

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. 2012-21-22203

CarMax Auto Superstores West Coast, Inc.....Respondent/Petitioner
v.

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

JOINT APPENDIX – VOLUME I

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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT COUNTY

Carolyn C. Matthews, Administrative Law Judge

Case No. 09-ALJ-17-0160-CC

CarMax Auto Superstores West Coast, Inc.....Appellant

v.

South Carolina Department of Revenue.....Respondent

RECORD ON APPEAL - VOLUME I

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SC COURT OF APPEALS

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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

SC 10-11-00001

Carmax Auto Superstores West Coast, Inc.,)	Docket No.: 09-ALJ-17-0160-CC
Petitioner.)	
vs.)	FINAL ORDER AND DECISION
South Carolina Department of Revenue,)	The Honorable Carolyn C. Mathews
Respondent.)	April 22, 2010

Appearances: For the Petitioner: John C. von Lehe, Jr. Esq.; Bryson M. Geer, Esq.
For the Respondent: Michael S. Traynham, Esq.; Lynn M. Baker, Esq.

STATEMENT OF THE CASE

This contested case is before the Administrative Law Court (ALC or Court) pursuant to S.C. Code Ann. § 12-60-460 (Supp. 2009). Petitioner appeals the South Carolina Department of Revenue's (Department's) determination that its corporate income tax returns for tax years 2002 through 2007 did not reflect accurately the extent of its business in South Carolina, as required by S.C. Code Ann. § 12-6-2320 (Supp 2009). After notice to all parties, a hearing was held on February 18th and 19th, 2010 in Columbia, South Carolina.

ISSUES OF LAW

1. Do the standard statutory apportionment formulas contained in the South Carolina Code fairly represent the extent of the taxpayer's business in South Carolina?
2. Is the Department's alternative apportionment formula reasonable?
3. Is the taxpayer's financing income appropriately sourced to South Carolina?
4. Are the Department's penalties properly applied to the taxpayer in this case?
5. Do the Department's actions in this matter violate the taxpayer's constitutional rights pursuant to the Commerce Clause of the United States Constitution?

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FINDINGS OF FACT

Having considered the witnesses' testimony and all exhibits presented at the hearing, taking into consideration the burden of persuasion and the credibility of the witnesses, the Court makes the following findings of fact by a preponderance of evidence:

1. Carmax Auto Superstores West Coast, Inc. (taxpayer) is a subsidiary of Carmax, Inc. The taxpayer, a retailer of used light trucks and automobiles, operates Carmax retail locations in several western states, including California, Utah, and Nevada.¹ Prior to 2004, the taxpayer also held and managed certain Carmax intangible property and received income from related entities for the use of that intangible property. The taxpayer received those royalties from South Carolina retailers, in addition to royalties from retailers in other states.

2. Carmax Auto Superstores, Inc. (East) is a related subsidiary of Carmax, Inc., which operates Carmax retailers in several eastern states, including South Carolina. Prior to 2004, East paid a percentage of its sales to the taxpayer pursuant to a royalty agreement, in exchange for the use of intangible property managed by the taxpayer. East has regularly filed South Carolina corporate income tax returns on its retail income, and receives a deduction from that income for royalty and other payments for South Carolina tax purposes.

3. Carmax Business Services, LLC (CBS) is another Carmax subsidiary that was formed in 2004 as part of a restructuring of Carmax, Inc. At that time, the intangible property previously held by the taxpayer was placed in CBS, in exchange for a 93.5% interest in the CBS's income distributions. East also contributed certain assets and turned over the Carmax financing operations to CBS, receiving a 6.5% interest in exchange.

¹The states in which the taxpayer operates a retail business require income tax filing under a different method than South Carolina, or do not impose an income tax at all.

4. After the restructuring, CBS provided various services to all Carmax entities and retailers, including East and the taxpayer. These services included managing the intangibles formerly held by the taxpayer, and providing financing services to all Carmax retailers. CBS received a per-car fee from retailers for its various management services. CBS also received financing income in the form of interest and fees from Carmax customers who financed their purchases. Some financing income was also received through the securitization of consumer installment agreements; that is, the bundling and reselling of those agreements to third party investors. The value of these securitized investments was partly attributable to regular payment of installments by end-consumers. Approximately 200 CBS full-time employees service the installment agreements—answering customer inquiries, contacting customers directly, processing payments, and otherwise managing the consumer side of the financing. Ten to 15 CBS employees manage the securitization process as one aspect of their jobs.

5. CBS is a “flow-through” entity for South Carolina tax purposes, and is not directly taxed on the income it receives from South Carolina. CBS’s net income is distributed to the taxpayer (93.5%) and to East (6.5%). Thus, the taxpayer received South Carolina source income in the post-restructuring audit years, despite its lack of retail operations in this State.

6. The taxpayer’s business structure provides it with a significant state tax benefit,² and shares features with the structures of other multi-state taxpayers who divide their retail operations into “East” and “West” operations and similarly benefit from this structure in the form of state tax savings.

²The Court does not imply, nor was it argued by the Department, that the tax benefit is the only benefit the taxpayer received from its corporate structure, nor was it argued that the taxpayer’s actions were in anyway improper. The tax benefits derived from the taxpayer’s business structure are relevant, however, to one of the legal issues presented: that is, whether or not the taxpayer’s apportionment method fairly represents its business in this State.

7. The 2004 restructuring was undertaken with consultation from Ernst and Young, which simultaneously provided state tax advice on the restructuring to Carmax.

8. The taxpayer originally filed timely South Carolina corporate income tax returns for tax years 2002 through 2007 utilizing a statutory formula – S.C. Code Ann. § 12-6-2250 (Supp. 2009) – also known as the three-factor or three-factor double weighted sales formula. By statute, this formula calculates a taxpayer's taxable income in South Carolina by computing a ratio of the taxpayer's total property, payroll, and sales.

9. The Department audited the taxpayer for tax years 2002 through 2007, and issued a proposed assessment on June 19, 2008, adjusting the taxpayer's apportionment formula and imposing penalties for substantial understatement and negligence. The taxpayer protested on October 20, 2008, and the Department issued a Determination on March 11, 2009.

10. After the audit and the Department's Determination, the taxpayer filed amended returns in September of 2009 utilizing a different statutory formula – S.C. Code Ann. § 12-6-2290 (Supp. 2009) – also referred to as the gross receipts formula. The gross receipts formula calculated the taxpayer's apportionment ratio³ by dividing the taxpayer's receipts from financing and intangibles in South Carolina by the taxpayer's receipts from financing, intangibles, and retail sales everywhere the taxpayer does business.

11. The Department contended that the taxpayer's filed returns failed to reflect fairly the extent of the taxpayer's business in South Carolina, even using the gross receipts formula in the amended returns. The auditor's proposed alternative apportionment formula relied on the statutory authority of § 12-6-2320(A). The proposed alternative apportionment formula divided

³The taxpayer's apportionment ratio is the fraction of the taxpayer's apportionable income (income to be divided amongst the states in which it does business) that is deemed taxable in South Carolina under the apportionment method used.

the taxpayer's income from royalties and financing from within South Carolina by the taxpayer's royalty and financing receipts from all locations in which it does business to determine the ratio of the taxpayer's apportionable income which is taxable in South Carolina.

12. SCDOR assessed penalties against CarMax West based on both negligence and substantial understatement, which totaled \$205,832. SCDOR produced no evidence of any written policies or procedures for auditors to use for guidance in determining whether to assess penalties in a given case nor evidence of any training provided to the auditors regarding the circumstances that would justify assessing penalties. Moreover, SCDOR does not appear to have correctly applied the relevant penalty statutes or made an independent and fair determination of whether penalties were justified under the statutes.

13. CarMax's witness testified that in supervising the preparation of the subject returns, she followed the tax return instructions and guidance provided in the returns themselves. More specifically, CarMax West started with its federal taxable income, made South Carolina adjustments and applied the statutory apportionment formula to determine South Carolina net income all in accordance with what the statute, tax return and instructions dictate. See S.C. Code Ann. § 12-6-2290 (Supp. 2009). She further testified that in preparing and submitting these returns she acted in good faith and with substantial authority, believed CarMax's position to be reasonable and made adequate disclosure on the return regarding CarMax's position.

CONCLUSIONS OF LAW

Based upon the above Findings of Fact, the Court concludes the following as a matter of law:

General Findings

S.C. Code Ann. § 1-23-600 (Supp. 2009) grants jurisdiction to the Court to hear contested cases under the Administrative Procedures Act. Additionally, § 12-60-460 grants the ALC the authority to conduct contested case hearings in matters concerning tax assessment.

The standard of proof is a preponderance of the evidence. Anonymous v. State Bd. of Med. Exam'rs, 329 S.C. 371, 496 S.E.2d 17 (1998). Additionally, the burden of proof is generally upon the party asserting the affirmative in an adjudicatory administrative proceeding. 2 Am. Jur. 2d Administrative Law § 354 (2004). The taxpayer in this matter requested a contested case hearing to challenge the Department's proposed assessment; thus, the taxpayer bears the burden of proof.

I. Application Of South Carolina's Alternative Allocation Statute.

The taxpayer, in both its original and amended returns for the years at issue, utilized standard apportionment formulas delineated by statutes – §§ 12-6-2250 and 12-6-2290, respectively. The Department's findings determined that neither method fairly reflected the extent of the taxpayer's business in South Carolina. The auditor proposed an alternative apportionment method pursuant to § 12-6-2320(A). That section provides that:

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

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

(Emphasis added). The statute provides broad authority for the Department to deviate from the standard formulas laid out by other apportionment statutes under limited conditions. Under the statute there are two significant checks on the Department's ability to deviate from statutory formulas. First, the statutory authority of the Department to require an alternative method is triggered only if the standard formulas of Title 12, Chapter 6 fail to fairly represent the extent of the taxpayer's business activity in South Carolina. Second, whatever method the Department proposes, it must be reasonable. The Court discusses each of these requirements in turn below.

A. Alternative apportionment applies to the taxpayer.

The standard apportionment formulas utilized by the taxpayer in this matter did not fairly represent the extent of its business in this State for a number of reasons. The Department's audit supervisor testified that Department auditors are instructed to closely examine taxpayers whose business structures may be linked with tax minimization strategies. The taxpayer's business structure is similar to numerous other taxpayers whose structures have provided significant state tax benefits.⁴ Although no taxpayer is obligated to pay more tax than is legally required, structures such as these require close examination to determine whether standard formulas properly reflect their business in this State, as required by statute. See also S.C. Code Ann § 12-6-2210(B) (2000) ("... 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 significant element of the business structure involved is the payment of a royalty by one division of a retail operation (in this case, East) to a different division (in this case, the taxpayer), and the mixing of that intangible income with the retail income earned by the latter

⁴ The taxpayer's business structure is of a type designed to create a state tax advantage. The taxpayer's expert testified that the taxpayer's business structure is utilized by other multi-state taxpayers, and that the vast majority of taxpayers so organized, also place their intangibles in a west coast company, like the taxpayer here.

entity for state tax reporting purposes. This payment provides a deduction to East, reducing its overall tax burden in those states in which it operates, including South Carolina. The mixing of the royalty payments with retail income produced a significantly lower apportionment ratio than that of the taxpayer's royalty income considered alone.⁵ The Department described this as a dilution of the apportionment ratio, and described the consequent reduction of the taxpayer's tax liability as a distortion of tax owed.⁶

The significance of considering the taxpayer's South Carolina source income apart from its retail operations is inherent in the language of § 12-6-2320 regarding "the extent of the taxpayer's business activity in this State." (Emphasis added). The South Carolina income tax must be "imposed on a base which reasonably represents the proportion of the trade or business [of the taxpayer] carried on within this state." S.C. Code Ann. § 12-6-2210 (2000). Where a taxpayer engages in a trade or business in another state but receives income from a separate line of business in this State, it is only reasonable that careful consideration be given to how that

⁵The taxpayer's retail income was included in the denominator of its apportionment ratio in its amended income tax returns. In a demonstrative exhibit, the Department showed that in tax year 2006, the taxpayer's filings reported a South Carolina ratio of .0972%. The Department compared the type of income actually earned in South Carolina to that type of income earned everywhere to arrive at a South Carolina ratio of .2537% for royalty receipts and 1.0054% for other intangible receipts (i.e., financing receipts).

⁶The taxpayer's apportionment ratio was also substantially lower than that of its sister corporation, East, in tax year 2006. East reported a South Carolina ratio of 2.7826% compared to the taxpayer's .0972%, despite the fact that both entities' businesses were substantially identical – both were retailers who also received income from the CBS partnership in that tax year. While the two ratios should not be identical given the differences in reporting methods used by the two entities, the gross disparity (East's ratio is roughly 25 times that of the taxpayer) supports the Department's position that the taxpayer's ratio is diluted and that the statutory apportionment formulas do not fairly represent the extent of its business here. The Geoffrey decision, cited by the Department, further supports the interconnection of the taxpayer's royalties with the sales of East in South Carolina. See Geoffrey v. S.C. Tax Comm'n, 313 S.C. 15, 22, 437 S.E.2d 13, 18 (1993) finding "[t]he real source of Geoffrey's [royalty] income is not a paper agreement, but South Carolina's Toys R Us customers."

taxpayer's business is represented in this State for tax purposes.⁷ In this case, the lines of business and the South Carolina ratios of the various entities involved showed that a standard statutory formula could not fairly represent the taxpayer's business activity in this State. Thus an alternative formula was warranted.

The taxpayer argued that § 12-6-2320 is not triggered in this case because the taxpayer is a "unitary business" and that, consequently, no portion of its business can be separately considered. The test which triggers § 12-6-2320, according to the taxpayer, is whether or not the taxpayer is "unitary." This argument is not consistent with the taxpayer's own testimony. Its expert testified that a unitary taxpayer whose business cannot be fairly represented by a standard formula is still subject to the provisions of § 12-6-2320.⁸ The term "unitary" is itself subject to a multitude of definitions and nuances – a taxpayer may be "unitary" in one sense, and yet be

⁷The Department's expert witness explained the propriety of the Department's application of § 12-6-2320 using a simile:

... [T]hink of the taxpayer – and so the activity, business activity in South Carolina as an apple. I mean, you see something going on. By an "apple," I mean a certain type of activity. Then you see it being mixed with a larger business that's got apples and oranges. ... So simply recognizing that the taxpayer was an apple company and that the other companies that have been in the denominator it was being mixed with was a fruit company, an apples and an oranges company, that's – that leaps out at you. ... [T]he apples here are the franchise payments, the royalties for intellectual property and financing later on, in the last couple of years; whereas, the oranges in this case were the retail sales. There were no oranges in South Carolina. ... One's an apple company; the other's a fruit company. They shouldn't be compared.

(Tr., pp. 330-331 (testimony of Dr. Glenn Harrison)).

⁸The language of § 12-6-2320 itself is silent as to the unitary or non-unitary nature of a taxpayer. Moreover there is no authority to suggest that a taxpayer that is in some sense "unitary" can utilize a standard formula no matter how unfairly the result represents its business in this State, or that a taxpayer's business is fairly represented per se by a standard formula simply because it is labeled "unitary."

easily divisible for some purposes. The taxpayer cited Exxon Corporation v. S.C. Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979), for the proposition that a taxing agency may not apply a "separate accounting" to a unitary business. The Exxon Court, discussing the unitary business concept, stated:

That term (unitary) is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business. A business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration as independent units.

273 S.C. at 599, 258 S.E.2d at 96 (Emphasis added).

The language of the Exxon decision does not support the all-or-nothing proposition that the taxpayer asserts. It is clear that even within the South Carolina Supreme Court's definition of the term "unitary," there is a range, at one end of which is a business which is too interconnected to be separated. The language does not support, as the taxpayer suggests, that if a taxpayer is in any sense "unitary," there is no possibility of or justification for a separate consideration of its various activities. Whether or not a division or separate consideration is possible or can be justified within this range depends on the purpose of that division or separation. Exxon did not consider the effect of the alternative apportionment statute, which both parties agree grants the Department broad authority for the purpose of fairly and reasonably determining a taxpayer's South Carolina income tax liability.⁹ In light of this Court's determination that the standard apportionment formulas do not fairly represent the extent of the taxpayer's business in this State, the question of whether a taxpayer is "unitary" or "non-unitary" is not outcome determinative.

⁹Under § 12-6-2320, the Department is given the authority not only to require "separate accounting," but also to require "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

B. The Department's alternative method is reasonable.

The Department's proposed method calculates the taxpayer's South Carolina ratio by dividing the income earned within South Carolina by the total derived from that type of income everywhere the taxpayer does business. The Department's method does not include the retail income earned by the taxpayer in other states in its ratio calculation. That income, and the taxpayer's retail operations, are not connected to South Carolina, and § 12-6-2320 is concerned with the taxpayer's business in this State. The taxpayer has described the Department's alternative method as a form of separate accounting. Because the Department's method considers only the business conducted in this State, and because separate accounting is a method expressly permitted by § 12-6-2320(A)(1), the Department's apportionment method applied to this taxpayer is reasonable.

The taxpayer raises two primary arguments challenging the reasonableness of the Department's method. First, the taxpayer argues that a unitary business, or a portion of one, cannot be subject to a separate accounting. Second, the taxpayer argues that the Department's method in this case attempts to reach extraterritorial income; that is, income that is not properly taxable in South Carolina. The unitary business concept has been discussed above, and that discussion applies in the context of the taxpayer's reasonableness argument as well. Assuming the taxpayer is unitary in some sense, this does not mean the taxpayer's South Carolina operations cannot be fairly and accurately considered apart from its retail operations for the limited purpose of calculating an alternative apportionment method.

The concern is that separate accounting may fail to account for the flow of values among the components of a unitary business. See, e.g., Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 222 (1980). In this case, however, the various activities and flows of value are

clearly delineated by the inter-company flow of funds from one legal entity to another.¹⁰ The fact that the activities conducted in South Carolina and the income earned from within South Carolina were largely part of the operations of a legal entity (CBS) which was separate from the taxpayer makes the division of the lines of business for this purpose even more reasonable and accurate. In other words, the taxpayer and its related entities have already valued the services and intangibles that flow from one to the other by making these inter-company transactions.

II. Sourcing Of The Taxpayer's Financing Income.

The taxpayer also argues that the Department is attempting to reach extraterritorial income. This argument is based on a misreading of South Carolina case law. The taxpayer cites Lockwood Greene v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), for the proposition that taxpayers should source their income to the location of their employees. Although the location of employees was the appropriate sourcing rule for the taxpayer in Lockwood, the Court in that case did not hold that the location of employees is the appropriate sourcing rule for all taxpayers. The Court specifically noted it was not persuaded that financing companies are comparable to engineering firms like Lockwood Greene. Id. at 450, 361 S.E.2d at 348. What the Court held in Lockwood was that South Carolina income tax must be imposed "upon a base which reasonably represents the proportion of the trade or business carried on within this State." Id. at 449, 361 S.E.2d at 347. Where a taxpayer's income flows from an interest in intangibles, such as a financing receivable, it is a far more reasonable

¹⁰The following testimony was elicited from the taxpayer's economics expert at trial:

Mr. Traynham: So, if I understand your testimony, the interdependency and the values that are exchanged between and amongst these entities are at least partly due to the intercompany flow of funds from one to another?

Dr. Wilder: Well, they're measured by the intercompany flow of funds. The value is measured by the intercompany flow of funds.

method of sourcing income. The United 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.**¹¹

307 U.S. 357, 365-66 (1939) (internal citations omitted) (Emphasis added).

The taxpayer would have the Court find that the income it derives from these intangible receivables is only properly taxed where its employees are engaged in activities related to the maintenance of the receivables. However, the customers cannot be dissociated either from the interest and fees earned by the taxpayer, or from the value of the securitized instruments the consumer debt later becomes.¹² Thus, the taxpayer's financing income should be sourced to South Carolina and included in the numerator of any apportionment ratio that may apply to its business in this State.

¹¹The Department's expert stated this principle succinctly at trial. "From an economist's perspective . . . [i]f it weren't for the South Carolinians buying these cars, that [financing] income would not be there, and that's the end of it to an economist."

¹²The taxpayer testified that the value of the its securitized instruments to third party investors was in part attributable to the faithful payments on financing agreements by customers. Moreover, the value of those instruments would be adversely impacted by the default in payment of a percentage of those customers.

III. Penalties

SCDOR assessed penalties totaling \$205.832 against the Taxpayer based on two statutory grounds: (1) negligence and (2) substantial understatement. Regarding the negligence penalty, the South Carolina Code provides that a penalty may be assessed where underpayment of tax is due to "negligence or disregard of regulations." S.C. Code Ann. § 12-54-43(F)(1) (2000). "Negligence" is defined as "failure to make a reasonable attempt to comply with the provisions of this title, and 'disregard' includes careless, reckless, or intentional disregard." S.C. Code Ann. § 12-54-43(F)(3)(2000). In this case, CarMax West was not negligent in its reporting. It had no opportunity to report its tax liability under the alleged alternative self-designed apportionment method used by SCDOR. Such alternative method is unpublished and no notice has been given by SCDOR that such a method exists. It would have been impossible for a taxpayer to file its tax returns under the method of taxation that SCDOR has used in making the assessment of additional tax that is at issue in this case.

As CarMax West's expert in state and local taxes, tax accounting and tax policy testified, from a tax policy standpoint, imposing a penalty in these circumstances would not be reasonable because of the lack of notice to the taxpayer that the standard formula was not the correct methodology. Therefore, I conclude that CarMax West has established by a preponderance of the evidence that there is no support for SCDOR to assess a negligence penalty in this case, and the penalty must be dismissed.

The Code further provides for mandatory penalties where a taxpayer substantially understates amounts owed; however, the amount of the understatement "must be reduced by that portion of the understatement that is attributable to the tax treatment of an item: (i) by the taxpayer if there is or was substantial authority for that treatment, or (ii) with respect to which

the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of the item by the taxpayer." S.C. Code Ann. § 12-54-155(B)(2)(b) (2000 and Supp. 2009) (emphasis added). It further states that "[a] penalty must not be imposed pursuant to this section with respect to a portion of an underpayment if it is shown that there was a reasonable cause for the portion and that the taxpayer acted in good faith with respect to the portion." S.C. Code Ann. § 12-54-155(D)(1) (2000 and Supp. 2009) (emphasis added). While SCDOR focuses on the mandatory nature of the penalty provisions, these exceptions also contain mandatory language.

In this case, the Taxpayer filed in accordance with the statutory method as well as the tax return forms and instructions. As the SCDOR witness testified, the tax returns and the instructions to those returns represent substantial authority. It is clear that CarMax West acted in good faith in following this authority and submitting its filing. Furthermore, it made adequate disclosure on its income tax returns, as conclusively evidenced by the fact that the audit report itself uses only that information that was reported on the return. Thus, because the Taxpayer had substantial authority and made complete disclosure on its returns, I conclude that CarMax West has established by a preponderance of the evidence that the substantial understatement penalty should not apply and must be dismissed.¹³

IV. Constitutionality of Department's Application of § 12-6-2320.

A. Commerce Clause.

¹³ Had SCDOR based its penalty assessment on the fact that the Taxpayer initially filed using the three factor formula and after audit changed to the single factor formula now in contention, there would still be substantial authority for its position. However the audit report does not assert a penalty based on the three factor versus single factor formula. It asserts a penalty based on a substantial understatement because the taxpayer did not follow the method used in the audit report. As set forth above, CarMax West had substantial authority for its reporting method.

The taxpayer argued in its pre-trial brief that the Department's application of § 12-6-2320 in this case violates its constitutional rights pursuant to the Commerce Clause of the United States Constitution. It is fundamental that a party claiming a violation of a constitutional right bears the burden of proving, by more than mere speculation, that the violation occurred. United States ex rel. Darcy v. Handy, 351 U.S. 454, 462 (1956) states:

While this Court stands ready to correct violations of constitutional rights, it also holds that "it is not asking too much that the burden of showing essential unfairness be sustained by him who claims such injustice and seeks to have the result set aside, and that it be sustained not as a matter of speculation but as a demonstrable reality."

See also Caldwell v. McMillan, 224 S.C. 150, 77 S.E.2d 798, 803 (1953) ("... the burden of proof of both law and fact must be borne by him who charges a violation of some provision of the Constitution ..."). The taxpayer has offered only vague arguments and assertions in its pre-trial brief, and has failed to meet its burden of establishing that a violation of a constitutional right occurred. In fact, no evidence or testimony was offered at trial relating to the constitutional issues raised by the taxpayer. Nonetheless, the Court addresses the Commerce Clause issue as follows:

Commerce Clause challenges to state tax laws are typically analyzed by employing the four part Complete Auto test: (1) a substantial nexus exists between the taxing state and the 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. Complete Auto Transit v. Brady, 430 U.S. 274, 279 (1977). The taxpayer has alleged that the Department's application of the statute at issue discriminates against interstate commerce.

One indicia of discrimination would be a tax treatment of an in-state taxpayer that was more beneficial than a tax treatment of an out-of-state taxpayer. See, e.g., Fulton Corp. v.

Faulkner, 516 U.S. 325, 331 (1997). In this case, the taxpayer offered no testimony or other evidence to establish that it was treated differently than a similarly situated taxpayer who was domiciled in this State. As stated above, the burden remains on the taxpayer to prove that discrimination does exist in a Commerce Clause challenge. See, e.g., Norton Co. v. Dept. of Revenue, 340 U.S. 534 (1951); Washington Rev. Dep't v. Stevedoring Ass'n, 435 U.S. 734 (1978).

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).¹⁴ Simply put, this test asks whether the taxing scheme - if applied by every taxing jurisdiction - would subject more than 100% of a taxpayer's income to taxation. Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 169 (1983). The taxpayer specifically alleged in its brief that the Department's formula would subject more than 100% of its income to taxation. Again, no testimony or other evidence to that effect was offered at the hearing in this matter.¹⁵ Notwithstanding, this Court

¹⁴Originally, the test was introduced by the Supreme Court in Container Corporation of America, as a test for the second prong of the Complete Auto test - the prong concerned with fair apportionment. That case foreshadowed the extension of the test to questions of discrimination when the Court stated that "[a]t least in the interstate commerce context, . . . the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." Container Corp. at 170.

¹⁵The South Carolina Supreme Court in Exxon ruled against the taxpayer's Commerce Clause violation claims, which were similarly based on a claim that more than 100% of the taxpayer's income would be taxed. The Court stated:

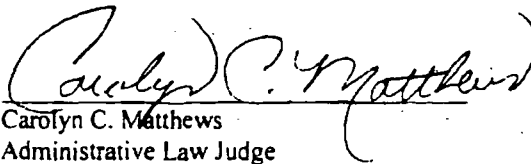
Turning to the question of multiple taxation and the Commerce Clause, the prevention of double taxation is, of course, the whole reason for apportioning income. . . . The record does not disclose what portion of Humble's income was taxed by all states

finds that a ratio dividing receipts from a particular state by receipts from everywhere, when applied by every taxing jurisdiction in which the taxpayer conducts its business, could necessarily tax no more than 100% of the taxpayer's income.

ORDER

1. The Department has demonstrated the Petitioner's apportionment formula fails to fairly represent its business in this State;
2. The Department's proposed alternative apportionment method is reasonable in light of the extent of the Petitioner's business activities in this State;
3. The penalties applied to the Petitioner by the Department for negligence and understatement are not reasonable under the facts of this case; and
4. The imposition of an alternative method in this case is not an unconstitutional violation of the Commerce Clause.

AND IT IS SO ORDERED.


Carolyn C. Matthews
Administrative Law Judge

April 22, 2010
Columbia, South Carolina

combined. If, in fact, Humble paid income taxes on more than one hundred (100%) percent of its income to all states combined, it has not attempted to prove that fact. . . . Humble has shown no multiple burden.

Exxon Corp. v. South Carolina Tax Commission, 273 S.C. 594, 607, 258 S.E.2d 93, 99-100 (1979).

[Handwritten notes]
2nd April 2010
H. C. B. K. O. A. - 1

ROA_000018

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT DIVISION
Docket No. 09-ALJ-17-0160-CC

CarMax Auto Superstores
West Coast, Inc.,

Petitioner,

v.

South Carolina Department of
Revenue,

Respondent.

COPY

ADMINISTRATIVE HEARING

Thursday, February 18, 2010

9:06 a.m. - 5:40 p.m.

AND

Friday, February 19, 2010

9:04 a.m. - 12:26 p.m.

The hearing before the Honorable Carolyn C. Matthews, was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 18th and 19th day of February, 2010 before Cassandra E. Vance, Court Reporter and Notary Public in and for the State of South Carolina.

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ROA_000019

APP_00022

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Also Present:

Adam N. Marinelli, Esquire; SCDOR
 Elizabeth R. Hamilton, Esquire; SCDOR
 Craig T. Cronheim, Esquire; CarMax, Inc.

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STIPULATIONS

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

1 **THE COURT:** Good morning, everyone. Got most of the
2 crowd here. I'm Carolyn Matthews. I'm the
3 Administrative Law Judge who's been assigned to
4 hear the case before me today. It is a
5 contested case entitled CarMax Auto Superstores
6 West Coast, Incorporated, versus South Carolina
7 Department of Revenue. It's our Docket Number
8 09-ALJ-17-0160-CC. And representing the
9 Petitioner, CarMax Superstores West Coast,
10 Incorporated, we have Mr. John von Lehe.
11 **MR. VON LEHE:** Thank you, Your Honor.
12 **THE COURT:** Good morning, Mr. von Lehe. And
13 Ms. Bryson is here, also.
14 **MS. GEER:** Good morning, Your Honor.
15 **THE COURT:** Both from Nelson Mullins. Representing
16 the Department of Revenue, we have Mr. Michael
17 Traynham.
18 **MR. TRAYNHAM:** Good morning, Your Honor.
19 **THE COURT:** Mr. Traynham, good morning. And
20 Ms. Lynn Baker I see.
21 **MS. BAKER:** Good morning, Your Honor.
22 **THE COURT:** And I believe you brought Mr. Marinelli?
23 **MR. MARINELLI:** Yes.
24 **THE COURT:** And we have Ms. Hamilton, too. Have I
25 gotten all the lawyers? Are there any lawyers

1 I'm overlooking?

2 MR. VON LEHE: Yes, Your Honor.

3 THE COURT: That's everybody. Thanks so much. This
4 case today involves a taxpayer's challenge to
5 the Department of Revenue's computation of its
6 corporate income tax and the corporate license
7 fees for tax years 2002 through 2007. And
8 taxpayer essentially asserts, as I understand
9 it, that they are entitled to use a statutory
10 apportionment formula, which is an alternative
11 to what the Department is using. The
12 Department says that that formula doesn't
13 fairly represent the extent of the taxpayer's
14 business in this State and that, therefore,
15 there's an alternative formula which should be
16 used.

17 There's also an issue in here raised by the
18 Petitioner with respect to violation of the
19 commerce clause with the method of computation
20 used by the Department. And I believe that's
21 a fair statement of the major issues in the
22 case.

23 But the way we'll proceed today, for anyone who
24 is not familiar with our procedures, is we will
25 have brief opening statements on behalf of each

1 party, with the Petitioner going first and
2 bearing the burden of proof throughout. And
3 then we will allow the Petitioner to go ahead
4 with their case, whatever witnesses and
5 evidence that's admissible under the rules of
6 the evidence in this State, same for the
7 Respondent, and then we will have brief closing
8 statements on behalf of each party. And I
9 appreciate your putting all exhibits here in a
10 notebook for me. That was most helpful. So
11 whenever you're ready, Mr. von Lehe or
12 Ms. Geer, whoever is going to proceed.

13 MR. VON LEHE: Thank you, Your Honor. Your Honor,
14 you know Bryson Geer. Also, I would like to
15 introduce those other people who are with us
16 today.

17 THE COURT: Certainly.

18 MR. VON LEHE: From CarMax, Mr. Craig Cronheim, who
19 is an attorney with the company, an in-house
20 attorney there, and Ms. Eileen Yost, who is in
21 their tax department. She's the head of their
22 income tax system.

23 THE COURT: Mr. Cronheim, Mr. Yost, glad to have you
24 both here.

25 MR. VON LEHE: And Ms. Yost will eventually be

1 called to the stand

2 THE COURT: Ms. Yost, I'm sorry.

3 MR. VON LEHE: She'll eventually be called to the
4 stand. We also have with us two witnesses that
5 we will ask to be qualified as experts. And
6 we'll talk about that when we get a little bit
7 closer to that. But, just for now, I'd like
8 for you to -- if they can stand, Mr. Phil Zinn
9 is with us.

10 THE COURT: Mr. Zinn.

11 MR. VON LEHE: He's with Price Waterhouse, which is
12 a CPA firm; he's a principal in that firm.

13 THE COURT: Yes, sir.

14 MR. VON LEHE: And also Dr. Ron Wilder who's here --

15 THE COURT: Good morning.

16 MR. VON LEHE: -- will be called as an expert
17 witness. He's an economist.

18 THE COURT: Wonderful.

19 MR. VON LEHE: We will ask you to qualify them
20 eventually as we get closer to that.

21 OPENING STATEMENT BY MR. VON LEHE:

22 MR. VON LEHE: Your Honor, yes, you did correctly
23 state the issues before the Court. I want to
24 just, not modify that, but just to embellish it
25 a little bit. The basic issue before the Court

1 today is whether or not this taxpayer is
2 entitled to have a tax computed based on its
3 total corporate net income. And then we get to
4 apportionment thereafter.

5 You will hear a number of different arguments
6 put forth today by us and by the Department of
7 Revenue. But one thing you will not hear, the
8 Department of Revenue will not tell you that it
9 has computed a tax based on this taxpayer's
10 total net income, because it has not done that.
11 As you pointed out in your opening state, it
12 used an alternative method. But that method,
13 in our judgment, goes beyond just a question of
14 a proper method of apportionment. It goes to
15 an initial question of whether or not this
16 taxpayer should be allowed to report its income
17 in total; in other words, should it be allowed
18 to have its computation based on its total net
19 income or is the Department of Revenue correct
20 in carving out some of that income and
21 computing its tax on only a portion of that
22 income.

23 We believe, obviously, that the taxpayer has
24 filed its returns correctly when it filed
25 beginning on line one of that tax return its

1 federal taxable income. That's what line one
 2 on the tax return says to do. Of course, the
 3 federal taxable income is the total income of
 4 the taxpayer and that's the way it begins. The
 5 form also says, "Please attach your federal
 6 income tax return to this form." And the form
 7 says that for a reason and the reason it says
 8 that is because, certainly, generally speaking,
 9 a taxpayer's South Carolina taxable income
 10 always begins with its federal taxable income.
 11 That is the beginning, initial difference that
 12 we have with the Department of Revenue. They
 13 have rejected that method saying that that
 14 method is erroneous. Of course, our argument
 15 is that it's not erroneous, that that is the
 16 proper way to begin the computation.
 17 Just a little bit of facts. We'll hear a lot
 18 about facts today, but just a little bit of
 19 facts. We have up on the board a look at
 20 really two entities, the two in blue; they
 21 happen to be owned by a publicly traded
 22 company. CarMax, as you're maybe aware, is the
 23 major retailer of used automobiles in the
 24 United States and it does that through those
 25 two blue entities down there at the bottom.

1 The one on the right is the taxpayer; that's
2 CarMax West. The one on the left we call
3 CarMax East and it is not the taxpayer. It,
4 however, sells cars throughout the East and in
5 South Carolina. The taxpayer itself sells cars
6 primarily out West. It doesn't have car sales
7 in the East and it doesn't sell cars in South
8 Carolina.

9 As I mentioned the way the taxpayer filed its
10 tax return, it just did one, two, three:
11 federal taxable income, it made certain
12 adjustments, which all taxpayers make but not
13 an issue here, came up with a line three on the
14 federal return. That line, even though it's
15 not called that -- came up with a line three on
16 the state return -- that line, even though it's
17 not called that on the return, that is
18 generally referred to, and I think everybody in
19 the courtroom would agree with this, is
20 something called "apportionable net income."
21 And to that figure, one applies an
22 apportionment formula, ordinarily.

23 So all multi-state taxpayers who are filing in
24 South Carolina today, or let's say all that I
25 know about -- I certainly don't know about

1 all -- but they're filing their returns that
 2 way. They're starting with their federal net
 3 income; they're making appropriate adjustments;
 4 they're coming down to something called
 5 "apportionable net income," and then an
 6 apportionment formula is applied to that.
 7 CarMax West, when it filed its return, it
 8 used -- it has used, what is before you, a
 9 gross receipts apportionment formula.
 10 Originally, it used a different apportionment
 11 formula. We looked at what they had filed. We
 12 looked at the audit report. We advised them to
 13 change their apportionment formula to a gross
 14 receipts formula and they did that. So all the
 15 numbers that are before you today, including
 16 the amended returns filed sometime ago, a few
 17 months, they all used -- we're using a
 18 single-factor apportionment formula to put
 19 before the Court as the correct method.
 20 I believe that when we originally filed using
 21 a three-factor formula that that was not the
 22 correct method, so they changed it. So the
 23 issue really has nothing to do with whether
 24 they are three-factor or one-factor. We've
 25 already said, "Okay, we're one factor." They

1 issued a little more tax; they paid it. We
2 have that issue settled -- settled the hard way
3 by paying the tax, but still we got that issue
4 (sic), so that's not before the Court.

5 So, again, that's what CarMax did. What has
6 the taxpayer done? All right. The taxpayer
7 has said, "We are not going to use federal
8 taxable income as a starting point." That's
9 what the Department of Revenue said, "We're not
10 going to use federal taxable income as a
11 starting point. Instead, we're going to tax a
12 portion of that income."

13 **THE COURT:** At first, it sounds like that would be a
14 very good thing.

15 **MR. VON LEHE:** Well, it does.

16 **THE COURT:** Looking to be educated.

17 **MR. VON LEHE:** This is the reason really why -- and
18 this is an example of how -- this case is an
19 example of how that is not always a good thing.
20 The taxpayer is maybe making a lot of money,
21 they may be making no money, that makes no
22 difference under the Department of Revenue's
23 calculation. We could have lost \$10 million.
24 Their calculation would be the same. We could
25 have made \$10 million. Because, you see, we

1 begin with the total income of the company.
2 They don't. They start with the segregated
3 portion of the income of the company, which is
4 unrelated to that corporation's income or loss.
5 You'll hear a lot of talk today about the
6 Geoffrey case, a case decided by Judge Stevens
7 many years ago and sort of become a key case in
8 South Carolina tax jurisprudence. And,
9 basically, that case says that Geoffrey was a
10 subsidiary of Toys R Us. Toys R Us took its
11 intangible properties, put it in a Delaware
12 holding company, paid sales in South Carolina,
13 paid royalties to the Delaware holding company
14 and said that the Delaware holding company did
15 not have to file in South Carolina.
16 The Court decided that that was wrong, that
17 they did have to file in South Carolina, so it
18 filed in South Carolina. It filed in South
19 Carolina based on its total corporate income.
20 That's how Geoffrey filed. That's what we want
21 to do. That's what we have done.
22 We didn't have to be hunted down like Geoffrey
23 was, found out. We've been filing returns here
24 ever since we started business, so we are a
25 return filer. We're not someone who's hidden

1 off in Delaware somewhere not filing a return.
2 We file returns. We file those returns in the
3 same way that Geoffrey was told to file his
4 return.

5 Therefore, in our opinion, the Geoffrey case is
6 one of our main precedence to set before you.
7 We've done what Geoffrey did. But, obviously,
8 it's being challenged for reasons which I'm
9 sure you will hear.

10 This was the beginning structure and it's worth
11 looking at just to see what the Department of
12 Revenue has done. This structure setup, CarMax
13 West over on the right (indicating) owns the
14 intellectual property, trade names, trademarks,
15 et cetera, of CarMax. It doesn't sell cars in
16 South Carolina. CarMax Auto Superstores East,
17 East does sell cars in South Carolina and it
18 pays a royalty to CarMax West, just as Toys R
19 Us paid a royalty to Geoffrey.

20 CarMax West filed a South Carolina income tax
21 return. It apportioned its income to South
22 Carolina based on royalties received in South
23 Carolina to total royalties. The Department of
24 Revenue's position, however, is: No, that is
25 not correct, that instead of doing that, it

1 should have not reported its net corporate
2 income to South Carolina. It should have just
3 reported the royalties and paid a tax on that,
4 without regard -- don't use the royalties in
5 the apportionment formula like we did to
6 apportion the share of total income; just tax
7 the royalties.

8 Now, in later years, on December 1st, 2004,
9 unfortunately, things got a little more
10 complicated.

11 **THE COURT:** Is that the formation of CBS?

12 **MR. VON LEHE:** Yes, it is. So here's a picture of
13 that, which you have seen, but it's not that
14 bad, but still, there it is.

15 The second part of the audit, of course, has to
16 do with what happened after the reorganization
17 for 2004, the formation of CBS. And what
18 happened there was, these two entities both
19 contributed property to a partnership, which
20 actually was an LLC taxed as a partnership
21 called CarMax Business Services. CarMax Auto
22 Superstores, Inc., that operates in South
23 Carolina, got back 6.5 percent. CarMax
24 Superstores West Coast got 93.5 percent. These
25 were done on business valuations, which I don't

1 think are being challenged. So that's the way
2 they were set up.

3 Therefore, after the formation of this entity,
4 it got the intellectual property. And so when
5 cars are sold by CarMax East and when cars are
6 sold by CarMax West -- but we're just
7 concentrating on East because that's where the
8 cars sales in South Carolina are -- the
9 royalties and management fees, which are also
10 charged -- this does all the management for
11 these entities (indicating) -- we'll get into
12 the details -- they go into the partnership and
13 then the partnership, this flows back through.
14 Since it's not a taxable entity, it's a
15 flow-through entity, these percentages come
16 back and go into the federal taxable income of
17 these entities, which, again, is the starting
18 point of where we began.

19 So where the Department of Revenue, again, has
20 said: "No, you can't start with your total
21 income, CarMax West. You can't do that. We're
22 going to tax the South Carolina portion of
23 CarMax Business Service's income, the
24 partnership, too."

25 So, again, their position is that CarMax West's

1 federal taxable income cannot be considered and
2 it doesn't make any difference what the entity
3 makes in total, that that is irrelevant to
4 their computation.

5 Again, that's our fundamental disagreement with
6 them. In the early years of this, they would
7 have taxed the royalties, just a flat tax on
8 the royalties, which we disagree with. Then
9 during the later years of this, they want to
10 impose a tax on CarMax Business Services, the
11 partnership, that portion of the income and not
12 consider the income of the entity itself as
13 being irrelevant.

14 THE COURT: Okay.

15 MR. VON LEHE: Your Honor, we're going to submit to
16 you as we move forward that this case has
17 really already been tried in a different
18 setting and that was in the Exxon case. Exxon
19 did -- it used a method similar to what the
20 Department of Revenue is proposing.
21 Exxon reported to South Carolina only a portion
22 of its income. It said, "Look, all we do in
23 South Carolina is marketing. We just got some
24 service stations in South Carolina. So you
25 can't tax our total income. You're only going

1 to be able to tax our marketing income," they
2 said. It just so happened that it didn't have
3 much marketing income. Most of the income of
4 that entity came from exploration and refining,
5 as they had it divided up. It's all one
6 entity, just like CarMax West is all one
7 entity.

8 But the matter went on to be tried and the
9 South Carolina Supreme Court said, "No, you
10 cannot divide up this income. This is a
11 unitary business." That term was used. That
12 term's got too many legal definitions. We
13 believe it has economic definitions. We
14 believe it has an accounting definition. But,
15 generally, it's an entity that the parts of
16 which are closely intertwined and it can't be
17 accurately broken up. They depend on and
18 contribute to each other, parts of the
19 business. We believe that's true for CarMax,
20 also. We do not believe its income can be
21 broken up.

22 So the Exxon went on, the case was tried, and
23 the South Carolina Supreme Court said, "No, you
24 can't break up your income that way. You've
25 got to pay a tax on your total -- start with

1 your total federal taxable income and pay the
2 taxes that way based on a method of
3 apportionment."

4 Now, with income, the question of fair
5 apportionment, which you mentioned, certainly -
6 - we certainly agree that a business should
7 apportion its fair share of income to South
8 Carolina. And the Department of Revenue has
9 rejected two things. One, it has rejected the
10 net income concept. I'm sure you'll hear how
11 they classify that. I will leave that in their
12 hands. They have also rejected the
13 apportionment method, which we have used, which
14 is the gross receipts apportionment method,
15 which is the statutory apportionment method.
16 We believe -- and they do that under a
17 provision of the law which says that if the
18 formula used -- and I'm going to change that a
19 little bit and this language talks about
20 method -- if it doesn't fairly represent the
21 taxpayer's business in South Carolina, then
22 they get a right to propose a change to that.
23 But it is our position, number one, that they
24 don't have a right to propose this kind of a
25 change. They could use a different

1 apportionment formula if they wish, but they
2 can't divide up this company's business.

3 Now, if they had simply taken our total net
4 income and applied an apportionment formula to
5 it and got a different answer, I would probably
6 be disagreeing with that also, because we
7 believe that the apportionment formula that we
8 used does properly reflect our income in South
9 Carolina, activities in South Carolina. The
10 apportionment formula does fairly represent our
11 income that comes from our actives in South
12 Carolina.

13 And I think the most obvious way of looking at
14 that is, CarMax West Coast doesn't do anything
15 in South Carolina. It has no employees here.
16 It has no property here. It has no activities
17 here. The only thing it has in South Carolina
18 is the same thing Geoffrey has. It's got
19 trademarks that are being exploited by an
20 affiliated company. That's all it does in
21 South Carolina. And it has paid a tax, like
22 Geoffrey did, based on that, on its net income
23 as apportioned according to those royalties.

24 THE COURT: Okay.

25 MR. VON LEHE: Your Honor, there is also an issue

ROA_000039

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APP_00042

1 over financing income. CBS, the entity in
 2 which you are familiar with, it does the
 3 financing of the automobile sales and the paper
 4 that is received from those sales. But all of
 5 the activities of the financing operation take
 6 place in Georgia and it does not perform
 7 financing activities in South Carolina.
 8 Therefore, it's our position that financing
 9 income ought to be assigned to Georgia and it
 10 should not be in the apportionment formula
 11 assigned to South Carolina. That's an issue.
 12 It's a sub issue in the case.
 13 And then, finally, there is one last issue.
 14 Penalties have been imposed on this taxpayer.

15 **THE COURT:** I know y'all contend that there's no
 16 real --

17 **MR. VON LEHE:** Well, we --

18 **THE COURT:** There's nothing that actually gives you
 19 notice of how they're computed or why, so ...

20 **MR. VON LEHE:** We do contend that, Your Honor. Yes,
 21 we do contend that. And here's a taxpayer that
 22 has filed in accordance with the instructions
 23 in the tax return and it has done everything
 24 that it should do along those lines. There may
 25 be one that I don't know about or two or

1 something that I don't know about that do it
2 differently, but I would venture to say that
3 every multi-state taxpayer that files in this
4 State files that way. We filed that way.
5 That's the way we filed. That's the way all
6 corporations file here. And yet we're still
7 being penalized. And there is nothing that
8 indicates -- there's nothing on that tax
9 return, nothing on those instructions, nothing
10 in the South Carolina publications, which of
11 course issues informative revenue rulings and
12 policy statements -- there's nothing in any of
13 that that indicates that a multi-state taxpayer
14 should do anything other than what the form and
15 instructions tell it to do.

16 And, of course, we believe that those forms and
17 instructions are accurate and all they're doing
18 is mirroring -- it's a mirror of the South
19 Carolina law that says, "Start with federal
20 taxable income." And that's what we did. So
21 thank you, Your Honor.

22 **THE COURT:** Thank you, Mr. von Lehe.

23 Mr. Traynham, we'll be glad to hear from the
24 Department.

25 **MR. TRAYNHAM:** Thank you, Your Honor. I'll try to

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1 be brief. Your Honor, I'd first like to
2 introduce the other folks who are here with the
3 Department today.

4 **THE COURT:** Certainly.

5 **MR. TRAYNHAM:** I believe you've met Mr. Donovan from
6 our audit division.

7 **THE COURT:** Mr. Donovan, glad to see you.

8 **MR. TRAYNHAM:** There's another gentleman here from
9 the audit division here for observation. I'll
10 let you introduce yourself.

11 **MR. SALEEBY:** My name is Andrew Saleeby. Good
12 morning, Your Honor.

13 **THE COURT:** Glad to have you, Mr. Saleeby.

14 **MR. TRAYNHAM:** And we have one other witness who we
15 will offer up for expert testimony, Dr. Glenn
16 Harrison --

17 **THE COURT:** Mr. Harrison, glad to meet you.

18 **MR. TRAYNHAM:** -- from Georgia State University by
19 way of Florida, so ...

20 **THE COURT:** Wonderful. Glad to have you here. And
21 I would mention that in the afternoon,
22 courtroom one, which is a lot bigger, will be
23 available, so if you want to move, we can do
24 it; if not, we can do it tomorrow or if you're
25 satisfied with the space here, we can stay

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1 right here.

2 MR. TRAYNHAM: I'll defer to the gallery on that,
3 Your Honor.

4 THE COURT: We'll see how it works out and if it
5 seems claustrophobic or whatever, we can move
6 to the bigger room. Go ahead, Mr. Traynham.

7 MR. TRAYNHAM: Thank you, Your Honor.

8 OPENING STATEMENT BY MR. TRAYNHAM:

9 MR. TRAYNHAM: Your Honor, what this case ultimately
10 comes down to is fairness. I'm sure that
11 you'll hear that a lot from the taxpayer, hear
12 that a lot from the Department, as well. The
13 question the Department is asking you to answer
14 today is whether it is fair for a corporate
15 taxpayer to take income from South Carolina,
16 from very specific sources, and mix that income
17 with income from a radically different source
18 that has no connection with South Carolina and
19 in so doing drastically reduce that taxpayer's
20 tax liability in this State.

21 The taxpayer has stated that it has no
22 employees in this State, it has no property
23 here, but it's sure earning a lot of income
24 here. We ask: Is it fair for it to be able to
25 drastically reduce its tax liability in this

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1 State when it has the benefit of the economic
2 markets here by mixing it with totally
3 unrelated income? And it's our position that
4 it's not fair or, to put it in more statutory
5 terms, this method does not fairly represent
6 the extent of the taxpayer's business activity
7 in this State.

8 Now, the taxpayer's talked a lot about its
9 entitlement to calculate taxable income based
10 on its total net income. Well, the authority
11 that the Department has relied on in this case,
12 the Statute 12-6-2320, envisions situations
13 where the general rules of calculating income
14 simply don't work, simply don't fairly reflect
15 the taxpayer's business.

16 And it's a little misleading to say that we
17 didn't consider the taxpayer's total net
18 income. We did consider the total net income,
19 but in combination with the income from West
20 Coast retail sales, the taxpayer's tax
21 liability was so diluted as to create a
22 drastically reduced and distorted tax
23 liability; thus, in the Department's view, the
24 alternative apportionment method was more
25 appropriate.

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1 Your Honor, you've heard a lot of discussion
2 already about the different entities that are
3 involved in this case and I won't belabor that
4 point. Needless to say, the flow of income in
5 this case is pretty apparent. You'll hear a
6 lot of testimony about it.

7 The taxpayer in this case is a retailer in
8 Western states. It does not do retail business
9 in South Carolina. It does earn significant
10 income from South Carolina by way of, in the
11 early years of the audit, royalty payments from
12 South Carolina retailers, and in the latter
13 years of the audit, by way of its partnership
14 interest in CarMax Business Services, LLC, or
15 CBS, as we've been referring to it. And CBS
16 performed not only the intangibles management
17 that the taxpayer formerly performed, it also
18 performed some other management services,
19 including financing services.

20 So income is coming from consumers in South
21 Carolina, flowing into CBS and, eventually,
22 flowing through CBS, as a disregarded
23 partnership, to the taxpayer. And the taxpayer
24 receives that income and mixes it in this large
25 pot with all of its other retail sales. And

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1 that's what we're concerned about is that
2 dilution that the mixing together creates.

3 The taxpayer brought up Geoffrey. There is a
4 very obvious distinction between this case and
5 Geoffrey. It's impossible to get over. The
6 taxpayer here has never disputed that it owes
7 a tax liability in this case, unlike the
8 taxpayer in Geoffrey. But what the taxpayer is
9 doing by mixing these two very distinct types
10 of income from very distinct geographic sources
11 is creating a pot of effectively untaxed South
12 Carolina income. And that's what we are
13 concerned about here.

14 The taxpayer originally filed its returns using
15 the three-factor or three-factor
16 double-weighted formula. They have amended
17 their returns subsequently, but you will hear
18 some testimony about the three-factor filing,
19 primarily, because that was the filing that our
20 audit was performed on. The amended returns
21 were not filed until after the audit was
22 complete and actually after the Department's
23 determination in this matter was issued; so
24 significantly after most of the audit findings
25 were done. So a lot of discussion will take

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1 place about the three-factor filing, as well as
2 the gross receipts filing, even though the
3 gross receipts filing is what's truly before
4 the Court today.

5 **THE COURT:** And I'm a little confused about this.
6 Obviously we're using Section 12-6-2250(A), the
7 three-factor filing.

8 **MR. TRAYNHAM:** Correct, Your Honor.

9 **THE COURT:** I've written it down and tried to
10 understand, but I think I have to see the
11 numbers to completely grasp it. And your
12 contention is that you're entitled to use an
13 alternative formula because that doesn't
14 accurately reflect their income in South
15 Carolina.

16 **MR. TRAYNHAM:** Correct, Your Honor.

17 **THE COURT:** But is there a statute which specifies
18 what that alternative is or do you just do it
19 on a case-by-case basis?

20 **MR. TRAYNHAM:** Your Honor, the statute that we
21 relied on in this case is 12-6-2320.

22 **THE COURT:** 2320. And it says "separate
23 accounting," but it doesn't really give a
24 formula, does it?

25 **MR. TRAYNHAM:** No, Your Honor.

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1 THE COURT: Okay. So it's more or less a case-by-
2 case -

3 MR. TRAYNHAM: Right.

4 THE COURT: -- determination, once you've made the
5 determination that you can use the alternative
6 formula.

7 MR. TRAYNHAM: Exactly, Your Honor. And that's more
8 or less what we're getting to. The central
9 question here is, first, does the taxpayer's
10 method of apportioning its income fairly
11 reflect the extent of its business in South
12 Carolina? And the Department would contend
13 that it does not.

14 If that is the case, we then must look at the
15 Department's proposed apportionment formula and
16 ask is that reasonable; that's the restraint on
17 the Department within the statute, that the
18 apportionment formula that we propose as an
19 alternative must be reasonable.

20 This statute gives us fairly broad authority in
21 the circumstances in which its implicated to
22 come up with a formula, as you said, on a
23 case-by-case basis. We are constrained to be
24 reasonable.

25 This Court has actually recently issued a

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1 decision on just how broad the powers of
2 12-6-2320 are. It doesn't directly apply to
3 this case, but the Media General
4 Communications, Incorporated, case that
5 recently came out talks a lot about how broad
6 the powers of 12-6-2320 are.

7 So I would just point out that those powers are
8 broad. So if a standard apportionment formula
9 fails to fairly reflect the taxpayer's business
10 in this State, the Department is entitled to
11 require an alternative apportionment formula
12 and that's what we've done here.

13 **THE COURT:** Okay.

14 **MR. TRAYNHAM:** Your Honor, we will offer up some
15 testimony addressing the financing issue, the
16 sourcing of the financing income -- I don't
17 want to belabor that point in opening -- as
18 well as whether or not penalties were
19 appropriate. But we simply ask Your Honor that
20 you keep in mind what we view as the central
21 question: Is the taxpayer's proposed method of
22 apportioning its income fair? Does it fairly
23 reflect its business? And we believe it does
24 not. Thank you.

25 **THE COURT:** Thank you, Mr. Traynham. Before we get

1 started with your first witness, are there any
2 stipulations with respect to admissibility of
3 the exhibits?

4 MR. TRAYNHAM: Your Honor, I don't believe that we
5 are going to stipulate to the exhibits. I
6 don't think there's going to be a lot of
7 objections, but I think we are both of the mind
8 that we need to see how the various exhibits
9 are going to come in.

10 THE COURT: Just easier to go through it case by
11 case? That's fine. I just thought we should
12 get some of that out of the way. So whenever
13 you're ready, Mr. von Lehe, you may.

14 MR. VON LEHE: If I could just reply.

15 THE COURT: Certainly.

16 REPLY BY MR. VON LEHE:

17 MR. VON LEHE: Just in reply, just briefly, Your
18 Honor. I think, you know, Mr. Traynham made an
19 eloquent argument, as he always does. I did
20 want to take issue with a couple of things he
21 said in reply. He said this taxpayer's earning
22 a lot of income here. That remains to be seen.
23 That's a matter that's before Your Honor to
24 make a decision on.

25 THE COURT: It's attorney opinion at this point,

1 Mr. von Lehe. Whatever you can prove is what
2 I have to make my decision on.

3 MR. VON LEHE: So I'm going to take issue with that
4 as a statement of fact. I think that's an
5 issue before the Court.

6 And so, Your Honor, another thing that I do
7 want to mention and the question is, you know,
8 the statute which gives them the authority to
9 use an alternate method, we don't believe that
10 that's without limitation. We don't believe
11 that. We still don't think you can carve up a
12 unitary business. The law of South Carolina
13 says you can't. So we certainly don't agree
14 that that statute is without limitation. We
15 don't believe that statute gives them a right
16 to tax the income of this partnership
17 separately, which is what they have done.

18 And, also, with regard to his statement about
19 the Media General case, which did as it now
20 stands allow some -- a method that we, quite
21 frankly, most tax practitioners were sort of
22 surprised that it did. But it's my opinion
23 that -- well, it's my understanding, anyhow,
24 that the Department of Revenue's position is
25 completely opposed to that Media General

1 decision and it's saying that that taxpayer had
2 no right to divide its income up that way or to
3 report its income that way. So I think the
4 Department of Revenue's reliance on Media
5 General would probably be inconsistent.

6 THE COURT: Okay.

7 MR. VON LEHE: So, Your Honor, with that, we're
8 prepared to go forward.

9 THE COURT: Whenever you're ready, you may call your
10 first witness.

11 MR. VON LEHE: And Ms. Geer will do that.

12 THE COURT: I'm sorry, what's her name?

13 MR. VON LEHE: Ms. Geer will do that.

14 THE COURT: Okay. Certainly, Ms. Geer, whenever
15 you're ready.

16 MS. GEER: Thank you, Your Honor. We would like to
17 call Eileen Yost to the stand.

18 THE COURT: Ms. Yost, if you would please come
19 around here to our witness chair and I will ask
20 our court reporter to administer the oath or
21 affirmation to you.

22 EILEEN YOST, having been duly sworn, testifies and
23 examines as follows:

24 MS. YOST - DIRECT EXAMINATION BY MS. GEER:

25 Q: Good morning, Ms. Yost.

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1 A: Good morning.

2 Q: Could please state your full name for the
3 record?

4 A: Eileen Yost.

5 Q: Okay. And what is your -- let's talk a little
6 bit about your background. What is your
7 position at CarMax?

8 A: My position, that I'm the tax director for the
9 CarMax group of companies.

10 Q: And how long have you been in that position?

11 A: About three years.

12 Q: And tell us a little bit about your educational
13 background.

14 A: I graduated from Binghamton University in 1989
15 with a Bachelor's of science degree in
16 accounting and I also hold a Virginia CPA
17 license for the past about 16 years.

18 Q: Okay. And --

19 THE COURT: Tell me what a CTA license is.

20 THE WITNESS: Certified public accountant.

21 THE COURT: Oh, CPA, I'm sorry, I misunderstood.

22 THE WITNESS: Okay.

23 THE COURT: Thank you.

24 Q: And tell us about your work experience upon
25 graduation through the present time.

1 A: So, starting in 1989 after graduation, I worked
2 for three years at a medium-sized public
3 accounting firm in New York. I did auditing,
4 tax and accounting work there. From there, I
5 went to Circuit City and I worked there for ten
6 years; eight of those ten years were in the tax
7 department. From that point, CarMax was
8 getting ready to be separated, spun off from
9 Circuit City, so I transitioned my role as the
10 income tax manager at Circuit City over at
11 CarMax to be the income tax manager. So that
12 was in 2002. In 2005, I was promoted to the
13 group manager of the tax department and I took
14 on additional responsibilities there from just
15 being the income tax manager to taking the
16 responsibility for the whole department, so the
17 sales and use group, the personal property
18 group, et cetera. And then in 2007, I was
19 promoted to the tax director and I've been in
20 that position for the last almost three years.

21 Q: Okay. And is one of your responsibilities as
22 tax director supervising the filing of
23 corporate income tax returns --

24 A: Yes, it is.

25 Q: -- okay, for CarMax? And that would be in

1 every state that a CarMax entity does business?

2 A: Yes, every entity, every state.

3 Q: Okay. And how many states -- let's just talk
4 about during the audit period that's at issue
5 here. How many states is CarMax filing in?

6 A: It was about 20.

7 Q: And were you involved in the preparation and
8 filing of the CarMax West returns in South
9 Carolina that are at issue here today?

10 A: Yes, I supervised the preparation. My staff
11 actually prepared the returns and then I
12 reviewed them prior to them being submitted to
13 the Department.

14 Q: All right. Now I want to move on and talk a
15 little bit about the history of CarMax. And
16 we've already touched on it some, but I'm going
17 to let you talk about it in more depth.

18 A: So, today CarMax is the nation's largest
19 retailer of used automobiles. To give everyone
20 a little bit of background on CarMax, it was
21 developed as a division of Circuit City back in
22 the early nineties. And the way that the idea
23 was formed was there had been a lot of research
24 done on the customer dissatisfaction with the
25 traditional policies and practices of

1 traditional automotive retailers with the sale
2 process, with the financing process, things
3 seemed a little shady. You weren't really
4 quite sure if you got a great deal or not when
5 you walked out. What CarMax does is, it
6 provides -- it's the first retailer to provide
7 high quality, late model used cars with no
8 haggle pricing. So the prices of all of the
9 cars are clearly marked on each car and there's
10 no negotiation involved at all in the sales
11 process or in any process of buying the car.
12 One of the things that CarMax does that was at
13 the time very revolutionary was it provided all
14 those products and services in a very
15 transparent way. So it would provide financing
16 services to the customers and, of course, we
17 had our own captive finance company, as well as
18 offering other finance company options to
19 customers. And one of the big differences
20 there was when the customer gave their credit
21 information to the sales consultant to be
22 transmitted to all of the finance companies,
23 the information would come back also
24 electronically, but the customer and the
25 finance consultant -- or the sales consultant

1 would sit together and review the information
2 as it came back. There was no finance manager
3 involved, there was no manipulation of the
4 interest rate based on the price that you were
5 buying the car for or anything. So at the time
6 that was a huge new opportunity for the vehicle
7 retailing market.

8 So we opened our first store in 1993 in
9 Richmond, Virginia, and today we have 77 used
10 cars superstores across the United States -- at
11 the end of audit period, 77.

12 Q: Okay. And you mentioned that -- or if you
13 didn't mention, I know we've already talked
14 about this -- that it started out as a
15 subsidiary of Circuit City?

16 A: It did. It started out as a subsidiary of
17 Circuit City back in the early nineties.

18 Q: And is it still a subsidiary?

19 A: It's not. In 2002, CarMax spun off from
20 Circuit City and now it's an independent,
21 publicly traded holding company.

22 Q: Okay. All right. And I want to talk a little
23 bit about the structure at the beginning.

24 MS. GEER: Your Honor, would you mind if the witness
25 came down and could actually point to the

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1 chart?

2 THE COURT: No. Whatever works for you.

3 MS. GEER: Okay.

4 A: So this is the -- this is the way that the
5 corporate organizational chart looked at the
6 time of the separation and all the way through
7 the reorganization in December of 2004.

8 THE COURT: Ms. Yost, where are the corporate
9 headquarters of CarMax?

10 THE WITNESS: In Richmond, Virginia.

11 THE COURT: Richmond, Virginia?

12 THE WITNESS: Uh-huh (affirmatively responds).

13 A: So, like I said, CarMax, Inc., is actually the
14 publicly traded holding company and if you
15 purchase stock online, this is the company that
16 you would buy. It had two subsidiaries, mainly
17 two subsidiaries. They both did retail sales.
18 CarMax Auto Superstores, Inc., which we call
19 CarMax East, owned and managed all of the used
20 car superstores on the East Coast and the
21 Midwestern states. In addition, it managed all
22 of the finance operations and it also did all
23 the corporate overhead management.
24 CarMax Auto Superstores West Coast, which we
25 call CarMax West, owned and operated all of the

- 1 retail superstores out in the Western states
2 and it also owned all of the intellectual
3 property, trade names and trademarks, that kind
4 of thing.
- 5 Q: Okay. And so since CarMax East owns the
6 intellectual -- I'm sorry, CarMax West owns the
7 intellectual property --
- 8 A: Uh-huh (affirmatively responds).
- 9 Q: -- is CarMax East making payments, royalty
10 payments to CarMax West for its use of that?
- 11 A: Yes, they did. They had a license agreement by
12 which CarMax East would pay a royalty to CarMax
13 West for the use of the trademarks and trade
14 names.
- 15 Q: And how was it determined the amount that
16 should be charged for that?
- 17 A: We had a transfer pricing study done by a third
18 party that allocated a -- it identified a
19 percent of sales as the royalty that would be
20 charged.
- 21 Q: All right. And then we talked about the
22 change, the reorganization.
- 23 A: Uh-huh (affirmatively responds).
- 24 Q: What was the date of that, again?
- 25 A: December 1st, 2004, was the corporate

1 reorganization.

2 Q: All right. So let's put that chart up.

3 A: (Witness complies.)

4 Q: And can you briefly describe what's happened
5 post reorganization?

6 A: Uh-huh (affirmatively responds). So post
7 reorganization, the CarMax, Inc., publicly
8 traded company contributed a hundred percent of
9 the stock of CarMax West Coast to CarMax East
10 Coast. So all that really means is that CarMax
11 West Coast became a subsidiary of CarMax East
12 Coast. So instead of being side by side, they
13 are now vertical (indicating).
14 We created -- we organized the CarMax Business
15 Services, LLC, which is the multi-member LLC
16 taxed like a partnership. Each of CarMax East
17 and CarMax West made asset contributions to the
18 LLC. CarMax East contributed the financing
19 operations and the corporate overhead
20 management, and CarMax West Coast contributed
21 all of the valuable intellectual property.

22 THE COURT: So all the actual car sales remained in
23 CarMax Auto Superstores West Coast and East?

24 THE WITNESS: East and West.

25 THE COURT: And all the intellectual property, the

1 financing and the corporate structure and --

2 **THE WITNESS:** Yeah, all that went down here.

3 So after the restructure was complete, CarMax
4 East and CarMax West were car retailers. They
5 got rid of all those extraneous corporate
6 overhead type of functions and they contributed
7 all of those to CBS. So at the end of the
8 reorganization, CarMax Business Services
9 provided all of the management services to each
10 of the subsidiaries or to each of their
11 members, they provided all the corporate
12 overhead services, provided all the financing
13 and all the intellectual property management.
14 And for that service that they provided, they
15 charged a management fee.

16 Q: And how did we come up -- how did CarMax come
17 up with the percentages that each would own
18 CBS?

19 A: A valuation study was done by a third party to
20 determine the value of all of the assets that
21 were being contributed to the LLC. And then,
22 you know, from the point that you knew the
23 values of the assets, it was just a math
24 equation to determine what the percentages were
25 of the total. So those are the current

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1 ownership percentages at the end of the audit
2 period, and they were also the profit and loss
3 percentages by which the income would be
4 distributed.

5 Q: All right. And it's clear to the Court,
6 because we've got a visual, but can you tell us
7 what the percentages were for the record?

8 A: Yes. CarMax West Coast had 93.5 percent of the
9 partnership and CarMax East Coast had 6.5
10 percent of the partnership.

11 Q: All right. And this may be obvious, but why is
12 it that CarMax West owns so much more?

13 A: Well, the trademarks and trade names are
14 extremely valuable. So when the valuation
15 allowance was done, a huge amount of the value
16 of what was being contributed really was the
17 trademarks. You know, the financing operations
18 obviously had value to them, but not as much in
19 comparison with the valuable trademarks and
20 trade names of the company.

21 Q: All right. I think that's all we're going to
22 do with the charts, so you can return to the
23 stand.

24 A: Okay.

25 (Off the Record)

1 Q: Would you mind turning to Exhibit Ten, which is
2 a copy of the master management services
3 agreement?

4 A: (Witness complies.) Okay.

5 Q: Do you recognize this document?

6 A: Yes.

7 Q: Okay. And can you just give us a brief
8 description of what it is?

9 A: Yes. After the restructuring, we needed to
10 have a contractual obligation between CarMax
11 Business Services and the entities for which it
12 was providing the services. So what this
13 agreement does is it lays out exactly what
14 those contractual obligations are, what the fee
15 represents that CarMax Business Services is
16 charging, so it describes the calculation and
17 the method of invoicing and payment to be done.

18 Q: And how are the fees charged, actually charged
19 and paid?

20 A: The fee is made up of a per-car charge... So for
21 every car that's sold by the superstores in
22 CarMax East and CarMax West, they're charged
23 per car. So every month, CBS will produce an
24 invoice by store location for the amount of the
25 number of cars that were sold times the

1 management fee per car and that invoice is
2 produced by dealership location and then every
3 month those invoices are paid by CarMax East
4 and CarMax West in cash by wire transfer.

5 MS. GEER: Okay. Your Honor, we would like to offer
6 Exhibit Ten into evidence at this time.

7 THE COURT: Mr. Traynham?

8 MR. TRAYNEAM: No objection, Your Honor.

9 THE COURT: Without objection, then, Exhibit Ten,
10 the Master Management Services Agreement,
11 admitted into evidence.

12 MS. GEER: Thank you, Your Honor.

13 (Joint Exhibit Number Ten was admitted into
14 evidence.)

15 Q: All right. And we've touched briefly on this,
16 but does CBS generate revenues from the
17 financing operations?

18 A: It does. After the reorganization, it now owns
19 and manages all of that financing, so it now
20 earns all the revenue from that.

21 Q: And can you tell us how that is allocated for
22 tax purposes?

23 A: Yeah. We've said a couple of times that CBS is
24 taxed like a partnership. So it provides each
25 of its partners or owners a schedule K-1;

1 that's really a tax form schedule. But it
2 delineates how the income is distributed by the
3 profit and loss percentage, by the six and a
4 half and by the 93 and a half percentages. And
5 then once the company's get that schedule K-1,
6 that's how they know how much to put on their
7 corporate tax return as income or loss.

8 Q: All right. Why did CarMax undergo this
9 reorganization?

10 A: So, like I had said earlier with the
11 pre-reorganization chart, that's the way the
12 CarMax company was structured at the time of
13 the separation from Circuit City. And while
14 that structure, I guess, worked fairly well for
15 Circuit City as a retailer, it wasn't quite the
16 way a national car retailer would be organized.
17 One of the big differences and was sort of a
18 pain point, I guess, all during this, but, you
19 know, the fact that the financing company and
20 the dealership operations are all in the same
21 legal entity caused a lot of problems.
22 So after the dust settled from the spinoff from
23 Circuit City in 2002, the CarMax management
24 team decided that they wanted to look for a
25 better, more effective, more efficient

1 structure for us as a national retailer of
2 cars, as opposed to a national retailer of
3 consumer electronics. So they went through and
4 they looked at what a better structure would
5 be.

6 And, like I said, one of the big pain points of
7 the way we were set up was that our vehicle
8 retail sales and our finance operations and
9 revenues were all in the same legal entity.

10 Q: So what kind of problems did that actually
11 cause you?

12 A: One of the things about vehicle retailers is
13 when a car retailer sells a car to a consumer
14 and the consumers chooses to finance the car,
15 it's all done through a form called a "retail
16 installment contract," and that's the more
17 legal form that's used.

18 Well, vehicle dealerships generate the retail
19 installment contracts. The finance companies
20 buy the retail installment contracts. So when
21 our dealership operations and our finance
22 company were all in the same legal entity, it
23 looked like we were buying the retail
24 installment contracts from ourselves. And it
25 was very confusing the way the forms generated,

1 that CarMax Auto Superstores, Inc., for
2 example, in South Carolina, would sell a car to
3 a customer and then it would assign it to
4 CarMax Auto Superstores, Inc.

5 So the regulators were confused by that. We're
6 such a highly licensed and regulated industry
7 that we would have a sales finance license, a
8 sales license, a dealer license, a business
9 license. So when the regulator saw all these
10 retail installment contracts being bought what
11 seemed to be by itself, it just caused a lot of
12 confusion.

13 Another part of that process is after the
14 finance company buys the retail installment
15 contracts. Many finance operations, as well as
16 us, we bundle those receivables. We call it a
17 "securitization" process. So we bundle the
18 receivables and we sell them on the open market
19 and it's a self-funding type of situation.

20 So, again, when the investors would come in and
21 look at it and they would see retail
22 installment contracts generated by East Coast,
23 sold to West Coast and then generated from West
24 Coast but sold to East Coast, it was just
25 confusing how that operation all worked.

1 Q: All right. So confusing to both regulators and
2 investors?

3 A: Yeah. And then the store folks that might move
4 around between stores, if they worked at an
5 East Coast store and they assigned it to
6 itself, so to speak, and then they went to a
7 West Coast store, it was just confusing for
8 everyone. And it just wasn't the way car
9 dealership operations are really set up in the
10 industry.

11 Q: So, in other words, nationwide, most car
12 dealerships that also have a finance entity --

13 A: Uh-huh (affirmatively responds).

14 Q: -- break it apart, have separate entities?

15 A: Yes, to my knowledge that's true.

16 Q: All right. Then let's talk a little bit about
17 the management services part of that.

18 A: Uh-huh (affirmatively responds).

19 Q: Can you just describe that for us, what CBS was
20 doing?

21 A: Okay. Yeah. So prior to the reorganization,
22 you can kind of see from the chart that the
23 different, what I call "corporate overhead"
24 types of things, like the general operations,
25 the financing, the intellectual property, that

1 was kind of broken up between the different
2 subsidiaries. So after the reorganization, we
3 put all of those things into one entity to
4 allow the corporate management functions to be
5 performed by one specific entity for the other
6 entities.

7 And, you know, between the, you know,
8 operational efficiencies and the shared
9 information services and everything that we
10 have, the proprietary systems, all of that, it
11 was just so much cleaner and it provided so
12 much more clarity to all the parties involved
13 to have that be done by one entity, the big
14 CarMax Business Services.

15 Q: All right. Leaving the two operating entities
16 to do just their car sales?

17 A: Focus on the car sales, that's their jobs.

18 Q: All right. Can you go into a little bit more
19 detail with us about the benefits of the shared
20 services and the systems and maybe talk about
21 some of the shared services and systems
22 themselves?

23 A: Uh-huh (affirmatively responds). So what CBS
24 provides to the CarMax East and CarMax West,
25 the dealership operations, the fee that's being

1 charged is made up of several components. One
2 component is obviously the intellectual
3 property management, one component is sales and
4 marketing support, or the marketing support,
5 one is strategic analysis, and then there's the
6 other general corporate overhead services, and
7 I would put, you know, H.R., legal, accounting,
8 tax, and all of that, that's kind of in that
9 bucket of other general overhead services.

10 The purchasing department was there, which
11 created efficiencies in the purchasing process.
12 All of our benefit plans were together, all the
13 401(k) plans, the pension plans, the medical
14 and dental benefit plans.

15 One of the large pieces of CBS is providing
16 analysis support for all of the data and all of
17 the proprietary systems that we have. So we
18 collect a tremendous amount of data on every
19 point in our process.

20 So from an analytical perspective, the folks in
21 the strategic analysis group at CBS provide a
22 lot of support to the store buyers in terms of
23 inventory models, how to price the cars that
24 they buy, when to take a markdown on a car, all
25 of that information is at CBS.

1 Another thing that they do is marketing. We
2 have a website, CarMax.com, and really what
3 that is is a marketing tool. You can't
4 actually buy a car online, but the CarMax.com
5 website is designed to be a marketing tool to
6 raise -- to build all the consumer awareness of
7 our brand, our consumer offer. Customers,
8 anyone can go to CarMax.com and search our
9 entire nationwide inventory of cars. They can
10 see everything from the make, the model, the
11 year, the price, the features, the color, many,
12 many pictures of the interior and the exterior
13 of the car. So really what's that designed to
14 do is be a marketing tool.

15 Q: Right.

16 A: It's not necessarily designed to sell the car
17 but it sure helps. If you're interested in a
18 car, you go to CarMax.com, find the car you
19 want to buy or you at least want to test drive,
20 you have all that information, you go to the
21 store. It's a very -- it's just a great
22 process for having it.

23 And the way that the intellectual property all
24 builds into that is, as you're raising consumer
25 brand awareness, the intellectual property

1 becomes more and more valuable. So as you
2 raise awareness, you sell more cars; as you
3 sell more cars, your intellectual property
4 becomes more valuable. As your intellectual
5 property becomes more valuable, you sell more
6 cars. So it's this circle that each of -- it's
7 a pure and interdependent relationship between
8 the value of your intellectual property and the
9 number of cars that you're going to sell.

10 **THE COURT:** I would note for the record, Ms. Yost
11 appears to understand both the accounting
12 functions and be a good marketer for the
13 company.

14 **MS. GEER:** She does, Your Honor.

15 **THE WITNESS:** Thank you.

16 **THE COURT:** Well, I should say for the record, too,
17 and, of course, it makes no difference to me
18 one way or the other, but my dad was for many
19 years involved as a G.M. dealer and had several
20 dealerships around the state at one time, so
21 I've always been intrigued with car dealerships
22 and the whole process of how it works.

23 **Q:** All right. Now I'm going to get you to flip in
24 your exhibit notebook to tab seven --

25 **A:** Okay.

1 Q: -- which is fiscal year 2005 CarMax, Inc.,
2 annual report.

3 A: Uh-huh (affirmatively responds).

4 Q: Do you recognize this document?

5 A: Yes.

6 Q: And does this document -- of course, there's a
7 lot contained in it --

8 A: Uh-huh (affirmatively responds).

9 Q: -- but does it describe a lot of these
10 efficiencies that you've been describing for
11 us?

12 A: Yes, it does. Specifically, when we look at --
13 well, it talks a little bit about the history
14 on -- I don't think my copy has good page
15 numbers. It talks a lot about the fragmented
16 competition. So in the history that I talked
17 about with the consumer dissatisfaction with
18 traditional auto dealers, it talks about the
19 fragmented competition, the need for changes in
20 our -- how CarMax was created. Further back,
21 it talks about our unique consumer offer, talks
22 about CarMax.com, and it also talks a lot about
23 our proprietary processes and systems and how
24 they all intertwined with each other to provide
25 the entire CarMax offer.

1 MS. GEER: Your Honor, we would like to move Exhibit
2 Number Seven into evidence.

3 THE COURT: Mr. Traynham?

4 MR. TRAYNHAM: No objection, Your Honor.

5 THE COURT: All right. Then Exhibit Number Seven is
6 admitted without objection. It's denominated
7 as Physical Year 2005, CarMax, Incorporated,
8 Annual Report.

9 (Joint Exhibit Number Seven was admitted into
10 evidence.)

11 Q: And are CBS and CarMax West held out to the
12 public as integrated?

13 A: They absolutely are. When we talk about -- and
14 you'll hear me say just the word "CarMax" when
15 I talk about it. When I talk about it
16 externally, it's all just simply CarMax. It's
17 all one big, integrated group of companies.

18 Q: All right. And I want to now move on and talk
19 a little bit about CarMax West connection to
20 South Carolina.

21 A: Okay.

22 Q: Some of this has already been covered in the
23 openings, but we're going to let you give us
24 all the details. What does CarMax West
25 actually do in South Carolina?

- 1 A: Nothing.
- 2 Q: All right. Does it have any employees?
- 3 A: No.
- 4 Q: Does it have any facilities or tangible
- 5 property?
- 6 A: No.
- 7 Q: Does it make any sales in South Carolina?
- 8 A: No.
- 9 Q: What services or benefits does CarMax West
- 10 receive from the state of South Carolina?
- 11 A: None.
- 12 Q: So if it does nothing, what is the connection?
- 13 A: So the connection is that pre-reorganization it
- 14 owned and managed and licensed all of the
- 15 intellectual property of the CarMax group of
- 16 companies. So the connection would be that
- 17 CarMax East, who is the seller of the cars in
- 18 South Carolina, use the intellectual property,
- 19 again, in my circle of life, so to speak, of
- 20 the dependence of the car sales on the
- 21 intellectual property.
- 22 Q: Okay. And post reorganization?
- 23 A: Post reorg, CarMax Business Services owns,
- 24 manages, and license the intellectual property.
- 25 But, again, through the partnership allocation

1 of it being a flow-through entity --

2 Q: Right.

3 A: -- CarMax West receives a share of that income.
4 So, again, it's as if it was receiving it
5 indirectly from CarMax East from the sale of
6 the cars.

7 Q: All right. And I would like to talk to you
8 about some ownership and management of these
9 entities.

10 A: Okay.

11 **THE COURT:** Ms. Yost, help yourself to the water.

12 **THE WITNESS:** I will. Thank you very much.

13 (Off the Record)

14 Q: All right. So pre-reorg, we're just talking
15 about CarMax West --

16 A: Okay.

17 Q: -- in this case. So, obviously, it's -- the
18 ownership and management are a little more
19 obvious in that case. But what about post
20 reorganization? Tell me about the ownership of
21 CarMax West and CBS.

22 A: Okay. As it relates to CarMax West, even
23 though they're now a subsidiary -- and when I
24 say "now," I mean post reorganization --
25 they're a subsidiary of CarMax East. Their

1 ultimate ownership has not changed. Their
2 ultimate owner is still CarMax, Inc. And
3 really the same thing applies to CBS. Even
4 though they're a multi-member LLC, they have
5 two members that more directly own them.
6 Still, every company in the CarMax group of
7 companies is still ultimately owned by CarMax,
8 Inc. So the ownership, even though
9 intermittent steps may have changed, the
10 ultimate ownership has not changed pre or post
11 restructure.

12 Q: Okay. And I also want to talk to you about the
13 management and I'm going to get you to look at
14 an exhibit. It's Number Eight.

15 A: Okay.

16 Q: And can you tell us what this series of
17 documents is?

18 A: Uh-huh (affirmatively responds). The first
19 document is a list of officers and then on the
20 next page the directors of CarMax East.

21 Q: Okay.

22 A: The page after that are the officers and
23 directors of CarMax West. And then the next
24 page are the list of officers and the members
25 of CBS.

1 Q: All right. And let's focus on the last two
 2 lists --
 3 A: Okay.
 4 Q: -- the CarMax West and the CBS; how do those
 5 compare?
 6 A: CarMax West and CBS have overlapping
 7 managements. Every officer of CarMax West,
 8 with the exception of one assistant secretary,
 9 is also an officer of CBS.
 10 MS. GEER: Okay. And, Your Honor, we would like to
 11 move Exhibit Eight into evidence at this time.
 12 MR. TRAYNHAM: No objection, Your Honor.
 13 THE COURT: All right. Without objection, then
 14 Exhibit Eight, list of officers and management
 15 of CarMax West and CarMax East --
 16 MS. GEER: And CBS.
 17 THE COURT: -- and CBS, admitted into evidence.
 18 MS. GEER: Thank you, Your Honor.
 19 (Joint Exhibit Number Eight was admitted into
 20 evidence.)
 21 Q: All right. Is the income from CarMax West car
 22 sales and the income that CBS receives from the
 23 financing and from the royalties, is that all
 24 put in one account?
 25 A: It is. It's all commingled.

1 Q: Okay.

2 A: Our cash management is centralized, so all the
3 money is commingled.

4 Q: And what about how the money is used? Is it
5 used for the benefit of all the CarMax
6 entities?

7 A: Yes, it is.

8 Q: All right. And we've already discussed in some
9 detail the shared services or systems between
10 CarMax West and CBS. Do both CBS and CarMax
11 West depend upon these shared services and
12 systems?

13 A: They do.

14 Q: And did these shared services and systems
15 create any savings or efficiencies --

16 A: Yes, they did.

17 Q: -- for the companies?

18 A: Yes, they did.

19 Q: And would you say that the different activities
20 of the business, or businesses -- and I would
21 include in that sales, marketing, intellectual
22 property, financing -- do those contribute to
23 and depend upon each other?

24 A: Absolutely.

25 Q: Okay. And you've given us some examples. Can

1 we just go over them again? How is it that you
2 would say they contribute to and depend upon
3 each other?

4 A: Well, the marketing, again, like I talked about
5 before, is really creating or enhancing the
6 customer image, the brand. But the brand, if
7 you really think about it, is the intellectual
8 property. So they absolutely depend on each
9 other to, again, facilitate the sales of the
10 cars. The more cars you sell, the more brand
11 awareness you achieve, and so on; so you'd sell
12 more cars and, again, it's that same circle.
13 They're all dependent on each other. The
14 stores really need a lot of that proprietary
15 data analysis that I talked about to be as
16 efficient and effective as they are in managing
17 the stores.

18 Q: Right. What about the financing piece of it?
19 Can you tell us how that relates or how that is
20 different?

21 A: Yeah. The financing piece is integral in
22 selling the cars. Many -- most, I probably
23 could say, cars that are sold, whether it's at
24 CarMax or anywhere else, are financed. So
25 having that captive finance company as an

1 option to your customers to sell those cars
2 really add and create incremental sales of the
3 cars. If you weren't able to offer that
4 financing at those terms, people may not be
5 able to buy cars.

6 Q: And how would selling more cars, if you're
7 looking at it from the reverse, how would that
8 contribute to the financing business?

9 A: I'm not sure I understand your question.

10 Q: Well, if you're selling more cars, does that
11 provide more opportunities for the finance
12 business to generate income --

13 A: Oh, absolutely.

14 Q: -- because of those opportunities?

15 A: I'm sorry, yes, it absolutely does. The more
16 cars you sell, the more receivables you
17 generate, and, obviously, the income flow from
18 the receivables is what, you know, generates
19 the income for CBS.

20 Q: Would you also say that there's a flow of value
21 between CBS and CarMax West?

22 A: Yes.

23 Q: And, again, we've been talking mostly about
24 post reorganization, but pre-reorganization,
25 when we only have CarMax West really at issue,

1 would you say that it's as integrated,
2 interdependent, and contributing to -- and
3 different lines of that contributing to and
4 depending upon one another?

5 A: Yes, definitely.

6 Q: All right. We're now going to turn to Exhibit
7 Four. Do you recognize these documents?

8 A: I'm not there yet.

9 Q: Oh, sorry.

10 A: That's okay. Okay, yes, document four. Okay.
11 Yes, those are the amended tax returns that we
12 filed, amended South Carolina income tax
13 returns.

14 Q: Okay. The ones that are at issue before the
15 Court today?

16 A: Yes.

17 Q: And you said earlier that you supervised the
18 filing of these?

19 A: I did.

20 Q: Can you explain for us, generally, how these
21 returns for CarMax West were prepared? Where
22 did you start?

23 A: Well, we always start -- in a state corporate
24 income tax return, we always start with federal
25 taxable income, so in this case we did that.

1 We made certain state specific modifications to
2 that number. One of easiest examples of a
3 modification would be the fact that for state
4 income tax purposes, a corporation is not
5 allowed to deduct their state income taxes that
6 they paid, so we always add those back. In
7 this case, I think we made a couple of
8 depreciation basis adjustments. Then we -- in
9 our case, it's usually an add-back, so we added
10 those two numbers together; so federal taxable
11 income plus or minus the state adjustments
12 would get --

13 Q: And none of those -- sorry to interrupt you,
14 but none of those adjustments are at issue in
15 this case?

16 A: They are not.

17 Q: Okay. Sorry.

18 A: The addition of those numbers would get you
19 total net income as reconciled or as we usually
20 call it "apportionable income."

21 Q: Or apportionable net income?

22 A: Apportionable net income.

23 Q: Okay.

24 A: Then we would calculate the apportionment
25 factor and in this case pre-reorganization, we

1 would create a numerator in the apportionment
2 formula by looking at the cars, the amount of
3 the cars that were sold, the dollar value of
4 the cars that were sold in South Carolina, plus
5 our extended service policy sales, which are
6 also covered by the license agreement, and then
7 we would take the royalty percentage of those
8 and that would be -- that would attribute the
9 amount of royalty that was earned in South
10 Carolina by virtue of the car sales.

11 Q: Okay.

12 A: So that would be our numerator. So we'd say
13 that's the income, the royalty that was
14 generated in South Carolina.

15 Q: And then what's the denominator?

16 A: The denominator would be the entire receipts of
17 the taxpayer, CarMax West Coast.

18 Q: Okay.

19 A: So we would have our numerator, we would have
20 our denominator, we would do the math and get
21 the fraction. We would then multiply that
22 fraction by the apportionable net income and we
23 would get South Carolina taxable income.

24 Q: Okay.

25 A: And then to that number, we would apply the tax

1 rate; the product of that would be the amount
2 of tax that was due.

3 Q: All right. And you went through the
4 pre-reorganization calculation?

5 A: Uh-huh affirmatively responds).

6 Q: Would you mind going through the post
7 reorganization?

8 A: Sure. So post reorganization, the same thing,
9 we would start with federal taxable income. We
10 would take plus or minus the state
11 modifications, we would come down to the
12 apportionable net income.

13 The apportionment factor numerator was
14 calculated the same way. We said this is the
15 amount of the royalties that would have been
16 attributed to South Carolina. And then the
17 denominator, again, we took the total receipts
18 of the company post reorg, that would have made
19 up auto sales, finance income, and the royalty
20 income, which is included in the management
21 fee. So the car sales, the management fee, and
22 the financing receipts --

23 Q: Okay.

24 A: -- would be the denominator. Again, do the
25 math, get the fraction of that, multiply it by

1 the apportionable net income, get South
2 Carolina taxable income, multiply that by the
3 tax rate to get the tax due.

4 Q: All right. And why did you file that way?

5 A: I believe that the tax return form, the
6 instructions and the laws of South Carolina
7 told me to do it that way, they directed me to
8 do it that way, especially by virtue of the
9 form and instructions.

10 Q: Okay. And let's look at those. I believe
11 they're behind tab five. This is a sample from
12 2005.

13 THE COURT: Do you wish to propose to introduce
14 those tax returns?

15 MS. GEER: I'm sorry. Thank you, Your Honor. We
16 would like to introduce Exhibit Four, which is
17 the amended tax returns at issue, into the
18 record.

19 MR. TRAYNHAM: No objection.

20 THE COURT: All right. Without objection, then,
21 those -- and it's years 2002 through what?
22 Let's see.

23 MS. GEER: I believe it's 2007.

24 THE COURT: -- okay, so through 2007 admitted into
25 evidence.

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1 MS. GEER: Thank you, Your Honor.

2 (Joint Exhibit Number Four was admitted into
3 evidence.)

4 THE COURT: Now we're at number three.

5 MS. GEER: Now we are actually at Number Five.

6 THE COURT: Number Five, okay.

7 Q: All right. Do you recognize these
8 instructions?

9 A: Yes.

10 Q: And did you review -- obviously, it might be
11 different for each year -- but the instructions
12 prior to filing these returns?

13 A: Generally, yes.

14 Q: Okay. And tell me specifically how these
15 instructions guided you.

16 A: On page five of the instructions, there's a
17 heading called "basis of return" and it says,
18 "The taxable income as shown on federal form
19 1120" -- and that's the form that we filed --
20 "is the basis of the South Carolina return,
21 with certain adjustments for federal and state
22 differences." So that's, again, how we would
23 always start a state return is to start with
24 federal taxable income and then make whatever
25 the state appropriate adjustments are.

1 MS. GEER: Your Honor, we'd like to move these
2 instructions into evidence.

3 MR. TRAYNHAM: No objection.

4 THE COURT: All right. Without objection then,
5 Exhibit Number Five, which is the 2005
6 corporate tax instruction -- and there's
7 something else behind here.

8 THE WITNESS: There's also a copy --

9 THE COURT: -- the corporate income tax return
10 admitted into evidence.

11 (Joint Exhibit Number Five was admitted into
12 evidence.)

13 Q: Oh. And, I'm sorry, I did want you to look at
14 the return.

15 A: Uh-huh (affirmatively responds).

16 Q: Is there anything on the return that guided you
17 in filing?

18 A: It's fairly straightforward. Line one says
19 federal taxable income per federal form 1120,
20 which is exactly how we prepared the returns
21 and so on through the lines.

22 Q: Right. So the next one, number two line is --

23 A: Right. We would make the --

24 Q: -- adjustments.

25 A: -- adjustments; three, we would add those

1 numbers or subtract those numbers from each
2 other to get net income as reconciled or I call
3 it "apportionable net income."

4 Q: Okay.

5 A: And then we would do the apportionment factor,
6 the taxable income and then the tax
7 calculation.

8 MS. GEER: Okay. And so both the tax instructions
9 and the income tax form itself are under
10 Exhibit Five.

11 THE COURT: Right. And both have been admitted into
12 evidence.

13 MS. GEER: Thank you.

14 Q: All right. Did CarMax West originally file
15 using another apportionment method?

16 A: It did.

17 Q: Okay. And tell me about that.

18 A: On its original returns, we filed using a
19 three-factor formula, and I believe it was
20 double-weighted sales.

21 When we had originally filed the returns, we
22 looked at our general business code that we
23 file under and that is a retailer. So we
24 mistakenly filed using the three-factor
25 apportionment. Through the audit process and

1 then through subsequent research, we realized
2 that we should have filed using a single-factor
3 sales formula versus the three-factor
4 double-weighted sales.

5 Q: Okay. And so you later filed these amended
6 returns that we referred to earlier?

7 A: We did.

8 Q: All right. And I think you've already told us
9 that during the audit period CarMax West filed
10 in -- or all the CarMax entities filed in more
11 than 20 states during the audit period?

12 A: Uh-huh (affirmatively responds).

13 Q: How many of those states use some method of
14 apportionment?

15 A: All of them do.

16 Q: What is it that they apportion?

17 A: They apportion -- again, starting with federal
18 taxable income, they would apportion that
19 federal taxable income plus or minus their
20 state specific adjustments.

21 Q: Okay. So after you filed the original returns,
22 what was the next thing that happened in this
23 process? Did you receive something from the
24 Department?

25 A: We did. We were notified of field audit from

1 the Department. And I don't know if it was
2 with the initial notification of field audit or
3 shortly after, we received what I would call
4 "work papers" or maybe as far as to say a
5 proposed assessment of CarMax West Coast.

6 Q: Okay. So you got a proposed assessment and is
7 that the assessment that's at issue?

8 A: Generally. There's been some changes to it,
9 but generally it's the same. It's the same
10 theory.

11 Q: All right. And then what happens?

12 A: Well, the field auditors came in and did their
13 field audit. We had our closing conference.
14 We were issued -- again, I don't know that we
15 were issued a final report at that time.

16 Q: Right.

17 A: But we were at least given work papers to
18 understand what the assessment was. And the
19 audit was for both CarMax East and CarMax West;
20 although, the CarMax East audit was concluded
21 with a small -- I think a small payment of tax
22 by us, so that's not part of the issue at all.

23 Q: Okay.

24 A: The issue is really just the audit
25 determination of CarMax West Coast.

1 Q: All right. So at some point did you receive an
2 audit report?

3 A: We did.

4 Q: All right.

5 A: We did. We received an audit report and then
6 we subsequently protested the audit report.

7 Q: All right. Let me stop you there. Let's look
8 at -- can you look at Exhibit One?

9 A: Uh-huh (affirmatively responds).

10 Q: And tell me what that is.

11 A: Exhibit One is the report of field audit.

12 Q: Okay. And this is the document that you
13 received?

14 A: Yes.

15 MS. GEER: Your Honor, we would like to move the
16 audit report into evidence.

17 MR. TRAYNHAM: No objection, Your Honor.

18 THE COURT: Without objection, then Exhibit Number
19 One, the field audit, admitted into evidence.

20 (Joint Exhibit Number One was admitted into
21 evidence.)

22 Q: And, Ms. Yost, can you summarize for us what
23 the Department's position in the audit was?

24 A: The Department -- during the audit, obviously
25 we had the issue of the original apportionment

1 factor, whether it should have been
2 three-factor, the way we filed, or whether it
3 should have been single-factor.

4 But, really, the issues that still stand are
5 the fact that the Department said that we
6 should not be using the statutory apportionment
7 formula and that they thought an alternative
8 apportionment factor would apply in CarMax
9 West's case. The second issue is the fact that
10 the Department sourced finance receipts into
11 the numerator of the apportionment factor to
12 South Carolina.

13 Q: Okay.

14 A: And then the third issue is that we were
15 assessed both the negligence and a substantial
16 underpayment penalty.

17 Q: Okay. And tell us again what the method was,
18 the alternative method that the Department
19 used.

20 A: In the pre-reorganization years, in essence
21 what happened is that they taxed just the
22 royalty. They didn't look at the starting
23 point of federal taxable income. They just
24 applied a tax to the royalties.

25 Q: Okay. And what about post reorganization?

- 1 A: Post reorganization, they wanted to tax a piece
- 2 of the finance receipts, as well as the
- 3 royalties. But, again, did not start with
- 4 federal taxable income, but carved out a piece
- 5 of what they wanted to tax. And, frankly, at
- 6 the end of the day, what it amounted to post
- 7 reorganization is that they were actually
- 8 taxing my partnership activities only.
- 9 Q: Of CBS?
- 10 A: Of CBS, yes.
- 11 Q: And how does the net income of the taxpayer,
- 12 CarMax West, as reported either for financial
- 13 accounting purposes or federal income tax
- 14 purposes or South Carolina income tax purposes
- 15 relate to the position of the Department?
- 16 A: It doesn't even come into play.
- 17 Q: Okay.
- 18 A: They said that we should not be starting with
- 19 federal taxable income.
- 20 Q: So it doesn't matter if the company itself --
- 21 A: We could have made \$10 million or lost \$10
- 22 million, it wouldn't have made any difference
- 23 as to the amount of tax that we were being
- 24 assessed by the Department.
- 25 Q: And you've already talked about that you're

1 familiar with the tax return instructions and
2 regulations.

3 A: Yes.

4 Q: Is there anything in those that would allow for
5 the method employed by the Department?

6 A: No.

7 Q: All right. I'm going to ask you to turn to
8 Exhibit Two.

9 A: (Witness complies.)

10 Q: Tell me if you recognize this document.

11 A: Yes.

12 Q: What is it?

13 A: It is CarMax West's protest of the audit or the
14 audit findings?

15 Q: Okay. Who prepared this letter?

16 A: I did in relation with my staff and external
17 tax advisors.

18 MS. GEER: Okay. And, Your Honor, we would like to
19 move Exhibit Two into evidence.

20 THE COURT: Mr. Traynham, any objection to that?

21 MR. TRAYNHAM: No objection, Your Honor.

22 THE COURT: All right. Then without objection, the
23 protest filed October 20th, 2008, admitted into
24 evidence.

25 MS. GEER: Thank you, Your Honor.

1 (Joint Exhibit Number Two was admitted into
2 evidence.)

3 Q: All right. And does this letter basically set
4 forth the issues that we've already discussed
5 and why CarMax West disagreed with the
6 Department's audit?

7 A: Yes, it does.

8 Q: Okay. If you'll now turn to Exhibit Three.

9 A: (Witness complies.)

10 Q: And tell me if you recognize this document.

11 A: I do.

12 Q: What is it?

13 A: It is the Department's final determination.

14 Q: And was this issued after your protest letter?

15 A: It was.

16 Q: Okay. And did the Department's position change
17 at all?

18 A: It did not.

19 Q: Okay. All right. So the Department upheld
20 their initial assessment?

21 A: They did.

22 MS. GEER: Your Honor, we would like to move Exhibit
23 Three into evidence.

24 MR. TRAYNHAM: No objection, Your Honor.

25 THE COURT: Exhibit Three, Department final

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1 determination dated March 11th, 2009, admitted
2 without objection.

3 MS. GEER: Thank you, Your Honor.

4 (Joint Exhibit Number Three was admitted into
5 evidence.)

6 Q: All right. And we've already talked about that
7 you filed amended returns.

8 A: Yes.

9 Q: Did you receive anything from the Department
10 after those amended returns were filed?

11 A: We did.

12 Q: What did you receive?

13 A: We received an interest calculation on the
14 additional tax that we had paid. We also
15 received a revised audit report reflecting that
16 we had changed the method and that that issue
17 no longer applied and it changed the amount of
18 the total assessment.

19 Q: Okay. And if you'll flip in your book to
20 Exhibit Twenty-nine.

21 A: (Witness complies.)

22 Q: Do you recognize that document?

23 A: I'm sorry, I'm not there yet.

24 Q: Okay. Sorry.

25 A: I'm having some binder issues.

1 Q: There's a lot to flip through.

2 A: Okay. Yes, this is what we received

3 subsequently from the Department after they had

4 acknowledged receipt of our amended returns.

5 Q: Okay. So this basically does the mathematical

6 calculations, again taking into account the

7 difference in your amended returns?

8 A: It does.

9 MS. GEER: Okay. Your Honor, we would like to move

10 this Exhibit Twenty-nine into evidence.

11 MR. TRAYNHAM: No objection.

12 THE COURT: All right. Without objection, Exhibit

13 Twenty-nine, calculations --

14 MS. GEER: I guess it's a revised assessment.

15 THE COURT: -- okay, calculations revised assessment

16 by the Department of Revenue admitted into

17 evidence.

18 (Joint Exhibit Number Twenty-nine was admitted into

19 evidence.)

20 Q: All right. I'm going to move now to the topic

21 of the financing receipts. Can you describe

22 for us what happens when a customer walks into

23 a store and wants to buy a car and wants to

24 finance it?

25 A: Okay. So when a customer walks into a store to

1 buy a car, they -- you know, like I talked
2 about earlier, they may have looked a little
3 bit on CarMax.com, picked out the car they
4 wanted to buy. They'll test drive the car,
5 normally. And then once they've made their
6 decision to purchase their car, they need to
7 decide how they want to pay for it.

8 So in the case that they want to finance it --
9 and I'll use a fairly easy example -- that the
10 price on the car says \$20,000; the customer has
11 a \$5,000 down payment and they want to finance
12 the additional \$15,000.

13 So the customer would provide all of the credit
14 information to the sales consultant. The sales
15 consultant would transmit all of that credit
16 information to not only CBS, who is our captive
17 finance operation provider, but also to some
18 other third-party finance companies that we do
19 business with.

20 So in this case, let's just say that they
21 transferred the information both to CBS and to
22 two other finance providers, third-party
23 finance providers. So all the information is
24 transmitted electronically. All the
25 information, all the decisions are --

1 THE COURT REPORTER: Hold on.

2 (Off the Record)

3 THE COURT: We've been going for almost two hours,
4 why don't we take a 15-minute break.

5 (Break taken from 10:55 to 11:06 a.m.)

6 THE COURT: All right. Whenever you're ready,
7 Ms. Geer, you may recommence your direct
8 examination of Ms. Yost.

9 MS. GEER: Thank you, Your Honor.

10 Q: Ms. Yost, when we left, you had just started
11 telling us about the example of when someone
12 comes in to purchase a car.

13 A: Right.

14 Q: And if you'll just start back at the beginning
15 because we didn't get very far into it.

16 A: Okay. So in my example, a customer would come
17 into a CarMax superstore and want to buy a car.
18 So the process would be that throughout
19 whatever process they did, they picked out the
20 car, they did a test drive, they are ready to
21 purchase the car. In my example, I had said
22 that the customer is purchasing a \$20,000 car
23 with a \$5,000 down payment and financing the
24 balance of \$15,000.

25 So when the customer would give all of their

1 credit information to the sales consultant, who
2 would electronically transmit all of that
3 information to the finance companies, they
4 would always transmit to CBS, who is our
5 captive finance company. They would also, in
6 my example, transfer to two other third-party
7 finance companies.

8 Now, in reality, they may transmit to a lot
9 more than that, but in my example I said that
10 they were transmitting to two.

11 So when all of the electronic information comes
12 back, what it's going to show is if any or all
13 of those three finance companies would be
14 prepared to offer the consumer financing. So
15 wherever the finance companies are located is
16 where those decisions are made.

17 So in our case, the finance operations of
18 CarMax Business Services are located in
19 Georgia. So all of the credit worthiness
20 decisions, for lack of a better way to say it,
21 are all -- all those decisions are made in
22 Georgia and the information that's transmitted
23 back to the store where the customer is is
24 basically what the terms of the loan would be.
25 So if all three of those finance companies

- 1 approved the customer for the loan, they would
 2 have three choices of financing. So their
 3 choices could vary depending on the length of
 4 the loan that would be offered to them. It
 5 could vary on interest rate. It could vary on
 6 the monthly payment. The customer would pick
 7 which of the terms best suited their needs.
 8 So in my example, let's say that they pick the
 9 CarMax Business Services financing opportunity.
- 10 Q: Okay.
- 11 A: So what would happen, as the sale process
 12 continued, the retail installment contract that
 13 I talked about a while ago would print and
 14 that's the legal document that initially
 15 extends the credit to the customer, but then
 16 that's the document that is the note, I guess
 17 for lack of a better word, that's purchased by
 18 the finance company from the dealership. So at
 19 the bottom that would say "assigned to CarMax
 20 Business Services, LLC." That assignment is
 21 accepted in Georgia.
- 22 Q: Okay. And let's go back a little bit, too. In
 23 South Carolina --
- 24 A: Uh-huh (affirmatively responds).
- 25 Q: -- who is listed before CBS on the retail

1 installment contract?

2 A: So CarMax Auto Superstores, Inc., or CarMax
3 East --

4 Q: Okay.

5 A: -- would be listed as the seller of the vehicle
6 and then it would be assigned to CarMax
7 Business Services or in some cases it might say
8 "CarMax Auto Finance," which is just the "doing
9 business as" name of the finance operations.

10 Q: All right. So who would have a gross receipt
11 of the 20,000?

12 A: Oh, absolutely CarMax East Coast does, because
13 they're the seller of the car. So if you think
14 about it from an accounting perspective, that
15 \$20,000 is recorded as a sale in the CarMax
16 East books and records.

17 Q: Okay.

18 A: So to continue that down the process, that
19 \$20,000 is then included in the net income of
20 the company, which also factors into the
21 federal taxable income of the company. In
22 addition, the way that \$20,000 is apportioned
23 or taxed by South Carolina is that that \$20,000
24 is in the numerator of the CarMax East Coast
25 South Carolina sales factor, as well as all the

1 other car sales generated by CarMax East Coast
2 and, you know, that could be \$5 billion or
3 whatever it is. But all of the sales of the
4 cars in South Carolina would be in the
5 numerator.

6 Q: Okay. So bottom line is the \$20,000 is
7 reported on CarMax East's tax return in South
8 Carolina --

9 A: Yes.

10 Q: -- and taxes are paid thereon.

11 A: Yes.

12 Q: Does CBS, or I know you sometimes refer to it
13 as CAF, does it provide financing to anyone
14 other than CarMax customers?

15 A: No, it doesn't. It's a captive finance
16 company, which means it only provides those
17 services to the CarMax group of companies, the
18 CarMax dealerships.

19 Q: Okay. And you've touched on this a little bit
20 already. What happens to the contracts once
21 they're assigned to CBS?

22 A: So once the contracts are assigned to CBS, CBS
23 records them in their loan system; CBS always
24 remains the servicers of those loans. And what
25 I mean when I say the "servicer" is that they

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1 operate a call center in Georgia and all of
2 the, you know, associates in the call center
3 manage that portfolio of receivables.

4 So a customer can call the 800 number and get
5 the balance on their account, find out when
6 their next loan payment is due, get a payoff
7 amount, various things that you would normally
8 think of in a call center. If the customer's
9 payment was late and it went into collections,
10 the associates in the call center in Georgia
11 would make the call to the associate -- I'm
12 sorry, not the associates, the customers that
13 have the loans, you know, to remind them that
14 their car payment is late. It's a very typical
15 call center.

16 Q: Okay.

17 A: In addition to that, I talked about the
18 securitization process a little bit earlier.
19 We don't keep -- I say "we". I'm saying CBS
20 when I say "we." CBS does not keep the
21 receivables that it generates. It securitizes
22 them. And, again, what I mean by that is that
23 they would bundle those receivables and sell
24 them on the market.

25 Q: To investors?

1 A: To investors on the open market. But it always
 2 services those. Even after the securitization
 3 process is over, it always services the loans.
 4 So the customers would never know that their
 5 loan has been securitized. They always are
 6 using CBS or CAF as the person that holds their
 7 loan.

8 Q: All right. And do they actually think of it as
 9 CarMax?

10 A: Yes. Generally, yes. The customers themselves
 11 probably think of it as CAF.

12 MR. TRAYNHAM: Objection, calls for speculation.

13 THE COURT: What was the question?

14 MS. GEER: Whether the customers think that they're
 15 being serviced by CAF or CarMax.

16 MR. TRAYNHAM: Asking the witness what the customers
 17 think.

18 THE COURT: I'll sustain that. Can you rephrase
 19 that, Ms. Geer?

20 Q: Do the associates point out to customers that
 21 they're speaking with CBS or CAF folks or do
 22 they speak as if they are part of CarMax?

23 A: The associates refer to themselves as CarMax
 24 Auto Finance. In addition, the customers'
 25 checks, if they make their auto loan payments

1 by check, their checks are made out to CarMax
2 Auto Finance or CAF.

3 Q: All right. And so what are the financing
4 receipts that we keep talking about that are at
5 issue in this case? What are they made up of?

6 A: Generally, it's the interest income that would
7 be earned from the loan. And, also, the fact
8 that CBS is the servicer, they actually receive
9 a fee for servicing the receivables, and then
10 whatever income is generated by the actual
11 securitization process, as well.

12 Q: And do any of those -- so this is all post
13 sale, correct?

14 A: All post sale.

15 Q: And does anybody on behalf of CarMax that deals
16 with these contracts post sale live in South
17 Carolina or work in South Carolina?

18 A: Are you asking me if the CarMax Business
19 Services associates work?

20 Q: Yes.

21 A: They do not -- none of them are in South
22 Carolina. They are all located in Georgia.

23 Q: Okay. All right. And so when you filed the
24 South Carolina returns --

25 A: Uh-huh (affirmatively responds).

1 Q: -- at issue, how did you treat these financing
2 receipts?

3 A: I treated the financing receipts as generally
4 being an apportionable receipt. And what I
5 mean when I say that is that I included them in
6 the denominator of the --

7 Q: In the total income?

8 A: In the total income. They're in the income and
9 they're in the denominator of the sales
10 fraction.

11 Q: Okay.

12 A: But since none of the activities that were
13 involved in producing the income were done in
14 South Carolina, I did not attribute a numerator
15 to South Carolina.

16 Q: To South Carolina. And you've said earlier
17 that CarMax during the audit period filed
18 returns in over 20 states. How many of those
19 states use either -- are looking at the cost of
20 performance or the economic activity or a
21 similar standard in order to determine where to
22 source income?

23 A: Most of them do.

24 Q: All right. I'm going to move now to talk a
25 little bit about the penalties that were

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1 assessed. And you stated earlier that you
2 understood that CarMax West had been assessed
3 penalties for both negligence and substantial
4 understatement?

5 A: Yes, it was directly on the audit report.

6 Q: Do you believe that you had substantial
7 authority for reporting CarMax West income as
8 you did?

9 A: Yes.

10 Q: What authority did you rely upon?

11 A: I relied upon the instruction to the tax
12 return, the tax return form itself, and then
13 subsequently the statutes.

14 Q: And do you believe that CarMax West made
15 adequate disclosure on its income tax returns
16 in South Carolina?

17 A: I do.

18 Q: Was there any way for CarMax West to know that
19 they were supposed to file the returns using
20 the method that the Department is using now?

21 A: No.

22 MS. GEER: Thank you, Ms. Yost. If you'll answer
23 any questions that Mr. Traynham has.

24 THE COURT: Thank you, Ms. Yost.

25 Mr. Traynham, your witness on cross-examination.

1 MR. TRAYNHAM: Thank you, Your Honor.

2 MS. YOST - CROSS-EXAMINATION BY MR. TRAYNHAM:

3 Q: Good morning, Ms. Yost.

4 A: Hi.

5 Q: Good to see you again, or for the first time.
6 We've talked on the phone not terribly long
7 ago.

8 A: Right.

9 Q: Ms. Yost, it's CBS that currently manages
10 CarMax's intellectual property and intangibles,
11 correct?

12 A: Yes.

13 Q: And it was CBS that was performing this role in
14 the latter years of the audit period, correct?

15 A: Yes.

16 Q: And CBS also manages CarMax financing
17 operations currently, correct?

18 A: Yes.

19 Q: And for South Carolina tax purposes, CBS is
20 taxed as a partnership?

21 A: It is.

22 Q: Would that be it's a disregarded entity for tax
23 purposes?

24 A: I would more consider it to be a flow-through
25 entity than a disregarded.

1 Q: Okay. So it would file an information return,
2 but not necessarily pay taxes on its income?

3 A: For federal purposes, it files an actual tax
4 return. In most states, it isn't even required
5 to file because all the incomes flow to the
6 partners.

7 Q: Okay. All right. So all the income flows to
8 the partners. And when you say that, you mean
9 the net income of the partnership?

10 A: I do, the net income or loss.

11 Q: Or loss depending on what happens, sure. So
12 the income, net of any expenses incurred by the
13 partnership, flows through to the partners, in
14 this case CarMax West and CarMax East.

15 A: Yes.

16 Q: And the income that flows through CBS to the
17 taxpayer, CarMax West, is the only income that
18 CarMax West receives from South Carolina,
19 correct?

20 A: From South Carolina.

21 Q: Okay.

22 A: Yes.

23 Q: Now, the taxpayer's only activity today,
24 ignoring its partnership interest in CBS, is as
25 an automobile retailer, correct?

1 A: Yes.

2 Q: And prior to the formation of CBS, the taxpayer
3 engaged in retail sales and engaged in
4 management of intangible property on behalf of
5 CarMax, correct?

6 A: Yes.

7 Q: Was there any particular reason why West held
8 the intangibles of CarMax as opposed to East?

9 A: The structure -- the pre-reorganization
10 structure is what we inherited from our
11 previous parent company, Circuit City.

12 Q: Okay. I'll just put this up very quickly.
13 Now, Ms. Yost, prior to your employment with
14 CarMax, you worked for Circuit City, correct?

15 A: I did.

16 Q: And were you aware of any discussions or were
17 any reasons given to you for the structure that
18 was inherited from Circuit City for West
19 holding the intangibles as opposed to East or
20 a third entity?

21 A: What I really know about the reasons why CarMax
22 was set up the way that it is, is because it
23 was extremely similar to the way that Circuit
24 City was set up.

25 Q: But you're not aware of any reason why it would

1 be important to them for the intangibles to be
2 in a West Coast retailer as opposed to an East
3 Coast retailer?

4 A: I don't know that directly.

5 Q: Anything you know indirectly?

6 A: You know, I know that from a Circuit City
7 perspective, they had an extremely strong
8 management of their West Coast operations,
9 which were significantly larger than the CarMax
10 West Coast operations.

11 But when CarMax West Coast was set up, I was a
12 staff person in the tax department and,
13 therefore, really wasn't making those type of
14 strategic decisions and, in some case, wasn't
15 involved in any of the decision-making.

16 But I do know that the Circuit City West had an
17 extremely strong management team out on the
18 West Coast and that some of the intellectual
19 property -- they were looking for strategic, I
20 guess, merchandising would be the best way to
21 say, merchandising opportunities with
22 manufacturers in Asia and having the IP on the
23 West Coast in their situation could facilitate
24 any dealings that they had. But as it
25 specifically relates to CarMax, like I said, we

1 were just set up to be an image of a model that
2 apparently was working for Circuit City.

3 Q: Okay. And during the years prior to CBS's
4 formation, what states was West Coast? What
5 states was the taxpayer actually operating
6 retail stores?

7 A: Operating retail stores?

8 Q: Yes.

9 A: Prior to the reorganization, they were in
10 California, Nevada, and one other state that I
11 frankly can't recall right now, but it was in
12 the western part of the United States.

13 Q: Okay. Now, Nevada does not require income tax
14 filing, correct?

15 A: Right, Nevada does not have a corporate income
16 tax.

17 Q: Okay. What about California?

18 A: It does.

19 Q: Does it require combined reporting?

20 A: It does.

21 Q: Okay. And what is "combined reporting," if you
22 don't mind telling us?

23 A: Combined reporting would look at whether or
24 not -- again, I use the word "unitary" and I
25 use it from more of a tax or accounting

1 perspective -- but it looks at, you know, how
2 your business is integrated and whether or not
3 there's dependencies and things like that and
4 ownership, common ownership, and whether or not
5 you would file a combined return if their
6 statutes require that.

7 Q: Okay.

8 A: And we did that in California.

9 Q: Okay. So --

10 A: And we did that in the other state that I can't
11 remember what it was.

12 Q: Okay. So combined reporting would essentially
13 look at a group of entities and its total
14 business and total tax liability?

15 A: It would.

16 Q: Okay. And it would ignore any intercompany
17 transactions between and amongst its entities,
18 as well.

19 A: That's true. In addition, CarMax West, the
20 taxpayer, pre-restructuring also filed in other
21 noncombined - as you said, noncombined states.

22 Q: Okay. States from which it was getting
23 intangible income?

24 A: Yes.

25 Q: Okay. All right. But the states prior to the

1 formation of CBS, the states in which the
2 taxpayer operated retail locations --

3 A: Uh-huh (affirmatively responds).

4 Q: -- were states that required combined reporting
5 or states which did not require income tax
6 filing. Would that be a correct statement?

7 A: In the states that they had dealerships, yes,
8 that's true.

9 Q: Okay. And what about after the formation of
10 CBS, what states was the taxpayer doing retail
11 sales in at that point?

12 A: After the restructure, we added a store in New
13 Mexico, I believe Utah -- I'm trying to
14 distinguish between the stores we had at the
15 end of the audit period and the stores that we
16 had today.

17 Q: Okay.

18 A: That may be it. New Mexico and Utah, I
19 believe, we added.

20 Q: And do New Mexico and Utah require combined
21 reporting, as well?

22 A: I know Utah requires combined reporting. I
23 don't know for a fact whether New Mexico
24 requires it, but we do file that way in New
25 Mexico.

1 Q: Okay.

2 A: In addition, we also, after the reorganization,
3 filed in addition what I would call "separate
4 company" states, like Virginia and Georgia, by
5 virtue of the fact that because CarMax Business
6 Services was doing business in those states,
7 the flow-through of their income and
8 apportionment factors required CarMax West to
9 also file tax returns in those states. So we
10 added a handful more separate company states
11 that West Coast was required to file in.

12 Q: And, again, those were states for which
13 intangible or in this case partnership
14 income --

15 A: Yes.

16 Q: -- was flowing to the taxpayer.

17 A: Exactly. Exactly.

18 Q: Okay. Thank you. Now, it's been said
19 ad nauseum, but just to restate, CarMax West
20 has never operated a retail store in South
21 Carolina.

22 A: That is true.

23 Q: The payments the taxpayer received, either from
24 retailers in the early audit years or from a
25 partnership in later years, those fees were

1 paid on a per-car basis; is that correct?

2 A: They are. I want to make sure I understand
3 your question. Pre-reorganization it was not
4 on a per-car basis.

5 Q: Okay. Was that a percentage of sales basis?

6 A: It was a percentage of sales
7 pre-reorganization; it was a per-car charge
8 post reorganization.

9 Q: Okay. Thank you for the clarification. So
10 when CBS was formed -- well, let me back up
11 just a moment. So just as an illustration, in
12 the latter years of the audit period, after CBS
13 is formed, a car is sold in South Carolina and
14 the retailer would remit a set fee for that car
15 to CBS for managing tangibles and other
16 management services.

17 A: The entire management fee.

18 Q: Okay.

19 A: Uh-huh (affirmatively responds).

20 Q: And prior to the formation of CBS, that fee was
21 remitted -- a percentage of sales was remitted
22 directly from the retailer to CarMax West.

23 A: Yes.

24 Q: Now, the income flowing through CBS you've
25 stated involves lots of management services,

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1 including finance revenue, correct, or finance
2 service revenue?

3 A: The finance revenue flows from CBS, but it's
4 not included in the management fee.

5 Q: Okay. So it's a separately stated fee?

6 A: I wouldn't call it a "fee." The financing
7 operations, through the securitization process
8 that I talked about, are designed to be
9 self-funding and self-sufficient, so there
10 isn't an actual fee, per se, that is charged.
11 During the audit period, one of the mechanisms,
12 I guess, to do what I think you're asking is
13 that CarMax Business Services, CBS, the
14 financing entity -- and this happened pre and
15 post reorg - they would charge an origination
16 fee --

17 Q: Okay.

18 A: -- to -- I'm sorry. Yes, they would -- I'm
19 saying this backwards. East Coast and West
20 Coast as retailers would receive an origination
21 fee from CBS. So, in other words, what I'm
22 saying is, a lender -- and this happens with
23 our third-party lenders, as well, by virtue of
24 the fact that the dealership is originating the
25 credit; they get paid for doing that. So I

1 don't know if that answers your question, but
2 that's -- that was the mechanism for kind of
3 the interchange of the retail installment
4 contracts.

5 Q: All right.

6 A: Does that make sense?

7 Q: I think so. Let me ask a couple more questions
8 and then maybe we'll clarify things.

9 A: Okay.

10 Q: Would it fair to say that some of the financing
11 income that flows through CBS is derived from
12 interest and fees charged to consumers that buy
13 these cars?

14 A: Yes.

15 Q: And you talked a lot about the securitization
16 that goes on within CBS --

17 A: Uh-huh (affirmatively responds).

18 Q: -- that process where you lump these loans
19 together and sell them off to third parties as
20 investments.

21 A: Uh-huh (affirmatively responds).

22 Q: Is that a fair simplification in
23 securitization?

24 A: Yes. Yes.

25 Q: Kind of an oversimplification, I would imagine.

1 A: It is. It's much more complicated than that,
2 but that's a good description of it.

3 Q: Now, what makes these securitized loans or loan
4 bundles valuable as investments to third
5 parties?

6 A: What makes them valuable?

7 Q: Or to ask another way, why would a third party
8 want to buy loans from CBS or these securitized
9 loans?

10 A: Generally, I guess they would do that because
11 the loans that are originated by CBS, I think
12 in most cases, are what they would call "prime"
13 loans, meaning good credit customers. So the
14 income stream from those is certainly not
15 guaranteed, but a prime customer, I guess, is
16 more likely to pay --

17 Q: Okay.

18 A: -- their loan off than a nonprime or subprime
19 customer. I think it's hard to explain because
20 of the oversimplification of it --

21 Q: Sure.

22 A: -- because there's debt instruments involved
23 and interest payments to investors and all of
24 those things that are involved. But it all
25 generally, from my understanding, is prefaced

1 on the fact that they think the customers are
2 good customers and will pay without going into
3 default.

4 Q: Okay. So part of their consideration is that
5 the customers are likely to pay these loans
6 back.

7 A: That's my understanding.

8 Q: Okay. And about -- and this may be a getting
9 a little out of the scope of your knowledge,
10 but if you have a ballpark figure, about how
11 many loans would be bundled into a single
12 securitized instrument? Are we talking five?
13 500? 5,000?

14 A: I don't know it from a number of loans
15 perspective, but I could tell you the general
16 relative dollar amount that's done that's
17 securitized out in the public market.

18 Q: Okay. How much?

19 A: Generally, between 500 and \$700 million.

20 Q: Is that per instrument or just over the scope
21 of all securitization?

22 A: That would be what we call a "deal." A public
23 deal would be that value of receivables. And
24 I don't have any idea of how many loans would
25 be in there.

1 Q: All right. Now, if a disproportionate number
2 of CarMax consumers just suddenly started to
3 default on their loans, that would drastically
4 affect the value of those securitized
5 transactions, would it not?

6 A: I would have to assume so, but that's not
7 really my -- I don't know that much about that
8 side of the business, but that makes common
9 sense.

10 Q: Okay. Ms. Yost, would it be fair to say that
11 the CarMax customers who enter into financing
12 agreements are located pretty much everywhere
13 CarMax does retail business?

14 A: Yeah.

15 Q: And that would include South Carolina,
16 obviously.

17 A: Absolutely.

18 Q: And those customers when they go into a CarMax
19 location, you stated that they are helped by a
20 sales associate --

21 A: Uh-huh (affirmatively responds).

22 Q: -- and pick out their car. They go through the
23 whole process of test driving it and they
24 decide to finance all or a portion of the
25 vehicle.

1 A: Right.

2 Q: And so that financing process, it begins there
3 in the retail location, correct?

4 A: It does. In the industry, it's the retailer
5 that -- the words that I use are the retailer
6 "extends credit."

7 Q: Okay.

8 A: The retailer itself does not hold the
9 receivable or the note. It's just an initial
10 extension of credit -- and I called it a
11 "retail installment contract" -- that's then
12 subsequently purchased by the finance company.
13 So the loan is really with the finance company.
14 It's just an initial extension of credit that's
15 done at the store.

16 Q: And at some point during the audit period, the
17 retail stores were receiving origination fees
18 for that and things of that nature.

19 A: Exactly.

20 Q: And the customer executes the loan agreement or
21 installment agreement there in the retail
22 location, signs the note, for lack of a better
23 word.

24 A: At that point, I don't know that I would call
25 it a "note". But, yes, it signs the retail

1 installment contract that it knows is going to
2 be purchased by the finance company that they
3 selected off the computer screen in my example
4 that I've talked about. They picked whether
5 they wanted CarMax Auto Finance or Bank of
6 America or Wells Fargo. They picked that
7 finance company. So, again, it's absolutely
8 without question the customer's understanding
9 that their loan will be with that finance
10 company that they chose. So I can tell you a
11 hundred percent the customer does not think at
12 any point that their loan is with the
13 dealership.

14 Q: Okay. The customer associates the loan with
15 the --

16 A: With the finance company.

17 Q: Right.

18 A: Okay.

19 Q: Once they've executed that agreement,
20 installment agreement, loan, however you want
21 to describe it, the automobile that they
22 purchased or financed, I guess, would be
23 collateral to ensure that they have paid or
24 will continue to pay faithfully on that
25 installment agreement?

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1 A: Yes. My understanding is that CBS or whoever
2 the lending company is would file all the UCC
3 forms that need to be filed and attach as
4 collateral and, you know, that general process,
5 I guess, of creating collateral.

6 Q: Okay. Now, in the history of CarMax as a
7 retailer, have you ever had a customer default
8 on an installment contract? I know that's --

9 A: I'm pretty confident that they have.

10 Q: Sure, of course. Now, what would be the
11 response to a default like that? You mentioned
12 earlier that if a customer is late on a
13 payment, the CBS call center would call them
14 and let them know that they're late. If they
15 go further than that, just simply refuse to
16 pay, what would CarMax do in response?

17 A: Generally, depending on where the default
18 occurred, they could repossess the car. I'm
19 frankly not in a position to really go through
20 what the details of that might be. Although,
21 I think if you think of it, whether it's your
22 car or your credit card, if you're in default,
23 you're going to continue to get calls to pay
24 whether it's a minimum payment or whatever it
25 is. But at some point, they're going to -- the

1 company is going to try to recoup their losses.
2 In the case of a car company, I know that we do
3 repossessions, but I don't know the details of
4 at what stage that would occur.

5 Q: Okay. Would CarMax possibly pursue other legal
6 action besides repossession?

7 A: It would make sense that they would, but,
8 again, I don't have a lot of knowledge about
9 that area of the business.

10 Q: Okay. I know you stated this earlier, but just
11 to ask again, when exactly was CBS formed?

12 A: Well, CBS the legal entity was formed, I
13 believe, in April of 2004.

14 Q: Okay.

15 A: And then the restructuring actually occurred in
16 September of 2004. So the entity was formed
17 just for needing it prior to the actual day of
18 the restructuring.

19 Q: Okay. And up until that time, CarMax East was
20 actually handling the finance operations for
21 CarMax, the CarMax family.

22 A: It was.

23 Q: And you stated that there were some significant
24 issues involved in having that single entity
25 handle the retail side and the financing side.

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- 1 A: Yes.
- 2 Q: There were some operational issues, some
- 3 regulatory issues.
- 4 A: Uh-huh (affirmatively responds).
- 5 Q: Be fair to say?
- 6 A: Sure.
- 7 Q: And that was one reason why CBS came into
- 8 existence.
- 9 A: It was.
- 10 Q: When CBS was formed, the taxpayer contributed
- 11 its intangible property to the partnership --
- 12 A: Uh-huh (affirmatively responds).
- 13 Q: -- for an interest in the partnership, right?
- 14 A: Yes.
- 15 Q: And that interest is 93 and a half percent, I
- 16 think was on the other chart, correct?
- 17 A: Yes. Yes.
- 18 Q: And that percentage was based on a third-party
- 19 valuation of the intangible property?
- 20 A: Of all the property, yes.
- 21 Q: Of all of the property that was contributed.
- 22 And who performed that valuation?
- 23 A: Ernst & Young.
- 24 Q: East contributed the financing operations that
- 25 it had formerly held.

1 A: Uh-huh (affirmatively responds).

2 Q: Sorry, verbal response, just for the record.

3 A: I'm sorry, yes. In addition, it contributed

4 all of the management overhead functions.

5 Q: Okay. And this is the arrangement that's

6 ongoing at this time?

7 A: It is.

8 Q: Is all of CBS income payments by retail

9 operators?

10 A: Can you ask that a different way? Do you mean

11 from a management fee perspective or ...

12 Q: Just the income that flows out of the

13 partnership, is all of that income coming from

14 the retailers directly or is there some coming

15 from other sources?

16 A: The way I think you're asking the question,

17 there's different components of what the income

18 is that's in CBS. So part of the income is

19 from the management services --

20 Q: Okay.

21 A: -- which is from the retailers.

22 Q: Okay.

23 A: But the finance receipts are not from the

24 retailers. That's the part I'm confused.

25 Q: Okay.

1 A: Am I answering your question?

2 Q: Yeah.

3 A: So there's two income streams.

4 Q: Okay. Let me see if I can try to clarify it a

5 little bit.

6 A: Okay.

7 Q: The financing income portion --

8 A: Yes.

9 Q: -- you stated earlier that some portion of that

10 comes from interest and fees from the

11 customers, correct?

12 A: Uh-huh (affirmatively responds).

13 Q: So I guess that's not directly coming from the

14 retailer, that'd be coming from the customer?

15 A: Yes.

16 Q: Okay.

17 A: Yeah, the customer that holds the loan.

18 Q: Okay. Gotcha. So, Ms. Yost, where is West

19 Coast's corporate office located?

20 A: They have a corporate office out in California.

21 Q: And you stated earlier that CBS corporate

22 office is located in Richmond, Virginia?

23 A: It is.

24 Q: And you also stated, I believe, that CBS houses

25 a large number of employees working on the

1 financing activities in Georgia?

2 A: Yes.

3 Q: That's about 300 employees in that call center?

4 A: Yeah, about.

5 Q: Give or take?

6 A: Give or take, yeah.

7 Q: And these call center employees, their

8 full-time job I think you described it as

9 contacting the customers, answering customer

10 inquiries --

11 A: Uh-huh (affirmatively responds).

12 Q: -- it makes some data processing. Is that fair

13 statement of what their job ...

14 A: Generally, yes. They also have some accounting

15 functions there, some legal functions and

16 things like that, and I consider those all to

17 be in the call center.

18 Q: Okay.

19 A: So there's a portion that answer the phone and

20 a portion that do other things.

21 Q: Do you have any sense of what percentage of

22 that, give or take, 300 employees are dedicated

23 full-time call center, just taking care of the

24 customer, financing, servicing?

25 A: I don't, but I would think more than half.

1 Q: More than half? Okay. So just as a ballpark
2 approximation, 150 call center employees
3 dedicated to servicing customer loans.

4 A: Yeah, probably 200 of the 300.

5 Q: All right. About how many CarMax or CBS
6 employees are full-time dedicated to the
7 securitization process?

8 A: I don't know that I would say that there's any
9 employees that are full-time dedicated to the
10 securitization process, but I would say that
11 there's a team of folks, maybe in the ten to 15
12 range, that the securitization process is at
13 least part of their job responsibility.

14 Q: Okay. So ten to 15 who spend some of their
15 time working on the securitization.

16 A: Yes, yes.

17 Q: Ms. Yost, in your job responsibilities, you are
18 responsible for filing the original corporate
19 income taxes involved in this case, correct?

20 A: I was. Uh-huh (affirmatively responds).

21 Q: And I refer you to, I believe, tab fourteen in
22 the exhibit notebook. And there's several of
23 them here, so I'll just ask you to look over
24 these. Take as long as you want, but do these
25 appear to be true and accurate copies of the

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1 original returns that CarMax filed in this
2 case?

3 A: (Reading.) Yes, they do.

4 MR. TRAYNHAM: Okay. Your Honor, we would offer
5 these original CarMax West returns as an
6 exhibit for the Court to consider.

7 THE COURT: Mr. von Lehe, Ms. Geer, any objection?

8 MS. GEER: No objection, Your Honor.

9 THE COURT: All right. Without objection, then the
10 returns at Exhibit Fourteen, original returns
11 submitted by CarMax, admitted into evidence.

12 MR. TRAYNHAM: Thank you, Your Honor.

13 (Joint Exhibit Number Fourteen was admitted into
14 evidence.)

15 Q: Ms. Yost, these original returns, you've stated
16 were filed based on what's commonly referred to
17 as the three-factor or three-factor
18 double-weighted formula?

19 A: Yes.

20 Q: And, subsequently, amended returns were filed
21 using a different formula, correct?

22 A: Yes.

23 Q: And do you recall when those amended returns
24 were filed?

25 A: I believe September of 2009 or somewhere in

1 that vicinity.

2 Q: So that would have been after the Department
3 issued its determination and response to the
4 taxpayer's protest?

5 A: Yes.

6 Q: Would you concede that the three-factor formula
7 originally filed is not the appropriate formula
8 for the taxpayer to use in South Carolina?

9 A: Yes, that's why I amended the returns.

10 Q: Didn't figure I'd have a problem with that
11 concession, but had to ask.

12 MR. TRAYNHAM: Your Honor, if I could have just one
13 moment.

14 THE COURT: Take your time, Mr. Traynham.

15 Q: Ms. Yost, I think we're almost done.

16 A: Okay.

17 Q: Just a couple more questions. You talked a lot
18 about the shared processes and management
19 services that CBS provides to the West. Fair
20 to say that they provide those same benefits
21 and services for East, as well?

22 A: Yes.

23 Q: And one final question, the valuation that was
24 done by when you said Ernst & Young --

25 A: Uh-huh (affirmatively responds).

1 Q: -- did CarMax or CarMax West or any associated
2 entity have any other relationship with Ernst
3 & Young at the time the valuation study was
4 performed?

5 A: I'm not sure exactly what you're asking, but
6 Ernst & Young acted as an advisor to the
7 company as it related to the corporate
8 reorganization and it was through that
9 transaction, I'll call it, that -- the
10 valuation was just one step in the bigger
11 process. So did that answer your question?

12 Q: Yeah. Were they performing any auditing
13 functions for CarMax at the time?

14 A: Oh, no, they were not our auditor. They were
15 more of just a state tax consultant in a bigger
16 view. I mean, every large corporation has a
17 state tax advisor and that's what they were.

18 MR. TRAYNHAM: Thank you very much.

19 THE COURT: Anything on redirect?

20 MS. GEER: Just one issue I want to make sure was
21 clear.

22 MS. YOST - REDIRECT EXAMINATION BY MS. GEER:

23 Q: Ms. Yost, the underwriting -- I call it
24 "underwriting" -- the work performed by the CBS
25 associates to evaluate the loan applications by

1 the customers --

2 A: Uh-huh (affirmatively responds).

3 Q: -- are all of those associates also in Georgia?

4 A: Yes, they are. I would call that "credit
5 extension."

6 Q: Okay. Credit extension.

7 A: And, yes, those are all -- all those decisions,
8 all those associates are physically in Georgia.

9 Q: Okay. But there's no income or fees related to
10 that work performed that are included in the
11 financing receipts at issue here.

12 A: No, I don't believe that there is.

13 Q: Okay. So everything that's at issue here is
14 post the credit extension and post sale?

15 A: Yes.

16 MS. GEER: That's all I had.

17 THE COURT: Thank you very much. You may be
18 excused, Ms. Yost.

19 (Witness excused.)

20 THE COURT: Whenever you're ready, you may call your
21 next witness, Mr. von Lehe.

22 MR. VON LEHE: Thank you, Your Honor. We would like
23 to call Mr. Phil Zinn to the stand.

24 THE COURT: Mr. Zinn, if you'd please come around
25 here to our witness chair and I'll ask our

1 court reporter to administer the oath or
2 affirmation to you.

3 PHILIP M. ZINN, having been duly sworn, testifies
4 and examines as follows:

5 MR. ZINN - DIRECT EXAMINATION BY MR. VON LEHE:

6 Q: Mr. Zinn, where are you employed and in what
7 capacity?

8 A: I'm currently employed as a principal with the
9 accounting firm of PricewaterhouseCoopers in
10 New York and currently serve as the National
11 Practice Leader for the State and Local Tax
12 practice and have had that role for the last
13 six years.

14 Q: And what have you been asked to do in this
15 case?

16 A: I have been asked to look at a couple of
17 issues. First, I've been asked to look at the
18 statutory South Carolina apportionment formula
19 as applied to the taxpayer, CarMax West Coast's
20 facts and to effectively look at that. And
21 I've also been asked to look at the application
22 of the Department of Revenue's alternative
23 formula to the taxpayer's facts and in each
24 case view that with respect to the taxpayer's
25 activities in South Carolina.

1 Q: Mr. Zinn, have you been asked to make an
2 examination based on tax accounting?

3 A: Yes.

4 MR. VON LEHE: And, Your Honor, at this particular
5 point, we would like to first introduce
6 Mr. Zinn's resume, which is Number Twenty-seven
7 in the exhibit list, I'm informed.

8 THE COURT: Any objection to that introduction? You
9 wish to admit it into evidence?

10 MS. GEER: The CV is Twenty-seven.

11 MR. VON LEHE: That's what I said, Twenty-seven.

12 MR. TRAYNHAM: No objection, Your Honor.

13 THE COURT: All right. Without objection, the CV is
14 admitted into evidence.

15 (Joint Exhibit Number Twenty-seven was admitted into
16 evidence.)

17 MR. VON LEHE: Your Honor, we are prepared to ask
18 questions and for the purpose of qualifying
19 Mr. Zinn as an expert in the area of state and
20 local taxation and particularly as it's related
21 to tax accounting and tax policy. If the
22 Department of Revenue will agree to his
23 expertise as an expert witness, then we will
24 not go through that background.

25 MR. TRAYNHAM: One minute, Your Honor.

1 THE COURT: How say you, Mr. Traynham?

2 MR. TRAYNHAM: Your Honor, we'll stipulate to his
3 qualification as an expert in those areas.

4 THE COURT: In the areas of, as I believe
5 Mr. von Lehe enumerated, state and local
6 taxation, tax accounting and tax policy?

7 MR. VON LEHE: That is correct.

8 THE COURT: All right, then.

9 MR. VON LEHE: Thank you.

10 THE COURT: So qualified.

11 Q: Specifically, Mr. Zinn, what questions have you
12 been asked to address?

13 A: Specifically, I've been asked to address
14 whether or not the statutory apportionment
15 formula that the taxpayer, CarMax West, used
16 with respect to their amended returns, which
17 was the single gross receipts factor, was
18 proper with respect to properly attributing the
19 tax in South Carolina to the activities. And
20 then I was also asked to address whether or not
21 the Department of Revenue's use of an
22 alternative formula was proper based on, again,
23 the activities of the taxpayer in South
24 Carolina.

25 Now, implicit in that analysis was a

1 determination as to whether or not the
2 activities with respect to CarMax West provided
3 a distorted result such that, again, the
4 Department of Revenue was proper in asserting
5 the alternative formula.

6 Q: And what have you been asked to review and what
7 have you reviewed in deriving your opinion in
8 this matter?

9 A: I reviewed the taxpayer's -- CarMax's 10-K for
10 the years in question to get a background of
11 information with respect to their operations
12 and financial information. I looked at some
13 treatises with respect to state tax by Walter
14 Hellerstein and his brother -- or cousin,
15 Jerome, with respect to apportionment and the
16 unitary business principle. I reviewed the
17 depositions in this case. I reviewed all of
18 the, what I would call, pleadings, the South
19 Carolina Department of Revenue's audit
20 assessment, the taxpayer's protest, the
21 Department of Revenue's determination with
22 respect to the protest. I also reviewed the
23 pleadings recently filed by Mr. Traynham with
24 respect to this proceeding. And I reviewed
25 certain cases and I think that was about it.

1 Q: Did you look at something called the UDITPA?

2 A: Yes. I also looked at --

3 Q: And what does UDITPA mean?

4 A: UDITPA means Uniform Division of Income for Tax
5 Purposes Act and it is a model, piece of
6 legislation, and I reviewed that, along with
7 the Multistate Tax Compact, which provides the
8 regulations under UDITPA that were drafted by
9 the Multistate Tax Commission. I also looked
10 at the taxpayer's originally filed tax returns
11 for South Carolina, as well as the amended
12 returns.

13 Q: So in your review, did you become acquainted
14 with the structure of the taxpayer both before
15 and after the December the 1st, 2004
16 reorganization?

17 A: Yes.

18 Q: And is this chart a chart with which you are
19 familiar, that you looked at?

20 A: Yes, I'm familiar with the chart.

21 Q: All right. And what does that chart show
22 concerning the relationship of -- well, we have
23 on that chart CarMax East and the taxpayer,
24 CarMax West, and any revenue which might be
25 generated and paid between them?

1 A: I'm not sure I understand your question.

2 Q: What does that chart show concerning the
3 relationship of those two entities and what
4 does that chart show concerning any payments
5 which were made between those two entities?

6 A: Oh, okay. What the chart shows is that CarMax
7 Auto Superstores West Coast, Inc., had
8 intellectual property that CarMax Auto
9 Superstores, Inc., which was CarMax East, was
10 using in their business operation, and as a
11 result, there was a fee that was paid for the
12 use of those intangibles.

13 Q: And after reorganization, have you had occasion
14 to examine this chart?

15 A: Yes.

16 Q: And what does this chart show with regard to
17 the organization of the entities and the
18 payments between them?

19 A: After the reorganization, the intangibles were
20 now owned by CBS, and so payments with respect
21 to the intangibles now were being made by --
22 again, East Coast were making the payments
23 based on the appropriate percentage share that
24 they had as, again, the intangibles were now
25 owned by CBS. And I believe that there were

1 also charges for the management fees that
2 Ms. Yost talked about earlier.

3 Q: All right, sir. How does did the taxpayer,
4 West Coast, how did it report its income to
5 South Carolina?

6 A: The taxpayer reported its income to South
7 Carolina -- on its original return, it looked
8 at the federal taxable income and then it went
9 and made adjustments under the statutory
10 modifications that were mentioned earlier and
11 came up with an amount of income, net
12 reconcilable income, I think was the term, that
13 was then subject to apportionment and that was
14 the calculation of the income for South
15 Carolina purposes.

16 Q: And as you've pointed out, the taxpayer did
17 later amend its returns.

18 A: Yes.

19 Q: What was the difference in how it filed
20 originally and how it amended?

21 A: In terms of the original returns, the taxpayer
22 used a three-factor apportionment: property,
23 payroll and sales, double-weighted. And the
24 amended return was based on a single gross
25 receipts factor.

1 Q: And was that the only difference in the way the
2 returns were filed?

3 A: Yes, to my knowledge.

4 Q: Why did the taxpayer -- in the years after the
5 reorganization, why did the taxpayer include
6 the income of CBS?

7 A: CBS is a LLC that is disregarded for federal
8 purposes and treated as a partnership;
9 therefore, it's a flow-through entity. And as
10 a result, that income flows through to the two
11 partners, which would be CarMax East and CarMax
12 West. So that income is not taxed at the CBS
13 level but is taxed at the partners.

14 Q: Did you say that you did look at the tax
15 returns that the taxpayer filed?

16 A: I did.

17 Q: Did the taxpayer follow the instructions on
18 those returns?

19 A: Yes, they did.

20 Q: And under what method, then, did they report?
21 Did the taxpayer begin by reporting its total
22 corporate net income?

23 A: Yes. They started off with their federal
24 taxable income and, again, made the
25 modifications, the statutory South Carolina

1 modifications, came up with the income subject
2 to apportionment, and then applied the
3 applicable South Carolina apportionment
4 percentage. And, again, on the originally
5 filed returns, they used a property, payroll,
6 and double-weighted receipts factor and on the
7 amended returns, they used a single gross
8 receipts factor.

9 Q: Now, on those amended returns and that single
10 gross receipts factor which they used, and
11 which is before the Court, what did it classify
12 as gross receipts from within this State of
13 South Carolina?

14 A: Before the reorganization, they classified
15 gross receipts from within South Carolina as
16 the royalties.

17 Q: All right. And after the reorganization?

18 A: After the reorganization, again, they looked at
19 the flow-through from CBS and attributed the
20 royalty portion of the flow-through as South
21 Carolina receipts.

22 Q: And what did they do with financing revenue,
23 CBS financing revenue?

24 A: With respect to financing revenue, they did not
25 include any financing revenue with respect to

1 the numerator of the apportionment factor.

2 Q: All right, sir. Now, I believe you stated
3 you've reviewed the audit report?

4 A: Yes.

5 Q: And what did the audit report propose?

6 A: The audit report proposed that an alternative
7 formula be used and it did propose that because
8 it said that the taxpayer's method of filing
9 the return or their use of the apportionment
10 method, the statutory apportionment method, did
11 not properly reflect income in the state of
12 South Carolina.

13 So what the audit report actually did was it
14 only looked at the royalties coming in from
15 South Carolina customers or attributable to
16 South Carolina and effectively did a separate
17 accounting with respect to those royalty
18 receipts. And, again, that was the tax base
19 that was used for the years prior to the
20 reorganization.

21 Q: And what did the audit report do with the
22 taxpayer's federal net income?

23 A: They disregarded it. It was not, again, part
24 of the calculation.

25 Q: And what was the relationship, if any, of the

1 amount of tax alleged to be due in the audit
2 report and the taxpayer's total net income?

3 A: I'm not sure I understand.

4 Q: What is the relationship, if any, of the tax
5 proposed in the audit report and the taxpayer's
6 total net income from its operations? Was
7 there a relationship and, if so, what was it?

8 A: I guess the relationship was that it was a much
9 higher percentage of the income than was
10 reported on the original returns.

11 Q: Did it make any difference if that federal net
12 income figure was higher or lower? Did the
13 audit report have any relationship to that?

14 A: No. Again, the methodology used by the
15 Department completely ignored the taxpayer's
16 federal taxable income and focused solely on
17 the royalty receipts.

18 Q: What if the taxpayer had had a loss on its
19 federal income tax return, would that have
20 affected the amount the audit report came up
21 with as tax due?

22 A: No, it would not have affected it.

23 Q: Now, from a tax accounting standpoint, would
24 you please describe the concept of a "unitary
25 business."

1 A: A "unitary business" -- and, again, a unitary
2 business really -- you have to look at an
3 economic unit. And, again, we have a couple of
4 different concepts in that you can have -- in
5 a single, legal entity, you can have multiple
6 businesses; some of which may or may not be
7 unitary. But, also, again, when you look at
8 the unitary concept, you're generally talking
9 about a controlled group of taxpayers, usually
10 a federal consolidated group, that effectively
11 have, again, relationships with each other.
12 They're generally -- you have mutual
13 interdependence. Again, the activities that go
14 on between the companies generally contribute
15 and depend upon each other. You generally have
16 functional integration with respect to lots of
17 different intercompany transactions going on
18 between the companies involving intercompany
19 sales, intercompany provision of services,
20 intercompany uses of intangibles; you can have
21 centralized purchasing. So there a number of
22 intercompany type things that go on.
23 A unitary business also has centralized
24 management. And, again, you have an executive
25 force that has a responsibility, not just for

1 one part of the business, but for an overall
2 business. So, again, you may have in your
3 business operation, you know, local management
4 people, but they ultimately are answerable with
5 respect to this other group of management
6 folks.

7 And, again, the management part of it, it
8 really needs to have operational impact, as
9 opposed to just mere stewardship.

10 And the third aspect would be economies of
11 scale. Generally, in a unitary business, we
12 see economies of scale. Again, very often
13 showing up with respect to reduced costs, with
14 respect to internal operations, can also need
15 to reduce cost with respect to transportation,
16 reduce costs with respect to manufacturing.
17 So, again, economies of scale would look at,
18 again, the ability -- again, what a bigger
19 organization to reduce the cost of the overall
20 economic unit.

21 Q: Please describe the characteristic of a unitary
22 business from a tax accounting standpoint and
23 how and if that business can be divided up and
24 its part separately accounted for.

25 MR. TRAYNHAM: Objection, Your Honor. I think

1 that's a compound question. It calls for a
2 little too much narrative.

3 MR. VON LEHE: All right. I'll back off, Your
4 Honor, and start --

5 THE COURT: All right. Then maybe break that down a
6 bit.

7 MR. VON LEHE: I can break that down.

8 Q: Please describe with regard to a unitary
9 business tax accounting, if possible, for
10 portions of that business.

11 A: Okay. I'm not quite sure I understand your
12 question.

13 Q: Can a unitary business be separately accounted
14 for accurately?

15 A: Okay. A unitary business cannot be separately
16 accounted for accurately. That is why when you
17 look at, you know, the unitary business
18 principle and combined reporting, the
19 calculation of the tax as opposed to a separate
20 company basis, as South Carolina is, the tax is
21 based on a combined income and a combined
22 apportionment of all the members of the unitary
23 group.

24 And the reason that it can't be combined is, if
25 you look at the interrelationships between the

1 members of the unitary group, what happens is,
2 you know, different values come out and flow as
3 a result of activities that take place among
4 those group members.

5 And it's kind of like, you know, when you look
6 at, you know, adding up one and one; normally,
7 you would get two. But with a unitary
8 business, you can get three, in that the sum of
9 all the parts is really greater than what the
10 whole is.

11 And to, again, take a unitary business and to
12 cut it up into segments, basically what that
13 does, from a tax accounting perspective, is it
14 prevents the proper reflection of the overall
15 income from coming out.

16 Q: You say the sum of the parts can be greater
17 than the amounts added together --

18 A: That's correct.

19 Q: -- or two parts added together. Can the sum of
20 the parts also be less than the two added
21 together?

22 A: (No response.)

23 Q: In other words, is it possible for a unitary
24 business to have a portion of that business
25 which makes -- which when combined with the

1 other portions of the business produces a lower
2 income?

3 MR. TRAYNHAM: Objection, leading.

4 THE COURT: I'll permit the question. You may
5 answer, Mr. Zinn.

6 A: Yes. I mean, that's certainly possible. But,
7 again, you know, the concept of a unitary
8 business is generally the business is creating
9 synergies. Again, whether something happens to
10 be more profitable or less profitable is going
11 to depend on a variety of other circumstances.

12 Q: All right, sir. Given your answer, that a
13 unitary business is certainly not readily or
14 even possibly able to be divided up into
15 portions and those portions separately taxed,
16 have any methods been devised to properly
17 account for the income of those business and,
18 if so, what are they?

19 A: Yes. I mean, again, the unitary principle
20 effectively, of course, sets up what the base
21 of the tax is. But in multi-state taxation,
22 because we're dealing with many states, what
23 also has developed is the concept of
24 apportionment. And, again, apportionment --
25 when we really want to start with

1 apportionment, we look back to the late fifties
2 and the origin of the Uniform Division of Tax
3 Purposes Act -- and, again, that was a model
4 piece of -- not legislation, but, again, was
5 done by the National Conference of
6 Commissioners with respect to model acts.

7 And, effectively, what that did was to come up
8 with an approach that looked at three factors
9 in terms of apportioning the income of a
10 multi-state taxpayer. And those factors were
11 property, payroll and sales. And, again, the
12 rationale that was given back at the time -- I
13 think it was 1957 -- was that they wanted to
14 have these three factors because they each
15 reflected different aspects of a company's
16 business.

17 The property factor represented, you know,
18 again instate presence with respect to the
19 physical assets of the company. Payroll,
20 again, was going to be based on wherever those
21 people were located. And then receipts, again,
22 were based on, you know, where -- depending on
23 the type of business you had, when you were
24 dealing with tangible personal property
25 related, look at it on a designation or a

1 market basis. And when you were dealing with
2 intangible type activity, it looked more at,
3 you know, where the income producing activities
4 were.

5 Q: And the title of that act again -- or not act.
6 The title of this model legislation again was
7 what?

8 A: It's the Uniform Division of Income for Tax
9 Purposes Act; it's UDITPA.

10 Q: The Uniform Division of Income for Tax Purposes
11 Act?

12 A: Correct.

13 Q: And that act has regulations promulgated with
14 regard to it by that group that you mentioned?

15 A: There were regulations promulgated by the
16 Multistate Tax Commission.

17 Q: All right, sir. And I would like for you to
18 please turn in the exhibit book in front of you
19 to Eighteen A.

20 MS. GEER: Six.

21 MR. VON LEHE: Six?

22 Q: Pardon me, Six, I'm sorry.

23 A: (Witness complies.) Okay.

24 Q: Can you identify what that Exhibit Six is?

25 A: Yes, it's the Multistate Tax Compact -- it is

1 the UDITPA statute.

2 Q: And behind that statute are there some
3 regulations?

4 A: Yes.

5 Q: And what are those regulations?

6 A: It's the -- again, it's the Multistate Tax
7 Commission allocation and apportionment
8 regulations.

9 MR. VON LEHE: Your Honor, we would like to move --
10 submit that into evidence.

11 MR. TRAYNHAM: No objection, Your Honor.

12 THE COURT: All right, Mr. Traynham. Without
13 objection then, Exhibit Number Six, the
14 Multistate Compact and regulations promulgated
15 thereunder admitted into evidence.

16 (Joint Exhibit Number Six was admitted into
17 evidence.)

18 Q: What are the elements of a unitary business
19 from an accounting point of view, Mr. Zinn?

20 A: I'm not sure I understand what you mean by
21 "elements."

22 Q: What elements -- describe the business, then,
23 with regard to how the -- first of all, first
24 question, can a single entity have a unitary
25 business in it?

- 1 A: Yes.
- 2 Q: Okay. Can two entities be unitary with regard
- 3 to each other; is that possible?
- 4 A: Yes.
- 5 Q: Okay. What determines whether that single
- 6 entity or those two entities would be
- 7 considered unitary?
- 8 A: Again, it would be a lot of the things that we
- 9 just talked a minute or so ago with respect to
- 10 whether or not the activities with respect to
- 11 the respective entities contribute or depend
- 12 upon each other, whether there is functional
- 13 integration between the two entities, whether
- 14 there's economies of scale between the two
- 15 entities.
- 16 Q: Prior to the reorganization on December 1,
- 17 2004, have you examined the activities of the
- 18 taxpayer and its functions with regard to
- 19 whether it is a unitary business or not?
- 20 A: Yes.
- 21 Q: And what is your conclusion?
- 22 A: My conclusion is it was a unitary business.
- 23 Q: Did you examine the relationship -- after the
- 24 reorganization, did you examine the
- 25 relationship of the taxpayer to CBS, a

1 partnership in which it owned 93.5 percent
2 ownership interest?

3 A: I did.

4 Q: And what was your conclusion with regard to
5 whether or not those two entities, that
6 partnership and its corporate partner, were
7 unitary?

8 A: My conclusion was that the partnership and West
9 were unitary.

10 Q: Mr. Zinn, please tell me, have you examined the
11 activities of the taxpayer, CarMax West, in
12 South Carolina?

13 A: I have.

14 Q: Okay. And what are those activities?

15 A: The activities for CarMax West in South
16 Carolina are limited to its licensing of
17 intangibles to -- I'm sorry, before the
18 reorganization it was the licensing of the
19 intangibles.

20 Q: And after the reorganization, what relationship
21 did it have through the partnership in which it
22 owned 93.5 percent?

23 A: With respect to after the reorganization,
24 again, because the partnership was licensing
25 the intangibles in South Carolina creating a

1 tax nexus, it also had tax nexus in South
2 Carolina, and, again, based on the location of
3 the intangibles.

4 Q: All right, sir. So you have examined the
5 taxpayer's activities in South Carolina both
6 before and after the reorganization?

7 A: Yes.

8 Q: And those of the partnership in which it owned
9 a 93.5 percent interest?

10 A: Right.

11 Q: All right. I'm going to ask you this: What is
12 your expert opinion concerning whether from a
13 tax accounting point of view the apportionment
14 formula used by the taxpayer accurately
15 accounted for its income in South Carolina?

16 A: I believe that, again, my opinion is that the
17 taxpayer's use of the statutory formula
18 properly accounted for its income in South
19 Carolina.

20 Q: You stated earlier that you had reviewed the
21 audit report and the calculations made in the
22 audit report.

23 A: Yes.

24 Q: In general, you said those calculations were
25 based on what?

1 A: Again, the calculations with respect to the
2 years prior to the reorganization were based on
3 purely the royalty income attributable to South
4 Carolina customers and, again, effectively
5 taxed on that basis. And with respect to the
6 years after the reorganization, what the audit
7 report did, it segregated out the activities of
8 93 and a half percent of activities that were
9 flowing through from CBS and effectively taxed
10 that, again, the South Carolina portion of
11 that. And in the numerator, what they included
12 was both the effective royalties, as well as
13 the financing from South Carolina customers.

14 Q: All right, sir. And what is your opinion from
15 a tax accounting point of view of whether the
16 method of apportionment which was used in the
17 audit report fairly represented the extent of
18 the taxpayer's business conducted in South
19 Carolina?

20 A: I don't feel that it fairly reflected the
21 business conducted in South Carolina.

22 Q: And is it your opinion that it taxed too much
23 or too little?

24 A: Too much.

25 Q: Please comment on the audit report method from

1 a tax accounting perspective.

2 A: Well, the audit report looked at the taxpayer's
3 federal taxable income and then it came up
4 with -- it looked at the federal taxable income
5 vis-a-vis West Coast and East Coast and then
6 came up with a percentage based on the gross
7 receipts of each of the companies and concluded
8 that because the gross receipts percentage for
9 West Coast was so much higher than it was for
10 East Coast, that there was distortion.

11 And once they concluded that there was
12 distortion, they basically utilized the South
13 Carolina apportionment formulas, the statutory
14 ability to come up with a different
15 apportionment and -- what we call Section 18.
16 And, effectively, that's why they chose a
17 formula that completely disregarded taxable
18 income and focused on, again, the royalties.

19 Q: All right, sir. With regard to the taxpayer's
20 method of reporting income in South Carolina,
21 what is your opinion as to whether or not that
22 method fairly reflected the taxpayer's
23 activities in this State?

24 A: I believe that the taxpayer's method of filing
25 under the gross receipts method, applying that

1 to all of CarMax West's unitary operation
2 within its legal entity, did fairly reflect the
3 taxpayer's activity in South Carolina.

4 Q: So you mentioned a moment ago a portion of
5 UDITPA, the Uniform Division of Income for Tax
6 Purposes Act; I believe you mentioned Section
7 18.

8 A: Yes.

9 Q: Could you turn to that section?

10 A: (Witness complies.) Okay.

11 Q: Section 18, do you know -- and perhaps we could
12 stipulate to this, but I will ask you -- do you
13 know if the wording in that Section 18 is the
14 same wording that's used in the South Carolina
15 code?

16 A: Yes, I believe it's identical.

17 Q: Okay. There are you said regulations in front
18 of you pertaining to UDITPA, correct?

19 A: Yes.

20 Q: And is there a regulation pertaining to Section
21 18?

22 A: Yes, there is; it's Regulation IV.18.(a).

23 Q: And on what page does it appear on what you
24 have?

25 A: It's on page 37.

1 Q: And does it say when this alternative method --
2 does it say when this is to be used?

3 A: The alternative method can be used if the
4 taxpayer petitions the taxing authority to use
5 it, or if the tax administrator requires it to
6 be used with respect to the taxpayer's
7 business. And there is a caveat there in that
8 the taxpayer -- I'm sorry, the tax department's
9 use of the method, okay, per the statute, has
10 to be reasonable. So they have to come up with
11 something that's reasonable, okay, with respect
12 to this alternative method.

13 And, again, the statute further goes on -- the
14 regulation further goes on to talk about the
15 fact that separate accounting might be a method
16 that would be used. Inclusion of an additional
17 apportionment factor, whether it's an
18 additional property factor or an additional
19 payroll factor, that can be used. The
20 exclusion of a factor, I've seen states use
21 that. Or, again, a catchall, any other
22 methodology that would effectuate a fair
23 apportionment of the income for the state.

24 Q: And is there any language in that regulation
25 which states when this is triggered? Is there

1 any language in that regulation, if you look at
2 it, that speaks in terms of "unique and
3 nonrecurring"?

4 A: Yes. I mean, when the statute came up, the
5 drafters of UDITPA recognized that they could
6 not come up with a perfect apportionment
7 formula and that there would be cases where
8 this escape clause, so to speak, would need to
9 be used. But they also indicated that they
10 thought that it would only be limited, okay, to
11 unique and nonrecurring situations where you
12 had unusual fact patterns. And, again, if you
13 look at what's happened in multi-state
14 taxation, again, you know, the use of this
15 formula is, you know, done on an, again,
16 exception basis.

17 Q: And what about this taxpayer's business
18 activities, what about them, those activities,
19 if anything, is unique and nonrecurring?

20 A: I don't see anything that's unique, very unique
21 or nonrecurring with respect to that, but ...

22 Q: Now, the audit report, which you say you've
23 read, their calculations in that audit report
24 that state that what the taxpayer's has
25 reported has distorted its income; is that

1 correct?

2 A: Yes.

3 Q: And what does the audit report base this
4 distortion conclusion upon?

5 A: Again, as I mentioned earlier, the audit report
6 contained a calculation that looked at West
7 Coast and East Coast's, what I would call,
8 "gross profit percentage" and -- or actually it
9 would be the percentage of taxable income. And
10 because the percentage for West Coast was high
11 or a lot higher than it was for East Coast, the
12 Department of Revenue said that it was
13 distortive.

14 But I didn't see any analysis in terms of why
15 that was the case. There was just a statement
16 that based on the percentage, that the
17 percentage was much higher. And I wasn't
18 surprised by seeing such a higher percentage
19 difference. That's what happens when you have
20 a unitary business. You can't look at two
21 separate legal entities and, again, come to a
22 conclusion alone with respect to, again, the
23 amount of tax that's attributable to them.

24 Q: What does the calculation -- what, if anything,
25 does the calculation which compares the

1 profitability of these two entities, West Coast
2 and East Coast, what does that have to do, if
3 anything, in your opinion, with whether or not
4 the method which the taxpayer used properly
5 reflects its activities in this State?

6 A: I don't think it shows anything. Again, I
7 think if you look at -- if you look at the
8 taxpayer and because they are a unitary
9 business, they have different components within
10 the same legal entity that have a higher profit
11 margin. So, again, it's not surprising that
12 the profit percentage that the auditor came up
13 with in West Coast was significantly higher
14 than East Coast. So I found it irrelevant.

15 Q: Would the fact -- and I'm going to make a
16 hypothetical here since you're an expert.
17 Would it make any difference in this
18 comparison, which has been used in the audit
19 report, would it make any difference if the
20 taxpayer made a lot of income in South Carolina
21 or lost a lot of income in South Carolina?
22 What difference would that have as to whether
23 the profit of these two entities are on a
24 federal taxable income basis, which is what the
25 audit report says -- how is it related, if it's

1 related?

2 A: Well, I mean, again, I think the auditor did
3 what he did because of the actual results
4 between East and West. And if you go ahead and
5 you change those results, I'm not quite sure,
6 you know, how that would play out in terms of
7 the income between the two entities.

8 But, again, ultimately what the auditor did was
9 he didn't want to -- I mean, because of the way
10 that the company is doing business, what the
11 auditor basically jumped to was to really just
12 look at the portion of the activity that he
13 thought was taking place in South Carolina, and
14 that would be the royalty, and effectively
15 stopped his inquiry and calculated tax, much
16 like you would do in a traditional Geoffrey
17 situation with respect to, again, effectively
18 taxing the royalties attributable to South
19 Carolina.

20 Q: Did Geoffrey pay a tax on its entire net
21 income?

22 A: Yes.

23 Q: Does this audit report assess the tax against
24 this taxpayer's entire net income?

25 A: No, it does not.

1 Q: I'm going ask you about financing receipts,
2 okay? Please describe the CarMax financing
3 function both before and after the
4 reorganization.

5 A: Before the reorganization, the financing
6 function was part of East Coast. I think it
7 was referred to as CAF. After the
8 reorganization, the financing function now
9 resided in CBS. In both cases, as I understand
10 it, the function was located in Atlanta,
11 Georgia, in terms of where the people
12 associated with the function took place.

13 Q: And what's your understanding of the dispute
14 among the parties concerning the financing
15 receipts?

16 A: Well, the taxpayer filed the amended return and
17 did not include any of the financing receipts
18 in the numerator of the apportionment factor.
19 And the taxpayer's position, which I think is
20 supported by the statute, again, looked at
21 where the income-producing activity related to
22 those financing receipts took place. And the
23 activity for that took place in Atlanta,
24 Georgia, so they did include those receipts in
25 the denominator, but did not include them in

1 the numerator.

2 The audit report, and the Department's
3 position, was that with respect to financing
4 receipts, that instead of the income-producing
5 activity test being the rule, that you would
6 instead source those receipts on a customer
7 location basis. And the audit report included
8 the financing receipts based on the amount of
9 financing income associated with South Carolina
10 customers.

11 Q: In tax accounting, is there a concept of
12 matching income and expenses?

13 A: Yes, there is. And if you look at the majority
14 of the states, as Ms. Yost said earlier, the
15 majority of the states would tax this kind of
16 income on a cost of performance or an
17 income-producing activity basis. And that,
18 again, is good tax policy in terms of matching
19 the income and expense attributable -- matching
20 the income with the expenses of the people
21 associated with the financing function, as well
22 as their office space and other expenses.
23 We've seen that being eroded more recently as
24 some states have gone to market sourcing. And,
25 again, I think they do that more from a tax

- 1 policy perspective in terms of whether it's
- 2 raising revenue or, again, you know, trying to
- 3 effectively, you know, do something different.
- 4 But right now, the majority of the states still
- 5 use the income-producing activity or the cost
- 6 of performance rule with respect to this kind
- 7 of ...
- 8 Q: And what is your opinion from a tax accounting
- 9 perspective as to whether or not these receipts
- 10 should have been included in the numerator of
- 11 the apportionment formula?
- 12 A: I think from a tax accounting perspective,
- 13 again, the concept of matching income with
- 14 expenses really does makes sense and that's how
- 15 I would do it.
- 16 Q: And what would that indicate?
- 17 A: It would indicate that CarMax prepared the
- 18 returns properly by not including the interest
- 19 in the apportionment factor.
- 20 Q: All right, sir. I'd like for you to turn to
- 21 Exhibit Number Twenty-six.
- 22 A: (Witness complies.) Okay.
- 23 Q: Do you recognize that?
- 24 A: I do.
- 25 Q: And what is that?

1 A: That's my expert witness report.

2 Q: All right, sir. You prepared that report for
3 the purposes of testifying in this case?

4 A: Yes.

5 MR. VON LEHE: All right. Your Honor, at this
6 point, we would like to move for the admission
7 of Mr. Zinn's report into evidence.

8 THE COURT: Mr. Traynham?

9 MR. TRAYNHAM: Your Honor, I'm not certain that a
10 proper foundation has been laid for it yet.
11 Simply the fact that Mr. Zinn has prepared it
12 as part of his services doesn't seem to qualify
13 it as a relevant exhibit.

14 THE COURT: You want to lay a foundation for it,
15 Mr. von Lehe?

16 MR. VON LEHE: Yes, I would like to.

17 Q: Mr. Zinn, you stated that is the report that
18 you prepared, right?

19 A: Yes.

20 THE COURT: And I would note for the record that I
21 believe he has testified as to all the various
22 documents and pleadings and prehearing
23 statements, tax returns, et cetera, which he
24 did review before we came here.

25 MR. VON LEHE: He has, Your Honor.

1 Q: And I also want to ask you this: Did you
2 address the same questions in this report,
3 which you have just addressed in your
4 testimony?

5 A: Yes, I have.

6 Q: All right. And is that report consistent with
7 those answers?

8 A: Yes, it is.

9 Q: In all respects?

10 A: Yes.

11 MR. VON LEHE: Your Honor, we would like to move for
12 the admission of the report.

13 MR. TRAYNHAM: No further objection, Your Honor.

14 THE COURT: All right, then. Thank you very much.
15 After questioning and without objection,
16 Exhibit Number Twenty-six, report prepared by
17 Mr. Zinn, is admitted into evidence.

18 MR. VON LEHE: Thank you.

19 (Joint Exhibit Number Twenty-six is admitted into
20 evidence.)

21 Q: Mr. Zinn, are you aware that a penalty has been
22 assessed in this case?

23 A: Yes, two penalties.

24 Q: Two penalties have been assessed. And what is
25 the nature of those penalties?

1 A: One penalty was for substantial underpayment
2 and the other was for negligence.

3 Q: And are you familiar, in general, with the
4 requirements throughout the various states of
5 the substantial understatement penalty?

6 A: Yes.

7 Q: Are you familiar with the federal code section
8 on the substantial understatement penalty?

9 A: Yes, that would be Section 6662.

10 Q: All right, sir. And have you reviewed that
11 code section?

12 A: Yes.

13 Q: Is there language in that code section
14 substantially identical to the language in the
15 South Carolina penalty provision about
16 substantial understatement?

17 A: Yes.

18 Q: Under what criteria is this penalty imposed or,
19 another way, under what criteria is this
20 penalty not imposed?

21 A: Generally, the penalty would not be imposed if
22 the taxpayer has a -- I'm trying to think of
23 the word -- a substantial authority with
24 respect to taking the position.

25 Q: Okay. That's one time in which it is not

1 imposed, when there is substantial authority in
2 taking the position?

3 A: Right. And the second portion/part would be
4 when there is proper disclosure in the tax
5 return.

6 Q: Or if there's proper disclosure on the tax
7 return?

8 A: Yes.

9 Q: Now, what would qualify, in your experience,
10 for substantial authority? Would a tax return
11 instructions telling someone what to do, would
12 that ordinarily be substantial authority?

13 A: I think it would be. I think assuming that the
14 taxpayer followed the instructions to the
15 return and relied on those instructions, then
16 I think that they would have substantial
17 authority for the position that they took.

18 Q: Now, you stated earlier that you had looked at
19 these tax returns?

20 A: Yes.

21 MR. VON LEHE: And I guess to kind of move this
22 along, Your Honor, with permission.

23 Q: You said the taxpayer has filled out the
24 returns in accordance with the return and the
25 instructions?

- 1 A: Yes.
- 2 Q: All right. A negligence penalty, you
3 mentioned, has also been imposed; is that
4 correct?
- 5 A: Yes.
- 6 Q: And when is a negligence penalty ordinarily
7 imposed?
- 8 A: Generally, the negligence penalty takes place
9 when you have a disregard for the statute, for
10 the law.
- 11 Q: And this taxpayer, you have stated, filed a tax
12 return, first of all. They filed a tax return,
13 correct?
- 14 A: Yes.
- 15 Q: They didn't have to be hunted down; they filed
16 voluntarily?
- 17 A: That's correct.
- 18 Q: And it's also your opinion that they filed that
19 return in accordance with the instructions, I
20 believe you just said.
- 21 A: Yes.
- 22 Q: So from a standpoint of tax policy, what is
23 your opinion concerning imposing a penalty on
24 a taxpayer under these circumstances?
- 25 A: From a tax policy perspective, I have a very

1 difficult time understanding how a tax
2 authority can impose a negligence penalty when
3 they assert Section 18.

4 What's happened, obviously, is that the
5 taxpayer followed the statute in terms of
6 filing their tax return and, you know, for a
7 number of reasons, the taxing authority
8 disagreed. But, again, recognized that in
9 order to assess additional tax, they had to
10 object to the methodology that the taxpayer
11 used.

12 There was nothing to put the taxpayer on notice
13 that the fact that they were following the
14 statute in their particular case wasn't
15 correct. And, again, to impose a negligence
16 penalty when the Department is, again, saying,
17 "Okay, you know, we understand what happened
18 here, but the -- again, the normal formula
19 doesn't work and we're going to do something
20 else," and the taxpayer has no understanding of
21 what that might be, I think it's fairly
22 unreasonable to assert a negligence penalty.

23 MR. VON LEHE: Your Honor, if I could have one
24 moment --

25 THE COURT: Take your time, Mr. von Lehe.

1 MR. VON LEHE: -- then we'll conclude.

2 (Off the Record)

3 MR. VON LEHE: Your Honor, a couple of additional
4 questions.

5 THE COURT: Certainly.

6 Q: Mr. Zinn, with regard to the organizational
7 structure and CBS that we're looking at, with
8 regard to an alternate method proposed by the
9 Department of Revenue in the audit report, what
10 is it trying to do, in your opinion, with
11 regard to CBS?

12 A: What it's trying to do is basically separately
13 account for the royalty income, as well as for
14 the interest income and completely carve that
15 out separately from what is flowing through
16 into West Coast based on 93 and a half percent.
17 So it's kind of like a separate accounting with
18 respect to that activity.

19 Q: And with regard to unitary businesses, which
20 you testified you believe this is, what is your
21 opinion on the accuracy of trying to do that?

22 A: I think it's inappropriate. Again, a unitary
23 business is something that, you know, you
24 can't -- you can't take one part of the unitary
25 business out and separate it, again, because

1 they all contribute and depend upon each other.
2 So, for example, you know, there was a lot of
3 discussion about the intangibles and the impact
4 that they had with respect to the CarMax
5 business. And, again, to separate that out and
6 say it's going to be independent doesn't make
7 any sense in terms of, again, recognizing the
8 impact that that has on the overall income of
9 the company. So it's not possible or
10 reasonable to do separate accounting when you
11 have a unitary business because you won't be
12 reflecting the proper amount of income.

13 Q: With regard to the Uniform Division of Income
14 for Tax Purposes Act, which you have in front
15 of you, how familiar are you with that act?

16 A: I'm fairly familiar.

17 Q: Fairly familiar?

18 A: Uh-huh (affirmatively responds).

19 Q: Have you had occasion to examine it in the
20 past?

21 A: Yes.

22 Q: Have you had occasion to apply it in the past?

23 A: Yes.

24 Q: Okay. Are you familiar with Section 18 of that
25 act?

1 A: Yes.

2 Q: How familiar are you with that?

3 A: Very familiar.

4 Q: In your opinion as an expert, does Section 18

5 of that act give any authority for the

6 Department of Revenue to do what they're

7 attempting to do to a unitary business?

8 A: Well, I think the section gives the Department

9 latitude to make, again, adjustments if they

10 feel that income isn't properly reflected. But

11 in this particular case, I think it falls

12 because part of the statute says that what they

13 do has to be reasonable. And I would say that

14 to use Section 18 to carve up a unitary

15 business is not reasonable. So, in that

16 regard, I feel like the Department's use of the

17 statute is improper.

18 Q: All right, sir. Thank you. Oh. And, also,

19 Mr. Zinn -

20 MR. VON LEHE: Your Honor, perhaps I could just get

21 Michael's help on this. We haven't moved to

22 put the two charts in evidence. May we by

23 agreement?

24 MR. TRAYNHAM: I've used them, too, so I think I'd

25 be remiss --

1 MR. VON LEHE: Your Honor, we therefore move that
2 these two charts be placed in evidence.

3 THE COURT: All right, then.

4 MR. VON LEHE: They're Exhibit Number Nine.

5 THE COURT: All right. Then without objection, the
6 two charts, which have been utilized in the
7 courtroom today, the original structure of
8 CarMax and the structure post reorganization,
9 admitted into evidence as Exhibit Number Nine.
10 Thank you, Mr. von Lehe.

11 MR. VON LEHE: Thank you, Your Honor.

12 (Joint Exhibit Number Nine was admitted into
13 evidence.)

14 MR. VON LEHE: Your Honor, that concludes my direct
15 examination of Mr. Zinn.

16 THE COURT: Thank you very much. And before you
17 begin cross-examination, it looks like this
18 would be a good time and break for lunch.

19 (Lunch break from 12:43 p.m. to 2:08 p.m.)

20 THE COURT: All right. When we recessed,
21 Mr. Traynham was about to begin your
22 cross-examination of Mr. Zinn. So whenever
23 you're ready, if you'll come up here, we'll
24 proceed with that.

25 MR. TRAYNHAM: Thank you, Your Honor.

1 MR. ZINN - CROSS-EXAMINATION BY MR. TRAYNEAM:

2 Q: Mr. Zinn, I believe you stated in your earlier
3 testimony that the Department in its audit
4 looked at the taxpayer's federal taxable income
5 and determined that some distortion had taken
6 place. Was that your testimony?

7 A: Yes.

8 Q: And in its proposed alternative adjustment or
9 alternative formula, the Department did not
10 include income from car sales of the taxpayer,
11 correct?

12 A: Yes.

13 Q: Mr. Zinn, CarMax West does not sell automobiles
14 in South Carolina, does it?

15 A: Does not.

16 Q: And never has?

17 A: Has not.

18 Q: Its only source of income from South Carolina
19 are currently its distributions from CBS,
20 correct?

21 A: Currently, yes.

22 Q: Okay. And prior to the reconfiguration of
23 CarMax, it received royalty income payments
24 from South Carolina customers.

25 A: That's correct.

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APP_00183

1 Q: So from an operational perspective, looking at
2 its activities today, all CarMax West is doing
3 is selling cars in states other than South
4 Carolina and collecting some distribution from
5 CBS. Would that be a fair statement?

6 A: Yes.

7 Q: All right. Mr. Zinn, you would agree with me
8 that South Carolina Code Annotated 12-6-2320 is
9 based on Section 18 of the model code UDITPA,
10 correct?

11 A: Yes.

12 MR. TRAYNHAM: I'd like to put that up on the
13 overhead with Your Honor's permission.

14 THE COURT: Please help yourself.

15 (Off the Record)

16 Q: And looking at Exhibit Nine, which you
17 discussed earlier -- I'm sorry, it wasn't
18 Exhibit Nine. It must have been a different
19 exhibit.

20 MR. VON LEHE: Six.

21 MR. TRAYNHAM: Exhibit Six, thank you.

22 Q: Looking at Exhibit Six, the language of Section
23 18 is substantially identical to Section
24 12-6-2320(A), is it not?

25 A: Did you say Section 17?

1 Q: Section 18, I'm sorry.
 2 A: Section 18, yes.
 3 Q: Okay. And you're fairly familiar with UDITPA.
 4 You testified to that effect, correct?
 5 A: Yes.
 6 Q: You're familiar with its history and its
 7 drafting?
 8 A: Uh-huh (affirmatively responds).
 9 Q: And who wrote UDITPA?
 10 A: Professor Pierce.
 11 Q: And when approximately was UDITPA drafted?
 12 A: 1957, I believe.
 13 Q: Now, looking at the Statute 12-6-2320, which
 14 you testified is based on and identical to
 15 UDITPA Section 18, separate accounting is
 16 specifically listed in subsection one as one of
 17 the alternative methods that can be used by a
 18 taxing agency when this statute is implicated;
 19 is that correct?
 20 A: Yes.
 21 Q: And in looking at subsection four, there is
 22 what you described as the catchall, any other
 23 method to effectuate an equitable allocation of
 24 apportionment of the taxpayer's income; isn't
 25 that correct?

- 1 A: It is, but each of those would be caveated by
- 2 the fact that they have to be reasonable.
- 3 Q: Sure, they have to be reasonable. Absolutely.
- 4 That's sort of the cap. But within that
- 5 reasonable caveat, wouldn't you agree that this
- 6 gives rather broad authority when the statute's
- 7 implicated for an agency to create or formulate
- 8 an alternative apportionment formula?
- 9 A: Yes.
- 10 Q: In fact, there is some comments to UDITPA that
- 11 state that, do they not?
- 12 A: Yes, there are.
- 13 Q: Okay. Now, it's your position that a relief
- 14 provision like this, like 2320, should be used
- 15 only in unique and nonrecurring circumstances,
- 16 correct?
- 17 A: Yes.
- 18 Q: All right. And that position is based on the
- 19 proposed regulations from the Multistate Tax
- 20 Commission?
- 21 A: Yes.
- 22 Q: It was not the MTC or the Multistate Tax
- 23 Commission that wrote UDITPA, was it?
- 24 A: No.
- 25 Q: South Carolina has not adopted the MTC proposed

- 1 regulations?
- 2 A: It has not.
- 3 Q: But they have adopted the model code's relief
- 4 provision of UDITPA, Section 18.
- 5 A: Yes.
- 6 Q: Now, is there any language in Section 12-6-2320
- 7 that says this provision is only to be used in
- 8 unique and nonrecurring circumstances?
- 9 A: Not in this statutory section, no.
- 10 Q: Are you aware of any statutes in South Carolina
- 11 that say such an alternative apportionment
- 12 formula should only be used in unique and
- 13 nonrecurring circumstances?
- 14 A: Not in South Carolina statutes.
- 15 Q: Any regulations you're aware of in South
- 16 Carolina?
- 17 A: Not in South Carolina.
- 18 Q: When were the proposed regulations, the
- 19 Multistate Tax Commission regulations that are
- 20 included as part of Exhibit Six, drafted?
- 21 A: I'm not entirely sure. I think they were in
- 22 the seventies at some point.
- 23 Q: And at the top of page one of the Multistate
- 24 Tax Commission allocation and apportionment
- 25 regulations has an adopted on date. Can you

1 read that for the Court?

2 A: Sure. Originally adopted in 1973 and then
3 revised through August 2nd, 2007.

4 Q: And that February 1973 date, that's consistent
5 with your recollection of the history of those
6 regs?

7 A: Yes.

8 Q: So since 1973, these proposed regs have been
9 published and available to the public.

10 A: Yes.

11 Q: And in that time, the South Carolina General
12 Assembly has not determined that it was
13 necessary for South Carolina to adopt those
14 proposed regulations?

15 A: I really can't speak to the intent of the
16 Assembly or their state of mind, so I -- they
17 have not done it, but I can't say that they
18 didn't intend to.

19 Q: Fair enough. Mr. Zinn, would you agree with me
20 that they are numerous definitions and meanings
21 for the term "unitary" when applied to a
22 taxpayer?

23 A: Yes.

24 Q: There are some meanings used in a tax
25 accounting context, for example?

- 1 A: Uh-huh (affirmatively responds).
- 2 Q: Possibly a different definition could be used
- 3 in an economic context?
- 4 A: I suppose.
- 5 Q: And there is a, perhaps, legal definition or
- 6 legal definitions in case law for "unitary"?
- 7 A: Various courts have provided opinions as to
- 8 what does or does not constitute a unitary
- 9 business. I don't know that there's, quote, a
- 10 hard and fast definition.
- 11 Q: Okay. So there's not a hard and fast
- 12 definition of "unitary," per se.
- 13 A: Yes.
- 14 Q: Let's go back just a second for the concept
- 15 that you were describing, a unique and
- 16 nonrecurring circumstance. You testified that
- 17 you didn't see anything all that unique about
- 18 the way the taxpayer is doing business. Is
- 19 that a fair statement of your previous
- 20 testimony?
- 21 A: Are we talking about before or after
- 22 reorganization?
- 23 Q: Well, let's talk about both. Let's start with
- 24 prior to the reorganization. Would you say
- 25 that there is anything unique about their

1 organization at that point?

2 A: No, I don't think it was unique.

3 Q: Okay. So you would describe it as common?

4 A: I wouldn't describe it as common.

5 Q: Okay. Have you seen it in other taxpayers?

6 A: Yes.

7 Q: What specifically about the structure of the
8 taxpayer or the way that the taxpayer was doing
9 business prior to its reconfiguration have you
10 seen -- what common elements have you seen in
11 other taxpayers?

12 A: I have seen other taxpayers that have business
13 operations, depending on where their business
14 operations are, splitting their company up
15 between an East and a West.

16 Q: Okay. Is there any significance to splitting
17 up a, for example, retail operation between
18 East states and West states?

19 A: As I understand it, in many cases, the way
20 companies are managed, they may have, again,
21 management structures that correspond with
22 various territories. That's a reason why I
23 know that some companies that do that.

24 Q: And in any of these other circumstances you've
25 seen where there was a splitting of a

1 nationwide or multi-state business amongst East
2 and West, were intangibles located in the
3 western portion of the retail company?

4 A: Some of them, yes.

5 Q: Okay. Are you aware of anywhere the
6 intangibles were located in the East company?

7 A: No. I'm sorry, yes.

8 Q: Okay. Approximately how many of the taxpayers
9 you're familiar with who have had a similar
10 structure have had their intangibles located in
11 an East company?

12 A: One.

13 Q: Out of approximately, ballpark, how many
14 taxpayers?

15 A: Maybe 20.

16 Q: So the vast majority of taxpayers who split
17 their business amongst East and West states
18 seem to put their intangibles in the western
19 portion of their business.

20 A: Yes.

21 Q: Okay. And would those taxpayers then have the
22 East retailers pay some fee or some portion of
23 their sales to the Western portion of their
24 business for use of those intangibles?

25 A: Yes.

1 Q: Mr. Zinn, you've examined UDITPA Section 18
2 extensively, correct.

3 A: Yes.

4 Q: And in the process, you've become very familiar
5 with Section 12-6-2320, correct?

6 A: Uh-huh (affirmatively responds).

7 Q: Tell me, in your opinion, what circumstances,
8 what hypothetical circumstances can you come up
9 with that would warrant the Department using
10 this relief provision, this statute 2320?

11 A: Well, a common opportunity for it would be when
12 there are no -- if one of the factors is
13 missing. And, in fact, it's missing from both
14 the numerator and the denominator. I've seen
15 many states throw that factor out under UDITPA.

16 Q: Okay. If a hypothetical unitary taxpayer could
17 not, for whatever reason, fairly reflect the
18 extent of its business in this State using one
19 of the standard apportionment formulas, either
20 the three-factor or the gross receipts, would
21 12-6-2320 permit the Department to require an
22 alternative apportionment method?

23 A: It would permit them to require one as long as
24 they could come up with one that was
25 reasonable.

1 MR. TRAYNHAM: I have no further questions.

2 THE COURT: Thank you very much. Any questions on
3 redirect, Mr. von Lehe?

4 MR. VON LEHE: No questions, Your Honor.

5 THE COURT: Thank you so much, Mr. Zinn. You may be
6 excused.

7 (Witness excused.)

8 THE COURT: And, Mr. von Lehe, your next witness.

9 MR. VON LEHE: Your Honor, yes, we'd like to call to
10 the stand Mr. Ron Wilder.

11 THE COURT: Mr. Wilder, please come around here to
12 our witness chair and I'll ask the court
13 reporter to administer the oath or affirmation
14 to you.

15 MR. VON LEHE: Dr. Wilder I meant to say, Your
16 Honor, rather than Mister. Please forgive me.

17 THE COURT: Pardon me, sir. We certainly want to
18 call you by your honorific title.

19 MR. VON LEHE: I mean to say Doctor.

20 THE COURT: That's quite all right.

21 RONALD P. WILDER, having been duly sworn, testifies
22 and examines as follows:

23 DR. WILDER - DIRECT EXAMINATION BY MR. VON LEHE:

24 Q: Dr. Wilder, please state your full name and
25 address.

1 A: My name is Ronald P. Wilder. I live at 707
2 Trafalgar Drive here in Columbia, South
3 Carolina.

4 Q: And I understand that you fairly recently
5 retired from the University of South Carolina?

6 A: Yes, that's right. Retirement was marked by my
7 being named Distinguished Professor Emeritus,
8 which is the University's title for folks such
9 as me.

10 Q: And prior to that time, what positions did you
11 most recently hold there?

12 A: I was at -- I was in the Department of
13 Economics in the Moore School of Business there
14 for about 36 years in various ranks and the two
15 most recent positions I held were Professor of
16 Economics and then for several years, 12 to 15
17 years, I was a chair of the Economics
18 Department, as well.

19 Q: And why are you here today? What's your
20 involvement in this case?

21 A: I was asked to study some of the facts in this
22 case with the possibility that I might be used
23 as an expert witness about the economic aspects
24 of the issues in this case.

25 MR. VON LEHE: Your Honor, at this point we would

1 like to submit Dr. Wilder's resume, which is
2 Exhibit Number Twenty-eight, into evidence.

3 **THE COURT:** Mr. Traynham, any objection?

4 **MR. TRAYNHAM:** No objection, Your Honor.

5 **THE COURT:** Without objection, then Dr. Wilder's
6 resume/CV admitted into evidence as Exhibit
7 Twenty-eight.

8 (Joint Exhibit Number Twenty-eight was admitted into
9 evidence.)

10 **MR. VON LEHE:** Your Honor, I have a series of
11 questions that I will omit if counsel has no
12 objection to Dr. Wilder being qualified as an
13 expert in economics.

14 **THE COURT:** Mr. Traynham?

15 **MR. TRAYNHAM:** We have no objection to that
16 qualification, Your Honor.

17 **THE COURT:** Without objection then, Dr. Wilder is
18 qualified as an expert in economics.

19 **Q:** Dr. Wilder, what specifically have you been
20 asked to give an opinion on in this case?

21 **A:** The two specific issues that I was asked to
22 study, first, was the question of whether the
23 taxpayer's method of computing South Carolina
24 corporate income tax fairly reflected its
25 business activities in South Carolina and,

1 secondly, to examine the unitary business
2 concept from an economic point of view.

3 Q: All right, sir. And what materials have you
4 reviewed in connection with the case?

5 A: I started with the South Carolina corporate
6 income tax returns for CarMax West and I looked
7 at the amended returns. I also looked at the
8 field audit report and the Department of
9 Revenue's finding on this case. And then I got
10 some materials from CarMax, including the
11 report of Mr. Zinn and the organizational
12 chart. I talked on the phone with Ms. Yost
13 about some of the organizational
14 characteristics the company and some of the
15 details about why CarMax was organized that
16 way. I also looked at some of the economics
17 literature on topics that I thought pertained
18 to this case. And I think the last thing that
19 I looked at was an article or two that I had
20 written in the past that dealt with vertical
21 integration.

22 Q: And did you look at anything in the area of
23 public finance?

24 A: I did consult a public finance textbook on
25 the -- dealing with the topic of concepts of

1 fairness.

2 Q: All right, sir. You may have said this, but
3 just to sort of speed things up, did you look
4 at the tax returns?

5 A: Yes, I did look at them, South Carolina tax
6 returns, the amended returns for CarMax West.

7 Q: And I think you said you looked at the audit
8 report; is that correct?

9 A: Yes.

10 Q: Did you look at the agency determination?

11 A: Yes, I did.

12 Q: And did you look at the prehearing statements
13 of the taxpayer?

14 A: Just very quickly, yes.

15 Q: Did you read the report of Phil Zinn?

16 A: Yes.

17 Q: And did you read the deposition of Dr. Glenn
18 Harrison?

19 A: Yes, I did.

20 Q: Question, does the concept of economic theory
21 include the question of where income is earned
22 and, if so, in what way?

23 A: At a general level, economics defines "income"
24 as the difference between a firm's revenues and
25 its costs. Taking that to a more particular

1 level, to the level of a particular firm or a
2 particular industry, then more detailed topics
3 about the operations of firms come into play.

4 For example, topics such as how firms decide
5 what to produce, how firms decide their
6 internal organization, whether to have -- be
7 specialized in a single product or to have
8 multiple products, whether to have vertical
9 integration among the stages of production, how
10 large to grow, and geographic location then
11 becomes a factor; also, where firms make
12 decisions based upon, on the demand side, based
13 on consumer demand, and on the supply side,
14 based on production methods, inputs, the prices
15 of inputs, wages, labor wages, and those sorts
16 of topics.

17 Q: I was going to ask you some questions about the
18 terms "unitary business" and "unitary income."
19 Does the term "unitary business," does it have
20 meaning in the field of economics?

21 A: The direct term in economics that relates to
22 the unitary business concept is the firm or the
23 business firm. There's a classic paper by
24 Ronald Coase titled the "Nature of the firm,"
25 which is one of the two or three major papers

1 that led to his being awarded the Nobel Prize
2 in economics in 1991.

3 Coase's thoughts about the nature of the firm
4 is that the firm is making choices between
5 whether to undertake activities within the firm
6 or to divide the goods and services associated
7 with those activities on the marketplace. And
8 he points out that using the market may be
9 costly, that in some cases it's more
10 economical, lower cost, to carry out the
11 activity within the firm rather than purchasing
12 the good or service on the open market.

13 And he points out that the efficiency of the
14 firm may be related to whether to produce
15 multiple products within the same firm, whether
16 to be vertically integrated, and then the
17 margin at the last step in decision-making,
18 comparing external versus internal with the
19 activities..

20 Q: Sir, you may have already answered some of
21 this, but what is the meaning of the term
22 "unitary" from an economic standpoint?

23 A: So, taking Ronald Coase's concept of the nature
24 of the firm into this area, there's a
25 well-written paper by Charles McLure, an

1 economist, that talks about the decision
2 process in deciding whether a firm is a unitary
3 business or not. He makes use of the concepts
4 in Ronald Coase's paper concerning the
5 efficiencies that can be gained by carrying out
6 activities within the firm. And in McLure's
7 view, a unitary business must meet certain
8 tests. First, does -- and the context here --
9 let me go back to the main context. The
10 context here is a multi-unit company, because
11 it's only in a multi-unit company that the
12 question of unitary business is especially
13 relevant.

14 So for a multi-unit company, the first test
15 according to McLure is whether or not the units
16 of the firm have common management and control.
17 The second test is whether or not the units of
18 the firm are interdependent at all upon one
19 another. In other words, are there
20 efficiencies gained in one unit because of the
21 existence of the other units? Is there
22 vertical integration within the firm? Are
23 there economies of scale or economies of scope
24 gained by having multiple units operate
25 together?

1 So, if there is such interdependence among the
2 units, then McLure would say that as long as
3 they're not trivial, as long as they're
4 substantial, then that passes his test of
5 whether or not a particular firm is a unitary
6 business.

7 So the key there is whether or not the multiple
8 units are interdependent upon each other. And
9 as McLure says, the purpose of the exercise on
10 unitary business is to answer the question of
11 whether or not separate accounting would be
12 appropriate and could accurately measure the
13 income of an individual unit separately.

14 So if the firm is a universal business, then
15 the point made by going through the decision
16 process on unitary business would be that it's
17 not appropriate and would be inaccurate to
18 measure the income of a separate unit within
19 that unitary business rather than measuring the
20 income of the business as a whole.

21 Q: You mentioned a term, "vertically integrated
22 business." What is a "vertically integrated
23 business"?

24 A: If we think of the stages of production running
25 at the beginning, let's say from the raw

1 material stage, if we're speaking of
2 manufacturing, then going through manufacturing
3 products, components, the assembly of
4 components into a finished good, the sale of
5 the good to the consumer, each of those stages
6 is a vertical stage in the concept of vertical
7 integration. So that a vertically integrated
8 firm is one that participates in more than one
9 of those vertical stages.

10 If you take the case of the taxpayer, CarMax
11 West, as an example, it is vertically
12 integrated in the sense that it participates in
13 the stages of purchasing used cars,
14 refurbishing used cars, selling cars, matching
15 up the buyer with finance, and carrying out
16 some of the finance activities in the CBS
17 subsidiary partnership after the
18 reorganization. So each of those is a separate
19 vertical stage and CarMax West is vertically
20 integrated in that sense.

21 Q: And is Exxon an example of a vertically
22 integrated business?

23 A: I believe it is to the extent that Exxon
24 participates in exploration, drilling and
25 production of petroleum products,

1 transportation, refining, and still directly
2 participates in retailing, that stage, as well.

3 Q: In your preparation for your testimony today,
4 did you have occasion to study the structure
5 and business functions of the taxpayer and
6 related entity both before and after the
7 reorganization?

8 A: Yes. I looked at the structure and
9 organization of the taxpayer, CarMax West,
10 before and after the reorganization.

11 Q: And did you have a conclusion as to whether or
12 not CarMax West is a unitary business?

13 A: Yes. I believe that CarMax West, together with
14 its partnership in the CBS unit, that that
15 combination is a unitary business, that it
16 shares a common management, the units within
17 those do, and that because of its vertical
18 integration and multiple service production,
19 and because of economies and efficiencies
20 related to the vertical integration in the
21 multiple service production, that the units are
22 interdependent and that with common management
23 and interdependence among the units it meets
24 the test for unitary business from an economics
25 point of view.

1 Q: And I want you to look at two different phases.
2 I believe you're talking now, since you spoke
3 of CBS, I assume you were speaking after the
4 reorganization. What about prior to the
5 reorganization when the taxpayer -- when there
6 was no CBS and there was just the taxpayer
7 itself, was that one entity a unitary business?

8 A: I believe that it was a unitary business, that
9 in addition to its retail sales of automobiles,
10 it also held the intellectual property related
11 to the trademarks and trade names and that
12 those activities were interdependent with
13 efficiencies in economies as a result of
14 carrying out both.

15 Q: What, if anything, was the relationship of the
16 royalty income paid by CarMax East to CarMax
17 West prior to the reorganization?

18 A: The royalty payments, which are made by the
19 individual stores, went to CarMax West as
20 payment for the use of the asset trademarks and
21 trade names. Those assets, the trademark and
22 the trade names, were valuable as the firm
23 developed and grew. And the familiarity of the
24 consumer with the company through its trademark
25 and trade name and business model, as has been

1 mentioned yearly in testimony today, point out
2 the value of the intellectual property. I
3 should also say that the interdependence of the
4 trademark/trade name and the retail sales of
5 used cars is related back to the unitary
6 business concept.

7 Q: After the reorganization, beginning in 2004,
8 what, if any, is the relationship between the
9 taxpayer's share of the income of CBS?

10 A: After the reorganization, now the partnership
11 CBS has ownership of the intellectual property,
12 the trademark and the trade names, it also
13 holds the auto finance company, CAF, and
14 provides corporate overhead management and
15 services. It's within the unitary business of
16 the taxpayer, CarMax West -- that is, CarMax
17 West in its retail car sales on the West Coast,
18 together with CBS, represent a unitary
19 business. It, again, meets the common
20 management control and the interdependence
21 among the units test.

22 Q: All right, sir. I want to ask you some
23 questions about whether or not that portion of
24 the taxpayer's total net income that it
25 reported in South Carolina or whether or not

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1 that which it did using the standard
2 apportionment formula, whether or not that
3 income may or may not have fairly represented
4 the extent of the taxpayer's business activity
5 in this State. And the first question I want
6 to ask you is: Were you asked to address the
7 question of whether the income reported to this
8 State by the taxpayer in using the gross
9 receipts apportionment formula fairly
10 represents the extent of the taxpayer's
11 activity in this State from an economic point
12 of view?

13 A: Yes, I was asked to study that point.

14 Q: And what was your conclusion?

15 A: My conclusion is that the method used by the
16 taxpayer, CarMax West, does fairly represent
17 the business activity in South Carolina. And
18 the question of fairness I would like to focus
19 on, what is fair in an economic sense or in a
20 public finance economic sense.

21 One of the principles of fairness that's been
22 developed is the benefit principle. The
23 benefit principle -- which probably goes back
24 to Adam Smith or one of the economists way
25 back -- the benefit principle is that those

1 individuals or firms that receive the benefits
2 of the public expenditures supported by tax
3 revenue should be the ones who pay the taxes
4 that support that public expenditure.

5 So, for example, in another area, another
6 industry, consider the gasoline tax on the
7 benefit principle. The gasoline tax supports
8 highway construction and maintenance and it
9 corresponds to the benefit principle in the
10 sense that individuals who drive vehicles pay
11 more taxes than individuals who don't drive and
12 individuals who drive further distances pay
13 more taxes than those who drive shorter
14 distances. So that's an example of the benefit
15 principle in another setting.

16 As far as the taxpayer, CarMax West, is
17 concerned, the benefit principle suggests that
18 the taxes fairly owed by CarMax West in South
19 Carolina shouldn't be very high. Why do I say
20 that? CarMax West has no employees in South
21 Carolina, no property; its only activity in
22 South Carolina is the receipt of royalties and
23 payments for other services after the
24 reorganization, so that it receives little or
25 no direct benefit from public expenditures such

1 as highways, law enforcement, schools and the
2 like.

3 Q: I believe you said you had seen and studied the
4 audit report.

5 A: Yes, I have.

6 Q: Okay. What's your opinion of the method used
7 in the audit report from an economic standpoint
8 which seeks to tax an isolated portion of the
9 taxpayer's receipts and what do you base that
10 opinion on?

11 A: The Department of Revenue's audit report
12 approach fails to take into account the unitary
13 business concept. It applies separate
14 accounting to a firm that is a unitary
15 business. Doing that, because of the
16 interdependence among the units, is likely to
17 lead to errors in calculating income and,
18 therefore, to errors in calculating tax.

19 Q: And what do you understand to be the major
20 complaint of the Department of Revenue's audit
21 report in rejecting the taxpayer's reported
22 income?

23 A: One aspect of the complaint is that the audit
24 report suggests that the income -- the
25 corporate tax income paid in South Carolina is

1 too low and that because it does receive
2 substantial revenue from South Carolina, it
3 should pay more taxes than the taxpayer states
4 in its tax return.

5 Q: What about the inclusion of car sales in the
6 denominator of the apportionment formula, is
7 that a complaint that you see in the audit
8 report or that you have heard here today?

9 A: Yes. Yes, I've heard that today and I've seen
10 it. That question of inclusion or exclusion of
11 CarMax West's car sales from the denominator of
12 the ratio also relates to the unitary business
13 concept. The other revenues that CarMax West
14 receives are related to efficiency with CarMax
15 auto sales everywhere, including those on the
16 West Coast. So, for example, the
17 trademark/trade name is valuable to the extent
18 that the retail auto stores are performing
19 well, and that they're profitable, that the
20 firm is growing and there's a circularity
21 between the success of the firm and the value
22 of the trademark and trade names.

23 Q: In your opinion as an economist, do these car
24 sales out West, do they contribute to the
25 income of the taxpayer as reported to South

- 1 Carolina?
- 2 A: Yes, they do.
- 3 Q: What would be the result if the CarMax West car
- 4 sales were not included in the denominator of
- 5 the apportionment formula?
- 6 A: If the car sales were not included, the
- 7 traditional approach of apportionment formulas
- 8 would not hold well since this is a unitary
- 9 firm, but the effect of the exclusion of the
- 10 car sales would cause the tax income -- the tax
- 11 return income liability to be overstated.
- 12 Q: And what would it do with regard to reflecting
- 13 the taxpayer's activities in this State?
- 14 A: Since I believe that the method used by the
- 15 taxpayer fairly reflects the taxpayer's
- 16 business actives in this State, then I believe
- 17 that that method the Department of Revenue
- 18 utilizes would not.
- 19 Q: All right, sir. I want to talk to you a little
- 20 bit about this financing income which is an
- 21 issue. What is your understanding concerning
- 22 the dispute about financing income, the
- 23 treatment of financing income?
- 24 A: In determining the apportionment ratio, the
- 25 taxpayer, CarMax West, excludes financing

1 income from the numerator of its ratio, while
2 the approach taken by the Department of Revenue
3 includes the financing income in the numerator.
4 So CarMax West excludes; Department of Revenue
5 includes it.

6 I believe that the approach taken by CarMax
7 West is justified and I base that opinion on
8 applying the value-added concept to the
9 production of financial services. The value-
10 added concept is the same concept used in
11 computing national gross domestic product,
12 looking at the addition in value at each stage
13 of production.

14 In terms of the financing activities, other
15 than the initial customer contact at the point
16 of sale, the production of the financing
17 service takes place almost entirely in Georgia
18 where the CBS financing unit is located
19 geographically.

20 As a result of that location and as a result of
21 the value added, primarily being in a different
22 state, in Georgia, I believe that the tax --
23 the state corporate income tax related to that
24 should be paid to Georgia and not South
25 Carolina and on that basis, I support the

1 approach to the apportionment ratio taken by
2 the taxpayer, CarMax West.

3 Q: From an economic standpoint, is there a concept
4 of matching income and expenses?

5 A: There's a general concept that to accurately
6 measure income, the income -- let me start that
7 again -- the revenues and costs of an activity
8 should be consistent with each other. So in
9 that sense, the matching of income and expense
10 is appropriate. And most of the expenses of
11 the financing activity and CBS and most of the
12 value added in the financing activity take
13 place in Georgia.

14 Q: All right, sir. I want to ask you some
15 questions about distortion. You said you read
16 the audit report.

17 A: Yes.

18 Q: Did you examine the distortion examples --
19 alleged distortion examples -- distortion
20 examples used in the audit report?

21 A: I looked at them quickly. Do we have it in
22 the ...

23 Q: Yes, we do have it. We have the audit report.
24 That would be in the first audit report.

25 MS. GEER: Number one.

- 1 Q: But I'm going to ask you a question that may
2 not require the Court's time in reading back
3 through the numbers in there, if you can answer
4 it; if not, we'll look at it. What does the
5 audit report have to say, if anything, about
6 the gross profit of the taxpayer and the gross
7 profit of CarMax East Coast?
- 8 A: The audit report points out that the rate of
9 return on gross receipts is much larger for
10 CarMax West than it is for CarMax East.
- 11 Q: And is that what this distortion example, to
12 the best of your knowledge, is all about?
- 13 A: That's --
- 14 Q: Drawing those two comparisons?
- 15 A: That's at least part of the argument.
- 16 Q: And from an economic point of view, what does
17 the relative gross profit of these two entities
18 have to do with whether or not the taxpayer has
19 reasonably -- that the income the taxpayer
20 reported reasonably represents the income
21 earned by it in South Carolina? What
22 relationship is there?
- 23 A: Well, CarMax East and CarMax West are separate
24 firms, separate unitary businesses, and as a
25 result of that, I think that comparing the

1 profitability on gross receipts of CarMax West
2 to that of CarMax East is not relevant to the
3 question of whether the income tax paid by
4 CarMax West fairly represents its business
5 activity in South Carolina.

6 Q: All right, sir.

7 MR. VON LEHE: Just one minute, Your Honor, with
8 your indulgence.

9 THE COURT: Take your time, Mr. von Lehe.

10 MR. VON LEHE: Thank you, Your Honor.

11 THE COURT: Please answer any questions Mr. Traynham
12 may have for you, Dr. Wilder.

13 MR. TRAYNHAM: Thank you, Your Honor.

14 DR. WILDER - CROSS-EXAMINATION BY MR. TRAYNHAM:

15 Q: Dr. Wilder, prior to your being hired as an
16 expert in this case or being consulted as an
17 expert in this case, I guess I should say, you
18 had no experience researching allocation and
19 apportionment of taxes, did you?

20 A: This was my first case involving that, yes.

21 Q: And the first time you've examined
22 apportionment formulas and things like that?

23 A: This case, yes.

24 Q: You're not being offered as an expert in tax,
25 are you?

1 A: No, as an expert in economics.

2 Q: You're not an expert in tax law, either.

3 A: No, my expertise is in economics.

4 Q: So when you're testifying as to your
5 understanding of the definition of "unitary,"
6 that is all, as you stated, from the economics
7 perspective, correct?

8 A: Yes.

9 Q: And would you agree with the testimony of
10 Mr. Zinn and some others that there are other
11 definitions of "unitary" floating around out
12 there that might be used in a tax accounting
13 context or a legal context?

14 A: There may be. The one that I'm focusing on in
15 this study is on the economic concept
16 identified by Charles McLure.

17 Q: Okay. And you mentioned Mr. McLure earlier as
18 someone who wrote a paper you consulted in
19 preparing for this case?

20 A: Yes.

21 Q: Is Mr. McLure someone of some significance in
22 state tax incidence?

23 A: He's a well-known public finance economist with
24 a long history of studying taxation, including
25 state taxation.

- 1 Q: Public finance is that branch of economics that
- 2 deals heavily with taxation. Would that be a
- 3 fair statement?
- 4 A: With taxation and expenditures.
- 5 Q: Is public finance one of your primary areas of
- 6 research?
- 7 A: It's something that I've been interested in,
- 8 but I have not written many papers on public
- 9 finance.
- 10 Q: It was not listed as an area of teaching and
- 11 research on your curriculum vitae, was it?
- 12 A: No, it was not.
- 13 Q: In your preparation for this case, did you
- 14 happen to read any papers from the Journal of
- 15 Regional Science?
- 16 A: No, I did not.
- 17 Q: Are you familiar with that journal?
- 18 A: Yes, I am.
- 19 Q: Is it a fairly significant publication on state
- 20 tax policy and the like?
- 21 A: I'm not aware that it has a lot of coverage of
- 22 state tax, but I haven't read it much over the
- 23 years.
- 24 Q: Okay. Fair enough. Now, Dr. Wilder, I
- 25 understood your testimony to be the taxpayer in

1 this case receives no benefit or some
2 de minimis benefit from South Carolina; is that
3 correct?

4 A: Minimal benefit from public expenditures in
5 South Carolina.

6 Q: Okay. Could you give us some examples of what
7 types of benefits you would consider
8 significant for a taxpayer?

9 A: Those public services and public expenditures
10 that support the activity of the business.
11 Those might include highways, law enforcement,
12 schools, cultural amenities, those sorts of
13 things, public expenditures.

14 Q: So police protection would be a significant
15 benefit to a taxpayer?

16 A: To most of them, yes.

17 Q: Legal protection, access to the courts, would
18 those be considered benefits to a taxpayer?

19 A: Yes.

20 Q: Dr. Wilder, you expressed that from an economic
21 perspective, the activities of CarMax West are
22 in some sense unitary with the activities of
23 CBS because of the benefits they share in and
24 amongst themselves; is that correct?

25 A: Yes.

1 Q: Would it be your position that CarMax East
2 would also be unitary with the activities of
3 CBS?

4 A: Only to a lesser extent because of the
5 ownership fraction, the lesser ownership
6 fraction that CarMax East has with CBS.

7 MR. VON LEHE: Your Honor, I may be a moment late on
8 this, but I'm going to object to this as being
9 outside the area of the direct examination, the
10 relationship between CarMax East and CarMax
11 West as to whether or not they are two unitary
12 businesses. I didn't ask Dr. Wilder any
13 questions about that, so therefore I would
14 object to his going into a new area of
15 testimony.

16 THE COURT: Well, it appears to me, certainly in
17 South Carolina, the scope of cross-examination
18 is pretty broad and really can normally relate
19 to any matter which is an issue and it appears
20 to me that the unitary nature of either of the
21 businesses has been made, is at least an
22 underlying issue, so I'm going to overrule that
23 objection and permit it.

24 You may continue, Mr. Traynham.

25 MR. TRAYNHAM: Thank you, Judge Matthews.

1 Q: Dr. Wilder, you stated that to a lesser extent,
2 both East and West are engaged in retail sales,
3 correct?

4 A: Yes, they are.

5 Q: And both receive the common management
6 services, financing services and intangibles
7 management from CBS, correct?

8 A: That's right.

9 Q: And based on -- forgive me, I've forgotten
10 which exhibit it was referred to earlier.
11 Based on the previous testimony of the
12 taxpayer, the management has a lot of
13 commonality and overflow between West and East,
14 does it not?

15 A: Yes, it does, but my focus is on CarMax West
16 because it is the taxable entity in this case.
17 CarMax East is not the taxable entity in this
18 case.

19 Q: But you testified that you had examined the
20 structure of the entire CarMax corporation, the
21 related entities, did you not?

22 A: Yes.

23 Q: All right. Dr. Wilder, you testified that CBS
24 provides significant benefits to West, that
25 West and the activities of CBS are

1 interdependent among each other. But can I ask
2 you to be a little more precise about how
3 exactly those activities benefit one another,
4 how the flows of value go back and forth
5 between CBS and CarMax West?

6 A: CBS provides services to CarMax West and, in
7 turn, the retail auto stores and CarMax West
8 pay royalties and fees to CBS, so there's an
9 exchange of money for value. Services are
10 valuable. There's an internal price set and
11 for each car which is sold, the payment is made
12 by the stores in CarMax West to CBS.

13 The services that CBS provides, based on
14 everything I've seen and heard, are valuable to
15 the successful operation of the retail stores.
16 And so that the success of the retail stores
17 depends on the quality of the business services
18 and in another sense, the value of the
19 trademark, that is now held by CBS, trademark
20 and trade names depends on the success of the
21 auto retail stores.

22 Q: Okay. So if I understand your testimony, the
23 interdependency and the values that are
24 exchanged between and amongst these entities
25 are at least partly due to the intercompany

1 flow of funds from one to another?

2 A: Well, they're measured by the intercompany flow
3 of funds. The value is measured by the
4 intercompany flow of funds.

5 Q: And these services that flow between West and
6 CBS, these are the exact same services that
7 flow between CBS and CarMax East, correct?

8 A: That's -- yes, that's my impression. The main
9 difference between the two is the ownership
10 share of CBS. So that the revenue flowing back
11 to CarMax West Coast is a greater fraction of
12 CBS income than that going to CarMax East.

13 Q: So from your perspective, that's really the
14 only difference is the ownership share of CBS?

15 A: The difference between CarMax East and West?

16 Q: (Nods head affirmatively.)

17 A: Yes.

18 MR. TRAYNHAM: Thank you, Dr. Wilder.

19 No further questions, Your Honor.

20 THE COURT: Any questions on redirect, Mr. von Lehe?

21 MR. VON LEHE: No redirect, Your Honor.

22 THE COURT: Thank you so much, Dr. Wilder. You may
23 be excused.

24 (Witness excused.)

25 THE COURT: And I believe you have one more witness,

1 Mr. von Lehe?

2 MR. VON LEHE: No, Your Honor, that concludes our
3 presentation.

4 THE COURT: All right. Thank you very much. Well,
5 Mr. Traynham, whenever you're ready, you may
6 call your first witness.

7 MR. TRAYNHAM: Thank you, Your Honor. Your Honor,
8 our first witness will be Tim Donovan.

9 THE COURT: Mr. Donovan, if you'll please come
10 around here to our witness chair and I'll ask
11 our court reporter to administer the oath or
12 affirmation to you.

13 TIMOTHY DONOVAN, having been duly sworn, testifies
14 and examines as follows:

15 MR. DONOVAN - DIRECT EXAMINATION BY MR. TRAYNHAM:

16 Q: Mr. Donovan, who is your current employer?

17 A: The South Carolina Department of Revenue.

18 Q: And how long have you been with the Department?

19 A: A little over 19 years.

20 Q: What is your current title with the Department?

21 A: I am the non-resident supervisor of audits, as
22 well as the manager of the voluntary disclosure
23 program.

24 Q: And how long have you held that title?

25 A: Roughly three years.

1 Q: And you say that you've been with the
2 Department for about 19 years, so if you could
3 just briefly outline your experience with the
4 Department prior to your taking this title.

5 A: For the first three years, I was a domestic
6 auditor in the Aiken district office, primarily
7 auditing individual income tax and sales and
8 use tax. In 1995, I moved to a non-resident
9 audit position, primarily auditing sales and
10 use tax from '95 -- well, I take that back,
11 from '93 to 1998, so I did that for five years.
12 From 1998 to 2006, I was a tax analyst in our
13 office of appeals, handling tax appeals of
14 appealed audits.

15 Q: What are your duties in your current position
16 as an audit supervisor?

17 A: As the audit supervisor, I have a staff of
18 roughly 16 auditors that audit basically
19 non-resident corporations; those are
20 corporations that are doing business in South
21 Carolina, but their primary business location
22 is located outside of South Carolina. And my
23 staff does both the corporate income tax, as
24 well as the sales and use taxes.

25 Q: Were you the audit supervisor for the

1 Department employee or employees who audited
2 the taxpayer in this case?

3 A: I was.

4 Q: So you're familiar with the taxpayer and the
5 related entities that are involved in this
6 case?

7 A: I am.

8 Q: And you've observed the testimony that's been
9 given today about the activities of the
10 taxpayer and its related entities?

11 A: I have.

12 Q: Okay. Tell me, if you would, Mr. Donovan, what
13 is your understanding of the business
14 operations of the taxpayer as it stands today?

15 A: CarMax Auto Superstores West today is
16 essentially a used car retailer in, basically,
17 primarily the West Coast states.

18 Q: And there's been a lot of testimony about the
19 reconfiguration of the CarMax company, the
20 CarMax family, so to speak, and the formation
21 of CBS, CarMax Business Services. Would you
22 tell me what your understanding is of the
23 taxpayer's operations prior to the formation of
24 CBS?

25 A: Prior to the formation of the CBS, essentially

1 you had CarMax Auto Superstores, Inc., which is
2 basically what we have referred to as CarMax
3 East, and CarMax Auto Superstores West Coast,
4 which has been CarMax West, as basically two
5 entities located up under the parent company of
6 CarMax, Inc.

7 Q: Mr. Donovan, tell me, generally, where do you
8 understand the taxpayer's retail operations to
9 take place?

10 A: CarMax West retail operations are in the West
11 Coast states, typically California and -- I
12 don't know all the locations. I think they
13 were mentioned earlier.

14 Q: And other than those retail operations, what
15 other sources of income does the taxpayer have
16 today?

17 A: Today, CarMax West gets basically flow-through
18 income from CBS, basically flowed up from that
19 partnership receipts related to auto finance
20 and royalty receipts.

21 Q: Okay. What do you understand CBS's operations
22 to be?

23 A: Basically, they manage and operate the
24 intangibles, a little bit of management and
25 overhead, as well as the receivables and

1 securitization of auto loans.

2 Q: And the other major player that we've been
3 discussing a lot today is CarMax East or CarMax
4 Auto Superstores, Inc. What do you understand
5 CarMax East's business to be?

6 A: Primarily, their business is retail store
7 locations in the East and Southeast, as well as
8 they do -- I guess they receive a small portion
9 of the same flow-through income from CBS.

10 Q: Okay. Mr. Donovan, just to summarize, it's
11 your understanding that the taxpayer in this
12 case ultimately receives some income that flows
13 through CBS that originates in East Coast and
14 Southeast retailers, including South Carolina
15 retailers?

16 A: Yeah, that's correct.

17 MR. VON LEHE: Your Honor, I'm going to object.

18 THE COURT: And your objection is?

19 MR. VON LEHE: I'm going to object to the leading
20 nature of the question, Your Honor.

21 THE COURT: Sustained. Can you rephrase,
22 Mr. Traynham?

23 MR. TRAYNHAM: Sorry, Your Honor, I was just
24 attempting to summarize, but I'll try and be
25 more direct.

1 THE COURT: I understand.

2 MR. TRAYNHAM: I'll withdraw that question for now.

3 Q: Mr. Donovan, as audit supervisor, did you
4 review the audit findings and proposed
5 adjustments in this case?

6 A: I would have reviewed them probably after the
7 findings would have went out and when the
8 protest came in.

9 Q: Did you agree with the audit findings and
10 adjustments that were proposed in this case?

11 A: I did.

12 Q: What adjustments precisely did the auditor
13 propose in this audit?

14 A: The auditor for the pre-reorganization
15 essentially was taxing the -- he basically came
16 up with an alternative apportionment method for
17 CarMax West in that he proposed that the
18 royalty income from South Carolina stores to
19 the royalty income everywhere applied back to
20 the royalty income less, you know, any
21 expenses.

22 Post reorganization, an alternative method was
23 used to essentially take the income, the South
24 Carolina income, up from royalties, as well as
25 the receipts that were sourced by the financing

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1 piece as the numerator to the -- I believe it's
2 the financing and royalty receipts received
3 everywhere.

4 Q: All right. Mr. Donovan, would you explain to
5 the Court what an "apportionment formula" is
6 and what it does?

7 A: "Apportionment formulas" are essentially
8 formulas that are designed to -- basically for
9 the taxing jurisdiction to come up with a ratio
10 of what piece of the apportionable income of
11 the taxpayer would be taxed to the state or the
12 taxing jurisdiction.

13 Q: Okay. And that ratio, that ratio you mentioned
14 earlier, something about a numerator, would
15 that be where this numerator would come into
16 play?

17 A: Correct. It's a ratio of the numerator being
18 the activity in South Carolina with the
19 denominator being the activity overall.

20 Q: Okay. So in this case, there's been a lot of
21 discussion about things included in numerators
22 and things included in denominators. If a
23 taxpayer were to include a large amount of --
24 any amount, really, of income in the
25 denominator of that ratio that were not

1 included in the numerator of that ratio, what
2 effect would that have on their tax liability
3 in this State?

4 A: Essentially, it would reduce it, if I
5 understood your question correctly.

6 Q: If a taxpayer were to exclude a portion of
7 income from the numerator of that ratio and not
8 change anything about the denominator, what
9 effect would that have on their tax liability
10 in this State?

11 A: Could you state that again?

12 Q: Sure.

13 A: If a taxpayer excludes --

14 Q: Some portion of income --

15 A: -- income from the numerator ...

16 Q: -- from the numerator, what effect would that
17 have on their tax liability in this State, all
18 other things being equal?

19 A: If you exclude it from the numerator,
20 essentially your numerator is going to be
21 smaller, so it still would depend on your
22 denominator, I believe.

23 Q: All other things being equal, you've got the
24 same denominator for two different ratios --

25 A: Uh-huh (affirmatively responds).

- 1 Q: -- and a smaller numerator --
- 2 A: It would lessen it.
- 3 Q: It would reduce their tax liability?
- 4 A: Correct.
- 5 Q: All right. Mr. Donovan, what type of
- 6 apportionment formula did the taxpayer
- 7 initially use in reporting its income tax
- 8 liability in South Carolina?
- 9 A: Initially, it used a three-factor
- 10 double-weighted sales ratio.
- 11 Q: And three-factor double-weighted sales, what are
- 12 the three factors in that formula?
- 13 A: The three factors are sales, property and
- 14 payroll.
- 15 Q: And why is it called double-weighted?
- 16 A: Because you will count the sales portion twice.
- 17 Q: And is this three-factor double-weighted
- 18 formula provided for by some South Carolina
- 19 statute?
- 20 A: It is.
- 21 MR. TRAYNHAM: Your Honor, with your permission, I'd
- 22 like to put the statute on the overhead.
- 23 THE COURT: Certainly.
- 24 Q: Mr. Donovan, do you recognize the statute
- 25 that's been underlined on this document?

- 1 A: (No response.)
- 2 Q: Can you read the statute that's been underlined
- 3 on this document?
- 4 A: 12-6-2250, is that the one you're referring to?
- 5 Q: Yes.
- 6 A: Yes.
- 7 Q: You recognize the statute?
- 8 A: Yes, I do.
- 9 Q: Is this the statute that provides for the
- 10 three-factor formula?
- 11 A: Yes, it is.
- 12 Q: If you can, Mr. Donovan, would you just read
- 13 the first couple of sentences of 12-6-2250(A)?
- 14 A: I will attempt to. It says, "A taxpayer whose
- 15 principal business in this State is, one,
- 16 manufacturing" -- and I believe it says -- "or
- 17 a form of collecting, buying, assembling, or
- 18 processing goods and materials" -- and I can't
- 19 read the rest of it -- "within this State," I
- 20 believe.
- 21 Q: Okay. That's fine.
- 22 A: It's not a very good screen up here, I'm sorry.
- 23 Q: I think it's probably a problem with the copy.
- 24 A: I've got a yellow screen and not a white
- 25 screen.

- 1 Q: Mr. Donovan, you are familiar with this statute
2 from previous experience with the Department,
3 are you not?
- 4 A: Pretty much, yes.
- 5 Q: And you are familiar with the Department's
6 application of this statute?
- 7 A: Yes, I am.
- 8 Q: What type of lines of business are taxpayers in
9 who typically file using this three-factor
10 double-weighted formula?
- 11 A: Typically it's going to be -- you know, as
12 outlined by the statute, it's going to be the
13 manufacturers, the collectors, the buying,
14 assembling and processors, you know, or any
15 selling or distributing or dealing in tangible
16 personal property within this State.
- 17 Q: So, essentially, manufacturers or retailers are
18 kind of the general broad --
- 19 A: Correct.
- 20 Q: -- types of taxpayers? And is that consistent
21 with your understanding of the statute, with
22 the Department's application of the statute?
- 23 A: Yes.
- 24 Q: And does it matter at all where those retail or
25 manufacturing activities take place in order to

1 utilize the three-factor double-weighted
2 formula?

3 A: Yes, it does. Essentially, the Department has
4 consistently said that those activities have to
5 take place within this State; that's by
6 statute.

7 Q: And you were stating earlier that the audit
8 proposed adjustments in this case changed the
9 way or proposed to change the way that the
10 taxpayer calculated their state tax liability,
11 correct?

12 A: Correct.

13 Q: And you agreed with that adjustment, correct?

14 A: Yes.

15 Q: So you felt that this formula was not
16 appropriate for this taxpayer?

17 A: That's correct.

18 Q: And why not?

19 A: The taxpayer's, in this instance, only
20 connection with South Carolina is through the
21 financing of vehicles and the receivment (sic)
22 of royalties related to intellectual property.

23 Q: And the taxpayer eventually filed amended
24 returns in this matter, correct?

25 A: That's correct.

1 Q: Do you recall when those amended returns were
2 filed?

3 A: I believe it was in September of '09.

4 Q: After the audit, initial audit had been
5 concluded?

6 A: Correct.

7 Q: What formula did the taxpayer use in those
8 returns?

9 A: They used a gross receipts formula.

10 Q: Let's see if we have any better luck with this
11 one on the overhead. Mr. Donovan, do you
12 recognize this statute?

13 A: I do.

14 Q: Does this appear to be the statute that
15 provides for the formula you just referred to?

16 A: It does.

17 Q: And, if you could, just read that first portion
18 of the statute for tax years through 2010.

19 A: "If the principal profits or income of a
20 taxpayer are derived from sources other than
21 those described in Section 12-6-2250 or Section
22 12-6-2310, the taxpayer shall apportion its
23 remaining net income using a fraction in which
24 the numerator is gross receipts from within
25 this State during the taxable year and the

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1 denominator is total gross receipts from
2 everywhere."

3 Q: So there's no restriction in this statute on
4 nonretailers or nonmanufacturers using it, is
5 there?

6 A: Correct. This is essentially a catchall for
7 anybody other than the ones outlined in other
8 two statutes.

9 Q: So what's wrong with the taxpayer using the
10 gross receipts formula in this case?

11 A: In this case it still did not accurately
12 reflect the business that was carrying on in
13 this State.

14 Q: What did the auditors proposed adjustment of
15 the taxpayer's return do so differently from
16 the three-factor formula and the gross receipts
17 formula?

18 A: Essentially, we looked at the business that was
19 taking place within this State, which was the
20 finance income and the royalty income or the
21 business -- essentially the business of CarMax
22 Business Services in those years.

23 Q: Was the formula that the auditor proposed
24 provided for by statute?

25 A: It is an alternative formula under the statute.

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1 Q: And what statutory authority does the
2 Department have for requiring or using an
3 alternative apportionment formula?

4 A: I believe it's found later in the statute,
5 under 23 -- I'm not good with citing the code,
6 but ...

7 Q: Is it the statute that we've been discussing
8 today, Mr. Donovan?

9 A: It is.

10 Q: 12-6-2320 ring a bell?

11 A: That would be it.

12 Q: Mr. Donovan, if you would, just read the
13 opening paragraph of 12-6-2320.

14 A: Section A?

15 Q: Yes, please.

16 A: "If the allocation and apportionment provisions
17 of this chapter do not fairly represent the
18 extent of the taxpayer's business activity in
19 this State, the taxpayer may petition for, or
20 the Department may require, in respect to all
21 or any part of the taxpayer's business
22 activity, if reasonable."

23 Q: Okay. I'll stop you there. Mr. Donovan, the
24 statute clearly says, "If the allocation and
25 apportionment provisions do not fairly

1 represent the extent of the taxpayer's business
2 activity in this State" -- so there's an "if"
3 at the beginning of this statute -- how
4 precisely did the taxpayer's chosen method of
5 apportioning its income in South Carolina fail
6 to fairly apportion or represent its business
7 activity in this State?

8 A: I'm sorry, can you restate that?

9 Q: How did the taxpayer's chosen method of
10 apportionment fail to fairly reflect the extent
11 of its business in this State?

12 A: The taxpayer's chosen method, even after
13 amending returns to a gross receipts method,
14 continued to basically understate the -- or did
15 not fairly represent the activity within this
16 State.

17 Q: Mr. Donovan, I'd like to refer you to proposed
18 Exhibit Twelve in the exhibit notebook.

19 A: (Witness complies.)

20 Q: Just let me know when you've gotten there.

21 A: I am there.

22 Q: Okay. Mr. Donovan, can you tell the Court what
23 this document is precisely?

24 A: This is just an example that I had drawn up to
25 kind of illustrate the distortion of basically

1 an East/West operation.

2 Q: So you created this document?

3 A: Yes.

4 Q: And just to be as clear as possible, you stated
5 the word "distortion," distortion is up at the
6 top of this document. What precisely does
7 "distortion" mean in this context?

8 A: "Distortion" in this context is just to simply
9 show the tax savings or the reduction in tax by
10 employing this method.

11 MR. VON LEHE: Your Honor, if I may.

12 THE COURT: Yes.

13 MR. VON LEHE: I'm going to object to any testimony
14 concerning this exhibit, as this exhibit, and
15 another which follows it, show a computation --
16 which sort of my fears have now been realized
17 as to where this is heading. Do you remember
18 I objected -- this will take just a minute,
19 because it's a pretty big thing, it really is.

20 THE COURT: Whatever you've got to say,
21 Mr. von Lehe, I want to hear.

22 MR. VON LEHE: It's a very big change in direction,
23 shall we say, as to what's being looked at for
24 this taxpayer.

25 About two days ago, I guess it was, after all

1 these months, after we've been through this
2 audit report, we've protested it, we've come to
3 this Court, a new method of computing this
4 taxpayer's income is being proposed.

5 Now, it is not being proposed for purposes of
6 asserting a tax on this taxpayer, but it is
7 being proposed for showing, quote, distortion.

8 And what these figures represent, and what it
9 is of certainty that Mr. Donovan is going to be
10 asked to testify to, is that if you take the
11 income of CarMax East and you combine that
12 income with CarMax West, Your Honor, they're
13 going to say, "We want you to see that result."

14 I don't want you to see that result, because
15 that result is completely -- number one, it had
16 nothing to do with the preparation of this
17 audit report, because it's not in the audit
18 report. This will -- if need be, that will
19 have to be conclusively on cross-examination.

20 But this thing was never a part of why they did
21 this to this taxpayer. Never was a part of
22 that consideration.

23 Now, two days before the case is to be tried,
24 this combination of combining the income of two
25 entities comes to the forefront as something to

1 show you. We object to that for the following
2 reasons: It had nothing to do with the way
3 this taxpayer's income was taxed or their
4 reasons for taxing this taxpayer, because it's
5 never been seen before and it's not in the
6 audit report. It's not even in the audit
7 report after we filed the amended returns,
8 which have been fairly recently as have been
9 mentioned here a number of times today.

10 So any combination, which a different method of
11 taxation, which has not been proposed prior to
12 a couple days ago and which is being shown to
13 Your Honor for a reason to show you, "Look, if
14 we combine these two entities, look at what all
15 the income would be," we consider it to be
16 completely irrelevant to the question that is
17 before Your Honor and, quite frankly, I don't
18 want you to see that. I think it's prejudicial
19 to the taxpayer because it has not been used in
20 the preparation of the audit report and,
21 therefore, Your Honor, that is our objection.

22 **THE COURT:** Mr. Traynham?

23 **MR. TRAYNHAM:** Your Honor, I think there are several
24 things that I need to address there. As a
25 preliminary matter, we are proposing this

1 exhibit as demonstrative, not as substantive
2 evidence, simply to explain the concept of
3 "distortion." To that end, I think that the
4 objections Mr. von Lehe have raised go to the
5 weight of the evidence rather than its
6 admissibility. I believe we have already heard
7 testimony from Ms. Yost that in other states,
8 specifically the states in which the taxpayer
9 does retail business, it files on a combined
10 basis.

11 We are simply using the combined basis of
12 reporting as a comparison. We are not asking
13 the Court to impose combined reporting on the
14 taxpayer in this case. It's simply another
15 barometer for the Court to consider and give
16 whatever weight it feels is worthwhile in
17 considering whether or not distortion has
18 actually occurred in this case.

19 To the extent that the taxpayer was only given
20 two days notice on this, no exhibits were
21 exchanged prior to two days from today, so I
22 don't think that that's really all that
23 important here.

24 **THE COURT:** Well, Mr. Traynham, does CarMax East
25 file in South Carolina?

1 MR. TRAYNHAM: CarMax East?

2 THE COURT: Does?

3 MR. TRAYNHAM: Yes, ma'am.

4 THE COURT: Okay. But there's no debate, at least
5 it's not before me, with respect to any
6 taxation issue at all with CarMax East, right?

7 MR. TRAYNHAM: That's correct.

8 THE COURT: Okay. I mean, this is only the
9 relationship between CBS and CarMax West and
10 whether or not CarMax West has paid taxes based
11 on a valid computation which was a fair
12 allocation throughout.

13 So I'm going to sustain the objection of
14 Mr. von Lehe to this exhibit and this analysis,
15 because if it's -- and this is my, right now,
16 layman's interpretation of this, but if it is
17 a distortion that's being exhibited, it appears
18 to me that would have to be inherent to
19 whatever CarMax West has filed and at least in
20 this State, since they don't file jointly or in
21 combination, it has no real -- I mean, I can
22 see that you might -- you could argue that it's
23 relevant because it does show if you combine
24 them together how the distortion. But to this
25 particular case before me, I don't think it's

1 relevant and I think its prejudicial effect
2 would outweigh its probative value, even though
3 I'm the finder of fact and I can, you know,
4 discount it or give it such weight as I deem it
5 merits. But in this particular instance, I'll
6 sustain Mr. von Lehe, that it's not relevant to
7 this inquiry and could be prejudicial.

8 MR. VON LEEHE: Thank you, Your Honor.

9 MR. TRAYNHAM: Your Honor, if may.

10 THE COURT: You'd like to make a proffer of it for
11 the record?

12 MR. TRAYNHAM: I would like to make a proffer of it
13 for the record, Your Honor.

14 THE COURT: Okay.

15 MR. TRAYNHAM: And just for completeness of the
16 record, Your Honor, part of the testimony that
17 we are going to be presenting is that this
18 structure is part of a tax-savings mechanism;
19 part and parcel of that tax-saving mechanism is
20 the mechanism of the combined reporting method.
21 So that adds to the relevance of it.

22 However, that being said, Your Honor, would it
23 be possible to request a five minute recess to
24 redact these exhibits to exclude the combined
25 reporting portion of it and present a secondary

1 exhibit in order to --

2 THE COURT: That refers only to CarMax West and CBS,
3 not the combined. Is that what you want to do?

4 MR. TRAYNHAM: Yes, Your Honor.

5 THE COURT: Sure.

6 MR. TRAYNHAM: Just to exclude -

7 THE COURT: Yeah, we've been going for, gosh, an
8 hour and 45, anyway. Yeah, let's take -- I've
9 got ten to 4:00. Let's come back at five after
10 4:00.

11 MR. TRAYNHAM: To be clear, Your Honor, we would be
12 proposing to exclude that portion of both
13 Twelve and Thirteen --

14 THE COURT: Both of those two demonstrative
15 exhibits.

16 MR. TRAYNHAM: -- that include the "combined"
17 heading.

18 THE COURT: Okay. Great. Thank you, sir.

19 (Break taken from 3:41 to 3:54 p.m.)

20 THE COURT: All right. Mr. Traynham, whenever
21 you're ready, you may continue.

22 MR. TRAYNHAM: Thank you, Your Honor. I apologize,
23 Your Honor. I only made a single copy. I'll
24 have to make more copies for later.

25 THE COURT: We can make more copies, if you need

1 them, Mr. Traynham.

2 **MR. TRAYNHAM:** If I may approach the witness?

3 **THE COURT:** Certainly.

4 **Q:** Mr. Donovan, this is a redacted version of the

5 document we were just discussing a minute ago.

6 **MR. VON LEHE:** Your Honor, I have to see my copy.

7 **MR. TRAYNHAM:** I apologize.

8 **MR. VON LEHE:** If I could have just a moment to take

9 a look at it.

10 **THE COURT:** Certainly.

11 **MR. VON LEHE:** Your Honor, I looked at it -- not to

12 interrupt. I'm sorry if I did.

13 **THE COURT:** No, you're not. I was just looking to

14 see ...

15 **MR. VON LEHE:** But I did look at it. I see where

16 the combined reporting has been taken out. As

17 for the rest of it, I'd like to hear what he's

18 got to say about it before I decide whether I

19 have any objection to it. But I do see where

20 the combined reporting has been taken out.

21 **THE COURT:** Certainly.

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

23 **THE COURT:** Well, go ahead and ask questions

24 regarding this exhibit -- or not admitted as an

25 exhibit yet, but regarding whatever this

1 compilation is, Mr. Traynham.

2 MR. TRAYNHAM: Your Honor, could we possibly make
3 some extra copies of that before we proceed?

4 THE COURT: Sure.

5 (Off the Record)

6 MR. DONOVAN - PROFFERED DIRECT EXAMINATION BY MR.
7 TRAYNHAM:

8 Q: Mr. Donovan, you're now looking at a redacted
9 version of the document we were just
10 discussing, correct?

11 A: Correct.

12 Q: And you stated that you created this document?

13 A: Yes.

14 Q: What was the purpose for creating this
15 document?

16 A: Essentially, just to kind of show the outline
17 of the East and West operations --

18 Q: Okay.

19 A: -- and how they're taxed.

20 Q: Okay. And the title of this document is
21 "distortion example." I think we were just
22 beginning to discuss it. Would you tell the
23 Court again what is meant by "distortion" in
24 this context?

25 A: Essentially, "distortion" is kind of to just

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1 show how much less income is attributed to
2 South Carolina.

3 MR. VON LEHE: Your Honor, if I may.

4 THE COURT: Yes.

5 MR. VON LEHE: A hypothetical example, which I
6 understand this to be, I'm going to object to
7 this as being irrelevant. There's no reason
8 for a hypothetical example in this case. We
9 have to take this taxpayer's income and look at
10 its activities in South Carolina; otherwise, it
11 is irrelevant.

12 And I'm also not sure about how a hypothetical
13 example fits into what we're trying to
14 accomplish in this case and I assume that
15 objection also goes to the relevancy. So that
16 is my objection.

17 THE COURT: Okay. Mr. Traynham?

18 MR. TRAYNHAM: Your Honor, we've used hypotheticals
19 in almost all of our examination today. We use
20 hypotheticals in the courtroom every day.
21 Again, this is simply a demonstrative. It's an
22 illustration that will hopefully allow
23 Mr. Donovan to better explain to the Court the
24 concept of "distortion" before we get into the
25 specifics of this taxpayer.

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1 THE COURT: In that regard, as a demonstrative
2 exhibit only, to explain what "distortion" is
3 I'll permit the questions.

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

5 THE COURT: And you may cross-examine as thoroughly
6 as you'd like, Mr. von Lehe.

7 MR. VON LEHE: Thank you, Your Honor.

8 MR. TRAYNHAM: Thank you, Your Honor. Do I
9 understand that to mean this is admitted as an
10 exhibit, Your Honor?

11 THE COURT: My understanding was it was going to be
12 a demonstrative exhibit.

13 MR. TRAYNHAM: As a demonstrative, Your Honor?

14 THE COURT: Yes.

15 (Proffered Joint Exhibit Numbers Twelve and Thirteen
16 were admitted into evidence.)

17 Q: Mr. Donovan, the first column or heading
18 underneath the title of this document is "East
19 Coast Company." There are kind of a sea of
20 numbers here. Can you tell the Court where
21 these numbers are coming from?

22 A: Again, this was just put together as an
23 example. And to kind of give you a little
24 background as to what the example is, is
25 essentially what we're looking at is the East

1 Coast operations with \$5 million worth of
2 sales, a million dollars' worth of property, a
3 million dollars' worth of payroll and before
4 any royalty payments or any other items, it
5 would essentially -- or but for any royalty
6 payments, this company would make one million
7 dollars for the tax year.

8 Q: For South Carolina purposes?

9 A: That would be their apportionable income.

10 Q: But for the royalty payment?

11 A: But for the royalty payment.

12 Q: And each of these categories, you've got sales
13 twice, property and payroll, across from them
14 and then pass the sales numbers, there's a
15 ratio of -- it appears to be 20 percent.

16 A: That's correct.

17 Q: Where is that ratio coming from?

18 A: Essentially, this is taking a three-factor
19 formula with the double-weighted sales. So the
20 example is basically to show that essentially
21 20 percent of the business is in South
22 Carolina. So you have a million dollars' worth
23 of sales counted twice. You have property of
24 200,000 and payroll of \$200,000 all taking
25 place in South Carolina. You have five million

1 dollars' worth of sales, a million dollars'
2 worth of property, a million dollars' worth of
3 payroll, those occurring company-wide. The
4 factors are basically added together and then
5 divided by our four factors, or by a number of
6 four, which gives us basically the South
7 Carolina taxable ratio when applied back to
8 apportionment income.

9 Q: Okay.

10 A: In this example for East Coast, we are making
11 an assumption or basically highlighting that in
12 this particular instance, East Coast is paying
13 West Coast a five percent royalty on all of its
14 sales.

15 So with that, East Coast's apportionment income
16 would be reduced by the amount of royalty that
17 was paid to West Coast. So the apportionment
18 income for East Coast would be the \$750,000.
19 When multiplied by the South Carolina ratio,
20 you have a South Carolina taxable income of
21 150,000 with a tax amount due of 7500.

22 Q: Okay. And these ratios for sales, property,
23 payroll, things like that, this is the
24 numerator over the denominator concept you were
25 talking about earlier?

1 A: That's correct. The "South Carolina" and the
2 column to the left, essentially, would be your
3 numerators. The column for "everywhere" is
4 your denominator.

5 Q: And down below that is double-weighted sales
6 ratio of 80 percent and another number beneath
7 that is 20 percent. Is that what you referred
8 to as the "South Carolina" ratio?

9 A: Correct. The 80 percent is the sum of the four
10 ratios and then the 20 percent is dividing it
11 by the number of ratios that we were looking
12 at.

13 Q: So the bottom line in this example, this
14 generic example, is the East Coast company
15 would have a tax liability in South Carolina of
16 \$7500?

17 A: That's correct.

18 Q: Now, tell us again, why is sales listed twice?

19 A: Under the statute, it's a double-weighted sales
20 formula.

21 Q: That's just the way the statute reads?

22 A: Correct.

23 Q: Now, what's going on in the West Coast company?
24 Take us through that briefly, if you could.

25 A: With the West Coast company, again, we're

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1 basically going under the assumption that West
2 Coast would have a million -- I mean, five
3 million dollars' worth of retail sales, a
4 million dollars' worth of property and a
5 million dollars' worth of payroll.

6 Again, West Coast essentially, in this example,
7 is receiving a five percent royalty from East
8 Coast. So that's why you will see that your
9 sales are increased from five million to
10 5,250,000.

11 When tracking for your South Carolina portion
12 of your numerator for sales, it's basically the
13 royalty rate of five percent times the South
14 Carolina sales of a million dollars, which gets
15 you to the \$50,000. You would then, basically,
16 calculate your four factors. In this
17 particular instance, West Coast, as the
18 operations does not have any property or
19 payroll in South Carolina, so essentially they
20 would only calculate two factors and divide it
21 by the four.

22 MR. VON LEHE: Your Honor, by your leave, I'm going
23 to object again to this. It may be
24 hypothetical, it may be an illustration, but
25 these assumptions have nothing to do with the

1 case. I don't know where -- without his laying
2 a background as to why he's using these numbers
3 and making these assumptions, I can see no
4 relevance to this and, in fact, it appears to
5 me to be prejudicial.

6 THE COURT: Mr. Traynham?

7 MR. VON LEHE: Evidence to show distortion with no
8 foundation presented.

9 MR. TRAYNHAM: Your Honor, again, it's simply an
10 illustration.

11 THE COURT: Well, you know what would be really
12 helpful, if somebody would give -- I was just
13 starting to think about this. I need some
14 numbers if I'm going to make a decision in this
15 case. I don't really have the numbers. I
16 mean, I obviously can go through and pull out
17 every one of these tax returns and the amended
18 tax returns. But I truly do not understand, if
19 they aren't paying enough -- I don't understand
20 the threshold issue right now of when do you
21 decide -- when does the Department decide that
22 it's not fair, that what they're doing is not
23 fair? I truly do not have a grasp of that.
24 And if you can get somebody to answer that,
25 Mr. Donovan, or with Mr. Harrison, I would be

1 glad to understand that. But I don't
2 understand how just looking at the raw numbers
3 which they filed tax returns the Department can
4 look at them and say "not a fair
5 apportionment." That's what's perplexing me
6 about this statute.

7 So if you can -- and maybe you're going there,
8 Mr. Traynham, but right now I'm kind of baffled
9 about -- I'm as baffled about this as any case
10 I've ever had in 11 years as far as what is --
11 how the agency makes a determination to do
12 something other or decides that what the person
13 has submitted is incorrect.

14 So I'm really not trying to be obtuse here.
15 I'm just trying to get at the heart of the
16 matter. So I'd appreciate any direct and/or
17 cross-examination that can elucidate some of
18 that.

19 **MR. TRAYNHAM:** Your Honor, I think that's --

20 **THE COURT:** I mean, you both wrote beautiful briefs
21 and I thought I understood this thing. But I
22 truly, again, do not understand how you get
23 from, "We filed X number of tax returns every
24 year," and then all of a sudden the Department
25 looks at it and goes, "Not a fair amount." How

1 does that determination come about?

2 MR. TRAYNHAM: Well, Your Honor, I think we're
3 trying to get to that with the illustration in
4 this case.

5 THE COURT: Okay.

6 MR. TRAYNHAM: If it's not clear from the
7 illustrations, then I can try and elicit that
8 from testimony.

9 THE COURT: Well, I guess I'm kind of agreeing with
10 Mr. von Lehe on this one. I mean, let's take
11 the actual numbers that are shown on the
12 returns and how the Department -- who in the
13 Department looked at it and said, "It's not
14 fair." I don't see any definition of
15 "fairness" or how you determine what isn't
16 fair. Hadn't heard of any revenue rulings or
17 anything that interprets that provision to say
18 what is or what isn't fair. So I'm a little
19 lost here. This is pretty far into the case.
20 So I don't mean to interrupt you, Mr. Traynham.
21 I'm just trying to give some direction to
22 everybody here.

23 MR. TRAYNHAM: Certainly, Your Honor.

24 THE COURT: Okay.

25 MR. TRAYNHAM: And I can understand that, Your

1 Honor. There is no statutory definition of
2 "fairness." It is -- and I may be crossing
3 into some argument here and I hope I'm not, but
4 just to try and help the Court out.

5 **THE COURT:** Sure.

6 **MR. TRAYNHAM:** I believe that the testimony we've
7 elicited thus far from Mr. Zinn, the testimony
8 we'll elicit later, is such that it is a
9 case-by-case determination.

10 **THE COURT:** Yes, I understand that. And I
11 understand that they contend, of course, that
12 it's unitary and you contend that it's not.
13 And you both are referring to the standards
14 established in Section 18 of UDITPA. And
15 you're saying it doesn't apply and they're
16 saying it does. I understand that part of it.
17 But I still don't understand how just when you
18 start getting raw tax returns in, you look at
19 it and say, "Not fair computation." That's
20 what's not clear to me.

21 Okay. Like I said, you both wrote beautiful --
22 Ms. Geer and Mr. Traynham, beautiful briefs,
23 very well written out. I think I understand
24 it. I just don't understand the particulars of
25 how you get to the threshold analysis.

1 MR. TRAYNHAM: Your Honor, if I may. It may be
2 helpful, if there's no objection to it, if we
3 move on to the illustration that uses the
4 actual numbers --

5 THE COURT: That would be most helpful.

6 MR. TRAYNHAM: -- from the taxpayer's return.

7 THE COURT: That you, sir. I think that would be
8 helpful.

9 MR. DONOVAN - DIRECT EXAMINATION (Continued) BY MR.
10 TRAYNHAM:

11 Q: Mr. Donovan, do you have that example in front
12 of you?

13 MR. VON LEHE: Your Honor, may I for a second --

14 THE COURT: Sure.

15 MR. VON LEHE: And perhaps you would want to
16 consider this later, but am I to understand
17 that my objection to these hypothetical numbers
18 is sustained?

19 THE COURT: Yes, I'll sustain that. It's just
20 confusing me.

21 MR. VON LEHE: Thank you, Your Honor.

22 THE COURT: And confusing me is not the basis of
23 my -- I agree with you, that I don't believe
24 that whatever probative value they have is
25 outweighed by the prejudicial effect as set

1 forth in Rules 401 and 403, and that's why I'm
2 excluding it, for the record.

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

4 **MR. TRAYNHAM:** Thank you.

5 Q: Mr. Donovan, just to briefly lay a foundation
6 here, are you familiar with this second
7 document?

8 A: I am.

9 Q: Can you tell the Court what this document
10 shows?

11 A: This document shows basically the factor filing
12 for CarMax East Coast, as well as CarMax West
13 Coast's operations as originally filed, plus as
14 amended in September of '09.

15 Q: So the numbers on this document are taken
16 directly from the filings of the taxpayer in
17 this case?

18 A: That's correct.

19 **MR. VON LEHE:** Your Honor, I need to make sure that
20 I have a copy of what he's looking at, if I
21 may.

22 (Off the Record)

23 Q: Mr. Donovan, if you would, just read the
24 heading at the top of this document for us.

25 A: This document says "Distortion Example CarMax

1 Superstores Period Ending 2/28/2006."

2 Q: Is there anything significant about the '06 tax

3 year?

4 A: No.

5 Q: Was this year just chosen as an arbitrary

6 example of the issue that the Department took

7 in this matter?

8 A: Yeah, it would probably just most likely been

9 the returns that were sitting on top at the

10 time.

11 Q: Fair. Would this document assist you with your

12 testimony in this matter?

13 A: I believe so.

14 MR. TRAYNHAM: Your Honor, with that I would offer

15 this into evidence.

16 THE COURT: And this is what number?

17 MR. TRAYNHAM: I don't believe that this one was

18 premarked since it's a redacted version.

19 THE COURT REPORTER: Thirty-one

20 MR. TRAYNHAM: Thirty-one.

21 THE COURT: All right, then. There's no objection

22 to that, Mr. von Lehe?

23 MR. VON LEHE: Your Honor, we don't have an

24 objection. I would like to hear -- if you

25 don't mind, I would like to hear what is in

1 here. Just have Mr. Donovan describe what this
2 is, not why it causes distortion. Then I'll be
3 able to tell you whether I object to it or not.
4 You know what they have written in front of me
5 here, what is this?

6 **THE COURT:** All right. And I'm sure Mr. Traynham
7 will lay a foundation for that.

8 **MR. TRAYNHAM:** Certainly.

9 **THE COURT:** And he can look at it further if he
10 wants, Mr. von Lehe.

11 **MR. VON LEHE:** Thank you.

12 **MR. TRAYNHAM:** Certainly, Your Honor.

13 **Q:** Mr. Donovan, if you would, just tell us a
14 little more detail about what this document
15 contains, where the numbers come from, and what
16 it conveys.

17 **A:** Starting with the East Coast company as filed,
18 this is CarMax East. Where you see "sales,
19 property and payroll," you'll see a heading of
20 "South Carolina" a heading of "everywhere" and
21 a heading of "ratio." Each in that column
22 comes directly from the -- I believe it's the
23 H-1 schedule on the return that was filed.
24 Where you see "apportionment" -- if you move to
25 the right, you'll see a column that starts with

1 "apportionable income, 67 million," that would
2 be the apportionable income directly from the
3 return.

4 Again, the "South Carolina" ratio is coming
5 directly from the return; near "South Carolina
6 taxable income and tax due" come directly from
7 the face of the South Carolina 1120 for East
8 Coast company.

9 Moving on to West Coast company as originally
10 filed. Again, these figures are coming with
11 the sales, property and payroll are coming from
12 the H-1 schedule of the return. The
13 apportionable income, South Carolina ratio and
14 South Carolina taxable income indexed to all
15 come from the face of the return.

16 West Coast as amended, you'll see gross
17 receipts ratio as amended by taxpayer on
18 9/10/09; the gross receipts, again, of 1.2
19 million; and the gross receipts everywhere of
20 1.2 billion, come directly from the schedule
21 from the tax return. Apportionable income
22 didn't change on the amended return. The ratio
23 moved up a little bit and the additional tax
24 due or the tax due for that return as amended
25 was 7759.

1 Q: Mr. Donovan, what on this document is important
2 to you in conveying the concept of distortion
3 or in assisting in your testimony?

4 A: Well, it's this document as well as everything
5 that -- as far as the whole business structure
6 of the taxpayer. As you can see, most of the
7 operations or the -- most of the sales and
8 operations take place in the East Coast
9 company, which has -- the majority of the
10 stores are located in the East Coast.

11 What you also see is the sales that are
12 received for the West Coast company. Roughly,
13 they're showing gross receipts everywhere of
14 1.2 billion for the West Coast company. And
15 then kind of analyzing that, you know, the
16 apportionable income for the East Coast being
17 67 million, where the apportionable income with
18 a tremendous amount of less -- lesser amount of
19 sales has risen to the, you know, 159 million
20 dollars' worth of apportionable income. So
21 those are the type of things that the auditor
22 would have probably looked at and to dig a
23 little bit further as to, you know, why these
24 differences take place.

25 Q: Okay. Would the differences in the South

1 Carolina ratios have anything to do with the
2 auditor's interest?

3 A: Well, the first thing that would have probably
4 brought -- you know, once the auditor realized
5 that West Coast did not have any retail
6 operations in South Carolina, you know, the
7 first thing would have caught his eye is
8 that -- you know, the four-factor formula did
9 not apply.

10 MR. VON LEHE: Your Honor, I hate to slow things
11 down, but this is hearsay, of course, his
12 testifying as to what the auditor may have
13 done, may have thought, et cetera, et cetera,
14 et cetera. If they want to rephrase that and
15 put it in terms of what Mr. Donovan feels, then
16 obviously that's a different story. So
17 objection is on hearsay.

18 THE COURT: I'll sustain that.

19 MR. TRAYNHAM: I'll restate the question.

20 Q: Mr. Donovan, what do you instruct your auditors
21 as audit supervisor to look for in determining
22 whether or not to audit a non-resident
23 taxpayer?

24 A: Essentially, they're -- we teach them to look
25 at business structures. Since the Geoffrey

1 case, we've seen several different things
2 evolve in tax strategies of corporations. You
3 know, originally, you know, in a simple
4 Geoffrey case, you would have had CarMax Auto
5 Superstores East just paying a, you know,
6 Delaware holding company. And, you know, once
7 Geoffrey was decided upon, you know, we started
8 seeing a shift towards what we would call a
9 second tier Geoffrey, is that, you know, one
10 company such as CarMax East may pay CarMax West
11 a royalty fee and then CarMax West would turn
12 around and sublicense it out to CarMax Business
13 Services. And so it was one item removed, one
14 step removed and --

15 **THE COURT:** Mr. von Lehe?

16 **MR. VON LEHE:** Your Honor, objection based on
17 speculation. If this is directed at this
18 taxpayer, it's pure speculation.

19 **THE COURT:** Well, I'm going to overrule that. It
20 appears to me Mr. Donovan is just testifying
21 about the general procedure when they have what
22 he refers to as a second tier Geoffrey
23 situation and he hasn't even said this is one.

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

25 **THE COURT:** But my understanding is he's just

1 testifying as to his knowledge of that
2 situation.

3 **THE WITNESS:** And I'll try not to use CarMax as part
4 of the example as we go on.

5 A: So, essentially, we would have a Company A
6 paying Company B a royalty that was then paying
7 Company A another royalty. Federally, all of
8 this gets rolled up and just taxed normally as
9 income, as federal taxable income. But for
10 separate entity states, everything is broken
11 down to the separate entity.

12 And so after -- the second tier royalties kind
13 of faded away in the sense that -- I guess for
14 some reason we're starting to see them fade
15 away, but -- now, this is like something new
16 that the Department is seeing in which the
17 royalty piece will be placed into the West
18 Coast. The East Coast stores will pay the West
19 Coast and then the West Coast stores
20 essentially try to take a benefit of being able
21 to reduce their South Carolina ratio by
22 including all of these other receipts and
23 factors.

24 **MR. VON LEHE:** Your Honor, if I may, I am going to
25 object to this. This does seem to be directed

1 at us.

2 MR. TRAYNHAM: Your Honor, I think I can clarify
3 that.

4 MR. VON LEHE: And I see no background for that. I
5 find no -- there is no background laid for
6 that. If he's saying that CarMax did this,
7 which is what this seems to be, there is
8 absolutely no background have been laid as to
9 how he might know that or not know that.

10 THE COURT: Okay. Yeah, Mr. Traynham, can you
11 clarify exactly what we're talking about here,
12 whether it's CarMax or generic or ...

13 MR. TRAYNHAM: If I can have a little leeway to ask
14 a question of Mr. Donovan.

15 THE COURT: Sure.

16 Q: Mr. Donovan, are you saying that you have seen
17 this West/East scenario that you're describing
18 in other taxpayers?

19 A: Yes, I have seen them in other taxpayers.

20 Q: And you would describe this as a red flag for
21 your auditors to look for?

22 A: That's correct.

23 Q: Mr. Donovan, you described the red flag
24 scenario as a West/East situation. Can you go
25 into a little more detail about why that would

1 concern the Department -- I'll leave it at
2 that.

3 A: It concerns the Department because,
4 essentially, it's -- you know, we see basically
5 the intellectual property moving from location
6 to location and all of this money is being paid
7 into basically a company which has, you know,
8 very little representation in South Carolina,
9 other than the intellectual property. When --
10 you know, when it's done in this method,
11 essentially the amount of tax liability is
12 reduced drastically.

13 Q: And why is the tax liability of generic
14 taxpayer reduced in South Carolina under this
15 scenario?

16 A: Because they're essentially paying out -- the
17 royalty expense that is born by the East Coast
18 store is essentially deducted and that income
19 is basically transferred to another entity
20 outside of South Carolina.

21 Q: Okay. And does that entity then not pay tax in
22 South Carolina?

23 A: We still contend that they do have a filing
24 requirement and should be paying taxes in South
25 Carolina.

1 Q: And do these West Coast entities you're
2 describing pay tax in South Carolina?

3 A: Generally, most of them do; some of them don't.

4 Q: So what's the problem for the ones that do pay
5 tax in South Carolina?

6 A: The ones that are paying, again, are either --
7 their income is still -- it's distortive in
8 that, you know, it doesn't accurately reflect,
9 you know, the business within South Carolina.

10 MR. VON LEHE: Your Honor, I keep getting the
11 feeling this is directed at CarMax. If not,
12 I'll wonder why he's even talking about this.
13 Number one, if it's not being directed at
14 CarMax, then it's completely irrelevant, okay?
15 Number two -- this is an objection. Number
16 two, if it is being directed at CarMax, there's
17 been absolutely no background shown as to why
18 this is distortive and he says it's distortive
19 and gives no reason for it --

20 THE COURT: Mr. Traynham -

21 MR. VON LEHE: -- one entity is paying to another
22 entity.

23 MR. TRAYNHAM: Your Honor, we're attempting to show
24 how it's distortive. We're attempting to
25 provide the background for why it would be

1 relevant to CarMax or any other taxpayer, for
2 that matter. What we're trying to establish
3 here is what auditors look for and what might
4 have triggered them onto CarMax in this case.

5 **THE COURT:** Okay. And what you're essentially
6 saying is, as I understand what Mr. Donovan
7 says, when companies set up other companies to
8 handle some of the intellectual property and
9 some of the other things, it looks as if
10 they're trying to shield that from South
11 Carolina tax paying and what can sometime be
12 inferred.

13 **Q:** Mr. Donovan, would that be a fair statement of
14 your testimony?

15 **A:** Yes.

16 **THE COURT:** That's what you're saying.

17 And, Mr. von Lehe, you're saying there's no
18 foundation laid all, so that's what CarMax is
19 saying.

20 **MR. VON LEHE:** That's correct, because I think that
21 testimony is being given to be directed at us.
22 And I don't think there's any question about it
23 and I'm sure Mr. Traynham will agree.

24 **MR. TRAYNHAM:** I wouldn't disagree, Your Honor. I
25 think the foundation has been laid, however.

1 There's been ample testimony about the business
2 operations of this taxpayer about where its
3 intangibles are and how the income flows from
4 entity to entity, from South Carolina to the
5 taxpayer.

6 Mr. Donovan is attempting to testify that he
7 has seen other taxpayers with similar business
8 structures and how that has been viewed in
9 other context as a potential red flag for
10 audit. I think that it's perfectly relevant.

11 **THE COURT:** And I believe that point is established,
12 then. So I would like to move on, then, to
13 whatever the specifics are of anything having
14 to do with CarMax.

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

16 **THE COURT:** Their numbers, their numbers only, why
17 you believe the Department made the right
18 determination in deciding that none of these
19 statutory formulas are correct and they have
20 the right to do the alternative formulation.

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

22 **Q:** Mr. Donovan, referring back to what I believe
23 has been marked Exhibit Thirty-one, would you
24 take us briefly through the East Coast company
25 as filed -- actually, scratch that.

1 Mr. Donovan, why is the East Coast company
2 relevant to this illustration?

3 A: It's relevant to this illustration for the fact
4 that, you know, you see the amount of business
5 that the East Coast company is doing through,
6 you know, over five, almost close to 6 billion
7 in sales for this year, for this particular
8 year. You know, you see the amount of
9 apportionable income related to those sales for
10 the East Coast and, essentially, the South
11 Carolina portion of the East Coast's company.

12 Q: Mr. Donovan, does income flow from East Coast
13 into CBS?

14 A: Yes. East Coast is paying CBS per their
15 agreement.

16 Q: Would East Coast receive a deduction for any
17 payment made to CBS in South Carolina?

18 A: Correct. They were taking an expense, which
19 was a deduction in South Carolina.

20 Q: So East Coast's tax liability would be reduced
21 pursuant to any payment that it made to CBS.

22 A: That's correct.

23 Q: And is it also your understanding that CBS net
24 income is distributed to the taxpayer in this
25 case, largely?

1 A: Largely, yes.

2 Q: Ninety-three and a half percent of that net
3 income is distributed to the taxpayer?

4 A: Correct.

5 Q: Mr. Donovan, what is the East Coast company's
6 as filed South Carolina ratio --

7 A: It is --

8 Q: -- as per this example?

9 A: Well, it's not an example, but per the tax
10 return for this particular year, East Coast was
11 2.7826 percent.

12 Q: What does that mean, what does that
13 2.78 percent mean?

14 A: That is the -- basically the ratio of -- or the
15 apportionment ratio that would be applied to
16 apportionable income on the return and,
17 basically, be, you know, South Carolina's
18 taxable piece of the apportionable income.

19 Q: And just for clarity, why is the apportionable
20 income of East Coast less than its sales from
21 everywhere?

22 A: Because you have probably some of -- a
23 considerable amount of expenses in order to,
24 you know, generate that much in sales.

25 Q: To get to the apportionable income? What's the

1 bottom line tax liability for East Coast
2 company as filed?

3 A: For this particular year was \$94,452.

4 Q: Okay. So a little less than three percent of
5 East Coast's total apportionable income was
6 apportionable to South Carolina and taxed with
7 five percent; is that correct?

8 A: That's correct.

9 Q: If you would, take us briefly through West
10 Coast company as originally filed.

11 A: West Coast originally filed had -- as you heard
12 earlier, they were reporting as part of their
13 South Carolina receipts the amounts of the
14 royalties that were -- flowed, you know,
15 through CBS as their numerator. The gross
16 receipts everywhere for the West Coast is the
17 \$1.2 billion. They had 46 million in property
18 and I believe that's an 8 million in payroll.
19 It's an eight or a six. Their ratio,
20 essentially, for -- per the return
21 was .0486 percent, which was applied to
22 159 million in apportionable income for a South
23 Carolina tax due of \$3877.

24 Q: So not quite five one-hundredths of a percent
25 of their apportionable income was apportioned

1 to South Carolina pursuant to their original
2 return?

3 A: That's correct.

4 Q: Okay. So the total liability of the two
5 companies per those original returns is roughly
6 \$98,000?

7 A: Correct.

8 Q: Now, Mr. Donovan, you testified earlier, and
9 there's been a lot of testimony that the West
10 Coast company, the taxpayer, amended its
11 returns after the audit period was closed,
12 after the audit report was filed and all of
13 that. Would you take us through the gross
14 receipts formula on this form?

15 A: The gross receipts formula essentially keeps --
16 all it does is remove the property and payroll
17 and one of the sales pieces and basically takes
18 your South Carolina receipts over your receipts
19 everywhere for a ratio of .0972 percent.

20 Q: So not quite one-tenth of a percent of the
21 taxpayer's apportionable income is apportioned
22 to South Carolina pursuant to the amended
23 returns.

24 A: That's correct.

25 Q: And that's compared to just over two and a

1 half percent of their apportionable income for
2 East Coast?

3 A: Correct.

4 Q: And both of these returns as originally filed
5 and as amended, in order to calculate their
6 sales ratio, did the taxpayer include sources
7 of income other than intangibles and finance
8 income?

9 A: Yes. It would have included the income of
10 CarMax West retail operations.

11 Q: So all of the retail sales that the taxpayer
12 conducts in West Coast states?

13 A: Correct.

14 Q: And in that ratio, the numerator and
15 denominator, where would those sales have gone?

16 A: I'm sorry, can you just say it again?

17 Q: Sure. We've been talking about these ratios.

18 A: Uh-huh (affirmatively responds).

19 Q: Where would the taxpayer's retail sales from
20 West Coast states go in that ratio of sales?

21 A: They would go to the state or jurisdiction
22 where the sales took place.

23 Q: Would it go in the numerator or the
24 denominator?

25 A: It would go in the denominator.

1 Q: Okay. And as you stated earlier, if you
2 increase the denominator, it reduces the tax
3 liability; is that correct?

4 A: Correct.

5 Q: Mr. Donovan, if you would, explain to us in a
6 little more detail what the Department's
7 alternative adjustment, or equitable
8 apportionment as it's labeled in this document,
9 does that the standard formulas do not do.

10 A: Essentially, the auditor or the Department
11 basically took the position that the formula,
12 even the gross receipts formula that was used,
13 did not accurately reflect the income of the
14 business in South Carolina and therefore came
15 up with an alternative ratio. And the first
16 item -- and it's broken out here, but if you
17 were to add them together, you essentially
18 would get to the same number.

19 But in the first one, we took the royalties in
20 South Carolina to the receipts everywhere that
21 flowed from CBS to CarMax West; that ratio was
22 2.637 percent. The taxpayer -- I mean, the
23 Department calculated apportionable income as
24 the income that flowed from CBS to CarMax West
25 and applied the tax rate. And then for the

1 other intangibles, sourcing of the receivables,
2 the same calculation was done.

3 Q: The everywhere flow-through receipts, what type
4 of -- what income sources created those
5 flow-through everywhere receipts?

6 A: The everywhere receipts would have been,
7 essentially, the royalty receipts, as well as
8 the receipts from financing and other, I guess,
9 overhead management receipts.

10 Q: So, if I understand you correctly, the
11 Department's alternative adjustment took
12 royalty and finance income from South Carolina
13 and compared it with royalty and financing
14 income from everywhere that the taxpayer
15 received it. Would that be a fair statement?

16 A: That's correct.

17 Q: And the South Carolina ratio that it came up
18 with for royalties was what again?

19 A: For royalties it was .2637 percent.

20 Q: Okay. And the South Carolina ratio for what's
21 described as "other intangibles," would that be
22 financing receipts?

23 A: Yes.

24 Q: What was the South Carolina ratio for those?

25 A: It was 161,216,665. Is that -- I'm sorry, I

1 might have been ...

2 Q: The South Carolina ratio, I'm sorry, not the
3 taxable income.

4 A: Yeah, 1.0054 percent.

5 Q: And what's the bottom line under the
6 Department's alternative adjustment for this
7 particular year?

8 A: For this particular year, the bottom line is we
9 would have calculated the total tax amount due
10 of 102,303.

11 Q: Mr. Donovan, below this is partnership
12 flow-through information. What exactly is the
13 relevance of the partnership flow-through
14 information?

15 A: That is basically a breakdown -- that you see
16 above, that is the breakdown of the South
17 Carolina portion of the royalty receipts, as
18 well as the receipts from the securitization
19 and other income.

20 Q: Okay. And underneath "partnership flow-through
21 information," it says "Partnership Net Income
22 Flow-through To West," correct?

23 A: Correct.

24 Q: So the partnership income is flowing to the
25 taxpayer net of any expenses that the

1 partnership activity would have incurred,
2 correct?

3 A: Correct, 161 million would have been less than
4 the expenses for the partnership.

5 Q: So if, hypothetically, the partnership incurred
6 expenses related to its financing activities or
7 its intangibles management, those would have
8 been taken out at the partnership level?

9 A: That's correct.

10 Q: Mr. Donovan, would a comparison of the South
11 Carolina ratios for the type of income actually
12 earned in South Carolina versus the South
13 Carolina ratios as reported be something that
14 an auditor under your supervision might
15 consider in determining whether an adjustment
16 was appropriate?

17 A: Yeah. That would be one of the factors, yes.

18 Q: And if those South Carolina ratios were
19 significantly out of wack between the two
20 methods, would that --

21 MR. VON LEHE: Your Honor, again, as to what an
22 auditor under his supervision might have
23 considered, that's speculation, and it leads to
24 hearsay testimony.

25 MR. TRAYNEAM: Your Honor, I think in his position

1 as an audit supervisor, he can testify -- I can
2 rephrase the question to ask what he would have
3 instructed his auditors to consider or look
4 for.

5 **THE COURT:** If he knows of his own knowledge if the
6 item would raise a red flag, then he may
7 testify to that.

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

9 **THE COURT:** But not as to what a random auditor
10 would do. Thank you, sir.

11 **MR. TRAYNHAM:** Thank you, Your Honor.

12 **Q:** And, Mr. Donovan, would you instruct your
13 auditors to look for these types of ratio
14 inconsistencies?

15 **A:** Yes, they're essentially instructed to look
16 for, you know, where the flow of income goes
17 and, you know, how it's reported.

18 **Q:** Are they instructed to look for combinations of
19 different types of income which have no
20 connection to the State?

21 **A:** Correct.

22 **Q:** Mr. Donovan, you stated that for years during
23 which CBS was formed, any expenses incurred in
24 those partnership actives were expended or
25 deducted at the partnership level, correct?

- 1 A: They should have been, yes.
- 2 Q: Was any information requested from the taxpayer
- 3 regarding expenses related to intangible
- 4 property in the years prior to the formation of
- 5 the LLC, CBS?
- 6 A: It was part of the auditor's request for
- 7 information, but we did not receive any
- 8 response back as to what the expenses were for
- 9 maintaining the intellectual property.
- 10 Q: So the taxpayers didn't provide us with any
- 11 information about expenses related to
- 12 intangibles in those early audit years?
- 13 A: That's correct.
- 14 Q: If properly supported information regarding
- 15 those expenses had been provided to the
- 16 Department, would that have affected the
- 17 proposed assessment?
- 18 A: Yes, we would have reduced the assessment.
- 19 Q: Mr. Donovan, you stated earlier that part of
- 20 your duties as an audit supervisor and what
- 21 you've done in this case would include
- 22 reviewing taxpayer protest letters, correct?
- 23 A: That's correct.
- 24 Q: Did you review a protest letter in this case?
- 25 A: I did.

1 Q: Do you recall an issue raised by the taxpayer
2 regarding the proper sourcing of certain items
3 of income?

4 A: I do vaguely remember it, yes.

5 Q: Would you briefly tell the Court what your
6 understanding of the taxpayer's argument in
7 that regard is?

8 A: My understanding was that they essentially felt
9 that the income should be sourced to where the
10 personnel was that was actually working on
11 processing certain papers and call centers and
12 so forth.

13 Q: Are you familiar with the Department's
14 practices on sourcing income?

15 A: I am.

16 Q: Does the Department always source a taxpayer's
17 income to the location of its employees?

18 A: No.

19 Q: Would the Department sometimes source a
20 taxpayer's income to the location of its
21 employees?

22 A: Generally, where you have income that's related
23 to personal service, such as engineers,
24 accountants, attorneys, that would be sourced
25 to where the, you know, employees or payroll

1 are actually doing the work.

2 Q: Would it be fair to say that the proper
3 sourcing determination would depend on the type
4 of business involved?

5 A: It would.

6 Q: What position does the Department take on where
7 income from a financing operation should be
8 sourced?

9 A: The Department takes the position that the
10 income should be sourced where the customer
11 actually making the payments or where the
12 accounts receivable is actually located.

13 Q: Mr. Donovan, there's been testimony that two
14 distinct types of penalties were imposed in
15 this case, an understatement penalty and a
16 negligence penalty. Could you tell the
17 Court -- it's somewhat self-explanatory, but
18 just to elucidate a little bit, what is the
19 understatement penalty?

20 A: The understatement penalty -- and, again, I
21 don't know the statute right off the top of my
22 head -- is, you know, where there's an
23 understatement of tax on the return. It must
24 be -- you know, it's a penalty that must be
25 applied. And, again, without the statute, I'm

1 not going to be able to tell you what the rates
2 are.

3 Q: That's fine. You said "must be applied." Does
4 the Department have no discretion about
5 applying an understatement penalty?

6 A: The statute says "must."

7 Q: What about the negligence penalty, are we given
8 any discretion in that?

9 A: I think there is a little bit more discretion.
10 I think it was testified to earlier, and I
11 don't disagree that it's the intentional
12 disregard of, you know, the statutes or -- I
13 don't know -- again, don't know the
14 verbatim ...

15 Q: Fair. And in terms of that discretion, who
16 would make the determination of whether or not
17 to apply a negligence penalty?

18 A: Essentially, that is up to the auditor doing
19 the review.

20 Q: Now, at the time the auditor in this matter
21 initially applied these penalties, the only
22 filings the Department had from this taxpayer
23 were filed under the three-factor formula,
24 correct?

25 A: That's correct.

1 Q: Mr. Donovan, in your experience --

2 MR. TRAYNHAM: Sorry, Your Honor, if you would give
3 me one second.

4 THE COURT: Take your time, Mr. Traynham.

5 Q: Mr. Donovan, if I could return to your
6 testimony earlier regarding East/West strategy
7 or East/West business structure. Is there any
8 significance in your mind to placing intangible
9 property in a West Coast division of a
10 multi-state retailer as opposed to an East
11 Coast entity?

12 A: Well, the West Coast states essentially are a
13 unitary combined state. So, essentially,
14 whether you put it in the East Coast or the
15 West Coast, the tax difference does not switch
16 at all if it's located in the West Coast -- or
17 even in the East Coast.

18 But for East Coast, unitary -- I mean, sorry,
19 separate entity states. When the intellectual
20 property is placed in a West Coast operation,
21 the separate entity states, unless they have
22 add-back statutes or some other type of
23 mechanism, you know, you have to look at it on
24 a separate entity basis and then determine
25 whether or not there's been any, you know,

1 distortion or moving of income.

2 Q: So from the West Coast states' perspective, it
3 doesn't matter at all where the intangible
4 property is in this type of structure.

5 A: No.

6 Q: But there is some perceived benefit from your
7 perspective in an East Coast separate filing
8 state?

9 A: That's correct.

10 Q: Okay. So it's your testimony that this
11 structure would lead to tax savings in separate
12 entity states?

13 A: Correct.

14 Q: Is South Carolina a separate entity state?

15 A: It is.

16 Q: Would this sort of business structure be
17 perceived by you as a tax-savings device?

18 A: It would be.

19 MR. VON LEHE: Your Honor, again, I must object to
20 the leading of the witness. "Would this be
21 perceived by you as a tax-savings device," is
22 a leading question.

23 THE COURT: Yes, sir, it is. But I think it's
24 probably within Mr. Donovan's area of
25 expertise.

1 Can you reach that without leading,
2 Mr. Traynham?

3 MR. TRAYNHAM: I will attempt to, Your Honor.

4 THE COURT: Okay.

5 Q: Mr. Donovan, what about this structure -- what
6 effect would this structure have on a taxpayer
7 from a tax perspective in an East Coast
8 separate filing state?

9 A: It would have a significant tax benefit.

10 Q: And how would you perceive that business
11 structure?

12 A: I would perceive it as, you know, basically a
13 structure that is there for the, you know, tax
14 savings.

15 Q: And would you instruct your auditors to look
16 for this general type of business structure for
17 that reason?

18 A: Well, it's really a matter of several different
19 things, but that would be one of the items that
20 they would look at.

21 Q: Would the use of a perceived tax-savings device
22 be a valid consideration for an auditor in
23 determining whether to apply penalties?

24 A: It would be.

25 MR. TRAYNHAM: Your Honor, if I could.

1 THE COURT: Take your time.

2 MR. TRAYNHAM: Your Honor, just out of an abundance
3 of caution, in light of Mr. Donovan's testimony
4 regarding the relevance of combined reporting,
5 I'd like to re-offer the original exhibit
6 unredacted, only the one relating to the CarMax
7 numbers as actually reported.

8 THE COURT: CarMax numbers. And you object to that?

9 MR. VON LEHE: Yes, we do object to that, Your
10 Honor, for the same reasons that I gave
11 earlier. Combined reporting example is not
12 relevant. We've got separate taxpayer -- I
13 object for the same reasons that we objected to
14 for the hypothetical one.

15 THE COURT: This is the proffer of Number Twelve
16 redacted or Thirty-one?

17 MR. TRAYNHAM: I believe it's actually Thirteen,
18 Your Honor.

19 THE COURT: Thirteen?

20 MR. TRAYNHAM: Yes, Your Honor, it would be
21 Thirteen.

22 THE COURT: Okay. Well, I'm going to stick to my
23 original ruling and exclude it.

24 MR. TRAYNHAM: Thank you, Your Honor. Just wanted
25 to make sure the proffer was --

1 THE COURT: Yes, sir. Your record is preserved.

2 MR. VON LEHE: Thank you, Your Honor.

3 MR. TRAYNHAM: Your Honor, we have no further
4 questions.

5 THE COURT: Thank you very much. Cross-examination,
6 Mr. von Lehe.

7 MR. VON LEHE: Yes, Your Honor. Thank you, Your
8 Honor.

9 MR. DONOVAN - CROSS-EXAMINATION BY MR. VON LEHE:

10 Q: Mr. Donovan, good afternoon.

11 A: Good afternoon.

12 Q: Mr. Donovan, I want to ask you some general
13 questions and then we'll get to -- hopefully
14 they'll be the same things you covered with
15 Mr. Traynham. Let me ask you some questions
16 about how this taxpayer actually filed its
17 returns. And I could ask you to take a look at
18 one of their returns, if you wish. It's
19 example number four, if you want to take a look
20 at it, but you may not need to. There may be
21 no doubt in your mind. Did this taxpayer begin
22 on line one by reporting federal taxable
23 income?

24 A: I would say that's safe to assume without
25 looking.

- 1 Q: As far as you're concerned, were the
- 2 adjustments that it made to that income on line
- 3 two, were they, as far as you're concerned, not
- 4 relevant to the tax assessment that was
- 5 proposed?
- 6 A: (No response.)
- 7 Q: The taxpayer makes certain adjustments on line
- 8 two, right?
- 9 A: That's correct.
- 10 Q: Did they have any problem with those
- 11 adjustments? Did the auditor?
- 12 A: I don't recall the auditor having -- making any
- 13 adjustments to line two.
- 14 Q: Line three, is it sometimes referred to as
- 15 "apportionable net income" in the audit
- 16 reports?
- 17 A: Line three?
- 18 Q: Yes.
- 19 A: Yes, I believe so.
- 20 Q: Okay. And is it to that figure that an
- 21 apportionment formula is ordinarily applied?
- 22 A: That's correct.
- 23 Q: So that's what this taxpayer did, correct?
- 24 A: Correct.
- 25 Q: Now, on its original returns --

1 MR. VON LEHE: We've said this so many times, Your
 2 Honor. I hate to go back over it, but ...
 3 Q: -- they used a three-factor formula.
 4 A: Correct.
 5 Q: But then it amended its returns and used a
 6 single-factor formula.
 7 A: That's correct.
 8 Q: You said you felt that the single-factor
 9 formula still was not appropriate for this
 10 taxpayer.
 11 A: That's correct.
 12 Q: However, would you agree that it's more
 13 appropriate than a three-factor formula? Would
 14 you agree with that?
 15 A: I would agree to that, yes.
 16 Q: And I believe in the examples that you just
 17 looked at with Mr. Traynham a moment ago, using
 18 the three-factor formula produced less income
 19 than the use of a single-factor formula
 20 produced?
 21 A: That's correct.
 22 Q: I want to sort of recap the filing status,
 23 then, which you have just done. And I believe
 24 you said you disagree with that method. Now,
 25 the audit report applied a method which did not

1 consider the taxpayer's federal net income; is
2 that correct?

3 A: I don't know that it didn't consider it,
4 because essentially the audit report, if I
5 remember correctly -- and if you want me to
6 turn to it, I'll be more than glad to discuss
7 it -- but the audit report typically is going
8 to -- if I remember correctly, has
9 apportionable income as its starting basis.

10 Q: I may need you to take a look at that. But let
11 me ask you this perhaps before throwing --

12 A: It depends on the auditor, typically.

13 Q: We may be in agreement here without having to
14 dig back through it. But is it not your
15 understanding that this audit report does not
16 consider federal net income as the beginning
17 point for this taxpayer's income? Is that not
18 your understanding?

19 A: Although not highlighted, I'm not sure that it
20 doesn't -- you know, that it basically by
21 starting with apportionable income, you're
22 basically talking about federal taxable income
23 less any adjustments. So it's essentially
24 starting with apportionable income.

25 Q: I'm afraid you are going to have to look at

1 that.

2 A: Okay.

3 MR. VON LEHE: Your Honor, if we could give him a

4 moment to take a look at that.

5 THE COURT: Certainly. Exhibit Number One, I

6 believe.

7 MR. VON LEHE: The audit report is Exhibit Number

8 One.

9 THE WITNESS: Auditors do it different ways, so I

10 may eat my words. Exhibit One?

11 THE COURT: Yes.

12 THE WITNESS: (Reading.) Okay. So I'm looking at

13 schedule A. Is that ...

14 THE COURT: Uh-huh (affirmatively responds).

15 THE WITNESS: I see period ended February -- and

16 you'll see a column of February '02, '03, '04,

17 '05 -- apportionable income per return

18 adjustments. And then he lists the royalty

19 receipts.

20 Q: Yes. But his apportionable income as adjusted,

21 yes, they are the gross royalty receipts, but

22 that's not federal net income less the standard

23 adjustments, correct?

24 A: That's correct.

25 Q: All right. So that's where I want to get to.

1 So he doesn't use federal net income; he uses
2 royalty receipts in the first years, correct?

3 A: That is correct.

4 Q: Right. I was in hopes we could agree on that,
5 because that's what everyone else here today
6 has testified to and, certainly, my assumption
7 is that that's what he did. So we can begin
8 with the fact, then, that he did not use
9 federal net income as a beginning number to
10 reach what he ended up believing to be this
11 taxpayer's South Carolina taxable income.

12 A: Correct. He went -- he listed the taxpayer's
13 apportionable income on his work papers.

14 Q: And that was royalty receipts.

15 A: Correct.

16 Q: Right?

17 A: Correct.

18 Q: And in later years, he used a different
19 apportionment formula, which you've described,
20 to come up with what is roughly the income of
21 CarMax Business Services, LLC. But, again, he
22 did not start with federal taxable income.

23 A: Correct.

24 Q: All right. Now, when he applied a tax to
25 royalty income only in those first three years,

1 or two or three or four, didn't he tax gross
2 receipts? Didn't he apply a five percent tax
3 to total royalties?

4 A: He applied a five percent tax to royalties that
5 were paid from South Carolina.

6 Q: And no deductions were taken; is that correct?

7 A: That's correct. The auditor had asked several
8 times for the expenses related to those
9 royalties but did not receive the information.

10 Q: Okay. So he ended up applying five percent
11 against the total.

12 A: Correct.

13 Q: And when he applied -- when he taxed -- in the
14 later years, after the reorganization, he
15 applied the tax rate to roughly the income of
16 CarMax Business Services; did he not?

17 A: That's correct.

18 Q: Now, when he did that, he did not look at any
19 of the expenses of CarMax West Coast.

20 A: Correct. He would have only allowed the
21 expenses of CarMax Business Services.

22 Q: So all of CarMax West Coast's expenses would
23 not have been considered.

24 A: Expenses and income would not.

25 Q: Or its income.

1 A: That's correct.

2 Q: In the later years, why didn't the auditor just
3 attempt to tax CarMax Business Services?

4 A: Essentially, that's what the -- essentially,
5 that's what the audit report reflects, is that
6 we're taxing the income that flows through to
7 the taxpayer of CarMax Superstores West Coast.

8 Q: But, generally, that is a nontaxable entity; is
9 it not?

10 A: CarMax Business Services?

11 Q: Yes.

12 A: That's correct.

13 Q: So he's basically --

14 A: My understand is it's an LLC reporting as a
15 partnership.

16 Q: You're correct. So, basically, he's calculated
17 a tax -- if you want to call it
18 "calculating" -- and applied that tax against
19 CarMax West, but it's the same tax that would
20 have been applied to the partnership, if it had
21 been a taxable entity?

22 A: Correct. And that was what the Department felt
23 was the most -- what most accurately reflected
24 the taxpayer's business in South Carolina.

25 Q: So, basically, what this audit report has done

1 is to carve out a portion of the income of West
2 Coast and tax that; is that correct?

3 A: It was essentially taxing the business of, in
4 the later years, CarMax Business Services; in
5 the early years, the royalty income.

6 Q: You're familiar with unitary businesses.

7 A: Yes.

8 Q: You've worked many years with them.

9 A: I wouldn't say many, but ...

10 Q: You know one when you see it?

11 A: Yes.

12 Q: Is it not a fact from everything you've heard
13 about this taxpayer and all the information
14 you've gathered that this taxpayer is, in fact,
15 a unitary business?

16 MR. TRAYNEAM: Your Honor, objection. Without
17 further qualification of that question, he's
18 asking Mr. Donovan for a legal conclusion.

19 THE COURT: Mr. von Lehe?

20 MR. VON LEHE: Yes, this is a tax question. It's a
21 matter, Your Honor, that any tax -- certainly
22 a man of Mr. Donovan's position, head of taxing
23 businesses and deciding whether or not -- how
24 to apply these apportionment formulas -- it's
25 just a part of what he knows.

1 THE COURT: Because it appears to me that obviously
2 Mr. Donovan, been there a long time, has been
3 a supervisor of audits and because he certainly
4 has discussed Section 18 of UDITPA and its
5 corresponding statute and, you know, I'll
6 permit him to answer as to his interpretation
7 of whether or not his business falls into that
8 classification under the South Carolina
9 statute.

10 MR. VON LEHE: Yes, Your Honor.

11 MR. TRAYNHAM: Thank you.

12 MR. VON LEHE: This is not to be binding on you, of
13 course.

14 THE COURT: No, of course not.

15 MR. VON LEHE: It is a legal conclusion, but I would
16 like to know his interpretation -

17 THE COURT: I think that's fair.

18 MR. VON LEHE: -- of whether or not this, in his
19 opinion, is a unitary business.

20 A: My interpretation would be, looking at this
21 post reorganization chart, is that CarMax,
22 Inc., which is highlighted in the yellow, is a
23 unitary business of operating all of these
24 other members.

25 Q: Can't one corporation operate a unitary

1 business?

2 A: Can one corporation? One corporation is a

3 unitary business.

4 Q: Isn't it possible and don't you have a

5 regulation that distinguishes a single

6 corporation where it has two unrelated

7 businesses, but then it says if those

8 businesses are related then we're going to

9 combine them? Are familiar with that reg?

10 A: Unfortunately, no, I'm not.

11 Q: But just because we're looking at one entity,

12 that doesn't mean that you don't still have a

13 unitary business test to apply, does it?

14 A: Well, there are tests for unitary businesses.

15 But if you're asking my opinion, the test would

16 apply -- you know, when you're talking about

17 unitary businesses is that all of the companies

18 that are unitary are one unitary group.

19 Q: I can understand that answer, but it's not the

20 question I'm asking you. I want to know if

21 CarMax West is a unitary business. And I'll

22 ask you another question, okay? Exxon.

23 A: Uh-huh (affirmatively responds).

24 Q: Is it a unitary business, to the best of your

25 knowledge?

- 1 A: To the best of my knowledge, yes.
- 2 Q: I mean, it's all one --
- 3 A: I haven't looked at their structure lately,
- 4 so ...
- 5 Q: Let's assume this: You have refining -- you've
- 6 got production, refining and sales, all in one
- 7 corporation. Make that assumption for a
- 8 moment.
- 9 A: Uh-huh (affirmatively responds).
- 10 Q: Those are the facts of the Exxon case, so it's
- 11 not just a hypothetical.
- 12 A: Right.
- 13 Q: But, still, let's make that assumption. Isn't
- 14 that single entity a unitary business?
- 15 A: I believe it is, yes. I believe that is the
- 16 ruling of the Court.
- 17 Q: And isn't it a fact that those elements cannot
- 18 been effectively separated and taxed
- 19 separately?
- 20 A: I think -- yeah, I think that's what the Court
- 21 ruled.
- 22 Q: That is what the Court ruled, but what's your
- 23 judgment of it? Do you agree with that?
- 24 That's what I want to know.
- 25 A: I would have to agree with it, yes.

- 1 Q: All right. But, now, this entity by itself,
2 CarMax West, is it a single unitary business?
- 3 A: (No response.)
- 4 Q: Not all these others on the board; just that
5 one, just the taxpayer.
- 6 A: I mean, if you're looking at it just solely by
7 itself?
- 8 Q: I am for this question.
- 9 A: I mean, you could say that it's unitary.
- 10 Q: But what would you say?
- 11 A: I still go back to I got to look at everybody.
12 You know, I mean, it's the whole operation.
13 Because, I mean, without CarMax East and
14 without CarMax, Inc., you know, what does --
15 you know, how does CarMax really gain its
16 income other than, you know, just the few --
17 you know, a few retail locations, so ...
- 18 Q: At the risk of another effort here, how do you
19 feel about CarMax West and CBS, the partnership
20 in which it owns 93.5 percent? Are those two
21 entities unitary?
- 22 A: I mean, again, I think we're beating a dead
23 horse. Most likely I'm going to say that
24 CarMax, Inc., is a unitary business and runs
25 all of these different portions of its

1 business.

2 Q: All right, sir.

3 A: Just as Exxon, you know ...

4 Q: All right, sir. Do you disagree with what you

5 heard about the elements of a unitary business

6 today? You've heard a lot of talk about them.

7 A: No, I think those are pretty much established.

8 Q: Now, when you, again, were speaking today, I

9 think one of the first things you said was --

10 answered was, you were asked about this

11 alternative method. And I believe you said

12 that the auditor, quote, "came up with an

13 alternative," I think is the exact wording that

14 you used. "The auditor came up with an

15 alternative method."

16 A: Okay.

17 Q: Does that sound -- do you agree with --

18 A: It was the auditor's calculation, you know,

19 with input from myself and others.

20 Q: Okay. But is there some set of standards under

21 which such a calculation is derived?

22 A: The standard? I don't know of any bright-line

23 standard.

24 Q: There's nothing published, is there?

25 A: No.

1 Q: There's nothing a taxpayer could read and look
2 at.

3 A: No, sir.

4 Q: Or a judge could read and look at --

5 A: Correct.

6 Q: -- which would set such a standard? There
7 would be nothing to give guidance outside of
8 the Department to taxpayers or to those who
9 represent them?

10 A: Nothing on this particular issue, no.

11 Q: Or for Her Honor to make a decision based on?

12 A: No.

13 Q: Okay. So in other words, what was done is not
14 found in the statutes, the regulations or the
15 policy documents, specifically?

16 A: Could you repeat that?

17 Q: Is it found in the statutes, the regulations or
18 the policy documents that tells you to do what
19 was done to CarMax West?

20 A: How it was done as far as the formula itself?

21 Q: Yes.

22 A: No, it is just an alternative calculation

23 Q: All right. I have got some questions here
24 about unitary business, so I want to ask you
25 about the concept. I think I have gone through

1 most of these already, so I think I already
2 know what your answer is, so I won't repeat
3 myself, but I might ask you these elements.
4 You ever heard of anything called "three
5 unities"?

6 A: I have but I can't recite all three.

7 Q: You ever heard of "contribution and dependence"
8 when one is looking at a business?

9 A: Correct.

10 Q: And what is that test? What is one looking for
11 there? What's the reason for that test?

12 A: It's basically that the contribution of -- you
13 said of ownership?

14 Q: Yes. I said contribution and dependence that
15 time, is what I mentioned.

16 A: Okay. That's basically -- you know, I think
17 we've talked about that earlier. I'm not going
18 to be able to speak, you know, definitively on
19 all three of the unity tests.

20 Q: All right. Do you know whether or not the
21 auditor -- since you mentioned you did work
22 with him on this -- do you know whether or not
23 the auditor made an evaluation of whether or
24 not CarMax West and CarMax Business Services
25 were a unitary in this case? Do you know if

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- 1 there was any such evaluation made?
- 2 A: I'm not sure if there was a direct evaluation
- 3 of unitary simply because, you know, the
- 4 Department still takes the position we're not
- 5 a unitary state for -- you know, when it comes
- 6 to taxing and to, you know, do that
- 7 calculation, you know, is not -- I mean, it ...
- 8 Q: Well, you used the term "not a unitary state."
- 9 Your reference is to the combining of otherwise
- 10 noncombined entities?
- 11 A: Correct.
- 12 Q: Such as the, let's say, skirmish that we
- 13 recently had over whether or not you should put
- 14 before the Court a combination of CarMax East
- 15 and CarMax West; that would have been a
- 16 combining of those two.
- 17 A: Correct. Well, you would have combined
- 18 everybody and just put them under CarMax, Inc.
- 19 Q: But that would have been in a unitary state,
- 20 which we are not.
- 21 A: Correct.
- 22 Q: Every entity stands on its own feet here; is
- 23 that correct?
- 24 A: That's the Department's position.
- 25 Q: And is that also your understanding of the law

1 and regulations?

2 A: Yes.

3 Q: Okay. If this entity is a unitary business --
4 okay, if you would give me that for a moment --
5 CarMax West, if it is a unitary business, then
6 is it not a fact that it cannot be accurately
7 divided up?

8 A: I mean, you can ...

9 Q: Accurately?

10 A: Well, it would be difficult.

11 Q: All right. Is it not a fact that ordinarily
12 separate accounting is applied to entities
13 which are not unitary; is that true?

14 A: I'm not the person to ask about separate
15 accounting.

16 Q: But what's been done to this taxpayer is a form
17 of separate accounting, is it not, or am I
18 mistaken on that?

19 A: I don't know that we've ever characterized it
20 as separate accounting.

21 Q: You don't think it's been characterized as
22 separate accounting?

23 A: I don't believe so.

24 Q: What if it were shown that it has been
25 characterized as separate accounting, would it

1 be your feeling that such a thing would be
 2 proper or improper?
 3 A: I think it's still allowed under the statute.
 4 Q: But as applied to this taxpayer, do you think
 5 it would be allowable?
 6 A: Yes.
 7 Q: Even if this taxpayer were unitary?
 8 A: Again, I don't know the rules of saying things
 9 are unitary and separate accounting --
 10 Q: All right, sir.
 11 A: -- as to where you go from ...
 12 Q: So let me ask you this: Do you have any
 13 authority that would allow a separate
 14 accounting for a unitary business? Do you know
 15 of any authority which would allow separate
 16 accounting for a unitary business?
 17 A: I don't have an opinion on that question.
 18 Q: All right. Let me talk to you for a little bit
 19 about the so-called distortion that's been
 20 mentioned.
 21 A: Uh-huh (affirmatively responds).
 22 Q: Now, the audit report, the only thing that I
 23 see in the audit report that talks about
 24 distortion is a comparison of the gross profit
 25 of CarMax West and CarMax East. That's what I

1 see in the audit report. Do you see anything
2 else in there where he -- any other reasons
3 that he gave for alleging distortion?

4 A: (Reading.) No, according -- looking at that,
5 that's the only one that he did.

6 Q: All right, sir. Now, as I understand what he's
7 done there, and I'd like to get your agreement
8 or disagreement on it, he's taken the income,
9 the gross income of those two entities, and
10 said, "Look, one of these entities is a lot
11 more profitable than the other." I think he
12 says about 12 times, the number comes out. He
13 says that CarMax West is about 12 times more
14 profitable than CarMax East.

15 A: Okay.

16 Q: Do you see that?

17 A: You got a particular page?

18 Q: It's a thousand something -- 2,200 percent or
19 something like that, so about 12 times. Yes,
20 I can find that page.

21 A: Yes, row two, he's saying it's about
22 2100 percent.

23 Q: Okay.

24 A: And it kind of varies between there and, you
25 know, eight or 900 percent.

1 Q: So does it appear to you as it appears to me
2 that he finds distortion here because one of
3 these entities is much more profitable than the
4 other? Is that what you see in the audit
5 report? If you see something else, let me know
6 what you see.

7 A: No, in the audit report that's what he states.

8 Q: All right. And I want to ask you this: What
9 does that have to do with this taxpayer's,
10 CarMax West, activities in South Carolina and
11 whether or not the apportionment formula fairly
12 represents those activities?

13 A: Well, I think what he was showing is that, you
14 know, all things being equal, of being a
15 company that sells used cars, is that there
16 should be, you know, some coalition of return
17 on sales or income to sales. You know,
18 essentially with this, I guess if you were to
19 look possibly further up at the consolidated
20 return, I would suspect that that gets a little
21 bit closer back to the CarMax Auto Superstores'
22 ratio. But, you know, without those returns in
23 front of me, I would be speculating.

24 Q: We don't use combined reporting, correct?

25 A: That's correct.

- 1 Q: Now, I want to ask you this: What if CarMax
2 West Coast, what if, for some reason, whatever
3 it may have been -- forgive me, but let me make
4 up some reasons -- mismanagement or anything
5 that might have happened out there, the lack of
6 insurance and an earthquake occurred or
7 something like that and it lost a whole bunch
8 of money, okay? If that had happened, would
9 that affect what income it made from its
10 activities in South Carolina? If the entire
11 entity made or lost money, what does that have
12 to do with the profitability of the activities
13 that that entity's got in South Carolina?
- 14 A: Are you talking about the -- can you rephrase
15 your question?
- 16 Q: I'm saying, CarMax West Coast made a lot of
17 money.
- 18 A: Because we jumped from topic to topic.
- 19 Q: Yes, we did. CarMax West Coast made a lot of
20 money. We're just talking about that.
- 21 A: Uh-huh (affirmatively responds).
- 22 Q: He says that's the reason that there's a
23 distortion; that's what he says. Now, if that
24 entity had not made a lot of money, but its
25 South Carolina operations had been big South

1 Carolina operations -- we know they weren't,
2 but let's just assume they were big South
3 Carolina operations and it made a lot of
4 money -- would the fact that that entity lost
5 money in total, would that have had any effect
6 on whether or not a properly applied
7 apportionment formula would properly reflect
8 its income?

9 A: Well, I mean, I think you would have to look at
10 all the factors. But, I mean, you know, there
11 are -- if I understand your question correctly,
12 you know, there are going to be circumstances
13 where, you know, a company is going to have
14 negative federal taxable income and positive
15 apportionable income, you know, whether it be
16 through normal adjustments or adjustments
17 through an alternative apportionment -- an
18 adjustment.

19 Q: I think what I'm trying to get to is this: The
20 purpose of the apportionment formula is to
21 measure the income from somebody's business
22 activities in South Carolina; is that true?

23 A: That's correct.

24 Q: Okay. If a taxpayer has minimal business
25 activities in South Carolina, would one not

1 expect it to have a small apportionment
2 formula?

3 A: Let's see. If you're talking about
4 four-factor, obviously that would be the case.

5 Q: Think of terms of single-factor for a moment
6 with you. Let's say they have minimal South
7 Carolina gross receipts --

8 A: Right.

9 Q: -- or they have large gross receipts outside
10 the State and they have minimal South Carolina
11 activities, then wouldn't one expect a small
12 apportionment formula for it?

13 A: If they had minimal sales into South Carolina,
14 I would agree.

15 Q: Now, CarMax East does a lot more in South
16 Carolina than CarMax West; does it not?

17 A: That's correct.

18 Q: It's got some stores here, et cetera. Do you
19 know this apportionment formula, this so-called
20 apportionment formula that the auditor applied,
21 is creating about as much income for West as it
22 is for East?

23 A: That's correct.

24 Q: Does that make any sense?

25 A: I mean, it's -- East is paying a lot of money

1 to West for the right to use. So, I mean, it's
 2 just the way ...
 3 Q: I understand that. But aren't we trying to
 4 measure the income from what an entity does in
 5 this State?
 6 A: Correct.
 7 Q: And isn't it true that CarMax West Coast has
 8 minimal activities in this State?
 9 A: You know, through their use of trademarks, I
 10 don't know that I would say that that's
 11 minimal.
 12 Q: But that is what they had; is that correct?
 13 That is what they have. That's all they have,
 14 the use of those trademarks in South Carolina.
 15 A: Well, as well as the financing of vehicles.
 16 Q: And they finance vehicles. That's a small part
 17 of this, is it not, the question of financing
 18 receipts?
 19 A: I don't know the breakdown between the two.
 20 MR. VON LEHE: All right. Your Honor, if I could
 21 have just one moment.
 22 THE COURT: Take your time, Mr. von Lehe.
 23 MR. VON LEHE: A few questions, Your Honor, about
 24 this penalty.
 25 Q: Before that, though, I want to ask you one

- 1 other one. Isn't it true that this structure,
2 which you say has been very beneficial to these
3 taxpayers, isn't it true that the benefit of
4 that structure is going to depend on how much
5 money they make and if they make money? What
6 if they had net operating losses? A structure
7 would not be of any benefit, would it?
- 8 A: If who had net operating losses?
- 9 Q: CarMax West Coast.
- 10 A: If they had net operating losses, that this
11 structure wouldn't be any benefit?
- 12 Q: Correct.
- 13 A: That's including the flow-through from CarMax
14 Business Services and everything else?
- 15 Q: Yes, yes, yes.
- 16 A: If they had net operating losses for that
17 particular year, they would not owe any South
18 Carolina taxes.
- 19 Q: Now, there's been a lot of talk about the
20 inclusion of the West Coast sales in the
21 denominator of the sales factor, correct?
- 22 A: Correct.
- 23 Q: That is one of the major objections that the
24 Department has in this particular case; is that
25 correct?

- 1 A: That's correct.
- 2 Q: Okay. But is it not a fact that those sales
- 3 contributed to the income of CarMax West Coast?
- 4 A: Correct.
- 5 Q: So that the portion -- if it were not for those
- 6 sales, no matter what the apportionment formula
- 7 may have been, no income would have been
- 8 apportioned to South Carolina, would it?
- 9 A: Can you restate that, I'm sorry?
- 10 Q: Yes. Doesn't CarMax West Coast, doesn't it
- 11 have to have those sales in order to have
- 12 income?
- 13 A: Currently, no, because they would still get the
- 14 income from CarMax Business Services.
- 15 Q: They would get that income. But what if they
- 16 had no sales, they'd have a bunch of losses to
- 17 offset it with, would they not?
- 18 A: If they had no sales ...
- 19 Q: They still have all their own expenses.
- 20 A: Well, I mean, it's -- I guess I made that
- 21 statement that if CarMax was not operating
- 22 retail stores --
- 23 Q: Uh-huh (affirmatively responds).
- 24 A: -- they would still have the income from CBS.
- 25 Q: So you're thinking as if, perhaps, it was just

1 a shell and did nothing else?

2 A: Well, obviously, it's making sales.

3 Q: Those sales contribute to its income, don't
4 they?

5 A: Correct.

6 Q: About the penalty, I want to ask you some
7 questions about it. I'm not quite sure where
8 we are on this penalty right now.

9 THE COURT: Mr. von Lehe, let me interrupt you one
10 second.

11 MR. VON LEHE: Yes.

12 THE COURT: How much more do you have? Because we
13 still got Dr. Harrison, right?

14 MR. TRAYNHAM: Your Honor, I may have one or two
15 questions on redirect with the Court's
16 indulgence. Dr. Harrison's testimony, given
17 the way this afternoon has gone, could take
18 several hours in combination with closing.

19 THE COURT: Yeah. Well, that's what I was thinking.
20 We're not going to finish tonight, unless we
21 stay here until nine o'clock.

22 MR. VON LEHE: Agreed, Your Honor.

23 THE COURT: I don't think it's going to happen. But
24 if you want to go ahead and finish your
25 cross-exam --

1 MR. VON LEHE: I would like to do that, Your Honor.

2 THE COURT: Certainly. Let's do that.

3 MR. VON LEHE: I would like to do that.

4 Q: So just some questions about the penalty. Do
5 you believe that these penalties, you yourself,
6 do you believe they ought to be applied?

7 A: Well, I think you have to apply the
8 understatement penalties. I think negligence,
9 you know, I see the arguments on both sides.

10 Q: Now, according to what the auditor said, you
11 said that he named the person in the Department
12 and said that "She said you always write down
13 a negligence penalty on this type of case."
14 This is what he said in his deposition. Do you
15 agree with that?

16 A: I think if it's gotten egregious, that it
17 should be applied.

18 Q: But in this particular case, you think that
19 perhaps it would be judgmental as to whether it
20 should apply or not?

21 A: I mean, again, it's like beauty, it's in the
22 eyes of the beholder.

23 Q: This taxpayer filed a return, though, did it
24 not?

25 A: It did file a return, yes.

1 Q: Now, about the negligence penalty. What notice
2 would a taxpayer have had that it should do
3 what the auditor says it should do?

4 A: I think even going back and listening to
5 Ms. Yost's comments is that, you know, they
6 hired some outside state and local reputable
7 firms and so, you know, through that they
8 should know that -- you know, that the states
9 may take a position, a tax position against,
10 you know, a structure such as this.

11 Q: You mentioned the understatement penalty and
12 that that had to be applied.

13 A: Correct.

14 Q: That is true, that it does have to be applied.
15 But isn't it also true that there's a second
16 step to be looked at and that's to determine
17 whether or not the taxpayer has got substantial
18 authority for its position?

19 A: It's been a while since I looked at the
20 statute, so ...

21 Q: "The amount of the understatement penalty must
22 be reduced by that portion of the
23 understatement by which is attributable to the
24 tax treatment of any item by the taxpayer if
25 there is or was substantial authority for such

1 treatment."

2 So if the taxpayer had substantial authority
3 for its position, should a substantial
4 understatement penalty be applied?

5 A: And I guess my position is, I think that's what
6 we're here today for, is to allow the Court to
7 decide whether or not that's a substantial
8 position.

9 Q: Wouldn't you agree that a tax return and a set
10 of instructions is substantial authority in
11 indicating to a taxpayer what they can and
12 cannot do?

13 A: The instructions would be an authority.

14 Q: Also, the penalty is also to be reduced -- "any
15 item with respect to which the relevant facts
16 affecting the item's tax treatment are
17 adequately disclosed in the return ..."

18 Is there any question about disclosure here?
19 Was there anything -- it was all laid out in
20 the return as to how they were filing, right?
21 All their income was shown there.

22 A: They did show their income, yes.

23 Q: It's just a question of, shall we say, the term
24 you used, coming up a with a different method.
25 That's got nothing to do with what the taxpayer

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1 disclosed.

2 A: That's correct.

3 Q: You could take this return and make these
4 adjustments. Nobody had to go out there and
5 dig through all of their records to make these
6 adjustments, did it? I mean, I know they did.

7 A: Yeah.

8 Q: But, I mean, can't you get it off of what the
9 returns shows?

10 A: I haven't looked at the returns that thoroughly
11 to ...

12 Q: All right, sir.

13 **MR. VON LEHE:** One moment, Your Honor.

14 Q: Were you aware of the fact that the proposed
15 assessment was sent out before the auditor even
16 went out there?

17 A: The proposed assessment with my signature?

18 Q: No. I think it was a set of working papers.

19 **MR. VON LEHE:** Do we know? With their signature?

20 **MS. YOST:** It was a set of working papers.

21 Q: Set of working papers.

22 A: I was not aware of that, no.

23 Q: Didn't that indicate that the auditor had the
24 information on the return to make the
25 adjustment?

1 A: If the --

2 Q: It drew up the working papers and send them out
3 there before he ever went out there?

4 A: If the final work papers did not vary greatly,
5 I would say that the auditor obviously had
6 enough information.

7 MR. VON LEHE: All right, sir. Thank you very much.

8 THE COURT: Redirect, Mr. Traynham?

9 MR. TRAYNHAM: Thank you, Your Honor. And I'll be
10 very brief.

11 MR. DONOVAN - REDIRECT EXAMINATION BY MR. TRAYNHAM:

12 Q: Mr. Donovan, there was some discussion about
13 the lack of a bright-line standard and whether
14 or not there's any publications regarding the
15 type of statute that might be applied to this
16 taxpayer. Tell me, would you use the type of
17 formula utilized by the auditor in this case
18 for a similarly situated East/West taxpayer?

19 A: Yes. We've used the formula several times.

20 Q: So you have used a similar formula in previous
21 cases with these issues?

22 A: Correct.

23 MR. TRAYNHAM: Thank you, Mr. Donovan. No further
24 questions, Your Honor.

25 THE COURT: Thank you so much, Mr. Donovan. You may

1 be excused.

2 And you had another question?

3 MR. VON LEHE: No. Thank you, Your Honor.

4 THE COURT: All right. And with that, we'll recess.

5 (The proceedings adjourned at 5:40 p.m. on Thursday,
6 February 18, 2010, and reconvened on Friday, February
7 19, 2010 at 9:04 a.m.)

8 THE COURT: Good morning, everyone. When we
9 recessed yesterday, I believe the
10 cross-examination of Mr. Donovan was complete
11 and I would note for the record that this is
12 day two of the case which is entitled CarMax
13 Auto Superstores West Coast, Incorporated,
14 versus South Carolina Department of Revenue,
15 our docket number is 09-ALJ-17-0060-CC, and
16 that all parties are present and represented by
17 counsel.

18 And it is now the Department of Revenue's case
19 and, Mr. Traynham, when you're ready, you may
20 call your next witness.

21 MR. TRAYNHAM: Thank you, Your Honor. Your Honor,
22 one preliminary matter -

23 THE COURT: Sure.

24 MR. TRAYNHAM: -- just as a matter of clarification,
25 I believe that Your Honor admitted proposed

1 Exhibit Thirty-one yesterday as a demonstrative
2 exhibit.

3 THE COURT: Yes.

4 MR. TRAYNHAM: I just wanted to make sure that was -

5 THE COURT: Yes, that is correct.

6 MR. TRAYNHAM: -- on the record. There's some
7 question about that. Thank you, Your Honor.

8 (Proffered Joint Exhibit Number Thirty-one was
9 admitted into evidence.)

10 MR. TRAYNHAM: Your Honor, the Department would call
11 as its next witness Dr. Glenn Harrison.

12 THE COURT: Dr. Harrison, you move to the front row
13 today. If you'll come over here, I'll ask our
14 court reporter to administer the oath or
15 affirmation to you.

16 GLENN HARRISON, having been duly sworn, testifies and
17 examines as follows:

18 DR. HARRISON - DIRECT EXAMINATION BY MR. TRAYNHAM:

19 Q: Good morning, Dr. Harrison.

20 A: Good morning.

21 Q: Dr. Harrison, what is your current title?

22 A: My current title is C.V. Starr Chair in Risk
23 Management & Insurance at the Department of
24 Risk Management & Insurance, the Mack College
25 of Business, Georgia State University.

1 Q: And what are your duties in that capacity?

2 A: Actually, I have one other title I should
3 mention. I'm also director of the new center,
4 the Center for Economic Analysis of Risk. My
5 duties for both of those are teaching in the
6 areas of economics, risk management, enterprise
7 risk management and directing the research
8 activities of the new center.

9 Q: And the economic analysis of risk, what exactly
10 does that entail, Dr. Harrison?

11 A: Actually, a little bit of everything. To the
12 extent that risk is a factor in our economic
13 lives, we study the behavior of risk as it
14 affects individuals, as it affects households,
15 as it affects organizations, as it affects
16 societies.

17 We also study risk in a noneconomic sense, so
18 it's not just limited to what people might
19 normally think of as financial or economic
20 risk. It includes health risk, litigation
21 risk, political risk.

22 Q: Dr. Harrison, what are your primary areas of
23 research?

24 A: Well, over the years I've done a lot of
25 research in various areas, as my CV will show.

1 My primary areas of research, broadly defined,
2 would be economics, applied economics,
3 specifically with applications in behavioral
4 economics, international trade, in public
5 finance, in law and economics, in environmental
6 and resource economics and several other
7 miscellaneous areas.

8 Q: And you mentioned your CV. I'd refer you to
9 what's been tabbed Exhibit Thirty in the
10 exhibit notebook. Right at the back.

11 **THE COURT:** Off the record.

12 (Off the Record)

13 A: Okay. I have it.

14 Q: Is this your most recent CV?

15 A: Yes, it is my most recent CV. Since then I've
16 had, actually, a couple of papers accepted, but
17 nothing of great significance in terms of this
18 case.

19 Q: And this CV contains your work experience, your
20 teaching experience, expert testimony and so on
21 and so forth?

22 A: Yes, it does.

23 **MR. TRAYNHAM:** Your Honor, we would offer this as an
24 exhibit to the Court.

25 **MS. GEER:** No objection, Your Honor.

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1 THE COURT: Thank you. Without objection, Exhibit
2 Number Thirty admitted into evidence, CV of Dr.
3 Glenn W. Harrison.

4 MR. TRAYNHAM: Thank you, Your Honor.

5 (Joint Exhibit Number Thirty was admitted into
6 evidence.)

7 Q: Dr. Harrison, when you were describing your
8 areas of research, you mentioned public
9 finance. Could you tell us what exactly the
10 research area of public finance entails?

11 A: Sure. Public finance deals with the design and
12 analysis of the effects of tax policy and
13 expenditure policy by local governments, by
14 state governments, by federal governments and,
15 also, at an international level. So it's
16 looking at the general fiscal incidences
17 economists would use: how does the state effect
18 policy, how does the state design policy, what
19 are the effects of policies that the state
20 designs.

21 Q: So you frequently examine tax law, tax
22 statutes, tax policy from an economic
23 perspective?

24 A: Oh, that's an essential part of public finance.
25 It's also an essential part of international

1 trade, because we think of tariffs as taxes, so
2 it's the same methods of economic analysis that
3 are used.

4 Q: Dr. Harrison, would you just briefly summarize
5 your work history prior to your job with
6 Georgia State University for the Court?

7 A: Sure. Before moving to Georgia State, this
8 August, last August, I was an endowed Chair at
9 the University of Central Florida in Orlando,
10 and that was about six years. And before that,
11 I had an endowed chair here at the University
12 of South Carolina for -- I believe it was about
13 13 years -- it's just a matter of record -- and
14 that was the Moore School of Business. Before
15 that I was a professor at University of New
16 Mexico, University of Western Ontario, and I
17 did my Ph.D. before that at UCLA. And before
18 that I was -- did my undergraduate degree in
19 Australia.

20 Q: And you were an Australian football star, as
21 well, weren't you?

22 A: I was an Australian football player and my --
23 my card sells for about 13 cents on eBay at the
24 moment, so if you want to call that a star,
25 then thank you very much.

1 Q: Fair qualification. Dr. Harrison, as part of
2 your teaching experiences through your various
3 academic positions, you've taught a course
4 called "Economics and Law," have you not?

5 A: Yes. In fact, I taught that for several
6 decades starting here in South Carolina and
7 through to the present.

8 Q: What exactly does that course and that subject
9 area entail?

10 A: Well, the subject area as a whole deals with
11 the interrelationship between the law and
12 economics. To what extent legal doctrines,
13 Supreme Court cases, laws affect economic
14 behavior and, in the direction, to what extent
15 laws can be viewed as a response to economic
16 necessities, to what extent they can -- the
17 common law, for example, can be viewed as
18 evolving to be efficient from an economist's
19 perspective. So it's a two-way street in terms
20 of the field of law and economics.

21 Q: Does this experience give you the expertise to
22 draw legal conclusions or give opinions?

23 A: Certainly not. I certainly offer them to
24 anyone who asks, but I wouldn't call myself an
25 expert in that. I am careful about that.

1 Q: Your examination of the law and economics is
2 the law from an economic's perspective; would
3 that be a fair statement?

4 A: Yeah, certainly, and it involves reading
5 Supreme Court cases. In fact, most of the
6 classes that I teach, I like to teach them in
7 a case study mode where -- because a lot of the
8 law students that take those classes are used
9 to that and so we start with Supreme Court
10 decisions and work backwards to the economics.

11 Q: Dr. Harrison, could you briefly summarize your
12 educational background?

13 A: Yes. I have a -- as I mentioned briefly, an
14 undergraduate degree in Australia, Bachelor of
15 Economics, with honors. I have a Master of
16 Economics from a university in Australia. Then
17 I have a Ph.D. in economics from UCLA.

18 Q: Okay. Dr. Harrison, you stated that your CV
19 contains your expert testimony, your prior
20 experiences as an expert. What types of issues
21 have you opined on in previous cases as an
22 expert?

23 A: Well, it's a wide range of issues, but, most
24 particularly, I've been working on the
25 calculation of damages, both compensatory and

1 punitive damages. That would characterize, I
2 think, the bulk of most of my testifying over
3 the years.

4 But I've been doing a number of other issues,
5 looking at questions such as the use of --
6 questions of relationship between punitive
7 damages and compensatory damages, the manner in
8 which one looks at accounting statements in
9 order to calculate compensatory damages, the
10 manner in which one looks at claims data,
11 particularly in a medical context in terms of
12 drugs to calculate damages. So it's the
13 relationship between accounting statements and
14 damages as they appear in court.

15 Q: You previously testified before the South
16 Carolina Administrative Law Court as an expert?

17 A: Yes, I have.

18 Q: And in what area were you qualified as an
19 expert in there?

20 A: Actually, I don't recall the exact designation.
21 I believe it was in economics and it was
22 looking at tax policy, regional tax policy, but
23 I don't recall the exact designation.

24 Q: Your academic research and your experiences as
25 an expert witness, have they led you to examine

1 economic rationale for tax systems or tax
2 statutes?

3 A: Oh, yes, that's an essential part of the area
4 of public finance that I was talking to you
5 about.

6 Q: And would you tell the Court in just a little
7 more detail about your experiences specifically
8 examining those tax systems and statutes?

9 A: Sure. Well, perhaps the first paper that I
10 ever wrote in this area, which is listed on my
11 CV under -- on page ten, that's the first
12 publication in 1984 -- and it's terrifying to
13 realize I'm that old -- "General Equilibrium
14 Analysis of Regional Fiscal Incidence," was
15 actually an attempt to look at what are the
16 interregional, interstate implications of taxes
17 in one area when you do or do not have mobility
18 of factors from one state to another. What's
19 the effect of imposing a tax in one state on
20 whether capital/labor will move out of that
21 state or move into that state, so it's to do
22 precisely those sorts of questions.
23 I've also published a number of other papers on
24 tax policy looking specifically at questions
25 such as tax incidence, how does one define

1 economic tax incidence as distinct from the
2 nominal legal incidence of the tax.

3 Q: And referring again to your CV, are there any
4 other publications of particular note that you
5 feel might be relevant to the issues in this
6 case as you understand them?

7 A: Yes. There's one in particular, because I was
8 hearing a lot of discussion and I'm realizing
9 that there's a lot of discussion here about the
10 manner in which one can examine the accounts of
11 certain books -- of certain companies to
12 identify components. And this is one that is
13 Mooresville -- I can't find the exact reference
14 right now. Oh, yes, it's on page 16. It's
15 publication 11. It's listed under the Law and
16 Economics section. "Mooresville Honda Company:
17 A case in forensic accounting," which was
18 published in the "Journal of Accounting
19 Education," which illustrates the manner in
20 which one can, as I mentioned earlier, look at
21 accounting statements in order to identify
22 damages, even if one might think of the company
23 as unitary in some sense.

24 Q: And, Dr. Harrison, what have you been asked to
25 do in this case?

1 A: The broad question I was asked to look at is
2 the economic nexus between South Carolina and
3 the taxpayer and the extent to which that
4 economic nexus, the amount of economic
5 activities that the taxpayer has in South
6 Carolina, is connected to the audit statements
7 that were made.

8 So I was asked to look at the economic aspects
9 of the determination that the Department made.
10 And, also, to look specifically at some of the
11 concepts that have arisen in the dispute that
12 has been raised, such as a unitary business,
13 such as those sorts of things, economic
14 consequences of those.

15 Q: And what have you reviewed in preparing for
16 this case?

17 A: I have reviewed the heavy tax filings of the
18 taxpayer. I reviewed the Department's
19 determination, that included the audit report,
20 the field audit report. I have reviewed the
21 taxpayer's letter of protest, I think it's
22 called. I have reviewed the depositions of
23 Mr. Zinn and Ms. Yost. I've reviewed the
24 expert report of Mr. Zinn. Actually, I don't
25 recall if I've read the deposition of Mr. Zinn.

1 I certainly have read his expert report. I've
2 read the deposition of Dr. Wilder. And I have
3 reviewed South Carolina codes that are relevant
4 for this case, a number of academic
5 provocations that pertain to this question.

6 Q: Did you review any South Carolina case law?

7 A: Yes, I did have a chance to look at some
8 aspects of the Exxon case that's referred to,
9 which is where the South Carolina Supreme Court
10 gave, I thought, a rather excellent definition
11 of what a unitary business is.

12 It actually also appeared in the taxpayer's
13 letter of protest, so I had a chance -- I
14 wanted to have a chance to look at the
15 definition in context to see if that was, in
16 fact, what they meant or they were using that
17 as a straw man. I had occasion to read
18 Geoffrey, as well.

19 Q: And did you have occasion to read any other
20 academic articles, papers, publications on the
21 subject matter implicated in this case?

22 A: I had a chance to look at some of the Supreme
23 Court cases that deal with the concept of
24 unitary business, unitary income and unitary
25 business, going back to the Allied-Signal case

1 back in '92 and then there's a more recent case
2 in 2008, the MeadWestvaco. This is the
3 Lexis/Nexis sale with the Illinois Department
4 of Revenue where essentially the Supreme Court
5 revisited the interpretation and the use and
6 abuse of the concept of unitary business.

7 Q: Did you -- Dr. Wilder testified yesterday about
8 an article by a gentleman named Charles McLure
9 involving economics and the concept of unitary
10 business. Did you have an opportunity to
11 review that article?

12 A: Yes, I was particularly interested in that
13 because I have a long association with Charles
14 McLure. He was actually the published
15 discussant on the very first paper that I ever
16 wrote on public finance, the one I told you
17 about, "Regional Fiscal Incidence." I was
18 quite honored that he was -- he had a
19 discussion on, a comment on that paper. It was
20 published in that volume.

21 So when Dr. Wilder mentioned that, I thought
22 McLure always says smart things, so I went back
23 and read that and I was quite struck with it
24 being a very, very prescient article,
25 essentially presenting a point of view that's

1 consistent with my interpretation of the South
2 Carolina Supreme Court's definition here,
3 that -- in brief, that the concept of a unitary
4 business is a very elastic one. It's not a
5 hard and fast --

6 Q: We should probably get to that after you've
7 been qualified, but I appreciate it.

8 A: Certainly.

9 MR. TRAYNEAM: At this time, Your Honor, we would
10 offer Dr. Harrison as an expert in economic
11 principles, generally, but also in the field of
12 law and economics. Not as an expert in the
13 law, I want to qualify that, but as an expert
14 in the intersection of law with economics.

15 THE COURT: Mr. Von Lehe, Ms. Geer?

16 MS. GEER: Your Honor, we don't have any objection
17 to him being qualified as an expert in the
18 field of economics generally, but I'm not sure
19 the field of law and economics, I think we have
20 an objection to that narrow of field.

21 THE COURT: Would you like to ask him some questions
22 in that regard first?

23 Because the qualification you're seeking is an
24 expert in economics and the intersection of law
25 and economics; am I correct?

1 MR. TRAYNHAM: Law and economics, yes, Your Honor.
2 Essentially what we're seeking is his expert
3 opinion on legal precedents and statutes from
4 an economic's perspective. Not a legal opinion
5 as to what case law says or what statutes are
6 meant to do legally, but what economic
7 rationale for these things could be.

8 MS. GEER: Your Honor, may I have a moment?

9 THE COURT: Certainly.

10 MS. GEER: Your Honor, we don't have an objection,
11 actually.

12 THE COURT: All right, then, without objection,
13 Dr. Harrison is qualified as an expert in
14 economics and the application of --

15 MR. TRAYNHAM: Economics to the law.

16 THE COURT: -- economics to legal -- or legal
17 interpretations. Okay, fine, so qualified.

18 MR. TRAYNHAM: Thank you.

19 Q: Professor Harrison, as part of your as
20 preparation for this trial, did you examine
21 South Carolina's apportionment statutes?

22 A: Yes, I did, Sections 2250, 2260, 70 and 80,
23 which gives some definition to 2250, the actual
24 formulas; 2290, that pertains to gross
25 receipts, that's relevant here, and, most

1 importantly, 2320.

2 Q: And I think in your deposition you described
3 South Carolina apportionment statutes as sort
4 of a flow chart system or a tier system. Could
5 you explain to the Court how exactly you
6 perceive the rationale for these apportionment
7 formulas?

8 A: Sure. And I think -- I would think of it more
9 like a hierarchy, so that at the very beginning
10 you've got 2520, which is saying, if the
11 business is in the spirit of UDITPA a business
12 that we normally see that has tangible
13 property, that has employees in South Carolina,
14 that has a broad level of economic activity in
15 South Carolina, we can apply this three-factor
16 double-weighted apportionment formula.

17 South Carolina has modified the UDITPA to
18 suggest you put extra weighting on one of the
19 factors, but that's quite standard. You see
20 that across the states.

21 So at the top tier, we have case law that says,
22 if you fall into this large category, here
23 is -- here are the rules that we'll apply to
24 determine your tax.

25 2250 says nothing about the tax base. It says

1 once the apportionable amount is determined --
2 and, indeed, Pierce talked about that in his
3 earlier papers. He said, "We take as given
4 what the tax base is." We then determine how
5 it should be allocated to South Carolina, given
6 that it's a multi-jurisdiction corporate
7 entity.

8 But then, of course, that's -- that may be the
9 majority of businesses, but it's not all of the
10 businesses. So there's a recognition,
11 particularly in 2290, of different types of
12 businesses that might need a different type of
13 single factor, as has been referred to in this
14 trial: single factor, maybe gross receipts
15 determination.

16 But, most importantly, there's a recognition
17 that whilst the majority is covered by 2250 and
18 a large part of the minority may be covered by
19 2290, there's going to be some cases that are
20 simply not covered by this. Could be because
21 of innocent activities of the taxpayer. Quite
22 honestly -- and we can see this clearly in the
23 design of these tax principles -- there's a
24 recognition that taxpayers are taught how to
25 hide taxes. Taxpayers are given courses on how

1 to evade and avoid taxes. And so we need a
2 recognition that we have to have methods that
3 can handle that.

4 **MS. GEER:** Your Honor, we would object to this type
5 of testimony. If they're pointing to CarMax,
6 there's been no evidence that CarMax has been
7 set up in this way, so we would object to the
8 testimony on those grounds and that question.

9 **MR. VON LEHE:** Your Honor, if I might add to that,
10 we certainly would object to it with regard to
11 CarMax. If it's not with regard to CarMax, we
12 object to it as being irrelevant to this case.

13 **MR. TRAYNHAM:** Your Honor, I would beg to differ
14 that no testimony or evidence has been offered
15 that CarMax is set up in this fashion. But I
16 would also state for the record that thus far,
17 Dr. Harrison is testifying as to his perception
18 of the rationale behind the apportionment
19 statutes. Right now he's talking about 2320.

20 **THE COURT:** He is, but, again, it appears to me that
21 Dr. Harrison is making, in a sense, a value
22 judgment that companies in general are taught
23 ways of evading taxes and I'm not sure that --
24 you know, what that has to do with this
25 particular case.

1 I mean, obviously, that's his experience and he
2 has observed that, then it's a generic comment,
3 I don't think it's objectionable, but I don't
4 think it's relevant to this case and I agree
5 with Mr. Von Lehe on that.

6 Q: So getting back to 12-6-2320, Dr. Harrison, I
7 believe you stated that there is a recognition
8 in that statute and in the apportionment
9 statutes, generally, that there are going to be
10 exceptions that do not fall within the standard
11 statutory formulas and that is what that
12 statute is there for?

13 A: Absolutely, whether those are by intent or
14 just -- they just happen and that's -- that's
15 just a recognition that accounting -- the
16 application of accounting rules cannot cover
17 every possibility in terms of a single formula
18 or even two formulas.

19 MR. VON LEHE: Your Honor, objection, conclusion of
20 law. He's testifying about a South Carolina
21 statute.

22 THE COURT: I'm sorry, I was taking notes and I
23 totally missed what you said, Dr. Harrison.
24 Would you repeat that and then I'll --

25 MR. TRAYNHAM: Perhaps, Your Honor, if we could have

1 that question either read back or if he could
2 repeat it.

3 **THE COURT:** Can you tell us what exactly was said,
4 Madam Court Reporter?

5 (The question was read back at this time.)

6 **Q:** Getting back to 12-6-2320, Dr. Harrison,
7 I believe you stated that there's a
8 recognition in that statute, in the
9 apportionment statutes that there are
10 going to be exceptions that don't fall
11 within the statutory formulas and that is
12 what that statute is there for ...

13 **THE COURT:** Okay. Well, let's talk about -

14 **MR. VON LEHE:** I think that's close enough, what she
15 just read back. It's a reference to the South
16 Carolina statute, he's being asked to give an
17 opinion on. It's a conclusion of law, I
18 submit.

19 **MR. TRAYNHAM:** If I may restate the question.

20 **THE COURT:** Okay. Yeah, could you restate the
21 question, Mr. Traynham?

22 **Q:** Dr. Harrison --

23 **THE COURT:** I'll stop taking notes for a minute..

24 **Q:** -- in your opinion as an expert in the
25 intersection of economics and law, what

1 economic rationale is there for a statute like
2 12-6-2320?

3 A: The economic rationale would be that, as I
4 noted earlier, there's going to be some
5 fraction of companies -- it might be a small
6 fraction, might be a large fraction of
7 companies -- that will not be able to be taxed
8 according to the rules that are set out in 2250
9 or even 2290. That just has to do with the
10 nature of economic activity, the nature of the
11 accounting for that economic activity, so it's
12 appropriate that laws are designed in order to
13 address that residual category.

14 Q: Dr. Harrison, you referred earlier to
15 12-6-2250, the double-weighted three-factor
16 formula. Are you familiar with the history of
17 the formula that's utilized in this statute?

18 A: Yes, I am.

19 Q: Okay. And where does this formula come from?

20 A: Well, as Mr. Zinn testified yesterday, I mean,
21 it had its origins in the attempt to --

22 MS. GEER: Your Honor, I apologize, I'm a little
23 late, but I still think that this is falling
24 along the lines of interpreting South Carolina
25 law in speaking about the history of this

1 particular statute and I'm not sure that he's
2 been qualified as an expert in taxation or the
3 laws related to taxation, so we would object to
4 that line of questioning.

5 **THE COURT:** I think it's within the ambit of what
6 he's qualified to do and it's certainly just --
7 obviously, it's an opinion and I will give it
8 such weight as I think it merits. But, to me,
9 he's just explaining what he thinks the
10 rationale is for these statutes.

11 **MR. TRAYNHAM:** Yes, Your Honor.

12 **THE COURT:** And I think that's a little different
13 from giving an interpretation as to what the
14 law means.

15 **MR. TRAYNHAM:** Thank you, Your Honor.

16 **THE COURT:** Yeah, I'll continue to listen closely,
17 but I thank you.

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

19 **THE COURT:** Uh-huh (affirmatively responds).

20 **A:** Could you restate the question?

21 **Q:** Certainly. And where exactly does this formula
22 come from?

23 **A:** Well, it comes from a discussion in the public
24 finance literature and the tax literature and
25 the accounting literature. They had to come

1 together in order to talk about these things.
2 And that was the work of Professor Pierce, who
3 is a professor -- who was a professor of law,
4 but was also advised by professors of economics
5 that worked in public finance and also
6 accountants. So he was the lead drafter of
7 these -- let's call it a model statute, which
8 I think is the best way. It's not a statute.
9 It is, as I understand it, accepted by a number
10 of states in part, but it was developed as a
11 model statute.

12 Q: And that model statute is commonly referred to
13 as UDITPA?

14 A: UDITPA, yes.

15 Q: And what about 12-6-2290, is it your
16 understanding that this a UDITPA-type statute?

17 A: Yes. The original idea behind, again, this
18 model statute was -- from an economist point of
19 view, was to recognize that there can be
20 certain rules that can be set down for a large
21 number of economic entities, firms -- we're
22 talking about corporate firms now, in multi-
23 jurisdictional settings. That's the economic
24 context that we're talking about. You can set
25 down some rules and that's useful in terms of

1 due process, firms knowing exactly what's going
2 to happen in terms of taxes. But, again, in
3 the spirit of the hierarchy, that there are
4 some that are going to be residuals and are
5 going to be captured well for the purposes of
6 an individual state for its objectives by these
7 apportionment formulas.

8 Q: And in the economic literature and public
9 finance literature that you've encountered,
10 written on and researched, you've had
11 occasion -- have you had occasion to study
12 UDITPA, its history, its drafting and so forth?

13 A: Yes, yes, it's commonly covered in detailed
14 textbooks on public finance, particularly those
15 with a U.S. emphasis.

16 Q: And in your understanding of that history, did
17 the drafters intend for that three-factor
18 formula to encompass all taxpayers?

19 A: Well, I -- I'm not going to opine about what
20 their intentions were, but certainly as I read
21 what they've done, as an economist, it seems to
22 me quite reasonable what they're saying.
23 Almost explicitly, and, indeed, it's -- you can
24 see that in the South Carolina codes, is if
25 you're this type of firm, here is a rule that

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1 we believe is appropriate for you. That's what
2 the code literally says.

3 2290 says the same thing, if you're this type
4 of firm, here's a formula that works for you.
5 And then 2320 is saying if you don't fit into
6 one of these, we have certain avenues available
7 to determine your taxes, constrained by
8 reasonableness, and that's -- that's an
9 important constraint.

10 Q: Okay. Now, what about 12-6-2320, is this
11 language related to UDITPA?

12 A: Yes, it actually follows relatively closely, as
13 Mr. Zinn noted, from Section 18 of UDITPA.
14 It's not exactly the same as the regulations
15 that were written because very often if you
16 have a statute, you'll have regulations written
17 pursuant to it, and so they had draft
18 regulations written pursuant to the draft
19 statute. Those regulations did not find their
20 way into the South Carolina codes, for whatever
21 reason. I just take the codes as I find them
22 and read them.

23 Q: And would you agree with Mr. Zinn's testimony
24 from yesterday that 12-6-2320 provides broad
25 powers to a taxing agency?

1 A: Oh, yes, and that's the clear intent, with the
2 qualification that everyone keeps saying, and
3 it's an important one, that those powers be
4 exercised in a reasonable manner and for the
5 purpose that's listed in 2320. There is a
6 specific purpose that is stated there in terms
7 of why those powers have been given.

8 Q: From an economic perspective, Professor, what
9 reason might there be for creating such a broad
10 statute, as opposed to giving more specific
11 guidance on specific situations?

12 A: Precisely because you cannot write -- from an
13 economist's perspective, you cannot write a
14 contract for every circumstance. You cannot
15 anticipate every possibility. That's the very
16 general law and economics answer as to why we
17 have breach of contract, for example. You
18 cannot write a contract that thinks about every
19 possibility that can occur.
20 Similarly, in terms of statutes, thinking of
21 statutes, if you like, as an implied contract
22 between the state and the actors in the state,
23 you can't write a contract, a statute that
24 considers every possibility, whether it's an
25 economic possibility, the nature of the

1 economic -- the economic nature of the firm,
2 the nature of the accounting that's employed.
3 So you need to have these residual -- I like to
4 think of them as residual powers. They're
5 broad, but they are constrained and that's an
6 important part of 2320.

7 Q: Professor, you've had ample occasion to examine
8 12-6-2320 in your preparation for this case,
9 have you not?

10 A: Yes, indeed.

11 Q: And the language of 2320 indicates that there
12 is a triggering mechanism for that statute,
13 correct?

14 A: Yes, it's in plain English.

15 Q: What is the trigger, so to speak?

16 A: Well, the trigger, it would -- if I could see
17 the exact language, but it is whether the
18 activities of the taxpayer are fairly
19 represented, the business activities are fairly
20 represented by the previous formulas.
21 Again, think of it in a flow chart or a
22 hierarchy. The trigger is those -- the
23 apportionment formula standardly applied from
24 2250 or the single-factor formula from 2290,
25 does that fairly represent the business

1 activity in South Carolina. And if the answer
2 is "no" -- and that's the question the Judge
3 was asking yesterday, if there is some
4 determination that it does not, that's the
5 trigger, and that's in plain language.

6 Q: In examining the taxpayer and its filings and
7 its -- and the issues in this case, is there
8 anything economically about this taxpayer that
9 in your view would not be fairly represented by
10 the method they've chosen to apportion their
11 tax?

12 A: Yes, actually, in terms of the economic
13 structure of the firms that we're talking
14 about. The firm we're talking about, it was
15 perfectly obvious and it was perfectly obvious
16 from the field audit report what that was.

17 Q: Okay. Would you tell us, in your opinion, what
18 it was that triggered the examination by the
19 auditor -- or, excuse me, wouldn't ask you to
20 opine on what the auditor might have thought or
21 intended, but what from your perspective
22 economically is the trigger that would
23 implicate 12-6-2320 for this taxpayer?

24 A: Sure. As I was reading in the documents, it
25 was clear to me that the trigger -- again, the

1 answer to the Judge's question yesterday -- was
2 the type of activity that occurred. It wasn't
3 the level of activity, necessarily. That
4 can -- as Mr. Donovan testified yesterday in
5 terms of the instructions he gives auditors, it
6 might be the level of the activity. Whether
7 it's less than two percent or less than one
8 percent, that might be a trigger for them.

9 But here, the clear trigger was that it was an
10 apples and oranges problem. And if I can use
11 a metaphor, think of -- think of the taxpayer -
12 - and so the activity, business activity in
13 South Carolina as an apple. I mean, you see
14 something going on. By an "apple," I mean a
15 certain type of activity. Then you see it
16 being mixed with a larger business that's got
17 apples and oranges. And I'll explain what I
18 mean by an apple and an orange in this
19 particular case in a second.

20 So simply recognizing that the taxpayer was an
21 apple company and that the other companies that
22 have been the denominator it was being mixed
23 with was a fruit company, an apples and an
24 oranges company, that's -- that leaps out at
25 you. And I saw that in the testimony of Mr.

1 Donovan. I saw it in the documents in the
2 audit report.

3 So to be specific about apples and oranges, I
4 mean, the apples here are the franchise
5 payments, the royalties for intellectual
6 property and financing later on, in the last
7 couple of years; whereas, the oranges in this
8 case were the retail sales. There were no
9 oranges in South Carolina.

10 So it wasn't a matter of was there a bright
11 line in terms of amount of dollars. It was
12 simply a matter of type. Exactly as
13 Mr. Donovan said yesterday, the type of
14 economic structure of the firms is sort of
15 clearly different. One's an apple company; the
16 other's a fruit company. They shouldn't be
17 compared.

18 Q: Dr. Harrison, you stated that you've reviewed
19 the taxpayer's protest letter and expert report
20 in this matter, correct?

21 A: Yes, I reviewed Mr. Zinn's expert report, if
22 that's the one you're talking about.

23 Q: Do those documents include the taxpayer's own
24 description of its business activities?

25 A: Yes, I think they have -- the facts for the

1 factual part of the protest letter I thought
2 were quite straightforward.

3 Q: Based on your review of those business
4 activities, do you think it makes any economic
5 sense for the taxpayer to utilize the
6 three-factor formula of 12-6-2250?

7 A: No, it was perfectly clear that the taxpayer
8 did not engage in the type of activities that
9 were triggered by 2250.

10 Q: Do you believe, based on your review of the
11 taxpayer's activities, that the gross receipts
12 formula of 12-6-2290 can in any economic sense
13 accurately reflect the extent of the taxpayer's
14 business in this State?

15 A: Well, it can if there is an adjustment to the
16 tax base, and if there's an adjustment -- and
17 that's exactly what 2320 is for. So, indeed,
18 you might use a gross receipts, but you have to
19 change the tax base. And that's precisely what
20 2320 provides and, in fact, requires the
21 Department to do, if those triggers are met and
22 if it does it in a reasonable manner.

23 Q: Dr. Harrison, have you had occasion to examine
24 combined income tax reporting methods in any of
25 your research or expert services?

1 A: Yes, I have.

2 Q: And there's been some testimony on that
3 previously, but would you briefly outline for
4 the Court what combined reporting is, what
5 economic sense it makes?

6 MS. GEER: Your Honor, we would object to this line
7 of questioning. Combined reporting, as we've
8 talked about in our previous objections, is not
9 at issue in this case.

10 MR. TRAYNHAM: Your Honor, I would dispute that it
11 is an issue in this case. Mr. Donovan has
12 testified, the taxpayer has testified, that
13 West is doing its retail operations in combined
14 reporting states. South Carolina is not one.
15 The intersection of those two types of filings
16 is what creates one of the concerns that we had
17 here. I think that it's necessary to at least
18 have some explanation of how the combined
19 filing in other states could impact its tax
20 liability here in South Carolina overall.

21 THE COURT: Let me think about that one. I mean,
22 there was testimony about combined reporting
23 and it was clear that there's no dispute that
24 South Carolina is not a combined reporting
25 state.

1 MR. TRAYNHAM: Correct, Your Honor.

2 THE COURT: So you're objecting to relevance of
3 combined reporting --

4 MS. GEER: Yes.

5 THE COURT: -- and then the whole theory of it in
6 other states, since we don't do it.

7 MS. GEER: That, and that the key issue in this case
8 is did the -- does what -- how CarMax reported
9 in this case, does that fairly reflect their
10 business activities in South Carolina. And
11 whether other states use combined reporting, I
12 don't know how that's relevant to that
13 question.

14 THE COURT: I'll sustain the objection.

15 MS. GEER: Thank you, Your Honor.

16 MR. TRAYNHAM: Your Honor, I'd like to ask another
17 question which I think is extremely relevant
18 and I know it's going to be objected to, and
19 I'm not trying to be sneaky about it. That's
20 why I'm prefacing it.

21 THE COURT: No. I am not accusing anyone in any
22 effect, lawyers or corporations or witnesses,
23 of being sneaky.

24 THE WITNESS: I'll keep my mouth shut until
25 everyone's --

1 THE COURT: Absolutely.

2 MR. TRAYNHAM: So I'll instruct my expert not to
3 answer until --

4 THE COURT: Okay. But that's certainly your right.
5 It's their right to object and it's my job to
6 rule on it. So whatever you want to ask, ask.

7 Q: Dr. Harrison, you heard Mr. Donovan's testimony
8 regarding the recurrence of business structures
9 that divide retail operations between East and
10 West operations and place intangibles in
11 western combined reporting states, correct?

12 A: Yes.

13 Q: Is there an economic benefit to a taxpayer
14 placing this -- structuring itself in such a
15 fashion?

16 MS. GEER: Your Honor, we would object to that
17 question. Again, there's been no evidence of
18 any improper reasons for CarMax setting their
19 business structure up in this way and so I
20 don't know how it's relevant to this case for
21 us to discuss why other companies might set
22 their companies up like that.

23 THE COURT: In this case, I'm going to overrule you
24 because it appears to me it is very relevant
25 because -- I mean, asking if there's an

1 economic advantage of an economist seems to me
2 one of the kind of threshold questions and, I
3 mean -- I don't think anyone is alleging
4 anyone's doing anything illegal.

5 And, let's face it, it's -- I can take judicial
6 notice of the fact that everyone wants to take
7 advantage of the tax laws, personally,
8 professionally or as a corporation, to benefit
9 so they end up paying minimal amounts of taxes
10 to the state, federal, local and county
11 governments. So I don't think anyone's
12 alleging anything nefarious here. So I will
13 permit that question.

14 MR. TRAYNHAM: Thank you, Your Honor.

15 THE COURT: You may need to rephrase it -- or need
16 to repeat it, Mr. Traynham.

17 A: Yes, there can be a clear economic advantage
18 and by that I mean, the company gets to retain
19 more profits and distribute more profits than
20 it would otherwise. That's a clear -- as a
21 matter of definition, an economic advantage,
22 exactly as was said, whether it's done legally
23 or illegally and it could be done perfectly
24 legally.

25 Q: And would that economic advantage to the

1 taxpayer in doing so have any -- would any of
2 it flow from state tax issues or incidence?

3 A: I'm not sure I follow the question.

4 Q: Okay. Let me see if I can restate it. You
5 stated that there is a clear economic benefit
6 to the taxpayer structuring itself in the
7 fashion described by Mr. Donovan yesterday.

8 A: There can be, yes.

9 Q: There can be. Would such an economic benefit
10 be in part derived from tax savings?

11 A: Oh, yes. In fact, that's precisely how it is
12 and, indeed, we have classes in business
13 schools, as indicated, that precisely teach
14 firms how to do that. Again, legally. No
15 firm -- I'm not aware of any classes teaching
16 people to do things illegally --

17 Q: Certainly.

18 A: -- but to be aware of the tax statutes. We
19 have at the Moore School of Business and the
20 School of Accounting, there is a large M tax,
21 master tax program, but it has a series of
22 classes. In my business school -- I've been in
23 business schools all my life and we have a
24 large series of classes in finance departments,
25 in my department and the accounting department

1 precisely on this issue, both in the
2 international arena, in the domestic arena in
3 terms of states.

4 Q: Certainly. And, to your knowledge, no one in
5 this case is alleging that anything criminal or
6 illegal is taking place, correct?

7 A: That's correct. As Mr. von Lehe said, you
8 didn't have to hunt down the taxpayer.

9 Q: Dr. Harrison, hypothetically, if the taxpayer
10 were set up in such a fashion to create tax
11 savings, if that tax savings went far enough
12 that the taxpayer's business was not properly
13 represented by a standard statutory formula,
14 could that implicate the provisions of
15 12-6-2320?

16 A: Yes, it seems to me in terms of the economics,
17 in terms of the economic rationale for the
18 state, from a state's point of view, whether
19 it's South Carolina or some other state, if
20 they don't have other systems in place, such as
21 combined reporting, then they would want to
22 have something like 2320 in place to precisely
23 do the same thing.

24 Q: Dr. Harrison, are you familiar with the method
25 the auditors proposed in calculating the

1 taxpayer's taxable income in this case?

2 A: Yes, I am.

3 Q: Would you briefly describe to the Court your
4 understanding of how that method worked,
5 exactly.

6 A: Sure. And, again, I'll use my economist
7 metaphors. The auditor decided in order to, in
8 the spirit of 2320, to get a fair
9 representation of the business activity in
10 South Carolina, to compare the apple that it
11 saw in South Carolina with the apples in the
12 rest of the -- rest of the company, not with
13 the apples and oranges. That's it. That's
14 literally it. And then he applied a
15 single-factor formula to them. But it's that
16 simple adjustment in order to have a
17 commonsense recognition of the extent of the
18 business activity in South Carolina. Anything
19 else would ridiculously dilute that
20 calculation.

21 Q: Do you believe that the exclusion of those
22 oranges, in this case the retail sales from the
23 taxpayer, from such a calculation is
24 economically appropriate?

25 A: Yeah, otherwise you would simply be combining

1 apples and oranges, to use the -- to continue
2 the metaphor -- more seriously, in the sense
3 that you would not be reflecting the level of
4 economic activity here. That would be diluted,
5 as the -- as was being expressed earlier.

6 Q: To your knowledge, Dr. Harrison, does the
7 taxpayer receive any income from retail auto
8 sales in South Carolina?

9 A: No, and there's been a lot of testimony. I
10 don't think there's been any dispute about
11 that, whatsoever.

12 Q: So what activities does the taxpayer engage in
13 within South Carolina, based on your
14 understanding?

15 A: Well, there is intellectual property reflected
16 in the retail -- the retailing of cars in South
17 Carolina. There are South Carolinians who are
18 purchasing cars, that use the software, that
19 use the financing, more recently, and, but for
20 those customers, those South Carolinians
21 purchasing those contracts, there wouldn't have
22 been any income, so it's that activity, from an
23 economist's perspective, that's generating the
24 income that the auditor was deeming was
25 appropriate for South Carolina to tax.

1 Q: Dr. Harrison, I'll put it to you very
2 specifically. Do you believe the alternative
3 approach utilized by the Department reflects
4 the economic reality of the taxpayer's business
5 activities in this State?

6 A: I believe that it is significantly closer than
7 the alternative methods that were provided by
8 the South Carolina code. Whether one could do
9 even better, I think it was an excellent job in
10 this case.

11 Q: Dr. Harrison, you heard Dr. Wilder's testimony
12 yesterday regarding the benefits or the lack of
13 benefits that the taxpayer receives from South
14 Carolina; did you not?

15 A: Yes, I did.

16 Q: Would you agree that the taxpayer receives no
17 benefits from South Carolina?

18 A: No. No, and I thought it was perfectly obvious
19 from the follow-up testimony that the taxpayer
20 is receiving a benefit this very instant in
21 this very court, for example.

22 Q: Dr. Harrison, one of the issues raised by the
23 taxpayer is a question of sourcing. Are you
24 familiar with the taxpayer's arguments on that
25 issue?

1 A: Yes, I am.

2 Q: In your view, should the taxpayer's income from
3 financing activities be sourced to South
4 Carolina?

5 A: Well, I -- let me answer it this way. I know
6 there's some legal issues here and I'm not
7 going to express on those because there are
8 some legal interpretations. Again, from an
9 economist's perspective, I think the answer is
10 very, very simple. But for the South
11 Carolinians that go and buy these cars, that
12 income would not be there. And in some legal
13 settings, I think the same type of analysis is
14 used; in terms of damage calculations, for
15 example, which I am an expert on. But I'm not
16 presenting from -- I know there's legal
17 definitions of these things. I'm keeping away
18 from those.

19 From an economist's perspective, it's perfectly
20 obvious. If it weren't for the South
21 Carolinians buying these cars, that income
22 would not be there, and that's the end of it to
23 an economist.

24 Q: Does the fact that the employees that are
25 servicing those finance agreements are located

1 in a state other than South Carolina have any
2 impact on your opinion?

3 A: It has impact on the -- on the net income that
4 should be -- that should be taxable in South
5 Carolina. There are some expenses that need to
6 be netted out, but no one's disputing that.
7 Certainly has no effect on the opinion in terms
8 of the sourcing of income, from an economist's
9 perspective.

10 Q: And, just to be clear, on the netting out of
11 expenses, is it your understanding that the
12 taxpayer is getting credit for expenses related
13 to those finance employees?

14 A: Yes, that is my understanding, that we're
15 talking about net income in these cases.

16 Q: Net income flowing from CBS?

17 A: Correct, yes.

18 Q: Dr. Harrison, you heard a great deal of
19 testimony regarding whether or not the
20 taxpayer's a unitary business and you referred
21 to that earlier. Would you agree with
22 Mr. Zinn's testimony that there are multiple
23 definitions of a unitary business?

24 A: Yes, and Mr. von Lehe said it in his opening
25 statement, and they're both very accurate

1 statements, that there are economists'
2 definitions, there are accountants'
3 definitions, there are lawyers' definitions,
4 and each of them serve different purposes. And
5 the statutory definitions might not even be the
6 same as some lawyers' definitions.

7 Q: Dr. Wilder commented on a discussion of the
8 unitary concept in a paper you stated that you
9 read by Charles McLure. What's your
10 understanding of Dr. McLure's exposition on the
11 subject of the unitary theory?

12 A: Well, the nature of the paper was -- it was a
13 wonderful paper where he's basically saying --
14 there's been a number of recent Supreme Court
15 decisions on this and they're using -- they
16 talk about three factors that are often used
17 and they go by different names and different
18 labels. And he was simply asking the question:
19 How should an economist interpret this? This
20 is lawyers talking about a concept that
21 economists also have some opinions on. How
22 should we interpret it? And in his article, he
23 was precisely saying, "Which of these three
24 factors really reflect what an economist would
25 regard as the core of a unitary business?" And

1 essentially concludes that one of them does and
2 two of them don't.

3 Q: You said one of them does and two of them
4 don't.

5 A: Yeah, let me expand on that a little bit. So
6 McLure is arguing and he starts out by saying,
7 at the base of the concept of unitary
8 business -- which goes back to, you know,
9 states trying to figure out how to tax
10 railroads. I mean, this has been around for a
11 long, long time. There has been multi-
12 jurisdictional problems for years, and it goes
13 back to the commerce laws and state
14 incidence -- tax incidence.

15 The problem with a unitary business -- the
16 issue that's raised is when you cannot
17 reasonably pull apart from an accounting
18 purpose or for an economist's purpose or from
19 a legal purpose, parts of the entity, when the
20 whole has to be considered as a whole. And
21 there can be many, many reasons for that. And
22 that's what McLure was saying.

23 He's focusing on the taxation of profit. I
24 mean, he's -- he's -- his paper is exactly on
25 the -- on topic in terms of why we're here

1 today. For what purposes can you, from an
2 accounting perspective as an economist,
3 identify component parts of a unitary business.
4 And some of the criteria -- and I'll talk about
5 two that he mentions explicitly, from an
6 economist's perspective have no necessary role
7 here. One is whether you have common control,
8 common management. That's one of the criteria.
9 By itself, that does not necessarily mean you
10 can't split them apart. It could be that you
11 have one -- one owner, but they're completely
12 separate entities from an accounting point of
13 view.

14 Now, the reason that might be important
15 criteria is if you want to find one person
16 legally responsible. So McLure is saying, "I,
17 as an economist, understand why that criteria
18 is there." For some purposes, for some legal
19 criminal purposes, for example, you may want to
20 have a clear chain of command and realize who
21 is ultimately responsible.

22 But in terms of the accounting question, which
23 is at issue here -- and this is what McLure is
24 saying, the paper that Dr. Wilder was talking
25 about -- you may be able to tear those apart.

1 So that's one of the -- one of the criteria
2 that's often used for determining if a firm is
3 unitary that is irrelevant in terms of
4 determining whether you can separate it out
5 from an accounting or profit point of view.
6 The other one was whether there is -- it's sort
7 of called sometimes "functional integration."
8 The first is kind of executive integration and
9 the second is kind of functional integration.
10 Do the firms -- are they fundamentally
11 connected in terms of the manufacturing
12 process? And by itself, that doesn't
13 necessarily cause problems. You can have
14 simple accounting for each firm and they simply
15 do business with each other.
16 The third one, which is related to that and
17 does cause the problem, is where for some
18 reason, whether it be transfer pricing or
19 manipulation or nonmanipulation, whether it's
20 legal -- it's all legal -- whether it's
21 economies of scope, economies of scale -- and
22 these were the sorts of thing that Dr. Wilder
23 was talking about -- you cannot easily tear
24 apart, in an accounting sense, the income.
25 So I can give you a specific example of that.

1 Let's say you're trying to figure out what this
 2 particular court or this Judge costs in terms
 3 of running -- running her -- her unitary
 4 business, but let's say she shares the services
 5 of people outside with other judges. And
 6 that's done. I've been here before. How do
 7 you allocate the services of those people
 8 outside who are here all the time to this
 9 particular case? That's a very difficult thing
 10 to do.
 11 So that's an instance where for some purposes
 12 you cannot figure out what the -- let's say
 13 you're trying to figure out the cost of this
 14 case. That would actually be rather difficult
 15 to do. It's not impossible to do. But, for
 16 other purposes, you can. You can, for example,
 17 say what is the variable cost of this case? We
 18 regard those as fixed costs. Those costs are
 19 going to be -- those people are going to be
 20 outside all the time. So if the question is,
 21 what is the variable cost of this -- of running
 22 this case? You can answer that.
 23 So here's the general point. The point that
 24 McLure is saying is that the unitary business
 25 concept is not monolithic. It depends on the

1 purpose, whether it's legal, accounting,
2 economic. And even within economic or
3 accounting, there are some questions you can
4 answer and some that you can't.

5 Q: Okay. And I understood from your statements
6 earlier in your testimony that you agreed with
7 Dr. McLure's position on the unitary theory.

8 A: Yes, I think it's a very articulate position
9 and I would encourage people who work in this
10 area to read it.

11 Q: So it would be your position that the unitary
12 concept doesn't necessarily mean that something
13 can't be broken apart for any reason
14 whatsoever, a unitary business?

15 A: That's right. I reject the -- if I can -- if
16 you forgive me, characterizing Mr. von Lehe's
17 pregnancy theory of unitary business, that
18 you're either completely unitary for all
19 purposes or you're not -- it is not that.
20 And, literally, the South Carolina Supreme
21 Court's definition, which is consistent with
22 McLure's, is consistent with an economist's
23 definition, says that in plain language.

24 MR. VON LEHE: Your Honor, in that respect, as to
25 what the South Carolina Supreme Court's

1 decision says, I must take objection to that.
 2 That is a legal conclusion for Your Honor to
 3 decide, not for an economist, not even for
 4 another lawyer. So I object to that on the
 5 grounds that he's just given a legal conclusion
 6 which is within the purview of this Court.

7 **MR. TRAYNHAM:** Your Honor, I believe Dr. Harrison's
 8 statement was that his understanding of the
 9 opinion of the Court is consistent with his
 10 understanding of the economic theory espoused
 11 by Dr. McLure. In the context of his
 12 qualification, I think it's a relevant and non-
 13 objectionable statement of opinion.

14 **MR. VON LEHE:** Again, his opinion of what our South
 15 Carolina Supreme Court has said is a legal
 16 conclusion, pure and simple.

17 **THE COURT:** I understand your concern, Mr. von Lehe,
 18 but I think in the context of what Dr. Harrison
 19 has testified, that he has studied over the
 20 decades and the fact that he is not qualified
 21 as an expert in the law but he's giving us a
 22 layman's opinion of it, and it will certainly
 23 be one opinion, in addition to yours, in
 24 addition to Mr. Traynham's, Ms. Geer's, and
 25 whoever else, so that objection is overruled.

1 MR. VON LEHE: Your Honor, thank you. As long as
2 that decision as to what our South Carolina
3 Supreme Court has said is in your good hands,
4 I feel fine about that.

5 THE COURT: Very diplomatic, Mr. von Lehe. Thank
6 you.

7 MR. VON LEHE: I don't feel fine about it being in
8 Dr. Harrison's hands.

9 THE COURT: I understand. That's the nature of the
10 beast we've got here. I think you're not
11 referring to any individual, but the legal
12 concepts themselves.

13 Okay. You may proceed, Mr. Traynham.

14 Q: Dr. Harrison, you mentioned the South Carolina
15 Supreme Court's definition of "unitary
16 business." Where do you understand that
17 definition to come from, what case?

18 A: Well, actually, it was -- well, interestingly,
19 it wasn't their definition. It was the
20 definition of the North Carolina Supreme Court,
21 which they quoted approvingly in the Exxon
22 case. I think it was '79? That's the one
23 that's being referred to here. It also appears
24 in the taxpayer's protest letter. I mean, the
25 language is excellent from an economist's point

1 of view, not -- I'm not interpreting it as law,
2 but literally taking that definition, as an
3 economist, I can take that into my classroom
4 and present McLure's articulate position.

5 MR. TRAYNEAM: Okay. And, Your Honor, if I may, I'd
6 like to put a portion of one South Carolina
7 Supreme Court decision up on the overhead.

8 THE COURT: Certainly.

9 Q: Dr. Harrison, are you familiar with the Exxon
10 decision that was cited in the taxpayer's brief
11 and protest letter?

12 A: Yes, I read the whole decision.

13 Q: Is the Exxon decision one of the decisions that
14 discusses the unitary concept in South
15 Carolina?

16 A: Yes, it's actually one of the more important
17 ones, I think.

18 Q: Is this highlighted language -- with some
19 personal notes on it, I apologize for -- is
20 that the language that you're referring to when
21 you talk about the South Carolina Supreme Court
22 definition?

23 A: Yes, that's the language I recall precisely.
24 I mean, the part in brackets is added by way of
25 putting this quote in context, but I don't

1 think anyone would dispute that.

2 Q: And would you mind just reading that
3 highlighted language, for the record.

4 A: Sure. "That term" -- bracket -- "'unitary' is
5 simply descriptive and primarily means that the
6 concern to which it is applied is carrying on
7 one kind of business; a business, the component
8 parts of which are too closely connected and
9 necessary to each other to justify division or
10 separate consideration as independent units."

11 Q: Dr. Harrison, as a layperson in the law, but as
12 an economist reading this language, does this
13 indicate to you that the unitary concept is an
14 all or nothing proposition?

15 A: No, it doesn't. And, again, I'm talking about
16 something I would present to students in an
17 economics class, if I was using this
18 definition.

19 Q: Okay. If you were to interpret this language
20 to an economics class from an economic's
21 perspective, what would it mean in more
22 expansive layman's terms?

23 A: Well, there's a couple of key parts to this and
24 let me emphasize those three parts. The first
25 that says "that are too closely connected." So

1 that immediately tells you it's a matter of
2 degree; it's a continuum. It doesn't say it's
3 all or nothing. So it's a matter of how
4 closely connected they are. That's the first
5 thing.

6 So the second part is when it says it's
7 necessary to each other to justify division or
8 separate consideration. Let's focus just on
9 the word "justify." Now, this is very
10 important to an economist. There are many
11 purposes for which you might want to consider
12 them as independent units.

13 Take the example that I was talking about here,
14 just as an economist or an accountant's mind,
15 what is the cost of this trial? If you were
16 trying to figure out the total cost of this
17 trial, taking into account apportioning the
18 costs -- let's use that language, as an
19 economist will use it -- and the cost of the --

20 the fixed costs outside, fixed cost of the
21 building, that would be difficult. It's
22 doable. People do it in managerial accounting
23 all the time, it's done, but it falls some
24 degree of speculation and it might not be
25 regarded as reasonable. I'm using that

1 language deliberately.

2 If, however -- and this is for a different
3 purpose -- you want to figure out what is the
4 variable costs, the cost of but for this case
5 would have -- would not have occurred, you can
6 do that. You can add up the costs of the court
7 for this particular time. That's -- so the
8 question, the point here is, justified for what
9 purpose? For some purposes, you can tear them
10 apart. For other purposes, you can't.

11 The final point here, that I think is very
12 important, is it doesn't say division in the
13 sense of tearing them apart. It says "division
14 or separate consideration." If all you want to
15 do is figure out what are the costs due to this
16 part and this part -- which is, indeed, what
17 managerial accounting does all the time;
18 they're looking at profit centers -- you often
19 can do that. And there are many, many
20 instances where firms do precisely that. They
21 can identify the costs of one part of the
22 business, even though you might think of it as
23 a unitary business for other purposes. So it's
24 not monolithic. That's the point.

25 Q: Dr. Harrison, would you agree that one of the

1 concerns from an economics' perspective -- and
2 I believe Dr. McLure expressed it as well --
3 that with a unitary business is, it can
4 sometimes be difficult to break out various
5 values that flow in and amongst the various
6 parts.

7 A: Absolutely, and this was -- I think this is the
8 point that Dr. Wilder was making quite
9 correctly. There can be what's called in
10 economics "economies of scope." It's not so
11 much economies of scale. That's actually a
12 misnomer. "Economies of scope" refer to when
13 you're producing multiple products -- say
14 you're producing two or three or four
15 products -- that the average cost of producing
16 the two or three or four products can be lower
17 than if you were producing them separately.
18 Now, this is what Mr. Zinn referred to,
19 sometimes one plus one can equal three. Well,
20 that's probably not a particularly good
21 phrasing of it. The point he was getting at
22 is, you can get these economies of scope in
23 producing a range of different products.
24 For example, you're producing a car. You can
25 produce a red car, a blue car, a white car, a

1 black car a lot cheaper than if you just
 2 produce a red car, we build a factory just to
 3 produce a blue car. I mean, that's a silly
 4 example, but it illustrates what we mean in
 5 economics by economies of scope.
 6 So when you have economies of scope, you can
 7 still sometimes -- there is a well-developed
 8 theory here -- apportion costs. It involves a
 9 lot more work than just simply looking at the
 10 books. It involves some statistical analysis.
 11 It's the type that is ordinarily undertaken by
 12 managerial accounting people. That's what they
 13 do. But whether it can be done in a reasonable
 14 manner, whether it can be done reliably, that
 15 is a good -- it varies from case to case.

16 Q: Do you agree with Dr. Wilder's testimony from
 17 yesterday that the flow of income amongst the
 18 component parts in this case is a fair measure
 19 of the values that are shared amongst them?

20 A: I didn't actually understand his comment.

21 Q: Okay. That's fair. Dr. Harrison, have you
 22 ever written anything that relates to this
 23 unitary issue that we're discussing?

24 A: Yes. I have published a paper that looks at
 25 the ability to identify exactly the sorts of

1 variable costs that I was using in terms of the
2 example of the Court, but in an accounting
3 context, in an economist's calculating damages,
4 how you would take accounting statements and
5 then, from an economist's point of view,
6 calculate damages about one component of the
7 business that you might think is unitary. But
8 you can still, for some purposes, calculate
9 component variable costs.

10 Q: Dr. Harrison, does the question of whether or
11 not this taxpayer is unitary have any relevance
12 in your economic analysis of this case?

13 A: It does, but it depends on the definition of
14 "unitary." And one shouldn't simply toss that
15 label around as if it provides freedom for
16 someone to do anything they want. That's the
17 whole point of my testimony here, actually, is
18 that the word "unitary" can mean a lot of
19 different things and that it shouldn't just be
20 used in some unqualified sense.

21 Q: Dr. Harrison, just to return very briefly to
22 the tax savings of the generic business
23 structure we were discussing earlier. You
24 stated, I believe, that part of the economic
25 savings from such a structure is -- or some

1 majority, actually, of that savings is from tax
2 savings, correct?

3 A: Well, I'm not sure that I said "majority," but
4 certainly a large part of it. That's often why
5 you see that type of structure, from an
6 economist's point of view.

7 Q: And from your study of these structures and in
8 your observations as an economist, is that tax
9 savings derived in any sense because of the
10 interplay between separate accounting or
11 separate entity states and combined entity
12 states?

13 A: Yes, indeed. This is the sort of thing that if
14 you had -- if you required combined reporting,
15 one would not run into.

16 MR. VON LEHE: Your Honor, again, I believe you've
17 already sustained an objection to this
18 testimony concerning combined reporting.

19 THE COURT: Yes, I'll agree with you on that.

20 MR. VON LEHE: I'd like to renew that objection.

21 THE COURT: But insofar as just incidental, I'm not
22 going to worry about it, but -- since South
23 Carolina doesn't have combined reporting, I do
24 sustain the objection to any inquiry into that
25 fact.

1 MR. TRAYNEAM: Thank you, Your Honor.

2 Q: Just to reiterate, the East/West structure that
3 we have discussed can provide tax savings to
4 businesses?

5 A: That's correct. Businesses, depending on the
6 nature of the accounting systems that
7 particular states use.

8 Q: And based on your study of the taxpayer in this
9 case, whatever other benefits may derive from
10 its business structure, is it your opinion that
11 their structure is providing them some tax
12 savings?

13 A: Well, yes, but that's largely derived from
14 simply hearing the direct testimony of Ms. Yost
15 yesterday when she was asked, in clear terms,
16 who was it that provided the advice on the
17 reorganization and she talked at some length
18 about how Ernst & Young was retained to provide
19 the tax advice.

20 MS. GEER: Your Honor, I think he's misstating her
21 testimony, so we would object to that.

22 MR. TRAYNEAM: I think the record will reflect that
23 he is accurately reflecting Ms. Yost's
24 testimony.

25 MR. VON LEHE: There's no such statement by Ms. Yost

1 in the record, Your Honor, nothing about tax
2 advice from Ernst & Young.

3 MR. TRAYNHAM: I believe she specifically stated
4 that Ernst & Young was serving as a state tax
5 adviser as part of their services in advising
6 them on the restructuring.

7 THE COURT: Let's see, I've got a lot of testimony
8 by Ms. Yost.

9 (Off the Record)

10 THE COURT: I remember a good deal of testimony
11 about the restructuring in 2004 and creating
12 CBS and -- I mean, I'm sure, obviously, it was
13 done for some reason, but I don't remember
14 specific testimony about who advised them to do
15 it or why or -- and I don't remember it. I
16 guess we'll have to let the record speak for
17 that and just strike that.

18 MR. TRAYNHAM: I'm sorry, Your Honor, just for
19 clarification, did you say we would strike that
20 testimony?

21 THE COURT: Yes, strike that testimony with respect
22 to Ernst & Young, because I don't specifically
23 remember it and unless there's some way you
24 can -- I assume it would take going back to --

25 MR. VON LEBE: May I suggest that, by leave of the

1 Court, we take a moment to review the
2 testimony, perhaps?

3 THE COURT: Yes, that would be great.

4 MR. VON LEHE: I certainly don't want to --

5 THE COURT: We've been going for an hour and a half,
6 almost. Let's take fifteen minutes and come
7 back at -- I've got 10:25, so 10:40.

8 MR. VON LEHE: Thank you.

9 (Break taken from 10:24 to 10:35.)

10 THE COURT: All right. We'll go back on the record,
11 then. Did anyone have a chance to confirm
12 whether or not there was testimony regarding
13 Ernest & Young's consultation before CBS was
14 created?

15 MR. TRAYNHAM: Yes, Your Honor, and, if we may, we'd
16 like to have that brief snippet of testimony
17 read back into the record.

18 THE COURT: If you don't mind, that would be great.
19 Thank you, Madam Court Reporter.

20 (The question was read back at this time.)

21 Q: And one final question. The valuation
22 that was done by Ernest & Young --

23 A: Uh-huh (affirmatively responds).

24 Q: Did CarMax or CarMax West or any
25 associated entity have any other

1 relationship at the time the valuation
2 study was performed?

3 A: I'm not sure exactly what you're asking,
4 but Ernest & Young acted as an advisory to
5 the company as it related to the corporate
6 reorganization and it was through that
7 transaction -- I'll call it that -- the
8 evaluation was just one step in the bigger
9 process. Did that answer your question?

10 Q: Yeah. Were they performing any auditing
11 functions for CarMax at the time?

12 A: No, they were not our auditing, more of
13 just a state tax consultant. In a bigger
14 view every large corporation has a state
15 tax advisory -- or advisor and that's what
16 they are.

17 THE COURT: Okay.

18 (Off the record.)

19 MR. TRAYNHAM: I hate to do this to you, but I was
20 hoping you could read back the last question I
21 had asked.

22 MS. GEER: And, Your Honor, before we move on, would
23 it be okay for us to restate what our objection
24 was that started this whole thing?

25 THE COURT: Absolutely.

1 THE COURT REPORTER: Hold on, I'm going back to
 2 search for his and then you started --
 3 MS. GEER: Oh, I'm sorry.
 4 THE COURT REPORTER: Do you want me to -
 5 THE COURT: When he asked it, that would be the
 6 appropriate time for you to make your objection
 7 again, or you want your objection first?
 8 MS. GEER: Well, it's the question that he already
 9 answered.
 10 THE COURT: Okay. Okay.
 11 THE COURT REPORTER: Do I need to read back?
 12 THE COURT: I guess it would be the very last
 13 objection.
 14 MS. GEER: Yeah.
 15 THE COURT REPORTER: You want me to read back the
 16 objection?
 17 THE COURT: Yes.
 18 MS. GEER: That's fine.
 19 THE COURT: That's what I want to hear.
 20 MS. GEER: I actually just wanted to restate it, but
 21 I'm fine to hear it, as well.
 22 (The objection was read back at this time.)
 23 MS. GEER: I think he's misstating her
 24 testimony. We would object.
 25 MR. TRAYNHAM: I think the record will reflect

1 that he's accurately reflecting Ms. Yost's
2 testimony.

3 MS. GEER: There's no such -- there's no
4 statement about tax advice. I believe she
5 stated Ernst & Young was serving as a
6 state tax advisor as part of their
7 services on restructuring.

8 (Off the Record)

9 MS. GEER: And so, Your Honor, may I -- I just
10 wanted to maybe clarify the record a little
11 bit. Our actual objection is more that it's
12 mischaracterizing her testimony than maybe --
13 maybe it's a little bit of both, misstating and
14 mischaracterizing. But, basically, she did
15 testify that Ernst & Young was consulted on the
16 restructuring.

17 THE COURT: Uh-huh (affirmatively responds).

18 MS. GEER: She did testify that they received state
19 tax advice from Ernst & Young.

20 THE COURT: Yes.

21 MS. GEER: The implication or characterization
22 appeared to me to be that she consulted Ernst
23 & Young to provide restructuring advice to
24 realize some tax savings, that that was the
25 purpose of it or something along those lines,

1 and that is what we objected to. She did not
2 testify that that was the purpose of the state
3 tax advice that they received from Ernst &
4 Young.

5 **THE COURT:** All right. Thank you, Ms. Geer. Your
6 objection is noted for the record --

7 **MS. GEER:** Thank you.

8 **THE COURT:** -- and your clarification. And since
9 it's been read back, we can agree on what was
10 said now and you may proceed, Mr. Traynham,
11 with further questions.

12 **MR. TRAYNHAM:** Thank you, Your Honor.

13 (Off the Record)

14 **Q:** Dr. Harrison, if the taxpayer is, as they say,
15 in some sense or in any sense unitary, does
16 that, to you, mean that they cannot accurately
17 economically be broken apart into their
18 component businesses?

19 **A:** No, it does not. But it does depend on the
20 purpose for which one is breaking apart or
21 separating, giving separate consideration. And
22 for some purposes, they can be; for others,
23 quite possibly, they cannot be.

24 **Q:** Do you believe that for the Department's
25 purposes in this audit the taxpayer can be

1 broken apart into component business structures
2 and that reflect the economic reality of their
3 business?

4 A: Yes, in this case it was particularly easy to
5 do that, so that it did reflect the economic
6 reality of their activities in South Carolina.

7 Q: And why do you say that it was easy to do so in
8 this case?

9 A: Well, because, to use my metaphor and they only
10 had an apple in South Carolina. If they had an
11 apple and an orange, one orange, a little
12 orange, that might have been very, very
13 difficult to do. So the fact that it was so
14 crisply different in South Carolina, it was
15 blatantly different in terms of the accounting,
16 made it relatively easy to do in this case.

17 MR. TRAYNHAM: Thank you, Dr. Harrison. Please
18 answer any questions the taxpayer's counsel may
19 ask you.

20 THE COURT: Mr. Von Lehe, Ms. Geer, your witness for
21 cross-examination.

22 MS. GEER: Thank you, Your Honor. May I have just
23 one moment?

24 THE COURT: Certainly.

25 (Off the Record)

1 THE COURT: Are you ready, Mr. von Lehe or Ms. Geer?

2 MS. GEER: We're ready. Thank you, Judge.

3 THE COURT: All right.

4 DR. HARRISON - CROSS-EXAMINATION BY MS. GEER:

5 Q: Good morning, Dr. Harrison.

6 A: Good morning.

7 Q: So I believe that you've been qualified as an
8 expert in the field of economics and law in
9 economics, correct?

10 A: That's correct.

11 Q: Okay. And not in the field of tax statutes or
12 tax law generally. You have not been qualified
13 as an expert in those fields; is that correct?

14 A: Not in those words, but to the extent that tax
15 statutes are part of economics in the law, I
16 certainly have opinions.

17 Q: On economics in the law?

18 A: Yes.

19 Q: All right. And have you written any papers or
20 articles on allocation and apportionment,
21 specifically?

22 A: Not on allocation or apportionment
23 specifically, no.

24 Q: Okay. Have you ever testified, other than in
25 this case, on a matter involving an allocation

1 or apportionment statute?

2 A: No, I have not testified on that. I have
3 worked on some cases, but I haven't testified.

4 Q: Okay. And what other case have you worked on
5 that deals with allocation and apportionment?

6 MR. TRAYNHAM: Your Honor, I'm going to offer an
7 objection to that. To the extent that the
8 counsel is asking him to identify other
9 taxpayers that he may have worked on, if those
10 taxpayers have not come before this Court, then
11 short of an order of Your Honor -- basically,
12 what I'm asking you for is Dr. Harrison would
13 have to be ordered to identify any taxpayers.

14 THE COURT: Certainly. Okay.

15 MS. GEER: We're not trying to get the identity.

16 MR. VON LEHE: We definitely don't want any other
17 taxpayers identified, Your Honor. I can
18 promise you that. That, we don't want.

19 MR. TRAYNHAM: That's all I was trying to ...

20 MR. VON LEHE: But if he could identify, to at least
21 some extent, what he's been working on, that's
22 what --

23 THE COURT: Sure.

24 MR. VON LEHE: -- we would like to know that.

25 THE COURT: Certainly.

1 MR. TRAYNHAM: As long as it's broad issues, Your
2 Honor, we have no objection.

3 THE COURT: With that caveat, we'll proceed.

4 Q: So what -- can you tell us the matters that you
5 referred to that you've worked on that deal
6 with allocation and apportionment? Can you
7 tell us generally about those matters?

8 A: Yes, I believe I can, and I'll try to do that
9 in a way that doesn't -- certainly doesn't
10 identify the taxpayer, which is -- we're trying
11 to avoid here. It has to do with apportionment
12 and the extent to which -- the extent to which
13 certain accounting activities by the taxpayer
14 can lead to, according to the South Carolina
15 Department of Revenue, a misrepresentation of
16 the business activity in South Carolina and the
17 extent to which the provisions of the tax code
18 that we're talking about, 2250, 2290 and
19 certainly 2320, can be appropriately used to
20 redress that from the Department's perspective.

21 Q: Okay. And so can I assume from the way you're
22 phrasing things that you are consulting with or
23 assisting the Department on those -- that case
24 or cases?

25 A: Yes, I acted as a consultant to the Department

1 on those cases.

2 Q: Okay. And how many cases are we talking about?

3 A: We're talking about one case. I've discussed
4 the issues in very general terms with other
5 individuals from the Department of Revenue on
6 other cases, but I don't believe I've been
7 retained on those cases.

8 Q: Okay. Dr. Harrison, when I took your
9 deposition -- probably a couple of months ago
10 now -- I remembered your telling me that you
11 didn't like the concept of a unitary business
12 and that what you preferred to talk about were
13 economies of scope. And, based on your
14 testimony today, it sounds like to me you're
15 actually okay with the concept of a unitary
16 business, at least as set forth in the Exxon
17 case. Am I understanding that correctly?

18 A: No, I think that's -- that's not quite right.

19 Q: Okay.

20 A: What I was trying to say in the deposition, if
21 I can give it a general --

22 Q: Yes.

23 A: -- characterization, was that the notion of
24 unitary business has been abused. It's been
25 used to mislead and to mischaracterize. And

1 I'm not at all saying that it is in this case.
2 I'm just talking about my general understanding
3 of the literature and the manner in which the
4 concept has been used and that it would be far
5 better for courts and for economists, in fact,
6 to go back to basics and look at a clear
7 definition of the concept, rather than using it
8 in some monolithic sense. That's what I was
9 trying to convey.

10 I think that to speak to particularly this
11 definition that the South Carolina Supreme
12 Court approves of, I think that conveys
13 precisely the sense in which the concept may be
14 valid. It has -- it's a continuum. It could
15 mean that sometimes you can and sometimes you
16 can't. It -- you can't consider them
17 separately and you have to do it on a
18 case-by-case basis.

19 Q: Okay. And you've said you've read the entire
20 case, correct --

21 A: I --

22 Q: -- or just --

23 A: -- certainly looked at the bulk of the case.
24 I cannot say that I recall every paragraph of
25 it.

1 Q: Okay. Well, do you recall that the court in
2 that case actually applied the three unities
3 test and the contribution and dependence test
4 to evaluate whether Exxon was a unitary
5 business in that case?

6 A: I recall that it certainly used that and I
7 believe that in that decision it was weighing
8 those in terms of whether they would be
9 appropriate for the purposes of that case.

10 Q: Okay. And what is your testimony from an
11 economic perspective as to whether those two
12 tests are from an economic perspective
13 appropriate?

14 A: Which -- just to be clear, which precisely two
15 tests are you referring to?

16 Q: The three unities test and the contribution and
17 dependence test.

18 A: They can be valuable. As I've tried to
19 indicate, there are a number of
20 characteristics. This is this broad category
21 that McLure talked about and the Dr. Wilder
22 talked about, and I would, as well, economies
23 of scope, economies of scale. There's any
24 number of factors and, indeed, McLure says --
25 includes cases where companies might have

1 manipulated transfer prices. Whether it's done
2 legally is not -- is not the issue here. He
3 explicitly talks about those cases. So there's
4 a -- what I'm getting at is there's a diverse
5 range of circumstances that might lead to it
6 being difficult to separately consider the
7 independent units, so it's not like there's any
8 one simple, bright-line test.

9 Q: And are you familiar with what the three
10 unities test looks at?

11 A: Yes, I'm familiar in a broad sense, but I -- my
12 reading of that literature has led me to not
13 try to memorize them, simply because I find
14 them misleading and that they can be misleading
15 and just not worth it. It's like trying to
16 remember what are the three biggest hits of
17 Britney Spears. Who cares?

18 Q: I'll agree with that. The three unities are
19 the unity of ownership, management and
20 operations. Does that refresh your memory on
21 what the three unities --

22 A: Yes, they --

23 Q: -- test looks at?

24 A: Yes, they're similar to the ones I was talking
25 about earlier in terms of McLure, who was

1 talking about the criteria that he's been
2 discerning from the Supreme Court. I call them
3 an "executive function" in terms of ownership.
4 I also talked about -- the term that the
5 Supreme Court often uses is "functional
6 integration," which is -- I think is this one
7 in terms of, are the physical processes
8 connected in some sense, they share factory
9 space or they share workers, in terms of the
10 example with the Judge.

11 And then the third one had to do with a broad
12 mingling of accounting reasons or economies of
13 scope, that you can't in any economic or
14 accounting sense reliably tease them apart.

15 Q: All right. I might have lost you a little bit,
16 but back to the three unities test, what is
17 your opinion as to whether CarMax West and CBS
18 meet the three unities test?

19 A: I have no opinion because it's completely
20 irrelevant to the -- my evaluation of whether
21 the Department of Revenue appropriately
22 evaluated the business activity in this State.

23 Q: Okay. All right. And are you familiar with
24 the contribution and dependency test?

25 A: Yes, I have heard of that and I've read about

1 it in some places.

2 Q: What does that test look at?

3 A: Well, that's the one that is a bit of a
4 catchall that is looking at the ability of the
5 individual enterprises to be -- to identify the
6 accounting contribution, to identify the
7 economic contribution, to identify the physical
8 contribution in terms of physical output --
9 physical inputs and physical outputs, so it's
10 a bit of a catchall and that's the third
11 category that I was referring to.

12 And, as I said in deposition, economists talk
13 about it, that part of the elephant in one way,
14 accountants talk about that same elephant in
15 another way, and lawyers, bless them, talk
16 about it in yet another way. So the -- it's an
17 amalgam of factors and that's why I find it
18 very vague and it has to be done on a
19 case-by-case basis.

20 Q: All right. So isn't one of the -- and you may
21 be just stating this a different way, but isn't
22 one of the things that the contribution and
23 dependency test looks at is whether the
24 different components of the business contribute
25 to and depend upon each other? Isn't that sort

1 of at the heart of that test?

2 A: Yes, but almost each of the words that you
3 talked about are begging for a definition,
4 either from an economist, accountant or lawyer.
5 And I'm not criticizing you. I think you
6 accurately stated it, but that's precisely the
7 problem, that these are very vague terms.

8 Q: Okay. And you were present in the courtroom
9 for Ms. Yost's testimony, were you not?

10 A: Yes, I was.

11 Q: Okay. Did you hear her testimony about the
12 different parts of the CarMax West and CBS
13 business and how they contributed to and
14 depended upon each other, and I'll give you a
15 couple of examples.

16 One example she gave was the intellectual
17 property and the sale of cars. And she talked
18 about the interrelationship of them and how,
19 you know, as you sell more cars, your
20 intellectual property becomes more valuable.
21 As your intellectual property becomes more
22 valuable, your name is more well known and that
23 increases your car sales.

24 A second example was the financing and the car
25 sales. As you sell more cars, you're going to

1 have more opportunities to finance cars and to
2 earn money that way. And financing, by being
3 able to offer financing to your customers,
4 you're able to sell more cars. Did you hear
5 those two examples in Ms. Yost's testimony?

6 A: I heard those examples, but I suspect that I
7 did not draw the conclusion that you're drawing
8 from them.

9 Q: Okay. Well, tell me why you would not draw the
10 conclusion that I'm drawing, which is that they
11 appear to contribute to and depend upon each
12 other?

13 A: Well, part of it was because it was very vague.
14 When one simply says intellectual property
15 contributes to this and there's some -- and
16 when one uses words like "synergy," it's not at
17 all clear to an economist, to me, exactly in
18 what sense they contribute.

19 The sense in which the bailiffs outside
20 contribute to the function of this court, I can
21 understand. That level of specificity, I can
22 understand. When people simply say this
23 contributes to that and assert it, I don't see
24 why. Nor do I see anything in the audit papers
25 or the response of the taxpayer that explain

1 precisely those connections as it pertained to
2 the activity in South Carolina. I'll finish
3 up, if you like.

4 Q: Yes, please, sorry.

5 A: I was really focusing on the activity in South
6 Carolina, what's before us here was, what I was
7 asked to look at is, is there some
8 interdependence, some necessary interdependence
9 between the activity in South Carolina and the
10 activity elsewhere. And I didn't see any.
11 Even if by some criteria, you might say it's a
12 unitary firm --

13 Q: Uh-huh (affirmatively responds).

14 A: -- I didn't see any that would mean that one
15 could not undertake separate consideration,
16 exactly as the auditor did of the activities in
17 South Carolina.

18 Q: Well, I want to talk to you about this
19 "necessary" that you've thrown in there.
20 I thought that you agreed with me when we were
21 at your deposition that it's not -- doesn't
22 have to be absolutely necessary that the
23 business does these different component parts,
24 but it could be necessary from a profit
25 standpoint, that it's profitable to put these

1 businesses together to gain efficiencies, to
2 gain cost savings. It doesn't have to be
3 absolutely necessary that these two
4 businesses -- or three or four, however many
5 different activities you have -- function
6 together. Are we missing each other again on
7 the "necessary"?

8 A: Yes, completely.

9 Q: Okay.

10 A: That strikes me as the type of semantics I
11 would not use. I would phrase it -- and I'm
12 sure I would in deposition, because I just
13 wouldn't phrase it that way.

14 Q: Uh-huh (affirmatively responds).

15 A: Economists always like to use the subjective.
16 It's possible that one could have some
17 economies of scope. It is possible that they
18 could contribute. You have to look at the
19 individual -- to the individual business entity
20 to decide if they are. You have to know a lot
21 more about the functioning of the business to
22 know, if indeed, they are.

23 And from an economist's perspective. From an
24 accountant's perspective, you need to know how
25 they do their accounting. That's not my narrow

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1 area of expertise, but I'm aware that there are
2 different ways of doing accounting that can
3 make it easier to separate out the components
4 of a firm and certain ways of accounting that
5 can make it -- not deliberately, but just make
6 it hard to do that.

7 Q: All right. I'm not sure that you've answered
8 what I'm asking, but I may not be asking it
9 clearly, so let me try again. Bear with me for
10 a minute.

11 I'm going to ask you about -- go back to this
12 economies of scope that you keep talking about.
13 Give me your description of what "economies of
14 scope" is.

15 A: Sure. And this is also, I think, the concept
16 that Dr. Wilder talked about, quite correctly,
17 so -- and let me do that by differentiating it
18 from something that is often referred to,
19 economies of scale.

20 Q: Okay.

21 A: Economies of scale refer to when you simply
22 scale up the activities of the businesses, that
23 you lower the average costs --

24 Q: Okay.

25 A: -- of producing a thing. So if you have three

1 or four courtrooms here and one bailiff
2 servicing them, then you can spread the
3 services, the cost of that bailiff, across the
4 three or four courtrooms.

5 Q: Right.

6 A: That's an economy of scale.

7 Q: Okay.

8 A: An economy of scope might be if you produced
9 different types of products --

10 Q: Uh-huh (affirmatively responds).

11 A: -- in the same business, that you can lower the
12 unit costs of either or both of those by
13 producing them together. A simple example, the
14 textbook example is you're producing an iPod
15 and it comes in three or four different colors.
16 It makes sense to have the same factory do that
17 and chose a machining, a tooling such that you
18 simply put a different color on it at the very
19 end, rather than having one factory that does
20 one color. That would be silly. One factory
21 that does another color, that would be silly.
22 So it's better to have one factory and have a
23 certain type of engineering at the end. So
24 that would be where you would have economies of
25 scope in producing -- and here I'm defining the

1 product as the iPod and the color --

2 Q: Right.

3 A: -- the iPod in a certain color, just to make a
4 point. So that's an economy of scope.

5 Economies of scope can be very, very broad.

6 They can also be to firms -- to products that

7 seem to be quite unrelated. That's to do with

8 enterprise risk management. The idea is that

9 you're not putting all of your eggs in one

10 basket. So from the total company's point of

11 view, if the widget -- if this industry goes

12 sour, this industry probably does not. That

13 can be good from the overall company's point of

14 view.

15 Q: Uh-huh (affirmatively responds).

16 A: That also is an economy of scope.

17 Q: Okay. And are you aware, have you seen this

18 economies of scope -- I know you've done a lot

19 of academic research on this. Have you seen

20 this economies of scope concept discussed in

21 any court cases? Are you aware of any courts

22 that apply this test?

23 A: Oh, yes. In fact, it originated as a result of

24 the AT&T litigation. It was, in fact, the --

25 it went up to the Supreme Court. It was

1 developed by Panzer and Lily, who were
2 testifying on behalf of Bell Labs on behalf of
3 AT&T, arguing that there were economies of
4 scope. So, in fact, the concepts were
5 developed by economists -- great economists
6 precisely to present evidence that was
7 presented in court. There are many, many
8 cases. Judge Green was, in fact, the Judge
9 that handled those cases in that litigation.
10 It's been subsequently used in a large number
11 of antitrust cases, so it's -- it's standard
12 stuff.

13 Q: In antitrust cases, okay. And I'm talking
14 about unitary business cases. I should have
15 put that as my caveat at the beginning of my
16 question. Are you aware of any courts that
17 applies this economies the scope in analyzing
18 whether a business is a unitary business?

19 A: Actually, I have seen some cases where it's
20 being referred to and --

21 Q: Okay.

22 A: -- some cases where the term "economies of
23 scale" have been used, but then the examples
24 that they use are actually economies of scope
25 and with -- forgive me, that may just be

1 lawyers misapplying --

2 Q: Right.

3 A: -- terms that look similar. But the anecdotes
4 are exactly economies of scope.

5 But as Dr. Wilder said, there can also be
6 economies of scale/scope; the two often go
7 together and it's not as if it's improper to
8 have the two. So I have seen cases where it's
9 been referred to, not in any particularly deep
10 way, usually, if I can characterize it, as what
11 I would call, as an economist, a hand-waving
12 manner of saying, oh, there are economies of
13 scope, hence it's unitary.

14 Q: Uh-huh (affirmatively responds).

15 A: And that is the thing that I think is
16 inappropriate.

17 Q: I see. But this economies of scope concept is
18 not discussed in the Exxon case. Would you
19 agree with that?

20 A: Which -- I mean, there's been lots of Exxon
21 cases, many of which I've been involved in.

22 Q: It's the one up on the screen.

23 A: No.

24 Q: Okay.

25 A: Not that I'm aware of.

1 Q: All right. And one of the things that I'm
2 getting is, a key in your mind is that CarMax
3 West -- and I think it's actually probably more
4 technically accurate to say CBS is doing
5 certain lines of business in South Carolina,
6 but not others; is that accurate?

7 A: If I understand what you're saying, they're
8 doing -- this is my oranges and apples --

9 Q: Yes.

10 A: -- thing, right, that they're doing certain
11 activities in South Carolina. They do those
12 activities elsewhere, to be sure, but elsewhere
13 they do other things, specifically retail
14 services.

15 Q: All right. So would it be your position that
16 a business cannot be unitary if it does not
17 engage in all of its actives in all states?

18 A: No. No, again, that's a too unconditioned
19 statement. That's my problem. The term
20 "unitary" is one that you cannot -- that's
21 possible --

22 Q: Okay.

23 A: -- but the way you stated it is, from my
24 perspective as an economist understanding this
25 concept, is too unconditional. That's all.

1 Q: All right. So I'll say it in the reverse.
2 You're saying that a business could still be
3 unitary even though it only does certain lines
4 of business in certain states.

5 A: Yes, it could be, but with the caveat that I'm
6 interpreting the term "unitary" in a way I've
7 been very clear about, that it is a very broad
8 concept and the fact that something is unitary
9 does not mean that for some purposes you cannot
10 give separate consideration to the independent
11 units. And that's what is being done here in
12 this case.

13 Q: In this particular case, it seems to me that
14 that's the main support that you give to your
15 position that it's fair and reasonable here,
16 that it's easy to separate, is because they're
17 only doing the financing and intellectual
18 property in South Carolina. So if you can help
19 me understand why if sometimes it's okay to
20 only do certain lines in certain states, then
21 why is it not okay here?

22 A: I have no idea what you're asking me, so I --
23 I don't understand the question.

24 Q: Let me see if I can restate it. You said
25 that -- I first asked you the question of: Can

1 a business be -- not be unitary if it does not
2 engage in all activities in all states? And
3 you said no, that's not necessarily true.

4 A: Right, and I'm trying to work through the
5 double negatives.

6 Q: Yes, I'm sorry.

7 A: And I'm just careful because I don't want to
8 say something that is incorrect. That's why
9 I'm being --

10 Q: I appreciate that. All right. So then the
11 converse of that is that you can still have a
12 unitary business even though the company is
13 engaging only in certain of the activities in
14 certain states, correct?

15 A: Yes, I agreed with that. For example, if you
16 used the -- if, for some reason, you want to
17 use the criteria of executive, common
18 management, then in that case there appears to
19 be a common management structure from that
20 perspective. But that does not mean that --
21 again, to take the definition, that you cannot
22 give separate consideration in this case to the
23 activities of the firm in South Carolina. And
24 that's what's before the case -- the Court.

25 Q: Well, that's where I'm having trouble figuring

1 out what your test is. What is it about the
2 fact that in South Carolina there's only the
3 intellectual property and financing receipts,
4 what is it about that only being done in South
5 Carolina that means you can't look at the
6 business -- the entire unitary business?

7 A: No, if I may rephrase --

8 Q: Yes.

9 A: I'm trying to rephrase your question. Let me
10 sort of state how I would present that. You
11 don't require to see -- if you see it as a
12 unitary business for the business as a whole,
13 that's fine. It matters not in terms of
14 whether you're able to give separate
15 consideration to the royalty and financing
16 aspects.

17 What I'm hearing in your question -- and
18 forgive me if I'm characterizing your --

19 Q: No.

20 A: -- question, but I'm trying to sort of help us
21 here --

22 Q: Yes.

23 A: -- is that the moment it's regarded as unitary,
24 you can't tease anything apart. The
25 denominator has to be this apples and oranges,

1 to use my earlier metaphor. I reject that as
2 wrong, in my view, for the reasons I've
3 explained. For some purposes, you cannot tease
4 those apart. But for this particular purpose --
5 -- and that's the fluidity of this definition,
6 that's precisely why we went through the
7 individual components -- you can justify
8 separate consideration, and that's exactly what
9 was done here.

10 Q: Right. But the answer (sic) is why? Why can
11 you justify it? And I had understood your
12 testimony to say the "why" is because they only
13 do these two activities in South Carolina. Is
14 there something more to it than that?

15 A: Actually, no. I think that's exactly it.
16 Because it is just royalty and finance and you
17 can identify those in the larger entity outside
18 of South Carolina, precisely as the auditor
19 did; it was possible to do that.
20 They are other ways to do it. You could -- you
21 know, even though South Carolina does not
22 require combined reporting, you could request
23 it, pursuant to 2320. So there are any number
24 of ways you could do that.

25 Q: All right. So what I hear you saying is that

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1 separate accounting is easy in this case
2 because the revenue sources can be segregated,
3 intangibles versus retail sales, or apples
4 versus oranges. Is that --

5 A: Well, there's a couple of things in there that
6 I would actually want an accounting expert to
7 talk about, so ...

8 Q: Okay.

9 A: But essentially the idea is, in this instance,
10 it was possible for the auditor to separate out
11 the royalty and financing from -- and, indeed,
12 this is in the report --

13 Q: Right.

14 A: -- for the rest of the entity, separate out the
15 apples from the oranges --

16 Q: Right.

17 A: -- and simply compare the apples to the apples
18 in South Carolina. In other instances, that
19 might be much more complicated.

20 Q: Right.

21 A: And then there are many, many other things that
22 can be done. As I said, under 2320, there's a
23 lot of flexibility as long as it's reasonable.

24 Q: Right. But isn't the whole point -- you're
25 talking about apple and orange revenue and

1 isn't the whole point behind the unitary
2 concept is that you're not taking into account
3 the cost, that it's difficult to attribute the
4 cost of each of those lines of business or
5 separate activities when the business is
6 unitary?

7 A: No. Again, you're -- we do have a disagreement
8 here --

9 Q: Uh-huh (affirmatively responds).

10 A: -- in terms of understanding the concept.

11 Q: Okay.

12 A: What I'm hearing you say is the moment you
13 declare it to be unitary for whatever
14 purpose -- let's just take, for example, the
15 purpose is they are common ownership, so in a
16 criminal action we can go after someone, a
17 perfectly, proper legal purpose. As a result,
18 all of the accounting has to be taken as a
19 whole.

20 The answer is no, for two reasons. One, there
21 can be many purposes for which one could
22 declare something unitary and you could still
23 separate -- justify separate consideration.
24 And I've given examples of that.

25 The other point to mention here is that even if

1 you deal with a unitary business that is truly
2 unitary in the full Harrison sense of the
3 term --

4 Q: Uh-huh (affirmatively responds).

5 A: -- you still have recourse, pursuant to 2320,
6 to ways to fix it. You simply request the
7 combined reporting, which you can do if the --
8 pursuant to 2320, if the taxpayer has done it.
9 I don't want to get into that, but what I'm
10 trying to get at -- because here they didn't
11 need to do that. It was simpler. There was
12 simply apples and they went after -- there was
13 an apple in South Carolina and, from the
14 existing separate accounting for the rest of
15 the entity, they were able to identify the
16 apples elsewhere, and they were done.

17 Q: You were here for Mr. Donovan's testimony, as
18 well, correct?

19 A: Yes, I was.

20 Q: Did you hear him discuss that he believed this
21 whole group of entities -- mainly he was
22 pointing to CarMax, Inc., as it operates all
23 the different entities, that that -- he thought
24 that was unitary?

25 A: I don't recall his precise testimony, but I do

1 think that's a reasonable characterization of
2 his answer to some of the questions, so I'm
3 not -- I'm not disputing it, but I don't want
4 to put words in his mouth.

5 Q: Well, for purposes of this question, let's
6 assume he said something along those lines.
7 Would you agree or disagree with that?

8 A: Well, I would have a different definition of
9 "unitary." And I think that's important. And
10 Mr. Donovan, who was expert in his area -- I've
11 been asked to present an opinion about what
12 this beast called the "unitary business" is and
13 I think one of the things we actually all agree
14 is it can mean different things to different
15 areas of expertise. And one of the things that
16 this Court has to wrestle with is how those
17 concepts gel together. And that's important.
18 It is a matter of law, it is a matter of
19 accounting, it is a matter of economics.
20 But I'm saying Mr. Donovan may have had -- may
21 have been responding to a question which he
22 interpreted as, is it a unitary business in any
23 one of these sense. That was the way in which
24 I interpreted Mr. von Lehe's questioning at
25 that time.

1 Q: Uh-huh (affirmatively responds).

2 A: And that would be a correct response. As I
3 said to you a moment ago, in terms of saying
4 one of those criteria, common ownership, let's
5 say, or executive function -- let's be a little
6 bit broader -- it is unitary. Doesn't mean
7 it's unitary in other respects. That's what
8 I've been trying to say.

9 Q: Okay. So you would not agree that the business
10 as a whole is unitary for purposes of this
11 case?

12 A: For the purposes of this precise case, whether
13 it is unitary makes no difference.

14 Q: Okay.

15 A: So, again, I'm trying to -- I can call it
16 unitary; I could say it's not unitary. It
17 makes no difference for the purposes of this
18 case. For other purposes, it might.

19 Q: But can you just answer a "yes" or "no" as to
20 whether it's unitary?

21 A: Well, no, that would be a misleading answer.
22 I'm not trying to say -- are you asking me as
23 an economist? Are you asking me --

24 Q: Yes.

25 A: -- in terms of as an economist?

1 Q: Let me ask you as an economist.

2 A: As an economist, it is not unitary unless one
3 can expand the senses in which it is unitary
4 and the purposes for which one might want to
5 separately consider it.

6 It is not a "yes" or "no" issue. I'm not
7 trying to dodge here. I'm trying to be honest
8 that that's precisely our difficulty. In some
9 sense you would like it to either be unitary or
10 not and if it's unitary in some sense, it's
11 unitary for everything. I think that's a
12 misreading of this definition and the way an
13 economist would use the concept.

14 Q: So how do you view, as an economist, the group?

15 A: I view them as a yellow company, a couple of
16 blue companies. Honestly, I don't view them.
17 I have seen no reason -- and I'm serious now --
18 I see absolutely no reason to try to label it
19 in some sense.

20 The purpose here is to identify, can we figure
21 out the economic nexus of the activity in South
22 Carolina, the extent of the activity. For that
23 purpose, I care not whether you call it a
24 yellow company, you call it a unitary company
25 or whatever. For this purpose, it's

1 irrelevant.

2 Q: Okay. So, in other words, for the purpose --
3 in your mind, in your view, whether it's a
4 unitary business or not is irrelevant.

5 A: For the -- sorry.

6 Q: Okay.

7 A: For the purposes of this case, yes.

8 Q: All right. And you spoke of this in your
9 direct testimony, but I just wanted to repeat
10 it. You do agree that the Department's ability
11 to deviate from this standard apportionment
12 formula is limited by reasonableness. Whatever
13 alternative method they pick has to be
14 reasonable.

15 A: Yes, it actually has two limits --

16 Q: Okay.

17 A: -- going in and going out. The going in
18 limitation is that it has to be triggered by
19 this requirement that the other -- thinking of
20 the hierarchy.

21 Q: Yes.

22 A: The other formulas don't fairly represent the
23 business activity in South Carolina. That's a
24 restriction.

25 And then as a civil libertarian, I love the

1 idea that there is a restriction going out,
2 that the State Department of Revenue is
3 constrained. It cannot do something that is
4 arbitrary.

5 Q: The auditor in this case focused on the fact
6 that CarMax West was relatively more profitable
7 than CarMax East. Did you notice that in the
8 report?

9 A: I recall that in the report and in some of the
10 questions of Mr. Donovan, the supervisor, yes.

11 Q: Did you -- as an economist, does that, in your
12 mind, have any relevance to this case?

13 A: It could be relevant as one of the criteria
14 that they used. As Mr. Donovan was testifying,
15 I think quite clearly yesterday, he instructs
16 his auditors that there are certain flags,
17 certain things to look for.

18 Q: Right.

19 A: And I would hope that auditors would do that.
20 So that one of them could be relative
21 profitability.

22 Q: Wouldn't it be true, though, that any company
23 that engages in different lines of business or
24 types of activities of business is going to
25 have different profit levels for those

1 different businesses?

2 A: In general, yes. When you talk about profit
3 centers and, indeed, that is a major part of
4 economics and accounting that's devoted to
5 trying to identify those profit centers. So
6 that will happen, yes.

7 Q: And I think I heard you say this in your
8 direct. I wanted to make sure I understood it,
9 that you agree that there are some important
10 due process principles that are furthered by
11 the apportionment formula, in that the
12 taxpayers can know in advance what their tax
13 burdens are for engaging in an activity in a
14 state?

15 A: Yes, I --

16 Q: Is that a fair --

17 A: I did say that --

18 Q: -- statement?

19 A: -- and, indeed, I see 2320 as an important part
20 of that, particularly if the taxpayer has the
21 benefit of advice from professionals, tax
22 advisers, which I understand the taxpayer does.
23 The taxpayer is able to read 2250, 2290 and
24 also 2320 and understand that the expectation
25 by statute is that they provide taxable -- tax

1 information that fairly represents their
2 activity in South Carolina. I don't think that
3 the taxpayer is somebody who simply starts on
4 line one and goes to line two and follows the
5 instructions.

6 Q: Let me talk to you a little bit about the
7 sourcing of the financing receipts. As I
8 understood your testimony on direct, you are
9 aware that CarMax East sells cars in South
10 Carolina and CarMax West does not.

11 A: Sorry, you said CarMax East sells cars?

12 Q: Sells cars in South Carolina, but CarMax West
13 does not sell cars in South Carolina.

14 A: That CarMax West, the taxpayer, does not sell
15 cars here, that's right.

16 Q: Okay. Do you understand that CarMax -- when
17 CarMax East sells that car in South Carolina,
18 that it reports the income from that initial
19 contract in South Carolina and pays taxes on
20 that?

21 A: I wasn't aware they were the taxpayer here. Is
22 it -- I thought it was CarMax West is the
23 taxpayer at issue.

24 Q: That's correct. I'm just -- this is a -- just
25 bear with me here as I go through my --

1 A: It's something that's irrelevant, but you want
 2 to ask. Go ahead.
 3 Q: Not irrelevant.
 4 A: Okay, sorry.
 5 Q: Are you aware that when CarMax East sells these
 6 cars, it reports the income earned and pays
 7 taxes on the income earned from the sale of
 8 those cars?
 9 A: I did hear some direct -- I was generally aware
 10 of that and I did hear some direct testimony to
 11 that effect yesterday, yes.
 12 Q: All right. And so are you aware that the
 13 economic activity -- I'm sorry. Do you
 14 understand that the only issue in this case is
 15 the income earned from financing receipts after
 16 this initial sale?
 17 A: That's the activities of CBS, the green bit,
 18 yes.
 19 Q: Right, okay and you're also aware that all of
 20 the activity done by CBS is done in Georgia,
 21 correct?
 22 A: No, I wouldn't characterize it as "activity"
 23 and I think that's -- that's an important word
 24 to use there --
 25 Q: Okay.

1 A: -- because the word "activity" appears in 2320,
2 so I would be very careful about that --

3 Q: Let me restate that.

4 A: -- as an economist.

5 Q: You are aware that all of the employees that
6 perform services for CBS after the initial sale
7 to service and handle securitizing of these
8 contracts are in Georgia?

9 A: Yes, that's more accurate.

10 Q: And so in determining where to source these
11 receipts to, do you not think that great weight
12 should be given to where that activity is
13 taking place?

14 A: No, for the reasons I explained in direct
15 testimony, that there is a simple "but for"
16 test that an economist would use, and in some
17 contexts lawyers would use. But for the South
18 Carolinian that undertook the purchase of the
19 car --

20 Q: Uh-huh (affirmatively responds).

21 A: -- that revenue would not have occurred.

22 Q: Okay.

23 A: I fully understand that that involves some
24 legal issues, which I'm not an expert on, but,
25 from an economist's perspective, it seems

1 perfectly natural that but for the South
2 Carolinians buying the cars, there wouldn't be
3 the revenue.

4 Q: Well, from an economist's point of view, do the
5 CBS associates -- I think there's 300 of
6 them -- do they not add some value to the
7 process?

8 A: There are costs reflected there and that's
9 reflected -- to my understanding, that's
10 reflected in the net income that is being --
11 that is at issue here. So we're not talking
12 about gross income, necessarily.

13 Q: Right. Then let me get you to answer my
14 specific narrow question: Do you not think
15 that they add value?

16 A: They would certainly add value, having somebody
17 to answer a phone or even a computer to answer
18 a phone, wherever it's located, will add value
19 to it. There's no question about that.

20 Q: And would you agree with me that if you did
21 source these receipts to Georgia, that that
22 would have a benefit of matching the expenses
23 with the income?

24 A: No. No, I don't see that at all, either an
25 economics or an accounting perspective. The

1 matching principle is fundamental to economists
2 and to accountants. Doesn't necessarily follow
3 that you should allocate them in that
4 geographic manner at all.

5 Q: All right. So you agree that there is a
6 matching principle in the law of economics and
7 accounting?

8 A: There's a matching principle in accounting and
9 it's the same matching principle, actually, in
10 economics essentially.

11 Q: Right.

12 A: The things that we're matching are defined
13 slightly differently, but the principle is the
14 same, both in space and in time. You want to
15 try to match the revenues with the expenses, if
16 you can, so that you have -- you can look at
17 profit in the same -- for the same time period
18 you're matching revenues and expenses.

19 You cannot always do that. There are things
20 like bad debts that you only realize later on,
21 for example.

22 Q: Right.

23 A: But to the extent that you can, you want to in
24 time match them. The same thing is true
25 spatially for some purposes. For other

1 purposes, you might want to keep them separate.
 2 THE WITNESS: Can I ask for you to give me a moment
 3 for a break?

4 THE COURT: Absolutely.

5 THE WITNESS: I don't know if there's going to be --

6 MS. GEER: No, that's fine.

7 THE COURT: Let's take ten minutes.

8 (Break taken from 11:20 to 11:30 a.m.)

9 THE COURT: All right. When you're ready, you may
 10 continue your cross-examination of Dr.
 11 Harrison.

12 MS. GEER: Your Honor, we are actually done.

13 THE COURT: Okay. Anything on redirect, Mr.
 14 Traynham?

15 MR. TRAYNHAM: Just very, very briefly, Your Honor.

16 DR. HARRISON - REDIRECT EXAMINATION BY MR. TRAYNHAM:

17 Q: Dr. Harrison, you were testifying about the
 18 value added to the financing income by the
 19 employees located in Georgia, I believe. Tell
 20 me, in your opinion, would there be anything to
 21 add value to without an auto buying customer?

22 A: No. Precisely but for that customer, that
 23 South Carolinian resident, there wouldn't be
 24 anything to add value to.

25 Q: You were also testifying about the matching

1 principle. Is matching concerned with
2 deducting expenses from the income they help to
3 produce?

4 A: That's the broad idea and so that you want to
5 do that in the same time period and, for some
6 purposes, in the same country and, for some
7 purposes, in the same state, but not
8 necessarily.

9 Q: And is it your understanding that the income
10 from CBS is -- that's flowing to the taxpayer
11 is net of those expenses that it created?

12 A: Yes, that was my understanding.

13 Q: Just one final thing. Dr. Harrison, your
14 opinion has been ad nauseam over the apples in
15 South Carolina versus --

16 MR. VON LEHE: Mr. Traynham, you're characterizing
17 your witness -

18 THE COURT: I was going to say, Mr. Traynham, you
19 remember that's your witness.

20 MR. TRAYNHAM: I apologize for the abuse of my own
21 witness, Your Honor.

22 THE WITNESS: I think he knows that I'm Australian
23 and we're hard to insult.

24 THE COURT: Well, that's okay, we're hard to
25 nauseate, so ...

1 MR. TRAYNHAM: All you have to do is add "I'm
2 joking" to the end, and it's no longer an
3 insult, right?

4 Q: But, Dr. Harrison, you have testified that you
5 were very concerned with the apples type of
6 business in South Carolina versus the oranges
7 the taxpayer earned everywhere else. Would
8 that be a fair characterization?

9 A: Well, the apples and oranges they earned
10 elsewhere, yes.

11 Q: And so your focus in your testimony has been on
12 the actual business operations the taxpayer is
13 taking on in South Carolina; would that be a
14 fair statement?

15 A: Yes, as the State sees it, yes.

16 Q: And we've been discussing at length 12-6-2320.
17 Based on your economics reading of this
18 statute, is this statute concerned about the
19 type of activity, the type of business that a
20 taxpayer carries on in the State of South
21 Carolina?

22 A: That can be --

23 MS. GEER: Your Honor, we would object to that,
24 asking for a legal conclusion.

25 MR. TRAYNHAM: Your Honor, he's given an economics

1 opinion as to his interpretation as an
2 economics expert on statutes previously. I'm
3 simply asking for, again, not a legal opinion,
4 but if his reading of the statute seems
5 economically concerned with the activity of a
6 taxpayer in South Carolina.

7 MS. GEER: I think the way he phrased it was, "Is
8 that what the statute is doing," but ...

9 THE COURT: Can you rephrase, Mr. Traynham?

10 MR. TRAYNHAM: Certainly, Your Honor.

11 Q: Dr. Harrison, based on your reading, does this
12 statute seem economically concerned with the
13 activities of a taxpayer in South Carolina?

14 A: Yes, in two parts. The first part would be the
15 trigger mechanism, if you like, that was the
16 apportionment provisions fairly represent the
17 extent of the taxpayer's business. In that
18 sense, it's the nature; is it apples or apples
19 and oranges. And, also, subsequent to that,
20 how one actually does the accounting and the
21 auditing.

22 But, most importantly, in terms of the
23 economics and this hierarchical sense of the
24 codes, that's the sense in which it relates in
25 the statute.

1 MR. TRAYNHAM: Thank you, Dr. Harrison.

2 No further questions, Your Honor.

3 THE COURT: Thank you very much.

4 Do you have any recross, Mr. von Lehe and Ms.
5 Geer?

6 MS. GEER: No, Your Honor, we do not.

7 THE COURT: Thank you. You may be excused.

8 (Witness excused.)

9 THE COURT: And that concludes the Department's
10 case, Mr. Traynham?

11 MR. TRAYNHAM: Yes, Your Honor, we have no further
12 witnesses.

13 I understand the taxpayer may want to call some
14 witnesses in rebuttal.

15 THE COURT: I was going to say, do you have any
16 witnesses in reply?

17 MR. VON LEHE: Your Honor, if we could have a moment
18 to discuss --

19 THE COURT: Certainly.

20 MR. VON LEHE: -- whether we do or not and --

21 THE COURT: Certainly.

22 MR. VON LEHE: Thank you.

23 THE COURT: Thank you.

24 MR. VON LEHE: Your Honor, we have nothing further
25 to present to the Court. We would like to

1 present brief closing arguments when -- at an
2 appropriate moment.

3 THE COURT: Certainly. Well, I think this is the
4 appropriate moment and I'll be glad to give you
5 15 minutes and 15 minutes for Mr. Traynham.

6 MR. VON LEHE: Thank you, Your Honor.

7 THE COURT: So whenever you're ready.

8 MR. VON LEHE: Thank you, Your Honor. I'm ready.

9 CLOSING ARGUMENT BY MR. VON LEHE:

10 MR. VON LEHE: And, Your Honor, first of all, thank
11 you very much for your time and everyone else
12 in the courtroom during the last basically day
13 and a half.

14 I'm not going to go back over in detail
15 everything that has been done, but I do want to
16 point out some things that we believe are
17 important to a correct determination to give
18 Your Honor ample opportunity from our side for
19 a correct determination in the case.

20 First of all, the issue in the case -- and I
21 think everyone basically has agreed to this --
22 and it's whether or not the Department of
23 Revenue can properly change the method of
24 reporting that's been used by the taxpayer?
25 Can they change that method?

1 Everyone basically has agreed that it's
2 correctly used the standard method, in other
3 words, that it has begun with its federal net
4 income, in accordance with the laws of the
5 State of South Carolina, the regulations of the
6 State of South Carolina, the tax forms and the
7 instructions to those tax forms, that it has
8 begun with its federal net income.

9 Now, we are going to classify that income, you
10 know, as it's unitary income. That's the way
11 the taxpayer is going to classify that.
12 Obviously, that is not agreed to, but we will
13 classify it that way. We believe we have
14 proved to Your Honor that it is unitary income.
15 We began with that unitary income of this
16 entity, made appropriate South Carolina
17 adjustments, which are not -- no one's
18 disputed, and we've applied that method of
19 apportionment, which we would assume the
20 Department of Revenue would agree to if they
21 thought that the general method of reporting is
22 correct; in other words, the gross receipts
23 method.

24 They have rejected the statutory methods, but
25 I would assume that if a statutory method were

1 to apply, they would agree that it would be the
2 gross receipts method, not the three-factor
3 method, since they in the audit report said the
4 three-factor method was wrong. So that's what
5 the taxpayer has done.

6 The Department of Revenue has objected to this.
7 It's offered what it refers to in the audit
8 report and I think has been classified here as
9 an alternative apportionable method which does
10 not use the taxpayer's corporate net income.
11 It does not use that. Instead, it seeks to
12 divide off, carve off, whatever one wants to
13 say, separate portions of this taxpayer's
14 income.

15 And the question, then, is when does the
16 Department of Revenue have the authority to
17 reject the statutory method of reporting
18 income? When can it do this?

19 That authority is given in Section
20 12-6-2320(A), and it says that the Department
21 of Revenue or the taxpayer, for that matter,
22 may do this. Taxpayer would have to petition
23 and the Department of Revenue would then have
24 to review that and make a decision on that. Or
25 the Department of Revenue may themselves do

1 this, when the formula, the statutory formula,
2 the standard formula as applied to the
3 taxpayer's income doesn't fairly represent the
4 extent of the taxpayer's business activities in
5 South Carolina.

6 And, therefore, we have this question. If it
7 does this, then it is also clear in the statute
8 as you read down -- it's number four down here.
9 You would have to -- excuse me, it's number
10 three. It gets down to "will fairly." The
11 Department of Revenue would have to propose
12 something that will fairly represent the
13 taxpayer's business activities. And I believe
14 that both sides are saying -- we're saying what
15 we did does fairly represent the taxpayer's
16 business activities and I assume they're saying
17 that what they did fairly represents the
18 taxpayer's business activities.

19 Your Honor, when this matter began in your
20 opening statements to this case, you stated a
21 standard rule in the area of taxation and you
22 said the taxpayer has the burden to show that
23 the assessment is incorrect. All right. That
24 is obviously a correct statement of the law;
25 however, it is not in this case.

1 In this case, it is universally accepted -- and
2 I'll give the cites on this in a moment -- that
3 the party who seeks to deviate from the
4 standard apportionment formula has the burden
5 of showing that that formula does not
6 reasonably represent that taxpayer's business
7 activities. This is the Department of
8 Revenue's burden.

9 And the cites to that, Your Honor, are -- the
10 case relied upon probably most heavily in the
11 Department of Revenue's pretrial brief, that
12 case in the matter of the protest of Wal-Mart
13 Stores -- I believe a copy of that case has
14 probably been hand up to Your Honor, but, in
15 any case, I certainly have a copy of it here.

16 And this statement in that case is on page 22
17 and in that decision the Court in New Mexico
18 states, "As the party who wishes to depart from
19 the standard three-factor formula under
20 UDITPA" - which we've all agreed is the same
21 language as ours -- "the Department has the
22 burden of justifying any modification of the
23 standard formula."

24 It then cites a New Mexico Supreme Court case
25 of K-Mart. That case, I also have with me.

1 And in the K-Mart case in the New Mexico
2 Supreme Court at paragraph 50, the -- and that
3 case is found 135 New Mexico 177. We will also
4 hand it up. In that case, New Mexico Supreme
5 Court said KPI, who was the taxpayer, objects
6 that section blah-blah should -- that's the
7 UDITPA - should be used only under usual
8 circumstances, et cetera, et cetera.

9 KPI also cites out-of-state case law for the
10 universally-accepted proposition UDITPA
11 Section -- here stated as 7-4-19, but it's
12 Section 18 -- "should not be sparingly and the
13 Department has a heavy burden of persuasion to
14 justify any modification of the UDITPA
15 formula," citing a couple of other cases.

16 So we would submit to Your Honor that in this
17 particular case it is the Department of
18 Revenue's burden to show that this
19 apportionment formula does not fairly represent
20 the taxpayer's business activities in South
21 Carolina.

22 And here it is also clear that the Department
23 of Revenue has presented no credible evidence
24 that the standard method does not fairly
25 reflect income. They have given no criteria

1 upon which to measure this. There are no
2 published rules, regulations, policy documents
3 for any taxpayer to follow as to what they
4 should have done.

5 Since there are no documents, no published
6 documents, information for any taxpayers, they
7 clearly nothing published, rules, regulations
8 or standards that this Court may use.
9 Therefore, they simply want the taxpayer and
10 the Court to accept what they have done. No
11 ascertainable standard exists as to when in
12 their judgment or what criteria they have used
13 to say that these apportionment formulas don't
14 reasonably represent the income from the
15 taxpayer's business activities here.

16 We submit that statements of the audit report
17 that one entity made more money than the other
18 entity is totally irrelevant or at least it
19 gives no indication that the taxpayer's
20 business activities are not properly reflected
21 by the apportionment formula.

22 Now, I see a big problem coming from a
23 precedential standpoint, should the Department
24 of Revenue's position be accepted, and that
25 problem would be that it will create a system

1 of administrative and tax enforcement chaos.
2 The Department of Revenue will, without any
3 criteria sent to taxpayers -- or even
4 themselves. They do not even have internal
5 criteria. You'll recall the testimony on that.
6 There is no internal criteria that sets when
7 this so-called trigger takes place. Without
8 anything at all to go by, no taxpayer is going
9 to know how to file in South Carolina.
10 There is a criteria which we're going to
11 submit, that I may go ahead and say it now, and
12 that criteria has got to be, "Is this a unitary
13 business?" That is where we have a fundamental
14 disagreement with the Department of Revenue in
15 their brief, that is where we have a
16 fundamental disagreement with Dr. Harrison's
17 testimony, which he just said it doesn't matter
18 if it's a unitary business or not; that doesn't
19 mean it can't be separated.
20 We disagree with that. We submit that the
21 South Carolina Supreme Court in the Exxon case
22 also disagrees with that. You'll recall in the
23 Exxon case, as I think I stated earlier, that
24 Exxon said, "Look, we only do one thing in
25 South Carolina, and that's sell gasoline. We

1 don't have any oil wells in South Carolina."
2 Unfortunately, that's true. "We don't have any
3 refineries in South Carolina." And they did
4 not. "All we've got is some gasoline stations
5 and gas pumps, so that is the only thing we
6 have. Those are our South Carolina apples, so
7 to speak."

8 If someone -- if their lawyer had been arguing
9 using Dr. Harrison's comparisons, I'm certain
10 he would have said to the South Carolina
11 Supreme Court, "All we've got here are the
12 apples of selling the gasoline and the oranges
13 of the production and the refining are all
14 located out of state."

15 But the Court said, "No, we don't tax a
16 business like that, unless that business can be
17 reasonably separated," meaning that it is not
18 a unitary business. It laid down certain
19 rules, certain tests, tests which appear to be
20 irrelevant to Dr. Harrison, but that's his
21 business.

22 They're very relevant to us, and I'm sure to
23 this Court, the three unities test. That test
24 is there. The contribution and dependence test
25 is there. We submit, and testimony has shown,

1 that we meet those tests, that we have one
2 unit -- before this reorganization, there was
3 one unitary business in that single
4 corporation, just like Exxon had a single
5 corporation and it had a unitary business in it
6 of producing, refining and selling petroleum
7 products.

8 We have a unitary business of refurbishing used
9 automobiles, of marketing those automobiles,
10 financing those automobiles, selling those
11 automobiles.

12 After the reorganization, the taxpayer and CBS
13 were unitary together, the 93.5 percent
14 partnership that the taxpayer owned. Those two
15 remained unitary through those same functions,
16 so it had -- the three unities existed. And
17 also it had inferred contribution and
18 dependence among its parts, as has been
19 testified throughout this record.

20 Your Honor, therefore, there is a criteria so
21 that when these matters come up, there is a
22 criteria upon which a judgment can be made and
23 that judgment is, is this a unitary business?
24 Should it turn out that it's not a unitary
25 business, then all businesses are not unitary.

1 They're not all related to each other. It
2 would be possible to have a gold mine in
3 California and a haberdashery down here on
4 Assembly Street and one brother runs one out
5 there and one brother runs one here, or sister
6 runs one here, and maybe they don't have
7 anything to do with each other. Those are not
8 unitary businesses, that's clear.

9 There's a regulation on that, by the way, which
10 we will eventually cite to you. It's not in my
11 pretrial brief, but I didn't quite visualize
12 this coming up, to tell you the truth, but we
13 will cite it -- which the Department of Revenue
14 does concentrate on one entity and says when it
15 might be unitary or not unitary in that one
16 entity. That is the situation that we face.

17 Now, I want to turn to a couple of other
18 elements here and that is that this -- put
19 another way, this section of the law,
20 12-6-2320, when it gives the Department of
21 Revenue this authority, this is not unfettered
22 authority. It does not intend and it cannot
23 intend to give the Department of Revenue
24 authority to do something which is not in
25 accordance with established South Carolina law,

1 like the Supreme Court opinion in Exxon. It
2 has -- it's got to be put into proper criteria
3 and it cannot be an unfettered, unbridled, you
4 know, do anything you want to with this
5 taxpayer set of circumstances. They've got to
6 follow the South Carolina set jurisprudence on
7 what can be done and what cannot be done.

8 And we submit a unitary business cannot be
9 separated accurately from an accounting
10 standpoint and the law throughout this country
11 establishes that and particularly our own law
12 in Exxon and in other cases, which we will cite
13 to Your Honor at the appropriate time.

14 I want to mention one or two other things.
15 We've discussed the fact that -- there's been
16 a lot of testimony here about the fact that
17 there's a tax advantage to the way this --
18 these organizations are set up, entities are
19 set up. But there's been nothing in this
20 record that indicates that this is some sort of
21 a tax scheme set up to avoid taxes.

22 The only thing in the record is that there were
23 good business reasons to set this up. And
24 Mrs. Yost testified to that during her
25 testimony. So there's nothing and no one -- I

1 don't think anyone is alleging that this is a
2 tax scheme. There's a -- there may have been
3 a statement in the audit report earlier, but
4 the auditor wasn't here to discuss that, can't
5 cross-examine him on that, but, be that as it
6 may, I don't believe since we've been here for
7 the last day and a half, I don't think I've
8 heard that term used and I don't believe it's
9 part of the Department of Revenue's
10 presentation in this case.

11 So we come down to -- I'm going to check my
12 notes on this and make sure I didn't leave out
13 something.

14 **THE COURT:** Take your time.

15 **MR. VON LEHE:** We come down to this. We're going to
16 reach a point where we begin to think about:
17 What have they done? There seems to be a
18 little bit of difficulty in classifying that.
19 I think I did ask some questions about whether
20 or not this was a form of separate accounting.
21 I'm not sure that that answer came back that it
22 was or it wasn't.
23 If I had to classify it, if I did classify it
24 as separate accounting, I would certainly
25 classify it as faulty separate accounting. But

1 separate accounting cannot be used for a
2 unitary business. I do not see this as
3 separate accounting, because I don't see
4 anybody saying, "Well, here's the income; here
5 are the expenses in South Carolina." One
6 usually sees a separate accounting computation,
7 it applies to some finite entity located in a
8 state. Like if someone had 20 department
9 stores and they were two of those department
10 stores in South Carolina, one might try to
11 determine -- or one in South Carolina, one
12 might try to determine what's the income of
13 that particular store, that kind of thing.
14 Even that's been rejected by the way they
15 brought this case, because that ended up being
16 a unitary business; therefore, it was still
17 rejected. But we believe even this case defies
18 separate accounting. It's just the nature of
19 this unitary business does not allow one to
20 focus on a separate accounting principle and,
21 of course, Mr. Zinn testified to this effect.
22 I'm not certain what their testimony is on
23 that, but whatever it is, we believe that
24 separate accounting is not appropriate.
25 And, Your Honor, then my last presentation on

1 this, because we want to talk a little bit
2 about the penalties which have been assessed.
3 There are two penalties that have been
4 assessed. One's the substantial understatement
5 penalty, which I think it was testified to,
6 "Well, you know, we always put that down." I
7 can understand that, I guess, if one doesn't
8 have time, a chance to look at it. But when
9 one does view it, the criteria in the code
10 for -- which says there can be no substantial
11 understatement penalty is, number one, was
12 there substantial authority for the taxpayer's
13 position?

14 If I have ever seen a case in my life where
15 there's substantial authority for what this
16 taxpayer did, this is that case. All they did
17 was follow the straight law on the subject and
18 regulations, the tax return, et cetera,
19 et cetera, so there's no question. Of course,
20 the Department's witness, he did say that, yes,
21 the tax instructions are substantial authority,
22 and this is what they followed.

23 And then there's a question of disclosure and
24 he also testified that, yes, you could take
25 what was in the tax return and prepare at least

1 a draft audit report based on that. In fact,
2 that's what they did. So they had everything,
3 so there was complete disclosure. So we see
4 absolutely no reason for substantial
5 understatement penalty.

6 And then the negligence penalty, Your Honor,
7 again, that requires some kind of intentional
8 disregard for rules. And how can you have an
9 intentional disregard for a rule that you can't
10 find? If there's no rule, you can't have an
11 intentional disregard for that rule. So we
12 submit that that is certainly not the case and
13 would ask Your Honor to view those penalties in
14 that light.

15 This whole thing started many years ago, and
16 it's in their pretrial brief, with this case
17 called Geoffrey. And in the Geoffrey case,
18 intangibles were placed in a Delaware holding
19 company and the matter went to the South
20 Carolina Supreme Court and the South Carolina
21 Supreme Court said, "Look, having intangibles
22 here is enough to subject you to tax."
23 Taxpayers are still complaining about that.
24 Fine. They're doing that on a national scope.
25 Fine. They're trying to get the U.S. Supreme

1 Court to look at it, and everybody knows that,
2 and that's fine.

3 But South Carolina's got the Geoffrey case and
4 we recognize it. We have tried to comply with
5 that case. So what did Geoffrey end up having
6 to do? It ended up having to file based on its
7 federal net income, its appropriate South
8 Carolina adjustments -- assuming Geoffrey had
9 filed. I mean, I assume today if they're
10 filing, this is what they're doing. But the
11 thing about it is, that case said we're going
12 to impose a tax on the net income of this
13 company. If Geoffrey had had no income, it
14 would have paid no tax. If we had no income,
15 we'd still be paying the same tax they've
16 assessed because our net income is irrelevant
17 to the tax which they've assessed. So we've
18 done what Geoffrey said.

19 The other case cited in their brief is the
20 Wal-Mart case, which I just referenced a moment
21 ago. Again, that case is a case which is
22 directly on point in supporting what this
23 taxpayer has done. What Wal-Mart did was it
24 had an intangible holding company, also. We
25 don't have that. Our intangibles are in a

1 company which is more of a viable company that
2 does other things. But, nevertheless, they had
3 set up an intangible holding company in
4 Wal-Mart. They had filed, apparently, but had
5 filed using the three-factor formula.

6 The Department of Revenue in New Mexico invoked
7 Section 18 of UDITPA and said, "We're going to
8 propose an alternative formula. We're going to
9 use a single factor gross receipts," because
10 they didn't sell tangible personal property,
11 apparently, in New Mexico. And it's true that
12 the taxpayer in this case doesn't sell tangible
13 personal property, doesn't sell cars in South
14 Carolina.

15 So what it did in Wal-Mart, it said, "Look,
16 we're going to reduce these three factors to
17 one and you're going to pay on gross receipts
18 on your net income." That's what we've done.
19 So, Your Honor, we believe that established
20 authority, throughout the country supports the
21 method that we have filed under.

22 We certainly believe that there is a place and
23 a time for this code section to be invoked,
24 12-6-2320. We just disagree that this is the
25 place and time for that code section to be

1 invoked and it is the Department of Revenue's
2 burden to convince this Court that we are
3 wrong. Thank you, Your Honor.

4 **THE COURT:** Thank you, Mr. Von Lehe.

5 Mr. Traynham?

6 **MR. TRAYNHAM:** Thank you, Your Honor.

7 **CLOSING ARGUMENT BY MR. TRAYNHAM:**

8 **MR. TRAYNHAM:** Your Honor, as an initial matter, I
9 think the Department would object to the
10 raising of the precedential value, the concerns
11 there. I don't think that's relevant.

12 I also think that Mr. Donovan's testimony in
13 this matter established that alternative
14 apportionment has been used in other cases with
15 other taxpayers. We're not living in the End
16 Times now as a result, so I don't think it's --
17 I don't think that it's relevant to these
18 considerations.

19 Your Honor, we said at the outset that this
20 case presents the question of how to fairly
21 calculate the income. The taxpayer engaged in
22 several lines of business, some of which have
23 a connection to South Carolina and some of
24 which do not.

25 The threshold question, as the Court has put

1 it, is: How does the Department determine when
2 a standard statutory formula does not fairly
3 represent the taxpayer's business in the state?
4 And that is the threshold question.

5 Even the taxpayer's expert conceded that if a
6 standard formula does not fairly reflect the
7 business of a unitary taxpayer, 12-6-2320 would
8 apply to that taxpayer. So the threshold
9 question is whether or not the standard formula
10 form fairly represents a taxpayer's business,
11 not whether or not they're unitary.

12 Now, what triggers that statute differs from
13 case to case. There is no bright-line rule.
14 There's a case -- I believe we cited it in our
15 brief -- 20th Century Fox. It wasn't cited,
16 Your Honor. We have a copy of that case with
17 us today which establishes that. It applies a
18 very similar statute derived from UDITPA 18.
19 It basically stands for, among other
20 propositions, that it's going to be a
21 case-by-case scenario.

22 But, in general, as has been testified to over
23 the last two days, the Department auditors are
24 instructed to look for telltale signs of what
25 the Department perceives as tax minimization

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1 strategies. The taxpayer's business structure
2 in this case is replete with those red flags,
3 so to speak.

4 The auditors can then examine the taxpayer more
5 closely and look at the apportionment ratios of
6 the taxpayers, as filed in South Carolina,
7 compared to the ratio of the type of income
8 they are actually earning in South Carolina to
9 that type of income they earn everywhere they
10 do business.

11 If those two ratios are grossly out of whack,
12 then the effect of the standard formula is
13 distorted and cannot fairly represent the
14 extent of the taxpayer's business in this
15 State. That's the circumstance we're faced
16 with here.

17 The taxpayer's concerned that we're trying to
18 divide out a portion of their business. The
19 taxpayer is very much active in two distinct
20 businesses, with a nontaxable flow-through
21 partnership performing all of the services that
22 earn income in South Carolina and a separate
23 legal entity conducting retail sales in the
24 West Coast in combined filing states. That's
25 been testified to by the taxpayer.

1 Those sales have nothing to do with this state,
2 but the income that flows from South Carolina
3 clearly does. What we're after is a fair
4 measure of the business the taxpayer is
5 actually carrying on in this State, which is
6 what the statute is concerned with; in this
7 case, it's financing and royalty income.

8 Your Honor, we've made the analogy between the
9 Geoffrey case and the taxpayer before. The
10 taxpayer has raised Geoffrey, but I think it's
11 worth revisiting. In Geoffrey, the taxpayer
12 did not think that it bore a tax burden in
13 South Carolina, didn't think that it owed a
14 tax. All it had was intangible property, no
15 personal property, no employees. But the Court
16 disagreed. Supreme Court clearly said that
17 intangible property is sufficient to establish
18 a tax liability.

19 Now, the taxpayer made the point that the
20 taxpayer there paid tax on its net income. I
21 think the opinion in that matter clearly
22 establishes that the only income Geoffrey
23 earned was intangible income. So that's all
24 we're trying to tax in this case, intangibles
25 from intellectual property and trademarks and

1 the intangible financing income that flows out
2 of South Carolina.

3 Now, obviously, there are very distinct
4 differences between this case and Geoffrey.
5 The first, and most obvious, is that the
6 taxpayer's not disputing it owes a tax in South
7 Carolina. But, as we stated in our opening,
8 what they've done by taking the apples from
9 South Carolina and mixing it with the apples
10 and oranges from everywhere else, is to mix
11 this all up, dilute their tax liability in
12 South Carolina and create a pot of effectively
13 untaxed income. They're not fighting tax
14 liability, but they are effectively getting
15 away without paying their fair share of tax.

16 As Mr. Donovan stated, this is an evolution of
17 taxpayer business structures that he has
18 observed since the Geoffrey decision in an
19 effort to reduce tax liabilities.

20 Your Honor, we're not contending that tax
21 minimization is illegal or illicit. No one
22 wants to pay more tax than they absolutely have
23 to. But a tax minimization plan can go too far
24 and it can reach the point where a taxpayer's
25 business in this State is no longer fairly

1 represented by the standard apportionment
2 formulas.

3 Mr. Donovan testified that he's observed
4 multiple taxpayers employ an East/West
5 strategy, as he described it, to reduce their
6 overall tax liabilities in separate entity
7 states like South Carolina.

8 And even Mr. Zinn could only think of one
9 taxpayer that he's seen employ an East/West
10 division who did not put their intangibles in
11 the West Coast states.

12 Ms. Yost testified that the taxpayer files
13 combined or files not at all in the states that
14 it does retail business in on the West Coast.

15 She stated that the firm that performed their
16 valuation studies, the firm that was advising
17 CarMax on its restructuring, was also serving
18 as a state tax adviser. Your Honor, whatever
19 other benefits may have come from this
20 restructuring or this business structure prior
21 to the restructuring, I don't think that it can
22 reasonably be denied that CarMax overall
23 enjoyed significant state tax savings in
24 separate accounting states. Again, we're not
25 alleging that that's illicit or criminal in any

1 sense, but if it goes too far and fails to
2 fairly represent their business here, 12-6-2320
3 is implicated.

4 What the Department has done here is not
5 unreasonable. It's very straightforward.
6 Rather than mingling a large pot of funds that
7 have nothing to do with South Carolina with the
8 type of income that's earned here, the
9 Department simply utilized a statute to look
10 only at that type of income the taxpayer earns
11 in this State. And this is not an
12 unprecedented use of alternative apportionment.
13 Using a version of UDITPA 18 to tax intangible
14 receipts has been upheld in the past, as cited
15 in the Department's brief. And, Your Honor, I
16 understand that the Wal-Mart decision cited in
17 our brief can be rather difficult to come by
18 and find in commercial databases. We have a
19 copy of that to hand up to the Court.

20 **THE COURT:** That would be very helpful. Thank you,
21 Mr. Traynham.

22 **MR. TRAYNHAM:** Your Honor, the taxpayer wants to
23 argue that the minimal tax liability that it
24 reported is appropriate because, as one witness
25 put it, the State, South Carolina, provides no

1 benefits to the taxpayer. I think they've
2 grossly overstated their case.

3 The taxpayer in Geoffrey made very similar
4 arguments and the court stated that the
5 taxpayer's protections, benefits, and
6 opportunities from South Carolina were
7 manifested by the fact that it earned income in
8 this State. The same can certainly be said of
9 the taxpayer here.

10 Its interests are protected by our laws and our
11 courts and it derived a financial benefit by
12 having access to our economic marketplace. If
13 a customer defaults on an installment payment
14 with CBS, south Carolina courts and law
15 enforcement are here to help protect the
16 overall CarMax interests, whether through
17 repossession or litigation. These are benefits
18 clearly provided by the State.

19 Your Honor, the taxpayer has argued that its
20 financing income should not be sourced to South
21 Carolina because of the location of its
22 employees. It argues it in its brief and it's
23 argued it throughout this proceeding. Your
24 Honor, it's our position that this argument
25 simply misreads the Lockwood Greene case.

1 Lockwood Greene did not hold that the location
2 of employees is the appropriate sourcing method
3 for every taxpayer. In fact, the Lockwood
4 court distinctly distinguished financing
5 companies from personal service companies like
6 the Lockwood taxpayer.

7 Financing operations like the one involved here
8 are more appropriately sourced to the location
9 of their customers. The vast majority of the
10 taxpayer's finance servicing resources are
11 dedicated to servicing the customers' loans,
12 because that's where the value is created. I
13 believe they testified that around 200 of their
14 300 employees in Atlanta are call center
15 employees who deal directly with the customer
16 side of the transaction.

17 On the other hand, the securitization aspects
18 of their business are a part-time concern for
19 between ten and 15 employees. Clearly, the
20 value is flowing from the consumer in this
21 financing income.

22 Ms. Yost conceded that whatever value is
23 derived from securitizing these transactions is
24 still dependent on the faithful payment of
25 consumers like those in South Carolina. As I

1 believe she put it, that's just kind of common
2 sense.

3 The initial transaction in South Carolina
4 creates a receivable, consumer owes CarMax for
5 the car it's purchased or some portion of the
6 car it's purchased and that receivable, much
7 like the trademarks in Geoffrey, give the
8 financing company a distinct connection with
9 this State, as does the presence of the
10 collateral in the form of the car itself.

11 The expert suggested that the income should be
12 sourced to the location of the employees to
13 match expenses to income. He talked about the
14 matching principle. We believe that's a red
15 herring.

16 The concern with matching, as testified to by
17 our expert, is that expenses should generally
18 be deducted against the income it helps to
19 create. That's happened in this case.
20 Expenses are deducted against the income within
21 the partnership. Only the net income flows out
22 of that partnership to the taxpayer.

23 In the years prior to the restructuring, when
24 West itself was handling intangibles, our
25 auditors specifically requested that the

1 taxpayers provide them information about any
2 expenses associated with that intangible income
3 and the taxpayer failed to do so. I don't
4 think it's very equitable for them to now
5 prevail on a claim that they weren't given
6 credit for any of those expenses. Simply put,
7 Your Honor, it's our position there is no
8 matching issue here.

9 The Department -- excuse me, the taxpayer has
10 also argued that the Department's alternative
11 apportionment method is not appropriate because
12 the taxpayer is a unitary business, one of the
13 cruxes of their case.

14 This argument has several flaws, not the least
15 of which is that the Department's statutory
16 authority for requiring alternative method,
17 12-6-2320, makes no mention of a unitary
18 business. It is not dependent on whether the
19 taxpayer is unitary or not.

20 If a unitary taxpayer's business cannot be
21 fairly represented by a standard formula, it is
22 still subject to Section 12-6-2320, as much as
23 a nonunitary taxpayer would be. That section
24 provides the Department with broad authority,
25 with the proviso, as everyone has testified,

1 that its alternatives be reasonable.

2 The operative question, Your Honor, is not
3 whether the taxpayer is unitary but whether or
4 not the standard formulas fairly represent the
5 taxpayer's business. Mr. von Lehe would have
6 the question that triggers this provision, this
7 12-6-2320 statute, be whether or not the
8 taxpayer is unitary.

9 But even his expert doesn't agree with him
10 there. His expert conceded that a unitary
11 taxpayer can still be subject to this if it's
12 not fairly represented.

13 The standard formulas created distortion and
14 drastically understate the taxpayer's income
15 tax liability in this case. The concern with
16 a unitary business that the taxpayers emphasize
17 is the difficulty with determining the flow of
18 values between the component parts and breaking
19 out a portion of the business.

20 But in this case, Your Honor, we don't have
21 that problem. The taxpayer's economic expert,
22 in one of his last answers on
23 cross-examination, specifically stated that the
24 flow of funds between the entities is a measure
25 of the values that they share. There's no

1 difficulty separating a portion of the business
2 from this taxpayer, unitary or not, because in
3 a very real sense it already operates as a
4 separate business. It earns apples here and
5 oranges in the West. And 12-6-2320 is
6 concerned with what's going on here, the extent
7 of their business activity in South Carolina.
8 Your Honor, even if the unitary issue were
9 completely relevant to this case, it's
10 questionable whether or not the activities the
11 Department seeks to tax are unitary with that
12 retail activity to the extent and in the same
13 sense that the taxpayer would suggest. As our
14 expert testified, "unitary" means a lot of
15 things and in the sense that the Supreme Court
16 of South Carolina means it, it's a continuum.
17 It's not an all or nothing proposition.
18 Some of the things that indicate there may be
19 some problems with unitary. The operations
20 here are completely divorced from one another
21 geographically. The taxpayer conducts no sales
22 in South Carolina. The activities are, in the
23 later audit years, performed by legally
24 separate entities. The taxpayer's own tax
25 manager has testified that there were

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1 significant operational and regulatory issues
2 in combining the operations of a retailer with
3 a finance company.

4 Your Honor, if the Court finds that the unitary
5 issue is relevant in determining whether or not
6 the Department's alternative method is
7 reasonable, we would still offer that we have
8 established through our testimony that what
9 they have done does not fairly represent the
10 extent of the taxpayer's business activity in
11 this State.

12 In other words, Your Honor, the trigger's been
13 pulled. If there's a flaw in what the
14 Department has done, the solution is not to
15 allow the taxpayer to rely on something that
16 gives it an unreasonable representation of its
17 business here. The proper solution would be to
18 remand it to the Department for an appropriate
19 measure through the alternative apportionment
20 formula to determine what their tax liability
21 should be here.

22 Your Honor, I'd like to speak very briefly on
23 a couple of other issues. The taxpayer has
24 repeatedly stressed that it's done nothing
25 illicit. We don't disagree with that, nothing

1 illegal. It's filed returns, it's followed the
2 instructions in the tax returns, it's applied
3 a statutory formula, and there's no
4 publications that give it any guidance about
5 this specific statute -- or, excuse me, the
6 specific formula that was applied in this case.
7 Your Honor, all of these arguments go to
8 whether or not penalties are appropriate, not
9 whether it's appropriate for the Department to
10 utilize 12-6-2320 to get a fair representation
11 of their business here.

12 In any case, in terms of the negligence
13 penalty, both sides have presented some
14 arguments. Here, we would contend that the
15 rule that the taxpayer has disregarded is
16 12-6-2320. They stated that they considered
17 all of the statutes in South Carolina. They
18 had a state tax adviser and yet they didn't
19 realize that they were going to be expected to
20 fairly represent their business in South
21 Carolina? Seems a little farfetched. But,
22 Your Honor, the arguments they presented on
23 those issues really only go to whether or not
24 penalties are appropriate, not whether what the
25 Department has done here is appropriate.

1 As one final matter, Your Honor, I'd like to
2 discuss the Constitutional issues that were
3 raised in the taxpayer's brief. Your Honor, we
4 do not disagree with Mr. von Lehe's discussion
5 of our burden in this case. We welcome that
6 burden. If we can't show that they have not
7 fairly represented their business in South
8 Carolina, we should not be allowed to apply
9 this statute.

10 But it is fundamental that when a taxpayer
11 raises a possible Constitutional violation,
12 it's their burden to show the Constitution has
13 been violated. No evidence has been presented
14 on that issue, Your Honor. Only legal
15 arguments and bald assertions in the pretrial
16 brief. No testimony or any other evidence has
17 been presented that would establish that any
18 Constitutional rights have been violated in
19 this case and we would ask, Your Honor, that
20 that issue not be considered at all.

21 Your Honor, I have nothing further. We would
22 welcome the opportunity to offer any memos or
23 post-trial briefs the Court feels are necessary
24 at its request.

25 **THE COURT:** Thank you very much.

1 MR. VON LEHE: Your Honor, just a brief statement in
2 reply, if I may?

3 THE COURT: Sure. Thank you, Mr. Traynham.

4 MR. TRAYNHAM: Thank you, Your Honor.

5 REPLY BY MR. VON LEHE:

6 MR. VON LEHE: Your Honor, we disagree with the
7 Department about the burden of proof, as I
8 understood his argument, that once they show
9 that our method somehow is not properly
10 reflected, then they don't have the burden of
11 coming back and showing that theirs does
12 properly reflect the income. That is not the
13 law as I read it in these cases. The position
14 being, as given in these cases, that the
15 Department has the burden of justifying any
16 modification, any modification of the standard
17 formula. So if they want to modify it,
18 whatever this method is --

19 THE COURT: Hold on.

20 MR. VON LEHE: -- they used -- that by whatever
21 method they used, that's their burden.

22 THE COURT: Well, I will tell all counsel, I'm going
23 to have to really look at those cases because
24 the Administrative Procedures Act of South
25 Carolina gives the threshold burden as being

1 that the petitioner's case must be proved by a
2 preponderance of the evidence. And, obviously,
3 there are instances in which that is not the
4 case and which there is a shifting of the
5 burden and I know with tax statutes and tax
6 benefits, you know, there's a different burden
7 that's subsumed within that. So, you know,
8 I'll be glad to hear from both of you, but I
9 really need to sit down with those cases and
10 see exactly where we are on that.

11 **MR. VON LEHE:** Very well, Your Honor. But I do take
12 issue with, if I understood it, that they don't
13 have the burden of showing that their formula
14 fairly reflects the taxpayer's activities in
15 South Carolina. We submit that the case law is
16 that it does. So we take issue with that,
17 assuming that is what he said and meant.
18 Your Honor, this is the fundamental
19 disagreement of the parties. They have applied
20 some form, even though nobody's actually come
21 out and said it, that I know of, of separate
22 accounting. They've done that. They've
23 applied some form of separate accounting by
24 taking certain portions of this taxpayer's
25 income and attempting to separately account and

1 tax that.

2 And you cannot do that with a unitary business.
3 And this section upon which they rely does not
4 mention unitary business, but it does mention
5 separate accounting. And by mentioning
6 separate accounting, it assumes -- because the
7 laws are absolutely clear that separate
8 accounting does not apply to a unitary
9 business. This is what they have done. There
10 is no getting away from it. We think that
11 method is flawed, that separate accounting
12 method is flawed, but that is what they have
13 attempted to do.

14 Your Honor, the question of Constitutionality
15 of the statute, of course, as Your Honor well
16 knows, that is -- the question of whether a
17 statute is unconstitutional on its face is not
18 within the proper purview of the Administrative
19 Law Court --

20 **THE COURT:** Certainly not, only the application.

21 **MR. VON LEHE:** -- but the application certainly is,
22 so I want to come back to this for a moment.
23 We do believe that adequate evidence has been
24 introduced, Your Honor, to you to show that
25 they have violated this taxpayer's

1 Constitutional rights under the commerce clause
2 and the due process clause by taxing income
3 that is earned outside of this state.
4 And how have they done that? They've done that
5 by taking what they choose to tax and applying
6 a tax to that, which is out of all proportion
7 to what this taxpayer actually earns in South
8 Carolina. Perhaps one of our witnesses did say
9 that they don't do anything here. Well, they
10 do have -- I know I said that they have
11 copyrights here that are exploited by related
12 entities. I know I said that.
13 But, Your Honor, that's hardly the same as an
14 entity that requires a lot of services from the
15 state. It doesn't. If one wants to reflect
16 upon the right to defend an assessment which
17 should have never been made in the first place,
18 I'll grant that, that we have been granted the
19 right to come into a court and defend ourselves
20 against an assessment that we believe never
21 should have been made. But there are very,
22 very few -- what this goes to is this: There
23 are very, very few services being offered here
24 and that is where the formula is working.
25 That's where that formula is working.

1 Look, they proposed a tax against this taxpayer
2 that's in the range of not more than what they
3 proposed against CarMax East, which has got big
4 superstores here selling cars. They come up
5 with a tax that's equal to or more than that.
6 That is an absurd result. That is a result
7 which is shocking enough to be unconstitutional
8 and I submit that we have met the burden of
9 proof in that respect.

10 Your Honor, the question of remand, that has
11 never been mentioned. I'm sure that
12 Mr. Traynham would agree with me, there have
13 been many attempts to settle this case.

14 **MR. TRAYNHAM:** I would not agree with that, Your
15 Honor. There's been one attempt to settle this
16 case, that I can recall.

17 **MR. VON LEHE:** I'm sure Mr. Traynham will agree with
18 me there's been one attempt to settle this
19 case. Your Honor, we believe remand would
20 simply clog up the court system.

21 **THE COURT:** This isn't a remand case. I'll go ahead
22 and tell you that.

23 **MR. VON LEHE:** Thank you, Your Honor, I will,
24 therefore, stop hitting that nail.

25 Your Honor, I believe we've addressed the

1 issues that we wanted to address on reply.
2 Thank you very much.

3 **THE COURT:** Thank you, sir.

4 And you had something else to say, Mr.
5 Traynham?

6 **MR. TRAYNHAM:** No, Your Honor, just to repeat our
7 offer that we'd be more than happy to brief any
8 issue, including the Constitutional issue, but
9 we maintain our position that they have not
10 met --

11 **THE COURT:** Right.

12 **MR. TRAYNHAM:** -- their burden on that issue.

13 **THE COURT:** Well, what I would suggest is, rather
14 than briefs, is that I would like for each of
15 you, once you receive the transcript, if you'll
16 notify the Court when it. It will probably
17 take, what, several weeks?

18 **THE COURT REPORTER:** At least three.

19 **THE COURT:** At least three. If you would notify us
20 and then I would like to get proposed orders
21 from each of you and, keeping in mind, that the
22 statute requires that my final order has to be
23 in the form of findings of fact and conclusions
24 of law.

25 And I think you both very extensively and

1 adequately stated what the issues are in this
2 case, of which there are multiple issues.
3 After we get past the threshold issue of the
4 unitary nature of the business, there's still
5 other subissues there.

6 And I would say 30 days after the receipt of
7 the transcript. If anybody has a problem with
8 that -

9 MR. TRAYNHAM: No, Your Honor.

10 THE COURT: -- let me know.

11 And I do have a rule, which I don't think any
12 other judge in the State has and I stick to it.
13 It's called the 30-day rule, and that means you
14 will get an order within 30 days after I
15 receive those proposed orders or my law clerk
16 will call you and tell you what's going on,
17 because I practiced law myself for 21 years
18 before I came here and I don't like sitting
19 around waiting and I don't like telling clients
20 that -- they don't know what the Judge is
21 doing, have no idea why it's taking nine
22 months, a year and a half to get an order. So
23 that won't happen.

24 Anyway, I appreciate you all. I think everyone
25 argued their case very zealously and vocally

1 and I think all parties should feel that they
2 have been well represented by their counsel.
3 And these are some novel issues. I've not seen
4 these issues in this courtroom before and I
5 thank you for educating me, to the extent that
6 that's possible. Everybody have a good trip
7 back to wherever you're going.

8 **MR. TRAYNHAM:** Thank you, Your Honor.

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

10 (Proceedings concluded at 12:26 p.m.)
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CERTIFICATE

This is to certify that the within hearing consisting of Four Hundred Fifty-One (451) 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 March 8, 2010.

Cassandra E Vance
Cassandra E. Vance
Court Reporter

Notary Public for South Carolina
My Commission Expires: February 26, 2018

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