

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 IV 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.

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1 studied combined unitary reporting to your
2 knowledge? Has South Carolina ever studied
3 combined unitary reporting?

4 A: No.

5 Q: Have they ever considered it?

6 A: Yes. There was the TRAC Commission, the
7 author of whom was lead counsel in the
8 AutoZone case. And they studied combined
9 reporting and they studied separate entity
10 reporting. And they recommended that the
11 legislature study combined reporting.

12 Q: And what happened?

13 A: Well, all I know is that no bill was ever
14 introduced.

15 Q: All right, sir. Now, do you favor one of
16 these methods over the other? Do you favor
17 separate entity reporting or do you favor
18 combined reporting from a tax policy
19 standpoint?

20 A: If we were writing a clean slate and if this
21 were a legislative hearing, and if we weren't
22 part of the green states, I would recommended
23 combined reporting. It has advantages, and
24 I've written about them as I'm sure you'll
25 hear. So, I like it. But this is not a



1 legislative hearing and we're not writing on
2 a clean slate.

3 Q: All right, sir. What are the advantages of
4 the two different systems, tax policy ---

5 A: A separate entity has the advantage of being
6 attractive to most businesses. It gives them
7 flexibility. The don't like combined
8 reporting as a general proposition. It put
9 Humpty Dumpty back together again and, and
10 business likes Humpty Dumpty because they
11 structure themselves in a tax efficient
12 manner, unencumbered by being put back
13 together again. So, one of the things about
14 a separate entity state is it respects the
15 way a business is structured. And businesses
16 obviously like that. They like the freedom
17 to structure themselves as they fit
18 unencumbered. Combined reporting takes away
19 that flexibility from a, a business. That's
20 probably the Number 1 advantage. Whi- -- or
21 Number 1 reason businesses are not fans of
22 combined reporting and usually oppose it when
23 it's being proposed. Combined reporting will
24 undercut the use of aggressive tax
25 minimization strategies, like the Delaware



1 holding company problem where you had
2 corporations forming in many cases almost a
3 shell corporation in Delaware, which had a
4 favorable statute that said if you manage
5 intangibles here in Delaware, we will not tax
6 you on the income that you get from the
7 management of those intangibles. And so,
8 there was a period when corporations would
9 transfer their trademarks to this Delaware
10 corporation, which typically had no employees.
11 It was basically a law firm that represented
12 them, had just a veneer of being a real
13 corporation. And then, they would then
14 license back the trademarks. They would pay
15 royalty. They would deduct the royalty. And
16 Delaware would tax the re- -- recipient on
17 the receipt of that royalty. Combined
18 reporting would blow through that and say,
19 okay, Delaware housing company, you're part of
20 Humpty Dumpty. We're putting you back
21 together again. So, it has that advantage.
22 It has the advantage if you impose it on a
23 worldwide basis, which California used to do,
24 but was greatly resented by the international
25 business community. It undercuts the use of



1 tax havens abroad. You know, the Bahamas,
2 Bermuda, places only stamp collectors have
3 heard of, like Nauru. And so, imposed on a
4 global basis, which I've always been in favor
5 of, it completely blows through the use of
6 tax havens. So, it's very attractive,
7 especially in a shrinking world like the one
8 that we are now in. So, it has that
9 advantage.

10 Q: Have you been in the courtroom for the last
11 three days?

12 A: I have been.

13 Q: Did, did you hear -- have you listened to all
14 the witnesses that have been here thus far?

15 A: I did.

16 Q: Did you hear the Department of Revenue's
17 audit supervisor testify?

18 A: I did.

19 Q: And from that testimony, did, did you recall
20 his saying that South Carolina is a separate
21 return state?

22 A: Yeah.

23 Q: I'm not sure if he spoke of the single factor
24 apportionment formula, so I won't ask you
25 about that. But I will ask you, did you hear



1 Ms. Yost's testimony? Eileen Yost.
 2 A: Is it my what?
 3 Q: Did you hear Eileen Yost's testimony today?
 4 A: Yes.
 5 Q: Did you hear her describe the method that
 6 CarMax used in filing?
 7 A: Yes.
 8 Q: And what method did she describe?
 9 A: They, they filed under the statute of
 10 separate entity report.
 11 Q: All right. And did she also say that they
 12 used the single sales factor?
 13 A: Yes. That's what the statute provides,
 14 requires.
 15 Q: All right.
 16 **OBJECTION:**
 17 **MR. ANTLEY:** Objection, Your Honor.
 18 Q: Based on a ---
 19 **MR. ANTLEY:** He's making ---
 20 **THE COURT:** I sustain that objection.
 21 Q: Don't, don't get over in that area, please.
 22 Let's just kind of keep it as far as away
 23 from any discussion of law as we can. In
 24 general -- at the risk of repeating
 25 ourselves, but much more narrow now. In



1 general, how is a separate return computation
2 made and how is a unitary return computation
3 made? Start with the separate return.

4 A: So, in a separate return, you would look at
5 the corporations that have nexus with the
6 state. Each one of them would file a return
7 showing their income. And they would then
8 calculate whatever the relative apportionment
9 was. And they would apply that times their
10 income, and that would be the taxable income.
11 And then, they would apply whatever their
12 rate was in South Carolina, take whatever
13 credits that might be entitled to. Nice and
14 simple. If it were a combined report, that
15 same corporation that has nexus with South
16 Carolina or whatever the taxing state is in a
17 combined report, like California, whatever it
18 is, they would have to determine whether they
19 were a unitary business and then they would
20 file a return that would take into account
21 all the members of the unitary business.
22 Even those that do not have nexus directly
23 with South Carolina or whatever the taxing
24 state was, California, whatever is imposing
25 this combined return. So, as long as one of



1 them have nexus with the taxing state and was
2 part of a unitary business, they would put
3 Humpty Dumpty back together again and that
4 would determine the size of the pizza pie.
5 Then they would calculate whatever the
6 apportionment formula was based on the entire
7 unitary group. And that would be applied to
8 the taxable income of the group.

9 Q: All right, sir. I'm going to ask you this;
10 did you hear Ms. Yost describe how CarMax
11 West reported?

12 A: Yes.

13 Q: And what's your -- what's your -- what's your
14 recollection of what she said?

15 A: I believe she said that West filed its own
16 tax return. And by the way, it was she who
17 said how they reported under the apportionment
18 formula. That wasn't my interpretation.
19 That's what she said.

20 Q: So, West, you said that she -- she said that
21 West reported as, as separate ent- -- a
22 separate entity return?

23 A: Yes.

24 Q: Okay. I want to you to listen to this
25 example. Let's say that, that a corporation



1 filing in South Carolina, it has no sales of
2 cars in South Carolina, which I believe you
3 remember the testimony today that West had no
4 sales of cars in South Carolina. And it was
5 also some testimony given by the Department's
6 expert in economics, that combined reporting
7 would reach the same result as separate
8 return reporting if separate return -- if, if
9 the transfer pricing was accurate. If the
10 transfer pricing is accurate in a separate
11 return state, it will derive the same -- the
12 consequences will be the same as combined
13 reporting. Is that your understanding and if
14 not, why not?

15 A: Well, I ---

16 **OBJECTION:**

17 **MR. ANTLEY:** Objection to the extent that calls for
18 a legal opinion.

19 **MR. VON LEHE:** No. Not a legal opinion, just
20 simply a question of how would the
21 computation -- the, the way -- the way it is
22 computed is well known. It's in the record.
23 It's been in the record for two or three
24 days.

25 **THE COURT:** Well, my question to you is, how does



1 this testimony help me understand the
2 discernment of, of the facts of this case as
3 opposed to legal conclusions?

4 **MR. VON LEHE:** It'll be -- I believe it would be
5 very helpful, Your Honor, particular with
6 regard to the economic testimony, which has
7 been given. A part of which -- part of that
8 testimony was, well, if it concluded -- so,
9 like maybe the fifth, I think that particular
10 witness had like five different things he
11 commented on. And the fifth one was well, if
12 you do the separate return right, and you got
13 the right transfer pricing, you're going to
14 get the same result as you would under a
15 combined return. We dispute that, and
16 Professor Pomp can tell us whether or not
17 that is a fact or not a fact. It's a fact
18 you will eventually probably, probably have to
19 resolve in your, your, your decision.

20 **MR. ANTLEY:** Your Honor, he's not qualified as an -
21 - as an expert in economics. It sounds like
22 they're trying to use him to rebut an expert
23 economist's testimony.

24 **MR. VON LEHE:** That wasn't economics' testimony
25 that was given. I, I probably should have



1 objected to that. That wasn't economics'
2 testimony. That was tax testimony. This is
3 a tax lawyer now.

4 **MR. ANTLEY:** Lawyer is the important part there,
5 Your Honor.

6 **MR. VON LEHE:** Well, however, he's not testifying
7 according to law. He's hopefully will simply
8 tell Your Honor that look, this, this --
9 these two things because of the systems that
10 are used, the separate entity system and a
11 combined system don't match up.

12 **THE COURT:** I think at this point in time, he is
13 interpreting the law and as to the -- how
14 that will be applied with this, the facts of
15 this case versus inter- -- given me policy
16 that will help me discern the fact. At least
17 so far from what I've heard. So ---

18 **MR. VON LEHE:** All right.

19 **THE COURT:** --- I'll sustain it at this point.

20 **MR. VON LEHE:** Your Honor, of course, one of the
21 things that you will be deciding is -- and
22 the primary thing you'll be deciding is does
23 the standard formula fairly reflect the extent
24 of the taxpayer's business activities in this
25 state.



1 **THE COURT:** That's where I started. I want to
2 understand ---

3 **MR. VON LEHE:** You said that at the beginning of
4 all of this. And of course, that is what the
5 law says. There's no question about that.
6 That's, that's not a paraphrase. That's a --
7 that's a quote from the law. Professor Pomp,
8 of course, is aware of this. He -- his
9 testimony along these lines would help you --
10 when someone -- when -- when, when someone, I
11 don't care if it's an economist, who it is,
12 says to you, look, if you just fix this
13 transfer pricing then these things are going
14 to come out the same, that's very harmful
15 from your being able to make a decision as to
16 whether or not the standard formula, which is
17 a separate entity formula -- it's very
18 harmful to your -- to, to your decision
19 making in whether or not -- if in fact it did
20 line up, then they would be the same. So,
21 that's why I think you would benefit from
22 Professor Pomp's answer.

23 **THE COURT:** Any response?

24 **MR. ANTLEY:** Your Honor, I think it, it may be
25 harmful for their case. I don't think it's



1 harmful your -- for your decision making. I
2 think he kept referring again to the transfer
3 pricing study, transfer pricing analysis.
4 That is outside the scope of Professor ---

5 **THE COURT:** Well ---

6 **MR. ANTLEY:** --- Pomp's qualifications.

7 **THE COURT:** Well, let me just go back to what --
8 oops. I clicked on the wrong thing. I am
9 open to hear Professor Pomp explain to me how
10 policy would help me determine whether under
11 the facts of this case the apportionment
12 fairly represents the extent of the taxpayer's
13 business activities. I don't think it's
14 proper for Professor Pomp to explain the
15 legal interpretation of what his -- the
16 meaning of fairly represents the extent of
17 the taxpayer's bu- -- business in this state.
18 And there is my struggle right now. I feel
19 like your starting to touch on the latter
20 rather than the former.

21 **MR. VON LEHE:** We'll try to keep it in the road,
22 Your Honor.

23 **THE COURT:** Okay.

24 Q: Professor Pomp, from general terms, from your
25 general background knowledge, etcetera,



1 etcetera, without regard to South Carolina
2 law, I want to ask you about a concept known
3 as alternative apportionment.

4 A: Yes.

5 Q: Are you familiar with that concept?

6 A: I am.

7 Q: All right. Would you describe for the Court
8 what alternative apportionment does and the
9 background of alternative apportionment in
10 this country?

11 A: UDITPA 1957 had a, a last provision section
12 18, right at the end, and it said as you, you
13 correctly have already paraphrased that if the
14 apportionment provisions of this article -- in
15 other words, if that standard three-factor
16 formula, because that's what it was at the
17 time, do not represent the extent of the
18 taxpayer's business activity in this state,
19 then the taxpayer may petition for something
20 different or the tax administrator may require
21 something different. And this was -- we, we
22 don't have much legislative history on this.
23 We have an article by Professor Pierce who is
24 the reporter for the Uniformed Law Commission
25 in their deliberations on UDITPA. He was a



1 law professor at the University of Michigan.
 2 And he wrote an article after -- shortly
 3 after UDITPA was promulgated. And here's
 4 what he said about Section 18; he said that
 5 this is for the unusual ---

6 **OBJECTION:**

7 **MR. ANTLEY:** Objection, Your Honor.

8 A: --- arbitrary ---

9 **MR. ANTLEY:** That's hearsay. He -- he's talking
 10 about what someone else has said.

11 **MR. VON LEHE:** Well, Your Honor, as an expert he
 12 can testify on hearsay, obviously.

13 **THE COURT:** If it's reasonably relied upon by
 14 experts in his field.

15 **MR. VON LEHE:** Indeed.

16 **THE COURT:** And if that's your objection, I'll,
 17 I'll let him lay the foundation for that.

18 **MR. ANTLEY:** I was going to say, if, if he can rely
 19 on that, but he cannot enter that into the
 20 evidence. We ---

21 **THE COURT:** That's true. Well ---

22 **MR. ANTLEY:** I think there was a similar objection
 23 made to some of our demonstratives where he
 24 could rely, but cannot enter it into the
 25 record.



1 MR. VON LEHE: You ---

2 THE COURT: I don't think I -- under 703. Let me
3 see, disclosure of it. 705. Yeah. He can
4 testify to it, but there is a case law about
5 publishing underlying data and getting around
6 the, the ultimate issue and how it affects
7 the, the fact finder. Because -- but that --
8 because that's hearsay and so, I -- I'm going
9 to -- I'll have to go find that case. I tell
10 -- I'm going to allow this in but it's
11 subject to your objection and me reading that
12 -- the case, unless y'all can pull that case
13 up for me. Do you know what I'm talking
14 about?

15 MR. ANTLEY: I would have to look it up, Your
16 Honor.

17 THE COURT: Well.

18 MR. ANTLEY: I don't have the name off the top of
19 my head.

20 THE COURT: All right. Hold on one moment. All
21 right. I'm not finding it, but it must have
22 been last year.

23 MR. VON LEHE: Your Honor, could I make a
24 suggestion?

25 THE COURT: Yes, you can.



1 **MR. VON LEHE:** I would suggest that we -- that we
2 go ahead with my questioning Professor Pomp
3 concerning the history of UDITPA in Section
4 18. And if -- and if -- and we come to this
5 point where I would like to have this -- him
6 testify as to this particular quote, we would
7 reach that -- reach that then. It won't be
8 long.

9 **THE COURT:** Okay. You go ahead.

10 **MR. VON LEHE:** Is that satisfactory?

11 Q: Professor Pomp, please, please give us the
12 history of UDITPA in Section 18. Do not
13 quote -- do, do not quote from the quote that
14 you perhaps started to.

15 A: This is meant for the unusual, arbitrary or
16 unreasonable situation for which the standard
17 formula just doesn't work well. And I think
18 the drafts persons understood that this three-
19 factor evenly weighted formula isn't going to
20 be able to handle everything that comes
21 along. How can one size fit all? So, they
22 knew that. And they wanted to have a safety
23 valve. Now, sometimes we have special
24 formulas for special industries. And that's
25 the way we deal with weaknesses in the



1 formula, but short of that, we have Section
2 18 to handle the unusual, the arbitrary, the
3 unreasonable situation. And they have set
4 out the ground rules for when you can be in
5 Section 18 or not. And one of the things
6 that the multi-state tax Commission did was
7 propose refinements in Section 18, which is
8 part of what my hearing officer report was
9 about.

10 Q: From a tax policy point of view, when should
11 Section 18 be used or adopted to deviate from
12 the general formula?

13 A: It should not be interpreted broadly because
14 the broader it is interpreted, the more it
15 undercuts reliance interest. Now, the
16 taxpayer should be entitled to rely on what a
17 statute says and you certainly don't want
18 bait and switch where the statute says X, the
19 taxpayer comes to a state, makes a major
20 investment, only to find out that Section 18
21 is going to be triggered. This happens to
22 have been a recent situation in another
23 state. So, we want to protect reliance
24 interest. We want people to be able to read
25 a statute and know how to make out a return.



1 And so, Section 18 has to be applied
2 judiciously or else it's going to swallow up
3 the standard formula.

4 Q: And what do you mean by reliance interest?
5 Please expand on that.

6 A: That in our, our capitalist form of economy,
7 taxpayers are respected in, in structuring
8 their economic activities, unless there is
9 good reason to undercut that expectation.
10 It's like one of the things you, you study in
11 early contracts class in, in law school. You
12 know, why do we have contract law? Why do we
13 think that's good? Well, we think that's
14 good because it encourages economic
15 transactions. And it's the same thing here,
16 that the more a taxpayer can rely on a
17 statute, the more likely economic transactions
18 will occur. And people have expectations and
19 reliance interest that should be protected
20 unless there's good reason not to.

21 Q: Does it have anything to do with the question
22 of whether or not a taxpayer ought to be able
23 to determine what their taxes are going to be
24 by reading the law?

25 A: Yes. That's absolutely right. You ought to



1 be able to read a statute and know what the
2 consequences will be. And that's why when I
3 get asked to cost out an investment and I'm
4 given a structure, of course, what do I do, I
5 read the law and apply the law.

6 Q: All right. I have -- Your Honor, I think I'm
7 going to go ahead and give it a try for this
8 quote. Have you ever heard of Professor
9 Pierce?

10 A: Yes.

11 Q: All right. Who is he or who was he?

12 A: It's a was at this point. He was the
13 reporter for UDITPA, a professor at the
14 University of Michigan Law School.

15 Q: And did he publish an article?

16 A: He did. It's about as close to legislative
17 history as we have.

18 Q: And do you recall from this article what he
19 said about the application of Section 18?

20 A: I do.

21 Q: And what did he say?

22 A: He said it should be ---

23 **OBJECTION:**

24 **MR. ANTLEY:** Objection. Hearsay. Also, relevance.

25 And I ha- -- and I think we still have not



1 gotten into any factual information with this
2 particular case.

3 **MR. VON LEHE:** Well, this is a quote from a ---

4 **THE COURT:** Well, on the hearsay, I'll address
5 that. That's -- the case I was talking about
6 was State versus Jenkins. The opinion number
7 is 28089. It said that when the -- regarding
8 the admission of -- the expert's admission of
9 inadmissible evidence, in other words, just
10 like I said, an expert can rely on hearsay.
11 And then, can the expert publish that
12 hearsay? And the Court said that -- the
13 Trial Court, which is me, must consider two
14 things; the information's probative value in
15 assisting, it said the jury, but it would --
16 here, it'd be the Court, to weigh the
17 expert's opinion on -- on one hand and the
18 risk of present -- prejudice resulting from
19 the potential misuse of the information for
20 substantive purposes. So, I have to do a
21 weigh factor. So, on that objection, do you
22 wish to respond within the context of State
23 v. Jenkins?

24 **MR. ANTLEY:** Yes, Your Honor. I, I think there's
25 very little probative value in that testimony.



1 It's -- and one of my objections I made to
2 this same statement is, is this, this is not
3 relevant to what's before the Court, what
4 Professor Pierce said about a model statute
5 70 years ago. We're, we're talking about
6 South Carolina's current statute. That's what
7 that issue. And that's for Your Honor to
8 decide. Anything -- maybe there's an
9 implication of a legal argument in his
10 testimony that this -- UDITPA is the
11 equivalent of South Carolina law. So, this
12 is how Your Honor should interpret South
13 Carolina law. Again, that's a legal
14 argument. So, it's either a disguised legal
15 argument or it's simply not relevant.

16 **THE COURT:** Mr. Von Lehe.

17 **MR. VON LEHE:** Yes, Your Honor, certainly it's not
18 a legal argument. This is just a question of
19 what did this man say. He was a reporter
20 for, for UDITPA. A little background, which
21 I, I could -- I could ask -- I could ask the
22 Professor here to comment on that and I'll --
23 it would be objectionable. But I'll just say
24 it myself. This is one of the most important
25 voices in state and local taxation known



1 throughout the country, particularly for this
2 article, which he published soon after the
3 adoption of UDITPA, which has kind of been a
4 guiding light all these years as when is
5 Section 18 supposed to be invoked. Of
6 course, our position is it should not be
7 invoked here obviously, their's is it should
8 be.

9 **THE COURT:** Well, how, how does that help me
10 discern not the legal conclusion in this
11 case, but the application of the facts.

12 **MR. VON LEHE:** Yes. Well, you would be looking at
13 the facts under these -- under this -- this
14 is helpful criteria and looking at the facts
15 of the case and deciding whether or not to
16 apply Section 18 at all. It would help if
17 it's back ---

18 **THE COURT:** 18 is not applicable here, is it?

19 **MR. VON LEHE:** Pardon me?

20 **THE COURT:** 18 is not applicable in this state.

21 **MR. VON LEHE:** Well, Counsel had just said it a
22 minute ago. We, we have adopted an, an
23 identical replica of Section 18 and it's been
24 there for, for, for many, many years.

25 **THE COURT:** And his testimony would help me in



1 determining how to legally interpret that --
2 the statute or ---

3 **MR. VON LEHE:** It would hel- -- it would help you -
4 --

5 **THE COURT:** --- interpret the facts?

6 **MR. VON LEHE:** It would help you interpret the
7 facts, because the facts are critical here.
8 The, the, the factual question being that,
9 that taxpayer's activities in the state of
10 South Carolina, and are they captured by the
11 standard formula. That's what the case is
12 all about. And obviously, you've said it
13 yourself a couple of times already today and,
14 and before. So, yes. This testimony would
15 help you in, in those facts.

16 **THE COURT:** I'm going to sustain the objection.

17 **MR. VON LEHE:** All right, sir. I have a
18 demonstrative, which I would like to put up
19 on the screen, Your Honor. Hopefully, it
20 works this time. Bobby, is it going to work?
21 If not -- if not, maybe we would ask for some
22 help from the Court to, to get it.

23 **MS. PEREZ:** Is it connected?

24 **MR. STREISEL:** I don't know why it's not -- the
25 last two times ---



1 MR. VON LEHE: Well ---

2 MR. STREISEL: I plug it in and it doesn't show up.

3 MR. VON LEHE: You could ---

4 MR. STREISEL: It has been.

5 MR. VON LEHE: Could I ask the Court to ---

6 MS. PEREZ: You can use the ELMO.

7 THE COURT: The ELMO.

8 MR. VON LEHE: Bobby, you can use it.

9 MR. STREISEL: If I can find the ---

10 MR. VON LEHE: Please put it on the screen.

11 MR. STREISEL: But I don't -- I don't know why it

12 stopped working.

13 MS. PEREZ: Yeah. I can get IT to check it when we

14 get a break.

15 MR. STREISEL: Yeah. I mean, we can ---

16 THE COURT: We have technological redundancy.

17 MR. VON LEHE: I'm afraid I got left behind in

18 that, Your Honor.

19 MR. ANTLEY: Your Honor, before it's published, if

20 we could just see it, so ---

21 MR. VON LEHE: Yeah.

22 MR. ANTLEY: --- we know what's about to be shown.

23 MR. VON LEHE: We certainly can do that.

24 THE COURT: Well, it's really not published.

25 MR. VON LEHE: It didn't make it. It didn't make



1 it.

2 **THE COURT:** Well, he took it off. He took it off -

3 --

4 **MR. VON LEHE:** Oh.

5 **THE COURT:** He's going to put it back up. All
6 right. You can blow that up if need be.

7 **MR. VON LEHE:** Yeah. Could it be a little bigger?
8 That's it. Oh, yeah. All right. Whoa,
9 Bobby. Whoa.

10 **MR. STREISEL:** Does that work?

11 Q: Can you see that, Professor Pomp?

12 A: I do.

13 Q: You do. All right. What, what, what is this
14 and where did it come from?

15 A: I had this made based on the tax returns of
16 these three fiscal years.

17 Q: Did you have those tax returns in your hand?

18 A: Yes. I did.

19 Q: All right. So, what do we see up here?

20 A: Well, the important thing is the South
21 Carolina numerator because that's the amount
22 of ---

23 **OBJECTION:**

24 **MR. ANTLEY:** Objection, Your Honor. This is going
25 beyond the scope of tax policy. He's, he's



1 now interpreting return -- South Carolina tax
2 returns specifically.

3 **MR. VON LEHE:** It's not ---

4 **THE COURT:** It's not far enough down the field for
5 me to discern what he's -- I can strike it if
6 necessary, but I don't -- he hadn't testified
7 enough for me to discern it at this point in
8 time.

9 **MR. ANTLEY:** Understood, Your Honor.

10 Q: Okay. Go ahead, Professor.

11 **THE COURT:** We have comfortable seats now. You can
12 enjoy them for a while.

13 Q: Go ahead, Professor.

14 A: This one's not so comfortable.

15 Q: Please.

16 A: This is the numerator of that sales factor.
17 South Carolina sales and the numerator, and
18 sales everywhere in the denominator. And
19 this is for East.

20 Q: And this shows a numerator of East?

21 A: It'd be about -- you know, you can see the
22 variation. Close to 400 million in '16, 427
23 million, 470 million in fiscal year '18.

24 Q: Okay. What does that -- what does that
25 figure represent with regard to sales in



1 South Carolina?

2 A: That would be approximately the sales in
3 South Carolina.

4 Q: All right. And why would that be relevant
5 to, to the taxpayer's business activities in
6 this state? How is that relevant?

7 A: Well, you start off by asking what are the
8 business activities of East in South Carolina,
9 and the lion's share those activities is this
10 sale of cars.

11 Q: Okay.

12 A: And now, the question is whether that number
13 fairly represents the taxpayer's business
14 activity in the state, where His Honor has
15 kind of started us off this afternoon.

16 Q: All right.

17 A: So, does the sales factor fairly represent
18 the business activity, which is the selling
19 of cars in South Carolina.

20 Q: All right, sir. And these other figures that
21 are up there?

22 A: Well, I, I wanted to see them. But they're
23 really not relevant to ---

24 Q: All right.

25 A: --- the threshold question that has to be



1 answered by His Honor before reaching the
2 application of alternative apportionment
3 because you don't get to alternative
4 apportionment unless there's something about
5 the sales factors that does not represent the
6 extent of the sales in South Carolina.

7 Q: All right, sir. Thank you.

8 **MR. VON LEHE:** If you could take that down, Bobby,
9 whenever you wish.

10 Q: All right. Professor Pomp, I'd like to move
11 on and ask you some questions about transfer
12 pricing with regard to your, your background
13 and your general knowledge o when it is used
14 and why it's used. What tax policies
15 underlie the use of transfer pricing studies?

16 A: That when you have intercorporate
17 transactions, they should mirror what would
18 have resulted if the parties were unrelated.
19 You're trying to get a measure of what the
20 proper income is and whether that is the
21 number that would result if they weren't
22 related and you were dealing with a stranger.

23 Q: And when is this used, generally speaking?

24 A: Well, it's certainly used in separate entity
25 states, because in a combined reporting state



1 it does not become relevant because if you
2 have a parent doing business with its
3 subsidiary and you're a combined reporting
4 state, those two entities would be added
5 together and the intercorporate transactions
6 would be eliminated. That's one of the
7 virtues of combined reporting.

8 Q: Transfer pricing, can it be adjusted and when
9 should it be?

10 A: When -- the first thing I would note is that
11 transfer pricing has nothing to do with
12 Section 18 of UDITPA. That Section 18 of
13 UDITPA and His Honor will have to decide how
14 much of Section 18 of UDITPA is relevant in
15 South Carolina. But that is an issue of
16 whether or not the apportionment formula is
17 working properly. It has nothing to do with
18 the base of the tax. UDITPA has nothing to
19 do with the calculations of taxable income.
20 It has nothing to do with the rates that a
21 state should use. It has nothing to with the
22 credits a state should use. That's -- wasn't
23 in front of the Uniformed Law Commissioners.
24 It's just whether the apportionment formula is
25 performing adequately. We're talking about a



1 measure of the base now. Is the income
2 that's being reflected on the parent's return,
3 on the subsidiary's return, does that
4 represent and reflect what would have resulted
5 if they were unrelated entities? So, we're
6 not in an alternative apportionment. We're
7 not in Section 18. We're just left with a
8 plain vanilla question. It's the same
9 question if I took some travel and
10 entertainment and the auditor says you took
11 too much. I go, all right. And the auditor
12 says, I'm going to reduce it. Well, fine.
13 Or hey, you took too much appreciation, I'm
14 going to reduce it. Okay. You know, just
15 plain vanilla questions on the base. You
16 took too much by way of transfer price.
17 Well, then reduce it to what you think is the
18 proper transfer price. That is always within
19 the realm of the auditor to do and has
20 nothing to do with alternative apportionment
21 because that's a base issue. It's not an
22 apportionment issue.

23 Q: And when you say base, what do you mean?

24 A: The calculation of taxable income, how much
25 is properly reported by one entity, how much



1 by the related entity. Are they manipulating
2 the price between them to move and come
3 around or are they using a price that is what
4 strangers would be using in an unrelated
5 situation?

6 Q: So, as I ---

7 **THE COURT:** So, it appears to be that if a
8 corporation files a tax return under your
9 theory, and you can respond to this, that
10 does not fairly report the income in the
11 state of South Carolina, that the state
12 wouldn't simply just recognize that the
13 corporation failed to do that, your
14 interpretation would be that the onus is
15 placed upon South Carolina to now go and
16 modify the, the tax return to achieve a fair
17 apportionment using the separate entity
18 requirement without going to any other
19 formula. And why would that onus be placed
20 on South Carolina to do that?

21 A: It's the same onus that is already ---

22 **THE COURT:** Don't object to that.

23 A: It is the same onus that is already imposed
24 on the tax department anytime a taxpayer
25 takes a deduction that the Department objects



1 to. This is not a question of apportionment,
2 although I didn't think you meant it
3 technically as apportionment.

4 **THE COURT:** Well, I'm sorry.

5 A: Yeah. But that's okay. You meant the
6 allocation.

7 **THE COURT:** Adjustment. The allocation.

8 A: That this is the same issue whenever a
9 deduction is taken on a return. The auditor
10 is entirely appropriate to challenge a
11 deduction. We want to see them challenge
12 deductions. And they've got a spot if
13 there's an abuse going on. And it's no
14 different than if I'm trying to disguise my
15 personal entertainment as business or ---

16 **THE COURT:** Is there a different between
17 challenging a deduction and coming up with a
18 different adjustment to the tax return?

19 A: When they challenge the deduction, they can't
20 just say oh, it's zero. If I took
21 depreciation, this asset was depreciable and I
22 use the wrong method of depreciation, they
23 can't simply, simply say, oh you get no
24 depreciation whatsoever. No. They will make
25 an adjustment under the proper rules of



1 depreciation and that will reduce my deduction
2 and increase my tax. This is similar. This
3 is exactly what the IRS does, as I think
4 you'll hear from Dr. Cody tomorrow. So, this
5 is really part and parcel of what auditors do
6 all the time: take a deduction and adjust it.
7 Now, this may be a little bit more technical,
8 but you know, that's life.

9 **THE COURT:** All right. Proceed.

10 Q: Now, you've heard a lot of testimony in this
11 courtroom about this management fee.

12 A: Yes.

13 Q: You've heard a lot of testimony about this
14 management fee?

15 A: Yes.

16 Q: Let's assume it's off. What would be the tax
17 policy -- the correct tax policy response to
18 that?

19 A: His Honor is going to have to decide what the
20 appropriate adjustment should be. He's going
21 to hear from one party. He's going to hear
22 from the other. He's going to have evaluate
23 the credibility of the experts and make his
24 own decision.

25 Q: Are you saying you don't just automatically



1 go to combined reporting? Are you saying
2 that?

3 A: Well, combined reporting is set forth under
4 alternative apportionment. Alternative
5 apportionment requires there to be a defect
6 in the sales factor. What is the defect in
7 the sales factor? Why doesn't the sales in
8 the state fairly represent the amount of cars
9 sold? No defect in this case in the sales
10 factor. And so, the question becomes really,
11 it's not a combined reporting case. And I
12 think the Department, they -- well, not a
13 combined reporting case. So now we're in the
14 plain common law of adjusting discussions on
15 a tax return. You don't need a special
16 statute for that. You may have one, but you
17 certainly don't need a special one. I can't
18 just do willy nilly what I want on the
19 return, obviously, so.

20 Q: Did you hear the audit supervisor's statement
21 about the use of transfer pricing? Did you
22 hear his testimony when asked about that?

23 A: I heard him say he couldn't care less.

24 Q: All right. And I want to give you an
25 example, all right, and tell me from a tax



1 policy standpoint what it's -- what you're
2 reaction is to it. Suppose a corporation
3 were to buy something from an unrelated
4 party, paid \$100 for it. The corporation
5 just purchases something from the outside.
6 Now, suppose they -- that they buy the same
7 good from a related party, a subsidiary, paid
8 \$100 to the sub- -- the subsidiary. Used
9 cash, by the way. Cash transfer. Not just a
10 book entry, but used cash. Now, and they
11 have a transfer pricing report. It shows
12 that \$100 is what would be paid to an
13 unrelated party. Under those circumstances,
14 would it be good tax policy to simply ignore
15 that transfer pricing study upon which they
16 base that \$100?

17 A: Not at all. If you have a price with an
18 unrelated third party, and it turns out that
19 is exactly the same price that you are using
20 with your related party, what better evidence
21 could you possibly want that that
22 intercorporate treatment has been properly
23 booked. I don't care whether it's cash or --
24 I mean, cash is so 20th Century concept. So,
25 cash or journal entry, whatever, it doesn't



1 matter.

2 Q: I want to ask you about some business
3 structure. Okay. Now, what are some -- what
4 are some of the tax policies that are
5 involved in a taxpayer choosing a business
6 structure, choice of business structure?

7 A: Well, I mean a choice of your business
8 structure can be driven by many
9 considerations. The overriding one is
10 typically limited liability. And that's the
11 first thing you learn as a law student in a
12 biz org's class is we use limited liability
13 companies today, corporations to limit
14 liability. That's the number one thing.
15 Second, we may use it to get a better measure
16 of the profitability of certain activities.
17 Put all similar activities in the same entity
18 and then we can take a look at, at just how
19 profitable they are when we go to budget.
20 Another could be regulatory constraints or
21 forcing us to separate out, let's say
22 financing from the sale of cars. And so, we
23 have to move our financing activities and
24 separate them from the dealerships. And, you
25 know, depending on the unique aspects of a --



1 of a business, there could be other business
2 motivations into why we're doing certain
3 things. It could be there was a duplication
4 of services that went on, parent was
5 providing legal services, subsidiary had a
6 legal services. So, you want to put
7 everything together in the same entity, so
8 you don't duplicate. It could be services
9 were being provided and not charged for. All
10 right. Put them in the same entity and now
11 we'll make sure they charge for things. And
12 then, obviously, you want a tax efficient
13 structure. Nothing wrong with that. Our
14 students are having trouble finding jobs right
15 now. We don't want to put them out of work.
16 Of course, you can structure yourself taking
17 into account taxation. No one has to overpay
18 their taxes, a famous Supreme Court quip.
19 And so of course, you're going to do
20 something that's tax efficient while you're at
21 it.

22 Q: I'm going to give you a short list of, of, of
23 structures that taxpayer -- that a taxpayer
24 might choose. And I want your reaction from
25 a tax policy standpoint as to why such a, a



1 list is complete or incomplete. What if I
2 had a decision to use a corporation?

3 A: Sure. And no problem -- it should be
4 respected. If you want to use a corporation,
5 why not?

6 Q: It's a business structure, isn't it?

7 A: Yes.

8 Q: Or is it? What about to use a partnership?

9 A: You know, the part- -- partnerships are part
10 of the, the attractiveness of the limited
11 liability companies, which didn't always
12 exist. But part of their attractiveness is
13 they eliminate one level of, of tax. They
14 don't pay the corporate tax because they're a
15 pass-through entity. So, they are often
16 driven solely by tax considerations. Nothing
17 wrong with that.

18 Q: What about the question of where do I
19 incorporate my business? Where should I move
20 my plant? Where should I become a resident?

21 A: You know, residency is, is an interesting
22 situation because no one thinks that if I
23 move to Florida and I admit under deposition
24 I am solely in Florida because there's not an
25 estate tax and not an income tax and I owe it



1 to my children and grandchildren. And I do
2 everything proper. In other words, I am a
3 bona- -- bonafide resident of Florida. I'm
4 not playing games where I'm up north half the
5 year. I'm really in Florida and I hate every
6 minute of it. I was told keep out of the sun
7 and I, I don't like it, but the money that I
8 save is so severe. It's just -- I just can't
9 not do it. I don't think if I move from say,
10 a state of the north to Florida, and under
11 deposition I said, I'm here only for tax
12 purposes, they would say, oh, you're still a
13 resident of our state. Really? Why?
14 Because you moved for tax reasons. That
15 would be respected. If a plant comes here
16 and they say, you know, we did it only
17 because this state has a favorable tax
18 climate. Otherwise, we wouldn't be here.
19 We're her because you have X, Y, and Z. The
20 state from which they moved would never say,
21 I'm sorry; you're still located in our state
22 because you made that for purely tax reasons.
23 So, we have a lot of this change of structure
24 that gets respected. And nothing wrong in
25 that.



1 Q: I want to ask you about this, this structure
2 and these reasons for structure. I want to
3 know the tax policy for or against a taxpayer
4 being able to do this. Taxpayer has got some
5 business issues that need -- it needs to
6 address. That is fi- -- a financing function
7 to be separate from its retail stores for
8 regulatory reasons. It wants to segregates
9 its management function to provide those
10 services for all entities. It wants to avoid
11 duplication. It wants to avoid giving away
12 percentages of its -- of what it sells. They
13 want to charge the right amount for it. They
14 want to track that. They want to limit
15 liability, especially in California. Does any
16 of this sound familiar?

17 A: Yes.

18 Q: All right. Is it good -- is this in keeping
19 -- for these to be business reasons, to do
20 something, is this in keeping with good tax
21 planning and if not, why not?

22 A: Well, totally consistent in structuring a
23 business to take these considerations into
24 account.

25 Q: Is there any incongruous about a multi-state



1 taxpayer having multiple subsidiaries?

2 A: I've never seen one that did not that was
3 part of the Fortune 500. You know, if for no
4 other reason than limited liability. I've
5 never seen a fortune 500 company operated as
6 one entity.

7 Q: All right, sir.

8 A: Maybe they exist, I've just never heard of
9 it.

10 Q: Do you know whether or not when they filed in
11 a, a separate entity state, did they use
12 transfer pricing?

13 A: Who is they?

14 Q: These companies that you say that you --
15 that, that, that you, you, you ---

16 A: I see.

17 Q: --- you know -- you know that filed, and
18 there are many of them, you know they have
19 subsidiaries.

20 A: Yes. Well, it has been common in, in recent
21 times that there be a transfer pricing
22 report. I can't say when I first started in
23 this business, almost 50 years ago, that it
24 was as common as it is today. Today, it's
25 routine.



1 Q: Many companies will have one entity providing
2 administrative services to the group, is that
3 true?

4 A: Yes. I mean, it's very common that you have
5 an entity that provides legal and accounting,
6 and advertising, and HR, and all of that,
7 support services.

8 Q: But they have separate emphasis on proprietary
9 software or algorithms that tell you how much
10 to buy or sell their items for?

11 A: Well, a lot of businesses have something
12 that's proprietary, whether it's the Coke
13 formula, whether it's a search algorithm like
14 Google or whether it's an algorithm like some
15 of the live streaming platforms have, a pop-
16 up ad you might be interested in next. How
17 do they know that? Because they have an
18 algorithm. They've analyzed your buying
19 habits in the past. So, this is very common
20 today.

21 Q: Why don't they just license this out to have
22 outside entities do it for them?

23 A: I know. It's -- I -- you always have to
24 chuckle when you read, well, do they license
25 this out? Why in the world would you license



1 it out? You're going to license it to your
2 competitors so they can eat your lunch. I
3 mean, of course, you're not going to license
4 it out. Coke is not going to license it out
5 any more than Google licenses out its search
6 algorithm. It's a funny question to even
7 ask, did they license it out.

8 Q: All right. So, I want to ask you a little
9 bit about corporations, and as it will relate
10 to what we're talking about in this case.
11 Are there tax poli- -- policy considerations
12 related to the ownership percentages of a
13 corporation? Are they fixed in time or do
14 they change?

15 A: Well, let's, let's incorporate. You're an
16 affluent tax lawyer, you'll put in 90. I'm
17 just a professor, I'll put in 10. And we'll
18 form a corporation. You'll get 90 percent of
19 the shares. I'll get 10 percent of the
20 shares. You'll get 90 percent of the
21 dividends. I'll get 10 percent of the
22 dividends. If the corporation liquidates,
23 you'll get 90 percent of the assets, I'll get
24 10 percent of the assets. And that is fixed
25 in time. And I don't care whether the



1 corporation becomes terrific and we made a
2 shrewd in- -- investment in, in our startup.
3 I don't care if it falls on hard times. It
4 just doesn't matter. You'll be 90. I'll be
5 10. You give your shares to your sons. I'm
6 still 10. You may give it to a charity. I'm
7 still 10. It doesn't matter. It's history
8 and it's fixed. And you're always going to
9 be the 90. I'm always going to be the 10.
10 You know, unless their stock splits into
11 dividends or something like funny going on.
12 So, nothing odd about that.

13 Q: Would these same considerations apply to a
14 partnership or, or an LLC taxed as a
15 partnership, a pass0through entity in other
16 words?

17 A: Yes.

18 Q: And did you hear the audit supervisor's
19 discussion of something called the matching
20 principle?

21 A: I did.

22 Q: And was it historical testimony as well as
23 you recall that look, the matching principle
24 is being violated because the payments that
25 one entity is making into the corporation are



1 being changed when they come out as
2 distributive share? In other words, one of
3 the entity is paying in 75 percent, but only
4 getting 6.5 percent out and that somehow
5 violates the matching principle. How -- does
6 it? Does it not? If so, how?

7 A: Yeah.

8 **OBJECTION:**

9 **MR. ANTLEY:** Objection, Your Honor. The matching
10 principle is a legal concept. It's a legal
11 doctrine and he's asking him to provide a
12 legal opinion.

13 **MR. VON LEHE:** It's not a legal opinion, Your
14 Honor.

15 **THE COURT:** I thought that was an accounting
16 concept.

17 **MR. VON LEHE:** It is. It is.

18 **THE COURT:** I'm asking.

19 **MR. ANTLEY:** He's not an accountant, Your Honor.

20 **THE COURT:** Well, it's a ---

21 **MR. ANTLEY:** Then, the objection would be outside
22 the scope of his qualifications.

23 **THE COURT:** Any response to that?

24 **MR. VON LEHE:** Yes, Your Honor. The matching
25 principle is known throughout business, not



1 just to accountants, not just to tax lawyers.

2 It's a general concept ---

3 **THE COURT:** Is -- Professor, is the account -- the,
4 the matching principle, is it a concept of
5 tax policy?

6 A: It is, Your Honor. And we all teach it.
7 Anyone who teaches the first tax course to
8 law students talks about matching. But not
9 in the way the audit supervisor used it. He
10 used it, it's a -- it's not a principle the
11 way used and -- which I will explain. But
12 it's certainly a principle of tax policy.

13 **THE COURT:** Well, I'll overrule the objection.

14 Q: Go ahead, please.

15 A: Well, let's start with the proper use of the
16 matching principle. Everyone who takes basic
17 tax learns the following paradigm, that if
18 you borrow money to buy tax exempt bonds, you
19 can't deduct the interest on the borrowed
20 money because you have a deduction that's
21 generating exempt income. And that violates
22 the matching principle. If you're taking a
23 deduction, it should be to generate taxable
24 income. That's the matching principle that
25 every law student learns. Today, we have a



1 fancy name for it. It's called tax
2 arbitrage. That there's a mismatch between
3 two legs of the same transaction for the same
4 taxpayer. That your deducting the first leg
5 of it, but you're never reporting any income
6 on the second leg of it. And so, you have
7 the classic tax arbitrage situation and it
8 rears its head in many different contexts.
9 That's the typical ma- -- matching principle.
10 The principle I heard articulated was that
11 somehow I should only be able to take out of
12 this entity what I put into the entity. And
13 if you think about the corporate context,
14 which is a little easier to really get your
15 hands around, at least for me and my
16 students. I get dividends from corporations.
17 I don't do a thing for that corporation. I'm
18 not generating any income for that
19 corporation. I'm not buying anything from
20 that corporation. Yet I get a dividend.
21 There's no matching principle that says I
22 only can take out what I put into the
23 corporation. There's no principle like that.
24 So, I don't know where this matching, so call
25 matching principle arises from. I've never



1 seen that discussed ever, anywhere, so. And
2 it makes no sense when you think about it as
3 a corporation. So, that's not -- you don't
4 require there to be any kind of match. I
5 could have stock in CarMax and never bought a
6 car or sold a car to CarMax. So, there's no
7 matching principle. If there were, then most
8 would be able to get dividends because how
9 many of us worked for the corporation, or as
10 an employee or do business with the
11 corporation necessarily. So, I've never heard
12 that context for a so-called principle. I
13 don't think it's a principle. It's self-
14 serving in this case, so.

15 Q: And, and from an annual standpoint, if it
16 were -- if, if it were not fixed, what would
17 happen?

18 A: If your ownership ---

19 **THE COURT:** If it was not fixed?

20 **MR. VON LEHE:** Uh-huh. If -- yes. Fixed from the
21 beginning throughout the life of the entity.
22 10 percent of your corporation now is 10
23 percent of the corporation 20 years from now.
24 I know it sounds rudimentary, Your Honor, but
25 it's relevant here.



1 A: So, you have 90 shares, I have 10 shares. If
2 we had the so-called matching principle and
3 this got adjusted every year, I don't know,
4 one year you'd have more or less than 90.
5 I'd have more or less than 10. I don't even
6 know how you begin to thing about it. But of
7 course, we don't do that. Your -- your stock
8 ownership, it's history. It's fixed in time.
9 It's backwards looking. It has nothing to do
10 with, with this matching principle.

11 Q: So, there's no fluctuation for the ---

12 A: Right. Your 10 -- your 90 shares are your 90
13 shares and always will be.

14 Q: Right.

15 A: You know, unless there's something funny going
16 with the corporate restructure, you know, all
17 that.

18 Q: All right. I want to ask you a few more
19 questions. These relate to the issue of
20 economic substance. And my understanding that
21 economic substance is a major concept in the
22 area of, of tax policy. Is it or is it not?

23 A: It is.

24 Q: Right. And what is economic substance in the
25 area of tax policy?



1 A: It, it has different meanings, unfortunately.
2 It has a lot of inconsistent case law. You
3 know, we heard referenced yesterday the
4 economic substance in the regulations under
5 482. And when you look at those regulations,
6 the IRS will respect structures, unless
7 there's no economic substance. And, you
8 know, what do they mean that? I suspect they
9 mean, well, you don't really have people
10 working here ---

11 **OBJECTION:**

12 **MR. ANTLEY:** Objection, Your Honor.

13 A: --- or anything else.

14 **MR. ANTLEY:** He's, he's ---

15 **THE COURT:** Whoa. Whoa. Stop.

16 **MR. ANTLEY:** There's -- first is speculation of
17 what the IRS means, and there's also legal
18 opinions as to the 482 regulations, and the
19 legal concept at this time of economic
20 substance.

21 **THE COURT:** Mr. Von Lehe.

22 **MR. VON LEHE:** Yes, Your Honor. Well, of course,
23 Section 482 has been discussed since day one
24 here. And I'm sure we'll continue throughout
25 the balance of this. One of the things that



1 was talked about yesterday, I've forgotten by
2 who. I really think by both sides of
3 witnesses, as well as the question of the ---

4 **THE COURT:** Well, Dr. DeRamus testified about the
5 application of economic substance from an
6 economist standpoint.

7 **MR. VON LEHE:** He did.

8 **THE COURT:** But he wasn't interpreting the law or
9 the regulation.

10 **MR. VON LEHE:** So, he said, Your Honor. However, I
11 would have an argument against that. When
12 you're looking at a regulation of the
13 Internal Revenue Code, and you're -- and
14 you're looking for the words tax substance,
15 which I don't think they were able to find,
16 but we know it's in there. We know it's in
17 there. I'm just wanting to -- broadly
18 speaking, I'm not going to ask for an
19 interpretation of this in this Internal
20 Revenue Code context. It's just one of the
21 places from which the term tax substance
22 originates. There are many others that -- it
23 doesn't just come out of 482 of the Internal
24 Revenue Code. Tax substance permeates
25 everything that we do in the tax area,



1 whether you be an accountant, CPA.

2 **THE COURT:** Well, I'll just ask in that regard, but
3 what the -- the meaning of -- was it 482?
4 With ---

5 Q: Stay out of 482, if you will, and talk about
6 economic -- and, and talk about economic
7 substance.

8 A: Yes. I think when you said ---

9 **THE COURT:** Well ---

10 **MR. ANTLEY:** He ---

11 A: --- tax substance you meant economic
12 substance.

13 **THE COURT:** Yeah.

14 **MR. ANTLEY:** And, and, Your Honor, he said based on
15 case law too. It wasn't just limited to 482.

16 **THE COURT:** Well, let's just -- I'll let him start
17 again. You -- you've heard the objection.

18 A: Yes.

19 **THE COURT:** And then you can jump out of that
20 comfortable seat if you want to.

21 Q: What does it -- what does it mean, Professor
22 Pomp, what does it mean?

23 A: Yeah. It means are you -- are you a shell
24 corporation or do you really have people.
25 If you have people, are they figureheads or



1 are they actually doing something? It's sort
2 of what you would think when we say, oh, that
3 entity has substance to it. It's got a
4 couple hundred people and they're working on
5 algorithms and software, and everything else.
6 Well, that's real substance. So, you know,
7 it, it had its roots during the go-go days of
8 tax shelters when you would invest in what
9 was clearly not viable entities. And did it
10 solely for tax benefits. That there was
11 really no chance you were going to make an
12 economic profit without the tax benefits. It
13 never would have occurred in a world without
14 taxes. So, one way I like to think about
15 economic substance is would this, whatever
16 this is, this structure, this transaction,
17 would it have occurred in a world without
18 taxes? And in a world without taxes, you
19 would still worry about limited liability and
20 you would still worry about regulatory
21 constraints. And you would still worry about
22 being able to measure the profitability of
23 certain transactions. So, that's the way, I,
24 I think about it. The tax shelters would
25 never have occurred in a world without taxes.



1 Purely tax driven.

2 **THE COURT:** I guess for the record to be clear,
3 that was a well-worded revision, but it did
4 sound like there was a lot of it that was
5 interpreting the meaning of the regulation.
6 So, I -- I'll just -- as a judicial
7 standpoint, I will take that testimony for
8 what it's worth.

9 **MR. VON LEHE:** Thank you, Your Honor.

10 Q: Thank you, Professor Pomp.

11 **THE COURT:** All right. Let's take a quick break.

12 (Off the record from 3:47 p.m. to 4:04 p.m.)

13 **THE COURT:** Have at it.

14 **OBJECTION:**

15 **MR. ANTLEY:** Your Honor, just for the record, I
16 would like to renew the Department's objection
17 and moved to strike Professor Pomp's testimony
18 under Dawkins and Vortex. His, his testimony
19 was -- contained legal opinions and arguments.
20 They were not relevant and there were no
21 connections to the facts or there was no
22 testimony that was helpful to the Court in
23 the interpretation of those facts.

24 **THE COURT:** Well, that would be a belated objection
25 at this point. Any objections that you made



1 during the trial would be subject to review
2 about whether those objections at that time
3 were properly made, but at this point, I'm --
4 I would overrule that as a belated objection.

5 **MR. POMP - CROSS-EXAMINATION BY MR. ANTLEY:**

6 Q: Professor Pomp, your opinion relies on CBS's
7 ownership percentages reflecting the value of
8 CarMax East and CarMax West contributions?

9 A: Which opinion?

10 Q: Your opinions in this matter.

11 A: I gave a lot of opinions. I'm not sure which
12 ones you are referring to.

13 Q: Okay.

14 A: If you can give me an opinion, I could answer
15 it yes or no or whatever.

16 Q: Okay. Do you recall when I asked you in your
17 deposition if the percentages were to re- --
18 were reversed, would that affect your opinion
19 at all?

20 A: Which percentages were you referring to?

21 Q: The ownership percentages of CBS.

22 A: CBS's ownership percentages of what? What
23 does CBS own?

24 Q: The ownership of CBS.

25 A: Oh, the ownership of CBS. So, you mean, in



1 my example, you noticed I, I didn't talk
2 about 6.5 or 93.5. I talked about John
3 owning 90 and I owning 10. And if I own 90
4 and John owned 10, my opinions would not
5 change.

6 Q: Okay. Do you still have the copy of that
7 deposition in ---

8 A: Yes.

9 Q: --- front of you? If you could go to Page 66
10 and just let me know when you're there.

11 A: 56?

12 Q: 66.

13 A: 66. Okay. Okay.

14 Q: Okay. So, you're there. If you could look
15 at Line Number 24.

16 A: Line 24. Question.

17 Q: If you -- if you just -- if you're there, let
18 me know and I -- and I'll read it and if
19 you'll just let me know if I'm reading this
20 correctly. Okay? Are you there?

21 A: I am.

22 Q: Okay. Question: If the percentages were
23 reversed, would that affect your opinion at
24 all? Answer: No. As long as those
25 percentages reflected the value of the



1 contributions. I mean, you couldn't just --
2 you couldn't just switch the percentages if
3 they had nothing to do with the value of the
4 con- -- contributions. So, I'm assuming if
5 East gave contributions that were 93.5 percent
6 of what has been contributed, then East would
7 have a 93.5 percent ownership interest. I
8 mean, those percentages followed the value of
9 the contributions. So, I have no problem
10 with that. It's the way it should be. Did I
11 read that correctly?

12 A: You did.

13 Q: Okay.

14 **MR. ANTLEY:** No further questions, Your Honor.

15 **THE COURT:** You may step down.

16 A: Thank you, Your Honor.

17 **THE COURT:** I'll have to say, that went quicker
18 than I thought. Do you have any other
19 witnesses today?

20 **MR. ANTLEY:** It's your case.

21 **THE COURT:** Yeah. I looked over that direction.

22 **MR. ANTLEY:** They were looking at us.

23 **MS. WOOTEN:** They were looking at us.

24 **THE COURT:** Oh, they were.

25 **MR. ANTLEY:** Yeah.



1 **MR. STREISEL:** Can we take a short break? We got
2 to go grab Bryson.

3 **THE COURT:** Okay.

4 **MR. VON LEHE:** Thank you, Your Honor.

5 (Off the record from 4:09 p.m. to 4:14 p.m.)

6 **MS. GEER:** Your Honor, CarMax would call Dr. Brian
7 Cody.

8 **MS. PEREZ:** They're going to start using their
9 side. If you could just fix that side. So,
10 right on the end.

11 **COURT REPORTER:** Please raise your right hand. Do
12 you solemnly swear the testimony you're about
13 to give is the truth, the whole truth and
14 nothing but the truth, so help you God?

15 **DR. CODY:** I do.

16 **COURT REPORTER:** Thank you very much, sir. Please
17 state your name for the record.

18 **DR. CODY:** Yes. It's Brian Joseph Cody.

19 **DR. CODY - DIRECT EXAMINATION BY MS. GREER:**

20 Q: Dr. Cody, can you tell us what your basic
21 opinions in this case are?

22 A: Yes. It -- my basic opinions are, are three.
23 The first is when we look at the Ernst and
24 Young transfer pricing studies, that they are
25 reliable, that they were done in a diligent



1 fashion, and that they provided reasonable
2 basis upon which for CarMax, and by that I
3 mean CBS, has its -- has its management fees
4 with CarMax East and CarMax West. That it's
5 reasonable to rely on those to set that --
6 those management fees. That's first. The
7 second opinion is when we look at the
8 structure of the -- of the business, the, the
9 legal and operating structure of the business,
10 that that structure is not unusual in, in any
11 way, as I see it both from a straight
12 transfer pricing perspective and from a
13 industry perspective, it's something that
14 I've, I've seen before and nothing unusual.
15 And then the third is that the alternative
16 that's been offered by the state and, and
17 discussed by Dr. DeRamus, that that does not
18 reason -- that those methods do not
19 reasonably reflect the amount of activity of
20 CarMax East in South Carolina and therefore
21 would not appropriately or reasonably
22 determine its taxable income in this state.

23 Q: All right. Let's talk about your background
24 and qualifications.

25 **THE COURT:** I'm going to stop you.



1 (Off the record from 4:16 p.m. to 4:21 p.m.)

2 Q: All right. So, we put Joint Exhibit 58,
3 which is -- what is -- what is this?

4 (Joint Exhibit 58 was referenced at this time.)

5 A: This is a copy of my CV.

6 Q: Okay. And does this accurately summarize
7 your educational and employment background?

8 A: I -- yes, it does.

9 Q: Is there -- have there been any updates since
10 this one that you're aware of?

11 A: If you can scroll up a little bit or down on
12 the page, whichever makes sense. Just down
13 to the expert reports and testimony. I think
14 you can stop. Yes. Since I provided this
15 CV, I have been involved with some additional
16 cases.

17 Q: Okay. Do you want to just run through what
18 those are?

19 A: Sure. There -- I testified here in South
20 Carolina on a, a matter last fall having to
21 do with transfer pricing. It was with
22 respect to a retailer. I have issued a -- an
23 expert report in a matter for the --
24 involving the state of Minnesota for a, a
25 financing operation. I also recently



1 testified -- wrote an expert report and
2 testified as an expert in a South Dakota
3 having to do with a -- with a finance
4 company.

5 Q: Okay.

6 A: Yeah. I, I believe that's it. I believe.

7 Q: All right. Can you briefly tell us about
8 your educational background?

9 A: Yes. I have two Bachelors of Arts, both
10 summa cum laude. One is in French, the other
11 is in economics, both for the University of
12 Missouri Columbia. That was where I did my
13 undergraduate work. After completing
14 undergraduate work I went to the University
15 of North Carolina, Chapel Hill, where I
16 earned my PhD in economics.

17 Q: And can you summarize your employment history
18 for us?

19 A: Yes. After I completed my graduate work, I
20 went to work at the Federal Reserve Bank of
21 Philadelphia in the Research Department.
22 There I was a, a senior economist in the
23 research department where we performed various
24 bank activities. We would brief the bank
25 president before he would go down to the open



1 market committee meetings. It was a he at
2 the time. That was Ed Baney. We conducted
3 research, gave training, gave speeches on
4 behalf of the bank.

5 Q: Can, can you hold on one second?

6 **MS. GEER:** Would y'all mind scrolling? I forgot
7 that y'all were on it. I was sitting there
8 looking at Bobby going, can you scroll down.
9 Would you mind scrolling down to the -- where
10 the employment history begins?

11 A: Oh, no. Up. Up.

12 **MR. HARRINGTON:** Going back up?

13 **MS. GEER:** Oh, is it ---

14 A: It's up on the side.

15 **MR. HARRINGTON:** Up or down?

16 A: The first page.

17 **MR. HARRINGTON:** Okay.

18 **MS. GEER:** I just couldn't see it. Maybe I'm
19 blind.

20 A: There you go. That's perfect.

21 Q: Okay.

22 A: That's perfect.

23 Q: All right. Perfect. Sorry to interrupt.

24 A: Sure. So, that was my first position coming
25 out of -- out of graduate school.



1 Q: Yep.

2 A: During that time, I also taught international
3 finance in the business school, the Wharton
4 School the University of Pennsylvania.

5 Q: Uh-huh.

6 A: That's where I taught upper level graduates,
7 under -- undergraduates rather, and also MBAs
8 in, in, in the Wharton School. Then I left
9 the Federal Reserve Bank in early '91 and
10 began my career in transfer pricing. And I
11 joined Coopers and Lybrand as a manager in
12 their transfer pricing group in Chicago at
13 that point. And started learning transfer
14 pricing and applying it within the, the
15 context of taxpayers across a number of
16 different industries. I was at Coopers and
17 Lybrand for a little over two years, two, two
18 complete years. And then I went to Arthur
19 Andersen and started up their central region
20 transfer pricing practice. That was in '93.
21 I was with Andersen and I had a couple
22 different roles during that period with other
23 Andersen -- always in the intercompany
24 pricing -- transfer pricing group based out
25 of -- based out of Chicago. I became a



1 partner in Arthur Andersen and then was there
2 until basically Andersen was no more.

3 Q: Okay.

4 A: Right. And at that point, I, I left and I
5 joined a small valuation transfer pricing
6 firm. It was -- it's name was InteCap. I
7 did that in 2002. Two years later, InteCap
8 was bought by CRA International, a much
9 bigger public company that's a -- that's a
10 consultant enterprise. And so, I'd list that
11 as CRA International. That was the, the name
12 at the end of the time, so.

13 Q: Right. So, that encompasses that en- -- that
14 entire time. There, helped to be the
15 transfer pricing practice both in the Chicago
16 office but then more broadly across the
17 group, particular when CRA purchased InteCap
18 in 2004. And so, I had a number of roles
19 there, both conducting studies, as well as
20 reviewing and, and doing trading and, and
21 other things. Then in 2006, I left CRA
22 International and joined KPMG. And I was a
23 partner in principle, which is a non-CPA
24 partner with KPMG until I retired from KPMG
25 in September of 2020. I held many different



1 roles while at KPMG during those 14 some plus
2 role -- plus years. When I joined, I was
3 leading the Chicago transfer pricing group.
4 Then -- and as well as conducting studies,
5 doing training, speaking on behalf of the
6 firm, all those kind of normal activities.
7 Also, during that time, after spending some
8 time working with the Chicago group, I
9 oversaw the Western region transfer pricing
10 and economic and valuation services group for
11 KPMG. That group -- within KPMG, there's
12 tax. And then within tax, there were the
13 specialities. There's international tax,
14 state and local tax, and then there was
15 economic evaluation services. And within
16 economic evaluation services, we had transfer
17 pricing. We had valuation services, separate,
18 And then there was economic services.
19 Economic services did things like economic
20 impact studies. A company was going to set
21 up a, a factory. What would -- what benefits
22 would the local region have? Might use it to
23 help negotiate training credits and other
24 things like that. Right. So, I headed up
25 that group in the west. So, it was basically



1 everything from the Mississippi River west to
2 you hit water. Roughly, 300, 350 people
3 that, that I supervised there. Did that for,
4 for a while. Then I was asked to lead the
5 transfer pricing group in Dallas. And I did
6 that for a couple of years. And then for the
7 last several years, when I was at KPMG, I led
8 the economic and valuation services group a--
9 -- again. But this time at the national
10 office within KPMG. There was a group that
11 was called -- it -- it's still there, Called
12 Washington National Tax. It is really the --
13 as I say, the national office. It is the,
14 the technical center for, for KPMG.
15 Certainly, you work on, on projects. You
16 work on client matters. But then also, it's
17 important to -- you're, you're, you're
18 basically the voice for KPMG at that point.
19 When technical issues come down and they
20 can't be resolved, they're, they're brought to
21 Washington National Tax and specialists will
22 work on them and then, make a decision. What
23 is the firm's position on this matter, right?
24 And depending on the project, you might have
25 a WNT, Washington National Tax specialist on



1 your team. I served in, in that role many
2 times as well. And again, my role in, in
3 that Washington National Tax group was to
4 oversee, as I said, the economic and
5 valuation services group. So, again, transfer
6 pricing, the valuation specialists who did
7 those detailed complex studies, as well as
8 set the standards for valuation within the
9 firm, and as well as the economic services
10 group. Then I took my retirement from KPMG
11 in 2020. And in, in my retirement -- I would
12 say partial retirement, right? I set up my -
13 - just an independent consultancy, which is
14 what I -- what I do now. So, provide expert
15 testimony, advise in matters like this. But
16 also, I have a couple of former clients who
17 asked me to continue to provide advice and
18 consulting with them. I also consult with
19 the Dublin office, Dublin, Ireland office of
20 KPMG, to be a senior resource for them on
21 transfer pricing, on matters involving
22 transactions outside the U.S. really for, for
23 Irish clients. And so ---

24 **THE COURT:** Do you get free trips to Ireland?

25 A: We could -- I get some trips to Ireland.



1 There's work involved, so.

2 **THE COURT:** All right.

3 A: You try to balance it, you know. Yeah. But
4 it's nice. My, my, my dad came over from
5 Ireland when he was in his 20s, so we still
6 have some family there. So, I have that nice
7 tie. So, that was -- that's nice, so there's
8 that benefit that comes with it.

9 Q: All right. Any- -- anything else about your
10 employment history that you wanted to discuss?

11 A: I think that takes it through the -- through
12 the chronology, I believe.

13 Q: Okay. All right. Let's talk about your
14 transfer pricing experience. How many
15 transfer pricing reports would you estimate
16 that you've prepared for clients in your
17 career?

18 A: Oh, over the now 32 plus years, hundreds of
19 reports. And I, I would say that doesn't
20 count the, the, the updates, the annual
21 updates kind of things, but ---

22 Q: Okay.

23 A: --- initial studies. Yeah.

24 Q: Initial studies. All right. And then of
25 those, an estimated number of clients? I



1 knows there's repeat clients is an issue in
2 this business. Like what percentages or what
3 number of clients total?

4 A: Oh, gosh. Again, I would says hundreds of
5 some -- somewhat smaller than hundreds and
6 the hundred studies because ---

7 Q: Right.

8 A: --- you might do three studies for a client
9 on different matters. But again, a
10 substantial number. It's at least a couple
11 hundred.

12 Q: And what types of industries have these
13 clients been?

14 A: Really across the whole gamut of, of
15 industries. Everything from chemicals and
16 automotive to apparel to medical devices to
17 steel. And really, I would say though as, as
18 I work through those different and across
19 those different industries, over time, I built
20 a speciality in retail and consumer products.
21 And really over the last, I'd say close to 20
22 years, that was where the predominant share
23 of my industry work was, was in that, that
24 retail/consumer area. And I -- and during
25 that time, in the, the last decade or so, I



1 had headed up that group, if you will, of a
2 economists within KPMG's transfer pricing
3 group.

4 Q: And when you say that group, do you mean a
5 retail ---

6 A: That's right.

7 Q: --- transfer pricing group?

8 A: Retail and consumer products. Yes.

9 Q: And what experience do you have with
10 transactions similar to those addressed by the
11 Ernst and Young studies here?

12 A: Oh, I -- substantial experience. We look at
13 the, the transactions that -- the licensing
14 of intellectual property, trademarks, business
15 systems, and then the provision of, of
16 services, all the way from, I'll say the, the
17 basic administrative kind of services to
18 advertising, real estate, and I'll say, high-
19 valued business strategy services. Both in -
20 - brought a lot of -- across a lot of
21 industries, but also very much specific to
22 retail and to understand how within a retail
23 context those, those transactions are examined
24 in and organized. So, substantial.

25 Q: Okay. Well, what experience do you have of



1 valuating transfer reports -- I'm sorry --
2 transfer pricing reports that have been
3 prepared by someone else?

4 A: It was something ---

5 **MR. HARRINGTON:** I didn't touch anything.

6 (Laughter.)

7 A: That's okay for right now.

8 Q: Yeah.

9 A: I'd say substantial. It, it was a regular
10 part of what we did in, in a number of
11 different ways. For example, if KPMG were
12 the auditor for a company, right, part of
13 what would happen is the auditor would sign
14 off on the tax provision. So, we'd have our
15 tax group working on the tax provision.
16 Typically, conglomerate, right, a modern
17 company has intercompany transactions, right?
18 So, we would review the intercompany
19 transactions to see are they com- --
20 compliant, is there some risk associated with
21 those, should there be a reserve put up, is
22 there a potential for an adjustment. And
23 then typically, as part of that, the company
24 would have transfer pricing reports that have
25 been prepared by another firm, whether it's



1 E&Y or CRA or one of the, the public
2 accounting firms. So, we would review the
3 reports as part -- part of that. And it
4 would typically involve also getting
5 additional information from the, the service
6 provider. And so, there would be some
7 interaction, interaction there. Other times,
8 say where a company purchases another company
9 it acquires in a company wholesale, right?
10 And they want to integrate the two -- the two
11 businesses. Well, that, that acquired company
12 has its structure. It typically would have
13 intercompany transactions. And so, wanting to
14 review those studies to see how the pricing
15 is, how does it fit with the, the -- say, the
16 existing companies pricing. How reliable is
17 that? Were there changes that need to be
18 made to those? So, we would review those.
19 Certainly then also in the context of even
20 just internal review, right? And this was
21 something -- this was one of my roles within
22 KPMG where -- and I think Coopers had this
23 when I was there. I instituted it at
24 Andersen and at CRA, where there was a second
25 partner review. So, when a study was going



1 to go out, it needed to be first be reviewed
2 and signed off by a senior partner before it
3 could be issued. That program was -- had
4 been instituted at KPMG, and during the last
5 years of my tenure at KPMG, I was responsible
6 for that program. Made -- seen its -- its --
7 and so, that meant reviewing studies, right?
8 And also working with a team who reviewed
9 studies.

10 Q: And can you tell us is there a difference in
11 the amount of time or effort involved in
12 reviewing someone else's work versus
13 developing your own report?

14 A: Yes. There's, there's typically a fairly
15 large difference. Certainly, when you --
16 when you get a study, and you read it, right,
17 you see the facts as they're laid out, you
18 see the selection of the method, you see the
19 data that was used and the comparables,
20 right? And you, you have that in some
21 context, right? How does it fit with my
22 experience, right? But you can't just stop
23 there, right? You need to be able to verify
24 the facts, right? That can sometimes mean,
25 well, let me talk to the team who prepared



1 it. What did -- what did they do, right? It
2 can be, oh, I need to speak to some people at
3 the company to verify facts but it wouldn't
4 be the same level of effort that would have
5 gone into actually first preparing the --
6 preparing the report. So, typically, it's,
7 it's much less. And of course, it varies on
8 how I'd say straightforward the analysis is
9 versus a very complicated analysis. That can
10 impact it as well.

11 Q: Okay. Have you ever done in any work on
12 behalf of the IRS or a state taxing
13 authority?

14 A: I have. Yes.

15 Q: Can you tell us about that?

16 A: Yes. For the IRS, in several respects.
17 Provided some training and worked with them
18 on some, some advisory groups. For instance,
19 the last one that comes to mind was the IRS
20 was interested in how the, the service
21 providers, like KPMG and E&Y and others, how
22 they reviewed or how they viewed the various
23 data spaces and comparables, and what the
24 sources were. And how methods were being
25 applied. So, they wanted to understand,



1 understand that. So, they brought a number
2 of us in and had kind of an open forum to
3 discuss about that. Also, participated in,
4 in some other training for them. For state
5 authorities, while I was at Charles Rivers
6 Associates, CRA, I had an engagement with the
7 Massachusetts Department of Revenue. They
8 were interested in learning about transfer
9 pricing, how they could improve the quality
10 of their audits across a number of different
11 services areas. So, worked with, with them
12 as well. Yeah. And, and most recently, and
13 this has just been confirmed recently, I'm
14 going to be working with the International
15 Monetary Fund. They're an international
16 organization created as coming out of the
17 United Nations. They work with --
18 particularly with developing countries, but
19 countries all around the world from a finance
20 side: efficient markets, financial markets,
21 the integrity of the financial markets. And
22 in, in particular there, be part of a, a
23 small group that's going to go and work with
24 the South African government to help them
25 kind of reconstitute their tax function, and



1 in particular for me, to work with them on
2 their transfer pricing department. And so
3 I'll be doing that, that in the fall.

4 Q: Have you ever given any testimony before the
5 Organization for Economic Cooperation and
6 Development?

7 A: Yes. I have. So, the, the OECD,
8 Organization for, for Economic Cooperation and
9 Development is a -- it was a group that set
10 up after World War II to kind of help keep
11 everyone organized, right? Kind of build,
12 rebuild, help rebuild the economy of the
13 world after the -- after the war. One of the
14 things that OECD has done is to issue
15 guidelines on transfer pricing. Very much
16 modeled on the U.S. arm's-length standard.
17 But they have -- but they're -- they're an
18 international standard. So the OECD,
19 depending on the issue, has had various
20 public forums where you can be invited into
21 testify on a particular matter. And so I've,
22 I've, you know, participated in those public
23 forms. In particular, I testified on
24 intangibles and how we think about valuing
25 the intangibles and the databases in



1 particular that we use when we're thinking
2 about setting a royalty rate for the license
3 of a, of a patent or a trademark, something
4 like that, in an intercompany transaction.

5 **MS. GEER:** Okay. Are you still the one hooked up?

6 **MR. HARRINGTON:** Yes, ma'am.

7 **MS. GEER:** Would you mind scrolling down to where
8 his publications are listed?

9 **MR. STREISEL:** I, I can do it, if you unplug.

10 **MR. HARRINGTON:** Okay.

11 **MS. GEER:** You want to -- you can switch over.

12 **MR. STREISEL:** What do you want?

13 **MS. GEER:** Publications.

14 A: There you go.

15 Q: All right. So, are there -- could you point
16 us to any of your publications that are
17 related to the issues in this case?

18 A: Yes. I have -- I, I would say I have a
19 number of, of them. Just as I think about
20 the issues here, it's how we conduct a study,
21 how we identify the valuable activities,
22 right? How we apply methods, both generally
23 and in the state context. So, we'll kind of
24 look at those publications. The, the --
25 Getting to Know the Value Chain; one of the



1 subjects of that is looking at it in a
2 critical way. What does a company do to make
3 money, right? And how does that fit within
4 an analysis, a functional analysis? The
5 value chain is kind of a newer term as it's
6 applied to transfer pricing, but at its
7 heart, it's identifying where companies do
8 activity. So, that -- that's key there. The
9 next one, the, the transfer pricing policy,
10 COVID nine -- ni- -- COVID-19 as we look at
11 routine returns. What this was all about was
12 how to changing economic conditions impact the
13 returns that we see where we do a comparable
14 search and we're trying to find a return for
15 a selling activity or providing a service.
16 And one of the things that, that this
17 relevant for is that, going through COVID
18 where some industries were impacted more than
19 others, you even saw that on some retail,
20 right? We look at retail grocers. They did
21 pretty well, right? Apparel companies, brick
22 and mortar, not so well, right? So, it had
23 industry factors there. Then I had several
24 on, on customs there, but it was kind of more
25 general transfer pricing. If you go --



1 scroll down a little bit, Bobby, if you
2 would. Transfer pricing brave new world.
3 Again, that's -- that has this value chain
4 kind of flavor to it and, and how you look at
5 the analysis there. There we go. Skipping
6 past a couple of these, the fourth one down
7 that we see, this was the, looking at if you
8 have -- because clients might have or
9 companies might have a -- an adjustment on
10 their federal return initiated. And that
11 then has impacts on how they then either
12 organize or price their state transactions and
13 how then it kind of flows through. So, in
14 this case, working with some members of our
15 state and local practice at KPMG, I wrote an
16 article to explore those issues, which was
17 really important to, to understand because I'd
18 always done a lot of state work, to try
19 understand the implications. How are states
20 different? How do we think about different
21 and how the transfer pricing flow through?

22 Q: And just for the record, which one are you
23 referring to?

24 A: That's the, It Ain't Over 'Til it's Over,
25 Part Two.



1 Q: All right.

2 A: I won't be excused of too much clever here,
3 so. Okay. You can go down a little bit
4 more. Cost Sharing U.S. Developments. That
5 has, has an intangible flavor to it, and
6 we've got intangibles being developed over
7 time. The -- again, there's another cost
8 sharing article down below. Again, from an -
9 - and it involves the development of
10 intangibles, much like we have here when
11 discussing within some of the parties. We're
12 just about done. Go ahead. Down a little
13 bit more. There you go. That's good. An
14 importantly here, this goes back right to the
15 beginning of my transfer pricing career. The
16 second one down, the role of functional
17 analysis in intercompany pricing. So, right
18 from the very beginning, the very first
19 partner that I worked for, Deloris Wright was
20 there, she just ingrained into us the process
21 that we would go through. And so, really,
22 the, the role of functional analysis and how
23 you conduct one is a foundational piece in,
24 in -- across all the transfer pricing. And
25 so, this really sets out, just the standards



1 and how it develops over time. But that
2 certainly relevant to how we would conduct
3 our analysis. So, I think that's -- those
4 are -- those are the major ones, I'd say.

5 Q: Do you do any teaching?

6 A: I, I, I do and I have done teaching. Yes.

7 Q: And any classes or courses that you would say
8 are relevant to this case?

9 A: Yes. So, we've mentioned some of the, the
10 involvement in teaching already for, for tax
11 authorities. While I was at CRA, I would do
12 biannual or twice a year, I'd say that,
13 training with the European American Tax
14 Institute that involved training that I would
15 two, three-day courses in the spring and in
16 the fall. There, I provided test --
17 training, certainly internal training, that's
18 fine. But then also training to other
19 organizations. I've taught at the University
20 of Vienna on -- in their graduate level
21 transfer pricing course. I have participated
22 in training at Tax Executive Institution, TEI,
23 and the AICPA, American Institute of Certified
24 Public Accountants. Those, I think are
25 particular relevant here because those were --



1 those were state level. And we're talking
2 about transfer pricing in a state context
3 over time. I'm sure there's more, but
4 that's, that's what comes to mind.

5 Q: Okay. And you testified that you have a PhD
6 in economics. Is -- are there any specific
7 areas within economics that you feel you have
8 expertise?

9 A: Yes. So, my PhD was in international tax --
10 excuse me -- international finance and trade,
11 and econometrics. So, certainly there are --
12 just really the economic fundamentals of how,
13 how business is organized and how it operates
14 on not just internationally, but more
15 generally. And also, then just the, the
16 rigor of the, the statistical analysis that
17 one needs to do. That's really the
18 econometrics side. But also, we have that
19 broad training. And I would really say that
20 -- and that's what I used I'd say more when I
21 was at the Federal Reserve Bank. But then,
22 over the last 32 years, it's been much more,
23 I would say applied economics in a particular
24 subject area, which is transfer pricing. But
25 also, more broadly to tax issues and to some



1 income characterization issues, and also, some
2 finance issues on how we think about debt
3 equity and, and matters like that.

4 Q: Have you been retained as a testifying expert
5 before? I believe you've told us you have.

6 A: I have. Yes.

7 Q: Approximately how many times?

8 A: Approximately 25 times.

9 Q: And have they've been for both taxpayers and
10 -- or what have they been -- what, what type
11 of cases?

12 A: Yeah. So, out of those roughly 25 times, I
13 would say roughly 20 or so have been tax
14 related matters.

15 Q: Uh-huh.

16 A: Right. The other -- the others -- and, and,
17 and those have all been at either a state
18 level. A couple have been at a circuit court
19 level, so more on the civil side, but tax
20 transfer pricing related. And then the other
21 -- the other matters have been more in
22 general economics. So, I've, I've testified
23 twice in, in Federal Court. So, federal
24 district court, Federal Bankruptcy Court, on
25 the characterization of advances in a -- in a



1 minority shareholder related party context,
2 whether it is the funds that were advanced,
3 were they properly characterized as debt or
4 equity, right? So -- and, and those have
5 been in, in approximately a, a dozen. My, my
6 tax experience has been in roughly a dozen
7 different states.

8 Q: Okay.

9 A: Yep.

10 Q: Any testimony for a taxing agencies?

11 A: Yes. I am.

12 Q: Can you tell us about that?

13 A: Yes. While I working with the Massachusetts
14 Department of Revenue, that training stint
15 that I was talking about, a couple of cases
16 came up that they wanted my act -- actual
17 active involvement with helping to develop the
18 cases. So, in one of those cases, I was
19 deposed as part of the, the proceedings. And
20 I think that, that case in particular very
21 relevant to this matter because the -- what
22 was at issue were -- were headquarters costs.

23 Q: Uh-huh.

24 A: And how they were characterized. And how
25 they should be charged out. And they -- and



1 in that case the, the, the functions are
2 different than what we have here, but still
3 around that, we've got centralized functions
4 and how they're charged out to the -- to the
5 operations.

6 Q: And have you ever been excluded as an expert
7 witness?

8 A: No.

9 Q: Have you ever refused to serve as an expert?

10 A: Yes. I have, many times.

11 Q: Tell me about that.

12 A: It happens for -- it's happened for a couple
13 of reasons. I'll say the easy ones are,
14 well, I have a scheduling conflict, right?
15 Or, this would happen sometimes, particular
16 at, at KPMG, where there might be an
17 independence that the, the -- there's an
18 audit relationship with one of the parties
19 and so you get conflicted out as a -- as a
20 firm. Those we'll, we'll kind of put off on
21 sight. The, the more substantive ones are
22 when I've looked at the issues and what I'm
23 being asked to do, I feel that I -- I
24 wouldn't be of service. I, I couldn't
25 support really the, the opinion that I would



1 be asked to make. And in that case, I would
2 just refuse. I just couldn't.

3 Q: What do you do before you accept an
4 engagement?

5 A: Several things. One from an administrative
6 standpoint, this comes from having retired
7 from KPMG. First, what I have to do is I
8 have to seek permission from KPMG. So, there
9 is still a bit of an independence check. So,
10 there's that level of due diligence. Once I
11 get cleared there, then I ask for
12 information. I want to understand what the
13 issues are, what are the positions of the
14 parties. And do to that, I want to see
15 things like, well, is there a de- -- a
16 determine I can read to understand the -- say
17 the Department of Revenue's position. Can I
18 see some financials to see if it's related
19 party sales, what the returns are. Get some
20 sense of is there kind of a reasonable
21 allocations of income, if you will. If
22 there's -- if I can see say some of the
23 documentation, if I'm going to be asked to
24 kind of review the documentation at some
25 point. Let me look at the studies, right?



1 So, there's -- I, I look at those things
2 before I even decide whether or not I can
3 accept a -- even if I've been approved by
4 KPMG or released to, to go ahead and
5 negotiate, before I go ahead, I, I -- it's
6 just incumbent upon me to, to look at those
7 things.

8 **MOTION TO ADMIT AS EXPERT:**

9 **MS. GEER:** Your Honor, at this time, we would move
10 to have Dr. Cody admitted as an expert in
11 economics and transfer pricing.

12 **MR. ANTLEY:** No objection, Your Honor.

13 **THE COURT:** He's admitted.

14 **MS. GEER:** Your Honor, just from a timing
15 perspective, I don't know how late you want
16 to go. If you want to end at qualifications
17 or if you want to keep going.

18 **THE COURT:** Well, where are we on the schedule for
19 finishing tomorrow?

20 **MS. GEER:** So, I would estimate that my -- can we
21 just go off the record for a minute?

22 **THE COURT:** Okay.

23 **(Off the record from 4:52 p.m. to 4:53 p.m.)**

24 **Q:** Dr. Cody, can you tell us the role of a
25 transfer pricing study? What is the purpose?



1 A: The transfer pricing study can have a couple
2 of different roles. One role can be a
3 company is entering into a new transaction,
4 they have a new subsidiary, they have a new
5 rela- -- a new business. And they're going
6 to be transactions. And the company wants to
7 make sure that they get those transactions
8 priced accordingly or priced appropriately,
9 and a reasonable basis in compliance with the
10 482 that the Federal Regulations on, on
11 transfer pricing. So, we would typically
12 call those planning studies that we would do,
13 right? Then there are also studies that are
14 done for -- are called more compliance and
15 documentation purposes. Those look at say
16 the actual results that, that a company has
17 produced, say the profit levels that have
18 been produced, the prices that have been put
19 into place. And then a co -- and a report
20 that would critically examine those, develop
21 the, the -- all the, the analysis around
22 that. And those reports can be used for
23 compliance purposes. And because the, the,
24 the strict transfer pricing regulations don't
25 have documentation requirements themselves.



1 When we talk about 482, that section. I
2 think we heard testimony yesterday, the
3 documentation is really under a different
4 section, but that section lays out -- it's
5 6662-E. That section lays out what a
6 transfer pricing analysis is supposed to have
7 in terms of facts and industry analysis and
8 how it would be constructed. So, those are
9 the -- those are the broad categories that we
10 would -- that we would use.

11 Q: And I want to ask a little about -- a little
12 bit about E&Y. Who are they? What is their
13 reputation?

14 A: Yes. E&Y is one of the, we call them the,
15 the Big Four tur- -- tax and accounting and
16 advisory firms in the U.S., global firm,
17 along with in terms of that group, you would
18 say it's KPMG, it's PWC, it's Deloitte,
19 right? So, competitors with that. And then
20 we've got I'll say another couple of tiers of
21 smaller firms. Their transfer pricing group
22 has been part of their -- if you will, their,
23 their, their business since probably the late
24 '80s when, when all the firms started really
25 looking at transfer pricing as something that



1 their clients needed as, as a service that
2 they could help with. So, over that time,
3 E&Y has built a very strong transfer pricing
4 team. They've had former IRS officials being
5 part of their group. I've seen their reports
6 repeatedly over my career and always been
7 impressed with the, the quality and diligence
8 that they -- they the represent in their
9 analyses. So, I, I have very high regard
10 for, for their group.

11 Q: What is -- what are the risks to an E&Y or
12 anyone else of providing a poorly prepared
13 study?

14 A: Well, there, there are several. One is just
15 pure reputational risk, right? You get a --
16 you get a reputation for doing poor work,
17 you're not going to get much more work,
18 right? So, that's just from a, you know,
19 straight business. That, that affects every
20 business you can imagine, right? So, there's
21 that. But also, from a liability standpoint,
22 right? If, if a company is relying on your
23 study to file its tax return and it -- and
24 it's saying yes, we have this study and it
25 was done to the high standards and we've



1 relied on that, you can imagine their could
2 be some type of kind of the equivalent of a
3 preparer penalty or something like that.
4 Come -- some kind of fine or civil action
5 that the -- that the company might be or the
6 firm might be subject to, if it prepared a
7 poor report, was somehow found negligent.
8 So, it kind of runs the gamut of, of all of
9 those things.

10 Q: And so, we've talked about the risk to E&Y.
11 What are the risk to clients?

12 A: Clients certainly if they don't -- that 6662
13 Section that I talked about is really a
14 penalty section, right? And so, if their
15 pricing is off and -- they can be subject to
16 penalties, right? And so, one way to
17 mitigate the, the possibility for penalties is
18 to have a proper transfer pricing study,
19 right? To show that the company has
20 demonstrated good faith, made a good faith
21 effort to get it right. That they've done
22 their due diligence. That they've relied on
23 professionals who are qualified. And if so,
24 those penalty regulations say the district
25 director can, can waive the penalties that



1 might otherwise apply if there was a transfer
2 pricing adjustment. There's that, and again,
3 you -- we've seen companies in the newspaper,
4 right, when their transfer pricing -- large,
5 multinationals might have got their transfer
6 pricing wrong. So, even for them there is a
7 -- kind of a reputational risk associated
8 with it as well. So, very -- it can very
9 high stakes.

10 Q: Yep. All right. So, talking about transfer
11 pricing studies in general, can you talk to
12 us about like how often their a paired --
13 prepared?

14 A: Yes. So, typically, if, if it's a new
15 transaction, you, you would prepare, as I
16 said, like a planning study at the beginning,
17 right? We do that. Fine. Once you're kind
18 of in the documentation mode, right, say once
19 very three years or so, you might do a full
20 study. And by a full study, I mean, you go
21 back out and you interview personnel, not tax
22 people, right? You talk to the tax people
23 just to get things organized, but you talk to
24 the actual operating people, who are out
25 doing the various activities. That base



1 forms the basis of your analysis. So, that's
2 a very detailed analysis. That's also when
3 you do a real I'll say refresh of your
4 economic analysis, whether it's looking for
5 whatever kind of comparables you're looking
6 for. You would do that in detail in that as
7 well. And then you'll write that up, right?
8 And then it's really, it kind of depends on
9 I'll say facts and circumstances. Some
10 companies then do a -- kind of a small annual
11 update. They might update their comparables
12 every year. But it's not required, right?
13 If things really haven't changed, you might
14 do it only every three years or so, right?
15 You might still review it, have the -- say,
16 internally review it and say, oh, have our
17 facts changed? No. They haven't changed,
18 right? Has really the, the profits in the
19 industry and, and comparables, have they
20 changed? No. They haven't really changed.
21 So, you know, I'm going to devote my company
22 resources someplace else. And I'll come back
23 in another year and I'll refresh it. And
24 then it's much less of an effort. I verify
25 the facts, update the comparables, and then



1 write the -- write the study up. So, there's
2 a real difference in the effort. But you do -
3 - you make a business decision about how much
4 and how frequently, based upon the risk that
5 you have and quite frankly, the resources
6 that you have.

7 Q: Do the 482 regs speak to this issue?

8 A: They, they do actually because the, the, the
9 -- and I'm using 482 here broadly, right?
10 Because the -- within the documentation of
11 the 6662, they do talk about that the level
12 of effort that you put into your
13 documentation should reflect the -- I'll say
14 the importance, the risk, the, the role of
15 the transactions in your business. So, if
16 it's a relatively minor transaction with a
17 relatively insignificant subsidiary, you may
18 not spend all that much time. Low risk. You
19 want to get the pricing right, but it's not
20 like you're trying to get your, your crown
21 jewels valued correctly as it's the core of
22 the business, where you would exert a lot of
23 effort in your transfer pricing study. And
24 the regulations say that's okay; we would
25 expect you to, to do that.



1 Q: Can you talk just, just a little -- a little
2 background on the concept of transfer pricing
3 and, and the regulations?

4 A: Certainly. So, the matter comes up when
5 you've got two parties that are related. And
6 I'll talk about that a little bit later.
7 Where there is a presumption that you could
8 perhaps shift income between them, right, into
9 have this bifurcation between income and
10 expense and somehow an inappropriate result,
11 right? Well, this, this -- and so, within
12 the Internal Revenue code, there are
13 provisions to prevent that, right? So, this
14 -- the concept of transfer pricing really
15 goes back into the Internal Revenue code for,
16 I don't know, 80 years, 80 years, something
17 like that. It's advanced over time. And
18 really, what we have in the current state in
19 terms of what we call 482, came about in the
20 late 60s in the 1968 code, where we have the,
21 the arm's-length standard fully articulated
22 and we have -- start to have regulations.
23 Those regulations have been updated. It was
24 kind of an exciting time when I joined
25 Coopers because they were just getting



1 rewritten coming out of the '86 Tax Act. And
2 so, we went through temporary regs and
3 proposed regs, and, and all that. So, they
4 were rewritten and they continue to be added
5 onto. Most recently, the service regs were
6 in 2006. But importantly, the core element
7 of the transfer pricing sets the standard for
8 how we evaluate whether related parties,
9 companies within a group, are acting
10 appropriately from the pricing. And that's
11 what we have here that you can see in the,
12 the regulation 1.482-1, little B, the arm's-
13 length standard. They obviously could picked
14 any standard, but they went with arm's
15 length. Arm's length being you look to the
16 market. You look to the, the transaction
17 that you have between parties, related
18 parties. And you judge whether or not that
19 is a reasonable price by looking to how would
20 two unrelated parties under the same facts
21 and circumstances transact in the market,
22 right? That gives us the, the answer that
23 we're -- that we're seeking. That's the
24 arm's-length standard. And like I said,
25 that's the same standard that's been adopted



1 globally.

2 Q: Does it prescribe any particular process that
3 a company needs to follow to reach this
4 arm's-length standard?

5 A: It certainly does. Yes. As I described,
6 some of the due diligence that I did and I
7 typically do, right? This is -- as I said,
8 it's a very facts and circumstances exercise.
9 So, you want to understand how the company
10 operates, all the companies operate that are
11 involved with the transaction. So, we go
12 through what's known as a functional analysis
13 to look at those facts. You gather the
14 facts. You understand not just what the
15 company is doing overall, but what it's doing
16 in all the different legal entities, all the
17 different actors to the transactions,
18 prescribes looking at the industry and __
19 including an industry analysis. It talks
20 about how you select methods based upon the
21 facts and the data that are available. So,
22 that's how you price the transactions. It
23 then describes how you evaluate your market
24 results here, what would arm's length be.
25 And then, how you determine a -- the result



1 and then how you document it. So, the, the,
2 the regulations are really all -- are very
3 encompassing in terms of the analysis that's
4 expected if we're going to demonstrate an, an
5 arm's-length result.

6 Q: What is a controlled transaction?

7 A: A controlled transaction is a transaction
8 between -- now, it sounds circular, between
9 two controlled taxpayers, right? So, what
10 that means is a controlled taxpayer or
11 taxpayers that are related in some -- in some
12 sense from a -- from a corporate or business
13 standpoint, right? And it's a transaction
14 between them. It could be the sale of
15 product, provision of service, a loan, license
16 and intangibles, anything like that. So,
17 that's what the, the transaction is that
18 we're looking at.

19 Q: And what is a controlled group?

20 A: A controlled group is, is that group of, of
21 entities of taxpayers that are con- -- that
22 are in some sense commonly owned or
23 controlled, right? That defines, as I said,
24 all these related parties. The ones that we
25 would be concerned that if we -- to be able



1 to demonstrate that the transacting price for
2 whatever the transaction is, that it doesn't
3 reflect market conditions. So, that's -- we
4 would look to the group.

5 Q: And is there anything wrong under the
6 regulations with having common ownership or
7 control?

8 A: No, not at all. The, the regulations
9 actually -- when we're -- when the
10 regulations are defining control, it does it
11 in a very broad sense, right? It says
12 control can be common ownership. It can be
13 common boards. It can be, maybe not any
14 common ownership at all, but there's, there's
15 a relationship between the parties, a
16 dependency in some sense between, otherwise
17 unrelated parties that one could influence the
18 other in some way. So, control is very broad.
19 But it's not -- there -- there's no
20 prescription around this kind of control is
21 good, this kind of control is bad. It's
22 simply evidence of control. It says, all
23 right, there's some control potential between
24 these two parties. 482 applies. Now, let's
25 think about what we're doing.



1 Q: What role does ownership structure play in
2 the application of the arm's-length standard?

3 A: It's, it's a threshold issue, right?
4 Ownership is as I say could be one of the
5 criteria to establish that you're part of a
6 control group, that you're a related party.
7 But after that, ownership doesn't play any
8 role. You just don't see it in, in the
9 regulations. In fact, the regulations talk
10 about kind of a broad definition and then,
11 put it aside.

12 Q: When is ownership structure ever relevant?

13 A: Well, you might see ownership structure, as I
14 said, in determining what the related parties
15 are, right? Who is involved with the, the
16 transactions. That's when it's -- when it
17 can be important.

18 Q: I apologize. I think I -- you got further in
19 the outline than I did.

20 A: That's okay.

21 Q: All right. What is the definition of
22 organization under 482?

23 **THE COURT:** Well, wait a second. What did you say
24 about owner ---

25 A: I'm sorry, Your Honor.



1 **THE COURT:** What did you say about ownership
2 structure, when is it important?

3 A: It -- it's only -- I'm sorry. Ownership,
4 ownership structure, understanding oh, is it a
5 parent or the` sub, is it brother-sister.
6 It's important only when we're determining
7 who's part -- who's a related party.

8 **THE COURT:** So, if you set up an ownership
9 structure and ultimately avoid taxes, that's
10 fine?

11 A: Well, you would -- the ---

12 **THE COURT:** That's what I want to understand.

13 A: Right. And so, the, the structure itself,
14 you would need to then say, all right, well,
15 if their intercompany transactions within a
16 structure, I need to from a transfer pricing
17 perspective -- so, I'm just talking from a
18 transfer pricing perspective -- we would look
19 are those transactions priced appropriately.

20 **THE COURT:** Okay.

21 A: Right? And so, that's the -- that's where
22 482 comes in. The transfer pricing
23 regulations come in.

24 **THE COURT:** So, y'all look beyond the ownership
25 structure?



1 A: Right.

2 **THE COURT:** In this sense.

3 A: That's right. Yeah.

4 **THE COURT:** All right.

5 Q: All right. What is the definition of
6 organization under 482?

7 A: Yes. So, organization has a specific
8 definition and I think it goes to, to this
9 very point.

10 Q: Wait a minute. Let me see if we can -- is
11 that -- it's not up there, is it? Or yes, it
12 is. Can you just give us the reference
13 number?

14 A: Yes. It's -- this is the definition section.

15 Q: Uh-huh.

16 A: So, it's regulation 1.482-1, little I, 1.

17 Q: Okay.

18 A: And, and I think Your Honor, this goes partly
19 to your -- partly to your point here is that
20 organization says we -- as it's used in the -
21 - in the regulations, it's not specific in
22 terms of -- and it doesn't really care what
23 the organization or the ownership is. Is it
24 a corporation? Is it a partnership? Is it
25 an estate? Is it a trust? Is it a corp? It



1 doesn't really matter. Once we've determined
2 that we've got two taxpayers that are related
3 in this group sense, that there's some kind
4 of common control, then we're in the bounds
5 of 482 and we set it -- and then we set that
6 ownership aside as we're applying the --
7 applying the methods.

8 **THE COURT:** Okay.

9 Q: Do you ever look at the substance of the
10 entities or taxpayer or the substance of the
11 agreements that they're entering into?

12 A: Yes. Certainly.

13 Q: Okay. Talk, tell us about that.

14 A: This goes to the, the functional analysis
15 that I talked about. At it's -- at it's
16 heart, this functional analysis, which I said
17 is, is kind of a fact gathering. What it
18 does is it says we've got parties that are
19 engaged in a transaction. What are those
20 parties doing? What functions do they
21 perform? Are they -- are they selling? Are
22 they performing a service? Are they
23 manufacturing? What are they -- what are
24 they actually doing, right? Also then, what
25 risks are they bearing? Do they have



1 warranty risks? Do they have liability? And
2 so forth. And, and importantly there, what
3 kind of capability do that have to manage
4 that risk for instance, right? And then,
5 finally, we look at as a broad group, the
6 intangibles, the assets as well. The
7 physical and intangible assets of, of those
8 taxpayers, as they relate to the transaction,
9 and say what do -- what do they have? What
10 have -- what do they own? What have they
11 developed? And so forth. So, you look at
12 the substance of the taxpayers as they relate
13 to that transaction, right? I'm selling a
14 product from Company A to Company B. Well,
15 do I have the people who made that product,
16 the machines to be able to make it? Do I
17 have people that are making buying decisions
18 and doing? Is there substance in that
19 transaction? So, that's when we're really
20 looking at that economic substance in
21 substance. And it comes out in that
22 functional analysis.

23 Q: Would you ever need to know or consider who
24 contributed the assets to the company to
25 begin with?



1 A: No. As far as it -- generally it does not
2 come up. I mean, we look at the facts. Do
3 they have as -- again, if -- saying we've
4 got, you know, intangibles if that's the
5 asset. Do they have the capabilities to
6 maintain and develop, and exploit those
7 intangibles. If that's got the substance,
8 and that's it, right? We understand that.
9 But you need to look at, at the actual
10 operations. But whether they were self-
11 developed at some point or whether they were
12 licensed in or contributed in some kind of
13 transaction, it doesn't affect that
14 transaction, right, that we're looking at.

15 Q: Do any of the transfer pricing methods under
16 482 mention or reference or relate to
17 ownership structure or shares in a related
18 party as a comparability criteria that should
19 be included in your analysis?

20 A: No. No. You look at the comparability
21 criteria and they are looking at what
22 activities are being done. What's the
23 market? What's the kind of service or
24 something that's being done? The examples,
25 as they'll present the different transactions,



1 some says, oh, here's a parent and a
2 subsidiary. Oh, in another case, it'll be
3 oh, here's a, a brother-sister organization.
4 And so forth. The method doesn't -- the
5 methods don't say, on, in a parent subsidiary
6 situation, we use these methods. And in a
7 brother-sister, we use these other ones. And
8 oh, this one has a partnership, so we use
9 these methods. It -- it's not that at all,
10 right? As I said, organization encompasses
11 all of those. And you look at what the, the
12 activities are in the transaction.

13 Q: What are uncontrolled taxpayers?

14 A: Uncontrolled taxpayers are, if you will,
15 they're, they're the benchmark, if you will.
16 Remember I said that we need under the arm's-
17 length standard to have that market test,
18 right? I've got two related parties, I'm
19 supposed to say, how would unrelated tax --
20 taxpayers operate under the same facts and
21 circumstances. That's what an uncontrolled
22 taxpayer is. They are that unrelated party.
23 And I want to see how they're transacting,
24 how they've priced transactions under the same
25 facts and circumstances.



1 Q: What is the arm's-length result?

2 A: The arm's-length result is the, is what comes
3 out of that transaction. Is what I'm saying
4 is that is the, the fair price, the
5 reasonable price that two parties would enter
6 into. It's that market, market price that
7 satisfies the arm's-length standard. It can
8 be a particular price, oh, you know, price
9 that's a dollar a bottle. It could be a rate
10 of return. That's the arm's-length price.
11 So, that's, that's what we mean by arm's-
12 length price.

13 Q: What is the best method rule?

14 A: The best method rule, I'd just point a bit of
15 background on that. The regulations, as I
16 said, have, have developed over time. And as
17 both the IRS and taxpayers were asking for
18 additional guidance, the regulations specify
19 various methods that are -- can be used. And
20 so what the best method rule says is when you
21 are choosing your method, you are to choose
22 that method which is most, most re- --
23 reasonably and reliably allows you to
24 determine an arm's-length result. And so,
25 the best method rule says, under the -- under



1 the data, what method, and then under the
2 facts, what method can give you that most
3 reliable result. And that's how we make a
4 decision. There's not -- you don't have to
5 march down through all the different methods.
6 You can pick the one that's best.

7 Q: Okay. And what is the arm's-length range
8 under 1.482-1(e)?

9 **THE COURT:** Ms. Geer, are you picking definitions
10 that I could just go and read?

11 **MS. GEER:** Some of them, yes. But I'm also trying
12 to get him to explain them in layman's terms
13 so ---

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

15 **MS. GEER:** --- we can all understand them.

16 **THE COURT:** Okay.

17 **MS. GEER:** I'm almost ---

18 **THE COURT:** Some of your -- when he explains them,
19 they're kind of obvious, but ---

20 **MS. GEER:** Okay. Well, I -- I'm actually ---

21 **THE COURT:** We got -- we got ---

22 **MS. GEER:** --- almost done with that section.

23 **THE COURT:** All right.

24 **MS. GEER:** So, we'll ---

25 **THE COURT:** Okay.



1 MS. GEER: I will not ---

2 A: Yeah.

3 MS. GEER: --- be much longer.

4 A: Yeah.

5 MS. GEER: This is the last one.

6 A: Yeah. The arm's-length range really
7 represents what we see in the market is that
8 there's rarely one single price, right? If
9 you -- if somebody asked you what the price
10 of -- we had a banana here yesterday, right?
11 If somebody asked, you know, how much is a
12 banana? And you say, well, they're usually
13 between 30 and 70 cents a pound. Something
14 like that, right? That's the arm's-length
15 range, right? There it is, right? And you'd
16 say, oh, well, they're -- I can buy a banana
17 for 50 cents. That seems reasonable. That's
18 in the arm's-length range. It's that market
19 price. And so, that's what we, we generally
20 are using our benchmarks, our external
21 taxpayers or uncontrolled taxpayers to
22 establish a range of market results.

23 Q: And what is the purpose of an arm's length --
24 of the arm's-length range, 482?

25 A: Right. On a practical basis, it's, it's to



1 really recognize that normal market variation,
2 right? There is no one market price for
3 bananas. You go to different grocery stores,
4 they're different prices. So, if -- it
5 allows for that market variation. And what
6 it does though is it says -- it allows for
7 compliance. It says, if you have a result
8 within the range, you're going to be
9 compliant with 482, right? And recognizing
10 that there are different range -- different
11 prices in the market, it establishes that.

12 Q: What happens if for example, a taxpayer gets
13 into a disagreement with the IRS about
14 whether they are in the arm's-length range or
15 not?

16 A: Right. Well, if we're -- if we're just
17 talking about the arm's-length range, right,
18 and it's determined that the taxpayer is
19 outside of the range. Let's say the range
20 was between 2 and 5 percent, and the taxpayer
21 was at 8, right? Well, the regulations
22 specify that the IRS, the district director,
23 would adjust the transfer price to bring the
24 taxpayer to the median of that. And that's a
25 very important concept because it tells us



1 that the IRS doesn't change the method,
2 doesn't do something different with it. It
3 respects that transaction. It respects the,
4 the entity and it adjusts the price
5 accordingly in, in this example.

6 Q: So, you said respects the structure. Is that
7 what you said?

8 A: Yes. The transaction structure. Yes.

9 **MS. GEER:** Your Honor, I'm at a very good stopping
10 point if you want to call it for the day.

11 **THE COURT:** 9:30?

12 **MS. GEER:** That's good.

13 **MR. ANTLEY:** That's fine with the Department.

14 **THE COURT:** Do we need to do it earlier or 9:30 is
15 fine?

16 **MS. GEER:** That's good with me.

17 **MR. ANTLEY:** Early? Did you said earlier is good
18 with you or?

19 **MS. GEER:** No. I said 9:30 is good with me.

20 **MR. ANTLEY:** Oh.

21 **MS. GEER:** Can y'all do that?

22 **MR. ANTLEY:** I think 9:30 will be ---

23 **THE COURT:** Okay.

24 **MR. ANTLEY:** I mean, if, if you said like an hour
25 and a half more?



1 **MS. GEER:** Yeah. Yeah.

2 **MR. ANTLEY:** I think -- I think 9:30 would be okay.

3 **THE COURT:** All right. Thank y'all. We'll see you
4 tomorrow.

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

6 (Day 4 of the hearing adjourned at 5:22 p.m. on
7 Thursday, May 25, 2023.)

8 **DAY 5 - FRIDAY, MAY 26, 2023**

9 **CALL TO ORDER:**

10 **THE COURT:** You're still under oath.

11 **DR. CODY:** Understood, Your Honor. Thank you.

12 **DR. CODY - DIRECT EXAMINATION CONTINUED BY MS.**

13 **GEER:**

14 Q: Good morning, Dr. Cody.

15 A: Good morning.

16 Q: I'm going to get into the E&Y studies in this
17 case. What is the controlled transaction or
18 transactions in this case that are addressed
19 by those studies?

20 A: The E&Y studies, and by those I mean the 2012
21 and 2015, they cover the same transactions.
22 There are five individual transactions that
23 they -- that they looked at. Transaction 1
24 is the licensing of trademarks, trade names,
25 and business process intangibles. Transaction



1 2 is the provision of corporate support
2 services. Transaction 3 is the provision of
3 advertising services. Transaction 4 is the
4 provision of real estate services. And
5 Transaction 5 relates to the provision of
6 data analysis and business strategy services.

7 Q: And let's get back to your first opinion in
8 this case, which related to the management
9 fee payment, which was determined under those
10 studies. Can you remind us exactly what that
11 opinion is?

12 A: Yes. As I looked at the E&Y studies, I
13 determined that those studies were well done.
14 They met the standards of 482 and best
15 practice, and that they were reliable, that
16 they reached arm's-length results, and that
17 those results were reliable in compliance with
18 482. And that it was reasonable for CarMax
19 as it's pricing those management fees,
20 management services between CBS and East and
21 West to rely on that study.

22 Q: Okay.

23 A: Or those studies rather.

24 Q: And could you please walk us through your
25 overall process to reach that opinion?



1 A: Yes. So, I begin by looking at the facts.
2 So, of course, you look at the studies to get
3 some facts, but also I looked at the legal
4 entity org charts, looked at personnel lists.
5 You need to understand as part of the
6 functional analysis, who's doing what in each
7 of the entities, what are their functions,
8 understand the risk that they manage and
9 bear, as well as the, the assets, the
10 intangible and fixed assets. So, I looked at
11 those. I looked at the intercompany
12 agreements that were in place, as to
13 understand the form and see how it matched up
14 with the substance. Those are some of the
15 background documents on the company's
16 operations, as well as looking at their 10Ks
17 and so forth.

18 Q: Did you look at any documents provided to you
19 in connection with the case itself?

20 A: Yes. I read the Department's determination.
21 I needed to understand what they saw as the -
22 - as the issues involved and what their
23 position was. Yes.

24 Q: And why is it important for you to understand
25 the structure of the company and, and what



1 the company is doing?

2 A: Because again, when we -- when we think about
3 pricing and intercompany transaction and
4 we're, we're -- here's within context of the
5 482 regulation. We need to understand what
6 they're doing. And that's really how we
7 measure the economic substance. It's the
8 economic substance related to the transactions
9 that are at issue. So, if you don't have the
10 understanding of that, you're -- you really
11 are lost at that point. You don't have a
12 good starting point for your analysis.

13 Q: Does what industry a company is in play a
14 role?

15 A: Oh, it's, it's a critical role because you
16 need to understand the -- we call them value
17 drivers, but really, it's how a company makes
18 money, right? What generates the, the income
19 that it earns. So, retail is different than
20 pharmaceuticals. And then even within retail,
21 there are various -- there are many
22 differences. So, for instance, if I'm
23 operating a -- an apparel shop, I might be
24 buying 10 million units of -- you know, of,
25 of a coat, right? And it just varies by



1 size, but it's, it's basically the same coat,
2 right? Or if I'm selling new cars. If those
3 come off the -- off the assembly line,
4 they're all in the same condition, zero
5 mileage. That's one thing. But here we have
6 a used car market. So, I need to understand
7 what is particular, not just within retail,
8 not just within autos, but what's unique
9 about the used car market. And so, rather
10 than I buy 10 million jackets if I'm an
11 apparel manufacturer, I can negotiate one
12 price for those jackets from my vendor.
13 Every used car purchase is unique. Every
14 used car has a different attribute, different
15 mileage, different condition, different color,
16 different trim, maintenance history, so forth.
17 So, I have to both figure out how I'm going
18 to buy those cars, in what volume, what do
19 people want, how I'm going to price them, and
20 then I'm going to price them on the selling
21 side. So, it's not just well, I can -- I
22 bought my 10 million coats and I'm going to
23 set one price that's going to cover all of
24 them, every single product at this price.
25 And that's important because I need to



1 understand how does the retailer, how does
2 the company, how does the, the entity that's
3 responsible for those decision, what do they
4 do.

5 Q: What type of financial information did you
6 review?

7 A: The financial information was -- and this was
8 one of the very first things I, I actually
9 requested when I was doing my due diligence,
10 whether or not to even accept this matter,
11 was the financials for each of the entities.
12 So, I requested those financials, the profit
13 and loss statements and the income statements
14 for the entities for each of the -- each of
15 the years, so '16, '17 and '18. And those
16 financials are what I believe Dr. DeRamus,
17 when he was referring to the, the financials
18 in the -- in, in my file, it's, it's those
19 financials, the ones that I received early
20 on.

21 Q: Is there any -- was there any reason for you
22 to -- or for you or someone else to audit the
23 CarMax financials?

24 A: No. The, the financials that were provided
25 come out of the, the general ledger system.



1 It's from -- it's how they're produced. The
2 company has an external auditor that looks at
3 those systems, and basically approves, signs
4 off on those. Those systems are the ones
5 that are used for financial reporting
6 purposes. So, you know, SEC concerns. They
7 would be looking at them. The basis of
8 their, their tax filings, right? And so,
9 there's a lot of integrity already built into
10 those financials. There's no reason for me
11 to question the, the veracity of those -- of
12 those.

13 Q: And is that -- is that the, the case just in
14 this case or is that true in all transfer
15 pricing?

16 A: That's true in -- I'm sorry. Yes. That's
17 true in all transfer pricing cases. And if
18 you're relying on those data, that's what it
19 is.

20 Q: And did you speak to anyone within the
21 company?

22 A: Yes. I did. And, and this to me is a very
23 important part of doing my own analysis, even
24 if I was doing it from scratch. But in
25 particular when I'm reviewing somebody else's



1 work, I'm trying to check their understanding
2 of things. So -- of course, I spoke with
3 Eileen Yost at the tax department to, to
4 understand history and those things. But in
5 particular, because of the important role that
6 the data analyst, that, that data analytics
7 department plays, that the pricing group
8 plays, and their -- the resources there, I
9 felt it was very important that I, I speak
10 with people within that group. So, I spoke
11 with David Smith, who heads up that group. I
12 spoke with him several times, asking questions
13 about their operations, their resources, the
14 various plans and programs that they have in
15 place, to really get a -- an understanding
16 from a non-tax person what's going on in the
17 company.

18 Q: And did you feel like you had everything you
19 needed to do your analysis?

20 A: I certainly did. I considered what I needed.
21 I made requests. And I was never denied any
22 information that I had requested or would
23 otherwise need.

24 Q: All right. Let's talk about your -- you
25 mentioned you started with the functional



1 analysis. What did the functional analysis
2 that you performed show you as to what the
3 entities were doing in this case?

4 A: Well, let me start with CarMax East, right?
5 So, CarMax East, primary business activity is
6 to sell used cars. As we understand it does
7 engage in the purchasing of those cars. It
8 also sells them. It has some other streams
9 of revenue as well, extended service plans,
10 some would call GAP. Programs that help to -
11 - almost like an insurance policy sold to the
12 customer. Those other -- those other lines
13 of service and those are relatively minor
14 part of the business compared to their
15 overall car sales, right? So, from a
16 functional analysis standpoint, their job is
17 to execute on that retail model that's being
18 created by CBS. So, they are the executors
19 of that. They're expected to do a very good
20 job. That's an important part of the
21 functional analysis. You want your stores to
22 do well. There's no question about that.
23 But they are -- from a -- from a transfer
24 pricing perspective, their functional
25 analysis, they are executing those sales.



1 Q: And what did your functional analysis show
2 you as to how many stores there are?

3 A: There was -- the company was growing rather
4 rapidly over the -- over the audit period,
5 but on average CarMax East had about 140
6 stores, fewer at the beginning of the audit
7 period, more at the end, but roughly 140 on
8 average.

9 Q: What about in South Carolina?

10 A: They had three stores in South Carolina for
11 the predominant period in Charleston,
12 Columbia, Greenville. There was a fourth
13 store added partially through the 2018 year
14 and that was in Myrtle Beach.

15 Q: What about CarMax West?

16 A: From a functional analysis point, point of
17 view, CarMax West is just like East. And I
18 won't bore you with all the details, but just
19 everything I said about East pertains to West
20 as well.

21 Q: What about the number of stores in, in West?

22 A: West had on average, about 40 stores over the
23 period -- again, fewer at the beginning, more
24 at the end, but roughly 140 stores.

25 Q: You mean roughly 40?



1 A: Thank you. Yes. I meant ---

2 Q: Okay.

3 A: --- 40 stores. Yes.

4 Q: All right. And what about CBS? Oh, I'm
5 sorry. I forgot to ask you. How many stores
6 did West have in South Carolina?

7 A: No stores in South Carolina.

8 Q: All right. Now, if we could move on to CBS.

9 A: CBS has three say functional areas within
10 CBS, so you have the, the unit. The, the
11 most important of those is what I would call
12 the -- well, the brains of the operation,
13 right? That is where the strategy for the
14 retail is created. It's where over time, has
15 developed various tools to understand what
16 would help the company be profitable, make
17 decisions on investments on those systems.
18 So, it's everything around, around that. CBS
19 also then determines what training, what --
20 just ordinary systems, like a point of sale
21 system, but that every retailers has, is
22 responsible for, for those things. Real
23 estate decisions, all that. And so, that's
24 all part of that, that brains operation, if
25 you will, for, for CBS. All right. So,



1 that's, that's that part of it. A second
2 segment is CAF, the, the CarMax Auto Finance.
3 Here, CAF develops credit products for the
4 purchasers of the used autos. So, different
5 loan -- loans that are available. Their
6 customers are the actual third party people
7 who buy the cars, right? So, unlike the
8 other segment of, of CBS that I described,
9 which their, their, their focused on providing
10 services to CarMax East and West, CAF is
11 actually servicing people who buy cars. And
12 that's where the decision is made. The third
13 segment is more of a -- and this is where the
14 real corporate support, kind of administrative
15 side comes in. So, those kind of centralized
16 activities, sometimes called headquarter
17 activities, reside. So, we really have those
18 three segments of -- as I call segments,
19 right? Different pieces of CBS.

20 Q: All right. Is there anything else that --
21 besides what we've just discussed that was
22 part of your functional analysis?

23 A: No. That really sums it up in the
24 conclusions of it.

25 Q: Did you review E&Y's Functional Analysis?



1 A: I certainly did, yes.

2 Q: And what was your assessment?

3 A: They followed the -- a similar kind of
4 approach that I did. In fact, almost exactly
5 the same kind of approach that I did. They
6 interviewed people. They looked at documents
7 and, and came to same determination that I
8 did in terms of the, the, the role of East
9 and West and CBS within the -- within the
10 organization. As well as what the -- if you
11 will, the, the valuable activities are, those
12 -- and by valuable, I mean the ones that are
13 really driving the, the success of the -- of
14 the business and, and in a way that would
15 distinguish CarMax.

16 Q: All right. And we've heard testimony this
17 week about the 2012 and the 2015 study. Is
18 the -- are there any material differences
19 between them?

20 A: I really think the only difference between
21 those two studies is that the 2012 was the,
22 I'll say a baseline study. There was more in
23 depth fact gathering done there in terms of
24 interviewing people, confirming facts,
25 developing facts. The 2015 study is more



1 like what I had described in terms of an
2 update. Still need to verify facts, but they
3 didn't go back and re-interview people. So,
4 this is -- it's kind of what I would expect
5 to see on an evolution of a baseline to and
6 more of an update study then.

7 Q: For these next questions, I'm going to ask
8 you them generally as opposed to one report
9 versus the other, but will you please point
10 out if there's any question I ask where
11 there would be a different answer for the
12 other study?

13 A: Certainly.

14 Q: For one the studies, I should say. All
15 right. Can you described generally what the
16 E&Y studies did and how they work?

17 A: So, the EY studies describe their functional
18 analysis. So, once they have the functional
19 analysis, determine the, the transactions at
20 issue that are covered by the study, it then
21 went through a process called selection of
22 the best method. So, it looked at the
23 operations. It determined what method, what
24 pricing method would be most appropriate,
25 would be best based upon the facts of how the



1 company operates, the availability and
2 appropriateness of comparables, right? So,
3 given what we're saying is the -- are the
4 value drivers or the, the -- and the relative
5 roles, you pick a method and comparables
6 that, that fit those. Then, EY conducted
7 research on the third party comparables. As
8 we were saying yesterday, those are the
9 uncontrolled taxpayers. To then develop the
10 intercompany pricing policies or
11 recommendations that are consistent with the
12 arm's-length standard. And that's, that's the
13 process that EY went through for each of the
14 transactions.

15 Q: All right. Let's run through the
16 transactions. We're going to start with
17 Transaction 1. Do you recall which one that
18 is?

19 A: Yes. That's the licensing of trademarks,
20 trade names and business process intangibles

21 Q: Okay.

22 **MS. PEREZ:** And no one is connected on that side,
23 right?

24 **MR. HARRINGTON:** No. I'm not connected.

25 **MS. PEREZ:** Apologies, Your Honor.



1 (Off the record from 9:48 a.m. to 9:51 a.m.)

2 Q: All right, Dr. Cody. We were getting ready
3 to talk about Transaction 1. And can you
4 just walk us through this transaction?

5 A: Yes. So, in, in this figure, I just wanted
6 to summarize the intercompany service
7 transactions. And for, for me it's always
8 easier to understand things in a picture, if
9 you will. So, in the middle there, we have
10 the provision of the management services.
11 And I've listed each of the -- each five of
12 those, of the transactions. But I'll focus,
13 as we said, first on the licensing of
14 trademarks, trade names, and business process
15 intangibles. So, we have those, all of that
16 IP is owned in the CarMax Business Services,
17 CBS. You see that entity at the top. And
18 here, the, the shapes are not really -- are
19 not meant to do any -- to indicate anything
20 as we talked about before. These are
21 organizations within those parties, right?
22 So, don't in -- indicate anything in terms of
23 ownership or relationship or anything, because
24 it doesn't matter for the pricing. So, we
25 have then the provision of the licensing of



1 the trademarks, trade names and business
2 intangible -- business process intangibles
3 from CarMax Business Services to CarMax West
4 and CarMax Auto Superstores, Inc. CASI,
5 that's CarMax East there on the right. It
6 also then shows the, the transaction that
7 each of the dealers, the, the retail outlets,
8 East and West, have with their customers.
9 Here, I've only listed auto sales because
10 that's -- that is the predominant sale, but
11 we'd also have then the sale of those
12 extended service programs and so forth, right?
13 And then, we have -- coming up on the dotted
14 lines, the payment of the management service
15 fee. So, we have the component here for
16 Transaction 1. We have the payment of that
17 licensed fee from East and West back to
18 CarMax Business Services.

19 Q: All right. Can you -- can you walk us
20 through Transaction 1 in this chart?

21 A: Yes. So, this chart just summarizes based
22 upon the 2015 studies results. The methods
23 used, same as the 2012. As we've said, the
24 actual range is a little -- little different
25 because comps were updated. Comparables were



1 updated. But it's, it's basically the same.
2 So, we have for the license of those
3 trademarks, trade names and business process
4 intangibles, the best method that was selected
5 was the -- we call it the comparable,
6 uncontrolled transaction. What that means is
7 look at agreements between third parties for
8 similar licensing arrangements. The range
9 that was identified by EY was that the
10 payment based upon the agreements had an
11 adjusted range of one-half of 1 percent to
12 1.3 percent with a median of .6. So, median
13 is just the middle. It's not the average.
14 It's just, just the middle. The -- and then
15 the rate that was actually used by the
16 company was one-half percent. And then we
17 have the, the markup per vehicle sold. That
18 was not determined within this study. So we
19 have the -- really those three lefthand
20 columns of what we have from the -- from the
21 study itself. The process that EY went
22 through to determine this range, it was a
23 really a couple of steps, right? First, they
24 looked at within the context of trying to say
25 we have a -- we have a bit of a bundle here.



1 We have trademarks, trade names and business
2 process intangibles. So, we need to find
3 agreements that have those two things
4 together. And in particular, in the context
5 of retail operations. So -- and this is --
6 this is, accords with my experience as well.
7 The best information out there was really
8 around franchise arrangements, franchise
9 agreements. Franchise agreements, we often
10 think of McDonald's franchises. But there
11 are loads of franchises, right? So, we look
12 at -- in my experience, I've looked at, EY
13 looked at franchises that are close to what
14 CarMax does, right? The standard for
15 comparables is reasonableness. It's not
16 perfection. So, EY was able to identify a
17 number of franchise agreements that set rates
18 between the franchise or the, the developer
19 of trademarks, trade names, business
20 processes. And what they would then license
21 that bundle to their franchisees, right? But
22 it's very comparable to what we're discussing
23 from CBS to the stores, right? So, they had
24 that, that range. I believe those num- --
25 that range was about 2 to 5 percent or so.



1 But EY as it -- as it looked at those
2 agreements, it identified that well there are
3 some differences between those agreements and
4 what is actually covered by Transaction 1.
5 In particular, those agreements -- and this
6 is consistent with how franchises work and
7 what's included in that fee. There were some
8 other, other activities, other services that
9 were being provided such as ongoing corporate
10 support, assistance with real estate, and
11 other things like that that needed to be
12 adjusted out of that rate, out of that
13 overall -- that initial rate. That's very
14 much in keeping with -- not very much. It is
15 exactly in keeping with the regulations when
16 we'd say, are there differences between the
17 comparable and the controlled transactions
18 that would have an impact on the price and
19 that could reasonably be identified and
20 quantified. EY looked at that. And so then
21 they looked at some additional agreements,
22 said how we can adjust for those differences
23 then. We have a narrower range of services
24 and IP that's covered by Transaction 1 than
25 from these overall agreements. They adjusted



1 out that -- out the compensation for those
2 other transactions to make them more
3 comparable to Transaction 1. It had the
4 affect of reducing the range. And that's how
5 we went from an unadjusted range of about 2
6 to 5 percent within the EY study, down to the
7 range that we see here, the half a percent to
8 1.3 percent. So, that was a very, I'd say,
9 thorough and diligent process that EY engaged
10 in.

11 Q: And so, you may have just answered, but, but
12 just to be clear, what is your assessment of
13 E&Y's Transfer Pricing Analysis for
14 Transaction 1?

15 A: Yes. I, I agree with the -- their
16 determination in terms of the basis for the
17 transaction, the characterization of the --
18 I'll say the, the property involved, the
19 intangible property involved, the intangible
20 property involved, who should be compensated
21 for that and in what method based upon the
22 value in use that is related to the -- to the
23 sales. I agree with their selection of the
24 best method, the CUT method here. Looking at
25 those agreements and in both the -- their



1 overall approach in their identification of
2 the, the comparables and the adjustments that
3 they made. I felt that they were reasonable.
4 They comported with work that I've done, as I
5 said over -- focusing on retail for over 20
6 years and to how we would do these analyses.
7 So, this fit right in that range.

8 Q: Is there any basis in your mind for an
9 opinion that this arm's-length rate for
10 Transaction 1 should be zero?

11 A: No. None at all. And I -- I've heard
12 testimony to that effect, that while it's
13 dependent upon what the retail is doing
14 because that's where the experience happens,
15 and therefore, the, the stores are all
16 completely responsible for that trademark
17 value. It's just that that doesn't comport
18 with either the, the facts nor how retail
19 operates. Certainly, you expect the, the
20 stores, the dealers, restaurants, right, Jiffy
21 Lube Outlet to do a good job. And if they do
22 a good job, it reflects well on the
23 trademark. But one, they don't own the
24 trademark. If I have a local auto -- used
25 auto lot or if I have a local service station



1 that does oil changes, you know, it's Brian's
2 Service Station, it's Brian's Auto Mart,
3 right? But I would pay something to be able
4 to put CarMax on my auto lot. I'd be willing
5 to pay something to put Jiffy Lube on that
6 mark, right? And then I'm going to sign on
7 to following their procedures, right? I am -
8 - of course, I know how to change oil, right?
9 I'm a local service station. I know how to
10 change oil. But if I sign on with Jiffy
11 Lube, I learn the Jiffy Lube process, right?
12 That's valuable to me and I get to put that
13 name on there. That's all due to what's
14 coming from the Jiffy Lube Center, from the
15 CBS equivalent here. Everyone knows -- so,
16 Jiffy Lube doesn't allow someone just to put
17 their name on it and charge them nothing as
18 part of the overall charge. So, neither
19 should CarMax. It just doesn't make sense.

20 Q: Okay. And you started out, out your response
21 just now by saying from a factual standpoint.
22 I'm curious what your, your answer is as far
23 as how it relates to four -- 482. Would 482
24 support a zero payment in your ---

25 A: I ---



1 Q: --- for the Transaction 1?

2 A: Yes. So, from a -- again, from a 482
 3 standpoint, right, within the, the strict
 4 adherence to the regulations, right, it would
 5 say let's look at the substance of those
 6 transactions, right? What is generating the
 7 trademark value here that, that the value
 8 that I'm seeing when someone sees that CarMax
 9 name, sees that Jiffy Lube name? Well,
 10 they're expecting a consistent experience.
 11 What is the Jiffy Lube way to do things,
 12 right? That's the substance that 482 would
 13 say to look at. And who has created those
 14 processes? Who has -- who owns and creates
 15 that name and therefore, the value associated
 16 with it. So, you take the facts and then you
 17 apply them to the requirements and the
 18 regulations. And the regulations say look at
 19 the substance, look at those facts, and then
 20 apply your method. So, I need to -- I need
 21 to do that, and it's fully incon- -- it, it
 22 is fully consistent with what the regulations
 23 would have us determine.

24 Q: And what about the argument that but for
 25 these brick and mortar stores, there wouldn't



1 be any value there?

2 A: That argument is based on the -- what I call
3 the fallacy of the but-for, right? It's
4 true, no question, that but for that sale,
5 right, I walk in a buy a car from CarMax that
6 CarMax has -- that that generates revenue for
7 CarMax overall, right? But that doesn't tell
8 me anything about how CarMax makes money. It
9 simply tells me where dollars change hands,
10 right? It doesn't tell me, well, when I've
11 walked in and I saw that price and I -- yeah.
12 It's a no-haggle price. That's fine. But
13 it, it doesn't tell me anything about who
14 determined that's a fair price, and I look at
15 it and say, yes, that's a fair price for that
16 car. It's well conditioned. Yes, I had a
17 good experience, but those employees are, are
18 well trained, right? And I can walk into any
19 CarMax and they're well trained. So, the
20 fact that I turned the money over to my local
21 CarMax says that that's where I bought it.
22 But that's where it stops. It doesn't tell
23 me anything about how the company has
24 organized itself, how it has -- the
25 activities that it actually conducts and where



1 to, to generate income. So, I, I just think
2 that's a -- it's, it a fallacy.

3 Q: And separating out a little bit, what is ---

4 **THE COURT:** This ---

5 **MS. GEER:** I'm sorry.

6 **THE COURT:** --- fallacy of the but-for, is this
7 something you made up or does this exist in
8 transaction pricing?

9 A: The, the concept underneath it that you need
10 to look at the substance and the -- where the
11 transaction takes place, I see that as purely
12 within or, or solely with -- not solely.

13 **THE COURT:** I'm asking you about the phrase.

14 A: Yes. The, the phrase is just my choice of
15 words.

16 **THE COURT:** Okay. That's what I'm asking.

17 A: Yes. I'm sorry. Yes, Your Honor. Thank
18 you.

19 Q: What is your opinion regarding the value that
20 business process intangibles by themselves can
21 have?

22 **THE COURT:** Are we still on Transaction 1?

23 **MS. GEER:** Yes.

24 A: Yes. I -- the business process intangibles
25 by themselves I think are, are -- again, in a



1 retail context here, right, are, are keenly
2 important, right? As I think I was saying
3 before, the -- people know how to change oil,
4 but yet to learn how to do it the Jiffy Lube
5 way, right, for cars, know about all the
6 different makes and models of cars, how to do
7 it for them. I can run my own shop. I have
8 to learn how to do that myself. I have to
9 train my own employee on the process. So,
10 the fact that it -- that at a baseline
11 there's kind of common knowledge doesn't tell
12 me anything about the value. I see value in
13 the Jiffy Lube way. Everyone knows how to
14 make hamburgers, right, but McDonald's still
15 has a process of how to make hamburgers and
16 franchisees sign up and pay that fee because
17 they want to learn the McDonald's way. So,
18 the fact that's it -- that everyone says,
19 yes. Everyone needs to know how to run their
20 business, again, doesn't tell me that their
21 unimportant. In fact, it's really the
22 starting point. And then, saying, okay, they
23 do have value. Here's why, what went into
24 their development. And that tells me why
25 someone would pay.



1 Q: All right. Let's move on to Transaction 2.

2 **MS. GEER:** Can you switch back?

3 Q: All right. Can you walk us through
4 Transaction 2 for the corporate support
5 services?

6 A: Yes. So, Transaction 2, corporate support
7 services. These are kind of the more bread
8 and butter operations, right? It's processing
9 -- process payments, accounts receivable, how
10 to keep the books, make sure everyone's
11 laptop is working, those kinds of things.
12 So, this is relatively ordinary, just back
13 office type support. And again, we have
14 folks in CarMax Business Services that perform
15 those activities for the benefit of East and
16 West. That's the solid line we have coming
17 down there, so we have services being
18 delivered and then there's the payment of the
19 management service fee coming back to CarMax
20 Business Service as compensation for
21 performing those activities.

22 Q: All right. Can you walk us through the E&Y
23 analysis there?

24 A: Yes. They -- the -- for the corporate
25 support services, these are relatively



1 straight forward in terms of transfer pricing
2 analyses. We've seen these a lot, right?
3 Virtually every group has these in, in one
4 form or another, so. Here, the method that
5 was used was the comparable profits method.
6 Again, that looks at operating profit as a
7 percent of, in this case, cost, total cost.
8 Standard method, standard profit level
9 indicator, ratio that we use to price. Here,
10 EY looked at what I consider to be a standard
11 set of comparables, very much in line. They
12 identified a range of roughly 4 and a half to
13 12 and a half percent of return on total cost
14 with a median of 7.9 percent. And so, I felt
15 that that was -- those results were very, you
16 know, kind of consistent with what I had seen
17 for these relatively standard services.

18 Q: All right. And ---

19 **THE COURT:** Do you have an objection as to the
20 silence?

21 **MR. ANTLEY:** I just would like to have a copy of
22 these demonstratives. We don't have them ---

23 **MS. GEER:** Oh, I'm sorry.

24 **MR. ANTLEY:** --- previously, so I was just going to
25 ask her for that.



1 **MS. GEER:** Yeah. Yeah. Yeah. We can do that.

2 **MR. ANTLEY:** These -- these weren't provided
3 before.

4 Q: And how did the E&Y opinion compare -- on
5 this transaction compare to the -- Dr.
6 DeRamus' opinion?

7 A: Their -- Dr. DeRamus and E&Y, and I basically
8 all, all agree, their, their basic services,
9 we see them every day basically as transfer
10 pricing practitioners and, and companies. A
11 bit of difference on the exact comparables
12 that were selected, so I think Dr. DeRamus'
13 range was a -- was a bit lower. But not
14 materially, I would say. So, we basically
15 are in agreement on these.

16 Q: Okay.

17 A: Yeah.

18 **MS. GEER:** All right. Can you put -- okay.

19 Q: Once we get this exhibit up, we're going to
20 move on to ask you some questions about the
21 services cost method as a method.

22 A: Yes.

23 **MS. GEER:** We're connected still. It's not up.
24 I'm not sure why. Our slide was jinxed.
25 There we go. All right.



1 Q: Are you familiar with this regulation?

2 A: Yes.

3 Q: Can you talk to us about it? Which one is
4 it, first of all?

5 A: This is the -- it's called the da- -- we
6 refer to it at the dash 9 service regs. It
7 is Section 1.482-9. So, it's the regulation
8 within the transfer pricing regulation that
9 deal with services. As a -- as a complete
10 section, it was added in 2006 to provide
11 additional guidance on how to price services.

12 Q: If you'll just tell us basically what, what
13 does this mean?

14 A: In general what it -- thi- -- so, within the
15 service -- within the service regulations,
16 just like we have for other transactions,
17 property, intangibles and so forth, the IRS
18 as it developed the regulations set up
19 various methods that are specified. Specified
20 meaning they gave a name to a particular
21 formulation for it. And they added -- we've
22 got cost plus. We've got -- and that's what
23 was used basically in the, the EY report.
24 There are various methods that can be used.
25 One of them that was added in the 2006 was



1 this method called services cost method.
2 Just as background to the services cost
3 method, for relatively normal operations, low
4 value operations, both taxpayers and the IRS
5 were finding that they were spending an
6 inordinate amount time fighting about this,
7 right? And because it is -- what's the --
8 what's the plus, what's the base, how does it
9 get applied, what qualifies, all those kinds
10 of things. So, both sides were saying, let's
11 -- can we have some additional guidance. So,
12 the IRS developed and finally settled on the
13 services cost method. And what the services
14 cost method says that for certain services,
15 and that's important -- for certain services,
16 you can determine the arm's-length amount by
17 reference to total services cost. That's a
18 defined term, right? With no markup, right?
19 So, the service cost method, you can do
20 things at cost. And then importantly it
21 says, if a taxpayer applies a services co- --
22 cost method, so it's up to the taxpayer to
23 choose; then we'll, we'll deem it to be --
24 we'll consider it to be the method. This
25 just brings it in, in -- to make it



1 consistent with the best method rule because
2 it, it is -- the choice of the taxpayer to --
3 whether or not to apply it as long as it
4 qualifies.

5 Q: Okay. And what would qualify it?

6 A: You can see in the eligibility for the
7 services cost method, it sets out very
8 specific conditions, right? Because it is --
9 remember I said, it is a -- administrative
10 convenience that's being offered. So, the
11 IRS doesn't want to just provide it out there
12 willy nilly. It needs to be applied to
13 certain kinds of services. So, it says that
14 there are four conditions that need to be met
15 in order for an activity to be eligible to be
16 priced using the services cost method. Let
17 me quickly walk through those. The first
18 that we see there that's the little I. It
19 says the services is a covered service as
20 defined in paragraph of this section. There
21 are two pieces to that, right, as far as
22 covered services. One of those says the IRS
23 will publish a list of activities that if you
24 meet these activities, if you're on this
25 list, you're considered to be compliant.



1 It's a covered service. The IRS did issue
2 that list. It was in a revenue procedure
3 published in 2007. It's Rev. Proc. 2007-
4 00131. Publically available. All right.
5 And it lists 100, 101 activities there. So,
6 it could either be on that list or there's
7 another test that says, called low margin
8 services. And a low margin service would
9 says, conduct your, your comparable search,
10 and if the median return out of your arm's-
11 length range from that search, if it shows a
12 return on total cost, it's fine here, at 7
13 percent or less, then you qualify as a low
14 margin service. Okay. So, either your on
15 the list and that's good or you're a low
16 margin service. Check. You've, you've met
17 condition number one. Okay. Second is the
18 service is not on an excluded list. Well,
19 what's on an excluded list? There are thing
20 like manufacturing, research and development,
21 software development and, and a list of
22 others. Those are very specific and it is --
23 it's down in the regulations. Those are
24 activities that are seen as more core to the
25 business, right? And this is for those low



1 value services. So, if you're -- if you're
2 on that excluded list, you're out. All
3 right. So, check number two, right? The
4 third, because the IRS was trying to not be
5 too, too pre- -- prescriptive, it said, you
6 also need to consider whether or not the
7 activity really is fundamental to how the
8 business operates. Is it -- does it impact
9 how you make money basically, your relative
10 success or not. And they've called that the
11 business judgement rule. So, that if it
12 really is key to the business, even though it
13 might be fine with the two up above, but
14 you're unique in that way, if you fail the
15 business judgement rule, you're out. So, I
16 need to check one, two, three. And then
17 finally, because the -- this is an
18 administrative convenience, right? It's
19 administrative option that's available to the
20 taxpayer, there's some documentation
21 requirements. You keep books and records.
22 You show that you've elected the procedure.
23 And that's all part of your, your
24 documentation in, in filing. So, you need to
25 check all four of these before you can use



1 the, the SCM.

2 Q: Okay. And you mentioned a couple of times,
3 at the taxpayer's option. But can the IRS
4 compel a taxpayer to use the services cost
5 method?

6 A: No. The IRS cannot do that.

7 Q: Has the IRS issued any guidance on that
8 point?

9 A: Yes. They want it to be clear because the,
10 the language in the regulation says, if a
11 taxpayer adopts. And so there was some
12 discussion, what exactly does that mean? So,
13 the IRS u- -- issued this practice service
14 transaction unit memo, right, if you will, to
15 provide guidance to both the agents within
16 the IRS, but then also this is a public
17 document. So, this is to provide guidance to
18 taxpayers on how they could expect the agents
19 to act and what the -- what the, the
20 permissible activities of the IRS is. So,
21 this is their interpretation.

22 Q: Okay. And what -- where do we want to go on
23 here?

24 A: If you can just down just a page or two. We
25 -- let's stop there. So, the first sentence



1 just comes basically from the regs. The
2 services cost method, SCM, is a specified
3 transfer pricing method for which covered
4 services -- we've discussed those, right --
5 can be charged out at cost. That's just the
6 definition. The SCM is an elective method
7 and taxpayers are permitted to use other
8 methods under the regulations. Even for
9 covered services, right? So, you can -- this
10 is entirely at the taxpayer's discretion.
11 And to even further clarify that point, we
12 have the last sentence, which is highlighted
13 in green. It is important to note that the
14 Internal Revenue Service, IRS, cannot require
15 a taxpayer to use the SCM. And then
16 finally, the, the blue language there simply
17 says, points and, and says where that
18 guidance is on those -- on that list that's
19 available. And it reinforces the low margin
20 test, 7 percent or less.

21 Q: Are there any exceptions to this rule?

22 A: No.

23 Q: And do you see in your experience taxpayers
24 using the SCM?

25 A: I've never seen a taxpayer use it on a -- in



1 a domestic context. I have seen it used
2 occasionally in cross-boarder transactions,
3 but not in a domestic context.

4 Q: All right. So, how would what we -- what you
5 just discussed with IRS guidance impact the
6 conclusions on this slide? And this is, for
7 the record, DeRamus Slide 74.

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

9 A: So, here we have the results of Dr. DeRa- ---

10 **THE COURT:** We're still on Transaction 2?

11 **MS. GEER:** Yes, Your Honor.

12 **THE COURT:** And that's the transaction that they
13 pretty well agreed upon?

14 **MS. GEER:** Well, this applies to other ---

15 **THE COURT:** Okay.

16 **MS. GEER:** --- other transactions.

17 A: Yes. So, this slide shows just a summary of
18 the, the pricing results that Dr. DeRamus had
19 derived. So, for the transaction that we're
20 looking at, the back office comparables,
21 that's the corporate services. That's where
22 he said the ranges are pretty close. We
23 agree on the method. It's fine, right? The
24 -- and, and importantly the median here, 4
25 percent, that would pass the low margin test,



1 right? Just a look forward, if you will, we
2 have the comparables that Dr. DeRamus
3 determined for the other transactions.

4 Q: Right.

5 A: Right? We can see that median result on his
6 cost plus, for each of those, is above 7
7 percent.

8 Q: So, let's, let's go -- since we're on
9 Transaction 2, but we're looking to other
10 transactions, can you specifically point out
11 to the Court each transaction that you're
12 talking about?

13 A: Yes. So, Transaction 3, right? So,
14 Transaction 2 is the alternative back office.
15 Transaction 3 are the advertising comparables.
16 Dr. DeRamus determined a median cost plus
17 return for those activities of 8.3 percent.
18 So, it would fail the low margin test. It's
19 above 7. His comparables for transaction
20 number 4 shown here in that second from the
21 right, the alternative real estate
22 comparables, there the low margin test would
23 again be failed because the, the average rate
24 -- or excuse me -- the median rate is above 7
25 percent. And then finally, his alternative



1 for Transaction 5, he describes here as
2 strategic comparables, again, they would fail
3 the low margin test because they are -- they
4 have a median cost plus return of 9.2
5 percent, above 7.

6 Q: All right. Let's move on to Transaction 3,
7 the advertising and marketing. Can you walk
8 us through that transaction?

9 A: Yes. So again, much like the, the others, we
10 have the activity being performed CarMax
11 Business Services, so CBS. There it is the
12 advertising programs. It includes the
13 website. It includes, you know, mail
14 activities, mail advertisements. So, all
15 those activities that, that a normal retailer
16 needs in order to make its customers aware of
17 what's going on. Those are, again, typical
18 activities of, of a retail operation. In
19 this kind of arrangement, we would see those
20 as centralized and being performed in that
21 middle by the franchisor, like at -- like at
22 CarMax Business Services. And so, we see
23 those services being performed for CarMax East
24 and West. And that they then pay a fee, part
25 of the management fee to cover those



1 advertising services.

2 Q: All right. And switch over to the chart.

3 Okay. Let's walk through ---

4 A: Okay.

5 Q: --- the method and comps here.

6 A: So, for Transaction 3, the advertising
7 services, again it has a different acronym,
8 CUSP. It's basically, let's look at
9 agreements and find a -- find a rate.

10 Q: Okay.

11 A: It's like a CUT, but for services, right? No
12 difference basically. There, when we look at
13 advertising services in a retail environment,
14 particularly when we've got the kind of
15 structure that we have here, where we have,
16 if you will, the -- I'd say the brains, the
17 developer, the -- in that center, right, like
18 a franchisor providing the activities. What
19 is very, very common, and we see this, is
20 that there's a pooling of advertising, not
21 just activity, but expenses in that center.
22 And then that those expenses and activities
23 are reimbursed, compensated by the retail
24 operations. Why isn't -- why is that
25 important and why do -- why do retailers do



1 that, right? Well, if I'm -- if I'm Jiffy
2 Libby, right, and I -- and Jiffy Lube is one
3 of the comparables that we look at here,
4 right? If I'm Jiffy Lube, and I've got my
5 local Jiffy Lube franchise, right? There's a
6 certain amount of advertising that I would do
7 just for myself? But maybe I get some
8 benefits because it's consolidated, that's,
9 that's good. But also, maybe there's a Jiffy
10 Lube add on the Super Bowl, right? Maybe
11 it's on the -- on the website, right?
12 Someone goes out, they see that, and they
13 come by my shop, right? Well, how do I make
14 sure that I pay for the traffic if you will
15 that gets driven to my retail outlet from
16 that? If that's just discretionary, I'll
17 say, well, you know what, I'm not going to
18 pay for it. I'll just let the, the expenses
19 that the other members put on advertising and
20 I'll just benefit from that. That is a free
21 rider problem, and that is a concept that we
22 see in, in economics, a free rider, right? I
23 get the benefit without paying anything.
24 That's a mismatching, right? And so, what
25 franchises typically do is they have a



1 advertising fee. It's separate from
2 trademarks, trade names, business processes,
3 other services that are performed, corporate
4 back office, strategery -- stra- --
5 strategery? Strategic -- sorry -- services.
6 So, it's, it's separate, right? So, with
7 that as background, it's appropriate in this
8 context to look at those same franchise
9 agreements. That, that same model because
10 that's where -- we're in that retail model,
11 wonderful comparables, and see how they price
12 the advertising services, right? It's
13 sometimes referred to as cooperative
14 advertising, sometimes as paid into an
15 advertising pool. And out of that
16 advertising pool, the expenses of -- that are
17 say, CBS incurs directly with -- for -- with
18 advertisers, whether the franchiser or CBS or
19 Jiffy Lube Central engages with an outside
20 publicist or advertising company. And they
21 do some of the activities. It covers the
22 cost of those. And that typically is then --
23 and we see this. It's expressed as a percent
24 of revenue of the retailer, of the retail
25 outlet. And that's exactly what we have



1 here. Because there's real value there.
2 There's -- it doesn't relate just to the,
3 the, the pure kind of return on cost. But
4 there's -- we want to make sure that there's
5 a sufficient amount of spending going on
6 within the group and that everybody pays
7 their share. That's what kind of have here.
8 So, based on those third party comparables,
9 EY determined that an advertising fee between
10 2 and 5 percent, we see that as the range
11 within the comparables. And it also had a
12 median of 2 percent. So, it was actually
13 kind of skewed down as when you look at them.
14 So, 2 percent was not just the bottom, but it
15 was the middle. So, it was very frequent.
16 All right. And so, that was the
17 recommendation to price the advertising
18 services using these franchise agreements.
19 Wholly consistent with what we have in
20 Transaction 1.

21 Q: And so, what was your assessment of E&Y's
22 analysis on this transaction number 3?

23 A: I thought it was appropriate, right? Based
24 on the activities of CBS, how'd it had
25 organized relationships, not just as it dealt



1 with advertisers, but with third parties as
2 well and paid them. With the, the --
3 applying the economics to the substance of
4 the transaction within the 482 regulations, it
5 fit there, best method. So, I felt it was
6 appropriate and, and just based on my
7 experience, again, both the method and
8 quantity, if you will, of the rate,
9 reasonable.

10 Q: And Dr. DeRamus said you -- we should have
11 used the CPM method. What is your response
12 to that?

13 A: I disagree. The, the value of the
14 advertising services -- excuse me -- don't
15 tie directly to the cost when we look at the
16 expertise that goes into developing those.
17 Certainly, there's part of, of what we have
18 is reimbursement of ex- -- external expenses.
19 That's build into the -- to what EY has in
20 their -- in their chart. But looking at
21 simply the, the cost, that's not how it's
22 done in a retail environment and we see that
23 by looking at the comparables because again,
24 this goes back to the industry analysis. We
25 can't just impose how we think a price -- a



1 transaction should be priced without taking
2 into account how it fits into the business
3 and in the context of the industry. So, it,
4 it just doesn't comport with what we would
5 say from a functional analysis standpoint,
6 from an industry standpoint, which the regs
7 require us to look at. So, I don't agree
8 that that is the best method.

9 Q: What about his conclusion that the services
10 cost method should be used?

11 A: Completely disagree. Advertising services
12 would not qualify. They fail that covered
13 services. In fact, they fail both prongs of
14 the covered services. We saw on the --
15 previously that the -- it failed the low
16 margin test. I looked at the, the list of
17 covered services in that revenue procedure and
18 it says advertising services. Some can
19 qualify: collecting some data, things like
20 that. But engaging in advertising for
21 specific products and services, that's what we
22 have here, doesn't qualify.

23 Q: All right. Let's move on to Transaction 4,
24 real estate. All right. Can you walk us
25 through this one?



1 A: Yes. So, here we have various real estate
2 related activities performed in CBS. We've
3 talked about site selection, negot- --
4 property acquisition, negotiations of leases,
5 market research around where to place and all
6 those things, as well as ancillary services.
7 So, those -- the -- within the real estate
8 group at CBS, those activities are performed,
9 again, for the benefit of East and West.
10 That's the solid line coming down. And then,
11 of course, they, they are paying a management
12 fee coming back up, the dotted line.

13 Q: Okay. All right. And then walk us through
14 E&Y's study.

15 A: I won't -- I won't spend very much time at
16 all on, on this point because again much like
17 Transaction 2, we -- not just what I look at
18 when I see EY's, but they basically comport
19 with what Dr. DeRamus had. So, in terms of a
20 way to charge a method, look at a cost based
21 method, a CPM based on total cost, go out,
22 find companies that engage in real estate
23 services, perform real estate services. We
24 have the range here that E&Y determined that
25 had a median of 10 percent. You can see the



1 range between about 8 and 12 percent. Dr.
2 DeRamus' range was very similar. And so, we
3 came to the basic -- basically same
4 conclusion ---

5 Q: Okay.

6 A: --- on it.

7 Q: And, and would real estate qualify for the
8 services cost method?

9 A: No.

10 Q: Okay. All right. Let's move on to
11 Transaction 5, analytical and business
12 development.

13 A: All right. This is -- this is absolutely key
14 to the -- to the, the whole analysis here.
15 So, as we've said, not only do we have the,
16 the on -- the, the basic business process
17 intangibles, but on an ongoing basis there
18 are people within CBS, groups within CBS,
19 that are looking at not just strategy, but
20 how to develop systems and strategies that
21 continue to improve the profitability of the
22 company, right? Earn margin, improve margin,
23 drive additional volume. And so, they need
24 to be compensated for the -- for those
25 activities. And that's what we have here in



1 this -- in this fifth transaction. So, we
2 have the provision of those analytical
3 business development services to the -- to
4 the retail, right? And they pay a fee coming
5 back up to CBS for those services.

6 Q: All right. Can you walk us through the
7 method here?

8 A: Yes. So, for the analytical and business
9 development services, E&Y chose as the best
10 method, based upon its functional analysis.
11 So, for what is known as an unspecified
12 method within the regulations, right? And
13 the reference here, 1.482-9(h), is simply that
14 unspecified section in the regs just to be
15 clear.

16 Q: Okay.

17 A: Right? Unspecified methods are subject to
18 the best method rule, right? They're -- they
19 need to fit within the comparability criteria,
20 right? It's not just anything we make up.
21 They have to fit within the, the confines of
22 the regulations. So, what E&Y did was to
23 look at -- say, well, can I find external
24 comparables? Let's put that side for a
25 second. And this on everything we look at.



1 Is -- was there anything the company is doing
2 that could help me value what's going on
3 here, right? It's a question you ask on all
4 the other transactions as well. For
5 instance, corporate services, we might say,
6 oh, does CBS provide services to a third
7 party. If so, that could be a benchmark.
8 That's an internal comparable, right? If
9 they don't, we just move on. It doesn't
10 impact anything. It's just that source of
11 data is gone. I mean, it doesn't say, choose
12 a different method, just choose comparable.
13 So here, given the, the special activities
14 that we have here and that they're so core to
15 a used car business, E&Y investigated what
16 was actually being done within, within the
17 group. And so, it -- in its research, it was
18 able to determine the contribution of
19 various systems and strategies to the
20 profitability of CarMax. And so, it
21 determined based on those a range of prices,
22 charges, based on value that should be
23 compensated by the -- by the retail stores
24 for the development testing and implementation
25 activities of CBS. And that's the range that



1 we have in the range identified the -- for
2 2015, it was a range of \$491 to \$736.50 per
3 vehicle. The value was in that range. And
4 the, the company chose a, a range of 506.

5 Q: Okay. And where did the values for those
6 internal comps come from?

7 A: Here's a question I ask when I -- when I
8 looked at the E&Y studies, right, because we
9 are always a little bit -- and I agree with
10 Dr. DeRamus on this. When we're using
11 internal data, we need to be careful, right?
12 So, I wanted to know, right? And then the
13 regulations say be wary of internal data.
14 It's held to a higher level of scrutiny. So,
15 let's be really sure. Within the, the data
16 analytics pricing group, that group that is -
17 - their daily task is to think about how can
18 we improve the business of CarMax, how do we
19 improve the margins, how do we reduce costs
20 and so forth? They're responsible for
21 developing then from an idea, developing then
22 a tool. And we've heard a number of those
23 referenced in, in other testimony for
24 developing those. And then testing the
25 impact of those tools on margin, do they



1 actually deliver value. So, the numbers that
2 we have here and that are in the E&Y study,
3 are the result of the testing that was done
4 for the various tools that were developed.
5 They put them to the test and that's where
6 these data came from.

7 Q: And how is that testing that you're referring
8 to done?

9 A: I think if I go back to high school science,
10 you've got a -- you've got a control group,
11 right? And then you want to see the effect
12 of something on, on that. So, you got a
13 control group. You don't do anything to
14 them. And you've got your test group, so you
15 add something to that test group. And then,
16 you watch what happens. And the difference
17 in the outcome between those two, that tells
18 you what the impact of that was.

19 Q: Okay.

20 A: Right? I think of it that way in the data
21 analytics, modern parlance and tech. Those -
22 - that's known as AB testing. You've got
23 you're a group, control group. Your B tech
24 group is different, right? So, control or
25 AB. That's how they describe it. So, that's



1 what they -- that's what they do, right? So,
2 just with that testing, you think, well, like
3 okay, well, that, that sounds good, right?
4 They're, they're, they're testing the actual
5 outcome. But why are they doing it?

6 Q: Well, before you move to the why, can you
7 give us an example so we can understand
8 exactly how they're implementing that AB
9 testing?

10 A: Certainly. So, in speaking with David Smith,
11 that's how I understand the, the process
12 that they go through. I mean, Ms. Yost
13 reference an example yesterday in her
14 testimony, CarMax Book, right? There prior
15 to the development of CarMax Book, right?
16 The buyers in the retail outlets were allowed
17 to just routinely price cars that they were
18 buying at auction, right? CBS had the idea,
19 hey, I think we can do better by
20 standardizing and develop a tool that will
21 give us a market intelligence on how to buy
22 cars better, right? So, if I put together a
23 plan, gets a budget, develop the tool, right?
24 Tools in prototype. Tool is developed. Now
25 we say, okay, let's see if it works, right?



1 How do we do that? Well, we've got our
2 buyers that are just using their own
3 knowledge. That's our control group. That's
4 our A group, right? And we've got our buyers
5 that are going to use CarMax Book, right?
6 All right. They buy it. Follow, follow it
7 through to what happens on the margins.
8 What's -- what margin does CarMax realize on
9 cars that were purchased under the control,
10 the old method, and the margin that's
11 realized on the cars that are bought using
12 CarMax Book. The difference, right? And you
13 replicate this a lot of times. It's not just
14 once, right? You replicate this a lot of
15 times. That's where these values came from.
16 That's the kind of testing that goes on.

17 Q: Did you also hear -- are you aware of any
18 testing that was done on reconditioning at
19 CarMax?

20 A: Yes.

21 Q: Can you tell us about that?

22 A: Yes. I always thought of reconditioning as
23 kind of you take it down to the local -- you
24 know, you got a dink, a scratch, and you take
25 it down and they do what they do, right? And



1 as we said, reconditioning is typically done
2 in those local retail outlets. The data
3 analytics group, as part of their charge,
4 they're looking at the business and saying,
5 how can we improve, right? They said, hmm,
6 we're spending a lot of money reconditioning
7 cars because they do a lot of things for
8 cars. They paint, right? They fix them,
9 right, mechanically, those kinds of things.
10 So, let's just focus on paint because paint
11 was a large charge. Is there anything
12 different we can do on painting, right? And
13 so, again, in speaking with David Smith who
14 heads up that group, one thing that he said,
15 which really struck me and it made a lot of
16 sense, was that he said, CarMax takes a
17 manufacturing approach to recondition a new
18 car. Meaning that we ---

19 **OBJECTION:**

20 **MR. ANTLEY:** Objection, Your Honor. Hearsay.

21 **THE COURT:** I'll sustain that.

22 A: What's the approach we take? Well, much like
23 a manufacturing plant, we're looking at how
24 we do our processes. What's special about
25 our processes? And let's improve those.



OBJECTION:

MR. ANTLEY: Objection. Sounds like he's still speaking about what Mr. Smith said.

MS. GEER: I think he can still talk about his understanding of how CarMax works based on his discussion with the company. You're -- an expert is allowed to ---

THE COURT: Yeah. That's ---

MS. GEER: --- rely on that.

MR. ANTLEY: It -- it's similar to the objection made earlier. It -- it's, it's now putting statements by Mr. Smith into the record as evidence. He can rely on, on evidence that's un- -- inadmissible. It just can't be put forth as evidence.

THE COURT: Yeah. Ask the question again and let's just start this over.

Q: All right. Let's just start this again. What's is your understanding of how CarMax derived a value for what -- how the reconditioning services were driving value and what margins they were realizing from that?

A: Yes. It's, it's my understanding that CarMax used a manufacturing type approach, where they looked at precesses and they said -- and we'd



1 say, where am I spending money, a lot of
2 dollars, right? And can I improve that
3 process, right? So, to examine then, well, I
4 need to first look at a scratch, determine
5 the severity of it. So, how do I do that?
6 What are the criteria that I would use for
7 that? Then, based on those criteria, I need
8 to -- I would need to help the technician
9 make decisions. Is this something that
10 simply could be touched up? No. Does it
11 need additional buffing and sanding, and, and
12 so forth? Do I repaint the whole panel,
13 right? And to put into place then processes
14 around that discipline process, right? This
15 is something I see in retail all the time. I
16 was one of several million people who have
17 grown up and worked at a McDonald's, right?
18 They had -- this is how you cook a hamburger
19 and they have pictures and everything. So,
20 that's what they did. They put that process
21 in place. With that, they then did the same
22 kind of control group testing, AB testing,
23 for reconditioning. And what they found was,
24 they reduced the, the painting cost by, I --
25 \$100, \$150 a vehicle, right? And then they



1 used that information to make a decision on
2 rolling out the, that particular tool. It
3 seems obvious in retrospect, but clearly that
4 was not happening at the individual store
5 level. They were not acting in that way.
6 You bring the discipline from the center,
7 that's the value.

8 Q: And is CarMax also able to look at what other
9 companies are charging for reconditioning and
10 consider outsourcing it?

11 A: Yes. There are -- you've got your -- not
12 just your local auto -- auto body shop, but
13 there are national companies; Manheim for
14 instance. Very large company that deals with
15 used autos, new autos. They have data on
16 cars. It's my understanding that CarMax
17 investigated and actually tested Manheim and
18 that when -- they found that when Manheim was
19 doing this activities, the reconditioning, it
20 was costing more -- \$1,000 more, something.
21 And, and just not economical on how --
22 compared to what they could do coming out of
23 their, their processes.

24 Q: All right. And then I interrupted you a
25 while back. You were going to talk about



1 what CarMax does with this data.

2 **THE COURT:** Well, before you move on.

3 **MS. GEER:** Yes.

4 **THE COURT:** And you're on reconditioning right now.

5 Because you said, it seems obvious that they
6 -- what they did. Which I, I can clearly see
7 that. Why would you pay money for them to
8 perform that which was obvious? Because
9 that's what -- I mean, you're saying they're
10 giving value. To me your, your example is
11 just less value, because I mean -- what
12 they're providing is something that was
13 obvious and, and would not be worth what
14 they're paying for.

15 A: I think the, the reason that it's important
16 is that the, the local reconditioning
17 operations, right, they had the same
18 information. They could have changed their
19 processes. They weren't -- they weren't
20 doing it. They had experienced operators as
21 well. People that could make these
22 determinations. Oh, this scratch, you know
23 what, I could just buff this out, right?
24 They could have made those determinations.
25 But several things. One is that wasn't



1 happening. They had very high refurbishing
2 costs. So, even though it seems obvious in
3 retrospect, an obvious improvement, it wasn't
4 happening at the local level. Also, those
5 decisions were being made locally. So, it
6 might be, you have one shop doing one thing.
7 You have another one doing another.

8 **THE COURT:** Now, how do you know -- how you know
9 that?

10 A: Through my discussions with, with the company.

11 **THE COURT:** So, it's based on -- okay.

12 Q: So, what is CBS doing with this AB testing
13 data?

14 A: This really goes to, to the heart of how they
15 operate. So, on a regular basis, a group gets
16 together, high level executives in CBS, as
17 they're reviewing operations, right? And they
18 need to make decisions about how the business
19 moves forward. One part of that is the tools
20 and the systems that are coming out of this
21 data analytics group. Oh, if we implement
22 this reconditioning pro- -- protocol, it's
23 going to save us \$100 a car on a
24 reconditioning costs, right? Should we do
25 that because there's going to -- we're going



1 to need to do training and everything like
2 that. So, do we roll it out? That's one
3 part of it. The second part is, hey, our
4 costs are now lower by \$100 a car or based on
5 some other situation -- other, other tools.
6 It could be \$500 a car, right? What do we do
7 with that? Do we keep our sales prices to
8 the customer the same. Now, our cost are
9 lower and we just take that in margin, right?
10 That's one business strategy. Oh, do we pass
11 the savings on to the customer from this and
12 maybe we drive more sales because now I have
13 a lower price point. I don't take it in
14 margin, but I take it in volume, right?
15 That's another strategic decision. It kind of
16 says that, you know, how CarMax wants to
17 price its cars to its customers. So, this
18 group within CBS are taking these data and
19 making operational decisions based upon them.
20 That is -- that is how they are used. That's
21 why they were being developed and had been,
22 been used completely outside of any tax
23 discussions, any tax reasons. These are what
24 the company uses to make its decisions.
25 Because once they -- once they put this in



1 place, it rolls forward, right? Their
2 activity, great, we developed it. Moving on.
3 Now, I consider the next thing, right?

4 Q: All right. And, and as a transfer pricing
5 expert, when you were trying to make the
6 decision of whether or not to trust an
7 internal comparable versus going to an
8 external comparable, how does whether a
9 customer -- sorry -- whether a taxpayer
10 derived its data or values for what amount of
11 margin is being driven by something or what
12 value a certain activity has, how is it
13 relevant as to whether it's created for a
14 business purpose or a tax pur- -- purpose
15 impact that?

16 **THE COURT:** That was a long question.

17 **MS. GEER:** I know. I'm sorry.

18 A: It, it -- to me it's an important
19 consideration. I certainly have used and
20 relied on information that's been prepared by
21 the tax department for instance, right? You
22 have to go through due diligence to make sure
23 that you agree with them. Maybe you adjust
24 it, but you do that. That's fine. So, you
25 can rely on it. But when you can look at



1 data that's purely developed by the business,
2 that gives it a -- so much more credibility
3 just on the front, front end. You still need
4 to investigate and figure out why it was
5 done, the circumstances under, but there is
6 that -- there is that difference of
7 reliability.

8 Q: Talk to us about -- we've heard discussions
9 of systems versus strategies. Why does that
10 matter?

11 A: Here it's -- here it's important, right?
12 Because we already have the implemented
13 business process intangibles being compensated
14 through Transaction 1, right? So, those are
15 things that are rolled out. They're already
16 part of the implementation. They're out
17 there. So, we consider those systems. It's
18 a term that we see repeatedly in the E&Y
19 report, in discussing. Strategies are, are
20 those -- I'll say the newer ones that are,
21 that are -- they're, they're in development
22 and they're being then rolled out, right?
23 These are necessarily new things that can add
24 value, whether it's improved pricing, lowering
25 the cost. Those are what we want to capture



1 and, and compensate in Transaction 5. So, we
2 need to make sure when we're looking at the
3 data, that David's group is preparing based
4 on their development efforts and presenting to
5 this committee. Then we make sure we're not
6 double counting. So, I need to separate
7 business systems from strategy.

8 Q: And is it necessarily one or the other?

9 A: No. Some of these in, in the discussions
10 that took place, some of them have a common
11 element to them. So, maybe part of it has
12 been rolled out. It's part of the system,
13 but as we heard for instance, one of the
14 systems that Ms. Yost talked about yesterday
15 has been going through iterations over the
16 entire like 15 years, right? So, part of it
17 is new. Part of it has been rolled out. So,
18 that would be something that's has kind of
19 the character of both.

20 Q: And how did E- -- how did E&Y deal with that
21 issue?

22 A: So, what E&Y did was first to say, let's look
23 at each of the -- these major programs that
24 are being considered and the data, right,
25 that Mr. Smith's group has prepared for the -



1 - for this other purpose. Let's take the
2 ones that are -- that are the system. We'll
3 just take those off on the side. Those are
4 out, Transaction 1. And let's exclude then
5 an estimate of the contribution of system to
6 the, the improved margin, if you will that we
7 see. And so, we only have what's leftover as
8 the strategy component. And so, they
9 developed an arm's-length range based upon
10 their, their judgement, based upon their
11 discussions with the company.

12 Q: And did you review that analysis and what was
13 your assessment of it?

14 A: Yes. I, I found that analysis was, was
15 reasonable. It was -- it was diligent as
16 they looked at it. As they had discussions
17 with individuals and it comported with, with
18 my own investigation. Also, I think an
19 important point here, and this really goes
20 back to the reliability, is that these are
21 not forecast numbers, right? I would have
22 trouble with them for instance if they were
23 based on, well, Mr. Smith, David Smith goes
24 to this committee and says, hey, we would
25 like to develop a new tool. So, we would



1 like to have a million dollars to develop
2 this tool over, you know, the next six
3 months, whatever the number is, right?
4 Because we expect it to generate savings of
5 \$500 per car, right? That's a forecast,
6 right? Well, how do I know that that \$500 is
7 right? All right. It's a forecast. It's a
8 guess. Sometimes internal data are those
9 guesses. We often use forecast for, for you
10 know projections. That's fine in their
11 context. In this context though, these are
12 not forecasts. These are the results of
13 actual tests that were done. So, they're
14 proven results. And, and that's how --
15 that's how we know the, the reliability of
16 them.

17 Q: Would Transaction 5 qualify for the services
18 cost method?

19 A: Certainly not. No. It -- one, it, it fails
20 on the covered service. It clearly is not
21 anywhere on the list that's in that revenue
22 procedure that the IRS issued. And, based on
23 even Dr. DeRamus' comparables, the -- it
24 would fail the low margin test. So, it's
25 knocked out right on the very first criteria.



1 Q: And setting aside that, what is your response
2 to Dr. DeRamus' position that because E&Y
3 used the CPM method for transactions 2 and 4,
4 it should also have used that for Number 5?

5 A: I really find that that's wholly incorrect.
6 There's nothing that would say, because I
7 used one method for one transaction, that I
8 should use the same method for another. The
9 best method rule says, don't do that. The
10 best method rule says, look at the
11 transaction, apply the method that's
12 appropriate to that. Stay within the
13 confines of the regs.

14 Q: And do you think that CarMax could outsource
15 a function provided number 5?

16 A: Theoretically, yes, they could, right? There
17 are companies that help on working up tools.
18 When I was at CRA, some of the work that some
19 of the people in other groups did, they might
20 help a -- a pharmaceutical company or an
21 automotive company make a projection for what
22 they should price a car or a new drug in the
23 market. They do that kind of thing. So,
24 conceivably, they could do it. It's my
25 understanding that CBS actually considered



1 that for some things. And found that as they
2 spoke to the consulting firms, that both from
3 a technical side to deal with the, the
4 technical challenges, the data challenges that
5 they have, as well as then just really the
6 industry knowledge that's required to price a
7 used car, whether on the buying side or on
8 the selling side, that that expertise did not
9 exist outside of the company. That they were
10 better. So, while theoretically, you could.
11 Practically speaking, it's my understanding
12 that the answer was no. They couldn't do it.

13 Q: All right. And what is your overall
14 assessment of E&Y's analysis and conclusions
15 on Transaction 5?

16 A: I felt that E&Y had the, the functional
17 analysis done correctly in terms of the
18 characterization of CBS and its contributions.
19 I felt that it chose the best method based on
20 data that goes right to the heart, right to
21 the actual value created by the analytical
22 and business strategy tools that CBS develops
23 and then implements. That it was diligent in
24 making adjustments to those data as needed.
25 So, I feel that they -- that their results



1 are, are reasonable and I have confidence in
2 them.

3 Q: And so, what is your opinion -- do you have
4 an opinion to a reasonable degree of
5 certainty as an economist and transfer pricing
6 expert as to whether the management fee
7 payment to CBS was arm's length and reliable
8 and whether it was reasonable for CarMax to
9 rely upon it?

10 A: Yes. It's, it's my opinion that the analysis
11 that we have, that it is wholly reliable.
12 That it was developed through very diligent
13 process. They considered the facts,
14 considered the operations of the company as a
15 substance of the transactions, and went
16 through a diligent process to select the
17 methods. They appropriately applied the
18 regulations in the selection of those methods.
19 Made adjustments to the data as needed, as
20 the regulations would say, and developed
21 prices that stand the test, the arm's-length
22 test.

23 Q: And beyond evaluating each of these five
24 transactions as E&Y did, did you also do a
25 separate overall reasonableness test?



1 A: I did. Yeah.

2 Q: Can you tell us about that?

3 A: Yes. Could have the, the other -- just the,
4 the, the flowchart? It's just the other one.
5 Okay. I've, I've said several times and
6 likened this arrangement to a franchise
7 arrangement where CarMax Business Services is
8 like a franchise or it's like the, the
9 headquarters for Jiffy Lube, if you will, or
10 McDonald's as you will, right? And it is
11 providing a bundle of intangibles and services
12 to retailers, to its franchisees, who have
13 the, the sole charge of operating stores.
14 So, what do they provide? Well, they provide
15 trademarks and trade names. They provide
16 business process intangibles. How do you not
17 just change oil, but do it in the Jiffy Lube
18 way, an efficient way. Or what equipment do
19 you use? Will provide some corporate support
20 services because we know you need -- you need
21 payroll and you need -- you need your bills
22 paid and things. We'll help you with that.
23 We have -- we're providing some advertising
24 activities, some advertising services that
25 benefit the group. We help determine where



1 you're going to put your franchise, where
2 you're going to have your store, right? How
3 does it fit into the overall strategy? And
4 the finally, analytical business service --
5 services, it's that franchise or its
6 responsibility, that CBS equivalent, to
7 constantly look at how to make the business
8 better, right? I'm paying you, center, to do
9 that, right? I'm executing. You tell me how
10 to do it. So, from an economic model, we see
11 this in the industry. It's very common to
12 have an overall franchise. So, one of the
13 reasonableness tests that I did was -- fine,
14 E&Y priced the separately, each of the five
15 separately. Nothing wrong with that. But I
16 can also look at it as a whole and I've done
17 that before, to look at the, the total impact
18 of the pricing together. And so, that's,
19 that's the, the cooperative test that I, that
20 I did.

21 Q: And how does this inform your analysis any
22 further on the E&Y transfer pricing study?

23 A: Right. It -- to me, it confirmed the overall
24 reasonableness.

25 Q: Hold on one second.



1 MS. GEER: Can you put up demonstrative?

2 Q: Sorry. Before -- I should have put this up
3 before I started the question just so you can
4 see it. Do you know what this document is?

5 A: Yes. I, I prepared this document.

6 Q: All right. So, I wanted you to have that in
7 front of you as you give your answers.

8 A: So, to perform my overall test, my
9 corroborative test -- because here, what I'm
10 using is, is essentially a, an approach that
11 would be a CUT approach, where I'm looking at
12 a franchise agreement overall. So, even in
13 my corroborative test, I need to deal within
14 the confines of the regulations. I don't
15 just get to make up another method, right? I
16 got to pick my best method. All right. So,
17 here, we -- and this is showing the data for
18 East, CASI, CarMax Auto Superstores, Inc., we
19 have their sales for each of the three years
20 at issue and their operating income. That's
21 operating income before the management service
22 fee, right? We see that. And then the total
23 management service fee, that's all five
24 transactions together. We have those amounts.
25 So -- and then I calculate the operating



1 income afterwards. So, let's just look at
2 one year in particular here. So, for 2016,
3 CASI had total sales, total income of
4 approximately 9.6 billion dollars. On that,
5 before the management service fee was paid,
6 the had operating income of approximately 720
7 million dollars. We can see that there in
8 the middle. The management service fee that
9 was paid to CBS for 2016 was approximately
10 525 million dollars. See that there. And as
11 a percent total sales, the management service
12 fee was 5.45 percent. That's the 525 million
13 dollars divided by the 9.6 billion dollars,
14 roughly, right? How does that then compare
15 to the franchise, the franchise model, the
16 franchise agreements that we have? It compares
17 very, very reasonably. And let me break that
18 into two pieces here. Remember that the
19 management service fee has an advertising
20 component to it, right? Remember I said that
21 that's outside of the normal franchise
22 agreement. That's a separate charge, right?
23 So, if I look at 2016, I see a total charge
24 of 5.45 percent, of which 2 percent is
25 advertising. So, the non-advertising



1 component, that's Transactions 1, 2, 4 and 5,
2 have a rate of 3.45 percent. Total 5.45
3 minus the advertising of 3.45. If we look at
4 the franchise agreements, not just based on
5 my experience alone, but based on those that
6 E&Y had, remember we had a range of franchise
7 agreements of between 2 and 5 percent. So,
8 that 3.45 percent, which is the non-
9 advertising component, falls right within that
10 range of franchise agreements, entirely
11 reasonable. Just simply consider the
12 advertising component there, then the
13 additional 2 percent. So, you have a total
14 return, a total franchi- -- excuse -- fran- -
15 - management fee of 5.5 percent. Remember
16 that the advertising rates were around 2
17 percent, right? So, based on the comps, I
18 would expect a total range of 2 percent from
19 the franchise. We had that on the low end.
20 2 percent from advertising. So, for a low
21 end of 4. They had 5 percent on the high end
22 of the franchise. 2 percent advertising on
23 top of it. That's 7 percent. So, I have 4 to
24 7 percent all-in as my comparable range, my
25 arm's-length range. Here I see a rate of



1 5.45. Right in that range. That's what I
2 would expect. And you can see this same
3 result for 2017 and 2018. It fits right with
4 what we would expect form a -- from a
5 franchise model, from my corroborative model
6 within the context, again, of applying methods
7 under 482.

8 **MS. GEER:** Your Honor, for the record, I believe
9 we're on Demonstrative Number 4. Sorry.
10 Petitioner's, Petitioner's Demonstrative
11 Number 4.

12 **(Petitioner's Demonstrative 4 was referenced at**
13 **this time.)**

14 **MS. GEER:** Your Honor, this might be a good
15 breaking point for a restroom break.

16 **THE COURT:** Well, how much longer? I think it'd be
17 good to take a break when cross starts. But
18 I mean ---

19 **MS. GEER:** Well, it's going to be at least an half
20 an hour more, I think.

21 **THE COURT:** All right. We'll just take a short
22 break then.

23 **MS. GEER:** Thank you.

24 **(Off the record from 11:07 a.m. to 11:17 a.m.)**

25 **Q:** Dr. Cody, you talked to us earlier about



1 practices for frequency and level of detail
2 required for transfer pricing studies. How
3 does that apply to the 2015 and 2012 studies
4 here? And let's start with first the time
5 period.

6 A: The, the time period, so transfer pricing
7 studies are done on a couple of basis. One
8 basis would be for -- the term is planning,
9 but the planning really means forward-looking
10 in, in this context. So, do a study to set a
11 baseline for the setting of prices in a -- in
12 a future period. Then we'll typically do
13 updates for studies to refresh the
14 comparables, bring the study more up to date
15 from a financial standpoint. And then those
16 then are done say every -- sometimes every
17 year, sometimes every two, sometimes every
18 three. You still look at the -- at the data
19 to see if there's a need to do it. So, look
20 at them from a planning side and then from a
21 documentation side, proving out the results
22 for a particular year.

23 Q: And so, what are you conclusion as to whether
24 the, the E&Y studies went into the required
25 level and depth?



1 A: Yes. So, when I look at the, the E&Y study
2 for 2012, that is the -- I'll say, the, the
3 baseline, the more detailed study that's done
4 a -- on a say three to five-year period,
5 right? Where there's a big investigation of
6 the facts. You see that in the, the list of
7 interviews and so forth. And then you use
8 those results going forward. So, that's
9 entirely appropriate, right?

10 Q: All right. And I'm going to discuss
11 implementation of a transfer pricing study
12 with you. So, once a company has a transfer
13 pricing study that gives them arm's-length
14 ranges, how does it go about implementing
15 that study?

16 A: That's really where the -- working the
17 company is so important to understand the
18 financial systems of the company, their
19 processes and how it gets implemented. So,
20 for instance, when we say in the report that
21 there should be a -- that this service should
22 be priced out on a cost plus basis, right,
23 there's elements to that. Well, what's the
24 cost base? So, you need to figure out what
25 the cost base is. And then we would say, all



1 right, well, the cost base is 100 and the
2 cost plus is 5 percent. So, my, my total
3 charge should be 105, right? Well, how do I
4 implement that then, right? Particularly when
5 there are two parties like we have here, East
6 and West, I need to somehow divide that up
7 between them. So, I need to figure out how
8 to, to do that. And that's the
9 implementation part of it.

10 Q: And do the re- -- the 482 regs have any
11 requirements on how a taxpayer implements the
12 study?

13 A: No. No. They, they look at the -- at the
14 results. So, what is the, the impact on once
15 the, the price is implemented, what's the
16 result of that price within that transaction.

17 Q: And did you see anything problematic about
18 the way CarMax is implementing or implemented
19 these two transfer pricing studies?

20 A: Problematic? No. Not at all. I, I - in
21 fact, I was quite impressed with the, the way
22 that they, they implemented it. When --
23 particularly when we've got service fees that
24 go between parties, we need to figure out
25 some way to allocate those -- that, that 105



1 in my example, between the parties. That
2 sometimes is done on sales. It's done in
3 other things, but here we have a direct
4 measure. They're, they're selling vehicles.
5 So, in -- to me, it was entirely reasonable
6 that they would calculate a per vehicle
7 charge and implement it in that way, right?
8 Also, around the implementation, there's
9 always an issue of, well, when do I put the
10 charge in place? Sometimes we see companies
11 just wait until the end of the year and do a,
12 a journal entry to make everything
13 appropriate. And that's appropriate. That -
14 - that's fine. We see that as a perfectly
15 reasonable way to go. Sometimes companies
16 put a charge based on forecast or based on
17 budget, right? And then, then do a true-up
18 at the end of the year. That's perfectly
19 fine too, right? What we have in this case
20 is that CarMax calculated the per vehicle
21 charge that both East and West would be
22 charged equally. That they invoiced that on
23 a monthly basis, so it's very timely. That
24 they actually then true-up, so it's not just
25 on projected units, but it's on actual units.



1 So, they true those up on a monthly basis.
2 That's more diligence than I typically see.
3 I, I'd say this is kind of the gold standard
4 of implementation purposes because it's --
5 it's kind of what you would expect from a
6 service provider. You get a bill every
7 month, right? You pay your bill, right? You
8 go forward, right? So, it's -- to me, it's,
9 it's -- it, it really is very robust.

10 Q: All right. And then, so you mentioned
11 earlier some companies journal entry. And
12 then I think you just mentioned invoicing by
13 CarMax and payment. How did CarMax East and
14 West make those payments?

15 A: They actually moved the cash, which again is
16 something we often don't see, right? Again,
17 ways to do it on the books, but to actually
18 move cash mimics what you would expect to see
19 from, from third parties. So, again, very,
20 very I'll say robust and reliable
21 implementation. And I, I think it's easy to
22 also then see how the, the arm's-length price
23 under the regulations in this -- in this
24 regard and why it doesn't pay attention to
25 those ownership shares. And examp- -- a



1 simple example can, can demonstrate that.

2 Q: All right. What's your response to the
3 argument that the arm's-length result under
4 482 requires you to look at what is
5 ultimately reported on the state return?

6 A: That's not what it says. It simply that the
7 pricing for the transactions is done at a
8 operational -- a transaction basis. Two
9 third parties that are conducting business,
10 they don't have any idea what the, the tax is
11 of their -- of their trading partner. If I
12 go to a grocery store, would I be willing to
13 pay more for a banana because the grocery is,
14 is in a high tax jurisdiction? No. I'm
15 going to compare the price of the banana,
16 right? And I think -- and, and a real
17 example here that I think is, is so important
18 and this is based upon my personal experience
19 with, with an example and in retail in
20 particular. So, one of the advanced pricing
21 agreements that I helped negotiate was for a
22 retailer coming into the U.S., right? This
23 retailer happened to be based in Ireland,
24 right? It's a real company in Ireland.
25 Sometimes people talk, diminish the Irish



1 because it's kind of a tax haven, right? But
 2 this is a long standing retailer based
 3 Ireland, right? Corporate tax rate is 12 and
 4 a half percent, right? They have -- and they
 5 use a franchise model. They have franchise
 6 stores in -- all across Europe and they were
 7 coming into the U.S. So, they wanted to get
 8 assurance from the IRS on how the pricing
 9 would be respected and they use a franchise
 10 model. So, when we were going through the
 11 diligence with the IRS, one of the questions
 12 came up was, oh, do you provide franchise --
 13 do you license your stores to any third
 14 parties? And the answer was no. All the
 15 stores were, were company owned. So, that
 16 went away. The issue of what the parent's
 17 tax rate was had no role at all. The IRS --
 18 it did not come up in the discussions. The
 19 fact that it was lower than the U.S.
 20 corporate tax rate had no bearing on what the
 21 arm's-length price was. None at all.

22 Q: And what is the relevance of the tax
 23 motivations of parties under the 482 regs?

24 A: The 482 regs do not look at the tax
 25 motivation. They look at how the business is



1 organized and the substance of the entities
2 with respect to those transactions.

3 Q: What are your thoughts on the relevance of
4 the 2004 restructuring to determining the
5 arm's-length standard during the audit period?

6 A: As I've said, the, the ownership shares, the,
7 the distributive shares, has no bearing when
8 we're looking at the pricing for the
9 management service fees during the audit
10 years. We -- those transactions, we need to
11 look at the facts and circumstances related
12 to those transactions. That's in keeping
13 with the transfer pricing regulations. That's
14 -- that's in keeping with 482 regulations.

15 Q: So, you're saying you, you look at the
16 transactions that are being priced and you
17 cannot look back at an earlier transaction?

18 A: As long as we've got substance to those
19 transactions within it, then it's -- then
20 that's what you would do.

21 Q: And when you say substance to those
22 transactions, which transactions are you
23 speaking to?

24 A: The ongoing transactions, the transactions
25 during the year, right? And this actually --



1 I think this is a -- an important point.
2 It's a critical point, right? And it's --
3 it's one that Dr. DeRamus addressed in his --
4 his testimony. He described a case that he
5 was involved with having to do with Periggo.
6 I won't go into all the details of the case.
7 I think he certainly knows the details more
8 than I did. So -- but one of the important
9 things was there was an entity that was set
10 up within the, the structure. There was a
11 contribution to that entity. And then,
12 ultimately, there was a lot of income that
13 the taxpayer had assigned to that entity in
14 performing the transactions that we're here --
15 that they were to perform under the
16 structure, right? And ultimately, the IRS
17 had a disagreement with that and there was a
18 large assessment, right? And Dr. DeRamus
19 argued for the -- for the IRS. A key fact in
20 that case was that there was no -- there was
21 no substance in that company. The company
22 that was set up had no substance to it. It
23 couldn't perform the activities that it was
24 supposed to perform under it, right? It --
25 when I look at it, quite frankly, I agree



1 with Dr. DeRamus, right? There was no
2 substance and so applying a different transfer
3 pricing method than the one that had been put
4 into place follows from the fact that there
5 was not substance in that transaction, right?
6 That's entirely different than we have here.
7 We have substance in CBS. We have hundreds
8 of people. We have ownership of IP. So, the
9 really -- to, to use a similar kind of
10 approach and say we're going to adjust shares
11 and adjust prices and use Perrigo as a -- as
12 an analogy to that, I think it's fine, but
13 the difference becomes because there's such
14 difference in facts. No substance in Perrigo
15 drives the analysis. Here we have substance.
16 You should get to a different result.

17 Q: And what about the fact that in the Perrigo
18 case, were there any employees in that
19 company?

20 A: No.

21 Q: Okay. What about the fact that in this case,
22 CBS's employees are leased? Is there any
23 issue with that?

24 A: No. And the, the reason is is that CASS, so
25 that support services company, in my



1 understanding -- because I inquired about this
2 to understand. The employees are there for
3 business legal liability purposes, to try to
4 isolate liability associated with Workers'
5 Comp, slip-and-fall, for the CBS employees,
6 those kinds of things. CASS only has the
7 employees of, of CBS, right? It's not doing
8 it for the -- for the broad group. It's only
9 for CBS. It's for that business purpose.
10 CASS is not off on some other part of the
11 organization. It's right there. And CASS is
12 compensated for the -- basically, for the
13 administrative activities that it performs in
14 those employees. So, no. It's, it's
15 something. You see a real business reason.
16 In fact, the company wanted to be able to put
17 store employees for the same reason in a
18 similar company, if not in CASS. But because
19 of regulatory requirements associated with
20 titling vehicles and dealer license, they had
21 to be in the stores. That's the only reason
22 that we have a difference.

23 Q: And is leasing employees unusual? Have you
24 seen that in your experience?

25 A: I see it all the time.



1 Q: And does four -- do the 482 regulations have
2 anything to say about that issue?

3 A: No. No. Not at all. You organize your
4 business as you -- as you would, charge
5 arm's-length prices, make sure that the
6 substance fits.

7 Q: What are operational consequences?

8 A: Do you mean in, in general?

9 Q: Yes.

10 A: Operational consequences would be if I have a
11 change in business, what's different, right?
12 Do I have a different entity that's
13 performing an activity? Did employees move
14 from one company to another? Did operations
15 change? Is there a different flow of
16 services? And so forth. So, those are
17 operational changes.

18 Q: So, what is your response to Dr. DeRamus'
19 testimony that there were no operational
20 consequences of this restructuring?

21 A: Well, I think if you -- if you look at from
22 the outside, there were no changes in, in
23 CarMax overall, right? From the -- from the
24 outside and market, right? I think we heard
25 testimony from Ms. Yost yesterday, a lot of



1 her comments about CarMax at the beginning
2 were from that -- kind of that investor side
3 and -- with market facing side. But that's
4 not relevant to the transaction. 482 would
5 say for the entities, what are they doing?
6 Is there a change in what they did? Is there
7 a change in the transaction flow? Is there a
8 change in the substance of the transactions?
9 So, we don't just look at the company overall
10 and say, oh, the market doesn't see any
11 difference. There's -- there are no
12 operational changes. We look at the entities
13 within the company and are they doing things
14 differently. Have they moved? Are their --
15 is there substance difference there? That's
16 what we mean when we're talking about it in
17 the context of transfer pricing and the
18 regulations.

19 **THE COURT:** So, when you say a change in the
20 substance of what they're doing, so there was
21 a change here, if there is no change in the
22 substance of what they're doing, then how
23 would you evaluate that from a transfer
24 pricing standpoint?

25 **A:** Yes. So, if there was no change in



1 substance, so if we said, CarMax East was
2 doing the same things that they were doing
3 after the restructuring that they were doing
4 before.

5 **THE COURT:** Well, I -- that ---

6 A: Is that what you mean, Your Honor?

7 **THE COURT:** CBS is doing the same thing that CarMax
8 East was doing before the reorganization, does
9 that affect your analysis?

10 A: It's affect ---

11 **THE COURT:** No change to the substance is what I'm
12 getting at.

13 A: Yes. It's -- it certainly ---

14 **THE COURT:** Just move it.

15 A: And that's what we mean by restructuring.

16 **THE COURT:** Yeah.

17 A: So, we, we have -- we formed a company. We
18 move people. Actually, there's -- there is
19 additional things. We had the trademarks
20 come in that were not part of CarMax East.
21 And so, we have all those activities that are
22 being done in CBS. That is normal
23 restructuring. So, there -- there really is
24 an operational change in what CarMax East was
25 doing, CarMax Business Services is doing.



1 The regulations don't say that you have to
2 keep CarMax East, if you will, doing what
3 they're doing forever, if you actually affect
4 a restructuring and form a new company, move
5 people there, and do those things.

6 **THE COURT:** So, that's back to my question still
7 though.

8 A: I'm sorry.

9 **THE COURT:** If the reorganization doesn't result in
10 change in substance, then maybe I -- I'm
11 missing the phraseology that you would
12 normally use -- then you just shift people
13 over, but they're still doing the same thing,
14 does that affect the analysis from a transfer
15 pricing standpoint in, in your opinion?

16 A: No. We would say who is -- who would be
17 compensated for those activities. Previous to
18 that, CarMax East would have received the
19 compensation associated with those activities.
20 Post-restructuring, and the contribution,
21 CarMax Business Services would receive the
22 compensation. So, it, it affects the
23 transfer pricing analysis to say who would
24 receive the returns for performing those
25 activities. That, that definitely changes.



1 **THE COURT:** At what point did your functional
2 analysis begin that you've been telling us
3 about?

4 A: I first was contacted ---

5 **THE COURT:** No. I'm not talking your work, I'm
6 talking about your analytical aspect of the
7 functiona- -- functional analysis of these
8 comp- -- of this company.

9 A: Yes, Your Honor. It, it started really when
10 the, the first information that I received as
11 part of my due diligence because I, I asked
12 for company organization charts, the
13 financials, and, and, and ---

14 **THE COURT:** I'm looking at more -- when you're --
15 you started analyzing this company ---

16 A: Yeah.

17 **THE COURT:** --- in the functional analysis of the
18 management of the company, was it -- did you
19 -- you begin on the 2014 to 2015? At what
20 point does your analysis that you're
21 testifying about today begin ---

22 A: Yeah.

23 **THE COURT:** --- of CarMax?

24 A: Yes, Your Honor. Do -- you don't mean when
25 my personal time line started?



1 **THE COURT:** No.

2 A: Okay. I'm sorry. That's, that's the source
3 of confusion. Okay. I'm tracking with you
4 now. I'm sorry. My apologies, sir. I would
5 look at the, the ---

6 **THE COURT:** Not what you would, I want to know what
7 you did.

8 A: Yes. Thank you, Your Honor. Yes. I looked
9 at those years because those -- what are the
10 companies doing in those years.

11 **THE COURT:** What are -- who's year?

12 A: I'm not trying to be evasive. I'm just slow
13 on the uptake. Fiscal '16. Fiscal '17.
14 Fiscal '18.

15 **THE COURT:** Okay.

16 A: The years at issue.

17 **THE COURT:** Okay.

18 A: Sorry for that, Your Honor.

19 **THE COURT:** All right.

20 A: Thank you.

21 Q: And, Dr. DeRamus, can you give us an example
22 of a situation where there would not be
23 operational consequences?

24 A: Yeah. You said Dr. DeRamus, I think.

25 Q: Did I? Oh my God. I am losing my mind.



1 Apologies to both of you.

2 **DR. DERAMUS:** I started to answer.

3 **THE COURT:** No.

4 A: I'm sorry.

5 **THE COURT:** He was ---

6 **MS. GEER:** He wants to answer.

7 **THE COURT:** He was ready -- for the record, he --

8 Dr. DeRamus is more than willing to answer.

9 **MS. GEER:** I apologize.

10 Q: Dr. Cody.

11 A: I'm sorry. Can you -- can you ask the

12 question again?

13 Q: Yes.

14 A: I got thrown a little bit, so.

15 Q: Yeah. I know. I think I threw us all off.

16 Can you give us an example of a situation

17 where there would not be operational

18 consequences from a restructure? So we can

19 understand what that would look like.

20 A: Yes. I would say like the -- perhaps like

21 what we saw in that Perrigo case.

22 Q: Okay.

23 A: Right? Where a company was formed. There

24 was a contract assigned to it. There was a

25 service contract put into place, but there



1 are no people, right? There was no substance
2 there. I would say there, there was no
3 operational -- there was no operational
4 change.

5 Q: So, so the two companies that were created
6 had a contract where one was supposed to be
7 providing services to the other, but it could
8 not provide those services?

9 A: Yes. That's my understand of, of those -- of
10 those basic facts. And that's actually when
11 transactions get challenged. And I, I have
12 seen that, and actually advised clients that,
13 look, I don't see what's changed here, right,
14 for the parties that are transacting.

15 Q: We've heard some testimony about economies of
16 scale. Are there any economies of scale here
17 with respect to CarMax's purchase of
18 inventory?

19 A: No. You often see it in retail where -- go
20 back to my blazer for example. All right.
21 If I go to a vendor and say, all right, I'm
22 going to buy 50 of these, what's your price,
23 right? Oh, I'm going to buy 1,000 of these.
24 Can you do better on a per unit price, right?
25 Oh, I've got 10,000 outlets. Can I get a



1 better price? Those are economies of scale,
2 right, that we see. Here, CarMax is buying
3 roughly 2 million cars a year, right? But
4 each individual car purchase and sale stands
5 on its own. Buyers go to an auction, right?
6 They're buying cars, right? No two cars at
7 the auction are exactly alike. They don't
8 get a deal simply because they're big, right?
9 You don't see that. It's just the economies
10 of scale don't work in this. They oft- --
11 they often do in retail, but for the core
12 activities here, they just don't.

13 Q: What are you thoughts on the argument that
14 the E&Y study should have affir- --
15 affirmatively addressed CAF?

16 A: I don't agree with that. I don't agree with
17 that. The E&Y study recognizes that CAF
18 exists within CBS, but it explicitly says
19 that it is not within the scope of the -- of
20 the analysis. I certainly have done studies
21 in, in -- as you speak with the client. They
22 say, well, you know, this is what I want you
23 to -- this is -- this is the transactions to
24 look at. You do some rounding to see if, if
25 those would have any impact on your analysis.



1 If not, then that's fine. This is what my,
2 my task is. I'll look at CAF. CAF is that
3 separate business segment. So, I thought it
4 was entirely fine that it, it was carved out.
5 And, and E&Y recognized that it was not
6 within scope.

7 Q: And do 482 regs address how a business can
8 structure itself?

9 A: No. Only, only -- either from an operational
10 or from a, a legal entity structuring side?

11 Q: Yes.

12 A: No. It says -- talks about substance. And,
13 in fact, as we said -- as I said yesterday,
14 the, the regs apply whether it's a
15 corporation, whether it's a partnership,
16 whether it's -- so, you choose your form.

17 Q: How many different organization structures
18 would you estimate that you have seen when
19 preparing transfer pricing reports throughout
20 your career?

21 A: Oh, hundreds. The -- they're basically
22 different for every single company in one way
23 or another.

24 Q: And how does CarMax's structure compare to
25 other similarly sized companies you've seen



1 your career?

2 A: It, it certainly is different when -- how
3 the, the boxes are organized and everything
4 like that. But in terms of complexity, say
5 common approaches, it's, it's no different.

6 Q: I want to talk to you about passive
7 association benefits. What are your role --
8 sorry. What are your thoughts on the role of
9 passive association benefits as it applies to
10 this case?

11 A: So when I think about passive association,
12 it's, it's when being part of, of a group
13 gives me some kind of advantage, right? And
14 when I look at this case, they're priced into
15 the transactions. Every group can potentially
16 have passive associations. There are some
17 benefits to being part of the Jiffy Lube
18 franchise. Those are priced within the
19 franchise fee, the charges that come. So, to
20 the extent there are passive associations,
21 they're really priced within the transactions
22 that we have already addressed.

23 Q: Have you valued intellectual property before?

24 A: In, in limited circumstances, yes.

25 Q: What, what are the -- what is your experience



1 with that?

2 A: Yes. So, we, we have intellectual property,
3 intangible property as we look at it under
4 the 482 regulations between related parties.
5 That's fine, right? Licensing. So, my work
6 has been around, oh, we have a license of a
7 trademark. What's the -- in a particular
8 transaction, say for a particular
9 jurisdiction. Or we're licensing a
10 manufacturing process to a related party,
11 what's that? So, it's, it's, it's in those
12 kinds of transactions or transfers, if you
13 will, that I would do it as a 482 personally.

14 Q: So, for example, the, the 2004 E&Y valuation
15 study here, would you be able to give an
16 opinion on that?

17 A: No. Not after I saw what was entailed.

18 Q: Okay. And when did you figure out that you
19 would not be able to do that?

20 A: I had not seen the study prior to my
21 deposition and it was only after I was able
22 to spend some time with it, see the method
23 that was being applied, see the, the, the --
24 what was all encompassed and what was being
25 valued, that I determined that even though I



1 have done work in intangibles previously, I
2 had that transfer pricing valuation
3 experience, that this report was not something
4 that I as a transfer pricing professional was
5 qualified to render an opinion on.

6 Q: And what did the -- the method that was used
7 in that report involve that made you feel
8 that you were not able to, to review it?

9 A: The method that was involved as we've -- as
10 was discussed earlier in the week and as I
11 look at it, it was a method that essentially
12 valued the, the intangibles of a --
13 basically, of a business. There was a carve
14 out of, of CAF. There was adjustments to
15 working capital. There was adjustments to
16 the cash flows. And there was some other
17 adjustments to working capital. Those
18 elements go beyond what I would normally do
19 as a transfer pricing professional, that, that
20 I would say I need a valuation expert in
21 order to do that. It's beyond the scope of
22 what I would normally do. And that became
23 apparent to me as I -- as I looked at the
24 report.

25 Q: And can you explain to us how being a



1 transfer pricing expert di- -- differs from
2 being a valuation expert?

3 A: Yes. So, as we -- as you -- as we've heard,
4 transfer pricing experts, we have econ- --
5 we're economists typically, right? And so,
6 we apply those economic principles within the
7 confines of the regulations. Typically, a
8 valuation professional has additional training
9 certifications. So, for instance, a valuation
10 professional typically has more accounting,
11 financial statement analysis. That's why
12 they're typically, say, a CPA. All right.
13 Or they have an MBA in Finance, right?
14 Because that's where you get the -- kind of
15 rigorous training. I did international
16 finance. I taught international finance.
17 I'm not a valuation specialists. That's not
18 the same, same approaches. Not the same
19 lever -- level of rigor in the subject matter
20 area. You would also -- so, we'd have that
21 kind of training, plus certifications to make
22 sure that you are adhering to the standards
23 that are accepted in the valuation world.

24 Q: So, what type of credentials would you --
25 would you look for in a person to perform a



1 valuation like the one performed by E&Y in
2 2004?

3 A: I would look to someone who has a CFA,
4 certified or chartered financial analysis;
5 someone who has a certification in entity and
6 intangible valuation, someone who is perhaps a
7 member of the leading organization, the
8 American Society of Appraisers, and adheres to
9 their standards; someone who has -- is an
10 accredited business valuer. I would expect
11 those kinds of credentials.

12 Q: Did -- during your career has -- have you
13 ever come across situations where clients have
14 asked you to, to do this type of work and
15 what is your response typically? How would
16 you handle that?

17 A: Yes. If you remember I said I had a couple
18 of roles at KPMG, right? And some were doing
19 transfer pricing work, right, and just as a -
20 - as a line partner. So if I had gotten this
21 kind of request, I would have gone down the
22 hall to one of my valuation partners.
23 Remember, we're in the same organization,
24 economic valuation services. And I would
25 have said, hey, we have a related party



1 transaction, but the valuation is really
2 beyond our scope. Will you work with me on
3 this? So, I've, I've seen it in those and
4 that's where I would reach out, right? Also,
5 importantly, in my role when I led those
6 groups -- remember, I, I led the entire west
7 geography for KPMG of the blind people for
8 economic and valuation services. I led them.
9 As well as then for the last several years I
10 was at KPMG, I headed up the national office
11 for economic and valuation services. So, in
12 those roles, if someone came to me, a
13 transfer pricing person came to me, and
14 showed me what was going on, my response then
15 would be, well, who on the valuation side are
16 you getting to help you with this, right?
17 You're not qualified for doing this work.
18 They are. We need, you know, Joe, who is
19 actually a CFA to look at this and go through
20 the financials. And so, those are the things
21 that -- and I was involved with those kinds
22 of discussions. I was -- and, and in
23 particularly in the last role, I was the
24 arbiter, right? Because they would come up
25 and say, well, oh, transfer pricing person is



1 doing this. And my response would be, who
2 did you get from the valuation side? I
3 wouldn't be allowed to do that valuation.

4 Q: All right. I want you to assume that CarMax
5 East owns 100 percent of car -- sorry. Not
6 assume. CarMax East does own 100 percent of
7 CarMax West, correct?

8 A: Correct.

9 Q: And that's been true since 2004?

10 A: That's -- yes.

11 Q: So, if CarMax East puts \$100 into CarMax, an
12 entity that it owns 100 percent, from an
13 economic perspective, has CarMax West given
14 away that \$100?

15 A: (No response.)

16 Q: Do you want me to start over?

17 A: Please.

18 Q: Okay. If CarMax East owns 100 percent of
19 CarMax West ---

20 A: Yes.

21 Q: All right. CarMax East, if it puts \$100 into
22 CarMax West that it owns, from an economic
23 perspective, has CarMax East given away that
24 \$100?

25 A: No. Not at all, right?



1 Q: And why, why is that?

2 A: It owns the, the -- 100 percent of West. It,
3 it has its share. Now, they may not have
4 issued additional stock, but it has the
5 entire ownership. So, it has ultimately
6 that, that ownership because the \$100 is that
7 asset of the West.

8 Q: Okay. So, when CarMax East contributed
9 business process intangibles to CarMax West in
10 2004, from an economic perspective, did CarMax
11 East give away its business process
12 intangibles?

13 A: No. It received in value, if you will, the,
14 the shares, right? The, the -- kind of the
15 equivalent shares. It could have sold the
16 intangibles, taken the cash and bought shares
17 in West. So, we have an exchange of value
18 there.

19 Q: Does any economic principle allow you to set
20 aside or disregard the transfer or business
21 process intangibles from CarMax East to CarMax
22 West in 2004?

23 A: No.

24 Q: Does anything in the 482 regulations allow
25 you to set aside or disregard the transfer of



1 business intangibles from CarMax East to
2 CarMax West in 2004?

3 A: No.

4 Q: How does the fact that CarMax East owned some
5 business process intangibles in 2004 and
6 earlier impact the arm's-length price under
7 482 for the transactions addressed by the E&Y
8 studies during the audit period?

9 A: It, it does not impact them.

10 **MS. GEER:** Your Honor, can I have 30 seconds?

11 **THE COURT:** Sure. You need me to time you?

12 **MS. GEER:** I wish you wouldn't. All right.

13 Hopefully, I wasn't much off from my 30
14 seconds.

15 Q: Dr. Cody, do you recall the Court asked you
16 earlier what time period your analysis began?
17 Meaning, for example, whether you were
18 starting at the 2004 period versus at the
19 audit period?

20 A: Yes.

21 Q: Why did you start with the audit period and
22 then stay focused on that as opposed to
23 turning your attention to the 2004
24 restructuring?

25 A: Certainly I wanted to understand when I look



1 at the audit period, the legal entity
2 structure, right? And so, I had questions
3 about just, oh, how did we get there, right?
4 And I understood that there had been a
5 restructuring done, asked about what was
6 contributed, how did that happen, the facts
7 around that. I asked importantly, well,
8 what's happened to that structure over time?
9 It hasn't changed, right? I asked whether or
10 not that structure has been challenged by the
11 Department. The answer was no, right? I
12 looked through the documents of the
13 determination. Nothing in there about
14 challenging it. So, when I looked at the --
15 both the facts and the history of it, there
16 was no reason to think back that there'd be
17 any challenge or I had any reason to look at
18 it. I was satisfied with the substance. It
19 had been in operation for 15 years. That's
20 why I looked at the audit period as the focus
21 of my analysis.

22 Q: Well, under the 482 regs, did the 482 regs --
23 where did the 482 regs tell you to look?
24 What time period did they tell you to look to
25 when you were determining the arm's-length



1 price?

2 A: You look at the -- at the years in which the
3 transactions take place.

4 **MS. GEER:** All right. Thank you, Your Honor.
5 That's all I have.

6 **THE COURT:** So, I guess we're going to take a break
7 for a lunch.

8 **MR. ANTLEY:** That's fine, Your Honor.

9 **QUESTIONS FROM THE COURT:**

10 **THE COURT:** I do want to ask one question maybe
11 before we go. That is if I was to find that
12 Transaction 5 is overpriced, as the Court --
13 as the Court, how could I come to an
14 evaluation of how to reduce that price
15 properly? Because it seems that each one of
16 you offer your -- one's one price on one end
17 and one on the other. But is there a way
18 that I could analyze that myself to determine
19 a proper valuation?

20 A: Yes. I think if you look at the, the data
21 that's in the E&Y report for example and you
22 said, here's a range of values, maybe I could
23 adjust based on those -- on those values,
24 right? If I look at the substance
25 transaction and you say, this -- the, the



1 substance is there, but I think the prices is
2 off.

3 **THE COURT:** Yeah.

4 A: I could -- I could do it just that way. And
5 that would be a way that the IRS would, would
6 ---

7 **THE COURT:** Do the same thing.

8 A: --- could take a look at the same thing,
9 right, based on the -- on the facts. So, I
10 think there -- there's data that you have
11 available that you could do that, right?

12 **THE COURT:** Yeah. All right. I think I may have
13 had a -- oh, now this goes to transfer
14 pricing experts, period. But it just seems
15 to be, I'll go with odd, I can't think of a
16 better term right now, but odd that you're
17 trying to determine arm's-length transactions,
18 but you're going to the very people that are
19 doing the transactions to determine whether
20 it's arm's-length. And when you were telling
21 me about your talking to the employees who
22 have a stake in whether or not it's arm's-
23 length because they work for the company. It
24 -- can your respond to that?

25 A: Yes. So, I, I mentioned on a number of



1 occasions I spoke with operating people.
2 David Smith and there was at least one other
3 person involved with those conversations.
4 Those people, they're operating people. You
5 mention tax to them, you mention transfer
6 pricing to them, and their eyes glaze over.
7 They have no idea what I'm talking about.
8 They're concerned with running the business.
9 They're concerned what the impact that their
10 activities have. They don't have any idea or
11 appreciation for what the company is doing
12 from a tax standpoint or a transfer pricing
13 standpoint. Rather, their activities are
14 focused ---

15 **THE COURT:** Well, how do you know that? How do you
16 -- because you're assuming that. I, I get
17 that, but you don't know if the company has
18 contacted them and told them that to give you
19 a special viewpoint. I mean, so ---

20 **A:** Yes. And that's -- and I think that's a fair
21 point, but the way you do that is you speak
22 to a number of inter- -- excuse me -- a
23 number of individuals. You check their
24 statements then, and their view of what makes
25 the company successful. Not just take -- you



1 don't just take their point of view. You
2 don't just take their, their, their word.
3 You check it against public data. What is --
4 what do analyst say in terms of what makes
5 CarMax successful. And we can map that. So,
6 you do -- you do test this. And, and that's
7 been something that I've been doing for, for
8 30 years. We, we talked to people all across
9 the organization. You test their, their,
10 their remarks. So, for instance, in David
11 Smith's example, right, I heard what he said,
12 right? But then he showed me the data, the
13 actual results of the tests, right? The
14 numbers don't lie. That's what they're
15 actually making business decisions on. So,
16 it wasn't just David Smith saying, you know,
17 this is where all the value is. They could
18 show me numbers that were actually used by
19 the business, that came out of those tests
20 that were used by the business to make
21 decision. So, it's really taking all those
22 things in context that give me confidence
23 that whatever they say, I, I take what they
24 say and I look at it through the lens of the
25 data and through other sources.



1 **THE COURT:** Any follow-up question on what I have
2 asked?

3 **MS. GEER:** No, Your Honor.

4 **THE COURT:** Well, y'all -- okay. Thank y'all. Be
5 -- well, by my clock, it's 12:00 o'clock
6 even. 12:00 -- maybe 1:15?

7 **MR. ANTLEY:** That's fine, Your Honor.

8 **THE COURT:** All right. Thank y'all.

9 **(Off the record from 12:00 p.m. to 1:15 p.m.)**

10 **THE COURT:** Go ahead.

11 **MR. ANTLEY:** Okay.

12 **DR. CODY - CROSS-EXAMINATION BY MR. ANTLEY:**

13 Q: Good afternoon, Dr. Cody.

14 A: Good afternoon.

15 Q: Do you know whether the executive salary
16 costs are included in Transaction 2 or
17 Transaction 5?

18 A: I would have to look at the calculations. I
19 don't know offhand.

20 Q: All right. Does the company consider them to
21 be part of the general business services of
22 Transaction 2 or the -- in other words, the
23 data analysis group, services charged,
24 Transaction 5?

25 A: Again, I'd have to look at the calculations.



1 In the E&Y study, as we look at it,
2 Transaction 5 is the, the recommendations
3 there come out of those data that come from
4 the, the testing of the systems.

5 Q: Do you know the amount of cost associated
6 with the data analysis group associated with
7 Transaction 5?

8 A: I do not. I didn't consider it relevant.

9 Q: Do you know ---

10 **THE COURT:** Why not?

11 A: Because as I -- as I look at the -- how I
12 would price that group and price those
13 activities, their, their value is not related
14 to their -- the cost incurred in, in
15 performing the activities. When we think
16 about creating a system where they develop
17 say CarMax, CarMax Book or they develop the
18 ASRP, the system to price autos on the lot,
19 the value of that continues long after the
20 effort that it took to develop it and test it
21 stopped. So, the value is not related to the
22 cost. And so, for me, as I looked at it,
23 trying to measure the value of, of that group
24 and the activities based on costs, just, just
25 not a connection.



1 **THE COURT:** That's all.

2 Q: Do you know specifically how the company
3 allocated the costs to Transaction 2 and 4
4 versus 3 and 5?

5 A: I did not get into the -- to those details.
6 No.

7 Q: Was Ms. Yost involved in your meetings with
8 CarMax employees?

9 A: I believe Ms. Yost was observing during those
10 calls. Yes.

11 Q: You are qualified to value intellectual
12 property that was contributed to, to CBS,
13 right?

14 A: No. I was not.

15 Q: Okay. Do you recall when I deposed you?

16 A: I do.

17 Q: I'm going to open a sealed copy of your
18 deposition and pass it up to you.

19 **THE COURT:** You want to hide?

20 **MS. GEER:** Maybe.

21 Q: And -- all right. So, I -- I've handed you a
22 copy of, of your deposition. If you could
23 just turn to Page 1- -- let's see. Actually,
24 127.

25 A: I'm there.



1 Q: Okay. Okay. So, I'm going to -- if, if you
2 could look, we're going to -- I'm going to
3 start at Line 16. I'm going to read. If you
4 can just let me know if I'm reading this
5 correctly. Okay? Whenever you see Line 16
6 on Page 127.

7 A: I'm there.

8 Q: Okay. Question: So, are you saying you
9 would be qualified to value the intellectual
10 property that was contributed to CBS?

11 Answer: Yes. I could review that work.

12 Yes. Did I read that correctly?

13 A: You did.

14 Q: Your opinion does not rely on Joint Exhibit
15 15, the 2004 and 2005 valuation study, right?

16 **(Joint Exhibit 15 was referenced at this time.)**

17 A: I did not review that work.

18 Q: Okay. The distributive share of CBS should
19 reflect the business activity of CarMax East
20 and CarMax West, in other words the value of
21 their contributions, right?

22 A: Can you repeat the question?

23 Q: Of course. The distributive share of CBS
24 should reflect the business activity of CarMax
25 East and CarMax West, in other words the



1 value of their contributions.

2 A: No. Those are -- you've just talked about
3 two different things.

4 Q: Okay.

5 A: When we think of the distributive shares,
6 those are determined based on the formation
7 of the partnership, what each of the parties
8 contributed to that partnership. And we've
9 been through -- went through that. I won't
10 go through it again. The regular business
11 activities then of East and West, selling
12 cars, and then the management fee that's
13 charged, per them, that reflects their ongoing
14 business activities. It has nothing to do
15 then with the relative amounts that they've
16 put into car- -- the CarMax Business
17 Services. So, as we were saying, and I gave
18 in my example, those are really two -- in my
19 -- in my direct testimony, those are two
20 different things. And to say that I would
21 somehow gauge my distributive shares, my share
22 of the partnership based upon my act- --
23 business activities doing something else, it
24 just doesn't make sense to me. The
25 distributive shares are of the income that



1 was earned not by East and West, but that was
2 earned by CBS in its activities through its
3 activities providing services. It's not the
4 income of East and West. It's the income
5 that it produced, and therefore it should be
6 distributive based upon who contributed to its
7 capabilities.

8 Q: If you could turn to Page 35 of that
9 deposition in front of you. And just let me
10 know when you're there.

11 A: I'm here.

12 Q: Okay. And then if you could go to Line 17
13 and follow along as I read. And just let me
14 know if I've read this correctly. Okay. Is
15 that a fair representation of their business
16 activity for -- I mean, when I said their, I
17 mean is that a fair representation of CarMax
18 East and CarMax West business activity?

19 Answer: I believe it is because the
20 distributive share reflects the business
21 activity that is ---

22 A: I -- I'm, I'm sorry.

23 Q: I, I -- I have -- did I get wrong?

24 A: I'm, I'm having trouble following. I -- I --
25 -



1 **MS. GEER:** Yeah. We can't see this.

2 **A:** I thought I knew where you were, but I can't

3 find it.

4 **MS. GEER:** I think it's ---

5 **MR. ANTLEY:** Is it different? One moment.

6 **MS. GEER:** I think it's different that mine.

7 **MR. ANTLEY:** Well, if you could pass that back to

8 me. If I could use the ELMO then I can ---

9 **THE COURT:** Yeah.

10 **MR. ANTLEY:** So, we can make sure we're in the same

11 place.

12 **THE COURT:** Is that leftover?

13 **MS. GEER:** Yes.

14 **THE COURT:** We have your leftover work product.

15 **MR. ANTLEY:** I thought you might want it.

16 **THE COURT:** Thank you. Become part of the mystery

17 of law court.

18 **MR. STREISEL:** Pomp wanted to go again, so.

19 **THE COURT:** Oh.

20 **Q:** Okay. So, what projecting on the -- on the

21 screens there is the unsealed transcript of

22 your deposition. So, if you can look where

23 I'm at on Line 17 and just -- can, can you

24 see that on your screen?

25 **A:** I can.



1 Q: Okay. And just follow along. And let me
2 know if I've read this correctly? Okay. Is
3 that a fair representation of their business
4 activity for -- I mean, when I said their, I
5 mean, is that a fair representation of CarMax
6 East and CarMax West Business Activity.

7 Answer: I believe it is.

8 **THE COURT:** Well, it's -- slide it up a little bit.
9 There you go.

10 Q: I believe it is because the distribution
11 share reflects the business activity that is
12 -- that was the contribution to -- by each of
13 the parties at the time that partnership is
14 formed. Did I read that correctly?

15 A: You, you did. But I think that it doesn't
16 reflect my full answer on that question.

17 **MS. GEER:** Can y'all tell us what that cite is in
18 the transcripts we have?

19 **MR. ANTLEY:** No further questions, Your Honor.

20 **MS. GEER:** Your Honor, one minute. We're still
21 trying to find the cite.

22 **MS. WOOTEN:** 135.

23 **MS. GEER:** Yeah.

24 **MS. WOOTEN:** Y'all are using the condensed version.

25 **MS. GEER:** Yes.



1 MR. ANTLEY: Yeah.

2 MS. WOOTEN: I think it's a different one.

3 MS. GEER: Okay.

4 MR. ANTLEY: Yeah. I think that's what the issue
5 was.

6 MS. WOOTEN: It's either 17 or 21.

7 MS. GEER: Oh, yeah. Yeah. That's it. Yes. you
8 were done, right? You said you were done.

9 MR. ANTLEY: Yeah.

10 MS. GEER: Okay. Your Honor, may I approach the
11 witness?

12 THE COURT: Yes.

13 DR. CODY - RE-DIRECT EXAMINATION BY MS. GEER:

14 Q: Dr. Cody, you were just asked about a
15 statement in the deposition. I'm going to
16 give you a chance to look at the context
17 before and after the question, so you can see
18 what the context was. All right. Have you
19 had a chance to review the transcript?

20 A: I did.

21 Q: Okay. Do you have anything in response to
22 that?

23 A: Yes. As I said, the section that was read
24 represents just a small part of my answer.
25 There was some -- there were some -- several



1 clarifying questions back and forth between,
2 between us during the deposition. And then if
3 we continue over just to understand what the
4 transactions were, the contributions, and so
5 over on Page 137 of this deposition,
6 beginning at Line 12 -- excuse me. Beginning
7 at Line 9 rather. This is the question, it's
8 -- should I read?

9 Q: Yes. Please.

10 A: Thank you. The question is okay, to -- so,
11 to those distributive shares, are those any
12 reflections of those business activities that
13 you just named? And I was describing the
14 business activities of, of the various
15 parties. Answer: They, well, let me say,
16 there's two parts to that, two answers to
17 that, two parts to the answer to the
18 questions. All right. The total amount of
19 income that is distributed by those shares
20 back, the 6.5 and the 93.5, that reflects
21 income that was generated by the dealers
22 after taking into account all of the
23 activities of CBS. So, I'll say in that way,
24 it's reflective of business activities. All
25 right. The amount that's there. The actual



1 shares, the percent shares, have no relation
2 to the day-to-day business activities of those
3 operations of the dealers. Those percentages
4 were determined at the time the partnership
5 was formed. So, there's no reason that they
6 should, that they would reflect the 6.5 and
7 the 93.5. There's absolutely no economic
8 reason that they would reflect the daily
9 activity of those, of the two partners, that
10 are meant to capture the contributions that
11 were made by each of the parties to the
12 partnership when it was formed. So, those
13 are the two parts to that question. So, and
14 that's basically the finish of that. Yeah.

15 Q: All right. And, Dr. Cody, prior to your
16 deposition, have you received or reviewed the
17 valuation study?

18 A: No. I had -- it, it -- I was aware of it
19 that basically the day before, and had not
20 seen or reviewed it.

21 Q: So, so in what -- how would -- when did you
22 first even know of its existence and see a
23 copy of it?

24 A: During my deposition.

25 Q: Did you receive a copy of it in connection



1 with the exhibits to your deposition that
2 were provided to you before your deposition?

3 A: I did.

4 Q: Okay. But did you -- did you review the
5 entire study at that time?

6 A: No. I just took those documents as something
7 that might come up that I might be asked
8 about and so, I just kept them in a folder on
9 my -- on my computer and that's where they
10 stayed until I was asked about them.

11 Q: And had you been asked to give an opinion on
12 that valuation study prior to that date?

13 A: No.

14 Q: Okay. And, and so, can you just explain to
15 us why initially you thought you might be
16 able to review and evaluate that study?

17 A: Certainly. On the face of it, on the cover,
18 it, it -- if I remember correctly, it talks
19 about valuation of intellectual property. So,
20 as a broad matter, I have done that and as I
21 -- as I said. So, just based on that
22 information, and I would think well, I --
23 yes, I think I could do -- I could review
24 that. But based on no other information at
25 that time. So, it was that basis upon which



1 I answered that question ---

2 Q: Okay.

3 A: --- in my deposition.

4 Q: And after that deposition, were you asked to
5 review that study and were you asked whether
6 you could assist CarMax with evaluating that
7 study and providing an opinion on that
8 study?

9 A: I was.

10 Q: And what did you tell us?

11 A: I told you that I was not qualified to render
12 an opinion on that.

13 Q: And was the basis of that the reasons that
14 you gave in your prior testimony?

15 A: Yes.

16 **MS. GEER:** That's all we have, Your Honor.

17 **MR. ANTLEY:** No further questions, Your Honor.

18 **THE COURT:** You may step down.

19 A: Thank you, Your Honor.

20 **MS. GEER:** Your Honor, can I -- can I have one
21 moment please? Your Honor, CarMax has no
22 additional -- sorry. I just -- water went
23 down the wrong pipe here.

24 **THE COURT:** You're getting all choked up about
25 this.



1 **MS. GEER:** Yeah. I am. I'm sad that my, my case
2 is coming to a close here.

3 **THE COURT:** Yeah.

4 **MS. GEER:** All right. We have no further
5 witnesses, but I do have a housekeeping
6 matter.

7 **HOUSEKEEPING MATTER:**

8 **MS. GEER:** We filed earlier in the week deposition
9 designations from the 30(b)(6) of the
10 Department and so, we would like to offer
11 that transcript into the record at this time.

12 **MR. ANTLEY:** I want to be clear, transcript or
13 excerpts?

14 **MS. GEER:** Well, so I, I, I filed the designation,
15 which listed the excerpts and I think the way
16 the rule is supposed to work, not necessarily
17 in the non-jury context, but is that I would
18 then offer them during my case at trial and
19 they would be read, either the full or the
20 portions would be read into the record.
21 Since this is a non-jury ---

22 **THE COURT:** I have to read them.

23 **MS. GEER:** You have to read them. I apologize.
24 And so, what we have done is highlighted the
25 transcript for the deposition designations



1 that we have listed. So, that's what we've
2 done and -- as well as the exhibit. I have a
3 copy, if y'all want to see it That's your
4 copy.

5 **MR. ANTLEY:** Thank you.

6 **THE COURT:** Do you have an electronic copy?

7 **MS. GEER:** I, I do. Would you like me to send it
8 electronically instead of hard?

9 **THE COURT:** With the highlighted?

10 **MS. GEER:** Yes.

11 **THE COURT:** Okay. Yes.

12 **MS. GEER:** Do, do you want the hardcopy too or just
13 the electronic?

14 **THE COURT:** I go electronic. Do y'all want the
15 hard copy?

16 **MS. PEREZ:** (Nods head.)

17 **THE COURT:** Hard copy, yes.

18 **MS. GEER:** Okay.

19 **THE COURT:** All right. Is that -- is that marked
20 or does ---

21 **MS. GEER:** I guess that would be -- I -- I've never
22 marked them as an exhibit before, but we, we
23 did mark the, the Department's as, as an
24 exhibit. So, I can mark it as an exhibit or
25 I can just say it's testimony.



1 MR. ANTLEY: The ---

2 MS. GEER: I don't have a preference.

3 MR. ANTLEY: The, the CarMax se- -- deposition was
4 a joint exhibit.

5 MS. GEER: Yes.

6 MR. ANTLEY: This is ---

7 THE COURT: Yeah.

8 MR. ANTLEY: We just ha- -- we haven't -- this is
9 not a joint exhibit.

10 MS. GEER: No. This is not a joint exhibit.

11 THE COURT: Okay.

12 MS. GEER : It would need to be -- if we want to
13 make it an exhibit, I guess it would be
14 Petitioner's ---

15 THE COURT: I just -- I just asked the question.

16 MS. GEER: Yeah. I'll make it Petitioner's Exhibit
17 -- what am I on?

18 COURT REPORTER: She hasn't done any exhibits.

19 THE COURT: Yeah.

20 COURT REPORTER: You've only done demonstratives.

21 THE COURT: It'd be one.

22 MS. GEER: Petitioner's Exhibit 1.

23 COURT REPORTER: Okay.

24 MS. GEER: All right. Hold on one more minute.

25 MR. ANTLEY: And, Your Honor, the Department has



1 objections and counter designations that it
2 would offer to the Court.

3 **THE COURT:** Objections and counter designations.

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

5 **THE COURT:** Well, then I'll -- I'll -- I guess I
6 have to hear the objections first before I
7 can discern the counter designations. So,
8 are these offered in writing or, or are you
9 going to submit ---

10 **MR. ANTLEY:** I, I have -- I have them in, in, in
11 writing. I just provided a copy to opposing
12 counsel.

13 **THE COURT:** So, I'm going to read the objections,
14 rule on the objections while I quietly sit at
15 my computer and then, I decide about what I'm
16 going to ---

17 **MS. GEER:** I mean, I -- I might suggest just
18 because this might take quite a while that we
19 let the Department file this and then we
20 could have a separate, you know, virtual
21 hearing at some point later.

22 **THE COURT:** Yeah. I'm going to rule to myself.

23 **MR. ANTLEY:** I, I, think typ- -- I don't think -- I
24 don't know how many total they have, but I
25 don't -- I don't have the copies with the



1 designations in front of my right now, but I,
2 I think we would just go through and if, if
3 Your Honor would like to rule on the
4 objections, I'm, I'm prepared to make ---

5 **THE COURT:** Right now? Well ---

6 **MR. ANTLEY:** I -- I'm prepared to make them now.

7 **THE COURT:** Okay.

8 **MR. ANTLEY:** Your Honor, for efficiency sake, we're
9 -- we can wait and do this in a -- in a
10 separate hearing. I think that's a
11 reasonable offer.

12 **THE COURT:** Well, how about a conference call?

13 **MR. ANTLEY:** Okay.

14 **MS. GEER:** Yes. That would be great.

15 **MR. ANTLEY:** My I present my ---

16 **THE COURT:** Yes, you may. And if something ---

17 **MS. PEREZ:** I just have a quick question.

18 **MS. GEER:** Yeah.

19 **MS. PEREZ:** This was attached to it?

20 **MS. GEER:** Yes. That's an exhibit.

21 **MS. PEREZ:** That's an exhibit.

22 **MR. ANTLEY:** It's ---

23 **MS. GEER:** Yeah. So, so what -- let me explain.

24 I'll just explain for the record. During the
25 deposition, one of the topics the Department



1 requested to in lieu of providing a witness
2 on the 30(b) to- -- sorry, can't even talk --
3 on the 30(b)(6) topic to provide those bills
4 instead of having its witness testify to it.
5 So, those were provided, I believe after the
6 deposition.

7 **MR. ANTLEY:** They were, and we have an objection to
8 that as well.

9 **MS. PEREZ:** I'll have to separate them.

10 **THE COURT:** How about you provide us your
11 objections and your designations and I will
12 be leaving the record open for the
13 determination of ---

14 **MS. PEREZ:** You sure you want to do that?

15 **MS. GEER:** And, and, Your Honor, because -- I mean
16 it's totally appropriate. This is when he's
17 supposed to provide these, but because I
18 haven't had a chance to review them, it's
19 very possible that we might end up digging
20 through them and not having an objection on
21 some of his designations and/or not having a
22 problem with some of his objections. So, we
23 may be able to at least narrow the list ---

24 **THE COURT:** Yeah.

25 **MS. GEER:** --- beforehand.



1 **THE COURT:** And it's possible I may walk tomorrow.
2 All right.

3 **MS. GEER:** Your Honor, CarMax would rest its case
4 now.

5 **THE COURT:** Okay. Thank you. Rebuttal?

6 **MR. ANTLEY:** Yes, Your Honor. The Department calls
7 Dr. DeRamus in rebuttal.

8 **THE COURT:** And I think I -- Ms. Geer might have
9 beat you to it. You're still under oath.

10 **DR. DeRAMUS:** Yes, Your Honor.

11 **DR. DeRAMUS - REBUTTAL BY MR. ANTLEY:**

12 Q: Dr. DeRamus, were you here when Ms. Yost
13 testified about the way in which the company
14 was able to reduce the costs of painting
15 vehicles as part of the company's
16 reconditioning process?

17 A: Yes. I was.

18 Q: Okay. What is your understanding of which
19 entities performed the painting and
20 reconditioning activities?

21 A: That would be the operating companies, CarMax
22 East and CarMax West, where the retail stores
23 are located.

24 Q: Were you here when Ms. Yost testified that
25 the employees and the company's data sciences



1 group, as she referred to it, were involved
2 in the process of identifying costs savings
3 in this function?

4 A: Yes.

5 Q: And what legal entity are the individuals in
6 this data sciences group employed?

7 A: They're employed by CASS, C-A-S-S, the entity,
8 the, the entity that's below CBS.

9 Q: Are the costs of these employees paid by CBS?

10 A: Yes. Pursuant to a lease agreement, the CBS
11 pays for all the costs of those employees. I
12 understand during the years at issue, cost
13 plus approximately 2 percent markup. And
14 that's over, I believe the, the entirety of
15 their costs. So, that would include the
16 senior executives. Not just the members of
17 this group, but all of the headquarters'
18 employees, including the senior executives.
19 And I would expect it would also include the
20 -- all of the compensation including bonuses,
21 and I would assume even stock options and
22 things like that. At least from the -- from
23 the financial records that I've seen for CBS,
24 it would imply that's -- that that is the
25 case.



1 Q: Did you hear Ms. Yost testify that when the
2 data sciences group identifies an opportunity
3 to change prices or inventory, they make a
4 recommendation to the company's executive
5 leadership and it is those executives who
6 make the decision for any changes to those
7 policies and procedures for CarMax East and
8 CarMax West?

9 A: Yes. I did hear that.

10 Q: Okay. And are those executives also employed
11 by CASS?

12 A: Yes, they are.

13 Q: And does CBS pay CASS for those executives
14 costs at plus 2 percent?

15 A: Yes.

16 Q: Okay. So based on that testimony, do you
17 consider it reasonable and consistent with the
18 arm's-length standard for CBS to charge the
19 operating companies approximately \$400 per
20 vehicle for the functions of the data
21 analytics group?

22 A: No. And just to be clear, when we talked
23 about the data analytics group, this is
24 refer- -- in reference to Transaction 5.
25 The, the -- probably for a couple of



1 different reasons, their -- you know, first
2 and foremost, we can start just with the way
3 the taxpayer's chosen to structure itself.
4 So, it has placed these employees in this
5 employee company, CASS, and it is paying them
6 a -- an amount that presumably that the
7 company has established to be consistent with
8 the arm's-length standard, cost plus 2
9 percent. Those costs are all their salary
10 costs. As I mentioned a moment ago, it would
11 include their bonuses, their stock
12 compensation. So, it is -- to the extent
13 that the -- that the executives or the
14 members of that data sciences function are
15 adding value, the -- that value is presumably
16 reflected in the salaries those individuals
17 are able to earn. And that the -- and they
18 are then compensated for the cost of those
19 salaries by CBS plus 2 percent. So, from a
20 transfer pricing perspective, I believe Dr.
21 Cody mentioned the question of what happens
22 when you have an empty box. Well, in some
23 regards, CBS actually is an empty box. It
24 has no employees. It has some assets, but it
25 has no employees. So, what is it -- what is



1 the value added activity that goes on in that
2 moment between the employee providing a
3 service, a leased employee service, for which
4 it's compensated at cost plus 2 percent to
5 CBS and then the next instance in which that
6 service is provided to the operating
7 companies. There really isn't nothing that
8 C- -- CBS is not doing a function. The
9 function is performed by the employees, even
10 though we describe that function as
11 effectively being performed by CBS because CBS
12 is the one that leases these employees. So,
13 that's the, the first part I -- I'd start
14 with. And in my experience, working on
15 transfer pricing cases, often times there is
16 the issue of how does the, the, the taxpayer
17 -- how has the taxpayer structured that
18 activity and how's it structured those
19 contracts. And in, in an international
20 context, parties are often being -- have to
21 live with the structures they put in place.
22 Now, it's not a one way street. It's not a
23 two-way street. The taxpay- -- the
24 commissioner can look beyond the form and
25 impute substance, and, and impute a additional



1 payment of -- and ba- -- also, based on addi-
2 -- the actual functions and, and what the
3 commissioner determines to be the
4 substance of the transaction. So, if that's
5 the case, if a -- if a taxpayer is stuck with
6 the -- with the structures that it's -- it
7 already has put in place, then CBS is already
8 being fully -- or the, the -- that function
9 of the data analysis services group is
10 already fully compensated in the -- in the
11 cost plus 2 percent that is paid by CBS to
12 CASS. Now, setting that aside, fro- -- if I
13 kind of ignore that, that separation between
14 CBS, or that distinction between CBS and
15 CASS, and I just look back at kind of the big
16 picture economic issue, then the question
17 really comes down to whether there is some
18 unique -- and effectively, intangible property
19 and some kind of intangible service that's
20 being provided by these executives or by this
21 data analysis group. And here, certainly any
22 company out there that has mismanaged is
23 going to have to earn less profits than a
24 company that is well-managed. Good management
25 is valuable in the sense that you, you will



1 have a very different outcome for the company
2 as a whole if you have poor management. But
3 that does not imply that the -- that the, the
4 profits in particularly this case, is 70
5 percent of the profits or this \$400 payment
6 should necessarily come up to the headquarters
7 in return for performing a given activity.
8 So, Dr. Cody said something about the, you
9 know, the but-for fallacy. And I, I
10 vehemently disagree with his, his notion that
11 it's -- that there is a fallacy associated
12 with the but-for standard. I testified in a
13 lot of other matters in which damages are
14 assessed based on the application of but-for
15 principles and I've been asked to calculate
16 damages. And those damages have been awarded
17 based on those principles. But, I, I do
18 agree with the notion that you need to be a
19 little bit careful in terms of ascri- -- once
20 you have the a given activity, in terms of
21 saying, okay, in the absence of this
22 particular person, what would the -- or this
23 particular activity, what -- how would the,
24 the -- would the, the entity even function.
25 And therefore, if the -- if the -- if the



1 entity were to fall apart or if the entity
2 would have significantly lower profits, or if
3 it had nobody in the executive leadership, or
4 if it cut the, the, the data sciences team
5 tomorrow, yes, I expect the company's
6 profitability to suffer as a result. But
7 there's a very different question then what
8 is the whole purpose of this entity. The
9 purpose of this entity is to buy cars and to
10 sell cars. That is the locus of the primary
11 value added activity or the value generating
12 activity of, of the company. So, I believe
13 Dr. -- Dr. Cody referenced this is a
14 analogous to a manufacturing company. I've
15 worked for a lot of manufacturing companies.
16 Manufacturing companies spend a lot of time
17 trying to squeeze efficiencies out of all of
18 their operations. Sometimes those, those
19 efficiencies are identified in one plant and
20 they'll go and they'll put those -- they'll
21 try and implement those cost efficiencies in
22 another plant. Or they'll have -- and, and
23 sometimes, it'll be an individual at the
24 headquarters level. A senior engineer from
25 the headquarters goes out and is responsible



1 for the broader -- is often as referred to as
2 a manufacture engineering function. So,
3 they'll go around from plant to plant to
4 plant, identify what people are doing well,
5 what they're not doing well, reporting over
6 lessons learned from one plant to another and
7 getting down on employees if they're not
8 doing the job they're supposed to be doing.
9 So, that is not a function that I've ever
10 seen a company try to assert is then -- so,
11 that -- something that would require this
12 massive payment up to the headquarters in
13 response to every single efficiency approve --
14 improvement that, that came out of that, even
15 if the original idea came entirely from the
16 person who was at the -- at the management
17 level and, and at the headquarters level, and
18 did not originate at the local level. Here,
19 I think the question is really there also is
20 a lot of local involvement in generating
21 those costs savings. So, when Dr. Cody
22 mentioned this AB analysis, it's because there
23 were some demonstrated improvements in a
24 particular location at an operating level.
25 So, they took those efficiencies gained from



1 that experience, and they applied them
2 elsewhere. That is no different than what I
3 observe all the time in other types of large
4 multinational manufacturers and they are not
5 ones that give rise to some of these massive
6 payments for some sort of quasi-intangible
7 value being generated by the headquarters.
8 And I would -- I would say the same argument
9 applies to all the -- of the, the -- kind of
10 these broader management functions that the
11 company has asserted to be kind of these high
12 value generating functions. That would, would
13 go with -- that would apply equally to
14 questions about how much inventory to
15 purchase, what inventory to purchase, what
16 cars to purchase. And to the -- so -- and
17 how to price tho- -- those vehicles. These
18 are all decisions that have to be made by any
19 company. You have -- that's the purpose of
20 management is to make those fundamental
21 decisions about how to price and how much to
22 buy and, and also to have people involved in
23 negotiating the best prices forward and to
24 provide guidance to their -- to, to their,
25 their underlings, as it were, to help them do



1 a better job. But none of that gives rise
2 again to this kind of massive payment from
3 the operating companies up to headquarters
4 simply because they have that responsibility.
5 That is a necessary, an integral function of
6 operating any company.

7 Q: In talking about the data analytics functions
8 performed by this group and the policies
9 implemented by the company's executive
10 leadership, Ms. Yost testified that this is
11 what leads to the company's healthy gross
12 margins. Do you agree with that?

13 A: No. I, I think I -- I had a fair amount of
14 analysis in my, my direct testimony earlier
15 about the various factors that I consider to
16 be really driving the company's profitability.
17 Ultimately, it's because they are -- they are
18 able to purchase cars of a certain quality
19 and also implement reconditioning of those
20 cars and then sell them at a higher price
21 point in a way that customers find
22 attractive. And they can do it an enough
23 volume in order to earn a lot of money in the
24 process. So, it's not the, the fact that
25 they -- every -- all of its competitors out



1 there are similarly engaged in doing inventory
2 acquisition, pricing and everything else.
3 The, the part that really -- that, that I
4 think does -- or CarMax does stand a bit
5 apart is in this niche that's it -- that is a
6 pretty big niche. That, that it is be --
7 been able to carve out, which is the sale of
8 these low mileage, late model cars, where it
9 takes advantage of the fact that the prices
10 of new cars have increased over time, so that
11 customers who may otherwise would want to --
12 may otherwise would want a new car, they're
13 priced out of those cars. They're willing to
14 pay -- to -- so, they're -- they instead go
15 and look to used cars and they find
16 attractive cars and yet, these are also
17 customers for whom -- from whom the company
18 is able to extract a healthy margin on the
19 sale of those vehicles as compared to the ten
20 year old car with 120,000 miles, where you're
21 going to have a much more cost conscious
22 consumer associated with it. And you have a
23 greater level of competition with regard to
24 other sellers. So, this broader constellation
25 of factors that give rise to the gross



1 margins that the company is able to earn then
2 the individual act -- actions were the
3 analysis being performed by what I think is a
4 fairly small number of people in the grand
5 scheme of things, relative to the total
6 company's employment. Up in there -- in
7 there headquarters location.

8 Q: Does CarMax provide management consulting
9 services to other firms?

10 A: No. It does not.

11 Q: Does CarMax provide data science type services
12 to other firms?

13 A: No. It doesn't.

14 Q: Did those two facts have any implications for
15 determining the appropriate arm's-length
16 prices for the headquarters functions
17 performed by CBS or by CASS employees working
18 on CBS's behalf?

19 A: Yes. And I -- it, it comes up frequently
20 when as an economist if I hear a company
21 talking about some particular capability that
22 it has that is so incredibly valuable that it
23 should be compensated at these many orders of
24 magnitudes greater than the cost of providing
25 the service itself. And remember, that cost



1 is already a pretty healthy level of costs
2 because there are salaries that are bid up.
3 If that is a relatively scarce skill, they're
4 paying a fairly significant price for those
5 services. But if a company is providing
6 something as developed, like the, the greatest
7 whizbang capability in data analysis, that is
8 at a incredibly valuable skill that could be
9 -- that would be in high demand for other --
10 for other companies, even companies that
11 aren't directly related to or direct
12 competitors. So, for example, if you are like
13 the best inventor procurement group in the
14 world and you can achieve these massive costs
15 savings, and you're at a relatively modest
16 size retailer, then there is a huge
17 opportunity for you to sell that service to
18 other companies and to make far more as an
19 inventor procurement company than as a
20 retailer. I think the same thing applies
21 here. And I've seen it applied at other
22 companies. So, some companies will develop -
23 - actually, this data analytic capability. I
24 think the poster child for this is a company
25 called Capital One. And Capital One was cho-



1 -- was actually started not by a bank, not by
2 -- not by bankers, but by data scientists.
3 People looking at data trying to do data,
4 analyze data in different, different ways.
5 And they gradually realized there are ways in
6 which you can use data in order to profitably
7 expand different kinds of businesses. And
8 they've applied it to consumer loans, to
9 credit cards, to, to car loans, kind of a
10 broader range of activities. So, here you,
11 you kind of expand the scope of which -- with
12 which you use this particular capability
13 across a broader range of functions or else
14 you'll find other people to, to buy it. If
15 you don't, it's a pretty good indicator to me
16 as an economist that it may be an important
17 part. It's a competitive necessity in the
18 world today to have that capability. But it
19 is not driving the kind of value that the co-
20 -- that the company here is ascribing to that
21 particular function.

22 Q: What is your understanding of the taxpayer's
23 position with regard to why files -- or why
24 CarMax West files a tax return?

25 A: It's my understanding that it files a -- the



1 -- CarMax West tax return only because of the
2 royalty income that is paid to CBS and then
3 ultimately, 93.5 percent of which flows
4 through to, to CarMax West.

5 Q: And, and just to be clear, we're talking
6 about South Carolina tax return, is that
7 right?

8 A: Yes.

9 Q: Okay. Is it your opinion that CBS is
10 performing no other activities within South
11 Carolina or other East territories other than
12 collecting royalties?

13 A: No. And I would say actually Ms. Yost's
14 testimony on that I think was very helpful in
15 helping to flesh that out. I mean, going
16 into this, I mean in the analysis that I --
17 that I did based on the documentation, it
18 would appear even just based on the degree to
19 which the headquarters folks interact with the
20 local retail folks, that there is -- there's
21 not this clean separation between headquarters
22 and local staff the way you would typically
23 think of it in terms of looking at
24 organizational chart. There are HR folks at
25 the headquarters. There are HR folks here.



1 Ms. Yost's helpfully described the involvement
2 of the, the head -- some headquarters' folks
3 in local activities like -- I believe it was
4 zoning or licensing. So, those are
5 activities associated with building stores and
6 getting stores licensed, and doing all the
7 kinds of things that are necessary -- that
8 are necessary to actually generate income in,
9 in South Carolina. The, the other aspect is,
10 of course, the finance function. So, on the
11 finance side of things as the customer is in
12 the store, they're filling out the finance
13 application with the -- with local individual,
14 there is an involvement by, by CAF, by the,
15 the -- by -- and ultimately, CBS, the same
16 entity that they're paying the, the company
17 is paying royalties to, on -- in that
18 activity of, of getting the, the customer
19 approved for a loan. So, there is a -- there
20 is a tremendous, direct involvement of the
21 company on the finance side, both in the
22 origination side -- in the origination of, of
23 the loan and also in the customer service.
24 Those loans have -- the -- apparently, the,
25 the, the company is servicing a large



1 fraction of the loans that it originates.
2 That involves people providing customer
3 service on an ongoing basis to folks here in,
4 in South Carolina, in generating these initial
5 fees. So, there's a -- there, there will be
6 collections activities if somebody defaults on
7 a loan, so those vehicles have to -- there
8 has to be a collection recovery. Those
9 vehicles are then turned over to the stores
10 to then be resold as wholesale units. There
11 is still this kind of tremendous amount of
12 involvement of CAF business in the state of
13 South Carolina that I think -- that I took
14 away that Ms. Yost's testimony is kind of
15 helping to establish.

16 Q: Did you hear Ms. Yost describe the changes to
17 the data analysis function over the years?

18 A: Yes.

19 Q: Okay. Did you also hear her describe the
20 state of that data analysis function at the
21 time of the 2004 restructuring? And if so,
22 how did that impact your opinions, if at all?

23 A: So, as I try and piece between the -- or
24 piece the, the different observations
25 together, I think the re- -- the picture that



1 she is painting is one that is asserting that
2 effectively there's a very sophisticated data
3 analysis function today. And there was a
4 very limited data analysis function back in
5 the day, back in 2004. So, that is -- it --
6 certainly in my experience having been working
7 on kind of similar high-level data analytical
8 exercises since at least 1999, if before --
9 if not before that, I have seen an evolution
10 in the sophistication of, of data analysis as
11 applied to business problems. And I would
12 indeed expect the algorithms to change, the
13 volume of data that people can, can work with
14 to, to change over time. But at the end of
15 the day, her characterization seems to cut
16 against the very justification that the
17 company made at the time -- is, is using and
18 that Ernst and Young is using to support the
19 93.5 percent share of, of CarMax West in CBS.
20 So, in that -- she -- when she was -- I think
21 there was a question about what assets did
22 West contribute at the time. And the only
23 ones she -- I heard -- the only ones I heard
24 her identify were the trademarks and trade
25 names. I didn't hear her identify the



1 business process intangibles. Those business
2 process intangibles were front and center in
3 all of the restructuring documents that I
4 reviewed and they were front and center in
5 the E&Y valuation. And there is simply -- as
6 an economist, there is no way you're going to
7 get to a 2 billion dollar valuation for the
8 intangibles based solely on the bare legal
9 ownership of the West of those trademarks and
10 trade names. So, there is an inconsistency I
11 think in the way she's describing the --
12 that, that function, the importance of the
13 function or the relative value of that
14 function back then versus now, in a way that
15 I think ultimately it, it would -- it
16 undermines all or it's, it's co- -- it's
17 contradicted by the documents that I've seen
18 at the time of the restructuring. I
19 personally do not think that that function is
20 this great intangible generating asset that
21 the company asserts it to be. But the, the -
22 - but that is the entire basis of that comp-
23 -- of the company's 90 -- or I think it's --
24 the vast majority of the company's basis for
25 that 93.5 percent ownership share of CBS at



1 the time.

2 Q: If the company's pricing inventory or
3 reconditioning strategies are formulated
4 outside of South Carolina, as Ms. Yost's
5 testimony suggests, does that change your
6 opinion from an economic perspective of the
7 extent or importance of the company's economic
8 activity within the state of South Carolina?

9 A: No. And I would say -- well, first, I, I
10 think earlier in one of my earlier answers, I
11 mentioned how companies all around the world
12 of any -- almost any size, are going to have
13 a headquarters function and those
14 headquarter's functions involve people of
15 necessity at the senior level being involved
16 in basic questions of pricing, inventory,
17 operations. And so, that involvement in
18 itself does not justify kind of these large
19 payments out. But I think the, the, the
20 question really comes down to this; what kind
21 of framework or economic framework would I
22 use in evaluating what it means to have
23 econo- -- economic activity in the state of
24 South Carolina. And then, I think maybe the
25 analogy would be a goldmine. So, if you have



1 a goldmine operating in the -- in the state
2 of South Carolina, that's -- and it's a
3 company, but it headquarters in California.
4 But it's got a -- and a goldmine in, in South
5 Carolina. And that's all it has. And it's
6 selling all the output of its gold to South
7 Carolina customers. Where is the -- what,
8 what is the representation of the economic
9 value or the economic activity of that mine
10 in this state? I think it's the difference,
11 as an economist, I think of it in terms of
12 value added, which is third-party revenue less
13 third-party cost. Like how much you're
14 paying your employees, how much it costs to
15 run your -- run your machines. So, in that
16 scenario from the outset, the entirety of the
17 economic activity of that operation in South
18 Carolina is attributed -- is attributable to
19 what's going on here in South Carolina. And
20 that's regardless of the fact that there may
21 be a smart engineer or a -- an executive out
22 in California who decides the price at which
23 they're going to sell to South Carolina
24 customers. But the value creation activity
25 fu- -- the fun of the -- the fundamental



1 activity, the reason of being of that very
2 entity is as a goldmine, not as a -- it's not
3 a management consulting firm. If you had a
4 different scenario where all you had was a
5 management consulting firm and that's what
6 they did was provide manage -- management
7 consulting services, then the value maybe
8 generated from the California locations every
9 time they pick up the phone and provide
10 advice to clients. But that's not what you
11 would have in that example. I think that an
12 -- that, that would be kind of the extreme
13 example, but I think that applies equally in
14 the case of a -- here, in a retailer.
15 Particularly, retailers that are kind of
16 effectively that's all they do. Here, we
17 have a little bit of a ver- -- variation
18 because we have a retailer that also is
19 performing financing. But think about
20 retailers in general. It's not like they're
21 -- it's not like you have a manufacturer
22 and/or a distributor. You don't have these -
23 - kind of just se- -- big separation in va- -
24 - the value added activity that they're
25 doing. It's not like you have a -- like a



1 Korean car manufacturer located in Korea,
2 imports cars to the United States and sells
3 through a local distribution network. Those
4 would be areas in which the value added,
5 there are the economic activity being
6 performed in the state of South Carolina,
7 would be measured by the distribution activity
8 and only by the distribution activity
9 occurring that the company is performing, not
10 by the manufacturing activity. And in
11 manufacturing, I would expect frankly a larger
12 share of the value added in terms of the co-
13 -- raw materials costs and the cost of the
14 labor, etcetera, to build the, the product to
15 be incurring over in the manufacturing area,
16 with a much smaller amount of value added
17 going on in the -- in the distribution of the
18 labor. Mr. Pomp -- I think Professor Pomp
19 had the Gallo example. So, if you want to
20 use Gallo, I think that's another great
21 example. I would expect if Gallo was
22 producing wine, growing grapes and producing
23 wine in California, that the primary value
24 added activity is occurring in California.
25 If they open a distribution affiliate in



1 South Carolina, it's a separate legal entity,
2 I would expect a relatively modest amount of
3 activity -- economic activity associated with
4 the distribution function. But that's not
5 the case when you have these tightly
6 integrated, almost single -- what I consider
7 a single purpose or single purpose with an
8 asterisk, a company like a retailer. Here,
9 the asterisk, the finance -- I think -- I
10 testified before that I thought the finance
11 activity is in intimately related to the sale
12 of cars, that they are -- at the head.
13 That's not like an independent kind of
14 business entirely. But ultimately, I, I just
15 think that's where the -- where I think the,
16 the locus of the -- of the analysis should
17 be.

18 Q: Did you hear Ms. Yost describe how the stores
19 generate their retail installment contract in
20 the first instance for a financing
21 transaction?

22 A: Yes. I did.

23 Q: Okay. Does that impact your analysis?

24 A: Yes. Actually, it was a very helpful
25 additional data point in I think helping to



1 really drive home the point that there is a
2 really important intercompany transaction,
3 related party transaction that the taxpayer
4 has failed to provide any documentation for.
5 So, that retail installment contract is
6 initially owned by the stores. So, then
7 that's the question of trying to figure how
8 do we allocate the profits associated with
9 the functions performed by the stores versus
10 the functions performed by the back office
11 folks for the CAF business. Here, we
12 actually have the generation of an asset.
13 This re- -- this, this installment contract,
14 which is effectively the -- kind of the, the,
15 the loan agreement or the lease agreement
16 associated with the car or the, the financing
17 agreement for the car. That contract is
18 then, she described it, being transferred.
19 It's -- this is an intercompany transaction
20 now when you're taking that contract, that,
21 that, that installment contract and, and
22 transferring it from stores to CAF. That's
23 an intercompany transaction and that needs to
24 be priced. Now, that contract is already
25 fully established. The customer has already



1 signed on the bottom line. The company's
2 signed on the bottom line. So, that contract
3 is a valuable asset in terms of there's a
4 stream of interest payments or -- and monthly
5 payments, but ultimately, there's, there's
6 interest income that the company can expect
7 at -- call it 7 percent, 6, 7 percent that
8 the customer pays. The, the company is able
9 to borrow, we'd call it, 3 percent. That
10 delta is a huge -- hugely valuable asset. If
11 that were sold on the open market, I would
12 expect the stores to be able to capture the
13 vast majority of the value of that contract.
14 So, if anything that -- the notion of that,
15 that contract originating at the stores helps
16 the further establish that there is a large
17 amount of money left on the table with -- in
18 the transfer pricing of the finance business
19 that the company has entirely failed to
20 address.

21 Q: In her testimony, Ms. Yost said that over the
22 three years at issue, CBS's headquarters
23 costs, excluding the CAF portion of those
24 costs, were approximately \$700 per vehicle.
25 Do you recall that testimony?



1 A: Yes. I do.

2 Q: Do you agree with that calculation?

3 A: I -- it, it, it caused me to pause because I
4 had done other calculations. So, I haven't
5 been able to completely reconcile that number
6 to the number that I calculated previously,
7 but I think I have identified the reason for
8 the discrepancy between my calculations and
9 hers.

10 **MR. ANTLEY:** If you could pull up Respondent's
11 Demonstrative 2 and go to Slide Number 78.

12 **(Respondent's Demonstrative Exhibit 2, Slide Number**
13 **78 was referenced at this time.)**

14 Q: Is this the demonstrative from your direct
15 testimony where you derived a per vehicle
16 alternative management fee?

17 A: Yes. And it was -- when she called out the
18 number of \$700 per unit would be an all-in
19 costs per vehicle number, the number I was
20 focusing on was that \$528 number that I had
21 calculated. And that includes a --
22 approximately, I believe \$29 per unit of, of
23 markup. So, the cost that I am calculating
24 here are less than the cost that she was
25 calculating. That's why I noted -- I noted



1 that there was a discrepancy between our
2 figures.

3 **MR. ANTLEY:** Okay. And if you could pull up
4 Respondent's Demonstrative 3.

5 **(Respondent's Demonstrative Exhibit 3 was**
6 **referenced at this time.)**

7 **THE COURT:** Can I ask, if I went with that
8 management fee, then I would not need to --
9 would I -- with that avoid the issue of the
10 discrepancy in the ownership?

11 A: No, Your Honor.

12 **THE COURT:** I think I asked about this earlier, but
13 why not?

14 A: Well first, this only really addresses half -
15 - only gets you half of the way there.
16 We've, we're missing the whole finance -- the
17 amount of finance issue, right? So, there's
18 no -- so, if you were to asse- -- you were to
19 change the management fee from the amount
20 they used to the amount that I would propose.
21 There still -- there still needs to be an
22 arm's-length charge for the finance function.

23 **THE COURT:** So, if ---

24 A: And that's a big number.

25 **THE COURT:** If I go with Mr. Cody's numbers, still



1 I would have to consider the financial
2 aspects.

3 A: The -- in my view, you would have to consider
4 the financial aspects because there is an
5 intercompany transaction. It was not priced
6 at all and there's no value being provided to
7 the stores for the -- for what they are
8 actually providing in the financing function.

9 **THE COURT:** Have you provided us with how that
10 would be priced into all this separately?

11 A: Well, I, I called out a number that I saw
12 from the, the available documents where the
13 company in its -- in that 2004, 2005 study
14 apparently asserted that the value of the
15 origination was about \$314 per unit that the
16 -- that -- you know, that, that, that present
17 value analysis of the intangible, they kind
18 of -- the, the swap of there being a charge,
19 an intercompany charge of \$314 that the
20 finance company would pay the operating
21 companies for the origination of the loans.
22 So, if you -- if you were to use that number,
23 then that would get you -- the calculations
24 I've done come up to about 200 million
25 dollars in additional income that would swing



1 over from CBS over to, to East. And that
2 cal- -- I did that calculation based on ---

3 **THE COURT:** Well, that be giving all of East the
4 finance.

5 A: No, Your Honor.

6 **THE COURT:** Okay.

7 A: That, that would be only saying, let me just
8 take at face value the number that the
9 company came up with in 2004. The company
10 said this number ---

11 **MS. GEER:** Your Honor, I apologize. I just have a
12 question to know if I have an objection to
13 this. This looks different to me that's what
14 Slide 1 is.

15 **MR. ANTLEY:** This is -- this is Respondent's
16 Demonstrative 3. So, this is not 1 or 2.
17 You just have 1 and 2.

18 **MS. GEER:** Yes.

19 **MR. ANTLEY:** We haven't gotten into this yet. I
20 think -- I don't think I've asked him a
21 question about this.

22 **MS. GEER:** I know, but I would -- if this is not
23 one of the demonstratives that we received
24 before trial, then I would object to the use
25 of this. I -- I've never seen it.



1 **THE COURT:** Well, I'm not -- I want to finish up my
2 questions first.

3 **MS. GEER:** Yes, please.

4 A: Okay. So, so first ---

5 **THE COURT:** Well, I -- because what I'm trying to
6 do is understand with the finance, according
7 to your analysis ---

8 A: Yes.

9 **THE COURT:** --- part of the profits that originate
10 from finance should be attributed to, you
11 know, CBS East or West, depending on who's,
12 who's selling and thereafter financing.

13 A: Yes. I think -- it's my view that based on
14 the subtotal of what I've seen to date is
15 that the vast majority of those profits of
16 the finance functions should flow through to
17 the operating companies in the first instance.

18 **THE COURT:** All right. So, that's why I was asking
19 that.

20 A: So ---

21 **THE COURT:** That 314.50 ---

22 A: The, the 314 is a lower bound. It's just --
23 it's the only number I've seen out ---

24 **THE COURT:** Okay.

25 A: --- actually, a specific number. I don't



1 know how it was derived. I just -- I see it
2 used in a calculation and I see a rec- -- in
3 that Ernst and Young report, and a reference
4 to it as a number that CarMax itself has
5 calculated. So, that gives me kind of a low
6 ---

7 **THE COURT:** Calculated in, in what way? It ---

8 A: I ---

9 **THE COURT:** To, to the car sellers or to the ---

10 A: To ---

11 **THE COURT:** --- finance company or finance
12 operations entirely?

13 A: It is -- it was calculated and used in the
14 calculations as if it were a transfer price.

15 **THE COURT:** Okay.

16 A: As if it were a payment that was going to be
17 made or that would be made, or that was
18 appropriate to be made between CAF -- that
19 CAF would make a payment, every time somebody
20 comes in and generates a loan, that CAF would
21 make that payment to ---

22 **THE COURT:** To ---

23 A: --- to the ---

24 **THE COURT:** East or West.

25 A: To East or West.



1 **THE COURT:** There you go.

2 A: \$314 every time a car is, is financed. So,
3 that was there number. So, I consider that a
4 lower bound. I think my number -- based on
5 what I've seen and how I understand the
6 operation of finance business, I would
7 increase that number substantially. But that
8 number just as it were, a magic number, if
9 that number's helpful for you, would be about
10 200 million dollars in additional income that
11 would go to -- from CBS over to East as a
12 transfer pricing payment.

13 **THE COURT:** Well, if I was to take a more simple
14 approach with the management fee, would I not
15 just -- let's say they're saying 1,070. I
16 think it's 71 for one year, but it's 1,070
17 and I would subtract that fee you're
18 referencing from the management -- the
19 management fee per car unit and come up with
20 ---

21 A: That, that, that would be another way of
22 doing it, but again I would ---

23 **THE COURT:** What would be wrong with that?

24 A: Oh, one it'd be because I'd still consider
25 that to be an extreme lower bound on ---



1 **THE COURT:** Okay.

2 A: --- on the value of the payment based on
3 everything that I've seen. Like I said, that
4 retailing installment contract, the fact
5 that's in the hot little hand of the -- of
6 the store employee before it goes over to CAF
7 means that that's a hugely valuable asset.
8 And we see similar kinds of transactions all
9 the time, financial transactions, when you
10 have those kinds of contracts that third
11 party -- thir- -- that investors will pay.
12 The, the investors don't need a huge premium
13 on that kind of -- for that kind of contract.
14 So, you don't have to give up a lot of that
15 delta, that, that difference between that 7
16 percent interest that you're going to receive,
17 receive from the customer, and the 3 percent
18 you got to pay up to -- for, for to -- to
19 your own financing for, for that loan. Then,
20 that's a big delta. 3 percent is a lot -- is
21 a big spread. And the originator in that
22 instance with the, the, the entity that has
23 that contract is able to capture a large
24 fraction of that spread, so.

25 **THE COURT:** Well, then can that, that profit, I



1 guess is the term I'm looking for, be
2 captured using a separate entity reporting?

3 A: It, it can. So, and I think that's where --
4 in my opinion, is that the -- all of the
5 profits associated with that business really
6 should reside at East and West with the --
7 with a compensation to CAF of their costs
8 plus a modest markup.

9 **THE COURT:** And what would those -- so, how did
10 you, you --a while ago you gave me this -- a
11 specific total number of profits.

12 A: Yes.

13 **THE COURT:** So, how did you employ the use of that
14 ---

15 A: So, that was a different way. So, those two
16 different ways ---

17 **THE COURT:** Yeah.

18 A: --- of kind of, of, of getting to it, right?

19 **THE COURT:** I'm going to back to the different way
20 now.

21 A: Okay. So, let, let me start with the way you
22 asked and I think -- I think you're trying to
23 get at what would be a -- if, if East keeps
24 all the finance revenues generated by its
25 loans, how much should CAF -- so -- I'm



1 sorry. How much should CAF and therefore,
2 CBS receive? I, I think it is -- based on
3 the numbers that I've seen, the costs of the
4 -- of the CAF business are not that large, I
5 think it be a very, very modest amount, and
6 just for the sake of argument, I would say 15
7 million dollars in markup. So, that's the
8 mark- -- so, so everything comes -- stays
9 with -- I'm sorry. Stays with the profits
10 would stay with East, and a small markup is -
11 - reimbursement costs plus a small markup
12 would go back over to CBS. So, the question
13 is how much money -- that's where it's a
14 little hard to do it the way that the, the
15 way the taxpayer has done it is a per unit
16 vehicle that's being paid out to, to CBS
17 rather than thinking of it as an
18 apportionment of profit. The profit gets
19 apportioned in the first instance. There's a
20 cost reimbursement plus a markup. And that's
21 how I would generally -- how I've seen other
22 headquarter services do it. So, that would
23 be -- my option one would be if I'm ignoring
24 the ownership issues, those -- that 93 and a
25 half percent issue, then I would say give CAF



1 a modest markup on the cost -- re- -- re- --
2 a reimbursement of the cost plus a markup for
3 the processing, for the servicing, for the
4 call centers, etcetera. The book end of that
5 -- the book -- so, you say, may -- maybe you
6 would decide that that was not the right
7 number. And the -- there's a number --
8 there's a number out there, but unfortunately,
9 I don't have any documentation for how it was
10 derived. All I know it was the assertion by
11 the company of \$314 per unit. At \$314 per
12 unit, CAF is still retaining a lot more
13 profit than under what I consider to be the
14 meth- -- the best method. So, I hope that's
15 -- I don't know if that's giving you enough
16 specificity in terms of the numbers. And I
17 realize these are kind of big numbers and
18 it's a little hard to figure out how you
19 would add them up. It is one of the reasons
20 why I think combined entity reporting is the
21 right reason. It's because it does require a
22 lot of detailed information about CAF and
23 who's -- which entity is bearing which cost
24 and, and specifically what's behind those
25 costs to figure out which ones deserve a



1 markup, and if so, how much. And then to run
2 through the calculations. That's why I think
3 at the end of the day, the part I am very
4 confident in, in saying is that the amount of
5 markup left in, in CBS, if you kept those
6 ownership percentages the way they were and
7 the distributive shares the way they were,
8 the result that you would get from an
9 appropriately done transfer pricing approach
10 would get a number that's approximately the
11 same that you would get under a combined
12 entity report. It's just there's a little
13 bit left over in CBS, hopefully that siphoned
14 over to West because of West's disproportion
15 share. If you fix that share -- if you say
16 the distribu- -- the distrub- -- distributive
17 share should be, call it 75/25 or 80/20,
18 whatever it where the -- that -- where the
19 majority share goes to East instead of West,
20 then you're -- you should get an identical
21 results under combined entity reporting and --
22 or actually, the -- combined entity report- -
23 - port -- you should get kind of a very close
24 results. Again, it would depend on those
25 distributive shares that you would get under



1 combined entity reporting and transfer pricing
2 done correctly.

3 **THE COURT:** All right.

4 Q: All right. So, I think -- I don't know if I
5 got this question out earlier, but you had
6 mentioned your demonstratives from your direct
7 testimony. Have -- based on the testimony
8 of, of witnesses this week, have you revised
9 any of the calculations from those
10 demonstratives?

11 A: Yes. I have.

12 Q: Okay.

13 **OBJECTION:**

14 **MS. GEER:** Your Honor, we would renew our objection
15 to this demonstrative.

16 **THE COURT:** Under what grounds?

17 **MS. GEER:** Well, it wasn't provided before. And I
18 understand that he's saying it's because he
19 revised it, but the document that they gave
20 us had similar numbers, but with no
21 calculation description. So, this tells you
22 exactly how they're reaching each of these
23 numbers. And we did not receive those
24 calculations in the earlier -- in the earlier
25 one, which led us to not be able to determine



1 what was being done there or I -- I just
2 think it's prejudicial.

3 **THE COURT:** Well, I didn't follow that. Can you
4 give me another shot at that?

5 **MS. GEER:** Yeah. Hold on. Your Honor, I'll -- I
6 would just object based on that this is the
7 first time we've seen this, that he had
8 information to do calculations prior to trial
9 and could have done them then.

10 **MR. ANTLEY:** He made these calculations prior to
11 trial. The -- they were done in his prior
12 demonstratives. He has revised those
13 calculations based on testimony that he's
14 heard this week.

15 **THE COURT:** So, according to you this is the same
16 demonstrative you've used previously. You're
17 just revising it based on what was said.

18 **MR. ANTLEY:** Yes. And I'm -- and I'm happy to put
19 them. We can pull up 77 and ---

20 **THE COURT:** No. I'm ---

21 **MR. ANTLEY:** And -- to compare the two. I mean,
22 they -- they're not identical because he's
23 made changes to them based on testimony he's
24 heard.

25 **THE COURT:** Well, I'm, I'm going to let you go



1 forward with it.

2 **MR. ANTLEY:** Okay. Thank you.

3 **THE COURT:** Less -- especially in light of it's a
4 demonstrative.

5 **MR. ANTLEY:** Yes, sir.

6 **THE COURT:** I'm taking that into account.

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

8 Q: So, what we have in front of you is Slide
9 Number 1 of Respondent's Demonstrative 3.

10 **(Respondent's Demonstrative Exhibit 3, Slide Number**
11 **1 was referenced at this time.)**

12 Q: Is this your reconciliation reflected in a
13 set of revised -- or in a revised
14 demonstrative?

15 A: Yes. It is.

16 Q: Okay. Do your revised demonstratives change
17 any of your primary opinion -- four opinions
18 in this case?

19 A: No. They don't.

20 Q: Okay. And if you could go to the Slide 2.
21 Is this another revised demonstrative?

22 A: Yes. It is and I'd be happy to explain the
23 contents of that as well.

24 **THE COURT:** There's an objection.

25 **OBJECTION:**



1 MS. GEER: Same objection for the record, Your
2 Honor.

3 THE COURT: Yeah.

4 Q: Okay. If you could explain the contents?

5 A: Well, maybe it would be helpful to start with
6 the other one.

7 Q: I'm sorry. We can go back to slide ---

8 A: And maybe I'll start -- I'll, I'll start with
9 this one.

10 Q: Okay.

11 A: If, if, if -- I think it would be, be helpful
12 to orient the Court. So, so for example,
13 let's start with a 528 of the third line
14 from, from the bottom. That's the -- that's
15 the figure that, that I presented on that
16 slide, demonstrative you initially put up
17 during my direct. And this is where, like I
18 said, I had -- there was an attempt, when,
19 when I heard Ms. Yost talk about a \$700 cost
20 number, I ca- -- I came up with \$500. I was
21 trying to reconcile the difference. So,
22 ultimately, this is where I get to fi- --
23 finding out the bridge between her \$700
24 number and my \$500 number. So, maybe now if
25 we go ba- -- as this, this way in which -- I



1 don't know if you recall in my testimony I
2 had a -- an excerpt from the financials
3 showing how the company treated the, the
4 advertising costs. And there was a bunch of
5 adver- -- or there were a bunch of
6 advertising costs that were treated in the
7 first instance as being borne by East and
8 West, which was -- which is an oddity to me
9 that I would have thought all those
10 advertising costs were being borne by CBS
11 since that's where they advertising function
12 was or is. But in fact, it's showing up in
13 the financials as a large number of dollars
14 in the East and West column. And then there
15 was a reversal of those charge -- of, of that
16 charge. Not complete reversal. The numbers
17 didn't tie out exactly, but it looked to be -
18 - there was a -- some kind of cross charge or
19 journal entry to move the costs incurred
20 initially by East and West over to CBS. And
21 that's what this bottom, this \$184 number is.
22 So, the delta between her number and my
23 number is largely driven by this reversal of
24 the cross charges of the advertising costs
25 that I had not previously presented in my



1 analysis in the prior slide. Now, our
2 numbers aren't going to tie out exactly
3 because there are certain costs that I don't
4 think are appropriate to include in this,
5 things like shareholder expenses and things
6 like that. But -- and there's also profit in
7 my numbers and there weren't profit in --
8 numbers in her -- in -- hers, as I understood
9 it, was just a pure cost number. But maybe
10 if you back up to that slide that we had
11 earlier.

12 **MR. ANTLEY:** Okay. The slide earlier.

13 A: I can walk through the calculations.

14 Q: Okay.

15 A: So the numbers through that line that says
16 change in management fee about four, four up
17 from the bottom, those are identical
18 effectively to the numbers that were in the -
19 - in my earlier demonstratives. I -- I've
20 put the signs on it so people -- so to make
21 it easier for someone to replicate the math
22 to show how you can add up different numbers
23 and because certain things are expenses to
24 the operating companies and credits to CBS,
25 I've made sure to be careful about putting



1 the negative signs and the po- -- positive
2 signs so that as you come to the bottom you
3 could replicate the calculations by adding up
4 the appropriate elements. And I've labeled
5 each of those rows A through J in order for -
6 - to allow someone to follow the
7 calculations. I went through some of that
8 very quickly without the num- -- without the,
9 the benefit of those little letters on my
10 earlier testimony, but I thought it was
11 particularly helpful here just so someone
12 could see what the differences in those
13 calculations are. So, the -- so, here we
14 have the, the alternative intercompany
15 charges. Where the rubber meets the road is
16 this alternate intercompany cost, those, those
17 numbers in the fourth and fifth horizontal
18 line, Rows D and E. So, the, the first row
19 is the ones -- the costs that I assigned a
20 markup to. The next ones are the -- are the
21 costs that I consider to be appropriately
22 treated as pass-through expenses. There's a
23 double asterisks next to the 880,000 -- 880
24 million dollar number that's referenced at the
25 bottom. So, you can see the total amount of



1 markup that's imbedded in that calculation.
2 So of approximately 59 million dollars. And
3 when His Honor asked me about how -- what
4 would the transfer pricing on an all-in basis
5 look like if one were to include the fina- --
6 if I were to redo the financing function for
7 the arm's-length standard, and I called out
8 approximately a 20 million markup at most for
9 the finance functions based on my
10 understanding of the relative share of a cost
11 -- the finance business of CAF versus the
12 rest of the business. Actually, now, looking
13 at the number, I think 25 million dollars in
14 markup for -- for the finance is way over --
15 it is -- is probably overestimated because I
16 believe I -- that the total amount of costs
17 for that function are I think maybe around 10
18 percent of, of the -- of CBS's cost as a
19 whole, but I would need to go back and, and
20 verify that. But anyways, this provides you
21 kind of a general order of magnitude of where
22 -- what the numbers are. As we go through,
23 that total alternative management fee doesn't
24 change from what I calculated before.
25 Talking about the but-for world, if this --



1 the transfer prices had been done correctly,
2 I think that's how the numbers should have
3 been calculated based on adding up the costs
4 and then allocated on a per vehicle basis.
5 But there is -- that, that number that's says
6 change in management fee below, I had had
7 that as being identical to the change in the
8 profit of the -- of the two companies in my
9 prior slide and this is where I need to go
10 back and address this reversal of this cross
11 charge that's down below. So, that's where
12 I'm -- I wanted to be more careful to label
13 that as simply the change in management fee
14 comparing the management fee that was reported
15 in, in row -- in Row B to the, the management
16 fee that I -- that, in my opinion, should
17 have been paid using kind of a cost plus me-
18 -- the comparable profits method in Row F.
19 So, that gives you the change in management
20 fee. Now, we're not done though if we're
21 trying to reconcile to the -- to the impact
22 on profit. And that's where I need to
23 account for this cross charge that was made
24 by CBS to the operating companies for these
25 advertising charges that, that were popped up



1 in the first instance. There was a -- it was
2 an intercompany expense that I was leaving
3 out of a transaction between CBS and the
4 operating companies I was leaving out of my
5 prior calculations. But it was one that was
6 actually to a benefit of the operating
7 companies because it was a reimbursement to
8 them of expenses that had incurred. So here,
9 I'm effectively having to re- -- I, I
10 reversed that out to get the revised
11 operating profit, which then adds up. The
12 operating profit before the transfer pricing,
13 Row A; the alternative management fee, Row F;
14 and then, I'm giving CBS credit for this re-
15 -- reversal of this cross charge, which is
16 Row H. And that's why you see that 371
17 million dollar number on the far right that's
18 in, in Row H. That's effectively a credit to
19 increase their profit, to effectively move
20 those -- to, to get from reimbursement to, to
21 CBS for that cross charge, to then get the
22 revised operating profit for each of the
23 entities and then the change in the operating
24 profit is down below. So at the end of the
25 day, my calculations would suggest 900 million



1 dollars less operating profit in CBS, 701
2 million dollar more profit in, in East. And
3 that's again, before we touch the finance
4 function.

5 **THE COURT:** And that -- those figures are the ones
6 that take you to the next slide to reach the
7 528 I think it was?

8 A: Yes. I believe maybe now it's time to --
9 we'll, we'll go to the next slide so you can
10 see how I, I show these numbers.

11 **MR. ANTLEY:** Slide 2, please.

12 A: So ---

13 **THE COURT:** 712, ultimately.

14 A: Correct. Correct. So, the 528 is when I
15 said, what's the but-for way in which the
16 management prices should have been done. The
17 \$528 is what I think is the correct number,
18 but there is this lingering issue of this
19 cross charge that was made by the company of
20 \$184 that I would -- it ---

21 **THE COURT:** Per vehicle.

22 A: I'm sorry.

23 **THE COURT:** Is that per vehicle?

24 A: Per, per -- correct. That change is all on a
25 per vehicle basis. That's where you, you can



1 see that, that total alternative management
2 fee on Row F of 1 billion dollars. That's
3 the one I had before. I divide that by the 2
4 million vehicles to get 528. I take the
5 cost, that 300 million dollar cost that ---

6 **THE COURT:** Divide it by the ---

7 A: --- and divide that by the number of vehicles
8 to get to 184. So, the sum of that, the 712,
9 I think is more consistent with what I
10 consider to be a cost plus approach, giving
11 credit for this reversal. So, it's a little
12 bit of an odd situation because of the kind
13 of the circular nature in which the
14 accounting was done. But because there was
15 this \$184 payment, that, that were -- credit
16 that -- intercompany credit that was made, I
17 think it's appropriate to then effectively
18 give the company credit for having made that
19 payment.

20 **THE COURT:** But this 712 figure doesn't -- still
21 doesn't take into account your concerns about
22 the financials?

23 A: No. It doesn't. And, A, it doesn't, doesn't
24 address the -- my concerns about the
25 financial issue. And even independently of



1 that, ultimately, I don't think it's an
2 arm's-length result because as an economist,
3 unlike Dr. Cody, I cannot get away from the -
4 - what I consider to be non-arm's-length 93.5
5 percent ownership share of, of CBS that West
6 owns. That that ultimately means the profit
7 that's -- there -- there's still this funnel,
8 this non-arm's-length funnel, it's using the
9 transfer pricing mechanism. There was a
10 transfer price established for that -- those,
11 those ownership percentages and it's using the
12 whole transfer pricing system to move money
13 from East to West. So, then that resulted --
14 - that's non- ---

15 **THE COURT:** So, I mean if, if you go with this
16 management fee, you circumvent all the -- the
17 ---

18 A: No. No, Your Honor.

19 **THE COURT:** --- struggle.

20 A: Anytime you have any kind of profit being
21 paid to CBS -- if, if you have -- if you have
22 -- if you're just paying CBS at cost, then
23 there's -- then the allocation, the ownership
24 shares doesn't really matter because there's
25 no income of CBS distribute. There's nothing



1 left over. It just reimbursed all of its
2 cost. But if there's any -- there's \$1 of
3 profit that CBS earns, and if you don't alter
4 those distributive shares, 93 and a half
5 percent is gone of that dollar of -- that was
6 primarily contributed -- 75 percent of which
7 was contributed by East. 93.5 percent of
8 that dollar is going over to West. And
9 that's why I said in the results ---

10 **THE COURT:** But that would be considered -- if you
11 were to flip it, it would be considered
12 income to CBS East, which would be part of
13 the denominator. No. The numerator.

14 A: Well, if you were to flip ---

15 **THE COURT:** Is that what you're saying?

16 A: If you were to -- if you were -- the --
17 that's what I'm saying, if you were to leave
18 the distributive shares untouched, 93.5, 6.5
19 percent, any profit element paid by East into
20 CBS, the -- whether it's \$29 a vehicle or
21 \$500 or \$5,000 a vehicle, all that is being
22 ultimately distributed out 93.5 percent out to
23 West. And so that's going to be a non-arm's-
24 length result. Whether that number is 100 --
25 if it's \$100 too much or whether it's \$5,000



1 too much, that's, that's -- the, the question
2 is ultimately is it enough where you care in
3 some sense. And that's where I think
4 ultimately what we're getting to is how much
5 of a distortion is cau- -- is the amount of
6 the distortion caused by those, those
7 ownership shares is going to diminish the
8 smaller the markup being paid into the
9 waterfall. The smaller the amount of, of
10 profit that CBS has, it's still distortive.
11 In my view, it's not arm's length, but the
12 distortion itself is lessened. And in my
13 view, lessened substantially by, by the
14 approach I've taken here, but for the
15 treatment of the finance function versus what
16 the, the taxpayer implemented.

17 **THE COURT:** Okay.

18 Q: Did, did you finish discussing the revisions
19 that we see on Slide 2 of Respondent's 3?

20 A: Yes. I did. And just, just to note, I --
21 the other -- on the other slide I showed the
22 total amount of the markup being charged was
23 like 50 -- \$59 million dollars. That's
24 imbedded in my calculations here on a per --
25 I'm sorry. The one -- the, the -- go back



1 before that.

2 Q: Slide Number 1.

3 A: I have a note in there that shows the amount
4 of the markup on a per vehicle basis in the
5 next slide.

6 Q: Slide 2?

7 A: Yeah. Where it says \$29 per unit. So, you
8 can see of that 528 -- or of the 712 how much
9 is profit to CBS versus cost reimbursement.

10 **MR. ANTLEY:** Can you go to Slide 3?

11 **(Respondent's Demonstrative Exhibit 3, Slide 3)**

12 A: So, this is simply recreating the same slide
13 that I had in this -- in that -- in, in the
14 pre- -- the dem- -- the, the demonstrative
15 previously, is updating these percentages
16 based on these revised calculations. I
17 thought it was important to do these because
18 we are talking about the percentages of
19 profit. They're the ones we're calculating
20 things on a total adjustment dollars, total
21 management fee, per unit payments. But the
22 end of day, is still que- -- the question is
23 how much profit is left over in the various
24 entities. So, I've updated these percentages
25 to reflect the crediting of the -- of, of CBS



1 for the -- these advertising -- these, what
2 I'll call kind of circular advertising
3 expenses. So, that's where in this -- just
4 if you had the two sli- -- side by side
5 versus comparing to what I had before, the
6 white box in the -- on the thir- -- on the
7 top of the third bar is larger than what I
8 had before. And I was -- I was also struck
9 because Ms. Yost said, hey, if we compensate
10 the, the, the management fee at cost, then
11 you're still 50 percent higher than the
12 combined entity report -- than the combined
13 entity result. And I thought that was -- I,
14 I don't -- the numbers I'm getting are not
15 quite the same, but they still --
16 directionally consistent with my opinion.
17 There's a reason you don't get all the way
18 there is because you haven't addressed the
19 finance business. The reason that white box
20 is so large on that third column after the --
21 so, this is as you see the difference between
22 the, the second and the third columns is
23 after I've implemented the alternative
24 management fee, but before the distribution of
25 the shares, there's still, there's a 59



1 million dollars of profit in there for CBS,
2 the remainder of that whi- -- white box is
3 all finance profit. And then, when you go to
4 the final box, the light blue shows the 93.5
5 percent of that white box is going to West
6 and the sliver of, of bright green is going
7 to East. I just, just for the sake of
8 completeness because I don't want anybody to
9 get confused, the one -- there was on that
10 very first column, I, I did want make sure
11 that it was consistent with a -- an earlier
12 slide I had. I noticed that the scaling of
13 that particular column was a little bit off.
14 So, it should -- the reason it goes above 100
15 percent for the -- for the green and blue
16 bars is because initially, there's a -- about
17 a -- the 7 percent loss is sitting in CBS
18 before the transfer pricing because it's
19 incurred a whole bunch of costs associated
20 with the management company before it's being
21 reimbursed. So, that's consistent with one
22 of the very early slides I had in my
23 testimony. So, I think you'll see a change
24 in the axis where that one bar kind of pops
25 up above 100 percent to be consistent with



1 the actual data that it -- I think it was
2 just a, a software issue. It, it didn't --
3 wasn't reading the right data.

4 Q: And just to make sure the record is clear.
5 We're, we're talking about your -- or
6 Respondent's Demonstrative 3, Slides 1 through
7 3. Those revi- -- those are revisions that
8 correspond with Slide 77 through 79 of
9 Respondent's Demonstratives 2?

10 A: That's correct.

11 Q: All right. And, and now that -- after you've
12 discussed all these revisions, did these
13 revisions change any of your primary four
14 opinions in this case?

15 A: No. I -- as I -- as I mentioned, I, I still
16 think the big issue -- it doesn't change the
17 amount of profit at the end of the day, which
18 I think is the, the operative number, how
19 much profit should be allocated to CBS. And
20 under either applying a transfer pricing
21 method appropriately performed or under a
22 combined entity or under combined entity
23 apportionment method, it certainly doesn't
24 change my opinion about the lack of
25 reliability of the tra- -- of the transfer



1 pricing policy, the transfer pricing studies.
2 And, and it also, I -- it still confirms my
3 conclusion that says, really, the combined
4 entity apportionment approach will get you the
5 right number be- -- and it -- and it is
6 particular appropriate here because of the
7 size of that white box on top of that third
8 column. The fact that we've got this big
9 chunk of financing profit that the -- that
10 the taxpayer has not addressed anywhere. And
11 the most -- I think the most efficient way
12 of, of addressing that is through a combined
13 entity apportionment.

14 Q: Yesterday in his examination of Professor
15 Pomp, counsel with CarMax suggested that
16 according to your primary testimony earlier in
17 the week, you believe that as a general
18 matter, transfer pricing would produce the
19 same result as combined entity reporting. Is
20 that an accurate characterization of your
21 testimony from the other day?

22 A: Not at all. To be very -- just to make sure
23 it's very clear, my view is that there are
24 many circumstances in which separate entity
25 reporting and transfer pricing in general can



1 result in a reasonable reflection of a
2 taxpayer's economic activity in the state of
3 South Carolina, or applied obviously in my
4 international work, it's something that I
5 apply all the time in that work. So, I have
6 a healthy respect for applying the arm's-
7 length standard. I believe that in the vast
8 majority of circumstances, transfer pricing is
9 a good way to go, particularly in an
10 international context where there are treaties
11 and all kinds of things, where you're trying
12 to get uniform standard. Everybody around
13 the world, you want them to apply the same
14 standard in, in, in setting and enforcing
15 their, their transfer prices. My opinion
16 here is very much specific to this specific
17 taxpayer, that there are certain circumstances
18 particularly with a retailer and a
19 headquarters function where if the distortions
20 -- if, if the company has so mis-priced its
21 anal- -- its, its headquarter services, as is
22 this case here, I think a combined entity
23 apportionment method will get you something
24 that reasonably approximates what you would
25 get had they got it right in the first



1 instance. And when I say got it right, had
2 they done what I have done in other
3 circumstances, what I've seen other taxpayers
4 do in an international context, which is
5 really to go through your standard headquarter
6 services analysis, apply a reasonable markup
7 to those, identify which ones are low costs
8 services where you wouldn't -- where it
9 wouldn't be worth it to actually go through
10 and try and benchmark them. Things like
11 accounting costs, and no disrespect, but often
12 times legal costs by headquarters, they're not
13 marked up because they're considered low-value
14 services. So, there's a wide range ---

15 **THE COURT:** Ooh.

16 **MS. GEER:** That, that hurt.

17 A: So, there are wide ra- -- and though lawyers
18 perform very valuable functions for the
19 company, but yet they're considered within
20 this rubric of low value services at the end
21 of the day. They're not core to what the
22 company is doing. Like in this case, selling
23 car -- buying cars and selling cars.

24 Q: Can you give an example of how the use of
25 separate entity reporting using an appropriate



1 transfer pricing policy could produce a very
2 different amount of taxable income for the
3 state of South Carolina?

4 **THE COURT:** I'm sorry. Say that again.

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

6 Q: Can you give an example of how the use of
7 separate entity reporting using an appropriate
8 transfer pricing policy could produce a very
9 different amount of taxable income for the
10 state of South Carolina than combined entity
11 reporting?

12 **THE COURT:** A very different amount?

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

14 **THE COURT:** Couldn't he give lots of examples on
15 how he could produce very different amounts?
16 I mean, my job here is to try to figure out
17 what amount would be something I could
18 utilize in making this decision, isn't it?

19 **MR. ANTLEY:** Yes, Your Honor. So, if, if we could
20 allow him to ---

21 **THE COURT:** I'll allow him to answer.

22 **MR. ANTLEY:** I think it might ---

23 **THE COURT:** It's not ---

24 **MR. ANTLEY:** It might answer your que- -- it might
25 answer your question.



1 **THE COURT:** Okay.

2 A: So, so I think the issue goes to one whether
3 I'm attacking the use of separate entity
4 reporting, which I'm not; and two, whether
5 I'm somehow impugning the reliability of
6 transfer pricing as a method, which I'm not.
7 And there are many instances ---

8 **THE COURT:** Well, I think given that you're a
9 transfer pricing expert.

10 A: Yes, Your Honor. But also, I think it may be
11 helpful in terms of assessing what are the
12 types of circumstances that arise in which
13 separate entity reporting is -- where, where
14 combined entity reporting might be
15 particularly distortive. And those -- and
16 those scenarios would be if you have a
17 company -- I had -- I mentioned this example
18 of the Korean manufacturer with a U.S.
19 distribution affiliate. And that's common
20 around the world that you'll have companies
21 that centralize their manufacturing locations
22 and the primary source and the value add per-
23 -- being performed by the company is the
24 manufacturing of a sophisticated product, like
25 an automobile or a television set or a



1 computer. And now, there's additional
2 activities that the company will engage in
3 and will have a subsidiary that is engaged in
4 a distribution activity in a lo- -- in a
5 different jurisdiction. And where it may be
6 perfectly appropriate and generally, would be
7 perfectly appropriate for the, the majority
8 share of the pro- -- the combined system
9 profits to be earned by the manufacturing
10 entity versus that small function that's being
11 performed to distribute the product at
12 wholesale in another country. So, that's
13 where -- there, there, there are plenty of
14 other examples like that. I think the issue
15 comes down to when you have a retailer that
16 has implemented a transfer pricing -- and
17 that's all it is effectively retailing and
18 here we have retailer with an asterisks
19 because of finance. When that retailer is --
20 that's what it does. It sells cars. It
21 doesn't have these neatly set -- it doesn't
22 have a separable business the way a
23 manufacturer distributor does. So, when you
24 have that -- and if you have the distortions
25 described by Mr. Sharpe in terms of the



1 amount of profits being earned by one entity
2 versus another, that is something that to me
3 as an economist is, is a real alarm bell
4 moment. Why would there be such vast
5 distortions in terms of the profitability and
6 why would have such a -- how would have that
7 difference in a combined entity versus
8 separate entity reporting unless it's because
9 somebody got the transfer pricing wrong.
10 Somebody's overpricing the only transaction
11 that there is between the, the -- with the
12 way the company set up the trans- -- the,
13 the, the comp- -- the company has set up the
14 transfer pricing structure. It's going to be
15 between the headquarters for some separate
16 headquarter's function that they're going to
17 identify as being a super duper high value
18 one. That's where you're going to have a
19 greater danger of, of distortion under
20 separate entity reporting when you see these
21 distortion ratios as extreme as, as Mister --
22 as the ones that Mr. Sharpe described. So,
23 but I think there are lots of other examples
24 that -- think Professor Pomp kept referring
25 to a Gallo and manufacturers and other kinds



1 of, of entities that rely on separate entity
2 reporting when they de- -- may decide to come
3 to South Carolina. I, I, I mentioned a
4 conglomerate company. Nothing that I have
5 said really impugns the ability of those
6 companies to employ separate entity reporting
7 in filing their cal- -- in their, their South
8 Carolina taxes.

9 Q: Did you hear Professor Pomp talk about how a
10 remedy for a tax authority is to disallow a
11 dedu- -- deduction?

12 A: Yes. I did.

13 Q: Is that the only remedy that you have seen
14 applied in your transfer pricing work?

15 A: No. Not at all. I think there's the -- in
16 482 perspective or even if you're looking at
17 foreign tax authorities, there is wide
18 latitude to adjust the income of a taxpayer
19 such that the income, the results is
20 consistent with arm's-length dealings. So,
21 sometimes it might be a disallowance of a
22 deduction. Other times, it might be
23 determined with the -- where the, the IRS --
24 if it's the IRS, who's -- that is assessing
25 the, the adjustment, they would derive their



1 own estimate. They may apply a very
2 different method. They wouldn't -- in my
3 view, they wouldn't do what Dr. Cody suggests
4 and simply pick a number that Ernst and
5 Young, that ra- -- a different number in the
6 range that Ernst and Young produced. You,
7 you make an adjustment because that range is
8 inherently unreliable, that the arm's-length
9 result falls outside the range. So, you need
10 to come up with a very different method. And
11 so, in my view, the, the, the most reliable
12 method would be some kind of cost, ignoring
13 the ownership share issues would be a cost
14 plus ty- -- type, type arrangement. So, that
15 -- so, that is another remedy the -- that
16 the, the IRS can, can apply. It can also
17 completely disallow the -- or kind of look
18 through the transaction if it -- if it raises
19 a sham theory approach to the transaction.
20 Basically, it says as the government said in
21 the Perrigo matter in the first instance, it
22 alleged that it was a sham transaction.
23 There are other theories as well for an
24 adjustment. But so there -- but they -- as a
25 -- as a country that is committed to a number



1 of different tax treaties around the world
2 and that is also been on -- in the forefront
3 is trying to through various international
4 organizations to try and promote the use of
5 the arm's-length standard, the IRS does
6 generally and I -- I'm, I'm not sure I --
7 quite sure how it ever can deviate from using
8 the arm's-length principle in applying an
9 adjustment. That's primarily because you are
10 concerned with making sure that you don't
11 have double taxation. So, if the U.S. were
12 to do a global apportionment method and
13 somebody else were doing the arm's-length
14 standard or visa versa, you have the risk of
15 double taxation. I don't think that applies
16 here in this case. I don't think there's a
17 risk that the cal- -- the California is going
18 to affect that -- that the -- that South
19 Carolina is going to be taxing income that
20 California has already taxed. So, that's one
21 of the reasons why -- but there still is that
22 very, very broad authority that the IRS has
23 in terms of assessing in- -- an income
24 adjustment, including -- and I'm -- excuse
25 me. Dr. Cody referenced this notion that



1 somehow 2004's history -- we should forget
2 about 2004. We should forget about the
3 ownership percentages. This is where there's
4 this close linkage between Section 367(d)
5 transfers and there's an outbound transfer of
6 an intangible, and the provisions of 482
7 because 357(d) effectively says, you got to
8 look to 482, the transfer pricing analysis,
9 in order to appropriately price that transfer
10 of an intangible. Even if it occurred a long
11 time ago, it has implications ---

12 **OBJECTION:**

13 **MS. GEER:** Your Honor, I would just object with him
14 making these legal conclusions. I don't
15 think that's appropriate and I don't think
16 it's accurate.

17 **MR. ANTLEY:** I haven't heard a legal conclusion
18 yet. He's been talking about the 482 ---

19 **MS. GEER:** He said -- he said 367 applies here.

20 **MR. ANTLEY:** That's a -- that's part of the --
21 that's connected with the 482 regulations
22 which he's been qualified as an expert in.

23 **MS. GEER:** I, I do not think it is connected.

24 **MR. ANTLEY:** I think -- I think he just testified
25 to how it was connected. It's, it's actually



1 -- I, I ---

2 **MS. GEER:** I mean, Your ----

3 **MR. ANTLEY:** It's my understanding it's cited in
4 the regs.

5 **MS. GEER:** Your Honor, the Court can look at that
6 law, and I don't think we need an economist
7 up here telling us about a law that's not
8 within the 482 regs. I, I, I get that he can
9 speak to the 482 regs.

10 **THE COURT:** I, I tell you what, I -- I'll let him
11 to speak to the 4- -- 482 regs, and even the
12 one he referenced just now, but as far as the
13 connection between the two, I -- you'd have
14 to lay a foundation that that's part of ---

15 **MR. ANTLEY:** Okay.

16 **THE COURT:** --- transfer pricing analysis that they
17 would consider that, so. I sustain it at
18 this point.

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

20 **Q:** Dr. DeRamus, could you explain the connection
21 between the section you just referenced and
22 the 482 regulations?

23 **MS. GEER:** I -- sorry. I thought that your
24 sustaining my objection meant that he was not
25 entitled to talk about Internal Revenue Code



1 367(d), which is not part ---

2 **THE COURT:** Unless ---

3 **MS. GEER:** --- of the ---

4 **THE COURT:** Unless that's part of a transfer
5 pricing expert's analysis. And I, I would
6 like to hear him explain that.

7 **MS. GEER:** Okay.

8 **THE COURT:** So, it's -- if he will explain it
9 first. Then if that explanation is not good
10 enough, then I'll hear your expla- ---

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

12 **THE COURT:** --- your objection. Is that
13 satisfactory?

14 **OBJECTION:**

15 **MS. GEER:** For the record, I just want to place my
16 objection to him talking about it at all.

17 **THE COURT:** Okay.

18 **MS. GEER:** But I understand.

19 **THE COURT:** All right. Well, he's not going to be
20 talking about it until he explains it.

21 **MS. GEER:** Okay.

22 A: So, based on my experience, anytime that
23 there is a related party transfer of an
24 intangible asset, it raises transfer pricing
25 issues. And those issues can be -- can arise



1 from transfers even that occur before a co- -
2 - or during a closed year, before the audit
3 period or before the time period being
4 assessed. And one of the reasons my
5 understanding is because there is this linkage
6 between these so called 367(d) intangibles,
7 intangible that, that were -- that are
8 transferred outside the United States for no
9 compensation and there's -- there was a need
10 to establish a mechanism to figure out what
11 would be the appropriate compensation, the
12 arm's-length compensation for those
13 intangibles that were transferred out. So,
14 367(d) is simply the portion of the code that
15 references what you need to do when you have
16 an outbound transfer of an intangible for no
17 compensation. 482 is where you go to figure
18 out how that should be priced. So, there's
19 nothing in 367(d) that talks about how to
20 price it, other than to say treat it as an
21 installment sale based on my reading of that
22 -- of, of that language and based on the work
23 that I've done on that issue before, but ---

24 **THE COURT:** All right. Well, I think he's -- is
25 that sufficient?



A: But ultimately, what I'm still coming down to simply, it is a transfer of an intangible and the valuation of an intangible that occurred a long time ago, is it a proper subject of analysis for transfer pricing. And for that, my -- at least in my experience and my opinion, it's emphatically yes, it is.

THE COURT: All right. You've already testified now, but.

MS. GEER: I know, Your Honor. That's the prejudice that I was trying to avoid. I mean, 367(d) is an Internal Revenue Code Section that says in connection with any exchange described in Section 332, 351, 354, 356, or 361, a United States person who transfers property to a foreign corporation and then the rest. So, it, it, it does not --

THE COURT: I don't even know that all this foreign corporation stuff is pertinent for it right now for me to decide this case anyway, so.

MS. GEER: I just don't see how it's proper for an economist to be giving that. I understand that ---

THE COURT: Well, he's talking about ---



1 MS. GEER: --- he can look at the law.

2 THE COURT: He was talking about -- I, I will allow
3 him -- the testimony to go in solely on his
4 perspective as an economists and how he
5 carried -- he, he applies those regulations
6 to accomplish his view of transfer pricing.
7 So ---

8 MS. GEER: Those regulations being the 482
9 regulations?

10 THE COURT: No. The 37- ---

11 MR. ANTLEY: 367(d).

12 MS. GEER: But that's not a reg- ---

13 THE COURT: 367(d).

14 MS. GEER: --- regulation. It's a code section.

15 THE COURT: It's a code section?

16 MS. GEER: Your Honor, I understand your ruling,
17 but I, I, I would object. I would ask that
18 all of that testimony just -- that just
19 occurred be stricken because I don't think
20 it's proper. I don't think an expert
21 economist should be talking about an Internal
22 Revenue Code ruling -- sorry -- an Internal
23 Revenue Code statute that doesn't apply here.

24 THE COURT: Response?

25 MR. ANTLEY: I think he's explained how it -- how



1 it applied -- how it's relevant to his
2 transfer pricing analysis.

3 **THE COURT:** All right. I'm going to let it stand
4 under the caveat of what I just said earlier.
5 I'm still missing its relevancy, but go ahead
6 and proceed.

7 Q: I'm sorry. Did you finish your answer to my
8 -- to my last question?

9 A: I, I believe so. Yes.

10 Q: Okay. So, did you hear Dr. Cody describe his
11 review of the Ernst and Young transfer
12 pricing studies?

13 A: Yes. I did.

14 Q: In discussing his review of those studies,
15 did you hear Dr. Cody say it was important to
16 evaluate the economic substance of the
17 transactions and if you do so -- if you do,
18 talk -- do you agree with that position?

19 A: Yes. I do. And that's -- I, I agree
20 emphatically with that. And that's, that's
21 where one of the reasons why it's important
22 for me to look at the 2004, 2005 restructuring
23 and not simply ignore it. Is to look at the
24 substance of the activities being performed by
25 the parties, notwithstanding the form. In



1 particular, the -- one of the formal issues
2 we have is that West is the nominal owner of
3 both the trademarks and the business process
4 intangibles on December 1st when it wasn't
5 the owner of those intangibles on November
6 the 30th. It was not the owner of the
7 business process intangibles. So,
8 understanding the economic substance is really
9 important in trying to figure out whether
10 those 93 and a half percent, 6 and a half
11 percent shares are consistent with the arm's-
12 length standard. Looking at economic
13 substance is also important in thinking
14 through what are -- what would be the
15 appropriate arm's-length price in return for
16 these advertising services and back this
17 notion of the owner developer. So,
18 notwithstanding the fact that tran- -- where
19 the, the form of the transaction. It says
20 that West owns the trademarks. East was
21 responsible for the advertising before 2004,
22 and after 2004 it was paying twice the value,
23 the -- twice the cost of the advertising.
24 Actually, two and a half times if you add in
25 the trademark royalty. I effectively think



1 of that 2 percent advertising fee plus 5 per-
2 -- plus .5 percent trademark royalty and
3 combined is at 2 and a half percent royalty
4 for everything trademark related, that it only
5 costs the company 1 percent of, of sales to
6 actually -- to, to develop or maintain,
7 assuming that this is an advertising only
8 type intangible, the way I believe Mr. Cody
9 is really describing it. Again, I, I think
10 it's also why you need to look at the in- --
11 I agree with Mr. Cody ta- -- Dr. Cody. You
12 need to look at the industry and see what is
13 it that drives the value of a trade name.
14 And that is, like I said before, the, the
15 value of a trade name is by virtue of the
16 fact that you have -- it provides goodwill,
17 customers have good experiences going in
18 there. You have a sign. That sign is the
19 same name day in and day out so that a
20 customer knows to go back there and knows
21 that there are cars offered for sale there,
22 and, and can associate the car that they buy
23 with a corporate repu- -- reputation for
24 honesty and fair dealing, etcetera. There's
25 a lot of local activity associated with



1 generating that valuable trade name that
2 implicates the amount that the -- that arm's-
3 length amount that East should be paying to
4 CBS, both for the trademark and for the, the
5 advertising together. So, that's where the
6 economic substance really -- it's not simply
7 a throwaway line. It's a really important
8 issue to nail to, to nail to the ground
9 before -- really before you adopt the
10 approach the taxpayer has put forward.

11 Q: Did you hear Dr. Cody describe the services
12 cost method?

13 A: I did.

14 Q: Does that change your opinion?

15 A: No. And I think I, I -- so, I have generally
16 seen it applied as the an elective approach.
17 I had not previously seen that particular IRS
18 circular that he had -- that, that he -- that
19 he provided, and perhaps that helps to
20 clarify why I often heard of it as more of an
21 elective approach. I still think it's
22 appropriate in -- well, first of all, I think
23 if you can kind of writ large across the
24 company, there a lot of the functions that,
25 that, that vary a significant amount of



1 headquarters costs. A very large fraction of
2 those costs are comprised of these things
3 that are, I think typically included as low-
4 value services, including like the MIS, the
5 management information systems. That's where
6 a big amount of dollars is usually spent.
7 And other kinds of accounting and finance,
8 and other kinds of fees, fi- -- financial
9 management ty- -- type fees. So, I still
10 think it has applicability, particularly here
11 where we have kind of this -- a very unusual
12 fact pattern where you have the fact that if
13 you -- any dollar of profit that you
14 distribute out to CBS is going out in -- to
15 get to a non-arm's-length result. So, if you
16 can fix that through the -- by changing those
17 distributive shares or through some other
18 allocation income, then at the same time, at
19 the end of the day, I, I would be satisfied
20 that the result would be arm's-length, as
21 long as you don't have kind of the syphoning
22 off of income generated in the first instance
23 by East being syphoned off to West through
24 the magic of the -- of the ownership shares.

25 Q: Did anything Dr. Cody say in his analysis of



1 the trademark, Transaction 1, impact your
2 opinions in this case as to the reliability
3 of those studies?

4 A: No. I think simply saying that there are
5 agreements out there and that they are -- I,
6 I don't think that supports the, the
7 reasonableness of what the -- of what the --
8 what Ernst and Young did. There are very
9 specific requirements in the regs for
10 comparability when you apply this comparable,
11 uncontrolled transaction method. And though -
12 - you have to have a -- you have to have --
13 comp transactions have to be very closely
14 comparable, much more so than if you're doing
15 the pro- -- these profit ratio type analysis.
16 There you can have -- because there, you're
17 looking at profit ratios as opposed to
18 royalty rates. And royalty rates in
19 intellectual property transactions or even
20 franchise agreements for that matter, which
21 are not intellectual property transactions,
22 those will vary widely based on the profit
23 potential of the underlying property. Think
24 of on patent branded pharmaceutical product
25 and the, the royalty rates that are charged



1 for these products. These are upwards of 20
2 even 30 percent, 40 percent in some, some
3 instances when those products are being
4 licensed to third parties, as compared to the
5 royalty rate that you might get for Advil or
6 some consumer over-the-counter type, type
7 product. So, you have to have good
8 comparability and it's very hard to adjust a,
9 a number that -- particularly something that
10 is so I think off to the side from the
11 intellectual property that we're talking
12 about, which is trade ma- -- trademarks and
13 trade names according to the letter of the
14 intercompany agreement that we're trying to
15 price, according to the license agreement. I
16 said last time that the -- that E&Y is
17 effectively breathing in these broader
18 business process intangibles into the scope of
19 that contract. Dr. Cody seems to buy into
20 that, that approach, back to the notion of
21 the taxpayer is kind of stuck with the
22 contracts that it writes. My view, you
23 should stick with, with the four corners of
24 that contract. But even if you try and, and,
25 and breathe in some additional substance and



1 additional value into that license to get a,
2 a more, more of a reason to basis, this
3 notion of using Jiffy Lube and Biker's Dream
4 and to set the roy- -- set the, the royalty
5 rate and then for business process intangibles
6 that this company has developed based on the
7 specific nature of these intangibles that the
8 company has described, is -- there's this
9 complete disconnect, even if you're doing this
10 big haircut, you're only applying a 25 --
11 using these master franchise agreements from
12 Arby's, from fast food restaurants to, to cut
13 that down to 0.5 percent. There's some zero
14 analytical rigor in that exercise. It's just
15 -- it's a set of numbers, a set of -- set of
16 agreements, but does it not comport with the
17 requirements of that specific method under the
18 Section 482 regulations. And nor, nor -- and
19 also abstracts from the broader issue, the
20 substantive issue that I described earlier in
21 terms of what is it that West ever provided
22 them being the owner of the trademarks and
23 what is it that -- and why is that East would
24 ever pay, even a 0.5 percent royalty, which
25 is actually not that large. But when they're



1 paying 2 percent of, of advertising fee
2 already and they've been paying it since 2004
3 and they were doing the function and managing
4 that asset and had the lawyer -- all the
5 lawyers were defending the trademark prior to
6 that time period. That to me does not
7 comport with arm's-length interactions.

8 Q: Did anything Dr. Cody say in his analysis of
9 the business services and real estate
10 services, transactions 2 and 4, impact your
11 opinions in this case as to the reliability
12 of those studies?

13 A: Not really. It's when I, I -- as I said in
14 my direct that I -- I thought it was
15 reasonable to redo the comparables. The --
16 kind of the -- they, they were off I thought
17 by some amounts in certain years. But at the
18 end of the day, it didn't move that much
19 money. But I think the part -- the point
20 that Dr. Cody fundamentally misses is that
21 same approach -- this is still a business
22 service. And remember, that Transaction 2,
23 that accounts for the vast majority of the,
24 the expense, the headquarters expenses of CBS.
25 If you look at all the different line items



1 in the -- of the -- of cost items that -- and
2 the different departments that are included in
3 that, and that's the vast ma- -- majority of
4 the expenses of CBS excluding CAF. All you
5 have outstanding is basically adverti- -- the
6 advertising folks that I don't think are
7 included in there were the data analysis
8 group as well. I don't have -- I don't think
9 that those salaries are in there. But you've
10 got the vast bulk of that. If the CPM is the
11 right way to go, finding comparable companies,
12 developing a markup, a third-party markup is
13 the right way to go for that large fraction,
14 I'll call it 90 plus percent, maybe 95
15 percent of the headquarters function, I think
16 it should've be- -- Dr. Cody should've done a
17 deeper analysis to see whether that could be
18 reasonably applied for the entirety of it. I
19 concluded that it -- that, that it should be.
20 But that's where Dr. Cody and I disagree.

21 Q: Did anything Dr. Cody say in his analysis of
22 the advertisement services, Transaction 3,
23 impact your opinions in this case as to the
24 reliability of those studies?

25 A: No. And, and there I would -- my -- maybe



1 the vehemence of my disa- -- disagreement on
2 the Transaction 1 is el- -- that, that
3 vehemence kind of goes up an notch when you
4 go to Transaction 3, to the advertising
5 services. One is because now we're talking
6 not about a 0.5 percent royalty, but now
7 we're talking about a 2 percent administrative
8 services fee or royalty, however you want to
9 characterize it. It is a -- and it's -- it's
10 one thing to apply it in this notion of a
11 comparable controlled transaction analysis,
12 but the notion of a comparable uncontrolled
13 service price. In terms of the degree of
14 comparability that you need to have when
15 you're using comparables, I would rank it
16 first if like a CUSP kind of approach.
17 That's where the regs they talk about it is
18 if literally a company is providing accounting
19 services to one company and accounting
20 services to a related party and is charging
21 \$50 an hour or a \$100 an hour to the
22 unrelated party. Hey, that's great benchmark.
23 That's a CUSP for the related party
24 transaction. Here, he's just taking these --
25 again, back to these franchise agreements that



1 are based on these advertising fund
2 contributions that have nothing to do with
3 this particular industry. This is not a
4 franchised business. And there's not a
5 cooperative advertising fund being establish.
6 The degree of advertising required is very
7 different for this business versus another
8 business. So, for all those reasons, I
9 disagree with the -- with his conclusions on
10 that.

11 Q: Okay. During Dr. Cody's examination on
12 Transaction 5, the data analysis services, did
13 you hear that because -- the company's
14 analysis was based on comparables? Did you
15 hear that discussed?

16 A: I, I heard that assertion by counsel and the
17 -- and Dr. Cody's answer. It wasn't -- it
18 was -- made it sounds like, like he agreed
19 with that statement. I would say that it
20 completely mischaracterized what a comparable
21 is. The -- there is -- the, the company is
22 free to -- or the -- or Ernst and Young is
23 free to use an unspecified method, which is
24 what they used, but don't call it a
25 comparables analysis if you're not using



1 comparable transactions. So, you can use
2 comparable transactions, i.e., trans like
3 third-party licenses agree- -- licenses.
4 You can even attempt to use franchise
5 agreements. I don't think they're comparable,
6 but those are at least third-party agreements
7 in Transaction 1. You can use comparable
8 companies in applying the comparable profits
9 method. So, that's what they did for two --
10 what the company did or E&Y did for
11 transactions 2 and 4. But this analysis that
12 the company did was a purely an internal
13 calculation. I've seen no evidence that Dr.
14 Cody has reviewed in any detail or every --
15 even obtained the underlying calculations
16 themselves. All I have seen to date is the
17 appendix, which is a single table in the E&Y
18 report that had calculations performed by the
19 company. Dr. Cody suggested that somehow the
20 60 -- the 40/60 percent allocation of those
21 total costs or the remaining costs after the
22 subtraction of a certain amount, \$299 per
23 vehicle, he -- Dr. Cody represented that that
24 was E&Y's allocation. Reading the four
25 corners of the documentation, E&Y says it's



1 CarMax's allocation. So, CarMax is the one
2 that said, yeah, 40/60 I think -- we think is
3 what should be allocate to systems versus
4 strategy. That's not an independent analysis.
5 I have been in other situations where a
6 taxpayer has performed a similar kind of data
7 driven exercise to say, it's an unspecified
8 method. We have access to some really cool
9 data. Here it is. And so, in discovery, I
10 get that data and I'm able to analyze it in
11 order to test the reasonableness of the
12 calculations and the reliability of it.
13 Frankly, in the instance I'm thinking of now,
14 those calculations were completely wrong.
15 That if you did the calculations correctly,
16 you actually come up with a very different
17 answer then what the, the company did. I have
18 no doubt the company has documents that
19 describe or even summarize analyses that they
20 have done in this AB type setting that Dr.
21 Cody describes. That's very different than
22 saying, ascribing the -- any dollar value to
23 that particular function, particularly to the
24 extent that the function depends on the
25 activities of the stores themselves. You're



1 just more -- that you're going from economic
2 analysis to simply assertion. And here, not
3 just assertion by E&Y or assertion by Dr.
4 Cody, but it's assertion by the company
5 itself. So, that's where I, I think there's
6 literally zero probative value with those
7 numbers because there's no way to test any of
8 their reliability. And with regard to the
9 regs, the regs -- Dr. Cody did recognize the
10 regs were pretty explicit about this because
11 when you have -- when you're relying on a
12 method that is entirely dependent on company
13 internal data, that's a-- you, you have to
14 have a lot of evidence that these are
15 reliable data. And this is why generally in
16 deciding the best method, you will generally
17 tend to go to data that, that are less
18 reliant on internal data, things you can
19 actually look at, test, observe, different
20 parties can have different opinions on, but
21 you actually observe what those differences
22 are and how they impact the numbers. That's
23 what you do when you apply the comparable
24 profits method, when you use public companies.
25 And even -- is what you do when, when we have



1 transactions, when they -- like their method
2 one. When they're using a comparable control
3 transaction for -- I'm sorry -- for
4 Transaction 1, for the trademark. There's no
5 way to do any of that testing with
6 Transaction 5. It's just a set of numbers.

7 Q: Did anything Dr. Cody say in his analysis of
8 the data analysis services, Transaction 5,
9 impact your opinions in this case as to the
10 reliability of those studies?

11 A: No. Again, I, I saw no other support for
12 them. I thought the fact that his, his --
13 you know, the, the fact that he doesn't know
14 the underlying costs of those services, I
15 think is a -- kind of a, a big gap in the --
16 in the ability of someone to kind of render
17 an -- a reliable opinion about that -- about
18 the appropriate arm's-length charge for that
19 particular service. And it's one of the
20 things I've wrestled with here is the
21 incompleteness of the data. So, I think
22 normally, you would have access to all of the
23 different costs broken down into all the
24 different transactions at issue to then be
25 able to fully -- to estimate that. In my



1 earlier testimony, I had some initial
2 estimates that I arrived at in a -- at a very
3 high level, the magnitude of those costs.
4 Based on that analysis, it looks like this is
5 a department that maybe or a function that
6 maybe consumed something in the order of
7 maybe 10 million dollars maximum per year in
8 terms of salary costs. So, just to ascribe
9 270 or 200 and some odd million dollars of
10 profit to a department that, that has 10
11 million dollars of, of salaries, seems to be
12 of a -- a number that is simply not credible
13 on its face.

14 Q: According to your experience, would the 482
15 regulations prevent the IRS from evaluating
16 the headquarters functions by combining what
17 E&Y's -- E&Y calls transactions 2, 3, 4, and
18 5?

19 A: No. I think that's -- so, that's actually
20 how they would probably -- the -- or it's how
21 I would think of doing it in the first
22 instance is basically looking at the
23 headquarters functions as a whole and
24 determining an appropriate markup, if any, on
25 the -- on that function as a whole.



1 Particularly, if there's no the available cost
2 detail for each of the separate functions the
3 way -- if you want to slice it and dice it,
4 you can. But still at the end of the day,
5 it's one transaction because there is one --
6 the company -- the company has structured as
7 the management services agreement. So, you're
8 pricing the management services agreement.
9 You don't have a separate HR agreement, a
10 separate man- -- a separate data sciences
11 agreement. It's just one agreement. So, I
12 would think generally that the -- the
13 approach would be to price it as a single --
14 as a single group, which is why I also think
15 that if you're going to apply any kind of
16 markup, you'd use the, the comparable profits
17 method for that function as a whole.

18 Q: Did you hear the way in which Dr. Cody
19 describe his approach to analyzing the
20 management fees in aggregate?

21 A: Yes. I did.

22 Q: Does that impact your opinions?

23 A: No. It doesn't change my opinion that the
24 way I've done it is a much more reliable way
25 of doing it, i.e., applying the comparable



1 profits method if, if we're ignoring the
2 ownership percentage issues. The use in this
3 -- and Dr. Cody seems to dig in on the notion
4 of using the analogy of the franchise
5 agreement or the franchise arrangement. This
6 is not a franchise system. Franchises --
7 because the economics of franchises are very
8 different than the operation of a company
9 like CarMax. The position -- the relative
10 position of East relative to the -- to CBS is
11 not that of a individual franchisee facing a
12 large company franchiser. Like if I were to
13 want to go out and open up a McDonald's
14 franchise tomorrow, I'm -- the economic
15 position I'm in is very different than --
16 what I bring to the table is very different
17 than what the McDonald's company has to offer
18 and therefore, there's a certain bargain that
19 I'm willing to strike and a certain amount of
20 profits I'm willing to give up, system
21 profits that I may generate at my store to
22 the -- to the -- to the franchisor. It has
23 nothing to do with how the -- an arm's-length
24 division of profits would go between East and
25 the CBS headquarters function. So, even



1 aside from kind of the big conceptual issue
2 and where I think could -- if he's applied --
3 if he's going to apply an aggregate approach,
4 he should have done a comparable profits
5 method. What he's effectively doing is -- I
6 think ultimately, an undefined method. I've
7 never seen using franchise agreements in that
8 -- as a way of benchmarking what the return
9 should be. It's not an application of the
10 CPM. It's just his assertion that these are
11 reasonable agreements. So, it's almost like
12 using a CUT type analysis for the -- for the
13 transaction as a whole. But just looking at
14 the results, just I -- I would urge you to
15 pause for two seconds and, and think about
16 what it implies, saying that -- said that,
17 that 75 percent of the profits should accrue
18 to the headquarters. The fi- -- the 5
19 percent -- there's a 5 percent aggregate
20 franchise fee including the -- I think -- I
21 think it included the advertising fee. So,
22 third parties do that in fran- -- franchisees
23 are willing to enter into these deals all the
24 time with franchisers. So, 5 percent of the
25 7 percent total operating margin should go



1 to, to CBS. So, 70 percent -- over 70
2 percent of the profits should be going to
3 the, the head -- the headquarters function
4 simply because of what? Because of the data
5 management people, because of the executives
6 who are making some of the final decision.
7 That's the part where I think there's a
8 fundamental way in which the result itself --
9 I think should, should contradict my own
10 economic intuition as to what would be a
11 reasonable compensation for the headquarters
12 function. It's also -- I think about how it
13 would apply in the, the -- he's establishing
14 a principle, right? If this applies to
15 CarMax, it should apply equally to every
16 other retailer. Every other -- certainly
17 every other car dealer out there. Every car
18 dealer in Auto Nation is going to have its
19 own system. Well, what we know, what I know
20 is that based on my analysis on the car
21 dealer returns, their returns are a little
22 bit lower than CarMax's, principally because
23 they're selling a different product mix.
24 Newer cars have lower margins, etcetera. But
25 that would mean, not 70 percent, but for some



1 of these dealers, 100 percent of their
2 profits or it should be the most of to
3 headquarters function using Dr. Cody's
4 approach. That to me, I think on its face is
5 a ludicrous answer.

6 Q: Did you hear Dr. Cody's testimony regarding
7 economies of scale?

8 A: Yes. I did.

9 Q: All right. Does that impact your opinions?

10 A: No. I, I disagree with him on that. I mean,
11 there are -- I, I agree with him that on a --
12 that there's a different nature of the
13 purchasing function here, the inventory
14 purchasing function here than with other types
15 of retailers where -- kind of a large
16 national retailer might be able to negotiate
17 a lower per unit price with its supplier
18 because it's got massive amounts of national
19 or even international sales. Here, we have a
20 company -- the company benefits enormously
21 from economies of scale. It benefits -- it
22 is able to spread its costs, its central
23 costs over a greater volume of units. It has
24 large retail locations. The retail locations
25 themselves are relatively large in order to



1 be able to sell very large volume and large
2 variety of vehicles. It also means that it
3 is able to officially employ both the sales
4 staff on the floor because it's -- that sales
5 person is able to make a sale to a customer
6 across a broader range of vehicles. Not like
7 one sales person to five vehicles. There are
8 thousands -- there's -- I don't know how, how
9 many there are. I think there's several
10 hundred vehicles on any given lot. The, the
11 company benefits from economies of scale and
12 what I call scope because it has mechanics
13 and the appraisal lane. When somebody drives
14 in and says, I want to sell my car in the
15 appraisal lane, those same mechanics can be
16 employed in fixing and doing the
17 reconditioning work. They can also be
18 involved in doing the repair work. So, their
19 economies -- it's an enormous economies of
20 scale in that overall operation. And there's
21 also the economies of scale that it gets from
22 the -- and what call informational economies
23 of scale. And that's where if there is any
24 super secret value or extraordinary value in
25 the data analytical function, it's because it



1 is ga- -- gathering so many different data
2 points from its wholesale and its retail
3 sales. And those are valuable pieces of
4 information that can inform the company as to
5 how to make its pricing decisions. But those
6 are ultimately scale economies.

7 Q: Did you hear anything in Dr. Cody's testimony
8 regarding the financing business that would
9 impact your opinions?

10 A: No. I mean, ultimately, at the end of the
11 day the question is, I -- I do want to make
12 it clear that I -- my, my -- the fault I
13 don't -- when I say Ernst and Young failed to
14 analyze the financing function within -- I'm
15 just looking within the four corners of the
16 financing -- of the -- of the transfer
17 pricing study, it's -- if it's outside the
18 scope of the analysis, then that -- then the
19 fault lies with the taxpayer and not with the
20 preparer of the study. Not that -- that
21 notwithstanding, it's clear that Ernst and
22 Young was involved in the restructuring and
23 it did the analysis of the 2004 report. And
24 there, the failure to account for the value
25 of the finance function I think was -- is as



1 much on Ernst and Young as it is on the
2 company. But nonetheless, the -- at the end
3 of the day, the taxpayer has offered nothing
4 to establish a one arm's-length price for the
5 finance function that I know is -- there's a
6 substantial amount of value created at the
7 local level because of the origination of
8 that contract. And it's inconsistent with
9 also arm's-length dealings that we observe
10 when third parties provide the -- that
11 financing service. When, when they're willing
12 to pay for it. So, there's just nothing
13 left. So, which that to me tells me even --
14 everything we've seen, the, the absence of
15 the financing documentation is one where it,
16 in my view, leads inexorably to the
17 conclusion that a -- that a combined entity
18 apportionment method is the most -- going to
19 get you the most reliable results because we
20 don't have that factual basis to establish
21 what that transfer price would be for the
22 finance business.

23 Q: Did you hear Dr. Cody describe his experience
24 at KPMG where he testified that he would
25 generally refer to non-economists in the



1 valuation practice when there was need to
2 value intangible assets for transfer pricing
3 purposes?

4 A: Yes. I did hear that and I was frankly
5 somewhat surprised at that. I, I worked at
6 KPMG for five years between 1993 and 1998. I
7 worked extensively on intangible asset
8 valuations at that time period. If the
9 number of studies that I cited earlier were -
10 - was less than Dr. Cody's, it was because a
11 lot of those cases were fairly large
12 engagements involving complex, intangible
13 assets. And it wasn't just me. I, I wasn't
14 -- I wasn't the only person in the transfer
15 pricing group doing these kinds of analyses.
16 I was working with other colleagues who had a
17 similar background to me, other PhD
18 economists, other people without PhDs.
19 Actually, at that time, I was still in the
20 process of completing my PhD. And that was
21 where the valuation of intangibles would occur
22 in a transfer pricing context. Now, since
23 that time period, I have gone on and
24 testified on valuation studies of companies
25 more broadly, outside of the valuation context



1 and intangibles, outside of the transfer
2 pricing context. But in my experience at
3 that time, it was very much of a core
4 transfer pricing function because companies
5 engage in intercompany transactions involving
6 intangible assets, including moving those
7 assets around, including something called cost
8 sharing and buy-in arrangements, which were
9 started to get big around this time period,
10 where companies would agree to split the
11 costs associated with develop -- with R&E
12 Development and so, a company might have to
13 make a payment for the value of an intangible
14 in order to buy in to the technology that was
15 previously developed by a different related
16 party. That analysis fa- -- fell squarely
17 into the transfer pricing economist realm.
18 It may -- things may have changed after I
19 left, but that at least during my, my time
20 period, that was the case. But it's also
21 been consistent with my experience since then,
22 testifying in litigation matters on valuation
23 of intangibles and ta- -- and transfer
24 pricing cases. Not only have I testified in
25 those matters, but the opposing experts have



1 consistently been PhD economists, not
2 individuals coming out of an accounting
3 background or people with a valuation
4 certification. Primarily because as I
5 mentioned earlier, these are ultimately very
6 hard things to, to quantify reliably. And
7 they, they implicate deeply important economic
8 issues, and they require a level of analysis
9 you typically don't need when you're valuing
10 things like a, a house for, for a home sale.

11 Q: Did you hear Dr. Cody state that once you
12 have identified a controlled par- -- or who a
13 controlled party is, the ownership and
14 ownership percentages are irrelevant for
15 transfer pricing?

16 A: I did hear him say that.

17 Q: Do you agree with that?

18 A: No. I don't. Particularly, when those
19 ownership percentages are derived based on
20 transfer pricing principles, I think that is
21 fundamentally an important, a core transfer
22 pricing issue. We, we observed that in the
23 2004 ---

24 **OBJECTION:**

25 **MS. GEER:** Your Honor, just objection to keep my



1 running objection on this topic.

2 **THE COURT:** Oh, I forgot about that. Thank you
3 for reminding me.

4 A: So, even in the 2004, 2005 study, it is -- it
5 is a transfer pricing study. It cites the
6 regulations. It cites the 482 regulations.
7 It goes through a best method's analysis.
8 So, I think the -- when -- whenever you are
9 looking at the intercompany transactions and
10 the -- how those intercompany transactions are
11 used to change the results, that is a
12 appropriately in the scope of transfer pricing
13 analysis, even if it pertains to an asset
14 transfer that occurs before the years at
15 issue.

16 Q: Do the 482 regulations ever require one to
17 consider a co- -- a company's realistic
18 available alternatives in setting transfer
19 prices consistent with the arm's-length
20 standard?

21 A: Yes. This notion of a realistic available
22 alternative is something that comes up in I
23 think just about every subsection of the 482
24 regulations. And basically, it's the common
25 sense notion that if I'm doing something that



1 is giving me value, that's giving me --
2 earning me profits or that's giving -- that
3 is causing me a certain level of cost, I
4 would not voluntarily give up those profits
5 or that stream of profits to someone else. I
6 would not enter into an alternative
7 arrangement that would -- that I -- where I
8 would be worse off as a result. So, there
9 would have to be some meaningful exchange of
10 value, i.e., if I have an intangible, I'm not
11 going to give it somebody else for free. I
12 should be -- and if it's valuable, I should
13 be paid for it. But it applies to every of
14 the -- all the different transactions. And
15 here, I think it applies very much to the
16 issue of whether the, the ownership interest,
17 the 93 and a half percent ownership interest
18 is consistent with that reasonable, available
19 economic alternatives that East face on
20 November 30th, 2004, the day before the
21 transfer. So, based on the available
22 economic or real alternatives principle, East
23 would never have simply provided that, that
24 asset for no -- that -- if it were valuable,
25 you don't just gift it away, notwithstanding



1 Dr. Cody's assertion it wasn't -- that the
2 value didn't disappear. Those transfer --
3 for transfer pricing purposes, we have to
4 think of these as being between related
5 parties, as if these were un- -- well, as if
6 these were unrelated parties. These -- any
7 U.S. company, whenever there's a transfer of
8 assets or any kind of tangible transaction,
9 tangible or intangible transaction, if there's
10 a payment of profit, it's all still within
11 the company -- in the company family. The
12 cor- -- the corporate -- the corporation
13 still owns the profits that are being
14 reallocated. But those have important tax
15 implications and they can distort the income
16 in a particular tax jurisdiction. So, first
17 of all, that transaction is inconsistent with
18 the companies available economica- --
19 economical alternatives at the time, which was
20 simply to retain those intangibles, rather
21 than to not only give them away, but then
22 obligate itself to pay \$400 per unit for the
23 -- plus, other expenses for that -- for that
24 function. It's also inconsistent with the
25 available economi- -- economic alternatives



1 for the company, for East at the time, to --
2 that's performing the advertising where it's
3 costing it 1 percent of sales to turn around
4 and grant the ability of a different -- shift
5 that -- the responsibility for that function
6 to different related party and return for
7 incurring the obligation of two times those
8 expenses or two and a half times if you want
9 to throw in the trademark expenses. That's
10 inconsistent with the company's -- with the
11 company's available economic alternatives,
12 which tells me that the transfer pricing
13 around that function is way off. If it's 2
14 percent, if Dr. Cody lively accepts as being
15 reasonable, I think is a complete --
16 inconsistent with those available eco- --
17 economic alternatives.

18 Q: Assume that the Court concludes that Dr. Cody
19 is right and that you're wrong and that the
20 Court must simply take as given the ownership
21 shares of East and West in evaluating the
22 Department's propose use of combined reporting
23 for the years at issue, would it be
24 consistent with the arm's-length standard for
25 East to bear 75 percent of the management



1 fees paid to CBS if it only gets a 6.5
2 percent distri- -- distributive share of the
3 income of CBS?

4 A: No. And there's an entire section of the
5 regs called the dash 7 sections of the -- of
6 the 482 regs that talk to this type of
7 situation. It typically comes up in
8 something called a qualified cost sharing
9 arrangement. I think I may have reference
10 these previously. So, this is where a
11 company -- a company may establish an entity
12 that's going to do research and development
13 and different related parties are going to
14 contribute to the costs associated with that
15 function. It's a function that needs to be
16 performed. It's an R&D function. It's
17 likely to have a lot of value for that
18 company. And then the question comes up, how
19 should those costs be apportioned or how
20 should they be allocated from a 482
21 perspective between related Party A and
22 related Party B? And the regs talk about it
23 based on the anticipated benefit share. So,
24 if you are going to get 93.5 percent of the
25 benefits of that cost sharing arrangement,



1 then the entity that's getting that 93.5
2 percent benefit should be bearing 93.5 percent
3 of the costs. So, you don't -- this not --
4 because these are not trans- -- these are not
5 third-party transactions. These are related
6 party transactions and related parties can set
7 ownership percentages and move things around
8 however they want regardless of logic and
9 regardless of anything. That's why we have
10 to adopt the fiction as if these are parties
11 operating at arm's-length. And that is how
12 one would expect companies to operate at
13 arm's-length. If they had the need for some
14 significant costs, the headquarters level,
15 they provided all these assertedly wonderful
16 benefits in terms of data analysis and
17 strategy and everything else, then the parties
18 would agree to be -- if the -- if the shares
19 -- if you can't change the shares, if it's
20 93.5 and 6.5, then the cost going in should
21 be split in the same proportion by the same
22 entities, i.e., that would drastically reduce
23 the per vehicle charge, arm's-length charge by
24 the charge -- the paid by East to CBS. It
25 wouldn't be the same dollar per vehicle for



1 East versus West.

2 Q: Continuing with this hypothetical that the
3 Court concludes that Dr. Cody is right, that
4 you are wrong, and that the Court must simply
5 take as given the ownership shares of East
6 and West in evaluating the Department's
7 proposed use of combined reporting for the
8 years at issue, does that change your opinion
9 as to whether combined entity apportionment
10 reasonably approximates an arm's-length
11 result?

12 A: No. I think the -- maybe the best way to
13 think about this is with an analogy and
14 hopefully an analogy that you might enjoy as
15 we are the end of a long week. So, this
16 Memorial Day weekend, there are sometimes
17 economists like to go on a -- particular
18 transfer pricing economists like to go on a
19 long trip down the transfer pricing road.
20 Sometimes, that transfer pricing road is a
21 short trip. Sometimes, it's a longer trip.
22 So for example, my experience, when it's a
23 headquarters function, it's a pretty short
24 trip because you don't need to do a whole lot
25 of work in order to get to the arm's-length



1 result because it's a CPM or a service costs
2 method that gets you to the arm's-length
3 result. Here, based on the facts we have,
4 there is a pretty long winding road we can go
5 down and that we have gone down in looking
6 through the transfer pricing po- -- the
7 policies that the company has put in place,
8 the studies that it's used in 2012 and 2015,
9 the reasons why I think that those are
10 unreliable and how they are alternative ways
11 of, of getting to those numbers. But, so if
12 you stick with -- the way I think about it in
13 terms of thinking of it as a transfer pricing
14 trip is you're in a car and you're looking at
15 your fuel tank and your fuel tank has a gauge
16 where that, that little needle swings from
17 full -- you start off full and you're going
18 to empty. Imagine full is separate entity
19 reporting as the -- as the taxpayer has done
20 it, and empty is combined entity reporting.
21 And I have taken my interpretive -- my charge
22 is how much is the -- if I were to do the
23 transfer pricing correctly, how much is the -
24 - is that needle on the fuel gauge dropping
25 down towards empty? How close is it to empty



1 versus being full? The closer it is to full,
2 the more you would need separate entity
3 reporting or maybe slight tweaks to separate
4 entity reporting. The more you are to empty,
5 is the more that a combined entity reporting
6 method will provide a more reliable result,
7 the one more consistent with the arm's-length
8 standard. So, I've gone -- taken a long,
9 kind of tortuous, curvy, somewhat nauseating
10 at times, journey to get to my conclusion
11 that the num- -- that that fuel gauge goes
12 down to zero. It gets halfway to zero,
13 halfway to empty through the transfer pricing
14 reports that the company has put together,
15 the Ernst and Young reports, but then it's in
16 -- it's half full per -- as -- the way Ms.
17 Yost described it. Whether it's half or 50 -
18 - 40 percent is seen as immaterial. But it -
19 - it's -- but I'll call it half full when you
20 get -- before you address the financing
21 issue. The moment you look at the financing
22 issue, then it -- in my view, it immediately
23 drops to zero because there's nothing to
24 support the, the arm's-length nature of those
25 financing transactions. I think there's many



1 ways to get to zero. So, in my view, the --
2 in terms of the combined entity being the
3 right approach. One of the reasons why I had
4 such a visceral reaction when I saw that
5 2004, 2005 study is that you can almost set
6 aside the transfer pricing study because any
7 amount of profit being allocated to CBS in
8 the first instance gets you, in my view, to
9 this non-arm's-length result based on these --
10 this 93.5 versus 6.5 percent share. So, from
11 the get-go, I can -- I -- all of a sudden
12 that, that fuel gauge, if I take that
13 approach, drops to zero immediately. If I go
14 down the, the path of see if I can reverse
15 the order of my analysis and started with
16 finance, before I got out of the driveway,
17 that, that, that needle on the -- on the fuel
18 tank would drop down to halfway because I
19 don't see any documentation of the financing
20 function. So, if that first off ramp is
21 foreclosed, and for some reason because the
22 93 and a half percent and the 6 and a half
23 are fixed in stone, that I as an economist
24 can't go down that road as part of my
25 journey, then fine. I can still go down that



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1 road in terms of the distributive shares
2 issue that we just talked about earlier in
3 terms of appropriate cost sharing arrangement
4 under, under a cost sharing arrangement
5 analogy, the dash 7 rules. And we still get
6 to a -- this is still a non-arm's-length
7 result, but you would fix it not through
8 changing the distributive shares, but you'd
9 change it through the allocations that are
10 done to East and West via the per unit
11 charges to kind of change the disproportions
12 so it's 93.5 percent the cost borne by, by
13 East. Or you can go all the way down the,
14 the rest of the route and through the
15 analysis that we described earlier, the 60
16 million dollars or profit for the management
17 company that's left over in my analysis plus
18 for the sake of argument, call it 20 million
19 dollars for the -- for CAF. So, that means
20 you're not at zero. That means the needle on
21 the -- so, you're not going to -- it's, it's
22 not all the way down to the empty tank level
23 of combined entity reporting because you have
24 a little bit of additional gas in the tank
25 there that's going disproportionately to CBS,



1 if you don't address the -- to -- I'm sorry -
2 - to West because of the 93.5 percent. But
3 you're still in my view in terms of what is
4 the reasonable approximately, I think you're
5 pretty close to empty.

6 Q: Is there anything that you heard from the
7 witnesses that affect your opinions or would
8 you like to -- or that you would like to
9 respond to?

10 A: No. I think we've covered it. Thank you.

11 Q: Are your opinions to a reasonable degree of
12 certainty in the fields of transfer pricing,
13 economic principles and the valuation of
14 intangibles?

15 A: I'm sorry. Could you repeat that one more
16 time?

17 Q: Of course. Are your opinions to a reasonable
18 degree of certainty in the fields of transfer
19 pricing, economic principles and the valuation
20 of intangibles?

21 A: Yes.

22 **MR. ANTLEY:** No further questions, Your Honor.

23 **MS. GEER:** Could we have a break?

24 **THE COURT:** You may.

25 **MS. GEER:** Your Honor, could we have 15 minutes



1 please?

2 **THE COURT:** Well, how long -- how long is your
3 cross?

4 **MS. GEER:** Well, I'm -- I'm trying to cross some
5 things out, but it's, it's way shorter than
6 that was. I'm sure. I would guess an hour
7 maybe and maybe not. I might be able to
8 cross more off than that.

9 **THE COURT:** Let's just shoot for 10.

10 **MS. GEER:** I'll do my best.

11 **THE COURT:** All right.

12 (Off the record from 3:37 p.m. to 3:52 p.m.)

13 **DR. DeRAMUS - CROSS-REBUTTAL BY MS. GEER:**

14 Q: Dr. DeRamus.

15 A: Yes.

16 Q: So, you stated a number of times throughout
17 this trial that CarMax didn't provide you
18 with various information you wanted such just
19 financial materials, information about CAF and
20 other Transaction 5 documents. Now, you
21 can't ask for documents yourself directly,
22 correct?

23 A: I'm sorry. I can't asked directly?

24 Q: From CarMax.

25 A: That's correct. Yes.



1 Q: Okay. So, you have to get it through your
2 counsel, correct?

3 A: That's correct.

4 Q: Okay. And when -- you were retained at some
5 point before April 25th of 2022, correct?
6 That was the expert disclosure.

7 A: Okay. Yes. Then -- then yes.

8 Q: Does that sound right?

9 A: Yes.

10 Q: And are you aware that the Department has
11 produced your invoices in this case in lieu
12 of providing 30(b)(6) testimony about your
13 compensation?

14 A: I, I -- it sounded like there, there was some
15 pre- -- production of my invoices, but I
16 didn't know why that was produced or ---

17 Q: Okay.

18 A: --- what it was in lieu of.

19 Q: All right. So, does it sound correct to you
20 that in August of 2022 you would have
21 performed zero hours on this case?

22 A: If not zero, it would have been fairly
23 limited. Yes.

24 Q: And in September of 2022, .9 hours.

25 A: That sounds about right.



1 Q: Okay. And in October of 2022, zero hours.

2 A: That sounds right.

3 Q: And January of 2023, .3 hours.

4 A: That sounds about right.

5 Q: And in February of 2023, 3.2 hours.

6 A: If that's what the records say, yes. I
7 thought I started in February, but maybe I
8 started in -- more in March in earnest.

9 Q: Okay.

10 A: Because towards the end of February, I
11 started in earnest.

12 Q: And, and does it sound correct that the
13 August 2022 would be your first bill?

14 A: That sounds right.

15 Q: Okay.

16 A: I mean, it's -- yeah. I, I hadn't even
17 remembered there was a bill for work back
18 then, but that sound about right.

19 Q: All right. So, the grand total of your time
20 spent on this case through February of 2023
21 was 4.4 hours, does that sound right?

22 A: That sounds approximate. Yeah. If that's --
23 if that's what the records say, that would be
24 correct. I should say that also during that
25 time period, I may have instructed my staff



1 to be working on some of the analyses. So,
2 there may be some records for staff time ---

3 Q: Okay.

4 A: --- during ---

5 Q: Yeah. I'm just asking about your time at
6 this point.

7 A: Okay.

8 Q: All right. And so, based on your bills
9 provided to -- by the Department through
10 January 31st of 2023, it would have been 1.2
11 hours, correct?

12 A: If -- I was keeping track of the numbers you
13 said --

14 Q: The math. Yes.

15 A: --- but that sound about right.

16 Q: Okay. All right. And so, just to do one
17 more math exercise and then I will stop.
18 Through February of 2023, you had spent 4.4
19 hours, is that correct?

20 A: Again, if that what's the invoice says.

21 Q: Okay. And are you aware that the discovery
22 deadline in this case was March 17th of 2023?

23 A: That sounds familiar. Yes.

24 Q: Okay. And I'm assuming based on your time,
25 that the -- sometime in February 2023 or



1 March 2023 was when you realized that you
2 didn't have any information that you needed?

3 A: Well, it would have been as I be -- I can't
4 remember when we started talking, like those
5 hours that were done before that, how much of
6 those were spent discussing it with the
7 staff. But I did ask -- I had a senior staff
8 person assisting me on this, who I asked to
9 review the record. So, those may have been
10 discussions as part of that in terms of what
11 do we like -- basic questions in terms of
12 what kind of information do we have
13 available. I just don't recall the full
14 extent of those conversations.

15 Q: So ---

16 A: I know we were focused -- just because of the
17 timing of it, this was shortly after the
18 Tractor Supply trial that I was asking my
19 staff to work on things like the comparables
20 analysis to understand the transactions enough
21 to begin working on that, which is the more
22 time consuming part of the -- of the -- of
23 the work.

24 Q: Okay.

25 A: But I -- yeah. Again, I don't recall the



1 specifics.

2 Q: So, for reference, the Tractor Supply trail
3 was the end of January, is that correct?

4 A: That's correct.

5 Q: Okay. And so, when did you ask the
6 Department for records regarding, let's just
7 take an example, the CAF materials?

8 A: Well, I think I was surprised that there
9 weren't greater financial records produced in
10 the first round and I think that's where when
11 my discov- -- when my deposition date, I, I
12 had an earlier deposition date scheduled, and
13 that's when I reached out to counsel to
14 suggest that if there -- it was my
15 understanding that was ongoing production,
16 that there were delays in getting that
17 information produced. And I suggested that
18 perhaps it would be most efficient for
19 CarMax's time if I were -- if the deposition
20 was to be postponed until after that
21 information was produced so that it wouldn't
22 have this need for another deposition because
23 ultimately, I would want to review that
24 information. So, basically, I, I think
25 that's one of the reasons why my deposition



1 was pushed back until the la- -- later part
2 of March, was in anticipation of the
3 financial information becoming available to
4 me. Which then the first time I received
5 that information was as part of the back-up
6 for Dr. Cody's file.

7 Q: And do you know whether or not CAF
8 information specific to CAF was requested of
9 CarMax?

10 A: I don't recall. I should say, I do recall
11 reading Ms. -- I'm sorry. Because it was
12 about specific to CAF.

13 Q: Yes.

14 A: Because I do recall reading Ms. Yost's
15 deposition testimony prior to my test -- to
16 my deposition where there were -- there was
17 discussion about CAF in there and there was
18 some questions related to the CAF business,
19 but I don't know anything before beyond those
20 questions.

21 Q: I'm not asking you about that. I'm just
22 asking you about requesting documents related
23 to CAF.

24 A: No.

25 Q: And you mentioned several times that you



1 received financial information from Dr. Cody's
2 file that you used as part of your analysis,
3 is that correct?

4 A: That's correct.

5 Q: And I'll represent to you that CarMax
6 produced that information to the part -- to
7 the Department on March 14th, 2023, so I
8 assumed that you received it sometime after
9 that? Does that sound right?

10 A: That sounds right. Yes.

11 Q: Okay. And CarMax customers that are
12 financing cars that they purchase at CarMax,
13 you're aware that they can also finance some
14 them through third-party banks?

15 A: Yes.

16 Q: And based on your experience, would you
17 expect that CarMax also has contracts with
18 those third-party banks?

19 A: Yes.

20 Q: And you don't -- you haven't seen any of
21 those contracts or know what those contracts
22 say, have you?

23 A: No. I've seen some references to them in the
24 documentation. I thought there was a
25 reference to -- I know there -- there's a



1 reference somewhere to the, the way in which
2 the contracts might -- certain contracts might
3 be sold at discount or there may be
4 commissions paid for the -- for, for some of
5 those, those contracts. But I think it
6 depends on if it's a prime versus a subprime
7 ---

8 Q: Okay.

9 A: --- loan.

10 Q: The question is just have you seen the
11 contracts?

12 A: No. The only information I've seen is what's
13 in the documentation.

14 Q: Okay. All right. So, I want to make sure I
15 understood your testimony on the arm's-length
16 management fee payment. Slide 78 of your
17 demonstrative had said 528. Am I
18 understanding correctly that you're not saying
19 it's 712 per vehicle sold?

20 A: Well, in terms of ---

21 Q: Can you first answer yes or no, and then
22 explain?

23 A: Well, unfortunately, it's kind of a sort of.
24 So, it's -- that's kind of a sort of answer.

25 Q: Okay.



1 A: So, it is -- in the first instance, I think
2 the 528 represents the allocation of CBS's
3 cost, that actual cost that CBS itself as an
4 entity incurs in performing the, the
5 headquarters function independently of the CAF
6 function. And it's an allocation of the --
7 those costs to the stores with a markup on a
8 large fraction of those costs. So, there is
9 a -- that's why I said the management fee,
10 the -- if one were to say from the get go,
11 how, how would you establish the management
12 fee, that's how I would say you would do it.
13 Again, setting aside this issue of any
14 positive amount of profit going to CBS,
15 having this non-arm's-length ultimate resu- --
16 result through the waterfall. The additional
17 amount to get to the \$700 number is a -- as I
18 understand the financials, is really to, to
19 account for the fact that there was a credit
20 provided in the financial records to, to
21 CarMax East and CarMax West for the
22 advertising costs that were incurred by them
23 in the first instance. Again, this -- these
24 are things that I'm -- these are inferences
25 that I'm drawing based on the in- -- the do-



1 -- the, the data from Dr. Cody's file. I
 2 have not delved into a lot of those details.
 3 But that's where based on information
 4 available to me, I would expect there to be
 5 reasonable to credit -- __ additional amount
 6 of credit to get to that \$700 number. Same
 7 thing with that similarly in the way that
 8 it's been discussed in terms of making an
 9 adjustment on the CarMax West side if there's
 10 a ---

11 (Alarm sounds.)

12 **MR. STREISEL:** Are you guys plugged in over there?

13 **MR. HARRINGTON:** No, sir.

14 **MS. GEER:** Is it not working?

15 **MR. STREISEL:** No.

16 **THE COURT:** I'm plugged ---

17 **MS. PEREZ:** Oh, I don't have it on.

18 **MS. GEER:** Oh, it's, it's not on.

19 **MS. PEREZ:** I haven't connected it. I'm sorry.

20 You ---

21 **MR. STREISEL:** Oh.

22 **MS. PEREZ:** --- don't tell me, sometimes I ---

23 **MR. STREISEL:** You're good.

24 **MS. GEER:** Yeah. Sorry. We didn't realize that

25 you ---



1 **THE COURT:** I thought your timer was up over there.

2 **MS. GEER:** Yeah. We gotta go.

3 **THE COURT:** He had you on a clock.

4 **MR. STREISEL:** Wrong question.

5 A: But maybe to make it easy, the \$700 number I
6 think is the number that gets you to a
7 reimbursement of the costs incurred by CBS
8 because there is this round tripping of the
9 costs of this advertising costs. So, I do
10 need -- I think it is appropriate to account
11 for those costs in order to have the net
12 result. Because at the end of the day, what
13 I'm really concerned about is making sure
14 that the profit is in the right buckets, and
15 so then to have the arm's-length amount of
16 profit in CBS, the way I've calculated --
17 done the calculations the way I interpret
18 those data, I think you would need to make
19 that -- make that a \$700 number to account
20 for this -- at this what I consider -- I
21 don't know if it's accounting oddity, but it
22 is just how the company has recorded these
23 advertising expenses on the, the -- on the
24 operating company level in the first instance.

25 Q: Okay. All right.



1 **MS. GEER:** Let me go to -- can you go to Slide 56
2 and 57?

3 **(Slide Number 56 and 57 were referenced at this**
4 **time.)**

5 Q: You talked about the importance of
6 comparability. And so, I want to ask you
7 some questions about your comparability
8 analysis.

9 A: Okay.

10 Q: If I can get a slide up.

11 A: Yes.

12 Q: All right. Slide 56 and I think, 57. These
13 are companies that you used for Transaction
14 2, correct?

15 A: That's correct. Oh, wait. I'm sorry.

16 Q: I'll scroll down.

17 A: I see the -- I see it very quickly.

18 Q: Yeah.

19 A: But yes, tho- -- those are.

20 Q: Okay. All right.

21 **MS. GEER:** And then Slide 64.

22 **(Slide Number 64 was referenced at this time.)**

23 Q: These are the advertising services that you
24 used for Transaction 3, correct?

25 A: Correct.



1 Q: All right. And then Slide 73.

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

3 Q: These are the companies you used for
4 Transaction 5, correct?

5 A: That's correct.

6 Q: All right.

7 **MS. GEER:** And then I want to go to Joint Exhibit
8 63.

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

10 Q: All right. This memo contains the companies
11 you used for transactions 2, 3, and 5, which
12 we just reviewed in the previous slides ---

13 A: Yes.

14 Q: --- is that correct?

15 A: Yes.

16 Q: All right. And these companies were
17 collected on February 28th, 2023, correct?

18 A: I, I'm sorry. 2, 3, and 5, yes. Yes, they
19 were collected on that date.

20 Q: And your staff prepared this, correct?

21 A: Yes. Under my direction.

22 Q: Okay. And at the time of your deposition on
23 March 29th of 2023, you had spent no more
24 than two hours reviewing these companies to
25 conclude they were a reliable set of



1 comparables for CBS, correct?

2 A: I, I don't remember how much time I spent on
3 each of the individual sets versus
4 collectively, but it was a -- the, the
5 business descriptions are not particularly
6 long and so, they're included in the memo.
7 So, at the time, I spent reviewing those and
8 I had discussed it generally, the search
9 criteria with my staff. So, yes. That sounds
10 ballpark-ish.

11 Q: When we talked in your deposition, you, you
12 agreed that you had not spent more than two
13 hours reviewing these?

14 A: I just don't recall if it's two hours per set
15 or two hours in to- -- for across the three
16 sets. That's what I'm trying to remember.
17 But particularly for the -- for the -- for
18 the business services transactions, I thought
19 they were pretty straightforward. Yes.

20 Q: And at the time of your deposition, you would
21 not say that these 64 companies were in fact
22 comparable to CBS and instead, you said that
23 they were a draft set of companies that
24 potentially might be comparable to CBS,
25 correct?



1 A: Yes.

2 Q: And in fact, the memo, I think it's on Page
3 2, says these are potentially comparable to
4 CBS.

5 A: That's correct.

6 Q: And these highlighted companies -- these
7 highlighted companies from Pages 5, 6, and 7,
8 these are the ones that you used in your
9 demonstrative slides that we looked at,
10 correct?

11 A: That's correct.

12 Q: All right.

13 **MS. GEER:** Let's go to Page 5, the advertising
14 companies.

15 Q: All right. Do you agree that at the time of
16 your deposition, March 29th, there was not a
17 single one of these companies that you could
18 identify and explain the advertising functions
19 performed by that company, by the company?

20 A: Well, there was a not single one that I --
21 that I recalled in detail exactly what they
22 did, other than the fact that I recall they
23 performed advertising related companies.

24 Q: All right. So, at your deposition ---

25 A: I'm sorry. They -- say that they performed



1 advertising related services.

2 Q: So, at your deposition, you were asked to
3 identify any of the companies and explain
4 what advertising they did and explain how it
5 compared to CBS's advertising functions, and
6 you could not do that at that time, correct?

7 A: Not without looking at the business
8 descriptions of the actual companies. That's
9 correct.

10 **MS. GEER:** Go to Joint Exhibit 68. Actually, yes,
11 please.

12 **(Joint Exhibit 68 was referenced at this time.)**

13 Q: All right. So, this is Joint Exhibit 68.
14 All right. Let's look at Column A. At, at
15 the time of your deposition and I think you
16 told me that you didn't know anything about
17 CarMax Book, is that correct?

18 A: That's correct.

19 Q: And about ACR as well?

20 A: That's correct.

21 Q: And about ASRP, ASRP as well?

22 A: Correct.

23 Q: And I don't think I asked you about mixed
24 model and optimizer, or markdowns. Did you
25 know anything about those?



1 A: No.

2 Q: Okay.

3 A: Not, not in terms -- I mean, I know what
4 markdowns are, but what I meant was I, I was
5 -- I'm not familiar with these as the
6 specific models or the -- if it's like a
7 defined term with the company.

8 Q: Okay. So, you talked about the importance of
9 comparability and the due diligence to do
10 that, but you didn't know anything about the
11 items that were being compared there or
12 anything about the comparables in your sets?

13 A: Well, I did -- I had done the review of the
14 comparables. It's like I said, the
15 headquarters function is a pretty routine
16 function and it's something that we've done
17 before in other contexts and it's a fairly,
18 very -- I said, that's one of the short road
19 analyses when you're doing a transfer pricing
20 study, and, and so, a large number of
21 comparables. And so, I'd reviewed the
22 business descriptions to satisfy myself that
23 they were reliable for purposes of
24 implementing comparable profits method. And
25 keep in mind, the -- when I talked about



1 there's a -- kind of a rank ordering in the
2 degree of comparability that you need to have
3 when you apply a different method, then I
4 would say the CPM, the comparable profits
5 method, is the one where the regs talk about
6 more of the loosest, the broadest standard of
7 con- -- comparability because you're looking
8 at financial ratios and you're taking an
9 inter-quartile range of these financial
10 ratios. So, you really -- you do want to
11 make sure that you have companies that are
12 doing broadly similar functions, but the level
13 of comparability is very different than, for
14 example, a comparable uncontrolled transaction
15 method or this comparable uncontrolled
16 services price method.

17 Q: All right. Let's talk about financing
18 receipts. I think I heard you say that West
19 files tax returns because of the royalty, is
20 that correct?

21 A: That was my understanding based on the
22 companies filings in this case.

23 Q: Okay. Are you aware that 100 percent of the
24 CAF finance income is sourced to South
25 Carolina based on South Carolina receipts?



1 A: I am aware -- I think I had that in my
2 demonstrative, thank you, that's up there. I
3 think I talked about that in my direct that
4 it was my understanding, again, based on the
5 companies filings that it was reporting the
6 financing income in the -- on the -- through
7 West on, on the West tax return in, in terms
8 of deriving the apportionment ratio for South
9 Carolina. And that it was doing so pursuant
10 to a prior settlement of, of an earlier year.

11 Q: But sourcing those receipts to South Carolina
12 and CarMax West and CarMax East are both
13 paying tax to South Carolina based on the CAF
14 revenues that originated in South Carolina
15 with 100 percent of those receipts being
16 sourced to South Carolina, correct?

17 A: Well, as I said in my earlier testimony, yes,
18 they are -- they are sourcing it in the since
19 of applying the apportionment ratio, but then
20 the dollar of tax that's being -- the dollar
21 of, of ultimately profit, the taxable income
22 is going to be very different if you kind of
23 source -- if you do it through this apply --
24 applying this apportionment ratio through the
25 combined business of West versus having those



1 profits -- the profits of that business stay
2 with East in the first instance, simply
3 because of the way in which it's a basic
4 math, math issue because these are very high
5 profit, high margin financing activities that
6 in the apportionment approach is being
7 effectively diluted through, through -- on
8 West tax return through the overall margin
9 that West is earning, rather than having
10 those marg- -- all those revenues fall in and
11 the, and the profits and the taxable income
12 staying with the East in the first instance.

13 **MS. GEER:** All right. Let's look at Slides 3
14 through 7. Start with 3.

15 **(Slides Number 3-7 were referenced at this time.)**

16 Q: All right. The title of this slide is
17 Operating Margin for Other Retailers, correct?

18 A: That's correct.

19 Q: All right. And then, if we skip to four and
20 five, they have the same title, correct?

21 A: Correct.

22 Q: And Slide 6 is the MOTC for other retailers.
23 So, that one. And Slide 7 is the ROA for
24 other retailers, correct?

25 A: That's correct.



1 Q: All right. And Slides 5, 6, and 7 show
2 CarMax's operating margin on 5, MOTC on 6,
3 and ROA on 7, correct?

4 A: That's correct.

5 Q: All right.

6 **MS. GEER:** And then, let's go to Joint Exhibit 65,
7 Development of the Retailer Set.

8 **(Joint Exhibit 65 was referenced at this time.)**

9 Q: All right. And this document shows the
10 collection of the retailers on Slides 3
11 through 7 of your demonstrative, correct?

12 A: That's my recollection. Yes.

13 Q: All right. And so, the highlighted part
14 says, data were collected from S&P's capital
15 IQ on July 9th, 2021. The search resulted in
16 1349 companies for review. All companies are
17 matched to Tractor Supply's fiscal year 2014
18 to fiscal year 2016, the period under audit.
19 Did I read that correctly?

20 A: You did read that correctly. If you could
21 scroll down though, I think the -- they were
22 ultimately matched to -- yes. 2016 through
23 2018. So, the -- that wording was not
24 updated.

25 Q: Okay.



1 A: This was an additional search that was done
2 as part of the work on Tractor Supply.

3 Q: You have anticipated my next question. This
4 table of companies -- this table contains
5 companies that were used in, in Tractor
6 Supply as well, correct?

7 A: That's correct.

8 Q: All right.

9 A: In, in that same way in which I've used it
10 here in terms of setting the -- you know,
11 trying to figure out in general, is this a
12 high profit comp- -- company relative to
13 other retailers in general.

14 Q: Page 23. All right. This table contains
15 companies that were rejected as being used
16 for comparables when you collected this for
17 Tractor Supply, correct?

18 A: That's correct.

19 Q: All right. And on this CarMax, Inc. is
20 highlighted and the rejection reason is value
21 added services, correct?

22 A: That's correct.

23 Q: Okay. All right. Let's go to Slide 8.

24 A: And by value added services the ---

25 Q: You've answered the question.



1 A: Okay.

2 Q: Thank you.

3 MS. GEER: Slide 8.

4 MR. ANTLEY: Objection. He can -- he can finish
5 answering the question. He -- if it -- you
6 can't cut him off in the middle of his
7 answer.

8 THE COURT: Well ---

9 MS. GEER: He had answered the stub -- substance of
10 my question and he -- I, I don't think ---

11 MR. ANTLEY: That -- that's for him to decide.

12 THE COURT: Well, I don't know if that ---

13 MS. GEER: I don't think so.

14 THE COURT: I don't think that's for him to decide.

15 MS. GEER: I don't think that's correct.

16 MR. ANTLEY: He can clarify his answer, Your Honor.

17 MS. GEER: He can ---

18 THE COURT: Did you need ---

19 MS. GEER: --- clarify it through you.

20 THE COURT: Yeah. I think you ---

21 MR. ANTLEY: It -- it's an incomplete answer, Your
22 Honor.

23 THE COURT: I'm going to allow you to do redirect
24 on that. Maybe you can make some notes.

25 MS. GEER: All right. Is this Slide 8? My vision



1 is really bad. Yeah.

2 Q: Do the auto dealers in this Slide 8 of your
3 demonstrative have brick and mortar retail
4 stores?

5 A: I, I know certainly that some of them do. I
6 think a large -- I, I just can't remember
7 which one of them -- I went through their
8 10Ks in some detail, but I just don't recall
9 whether any of them did not.

10 Q: Okay.

11 A: I, I, think most of them did have brick and
12 mortar.

13 Q: All right.

14 A: If not all of them.

15 Q: All right. I want to talk to you about the
16 transfer of business process intangibles from
17 CarMax East to CarMax West. CarMax East
18 transferred business process intangibles to
19 West before CarMax West contributed assets to
20 CBS in exchange for its 93 and a half percent
21 ownership, right?

22 A: I'm sorry. Say that -- you said that really
23 fast. Try that one more time.

24 Q: You're complaining about me talking fast?
25 All right. Let me read it again. CarMax East



1 transferred business process intangibles to
2 CarMax West before CarMax West contributed
3 assets to CBS in exchange for its 93 and a
4 half percent ownership, right?

5 A: Well it happened all on the same day on
6 December 1st, but ---

7 Q: It was ---

8 A: Logically, it would have had to have
9 happened. I just don't know the ---

10 Q: Okay.

11 A: --- if it was the sequence of activities
12 specified in that memo.

13 Q: Okay. But during your deposition, on March
14 29th, you were not aware of this fact,
15 correct?

16 A: I was not aware of -- I could not figure out
17 how the -- how they tra- -- how the business
18 process intangibles got into the East side of
19 the ledger in fact, even whether they had
20 ever been transferred into East. I'm sorry.
21 I said, East. I should have said West. I
22 had -- let me just clarify that.

23 Q: All right. I want to ---

24 A: Prior to my -- at my deposition ---

25 Q: Oh, I'm sorry. I didn't ---



1 A: I had -- at my deposition, I had not been
2 aware that the business intangibles had been
3 transferred from East to West on December
4 1st. That was a result of a further review
5 of some of those documents.

6 Q: All right. Earlier, you talked about
7 economic substance relating to the 2004
8 restructuring. I want to be clear, are you
9 using economic substance in 482 regulations?

10 A: Yes.

11 Q: Okay.

12 A: Ev- -- everything that I'm doing in the
13 transfer pricing analysis is within the
14 context of my understanding of the 482 guide
15 -- guidelines.

16 Q: Okay.

17 A: Or regulations.

18 Q: So, you don't have some separate economic
19 substance that you're talking about here.
20 Your economic substance concept is, is derived
21 from the 482 regulations.

22 A: Well, see the 482 regulations in my
23 experience in transfer pricing analysis, I
24 think there is a -- so, again I think the,
25 the Perrigo trial has been referenced a



1 couple of times and economic substance was
2 very much front and center in, in part of
3 that -- in that litigation. So, there is a -
4 --

5 Q: I'm not asking about the Perrigo ---

6 A: Well, I know you're not asking about the --
7 about the -- about the, the trial, but I'm,
8 I'm saying that this is based on my
9 experience in terms of how the notion of
10 economic substance is used in enforcement
11 actions. And it actually is -- I, I would
12 say that the language in the regs is often
13 specifically related to contractual terms,
14 whereas in practice there is a much more
15 expansive way in which economic substance is
16 being analyzed.

17 Q: That is exactly what I wanted to talk to you
18 about. So, I asked you Wednesday if you
19 could point me to the place in the 482
20 regulations where it supported anything other
21 than economic substance as used in a
22 contractual sense to evaluate a specific
23 intercompany transaction and I thought you
24 told me that you couldn't point to any
25 regulations ---



1 A: Well, I said I couldn't point ---

2 Q: --- at that time.

3 A: I said I couldn't point to the specific
4 element. I think it's referenced something
5 like 50 times in the regulations. So, it's
6 there. I just didn't go through and try and
7 parse out the, the, the explanation, but I
8 just would say that it is consistent with my
9 -- with my work, my transfer pricing work
10 over ---

11 Q: Okay. But right ---

12 A: --- many years. If I may ---

13 Q: Right now I'm asking ---

14 A: If I may finish.

15 **THE COURT:** Let him finish answering the question.

16 A: That over, over many years, as well as my
17 work for the government, including for the
18 IRS, that the, the -- a proper approach from
19 a transfer pricing perspective is to examine
20 economic substance in this -- in the se- --
21 in the way that I have done it from a fairly
22 broad perspective.

23 Q: Okay. My question is focused on not your
24 experience and broad perspective, but I'm just
25 wanting to know if 482 regs -- 482 regs,



1 economic substance in those regs is related
2 to the contexts of looking at the economic
3 substance of the controlled transaction,
4 right?

5 A: The economic substance of the controlled
6 transaction?

7 Q: Yeah.

8 A: Well, that's the part where I -- again, I, I
9 would have go back and parse through the
10 language. To some extent, it sounds like
11 you're asking me for, well, A, my
12 recollection of the, the specific words, but
13 also maybe kind of a legal opinion as to how
14 the regs do or do not define economic
15 substance. I'm just telling you, based on my
16 experience, this is what I have done. What I
17 have done here is consistent with what I've
18 done elsewhere. And there, I've looked at
19 particularly in restructuring transactions,
20 this is the first thing that comes up is what
21 is the substance of those transactions. This
22 whole notion of a owner-developer rule, I
23 don't think the owner-developer rule is even
24 specified in the regs, but the whole notion
25 of, of economic substance comes in when you



1 apply that even as a concept because you're
2 looking at the substance of the transaction,
3 the substance of what people contribute. So,
4 I think it goes beyond just the -- it's
5 initially described in the definitional parts
6 about contractual terms. And I think that's
7 the first way it -- and, and the most obvious
8 way. It's because a party can write anything
9 it wants in a contract and so the economist
10 needs to see whether the conduct of the
11 parties is consistent with the terms in the
12 con- -- in the contract. That's the first
13 part that it comes in, in the most obviously.
14 But again, my view is that there -- the
15 concept really applies beyond just the
16 contract, but al- -- and also to the form and
17 the other things that I've, I've an- -- and
18 the other, other contexts in which I've
19 analyzed transfer pricing issues.

20 Q: All right. So, that's your view, but as we
21 sit here today, you cannot point to any
22 specific 482 regulation that supports using
23 economic substance to evaluate anything other
24 than controlled transaction, is that correct?

25 A: Well, 482 regs are a very long and ---



1 Q: I realize that. I'm just asking you, can you
2 point to any specific regulation and you can
3 just say yes or no?

4 A: Yeah. Well, it, it -- I, I can't point you
5 to a specific point in the regulations where
6 there is, you know, where -- that's those 50
7 par- -- references. I'd have to go through
8 and parse out each one. I would say that the
9 concept is imbedded in all the discussion of
10 intangibles. So, an intangibles -- and this
11 whole notion of realistic alternatives.
12 That's where your -- the whole notion of, of
13 valuating the, the realistic alternatives
14 means you're looking at the economic substance
15 of what's going on and not simply the fact
16 that they're -- you know, that the way the
17 party has structured a transaction or what
18 it's implemented. So, I think if it is at a
19 minimum implied by a broad range of
20 discussion that's in the regs, but I can't
21 point you to a specific point in the regs. I
22 don't -- as I sit here, I haven't memorized
23 those places.

24 Q: Okay. So, that answer is, is no. All right.
25 I will move on. Let's see. I had some



1 scattered notes here, so I apologize. All
2 right. You talked about qualified cost-
3 sharing agreements?

4 A: I have.

5 Q: Has East -- has CarMax East entered into a
6 qualified cost-sharing arrangement?

7 A: No.

8 Q: And is CarMax East jointly developing any
9 intangibles with another party?

10 A: Well, I think there is a way, again, looking
11 at the economic substance of what's going on.
12 I think there is a way in which you could
13 characterize that payment of the 1,100 to
14 \$1,200 per unit car or per, per unit
15 management fee as their contribution to
16 whatever intangibles are being developed by
17 the, the company. And so, for example, the
18 advertising. Is advertising generating the
19 great brand value? In that case, the --
20 CarMax East and CarMax West are both
21 contributing the moneys, the fu- -- the
22 funding that is used to pay those -- the
23 costs of that advertising campaign, not just
24 the cost, but two and a half times over, if
25 you include the, the advertising fee plus the



1 trademark royalty. So, I will say the same
2 thing on all of these, this notion of the --
3 these data analyst people, the, the data
4 analytics people. Their salaries are being
5 compensated many multiple times over by the
6 operating companies. So, to the extent of,
7 of analyzing which entity is actually
8 responsible for the costs of those, those
9 cost responsibility and then some. Well, not
10 just and then some. And then a lot is being
11 borne by the operating company's themselves,
12 which goes to this owner-developer rule. If
13 you have an entity that's responsible for
14 developing a function and it's taking a risk
15 associated with that function, then the --
16 you very much -- the -- from a transfer
17 pricing perspective you'd say, yes, that, that
18 entity is contributing to the development and
19 therefore, should obtain some benefit from the
20 use of those intangibles once they are
21 developed. That's one of the things that Dr.
22 Cody never addressed is this notion of
23 riskiness, right? And a risk -- the analysis
24 of -- not just the analysis of functions, but
25 when we do transfer pricing analysis, we look



1 at functions, risks, and assets. And even in
2 the E&Y study, it said all the risks are
3 effectively borne by the stores, with the
4 exception of the financing function because
5 the financing holds some of the -- of the
6 loans for some period of time before they
7 securitize them, I guess. They didn't go
8 into that level of detail, but they just
9 talked about the loans as being something, a
10 notion of risk. But from the car ---

11 Q: Can I -- can I just stop ---

12 A: I'm sorry. It's an important issue in terms
13 of ---

14 Q: I -- my question was such a minor -- it was
15 is East jointly developing an intangible with
16 another party, and this is ten minutes later.
17 That should be a yes or no question.

18 **MS. GEER:** He's welcome to go into this later.

19 **OBJECTION:**

20 **MR. ANTLEY:** Objection, Your Honor, to, to what she
21 -- what she's trying to do with the witness
22 in stopping him. And if I give an example.
23 So, she asked the witness, do you have a red
24 car. And the answer is I have a red car, but
25 I sold it 20 years ago. And you cut him off



1 before he says, but I sold it 20 years ago.

2 That is not a true answer. He is entitled to
3 give a true, complete answer.

4 **THE COURT:** Is your answer responsive to that
5 specific question?

6 A: Yes, Your Honor. It's very much an important
7 issue in terms of this whole notion of do- --
8 is there an intangible. If there is an
9 intangible being created ---

10 **THE COURT:** Well, let's hear the question one more
11 time.

12 **MS. GEER:** The question is, is CarMax East jointly
13 developing an intangible with another party.

14 **THE COURT:** All right. What ---

15 **MS. GEER:** What -- I still don't think I got an
16 answer, yes or no.

17 **THE COURT:** So ---

18 A: So, from an economic perspective, yes, they
19 are.

20 Q: Okay.

21 A: They are in the sense that they are
22 contributing with funds to -- for the
23 development of those intangibles and they are
24 in the sense that they are incurring the
25 risks associated with the development of those



1 activities because they're bearing the costs
2 associated with that.

3 **THE COURT:** All right.

4 A: From -- it's no a functional. The functions
5 ---

6 **THE COURT:** But you've already -- you've already
7 explained that.

8 A: Okay. Thank you.

9 **MS. GEER:** All right. Give me one minute. All
10 right. Almost done.

11 Q: All right. You've talked about how -- is the
12 Perrigo case -- Perrigo?

13 A: Yes.

14 Q: It that how you pronounce it? You've said
15 that that's similar to this case. And you've
16 said that economic substance was front and
17 center in that case, correct?

18 A: Well, if I said similar, I ---

19 **THE COURT:** Well, can I understand something?

20 **MS. GEER:** Yes.

21 **THE COURT:** You keep asking him about economic
22 substance.

23 **MS. GEER:** Yes.

24 **THE COURT:** And then Dr. Cody, who right out the
25 chute in my notes, he was talking about the



1 functional analysis, he said, we look to the
2 substance of the functions and the
3 intangibles.

4 **MS. GEER:** Yes.

5 **THE COURT:** So, is there a distinction here between
6 ---

7 **MS. GEER:** There -- there's a big distinction.

8 **THE COURT:** Between substance ---

9 **MS. GEER:** There's a big -- there's a big ----

10 **THE COURT:** --- and economic substance?

11 **MS. GEER:** No. Well, the distinction is e- --
12 between economic substance to look at a
13 transaction that's being priced. That's one
14 economic substance concept. Are the parties
15 doing what the contracts say they're doing?
16 So, is CBS actually providing a service to
17 CarMax East? Is CarMax East receiving that
18 service? That's, that's the proper use of
19 economic substance under the 482 regs. He is
20 using it as economic substance of an entity.
21 Is this entity -- look back at the
22 restructure, is it economic substance? He's
23 talked about whether leased employees or not
24 leased employees makes it not have economic
25 substance or whether the reorganization had



1 economic substance.

2 **THE COURT:** Okay.

3 **MS. GEER:** That's a completely separate concept.

4 **THE COURT:** I will cogitate on that.

5 **MS. GEER:** Okay.

6 **THE COURT:** Apparently down the road when y'all
7 explain it further.

8 **MS. GEER:** All right.

9 **THE COURT:** Okey doke.

10 **MS. GEER:** So, can you pull up ---

11 A: I'm sorry. You, you had asked a question and
12 it's characterized my, my earlier testimony
13 and I wanted to make sure that ---

14 Q: Yes.

15 A: --- testimony wasn't mischaracterized.

16 Q: Do you want to ---

17 A: Yes. You said -- I, I think there
18 substantial differences between the Perrigo
19 case and this case. I think the issue is
20 whether there are certainly analyses that I
21 think are relevant to apply in this case.
22 And part of my reason for thinking that they
23 are relevant is based on my prior experience,
24 including Perrigo. Just to be clear though,
25 I, I am not asserting and I think I -- I



1 thought I described this earlier, there's a
2 big difference between saying no economic
3 substance from a sham transaction kind of
4 theory, right? This is not what I've -- I'm
5 not saying zero economic substance associated
6 with CBS. This is not a Perrigo kind of
7 situation. I think there are certain aspects
8 of that -- of my analysis there that are
9 applicable here, particularly in terms of what
10 is within the proper scope of economic
11 analysis.

12 Q: Okay.

13 **MS. GEER:** All right. Can you pull it up?

14 Q: All right. Does this appear to be the
15 Perrigo case caption to you?

16 A: Yes.

17 **MS. GEER:** Okay. Can you go to Paragraph 65?

18 **THE COURT:** And we're looking at the complaint now?

19 **MS. GEER:** It'll be very brief. I promise, Your
20 Honor.

21 **OBJECTION:**

22 **MR. ANTLEY:** Objection. Relevance, Your Honor.

23 This is ---

24 **THE COURT:** Well, she just said it's going to be
25 brief.



1 **MS. GEER:** It will be very brief.

2 **THE COURT:** And you're going to match it up to a
3 legal point.

4 **MS. GEER:** I -- I'm going to match it up to the
5 point we were just discussing.

6 **THE COURT:** Okay.

7 Q: Okay. All right. So, Paragraph 65 is an
8 allegation of the sham entity theory.
9 Paragraph 66 is the sham transaction theory
10 allegation. Paragraph 67 is an allegation of
11 the assignment of income doctrine. Paragraph
12 68 is the shame entity theory, sham treatment
13 theory and the assignment of income theory.
14 All right. So, in the green -- let's see.
15 Number 69 says, as an alternative to the
16 foregoing primary common law theories, the IRS
17 contends that most of the income ---

18 **OBJECTION:**

19 **MR. ANTLEY:** Objection, Your Honor. She's just
20 reading into the record this, this -- is
21 making this part of the record and it's not
22 relevant. It's, it's inadmissable.

23 **THE COURT:** I, I don't get the relevance either.

24 **MS. GEER:** It is very relevant.

25 **THE COURT:** She says she's going to link it up.



1 I'll let her link -- I'll do like the same I
2 did with y'all is, is if she doesn't link it
3 up, I'll give you the option to make a motion
4 to strike it.

5 **MR. ANTLEY:** I, I just don't want to be -- last
6 time you said I was late.

7 **THE COURT:** I know. You're fine.

8 **MR. ANTLEY:** I don't want to be too late to ---

9 **THE COURT:** No. You're not. You're making an, an
10 objection to this. If, if down the road it -
11 - she doesn't link it up, I will strike it.

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

13 **THE COURT:** Because this is a complaint in a
14 different case.

15 **MS. GEER:** I understand, Your Honor, but it's been
16 talked about a lot. So, I, I -- if you'll
17 give one more minute I will be done with my
18 linking.

19 **THE COURT:** Okay.

20 Q: All right. So, so 69 says, as an alternative
21 to the foregoing primary common law theories,
22 the IRS contends that most of the income from
23 the sales of generic OTC -- oh, my gosh. I
24 can't pronounce that. Ome- -- Omepraz- -- -
25 prazolol.



1 A: Omeprazole.

2 Q: Okay. Should be reallocated from -- my
3 vision is bad. PITLP, LLC to plaintiff under
4 IRC, Section 482, and the treasury regulation,
5 thereunder, the section 482 alternative
6 theory. Is, is this the part of the case
7 that's referenced in 69 that your testimony
8 related to?

9 A: No. It related to the entirety of the case.

10 Q: Okay. Were you allowed to use the word, the
11 term economic substance during the trial of
12 that case?

13 A: I avoided the use of the word economic
14 substance because of the fact that there was
15 a sham transaction theory and so, that there
16 was a legal -- that, that phra- -- that
17 phrase was -- had more legal freight
18 associated with it than in the co- -- in a
19 typical transfer pricing case where I have
20 used economic substance in other testimony,
21 other transfer pricing cases. But in this
22 specific one, because of the nature, even
23 though I testified on issues related to the
24 sham transaction theory, ultimately, whether
25 it could be entity was devoid of economic



1 substance, which was required or I -- maybe
2 under certain theories, maybe required under
3 law to establishment. And then, that was --
4 that was too much of a -- more of a legal
5 opinion on that first theory as opposed to
6 the second theory. But it's because I was
7 testifying on both the transfer pricing issues
8 and on matters related to the sham
9 transaction theory that I was avoiding saying
10 that word so as not to make it sound like I
11 was rendering a legal opinion for, for an
12 issue that was squarely before the Court.

13 **MS. GEER:** That's all I have, Your Honor.

14 **OBJECTION:**

15 **MR. ANTLEY:** Objection to move to strike.

16 **THE COURT:** All right. Can you explain it?

17 **MR. ANTLEY:** Yes. She's asking about legal
18 theories in a separate matter. He's not --
19 he, he can't opine a legal -- he can't give
20 legal opinions and it's not relative.

21 **THE COURT:** Yeah. Why does this make a point here?

22 **MS. GEER:** It makes a point because there are
23 claims related to economic substance dealing
24 with validity of an entity or the, the
25 substance of an entity. They're not in 482.



1 They're the ones we talked about earlier.
2 There are sham transactions, shame entity.
3 He's a 482 person and he's trying to use
4 economic substance in this case along the
5 lines of how it can actually be used in these
6 other claims. He didn't even speak the word
7 economic substance and I, I hear his answer
8 to that, but I, I think it's because he was
9 not supposed to be talking on those other
10 legal claims. I think it's relevant.

11 **THE COURT:** Well, I'm not so -- I'm not so sure,
12 but I, I will go with the theory that you're
13 granted wide latitude on cross and I -- so, I
14 would just overrule that objection.

15 **MS. GEER:** Your Honor, that's all we have at this
16 time.

17 **THE COURT:** Redirect?

18 **DR. DeRAMUS - FURTHER REBUTTAL BY MR. ANTLEY:**

19 Q: Do you recall you were trying to clarify an
20 answer previously during your cross-
21 examination just now?

22 A: I recall there was a point I was trying to
23 clarify, but I can't recall what the question
24 was.

25 Q: Okay. Would it be helpful to see if we could



1 pull up Joint Exhibit 65? I think it was on
2 the topic of value added services.

3 **(Joint Exhibit 65 was referenced at this time.)**

4 A: Yes. Now, I remember. Thank you.

5 Q: That -- is that enough to jog your memory?

6 A: Yes.

7 Q: Okay.

8 A: So, the -- when the, what I'll call the
9 retailer set was first pulled, I did pull it
10 in the context of the -- or I instructed my
11 staff to pull it in the context of the work I
12 was doing relative to Tractor Supply. But
13 this is where I think the whole notion of
14 comparable gets thrown around a little bit
15 too easily. This was really -- this is not
16 being used to benchmark the returns that
17 either at that point Tractor Supply should
18 earn, whether to benchmark the returns that,
19 that CarMax should earn. I've never used
20 that retailer set. For any purpose other
21 than to try and answer the broader question
22 of is this a -- in general, is the 7 percent
23 margin that I observed CarMax earning, is it
24 unusually high? If it's unusually high, it's
25 usually an indication that they're either --



1 there's some intangible that might -- the
2 might be contributing or, or they may -- they
3 might have developed or that they occupied a
4 particular profitable niche, which is
5 something I've observed in other retailers
6 where there's a lot of barriers to
7 competition. Particularly, barriers to online
8 competition allowing retailers to have those
9 higher margins. So, it's really, I think
10 helpful and informative to, to be able to
11 compare how does CarMax stack up relative to
12 these other firms. And when we initially
13 pulled that set in Tractor Supply, one of the
14 reasons it wasn't -- including the Tractor
15 Supply case, there was no financing function.
16 So, value added services was really just a
17 catchall for retailers that had other things
18 that might be driving their profitability that
19 would cause the comparison for Tractor Supply
20 to be against other retailers to be -- to --
21 maybe to be a little off. So, it is the
22 case, you have some retailers doing a broad
23 range of value added services that have very
24 little to do -- little to do with retailers.
25 So, it's one of those broad screens



1 established for that purpose. But at the end
2 of the day, I think it is a, a relevant data
3 point, a helpful data point for me as an
4 economist to evaluate whether car -- how
5 CarMax stacks up relative to the other
6 companies, even though I don't think they're
7 comparable. I think they're a retailer. I
8 think they -- I would never use them to try
9 an establish the arm's-length return that
10 CarMax as an entity should earn because it's
11 -- the company as a whole. I -- I haven't
12 even gone through the process yet of
13 separating out the -- doing the functional
14 analysis at this -- at that stage of the --
15 of the analysis. That's what comes later
16 with the other -- the other comparables that
17 are the business function comparables, the
18 back office services, the advertising and
19 other type comparables. Those are the ones
20 that are being used for a -- the application
21 of a method, the CPM. Whereas the retailers
22 and even the dealers, it's more to try and
23 understand is this a high profit company, is
24 it a low profit company? If it -- if one or
25 the other, why is that the case?



1 MR. ANTLEY: No further questions, Your Honor.

2 QUESTIONS FROM THE COURT:

3 THE COURT: You've been asked about substance
4 versus economic substance.

5 A: Yes, Your Honor.

6 THE COURT: Can you from your perspective explain
7 the difference between those two?

8 A: There, there is none, Your Honor. It's --
9 I'm an economist, so ultimately, what I'm
10 looking at is if you want to call it economic
11 substance or business substance, it's the same
12 concept. I would say there, there is a very
13 different issue that comes up in these sham
14 transaction theories.

15 THE COURT: I, I don't need to know about that.

16 A: Versus -- okay. It's just a -- what -- as,
17 as a analytical -- as, as a concept, it is
18 something that I -- it is my view based on my
19 reading of the regs, my work over the years,
20 that an economist needs to look at the
21 economic substance of the parties, of the
22 transactions, and the development of those
23 transactions over time, the development of
24 intangibles over time in order to come to a
25 complete opinion about whether a given --



1 the, the income and the allocation of income
2 or apportionment of income is ultimately
3 reflective in an arm's-length result. So, I
4 need to do that in order to do my transfer
5 pricing analysis solely within 482. Now, it
6 is a more freighted term when you go to a
7 sha- ---

8 **THE COURT:** A more ---

9 A: --- a for -- more freighted term because it
10 has legal connotations. Because under a sham
11 transaction theory, you lit- -- the IRS
12 literally just disregards the entity,
13 disregards to the transaction, as if it never
14 happened. So, that's a very different --
15 that's got kind of the, the nuclear effect of
16 the sham transaction doctrine versus applying
17 the economic substance analysis in -- within
18 the con- -- confines of 482. So, it's always
19 a little bit of this discomfort between the
20 fact that you've got these -- the same
21 wording often applied to very different
22 contexts. There's some correspondence, but
23 one is literally zero. Zero economic
24 substance, no people, no risks, no functions,
25 no nothing, not a scintilla of, of



1 functionality versus what we observed in 482,
2 which is often that there is some structure
3 there. There is maybe some risk. They, they
4 might not have any people like, say like CAF.
5 But CAF does have assets. I'm sorry, like
6 CBS. CBS has no people. There is only CASS.
7 But, but CBS nonetheless still has some
8 assets. It's got -- that's where the company
9 housed the -- some of the intangibles. I
10 think the -- I'm assuming the physical assets
11 of the company, of CBS, the headquarters
12 building is literally a, a CBS asset, which
13 is different than what you would see in kind
14 of a pure -- often difficult, at least in my
15 experience, in a pure sham transaction kind
16 of theory.

17 **THE COURT:** All right. Follow up from what I
18 asked?

19 **MR. ANTLEY:** No, Your Honor.

20 **MS. GEER:** No, Your Honor.

21 **THE COURT:** All right. You may step down.

22 A: Thank you, Your Honor.

23 **MR. ANTLEY:** No more witnesses from the Department.

24 **THE COURT:** Was that your first rebuttal?

25 **MR. ANTLEY:** Yes.



1 THE COURT: Your -- your first redirect?

2 MR. ANTLEY: Of the day? Of the trial?

3 THE COURT: Yeah.

4 MR. ANTLEY: Maybe. I, I don't ---

5 THE COURT: Yeah.

6 MR. ANTLEY: Lucked out.

7 THE COURT: Okey doke. Thank you. All right.

8 Well, with that ---

9 HOUSEKEEPING MATTER:

10 MS. GEER: Your Honor, the only other housekeeping
11 matter is ---

12 THE COURT: Okay.

13 MS. GEER: Sorry. It's a brief one. We had worked
14 on updating the Joint exhibit list, so if we
15 could file that.

16 THE COURT: Oh, that's fine with me.

17 MS. GEER: Okay. And then I also have thumb drives
18 to give.

19 THE COURT: You have what?

20 MS. GEER: Thumb drives with the exhibits.

21 THE COURT: Oh, thumb drives.

22 MR. ANTLEY: And, and we have the -- a thumb drive
23 with the, the demonstratives that ---

24 THE COURT: Okay.

25 MR. ANTLEY: --- the Department's demonstrative.



1 (Off the record from 4:48 p.m. until 4:49 p.m.)

2 **THE COURT:** I assume we're going to do proposed
3 orders in lieu of closing arguments?

4 **MS. GEER:** Yes, Your Honor.

5 **THE COURT:** All right. So, I want the proposed
6 orders 30 days from the date the transcript
7 is made available to you. Is that ---

8 **MS. GEER:** Can we please do 45?

9 **MR. ANTLEY:** The Department's fine with either one
10 of those dates.

11 **THE COURT:** Well, then 45 it shall be. Anything
12 else?

13 **MS. GEER:** Well, as you know, I've been with you
14 for this week. The week prior we were
15 getting ready with all of these people for
16 this week and the Tractor Supply responses,
17 we basically turned in our proposed orders
18 right before we ---

19 **THE COURT:** Yeah.

20 **MS. GEER:** So, we, we have two weeks left to each
21 respond to our proposed orders. Is there any
22 chance that we could get even just a few
23 extra days?

24 **THE COURT:** Can I talk to my staff attorney about
25 that?



1 MS. GEER: You may.

2 THE COURT: And then I'll get back with you.

3 MS. GEER: Okay. That would be great.

4 THE COURT: Wait date? She goes out July 4th

5 apparently.

6 MS. GEER: Okay.

7 MS. PEREZ: No. Her last day is the 30th. June,

8 June 30th is her last day.

9 THE COURT: Oh, yeah. That's right.

10 MS. GEER: They're, they're currently due I believe

11 the 15th. June 15th. So, I was hoping for

12 the next Monday, but.

13 THE COURT: Well, let me get back with you.

14 MS. GEER: Okay. Thank you.

15 THE COURT: You -- you're going to stress out a

16 pregnant lady.

17 MS. GEER: I don't want to do that, but maybe she

18 has enough to like keep her busy with what

19 we've already provided was ---

20 THE COURT: Okay.

21 MS. GEER: --- what I was hoping.

22 THE COURT: All right. Anything else?

23 MS. GEER: Not from ---

24 MR. ANTLEY: No, Your Honor.

25 THE COURT: Well, thank y'all. It's been a joy



1 except for the pain. And hopefully, y'all
2 didn't cause too much of it.

3 **MS. GEER:** Hopefully.

4 **THE COURT:** All right. This hearing is adjourned.

5 **(There being nothing further, the hearing concluded**
6 **at 4:50 p.m.)**

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CERTIFICATE

This is to certify that the within hearing consisting of one thousand three hundred and four (1,304) pages, is a true and correct transcript of the testimony given by said witnesses after being duly sworn; said hearing was reported by the method of Stenomask with Backup.

I further certify that I am neither employed by nor related to any of the parties in this matter or their counsel; nor do I have any interest, financial or otherwise, in the outcome of same.

IN WITNESS WHEREOF I have hereunto set my hand and seal on December 13, 2023.



M. Sean Cary
Court Reporter

Notary Public for South Carolina
My Commission Expires: May 2, 2033



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INVENTORY of EXHIBITS

Caption:	CarMax Superstores, Inc. v. SC DOR	Date/Time:	May 22 — 26, 2023
Docket No:	21-ALJ-17-0182-CC	Judge:	Anderson

[illegible]

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

CarMax Auto Superstores, Inc.,) Docket No. 21-ALJ-17-0182-CC

)
Petitioner,)

vs.)

South Carolina Department of Revenue,)

)
Respondent.)
_____)

JOINT EXHIBIT LIST

Exhibit #	Description	Bates Numbers
1.	2003 CarMax Annual Report and 10-K	
2.	2004 CarMax Annual Report and 10-K	
3.	2005 CarMax Annual Report and 10-K	
4.	2016 CarMax Annual Report and 10-K	CarMax_ 002733-002854
5.	2017 CarMax Annual Report and 10-K	CarMax_ 002855-002986
6.	2018 CarMax Annual Report and 10-K	CarMax_ 002987-003114
7.	E&Y Transfer Pricing Report FYE 2/29/12	CarMax_001360-001599
8.	E&Y Transfer Pricing Report FYE 2/28/15	CarMax_ 001124-001359
	Federal Returns	
9.	Form 1120 (amended) FY 2016 - consolidated federal return	CarMax 000551-000681
10.	Form 1120 FY 2017 - consolidated federal return	CarMax_000726-000856
11.	Form 1120 FY 2018 - consolidated federal return	CarMax_000880-001058
12.	Form 1065 (amended) FY 2016 - CBS federal return	CarMax_003244-003278

13.	Form 1065 FY 2017 - CBS federal return	CarMax_003279-003308
14.	Form 1065 FY 2018 - CBS federal return	CarMax_003309-003340
	South Carolina Tax Returns	
15.	Form SC 1120 FY 2016 — CarMax Auto Superstores, Inc.	CarMax_000682-000691
16.	Form SC 1120 (Amended) FY2016 — CarMax Auto Superstores, Inc.	CarMax_000692-000703
17.	Form SC 1120 FY2017 — CarMax Auto Superstores, Inc.	CarMax_000857-000866
18.	Form SC 1120 FY2018 — CarMax Auto Superstores, Inc.	CarMax_001059-001071
19.	Form SC 1120 FY2016 — CarMax Auto Superstores West Coast, Inc.	CarMax_000714-000725
20.	Form SC 1120 FY2017 — CarMax Auto Superstores West Coast, Inc.	CarMax_000867-000879
21.	Form SC 1120 FY2018 — CarMax Auto Superstores West Coast, Inc.	CarMax_001072-001083
	Audit/Department Documents	
22.	Explanation of Audit Assessments and Adjustments	SCDOR 0496
23.	Proposed Assessment dated 9/04/2019	CarMax 000514-000516
24.	Corporate Working Papers of the Department	SCDOR_0474-0495
25.	Apportionment Schedules	SCDOR 0091-0100
26.	Report of Field Audit dated 09/04/2019	SCDOR_0153-0169
27.	Department Determination	CarMax 000537-000549
28.	SC Revenue Ruling 15-5	
29.	Audit Appointment Letter	CarMax 000003-000004
30.	IDR #1 Responses	SCDOR 0001
31.	IDR #2 Responses	SCDOR 0002-0004
	CarMax East Documents	
32.	CarMax Protest	CarMax 000526-000536
33.	CarMax Organizational Chart	CarMax 000425
34.	Master Management Services Agreement	CarMax 001097-001123
35.	Amendments to Master Management Services Agreement	CarMax_003382-003394
36.	License Agreement	CarMax 001086-001096
37.	Management Fee Breakout FY 2016-18	CarMax_002698-002700

38.	2016 Sample SC invoices, wire requests and monthly reconciliation	CarMax 0001650-001698
39.	Legal Entity Org Chart with Associate Counts	CarMax_003641
40.	CarMax East and West Initial Contributions to CAS dated 12-104	CarMax_001646-001649
41.	Memo to CarMax re: Certain Federal and State Income Tax Consequences of Proposed Restructure	CarMax_001805-001847
42.	Draft Board of Directors Corporate Reorganization Presentation dated 4-6-04	CarMax_001848-001863
43.	11/01/2004 CarMax memo re: purposes of restructuring	CarMax_001864-001867
44.	CarMax BOD meeting minutes dated 4-6-04	CarMax_001868-001911
45.	Business Purpose Notes	CarMax 001912
46.	Memo to Corporate Restructuring File dated 2-13-04	CarMax_001913-001919
47.	Audit Committee Notes and Board of Directors Corporate Reorganization Presentation dated 4-6-04	CarMax_001920-001936
48.	Memo to E&Y File re: Restructuring dated 9-6-04	CarMax 001937
49.	List of Officers and Directors for CarMax, Inc. and various subsidiaries	CarMax_001938-001965
50.	CarMax Profitability 8E stores	CarMax 002697
51.	IRS Overpayment Letter to CarMax	CarMax_001084-001085
	Other Documents	
52.	05/31/2005 E&Y memo to CarMax re: Treatment of Advance payments following restructuring	CarMax_001699-001720
53.	11/17/2004 E&Y memo re: state tax challenges	CarMax_001721-001804
54.	11/12/2004 E&Y Memo to CarMax re: potential restructuring.	CarMax_001805-001847
55.	E&Y Valuation of IP dated	CarMax 001600-001645
56.	2010 TRAC Commission Report	
57.	CV of Professor Richard Pomp	
58.	CV of Dr. Brian Cody	

59.	CV of Jack Small	
60.	CV of Ben Miller, Esq.	
61.	CV of Dr. David DeRamus	
62.	Memo (Car dealer set)	SCDOR 5849-5857
63.	Memo (Back office set)	SCDOR 5858-5963
64.	Memo (Real estate services set)	SCDOR 6318-6330
65.	Memo (Retailer set)	SCDOR 6331-6378
	Excel Spreadsheets	
66.	FY 16-18 Legal P&L	CarMax 002393
67.	CASS Associates	CarMax 002690
68.	E&Y supporting documentation	EY-CM-00000047
69.	FY 16-18 Legal Balance Sheets Summaries	CarMax 002702
70.	Spreadsheet from Brian Cody's file	CarMax 002397
71.	DeRamus Spreadsheet 1	SCDOR 6500
72.	DeRamus Spreadsheet 2	SCDOR 6501
73.	DeRamus Spreadsheet 3	SCDOR 6502
74.	DeRamus Spreadsheet 4	SCDOR 6503
75.	DeRamus Spreadsheet 5	SCDOR 6504
76.	DeRamus Spreadsheet 6	SCDOR 6505
77.	DeRamus Spreadsheet 7	SCDOR 6506
78.	DeRamus Spreadsheet 8	SCDOR 6507
79.	DeRamus Spreadsheet 9	SCDOR 6508
80.	DeRamus Spreadsheet 10	SCDOR 6509
81.	Excel file Spreadsheet	CarMax 003645
82.	Excel file Spreadsheet	CarMax 003646
83.	Excel file Spreadsheet	CarMax 003647
84.	CarMax Auto Superstores West Coast 'C' Corporation Income Tax Return for Tax Period Ending 02/29/2016	CarMax 000704
85.	Eileen Yost Transcript (9.22.22).pdf Exhibit 1_2022.08.17 Depo Notice 30(b)(6).pdf Exhibit 10_CarMax_001699.pdf Exhibit 11_Petitioner's PHS.pdf Exhibit 15_CarMax_000537.pdf Exhibit 16_CarMax_001868.pdf Exhibit 17_CarMax_001913.pdf Exhibit 18_CarMax_001912.pdf Exhibit 19_CarMax_001920.pdf Exhibit 2_CarMax_000514.pdf Exhibit 20_CarMax_001864.pdf Exhibit 21_CarMax_001938-001965_.pdf	

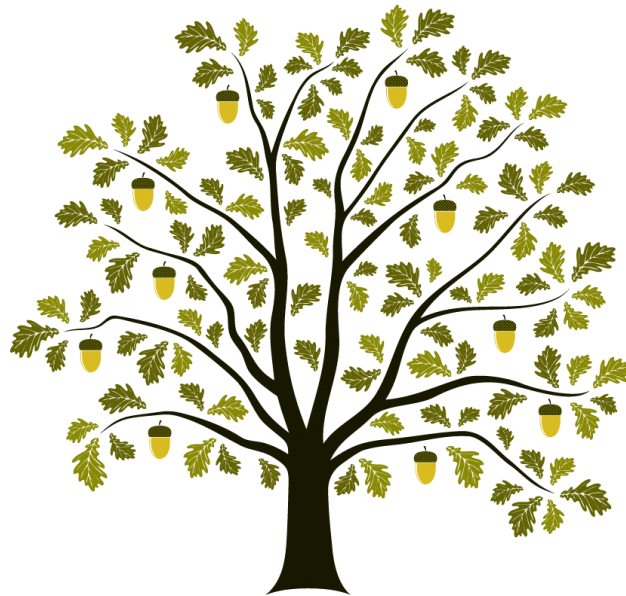
	Exhibit 3_CarMax_000526.pdf Exhibit 4_CarMax_000425.pdf Exhibit 5_FY ending 2018.2.28 10-K.pdf Exhibit 6_CarMax_001097.pdf Exhibit 7_CarMax_001086.pdf Exhibit 8_Employment Services Agreement CBS - CASS (2).pdf Exhibit 9_CarMax_000013 COMPRESSED.pdf Exhibit 9 CarMax 000013.pdf	
Respondent's Demonstrative 1	SOUTH CAROLINA DEPARTMENT OF REVENUE REPORT OF FIELD AUDIT: INCOME TAX & LICENSE FEE Excel Spreadsheet	
Respondent's Demonstrative 2	Dr. DeRamus Slides 1-96	
Respondent's Demonstrative 3	Dr. DeRamus Slides 1-3	

Transcript of the Testimony of

Orville Sharpe

March 17, 2023

CarMax v. SCDOR



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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

- - -

CARMAX AUTO SUPERSTORES, INC.,	:	
	:	DOCKET NO.
Petitioner,	:	
	:	21-ALJ-17-0182-CC
vs.	:	
	:	
SOUTH CAROLINA DEPARTMENT OF	:	
REVENUE,	:	
	:	
Respondent.	:	

VIDEOCONFERENCED 30(b)(6) DEPOSITION OF
SOUTH CAROLINA DEPARTMENT OF REVENUE
GIVEN BY ORVILLE SHARPE

DATE TAKEN: Friday, March 17, 2023
TIME BEGAN: 10:03 a.m.
TIME ENDED: 4:49 p.m.
LOCATION: Remote Deposition
REPORTED BY: Deidre Osborne, RPR

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A P P E A R A N C E S
(via videoconference)

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1 (It is hereby stipulated and agreed by and
2 between counsel for the respective parties that
3 this deposition is being taken in accordance with
4 the Federal Rules of Civil Procedure and that the
5 deponent does not waive reading and signing of
6 this deposition transcript.)

7 - - -

8 ORVILLE SHARPE, after having been first duly
9 sworn, was examined and testified as follows:

10 - - -

11 EXAMINATION

12 - - -

13 BY MR. STREISEL:

14 Q. Good morning, Mr. Sharpe. I'm Bobby
15 Streisel, and I'm here on behalf of CarMax.

16 And would you prefer "Mr. Sharpe" or
17 "Orville" or what?

18 A. "Orville" would be preferable.

19 Q. Okay. Sounds good. I can -- I can do that.

20 And -- and you've been deposed a number of
21 times, correct?

22 A. Yes.

23 Q. Okay. And so just going to go over a few
24 things here before I get started.

25 MR. STREISEL: And, well, I guess, first of

1 all, Trey, do you want to --

2 MR. ANTLEY: Yeah. I was going to say, if
3 you -- if you don't mind, I'll go ahead and just
4 state those objections.

5 MR. STREISEL: Yeah. Go ahead.

6 MR. ANTLEY: And I don't know if you plan on
7 marking this as an exhibit, but the notice of
8 deposition for the 30(b)(6) topics, if you don't
9 plan on marking it as an exhibit -- if we could
10 just mark that as an exhibit, so I --

11 MR. STREISEL: Let's make that Exhibit 1,
12 was my plan.

13 MR. ANTLEY: Okay.

14 MR. STREISEL: Yeah.

15 MR. ANTLEY: Okay. So Exhibit 1 is the
16 notice of the 30(b)(6) deposition?

17 MR. STREISEL: Yeah. With the Attachment A
18 topics.

19 MR. ANTLEY: Yes. Okay.

20 MR. STREISEL: Yes.

21 - - -

22 (Notice of 30(b)(6) Deposition marked Exhibit
23 Number 1 for identification.)

24 - - -

25 MR. ANTLEY: Okay. So, just for the record

1 I'd like to put the Department's objections to
2 the topics. As we discussed in our call on
3 Monday, March 13, 2023, the Department objects to
4 the 30(b)(6) topics. An objection that would go
5 to all topics would be that we can discuss -- we
6 have a witness who can discuss some of these
7 topics from the audit level, but after that,
8 anything else would have been prepared in
9 anticipation of litigation, protected by attorney
10 work product, attorney-client privilege or
11 attorney mental impressions. And the -- so that
12 would be once it reaches the Office of General
13 Counsel level, and then Department's analysis
14 would continue once it reaches that level, but
15 those -- but that subject would be protected or
16 privileged.

17 In addition to that objection, the
18 Department objects to topics for the following
19 reasons: Topic number 1, it's overly broad and
20 unduly burdensome not reasonably calculated to
21 lead to the discovery of admissible evidence.

22 Topic number 2, not reasonably calculated to
23 lead to the discovery of admissible evidence.

24 Topic 3, I think we're in agreement that in
25 lieu of -- of having someone testify to this

1 topic we would produce the Department's file,
2 policy file, for Revenue Ruling 15-5, subject, of
3 course, to any objection to attorney work client
4 or privilege objection or any objections as we --
5 as we provide that document.

6 Number 4, overly broad and unduly
7 burdensome, not reasonably calculated to lead to
8 the discovery of admissible evidence.

9 Number 5, not reasonably calculated to lead
10 to discovery of admissible evidence.

11 Number 8, the appropriate -- you know,
12 subject to the objection we said generally about
13 being able to speak to the audit level, that the
14 better witness for some of these questions would
15 be -- or this topic would be the Department's 482
16 expert.

17 Topic number 9, overly broad and unduly
18 burdensome, not reasonably calculated to lead to
19 the discovery of admissible evidence. Subject to
20 and not waiving that objection, the Department
21 could produce redacted invoices showing any
22 payments made to Bates White, in lieu of having a
23 person that would actually be designated to speak
24 on that topic, and I believe we're in agreement
25 on that issue.

1 That similarly for topic 10, the Department
2 can also produce the invoices specific to CarMax.

3 Topic number 11, not reasonably calculated
4 to lead to discovery of admissible evidence.

5 Topic 12, not reasonably calculated to lead
6 to discovery of admissible evidence.

7 14, the published guidance is -- portion of
8 that question, that guidance is publicly
9 available and speaks for itself.

10 17, topic 17, the statute and the cases
11 speak for themselves.

12 Topic 19, overly broad and unduly
13 burdensome.

14 Topic 20, overly broad and unduly
15 burdensome.

16 Topic 21 -- oh, sorry.

17 And topic 23, not reasonably calculated to
18 lead to discovery of admissible evidence.

19 Subject to and without waiving those
20 objections, the Department has designated Orville
21 Sharpe as its 30(b)(6) witness.

22 MR. STREISEL: Okay. Just a couple
23 questions, Trey. So topics 9 and 10, the fees
24 paid to Bates White.

25 MR. ANTLEY: Yes.

1 MR. STREISEL: So, I believe -- so you said
2 you're going to produce the invoices that have
3 that information, but Orville's not prepared
4 today to talk about that?

5 MR. ANTLEY: Yeah, I think. I think when we
6 spoke on Monday that seemed like that would be
7 acceptable, and rather than have a person have to
8 go through and memorize those numbers, just give
9 you guys the invoices so you're able to see it.

10 MR. STREISEL: That's fine. And redacted is
11 fine.

12 MR. ANTLEY: Yeah. So we wouldn't -- so we
13 wouldn't have the names of the taxpayers on it.

14 MR. STREISEL: Yeah.

15 MR. ANTLEY: The CarMax invoice would not be
16 redacted. That would have -- obviously would
17 have CarMax listed as a taxpayer.

18 MR. STREISEL: Okay. Okay. And then you
19 had an objection to topic 3, and you were going
20 to provide some information on that as well. Or
21 a production.

22 And I'll probably have some questions just
23 about his personal knowledge on that topic, and
24 we'll just see how that goes, and, you know, you
25 can object as needed during it if that helps.

1 MR. ANTLEY: Yeah. Yeah. If it -- I mean,
2 as long as it's understood that that's, you know,
3 him individually and not the 30(b)(6) witness,
4 then I'm fine with that. I think the best way to
5 talk about that from the Department -- from its
6 perspective would be that file that I think we
7 talked about. I think it's been produced in
8 other matters. You guys know what to expect.
9 That that would be the best -- the best way for
10 the Department to answer that question since the
11 individuals involved in the drafting and even the
12 issuing, the signing, of that policy document are
13 no longer at the Department.

14 MR. STREISEL: Okay. And just -- so just
15 one aspect of that topic 3 I asked about. The
16 reasons the Department, you know, did not
17 promulgate it as a regulation, and then it gets
18 into -- and still as of the date of the
19 deposition has not promulgated it as a
20 regulation. So that latter part of it basically
21 is saying what's the Department's position or its
22 reason for, you know, still never promulgating a
23 regulation under the APA. I feel like that is
24 something where -- would be proper for someone on
25 behalf of the Department to be answering that.

1 The 30(b) witness? Is that fair?

2 MR. ANTLEY: So --

3 MR. STREISEL: The only -- it's the only one
4 that gives me pause about saying everything is
5 just his personal capacity.

6 MR. ANTLEY: Yeah. So with that, the
7 problem with that is decisions on whether or not
8 to issue a regulation would be done in
9 conjunction or in consultation with the
10 Department's legal counsel, so we wouldn't be
11 able to get into any of those discussions, so he
12 can speak to that issue from what he knows, you
13 know, individually, but as far as the Department
14 speaking, anything -- I -- any witness that would
15 be able to speak to that would have to go into
16 attorney-client communications.

17 MR. STREISEL: Okay. Yeah. That's --
18 that's fine. Yeah, I understand. So we'll
19 just -- again, on that topic, we'll -- we will --
20 you know, it will be in his individual capacity
21 for this specific context, and we can, you know,
22 revisit it if we need to, but that's fine for
23 today, to view it that way.

24 MR. ANTLEY: And I might adjust the camera
25 so it's facing him a little better and not me,

1 but I'll be over here, and if you have any
2 trouble hearing me at any point just let me know,
3 and I'll speak up.

4 BY MR. STREISEL:

5 Q. All right. All right. Orville, your
6 deposition today is being taken pursuant to the rules
7 of South Carolina -- South Carolina Rules of Civil
8 Procedure and the Administrative Law Court Rules. Is
9 that your understanding?

10 A. Yes.

11 Q. Okay. And is it your understanding that
12 we're here today to take your deposition based on
13 your involvement in the audit of CarMax and also
14 based on the 30(b)(6) notice that was sent to the
15 Department for that case?

16 A. Yes.

17 Q. Okay. And I think how we'll do this is we
18 will start with the 30(b)(6) aspect of your
19 deposition, and then at the end we could switch to, I
20 guess, your individual capacity deposition, and I'll
21 just make clear when that switch is made. Otherwise,
22 everything we'll be talking about will be in your
23 capacity as a 30(b)(6) witness with the exception of
24 what Trey and I were just discussing for certain
25 topics.

1 Is that -- does that work for you?

2 A. Yes.

3 Q. Okay. And if there's ever a time where it's
4 unclear, you know, just let me know, and we'll just
5 make sure the record's clear since we have this
6 dual-capacity deposition going on.

7 Is that all right with you?

8 A. That sounds good.

9 Q. Okay. And Exhibit 1 of the deposition we
10 made the 30(b)(6) notice, and that included the list
11 of topics to be covered today.

12 And have you reviewed that?

13 A. Yes.

14 Q. And are you comfortable answering the topics
15 that you've been identified to cover?

16 A. Yes.

17 Q. Okay. Okay. And so just a few ground
18 rules. If there's any questions I ask that you don't
19 understand, please feel free to ask me to rephrase
20 them or clarify, and I'll do my best.

21 Is that understood?

22 A. Yes, sir.

23 Q. Okay. And no need to call me "sir" either.

24 A. Oh.

25 Q. And, yeah. I -- let's do our best to not

1 talk over each other when we can just to help the
2 court reporter out, keeping the record clear. And
3 also do your best to give yes and no answers rather
4 than nodding or shaking your head, just, again, for
5 the record.

6 If you hear objections throughout the
7 deposition from Trey, unless you're instructed not to
8 answer, please go ahead and answer the question, you
9 know, once he's made his objection. And if you need
10 a break at any time other than in the middle of a
11 question, just let me know, and we can take a break,
12 and I'll probably take some breaks too.

13 And, otherwise, any questions?

14 A. No.

15 Q. Okay. Can you please state your full name
16 for the record?

17 A. Orville C. Sharpe.

18 Q. And is there anything that would prevent you
19 from being able to tell the truth today?

20 A. No.

21 Q. And how many times have you been deposed? I
22 know it's been a number, but do you know how many?

23 A. I'd say eight, nine, or ten. Something like
24 that.

25 Q. Okay. And how many times, do you recall,

1 have you served as a 30(b)(6) witness for the
2 Department?

3 A. This is the second time.

4 Q. Okay. And the -- what was the first time?
5 Was that recently?

6 A. Yes, it was recently.

7 Q. And could you -- you've been at the
8 Department a long time, right? When did you start?

9 A. April 1978, so it'll be 45 years in April.

10 Q. Okay. Yeah. I assume I can talk -- I don't
11 know whether to talk about our case or not. But,
12 yeah, I remember from a recent trial you've been
13 there a while.

14 So you shooting for 50 years, right?

15 A. That's my goal. As long as my health holds
16 up and we don't have too many of these court cases.
17 Too many depositions.

18 Q. I'm with you on that.

19 So, yeah. I don't need to go through your
20 entire job history at the Department, but how many
21 positions have you held there in your 45 years?

22 A. Let's see. I started in April 1978, and
23 when I started, I was a sales and use tax auditor,
24 and I think I did that for maybe about 18 years. And
25 then after that I became a -- what we call a foreign

1 corporate and income tax auditor, and I did that
2 until -- I think -- I'm not sure whether I became a
3 foreign audit supervisor in '18 or '19. I always get
4 that confused, but I think I've been doing foreign
5 audit supervisor for about five years, so those are
6 the only three positions I've held.

7 Q. Okay. And I should have made this clear
8 earlier, but your background information is your, you
9 know, individual information as opposed to the
10 30(b)(6), and then we'll be talking about the
11 30(b)(6) topics, but that should be clear.

12 Okay. And so you said you became an
13 audit -- so you became a foreign audit supervisor in
14 2018 or 2019, you said?

15 A. Yes. For some reason I can't remember that,
16 but it was '18 or '19. I think it's been about five
17 years, so it must have been '18. Maybe -- yeah,
18 maybe '18. I think it was '18, but I'll -- I can let
19 you know for sure if you need to know that.

20 Q. That's close enough.

21 A. Yeah.

22 Q. Okay. Okay. So we're going to get into the
23 30(b)(6) topics now, and let's -- we're going to
24 start with the first topic, and I'm going to ask you
25 to -- well, you don't have to open it, but Exhibit 2,

1 going to talk about SC code.

2 MR. STREISEL: And let's make this Exhibit 2
3 for the deposition. And it's -- the alternative
4 apportionment statute is what I'll refer to it
5 as, but SC code 12-6-2320.

6 THE WITNESS: Okay.

7 - - -

8 (Alternative Apportionment Statute marked Exhibit
9 Number 2 for identification.)

10 - - -

11 BY MR. STREISEL:

12 Q. Are you ready?

13 A. Yes, sir. Yes.

14 Q. So, all right. Are you familiar with this
15 statute, I assume?

16 A. Yes.

17 Q. Okay. And the proposed assessment in this
18 case is based on the Department's use of this
19 statute, right?

20 A. Correct.

21 Q. Okay. And could you just, you know, briefly
22 tell me that the primary CarMax entities, what you
23 refer to them as?

24 A. Okay. For CBS, I call them CBS. For CarMax
25 Auto Superstores, Incorporated, I call that one West.

1 For CarMax Auto Superstores West Coast, Inc., I call
2 that one West.

3 Q. Okay.

4 A. The other one, I think maybe I said West,
5 but I mean CarMax Auto Superstores, Inc., is East.

6 Q. Okay.

7 A. So I call them the East, West and CBS.

8 Q. Okay. That works for me, and I will do the
9 same. I might say CarMax West or CarMax East, which
10 means West or East. Right?

11 A. Correct.

12 Q. Okay. If it's ever unclear, we'll make sure
13 we understand each other, but that works for me.

14 Okay. So back to this statute, and if I
15 refer to this as the alternative apportionment
16 statute, will you understand me to be talking about
17 12-6-2320?

18 A. Yes, because that's exactly what I refer to
19 it as.

20 Q. Perfect. Perfect. Okay. And -- all right.
21 So, that statute was used in this case and the -- or
22 the alternative method is combined unitary reporting,
23 right?

24 A. Correct.

25 Q. And to your knowledge -- so is -- this

1 alternative apportionment statute, is this the only
2 authority that the Department has used to require
3 combined reporting?

4 A. Well, we use the alternative apportionment
5 statute, and we also, of course, use the Media
6 General court case and our Revenue Ruling 15-5.

7 Q. Okay. Okay. And would you agree that -- so
8 as far as the source of power for the Department's,
9 you know, requirement of combined unitary reporting,
10 would you agree that it's the alternative
11 apportionment statute you're using and Media
12 General's interpreting that statute?

13 A. Correct.

14 Q. Okay.

15 A. And Revenue Ruling 15-5 explains basically
16 how to do a unitary combined write-up.

17 MR. STREISEL: Okay.

18 All right. And, Trey, I may have a question
19 for you on this one.

20 MR. ANTLEY: I'm here.

21 MR. STREISEL: Sorry. Yeah. So, number --
22 number one, I remember on our call last week that
23 might have to change the time period for this
24 one. It -- so this is the one -- yeah. Number
25 one, I think you said something about it would be

1 July 1st of 2019 on forward or something like
2 that. Is that right?

3 MR. ANTLEY: Yeah, that's right. If you
4 were to ask him about it, he can -- he can
5 explain the reason for the difference in the
6 period.

7 MR. STREISEL: Okay. Well, we'll go with
8 that that. All right.

9 BY MR. STREISEL:

10 Q. All right. Orville, since January 1, 2018,
11 through today, how many proposed assessments has the
12 Department issued that require combined unitary
13 reporting?

14 A. That -- this information is not -- was not
15 available from '18, but my manager, Rob, used our new
16 tax system, Doorway, and he was able to get three and
17 a half years. I think the period is 7/1/19 through
18 12/31/2022, three and a half years, and he came up
19 with 53 cases that were -- was alternative
20 apportionment, and all of those were unitary
21 combined.

22 Q. Okay. And that -- and that date was July 1,
23 2019, it was started?

24 A. Yeah. Right. Through 12/31/2022.

25 Q. Okay. And there were 53 proposed

1 assessments that require combined unitary reporting,
2 you said?

3 A. Correct.

4 Q. Okay. And do you know how many of those
5 proposed assessments were protested by the taxpayer?

6 A. No. I would say probably about -- I would
7 guess around 80 percent. Some of them pay.
8 Generally they don't pay. They protest, and it goes
9 to appeals, and I say -- I would say about -- of
10 those that are protested, maybe 50 percent of them
11 are settled, and they don't go to court.

12 Q. Okay. And I -- so the -- the ones that
13 don't settle go -- never mind. You answered that
14 already.

15 And so from January 1, 2018, through today
16 do you know how many Department Determinations have
17 been issued that upheld a proposed assessment that
18 requires the use of combined unitary reporting?

19 A. I think I went back to -- I thought it was
20 2008. But I think I went back to 2008, and I came up
21 with 17 Department Determinations. I must have got
22 the date off, but I think I went to -- I went back to
23 2008.

24 Q. Okay. And so I guess you are able to go --

25 A. Maybe I -- no. If it said 2018 in the --

1 did it say 2018 in the -- in that information?

2 Q. Yes.

3 A. Oh, okay. Then I -- then I would have used
4 2018. Well, no. That doesn't make sense, though,
5 because that would have been some -- shortly after
6 Revenue Ruling 15-5. But I think 17 is total for --
7 for any period. I think 17 is the total that they've
8 ever done that I'm aware of.

9 Q. Okay.

10 A. From day one, whatever day one is.

11 Q. And so let's -- so we'll start again with
12 the January 1, 2018, through today. How many
13 proposed assessments has the Department issued that
14 used the alternative apportionment statute to require
15 something other than combined unitary reporting?

16 A. Oh, we really can't track that. There --
17 there -- we -- there's -- I guess, now we are putting
18 in our reports the type -- the main audit issue, but
19 back then we didn't do that. So I wouldn't say it
20 would be that -- but I know that I've done some
21 alternative apportionment methods other than unitary
22 combined, but if I had to guess, I would say maybe
23 10, but I really don't know.

24 Q. Okay. And so the -- July 1, 2019, I think
25 is the date that you were able to start tracking the

1 combined unitary reporting proposed assessments. Am
2 I correct then that you're not able -- or that you
3 don't track other types of proposed assessments from
4 that date forward like you do for combined unitary
5 reporting?

6 A. Right. The -- we -- I think we had to go
7 back and look at the auditor's monthly reports, and I
8 don't think other alternative apportionment methods
9 we're able to track as easily. So we -- so, no, we
10 couldn't track that information. But I know that
11 I've done some, and I know others have done some, so
12 I would say probably my guess would be 10 to 15 for
13 that period, but -- that's an absolute guess.

14 Q. Okay. And -- all right. And are you --
15 what alternative apportionment method to your -- you
16 know, would you say is the most commonly used by the
17 Department from 2018 through today?

18 A. Unitary combined reporting.

19 Q. What would you say is the second most common
20 method?

21 A. The second most common method is -- I think
22 we've adjusted the denominator based on some churning
23 that occurs for people like stockbrokers. And
24 they -- I don't know if you're familiar with the
25 stockbroker, but they buy and sell stock for their

1 customers, and they turn over the stock daily. I
2 mean, it's thousands of transactions daily.

3 And some of these stockbrokers have
4 distorted their denominator by including trillions in
5 the -- in the denominator, so it dilutes the
6 apportionment ratio because the apportionment ratio
7 is understated because the denominator is overstated,
8 so I would say the churn is the one that we've used
9 the most.

10 But we also have used some matching
11 adjustments. I'm familiar with those, and other ones
12 that we've used, I believe is similar to a matching
13 adjustment, but I remember one company. They were --
14 they had a -- an intangible intellectual holding
15 company that was charging their affiliates royalties,
16 but yet the entity that was filing in South Carolina
17 was reporting -- was taking deductions for all the
18 R&D, but -- so we transferred the R&D to the
19 intellectual holding company, so that was an
20 alternative apportionment method that we did, but
21 those are ones that come to mind right now.

22 Q. Okay. So for the first one that you
23 mentioned about stockbrokers churning and altering
24 the denominator, generally speaking, approximately
25 how many of those have occurred since 2018 on forward

1 to your knowledge?

2 A. I would say three or four.

3 Q. Okay. And so are there -- Revenue Ruling
4 15-5, are you familiar with that?

5 A. Yes.

6 Q. Okay. And I believe you mentioned earlier,
7 but that -- you know, generally speaking, it explains
8 the way in which the Department does combine unitary
9 reporting when it is used. Is that fair?

10 A. Correct.

11 Q. Okay. And to your knowledge, is there any
12 other published guidance from the Department that
13 explains how some other alternative method is -- how
14 some other method works when used by the Department
15 like it's done by unitary reporting?

16 A. I don't think there's any out -- there's
17 no -- I'm not aware of any other -- when you say
18 "published," do you mean for everybody to see or --
19 even the public to --

20 Q. Yeah, yeah. I would say are you aware of
21 any publications from the Department available to the
22 public that says, "This is how the Department
23 determines" -- let me -- let me back that up. Start
24 over with this question.

25 Any published information from the

1 Department available to the public that explains the
2 way in which the Department implements an alternative
3 method under the alternative apportionment statute
4 other than Revenue Ruling 15-5?

5 A. Well, there's some court cases out there.
6 There are some methods that we tried. Of course,
7 there's the CarMax case, which we lost, as you know,
8 at the supreme court, and there's a Rent-A-West
9 Center case that we lost at the appeals court.

10 (Stenographer asks for clarification.)

11 THE WITNESS: Rent-A-Center West.

12 And we lost it at the appeals court on that
13 one. And then our -- there's another court case,
14 a California court case, when they used, I think,
15 alternative apportionment, and that was a
16 Microsoft case, and that was actually a churning
17 case too where they -- where they diluted or
18 where the -- where the denominator was overstated
19 by including receipts from the sale of short-term
20 investments.

21 BY MR. STREISEL:

22 Q. Okay. And so --

23 A. But there's no -- those are the ones -- just
24 the court cases. I don't think there's any published
25 guidance other than court cases.

1 MR. STREISEL: Okay. And so let's --
2 Revenue Ruling 15-5, let's make that Exhibit 3
3 for the deposition, please.

4 - - -

5 (Revenue Ruling 15-5 marked Exhibit Number 3 for
6 identification.)

7 - - -

8 BY MR. STREISEL:

9 Q. And, Orville, if you don't mind pulling that
10 up and letting me know when you're ready.

11 A. My computer's -- every time it goes down, it
12 dies, and I have to put in my password again. Okay.
13 Revenue 15-5. Okay. I got it up.

14 Q. Okay. Now give me a second to get it up.

15 Okay. And so other than explaining how the
16 Department implements combined unitary reporting when
17 used as the alternative method, what would you
18 generally describe as being the purpose of this
19 Revenue Ruling?

20 A. I think the purpose was to provide -- after
21 the -- it was issued shortly after -- well, no. It
22 was issued not shortly because it was issued in 2015,
23 and the Media General case was decided in 2010, so I
24 believe it was issued after the Media General case.

25 And I think taxpayers were asking, "Well,

1 why don't you have a ruling reflecting how to do a
2 unitary combination?"

3 And I think that was one of the reasons, but
4 it's helpful to, I think, taxpayers and the
5 Department on alternative apportionment in general,
6 and it describes, you know, reasons that alternative
7 apportionment might be used, and it talks about the
8 Media General case, and it talks about the CarMax
9 case, and it talks about, I think, a 20th Century Fox
10 case.

11 And then it goes on to provide some reasons
12 that an alternative apportionment method may be
13 imposed by the taxpayer, and then it goes on in great
14 detail, if unitary combination is the method that's
15 selected, how you actually do unitary combination
16 because prior to Media General we didn't know how to
17 do a unitary combination. We had never had any
18 training in how you do a write-up of a unitary -- a
19 unitary taxpayer.

20 Q. Okay. And, if you would, go to page 4 of
21 the Revenue Ruling, towards the bottom -- it starts
22 on page 4 and goes into page 5, the 20th Century Fox
23 case is referenced there.

24 A. Right.

25 Q. You see where I am?

1 A. Yes. Page 4 and the top of page 5?

2 Q. Yes. And so the alternative -- the
3 alternative apportionment statute, it requires the
4 alternative method used to be reasonable, right?

5 A. Correct.

6 Q. Okay. And this 20th Century Fox case on
7 page 4, the bottom of page 4 of the Revenue Ruling,
8 it talks about reasonableness, and it lists -- says
9 reasonableness has at least three components, and it
10 lists one, two, and three. You see where I am?

11 A. Yes.

12 Q. And then I think footnote two seems to say
13 that the second component doesn't apply in South
14 Carolina because we're not a UDITPA state, correct?

15 A. Correct.

16 Q. Okay. And so excluding the second component
17 of the test, is this the test that the Department
18 uses to determine whether the use of an alternative
19 method is reasonable under the alternative
20 apportionment statute?

21 A. Yes.

22 Q. And is this the test the Department uses to
23 determine whether its use of combined unitary
24 reporting is reasonable?

25 A. Is that the same question you asked -- just

1 asked? I thought it's -- yes. Yes. Yes. I think
2 that's the same question you just asked.

3 Q. I get -- the first one, I guess, would have
4 been is this the test used for any alternative
5 apportionment method?

6 A. Oh, yes. Both -- both. Yes.

7 Q. All right. Let's just -- let me just start
8 over just to make sure we get it clear. So for --
9 let me do it this way. Excluding the second
10 component of this test, is this the test that the
11 Department uses to determine whether its use of
12 combined unitary reporting is reasonable?

13 A. Yes.

14 Q. Okay. And then is this also the test that
15 they used to determine whether other alternative
16 methods are reasonable?

17 A. Yes.

18 Q. And so if this test, again, excluding the
19 second component, is not met in this particular case
20 with CarMax, does that mean the Department would
21 agree that its use of combined unitary reporting in
22 this case is not reasonable?

23 A. I'm sorry. I didn't hear all of that.
24 Could you repeat it?

25 Q. So in this case that we're here taking your

1 deposition about today, CarMax, if this
2 reasonableness test, excluding the second component,
3 again, is not met, does that mean the Department
4 would agree that its use of combined unitary
5 reporting is not reasonable?

6 A. Yes, I think so.

7 Q. And are auditors trained to apply this test,
8 foreign auditors?

9 A. Well, hopefully they are. They're --
10 they're supposed to be familiar with Revenue Ruling
11 15-5, so my hope is, yes, they are aware of this.

12 Q. Well, is there -- is there -- are you aware
13 of them being trained on how to apply this test and
14 to determine whether or not it's being met?

15 A. I don't think that we've had any training
16 other than -- we have had recent training on -- well,
17 you have to -- part of the -- you have to -- any
18 alternative method that's proposed has to be
19 reasonable, so I don't know if they specifically are
20 aware of this, but they should be because we go over
21 15-5 constantly.

22 But in order to -- your alternative
23 apportionment method has to be reasonable. Of
24 course, you know that was decided in the CarMax case,
25 but I don't know if -- we have had training on

1 unitary combinations through MTC. We've had two
2 training classes from the MTC.

3 And we also had a senior auditor recently --
4 that wouldn't have been during this audit period --
5 put on a class on unitary combinations, on how you
6 write it up, how you determine if they're unitary.
7 It was a very detailed class. It was a all-day
8 class.

9 So my -- what I'm saying is I hope they're
10 aware of this, but, you know, I don't know. But if
11 they submit it, I'm not going to sign off on the
12 audit if I don't think their apportionment method is
13 not -- is not reasonable.

14 Q. Okay. And so if you would get to page 7 of
15 Revenue Ruling 15-5 and section 5, the capital V?

16 A. Page 7? Section 5, "Methodology Used By
17 South Carolina"?

18 Q. Yes. And -- yes. And so I guess this
19 section 5, and I believe pages 7 through 11 it spans,
20 is this the section that describes the way in which
21 the Department implements combined unitary reporting
22 when it's used?

23 A. Well, it actually goes through page 8, and
24 it goes through -- oh, wow. It goes through page --
25 it goes through page 12, I believe. It goes through

1 page 12.

2 Q. Okay. Yeah. That's fair. Okay. And the
3 Department, have they ever required a taxpayer that
4 was not a member of a unitary business to use
5 combined unitary reporting?

6 A. Have they ever required a member that's
7 not -- can you repeat that? I'm sorry.

8 Q. Yeah. I can rephrase it. Combined unitary
9 reporting, is it fair to say that the Department only
10 uses this as an alternative method when there is a
11 unitary business?

12 A. Yes. Yeah. The members all have to be
13 unitary in order to use a unitary combination.

14 Q. And the bottom of page 8 of Revenue Ruling
15 15-5, it discusses Finnigan vs. Joyce apportionment?

16 A. Right.

17 Q. Do you see where I am?

18 A. Yes, I am. Yes, I -- yes, I do. Not "I
19 am."

20 Q. So the Department applies the Finnigan
21 method?

22 A. Right.

23 Q. And do you know how that decision was made
24 to use Finnigan as opposed to Joyce?

25 A. No, I don't.

1 Q. Do you know why that decision was made?

2 A. No.

3 Q. To your knowledge, has the Department ever
4 used the Joyce method for a taxpayer that it required
5 to use combined unitary reporting?

6 A. The Joyce method, I think that we've used
7 it, but we've used it accidentally because a lot of
8 the times in a unitary combination, they'll just
9 source receipts to the entities that actually have
10 activity in South Carolina. I don't think the
11 auditors have necessarily gone the next step to
12 determine if there were any other entities within the
13 unitary group that have activity in South Carolina
14 but not in that, so I would say, yes, we probably
15 have used it but accidentally. But I -- but we --
16 but we are a Finnigan state.

17 Q. To your knowledge, the Finnigan method, is
18 there one universal Finnigan method that exists, or
19 does it vary among states that use combined unitary
20 reporting?

21 MR. ANTLEY: Object to the form.

22 THE WITNESS: Well, I'm not sure what the
23 other states do, but my understanding is there's
24 just -- there's one Finnigan, and there's one
25 Joyce, and there's no difference between -- you

1 either use Finnigan or you use Joyce.

2 BY MR. STREISEL:

3 Q. And so where would I look to find rules that
4 explain exactly how the Department applies the
5 Finnigan method of apportionment when it requires
6 combined unitary reporting?

7 A. Well, it says it right here basically, I
8 think.

9 Q. And so are you saying that Revenue Ruling
10 15-5 is where I would look?

11 A. Yes.

12 Q. Okay.

13 A. Or you can also -- obviously, you can look
14 up those California court cases which are referenced
15 here if you're wanting more information, but they're
16 referenced, the California court cases, here.

17 Both of them are California court --
18 basically what Finnigan is, is it just -- if you have
19 a -- say you have 25 entities that are filing in the
20 unitary combined group. Only two of them have
21 connections in South Carolina while the other ones,
22 the other entities, have activities that are -- is
23 less than nexus, but they still -- nexus, but they
24 still -- but they have activity -- deliveries into
25 South Carolina but not enough to be nexus. You can

1 source those receipts to South Carolina because the
2 fact that one entity has nexus, all entities within
3 the unitary group have nexus.

4 Q. Okay. And so -- just so I'm clear, if you
5 are looking to make sure you are applying the
6 Finnigan method -- let me -- let me back that up.

7 So, Revenue Ruling 15-5 is where I would
8 look to understand exactly how the Department's going
9 to apply the Finnigan method. Is that accurate?

10 A. Yes. And also you -- you could look into
11 the California court cases that were referenced there
12 in the Revenue Ruling.

13 Q. Well, does the Department look up those
14 California cases and then follow what they are doing
15 when it is required combined unitary reporting, or
16 does it use the Revenue Ruling 15-5 or something
17 else?

18 A. We've used both of them, probably. But
19 we -- I think, though, that the auditors know the
20 difference between -- hopefully they do -- between
21 Joyce and Finnigan. But Finnigan just means that --
22 like I said, if you have 25 entities and five of them
23 have nexus in South Carolina, the other -- other ones
24 don't, but they still have some -- say they're a
25 retailer and they've had some shipments into South

1 Carolina, but those shipments are not enough to
2 create a nexus, you could still source those receipts
3 to South Carolina because you have nexus on other
4 entities, so the fact that you have one entity within
5 the unitary combined return that has nexus will
6 create nexus for all the other entities within that
7 unitary combined return.

8 Q. Okay. And so page -- page 10 of Revenue
9 Ruling, the final sentence of paragraph 5 and 6 both
10 mention "intrastate apportionment."

11 A. Page 10?

12 Q. And let me know when you see that. It's the
13 last sentence of paragraph 5, and then it's used
14 again in paragraph 6 of page 10.

15 A. Oh, I see. "The income apportioned to South
16 Carolina will then be divided among the members of
17 the group that have nexus with South Carolina and not
18 protected by Public Law 86-272 ('intrastate
19 apportionment')."

20 Is that what you're talking about?

21 Q. Yes. Yes. And so -- so what is intrastate
22 apportionment as it relates to the Finnigan method?

23 A. Well, this is saying that you -- this says
24 that -- "The income apportioned to South Carolina
25 will then be divided among the members of the group

1 that have nexus."

2 It -- I think it -- what it's saying is that
3 if you have three entities within a unitary group
4 that have nexus but you have other sourcing based on
5 Finnigan for other entities, then you combine the
6 total income for all the entities and then you only
7 source income to the specific entities that have
8 nexus in South Carolina.

9 Q. Okay. And so intrastate apportionment, is
10 it fair to say that it's how you -- it's how you
11 divided the total income apportioned to South
12 Carolina among the taxpayers with nexus to South
13 Carolina?

14 A. Right. But you include the Finnigan
15 entities, and you -- you allocate the Finnigan
16 entities to the entities that have nexus in South
17 Carolina.

18 Q. Okay. And so how does the Department
19 perform that step of intrastate apportionment or, as
20 we just described, determining how much income should
21 be allocated to each taxpayer with nexus in South
22 Carolina?

23 A. Based on the -- you take -- for each entity
24 within the state, you take the combined modified
25 unitary apportionable income. You multiply that by

1 the separate entity ratio and apportion the separate
2 entity ratio on a unitary combined basis. It'd be
3 different than a separate entity ratio, because the
4 numerator -- the denominator will include the unitary
5 combined receipts, not just the receipts for that
6 particular entity.

7 Q. Okay. I may come back to that later, but
8 we'll move on for now.

9 THE WITNESS: Excuse me, but I'm going to
10 have to take a break soon.

11 MR. STREISEL: That works. We can take a
12 quick break. Let's do that.

13 THE WITNESS: It's only going to take me
14 about five minutes. Okay?

15 MR. STREISEL: Okay. Let's take -- we can
16 take a five-, ten-minute break. I mean, I'll be
17 back here in five minutes, and we'll just go when
18 you're ready.

19 THE WITNESS: Okay. All right. Thank you.

20 - - -

21 (There was a recess from 10:56 to 11:04.)

22 - - -

23 BY MR. STREISEL:

24 Q. Orville, a few more questions about Revenue
25 Ruling 15-5. So, with respect to the section that --

1 I believe we said it's section 5, the capital V, that
2 starts on page 7 of the Revenue Ruling and ends on
3 page 12, I believe you said, this generally describes
4 the way the Department applies combined unitary
5 reporting, right?

6 A. Correct.

7 Q. Okay. And did the Department consider
8 promulgating this methodology as a regulation under
9 the APA?

10 MR. ANTLEY: Object to the form.

11 THE WITNESS: I don't think so. I think
12 they -- they only did it as the Revenue Ruling
13 because it -- as I indicated, it was just
14 guidance to the taxpayers. It wasn't based on a
15 change in the law or anything like that. To my
16 knowledge, it was just -- it's just guidance to
17 the taxpayers and to the Department.

18 BY MR. STREISEL:

19 Q. Are you aware of any harm that would occur
20 in promulgating the methodology as a regulation?

21 MR. ANTLEY: Object to the form.

22 THE WITNESS: No.

23 BY MR. STREISEL:

24 Q. So this came out in June of 2015, correct?

25 A. Yes.

1 Q. So after that date, you know, through
2 today -- so I'm talking about after Revenue Ruling
3 15-5 came out -- has the Department ever considered
4 promulgating the methodology as a regulation?

5 MR. ANTLEY: Object to the form.

6 THE WITNESS: Not that I'm aware of.

7 BY MR. STREISEL:

8 Q. Are you aware of any harm that would occur
9 were -- if the Department were to promulgate this
10 methodology as a regulation today?

11 MR. ANTLEY: Object to the form.

12 THE WITNESS: No.

13 BY MR. STREISEL:

14 Q. And the Department applies the methodology
15 in Revenue Ruling 15-5. That methodology, it's used
16 for time periods prior to the enactment of the
17 Revenue Ruling, right?

18 A. Yes. Well, it makes clear what period it
19 is -- it says applies to all periods open under the
20 statute on page 1. So then that's of, I think, 6/14
21 of 2015, if that's the correct date it was signed. I
22 believe it is. But it's anything that's still open
23 in the statute of limitations, so I think you can
24 probably go back three -- up to three years from
25 6/14/2015 because the normal statute of limitations

1 is three years.

2 Q. Did the Department consider using Revenue
3 Ruling 15-5 only prospectively, so after its
4 enactment?

5 MR. ANTLEY: Object to the form.

6 THE WITNESS: I don't know whether they did
7 or they didn't.

8 BY MR. STREISEL:

9 Q. When it's applied to periods before it was
10 enactment, do you agree that taxpayers would not
11 benefit from whatever notice it provides to
12 taxpayers?

13 A. The taxpayers would not -- let's see. Well,
14 it depends on what year you're talking about because
15 this came out in 6/14/20. Let me make sure that's
16 the right date. I think it's 6/14/2015. No.
17 6/12 -- sorry about that -- 2015.

18 But it depends on -- you have to look at the
19 statute of limitations and if they had extension of a
20 return. So, for example, the -- normally taxpayers
21 file the return -- the larger taxpayers file the
22 return. They usually get the -- the six-month
23 extension. So as of June 12 of 2014 -- 2015, the
24 2014 return would not have been filed, so maybe
25 the -- the return is before that, but not the 2014

1 return which hasn't been filed yet.

2 Q. Okay. Okay. I'm going to switch gears for
3 a little bit now. And so, specifically, I'm going to
4 talk about topic number 4 in the deposition notice.
5 And from January 1, 2018, through today, how many
6 proposed assessments that the Department issued that
7 adjusted the price of an intercompany transaction
8 that the taxpayer supported with a transfer pricing
9 study?

10 A. I know that I just -- we just wrote up one,
11 but I don't -- and we probably -- from '18 -- from
12 '18 forward, we probably didn't -- there weren't -- I
13 wasn't aware of any other ones.

14 Q. And you --

15 A. But I didn't -- but on the one I just wrote
16 up, we said that the shifting of the income from one
17 entity to the next didn't have any economic
18 substance. So because it didn't have any economic
19 substance, we didn't really have to consider the
20 transfer pricing.

21 So I know that before we started doing the
22 unitary combinations after the Media court case, we
23 did some matching adjustments which are a very
24 similar to a 482 adjustment. But I don't have any
25 idea how many. That would have been before 2018, so

1 generally we haven't made 482 adjustments, or we
2 might have -- may have some matching adjustments
3 which are very similar to the 482 adjustments, but we
4 don't normally make 482 adjustments because we don't
5 have any 482 experts with the Department of Revenue.

6 Q. Okay. So January 1, 2018, through today
7 you're not aware of making any 482 adjustments. Is
8 that accurate?

9 A. Right. Except for one that you could argue
10 that we recently made that was maybe a 482
11 adjustment, but we call it a economic substance. We
12 said the transaction lacked in the economic
13 substance, but I think you can -- one could probably
14 argue that that could have been a 482 adjustment.

15 Q. Okay. And so without telling me details
16 about the taxpayer or anything like that, so are you
17 saying in that one you just referenced that there was
18 a intercompany traction supported by a transfer
19 pricing study, and the Department just denied the
20 deduction entirely as opposed to adjusting the price
21 to something else?

22 A. No, we didn't deny the adjustment entirely
23 because we adjusted the price to something else,
24 so -- but we said that basically the transaction
25 lacked economic substance, but we did adjust the

1 price to a lower price that they paid.

2 Q. So it's a couple --

3 A. So, technically, I think you could say
4 that's a 482 adjustment, but we called it a -- that
5 the transaction lacked economic substance. I -- what
6 I remember is that what they said in the -- in the
7 482 that these employees and this business was doing
8 was not really what they were doing in our opinion,
9 and, therefore, we said that it lacked substance.
10 But -- but we did think they were doing something,
11 and so that was -- but -- so we did adjust the price
12 downward.

13 So we did -- so, technically, I think you
14 said -- you could say it was a 482 adjustment that
15 lacked -- the -- what they said that the -- in the
16 482 study that the taxpayer affiliate was doing was
17 not really in our opinion what they were doing, and
18 so they deserve a different markup than what they --
19 they received.

20 Q. Okay. And so was this a proposed assessment
21 or Department Determination or something else?

22 A. It was a proposed assessment that is now at
23 the appeals level.

24 Q. Okay. And so just to give an analogy to
25 make sure I understand what you're saying, is it

1 something like Company A is paying Company B \$10. A
2 transfer pricing study says that B is doing X and Y,
3 but you determined B was only doing X, so you reduce
4 the price from \$10 to something else?

5 A. Exactly.

6 Q. Okay. And so it sounds like -- it sounds
7 like a 482 adjustment, but it also sounds like you
8 didn't call it that when you made that adjustment.
9 Is that fair?

10 A. We said that it lacked economic substance.

11 Q. Okay. And so, I guess, what -- to the
12 extent you know, what legal authority would you be
13 citing in a proposed assessment saying, "Here's why
14 we are reducing the price?"

15 A. South Carolina has adopted the economic
16 substance -- I think we called it the common-law
17 standards in economic substance court cases, so
18 that's the support we would use.

19 Q. Okay. And so -- okay. And you said -- you
20 said -- at the beginning of this discussion you were
21 talking about -- something about matching that you've
22 used before that's sort of like a 482 adjustment.
23 Can you just tell me a little bit more about that?

24 A. Okay. I think the matching adjustment was
25 cited in the Department Determination. Basically

1 what it means is -- matching is an accounting concept
2 which basically means you match your expenses to your
3 income.

4 And I can use CarMax as an example. CarMax
5 East pays 74.5 percent of the -- of the management
6 that CBS receives. Well, they only get back 6.5
7 percent of the flow-through income from CBS. So
8 that -- that would be, like -- well, that means that
9 this income that is produced by this other entity --
10 but they are -- they should -- should have the income
11 that reflects those expenses, and they don't -- they
12 only get 6.5 percent of the flow-through income from
13 CBS, and to fairly reflect the expenses that they'll
14 pay, they really should be getting 74.5 percent of
15 that income from CBS, and to me, that's kind of,
16 like, similar to a 482 adjustment.

17 Q. Okay. And did you say that you used -- you
18 used that more regularly in the past than in recent
19 years?

20 A. We -- yes.

21 Q. Okay. And so how many adjustments have you
22 made -- so this would be the matching principle? Is
23 that fair to call it that?

24 A. Right.

25 Q. Okay. So January 1, 2018, through today,

1 how many proposed assessments have used the matching
2 principle?

3 A. I'm thinking maybe ten.

4 Q. Ten?

5 A. Yes, maybe ten.

6 Q. And just so I understand, so this case, as
7 an example, the Department's using combined unitary
8 reporting, right?

9 A. Right.

10 Q. And the determination also talks about the
11 matching principle as well, right?

12 A. Correct.

13 Q. So is this assessment one that you would
14 call an assessment that is using the matching
15 principle, combined unitary reporting or something
16 else?

17 A. I think it -- this is a combined unitary
18 reporting case, but I think the matching principle
19 supports use of the combined unitary reporting
20 method.

21 Q. Okay. And so in what way does it support
22 the use of combined unitary reporting?

23 A. Because it's accomplishing basically the
24 same thing that the matching principle would
25 accomplish. It's -- basically the management fee is

1 eliminated, so it -- and unitary combination, of
2 course, all intercompany transactions are eliminated.
3 So it's accomplishing basically the same thing that
4 the -- the matching principle would accomplish.

5 Q. Okay. And so the use of the matching
6 principle in this case, it would be used to deny some
7 or all of the deduction for the management fee that
8 East is paying to CBS; is that right?

9 A. It would -- not only would it deny the
10 management fee, it -- it would require that -- that
11 the -- that the income that flows back to -- to East
12 and West reflect the income that they contributed
13 to -- for CBS. So the income that flows back from
14 CBS to West would reflect 74.5 percent of the income,
15 not 6.5 percent. And the income that -- did I say
16 West? I meant East. If I said West, I meant East.
17 The income that flows back to East would reflect a
18 flow-through from CBS of 74.5 percent, and the income
19 that flows from CBS to West would reflect a 24 --
20 25.5 percent of the flow-through income, not 93.5
21 percent.

22 Q. Okay. So switch gears again a little bit.
23 So my understanding is that from 2000 -- at least
24 through 2015 on forward through today the Department
25 has not had a transfer pricing expert on staff. Is

1 that correct?

2 A. Right.

3 Q. Are you aware of them ever having one on
4 staff?

5 A. We haven't had one on staff, but whenever
6 the -- the audit gets to the litigation section, the
7 litigation will generally hire a 482 expert. And in
8 particular, I think -- in this case I think they
9 hired a 482 expert. So we -- we don't generally have
10 one. We don't have one at the -- we don't have an
11 expert on staff, but if we need one, we'll hire one,
12 but it's generally at the litigation level, and I
13 think one time they did hire one at the appeals level
14 before it got to litigation. So, no, we don't have
15 any on staff, but when we need one, we get one. Or
16 an expert.

17 Q. Okay. The one time at the appeals level, do
18 you know when that would have been?

19 A. Yeah. I think it would have been -- because
20 it was my case. It was about maybe five or six years
21 ago.

22 Q. And any reason in particular that there was
23 one hired for that particular instance but none
24 others that you're aware of?

25 A. I -- I'm not sure why they hired -- hired --

1 to be honest with you, I really don't remember, but I
2 guess they wanted to settle the audit. They didn't
3 want to move it forward. I guess under the hazard of
4 litigation, they felt like it was best to settle it
5 at that level.

6 Q. So does the Department ever use a transfer
7 pricing expert at the audit stage?

8 A. Not to my knowledge. Not that I'm aware of.

9 Q. Well, why don't they?

10 A. Well, first of all, Revenue Ruling 15-5 says
11 that a 482 failure is not determinative of whether an
12 alternative apportionment method would be required,
13 so we don't need one pursuant to Revenue 15-5. We
14 just got to prove, one, that the standard reporting
15 method doesn't fairly reflect the taxpayer's business
16 activity in South Carolina and, two, that alternative
17 apportionment method is reasonable. We don't have to
18 disprove at the audit level that the -- you don't
19 have to disprove the transfer pricing study at the
20 audit level pursuant to Revenue Ruling 15-5.

21 Q. Okay. So the -- you know, whether -- you
22 know, whether Revenue Ruling or -- excuse me.

23 So the reason you don't have one at the
24 audit level is because you -- you don't use a
25 transfer pricing expert at the audit level is because

1 you don't need it in order to meet the burden
2 required by the alternative apportionment statute to
3 require combined unitary reporting?

4 A. We don't need it because Revenue 15-5 says
5 it's not determinative whether a unitary combined
6 reporting method will be required. We have to prove
7 two things, and one of them is that the standard
8 reporting method does not fairly reflect the
9 taxpayer's activity in South Carolina and, number
10 two, the alternative apportionment method is
11 reasonable. We don't have to disprove the transfer
12 pricing study.

13 Q. Would you agree that the alternative method
14 to use under the alternative apportionment statute is
15 supposed to be based on the reason that the
16 taxpayer's business activity is not fairly reflected
17 in South Carolina?

18 A. The reason the taxpayer's -- yes. Of
19 course.

20 Q. Yeah. I guess -- or, perhaps, to state it
21 differently, the alternative method used, would you
22 agree that it is chosen based on whatever the source
23 of the problem -- that was a terrible question.

24 Let's just stop that one. Start over here.

25 How about this? Say that the Department,

1 for example -- say the Department determines that the
2 use of separate reporting doesn't fairly reflect the
3 taxpayer's business activity in the state, and they
4 use the alternative apportionment statute. Well, if
5 the reason that it doesn't fairly reflect activity in
6 the state is because of the transfer price used by
7 that taxpayer, wouldn't it be reasonable to adjust
8 the price of the audit stage rather than forcing
9 combined reporting?

10 MR. ANTLEY: Object to the form.

11 THE WITNESS: First, I'll just have to
12 repeat what I said before, is that we don't have
13 to disprove a transfer pricing study. All we
14 have to prove is that the statutory reporting
15 method doesn't reflect -- fairly reflect the
16 taxpayer's business activity in South Carolina
17 and, two, the alternative apportionment method is
18 reasonable.

19 And if you're talking about CarMax -- I
20 don't think you're talking about CarMax
21 specifically, but to us, it's obvious that CBS
22 should not be earning the type of management fees
23 that they're getting. I mean, it -- why should
24 all the income from East be shipped to CBS? I
25 mean, it's just -- there's no relevant reason

1 from what we can see. So, again, we don't have
2 to disprove the 482 study at the audit level.

3 BY MR. STREISEL:

4 Q. Well, is whether or not the -- you know, in
5 this case, say, CarMax and that management fee that
6 East is paying to CBS, is whether or not that
7 management fee an arm's length price relevant to your
8 conclusion that the standard method does not reflect
9 East's business activity in the state?

10 A. Well, like I said before, we don't look at
11 the arm's length pricing, per se. We look at the 482
12 because there's a lot of -- a ton of good information
13 in there. It talks about all the businesses and
14 their activity, and it tells what one entity is doing
15 to the other.

16 But as far as how they come up with their
17 pricing, we don't have anybody that's on our staff to
18 determine if that pricing is reasonable or not.
19 Obviously, I don't think that we -- we don't think
20 that. I mean, I'm not supposed to say what I think.
21 I guess I'm not going to say what I think because I
22 can't support it.

23 But we'll -- I'm pretty sure they're going
24 to have a 482 expert who probably you should direct
25 these questions to because he can answer, you know,

1 whether it's -- the transactions are at arm's length
2 or not.

3 But I can't answer that because I'm not a
4 expert. But we think that we supported our
5 adjustments based on our Revenue Ruling 15-5, the
6 alternative apportionment and Media General. So at
7 this point we've done at the audit level all we have
8 to do. But as I indicated, I think, they do have a
9 482 staff that maybe you need to ask these questions
10 to that expert.

11 Q. Okay. Do you agree it would be helpful to
12 have a 482 expert on staff at the audit stage?

13 A. Would it be helpful? I don't think it would
14 hurt, but I don't think that the -- that we can
15 afford it. You know, as you know, these experts are
16 very expensive, and even if we started to train
17 somebody in 482, it would be very expensive training,
18 and then we would have to buy this database or of the
19 comparables. Not "buy" but subscribe to the
20 database. Maybe it's something that management wants
21 to look at in the future, but we don't currently have
22 anybody that can do that.

23 Q. So has the Department considered using a
24 transfer pricing expert during the audit stage on a
25 as-needed basis to determine whether you can just

1 adjust the price for intercompany transactions?

2 A. No. We -- as indicated previously, we never
3 used it at the audit level but generally used it at
4 the litigation level, and it's been used one time I'm
5 aware of at the appeals level.

6 MR. STREISEL: All right. Let's take a
7 break. Are you good to take a five- or
8 ten-minute break, go a little longer, and then
9 take a lunch break? Does that work for you, or
10 is there a particular time you need a lunch
11 break?

12 MR. ANTLEY: That's with me.

13 THE WITNESS: I'm flexible. Whatever.

14 MR. STREISEL: Okay. Yeah. Let's take a
15 five-minute break and then go a little longer and
16 take a lunch break.

17 MR. ANTLEY: All right.

18 - - -

19 (There was a recess from 11:35 to 11:46.)

20 - - -

21 BY MR. STREISEL:

22 Q. Okay. So CarMax East owns 6.5 percent of
23 CBS, right?

24 A. Correct.

25 Q. And then CarMax West owns the other 93.5

1 percent of CBS?

2 A. Correct.

3 Q. That's been true since 2004, correct?

4 A. Yes.

5 Q. And are you aware that those percentages
6 were determined based on the value of assets that
7 each of those entities contributed to CBS?

8 A. Yes.

9 Q. And you're aware that the value of the
10 contributions was determined by the accounting firm,
11 Ernest and Young?

12 A. I didn't know that.

13 Q. Okay. So what is -- what was your
14 understanding of how those ownership percentages
15 were -- let me back this up.

16 What was your understanding of how the value
17 of the assets that East -- West and East contributed
18 to CBS was determined back at the time of the
19 restructuring?

20 A. I thought that the -- the West contributed
21 the intellectual property, and whatever the value of
22 the intellectual property is, that's how they came up
23 with the 93.5 percent. And East contributed the
24 financing operations and the corporate overhead, and
25 whatever those assets represented, that's how the

1 ownership percentage was determined for East.

2 Q. Okay. So it's -- so it sounds like you were
3 aware the ownership percentages were determined based
4 on the value of assets that each contributed to CBS,
5 right?

6 A. Correct.

7 Q. But you were not aware of who determined the
8 value of those assets when they were contributed; is
9 that fair?

10 A. Yes.

11 Q. Okay. And I think you said this but just to
12 make sure. So you were not aware that the value of
13 the assets that each East and West contributed to CBS
14 was determined by the accounting firm, Ernest and
15 Young?

16 A. Correct.

17 Q. The Department agrees that CarMax East does,
18 in fact, own 6.5 percent of CBS, right?

19 MR. ANTLEY: Object to the form.

20 THE WITNESS: Yes.

21 BY MR. STREISEL:

22 Q. And the Department agrees that CarMax West
23 does, in fact, own 93.5 percent of CBS, right?

24 A. Yes.

25 MR. ANTLEY: Object to the form.

1 BY MR. STREISEL:

2 Q. And so the Department did not make a
3 determination that those ownership percentages are
4 incorrect; is that right?

5 A. We didn't make a determination at the audit
6 level. I think the Department Determination may have
7 indicated that those ownership percentages were
8 incorrect.

9 Q. Okay. So are you saying that the Department
10 Determination determines those ownership percentages
11 are incorrect?

12 A. I think it indicated that the -- that the
13 ownership percentages were incorrect, or it
14 referenced the value. I think it said something like
15 the value of the -- of the intangibles contributed by
16 West to East should bear some relationship to the
17 customers of East and West because without the
18 customers, you would have zero value of the
19 intellectual property.

20 Q. Okay. So you said you are aware that the
21 value -- you are aware that the ownership percentages
22 of CBS were determined based on the value of assets
23 that East and West each contributed to CBS back in
24 2004, right?

25 A. Yes. The value of East that they

1 determined, yes.

2 Q. And so did the Department make a
3 determination that the valuation of the assets
4 contributed by CarMax West to CBS was incorrect?

5 A. They made a reference to that as I indicated
6 previously, and they said that the -- the value of
7 the intellectual property has no value without
8 contributing some of the value to the customers of
9 East and West. We could bring up the Department
10 Determination if you want to, and I can read that
11 part to you.

12 Q. Yeah. Let's do that.

13 MR. STREISEL: So let's make that Exhibit 4,
14 I believe.

15 - - -

16 (Department Determination marked Exhibit Number 4
17 for identification.)

18 - - -

19 THE WITNESS: This looks like it's on the
20 bottom of page 4 and the top of page 5.

21 BY MR. STREISEL:

22 Q. Okay. And so you're talking about page 4,
23 that final paragraph that begins with, "The taxpayer
24 alleges that CarMax Group assigned ownership
25 percentages," and then that paragraph ends on page 5

1 with, "business activity in South Carolina."

2 Am I in the right place?

3 A. Yes.

4 Q. Okay.

5 A. That's it.

6 Q. Okay. And so the first sentence of that
7 paragraph says, "The taxpayer alleges that CarMax
8 Group assigned ownership percentages of CBS based on
9 the value of the assets transferred to CBS by CarMax
10 East and CarMax West respectively."

11 Did I read -- is that right?

12 A. Yes.

13 Q. Okay. And do you know what the value of the
14 assets were that were contributed by CarMax East?

15 A. Well, I don't know what the value are, but
16 you said the value is based on a study made by an
17 accounting firm. I don't even remember the
18 accounting firm that you mentioned.

19 Q. So -- okay. So -- so the accounting firm,
20 Ernest and Young, or EY, they determined -- or the
21 value of the asset -- back that up.

22 So CarMax East contributed assets to CBS and
23 changed to 6.5 percent of CBS, right?

24 A. Correct.

25 Q. And you understand that the accounting firm,

1 E and Y, they are the ones that determined the value
2 of the assets that CarMax East used to support the
3 6.5 percent ownership that it took in CBS, right?

4 A. Correct.

5 Q. And so the value as determined by E&Y of the
6 assets that East contributed to CBS, did the
7 Department determine that the value of the assets as
8 determined by E&Y was incorrect?

9 A. We didn't determine that at the audit level,
10 but I'm saying that this paragraph to me seems to
11 support the proposition that the value wasn't
12 correct.

13 Q. Okay. And is there anything other than this
14 paragraph that makes you believe that?

15 A. Other than my own knowledge that -- that --
16 of, like, our Geoffrey case which basically said that
17 you can't disconnect the intangible property from --
18 from the customers who produce the loyalties that the
19 intellectual holding company receives. The Geoffrey
20 Company says that. So the customers can't be
21 disconnected from -- basically the intellectual
22 property has no value without the customers who
23 generate the loyalties on the -- on the intellectual
24 property.

25 Q. Okay. So has the Department determined what

1 the value is of the assets that CBS contributed to
2 CBS in 2004?

3 A. It says right here, "The retail stores are
4 what makes the intellectual property value. The
5 better the stores do, the more valuable the
6 intellectual property. Because the shifting is not
7 based on the extent of CarMax East's business
8 activity, the result is not a fair representation of
9 the taxpayer's business in South Carolina."

10 But it just says -- so it says the
11 intellectual property should be -- should be
12 attributed to the -- to the value that the
13 customers -- from the way I'm reading it, it says the
14 intellectual property valuation should be based on
15 the value that the customers that East and West
16 brings to that intellectual property.

17 To -- to me, it sounds like, "Okay. What --
18 what revenue do these customers generate in East and
19 West?" That's how you determine what the value of
20 the intellectual property is. That's what I'm --
21 from what I'm reading into what the Department
22 Determination says.

23 Q. Okay. And so -- so --

24 A. So it's the value of the customers. The
25 intellectual property should be based on the value of

1 the customers --

2 Q. Okay. So --

3 A. -- for the receipts for East and West.

4 Q. Okay. And so there -- there was a value
5 that was used for the assets that East contributed to
6 CBS back in 2004, correct?

7 A. Right.

8 Q. And you don't know what that value was,
9 correct?

10 A. No. I know what it was based on, according
11 to the transcript -- I mean, from the transcript that
12 I read from -- I forget her name. I think it's
13 Elaine or Alaine. And she said that the value that
14 was contributed to -- to -- from East to West was
15 based on the financing operations that were
16 contributed to CBS and the corporate overhead. So
17 whatever the value for the corporate overhead in the
18 financing operations, that's what was contributed to
19 CBS by East.

20 Q. So at the audit level, though, the
21 Department, you did not make a determination that the
22 value of the assets that East contributed to CBS in
23 2004 was something other than the value that E&Y used
24 for those assets when they were contributed; is that
25 correct?

1 A. Not per se. But I think that our distortion
2 example indicated that it was -- it was -- it was
3 wrong, that it didn't -- it didn't -- it was
4 distorted that East, who is the entity that produces
5 most of the income for the whole enterprise, had to
6 pay 74 -- they paid 74.5 percent of the intercompany
7 management received that CBS received, and then they
8 only received back 6.5 percent from the flow-through
9 of CBS.

10 That was distorted, so we did say that was
11 distorted, but we didn't say it was based, per se, on
12 the -- on the ownership percentages that were
13 assigned to East and West for their -- the ownership
14 in CBS.

15 Q. So I'm not talking about -- about any values
16 during the audit period. I'm just talking about --
17 and I can pull up the numbers if I need to. But the
18 value that East used for the assets that it
19 contributed to CBS in 2004, the Department has not
20 looked at that value used in 2004 and determined that
21 it was incorrect, right?

22 A. Not at the audit level. But I -- as I
23 indicated previously, I think that was mentioned in
24 the Department Determination which we just went over,
25 and I explained why I felt like that mentioned that.

1 Q. So the Department Determination, do you
2 agree that it doesn't say what the value of the
3 assets that CBS contributed -- excuse me. Let me
4 back this up.

5 Do you agree, the Department Determination,
6 it does not say what the value is of the assets that
7 CarMax East contributed to CBS back in 2004?

8 A. It doesn't say what the value is. But it
9 does say that it should be more in line with what --
10 who the customers are and what kind of -- and, I
11 mean, what -- the customers for this and retail sales
12 and wholesale sales because they do sell at wholesale
13 also.

14 Q. Okay. And do you at least agree, the
15 Department Determination, what we're -- you know, the
16 paragraph we were looking at, it doesn't say that
17 CarMax East -- oh, never mind. Let me change --
18 change the question.

19 So the assets that CarMax West contributed
20 to CBS back in 2004, I believe you mentioned
21 intellectual property. Is that right?

22 A. Yes.

23 Q. And I believe we covered this already, but
24 you understand now that the value of that
25 intellectual property back in 2004 was determined by

1 E&Y, correct?

2 A. Yeah. You told me that today.

3 Q. Okay. And has -- do you know what the value
4 was that E&Y determined was the value of that
5 property contributed by West to CBS back in 2004?

6 A. No, I don't.

7 Q. And so is it fair to say that you have not
8 determined that the value of that property as
9 determined by E&Y back in 2004 was incorrect?

10 A. We didn't determine that at the audit level.

11 Q. To your knowledge, has that been determined
12 at any other time?

13 A. Not that I'm aware of. But it seems, the
14 Department Determination, that the evaluation is
15 incorrect.

16 Q. Okay. And just so I'm clear, is that -- is
17 that based on your reading of the Department
18 Determination -- let me back that up.

19 Is it -- is that solely based on your
20 reading of the Department Determination or based on
21 something else?

22 A. My reading of the Department Determination.

23 Q. Okay. So you're just interpreting the --
24 what the Department Determination is saying, correct?

25 A. Yeah. And I feel like it's supported by the

1 Geoffrey case, which was not mentioned in there.

2 Q. Okay. Okay. Let's switch gears a little
3 bit. Give me one second.

4 If you would go -- let's make this Exhibit
5 5.

6 - - -

7 (Corporate Working Papers marked Exhibit Number 5
8 for identification.)

9 - - -

10 BY MR. STREISEL:

11 Q. And it is Corporate Working Papers. Let me
12 find the Bates label. This should be -- SCDOR_0474
13 is the first page, and the last one should be 0495.

14 MR. ANTLEY: Could you say that Bates label
15 one more time, Bobby, so I can maybe help him
16 find it?

17 MR. STREISEL: Yeah. SCDOR_0474 to 0495.

18 THE WITNESS: Oh, okay. I'm sorry. I found
19 it.

20 BY MR. STREISEL:

21 Q. Okay. These are Corporate Working Papers
22 for this particular case, right?

23 A. Yes. I don't know what -- whether these
24 were the original -- yeah. No. These -- this
25 must've been the final. This is the final. Okay.

1 Q. Okay. And if you would go to SCDOR_0489, it
2 should be page 16 of that PDF.

3 A. 489.

4 Q. Just let me know when you're there.

5 A. Okay. I found it.

6 Q. Okay. And, yeah. I'm just going to talk
7 about this page a little bit as an example. I think
8 the other two years were similar. But so this page
9 we're looking at now, it's -- is it fair to say that
10 this is the way that the Department calculated the
11 corporate tax due for 2018 when they used combined
12 unitary reporting in this case?

13 A. Well, this is, like -- we have two systems.
14 They -- we usually -- we do our write-up basically
15 on -- this is -- by the way, this is what we call
16 Doorway, which is our new tax reporting system, and
17 it was very new when we used this.

18 Basically we used it -- as foreign auditors,
19 basically we'll back into the numbers in these work
20 papers any way we can. You have to go back to the
21 Excel work papers converted to PDF to find out how we
22 actually, you know, write up the auditor adjustments.
23 We're just backing into -- to -- to the amounts
24 reflected on that Work Paper because this is how the
25 money is processed. It's processed through Doorway,

1 which is our tax reporting system.

2 But our Excel schedule is really our support
3 for the audit, and when the taxpayer gets it, we
4 convert the Excel to a PDF. So it's a PDF. So we
5 take the numbers from the PDF, and we back in to
6 them. Actually, she -- now she should have reflected
7 the information reported on the left side, but this
8 was fairly new when this came out, and I don't know
9 why she didn't reflect the reported amounts on the
10 left side.

11 Q. Okay. And so the audited column, I guess if
12 I go down to the very bottom -- the balance --

13 A. You have to go to the Excel Work Papers.
14 That's the best -- converted to PDF, but I can show
15 you how to get these numbers -- where these numbers
16 come from if you want to know that.

17 Q. Okay. And so would it -- I don't know if
18 you know without having it in front of you, but the
19 audit report, what I call the audit report in this
20 case, it has calculations to it that look a little
21 different that reach the same result, which, again, I
22 mean it -- that shows you the balance due. Is that a
23 better source to look at right now?

24 A. Yeah. That's the -- if you're talking about
25 the -- the Excel files converted to PDF, that's the

1 best source.

2 Q. Okay. Let's -- I guess we can pull that up
3 then and make it Exhibit 6 and just see if that's --
4 makes more sense to talk about.

5 - - -

6 (Report of Field Audit marked Exhibit Number 6
7 for identification.)

8 - - -

9 BY MR. STREISEL:

10 Q. So this is SCDOR_0153 to 0169.

11 A. Okay. I found it. Yes. This is the Excel
12 converted to PDF. That's what we call our audit
13 report, but we have to, like, really do -- we do
14 this, and then we have to put this into Doorway, so
15 we actually double. Well, we are working on a new
16 audit program, so hopefully in the future we only
17 have one report and not two reports.

18 Q. Okay.

19 A. These numbers go into our tax reporting
20 system, Doorway, and we'll get these numbers in any
21 way we can to balance to this amount.

22 Q. Okay.

23 A. So this is the -- basically this is the
24 audit report.

25 Q. Okay. And so looking on. And, yeah, I'll

1 refer to this as the audit report as well so we're on
2 the same page with that.

3 And so the first page of this, the billing
4 statement it says at the bottom, this gives the
5 total -- the total additional tax due determined by
6 the audit, right?

7 A. Yes.

8 Q. Page 1 it looks like 2,224,389 is the
9 additional tax due?

10 A. Right.

11 Q. And that's when combined unitary reporting
12 is used?

13 A. Correct.

14 Q. Okay. And if I go to page 3 of this
15 document which is SCDOR_0155 --

16 A. All right.

17 Q. -- it looks like the underpayment, the final
18 row here, matches up with the yearly totals of that
19 first billing statement that amounts to the \$2.2-plus
20 million owed for the audit period, right?

21 A. Correct.

22 Q. Okay. So I'm looking in the far right
23 column of this page right now, and very -- so that
24 would be 2018, the bottom number, 791,614, that's the
25 additional tax owed for tax year 2018 or --

1 A. Correct.

2 Q. -- for year ending 2018, right?

3 A. Right. Yes, sir.

4 Q. Okay. So one, two, looks like three rows
5 up, the balance, do you see it's 1,244,227? Do you
6 see where I am?

7 A. Yes.

8 Q. So that makes --

9 A. 1,244,227?

10 Q. Yes. Is that the total amount of tax that
11 collectively East and West owed to South Carolina for
12 2018 when combined unitary reporting is used?

13 A. No. The correct amount is on the far left.
14 Oh, yeah. Yes. 791,614. Is that what you're
15 talking -- oh, yes. 1,244,227. Yes.

16 Q. So -- so the -- the roughly 1.24 million, is
17 it -- I believe this is correct. That's the total
18 amount owed to South Carolina by the two entities
19 under combined unitary reporting, and then it looks
20 like they get a credit, I guess I'll call it, for the
21 amounts each already paid, and it leaves you with
22 791,614 of additional tax owed?

23 A. Yeah. Right.

24 Q. Okay. So for that 1,244,227 that is owed
25 collectively by East and West for 2018 when combined

1 unitary reporting is used, how does the Department
2 determine the amount that is owed by East versus the
3 amount that's owed by West?

4 A. We don't really -- we didn't really do it
5 here because we -- whenever you do a unitary
6 combined, whoever the lead corporation is, all the
7 money is placed on the lead corporation. It's not
8 allocated to -- to the separate entities. So if you
9 do a unitary combined, you generally only have one
10 entity that's reporting. In this case it would be --
11 the lead entity was -- was East. So all the money
12 would have been applied to East.

13 Q. Okay. So you select a lead corporation and
14 then assess the total tax against that lead
15 corporation; is that right?

16 A. Right.

17 Q. Okay. Why -- why is that?

18 A. Because if there -- on a unitary combined
19 basis, you only have one taxpayer, and that's whoever
20 the lead corporation is. You don't have ten
21 taxpayers or five taxpayers. You only have one
22 taxpayer.

23 Q. And --

24 A. Well -- and our system only allows us to put
25 the money on one entity.

1 Q. So how -- how does the Department chose
2 which entity is the lead entity and gets assessed all
3 the tax?

4 A. Well, you're -- generally it's the entity
5 that's earning all the money. That they think should
6 be earning all the money. In this case, it's East.
7 They're the ones that earn all the money in the whole
8 enterprise. Most of them. I mean, the substantial
9 portion of the money for whole enterprise.

10 Q. Okay. So --

11 A. But if I wanted to know what the income
12 would be for each East and West, you'd have to take
13 the -- you could take the unitary combined income,
14 multiply that times the unitary combined -- not the
15 unitary combined -- the ratio for each entity, and
16 that would -- should get balanced back through the
17 total income. Usually we do that on the work papers,
18 but she didn't do it here.

19 Q. Okay. So the Department selects the entity
20 that should have the income --

21 A. I said generally. It could be -- it doesn't
22 really matter what entity you put it on. You can
23 only put it on one entity.

24 Q. Would you agree that it could matter to the
25 entity that you put it on that it might matter who

1 you put it on?

2 A. It could matter to the entity? I don't see
3 how it would matter to them because if it's on a
4 unitary combined basis, you only -- that's one
5 taxpayer. That's not two taxpayers or ten taxpayers
6 or fifteen taxpayers. It's one taxpayer.

7 Q. Well, East and West are each South Carolina
8 taxpayers, right?

9 A. Right.

10 Q. So that's two taxpayers, right?

11 A. Correct.

12 Q. And so don't you think it might matter to
13 East what, you know -- or to West which one of them
14 gets assessed all the additional tax?

15 MR. ANTLEY: Object to the form.

16 THE WITNESS: I don't think it matters to
17 them because they can allocate it any way they
18 want to because all of these entities are wholly
19 owned. No, I don't think it would matter to
20 them.

21 BY MR. STREISEL:

22 Q. And so why wasn't CarMax West the lead
23 corporation?

24 A. As I indicated previously, we think East is
25 the one that produces all -- the majority of the

1 income. They're the ones that receive the majority
2 of the income from third parties.

3 Q. And that -- and that's why you selected East
4 as a lead corporation?

5 A. I'm not really -- that's why I -- what I
6 would do. I don't know why Jamie selected CarMax
7 Auto Superstores as the lead corporation, but that's
8 generally what I did typically. I would put it on --
9 on the primary entity that had the most activity in
10 South Carolina.

11 And, of course, that was CarMax Auto
12 Superstores, Inc., who had 100 percent of the
13 activity except for the financing and the royalties.
14 They had all the operating -- most of the operating
15 activity. West only had -- they didn't have any --
16 any stores in South Carolina. Auto superstores are
17 leased out to all the stores in South Carolina.

18 Q. So is it the Department's policy to select a
19 lead taxpayer in this type of situation where you
20 have multiple South Carolina taxpayers that are
21 being --

22 A. You have to -- you have to select a lead.
23 You can only put the money on one account. You can't
24 put it on ten or fifteen. On a unitary combination,
25 you have one taxpayer. You don't have five or six or

1 seven. You have one taxpayer.

2 Q. So earlier -- we can pull it up if you need
3 to, but Revenue Ruling 15-5, you're talking about the
4 use of Finnigan and intrastate apportionment. Do you
5 remember that?

6 A. Yes. But Finnigan did not apply in this
7 situation because the only two entities reporting
8 were East and West, and they were combined filing, so
9 it didn't apply in this situation. Finnigan didn't
10 apply to this audit.

11 Q. Under the intrastate apportionment aspect of
12 Finnigan, though, isn't that talking about dividing
13 up the total income apportioned to South Carolina
14 between the South Carolina taxpayers as in which
15 taxpayer's responsible for which portion of that
16 total income allocated to South Carolina?

17 A. Yeah. As I've indicated, we usually do --
18 show a breakout of the -- of the amount that's been
19 computed for each entity within the unitary combined
20 based on whether they have activity in South
21 Carolina. We did not do it in this case, but
22 generally we do. But ultimately it doesn't matter,
23 as I indicated, because all the money is applied to
24 one entity, not two, not three, not five, not ten.

25 Q. So why would a -- why would it be broken out

1 between each South Carolina taxpayer with nexus if
2 it's just all going to one taxpayer anyways?

3 A. I don't know. It's -- some auditors break
4 it out, and some don't. I always broke it out when I
5 was an auditor by each entity.

6 Q. And so is there any Department -- is there a
7 Department policy on the right way to do it, or does
8 it just depend on which auditor is doing it?

9 A. No. We should be -- we should be doing it
10 the way 15-5 says do it, but obviously it wasn't done
11 that way here.

12 Q. Okay. Are you aware -- so to my knowledge,
13 Revenue Ruling 15-5 doesn't -- I mean, it talks about
14 Finnigan and intrastate apportionment, correct?

15 A. Correct.

16 Q. And to my knowledge it doesn't say that all
17 of the additional -- well, it doesn't say the
18 Department will select a lead corporation or that
19 that lead corporation will be assessed all of the
20 additional tax owed on a combined unitary reporting.
21 Is that your understanding as well?

22 A. It does say that a unitary combined return
23 reporting is one taxpayer. So, therefore, you would
24 have to select a -- the one taxpayer that you're
25 going to bill because it's only one taxpayer. It

1 does say that when you have a unitary combined return
2 you only have one taxpayer. You don't have two; you
3 don't have three; you don't have five; you don't have
4 fourteen. You have one taxpayer.

5 Q. But it doesn't --

6 A. We can bring it up, and I can show you it
7 says that if you want me to.

8 Q. We don't need to now, and I believe I know
9 what you're talking about. But my -- my
10 understanding is it talks about you have one tax --
11 view it as one taxpayer to apportion the total amount
12 to the state, but then based on the Finnigan
13 intrastate apportionment, you break it out between
14 the taxpayers with nexus when it's time to give them
15 the tax bill.

16 A. No. You're talking -- Finnigan does not --
17 this does not -- Finnigan does not apply here. But I
18 think she should have shown a separate breakout for
19 each entity, but we didn't show that here.

20 Q. Okay. You said Finnigan doesn't apply here.
21 It was -- it was used, though, right?

22 A. No. You only use Finnigan when you have
23 entities that you are sourcing receipts to South
24 Carolina because they don't have nexus but they have
25 other activity that doesn't come to the level of

1 nexus because if you have one taxpayer that has
2 nexus, all entities within a unitary have nexus based
3 on Finnigan.

4 East and West all -- both already have
5 nexus, so Finnigan didn't apply because they already
6 have nexus in South Carolina. Finnigan applies when
7 you source receipts to an entity within a unitary
8 combined return that doesn't have nexus.

9 Q. So I'm trying to distinguish between whether
10 you're saying you didn't apply Finnigan or that you
11 did but it doesn't matter whether you applied
12 Finnigan or Joyce; you get the same result. That's
13 what I want to distinguish between. So did the
14 Department apply something other than Finnigan?

15 A. You can only apply Finnigan when you -- when
16 you assert nexus on entities within the unitary
17 combined return because of Finnigan. We didn't do
18 that here because both entities already had nexus.
19 East and West already had South Carolina nexus, so
20 Finnigan does not apply in this situation.

21 Q. So if you didn't use the Finnigan did you
22 use the Joyce method?

23 MR. ANTLEY: Object to the form.

24 THE WITNESS: We didn't use either method.

25 Oh -- oh, yes. We used Joyce because Joyce is

1 based on -- already an entity with nexus, yes,
2 Joyce is the one we use. But we typically -- we
3 would have used Finnigan if there would have
4 been -- say that they had fifteen additional
5 entities, and they have -- the fifteen additional
6 entities didn't have nexus pursuant to Public Law
7 86-272.

8 But because we already had nexus on one
9 other entity but the taxpayer still had shipments
10 in the state, they would have been protected by
11 Public Law 86-272, but because the other entities
12 have nexus -- we could have asserted -- we could
13 have sourced receipts to that -- those entities
14 despite the fact that they were protected by
15 Public Law 86-272 because we already had nexus on
16 two entities in this case that already had nexus.

17 BY MR. STREISEL:

18 Q. Okay. So you used the Joyce method here
19 when applying combined unitary reporting method.

20 A. We didn't use any of -- either Joyce or
21 Finnigan because we already had two entities, and
22 both of the two already had nexus.

23 Q. So not Joyce, not Finnigan.

24 A. Oh, okay. Joyce, we had to use Joyce.
25 Joyce. You have to use one of them. Joyce. They

1 only had two entities, but both of them had nexus.

2 MR. STREISEL: Okay. Okay. So let's --
3 it's 12:30. You want to take a hour break now
4 before switching topics? I think now is probably
5 a good break time. Does that work for you guys?

6 MR. ANTLEY: I think that's fine for us.

7 - - -

8 (There was a recess from 12:30 to 1:17.)

9 - - -

10 BY MR. STREISEL:

11 Q. All right. Orville, I'm going to go back
12 now to the alternative apportionment statute, and
13 it's Exhibit 2 in the deposition, and if you want to
14 pull that up, I'll -- just let me know when you're
15 there. Probably have it memorized, but let's pull it
16 up anyway. Let me know when you're ready.

17 A. Oh, okay. I see it. Okay. I got it up.

18 Q. Okay. And so you agree that, the statute,
19 before it can be used by the Department, the
20 Department must show that the standard method does
21 not fairly represent the extent of the taxpayer's
22 business activity in the state?

23 A. Correct.

24 Q. And so I just kind of want to talk a little
25 bit about this to understand how the Department is