THE STATE OF SOUTH CAROLINA
In The Supreme Court

PETITION FOR A WRIT OF CERTIORARI

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S.C. Supreme Court

Case No. 2009-ALJ-17-0160
Appellate Case No. 2012-212203

Carmax Auto Superstores West Coast, Inc., ... Respondent/Petitioner

v.

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

**BRIEF OF PETITIONER/RESPONDENT
SOUTH CAROLINA DEPARTMENT OF REVENUE
IN RESPONSE TO BRIEF OF RESPONDENT/PETITIONER
CARMAX AUTO SUPERSTORES WEST COAST, INC.**

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Rule 242, SCACR 1

Rule 211, SCACR 15

Pursuant to Rule 242(i), SCACR, the Petitioner/Respondent South Carolina Department of Revenue (Department) files its Reply to the Brief of Respondent/Petitioner.

ARGUMENTS

I. The Unitary Business Model is Immaterial to the Law of this Case.

The South Carolina Income Tax Act, as it relates to multistate corporations, has as its introduction S.C. Code Ann. § 12-6-2210 (Supp. 2009) ("Taxation of business; determination whether entirely or partly transacted or conducted within State."). Subsection (B) clearly states:

> If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed **upon a base which reasonably represents the proportion of the trade or business carried on within this State**. A taxpayer subject to taxation under this section is considered to have been transacting or conducting business partly within and partly without the State if the taxpayer is subject to a net income tax or a franchise tax measured by net income in another state, the District of Columbia, a territory or possession of the United States, or a foreign country, or would be subject to the net income tax in any other taxing jurisdiction if the other taxing jurisdiction adopted the net income tax laws of this State.

(Emphasis added). Therefore, the seminal principle in determining the legality of any income tax on a multistate taxpayer in South Carolina is the "reasonable representation of the trade or business carried on in this State," and cannot be subservient to a unitary business model, as urged by the taxpayer. Although it is possible for a unitary business model to comply with the legal requirements of reasonably representing the trade or business activity, in this taxpayer's case it does not. Furthermore, regardless of the

immateriality, there are significant questions as to how its corporate structure can be determined unitary when its business activity in this state is not homogenous with its activities elsewhere.

The taxpayer urges this Court to accept its reading of Exxon Corporation v. S.C. Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979), mistakenly claiming that case bars the Department from implementing an alternative apportionment method on a corporate structure such as CarMax. As the ALC recounted in paragraph 1 of its Order, the taxpayer operates a retail business for the sale of automobiles in California, Utah, and Nevada.[1] Additionally, the ALC recognized as significant, that the taxpayer received a distribution from the payment of royalties from a subsidiary, CarMax Business Services (CBS), which included royalties paid by its affiliate CarMax East (East). It is not disputed that the royalty income at issue was generated in South Carolina as East took a deduction from its South Carolina income tax for this expense. The Exxon opinion states:

> A Taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without shall be subject to the allocation formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. **The income from the unrelated business shall be directly assignable to the state where such business is conducted.**

(Emphasis added.) The factual issue of whether or not the taxpayer's retail sales are homogenous with its collection of royalties and financing income from South Carolina was answered definitively in the negative by the ALC. In Exxon the court's decision was

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ALC Order, p. 2 (Joint Appendix, Vol. I, p. 00005)[1]

supported by the fact that a vertically integrated activity defined it as "unitary." The significance of this finding is that the exploration and extraction of the natural resources were costs directly related to the retail sale of gasoline in South Carolina. In the case at bar, the record firmly supports the ALC's findings that the royalty income and financing income from CBS was not homogenous with the taxpayer's retail income from auto sales. Unlike Exxon Corporation, which sells gasoline in nearly every corner of this country, CarMax West only sells automobiles in three Western states. Its business is not homogenous, and any attempt by the taxpayer to liken itself to Exxon is squarely misplaced. A good faith effort to achieve a reasonable reflection of its business activity in South Carolina necessitates a tax base related to royalty income alone, as no retail sales occur here. To that end, the Department was not separately accounting or isolating the royalty income; it was preventing the taxpayer from distorting its true income from within South Carolina by diluting it with income from distinct sources outside of South Carolina.[2] Lastly, the Exxon holding does not prohibit the use of an alternative method of apportionment inasmuch as that opinion predated the enactment of S.C. Code Ann. § 12-6-2320, which, if nothing more, shows the taxpayer simply misapprehends the issues raised.

The taxpayer also urges this Court to find all of its activities constitute a unitary business by relying upon the decision of Eastman Kodak Corporation v. S.C. Dept. of Revenue, 308 S.C. 415, 418 S.E.2d 542 (1992). In that case, the Court found that the taxpayer's use of short term investments, which accounted for up to ten percent (10%) of

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[2]See ALC Order p. 9, fn 7. (Joint Appendix, Vol. I, p. 00012)

its net worth, were unitary with its business purpose in South Carolina. The taxpayer had invested in "safe harbor lease transactions" which were common at the time, and the taxpayer's investment and returns were of such "magnitude and frequency"[3] that it made a significant contribution to the taxpayer's general business. The Court specifically found:

> Based on Exxon and the testimony of record here, the safe harbor lease transactions cannot be segregated from Kodak's general business operations since: (1) the funding for the safe harbor leases came from the general corporate treasury; (2) no separate staff supervised the transactions; and (3) the magnitude of the transactions and resulting tax benefits suggest a significant contribution to Kodak's general business.[4]

(Emphasis added).

Unlike the Kodak and Exxon companies, in the case at bar the ALC had substantial evidence presented that the taxpayer's retail auto sales in western states were discernible from income received from South Carolina sources[5] and were indeed subject to separate consideration under the provisions of Section 12-6-2320.[6] As such, the Department has much more flexibility in determining a more accurate apportionment of a taxpayer's true South Carolina income which is subject to taxation.[7] Furthermore, Section 12-6-2320 allows the Department to disregard a corporate unitary structure in

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[3]Id. at p. 418.

[4]Id. at p. 420.

[5]ALC Order p. 9, fn 7. (Joint Appendix, Vol. I, p. 00012)

[6]Section 12-6-2320 was enacted in 1995, after the Court's Exxon decision.

[7]Media General at p. 152, "conclusion" section.

order to focus on the more imminent and constitutional issue of what activity is conducted in South Carolina.

The taxpayer's critical error in interpreting the Exxon decision is that the Court recognized that the corporate structures employed by Exxon ***did*** result in a model that reasonably reflected the business activity within this State. The Exxon Corporation's unitary business model included retail fuel sales and all vertically integrated ancillary activities in South Carolina, and thus all of those activities were properly included as a reasonable reflection of its business here. By merely citing the authority, the taxpayer attempts to cloak itself in a "unitary business" model, however it fails to carry the rule to its end – to evaluate its corporate structure against the law requires a reasonable reflection of business activity within South Carolina. The ALC did follow through with this inquiry and properly disagreed with the taxpayer, as its activity here is purely based upon royalties.

The unitary business principle is not the panacea for measuring a corporation's business activity within South Carolina. As discussed previously, Section 12-6-2210(B) of the South Carolina Code has mandated that the principal for determining the state income tax for a multi-state corporation is: "(B) If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed **upon a base which reasonably represents the proportion of the trade or business carried on within this State.**" (Emphasis added). Nowhere does one find an exception for a "unitary business" principle. Again, the taxpayer is asking this Court to disregard Section 12-6-2210.

Even with a determination that the corporate structure of the taxpayer is the equivalent to a "unitary business," this issue is devoid of significance, as the General Assembly has provided the means to resolving the issues raised by the taxpayer with Section 12-6-2210(B). The taxpayer has not argued that this statute is flawed; the taxpayer merely disagrees with its provisions and applications in this case. Again, as previously discussed, a corporate structure which operates and reports its South Carolina income tax in compliance with Section 12-6-2210 has complied with the law, and based upon the clear weight of the evidence presented at trial, the ALC was correct in finding that the unitary business model is not a dispositive issue concerning the Department's proposed methodology.

II. The Financing Receipts at Issue Should Be Sourced to South Carolina.

The facts of this case demonstrate that the financing contracts with South Carolina car buyers are entered into by CBS, and CBS then "bundled" or securitized financing contracts for sale to third parties. CBS naturally realized income from the sale of the securitized contracts and would make distributions to the taxpayer, as 93.5% owner, and to CarMax East as 6.5% owner. The ALC correctly found that the taxpayer's business of financial services was distinguishable from engineering services discussed in Lockwood Greene v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). Here, the ALC noted that Court's holding concerned the "base which reasonably represents the portion of the trade or business carried on within this State."[8] To that end, the sourcing rule announced by the ALC is aligned with the alternative apportionment method permitted by Section 12-6-2320(A)(4).

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[8]Lockwood Greene, at p. 449.

The record strongly supports the ALC's ruling as substantial evidence was abundant. The taxpayer's income flowed from intangibles, not professional services, and the base value of the intangible income was the South Carolina borrower's good faith adherence to the contractual obligations which are enforced by the courts of this State. In Lockwood Greene, the engineering services performed within this State were the commodity which generated the income. The taxpayer's own witness testified that the value, in part, of the securitized instruments to third party investors was the borrowers' faithful payments on the financing agreements.[9] Therefore, the ALC was correct in distinguishing the taxpayer's case from that of a professional engineering firm located and licensed within the State of South Carolina.

As the taxpayer seeks to disassociate its case from Geoffrey, Inc. v. S.C. Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (1993), it must make the critical admission that its financing division has nexus to this State. Like the taxpayer in Geoffrey, the taxpayer here collects payments from an intangible asset from a captive subsidiary. If the taxpayer had sold the securitized financing contracts to third party investors directly, it would still find itself with nexus and tax liability to this State. Despite inserting CBS, a pass through entity, the true value of its contracts remains the payment of monies from South Carolina residents. Without South Carolina customers entering into these agreements and dutifully making the required payments upon interest and principal balances, the assets are useless pieces of paper. Furthermore, upon a default by a customer, enforcement of such a note's obligations is also maintained by relying upon the infrastructure of this State. The United

[9]ALC Order p. 13, n. 12; Tr. pp. 103-105. (Joint Appendix, Vol. I, pp. 00124-00126)

States Supreme Court discussed this in Curry v. McCanless, when it stated:

> . . . rights [in intangibles] are but relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in courts. The power of government over them and the protection which it gives them cannot be exerted through control of a physical thing. They can be made effective only through control over and protection afforded to those persons whose relationships are the origin of the rights. Obviously, as sources of actual or potential wealth - which is an appropriate measure of any tax imposed on ownership or its exercise – **they cannot be dissociated from the persons from whose relationships they are derived.**

307 U.S. 357, 365-66 (1939) (internal citations omitted) (Emphasis added). Therefore, the ALC committed no error of fact or law in finding the taxpayer's income from the intangible assets was identical to the royalty agreements of Geoffrey and properly sourced to South Carolina.

Conveniently, the taxpayer asserts that the financing receipts should be sourced to Georgia, claiming that the "income producing activity" should be attributed to the servicing of the car loans there. A cursory review of Georgia's tax laws indicates the reason why the taxpayer hopes for such a finding, as Ga. Code Ann. § 48-7-31 (2013) states:

> (A) Gross receipts factor.
>
> (i) The gross receipts factor is a fraction, the numerator of which is the total gross receipts from business done within this state during the tax period and the denominator of which is the total gross receipts from business done everywhere during the tax period. For purposes of this subparagraph, the term "gross receipts" means all gross receipts received from activities which constitute the taxpayer's regular trade or business. **Gross receipts are in this state if the receipts are derived from customers within this state or if the receipts are**

otherwise attributable to this state's marketplace;

(Emphasis added.) The financing receipts would not be sourced to Georgia, as that state has codified the market based approach that the Department has properly asserted here, consistent with Section 12-6-2210. To adopt the taxpayer's assertion would result in a these receipts becoming "nowhere income" that would be untaxed. To that extent, the ALC agreed that the financing receipts are directly attributable to the South Carolina marketplace as the income producing activity occurred here, and any default upon those contractual obligations by a customer would necessitate the taxpayer taking advantage of the services and laws of this State's economy to protect that interest. Based upon the cogent evidence presented to the ALC, the Department's sourcing of the financial receipts should be upheld.

III. The Department's Assessment Did Not Violate CarMax West's Constitutional Rights.

The taxpayer's assertion that a finding of unitary business structure is not determinative to the application of Section 12-6-2320, and its claim of violations of the Due Process and Commerce Clauses lacks merit. In sum, the taxpayer offers no cogent evidence or argument to rebut the findings of the ALC that the Department's alternative method of apportionment more accurately defines and taxes the income related to its business in this State. Furthermore, the taxpayer offers no explanation as to why its attempt to over-inflate the apportionment denominator under the standard apportionment formula is a better representation of its activities in South Carolina. The taxpayer simply relies upon its unfounded belief that the unitary business model dictates that the standard statutory methodology should always be employed. This absolutist logic ignores the

statutory mandates of Section 12-6-2210 to reasonably reflect activity here in the tax base. To that end, the taxpayer's arguments must fail.

First, standard apportionment, as provided for in S.C. Code Ann. §§ 12-6-2250 and 12-6-2290, was challenged by the Department as its audit determined that neither method fairly reflected the true nature of the taxpayer's business in South Carolina. As such, the auditor proposed an alternative apportionment method pursuant to Section 12-6-2320(A).[10] As provided by the South Carolina Supreme Court in Media General, the Department has latitude to do so. In addition, as the discussion involving the burden of proof shows, the Department was justified in doing so.

Specifically, the taxpayer, as 93.5% owner of CBS, received a distribution resulting from a royalty payment to CBS by East, and East took a corresponding deduction in South Carolina for paying the royalty to CBS. CBS, a pass-through entity, paid no taxes, leaving the taxpayer receiving income generated in this State. Instead of paying tax on this income in a manner which reasonably reflected its true business activity in South Carolina, the taxpayer then inflated the denominator of its standard apportionment ratio by including its auto retail sales income from western states. The effect of this manipulation being that the numerator portion of the apportionment ratio, being comprised of royalty payments deducted by East in South Carolina, was made a smaller portion than if it had just been compared to royalty income earned nationwide by the taxpayer.[11]

The taxpayer then intimates that despite this dilution of the denominator, "the

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[10]ALC Order p. 6. (Joint Appendix, Vol. I, p. 00009)

[11]ALC Order p. 8; Tr. p. 227. (Joint Appendix, Vol. I, p. 00011)

apportionment is now the general rule and any other system, including the segregated method, is the exception."[12] As the authority cited for this proposition was issued in 1957, it is difficult to understand why the taxpayer proposes it should withstand the application of § 12-6-2320, enacted in South Carolina in 1995. A more relevant, and authoritative comment on the matter can be found in Container Corp. of American v. Franchise Tax Board, 463 U.S. 159 (1983), when the Court noted that "separate accounting" or other alternative methods of apportionment have been allowed when total formula apportionment, would "not fairly represent the extent of the taxpayer's business activity in the state."[13] Indeed, the taxpayer's position of defending the inclusion of its distinct business activity of retail auto sales in its apportionment denominator must yield to the principle that its business activity in this State must be fairly representative of the extent of its true activity in South Carolina. This proposition is unequivocally mandated by § 12-6-2320.

Commerce Clause challenges to state tax laws are typically analyzed by employing the four prong test set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977): 1) a substantial nexus exists between the taxing state and taxed activity; 2) the tax is fairly apportioned to income; 3) the tax does not discriminate against interstate commerce; and 4) the tax is fairly related to the benefits the state provides.[14] The taxpayer is ostensibly alleging that the assessment discriminates against interstate commerce. It complains that its tax burden is heavier than East, which does have retail

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[12]Taxpayer's Initial Brief p. 23, para. 1.

[13]Id. at p. 167, fn 3.

[14]Complete Auto, at p. 279.

operations in South Carolina; however, the evidence presented at trial clearly shows that East only receives a flow through distribution from CBS of 6.5%, while the taxpayer receives a 93.5% distribution. Moreover, East benefits from a deduction for royalties paid to CBS such that if that deduction were not taken East would pay the entire tax burden at issue. The ALC properly evaluated this four prong test, and determined the Department's assessment was constitutional.[15]

Since Complete Auto was decided, the Supreme Court has increasingly employed the "internal consistency test" to determine whether a taxing scheme creates unconstitutional discrimination. See, e.g., Armco, Inc. v. Hardesty, 467 U.S. 638 (1984); Tyler Pipe Industries v. Washington Dep't. of Revenue, 483 U.S. 232 (1987). Simply put, this test asks whether the taxing scheme, if applied in every jurisdiction, would subject more than 100% of a taxpayer's income to taxation. The taxpayer offered no evidence on this point at trial, nor presents any cogent arguments before this Court to support a finding of more than 100% taxation to reach a level of unconstitutionality. As such, this argument also must fail.

IV. The Court of Appeals' Decision in the Instant Case is Appealable in Light of this Court's Decisions in Charlotte-Mecklenburg Hosp. Auth. v. S.C. Dep't of Health and Envtl. Ctrl., 387 S.C. 365, 692 S.E.2d 894 (2012), and Bone v. U.S. Food Serv., 404 S.C. 67, 744 S.E.2d 552 (2013).

In the interest of brevity, the Department's position concerning the appealable nature of this case and the applications of Bone and Charlotte-Mecklenburg is fully addressed in the Brief of the Petitioner/Respondent. However, it bears repeating that the burden of proof issue is a pure question of law and those decisions do not prohibit this

[15] ALC Order p.16-18, Joint Appendix pp. 00019-21.

Court's review. Furthermore, it is the Department's contention that the preponderance of evidence presented to the ALC concerning the reasonableness of the proposed alternative methodology was sufficient to satisfy the proper burden of proof mandated by § 12-6-2320(A).

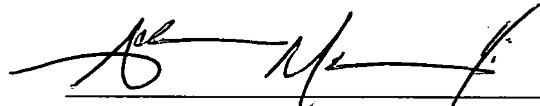
The taxpayer presented no evidence to dissuade the ALC of the distortive effects of applying the standard apportionment methods, nor was any other alternative method proposed. To that extent, regardless of whether the Department or the taxpayer held the burden, sufficient evidence was presented at trial to support the ALC's finding of reasonableness, and a remand to reconsider the factual findings related to the merits in this case would be improper. In fact, based upon the analysis contained in Bone and Charlotte Mecklenburg, the Department posits that this Court has the discretion to overturn the Court of Appeals' application of the erroneous burden of proof as a question of law, which is a distinguishable aspect of the issues in those cases, both of which required further fact finding. Here, an application of the proper burden would result in a determination that a remand on the merits is unnecessary and a waste of judicial resources in accordance with the APA's legislative intent to confine appeals to final orders. As previously discussed, sufficient evidence was presented at trial to support the findings of the ALC, and without clear error those findings should not be overturned.

CONCLUSION

The taxpayer's contention that the unitary business model is a dispositive issue is simply unsupported by statute and case law, and should be disregarded by this Court. The income generated from South Carolina financing receipts at issue in this case were properly sourced to this State, in accordance with Lockwood Greene and § 12-6-2210.

The taxpayer's claims of unconstitutionality were properly ruled upon by the ALC as unfounded, and should not be disturbed, as sufficient evidence was presented to support the reasonableness of the Department's assessment. And finally, the appealable nature of the burden of proof issue complies with the legal analysis promulgated by the Bone and Charlotte Mecklenburg decisions, as well as the legislative intent of the APA. In that regard, the Court of Appeals' decision to remand under an erroneous burden of proof should be overturned and the final order of the ALC affirmed.

Respectfully Submitted,



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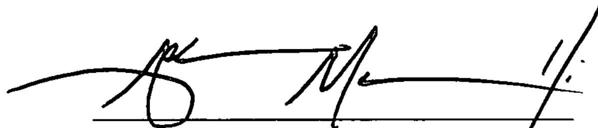
Appellate Case No. 2012-212203

CERTIFICATE OF COUNSEL

The undersigned certifies that this Final Brief complies with Rule 211(b), SCACR.



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PROOF OF SERVICE

I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, postage pre-paid, a copy of the Petitioner/Respondent's Reply Brief in the above referenced matter to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, 151 Meeting Street, 6th Floor, Charleston, SC 29401-2239 this 2nd day of December 2013.

Jean M. O'Connor