THE STATE OF SOUTH CAROLINA
In The Supreme Court

PETITION FOR A WRIT OF CERTIORARI

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

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

v.

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

SOUTH CAROLINA DEPARTMENT OF REVENUE'S RESPONSE TO AMICUS CURIAE BRIEF OF COUNCIL ON STATE TAXATION

Adam N. Marinelli (Bar No. 79031)
Counsel for Litigation
Roxanna M. Tinsley (Bar No.78641)
Counsel for Litigation
Milton G. Kimpson (Bar No. 7917)
Chief Counsel for Litigation
PO Box 11265
Columbia, SC 29211
Attorneys for Petitioner/Respondent
South Carolina Department of Revenue

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Pursuant to Rule 213, SCACR, the Petitioner/Respondent South Carolina Department of Revenue (hereinafter "Department") files its Response to Amicus Curiae Brief of Council on State Taxation (hereinafter "COST").

ARGUMENTS

I. THE ARGUMENTS PRESENTED BY AMICUS CURIAE SHOULD BE DISREGARDED AS THEY INVOKE NON-BINDING MODEL STATUTES AND REGULATIONS AND ARE UNSUPPORTED BY THE RECORD IN THIS CASE.

A. Any assertion that South Carolina has adopted the Uniform Division of Income for Tax Purposes Act ("UDIPTA") or is governed by the rules and regulations of that non-legislative model statute is patently false.

The Amicus' attempt to portray South Carolina as a member of the Multistate Tax Commission's ("MTC") UDIPTA group is not only misleading, but flies in the face of our State's tax code and this Court's jurisprudence governing the administration of taxation. Although our alternative apportionment statute mirrors the language of a single section of that model Act, South Carolina is unequivocally **not** a UDIPTA state. The brief presented by COST is rife with references to, and claims that South Carolina has adopted UDIPTA and its accompanying regulations as law.[1] In making these assertions, COST disregards the irrefutable facts that South Carolina is not a UDIPTA state, that our legislature has not adopted the rules and regulations accompanying UDIPTA § 18, and the long standing administrative practice of the Department in its administration of

[1] See e.g. Br. of Amicus Curiae at 1 ("South Carolina apportions the income of multistate corporate taxpayers by using a set of rules based upon the Uniform Division of Income for Tax Purposes Act.").

alternative apportionment methods remains consistent with the approach at issue[2] in the case at bar.

The attempts of both COST and the taxpayer to bootstrap rules and regulations promulgated by the MTC for UDIPTA states into South Carolina's tax jurisprudence should be vehemently disregarded by this Court as it is non-binding model law, contradicts the rulings of this Court,[3] and thwarts our Legislature's intent to provide the Department with the broad authority to tailor reasonable alternative apportionment methods for taxpayers whose business activity is not properly reflected by the statutory method. Despite the wishes of the taxpayer and COST, the plain and unambiguous language of Section 12-6-2320 places only two limitations upon the Department in its use of an alternative apportionment method – to establish a failure of the statutory method to properly reflect the business activity of the taxpayer and a showing of reasonableness regarding the proffered alternative. Any other mischaracterization of the wide berth granted by the Legislature in that code section should be disregarded.

Even assuming *in arguendo*, however, that this Court should seek instruction from the rules and regulations promulgated with UDIPTA, the liberties taken by Amicus disingenuously characterizes equitable alternative apportionment as an extreme exception that is only allowed in the "rarest and most unusual circumstances."[4] This representation

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[2]R. at 318.

[3]Media General Commc'ns, Inc. and Media General Holdings, Inc. v. South Carolina Department of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010) ("We agree with the ALC that the legislature has placed no explicit limitation on the alternative methods that may be used.").

[4]Br. of Amicus Curiae at 2.

is without merit. To the extent that this Court gives any credence to the words of the drafters of UDIPTA, the paraphrased thoughts presented by COST are found wanting. In the article quoted by Amicus, "The Uniform Division of Income for State Tax Purposes," Professor William J. Pierce's thoughts regarding alternative apportionment contained only one restriction in its use - reasonableness:

> [D]epartures from the basic formula should be avoided **except where reasonableness requires**. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, **because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics**.
>
> Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, **some more equitable method of allocation and apportionment could be achieved**.

35 Taxes 747, 748 (1957) (emphasis added). The language in UDITPA Section 18(A)(4) has long been a widely implemented option in other states that have needed to impose some form of alternative apportionment to arrive at an equitable tax base. To wit, the comment to UDITPA § 18 states:

> Section 18 **is intended as a broad authority**, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state.

(Emphasis added). John Warren, who represented the State of California at the Uniform Law Commission during the drafting of UDITPA, recently remarked:

> The original drafters probably thought of Section 18 as a tool to be used to avoid gross distortion under the facts of

> a particular taxpayer. The adopting states and the MTC, however, have chosen to use it in a **much broader way**. It has become the authority for devising special factors and formulas for whole industries, **and this is to be applauded**.

Written comments to the MTC 2005 Annual Meeting; Boise, Idaho, taken from The Project to Revise UDIPTA.[5]

As noted in the comments above, UDITPA § 18 was intended to be used not only in unusual cases, but also to achieve a "more equitable method of allocation and apportionment" when the standard statutory methods do not "fairly represent the extent of the taxpayer's business activity in the state."[6] It is abundantly clear that the drafters of UDITPA § 18 realized the potential shortcomings of a standard method when applied across the board to all taxpayers with vastly different business characteristics. And, in the modern era of advanced tax planning and diversified corporate organization, alternative equitable apportionment is widely utilized.

Regardless of whether or not this Court agrees with Amicus' contention that UDIPTA § 18 should be limited to rare and extreme circumstances, the immutable fact remains that our Legislature **did not adopt** UDIPTA or its accompanying regulations, and therefore the Department's use of section 12-6-2320 should be only analyzed

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[5]Found at: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf.

[6]See Richard I. Simons, "Fair Representation in the South Carolina Corporate Income Tax: Combined Reporting As Equitable Apportionment After Media General Communications, Inc. v. South Carolina Department of Revenue," 62 S.C. L. Rev. 743, 754-55 (2011).

pursuant to its plain language.[7] The clear and unambiguous language of section 12-6-2320 is not limited to rare circumstances, but rather only holds one limitation – a showing that the standard apportionment method was an inadequate reflection of business activity and that the proffered alternative is reasonable. In the case at bar, the ALC properly found that the taxpayer's "East/West" corporate structure resulted in a diluted tax base and the standard method did not reasonably reflect the taxpayer's business activity in this State. The taxpayer offered no evidence at trial to rebut the Department's showing of the statutory method's failure to capture a reasonable tax base, but rather argued the same approach that it has here – a purely legal analysis related to the unitary description of the business that is rooted in non-binding model law which has not been adopted in South Carolina. As outlined below, the record clearly reflects that the Department met its first burden in showing the statutory method was distortive. In that regard, absent a showing that the ALC was clearly erroneous in its factual findings that the Department presented a preponderance of evidence of statutory distortion and the reasonableness of its proffered alternative method, both the taxpayer's and COST's arguments related to UDIPTA should be disregarded by this Court.

B. Amicus' claims that the Department failed to show that the standard method did not adequately reflect the taxpayer's business activity is completely erroneous and unsupported by the record.[8]

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[7]This sharp distinction between the MTC's proposed regulations that South Carolina has not adopted and the plain language of section 12-6-2320 was presented to the ALC. See R. at 183-84.

[8]See Br. of Amicus Curiae at 7.

In order to fully appreciate the Department's rationale for the audit, it is vital to note that the "East/West" corporate structure has significant tax implications.[9] This corporate structure was designed per the advice of the taxpayer's state tax advisor, Ernst and Young,[10] and is an aggressive form of tax planning. The East entity, pre-reorganization, was charged inflated royalty fees by taxpayer, essentially deflating East's net income from car sales in South Carolina. Post-reorganization, the taxpayer held a 93.5 percent interest in Carmax Business Services, Inc. ("CBS"), which effectively channeled the majority of the partnership's income to the taxpayer. A telling fact illuminated before the ALC was that the taxpayer only operated in a few states in the West, and all of these states either have no corporate income tax or allow combined reporting.[11] The East entity operates the vast majority of the corporate group's retail stores, and its business activity is what arguably drives the value of the intellectual property.[12] Because of the East/West structure, however, East's income from the sale of cars is drastically reduced by the royalty payments to the Western entity pre-reorganization, and to CBS after the restructuring. This systematic shift of income from the East to untaxed western jurisdictions and states that allowed combined returns prompted the Department to look more closely at the taxpayer's filings.[13]

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[9] R. at 282-83.

[10] R. at 135.

[11] R. at 114-16.

[12] R. at 268.

[13] R. at 284.

Amicus' assertions that virtually no relevant evidence was presented that the standard method did not reasonably reflect the taxpayer's business activity in South Carolina are confusing at best. [14] To the contrary, ample evidence in the record supports the ALC's findings, including testimony from the Department's audit supervisor and its expert economist.[15] According to Amicus, the only evidence presented was that the "tax bill was lower under the standard formula."[16] This dismissive concession by Amicus is intended to pull this Court's attention from the next logical inquiry – just how low was it? A review of one year of the audit, for example, reveals that in 2007 Carmax West received $1,596,114 in South Carolina royalty payments from CBS. Under its returns as filed, using an apportionment ratio with an inflated denominator from its western retail sales, the taxpayer attempted to pay $3,670 in tax.[17] This is a tax rate of approximately two-tenths of 1%. This number should shock and outrage an individual taxpayer, whose income is generally taxed in the 30-35% range. Although this was not the only evidence of distortion presented to the ALC, this evidence alone strongly supports the ALC's factual findings that the standard formula failed to adequately represent the taxpayer's business activity in this State. Despite the wishes of Amicus, such an unreasonable dilution of tax liability should not be dismissed as an arbitrary fact.

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[14] Id.

[15] R. at 271, 347-349.

[16] Id.

[17] R. at 479.

Moreover, it is undisputed that the taxpayer in this case originally filed its South Carolina returns using the three-factor statutory method found at S.C. Code Ann. § 12-6-2250, which is solely reserved for taxpayers involved in manufacturing or otherwise "dealing in tangible personal property."[18] This method of filing did not fairly reflect its activity based purely upon the statutory language of section 12-6-2250, which expressly limits the three-factor formula to taxpayers "whose principal business in this State" is related to tangible personal property. (Emphasis added.) As the Department Determination[19] which upheld the auditor's findings in this case indicated, the sole source of income from South Carolina for the taxpayer is based upon the use of intangibles, and therefore by the very nature of section 12-6-2250, the taxpayer's business activity was not properly reflected.

Only after the audit was completed, the ensuing tax assessment protested by the taxpayer, and the Department Determination issued, did the taxpayer then amend its originally filed returns to use the single factor formula contained in S.C. Code Ann. § 12-6-2290.[20] Yet even under that formula the denominator utilized by the taxpayer was drastically inflated by its retail income from the few western states it operated in, resulting in an apportionment ratio that nearly eliminated any semblance of a fair and reasonable tax base. As the Department's expert economist testified at trial, the royalties and financing income were wholly unrelated to the retail sales in western states, and

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[18]R. at 89.

[19]R. at 490.

[20]R. at 134.

therefore were metaphorically "apples and oranges" for tax purposes. He further testified that the taxpayer's attempts to add "apples and oranges" into its denominator "would ridiculously dilute that calculation."[21] Thus, the Department's adjustment by removing the "oranges" from the tax base more reasonably reflected the business activity of Carmax West in South Carolina.

Despite the unfounded assertions of Amicus, the failure of the statutory method to fairly reflect the business activity of Carmax West in South Carolina was properly determined by the ALC and is fully supported by the record in this case. As such, that finding should remain undisturbed.

Conclusion

The plain language of Section 12-6-2320 should be the only controlling limitation placed upon the Department's discretion in invoking a reasonable alternative apportionment method. The Amicus' attempts to limit this Court's purview by non-binding model rules promulgated by the MTC should be disregarded. Furthermore, the Record on Appeal fully supports the ALC's findings that the statutory method was not a fair representation of business activity and that the Department's proffered method reasonable. As such, the Department respectfully requests that this Court affirm the ALC's findings and hold that the proper burden of proof was met by the State.

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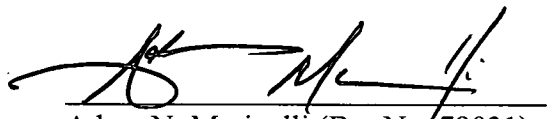
[21] R. at 357.

Respectfully Submitted,



Adam N. Marinelli (Bar No. 79031)
Counsel for Litigation
Roxanna M. Tinsley (Bar No.78641)
Counsel for Litigation
Milton G. Kimpson (Bar No. 7917)
Chief Counsel for Litigation
PO Box 11265
Columbia, SC 29211
Attorneys for Petitioner/Respondent
South Carolina Department of Revenue
MarineA@sctax.org
CourtOrders@sctax.org

February 28, 2014

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

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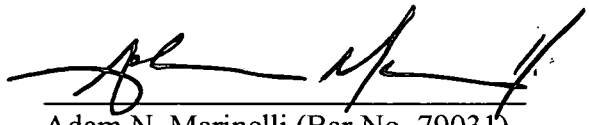
CERTIFICATE OF COUNSEL

The undersigned certifies that this Response to Amicus Curiae Brief of Council on State Taxation complies with Rule 211(b), SCACR.



Adam N. Marinelli (Bar No. 79031)
Counsel for Litigation
Roxanna M. Tinsley (Bar No.78641)
Counsel for Litigation
Milton G. Kimpson (Bar No. 7917)
Chief Counsel for Litigation
PO Box 11265
Columbia, SC 29211
Attorneys for Petitioner/Respondent
South Carolina Department of Revenue
MarineA@sctax.org
CourtOrders@sctax.org

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PROOF OF SERVICE

I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, postage pre-paid, a copy of the Department of Revenue's, Petitioner/Respondent, Response to Amicus Curiae Brief of Council on State Taxation as well as the Department's Motion to Argue Against Precedent in the above referenced matter to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, 151 Meeting Street, 6th Floor, Charleston, SC 29401-2239, Burnet R. Maybank, III, Esquire, Nexsen Pruet, LLC, PO Drawer 2426, Columbia, SC 29202, and Alexandra E. Sampson, Esquire, Reed Smith LLP, 1301 K Street, N.W., Suite 1100- East Tower, Washington, DC 20005-3317 this 3rd day of March 2014.

Jean M. O'Connor