a
10 fee?

11 A: Yes.

12 Q: And that, would you agree that they also
13 would not do it only for cost?

14 A: That is correct.

15 Q: Okay.

16 A: I think there are certain types of
17 arrangements where they may not markup certain
18 costs, or they may charge a commission on
19 certain costs, it would really depend on this
20 specific contract. So some, I could envision
21 different kinds of arrangements that third
22 parties might agree to.

23 Q: But they're not just going to agree to accept
24 their costs, correct?

25 A: That is correct, or not that, especially if



1 you're talking about the cost of the salaried
2 employees. They will try to charge a price
3 that recovers not just the costs, but the
4 profit element. But again, depending on
5 market conditions.

6 Q: Let's talk about transaction for the real
7 estate services. Do you agree that under
8 1.482-9(b), that real estate services would
9 not qualify for the services cost method?

10 A: I would need to go back and look and see if
11 that's one of the enumerated ones. I just
12 don't recall. I think the, there are aspects
13 to the real estate function that can be
14 fairly routine. I think like, I think their
15 legal office services are often kind of
16 lumped into the routine side of things, even
17 though there may be certain things the legal
18 department does that aren't routine.

19 Q: Why don't I give you the functions so that
20 you can comment on those functions?

21 A: Sure.

22 Q: Okay. So, are you aware that CBS pro- --
23 provides these real estate services? They
24 perform property acquisition services,
25 including market analysis, site



1 identification, due diligence on the viability
2 of a site, managing the entitlement and
3 permitting process, the zoning process, they
4 provide property management services. So if
5 that's the list of services, do you agree
6 that the services costs could be used?

7 A: I would expect ba- -- on normal
8 circumstances, absent this notion of the C- -
9 - of the CBS ownership issues, you would
10 apply, not the services cost method, but
11 you'd apply the comparable profits method.

12 Q: And yesterday, you had a bunch of PowerPoint
13 slides up dealing with this transaction four,
14 correct? I think it was four. Four slides
15 yesterday, dealing with transaction four?

16 A: I, I talked to some demonstratives. I can't
17 remember how many it was.

18 Q: Okay. And the per vehicle charge for this
19 transaction was \$3, right?

20 A: That's my recollection, yes.

21 Q: So \$3 of the roughly 1100 to 1200 per vehicle
22 charge, correct?

23 A: Correct.

24 Q: And about 90 percent of that \$3 charge is
25 simply covering the cost of providing that



1 service, right?

2 A: That's correct.

3 Q: And while you might quibble with the copyist
4 here, there, you actually think that the
5 price for this transaction is okay, right?

6 A: I don't think it's a, a -- it moves the
7 needle by any significant amount. Yes. So,
8 I'll just leave it at that.

9 Q: Okay.

10 A: I did provide some additional comparables that
11 I did. Some of that was to, to demonstrate
12 that I would have performed the comparables
13 analysis somewhat differently, but also some
14 of that was to feed into the broader question
15 of what should be the price for the services
16 writ large as opposed to doing this a piece
17 at a time?

18 Q: Let's talk about transaction five. Do you
19 agree that unspecified methods are
20 specifically authorized under 482?

21 A: Yes.

22 Q: Do you agree that if an unspecified method is
23 more reliable than a specified method, you
24 are always to use the unspecified method?

25 A: I would agree with that.



1 Q: Okay.

2 A: I would think it would require a fair amount
3 of substantiation to establish that, but,
4 which the taxpayer has not done here, but
5 yes, in principle, you always go with the
6 method that produces the most reliable result.

7 Q: Do you agree that the analytical and business
8 development services addressed by this
9 transaction would not be eligible for the use
10 of the service cost method under 1.482-9(b)?

11 A: I generally would agree that it's not the
12 type of function that I would put within
13 that. I think the company has described it
14 in fairly -- that function, in fairly general
15 terms. So for example, they talk a lot about
16 in terms of systems. So to the extent that
17 you're talking about a management information
18 systems, if that's part and parcel of that
19 function, or the cost associated with that
20 function does include MIS charges, the MIS
21 charge is often something that would be in
22 the services cost bucket, i.e., you wouldn't
23 apply a markup on that necessarily. But in
24 general, as a data analytical function, tied
25 in this notion of strategy and pricing, if I



1 were approaching this from scratch, I would
2 apply, and again, independent of the CBS
3 ownership issue, I would apply the comparable
4 profits method -- as, as the method where I
5 actually have more reliable data, and, and
6 not where I would not be relying entirely on
7 internal data, the way the company has done
8 and the way Ernst & Young has done.

9 Q: And I think it -- you said yesterday that you
10 believe it is critical to understand the
11 functions, the assets and the risk of the
12 transaction being priced.

13 A: That's correct. It's the first step in the
14 analysis.

15 Q: Were you able to do that as to transaction
16 five?

17 A: I think to, to a reasonable level of my
18 satisfaction. I don't have access to, to
19 interview the company individuals directly,
20 but I, I believe I understand the way in
21 which that function is performed sufficiently.

22 Q: At your deposition about two months ago or
23 less than two months ago, you didn't know
24 what CarMax book was, right?

25 A: That's correct.



1 Q: Do you know what it is now?

2 A: No.

3 Q: What about the ACR function? Do you know --
4 what do you understand about that?

5 A: The ACR function?

6 Q: Yes.

7 A: I don't know what it refers to.

8 Q: Okay. What about that ASRP, ASRP function?

9 A: I have not seen a reference to that.

10 Q: Okay.

11 A: Or I don't recall seeing a reference to that.

12 Q: Did you, did I hear you say that the
13 intangibles associated with this transaction
14 five and the functions performed by the data
15 analytics team were all created by CarMax
16 before 2004?

17 A: I said that there was a, asserted to be a
18 business process intangible at the time of
19 the 2004 restructuring. And so, any
20 intangible that would have been created by
21 that function would have been established
22 prior to that date, by created by East at
23 that time.

24 Q: So you're not saying that the transaction
25 five items, the services or functions that



1 are being performed under transaction five
2 during the audit period, you're not saying
3 all those didn't get created after 2004?

4 A: I think I said before that I would have ex- -
5 - I expect that there -- I know that there
6 are ongoing costs associated with that
7 function, which means that there are
8 activities being undertaken to either change
9 or modify or supplement those processes,
10 processes, maybe change the algorithms in some
11 way, collect additional data, incorporate
12 those data into those algorithms. I, I liken
13 it more to there was a software development
14 project, for example. So they would have the
15 software for that particular function would
16 have been created or al- -- there was an
17 algorithm based on the information from the
18 2004 restructuring. It existed, it had been
19 created prior to 2005, or prior to the 2004
20 restructuring. There's an algorithm that's
21 being used today. I expect that that
22 algorithm likely changed between then and now
23 and may have even been extended. So it's not
24 like I see it as a static piece of
25 intellectual property or a static intangible.



1 These are, or static functions, a function
2 that would have changed over time, in
3 response to broader change like in
4 technology, advanced computational power,
5 chain of in advanced methods for data
6 analysis that are more widespread now.

7 Q: Well let's, we can talk about some of the
8 specific ones. CarMax book, was that being
9 used? I mean, I think you said you didn't
10 even know about it, even currently. So do
11 you know if it was created before or after
12 2004?

13 A: I don't know. I haven't seen any reference
14 to it in the documentation studies.

15 Q: What about the, the ACR function or the ASRP
16 function?

17 A: I would answer it the same way. I haven't
18 seen any reference to those in the
19 documentation studies, or at least that I
20 recall.

21 Q: And I think yesterday you said that E&Y did
22 not use the best transfer me- -- pricing
23 method for this transaction? Is that
24 correct?

25 A: That's correct.



1 Q: And you said CPMs is the best method? If you
2 were to use a method?

3 A: Correct, setting aside the CBS ownership share
4 issue, if you're not going to allocate those
5 costs out or compensate, reimburse that at
6 cost, it would be appropriate to use the CPM.

7 Q: And I think you agreed earlier that for the
8 most part, with the exception of, I can't
9 remember which thing you accepted out, the
10 services cost method would not be appropriate
11 for these?

12 A: Well, I said in any kind of standard
13 framework, it wouldn't be and I kinda likened
14 the scenario here to some of the situation
15 I've, situations I've been in, in an
16 international context where notwithstanding
17 the explicit -- some of the explicit
18 statements in the regs about when to use the
19 services cost method. Sometimes you have a
20 unique fact pattern, where you will likely
21 get a more reliable result, a more consistent
22 arm's-length result, if you were to use it
23 here, rather than have a non-arm's-length
24 distribution of the income on the back end.
25 So that's why I said in the first -- if I



1 were to ignore all of the ownership issues,
2 the C -- the CPM is how, is the -- would be
3 the best method in that instance.

4 Q: Would CBS be the tested party?

5 A: Yes.

6 Q: Do you agree that using the CPM requires you
7 to identify reliable, comparable companies to
8 use as a benchmark?

9 A: Yes. Or I should say the, using the CPM or
10 any method is a matter of evaluating the
11 method that's going to get you the most
12 reliable result, and oftentimes with the data
13 that one can verify externally. So that's
14 why there's the regs, there's a lot of
15 emphasis on methods that use external data
16 rather than simply relying entirely on
17 customer -- on company provided data. But it
18 is a -- sometimes you don't have the perfect
19 method, and you'll go with the, the method
20 that gives you the most reliable result among
21 the list of enumerated methods and among the
22 list of other methods you might otherwise
23 apply.

24 Q: All right. Let's talk about the CAF
25 function. E&Y studies specifically say that



1 they are not addressing CarMax's financing
2 activities, correct?

3 A: The 2012 and a 2015 studies say that.
4 Correct. The 2004, 2005 valuation study does
5 address it.

6 Q: Okay.

7 A: But, yes, I think your questions about the
8 later ones.

9 Q: So they discussed the CAF activities, but
10 they say they're outside the scope?

11 A: That's correct.

12 Q: Okay.

13 A: They discuss it in fairly general terms.

14 Q: Did you determine the specific transfer price
15 for the CAF activities?

16 A: I think I said that, based on all the
17 information available to me today, I think
18 the appropriate compensation for the finance
19 function is for the profits associated with
20 that function to largely be allocated to the
21 car business entities in East and West, based
22 on their origination of those loans. I would
23 say there, this is a case in which I don't
24 have a whole lot of additional detail in
25 terms of the ins and outs, like, I don't have



1 a transfer pricing study to react to that
2 would have kind of a more complete set of
3 information to really unpack that. But I
4 think that's a -- given the information
5 available to me today, that is how, that is
6 the approach that I think is the most
7 reliable approach.

8 Q: So you did not perform a full transfer
9 pricing analysis to determine the arm's-length
10 charge for this transaction?

11 A: Well, I would say I performed it to the
12 extent that I was able to, based on my
13 understanding of the extent of integration of
14 the finance function within the broader CarMax
15 business. In other words, it wasn't simply a
16 -- of a nothing burger that I just ignored.
17 I did a fair amount of research into the
18 extent to which comparable companies, other
19 dealers have a finance function. I looked
20 extensively to see the role of that financing
21 function in generating sales and vice versa,
22 the role of selling cars and generating the,
23 that finance revenue. I looked to see how
24 those, this isn't simply individuals randomly
25 coming into a CarMax for a, a home mortgage,



1 it's, they're coming in looking for a car and
2 then getting a loan based on the car that
3 they're purchasing. So it was based on that
4 analysis that I concluded that the appropriate
5 arm's-length charge would have been to have
6 East compensate CBS at cost and were cost
7 plus for those functions. Particularly
8 because East was responsible for the entirety
9 of the CAF business prior to the
10 restructuring, i.e., I wouldn't expect at
11 arm's-length a company to give up a very
12 profitable business in order to then simply
13 see all the profits associated with that
14 business go away without some compensation for
15 it.

16 Q: All right. And you, you started doing your
17 substantive work in this case in February and
18 March of this year, correct?

19 A: That's correct.

20 Q: All right. So did you ask for the
21 information that you would have needed to be
22 able to do your own analysis of the
23 financing?

24 A: I asked for the underlying financial data,
25 the P&Ls, which were, as I only received



1 after Dr. Cody's deposition. I only received
2 the CAF Headquarter's costs last week. So I
3 have been asking for fairly detailed financial
4 data from the get go. There's no ---

5 Q: From the get go being February or March?

6 A: Yes. Correct, in terms of the financial
7 data. I -- in terms of the qualitative
8 information to understand exactly what's
9 occurring at the store level versus at the
10 headquarters level, there's just a limit,
11 limitations on my ability. I've relied on
12 the documents that have been produced in the
13 record. So, that's, that's what I relied on.

14 Q: Did, did you ask for that additional
15 qualitative information that you would need?

16 A: In terms of -- did I, I did not ask to
17 interview company officials, for example,
18 because I assumed that that would have been a
19 non-starter.

20 Q: Did you ask if there were any factual
21 depositions available for each review on that
22 issue?

23 A: I reviewed the -- Ms. Yost's deposition. And
24 I don't recall there being anything else
25 where that issue would have been raised in



1 any substantive way.

2 Q: Do you know if the Department deposed anyone
3 at E&Y?

4 A: I don't recall. I don't think so.

5 Q: Do you know if the Department asked for
6 information about the qualitative facts that
7 you would need to know about CAF from CarMax?

8 A: Uh ...

9 Q: Just, just a yes or no.

10 A: I don't recall. I don't, I don't know.

11 Q: Other than accepting applications from
12 customers, finance applications, and assisting
13 with completing the financing paperwork, can
14 you tell me specifically anything that the
15 employees at the retail stores do that is
16 part of the CAF function?

17 A: Well, they sell cars. So you can't generate
18 that, that, that finance income without
19 selling the car in the first place.

20 Q: Okay.

21 A: So I think the notion, I think I described
22 earlier, it's very different than simply
23 having kind of a salesperson go around and
24 sell to try and entice someone to take out a
25 home loan, home equity loan or a other kind



1 of consumer loan is tied to the vehicle being
2 purchased, and it's part and parcel of that
3 process.

4 Q: Right.

5 A: So I think that is a store -- is a function
6 associated with a brick and mortar retail
7 locations. Put another way, if you take away
8 the brick and mortar retail locations, I
9 think those loans go to zero tomorrow.

10 Q: Setting aside the car sales, is there
11 anything else about the financing piece that
12 you think the store employees are doing?

13 A: Well, I would say it's everything around that
14 process, that's where they, I would think
15 there is back -- maybe I'll make it easy for
16 you. I know that there are back office
17 functions being performed by employees of CBS
18 or CAF. There are folks that sit in Georgia
19 or Virginia that, primarily Georgia I believe,
20 that perform functions related to CAF, related
21 to the securitization of loans. But
22 ultimately the security of those loans, but
23 ultimately the ass- -- the cars that are
24 being sold at retail, they're being
25 securitized and bundled together at the CAF



1 level. But that's where I think there's
2 still a substantial amount of value creating
3 activity that -- with regard to the CAF
4 income, that occurs at the retail store
5 level.

6 Q: All right. Is this a good point for a
7 bathroom break?

8 **THE COURT:** All right. It's 2:59 by my clock.

9 (Off the record from 2:59 p.m. until 3:15 p.m.)

10 **COURT REPORTER:** All rise.

11 **THE COURT:** Ms. Geer.

12 Q: All right. Dr. DeRamus, when we left off, we
13 were talking about CAF. I still have a few
14 more questions on that.

15 A: Okay.

16 Q: All right. To your knowledge, what
17 activities are performed by CAF, after a loan
18 is entered?

19 A: The primary function I understand to be
20 related to the securitization process, so I
21 assume there are some systems that CAF is
22 also responsible for in terms of the credit
23 approval process, i.e., there's a --
24 headquarters has a nationwide computer
25 network, an individual at the store may enter



1 in a credit application, there's a decision
2 made. So they're pulling Bureau, Credit
3 Bureau reports. I'm not quite sure who's
4 maintaining them or who literally has the
5 access to the Credit Bureaus, but the, from
6 what I understand is that there's the
7 consumer information that's entered into the
8 at the store level, there's a decision made,
9 approve or disapprove. So there could be
10 some involvement or I expect there to be some
11 involvement by CAF itself in terms of setting
12 up those systems for the approval process,
13 but I think the bulk of the work, as I
14 understand it, because they're securitizing
15 all the loans that they're originating, is
16 that the bulk of that probably relates to
17 that function.

18 Q: Do they service the loans?

19 A: I believe they do to some extent, yes. I
20 think there are some collections activities.
21 I think there are also, to some extent, I'd
22 have to go back and review the, the -- there
23 was some discussion that in the documentation,
24 I just don't recall the specifics.

25 Q: When does the securitization contract happen?



1 A: Well, necessarily happens after the sale,
2 after the sale of the vehicle.

3 Q: How soon?

4 A: I don't know. I would expect it would happen
5 relatively soon, but I don't know the exact
6 timing.

7 Q: Does it -- does when it happens have any
8 bearing at all on your opinions?

9 A: Not, not at this point, no.

10 Q: So if you learned that it was a year later,
11 would that impact your opinions at all?

12 A: No, I think that, I mean, to some extent, it
13 would say something about the, because I know
14 there are some significant finance assets on
15 the books, so the question would be, which
16 entity should get a return on those assets.
17 Is it the stores or the CAF? So I might want
18 to delve into that a little bit further. To
19 some extent, this whole notion of a return on
20 those loans, does that make sense, some of
21 that comes to almost a, a passive association
22 benefit. So I would have to think through to
23 what extent that would be considered one of
24 these passive association benefits, i.e. their
25 -- the company as a whole is generating this



1 income, would you necessarily assign it to
2 the CA- kind of the revenue from some of that
3 to CAF simply because it's involved in that
4 securitization process, or simply because it's
5 able to obtain probably a favorable spread on
6 the interest of -- customers pay a certain
7 interest rate. There's a different rate in
8 which the company can borrow or the rate at
9 which it effectively gets when it securitizes
10 the loans. Is that spread a function of
11 effectively the company's operations as a
12 whole, which I think I'm generally of the
13 opinion that it is and therefore shouldn't be
14 assigned to CAF, necessarily. CAF itself,
15 as an entity, is not doing anything to create
16 that spread. But nonetheless, I think that
17 the note, if there are assets and risky
18 assets that CAF is sitting on top of, then it
19 could, it could, it could be appropriate for
20 it to earn some kind of return for holding
21 those assets, but that would be a function of
22 the risks associated with them.

23 Q: Okay.

24 A: Here, we're talking about auto loans secured
25 by autos.



1 Q: Right.

2 A: So I think the risks would be relatively low,
3 and therefore the compensation to that fact -
4 - that function would be relatively low.

5 Q: And so, if it, if it happened on day one and
6 it was securitize immediately, it would not
7 impact your opinions I'm assuming?

8 A: Well, then, there really wouldn't be any,
9 that issue wouldn't arise because CAF wouldn't
10 be incurring any risk at all by holding on to
11 the loan if ---

12 Q: Okay.

13 A: --- it's immediately securitized. So ---

14 Q: And so if that happened sometime between
15 several days later to a year later, it would
16 just kind of depend on where in that range it
17 fell as to how much it might impact your
18 opinions?

19 A: Correct. But again, I wouldn't expect it to
20 substantively move the needle in turn in a
21 meaningful way simply because these loans are
22 -- I consider them to be very low risk loans
23 because of the security interest that the
24 company has in the, in the vehicles
25 themselves.



1 Q: Certainly interest rates can fluctuate within
2 that time-frame?

3 A: They could, yes.

4 Q: And that would be a risk?

5 A: To some extent, yes. Although, again, this
6 is a, yeah, this is a relatively
7 sophisticated business, I could see a way of
8 locking in the, kind of the spread that, that
9 I expect the company likely does engage in
10 some kind of hedging activities, but I don't
11 know that for certain. That's another one of
12 those detailed issues I would need to look
13 at.

14 Q: Okay.

15 A: But because it's the unique nature of this,
16 of this loan product, i.e., it's an auto
17 loan, I think it does substantially reduce
18 that risk relative to any other type of loan.

19 Q: What activities, with respect to the CAF
20 loans, what activities do the store employees
21 do after the paperwork is signed?

22 A: I don't -- I would not expect them to be
23 doing anything more after that, after the
24 after the loan is originated, but I don't
25 know that for certain.



1 Q: Do you know whether CarMax has contracts with
2 third-party banks that also finance purchases
3 of vehicles from CarMax locations?

4 A: Yes. It's my understanding that, that they
5 do.

6 Q: Which third-party banks had contracts with
7 CarMax during the audit period?

8 A: For some reason, Capital One is the one that
9 caught my eye, but there were other ones. I
10 just don't recall the specific names. They
11 were listed, I believe, in the documentation
12 study.

13 Q: Can you describe the terms of the agreements
14 between CBS and any third-party banks?

15 A: Not specifically, I think the, the -- in
16 general, there were references to contracts
17 being sold at a discount, or a commission
18 being paid by third-party banks, I believe
19 these are the subprime loans. So a, when a
20 customer comes in, and if it's a, call it a
21 580 credit score customer, if that customer
22 is then going to be -- that auto loan is then
23 going to be financed by a third party rather
24 than by Capital One, then there would be
25 either kind of the negotiation of the



1 contract and then the sale of the contract,
2 or there would just be a straight commission,
3 and that contract would initially be with the
4 third-party provider directly. I just don't
5 recall which way it works with, with CarMax.

6 Q: Do you have direct knowledge, so not just
7 what you suspect might happen, do you have
8 direct knowledge of whether CarMax receives
9 origination fees from third-party banks for
10 the vehicles purchased at CarMax stores that
11 those banks finance?

12 A: So based on the financials that were produced
13 in Dr. Cody's work papers, it showed a
14 substantial amount of interest income, or I
15 think, I can't remember how it was coded in
16 the financials, whether it was listed as
17 commissions or something else, but there was
18 finance income associated with the, the, with
19 CarMax East and CarMax West. There was also
20 substantial expenses, there were substantial
21 expenses such that on net, it was a money
22 losing, or appeared to be a money losing
23 business for the, for East and West. It
24 wasn't like they were making money from the
25 finance function, so, but I do see income. I



1 just don't recall whether there was a
2 specific line item indicating whether it was
3 a commission or some other revenue received
4 for, for the sale of a contract.

5 Q: Do you know whether CarMax actually pays
6 third-party banks an origination fees for
7 certain loans?

8 A: I don't know that.

9 Q: Do you know the amount of any origination
10 fees paid to CarMax from any third-party
11 bank?

12 A: Well, that would be back to those financial
13 statements. It was -- not in terms of bottom
14 bank by bank basis.

15 Q: Yeah.

16 A: Or on a aggregate amount.

17 Q: Just like on a per, per car amount?

18 A: On a per car amount, I did not do that
19 calculation though. Actually should have said
20 I don't think I have the data to do that on a
21 per car basis. If you'll give me a second,
22 maybe I'm for some reason I'm thinking I may
23 have been a reference to some, some number
24 per vehicle somewhere but I would need to
25 review the documentation to refresh, refresh



1 my memory.

2 Q: Okay. And, I think you said a couple of
3 times that you didn't receive the P&Ls that
4 related to the CAF function until -- did you
5 say last week?

6 A: Correct, with the, with that kind of level of
7 detail, yeah, for CAF specifically that was
8 last week.

9 Q: Okay. Are you aware that CarMax provided the
10 information on May 5th?

11 A: On May 5th? No, I was not aware of that.

12 Q: Okay. Do you think a third-party bank would
13 agree to pay CarMax all of their profits as
14 in everything above the costs incurred by the
15 financing company earned on the loans that
16 originated in a CarMax Retail Store?

17 A: I'm sorry, could you repeat the question?

18 Q: Do you think that a third-party bank would
19 agree to pay CarMax all the profits, as in
20 everything above costs incurred by that
21 financing company, that are earned on loans
22 that originated in a CarMax Retail Store?

23 A: No, I would expect any for profit entity to
24 try and earn some element of profit. But I
25 also think that there is a substantial amount



1 of profit that would be earned by the by the
2 originator of that loan.

3 Q: You think that the originator of the loan ---

4 A: CarMax.

5 Q: --- CarMax, should earn some portion of the
6 profits of a third-party lender?

7 A: No, I meant in terms of the aggregate amount
8 of the -- there is a certain spread between
9 the, the interest that consumers pay and the
10 cost to the company of securing financing for
11 that particular loan, and I think the company
12 would, or a third party, if a third party,
13 were in that same situation, I think they
14 would be willing to give a substantia- -- if
15 this is -- the loan is being originated by
16 third party, I think they'd be willing to
17 leave the originator with a substantial
18 fraction, a very substantial fraction of that
19 total spread. I think that's why, because
20 CarMax is in the driver's seat, not to use
21 too fine of a metaphor on this, but they're
22 the ones who are originating the loan. And
23 banks operate on relative -- particularly for
24 relatively low risk products like this, I
25 think there are other banks are operating on



1 a relatively smaller margin. So a bank would
2 be willing to accept a relatively small
3 fraction of that, of that spread between what
4 the consumer is willing to pay ---

5 Q: Okay. And my ques- ---

6 A: --- and what the cost, or the cost to the
7 company of the, of the loan. It could be
8 that the company is securitizing that loan
9 out in the open market.

10 Q: So is what you're saying, that you think a
11 third party bank is going to agree to
12 basically just keep their cost plus a very
13 small markup in order to be able to place
14 their loans within CarMax?

15 A: I'm saying that in competitive financial
16 markets, the spreads that are typically,
17 investors typically require for products like
18 this, that are relatively low risk products,
19 are going to be relatively small. Actually,
20 this is one of the reasons why CarMax has its
21 own loan origination business. So for, there
22 are certain products, like or certain
23 customers, where it is different, it's a
24 different ballgame, there's a different, there
25 are different risks associated with subprime



1 lenders. And that is where the the company
2 has decided to rely primarily on third-party
3 lenders for those subprime loans, because
4 those do carry greater risks than, than
5 prime, than, than prime borrowers. So for
6 the prime borrowers, that's one of the
7 reasons why you have a substantial amounts
8 vary -- this, I think you saw in the
9 demonstrative the effective margin that the
10 company is able to earn relative to the
11 amount of interest income and other kinds of
12 servicing fees coming in at \$800 million
13 dollars relative to, I believe, a couple \$100
14 million dollars in kind of the, the cost and
15 the interest, cost to the company, as well
16 as the losses on associated with
17 repossessions. So that spread, it means it's
18 a very good business. And so there are, if
19 you're securitizing those loans, those prime
20 loans, it's likely that the, in terms of the
21 total amount of money to be had between the
22 ultimate third-party cost of financing those
23 and the amounts paid by consumers, the vast,
24 vast majority of that is earned by CarMax.
25 And it's earned by CarMax because it is the



1 one originating those loans. And there is a
2 very competitive market for a financial
3 market.

4 Q: Excuse me one second.

5 **MS. GEER:** I only have one copy of the slides,
6 would y'all be able to put up three copies.
7 I'm gonna go through three slides, put them
8 up when I get to them? I very much
9 appreciate it. Yeah, it's gonna be 74, 76
10 and 78.

11 Q: All right. So for the record, I've put up
12 the Department's slide from your direct. I
13 have number 74.

14 A: Yes.

15 Q: Okay. All right. At the bottom of that
16 you've got ---

17 **THE COURT:** This is the Demonstrative?

18 **MS. GEER:** Yes.

19 **THE COURT:** Okay.

20 **MR. ANTLEY:** Respondent's Demonstrative 2, I
21 believe. The Excel being Respondent's
22 Demonstrative 1.

23 **MS. GEER:** That, I'm gonna trust you on that. I
24 don't know. I think it's Respondent's
25 Demonstrative Number 2. Okay.



1 **(Respondent's Demonstrative Exhibit 2, Slide 74,**
2 **was referenced at this time)**

3 Q: All right. So the bottom where you've got
4 all the CBS functions including the financing,
5 when did you do that work?

6 A: Where I have the, all CBS functions -- I'm
7 sorry, the, the first row or the second row
8 of that bottom section?

9 Q: The bo- -- the bottom ---

10 A: The entirety of the bottom section?

11 Q: Yep.

12 A: So I did that -- well, the bottom line,
13 because that's -- the very bottom line was
14 done after last week after I received the CAF
15 expense breakout.

16 Q: Okay.

17 A: So that's when I was first able to do that.
18 So in terms of calculating those particular
19 percentages, I think it was worth what I did
20 at -- well, in the past probably few weeks as
21 I was going through the data, the financial -
22 - this is based on the financial data that
23 Dr. Cody provided in his deposition.

24 Q: Okay. So was all the work done after that or
25 was there some that was performed before



1 that?

2 A: Well, that, that final line, that one that
3 says excluding CAF, that was done last week
4 after receive -- after we received the CAF
5 data.

6 Q: Okay.

7 A: The, the line above that was done, if not
8 last, maybe a week, a week before that,
9 maybe, maybe two weeks before that.

10 Q: So not prior to your deposition?

11 A: No. It was after, I, like I said, it was
12 after, it was based on the financials that
13 Dr. Cody provided, so it was based on further
14 analysis of that data.

15 Q: Okay.

16 A: I'm sorry, if you're asking about the
17 specific percentage calculations, I wa- --
18 prior to my deposition, I did have certain
19 other calculations related, related to the
20 CBS, I'm sorry, the CBS Headquarter's
21 function.

22 Q: Okay.

23 A: Maybe I'm, I shouldn't be anticipating a
24 question.

25 Q: No, that's ---



1 A: But this is, the analysis that you're turning
2 to here, the demonstrative, that's the same
3 underlying database or the same underlying
4 data, it's just that there was a percentage
5 cal- -- percentage calculation that you see
6 on the slide that's up right now,
7 Demonstrative 74, where it says all CBS
8 functions including finance?

9 Q: Yes.

10 A: I had not done that specific, I did not
11 calculate that specific percentage back prior
12 to my deposition. Whereas the, there are
13 other calculations that I had done prior to
14 my deposition.

15 Q: Okay. All right.

16 **MS. GEER:** All right, so now for the record we have
17 Petitioner's Demonstrative Number 2, Slide
18 Number 76. Did I say Petitioner's?
19 Respondent's Demonstrative Number 2, Slide 76.

20 **(Respondent's Demonstrative Exhibit 2, Slide 76,**
21 **was referenced at this time.)**

22 Q: All right. This is --- I'm sorry.

23 **MS. GEER:** Need a break?

24 **COURT REPORTER:** (Shakes head.)

25 **THE COURT:** I think he said he needed a rock.



1 **MS. GEER:** To throw at me?

2 **THE COURT:** He did not identify.

3 **MS. GEER:** He didn't specify?

4 (Laughter.)

5 Q: All right, 76. This is related to what we
6 just discussed on slide 74, correct?

7 A: Uh ---

8 Q: This slide relates to that.

9 A: Well, it's a -- there are further
10 calculations. This is where I'm recalculating
11 the, the alternative intercompany cost plus
12 markup based on the information that -- the
13 data inputs, particularly for the comparable
14 companies that I've provided on that slide
15 before. So the top part of the slide before
16 is where I'm applying those -- I'm taking
17 those percentages and applying them to the
18 cost base for CAF in this slide.

19 Q: All right, and was this work for this slide
20 done before or after your deposition?

21 A: Before my deposition.

22 Q: All right. Now moving to slide 78.

23 **(Respondent's Demonstrative Exhibit 2, Slide 78,**
24 **was referenced at this time.)**

25 Q: Did you say earlier that you determined the



1 arm's-length price in this case for the
2 transactions addressed by the E&Y transfer
3 pricing studies?

4 A: So for trends -- I provided what I believe to
5 be my best estimate of that, yes. It could
6 be if you take that in, it's all tied up in -
7 - the CBS issue is always rearing its ugly
8 head. So, I think I mentioned that the -- I
9 believe that the arm's-length price, if you
10 consider the CBS issue, would be appropriately
11 determined on a -- as a basically a cost
12 allocation basis, no markup. But if you take
13 that aside, this is my estimate of that based
14 on the available information to me using the
15 comparable profits method without -- even
16 though I don't have the detail to provide --
17 to implement the those markups I have on a
18 cost category by cost category basis, I'm
19 just doing it as a lump sum.

20 Q: Okay. So in the aggregate, would you say
21 that in the aggregate that you have
22 determined an arm's-length price for the
23 transactions in the E&Y transfer pricing
24 setting?

25 A: I think to a, to a reasonable degree of



1 certainty, not, like again, not to the penny,
2 but it is what I think is a, an approximate
3 result. So.

4 Q: Okay.

5 A: Yes.

6 A: All right. And then at the bottom, the 528,
7 that's the alternative management fee per
8 unit. Are you saying that that, that 528 per
9 vehicle sold is the arm's-length price for
10 the transactions addressed by the E&Y transfer
11 pricing studies?

12 A: Effectively, I mean I'm saying it's the -- to
13 a reasonable degree of approximation, it is
14 what the closest thing that I can calculate
15 to an arm's-length price, yes.

16 Q: Okay. All right, and then let's go to four
17 rows from the bottom. It says, alternative
18 CBS HQ cost plus markup, and that number is
19 880,867,645. Do you see that?

20 A: Yes.

21 Q: All right. Is that value a markup on a set
22 of costs?

23 A: It --, sorry, it should include the costs and
24 the, and the markup, it's not just the
25 markup. I should have been very clear about



1 that.

2 A: Okay.

3 **MS. GEER:** Say that again.

4 A: It's the, it includes the cost base as well.
5 So if you divide that number by 1.07, you'll
6 get the costs. I just -- or 1.072, all
7 right, so I've applied taking the underlying
8 costs, this is over the entire audit year,
9 the audit period of three years, and I
10 multiply those by 1.072 to get that number.

11 Q: So the markup you applied was 7.2 percent?

12 A: I believe so. You had it in the earlier
13 demonstrative, that's the number that clicks
14 in my mind.

15 Q: Okay.

16 A: If you want to pull up that prior
17 demonstrative just to make sure I didn't
18 misspeak.

19 Q: It's, it's correct.

20 A: Yes.

21 Q: Or do you, do you need to see it?

22 A: No, no, you can confirm it. That's fine.

23 Q: Okay.

24 A: Thanks.

25 Q: Okay. All right. So then let's go to the



1 next line, three rows from the bottom,
2 alternative CBS HQ pass-through cost. And
3 that number is 180,328,961. Do you see that?

4 A: Yes, I do.

5 Q: Okay. And what is that?

6 A: Those are costs that I've identified from the
7 financial schedule that Dr. Cody provided that
8 appeared to be pass-through costs, i.e., these
9 are third-party costs, where generally
10 applying the comparable profits method, I
11 would not apply a markup to. These are
12 largely related to the advertising function.
13 So I think they already embed a profit
14 element associated with them. So I've
15 marked up the fee of the, the cost of the
16 salaries of the marketing staff, so those
17 are, would be embedded in the line, that line
18 above that, the \$880 million. These would
19 really be like the TV advertising expense
20 that is recorded on the, on the financials
21 that doctor, that Dr. Cody had, I did the
22 calculations both ways, both with and without
23 the -- applying the markup to all the costs
24 versus just on the -- for separating out the
25 pass-through costs. At the end of the day,



1 it doesn't move a lot of money. It's, you
2 know, if you do, if you apply the markup on
3 those pa- -- those pass-through costs, then
4 you're gonna increase that number by 7.2
5 percent. So I, but it, but I think this is,
6 the more reliable way to do it based on the
7 information available to me by the taxpayer's
8 activities.

9 Q: And so what cost -- you referenced that you
10 got the cost, the actual cost figure. I
11 assume there is a cost figure that you could
12 show us that is the non- pass-through cost --
13 -

14 A: It's ---

15 Q: --- broken out?

16 A: Well it was in the, the work papers that I
17 provided as part of my deposition. So I, my,
18 I had my staff code those, those cost items,
19 depending on whether a, they would be kind of
20 categorized in one bucket or another, i.e.,
21 would they be classic coded to be included in
22 the cost where you'd assign a markup or in
23 the bucket where they would just be pass-
24 through costs. There's also a code in there
25 for finance related costs that I did not



1 include in this explicit finance costs, and
2 for effectively shareholder type costs, that
3 you would do, like stock option expenses that
4 you wouldn't include in this. So I've
5 excluded certain cost elements, but it was in
6 the work papers that I provided in advance of
7 my deposition.

8 Q: So, today, you don't know what that number
9 is?

10 A: Well, I can see what the number is on the
11 spreadsheet. So it's \$182 million is the, is
12 the sum of those individual cost elements.

13 Q: Oh, okay, I didn't follow you. So ---

14 A: So, yes.

15 Q: So all of the costs that you are considering
16 are contained in that alternative CBS HQ
17 pass-through cost number?

18 A: Well, again, these are two different buckets
19 of costs.

20 Q: Okay.

21 A: The first, the one in the 880 and the larger
22 number, those are costs to which I've already
23 applied a ---

24 Q: A markup?

25 A: --- 7.2 percent markup.



1 Q: Okay.

2 A: So if you want to get the actual number of
3 those costs, divide by 1.072 ---

4 Q: Yeah ---

5 A: --- and that will give you the cost number
6 that, that went in there.

7 Q: So sorry, go ahead.

8 A: The second bucket, the, the number below the
9 182 is, those are costs that I identified
10 from Dr. Cody's work papers. Again, these
11 are the company's financial or the P&Ls, and
12 I'm not quite sure, they're not trial
13 balances, but they're not full on ---

14 Q: I know what you're saying.

15 A: --- income statements.

16 Q: Yes.

17 A: But it does provide a kind of line items of
18 expenses, particularly in the marketing, you
19 know, primarily in the marketing area that
20 appeared to be third-party costs. Like I
21 said, the TV ad- -- the cost of TV
22 advertising, literally the monies paid to
23 television.

24 Q: So are you saying that there is somewhere if
25 I wanted to be able to determine which cost



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1 you, you all had coded to be included and
2 which cost you had coded to not be included,
3 that's discernible from what you provided?

4 A: Yes, it is. And as I mentioned there are,
5 there's a, a coding numbers one, two, three
6 and four.

7 Q: Okay.

8 A: And I think it should be clear, once you get
9 that from the marketing department, you'll see
10 the one, that whichever code -- sitting here,
11 I would need to look at the files to remember
12 which particular number was used for the
13 pass-through cost.

14 Q: Okay.

15 A: But it's also clear even in the formulas,
16 that is the, when to calculate, to do the
17 calculations, I have a spreadsheet that
18 calculates it. It's pulling certain cost
19 categories with a certain flag associated with
20 it.

21 Q: Okay. So you're saying the key that tells me
22 which of the, like what one, two, three and
23 four are is clear so that I would be able to,
24 if I went back and looked at that work paper,
25 I would be able to tell exactly which line



1 item costs you are including and excluding?

2 A: Yes, you would, it would, it would require
3 using a, what I call an iota of inference,
4 i.e., you would see certain obvious costs
5 where there's -- so there's a number because
6 it's, like I said, four numbers that are
7 being used to code them. So one, being the
8 costs that are included in the, with markups,
9 you'll see that in the vast majority of the
10 cost items.

11 Q: Okay.

12 A: So I believe that was rule number one, but I
13 again, without having the work paper in front
14 of me, I don't recall exactly.

15 Q: Okay.

16 A: Then down below, you'll start to see another
17 one that pops up again, some of the fin- --
18 explicit finance related things ---

19 Q: Okay.

20 A: --- like the loan losses or the collection
21 costs or whatever it was. So that's
22 something that where those costs should not
23 appear here. And then, so that they won't,
24 because it's non-CAF related business.

25 Q: Okay. Yeah, and I want to make sure before



1 you move to the next one, can, can I make
2 sure I have a full understanding of what's in
3 that bucket.

4 A: It should be primarily finance related costs.
5 So again, it would be collections costs, bad
6 debt expense, maybe a reserve that was -- a
7 reserve established for, for bad debt.

8 Q: And why are those excluded?

9 A: Because this is trying to get the management
10 fee excluding CAF.

11 Q: Okay.

12 A: CAF is off to the side, this is just for the
13 four functions identified ---

14 Q: Okay.

15 A: --- before ---

16 Q: All right. Keep going.

17 A: The, the other item is going to be then a
18 flag for the so called pass-throughs, pass-
19 through costs, which somebody opening up the
20 file will see it primarily popping up in a
21 marketing line, particularly when you see TV
22 or radio advertising, as opposed to it's not
23 going to pop up in staff for example. The
24 staff costs are all in the, in that first
25 bucket. And in the last flag that you'll see



1 will be something that's only in there
2 sporadically, primarily to the Directors
3 salaries or for, again, shareholder type
4 activities that typically are not included in
5 kind of a fee markup, or actually an
6 allegation of fees for Headquarter's
7 functions. Those are shareholder type
8 activities ---

9 Q: Right ---

10 A: --- are typically not compensated through the
11 transfer pricing mechanism.

12 Q: So I'm gonna see that one of your numbers is
13 gonna say shareholder type activity?

14 A: Right. So it doesn't say -- it's a number,
15 so it doesn't say shareholders activities, but
16 you'll see it next to categories of
17 expenditures. That should be fairly obvious
18 that those are on- -- they're few in number,
19 and they relate only to activities that I
20 consider to be shareholder related.

21 Q: Okay. So I have to do a little bit of
22 deciphering to figure out which one is --
23 it's not a clear key, but if -- you're saying
24 that by looking at the ones that have that
25 number, I should be able to tell what they



1 are?

2 A: Yes, that's why I said, you'd have to have a
3 little bit of, use a little bit of inference,
4 or the other way to do it directly is I have
5 the formula for the derivation of that \$880
6 million, and that 182 million, and it has in
7 the formula, it specifies which flag or which
8 cells it's pulling from to pop- -- populate
9 that particular data field.

10 Q: So, do I have that formula?

11 A: You do.

12 Q: And what would that be in?

13 A: That would be in one of the sheets, you know,
14 one of the tabs of the ---

15 Q: Of the Excel?

16 A: --- of Excel spreadsheet that has the
17 calculations.

18 Q: Okay.

19 A: These are all the, these all have the kind of
20 primary data from Dr. Cody's work files, and
21 then they're just some summary calculations
22 that are pulling data from that, from that
23 broader database. But it's all self
24 contained within that single file.

25 Q: Okay.



1 A: I'm sorry. One thing I should have added is
2 because these numbers right here are after
3 the subtraction of the CAF numbers that there
4 is a further subtraction of the CAF
5 Headquarter's cost. That's what that, why I
6 kind of specified that in that very last
7 line. So at my deposition, I did the same
8 calculations, but I didn't have the CAF
9 expenses to subtract. Now I have those CAF
10 Headquarter's costs and I can, I had not
11 included the explicit finance costs that
12 popped up -- that were popping up in doctor,
13 Dr. Cody's work papers, but I didn't have a
14 breakout of the staff, the staff costs, the
15 salaries and fringes associated with other
16 expenses directed, directly associated with a
17 CAF business. And that's about, I believe it
18 was in the order of about \$25 million a year.

19 Q: And the third category, which all I wrote
20 down was pass-through TV radio. Is it, is
21 that it basically, is it mostly TV radio type
22 stuff or was there a ---

23 A: It's, it's that. I can't -- there may be
24 newspaper advertising, circulars, it's gonna -
25 - going to be line items where it appeared to



1 be these were payments to third parties, not
2 sal- -- that type of salary costs or internal
3 costs where I thought a markup would be
4 appropriate.

5 Q: Okay.

6 **THE COURT:** That indicate you're done?

7 **MS. GEER:** No. Just on this topic. Making sure he
8 has what he needs from me. All right.

9 **THE COURT:** How much longer?

10 **MS. GEER:** Let me see how much I have. I have two
11 sources, so that one should not be long and
12 then let me see where I am in here.

13 **THE COURT:** I'd like to finish this today if we
14 can, but I don't want to ---

15 **MS. GEER:** Yeah. I mean I would just say let's
16 keep going.

17 **THE COURT:** Okay.

18 **MS. GEER:** And ---

19 **THE COURT:** It doesn't appear Mr. Antley's going to
20 be doing a redirect.

21 **MS. GEER:** You're deferring that, right? No
22 redirect?

23 **THE COURT:** Well, he's not making any notes, so I
24 just ---

25 **MS. GEER:** He's got it all up here.



1 **THE COURT:** I need to take a quick two minute
2 break.

3 **MS. GEER:** Oh absolutely. Would you mind if we all
4 went to the restroom, like have a five minute
5 break?

6 **THE COURT:** I don't mind if all of you go, but ---

7 **MS. GEER:** I would like to go. May I?

8 **THE COURT:** Some people might wanna make that
9 election on their own.

10 **(Off the record from 3:52 p.m. until 3:58 p.m.)**

11 **COURT REPORTER:** All rise.

12 Q: All right.

13 A: I'm sorry, since you ---

14 Q: Yes?

15 A: I know it's somewhat unusual for me to answer
16 ---

17 Q: Before I ask the question? That is unusual.

18 A: It is more to amend my prior answer just to
19 make it easier in case someone is trying to
20 replicate the numbers.

21 Q: Sure.

22 A: Because when I was going through that
23 explanation ---

24 Q: Yep.

25 A: --- I was referring to the calculations that



1 I did prior to my deposition, which was prior
2 to receiving the CAF data. So, we did
3 provide updated files showing how I had took
4 the last step to address the CAF function as
5 well. So, there, I provided in my direct
6 testimony, the demonstratives had two
7 alternatives. I first showed the result
8 before addressing the CAF issue.

9 Q: Right.

10 A: Those will tie to the numbers I provided in
11 my, prior to my deposition.

12 Q: Okay.

13 A: There was a second slide where I had the
14 highlighted portion that says excluding CAF
15 costs, that was, that would be in the work
16 papers that were provided recently. And that
17 derivation of the per unit number, that was
18 done based on that second revised worksheet.
19 So, it does require looking at -- the easiest
20 one to follow is going to be my first work
21 papers and then someone can see how I did it
22 in the underlying work papers I provided
23 recently to address the CAF Headquarter's
24 costs as well.

25 Q: Okay. Thank you.



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1 **THE COURT:** And with that sena- -- scintillating
2 analysis, we move on.

3 **MS. GEER:** I don't think I ever have had a witness
4 to answer a question before I've asked one.
5 That was a new one.

6 **THE COURT:** Clairvoyance.

7 Q: All right.

8 **THE COURT:** You wanna go ahead and answer her next
9 one?

10 A: I think that's all I have to ask you, Dr.
11 DeRamus. You're excused.

12 Q: That is wishful thinking. All right. All
13 right. If there was absolutely no evidence
14 in this case from earlier than 2006, meaning
15 we don't know anything about what happened
16 before, we don't know anything about our
17 restructuring or the history of the CarMax
18 group, would you still conclude that the E&Y
19 transfer pricing studies failed to meet the
20 arm's-length standard?

21 A: Yes.

22 Q: And you seem to have a complaint with CarMax
23 East transferring assets to West. If, if
24 CarMax East transfers assets to its
25 subsidiary, CarMax West, what has East given



1 up? It, it owns 100 percent of West?

2 A: That is correct. And it, what it's giving up
3 is effectively a stre- -- of the, a, a very
4 substantial stream of income being funneled
5 through CBS to West. So that is one of the
6 reasons why. At the end of the day, there is
7 a certain amount of, of a fiction that one
8 needs to adopt in transfer pricing analysis,
9 and that's to assume that these are unrelated
10 parties. And then to treat the taxable
11 income by each of the parties as if they were
12 being earned by unrelated parties, or the
13 operating profit, whichever level you want to
14 go to on the income statement. So the
15 transfer of the business process intangibles
16 for the asserted value from, from West to --
17 I'm sorry, from East to West, and then from
18 West to CBS, had a significant impact on the
19 taxable income of West -- I'm sorry, of East
20 and West. It increased the taxable income
21 substantially of West. So I think, I think
22 of it as a siphoning of income, from what,
23 from East to West via the intermediary of
24 CBS. And the same way as if a US parent
25 company were to magically transfer a valuable



1 intangible, say a patent for a valuable drug
2 over to a Cayman Islands subsidiary, and
3 where it would not have to pay federal taxes
4 on the earnings of that subsidiary, and then
5 pay massive royalties on the sale of that
6 particular drug in the United States simply
7 because it had transferred this intangible.
8 So in an international context, that's where
9 it raises these so called 367(d) intangible
10 transfer issues.

11 Q: Right. But we're, we're not in an
12 international situation here, correct?

13 A: Correct. But the, the issue is applying
14 transfer pricing principles to the
15 restructuring, what is it about -- what
16 conclusions do I as an economist draw about
17 the, at the end of the day, the allocation
18 income or the apportionment of income that
19 the taxpayer has implemented with regard to
20 how much income is being earned by East, how
21 much income is being earned by West. And
22 that transfer, that transfer, that
23 instantaneous transfer on December 1st, 2004,
24 of the business process intangibles, substan-
25 -- had substantial impact on those ownership



1 shares. But for that one, that instantaneous
2 transfer, there would have been no basis for
3 this asserted 93.5 percent share of West.

4 Q: But you agree with me that CarMax East, after
5 it makes that transfer, it still owns, it's
6 made it to the sub, but it still owns 100
7 percent of the sub, which would include
8 anything that is within the sub?

9 A: Correct. The same way that in an
10 international context, some -- an entity that
11 transfers in intangible to a Cayman Islands
12 subsidiary still owns it.

13 Q: Right.

14 A: But it has, could have, significant tax
15 ramifications. And it needs to be considered
16 as part of the transfer pricing analysis,
17 even if it's still within the umbrella of the
18 single corporate group of families.

19 Q: I want to talk to you about your opinion on
20 no operational consequences.

21 A: Yes.

22 Q: Okay. So did the contributions to CBS have
23 any operational consequences for CarMax East?

24 A: No.

25 Q: What about West?



1 A: No. I mean, in terms of thinking about it
2 from the comp- -- I was thinking about that,
3 I was really thinking about it from the
4 company as a whole. Naturally, from a
5 functions, assets and risks analysis, all of
6 a sudden the new entity, CBS, if you're
7 respecting that particular entity and you see
8 the employees are sitting now underneath CAS,
9 you obviously have a change in which entity
10 is doing which functions. But what I meant
11 was, from an operational perspective of the
12 company as a whole, it's not like this was a
13 -- oftentimes we hear the term corporate
14 restructuring anymore, but I think is a more
15 me- -- operationally meaningful sense where
16 they will move offices, move people redo
17 operations, and oftentimes layoff a whole
18 bunch of people as part of that
19 restructuring. That's not what we observe
20 here. It's simply a changing of the hats and
21 a redrawing of some legal org charts.

22 Q: Okay. But you would agree -- I'm not looking
23 at the group right now, I want to look at the
24 individual entity. You would agree with me
25 that the contributions to CBS have operational



1 consequences for CarMax East?

2 **THE COURT:** Say that again, sorry.

3 **MS. GEER:** Did the -- I'll ask it a different way.

4 **THE COURT:** You started with, will you agree with
5 me?

6 Q: Did the contributions to CBS have any
7 operational consequences for CarMax East?

8 A: That's where I kind of maybe struggle a
9 little bit with the way you're phrasing the
10 question. I would say, because it had no
11 operational consequences for the company as a
12 whole, I wouldn't see it as having any
13 operational consequences for CarMax East,
14 unless you're really talking about more
15 looking in terms of an org chart, i.e.,
16 they're -- the same people are showing up and
17 doing the same things, except on December 1
18 they are, 2004, or maybe it's December 2nd,
19 they are now all of a sudden underneath the
20 umbrella of CBS and not under the umbrella of
21 CarMax East. So in that sense, there is a an
22 organizational change in terms of again, the
23 hats that you put, that you put on people, or
24 the, where you put them on one of these legal
25 organizational charts. But it didn't have



1 any operational consequences in terms of what
2 was being done in the stores or what was
3 being done in the Headquarters.

4 Q: All right, well, let's just say CarMax East,
5 for an example. CarMax East was performing
6 CAF and headquarter functions before the
7 restructuring, correct?

8 A: That's correct.

9 Q: But not after the restructuring, correct?

10 A: That's correct. That's what I meant before,
11 where you have a change in the functions,
12 assets and risks because you've nominally
13 assigned people from one entity to another.
14 You've move- -- you've nominally moved the
15 assets, the assets are, they're still showing
16 up in the same building, but that building is
17 now owned by CBS and not by, by CarMax East.

18 Q: So you won't ---

19 **THE COURT:** You said done in the same building?

20 A: They're still going into the same building.

21 **THE COURT:** Oh, going into to, okay.

22 A: Right. So it's not like there was any
23 change, it wasn't like there was a move to a
24 new headquarters, it was still exactly the
25 same in terms of the infrastructure. But you



1 did have a legal distinction in terms of now
2 that they're actually, the employees are part
3 of CAS. I think the asset is probably part
4 of CBS. So I think the employee, the CAS is
5 just people.

6 Q: Okay. We look at CBS, I mean, it did not
7 exist pre- restructure. It's performing
8 functions after the restructure, would you not
9 agree that that's an operational consequence
10 to CBS?

11 A: That's why I said I made a distinction
12 between kind of a there's been a change in
13 the functions of each of the entities
14 performed. But I don't see it as having
15 operational consequence in terms of what are
16 people doing? How is the company being run?
17 That's what I meant ---

18 Q: Okay.

19 A: --- from a holistic perspective.

20 **OBJECTION:**

21 **MS. GEER:** I'm going to ask some questions related
22 to the 2004 valuation. I'm only asking them
23 because they have, that issue has been
24 allowed in over my objections. And so I
25 would just like to reserve my rights on the



1 record to express, expressly reserve my rights
2 on the record to continue to object to
3 expressed or implied attacks on the 2004
4 valuation.

5 **MR. ANTLEY:** Your Honor, that sounds like she wants
6 to have her cake and eat it too. I don't
7 think that that, that's possible.

8 **THE COURT:** I hereby object to this evidence, but
9 now I'm gonna ask about this object --
10 evidence and object to it as I ask about it.

11 **MS. GEER:** I didn't hear what you, what you said, I
12 apologize.

13 **THE COURT:** It says, it sounds to me like you're
14 saying I hereby object to this evidence
15 coming in, but now I wanna ask about it, and
16 I'm reserving an objection to my own
17 questions to protect myself down the road.

18 **MS. GEER:** That is what I'm saying.

19 **THE COURT:** Well, you can do that, whether any
20 Appellant Court will buy it or not, I'll
21 leave it to them.

22 **MS. GEER:** Your Honor, may I have two minutes?

23 **THE COURT:** Yeah.

24 **MS. GEER:** Thank you. It might be three, and I, I
25 -- it's an important issue, and I'd like to



1 resolve it.

2 **THE COURT:** Okay.

3 **(Off the record from 4:11 p.m. until 4:15 p.m.)**

4 **MS. GEER:** All right. So I might clarify the
5 record a little bit here. So, I have
6 questions that I think both impact the 2004
7 valuation and that don't. I think that I'm
8 entitled to cross on anything that comes,
9 comes into evidence over my objection.

10 **THE COURT:** Okay.

11 **OBJECTION:**

12 **MS. GEER:** And so I'm just going to, for the record
13 expressly reserve the objections that I
14 previously made.

15 **THE COURT:** Okay.

16 **Q:** All right. I apologize. I lost my place
17 here. All right. So Dr. DeRamus, on March
18 29th of 2023, you were deposed in this case,
19 correct?

20 **A:** Correct.

21 **Q:** All right. And the- -- at the time of your
22 deposition, you could not tell us the precise
23 fair market value or arm's-length value of
24 the assets CarMax West contributed to CBS in
25 2004. Correct?



1 A: That CarMax West contributed?

2 Q: Yes.

3 A: Correct. I, yeah, I would say my
4 understanding has evolved a little bit since
5 then, as I continue to review the documents,
6 but yes, that's correct.

7 Q: Okay. And you could not tell us the precise
8 fair market value or the arm's-length value
9 of the assets CarMax East contributed to CBS
10 in 2004, correct? At your deposition?

11 A: At my deposition, I believe that is correct.
12 Yes.

13 Q: Okay. And you could not tell us the exact
14 percentage of CBS that CarMax West should
15 have received as a result of its contribution
16 to CBS in 2004 at your deposition?

17 A: I couldn't tell you an exact percentage, but
18 I think I gave you a similar answer, as I
19 provided here, in terms of what my opinion
20 is. I think I said something about it being
21 north of 70 percent or -- I mean, in terms of
22 the ownership share of East, I said that
23 arm's-length it would be, or something to the
24 effect, that at arm's-length it would be
25 something north of 70 percent. Whether I



1 said 70 percent or 80 percent, I don't
2 recall.

3 Q: Okay. My question was, you could not tell us
4 the exact percentage of CBS that CarMax West
5 should have received as a result of its
6 contribution to CBS in 2004?

7 A: Oh, that's right, you said CBS West, that
8 West, correct. Any two -- I'm sorry, that's
9 a two part question. Or one ---

10 Q: Actually I might have screwed you up.

11 A: Okay.

12 Q: I might have read, I might have read the
13 question before, because I, I let me see.
14 Yeah, I think I read the same one twice. All
15 right. You could not tell us the exact
16 percentage, exact percentage of CBS that
17 CarMax East should have received as a result
18 of its contributions to CBS in 2004.
19 Correct?

20 A: Not an exact percentage. That's correct.

21 Q: Thank you. And earlier today, you talked to
22 us about CarMax East transferring its business
23 process intangibles to CarMax West shortly
24 before CarMax East and CarMax West made
25 contributions to CBS in exchange for their



1 current ownerships in CBS, correct?

2 A: That's correct.

3 Q: And would you agree that you did not know,
4 you did not know that at the time of your
5 deposition?

6 A: Well, at my deposition, I hadn't figured out
7 how East was getting any kind of credit for
8 the contribution to the business process
9 intangibles. I'm sorry, how West was getting
10 any credit and evaluation for the contribution
11 of the business process intangibles. I
12 hadn't seen that specific sequence in detail
13 where it showed that back to back transfer of
14 the business process intangibles from West --
15 I'm sorry, from East to West, on December
16 1st. And then on that same day, from West to
17 CBS. So that was the piece where I, that was
18 kind of a piece of the puzzle that I had not
19 focused in on prior to my deposition.

20 Q: Well, at your deposi- -- sorry. At your
21 deposition, didn't you think that the
22 contribution was just the trademarks and trade
23 names?

24 Q: Well, at the time of my deposition, that's
25 correct. I thought the only thing that, that



1 either East would have had to contribute
2 would have been the trademarks and trade
3 names because it was my understanding at the
4 time the business process intangibles had been
5 developed by East. So I had, I had missed
6 that clause in that memo, where it talked
7 about it being this back to back transfer,
8 and that's where, I keyed on, keyed in on
9 that after my deposition.

10 Q: All right. And would you agree that you
11 never mentioned during your entire deposition
12 the transfer of business process intangibles
13 at all?

14 A: I don't recall -- I, I mean, I -- like I
15 said, I had not, I just could not fathom how,
16 in the valuation analysis, West rather than
17 East would get credit for the business
18 process intangibles. Now I understand
19 mechanically how that happened, but I still
20 think -- it doesn't change my view as to,
21 from an arm's-length perspective where that
22 value should have resided.

23 Q: Okay. All right. Yesterday, I believe you
24 said that valuing the intangibles of a
25 company requires a very detailed look into



1 the details of how the company operates, what
2 makes the company tick, what drives value,
3 etcetera, is that correct?

4 A: Yes.

5 Q: All right, and where is your valuation of the
6 assets that each entity contributed to CBS in
7 2004?

8 A: Well, like I said, I think I've done it only
9 at a very high level to describe different
10 principles that one could apply in determining
11 arm's-length ownership percentages for CBS.
12 One based on an expectation of the costs that
13 each would bear, another one based on the
14 cash that each would be contributing, another
15 one based on the assets they would, that they
16 would be continued, contributing either
17 physical, tangible, or intangible or
18 combination thereof. And that's where I
19 think I've kind of walked through a couple of
20 iterations where any way you slice it, it's
21 going to be north of 73 percent in terms of
22 the share, the arm's-length share for, for
23 East relative to its value contribution to
24 CBS at the time.

25 Q: All right. So when I said where in your



1 valuation, I was meaning like pieces of
2 paper, do you have, do you have anything that
3 captures your analysis?

4 A: No.

5 Q: Did you produce anything in this case that
6 would show any work on this issue?

7 A: It's -- okay, this is done mostly based on my
8 review of the documents. It did not, there's
9 no specific computation, unless you want to
10 refer to the the doc- -- my prior testimony
11 about the documents I reviewed, or my A, my
12 prior testimony about the relative shares,
13 percentage share of revenue shares, my prior
14 testimony about the appropriate allocation of
15 costs or the actual allocation of costs of
16 CBS between the two entities, or if you want
17 to refer to my analysis of the spreadsheet
18 that was used as part of the valuation. So
19 those would be the three main places that I
20 would point you to other than the rather
21 extensive analysis I've done of the 2004
22 transfer pricing report itself, walking
23 through, in more detail exactly how that was
24 done. Which I, testimony that I submitted,
25 that I provided earlier today.



1 Q: But that was not anything that you provided
2 to us in discovery, correct?

3 A: Correct. It's not a, it's not a written work
4 product associated with that analysis, other
5 than what was in, were in the demonstratives.

6 Q: And you mentioned that you did this at a high
7 level. Does that mean that you did not
8 determine an exact value of the assets that
9 East contributed?

10 A: Correct.

11 Q: Or I should say, an arm's-length value, or a
12 fair market value, which would you, which
13 term do you use arm's-length or fair market?

14 A: In a transfer pricing case, I tend to prefer
15 to use the word arm's-length value ---

16 Q: Okay.

17 A: --- because I think it's more consistent,
18 there's, there can be certain differences
19 between fair market value standards and arm's-
20 length and the arm's-length value, although
21 none that I could think of that would be
22 relevant here.

23 Q: Okay.

24 A: It would be close to what would be the,
25 almost, or I should say, effectively the same



1 as the fair market value standard in this
2 case.

3 Q: All right, so just to re-ask my question with
4 the right terminology, you did not determine
5 the value of the, the -- now, I didn't say
6 that right. You did not determine the arm's-
7 length value of the assets that East
8 contributed to CBS?

9 A: Not to any level of precision that I think
10 you're asking for.

11 Q: Okay. And same question for West.

12 A: Again, not to this level of precision that I
13 think you're asking for.

14 Q: And tell me again, I want to make sure I have
15 all the categories, right. What factual
16 information did you use to perform your high-
17 level analysis?

18 A: Well, again, I'm relying on the broader
19 documents in the record to just, to inform my
20 opinion as to which entity was performing
21 which functions. I am relying on the
22 schedules that, that spreadsheet that you,
23 that I referred to during my direct testimony
24 that showed the derivation of that percentage
25 of the of the 93.6 -- 93.5/6 and a half



1 percent figure. I'm relying on the E&Y
2 2004/2005 study, depending on how you want to
3 refer to it. And then some of the other
4 documents in the record about the
5 restructuring transactions. So there were
6 various memos by Ernst and Young, and I
7 believe some Board of Directors presentations
8 as well, as part of that background
9 information.

10 Q: Did you get any financial rela- -- sorry.
11 Did you get any financial records related to
12 the CarMax Group from this time period?

13 A: Not from CarMax, I did have information about
14 the financial performance of the company from
15 their public 10Ks or from the data -- the
16 commercial database that we use. That was,
17 that information was also included in some of
18 my demonstratives.

19 Q: Are 10Ks something that you would normally if
20 you were doing a valuation study, would that
21 be the extent of the financials that you
22 looked at?

23 A: Certainly not in the context of a had, had I
24 been doing this in 2004, and if the charge
25 was what is the arm's-length value of the



1 assets being contributed by the, by the two
2 entities. No, you'd be using a broader range
3 of information.

4 Q: Well, even if you were trying to determine it
5 today, wouldn't you want that same information
6 that you would want back then? Wouldn't you
7 want the financials from that time period?

8 A: Well, it's a, it's a little difficult to kind
9 of reconcile this issue of forecasts versus
10 actuals. So there are certain circumstances
11 when, when the use of forecast can be a
12 reasonable basis for a valuation. I think
13 you need, oftentimes when there's a dispute
14 about the valuation and you're trying to redo
15 it today or you're trying to evaluate the,
16 the details of what, what was done in a prior
17 time period, you need expansive, a fairly
18 expansive scope of discovery to obtain
19 information about how certain forecast were
20 prepared, whether there were alternative
21 forecasts, the reasonableness of those
22 forecasts, whether they changed over certain
23 time periods. So it's a pretty -- once you
24 get into the nitty gritty of trying to today
25 redo something that was done back in 2004,



1 there's often a need for a fairly expansive
2 scope of information. Here I think the, the
3 issue is really one of I think, do I have
4 enough information available to me today to
5 come to the conclusion that the 93.5 and the
6 6.5 percent split is not an arm's-length
7 allocation of the CBS profits today. And I
8 think I, the answer to that as emphatically,
9 yes. I have more than sufficient information
10 available to satisfy myself that that is a
11 non-arm's-length result. So I would just
12 leave it a, that. And also, I think I have
13 more than sufficient information to determine
14 that a, a reasonably arm's-length result would
15 be one that would approximate, that would be
16 at least something that would have East
17 owning something, approximately 73 percent or
18 north of CBS, not 6.5 percent. And based on
19 the facts and circumstances of this particular
20 case, and particularly based on the fact that
21 East owned, or if there are any intangible,
22 or if there's a significant intangible value
23 associated with the business process
24 intangibles, from an arm's-length perspective
25 that should have been credited to East rather



1 than to West.

2 Q: All right, let me ask it a different way. If
3 a client came to you today and said, hey, I
4 would like to pay for you to do your own
5 valuation analysis of a study we had done
6 back in 2004. What information would you
7 want to see from them?

8 A: Well, I would -- first I would want to have a
9 clear picture of the intangibles that are
10 actually being used in the business. So for
11 example, if the scope was simply to say, what
12 is the value of a trademark royalty, so if
13 the charge was -- someone said, here's a
14 trademark that was owned by, by West, and
15 that's all I have, so what is the value of
16 that contribution? That, from a transfer
17 pricing perspective, that's gonna be a very,
18 very small contribution, simply because the
19 history of the development of the trade, of
20 the trademark is one where I would not see a
21 ongoing payment or a royalty being paid. So
22 there's no, typically the term of art is
23 often relief from royalty approach. So, but
24 in a different kind of context, if you have a
25 different kind of asset, so for example,



1 patent, you might do a relief from royalty
2 approach. You might say, here's a patent,
3 what kind it is. So I want to figure out
4 what patent is being contributed from by one
5 related party to another, what's the value of
6 that patent. I may look to see whether there
7 are comparable patents out there, was there
8 royalty rates charged on those particular
9 patents. I might look for forecasts at the
10 time of the sales potential of that
11 particular product. I would look to see
12 where in the development pipeline that
13 particular product is to see whether I would,
14 how I would treat those forecasts. So
15 there's kind of a wide range of information
16 required.

17 Q: Okay.

18 A: Because there's a very different approach
19 depending on the scope of the intangibles
20 being analyzed, but it's a very specific,
21 intangible, so for example, a trademark, or a
22 patent, versus this notion of, there's just a
23 kind of broader bunch of bundle of
24 intangibles associated with a company. That's
25 the part where I think it's easy to run off



1 the rails, you know, the kind of approach
2 that, that E&Y did?

3 Q: Are you saying that you would not want to see
4 any financials of the company from the time
5 period when the valuation was performed?

6 A: Oh, no, I would want to see that. It's not
7 the only thing that I would want to see, but
8 ---

9 Q: Right. But you would want to see that? That
10 would be important if you were doing a full
11 blown analysis on your own for a client?

12 A: Correct. I would want to see forecasts. And
13 if this would be -- if I were doing this
14 analysis in 2004, I would want to, definitely
15 want to see forecasts associated with the
16 financial performance of the product line or
17 the business or whatever it was related to
18 the specific intangible property issue.

19 Q: And, again, whether it's at that time or
20 later, that information, the financial records
21 of the company, would be important no matter
22 when you're doing it?

23 A: Right. Well, I think we -- they also need to
24 c- --that's why I said, often, there's, there
25 could be a dispute between what was known or



1 knowable at the time of the valuation, and
2 how much to use information that is only
3 known ex-post. This is an issue that came up
4 in the Perrigo case where I concluded that
5 the informa- -- that the the forecast being
6 used was unreliable, unreliably low. So I
7 looked at alternative forecasts that were
8 prepared contemporaneously. I also looked at
9 the subsequent financial performance of the
10 firm. So it really is a context dependent
11 question in terms of how it's coming about.
12 But if the charge is, client comes to me, not
13 in litigation, there's an intangible that
14 needs to be valued, I would want to know
15 information about the commercial prospects of
16 that particular product.

17 Q: Would it be important to you to have all of
18 the information that -- let's, let's use this
19 case, as an example -- all the information
20 that E&Y had and relied upon and coming up
21 with their valuation?

22 A: So I think as an economist, economists always
23 like to have more information rather than
24 less, but I think there's more than
25 sufficient information available within the



1 four corners of E&Y's analysis for me to have
2 an opinion about their reliability or lack
3 thereof in that analysis.

4 Q: So you're saying that you feel very
5 comfortable testing the reliability of a
6 report without seeing any of the underlying
7 documentation supporting that?

8 A: Well, in this case, it does have the
9 underlying data. It shows -- it is, it's not
10 just a number, right? It's not just
11 \$1,996,000,000. It has a fair amount of
12 detail in the appendices with regard to the
13 specific assumptions being used. And it also
14 has a, and again, this is also being done
15 within a 482 context. The very -- they're
16 applying these principles of 482, they're
17 going through a best method analysis. And so
18 even there, I have, I have some pretty strong
19 views about the reliability of their entire
20 approach. So even before I get to the
21 numbers, I can see that there is a bit of a
22 major disconnect in terms of the overarching
23 way that the, that E&Y is approaching the
24 study. But then I can also drill down in how
25 are they doing the calculations. And in



1 those calculations, that's where I see a
2 major disconnect in terms of how the company
3 is valuing the car business versus the CAF
4 business, and how all of that is flowing
5 through to the calculation of those ownership
6 shares.

7 Q: Okay. So, it's not important to you to see
8 the underlying documentation of the study,
9 just the study itself is sufficient?

10 **OBJECTION:**

11 **MR. ANTLEY:** Objection, asked an answer.

12 Q: I'm fine. I think you told me a while back
13 that you determined the valuation study was
14 wrong, in February of 2023?

15 A: Correct. I think I -- yes. That was fairly
16 shortly after looking at the study, it was
17 clear to me that it was significantly flawed.

18 Q: I think the words you used were, the moment
19 you saw it?

20 A: Yes. Maybe I was -- I would have had to turn
21 the first page in order to make that
22 determination. So maybe that's a epsilon
23 after the moment I, I saw it, but yes, very
24 shortly thereafter.

25 **THE COURT:** You're speaking of the deposition?



1 MS. GEER: Yes, Your Honor.

2 Q: What would you say that CarMax East economic
3 activity in South Carolina is? Just CarMax
4 East.

5 A: CarMax East?

6 Q: Yeah.

7 A: It operates the stores, the retail stores,
8 the brick and mortar locations. It generates
9 sales, it purchases inventory. It effectively
10 generates the profits that the company is --
11 effectively, I think all the profits that the
12 company is earning, both on the car side and
13 on the finance side through that brick and
14 mortar retail activity. CarMax is, that's
15 what it is, it's a retailer. It's not a
16 retailer and a manufacturer, it's just a
17 retailer. So the entirety of the value,
18 economic value being generated by the company
19 is being generated by those brick and mortar
20 locations.

21 Q: And what is CarMax West economic activity in
22 South Carolina?

23 A: Well, so CarMax West, from an economic
24 perspective, it's only operating on the West
25 Coast, it's not operating in the state of



1 South Carolina. The only nexus that I see it
2 having with South Carolina is the fact that
3 it's the recipient of a royalty payment, what
4 I consider to be a non-arm's-length royalty
5 payment, from, that is nominally paid to CBS,
6 but then the vast majority of that is
7 funneled through or siphoned off over to
8 West. And then similarly, the way the party
9 has, the taxpayer has elected to deal with I
10 think a prior settlement with the Department,
11 it also appears to be recognizing some amount
12 of finance income in the -- South Carolina
13 finance income -- in the apportionment factor
14 applied to West. But from an economic
15 perspective ---

16 Q: That's not what I was asking.

17 A: --- it's not, West is operating over in,
18 entirely in the West or the West coast. But
19 it is a, kind of a recipient of the, of some
20 share of the profits, actually a significant
21 share of the profits of, of generated South
22 Carolina, not just directly through these
23 direct linkages that cause it to re- -- that
24 they're required to file a tax return, but
25 also through this bigger indirect linkage, in



1 terms of its ownership of CBS, where
2 effectively all these profits are be- -- or a
3 substantial fraction of these profits are
4 being siphoned off from East and flowing into
5 West via West's 93.5 percent ownership share
6 of CBS.

7 Q: Are you aware of any state that has a statute
8 that says you should file your tax returns
9 based on the economic activity in the state?

10 A: No, I'm, I'm aware of this, the, what's in
11 the South Carolina statute, but I -- aside
12 from that, I don't have an opinion or have
13 not looked at other state statutes.

14 Q: Is there anything specific in the 482
15 regulations that requires related parties to
16 maximize their taxes?

17 A: No.

18 Q: What about that prohibits related parties from
19 minimizing their taxes?

20 A: No.

21 Q: Is there anything in the 482 regulations that
22 says tax motivations are relevant to
23 determining the arm's-length price?

24 A: Are relevant or irrelevant?

25 Q: Are relevant.



1 A: I would have to go back and reviewing it --
2 you don't, you don't set the arm's-length
3 price, with a tax consideration in mind if
4 that's what you're asking. But there are, I
5 think, concerns where there is evidence of
6 that something was done purely for tax
7 purposes where there -- that might require
8 heightened scrutiny of whether the prices were
9 in fact arm's-length.

10 Q: And that's in the 482 regulations?

11 A: I believe so, but now I'm, I would need to go
12 back and look at that. I just don't recall
13 the specific thing that I'm thinking of.

14 Q: All right. So you, right now, you don't have
15 any specific 482 reg in mind?

16 A: No. I mean there's been a lot of discussion
17 in the 482 community, I would say more
18 broadly the transfer pricing community, about
19 so called profit shifting, base erosion and
20 profit shifting, BEPS. It even has an
21 acronym. But I don't ---

22 Q: I think that's going beyond my question. I
23 just wanna know about the regs.

24 A: Well, that's great. And that's why I'm
25 trying to remember how much of this was a



1 regs driven discussion, and how much of it
2 kind of made its way into the regs. That's
3 the part I just can't recall. I'm sorry, I
4 just don't recall.

5 Q: All right. Do you agree that it's very
6 common for multi-state businesses to have
7 specific subsidiaries and to have intercompany
8 transactions between those subsidiaries?

9 A: You said multi state?

10 Q: Yes.

11 A: I don't know about how common but I would
12 say, I would expect it to be very common. I
13 don't think the question is do I know it to
14 be common, I would expect it to be common for
15 multi-state for, for large companies to have
16 subsidiaries. I'll leave it at that.

17 Q: And to have intercompany transactions?

18 A: Well, anytime you have subsidiaries, if you
19 have transactions among those, those
20 subsidiaries, then by definition you're going
21 to have inter- -- you're gonna have
22 intercompany transactions. So yes, I would
23 expect that.

24 Q: Okay.

25 A: My -- again, my primary focus has always



1 been, to date, has been on international
2 transactions, aside from the prior work I've
3 done in South Carolina. So the, the one,
4 that cases I've been involved in, in South
5 Carolina, maybe a little bit of a bias set.
6 So maybe there are two-party or I'm sorry,
7 two-state or three-state operations, where
8 everything is done within that, that single
9 kind of corporate entity, I just don't know
10 the relevant prevalence of one versus the
11 other ---

12 Q: Okay.

13 A: --- for purely domestic companies.

14 Q: Do you know whether it's common for auto
15 retailers to have their financing function
16 sep- -- in a separate entity from the retail
17 stores?

18 A: I would say it's -- I, I -- in my research of
19 the other auto dealers in that auto dealer
20 set that I talked about in my direct
21 testimony, I noted they always reported it
22 out separately. I just don't recall the
23 extent to which those were being performed
24 through a distinct subsidiary. I think a lot
25 of them were actually recording -- yes, so



1 I'd be less, I'll just leave it at that.

2 There was a lot of -- I keep saying I'm gonna
3 leave it at that, and then I don't. A lot of
4 them earning -- are earning commission income,
5 so -- and that's the primary focus of their
6 financing activity, so that's where I would
7 be surprised if it were being done through a
8 separate entity. But I just, again, I just
9 don't recall the specifics.

10 Q: Are you aware that some states choose to have
11 separate entity reporting as their required
12 filing method, while others choose to have
13 combined unitary reporting as their filing
14 method?

15 A: That's my understanding. Yes.

16 Q: Okay. And are you aware that there -- states
17 have different policy reasons behind how they
18 choose their tax laws besides trying to reach
19 the most accurate result from an economic
20 perspective?

21 **OBJECTION:**

22 **MR. ANTLEY:** Objection, Your Honor. This is
23 calling for speculation as to what other
24 state's policies are.

25 **MS. GEER:** I asked him if he is aware that states



1 would have those.

2 **THE COURT:** If you're aware of what -- you wanted
3 to know if he is aware of what states do or
4 why they do what they do?

5 **MS. GEER:** I'll -- let me read the question again,
6 just say we're all clear.

7 **THE COURT:** Okay.

8 Q: I said, are you aware that states may have
9 other policy reasons behind how they choose
10 their tax laws besides trying to reach the
11 most accurate result from an economic
12 perspective?

13 **THE COURT:** That calls for him to speculate about -
14 - you're asking him whether he can discern
15 why states -- for the existence of their
16 policies?

17 **MS. GEER:** I'm asking him, is he aware that states
18 have ---

19 **THE COURT:** Okay, have?

20 **MR. ANTLEY:** Then, it is also assuming facts that
21 aren't in evidence.

22 **THE COURT:** I'm gonna let her ask it.

23 A: I'll ans- -- answer it the first time where
24 you said may have. I would expect as an
25 economist that states might have different



1 policy objectives. I just don't know. I
2 haven't followed the kind of legislative
3 history of specific enactment of state
4 legislation to be able to say as a factual
5 matter whether in fact one state has done
6 that or another or not.

7 Q: Okay. Well, as an example, a state might
8 choose for administrative convenience to allow
9 to have a certain tax law that might not get
10 the most economically accurate result, but
11 might accomplish another goal of it in being
12 administratively more easier to use.

13 **THE COURT:** That is speculation.

14 **MS. GEER:** All right. Sorry I'm trying to cross
15 off things that we've already covered so I'm
16 not duplicating.

17 **THE COURT:** Oh, keep on.

18 Q: I have one section I skipped over. All
19 right. I'm sorry. All right. Dr. DeRamus,
20 you have testified, I believe, that combined
21 reporting gets you to the same result as if
22 proper transfer pricing was used in a
23 separate reporting tax return?

24 A: To a reasonable approximation, yes, and that
25 a combined reporting would be a, would more



1 reliably reflect the economic activity of
2 CarMax in South Carolina than its use of
3 separate entity reporting, given the way it's
4 applied its transfer pricing policies.

5 Q: Okay. So I want to explore a little bit how
6 you get that estimate that you've got. So
7 what is the management fee price per vehicle
8 that you're using for that conclusion?

9 A: Well, I would say for that conclusion, I was
10 really looking at the aggregate numbers,
11 looking at the amount of income that is left
12 over in those slides -- I don't know if you
13 remember the bar charts that showed kind of
14 the waterfall, and how the income, how much
15 income or operating profit was left in the
16 entities, and you could be looking at the
17 relative share of the green bar versus the
18 blue bar in those, those waterfall charts.
19 So it was that, those, it was based on my
20 conclusion that if one were to allocate the,
21 a substantial fraction of the finance income
22 to the operating subsidiaries and with perhaps
23 a markup on cost for the CAF cost functions.
24 So that, in combination with the management
25 fee, the, this, that alternative management



1 fee that I had calculated that that would
2 eliminate the vast majority of the remaining
3 amount in CAF. So, CAF at that point -- I'm
4 sorry CBS at that point would then have a
5 relatively modest amount of, of profits. But
6 that profits would then be distributed down
7 to each of the entities and their respective
8 ownership share. I think I believe I also
9 said that the, I think at arm's-length, all
10 that CBS income would be allocated no less
11 than about 73 percent to East, and 27 percent
12 to West. So if you did that, effectively,
13 you're still, you're going to come out with
14 the income of, that all the income being
15 generated by CBS, I'm sorry, by East
16 effectively being in the East bucket. And
17 therefore, consistent with how you would get
18 if you applied either South Carolina's share
19 of East income. So East income now would be
20 an arm's-length amount of income. So South
21 Carolina's share of East income would be
22 reasonably approximately to what you get if
23 you just simply take the consolidated entity
24 and applied Ea- -- South Carolina share of
25 that consolidated, the way Mr. Sharpe



1 calculated for the combined entity portion
2 factor.

3 Q: So you didn't actually run any numbers to try
4 to figure out if your suspicion is correct,
5 in terms of looking at what was the net --
6 you did -- you didn't, I don't think you
7 answered my question. Did you determine a
8 management fee price per vehicle to use for
9 this analysis, I think you just said
10 aggregate number?

11 A: Well I, I provided it for informational
12 purposes, so you could compare the relative
13 magnitude. In my earlier demonstrative I had
14 a, an aggregate number as well, where I
15 calculated the alternative one, and I also
16 said that would be the number if you were to
17 ignore these ownership shares, the
18 disproportion of the ownership shares. So
19 there's two ways to fix the problem with the
20 ownership shares, right?

21 Q: Right.

22 A: One is to actually change the ownership
23 shares themselves to reflect an arm's-length
24 amount. If that's the result, then the end
25 result that you're going to get is going to



1 be the right, the, a, all the income being
2 earned in East is going to effectively stay
3 in East, it's just going to come back around
4 and, a portion is going to be coming back
5 through the ownership shares of, of CBS.

6 Q: What ownership, what CBS ownership percentage
7 are you using for this conclusion, when you
8 estimate that the separate entity return would
9 come up with the same result?

10 A: So on a, I'm using as a bench -- as a rough
11 benchmark, 73 percent as the, as the share
12 that would get you a result that would be
13 consistent with what you get, what a would be
14 consistent what would be an arm's-length
15 results.

16 Q: Okay.

17 A: Even if you had the transfer prices wrong in
18 the first instance, effectively, all of the
19 mispriced transfer prices, those, the, the,
20 the amount of the mispricing is going to be
21 coming back to East via it's 73 percent
22 ownership in, in CBS. If that ownership
23 share interest were set higher than that
24 based on for example the value of the assets
25 that I think, the, what I consider to be a



1 better estimate of the fair market value
2 assets or the cash contributed that own --
3 that percentage would be higher, not lower
4 than 73 percent. So as 80 percent or 85
5 percent, or 90 percent, you're gonna get even
6 more income flowing back into East, under
7 that method. That's why I've used 73 percent
8 as that general lower bound estimate of what
9 a arm's-length result would be for the
10 ownership of CBS. So ---

11 Q: I'm sorry, go ahead.

12 A: --- so that gives me a number that says,
13 okay, is that consistent with what I would
14 expect under combined and to report it, and
15 that's where you're just, you're dividing the
16 sales of the South Carolina sales by the
17 total and then allocating a portion of the
18 total income based on the number. We're
19 doing it based on, on South Carolina share of
20 East's income. You should be coming up with
21 roughly the same amount.

22 Q: Are you using 73 percent for each year?

23 A: You could, you could do it on your, different
24 on a year by year basis. I haven't gone
25 through and done the math to any degree of



1 precision, primarily because that 73 percent
2 isn't a number, number I consider to be a
3 precise number.

4 Q: Okay.

5 A: That's more, more of a lower bound estimate
6 and more of an establishment of principle
7 that says that is one way to do it. The
8 alternative way to do it is you could do --
9 and what I did in my alternative calculations
10 of the management fee, right, that actually
11 has a markup in there. So if I don't touch
12 the ownership share, then the, that markup, a
13 non-arm's-length fraction that markup is going
14 over to West. So that's why I think at the
15 end of the day, you're not -- and it does
16 also, does not address the finance function.
17 So I'm still left with this conundrum of how
18 to deal with the finance function. So if I
19 assume that CAF is going to arm's-length
20 price for CAF is such that East retains the
21 income associated with the finance business
22 that it generates and compensate CBS with a,
23 call it a 7.2 percent markup on CBS's cost of
24 about \$25 million a year, again, there's
25 going to be this little sliver of non-arm's-



1 length pricing that's funneled over to, to,
2 to West because of that, that ownership
3 share. So I can never -- unless I address
4 those ownership shares, any profit going over
5 to CBS is going to have a result that's a
6 non-arm's-length result. That's why I think
7 in this, particularly in this case, I think
8 it's why consolidated entity reporting -- I'm
9 sorry, combined entity reporting or a combined
10 entity reporting method, however you want to
11 describe it, comes to something that would
12 reasonably approximate the arm's-length
13 results, i.e., would get you, you wouldn't
14 leave this non-arm's-length price or this non-
15 arm's-length siphon of money going off over
16 to West.

17 Q: Okay. And what I'm trying to understand is
18 the math behind your prediction as to how the
19 tax return would look in a separate entity
20 return, when you use what you say, as an
21 arm's-length price. So I think I got down
22 here that you would use 73 percent for the
23 distributive share ---

24 A: As a minimum, yes, as a floor.

25 Q: Okay. And then you use aggregate numbers for



1 the management fee price per vehicle. I'm
2 not sure how that -- how you're doing your
3 math on that.

4 A: Well, that's why I said if you correct the
5 ownership shares of CBS it doesn't really
6 matter how you do the the, the transfer
7 prices in the first step, because all of the
8 financial activity that's being generated by
9 CBS, by East, even the finance income, 73
10 percent of that finance income, is coming
11 down to -- would come back to East through
12 the flow-through of a 73 percent share.
13 Assuming that the -- that East is financing
14 the same proportion of vehicles as West is,
15 which I think is a reasonable assumption.

16 Q: Okay.

17 **THE COURT:** So if we did a 75 percent -- in
18 calculating the taxes in this case, if we
19 presumed a 75 percent ownership of CarMax
20 East, that would, or distributive --
21 distribution share, I think is the phrase you
22 used.

23 A: Yes.

24 **THE COURT:** Then, that would fix a lot of problems.
25 Would there be any other change that would



1 need to be made to address these ---

2 A: As I've gone through it -- I mean, again,
3 it's like I said before, sometimes you get to
4 the right result through an ugly method.

5 **THE COURT:** Yeah.

6 A: So as an -- as a transfer pricing economist,
7 I always like to see the transfer pricing set
8 correctly in the first instance.

9 **THE COURT:** Yeah.

10 A: But in fact, if, if there is a -- if there's
11 too much money being paid by both East and
12 West for the management fee, as long as that
13 too much money comin- -- being paid in is
14 being distributed back out as the same amount
15 that's being paid in, there's no distortion,
16 right? So --

17 **THE COURT:** Would that 75 percent take care of the
18 financial issue?

19 A: The way I've looked at the math and the way
20 I've looked at the numbers, yes, it would.
21 Because the same way, as long as they're both
22 generating 75 percent of the finance income,
23 that's income that never appears under the
24 East umbrella to begin with, it's always fall
25 -- it's already falling down into CBS. But



1 then it, it would flow through in that last
2 step 75 percent over to East, and so it'd be
3 the same as if East earned all that money to
4 begin with.

5 **THE COURT:** All right.

6 Q: So it sounds like to me you did this very
7 high-level analysis. I just want to make
8 sure I understand for sure. Would you be
9 able to tell us, like looking at line one of
10 a tax return form, what number you would put
11 on line one for CarMax East for let's just
12 say 2016?

13 A: No, that's where I said I didn't -- my charge
14 is not to kind of compute -- recompute the
15 taxes or recompute the numbers ---

16 Q: Okay.

17 A: --- with a degree of, any degree of
18 precision. It was to really look to see
19 whether a combined empty entity report -- I'm
20 sorry, a combined entity apportionment method
21 would result in a taxable income number that
22 would be reasonably consistent with an arm's-
23 length transfer pricing approach ---

24 Q: Okay.

25 A: --- writ large.



1 Q: So you have not done the math behind that?

2 A: I've done a lot of math, I just haven't done
3 the math that's gonna populate the -- that
4 line one in the tax return.

5 Q: Okay. And just to be clear, I'm gonna ask it
6 for both East and West. So I asked earlier
7 about East, you don't know what goes on line
8 one, you wouldn't know for West as well?

9 A: That's correct. I've not done, I've not
10 recalculated those numbers to figure out what
11 would go into the tax return.

12 Q: For any of it?

13 A: For any of it, correct.

14 Q: So I don't have to go down ---

15 A: Yes.

16 Q: You don't know the line two state
17 modifications numbers either?

18 A: That's correct.

19 Q: Okay. Or any of the lines on the tax return?

20 A: That's correct.

21 **MS. GEER:** Your Honor, if I could have one minute?

22 Q: One more question related to what I was just
23 asking about. Are you familiar with what a
24 com- -- we had up there, a separate entity
25 return. Are you familiar with a combined



1 unitary reporting return?

2 A: Generally, I'm familiar with the documents
3 that were produced by the Department showing
4 its adjustment.

5 Q: I'm sorry, would you be able to do the math
6 on a combined unitary return, like we just
7 walked through with the separate entity
8 return?

9 A: Again, I didn't -- I wouldn't be the one to
10 tell you which numbers go in which boxes ---

11 Q: Okay.

12 A: --- under either a separate entity or a
13 combined entity return basis.

14 Q: And you did not do that analysis in this
15 case?

16 A: Oh, that's correct.

17 Q: Okay. All right. One second. All right.
18 I've got a demonstrative up here.

19 **THE COURT:** How much longer are you gonna be?

20 **MS. GEER:** I have one sheet of questions.

21 **THE COURT:** Okay.

22 **MS. GEER:** Yep. Almost done.

23 **THE COURT:** One sheet?

24 **MS. GEER:** But it's just a couple of questions. I
25 don't think it'll take long.



1 **THE COURT:** Okay.

2 **MS. GEER:** But I'm not making any promises to you
3 after what I did last time. But, I think
4 it'll be quick. All right, so we'll call
5 this Petitioner's Demonstrative, this is our
6 first one? Your Honor, I believe it's
7 Petitioner's Demonstrative number one.

8 **(Petitioner's Demonstrative Number 1 was referenced**
9 **at this time.)**

10 **Q:** All right. So your suggested arm's-length
11 price for the management fee payment is 528
12 per vehicle sold, correct?

13 **A:** Well, because it's a demonstrative, I'd put a
14 big asterisk next to that word, arm's-length
15 price. That's why in my demonstrative I
16 called it an alternative management fee,
17 simply because, again, that embeds some profit
18 element. And anytime there's a profit
19 element being paid to CBS, if you're sticking
20 with these, and with the actual owner's
21 interest, you're gonna have a non-arm's-length
22 result. Nonetheless, it's much closer to
23 what I think is a reasonable number, that E&Y
24 should have calculated, for example, in doing
25 its analysis. And it doesn't address the



1 whole issue of the finance function.

2 Q: All right. So if, in this example, East owns
3 6 and a half percent of CBS, and West owns 93
4 and a half percent, would 528 still be your
5 suggested alternative management fee?

6 A: You mean, taking as given the actual
7 ownership shares?

8 Q: As reflected here, yes.

9 A: Yes. So I think I just answered that maybe a
10 second ago.

11 Q: Okay.

12 A: I would not consider it to be truly arm's-
13 length in terms of wouldn't get you a, a
14 arm's-length result. I do think it would
15 substantially reduce the distortion caused by
16 the \$1,100 to \$1,200 dollar per vehicle
17 transfer prices that were actually implemented
18 by the taxpayer.

19 Q: Okay.

20 A: So it's, it's that, there's still a little
21 bit of that distortion. Again, setting aside
22 the old finance issue ---

23 Q: Okay.

24 A: --- but it could get you, it does resolve a
25 substantial amount of distortion.



1 Q: Okay. So just to make sure I'm clear, you,
2 you do not think that 528 -- you're not
3 suggesting that 528 is the correct arm's-
4 length price for the management fee payment?

5 A: Not if the 6 and a half percent and the 93.5
6 percent ownership shares, distributive shares
7 remain in place. I think ultimately, the
8 question for the Court or maybe thinking
9 about it from a big picture perspective, is
10 how much distortion is still left in, in that
11 particular payment. So it's 7.2 percent of,
12 of some, call it maybe \$35 per vehicle would
13 be the amount of the distortion, or \$35 per
14 vehicle is probably the amount of profit
15 embedded in there. And so 93.5 percent of
16 that is going to CarMax West. And to get to
17 a non-arm's-length result, at the end of day
18 it's resolving a substantial amount of the
19 distortion, but I have a hard time saying the
20 words that that is an arm's-length result
21 when I know that that, it's kind of going
22 still going through this non-siphon -- that
23 siphoning off the profits in a non-arm's-
24 length way.

25 Q: Okay.



1 A: So it's close, but it's not full -- not fully
2 resolving it, with regard to just the
3 management fee.

4 Q: So but I, let's, let's -- this question,
5 we're look -- we're considering only arm's-
6 length standard under 1.482-1(b). Under that
7 standard, let's just assume for me, that 528
8 is the management fee payment. That's the
9 arm's-length price.

10 A: So I'm sorry, what's your question?

11 Q: Hold on. What I'm trying to gather from you
12 is whether the arm's-length price under 1.482-
13 1(b) shifts based on what percentage East and
14 West own of CBS?

15 A: Whether the result is consistent with the
16 arm's-length standard does shift based on that
17 percentage ownership. The only way in which
18 it would not affect it is if all of those
19 costs were simply allocated at cost. If it's
20 just allocated at cost, if that number is not
21 528 per vehicle, but you take out the profit
22 element of about \$40 a car, so call it 488
23 for round numbers, then we're, I'm sorry, I
24 probably should have said \$40. It's
25 something less than \$35 dollars. So take off



1 \$35 dollars from that, then there's going to
2 be zero profit leftover. Then it's simply a
3 cost allocation between East and West. So
4 CBS has return- -- has reimbursed its cost
5 and then there's no distortion, there's no
6 non-arm's length result as, as a result of
7 the waterfall because there's no profit left
8 in that system.

9 **MS. GEER:** All right. That's all the questions I
10 have.

11 **THE COURT:** Okay. Your crystal ball was correct.
12 It's just way down the line.

13 **MR. ANTLEY:** No questions from the Department, Your
14 Honor.

15 **QUESTIONS FROM THE COURT:**

16 **THE COURT:** So I'm gonna ask a question I already
17 asked, but in a just a little bit different
18 way, and that is if the, I can't remember the
19 exact phrase you used, but if the
20 distribution share to CarMax East was 75
21 percent, would that fairly represent the
22 extent of the taxpayer's business activities
23 in this state?

24 **A:** As I understand the way the waterfall works
25 and the way the pass-through income would



1 show up, the CBS income would show up on
2 South Carolina's tax return, I think it
3 would.

4 **THE COURT:** All right.

5 A: I would probably defer to the auditors to say
6 -- to confirm that it's indeed -- that it's
7 not something that I don't know about in
8 terms of the way an LLC's income would pass-
9 through, but based on my understanding of how
10 the tax returns were actually prepared and
11 where I see the -- and even a financial
12 statements, where I see that allocation of,
13 of income between East and West going for
14 the, the CBS profit. So I could see it on
15 the, on the work papers that, that Dr. Cody
16 provided. So I see the 6 and a half percent
17 going off to one side, the 93.5 percent
18 popping off somewhere else, so assuming that
19 it all flows through the same way on the tax
20 return, yes, I think it should get you the
21 same result as if they got all the same
22 transfer prices correct to begin with.

23 **THE COURT:** Any follow-up questions on the specific
24 question I've asked?

25 **MS. GEER:** No, Your Honor.



1 **MR. ANTLEY:** No, Your Honor.

2 **THE COURT:** You may step down.

3 A: Thank you.

4 **THE COURT:** Thank the Lord.

5 A: I will.

6 **THE COURT:** All right. Tomorrow, I feel like we're
7 kind of behind now.

8 **MS. GEER:** I don't think we are, Your Honor.

9 **MR. ANTLEY:** I'm very concerned we're behind, but
10 my understanding is they have four to
11 possibly five witnesses.

12 **MS. GEER:** So we're not doing Jamie.

13 **MR. ANTLEY:** Okay. So, four.

14 **MS. GEER:** Three or four.

15 **THE COURT:** Let's start at 9:30 if not before.

16 **(Day 3 of the hearing adjourned at 5:12 p.m. on**
17 **Wednesday, May 24, 2023.)**

18 **DAY 4 - THURSDAY, MAY 25, 2023**

19 **RESPONDENT'S CASE IN CHIEF**

20 **CALL TO ORDER:**

21 **THE COURT:** Call your first witness.

22 **MS. GEER:** Your Honor, Carmax would call Eileen
23 Yost.

24 **COURT REPORTER:** Do you solemnly swear that the
25 testimony you're about to give is the truth,



1 the whole truth and nothing but the truth, so
2 help you God?

3 **MS. YOST:** Yes.

4 **COURT REPORTER:** Thank you, ma'am. Appreciate it.
5 Please state your name for the record.

6 **MS. YOST:** Eileen Yost.

7 **MS. YOST - DIRECT EXAMINATION BY MS. GEER:**

8 Q: Good morning, Ms. Yost.

9 A: Good morning.

10 Q: Can I call you Eileen?

11 A: Yes.

12 Q: And what is your current position at CarMax?

13 A: I'm an assistant vice president in tax.

14 Q: And can you tell us about your educational
15 background?

16 A: Yeah. I have a Bachelor's of Science in
17 Accounting from Binghamton University in
18 upstate New York.

19 Q: And are you a CPA?

20 A: I am. In Virginia.

21 Q: Okay. And tell us about your work experience
22 after you obtained your college degree.

23 A: So, I started working for a public accounting
24 firm for three years in New York, and then
25 after that I went to Circuit City and I



1 worked there for ten years. And then when
2 Circuit City spun off CarMax, I went to
3 CarMax. And I've been there for last 20
4 years.

5 Q: And tell us about the positions you've held
6 at CarMax and your responsibilities in, in
7 those positions.

8 A: Okay. So, when I started at CarMax, I was
9 the income tax manager. So, I basically just
10 had responsibilities for the income tax team
11 as opposed to some of the other tax teams.
12 But I was the leader of the team. I hired
13 people. I did all of the, you know,
14 performance reviews. Led my team to prepare
15 all of the tax returns, do compliance, do
16 audits. Basically, all the kind of corporate
17 tax work.

18 Q: What was your next position?

19 A: And then after that, over the course of the
20 next handful of years, I was promoted a
21 couple of times. My position right after
22 being income tax manager, it was called a
23 group manager and it was at that time that I
24 took on responsibility for the entire tax
25 team. So, when I say that, what I mean is



1 not just the income tax function, but all of
2 the indirect. So, all of the sales tax, real
3 estate tax, personal property taxes, things
4 like that. Pretty much everything except for
5 payroll taxes.

6 Q: Okay. And what happened after that?

7 A: After that, like I said, I'd been promoted a
8 couple times. So, that I was I think 2005.
9 2008, I was promoted to Director of Tax. And
10 then, I believe it was 2011, I was promoted
11 to Assistant Vice President. And really,
12 ultimately, it -- you know, now in that role,
13 you know, I'm responsible for the entire tax
14 team, all the strategic leadership of the
15 group. My team, I have about 17 associates.
16 At -- during the audit period I had 17
17 associates. And we really do everything soup
18 to nuts for tax. So, we do all the
19 compliance, all the tax accounting, all of
20 the audits and controversy. Pretty much
21 everything a tax department would do, again,
22 except payroll taxes.

23 Q: Okay. And how were you involved in the tax
24 returns for CarMax East in South Carolina
25 that are at issue in this matter?



1 A: Yeah. So, my team prepares all of the
2 federal and state tax returns. So, again,
3 they're preparing the turn- -- the returns.
4 I'm reviewing and signing the returns.

5 Q: And same question as to CarMax West returns.

6 A: Yes. Same exact for CarMax West.

7 Q: And would that apply to federal returns?

8 A: Yes. All federal and state.

9 Q: What about the returns for CBS?

10 A: Yes. Yes. CBS as well, all federal and
11 state.

12 Q: Were you also involved in the audit process
13 at all?

14 A: Yes. Again, at, at a little bit of a higher
15 level. My team is really the front line that
16 works directly with the auditors to make sure
17 that they get all the information that they
18 asked for and answer any questions. But I'm
19 always there, you know, understanding what's
20 going on and making sure that we're providing
21 the, the correct information.

22 Q: And when was CarMax formed?

23 A: It was formed in 1993 as a subsidiary of
24 Circuit City.

25 Q: And who owned CarMax at that time?



1 A: Circuit City did.

2 Q: What is special about the CarMax business
3 versus other auto retailers?

4 A: Yeah. So, it's interesting. You know,
5 CarMax was formed in 1993, and you know,
6 really the whole point of that was to rev- --
7 revolutionize the used car industry. It's a
8 very fragmented industry, and you know, we
9 went out to try to solve a lot of the, the
10 problems that customers had, or
11 dissatisfaction that the customers had with
12 the way they were buying used cars. You
13 know, if you think about, you know, a used
14 car salesman in a plaid jacket kind of thing.
15 That was the impression that everyone had of
16 used car dealerships. And we didn't want
17 that to be the way it was. So, we created
18 CarMax. Cir- -- cir- -- sorry. Circuit City
19 created CarMax and, you know, they created it
20 to have, you know, certain equities, we call
21 them. So, low, no-haggle prices; offering
22 financing to customers, whether it's through
23 our own financing or through other third
24 party finance companies; having a really large
25 lot of inventory and a varied mixed of that



1 inventory. And one of the most important
2 things that we did was to create a really
3 transparent process where every step of the
4 process was independent from the other, so
5 that the customer could actually see what was
6 happening in each step, instead of walking
7 away not really knowing if they got a great
8 deal. And the one thing I actually did leave
9 off of that was we also have a process where
10 we purchase cars from customers. We call it
11 our appraisal lane. So, I think later in my
12 testimony, you'll probably hear me say
13 appraisal lane. So, that's where a customer
14 would bring their car to CarMax and we would
15 buy the car from the customer, regardless of
16 whether the customer buys a car from us. So,
17 that's also again, when you think about a
18 trade-in, well, it's sort of like a trade-in,
19 except the customer could walk away with a
20 check just selling us their car and not even
21 buying a car from us. So, it's very
22 different than any other car dealer was
23 doing, especially at the time.

24 Q: And ---

25 **THE COURT:** Do you have apparel restrictions for



1 your sales people?

2 A: They have -- they have a list of different
3 uniform options that they have. Yes.

4 **THE COURT:** Do y'all out-lie -- outlaw plaid
5 jackets?

6 A: We absolutely outlaw plaid jackets.

7 Q: And can you talk about how the, the
8 transparency that you just mentioned and the
9 separation of the different pieces of the
10 process, how that differed from what was
11 traditional with the used car business?

12 A: Yeah. I think the, the no-haggle pricing at
13 the time was pretty revolutionary. I think
14 maybe Saturn dealers at one point did that,
15 but that was one of our biggest things. We
16 put a sticker price on a car and that's the
17 price. What's great about that for the
18 customer is that they know walking in what
19 the price is going to be of the car. And
20 they either want to buy that car for that
21 price or they don't. So, there's a lot of --
22 the customer has a lot of, I want to say
23 ownership, but that's not really the word I'm
24 looking for. They're really empowered to
25 know because everything is so transparent,



1 they can walk away saying, I knew exactly
2 what my price was going to be. I knew
3 exactly what my finance rate was going to be.
4 I knew exactly what every piece. I knew what
5 my trade-in was. We had found in our
6 research that, you know, the, the finance
7 manager at the store would, would change the
8 finance rate depending on how much they were
9 giving for the trade-in or how much they were
10 negotiating off the, the MSRP, the
11 manufacturer's suggested retail price of the
12 car. So, you kind of never really knew
13 exactly where you were in there, and at
14 CarMax, everything is transparent. Everything
15 is up front. The customer can see every
16 independent piece before they put the whole
17 deal together.

18 Q: And can you give us a high level description
19 of the car -- CarMax auto sales operations?

20 A: Yeah. So, I mentioned a couple of things,
21 but mainly what the stores do is they, they
22 purchase, they recondition, and they sell
23 cars. Now, within that, there's a couple of
24 different things. So, we would also -- so I
25 mentioned reconditioning. So, I'll start



1 there. I don't know how well known of a term
2 reconditioning is, but it's basically how we
3 would take a car and do -- I'll just use
4 service work for lack of a better way to say
5 it. To make the car ready for sell. So, if
6 we buy a car in the appraisal lane from a
7 customer, there may be things that need to be
8 done to it before it can meet our quality
9 standards to put on the lot. So, that's what
10 we call our reconditioning process. We also
11 sell extended service policies. We sell
12 guaranteed asset protection. I usually call
13 that gap and ESP, just to -- we like
14 abbreviations. We do the financing and we
15 also have partnerships with many third-party
16 finance companies. So, customers usually have
17 multiple options of the financing terms to
18 choose from. We also, during the audit
19 period, in some of our CarMax Auto
20 Superstores, we also sell new cars, although
21 it was -- it was starting to wind down a
22 little bit during the audit period. But in
23 some stores, in some states, we still sold
24 new cars. I probably missed something in
25 there, but that's, that's pretty much the



1 bulk of it.

2 Q: You mentioned the appraisal lane and how you
3 purchased from, from customers. Is there
4 another source of purchases?

5 A: There is. So, the appraisal lane -- so, we
6 have two, two ways that we acquire inventory.
7 One is through the appraisal lane. So,
8 that's where the customer would bring their
9 car to us and we would make them an offer and
10 we'll buy any car. Literally, any car,
11 whether it's running or not. We will buy any
12 car in the appraisal lane. But then the
13 other way is we go out to outside auctions
14 and we would buy cars at auction and then put
15 them through the reconditioning process and
16 then put them on our front lots.

17 Q: And focusing on the retail stores, what
18 contributes to the retail stores being
19 successful?

20 A: Yeah. Our retail stores are successful
21 because they are incredible executors. So,
22 you know, I mentioned a lot of the things
23 that they're responsible for, but what they -
24 - what they get is, they get a lot of really
25 detailed proven process and procedures from



1 CBS, who creates all the strategy, and our
2 stores are, again, wonderful executors. They
3 do a fantastic job with the customers in
4 actually getting those sales to occur.
5 Getting the reconditioning process done on the
6 car. You know, making sure that all the
7 customers paperwork is in order. One of the
8 things I didn't mention was in our business
9 office, basically, we, we avoid -- we help
10 the customer avoid a trip to the DMV. So, I
11 don't know what the DMV is like in South
12 Carolina. In Virginia, it's not a fun place
13 to be. So, we try to do all of the titling
14 and paperwork and license plates and
15 everything right there in the store for the
16 customer. So, again, it -- all of those
17 processes and procedures, the strategy around
18 those, is created at CBS. And the stores are
19 exceptional executors at getting it all done.

20 Q: All right. Let's talk about the CarMax
21 entities.

22 MS. GEER: My eyes are bad. Does it -- is it 33?

23 MR. HARRINGTON: Yes.

24 MS. GEER: Okay. Joint Exhibit 33.

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



1 Q: Eileen, can you tell us what, what this is?

2 A: Yeah. This is a CarMax Corporate org chart,
3 organizational chart.

4 Q: And how long has this structure been in
5 place?

6 A: This has been in place since 2004.

7 Q: And what is CarMax, Inc.?

8 A: CarMax, Inc. is our publically traded holding
9 company. That's technically the stock that's
10 traded on the stock market.

11 Q: And what are its business activities or
12 sources of revenues?

13 A: Really nothing. It's, it's just a holding
14 company.

15 Q: Okay. What about CarMax Auto Superstore
16 Services?

17 A: Yeah. CarMax Auto Superstore Services, it's,
18 it's a little bit lower down on the chart.
19 That is an employment services company. So,
20 that houses all of the employees that are
21 then leased to CBS.

22 Q: And what's the fee that is paid for the
23 leasing cover?

24 A: I believe during the audit period it was 2
25 percent.



1 Q: And what services does that compensate?

2 A: Yeah. It -- it's basically employment
3 services. So, if you think about like
4 employee administration, payroll
5 administration, benefit administration type of
6 stuff.

7 **THE COURT:** So, they're the Human Resource
8 department?

9 A: The, the people are in there. Yes. The
10 people are in CarMax Auto Superstore Services.
11 The processes are in CBS.

12 Q: Okay. Let's go to CarMax East. Sorry. What
13 is CarMax Auto Superstores, Inc.?

14 A: Yeah. CarMax Auto Superstores, Inc., I know
15 we -- I refer it to this way. Everyone, I
16 think up to this day has referred it to this
17 way. So, that's is what we call CarMax East.
18 It owns and operates, the, the CarMax stores
19 generally in the eastern part of the United
20 States. And I consider Texas to be east, not
21 west.

22 Q: And does it own any CarMax entities?

23 A: It owns CarMax Auto Superstores West Coast,
24 Inc., as well as you can kind of see my
25 little blue triangles here. These are just



1 single member LLCs. So, CarMax of Laurel,
2 LLC. I mentioned we sell new cars. Laurel
3 Toyota basically, CarMax of Laurel, LLC.
4 That's a Toyota franchise. And then down a
5 little bit below is CarMax Auto Mall, LLC.
6 That also holds some new car dealerships that
7 we had to put in a separate entity just for
8 reporting purposes. And I believe -- yeah.
9 So, CarMax West and then the two small LLCs.

10 Q: What are the business activities of CarMax
11 East?

12 A: So, the business activities of CarMax East
13 are really kind of, you know, what I've
14 talked about with the stores. So, because
15 they, they hold the stores, they do all of
16 the store operations. So, they, they
17 purchase, recondition the cars, offer the
18 financing, offer the extended purchase
19 protection plans, the ESP and GAP. They
20 purchase cars in the appraisal lane. They go
21 out to auctions and buy cars. So, they do
22 all of those functions.

23 Q: Do you know how many retail stores were in
24 CarMax East during the audit period?

25 A: Yeah. At the end of the audit period there



1 were 141.

2 Q: What -- and I should've asked this first.
3 What is the total number of CarMax retail
4 stores?

5 A: At the beginning of the audit period, there
6 were 144. At the end of the audit period,
7 there were 188 total.

8 Q: Okay. And do you know about how many re- --
9 how many vehicles were sold by CarMax East
10 during the audit period?

11 A: Yeah. It was -- it was about a million and a
12 half vehicles. We call them units. So, if
13 you hear me say units, that means cars.

14 Q: And what is CarMax East's business activity
15 in South Carolina?

16 A: It -- it's just selling -- it -- it's just
17 doing the -- those store operations. It's
18 just selling, purchasing, and reconditioning
19 cars.

20 Q: Okay. And how many stores did you have in
21 South Carolina during the audit period?

22 A: For the entire three-year audit period, we
23 had three. And then, at the end of the audit
24 period, we opened our fourth store in South
25 Carolina. So, that was the only opened for



1 like maybe three months in the last year of
2 the audit period.

3 Q: All right. What is CarMax Auto Superstores
4 West Coast, Inc.?

5 A: Yeah. So, CarMax Auto Superstores West
6 Coast, Inc., I think we've all kind of over
7 the last few days called it CarMax West.
8 They operate -- they own and operate the
9 stores in the western part of the United
10 States.

11 Q: And how many stores were in CarMax West
12 during the audit period?

13 A: At the end of the audit period, there were
14 47.

15 Q: And do you know how many vehicles were sold
16 during CarMax West during the audit period?

17 A: Yeah. There was a little over half a
18 million.

19 Q: And what is CarMax West's business activity
20 in South Carolina?

21 A: None, other than the ownership of their piece
22 of CarMax Business Services, LLC.

23 Q: And what is CarMax Business Services, LLC?

24 A: So, CarMax Business Services, LLC, we call it
25 CBS, because again, everything has to have an



1 acronym. They are the entity that does all
2 of our corporate management services, all of
3 our strategic services, and they also are the
4 entity that has the financing business.

5 Q: And is the financing business known under
6 another name?

7 A: It is. It's -- we also call it CAF, C-A-F,
8 or CarMax Auto Finance.

9 Q: And approximately what percentage of CBS's
10 income is attributable to financing receipts
11 versus management fees during the audit
12 period?

13 A: Yeah. It's about 50/50. Really close to
14 50/50.

15 Q: And what is CBS's business activity in South
16 Carolina?

17 A: In South Carolina, really all it does is
18 because it's the owner of the trademarks and
19 trade names that are used in South Carolina,
20 that's the only business activity they have.

21 Q: Can you give us a high-level description of
22 the management services activities that CBS
23 provides to the stores?

24 A: Yeah. So, CBS provides basically all of the
25 management functions for the entire group.



1 So, this would be -- you know, they, they own
2 and develop and manage and monitor the
3 trademarks and trade names. They provide all
4 of the corporate business management services.
5 So, you know, when you think about, you
6 know, finance and accounting, and legal, HR,
7 IT -- I'm sure I'm missing a lot of things.
8 Sales operations, training departments, things
9 like that, they do all of that. We also do
10 marketing advertising services. We do real
11 estate services. And then, we also have a, a
12 large quantitative analysis group. In today's
13 terms, we would call them our data science
14 teams. So, sometimes that's easier just to
15 say, but they, they provide a lot of the, the
16 business strategies around, you know, some of
17 our -- some of our main value drivers in the
18 stores.

19 Q: All right. And you talked about the general
20 management and administrative support piece.
21 What role, if any, do the stores play in
22 those services?

23 A: You know, they don't really play a role,
24 other than to understand and execute out any
25 strategy, process, procedures that come out



1 ,of those teams. The stores, again, are
2 really responsible for executing those, those
3 policies and procedures. A great example
4 would be, I think I've mentioned CarMax sales
5 training. So, you know, we, we try to, you
6 know, make our sales people the best sales
7 people they can be and all of that training
8 is developed at CBS and then de- -- delivered
9 in a way to the store so that the stores can
10 actually get trained in those -- in those,
11 you know, new techniques or, you know,
12 whatever that might be.

13 Q: Can you describe what the advertising and
14 marketing services would involve?

15 A: Yeah. Advertising and marketing is, is
16 pretty broad. CBS kind of acts like a, an
17 in-house advertising agency. So, they would
18 do everything from market analytics. They
19 would -- they're responsible for all of our
20 media buying, all of our broadcast, all of
21 our commercials, all of our creative work.
22 They would do -- I can't remember if I said
23 market analytics, but market analytics,
24 customer insight surveying. That's pretty
25 much it. I may have forgotten a couple of



1 things. But they work with a lot of the
2 teams, really to understand, you know, in a
3 collaborative way, like where should we open
4 new stores, what are the -- what are the
5 analytics going to be, what is the data tell
6 us about, you know, the, the people that live
7 there and what they -- what they want.

8 Q: Do they have anything to do with the website?

9 A: Oh, they do. Thank you. They own and manage
10 the website and one really interesting fact
11 about our website is over -- approximately 90
12 percent of customers at -- so, this is during
13 fiscal '18. Approximately 90 percent of our
14 customers that come to visit the store have
15 actually gone to the website first. So,
16 it's, it's an awesome website. It's pretty
17 clear that it's the awesome website that
18 drives our customers to our stores, drives
19 the foot traffic to the stores.

20 Q: And what role do the stores play in the
21 advertising and marketing?

22 A: You know, not much. Again, like I've kind of
23 said before, you know, the stores are
24 responsible for, you know, executing out
25 whatever the strategy is. The stores



1 definitely have signage in their stores.
2 They're -- you know, any kind of marketing
3 materials, pamphlets, anything like that.
4 During a grand opening, they might have a
5 little bit more responsibility in terms of
6 kind of executing some of the activities that
7 we do, like the ribbon cuttings and, and
8 things like that around a grand opening.

9 Q: And what do the real estate services
10 performed by CBS involve?

11 A: Yeah. Real estate is, is a pretty involved
12 process. So, when you think about -- you
13 know, I mentioned 144 stores at the beginning
14 of the audit period and 188 after. So,
15 that's a lot of stores that we opened in
16 those three years. So, our real estate
17 department is responsible for pretty much
18 everything involved in site acquisition,
19 permitting, zoning. They go to zoning
20 hearings all the time. They're involved,
21 like I had mentioned, with the marketing team
22 and any kind of analytics that needed to be
23 done around the market, they would participate
24 in what we call expansion planning. So,
25 what's the strategy around how we would



1 expand or open new stores. So, our real
2 estate team is involved in that. And then
3 they also do the property management services
4 afterwards.

5 Q: Okay. And what role do the stores play in
6 the real estate services?

7 A: Nothing at all. Nothing at all. It's all
8 done by CBS.

9 Q: All right. And what are the analytical and
10 business development services?

11 A: Yeah. So, so this team, I, I called it kind
12 of our data science team. So, they're
13 responsible for, you know, producing a lot of
14 the, the business strategies. Like, how, how
15 can we -- how can we maintain and approved
16 our great margin, our great gross margin,
17 gross profit that I think was talked about,
18 maybe on day one or two. You know, they're,
19 they're responsible for coming up with a lot
20 of the strategies and, and informing our
21 executive leadership about, you know, what,
22 what is the -- you know, what is the data
23 telling them. How, how might we look at the
24 business. You know, both -- it's a
25 competitive business that we have to make



1 sure we're pricing cars the right way. We
2 have to make sure that we're purchasing cars
3 the right way. And they, they tend -- they
4 tend to focus their efforts in three areas.
5 So, they would focus on pricing inventory and
6 reconditioning. Pricing, I mean, a couple --
7 I, I mean pricing in two different ways.
8 Pricing could be how do we price the car on
9 the front lot for sale. What's the -- what's
10 the number on the sticker price? Or it might
11 be what price should we pay in the appraisal
12 lane or what price should we pay for a car at
13 an outside auction. So, that's what I mean
14 by pricing.

15 **THE COURT:** There was pricing, inventory and what
16 was the third?

17 A: Operations.

18 **THE COURT:** Oh.

19 A: Operations, internally that's what we refer to
20 as our service business. So, that would
21 encompass our reconditioning and then, also
22 our retail service business. So, anybody can
23 go in and get an oil change and a tire
24 rotation. That -- that's what we call our
25 retail service.



1 Q: And I think that leaves inventory. Tell us -
2 --

3 A: Okay.

4 Q: --- about inventory.

5 A: So, inventory; I've mentioned inventory is
6 really important to our stores. It's having
7 the right number of cars. It's having the
8 right mix of cars. You know, how many, you
9 know, four wheel drives do I need in Colorado
10 in the winter versus how many would I need in
11 Florida, right? It's a -- it's a different
12 number. These -- this team is responsible
13 for putting the right number of cars in the
14 right mix at each store. And then,
15 reconditioning, is really, you know, every
16 dollar that we spend to recondition a car,
17 goes into the cost of inventory of the car.
18 So, you have to know what the customers are
19 willing to pay for because that's going to
20 mean, you know, in order for us maintain our
21 margins, that's going to mean if I put a lot
22 of money into the reconditioning of the car,
23 I'm probably going to have to, you know, put
24 a sticker prices on the car that reflects all
25 of that, and I have to know that the



1 customers are going to pay for that. So, we
2 try to keep those costs -- we try to do the,
3 the right amount of work and that takes a lot
4 of analysis to understand what the right
5 amount of work is in the reconditioning area.

6 Q: So, did you hear Dr. DeRamus say something
7 about that everyone has good analytics today?

8 A: I did.

9 Q: What is your response to that?

10 A: I did. I don't agree with that, especially
11 for CarMax. I certainly can't say whether
12 that's true for other businesses or not.
13 What's really interesting about it though is
14 if you think about used cars, every single
15 used car is unique. They are not
16 commodities. They are not TVs. It doesn't
17 even matter if you have two red 2012 Camry
18 XLEs. They're still different cars. They're
19 going to have different mileages. There's
20 something that's going to be different about
21 those cars that makes them unique. So, when
22 you try to do data analysis on a non-
23 commodity or on individual, unique products, I
24 think it takes special skills to do that data
25 analysis. The tools might be the same, but



1 the way the tools are used and the way that
2 the data -- the way that the, the information
3 is gleaned from the data is going to be very
4 different for used cars.

5 Q: Do you think it would be possible for CarMax
6 to outsource that function?

7 A: No. No. They've tried and, and it just
8 doesn't work. It doesn't work. There's
9 always going to be things that you can
10 outsource, but this is not one of them.

11 Q: And how are the stores involved in any of the
12 strategies you described?

13 A: Yeah. The stores are involved in terms of --
14 I -- I've mentioned it before, but executing
15 the process and procedures. So, for example,
16 if -- you know, if there's a -- if there's an
17 algorithm that, you know, a system that the
18 stores are, are told to use, the stores are
19 responsible for, for following those processes
20 and procedures. You know, we go through a
21 lot of testing in this algorithms, so a store
22 might be in a test group, in a pilot. They
23 might be, again, just trying to go through
24 all their A/B testing to make sure that the
25 algorithm is going to work. So, a store



1 could be involved from that perspective, but
2 again, they're just executing out on the
3 procedures, collecting -- you know, helping
4 the data science team collect the data.

5 Q: All right. And you mentioned A/B testing.
6 Can you elaborate on what that is?

7 A: Yeah. I'm a -- I'm a tax person, so I would
8 describe A/B testing just as the constant
9 iteration of the testing of the theories, of
10 the algorithms, of whatever tool or program
11 they're using because that -- there's no
12 other way to know if it's working unless
13 you're constantly testing it and, and
14 evaluating the results of the -- of the
15 theory.

16 Q: And like, can you just give us an example of
17 how you might test one of your tools or
18 products?

19 A: Yeah. So, I think a great example, you know,
20 might be in the -- in the paint area. So,
21 reconditioning, so there are times -- you
22 know, we, we go through a, a reconditioning
23 process from start to finish. One of the
24 areas in the process is paint. So, sometimes
25 we would buy a car in the appraisal lane that



1 has a scratch in it. And we're pretty
2 confident that the customer -- a customer
3 would not want to buy that car with this
4 particular scratch in it. So, there's
5 different ways that we would go through and
6 we would say, well, do we have to paint every
7 scratch on every car or are there other ways
8 to determine whether or not you could fix the
9 scratch, so to speak, without painting the
10 entire panel of the car. When you paint a
11 piece of a panel, you have to pain the whole
12 panel so that the panel color stays
13 consistent. So, there's many scratches that
14 don't need to be painted. Maybe they just
15 need to be sanded or wet buffed, or actually,
16 it's probably wet sanded. I probably said
17 that a little bit incorrectly. Buffed out or
18 wet sanded. Or maybe they just need to be
19 touched up in such a way where the whole
20 panel doesn't have to be painted. But, so
21 again, the stores would -- if a -- if a test
22 is being done at that particular store, the
23 painter, the person, the painter in the
24 service area would, would be involved in that
25 testing, but the testing is actually being



1 done over and over, and over again. Does it
2 work? Does that wet sanding process actually
3 remove the scratch. So, it's that kind of
4 testing that I would -- that I would think
5 through is a -- is a pretty good example.

6 **THE COURT:** An example of what?

7 A: An example of the testing process.

8 **THE COURT:** Are you saying that they're not doing
9 that at every other car dealership practically
10 in America?

11 A: I don't know if they're doing it or not,
12 doing it at every other car dealership. But
13 what we found is that we were painting 60
14 percent of our cars. And that costs a lot of
15 money to paint these cars. And one of the
16 theories that we had was that we shouldn't be
17 painting 60 percent of our cars. So, how can
18 we go in and go to -- go to the stores and
19 understand the process by which the painter
20 is making a decision to paint the cars. And
21 what we found through all of this analysis
22 and testing is that 60 percent of our cars
23 absolutely did not need to be painted, but
24 there were other ways to remove the scratch
25 that did not involve painting the entire



1 panel of the car that had the scratch.

2 **THE COURT:** I guess what I was asking about, isn't
3 there an entire industry out there of people
4 that specialize in going and touching up
5 scratches at car dealerships?

6 A: You know, there might be. But in our stores,
7 in our process, we weren't doing it the right
8 way.

9 **THE COURT:** Oh, okay.

10 A: We were -- we were doing it in an incredibly
11 expensive, inefficient way. So, again, I
12 think that's a great point because, you know,
13 I would say well, should the service manager
14 have known not to paint so many cars? Well, I
15 don't know if they should have known or not,
16 but they didn't know because they were
17 painting all the cars.

18 **THE COURT:** Okay.

19 A: So, CBS came in and said, hey, guys, I don't
20 think we should be painting this many cars.
21 Let me understand what's happening in that
22 decision tree to paint that car.

23 Q: And so, you say decision tree, what exactly
24 is that?

25 A: Yeah. So, so in that -- and the terms I just



1 used, I would say that's just anybody's
2 individual way they make a decision to pain
3 the car or not paint the car. So, after we
4 went through this process, we actually created
5 -- I'm sorry. I said we. CBS created a new
6 decision tree for the stores to follow. I
7 call it -- we call it an easy guide in-house.
8 But it -- it's essentially a decision tree.
9 It was -- you know, if the scratch is only
10 surface level, you should try to sand it
11 first. And if that doesn't work, wet sand it
12 and, and that should take care of the
13 scratch. If the scratch is a little bit
14 deeper than that, try this other technique.
15 If the scratch is -- if you can see metal in
16 the scratch, you're going to paint the
17 scratch. And it goes through this decision
18 tree, this easy guide that every painter in
19 the service area can understand and execute.
20 And what we've found was that after rolling
21 that out to all of our stores, overnight, we
22 were saving \$150 a car just in that one
23 process.

24 Q: Let's talk about a couple -- I want to talk
25 about a couple of other strategies or systems



1 and what testing was done with them.

2 A: Okay.

3 Q: So, tell us about CarMax Book.

4 A: Yeah. So, CarMax Book is really fascinating.
5 If anybody's ever tried to, you know, wanted
6 to trade in a car and they've gone to Kelley
7 Blue Book to do that, that's, that's a tool.
8 We thought we could do it better. So, we
9 created CarMax Book to basically tell -- to,
10 to tell us how to maximize profits when we go
11 out to an auction to buy a car. So, again,
12 this, this is kind of a funny story that I
13 think most people at CarMax probably know.
14 Our CEO at the time that this was created had
15 grown up in the organization in the
16 merchandising area, so in the buyer's area.
17 So, he was a buyer. And he knew our business
18 front and back. And he, he never thought
19 that basically a computer could put a value
20 on a car better than a person could put a
21 value on a car. And I think the quote was,
22 over my dead body will a computer ever price
23 the cars. But the data science team
24 absolutely was saying, no, I know we can do
25 it better. So, they went through iteration



1 after iteration, after iteration to try to --
2 try to mimic and, and put the right purchase
3 price on the car, and again, it was through
4 that testing. It was constantly looking at
5 the test results, evaluating the data, putting
6 numbers on the data and the information. And
7 finally, convinced the CEO that the computer
8 could do it better than the people. And it
9 was -- it was through that testing that they
10 were able to come to that determination.

11 Q: So, can you tell us like when you say
12 testing, how did they test CarMax Book to
13 just -- to determine ---

14 A: Yeah.

15 Q: --- whether it was working?

16 A: Okay. So, they would go out -- so, they
17 would go to -- so we go to -- we go to
18 wholesale auctions all the time to buy cars,
19 as I mentioned. So, our one way is the
20 appraisal lane. Our second way is the
21 wholesale auctions. So, a person would go to
22 the auction with the, the, the tools, the,
23 the algorithm. They would take a handheld
24 with them. I think maybe they were using
25 iPads at the time. But either way, it's a



1 handheld that had all the information on it.
2 And independently, the, the person, the buyer,
3 would go -- would bid on the cars and, and
4 buy the cars, and then separately, the
5 algorithm would price those same exact cars
6 that the buyer was pricing. And then it
7 would go through a system of looking well,
8 okay, so we bought that -- ultimately, we
9 bought that car, the buyer bid on the car and
10 bought the car. But then how did that car do
11 later? Did it sell for what we thought it
12 would sell? Were we able to make the margin
13 on the car based on the buyer's price versus
14 the computer price? And throughout that
15 testing, that constant going out, using
16 different buyers, going to different auctions,
17 going to different regions to test it, just
18 to make sure there were no, you know,
19 regional inconsistencies, we found that the --
20 that the algorithm achieved the expected gross
21 margin more often than the person, the buyer.

22 Q: Was there any testing, as far as using it in
23 some stores and not in others?

24 A: Oh, yes. Absolutely. So, again, I, I can
25 elaborate on that a little bit. So, I kind



1 of mentioned like it would follow a buyer to
2 an auction. But yeah. So, that's what would
3 happen. It would -- and when I say one
4 buyer, I mean, it was following 100 buyers at
5 a 100 different, you know, times. Because
6 again, auctions happen all the time. This
7 was happening over the course of time where
8 it could follow multiple buyers at multiple
9 auctions in multiple regions, all over the
10 United States where there's, you know, car
11 auctions. So, it -- it's that -- it ex- --
12 and I mentioned it is one person, but it's
13 the exponential number of times, right, that
14 this testing was happening, that this person
15 versus computer testing was happening.

16 Q: All right. So, in, in talking about how, can
17 you just tell us, is there any sort of
18 process overall as far as tracking what value
19 certain systems or strategies have? Do you
20 have a department that has ---

21 A: Yeah. So, so my data science team, you know,
22 really is responsible for doing that. And
23 then, you know, it -- it's, it's one thing to
24 say they can do it, they can write the
25 algorithms, they can test it, they can



1 quantify the results. But they're not the
2 ones that make the, the ultimate business
3 decisions in terms of, you know, what, what
4 should our gross profit level be. So, they
5 would take all this analysis that they do,
6 all these results, all this, you know, what I
7 call like proving that the algorithm works.
8 And they meet regularly with our executive
9 leadership team to talk about all these
10 different strategies. How are each of them
11 still performing? Do we need to make tweaks
12 to them? What if we made tweaks to them?
13 How does it -- how does it -- how do we make
14 business decision at the executive leadership
15 level based on the information that's coming
16 from the data science team? You know, in my
17 -- in my paint example, I said we, we were
18 able to save \$150 a car. So, then what do
19 you do with that \$150 a car? Do you take it
20 to margin? Do you just -- do you just say
21 great, we found a way to reduce the
22 reconditioning costs we're putting into the
23 car? So, do we just take it as additional
24 margin? Or do we actually lower the price of
25 the car for the customer? Because we're in a



1 really competitive business. So, whether a
2 customer wants to shop at CarMax and buy a
3 car or shop at the dealership across the
4 street, we have to make sure our offers are
5 competitive. So, we may decide, executive
6 leadership may decide based on the data from
7 the data science team, that they're going to
8 take that \$150 and give it back to the
9 customer through a reduced sticker price.

10 Q: And I want to ask about a couple of other of
11 the strategies or systems. Can you tell us
12 what ASRP is?

13 A: Yeah. ASRP is -- so, it -- think about it
14 like MRSP. It's the sticker price. So, it's
15 our front lot pricing tool. So, this is a --
16 it prices over 90 percent of our front lot
17 cars and it basically says, this is what this
18 car should be priced at, this is what the
19 customer should pay for the car.

20 Q: And what about ACR?

21 A: ACR is appraisal cost recovery. What that
22 does is it tells us -- it sets the prices in
23 the appraisal lane for what we should offer
24 the customer for their car to meet our gross
25 profit targets. And the, the interesting



1 thing about ACR, I think we're on -- or maybe
2 it was ASRP. I think we're on like our ninth
3 or tenth algorithm, our version of that. So,
4 again, these, these, these strategies, these
5 tools go through constant tweaking and
6 iteration. And some of them might be just
7 tiny little tweaks that we find. The other
8 of them might be more substantial that, that
9 again, kind of have to go through that
10 testing process again to ensure that they
11 work. But these tools are really what drives
12 a significant part of the gross profit. I
13 think it was mentioned either day one or two,
14 you know, how healthy our gross profit
15 margins were. And this is why.

16 Q: So, the examples you've given us just now,
17 like how long have those been around?

18 A: Well, you know, some of them have been around
19 longer than others. ASRP has probably been
20 around the longest. I believe 2003-ish on
21 ASRP. But some of them are much newer.
22 CarMax Book, I -- rolled out around 2011, I
23 believe. And then at, at some point in
24 between, I, I don't know the exact dates, but
25 at some point in between, all the other ones



1 were tested and rolled out.

2 Q: Do any CarMax entities conduct any research
3 and development activities?

4 A: Yes. We actually do. So, we, we have a lot
5 of activities that we do at CBS that qualify
6 for federal and state research and development
7 credits. Most of the projects that qualify
8 are around our customer facing technology and
9 products. The website is a great example of
10 a project that has qualified for research and
11 development credits. And again, that's all
12 done at CBS and then if it -- many of the
13 customer facing credits actually roll out to
14 the stores too, because they're customer
15 facing. But they're all developed at CBS.
16 The search op- -- the search engine
17 optimization is another great example of a
18 product that qualified for research and
19 development credits. It -- it's -- it -- I'm
20 a tax person, again, so simply it's -- if you
21 type used cars into Google, CarMax comes up
22 as one of the -- it comes up as one of the
23 outputs. That's not the right word. And we
24 try to get it as high as we can in the -- in
25 the list.



1 Q: What did you think about Dr. DeRamus'
2 suggestion that the management fee should only
3 be charged out by CBS to recover its costs?

4 A: Yeah. I thought that was an interesting
5 concept or way to think about it. I didn't
6 think it was allowed to just do that, but it
7 got me curious enough that I kind of dug into
8 it a little bit to see what it would look
9 like if all we did was charge out the cost
10 instead of, you know, charging the markup
11 like we currently do. And the, the, results
12 were actually even more interesting. The
13 results were that, as I ran all of the
14 recalculated numbers through the, the form of
15 the South Carolina tax return, that that --
16 the tax due under that alterna- -- I, I call
17 it alternative method -- that alternative
18 method was still 50 percent lower than the
19 combined assessment issued by the Department.

20 Q: And how did you make that determination?

21 A: Yeah. So, I, I basically looked -- you know,
22 we, we have our -- you know, our general
23 ledger system allows us to sometimes look a
24 little bit deeper than the main financial
25 statements. So, you know, I had to -- I had



1 to understand, I had to go through and, and
2 look at what the difference was in CBS
3 between the two revenue streams. You know,
4 we've talked about CBS being both the
5 management services and the financing
6 services. But on the face of the profit and
7 loss statement, the P&L, CBS is CBS. But a
8 little bit deeper in to the general ledger,
9 you can actually calculate query through the
10 call centers to see -- to isolate the, the
11 management services line of business versus
12 the, the financing line of business. So, I
13 could see exactly what the net operating
14 profit was of the management services versus
15 the financing. And from that point, well, I,
16 I knew what my net profit was, so I knew what
17 my total income and my total expenses were.
18 So, essentially, I just passed through the
19 total expenses kind of as a management fee,
20 so to speak, and, and then just kind of went
21 through the South Carolina calculation. So,
22 I adjusted the, the management fee. I
23 adjusted the distributive share of CBS that
24 then would have been passed through. Again,
25 this is kind of all math at some point,



1 right? But I knew what the numbers were. I
2 cal- -- I, I adjusted the distributive share
3 that went from CBS. So, at that point, I was
4 only distributing the finance. I adjusted
5 the apportionment factor, you know, to remove
6 the appropriate numerator and denominator
7 items to, to remove that income. And then, I
8 just put it through the South Carolina
9 calculation. So, I got to apportionable
10 income multiplied by the tax rate.

11 Q: And how much of the management fee payment
12 per vehicle covers the cost of the services
13 provided by CBS?

14 A: Yeah. Over the -- over the three-year audit
15 period, the cost just to provide the services
16 for CBS was \$701 per car.

17 MS. GEER: Bobby. Can y'all tell me whether I'm on
18 Petitioner's Demonstrative Number 2 or 3?

19 MR. STREISEL: 3.

20 MS. GEER: 3? Thank you.

21 Q: All right.

22 MS. GEER: This is Petitioner's Demonstrative
23 Number 3.

24 (Petitioner's Demonstrative 3 was referenced at
25 this time.)



1 Q: Eileen, can you tell us what this document
2 is?

3 A: Yeah. This is basically, the results of
4 everything that I just said that I did. So,
5 this is just a summary of what we did. So,
6 you can see at the top, the South Carolina
7 tax return -- sorry. The South Carolina tax
8 due for both CarMax East and CarMax West for
9 each of the three years and then, total, at
10 the, at the far right. And then we compared
11 those recalculations to the assessment. So,
12 the, the forced combination assessment, again,
13 for each of the three years, and in total.
14 And then, we did the math, did the difference
15 between those two. And then, when we
16 compared, so for example, in 2016, the
17 combined unitary assessment additional tax
18 owed of \$425,524, that compared to East was a
19 68 percent -- the, the combined unitary
20 reporting assessment was 68 percent higher
21 than my recalculated numbers. And then, when
22 we looked at it from ---

23 **OBJECTION:**

24 **MR. ANTLEY:** Objection, Your Honor. I -- this is a
25 demonstrative that I, I don't think we have



1 the underlying calculations for. So, we're
2 not -- it's -- I think this is pursuant to
3 the Court's order about providing that, that
4 documentation prior. And, and ---

5 **THE COURT:** When was it provided, this -- has this
6 ever been provided to you?

7 **MR. ANTLEY:** If I could just confirm.

8 **MS. GEER:** All right. Yeah. We provided this
9 document to you guys beforehand.

10 **MR. ANTLEY:** But the calculations behind this.
11 That ---

12 **THE COURT:** When did you provide it? And y'all,
13 y'all ---

14 **MS. GEER:** We provided this document on the noon by
15 Friday deadline.

16 **THE COURT:** Okay.

17 **MR. ANTLEY:** And, and this would be a -- this is a
18 summary of voluminous material?

19 **THE COURT:** But that was -- the purpose of the
20 deadline wasn't it to provide it to provide
21 it by that deadline, so you could -- I
22 remember there were two different deadlines.
23 One was for exhibits and one was for the
24 voluminous documents.

25 **MR. ANTLEY:** Your Honor, the issue is this is data



1 from the general le- -- ledger, which we do
2 not have.

3 **THE COURT:** Oh, okay. Can you respond to that? In
4 other words, you can't summarize documents if
5 it's -- if they don't -- if you haven't even
6 provided it to them.

7 **MS. GEER:** So, I'm not trying to give this into
8 evidence right now. It's a demonstrative and
9 she is providing through her oral testimony
10 the basis of the numbers.

11 **THE COURT:** Well, I would object to her testimony
12 as far as that goes. I think it's what
13 you're doing.

14 **MR. ANTLEY:** Yes, Your Honor.

15 **THE COURT:** Okay. At this point, I sustain the
16 objection until I ...

17 Q: All right. So, let's move to the financing.

18 A: I believe that there actually was some of
19 that data provided, if I could maybe
20 elaborate a little bit.

21 Q: Sure.

22 A: When I mentioned that I had to go to query,
23 the general ledger, to get the breakout, I
24 believe that that was already talked about
25 during prior testimony. It's what I would



1 call the CAF versus non-CAF P&L. So ---

2 Q: So, so were your calculations, did they all
3 flow from -- where did they all flow from?

4 A: (Answer was stricken from the testimony.)

5 **OBJECTION:**

6 **MR. ANTLEY:** Objection, Your Honor. She's giving
7 opinion testimony. She's not an expert.

8 **THE COURT:** All right. Well, number one, I'll --
9 if that -- that little small snippet, I'll
10 sustain that and strike that. My struggle
11 is, in the, the record wouldn't reflect this,
12 but when she said I believe, and there was an
13 inflection that indicated even more of a
14 question. I can't go on whether data was
15 sub- -- provided based on somebody saying
16 well, I believe, I'm not sure, but I believe.
17 I, I need a little bit more than that.

18 **MS. GEER:** Your Honor, at this time, I'll move on
19 and then if I ---

20 **THE COURT:** You can co- -- I'll allow you to come
21 back to it.

22 **MS. GEER:** Okay. Thank you.

23 Q: All right. Financing.

24 A: Okay.

25 Q: Can you give us a general description of the



1 financing services provided by CAF?

2 A: Yeah. So, so CAF is a, captive in- --
3 captive finance company. It's CBS
4 essentially. What they do is they provide
5 car loans to CarMax customers. You know, I -
6 - it might be helpful to kind of walk through
7 an example of ---

8 Q: Sure.

9 A: --- when a customer comes into a store to
10 finance a car. So, I had mentioned
11 previously that approximately 90 percent of
12 customers visit the website first before they
13 come to the store. So, let's just assume
14 that the customer did that and they picked
15 out their car just for sake of ease of the
16 example. So, when the -- when the customer
17 is ready to actually purchase the car, you
18 know, they need to indicate somehow to the
19 sales consultant how they're planning to pay
20 for the car, whether they're going to pay
21 cash, whether they need financing. And, of
22 course, many customers need financing to buy
23 the car. So, the, the sales consultant would
24 assist the customer in filling out their
25 credit application. And then that credit



1 application, I, I think of it as the, the
2 sales consultant pushes a button to send the
3 credit application electronically to the
4 finance companies. So, the finance
5 application would go to CAF and other finance
6 company providers to make a decision on
7 whether or not, you know, the customer,
8 customer is eligible for financing, you know,
9 what their rates might be, what their terms
10 might be, so to speak. So, when the decision
11 -- when the financing decision comes back, it
12 comes back to the sales consultant screen.
13 And I mentioned before, the sales consultant's
14 job is just to show the customer their
15 financing options. And then, the customer
16 gets to choose what they want to do. So they
17 could be approved for a 60-month loan at 6
18 percent, which equates to a certain, you
19 know, monthly payment. There could be other
20 terms. There could be a 48-month term.
21 There could be a 72-month term. And, the,
22 the cust- -- the customer gets to pick
23 whatever offers come back to them. So, once
24 they pick their offer. So, in this example,
25 let's say they pick the CAF offer, the



1 customer -- the sales consultant would
2 continue the paperwork process with a
3 customer, including getting all of the
4 paperwork signed, all of the financing
5 documents signed, just like all of the other
6 car sale paperwork, the buyer's order we call
7 it. And then, financing paperwork, we call a
8 retail installment contract. So, all that
9 paperwork would be signed by the customer,
10 and then the customer is super happy. They
11 get their picture taken with the yellow bow
12 on their car and they kind of go on their
13 way. In the meantime, the finance contract,
14 and this is true whether it's CAF of any
15 other finance company, that retail installment
16 contract is then assigned from the store to
17 the finance company. The store isn't the one
18 that holds the loan at the end of the day, so
19 they need to -- they need to assign that
20 retail installment contract, which effectuates
21 the loan with the finance company. So, then
22 CAF -- in this case, I said the customer
23 selected CAF, so CAF actually gets that
24 retail installment contract and that turns
25 into the customer's loan. But I kind of



1 glossed over a little bit of the, the sale
2 consultant pushes the button to send the
3 credit application, right? But -- so, what
4 happens behind the scenes there is -- again,
5 I'll just use CAF as the example. At CAF,
6 it's the CAF team that decides whether the
7 customer is -- you know, the, the credit
8 worthiness of the customer. Should the
9 customer get a 60-month term of the loan, a
10 48-month term, a 72-month term, what is the
11 interest rates based on the customer's credit
12 score, etcetera. All that's decided at CAF
13 and then shows up in to the offer that shows
14 up on the sales consultants -- the sales
15 consultants screen. But all, all that work
16 to determine the loan is done at CAF.

17 Q: Okay. Do you have finance managers in the
18 retail stores?

19 A: We do not. It's all very transparent.
20 Literally, the sales consultant sends it, they
21 have no input into the credit decision, and
22 the credit decisions come back directly form
23 the finance companies.

24 Q: And who decides what the loan terms will be
25 that are offered?



1 A: The finance companies do.

2 Q: And then what happens with the loan after
3 it's entered and assigned to CBS?

4 A: Yeah. So, CAF services all of their loans.
5 So, the customer gets like a welcome to CAF
6 email. You know, I, I don't know that
7 they're literally doing payment books anymore
8 like they used to do, where you would rip out
9 your payment from the book and send your
10 check. I think it's all done electronically
11 now. But it's essentially the same thing.
12 So, the customer would get their monthly,
13 their monthly statement from CAF. All
14 payments go to CAF. CAF services the loan.
15 So, if the customer has a question about
16 their loan, they call CAF. And, and what I
17 mean when I say that is there's a big call
18 center down in Georgia that houses all of
19 these CAF employees. So, when I say the
20 customer calls CAF, the customer is calling
21 the CAF call center where they have customer
22 representatives to answer the phones. So, if
23 they have a question about their loan, they
24 would call. If the customer misses a
25 payment, they would most likely get a



1 collection call, again, from the associates in
2 the call center. If they have -- if they
3 make their payment late and they have a late
4 fee, they might want to call the call center
5 to ask for their late fee to be waived. So,
6 a typical call center.

7 Q: What is the typical life of these loans?

8 A: You know, I've mentioned a couple of various
9 terms. I would say the typical life is 60
10 months. So, five years. I think that's a
11 fairly typical auto loan.

12 Q: And about how many associates at the end of
13 the audit period were in CAF?

14 A: I think there's about 500.

15 Q: All right. Is there anything else that
16 happens with these loans?

17 A: Well, well, yeah. So, again, you know, you
18 think about one customer, the way I've
19 described it because it's happening all over.
20 So, these loans get accumulated over time
21 and, you know, CAF is, is sort of designed to
22 be self-funding. So, they will ultimately
23 scrutinize the loans. So, they would
24 accumulate all of these individual loans until
25 they reach a certain kind of saturation



1 point. We typically during the audit period,
2 I believe waited until we were around 750
3 million dollars in these accumulated loans
4 before we, you know, sold them on the public
5 market in a public securitization deal. And
6 during the audit period, we did four of those
7 deals per year. So, about one a quarter.
8 But the -- but CAF still services those
9 loans. So, even after those loans go through
10 the securitization process, CAF is still the
11 servicer of the loans. So, the customers
12 still call CAF. The customers don't care
13 whether their loans are assigned or
14 securitized. They still call CAF. Their
15 relationship is with CAF.

16 Q: What factors determine what income CBS
17 generates after a CAF loan is entered into
18 with a customer?

19 A: Yeah. I mean, when you really think about a
20 car loan or any other loan, it's the -- it's
21 the car payment. You know, it's the -- it's
22 the finance income, the, the interest income
23 on the loan that just generates the income
24 for the finance company. I mean, there --
25 there can definitely be some late fees, some



1 non-sufficient check fees, but the bulk of
2 the income is really just the interest income
3 off the -- off the loans.

4 Q: How does the quality of servicing a loan
5 factor in to, to income generation?

6 A: Well, I think the quality of the servicing,
7 you know, speaks a lot to the people in the
8 call center. You know, I think about -- when
9 I think of quality of servicing, I mean, like
10 how do we help customers if they're
11 struggling to make their car payments, right?
12 But ultimately, the income is generated
13 through the payment. So, if a customer is
14 struggling to make their payments, we want to
15 try to, you know, help them pay as much as
16 they can, even if they can't make their full
17 payment all at once. But, I mean, the income
18 is dependent on the customers paying their --
19 paying their loan payments.

20 Q: And what are the specific factors that would
21 help determine the amount of income that's
22 generated?

23 A: The specific factors to determine the amount
24 of income. Again, it's going to basically be
25 the interest rate. I, I think that would be



1 the bulk of it is the, the interest rate.

2 Q: What information did the Department request
3 from CarMax East regarding CAF during the
4 audit?

5 A: There was none.

6 Q: What information did they request from CarMax
7 East during the litigation about the CAF
8 function?

9 A: Again, there was -- there was none or very
10 little.

11 Q: Let's talk about the intercompany agreements.

12 A: Okay.

13 Q: Is there an intercompany agreement related to
14 management services?

15 A: Yes.

16 Q: And who, who is that agreement between?

17 A: It would be between CarMax Business Services and
18 the, the store entity. So, CarMax Auto
19 Superstores, Inc., CarMax Auto Superstores
20 West Coast, Inc., CarMax Auto Superstores
21 California, LLC, which we really haven't
22 talked about much. And then I do believe
23 that even those single member LLCs that I did
24 mention in the corporate organizational chart,
25 I believe they're all parties to it because



1 they sell cars.

2 Q: Is there a licensing agreement?

3 A: There is.

4 Q: And who is that between?

5 A: That would be between the same parties, CBS
6 and all the operating entities.

7 Q: And what activities are performed related to
8 the IP and which entity does them?

9 A: Yes. So, C- -- so, CBS, CBS performs all the
10 activities. CBS is the owner of the
11 trademarks and trade names. So, they would,
12 you know, monitor. They would send cease and
13 desist letters. If we are looking to apply
14 for apply for a patent, CBS would do all of
15 that patent application work. So, all of
16 that work is done at CBS.

17 Q: Does CBS every hire third parties to assist
18 them?

19 A: Yes. Yes. They do, if needed.

20 Q: All right. Let's talk about transfer
21 pricing. What does CBS charge the stores for
22 the management services provided?

23 A: So, in the first year of the audit it was
24 \$1,107. And then, in the second two years of
25 the audit it was \$1,192. And that's per car.



1 So, it's invoiced at a per car rate.

2 Q: And how did CarMax determine the amount --
3 that amount?

4 A: Well, we would go through a process, you
5 know, at, at budget time. You know, we, we
6 talked about some of our transactions
7 previously that some are a percent of sales.
8 Some are a cost plus. So, there's, there's
9 information that we need to know every year
10 to do that. So, we need to know what we
11 think the sales is going to be for the year,
12 the budgeted sales. We need to know how many
13 cars or units we think we're going to sell in
14 order to do that calculation as well. And
15 then, we need the, the department budgets in
16 order to that cost plus markup.

17 Q: And does CarMax use transfer pricing studies?

18 A: We do. Yes. We use transfer pricing
19 studies. We do them every three years.

20 Q: Who performed the transfer pricing studies
21 during the audit period?

22 A: Ernst and Young.

23 Q: And so, you, you mentioned the per vehicle
24 charge. How is that charge paid?

25 A: So, we have a process at CBS where we



1 actually invoice every month for the, the
2 management fee. We do it initially on a
3 budget perspective and then we true it up to
4 actuals. So, we, we do the formal invoice
5 process and then we actually settle the
6 invoices in cash. So, we actually do wire
7 transfers to pay the, the stores, the
8 operating entities that are being charged, the
9 wire transfers of cash to pay for the
10 invoices.

11 Q: And I apologize if -- if I've already asked
12 you this or if you already said it. How
13 often are true-ups done?

14 A: The true-ups are done monthly.

15 Q: Okay. Did you have any involvement in the
16 transfer pricing studies that are at issue?

17 A: Yes.

18 Q: How?

19 A: Yeah. So, again, my team and I participated
20 in the studies. You know, the, the 2012
21 study was a little bit more I would say
22 involved than the 2015 study. Typically, so
23 we do transfer pricing studies every three
24 years. Typically, every other transfer
25 pricing study is a little bit more involved,



1 unless there's been a change in the business.
2 So, the 2012 study was one of the more
3 involved studies where there were a
4 significant amount of interviews done of our
5 -- at least vice president level business
6 unit leaders, you know, just to make sure
7 that the we were hearing everything that was
8 going on that would inform some of, you
9 know, the information in the transfer pricing
10 study. But a team and I are involved. You
11 know, sometimes it's just making sure that,
12 you know, people are showing up for their
13 interviews. And other times, it's gathering
14 financial information and things like that.
15 But in 2013, it was definitely a more
16 involved process and I personally sat in on
17 the interviews.

18 Q: What types of people were being interviewed?

19 A: Yeah. So, like our VP of strategy, our VP of
20 marketing, VP -- I think we interviewed our
21 CFO, our cer- -- Chief Financial Officer. I
22 think our -- maybe our Chief Operating
23 Officer, but I don't know if that was his
24 title at the time, so our, our VP of
25 merchandising. So, really covering all of



1 the areas of the business.

2 Q: So, I put Joint Exhibit 37 up on the screen.

3 **(Joint Exhibit 37 was referenced at this time.)**

4 Q: Can you tell us what this is?

5 A: Yeah. This, this is essentially the
6 calculation that my team would go through to
7 get that per car charge that I mentioned. Do
8 you want me to walk ---

9 Q: Yes.

10 A: --- through some of it?

11 Q: Please.

12 A: Okay. So, so at the top, like I mentioned,
13 the -- we have the different transactions.
14 We've heard some information about those.
15 Some of the -- some of the transactions are
16 done, like I said, on a percent of sales
17 basis. Some of them are done on a, on a cost
18 plus basis. So, we need know what those
19 values are. So, if we start up sort of
20 towards the kind of middle top left, we can
21 see that projected sales column. So, that 13
22 billion number, 13,054,475,597, that is our
23 budgeted sales for the year. And I would get
24 that from my financial planning and analysis
25 department. That number is just created as



1 part of our annual budget process. So,
2 again, I would use those numbers to do the
3 percent of sales calculations, like at the
4 top. In the -- in kind of the middle, the,
5 the analytical and business development
6 services fee -- oh, I'm sorry. And, and on
7 the far right, you can see the transaction
8 ranges that are there. So, I don't want to
9 skip over that. So, there's, there's a range
10 that's provided in the transfer pricing study.
11 Typically, we take the low or the median of
12 that range. So, in this case, in the
13 advertising and marketing for example, the
14 range was 2 percent to 4 percent with the
15 median at 2 percent. And we used 2 percent.
16 And then, it's, it's math to get to the, the
17 projected charge after markup. So, it's the
18 sales times the 2 percent would be that 261
19 million dollar number. And then, if you look
20 down at the bottom left, it says the project
21 -- fiscal '16 projected units to be sold.
22 So, that's the number of cars we expect to
23 sell. So, then we convert that 261 million
24 dollars into a per car charge. So, each of
25 the percents of sales are done the same way.



1 The value added services, that's where we
2 have the range there you can see of \$396.50
3 to \$475.80. We picked four -- in this
4 example, we picked \$413. So, that didn't
5 need to be converted to a per car charge
6 because it's already per car. So, that math
7 is the math. And then, the general support
8 services are done at cost plus. So, so we
9 would look at department budgets, again, that
10 are all provided to us through the annual
11 budget process. And then we would look at
12 the -- and use the markup. So, as you can
13 see, we've got a little bit of a mixture in
14 here of these six lines. Five of the lines
15 are transaction two with the same range and
16 median. And then the real estate services
17 has a transaction four, it's a little bit of
18 a different range with a different median, so
19 we used that median. And then, we just turn
20 -- again, we turned those numbers into per
21 car charges and then added them all up, and
22 they come to that \$1,107.

23 Q: And is there any review done to make sure
24 that the -- this -- is the price reviewed
25 periodically?



1 A: We review it every year. And when you think
2 about it, you kind of have to review it every
3 year because every year the projected sales
4 would change, the projected units would
5 change. Even if nothing else changes about
6 the, the ranges because, you know, in this
7 case, we were in the third year of the
8 transfer pricing study. So the ranges aren't
9 going to change, but the dollars associated
10 with the calculation would change. So, you
11 have to go through this analysis every year.

12 Q: And I think you may have said this in earlier
13 testimony, but I'm not sure you talked about
14 in here, so I just want to make sure we're
15 clear. How do you come up with the projected
16 units to be sold and the projected cost that
17 would be incurred ---

18 A: Yeah. It all comes through our annual budget
19 process. And when I say our, I mean CBS. I
20 don't mean the tax department.

21 Q: All right. What was the per vehicle invoice
22 rate for 2017 and 2018?

23 A: It was 1,192.

24 Q: And ---

25 A: So, we'd go -- we'd go through the exact same



1 process. You can see here that the projected
2 sales number ---

3 **THE COURT:** What was the previous year?

4 A: 1,107.

5 **THE COURT:** Okay.

6 A: You can see here in the 2017 calculation that
7 the -- both the projected sales and the
8 projected units to be sold have changed.
9 Again, new, new year, new budget. But the,
10 the calculation is done essentially the same
11 way. We -- now, this, this one I said the
12 fiscal '16 was the third year of that
13 transfer pricing study. That was the 2012
14 transfer pricing study. So again, these two
15 years, the fiscal '17 and '18 are the new
16 transfer pricing study. So, the fiscal fi- -
17 - the 2015 transfer pricing study. So, the,
18 the ranges may have moved and the medians may
19 have moved, but these are all according to
20 the new transfer pricing study. And then for
21 2018, again, same thing. There would -- new
22 year, new budget. We have the new projected
23 sales and the new projected units to be sold.
24 And then, we'd go through the same analysis.
25 And even though the per car charge is the



1 same as it was in fiscal '17, we still go
2 through the, the review of it. And one of
3 the things that we do for administrative ease
4 frankly is if, if when go through the
5 calculation, it gets really close. Like
6 let's say in this example, we had done the
7 calculation, and the per car total was 1195
8 instead of 1192, well, for administrative
9 ease, for my invoicing department who does
10 all the, it's a lot easier for them if the
11 rate doesn't change so that they can keep
12 that process with that per car charge in
13 there. And as long as a different number,
14 for example, is picked. As long as it's
15 within the range, we would do that. I mean,
16 why make it more difficult for the invoicers
17 than it needs to be, right? So, there may be
18 a little bit of an adjustment here in some of
19 the rates. Like, for example, in this
20 particular year, in fiscal '18, you can see
21 that instead of on the first line, on the
22 advertising and marketing services line, you
23 can see that I used 2.08 percent instead of
24 2.0 percent because in my example, I needed
25 three more dollars. Well, I, I probably went



1 the other way with that example. But it's
2 math. I would adjust one of these rates to
3 bring me down from 1,195 to 1,192. I
4 probably should have said the example the
5 other way around. I was at 1,189, and I
6 needed \$3 the other way. But essentially,
7 that's the thing. The most important thing
8 is that they're still within the ranges of
9 the transfer pricing study.

10 **MS. GEER:** Your Honor, would this be -- I'm at a
11 good stopping for a break. Could we have
12 five minutes?

13 **THE COURT:** All right. How, how much longer for
14 this witness?

15 **MS. GEER:** I'm about two-thirds through.

16 **THE COURT:** Okay. Well, let's just take a five-
17 minute break.

18 **(Off the record from 10:54 a.m. to 11:04 a.m.)**

19 Q: All right. I've put on the screen Joint
20 Exhibit 81.

21 **(Joint Exhibit 81 was referenced at this time.)**

22 Q: Are you familiar with this, Eileen?

23 A: Yes.

24 Q: And what is it?

25 A: I call it the CAF versus non-CAF P&L.



1 Essentially, what is it is I had -- I had
2 mentioned before that in our -- in our
3 typical profit and loss statement, we look at
4 CBS as just one legal entity, but the reality
5 is it has the two different business
6 activities in it. So, this is the, the
7 output for lack of a better word, of how I
8 separated each of the lines of this profit
9 and loss statement into the two different
10 business activities.

11 Q: And what did you use this for?

12 A: I used it to do that recalculation of the
13 South Carolina tax liability if I had removed
14 all of the markup of the management fee. So,
15 this is -- this is what I used to say, well,
16 what if I only passed through the cost of CBS
17 instead of the marked up per unit charge.
18 This is the information I used to do that.
19 Everything else, other than this was literally
20 just knowing the South Carolina tax return.

21 Q: So, what exact number did it allow you to
22 determine?

23 A: If, if you scroll all the way down, it
24 allowed me to determine the net operating the
25 profit of each the two business activities.



1 So, for example, the, the last line on this,
2 on this spreadsheet shows -- so, CBS, LLC,
3 the total company is in column D and then in
4 Column F, HQ I used to represent the
5 corporate management services. And you can
6 see the last line says pre-tax net operating
7 profit or loss. And there's a -- the
8 parentheses in this case are profit. There's
9 a net profit of \$239,000,555 -- \$555,730.
10 So, that's the net operating profit of the
11 management services line of business in CBS.

12 Q: And how would you use these or how would the
13 -- would, would these be used at all to -- do
14 they relate at all to the cost per vehicle?

15 A: Yes. So, so then what I did is, again, and,
16 and it's all in this profit and loss
17 statement. This is the net operating profit.
18 I had to know what the income was, which is
19 just on a separate line. It's just up
20 towards the beginning of the income statement.
21 So, if that's my net operating profit, if I
22 take that and net it against my income, I
23 know what my total expenses are. It -- it's
24 just math using the exact numbers in this
25 spreadsheet. And then, I took that cost and



1 divided it -- well, I did it for -- my \$701
2 that I said was all three years on average,
3 so for this one particular year, I would have
4 used that cost that I would get by taking it
5 out of net operating profit and adding back
6 the income or subtracting out the income,
7 whichever you want to think about it, and
8 dividing it by the number of cars that sold
9 that year.

10 Q: And earlier, you were discussing the ASRP.

11 A: Uh-huh.

12 Q: What is the version that you're currently
13 using the same version as when it was
14 created?

15 A: Oh, no. No. We're -- I said we're on like
16 the ninth or tenth algorithm of that. So,
17 there's, there's definitely been changes from
18 version one.

19 Q: All right. I'm going to talk to you about
20 the tax returns, your area. All right. So,
21 let's look -- let's talk about South Carolina
22 tax returns from CarMax East. Can you
23 explain for us generally how these returns
24 were prepared?

25 A: Yeah. So generally, we would look at our



1 federal pro forma 1120, and that's the
2 starting point of the South Carolina corporate
3 tax return. So, the federal taxable income
4 goes on Line 1 of the South Carolina return.
5 And then, we would do South Carolina
6 adjustments. For CarMax, a couple of
7 examples there would be depreciation. It's
8 not deductible like bonus depreciation that I
9 can take for federal purposes that the state
10 doesn't allow or state income taxes that are
11 not deductible for state purposes. So, I
12 would make those adjustments, plus or minus.
13 And then I would come down to, I think it's
14 called apportionable income. States call it
15 different things. I think it's apportionable
16 income. And then I would multiply that
17 number by the apportionment factor to get to
18 South Carolina taxable income and then,
19 multiply by the tax rate to get to tax
20 liability.

21 Q: Okay. And how do you know how to file that
22 way?

23 A: Well, again, my, my team is responsible for
24 knowing, you know, how to file all of the
25 state tax returns. We ac- -- we use a



1 software as well, but my team is responsible
2 for knowing what the South Carolina and other
3 state's filing methods are. We look at
4 various resources. We would look at the
5 instructions of the tax return. We look to
6 see -- one of the first things we do is we
7 look to see like what's new in the
8 instructions just to make sure that we've
9 caught any legislative changes or rate changes
10 or anything like that. But, you know, my, my
11 team is responsible for, for knowing what the
12 -- what the filing methods are.

13 Q: And what is the filing method in South
14 Carolina?

15 A: It's separate state with a single factor
16 gross receipts formula. Separate filing with
17 a gross receipts formula.

18 Q: And are you allowed to file a combined return
19 in South Carolina?

20 A: I -- no. Huh-uh. No.

21 Q: Would it be po- ---

22 **OBJECTION:**

23 **MR. ANTLEY:** Objection, legal conclusion.

24 **THE COURT:** Are you allowed to find ---

25 **MS. GEER:** She, she is ---



1 A: There's ---

2 **MS. GEER:** --- the person that is decide -- I'm
3 sorry. Were you ---

4 **THE COURT:** I was stopping her. She was ---

5 **MS. GEER:** Oh.

6 **THE COURT:** --- about to speak.

7 **MS. GEER:** She is the person that is responsible
8 for deciding how to file things and I'm just
9 asking her how -- what she knows about what
10 she needs to do.

11 **THE COURT:** I'll just -- how about to your
12 knowledge.

13 **MS. GEER:** Okay.

14 Q: To your knowledge, could CarMax East file a
15 combined unitary return?

16 A: No.

17 Q: What about could it request to be allowed to
18 file one?

19 A: If I requested an alternative apportionment
20 method, I think the answer is yes. I don't
21 know any other way to request to do it.

22 Q: But you could -- could not just on your own
23 voluntarily do it?

24 A: No.

25 Q: Okay. All right. How did the process differ



1 for CarMax West to what you just described
2 for CarMax East?

3 A: It didn't -- it doesn't differ at all.

4 Q: Does CarMax East file using the combined
5 unitary reporting filing method in any states?

6 A: Yes.

7 Q: And can you just describe why -- what the
8 circumstances are for that?

9 A: Yeah. If the -- if the state has a law that
10 says we're supposed to file combined, we
11 would file combined in that state.

12 Q: Does CarMax East use the separate entity
13 filing method in many states besides South
14 Carolina?

15 A: Oh, yes. A lot.

16 Q: Do you have an approximate number?

17 A: I would say probably about 20.

18 Q: Has any other separate entity state besides
19 South Carolina involved an alternative
20 apportionment method and required you to file
21 on a combined basis?

22 A: No.

23 Q: After you filed the original returns for
24 CarMax East and CarMax West, what happened
25 next?



1 A: So, shortly after they were filed, we were
2 notified of audit by the South Carolina
3 Department of Revenue.

4 Q: And what happened next?

5 A: Oh, well, then we had -- we had the audit.
6 They sent us an initial audit letter through
7 all the processes and procedures, requested
8 some additional information, and then we set
9 a date for the auditors to come onsite and
10 actually do the audit at the CarMax corporate
11 headquarters.

12 Q: And were you involved in that process?

13 A: I was involved a little on the outside. So,
14 again, my, my team is involved in -- their
15 responsible for deciding the date, meeting the
16 auditor, fulfilling the information requests,
17 meeting with the auditors while they're
18 onsite, making sure that they answer any
19 questions that come up during the audit. I
20 typically don't -- I'm always involved behind
21 the scenes, but I typically don't get
22 involved in the actual field work of the
23 audit.

24 Q: And while the Department was onsite, did they
25 share their thoughts on potential assessment



1 or calculations?

2 A: Yes.

3 Q: And ---

4 A: Yes. They, they shared that they were going
5 to assess under a unitary combined reporting
6 method.

7 Q: And did they actually share their calculations
8 with you?

9 A: Yes. I don't recall if it was immediately
10 onsite or if it was shortly after, but yes.
11 They, they shared all the calculations with
12 us. They shared the entire report with us.

13 Q: And was there any back and forth on the
14 calculations?

15 A: There was. There were some things in there
16 that were just wrong. They had a company in
17 the group that didn't belong in the group.
18 There were some apportionment tweaks I think
19 that we needed to make and, and yeah, just
20 some mathematical calculations.

21 Q: Okay. And did those get resolved?

22 A: They did. Yeah. We -- again, just like the
23 Department, we wanted to make sure that it
24 was clear that we didn't agree with the
25 methodology, but we at least wanted to make



1 sure that the, the calculations that were
2 being presented in the audit report were, you
3 know, as correct as they could be.

4 Q: And so, understanding you made them -- you
5 just said that you made it clear that you
6 disagreed with the method, but did you at the
7 end of the day agree -- disagreeing with the
8 method, but agreed with the calculations?

9 A: I agreed with the math, yes.

10 Q: Has the Department audited any of the CarMax
11 entities prior to this audit?

12 A: Yes. We were audited for fiscal '02 through
13 '07. I'm sorry. Yeah. Fiscal '02 through
14 '07, and fiscal '13 through '15. And then
15 this was fiscal '16 to '18.

16 Q: Okay. And what was the end result of the
17 fiscal year of 2002 to 2007?

18 A: So, the, the culmination of that audit was
19 litigation for CarMax West. So, CarMax West
20 had been assessed on a separate reporting
21 alternative apportionment method and that
22 ended up in Supreme Court.

23 Q: Did, did you mean to say separate reporting?

24 A: I, I meant to say separate reporting. Yes.

25 Q: Okay. Well, what, what was the alternative



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1 method that they used?

2 A: The alternative method was actually separate -
3 - I think it was called separate reporting.
4 Not separate filing. So, in this case, to --
5 separate reporting is different than separate
6 filing in terms of the, the option of the
7 alternative apportionment that was invoked.
8 So, it was trying to look at CarMax West as
9 if it was not -- that if it did not include
10 any of their vehicle sales. So, it was a
11 separate reporting in terms of the specific
12 liens of business, not separate entity filing
13 in terms of the tax return.

14 Q: It is sometimes referred to as separate
15 accounting?

16 A: I be- -- yes. It believe it is.

17 Q: All right. I want -- what happened with the
18 fiscal '13 through '15 audit?

19 A: So again, we did not agree with the
20 assessment. So, we went through all ---

21 Q: Before you go there, what, what was the
22 assessment?

23 A: I'm sorry. The assessment was on a combined
24 reporting alternative apportionment
25 methodology. And we didn't agree. So, we



1 went through all the steps to file our
2 protest. And that essentially culminated in
3 an appeals hearing with the Department at
4 which after discussions, the hazards of
5 litigation were high on the Department and we
6 ended up having a much different settlement
7 methodology as a result of that.

8 **OBJECTION:**

9 **MR. ANTLEY:** Objection. She's going into
10 settlement discussions.

11 **THE COURT:** That's not permitted under the rules of
12 evidence except with the exceptions.

13 **MS. GEER:** I -- I'm fine to ---

14 **THE COURT:** Okay. Let's move on.

15 **MR. ANTLEY:** And, and the Department moves to
16 strike any testimony regarding settlement
17 discussions.

18 **MS. GEER:** I, I just ---

19 **THE COURT:** Did she make any? Did she give any?
20 Did she ---

21 **MR. ANTLEY:** If, if the record had contained any,
22 but.

23 **THE COURT:** It's in ---

24 **MS. GEER:** There were no details.

25 **THE COURT:** Yeah.



1 MR. ANTLEY: Okay.

2 THE COURT: She started off with the ---

3 MR. ANTLEY: Perfect. Thank you.

4 THE COURT: You're, you're spring went pretty
5 quick.

6 Q: Was that matter resolved short of litigation?

7 A: Yes.

8 Q: All right. Let's talk about the
9 reorganization. What was the initial business
10 structure of CarMax?

11 A: So, the initial structure, CarMax East --
12 sorry. CarMax, Inc. was still the parent
13 company. CarMax East and CarMax West were
14 owned directly by CarMax, Inc. And then we
15 still had some single number LLCs below that.

16 Q: And who owned the trademarks and trade names?

17 A: CarMax West owned all the trademarks and
18 trade names.

19 Q: Has CarMax East ever owned the trademarks and
20 trade names?

21 A: No.

22 Q: Where were the management and financing
23 operations?

24 A: They were in CarMax East.

25 Q: When did CarMax spin off from Circuit City?



1 A: In 2002.

2 Q: And how did the structure look after the
3 spinoff?

4 A: Yeah. Right after the spinoff, it was the
5 same. The only difference was that CarMax,
6 Inc. was no longer owned by Circuit City.
7 So, the spinoff made CarMax's own separate
8 company, I guess, to, to say it that way.
9 So, CarMax, Inc. became -- we all just became
10 separate from Circuit City. So, it was that
11 structure. CarMax, Inc. and then, CarMax
12 East and West owned directly by CarMax, Inc.,
13 and then all the substi- -- the single member
14 LLCs. But we kept that structure that was --
15 that was in place when we spun off. We kept
16 that structure for a couple years afterwards.

17 Q: And when did that change?

18 A: In 2004.

19 Q: And what prompted that change?

20 A: So, there were some business problems that we
21 were trying to solve. One being compliance
22 and regulatory types of issues. You know,
23 when I -- when I talked about my example of a
24 customer coming into finance the car and, you
25 know, selling a -- doing all their finance



1 paperwork, and then that retail installment
2 contract being assigned to the finance
3 company? Well, when the financing operations
4 were in CarMax East, what that assignment
5 contract looked like, it was CarMax Auto
6 Superstores, Inc. assigning the retail
7 installment contract to CarMax Auto
8 Superstores, Inc. And it caused a lot of
9 confusion with the regulators. So, that was
10 definitely something we wanted to solve.
11 And, and traditionally, dealership operations
12 and financing in the -- in the industry are
13 not typically in the same legal entity. So,
14 that was another related thing that we wanted
15 to try to solve. And then the second thing
16 is we wanted to pull all the corporate
17 management services out of one individual
18 legal entity and bring that up into an entity
19 that could support that for the entire group.

20 Q: All right. I want -- let's elaborate a
21 little on the regulatory issues. What are
22 the differences in regulations regarding car
23 sales versus financing?

24 A: Yeah. There -- there's really different
25 regulations. I, I don't know if I can go into



1 excruciating detail on it, but when you think
2 about a car dealership, both of those
3 industries are highly regulated. One of the
4 other things that I didn't mention when I was
5 talking about my team is we do a lot of the
6 store licensing process. And it's incredible
7 how many licenses a store actually needs in
8 order to operate and sell motor vehicles.
9 So, there's a dealer license, a business
10 license, an auction license, if they're
11 holding auctions at that store, all kinds of
12 service licences. In some states -- I don't
13 believe in South Carolina, but in some states
14 we have smog or emissions licenses that we
15 have to have. It's a pretty extensive
16 process. Well, those regulations are totally
17 different for a finance company than they are
18 for an automotive dealership. And both of
19 those lines of business are actually regulated
20 by different regulators. I don't recall when
21 the CFPB, the Consumer Financial Protection
22 Board came into existence. I don't remember
23 if it was during the audit period or not, but
24 that is a whole separate set of regulations
25 that finance companies have to abide by that



1 really don't have anything to do with a motor
2 vehicle dealer. But yet, if, if one
3 regulatory agency came into audit one piece
4 of business, the whole business was opened
5 then to be ---

6 **OBJECTION:**

7 **MR. ANTLEY:** Objection, Your Honor. She's talking
8 about regulations. She's -- in different
9 states. I mean she's the tax director, but
10 she's, she's outside of her knowledge.

11 **THE COURT:** Well, it's -- I -- is it relevant?

12 **MS. GEER:** Well, I mean, it -- it's, it's relevant
13 to the, the business purpose for why the
14 restructure happened. What, what were the
15 regulatory issues that they were facing and
16 why did they need to restructure.

17 **THE COURT:** Well, she can generally -- she's
18 generally set, set that forth. I don't think
19 we need to go into specifics.

20 **MS. GEER:** That's fair, Your Honor.

21 Q: So, the issue of having finance operations
22 and car sales operations in the same entity,
23 is this something that's unique to CarMax?

24 A: It was unique to CarMax having them in the
25 same legal entity. The, the industry, what



1 we found, was -- did not have those. And if
2 you can think about like General Motors and
3 GMAC, their credit arm, they're not in the
4 same legal entity. So, we wanted to get
5 ourselves into a structure that was a little
6 bit more typical to the industry.

7 Q: All right. So, you've talked about some of
8 the concerns and the goals. How did CarMax
9 decide how to address these concerns and
10 goals.

11 A: So, we had identified these business problems
12 and then we kind of had to figure how we
13 wanted to solve them. And we had -- you know,
14 we had relationships with -- at the time it
15 was probably a stronger relationships with
16 three of the big four accounting firms; so
17 Deloitte, KPMG, Price Waterhouse Coopers, and
18 Ernst and Young. KPMG was our auditor, so we
19 knew we didn't want to really address these
20 types of situations with them. We wanted to
21 keep them as independent as possible. And we
22 had, you know, stronger relationships with two
23 of the other three. So, we basically went to
24 them and said, hey, we've got these business
25 problems that we want to solve, can you help



1 us come up with a way to restructure
2 ourselves to solve these problems. So, they
3 did. So, they -- the firms came back and
4 they presented some of their findings to us
5 and said, hey, this is what we think, you
6 know, could be some ways to solve the
7 problems. And we ended up selecting Ernst
8 and Young to help us do that.

9 Q: So, you talked about some goals that
10 precipitated those ---

11 A: Uh-huh.

12 Q: --- conversations. During those
13 conversations, did any additional goals or
14 concerns come up?

15 A: Yeah. There were a couple that came up. One
16 specifically was limited liability. You know,
17 how do you -- how do you segregate yourself?
18 Are there areas of the organization that you
19 might want to put some different lines around
20 in order to strengthen your liability
21 protection. And then the second one -- and
22 in my deposition I kind of called this an
23 outcome. So, I -- I'd call it a secondary
24 goal of making sure that whatever structure
25 we put in place was tax efficient. Making



1 sure that we knew what it was going to look
2 like. And to be perfectly honest, I'd be
3 fired if I didn't in my role. So, I had to
4 know what it was going to look like from a
5 tax perspective no matter what we did. So
6 that became, I guess, the secondary -- a
7 secondary goal is to make sure we understood
8 and, and frankly, made it as tax efficient as
9 possible. And one of the outcomes of the
10 legal liability was if, if -- we didn't
11 really talk about it, but on the
12 organizational chart there was a triangle
13 underneath CarMax Auto Superstores West Coast
14 that was titled CarMax Auto Superstores
15 California, LLC. So what we did is we, we
16 pulled all of our California stores out of
17 the CarMax West Coast legal entity and just
18 dropped them below in a single member LLC.
19 And that was purely for legal liability
20 purposes.

21 Q: Had CarMax entities been sued prior to the
22 restructure?

23 A: Yes.

24 Q: What about after?

25 A: Yes.



1 Q: All right. So, what structure did E&Y
2 recommend? Well, first of all, did -- were
3 there different structures considered?

4 A: There were a lot of different structures
5 considered and, you know, we went through a
6 lot of iterations on what it might look like.
7 And of course, it had to make -- it had to
8 make sense in, in terms of our business. So,
9 yeah. There were multiple structures that we
10 went through before we came up with a final
11 structure that was implemented.

12 Q: Okay. And, and what, what is the structure
13 that was implemented?

14 A: So, it, it was essentially the org chart that
15 we looked at earlier. So, it was CarMax,
16 Inc. still at the top, and then one part of
17 the restructure was CarMax West Coast being
18 part of CarMax East Coast. So, at the end of
19 the restructuring, CarMax East was the owner,
20 the parent company, of CarMax West. And
21 then, we created CarMax Business Services as
22 a -- as a multi-member LLC taxed as a
23 partnership. And created the CarMax Auto
24 Superstores California, LLC.

25 Q: What was the purpose of CarMax East in that



1 structure?

2 A: So, what we wanted to do ultimately was to
3 have the stores be in a structure, the
4 operating entities be in a structure where
5 their only operating and managing the stores.
6 So, CarMax, what was left in CarMax East at
7 the end of the restructuring was just the
8 stores. And what was left in CarMax West
9 after the restructuring was just the stores.

10 Q: And what was the purpose of CBS in that
11 structure?

12 A: Yeah. So, CBS was -- again, it was formed
13 to, to manage, you know, all of the corporate
14 management functions and the financing
15 functions. So, that's what their business
16 purpose was. That, that was what their
17 operations were at the end of the
18 restructuring. And of course, they held the
19 trademarks and trade names. They own the
20 trademarks and trade names.

21 Q: All right. And did each of the entities that
22 you've just mentioned perform the functions
23 that you just ment- -- mentioned after the
24 restructure and during the audit period?

25 A: Yes.



1 Q: And what are the ownership percentages of
2 CBS?

3 A: CarMax East owns 6 and a half percent of CBS,
4 and CarMax West owns 93 and a half percent of
5 CBS.

6 Q: And what were those percentages based on?

7 A: A valuation study that was done by Ernst and
8 Young.

9 Q: What did they each contribute?

10 A: So, CarMax East contributed the, the, the
11 corporate management services and the
12 financing, and CarMax West contributed the
13 intangible trademarks and trade names.

14 Q: And just for the rec- -- so the record is
15 clear, when you talked earlier about ASRP,
16 CarMax Book, ARS, who created all of those
17 tools that you discussed?

18 A: Yeah. ACR was the last one.

19 Q: I'm sorry. ACR.

20 A: That's okay.

21 Q: I wrote it down wrong.

22 A: CBS. CarMax Business Services did. Now,
23 ASRP, I believe was actually created prior to
24 2004, so that one would have been created by,
25 by CarMax East. But again, I, I don't know



1 how close before or after the restructuring.

2 Q: That's okay. What assets did CarMax East and
3 CarMax West contribute to CBS?

4 A: So, CarMax East contributed the financing
5 business and the corporate headquarters
6 functions. And CarMax West contributed the
7 intangible trademarks and trade names.

8 Q: And earlier you mentioned the ASRP, for
9 example, was on the ninth or tenth version.
10 Who is developing and testing that algorithm
11 to determine when and how to update it?

12 A: CBS, definitely.

13 **MS. GEER:** Those are all the questions we have.

14 **THE COURT:** All right.

15 **MS. YOST - CROSS-EXAMINATION BY MR. ANTLEY:**

16 Q: Good morning, Ms. Yost.

17 A: Good morning.

18 Q: The intercompany transactions reduced the
19 income of CarMax East, right?

20 A: Correct.

21 Q: CarMax East pays roughly 74.5 percent of the
22 management fees to CBS?

23 A: Yes.

24 Q: CarMax East's distributive share of the income
25 from CBS is 6.5 percent?



1 A: Yes.

2 Q: CarMax West pays roughly 25.5 percent of the
3 management fees to CBS?

4 A: Yes.

5 Q: CarMax West's distributive share income from
6 CBS is 93.5 percent?

7 A: Yes.

8 Q: In the pre- -- previous trial, CarMax trial,
9 CarMax presented testimony that CarMax West
10 and CBS were unitary?

11 A: Correct.

12 Q: CarMax's organiza- -- organizational structure
13 has not changed materially since the previous
14 trial?

15 A: That's true.

16 Q: CarMax, Inc. owns 100 percent of CarMax East?

17 A: Yes.

18 Q: And CarMax East owns 100 percent of CarMax
19 West?

20 A: Yes.

21 Q: CarMax East and CarMax West operate in a
22 similar fa- -- fashion?

23 A: Generally.

24 Q: Okay. CBS provides a service to CarMax East
25 that it doesn't have the resources to provide



1 itself?

2 A: Yes.

3 Q: CarMax holds its inventory of vehicles
4 exclusively at retail stores?

5 A: Your previous question about whether or not
6 CarMax East has the resources. It could have
7 the resources if they wanted to pay somebody
8 else to do it, but they don't currently have
9 anyone on staff to do that work.

10 Q: Presently.

11 A: Presently.

12 Q: Is, is -- was my question.

13 A: Okay.

14 Q: It's -- so, is your -- is your answer that
15 they do not -- that CarMax East does not have
16 the resources to provide it -- I'm sorry.
17 Let me state that question again. So, CBS
18 provides a service to CarMax East that it
19 does not presently have the resources to
20 provide itself?

21 A: I would ask you to define resources.

22 Q: Okay. So, do you recall when I asked you in
23 your deposition if CBS adds business value to
24 CarMax East?

25 A: Does CBS add business value. Yes,



1 absolutely.

2 Q: Okay. Do you recall that, that, that your
3 response was that CBS provides a service to
4 CarMax East, that it doesn't, doesn't have
5 the resources to provide itself?

6 A: So, I probably did say that. The reason that
7 I asked now is resources could be defined
8 differently. So, they definitely don't have
9 the people. What I didn't want to not answer
10 your question appropriately was whether or not
11 they had the cash, for example, to go and get
12 that service elsewhere. So, as long as we're
13 saying the same thing, then the answer is
14 yes. They do not currently have the, the
15 people to provide those re--- those services
16 for themselves.

17 Q: CarMax will transfer a vehicle from a CarMax
18 West store to a CarMax East store at a
19 customer's request, right?

20 A: Yes.

21 Q: Okay. The customer can make that request
22 through CarMax.com?

23 A: I know they can today. I don't specifically
24 remember if they can during the audit period,
25 but I think they could.



1 Q: Okay. Could they make that same request at a
2 store in South Carolina?

3 A: Yes.

4 Q: No cash changes hands between CarMax East and
5 CarMax West to move that inventory?

6 A: Correct.

7 Q: CarMax East, CarMax West, and CBS comingle
8 their cash?

9 A: Yes. We have centralized cash management
10 function.

11 Q: And that centralized cash management function
12 is for CarMax East, West and CBS?

13 A: Yes.

14 Q: The, the CarMax group, so CarMax East, CarMax
15 West and CBS, have centralized management,
16 right?

17 A: CBS provides that.

18 Q: So, does -- so, are you saying that the group
19 does have centralized management?

20 A: I'm saying CBS provides centralized management
21 to East and West.

22 Q: Okay. And the entire CarMax group?

23 A: Yes.

24 Q: Okay. Okay. I think -- I think you were
25 asked some questions earlier about the



1 management service agreement and maybe a later
2 amended version. Keith Browning was
3 authorized to sign for CarMax East, CarMax
4 West and CarMax Auto Superstores Services,
5 Inc. Also, to we referred to them as CASS.
6 Is that correct?

7 A: So, I believe it is. But I'd want to see the
8 document to make sure that he was signing for
9 those entities that you said. But I believe
10 that that is the case.

11 Q: Stuart Heaton was authorized to sign for CBS?

12 A: Again, I would want to see the document to be
13 sure, but Stuart Heaton would have had the
14 authority to sign for CBS.

15 **MR. ANTLEY:** Okay. If you could pull up Joint
16 Exhibit -- Joint Exhibit 34. Okay. And if
17 you could scroll to the signature portion.
18 Okay.

19 **(Joint Exhibit 34 was referenced at this time.)**

20 Q: So, I'll, I'll say the question again, so not
21 -- since you have the document now. Keith
22 Browning was authorized to sign for CarMax
23 East, CarMax West, and CarMax Auto Superstores
24 Services, Inc.?

25 A: Yes.



1 Q: Okay. And Stuart Heaton was authorized to
2 sign for CBS?

3 A: Yes.

4 Q: Okay. Mr. Browning and Mr. Heaton were both
5 physically located at the corporate
6 headquarters?

7 A: Yes.

8 Q: The attorneys that represent CBS also
9 represent CarMax East and CarMax West?

10 A: What do you mean by the attorneys? The in-
11 house counsel?

12 Q: Yes.

13 A: Yes.

14 Q: CBS has no employees, right?

15 A: Correct. It leases its employees.

16 Q: Okay. CB- -- CBS operates no retails store.

17 A: Correct.

18 Q: And CBS does not receive any revenue from
19 outside the CarMax group?

20 A: That is not correct.

21 Q: Okay. One of the reasons for the formation
22 of CBS was to reduce state income taxes,
23 right?

24 A: It was one of the secondary goals
25 understanding what the structure would look



1 like from a tax perspective.

2 Q: CarMax's business activities in South Carolina
3 were the same before and after the
4 reorganization with CBS?

5 A: Can you repeat the question?

6 Q: Of course. CarMax's business activities in
7 South Carolina were the same before and after
8 the reorganization with CBS?

9 A: Define CarMax in that sentence.

10 Q: CarMax group.

11 A: No. I don't -- I don't think I agree with
12 that.

13 Q: Okay. Do you recall when I asked you in your
14 deposition prior to the restructure how were
15 CarMax's business activities in South Carolina
16 different?

17 A: I, I don't recall specifically, but I'm sure
18 we talked about it. Yes.

19 Q: Do you recall that your answer was the stores
20 weren't any different now?

21 A: Oh, I would agree that the stores themselves
22 aren't any different, other than the fact
23 that -- but again, you said CarMax in
24 general. That's why I was trying to define.
25 I would tell you that CBS is new, so they



1 couldn't have been the same before and after.
2 And the, the West Coast stores have different
3 connection I would with South Carolina after
4 the restructuring in terms of the trademarking
5 and the trade name ownership. So, that's why
6 I say I didn't agree.

7 Q: So, the retail stores were the same?

8 A: The retail stores are the same.

9 Q: Okay. And I think -- I think you said this,
10 so I just want to make sure this is clear.
11 That understanding that you disagree with the
12 Department's method, you don't have any
13 disagreement with the final calculations. I
14 know -- I know you mentioned some back and
15 forth. Is that right?

16 A: Uh-huh. That's correct.

17 Q: Earlier you testified about these different
18 analytics that CarMax provides. And I think
19 -- I think you said something about all of
20 this analysis and testing. You mentioned
21 multiple buyers and multiple options, and ex-
22 -- an exponential numbers of times. I think
23 this was in reference to the painting of the
24 cars, the CarMax Book, ASRP, and ACR. It's
25 helpful to have a big data set for those



1 analytics, right?

2 A: Yes.

3 Q: Okay. And, and you reviewed Revenue Ruling
4 15-5 in detail, correct?

5 A: I have not recently, but yes, I have in the
6 past.

7 Q: Okay.

8 **MR. ANTLEY:** I beg the Court's indulgence. I think
9 I may only have a couple more questions.

10 Q: Okay. When you talked earlier about
11 contributions to CBS, you didn't mention value
12 business process intangibles, did you?

13 A: I don't think I did.

14 Q: Okay. What, what are those valuable pro- --
15 businesses process intangibles that were
16 contributed to CBS?

17 A: So, I, I think about those as propriety
18 systems. There can be some trade secrets. I
19 think about them as being our point of sale
20 system in the stores. It could be -- it --
21 again, it could be some of the trade secrets
22 or, you know, know how, however you want to
23 talk about it. That would be some things I'd
24 include in that list.

25 Q: Okay. And just a moment earlier, I asked you



1 a question about CBS receiving revenue from
2 outside the CarMax group.

3 A: Uh-huh.

4 Q: Okay. Do you remember when I asked you in
5 your deposition about that?

6 A: So, I, I do recall and I was reviewing my
7 deposition, as I read that back, I, I
8 honestly couldn't remember the context of
9 which the question was being asked at that
10 time.

11 Q: Okay. Do you recall me asking you is any of
12 that revenue from outside of the CarMax
13 group, in other words from a third party? Do
14 you recall that question?

15 A: I, I actually do.

16 Q: And ---

17 A: And it --

18 Q: And do you recall your response was no?

19 A: Yes. I, I do recall that my response was no.
20 What I was failing to think about in the
21 phrasing of the question at the time was the
22 fact that all of the CarMax customers that
23 are paying their loans, so that interest
24 income, that finance income that's coming into
25 CBS, all those customers are third parties.



1 So, in the deposition, that is not how I
2 interpreted your question, which led to my
3 answer being no. But in reality, all of
4 those customers are considered third party.
5 So, the answer should have been yes.

6 Q: And so, going, going back to my next to the
7 last question. So, who contributed the
8 business process intangibles to CBS?

9 A: West Coast. CarMax West.

10 MR. ANTLEY: No further questions, Your Honor.

11 MS. GEER: One moment, Your Honor. I don't think I
12 have any other further questions.

13 THE COURT: You may step down. Is now a good time
14 to break for lunch?

15 MS. GEER: Good with us, Your Honor.

16 THE COURT: Be back at 1:00 o'clock be good?

17 MR. ANTLEY: The, the ---

18 THE COURT: I'm ---

19 MR. ANTLEY: The only concern of the time, I -- I'm
20 ---

21 THE COURT: I'm looking at my computer, so mine
22 says 11:49.

23 MR. ANTLEY: That -- that's what mine says as well.

24 THE COURT: Is that -- so, that's an hour and 10
25 minutes. Is that enough?



1 MS. GEER: I mean, an hour and 15 would be great,
2 but ---

3 THE COURT: Okay. Well, then 1:15 then?

4 MS. GEER: That's good.

5 THE COURT: Okay.

6 MS. GEER: You had somewhere to be. Does that give
7 you the time you needed?

8 THE COURT: Yeah.

9 MS. GEER: Okay.

10 THE COURT: Okay. Thank you.

11 (Off the record from 11:49 a.m. to 1:16 p.m.)

12 THE COURT: Call your next witness.

13 MR. VON LEHE: Thank you, Your Honor. Your Honor,
14 we'd like to call as our next witness,
15 Professor Rick Pomp.

16 COURT REPORTER: Please raise your right hand. Do
17 you solemnly swear the testimony you're about
18 to is the truth, the whole truth and nothing
19 but the truth, so help you God?

20 MR. POMP: I do.

21 COURT REPORTER: Thank you, sir. Please state your
22 full name for the record.

23 MR. POMP: Richard E. Pomp.

24 COURT REPORTER: Thank you, sir. Appreciate it.

25 MR. POMP - DIRECT EXAMINATION BY MR. VON LEHE:



1 Q: Professor Pomp, what are -- what's your
2 involvement or role in this matter?

3 A: I was asked to discuss from a tax policy
4 perspective the history of separate entity
5 accounting, combined reporting, apportionment,
6 business structures, alternative
7 apportionment, nexus, separation of powers,
8 respond to things that have come up in the
9 State's presentation.

10 Q: So, you understand that you're here to
11 discuss state tax policy?

12 A: Yes.

13 Q: The state and local area?

14 A: Yes.

15 Q: Could you give us your background and
16 qualifications?

17 A: Well, starting with education, I have a
18 Bachelor of Science summa cum laude from
19 University of Michigan, a Juris Doctor magna
20 cum laude from Harvard Law School.

21 Q: And this is a copy of your CV?

22 A: That's probably not an up to date version.

23 Q: You say it's not up to date.

24 A: No. A few things since that was submitted.

25 Q: What's left off of it primarily?



1 A: I think three is a couple of articles and
2 maybe one or two honors. I, I have not seen
3 this in a while, so.

4 Q: And do those articles have anything to do
5 with the issues that -- in this case
6 specifically?

7 A: Excuse me. You'll have to speak up.

8 Q: Do they have anything to do with the issues
9 in this case, those ar- -- the articles that
10 have been left off?

11 A: You know, they might. Almost everything I
12 write incorporate some issue of tax policy.
13 If you didn't -- I mean, when, when we write
14 articles, it's not separating out tax policy
15 from more substantive parts of the article.
16 Otherwise, you might as well be H&R Block, so
17 it always incorporates po- -- tax policy.

18 Q: All right. I'm, I'm with you. I understand
19 there are a couple of, I would call them
20 distinguishing features or honors that have
21 been bestowed upon you since this CV was put
22 together. What are they?

23 A: Again, I don't know whether the Board of
24 Trustees distinguished professors on that
25 version of this CV or not, but I received



1 that. That's the highest honor the
2 university bestows on a faculty member. And
3 ---

4 Q: All right, sir.

5 A: And recently, I was invited to join the
6 American College of Tax Counsel. I'm not
7 sure whether I will accept that or not, but.

8 Q: So, is it common that tax professors receive
9 this distinguishing or ability to join this
10 college?

11 A: Yeah. Well, one of the reasons I'm not sure
12 I will join it is sort of what Groucho Marx
13 said, I don't want to be a member of any club
14 that would have me. It's fairly elitist
15 group with the federal tax folks thinking
16 they are above everyone else. And they look
17 down on the state tax people, and there
18 aren't many tax people that are members. And
19 both of them, I think, look down on tax
20 professors. So, I think it was a grudging
21 invitation.

22 Q: Well, hopefully, never mind. Now, what is
23 your -- what is your employment?

24 A: I am the Alva, A-L-V-A, P. Loisel, L-O-I-S-
25 E-L-L-E Professor of Law at the University of



1 Connecticut and an adjunct professor at NYU
2 in the L.L.M. program in taxation.

3 Q: And what is the Alva P. Loisel Professor?

4 A: It's a -- it's an endowed chair.

5 Q: Okay. What do you teach, Professor?

6 A: At NYU, I teach a two semester course. I
7 teach probably the only law school course
8 that's semester long on corporate income
9 taxation. Second semester is sales tax. At
10 U Conn, I teach multi-state federal tax,
11 corporate tax, American Indian taxation. Then
12 from time to time, tax policy, but not very
13 frequently.

14 Q: Well, if, if not obvious, how's tax policy
15 re- -- if it is, how is it related to these
16 courses that you teach?

17 A: One of the reasons I don't teach a formal
18 course on tax policy is that it's part of
19 every course I teach, so no reason to have a
20 semester long course on it.

21 Q: And have you taught elsewhere?

22 A: I have. I have taught at Harvard, Columbia
23 University of Texas, Boston College, a few
24 foreign law schools, University of Tokyo.
25 And there's one in Thailand that I can't



1 spell, so.

2 Q: And have you been qualified as an expert
3 witness on tax policy in other state tax
4 cases, and if so, how many times?

5 A: I have been, maybe about 130. Two per year
6 of my professional life.

7 Q: How do you decide whether or not to serve as
8 an expert witness in a tax litigation matter?

9 A: Well, it usually starts with a phone call.
10 Of course, what people don't appreciate are
11 the number of phone calls you get from, I
12 won't say cranks, but friends of friends is
13 the way it always starts. Of course, I've
14 never heard of the friend, but okay. Do you
15 have ten minutes? There are no ten-minute
16 phone calls. We know that. So, after about
17 30 minutes, they say, so what do you think?
18 I say three to five. They go three to five
19 thousand, that's what we -- oh, no, three to
20 five years. I would suggest you call a
21 criminal tax lawyer at this point. That's
22 really tax evasion. So, those are easy. We
23 get rid of those one, two, three. Then, if I
24 get a call from someone like yourself, I will
25 listen, of course. And I have -- I have



1 select criteria. A, it has to -- first of
2 all, I have to feel that your on the side of
3 the angels based on at least what you are
4 describing on the first phone call. I verify
5 that. I have to feel that the case is
6 cutting edge in some way. We either advance
7 the law or keep the law from a backwards
8 slide. I have to, of course, enjoy the
9 people I'm, I'm working with. That's, you
10 know, critical. Long week, tempers get a
11 little short sometimes. People get testy.
12 So, you really have to be with people who you
13 are, you know, enjoy. And it has to make me
14 a better scholar and a better teacher. You
15 know, one of the reasons I have done private
16 work and I did not start doing private work.
17 You know, most academic consider a stigma to
18 do private work. If you look at my resume,
19 there is no private work on the resume. But
20 I think it's very important, if you're
21 teaching, of course, an area like tax, that
22 you understand the world from the perspective
23 of a client. So, I have always felt I've
24 been enriched by doing the private work.
25 Anyway, so, I -- you know, if those three,



1 four criteria are satisfied, the next step is
2 usually to look at public -- paper that's in
3 the public domain. Let me see. Let me make
4 my own judgement about where I think the
5 merits of the case are. And if I think I can
6 add value and I believe in the cause, I will
7 be happy to join it.

8 Q: Now, do you work with both states and with
9 taxpayers?

10 A: I do. And I guess just looking at, at the
11 resume in preparation for this, because you
12 look track sometimes as years go on. But
13 currently, I am working with Alaska. I am
14 drafting a sales tax for Alaska. I drafted an
15 income tax for them a short time ago that
16 passed the House and did not pass the Senate,
17 but it's sitting there. I worked for --
18 recently worked for and testified in a case
19 brought by the Washington State Attorney
20 General. I consulted for the Washington
21 Insurance Commissioner. I am currently
22 consulting for the City of Mobile, Alabama on
23 a sales tax issue. As I look at the resume,
24 I have now worked with the state of
25 Connecticut, and the state of Delaware, North



1 Dakota, Kansas City, Missouri. Let's see
2 where else. Of course, will, will return
3 cases for South Carolina actually. Treasurer
4 of New Jer- -- of New Jersey. I work for the
5 City of San Francisco, state of West
6 Virginia, Tennessee Attorney General, Montana
7 Department of Revenue. And then federal
8 stuff like the IRS and the Justice
9 Department. Anyway, you, you can read it
10 yourself. And so, early on, I guess, I don't
11 know when -- maybe 10 years ago, 15 years
12 ago, I did some property tax cases on behalf
13 of the state. I believe one of them was
14 against you, if I remember correctly. We
15 won't mention how that came out. But -- and,
16 and I represented the County of Richland.
17 And, and then I have appeared here for I
18 guess a Rent-A-Center case. One of the TV
19 company's.

20 Q: Direct TV?

21 A: It was Direct, Direct TV, right? Yeah. And
22 let's see, of course AutoZone and Tractor
23 Supply and now, here.

24 Q: All right. So, that brings up to date.
25 You've written articles and books on state



1 tax matters. Do they include apportionment
2 of income, combined reporting, separate entity
3 reporting, and alternative apportionment, and
4 tax policy related to those matters?

5 A: I have. And I have a case book. And it's in
6 the ninth edition. There's parts of that on
7 combined reporting, alternative apportionment.
8 I've done a series of lawyer view articles,
9 one of which I never thought anyone read in
10 the Louisiana Law Review, but it seems to be
11 a favorite of the Department of Revenue here,
12 so. You may hear more about that later. So,
13 that makes three or four people who've read
14 that article. I have -- if we look most
15 recently -- John, let's go over to wherever
16 the publications are. They're not on this
17 version of the resume. I, I just have an
18 article coming out on the constitutional
19 infirmities of Maryland's new turnover tax on
20 digital advertising. And that deals with
21 apportionment. That's one of the, the
22 constitutional weaknesses in Maryland's tax.
23 Let's see. Is the Quad Graphics' decision
24 innocuous or a jurisprudential threat? That
25 just came out beginning of this year. That



1 deals with apportionment of sales taxes.

2 Exploring the flaws of gross receipts taxes
3 in a modern economy, that's forthcoming. A
4 little bit of apportionment in there. And
5 then there's a couple of eulogies here that
6 have nothing to do with tax, so. So, I would
7 say, those are the recent things.

8 Q: What is the Multi-State Tax Commission?

9 A: It's a voluntary organization of tax
10 administrators.

11 Q: And what has been your involvement with, if
12 any, with the Multi-State Tax Commission?

13 A: My involvement goes back to, I think, 1979,
14 when I -- through the MTC, I worked with
15 Frank Church, Senator Frank Church from, I
16 guess, Idaho, on stopping a U.S. Tax Treaty
17 with the United Kingdom that would have
18 prevented California, not by name, but a --
19 the treaty would have prevented the states
20 from using worldwide combined reporting. At
21 the time, California was the leading
22 practitioner of that. And as California
23 went, so went the number of states in its
24 fold, including Idaho. So, it was a revenue
25 threat to Idaho. And Frank Church formed an



1 alliance with a lot of senators from the
2 south. I don't know if South Carolina was
3 involved. They saw this as an affront to
4 state's rights issue. Why should the feds
5 tell the states what to do. And so, we were
6 able to stop that treaty by two votes. It's
7 the only time a tax treaty had ever been
8 voted out. And then, they took out this
9 offending provision and it sailed through the
10 Senate. So, that was my early experience
11 with the Multi-State Tax Commission. And
12 I've done other things for them. But roll
13 the clock forward and I was the hearing
14 officer for the Multi-state Tax Commission
15 when they took it upon themselves to revise
16 the Uniform Division of Income for Tax
17 Purposes Act, what we all call UDITPA, U-D-I-
18 T-P-A. And in my Hearing Officer report, I
19 have a section on alternative apportionment.

20 Q: And since you mentioned it, what is UDITPA?

21 A: That was passed by the Uniform Law Commission
22 in 1957. And this is the Commission that
23 brought us the UCC and other uniformed laws.
24 And they can only suggest, of course. They
25 have no powers to legislate. So, they hope



1 that they put together a, a final product
2 that everyone would find to be acceptable.
3 And they took it upon themselves to take on
4 the issue of how should a corporation
5 apportion its income, allocate and apportion,
6 but today we're only interested in
7 apportionment. And they have what we used to
8 call the standard evenly weighted three-factor
9 formula, property, payroll and sales. And
10 that was the heart of UDITPA, with each of
11 those factors being defined.

12 Q: All right. So, we may come back to that in a
13 while. But does, does one need to consider
14 tax policy when drafting a statute, and have
15 you ever participated in a drafting of tax
16 statutes?

17 A: Yes. I have drafted a few. Now, two for
18 Alaska. Worked on Connecticut's income tax.
19 Did evaluate a tax for Zambia. Wrote parts
20 of the Navajo tax code. So, I don't know how
21 you write a statute without understanding what
22 the foundational principles of tax policies
23 are. I mean, the two are so intertwined.
24 You'd make a fool of yourself if you wrote a
25 statute and just disregarded and ignored



1 constitutional constraints or, you know, any -
2 - or just what makes sense.

3 Q: All right, sir.

4 **MOTION TO ADMIT AS EXPERT:**

5 **MR. VON LEHE:** We would like to move at, at this
6 juncture that Professor Pomp be admitted as
7 an expert in tax policy and tax law in the
8 multi-state tax area, including tax policy
9 inherent in apportionment of income, combined
10 reporting, separate entity reporting, and
11 alternative apportionment.

12 **MR. ANTLEY:** The Department would like voir dire
13 Professor Pomp.

14 **MR. POMP - VOIR DIRE BY MR. ANTLEY:**

15 Q: Good afternoon, Professor Pomp. Tax policy
16 is what the law should be, not necessarily
17 what the law is?

18 A: That's correct.

19 Q: Okay. You do not have personal knowledge of
20 South Carolina tax policy considerations; in
21 other words, never lives here, been in the
22 legislature, or anything else?

23 A: Well, I think that overstates it. I have had
24 extensive conversations with three of your
25 former Tax Commissioners. I had -- one of



1 those was the author of the well-known TRAC
2 Commission Report. I have attended
3 conferences for probably 40 years throughout
4 the country where members of the DOR have
5 appeared on panels. So, I wouldn't say I'm
6 ignorant because I don't live here. One day
7 I may. I don't think I'll become any
8 smarter.

9 Q: Okay. Do you remember when I deposed you?
10 Do you remember that? I had a deposition and
11 deposed you.

12 A: Yeah. It was Zoom though, right?

13 Q: Yes. It was virtual.

14 A: Right.

15 Q: And you had a tooth, tooth issue, but. So,
16 do you recall when I asked you, so with tax
17 policy considerations, do you have any or, or
18 would your response be the same as the
19 historical background for South Carolina as
20 far as your personal knowledge. And do you
21 recall that your answer was sure? And then
22 to -- up to that point, do you recall?

23 A: No. I recall nothing about that. What was
24 the question?

25 Q: The, the question was, so with state tax



1 policy considerations, do you have any, would
2 your response be the same for the historical
3 background for South Carolina as far as your
4 personal knowledge? I'm still on your
5 deposition.

6 A: Yeah. I, I have no idea what the question
7 means today, but.

8 Q: I'll hand you a copy of it.

9 A: Sure. What page is it on?

10 Q: So, if you go to Page 49.

11 A: And what lines?

12 Q: It is Line -- it starts at Line 21.

13 A: 21.

14 Q: And once you're there, just let -- I'm going
15 to read and if you could just let me know if
16 I -- I'm reading this correctly. Are, are
17 you there?

18 A: I am.

19 Q: Okay. Question: Okay. So, with state tax
20 policy considerations, did you have any --
21 would your response be the same as to the
22 historical background for South Carolina as
23 far as your personal knowledge? Did I read
24 that part correctly so far?

25 A: Yeah. What does same refer to? Is that



1 something that preceded it? The same as
2 something that preceded it?

3 Q: If you could just let me continue and let --
4 just let me know if I'm reading this right.
5 So ---

6 A: Yeah.

7 Q: Answer: Sure. Question -- going --
8 continuing on to the next page. Question:
9 Okay. Answer: I mean, I do not live there,
10 have not been in the legislature or anything
11 else. So, yeah. Right. Did I read that
12 correctly?

13 A: Yes.

14 Q: Okay. Tax policy expertise requires you to
15 be able to understand statutes and
16 regulations, right?

17 A: It can. Sure.

18 Q: Tax policy expertise requires you to be able
19 to understand judicial opinions.

20 A: What? Additional?

21 Q: Judicial opinions.

22 A: It can. It depends on the context. Sure.

23 Q: Okay. It is hard for you to separate legal
24 expertise from tax policy expertise.

25 A: It can be depending on the context.



1 Q: And, and you were previously offered as an
2 expert, but the judge admitted you pro hac
3 vice to argue this -- the case instead?

4 A: That is true.

5 Q: Okay. A Virginia trial court found your
6 testimony to be, "a policy statement that in
7 Virginia may be more appropriately addressed
8 to the legislature".

9 A: Which case was that?

10 Q: The Corporate Executive Board versus Virginia
11 Department of Taxation.

12 A: Ah. I don't think I testified in that case.
13 I believe it was done on paper. I think I
14 submitted an affidavit. I mean, I'm not
15 sure. But, I, I think it was an affidavit.
16 Does it say I testified live?

17 Q: I -- I, I don't -- the question is just is,
18 is your testimony, whether or written or
19 live, do you recall that the court found that
20 a policy state -- that, that your testimony
21 live or written ---

22 A: Yeah.

23 Q: --- was a policy statement that in Virginia
24 may be more appropriately addressed to the
25 legislature?



1 A: Well, I, I don't remember it sitting here,
2 but if that's from the opinion, no reason I
3 doubt it.

4 Q: Okay. So, you don't have a reason to doubt
5 that.

6 A: Not if -- not if what you read me is from the
7 opinion, you know, with a page cite and
8 everything.

9 Q: Okay. A Wisconsin court found regarding your
10 testimony that the distinction between tax
11 policy versus tax law is a distinction
12 without a difference. Do you recall that?

13 A: Now, which case?

14 Q: The Sketchers case.

15 A: Sketchers. Yes.

16 Q: And you have been excluded twice by an
17 Administrative Law Judge in Illinois.

18 A: Which case? Was that Mead? Is one of them
19 Mead?

20 Q: I'm not sure of the ca- -- case. Do you
21 recall being excluded twice by an
22 Administrative Law Judge ---

23 A: I am not.

24 Q: --- in Illinois?

25 A: I don't, but if you tell me the cases, it



1 might trigger my memory. It's been 130
2 cases, you know. But I remember Mead, I was
3 not excluded. Although, if you read the
4 opinion carelessly, it seems like I was along
5 with another expert, but we were not.

6 Q: Okay. Do you recall getting deposed in the
7 Rent-A-Center case that you mentioned earlier?

8 A: I don't recall the deposition, but I was
9 involved in that case.

10 Q: Do you know if you were deposed?

11 A: I have no idea ---

12 Q: You don't ---

13 A: --- sitting here today.

14 Q: Okay. Do you -- s he's pulling that up, so
15 you don't recall ever saying that you were
16 excluded twice by the same ALJ in Illinois?

17 A: If you tell me the cases, I might have better
18 memory. I've testified in Illinois in a
19 number of cases so, over, over a number of
20 years, so which case are these, I mean I'd
21 like to read the context of the statement.

22 **THE COURT:** You could move on and we could come
23 back to it.

24 **MR. ANTLEY:** Yes, Your Honor.

25 Q: Okay. Your testimony has been limited



1 because it started to go towards a legal
2 opinion?

3 A: Well, that's true. There was one case where
4 at the tail end, the judge felt that it
5 crossed the line. And so, I was not rejected
6 as an expert witness, but the part that was
7 talking about constitutional law, I, I think
8 was rejected.

9 Q: Okay. You testified in an Oregon case where
10 the judge rejected your testimony as crossing
11 the line into legal opinion?

12 A: Which case?

13 Q: You don't recall an Oregon case?

14 A: Well, if you trying to -- trying to tell me
15 what happened, I think it's incumbent on you
16 to tell me what happened in what case.

17 Q: Do you recall when I deposed you in this
18 matter that I -- that I asked you if your
19 testimony had ever been rejected?

20 A: You probably did. I don't remember.

21 Q: Okay. If you could -- you have the
22 deposition ---

23 A: Yeah.

24 Q: --- transcript in front of you. If you could
25 turn to Page 12. And if you'd let me know



1 whenever you're there.

2 A: Yeah. What line?

3 Q: Okay. So, if you could look at Line --
4 starting at Line 21. And I'm, I'm going to
5 read and if you just let me know if I'm
6 reading this correctly. What were the cases
7 where your testimony was limited because it
8 started to go to the legal opinion? Answer:
9 Yeah. There was a case involving 86-272 out
10 of Oregon. I forget the name of that case,
11 but you know -- but you know my testimony was
12 accepted in part and then the part he thought
13 crossed the line were rejected. Although one
14 might reading the opinion think that there
15 was an influence, but formally it was
16 rejected. Did I read that portion correctly?

17 A: Correct.

18 Q: Okay.

19 A: And that was Santa Fe, where my opinion was
20 accepted in part, and the part that the judge
21 thought crossed the line was not accepted.

22 Q: Okay. And you also testified in a case with
23 Lehman Bank where your opinion was je- --
24 rejected because it crossed the line into
25 legal opinion.



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1 A: Well, you have to separate out. I was
2 accepted as an expert witness in both the
3 Oregon case and the Lehman. At some point,
4 the testimony crossed a line and that's the
5 part of the testimony that was rejected. I
6 was not rejected. A lot of my testimony
7 wasn't rejected. But the part that became
8 more constitutional in nature was rejected.

9 Q: And, and that -- and that was my question.
10 Your testimony. So, you, you testified, so
11 you testified in the Lehman Bank case, but
12 you -- but at least a portion of your
13 testimony was rejected because it crossed the
14 line into legal opinion.

15 A: Yeah. Let's see. I was about 95 percent
16 through my testimony and then the question
17 raised may be a legal issue and so, when that
18 testimony was rejected on that point, but 95
19 percent was accepted. So, I don't know how
20 you want to characterize it.

21 Q: And, and just for completeness, I'm going to
22 finish out that, that section and just let me
23 know if this is, this is -- if I'm reading
24 this correctly.

25 A: Sure.



1 Q: And again, when you read the opinions, you
2 wonder, yes, maybe it was rejected, but it
3 looks like it had some influence too. Or
4 influence, so. Excuse me. Did I read that
5 correctly?

6 A: Yes. But you have to ---

7 Q: --

8 A: And let, let me explain how this works in
9 real life.

10 **THE COURT:** Well, can I stop for a second here?

11 A: Sure.

12 **THE COURT:** This is voir dire. Whether he's going
13 to be qualified as an expert. And then, now
14 you're voir dire-ing him or asking him
15 questions about situations where he's been
16 qualified as an expert, but whether his, his
17 opinion is crossed the line. Now, if you
18 want to ultimately down the road make an
19 objection involving Vortex Sports in South
20 Carolina, you can certainly do so. But why
21 don't we just stay on the issue of whether
22 he's qualified as an expert? And then, we
23 can address that other issue later.

24 **MR. ANTLEY:** So, Your Honor, he was offered as an
25 expert in tax policy and tax law. So, that's



1 why these questions are important because they
2 go to where his testimony goes into the legal
3 ---

4 **THE COURT:** All right. Make that -- say, well, I
5 would qualify him as an expert in tax policy.

6 **MR. ANTLEY:** Okay. And, and then the second part
7 of that is these previous cases he's -- his,
8 his -- the line between tax policy and tax
9 law is a distinction without a difference.
10 And even in his own deposition testimony he
11 said that, that tax policy is what the law
12 should be, not what it is.

13 **THE COURT:** Okay. Well, I -- go ahead and finish
14 out ---

15 **MR. ANTLEY:** Okay. I, I ---

16 **THE COURT:** --- regarding this -- what -- regarding
17 his qualifications.

18 **MR. ANTLEY:** Okay.

19 A: I was in the midst of an answer.

20 **THE COURT:** Oh, okay. Go ---

21 A: I don't know if I could ---

22 **THE COURT:** Yeah.

23 A: --- just get closure. See, some of these
24 cases, there's a motion in limine. And
25 before they ever hear my testimony, they



1 bring a motion in limine. So, a judge is
2 sensitive to this. When there's a motion in
3 limine that the court has rejected, a judge
4 is very cautious now about assigning any
5 weight to my opinion. So, when I say, look,
6 the opinion had an influence, I can look at
7 the opinion and I could see it wasn't exactly
8 blocked and copied, but it certainly made its
9 way into the opinion. Am I cited? No.
10 Because to cite me could be reversible error
11 for having rejected the motion in limine.
12 So, this is just the way things work. So,
13 that's why you've got to read my opinion,
14 read the court case, and then see if you
15 sense any influence where it may have had a
16 role to play. Now, that's a more nuanced
17 investigation.

18 Q: Okay. So, in this area that you've been
19 offered as an expert on -- it's not your role
20 to opine on South Carolina law?

21 A: Correct.

22 Q: And you cannot talk about cases?

23 A: Well ---

24 Q: Specific cases.

25 A: South Carolina cases? Supreme Court cases?



1 Q: Any cases.

2 A: I don't know. That's really up for His Honor
3 to decide. I'm not here to talk about South
4 Carolina cases.

5 Q: So, have judges invited you to intrude on the
6 province the Court in your testimony prior?

7 A: I didn't hear the beginning.

8 Q: Have judges ever intruded or invited you to
9 intrude on the province of the Court?

10 A: Oh, yes. And if you want to hear just how
11 far that could go, I was testifying in a
12 Massachusetts case on a corporate income tax.
13 The judge said, I'd like to voir dire
14 Professor Pomp and proceeded to ask me a
15 question about a sales tax that he apparently
16 was working on. So, you could see, it's not
17 always ri- --rigorously followed, that line.

18 **MR. ANTLEY:** If you could -- if we could go back to
19 where we were.

20 Q: So, I -- I'm not sure if you can see this,
21 but if, if you can't, let me know. But I'm
22 looking at Page 9, Lines 11 through 22. Oh,
23 I'm sorry. We're moving. So, once we're --
24 we've stopped, I'll, I'll let you know.

25 **MR. ANTLEY:** Page 9.



1 **THE COURT:** Seems to skip Page 9.

2 **MR. ANTLEY:** It did.

3 **THE COURT:** It was there a minute ago. I don't
4 know if it ever was there. There's Page 8
5 and then there's Page ---

6 **MR. ANTLEY:** Stop please. Okay.

7 **THE COURT:** Okay.

8 Q: Okay. So, thi- -- this, this is your
9 deposition testimony from the Rent-A-Center
10 case. So, I -- I'm just going to -- are you
11 able to see that on your screen in front of
12 you?

13 A: Yes.

14 Q: Okay. Do you see on Line 11 where the
15 question is asked, now, have you ever been
16 excluded from testifying in court? Do you
17 see that?

18 A: Yes.

19 Q: Okay. And then if you could just -- we can
20 skip down to Line 21 to 22. And I'm going to
21 read this. Let me know if I've read this
22 correctly. I've been excluded twice by the
23 same ALJ in Illinois.

24 **OBJECTION:**

25 **MR. VON LEHE:** Your Honor, if I may -- if I may



1 impose an objection. As I understand it,
2 we're here to determine his qualifications,
3 not whether or not he's, he's going to
4 comment on, on legal questions or not.
5 That's my understanding of what we're here
6 and I think counsel has gone off track with
7 regard to his questions.

8 **MR. ANTLEY:** Sir, he's presented in, in setting up
9 his qualifications to be an expert, they've
10 listed a number of times that he's been
11 qualified as an expert. This is a speci- --
12 two specific examples when he was excluded.

13 **THE COURT:** I'll let him go into this.

14 Q: Okay. So, I'll, I'll read it again and if
15 you just let me know if I've read this
16 correctly.

17 A: Uh-huh.

18 Q: I've been excluded twice by the same ALJ in
19 Illinois.

20 A: Uh-huh.

21 Q: Did I read that correctly?

22 A: You did.

23 Q: Okay.

24 **MR. ANTLEY:** So, at, at this point, Your Honor, the
25 Department would object to Professor Pomp's



1 qualifications as a tax policy and tax law
2 expert and all, all the rest of the added on
3 there because any, any testimony regarding
4 that would not be admissible in this Court.
5 He will either testify about what the law
6 should be, which is not relevant, or offer
7 legal arguments and conclusions as he has in
8 previous matters, which intrudes on the
9 province of the Court. Neither is admissible
10 or helpful for the Court's understanding of
11 fact and issue in this case.

12 **THE COURT:** All right. Any response?

13 **MR. VON LEHE:** Yes, Your Honor. I think again,
14 the, the question is whether or not he's
15 qualified to, to, to testify as to tax policy
16 or tax law when, when it's appropriate. So,
17 this objection that's just been imposed, seems
18 to be asking the Court to do a whole string
19 of other things.

20 **THE COURT:** Well, I think he's asking me to
21 anticipate the questions and what the -- and
22 what his testimony is going to be. I -- I'm
23 going to qualify him as an expert in tax
24 policy and in doing so, he is able to testify
25 regarding tax policy, regarding issues that



1 may help the Court discern the facts. He
2 cannot testify regarding issues that would --
3 regarding the interpretation of the law. But
4 I'm going to find out how soon whether the
5 tax is used on the tax po- -- policy can help
6 me discern the facts in this case. All
7 right.

8 **MR. ANTLEY:** Thank you, Your Honor.

9 **MR. VON LEHE:** Thank you, Your Honor.

10 **MR. POMP - DIRECT EXAMINATION CONTINUED BY MR. VON**
11 **LEHE:**

12 Q: Professor Pomp, are there tax policy
13 considerations concerning whether or not a
14 state adopts different filing methods, i.e.,
15 whether it might be a combined method or
16 maybe a separate entity method? Are there
17 tax policy considerations for this?

18 A: Sure.

19 Q: And what are they?

20 A: Well, you, you have these two basic
21 approaches; combined reporting, separate
22 entity. So, let's take separate entity
23 first. Separate entity looks only at the
24 corporation that has nexus with the state and
25 that's the corporation that is the taxpayer.



1 And they will file their own return. It will
2 show their income. And they'll calculate an
3 apportioned percentage their factors, whatever
4 the states apportionment formula might be.
5 So, why is -- why are some states separate
6 entity states? I think the primary reason is
7 because the business community likes that.
8 And it is viewed as being good for economic
9 development. And, John, do we have a map
10 somewhere of the states that are separate
11 entity states?

12 Q: We do.

13 **MR. VON LEHE:** It's a little blurry, but could you
14 put it up, Bobby? Let's see.

15 A: I believe this happened on Twitter yesterday,
16 didn't it?

17 **THE COURT:** Maybe we need to move on. Oh, okay.

18 A: Well, when it is on the screen, Your Honor,
19 you will see -- ah, there we go -- that those
20 -- I don't know what color that is. But it
21 was ---

22 Q: Blue and green, I can tell you that.

23 A: Green. Okay. So, you notice that the green
24 states are basically all concentrated in --
25 we're in the southeast, a little bit north.



1 And that's not a coincidence. And the reason
2 I think it's historical that when this
3 country developed, it developed essentially,
4 not exclusively, but essentially on the east
5 coast and kind of northeast. And the early
6 constitutional cases actually involved
7 manufacturing on the northeast in states that
8 had just a property apportionment formula,
9 which is, when you think about what's the
10 best way to raise revenue. If you're a state
11 that has a lot of manufacturing, you're not
12 worried about anyone leaving and going to the
13 south, not in those days. But property,
14 because they were so property laden with the
15 manufacturing plants. So, we have the
16 Underwood tax -- typewriter case.

17 **OBJECTION:**

18 **MR. ANTLEY:** Objection, Your Honor. He's speaking
19 about a case.

20 **THE COURT:** I don't know what he's going to say
21 about it yet. You got -- are you going to --
22 -

23 **MR. ANTLEY:** I, I believe he's going to be offering
24 a legal opinion. I don't know how you talk
25 about a case without doing that, unless he's



1 going to talk about specific facts, which he
2 doesn't have personal knowledge of.

3 **MR. VON LEHE:** Your Honor ---

4 A: Just describe the case, Your Honor, not
5 interpreting it.

6 **THE COURT:** Okay. I'm going to let him describe
7 it.

8 A: Yeah. It -- the court basically said, if
9 you're a multi-state corporation, you have to
10 be able to apportion your income and it has
11 to be done fairly, not arbitrarily, all of
12 that. So, that's one case. There are other
13 cases, all northeastern cases. So, we get a
14 legal infrastructure in place. And of
15 course, we have a manufacturing infrastructure
16 and the northern states tend to dominate in
17 the early days of manufacturing. Well, with
18 the advent of air conditioning, the south is
19 now opened up for migration and for business
20 and for manufacturing. Now, how do they
21 compete because the north has been in place
22 for a while now with rules, a, you know, a
23 legal infrastructure, so businesses knew what
24 they were getting when they came to that
25 state. Their reliance interest were being



1 furthered. And so, how does the state start
2 to compete? And one of the ways they compete
3 is through their tax systems. And they
4 decide business likes states to be a separate
5 entity state. And so, we -- and you can see
6 this block of, of green states. We will be
7 separate entity states. Does it work? Well,
8 you find controversy among economists whether
9 it works or, or not. When you talk to people
10 here in South Carolina, as I have done three
11 -- at least three former tax Commissioners,
12 what did they say? The proof is in the
13 pudding. Hey, we've got BMW. We have Volvo.
14 We have Mercedes. Now, Gallo is coming here.
15 It's a pretty attractive tax climate. The
16 commerce department website sort of touts the,
17 the tax climate here in South Carolina. And
18 so, the separate entity approach takes hold.
19 And no state really wants to be an outlier.
20 You know, if you look at that block, imagine
21 the first state that says, we'll become a
22 combined reporting state that I'll talk about
23 now, as the alternative. Business may look
24 at it; well, we don't like combined
25 reporting, you know that. We like when you



1 were separate entity.

2 **OBJECTION:**

3 **MR. ANTLEY:** Objection, Your Honor. He's talking
4 about le- -- a legislative intent that he has
5 no personal knowledge of, other than speaking
6 through, through someone in the Executive
7 Branch.

8 **MR. VON LEHE:** Your Honor -- yes, Your Honor. He
9 has general knowledge of, of what is
10 attractive to, to, to industry through his
11 work throughout the years.

12 **THE COURT:** Well, he ---

13 **MR. VON LEHE:** He does have that knowledge. Now,
14 as to where he got it from, that's another
15 question, but he does have it.

16 **THE COURT:** Well, you'd have to lay a foundation on
17 that one. I'll sustain that.

18 **MR. VON LEHE:** I'd be happy to. I'd be happy to do
19 that.

20 Q: What is your -- what is the, the basis of
21 your -- of your statement that states prefer
22 separate entity filing methods to combination
23 methods?

24 A: Well, it's, it's based on everything you hear
25 at conferences. It's based on my personal



1 discussions with at least four -- three
2 former tax commissioners in South Carolina.
3 It's based on what I read on the commerce
4 department's website. It's almost general
5 knowledge in this filed. You know, you ask
6 anyone who's been around and they said, well,
7 of course, we know why states are separate
8 entities states because when a, a state is
9 debating combined reporting, all of the
10 arguments against combined reporting coming
11 out and the legislature is encouraged to
12 remain a separate entity state. So, you got
13 an awful lot of, of proof out there, and I
14 doubt anyone in this field would disagree
15 with the reason why we see a block of green
16 states on that map all in the same area of
17 the country.

18 **MR. VON LEHE:** That's the background, Your Honor,
19 from which he derives his knowledge that
20 these, these states are primarily separate
21 entity states and they do that -- well, I'll
22 get to that in a moment. I will -- and they
23 -- they're primarily separate entity states
24 and they are like that because that's more
25 attractive to businesses. He knows that.



MR. ANTLEY: Your Honor, he -- he's still has not talked at all about any legislative -- anyone for the Legislative Branch giving this as a reason. He's, he's relied on Department of Commerce website, which is part of the Executive Branch, former directors, commissioners ---

THE COURT: Is the information that you're about to relay to me information that is reasonably relied upon by experts in your field?

A: It's certainly in the case book as we talk about ---

THE COURT: That doesn't answer my question. One more time. Is the, the information that you're about to relay to me, information that is re- -- reasonably relied upon by experts in your field?

A: Absolutely.

THE COURT: I'll allow him to testify about it. You can cross-examine him on it.

MR. VON LEHE: Thank you, Your Honor.

Q: You looked at the map, the -- this demonstrative map. And you've spoken to it a few minutes ago. You talked about separate entity versus combined methods of, of



1 reporting. What about the factors that are
2 used such as sa- -- sales factor or property
3 factor, or payroll factor or combinations, how
4 do they fit into this question of attracting
5 businesses?

6 A: So, separate entity determines what the tax
7 base is. This is your taxable income and
8 only your taxable income. So, you could
9 think of that as, well, here's a pizza pie.
10 South Carolina and any state that has a
11 corporate income tax is going to have to
12 figure out what's their slice of that pizza
13 pie. How much can they tax? And they do
14 that by applying what we call an
15 apportionment formula.

16 **OBJECTION:**

17 **MR. ANTLEY:** Objection, Your Honor. We're getting
18 into South Carolina law and how taxes are
19 determined under ca- -- South Carolina
20 statutes.

21 **MR. VON LEHE:** No one mentioned South Carolina yet.
22 I wouldn't say that's it not impossible that
23 it will be mentioned, but I don't believe I
24 heard him say anything about South Carolina.

25 **MR. ANTLEY:** I thought he said states like South



1 Carolina.

2 **THE COURT:** He did.

3 Q: In that case, can you limit your answer to
4 states in general rather than choosing South
5 Carolina?

6 A: Sure. And nothing any ---

7 **OBJECTION:**

8 **MR. ANTLEY:** Objection to him speaking now about
9 other states. I, I don't know if helps that
10 now we're speaking about different state
11 statutes. We're still offering legal opinions
12 on state statutes.

13 **MR. VON LEHE:** We're not offering legal opinions,
14 Your Honor. We're simply saying what they
15 do.

16 **THE COURT:** Hold on a second.

17 **MR. ANTLEY:** And what other states do would not be
18 relevant to, to what South Carolina does.

19 **THE COURT:** Well, that would go to the relevancy of
20 all this. I don't think as far as your
21 objection is concerned, he's not making any
22 legal conclusions regarding this case. He's
23 just stating what the statutes say. So, I
24 mean, you can nod. You may not like that,
25 but that's my interpretation of, of Vortex



1 right now. And I read Vortex and Dawkins.
2 If you want to explain to me where in the
3 context of that case I'm wrong, I'll hear
4 from you.

5 **MR. ANTLEY:** Yes.

6 **THE COURT:** So. So, explain it to me.

7 **MR. ANTLEY:** I wouldn't -- I wouldn't want to say
8 Your Honor is wrong, but ---

9 **THE COURT:** No.

10 **MR. ANTLEY:** --- the, the position ---

11 **THE COURT:** I -- I'm opened to be -- I'm like
12 Professor Pomp. You can -- you can -- I may
13 be old, but you can still teach me, I think
14 he said. He, he may be wrong at times. I
15 may be, so.

16 **MR. ANTLEY:** It's the Department's position that,
17 that the Vortex case must be read in
18 conjunction with the South Carolina Supreme
19 Court case of Dawkins, which Your Honor also
20 mentioned.

21 **THE COURT:** Yeah.

22 **MR. ANTLEY:** And it -- just to point out, some
23 portions of Dawkins, in general, expert
24 testimony on ish- -- issues of law is
25 inadmissible. The, the -- because Professor



1 Freeman's affidavit primarily contained legal
2 arguments and conclusions, we hold that the
3 trial court properly refused to consider the
4 affidavit. Professor Freeman's affidavit
5 inappropriately attempted to usurp the Trial
6 Court's in determining whether petitioners
7 were entitled to summary of judgment.

8 Professor Freeman's affidavit reads as if it
9 could have been respondent's -- and this I
10 think is, is very relevant to what we have
11 here. As it, it could be -- have been
12 respondents oral argument to the trial court
13 at the summary judgement hearing. So, we're
14 going to down this lane of, of making legal
15 arguments, introducing them to the court
16 through, through the form of testimony.
17 Everything he's said today could be in a
18 brief. That there's, there's no ---

19 **THE COURT:** That's true.

20 **MR. ANTLEY:** There's no factual information that he
21 is -- that he is providing. So, he's, he's
22 within that context of, of Dawkins. And if
23 we look at Vortex, the Vortex in -- with
24 Professor Freeman's testimony in Vortex, the
25 court -- the, the Court of Appeals, so the



1 lower court -- appellate court found that the
2 trial court had ruled on the initial, the
3 threshold issue in that case. That, that
4 there was a fiduciary duty. Here, there's
5 been no ruling on a threshold issue. He --
6 his testimony is going towards the threshold
7 issue and that's whether or not the
8 taxpayer's business activity is, is, is re- -
9 - is fairly represented under the -- under
10 South Carolina's apportionment statute, the
11 standard, standard apportionment method.

12 **MR. VON LEHE:** Your Honor, this is just the
13 opposite. I mean, everything he said a
14 moment ago in that argument, we -- we're
15 doing just the opposite. We're not
16 commenting on a legal -- on, on a legal
17 matter. And therefore, quite frankly, this,
18 this testimony would have been admissible
19 under those -- under the criteria laid forth
20 in those cases, not inadmissible. That
21 should be a reason to admit it.

22 **THE COURT:** Well, I'll add a little bit further on
23 Dawkins. They were -- let's see. They were
24 quoting a previous opinion, I think it was
25 agreeing, that we disagreed and stated the



1 following; the testimony was not designed to
2 assist the PCR court to understand certain
3 facts, but rather was a legal argument why
4 the PCR court should rule as a matter of law.
5 See he hasn't gotten to that point yet. He
6 may be skirting toward it. And then if you
7 look at, at Vortex, you know, they, they say
8 kind of along the lines of what I ruled
9 earlier. He did not make improper legal
10 conclusions or instructions. I presume that
11 means conclusions, legal conclusions regarding
12 the case or instructions, but simply opine
13 regarding acts.

14 **MR. ANTLEY:** And ---

15 **THE COURT:** So, if he can opine regarding acts,
16 what acts were they speaking of that he was
17 able to opine in Vortex that he would not be
18 able to opine in here?

19 **MR. ANTLEY:** And, and that's issue when you look at
20 Dawkins and you read Dawkins in conjunction
21 with Vortex. It, it seems -- it almost seems
22 like a contradiction. So, I think the only
23 option you have is to read Vortex narrowly.
24 And some important parts of Vortex is they
25 noted that, that there was help -- some



1 helpful factual information. We haven't --
2 we haven't heard any specific facts from
3 Professor Pomp. He doesn't have any that
4 would be helpful up, up to this point for the
5 Court. And if Professor ---

6 **THE COURT:** Is it helpful for this Court because I,
7 I referenced relevancy. Is it helpful for
8 this Court to understand the background of
9 the making of the -- of laws in order to
10 interpret the law?

11 **MR. ANTLEY:** If the que- -- if I'm understanding
12 your question right, is -- if legislative ---

13 **THE COURT:** Because that's what he's testifying to.

14 **MR. ANTLEY:** If legislative intent is helpful for
15 the Court, I, I -- I can see how legislative
16 intent is helpful. If we're -- if we're in
17 an issue of statutory construction, but
18 Professor Pomp doesn't have any testimony that
19 is personal -- specific, personal knowledge of
20 legislative intent that he can offer this
21 court.

22 **THE COURT:** Mister ---

23 **MR. VON LEHE:** I'm saying it -- it's very
24 important, Your Honor, that this type of
25 testimony be given to the Court to give you



1 background in which to make certain fact
2 findings, which are ahead for you down the
3 road after this case has ended. It's very
4 important for you to have this information so
5 that you will have background and context to,
6 to help understand the principles involving
7 the case when the time comes to make a legal
8 judgement. Those cases which we're just
9 decided and discussed, I've also read them in
10 preparation for this, that testimony was
11 excluded because it was a legal opinion.
12 He's not giving a legal opinion. So, before
13 we get into more intricacies of those cases,
14 start with the fact that this is not a legal
15 opinion.

16 **THE COURT:** Well, he's not giving a legal opinion
17 at this point. I'm not sure contextually how
18 important it is for me to understand the
19 background to interpret the law. But I'm
20 going to allow him to proceed a little
21 further down this, this path. But I ---

22 **MR. ANTLEY:** Your Honor, if I could add one, one
23 point before ---

24 **THE COURT:** Yeah.

25 **MR. ANTLEY:** So, legislative intent, that, that is



1 a legal conclusion and that's for the Court
2 to decide.

3 **THE COURT:** Yeah.

4 **MR. ANTLEY:** It's, it's not something ---

5 **THE COURT:** I agree with that.

6 **MR. ANTLEY:** Thank you, Your Honor.

7 **MR. VON LEHE:** Thank you, Your Honor.

8 Q: You -- you've spoken about the separate
9 entity being an economic incentive driver.
10 What -- tell, tell us about the various types
11 of apportionment formulas that are used and
12 how -- which are attractive or unattractive
13 to a perspective economic development?

14 **OBJECTION:**

15 **MR. ANTLEY:** Objection, Your Honor. I -- I'm not
16 sure how he would be able to know what's
17 attractive for perspective economic
18 development. I also don't understand how
19 this relevant to, to the issue before the
20 Court today.

21 **THE COURT:** Let's go with the last one. How is
22 that ---

23 **MR. VON LEHE:** How is it ---

24 **THE COURT:** What's re- -- how is it relevant?

25 **MR. VON LEHE:** It's very relevant, Your Honor,



1 because here we have system of taxation that
2 we are defending, quite frankly, against an
3 attack wanting to change that system and make
4 into a -- from a separate return state to a
5 combination state. As the testimony goes on
6 in this case, we hope to prove that point to
7 you. We're certainly going to try. So,
8 background as to how these two systems work
9 and why someone such as a legislature and a
10 state would choose one method over another is
11 very important.

12 **THE COURT:** So, his position is that you're seeking
13 to modify the legal approach to utilize a
14 approach that is not used in this state, and
15 this testimony is offered to -- for me to
16 discern the differences between the two so
17 that I can understand whether y'all are or
18 are not seeking to depart from the statutory
19 approach required by South Carolina law.

20 **MR. ANTLEY:** So, we're following South Carolina law
21 by using the alternative apportionment statute
22 __, which specifically allows the method of
23 combined unitary reporting. So, the -- I
24 don't -- I don't see there being a, a
25 question there, other than legal argument



1 that, that counsel is, is welcomed to make,
2 but it's, it's just not appropriate for a
3 witness to admit testimony on that legal
4 argument.

5 **MR. VON LEHE:** Our reasons again, Your Honor,
6 stand. You stated them better than I could.
7 Trying to give you some background upon which
8 to examine these two different -- these
9 alternative methods of filing in South
10 Carolina.

11 **THE COURT:** Well, I would -- I'm going to take just
12 a short break.

13 **MR. VON LEHE:** Thank you, Your Honor.

14 **(Off the record from 2:17 p.m. to 2:21 p.m.)**

15 **THE COURT:** All right. I'm about to lose track of
16 what the objection was. But the bottom line
17 is I think what Professor Pomp is testifying
18 to at this point or I think what Professor
19 Pomp is telling us is very interesting, but
20 regarding this particular point, I, I think
21 it goes more to a legal interpretation. But
22 he, he can testify regarding -- and I'm
23 trying to find -- whether or not -- it -- he
24 can testify as to po- -- tax policy that
25 would help me determine whether or not the



1 apportionment fairly represent the extent of
2 the taxpayer's business activities in this
3 state, a factual aspect of that. So, I'm not
4 excluding him at this point in time. I'm
5 just going to narrow it to the factual
6 aspects that I -- that I have to consider.

7 **MR. VON LEHE:** Will do, Your Honor.

8 **THE COURT:** Or you'll try.

9 **MR. VON LEHE:** Appreciate it.

10 **THE COURT:** You may hear objections.

11 **MR. VON LEHE:** I wouldn't be surprised.

12 Q: Professor Pomp, you've heard His Honor a
13 moment ago. I want to ask you a question and
14 I want it answered in the context of what His
15 Honor has allowed, which is that it cannot be
16 a legal opinion or any kind, whether it be
17 South Carolina or other states. But I would
18 like to do this; what, what are the tax
19 policy reasons underlying the adoption of the
20 various types of apportionment formulas,
21 single sales, sales and property, sales
22 property and payroll, etcetera?

23 **OBJECTION:**

24 **MR. ANTLEY:** Objection, Your Honor. I don't see
25 the factual re- -- the, the ruling Your Honor



1 just made about this having to -- his
2 testimony having to relate to specific facts.
3 This, this is broad general question.

4 **THE COURT:** I don't know how that's going to link
5 up yet.

6 **MR. VON LEHE:** It shall, Your Honor.

7 **THE COURT:** The rules of evidence set forth that if
8 -- I'm -- I said Professor Von Lehe. If Mr.
9 Von Lehe asserts that he shall link it up,
10 that he is allowed to do that and then, we
11 can discern whether to strike it later on.
12 All right.

13 Q: Professor Pomp.

14 A: You have to kind of turn the clock back to
15 the early days when multi-state corporations
16 were becoming common. It didn't happen
17 initially. And when they started to become
18 common, of course, the, the issue arose; how
19 could each state determine its fair share of
20 a multi-state corporation's business? And
21 there were various approaches. And one of
22 the early approaches that was adopted by the
23 uniform commissioners is known as evenly
24 weighted three-factor formula. And the policy
25 behind this is to use in apportioning the



1 pizza pie, a state share of property,
2 payroll, and sales. And so, that formula
3 adopted by UDITPA, 1957, said here is the
4 formula, states. Figure out your state share
5 of property. Figure out your state share of
6 payroll and your state share of sales. Add
7 those together, divide by three. That'll be
8 the average presence the business has in your
9 state. Multiply that times the pizza pie and
10 that will give your slice of the pizza pie.
11 And that was the approach that started
12 gathering some momentum in 1957. And it was
13 attractive to the western and southern states
14 because it had that sales factor in it. So,
15 if you were manufacturing in the east and
16 selling in the west or the south, they would
17 at least have a seat at the table. They
18 would say, okay, we may not have a lot of
19 property, we may not have a lot of payroll,
20 but we have sales. And so, we'll -- when we
21 go to calculate our share of the pizza pie,
22 there will at least be something in it for
23 us. Don't forget, the uniform law commission
24 wants its proposals to be adopted across the
25 country, just like the UCC. It doesn't do



1 any good if the UCC is just adopted by
2 handful of states. So, how do we get those
3 market states involved? And they said
4 through the sales factor. Now, that's the
5 way it looked. Now, you fast forward into,
6 oh, maybe 1970s, and we become a little bit
7 concerned about how to use the state tax
8 system to encourage economic development. And
9 states say to themselves, you know what, we
10 have corporations in our in our state,
11 they're based here, and the have a lot of
12 property and a lot of payroll. And they
13 don't have a lot of sales in our state.
14 They're selling to other states essentially.
15 We're a headquarter state or a we're
16 manufacturing Mecca. And we want to become a
17 manufacturing Mecca. We want to encourage
18 manufacturing companies like Boeing and Volvo,
19 and BMW, Mercedes to come to our state. So,
20 you know what state -- if you use the
21 property factor and the payroll factor, you're
22 going to be hurting us because we're going to
23 have a lot property and payroll in your
24 state. So, that's not good. Why don't you
25 double weight the sales factor? Put more



1 weight on that because we don't have many
2 sales in your state. So, the more heavily
3 you weight the sales factor, the lower the
4 tax that we will pay. And so, we went
5 through a period where you started to see
6 across the country a, a movement to the
7 double weighted sales factor. So, now, it's
8 property plus payroll, plus twice sales
9 divided by four. And then states said to
10 themselves, gee, that's worked so well. Why
11 don't we use just sales because now we could
12 say to a company like Mercedes, Boeing,
13 Volvo, come to our state and we won't
14 penalize you for having property in our
15 state. We won't penalize you for having
16 payroll in our state. And to the extent,
17 you're basically selling outside our state
18 that numerator of the sales factor is going
19 be pretty small because the denominator is
20 going to be very big, it's your sales all
21 over the U.S. The numerator will be the
22 sales in this taxing state. And so, pretty
23 small numerator. Pretty big denominator.
24 That fraction becomes pretty small. So, even
25 though it's multiplied times a lot of taxable



1 income, it doesn't produce as much tax as it
2 would if property and payroll were being
3 taken into account. And that's why a company
4 like Gallo is one of the most recent
5 announcements I think of putting in over a
6 billion dollar investment, somewhere just
7 outside of Charleston. You know, you don't
8 grow grapes as far as I know in, in South
9 Carolina. And yet, the state is attractive
10 to Gallo. And I looked up the per capita
11 consumption of wine by state. It's not like
12 South Carolina even has a lot of heavy
13 drinkers here. You don't. So, what's Gallo
14 doing here? Well, that separate entity and
15 the single factor is pretty attractive to a
16 Gallo. Now, I don't know if that's the
17 reason they came. You know, is there
18 anything that entered into the decision?
19 Good port, good transportation, cheap labor,
20 but certainly the tax climate.

21 **OBJECTION:**

22 **MR. ANTLEY:** Objection. Speculation. He says he
23 doesn't know why they came. He is giving
24 reasons why.

25 **THE COURT:** I sustain that.



1 A: But certainly tax climate is influential. I
2 get asked to cost out what the state tax
3 would be under various scenarios by clients
4 if they were to come to this state or that
5 state. What would pay in state tax? I don't
6 know if that ends up being determinative.
7 I'm not in the C suite when they make the
8 final decision. All I know is that I am
9 asked to let them know what kind of tax
10 climate there is in the states that they are,
11 are looking at. So, the combination of
12 separate entity with just a sales factor is
13 attractive. Now, we get to combined
14 reporting. Starts in California. I suspect
15 Mr. Miller will tell you the story, as well
16 as, as the way I understood it. It's the
17 '30s. The movie industry has left New York,
18 migrated to California. A lot of different
19 locales if you're making a movie in
20 California. You have mountains. You have
21 the beach. You have desert. So, attractive
22 place. You have Hollywood, sound sets. And
23 so, the movie industry, which did very well
24 during the depression. It's one of the few
25 businesses that made a profit because for a



1 nickle, you could escape, go to the movies in
2 the afternoon of the weekend, get the news
3 reel, get maybe one or two features. It's a
4 pretty good deal for a small amount of money.
5 So, you made your movie in California. You
6 had the master print. In those days, you had
7 this big celluloid reel. And you were going
8 to distribute the movie, which meant you ran
9 prints off of the master. And they did that
10 or at least they transferred the print to a
11 Nevada corporation. Now, Nevada has been a
12 thorn in the side of California forever
13 because of it has no corporate income tax,
14 has no personal income tax. So, it's a real
15 problem for California. So, they create a
16 Nevada subsidiary and they transfer the master
17 print to Nevada. And it's distributed out of
18 Nevada. All the royalties on the
19 distribution, the, the shi- -- exhibition fees
20 and what not, flow into Nevada. And
21 California at that time that, Nevada, they're
22 all separate entity states. And California
23 looks at this and says, something is wrong
24 here. You used our infrastructure. They
25 used everything that makes California so



1 attractive to the movie industry to make your
2 movie and when it came time to realize the
3 income from it, you simply dumped into Nevada
4 that doesn't have a corporate income tax.
5 That doesn't seem right. And there you have
6 the origin of what's known as combined
7 reporting. The tax administrators without any
8 real statutory support put together Humpty
9 Dumpty. They, they added the Nevada
10 subsidiary back to the -- to the parent and
11 they said, okay, we're going to look at the
12 pizza pie as if it consists of Nevada and
13 California. And then, we will figure out our
14 slice of it by taking into account the
15 factors of the subsidiary plus the factors of
16 California. So, Nevada plus California, and
17 that will determine how much of that combined
18 income we will apportion to California. And
19 that is I think the birth of combined
20 reporting and copied by other states. If you
21 look at that map, it is not a coincidence. I
22 don't know. Bobby, can we have that up one
23 more last time? That those blue states tend
24 to be out in the west. Now, you have some
25 hold outs. Of course, Nevada doesn't have an



1 corporate income tax. State of Washington.
2 Anyway, you see it's basically the California
3 group. And that's the group that Senator
4 Church was representing. Anyway, I guess we
5 won't have it up. But so, it's not a
6 coincidence when you -- a little bit of
7 history and you look at this map and you can
8 make sense out of it. That's where history
9 is always so valuable in understanding. So,
10 that's combined reporting, the opposite of
11 separate entity. You would add back all of
12 the entities that are part of what we call
13 the unitary business. Put them all back
14 together again, eliminate intercorporate
15 transactions, figure out what the size of
16 that pizza pie, and then calculate your
17 apportionment percentage based on the group.

18 Q: All right, sir. I, I don't think there's
19 any disagreement about this, but nevertheless,
20 I guess we'll find out. But is it your
21 understanding, Professor Pomp, that South
22 Carolina is a separate entity reporting state?
23 Is that your understanding?

24 **OBJECTION:**

25 **MR. ANTLEY:** Objection to the extent it asked him



1 to opine on South Carolina law.

2 **MR. VON LEHE:** Would you stipulate to that -- to
3 South Carolina being a separate reporting
4 state, Counsel?

5 **MR. ANTLEY:** I think our position's clear on South
6 Carolina law. But that would be appropriate
7 for briefing or proposed orders.

8 **MR. VON LEHE:** Well, I ---

9 **MR. ANTLEY:** But it's not appropriate for testimony
10 from a live witness.

11 **MR. VON LEHE:** Well, I'm just asking you, would you
12 stipulate to it as -- I mean, there's no
13 question about it.

14 **THE COURT:** He's asking ---

15 **MR. VON LEHE:** Everybody in the room knows.

16 **THE COURT:** Say yes or no on that.

17 **MR. VON LEHE:** Will you stipulate to it?

18 **MR. ANTLEY:** No.

19 **MR. VON LEHE:** No. All right.

20 **MR. ANTLEY:** No. Not, not without conditions. I
21 think maybe if we worked on it for a few
22 days, we can come with -- up with a
23 stipulation we could agree on, but not
24 without conditions.

25 **Q:** So, Professor Pomp, has South Carolina ever

