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S.C. Supreme Court

THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Carolyn C. Matthews, Administrative Law Judge

Case No. 09-ALJ-17-0160-CC
Appellate Case No. 2012-212203

CarMax Auto Superstores West Coast, Inc.....Respondent/Petitioner
v.
South Carolina Department of Revenue.....Petitioner/Respondent

RESPONDENT/ PETITIONER CARMAX AUTOSUPERSTORES WEST COAST, INC. REPLY TO RESPONSE OF PETITIONER/RESPONDENT SOUTH CAROLINA DEPARTMENT OF REVENUE

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Pursuant to Rule 242(g) of the South Carolina Appellate Court Rules, Respondent/Petitioner CarMax Auto Superstores West Coast, Inc. ("CarMax West") files this Reply Brief in response to Petitioner/Respondent South Carolina Department of Revenue's Response ("SCDOR's Response") in this matter. For the reasons stated in CarMax West's Brief dated October 30, 2013 ("CarMax West's Brief") and herein, this Court should grant the relief requested in CarMax West's Brief, which asks this Court to rule on a number of issues upon which the South Carolina Court of Appeals declined to rule.

STATEMENT OF THE CASE AND STATEMENT OF FACTS

Please see CarMax West's Brief at pp. 2-12 for a statement of the case and statement of facts in this matter.

ARGUMENT

I. Whether the Income of a Business is Part of its Unitary Income is Both Material and Outcome Determinative.

Whether the income of a business is part of its unitary income is both material and outcome determinative. SCDOR's bold statement that the unitary nature of a taxpayer is "immaterial to the law of this case," which is similar to the ALC's conclusion that whether CarMax West was unitary was not "outcome determinative," is simply wrong. The unitary business concept is the linchpin of the allocation and apportionment statutes, and a court must first determine whether the income of a business is unitary or non-unitary before it can properly apply these statutes.

As the U.S. Supreme Court has stated many times, the whole reason behind the enactment of allocation and apportionment statutes is to properly allocate and apportion the income of unitary businesses that conduct their business partly within and partly without a particular state. See Mobil Oil Corp. v. Comm. of Taxes of Vermont, 445

U.S. 425, 439 (1980) (stating that "the linchpin of apportionability in the field of state income taxation is the unitary business principle"); Butler Bros. v. McColgan, 315 U.S. 501, 508-509 (1942). Allocation and apportionment statutes are generally used to define income that can and should be taxed separately (i.e., income that is not unitary or is unrelated to the business of the taxpayer) and income that is taxed under an apportionment formula (i.e., income that is unitary or is related to the business of the taxpayer). See Mobil Oil, 445 U.S. at 439.

South Carolina employs such a system. First, South Carolina allocates certain specified non-unitary income that is "not connected with the taxpayer's business" either to South Carolina or to other states. See S.C. Code Ann. §12-6-2220. Next, the balance of the taxpayer's income (i.e., that which is "connected with its business") is apportioned based on the applicable apportionment statute, which in this case is S.C. Code Ann. §12-6-2290 (known as the "gross receipts" apportionment formula). Thus, before one can determine how to allocate and apportion income under South Carolina's statutory scheme, one **must** determine whether the income at issue is part of the taxpayer's unitary income (i.e. connected with its business) or whether it is non-unitary income that is not connected with the taxpayer's business.

SCDOR accuses CarMax West of ignoring S.C. Code Ann. §12-6-2210, which provides that corporate income tax is to be imposed on multi-state taxpayers "upon a base which reasonably represents the ***proportion*** of the trade or business carried on within this State." S.C. Code Ann. §12-6-2210 (emphasis added). This accusation is without merit. Section 12-6-2210 provides that a ***proportion*** of the taxpayer's unitary business is subject to taxation with the implication being that it is the proportion of the

taxpayer's business in this State versus its business everywhere that should be considered. South Carolina's "gross receipts" apportionment statute (§12-6-2290), which CarMax followed in filing its returns, makes this implied premise explicit. This clear and straightforward statute apportions unallocated net income as follows:

	gross receipts from within this State
÷	*total* gross receipts from *everywhere*
	apportionment factor
x	unallocated South Carolina net income
	South Carolina taxable income

See S.C. Code Ann. § 12-6-2290 (emphasis added). CarMax West applied this standard formula to its unitary income such that its apportionment factor fraction included its royalty income from within South Carolina over its total gross receipts from everywhere (which would include its car sales in other states).

SCDOR's alternative method, on the other hand, ignores the statutory language as written and arbitrarily revises it to change the denominator from "total gross receipts from everywhere" to "total gross receipts from everywhere *for the same business activity conducted in this State*." Under this newly created formula, SCDOR excluded CarMax West's car sales from its "total gross receipts from everywhere" because CarMax West did not sell cars in South Carolina. (App. p. 314-315). Thus, it is CarMax West that seeks to follow the apportionment statute and South Carolina law and SCDOR that seeks to re-write or disregard it.

SCDOR also attempts to distinguish this case from Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 599, 258 S.E.2d 93, 96 (1979), which held that separate accounting should not be applied to a unitary business, by now arguing that Exxon's activities (i.e., oil exploration and production activities in other states versus retail sales

activities from gas stations in South Carolina) were unitary, homogenous and related, whereas SCDOR alleges that CarMax West's activities (sales of cars in other states versus income from royalties earned in South Carolina) are not. SCDOR Response at pp. 2-3. First, this is contrary to all testimony at trial, including that of SCDOR's **own** witness.[1] Additionally, because this issue was not raised below, it cannot be raised for the first time on appeal.[2]

Moreover, the term "unitary" in this context is synonymous with "homogeneous," "related" or "connected" as opposed to "unrelated" or "not connected." SCDOR apparently argues that CarMax West's royalty income here is not related, homogenous, and unitary to/with its income from the sales of cars in other states. However, the uncontested evidence presented at trial established that it was related, homogenous and unitary income. More specifically, as just one example of how CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) met the contribution and dependence test (one of many tests that can be used to determine whether a business is unitary),[3] a CarMax witness testified to the

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[1] SCDOR's own witness testified that he thought that the entire CarMax group of companies was a unitary business (App. p. 298, lines 20-24 and p. 301, line 18 - p. 302, line 1). Further, SCDOR presented no evidence whatsoever that CarMax West did not operate a unitary business.

[2] Wilder Corp. v. Wilke, 330 S.C. 71, 497 S.E.2d 731 (1998) (stating that it is axiomatic that for an issue to be preserved for appellate review, a matter may not be raised for the first time on appeal, but must have been both raised to and ruled upon by the trial court); Coggeshall v. Reprod. Endocrine Assocs., 376 S.C. 12, 655 S.E.2d 476 (2007) (stating that in order for an appellate court to rule upon an issue, the record must contain some evidence or documentation that the issue was raised to the lower court).

[3] CarMax West would also note that SCDOR appears to assert that because CarMax West is not a vertically integrated company like Exxon, it cannot be unitary. As a review of the South Carolina cases makes clear, vertical integration is but one of many ways that a company can

very obvious fact that as CarMax West sells more cars, the value of its intellectual property increases, and as the value of the intellectual property increases and the brand becomes more well-known, CarMax West sells more cars. App. p. 83, lines 1-17. How anyone could take the position that income from the sale of a product is not related to income from the brand name of that product is, frankly, incredulous. This contribution and dependence between the income from the brand name and the income from the sale of cars is the essence of a unitary business, and SCDOR can point to no evidence in the record that would support its bare allegation that the royalty income was not part of the unitary income of CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization). See CarMax Brief at pp. 17-18 (as to all evidence supporting a finding of unitary income).

Therefore, as set forth in its Brief, CarMax West respectfully requests that this Court enter a finding based on the uncontested evidence at trial that CarMax West (pre-reorganization) was and CarMax West and CBS (post-reorganization) are unitary businesses and that the royalty income based on the use of the CarMax trademark is a part of the unitary income of these businesses. CarMax West further asks this Court to remand this case to the ALC with the additional instruction that the ALC should consider (based on the record made at trial) how this finding impacts the determination of the proper apportionment method in this case.[4] Such instructions, which the Court of

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show that it is unitary. See CarMax Brief at pp. 15-16 (for full discussion of the tests that may be applied to determine whether a business is unitary).

[4] More specifically, the ALC should consider the above-discussed case law on the impropriety of applying separate accounting to a unitary business when evaluating (based on the record at trial) whether the standard apportionment method fails to reasonably reflect unitary business activities of CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) and whether SCDOR's alternative separate accounting method does.

Appeals did not give, will ensure that the ALC properly considers all relevant facts and law on remand, which will promote judicial economy and avoid duplicative proceedings and multiple appeals.[5]

II. The ALC Should Not Have Sourced CarMax West's Financing Income to South Carolina because South Carolina is a "Place of Activity" State.

The ALC should not have sourced CarMax West's financing income to South Carolina because South Carolina is a "place of activity" state versus an "origin of payment" state. SCDOR's Response basically asks the Court to ignore Lockwood Greene Engineers v. S.C. Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), which adopted the "place of activity" test and held that income should be sourced to the location where the activity producing that income takes place. This holding has since been codified at S.C. Code Ann. §12-6-2295.[6] Instead of following this law, SCDOR makes arguments (including a new one not previously raised) as to why South Carolina should adopt an "origin of payment" view in this case. It also mischaracterizes certain facts. For the reasons discussed below, this Court should reject SCDOR's arguments and allocate the financing income at issue outside of South Carolina, as all of the activity that produced the income took place out of state.

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[5] In the alternative, CarMax West requested that this Court remand this case to the ALC with instructions for the ALC to determine whether (based on the record made at trial) CarMax West (pre-reorganization) was and CarMax West and CBS (post-reorganization) are unitary businesses in light of the standard set forth in Exxon and related cases with instructions that if the ALC determines that they are unitary, then the ALC should further consider how that finding impacts the determination of the proper apportionment method in this case.

[6] This section states that "[t]he terms 'sales' as used in Section 12-6-2280 and 'gross receipts' as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated . . . (5) receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State. . . ." S.C. Code Ann. § 12-6-2295(5).

First, SCDOR asserts a new ground in its Response that it has not previously raised.[7] The gist of this argument is that the financing income might not be taxed in Georgia, the state where the activity producing the income takes place, and thus, the income should be sourced to South Carolina to avoid "nowhere income," i.e. income that no state taxes. SCDOR Response at pp. 8-9. This argument is flawed and not supported by South Carolina law or the record in this case. Each state has a right to choose its own method of apportionment. As the Court discussed in Lockwood Greene, there are two views of how to tax services: (1) impose taxes based on where the payments for goods or services originate ("origin of payment" or market based approach); or (2) impose taxes based on where the activity that generates the income takes place ("place of activity" or cost of performance approach). Lockwood Greene Engineers v. S.C. Tax Commission, 293 S.C. 447, 448, 361 S.E.2d 346, 347 (Ct. App. 1987). Each state is free to adopt the view it thinks is appropriate. The fact that Georgia may or may not source the financing receipts at issue to Georgia is irrelevant to the question of where South Carolina law sources them.

Additionally, SCDOR's continued attempts to liken the income resulting from CBS's servicing, bundling and securitizing activities (not income from mere ownership of a note or receivable) to the passive income from the ownership of intellectual property in Geoffrey v. S.C. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993) are without merit and do not provide a basis for distinguishing this case from Lockwood Greene. See CarMax West Brief at p. 24 (for full discussion of this issue).

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[7] Because SCDOR did not raise this ground at trial, this issue is not preserved for review. See infra, n. 2.

SCDOR also argues that the Court should apply an "origin of payment" view here because it alleges that part of the value of the securitized investments is the borrowers' faithful payments. SCDOR Response at p. 7. That is true of any receipt. The question here is not whether the borrowers' payments are part of the value of the retail installment contracts, but whether South Carolina is an "origin of payment" state (which view places more emphasis on the value derived from the payment of the receipts) or rather is a "place of activity" state (which view places more emphasis on the location where the activity producing the income takes place).

Finally, SCDOR's Response misstates certain key facts. More specifically, it mistakenly characterizes the retail installment contracts at issue as being entered into between South Carolina car buyers and CBS.[8] This mistake could lead one to wrongfully conclude that CBS does business in this State and could make it less clear that through this assessment, SCDOR is attempting to tax a partnership that conducts no business activities whatsoever in South Carolina.

CarMax West submits that under Lockwood Greene and the statute subsequently codifying it, South Carolina has adopted the "place of activity" view, and accordingly, the ALC should not have sourced the financing receipts at issue to South Carolina as the uncontested evidence established that all activity producing the income at issue took place out of state.

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[8] The facts at trial established that CBS is not a party to the retail installment contracts at issue and that none of its employees perform work in South Carolina. App. p. 105, l. 22 - p. 106, l. 9 and App. p. 110, l. 15-22. Instead, CarMax East, as the seller, enters into the contracts with its South Carolina customers. App. p. 105, l. 22 – p. 106, l. 8. CarMax East subsequently assigns the contracts to CBS, which then services the contracts and/or bundles and securitizes them for sale to third parties. App. p. 106, l. 2-9 and p. 107, l. 19 – 109, l. 7.

III. The ALC Should Have Found the Tax Unconstitutional Because it is Disproportionate to CarMax West's Activities in this State.

Rather than address the substance of CarMax West's arguments in its Brief, i.e. that the tax imposed by SCDOR is unconstitutional because it is disproportionate to CarMax West's activities in this state, SCDOR addresses arguments that have not been asserted and resorts to making baseless accusations of manipulation and distortion against CarMax West.

SCDOR's Response states that CarMax West is "ostensibly alleging that the assessment discriminates against interstate commerce" and claims that CarMax West failed to offer evidence sufficient to prove this claim under the internal consistency test. SCDOR's Response at pp. 11-12. CarMax West has never alleged discrimination and so the internal consistency test is not relevant.

Instead, CarMax West has argued and continues to argue that the tax is unconstitutional because it levies a burden that is out of all proportion to this taxpayer's minimal activities in this State and because it taxes extraterritorial values. CarMax West presented substantial and uncontroverted evidence to support this argument. See CarMax West Brief at pp. 25-27. Furthermore, SCDOR presented **no** evidence to support such an exorbitant tax in light of the minimal in-state activities of CarMax West.

Instead, SCDOR's Response resorts to false and misleading characterizations of CarMax West's use of the standard apportionment formula, which is ***dictated by statute***, as being manipulative or distortive. See SCDOR's Response at pp. 3, 9 and 10. It is uncontested that CarMax West applied the standard statutory apportionment formula. Its "chosen method" is the one set forth in and required by the statute, not a formula

that CarMax West created or even had the option of choosing. The auto sales from western states that SCDOR claims CarMax West included to "inflate" the denominator of the standard apportionment ratio are specifically ***required*** to be included in the denominator by statute. CarMax West followed the requirements of the statutorily dictated method as written and did not "inflate" or "manipulate" the formula in any way.

Because CarMax West presented substantial and uncontroverted evidence to support its argument that its constitutional rights were violated by a tax that levied a burden that is out of all proportion to this taxpayer's minimal activities in this State and because it taxes extraterritorial values, CarMax West asks this Court to review the Court of Appeals' decision to determine whether judgment should have been entered in favor of CarMax West on this issue.

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

In addition to the argument set forth in CarMax West's Brief that Charlotte-Mecklenberg and Bone and are not applicable to this matter (see CarMax West's Brief at pp. 27-32), this Court's recent opinion in Shatto v. McLeod Reg'l Med. Ctr., 2011-201186, 2013 WL 6654374 (S.C. Dec. 18, 2013) provides further support that this decision is ripe for review by this Court.

In Shatto, this Court granted certiorari to review a decision of the Court of Appeals, which had reversed a decision of the Worker's Compensation Commission (the "Commission") and remanded the case back to the Commission for additional findings in light of its ruling. Id. at 2-3. The parties agreed that the decision of the

Court of Appeals was a final decision, that Bone was inapplicable and that this Court had jurisdiction to hear the appeal. Id. at n.4. This Court agreed. Id. In support of its conclusion, the Court pointed to S.C. Code Ann. § 1-23-390, which provides that appeals to the Supreme Court to review decisions of the Court of Appeals should be pursued "by taking an appeal in the manner provided by the South Carolina Court Rules as in other civil cases." Id. It then examined SCACR Rule 242(a), which allows the Supreme Court to grant certiorari "to review a *final decision* of the Court of Appeals," and noted as support for its conclusion that the case was ripe for review that the rule speaks to a "final decision" and not a "final judgment." Id. (emphasis in opinion).

Similarly in this case, both CarMax West and SCDOR agree that the decision of the Court of Appeals is final, that Bone has no application here, and that the Supreme Court may review the Court of Appeals' decision. SCACR Rule 242(c)) provides that "[a] decision of the Court of Appeals is not final for the purpose of review by the Supreme Court until the petition for rehearing or restatement has been acted on by the Court of Appeals." In this case, the parties have complied with Rule 242(c) as both parties petitioned the Court of Appeals for a rehearing and it was denied. See App. at 1208-1209. Thus, the Court of Appeals' decision is final and reviewable, and CarMax West respectfully asks this Court to so find.[9]

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[9] In addition, CarMax West must briefly address the request made in section IV of SCDOR's Response that this Court enter judgment for SCDOR because sufficient evidence was allegedly presented at trial to support the findings of the ALC even if the proper burden of proof had been applied. This argument goes well beyond the scope of the question posed by this Court, and, in fact, addresses an issue on which SCDOR petitioned for certiorari but which this Court denied. App. p. 1280 (SCDOR Petition for Certiorari at p. 1 (question # III); App. p. 1398 (Order dated August 29, 2013 (denying certiorari as to question #III). See also App. p. 1301-1303, CarMax West's Return to SCDOR's Petition for Writ of Certiorari (explaining why SCDOR did not satisfy the burden of proof and thus why this Court cannot enter judgment for SCDOR).

CONCLUSION

For the above-stated reasons, CarMax West respectfully requests that this Court find that this case is reviewable and rule on the issues raised by Appellants, upon which the Court of Appeals did not rule. More specifically, CarMax West asks that this Court rule as follows:

I. Rule that the Court of Appeals erred in failing to determine that the CarMax businesses at issue are unitary; and

   A. Enter a finding that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) are unitary businesses and that the royalty income based on the use of the CarMax trademark is a part of the unitary income of these businesses based on the uncontested evidence at trial and instruct the ALC on remand to consider based on the record made at trial how this finding impacts the determination of the proper apportionment method in this case, including that it should consider Exxon and related cases on the impropriety of applying separate accounting to a unitary business when evaluating whether the standard apportionment method fails to reasonably reflect the unitary business activities of CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) and whether SCDOR's alternative separate accounting method does; or

   B. In the alternative to A, remand this case to the ALC with instructions to determine based on the records made at trial whether CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) are unitary businesses in light of the standard set forth in Exxon and related cases with instructions that if the ALC determines they are unitary, then the ALC should further consider how that finding impacts the determination of the proper apportionment method in this case as set forth in A.

II. Rule that the Court of Appeals erred in failing to rule that the financing receipts at issue should not be sourced to South Carolina, reverse the ALC on this issue and dismiss the portion of the assessment related to the financing receipts.

III. Rule that the Court of Appeals erred in failing to rule that CarMax West's constitutional rights were violated; and

   A. Find that CarMax West's constitutional rights were violated and dismiss the assessment in its entirety; or

B. In the alternative, remand this issue to the ALC with instructions that it must reconsider this issue based on the record made at trial in light of the fact that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) are unitary businesses and the fact that all activities that generate the financing income take place out-of-state.

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PROOF OF SERVICE

I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for Respondent/Petitioner, do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

Pleadings: RESPONDENT/PETITIONER CARMAX AUTO SUPERSTORES WEST COAST, INC. REPLY TO RESPONSE OF PETITIONER/RESPONDENT SOUTH CAROLINA DEPARTMENT OF REVENUE

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