

THE STATE OF SOUTH CAROLINA  
In The Supreme Court

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

Carolyn C. Matthews, Administrative Law Judge

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

Appellate Case No. 2012-21-22203

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

v.

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

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**JOINT APPENDIX - VOLUME III**

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John C. von Lehe  
Bryson M. Geer  
NELSON MULLINS RILEY & SCARBOROUGH LLP  
151 Meeting Street/6<sup>th</sup> Floor  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for Petitioner

Milton Kimpson, Esq.  
Adam N. Marinelli, Esq.  
Roxanna M. Tinsely, Esq.  
South Carolina Department of Revenue  
301 Gervais Street, 3<sup>rd</sup> Floor  
Columbia, SC 29211  
(803) 898-5131

Attorneys for Respondents

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THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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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 III

John C. von Lehe, Jr.  
Bryson M. Geer  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200  
*Attorneys for Appellant*

Harry A. Hancock  
Milton G. Kimpson  
South Carolina Department of Revenue  
P.O. Box 12265  
Columbia, SC 29211  
*Attorneys for Respondent*

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**STATE OF SOUTH CAROLINA  
ADMINISTRATIVE LAW COURT**

Carmax Auto Superstores West Coast, Inc., )

**Docket No.: 09-ALJ-17-0160-CC**

**Petitioner,**

**VS.**

## FINAL ORDER AND DECISION

South Carolina Department of Revenue,

Respondent.

**Appearances:**

For the Petitioner: John von Lehe, Esq.; Bryson M. Geer, Esq.

For the Respondent: Michael Traynham, Esq.; Lynn Baker, Esq.

### STATEMENT OF THE CASE

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

## ISSUES OF LAW

1. Do the standard statutory apportionment formulas provided for by 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?

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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?

#### **FINDINGS OF FACT**

Having observed the witnesses and exhibits presented at the hearing, and 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 is a retailer of used light trucks and automobiles operating Carmax retail locations in several western states including California, Utah, and Nevada.<sup>1</sup> 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 these intangible royalties from South Carolina retailers, as well as those 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

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

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.

4. Beginning 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 – the bundling and reselling to third party investors – of consumer installment agreements. The value of these securitized investments was at least partly attributable to faithful payment of installments by end-consumers. Approximately 200 CBS employees' full-time job is servicing the installment agreements – that is, 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 of many aspects of their job.

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,<sup>2</sup> 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.

7. The 2004 restructuring was undertaken with consultation from Ernst and Young, who 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

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<sup>2</sup>The 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 illegal or illicit. The tax benefits of 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.

taxpayer protested on October 20, 2008, and the Department issued a Determination on March 11, 2009.

10. After the completion of the audit and the issuance of the Department 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 ratio<sup>3</sup> 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 took the position that the taxpayer's filed returns failed to fairly reflect the extent of the taxpayer's business in South Carolina, even using the gross receipts formula of 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 the taxpayer's income from royalties and financing from within South Carolina, by the taxpayer's royalty and financing receipts from everywhere it does business to determine the ratio of the taxpayer's apportionable income which is taxable in South Carolina.

#### **CONCLUSIONS OF LAW**

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

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<sup>3</sup>The 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.

### **General Findings**

S.C. Code Ann. § 1-23-600 (Supp. 2008) 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 in these administrative proceedings 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. (See Tr., p. 165, (testimony of Philip Zinn)). Under the statute there are two significant checks on the Department's ability to deviate from statutory formulae. 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, once that trigger is pulled 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.<sup>4</sup> While no taxpayer is

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<sup>4</sup>Ample testimony established that the taxpayer's business structure is of a type designed to create a state tax advantage. (See Tr., pp. 264 – 266 (testimony of Tim Donovan); Tr., pp. 337-338 (testimony of Dr. Glenn Harrison)). The taxpayer's expert also testified that the taxpayer's business structure is utilized by other multi-state taxpayers, and that the vast majority of taxpayers so organized place their intangibles in a west coast company, like the taxpayer here. (See Tr., pp. 169-170 (testimony of Philip Zinn)).

obligated to pay more tax than is legally required, structures like those involved here may 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 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.<sup>5</sup> 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.<sup>6</sup>

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<sup>5</sup>The 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).

<sup>6</sup>The 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

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 taxpayer's business is represented in this State for tax purposes.<sup>7</sup> In this case, the lines of business and the

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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."

<sup>7</sup>The Department's expert witness explained the propriety of the Department's application of § 12-6-2320 using a metaphor:

. . . [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.

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.<sup>8</sup> (See Tr., p. 171 (testimony of Philip Zinn)). The term "unitary" is itself subject to a multitude of definitions and nuances – a taxpayer may be "unitary" in one sense, and yet be easily divisible for some purposes. (See Tr., p. 392 (testimony of Dr. Glenn Harrison)). 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.

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

<sup>8</sup>The 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."

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 spectrum, at one end of which is a business which is too interconnected to be accurately separated. The language does not support, as the taxpayer suggests, that if a taxpayer is in some 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 spectrum would naturally depend 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.<sup>9</sup> 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 the taxpayer's unitary or non-unitary status does not control the application of § 12-6-2320 to the facts of this case.

**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 that type of income earned 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,

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<sup>9</sup>Under § 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."

and the taxpayer's retail operations, are in no way 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 to 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 with separately accounting for a unitary business is that separate accounting may fail to account for the flow of values amongst 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.<sup>10</sup> The

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

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. While 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 that 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

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**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.

See Tr., pp 199-200.

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, the location of the customer from whom that receivable derives is a far more reasonable 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.**<sup>11</sup>

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. But the customers themselves 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.<sup>12</sup> Thus, the

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<sup>11</sup>The 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.” (Tr., p. 342).

<sup>12</sup>The 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. (See Tr., pp. 103-104). Moreover, the value of those instruments would be adversely impacted by the default in payment of a percentage of those customers. (See Tr., p. 105).

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.

### III. Penalties

The Department's auditor applied penalties for substantial understatement and for negligence, both of which are provided for by statute. Specifically, S.C. Code Ann. § 12-54-155 (Supp. 2009) provides for the substantial understatement penalty, and states:

(A)(1) If there is an underpayment attributable to either a substantial understatement of tax for a taxable period or a substantial valuation misstatement, there must be added to the tax an amount equal to twenty-five percent of the amount of the underpayment.

\* \* \*

(B)(1)(a) For purposes of this section, there is a substantial understatement of tax for a taxable period if the amount of the understatement for the taxable period exceeds the greater of ten percent of the tax required to be shown on the return for the taxable period or five thousand dollars.

(Emphasis added). The negligence penalty is provided for by S.C. Code Ann. § 12-54-43(F) (Supp. 2009) and provides:

(F)(1) If part of an underpayment of tax or part of a claim for refund of tax paid is due to negligence or disregard of regulations, there must be added to the tax an amount equal to the sum of five percent of the underpayment or claimed refund and an amount equal to fifty percent of the interest payable under Section 12-54-25.

\* \* \*

(3) For purposes of this subsection, "negligence" includes a failure to make a reasonable attempt to comply with the provisions of this title, and "disregard" includes careless, reckless, or intentional disregard.

While both penalties are expressly mandatory (in that both must be applied), the determination of when a substantial understatement occurs is significantly more objective

under the statute. The application of the negligence penalty is made, in practice, at the discretion of the auditor.

In this case, the Department adjusted the taxpayer's tax return pursuant to a reasonable alternative apportionment formula and applied the substantial understatement penalty when the tax which should have been reported exceeded the tax that was actually reported by more than ten percent. The negligence penalty was also applied, and testimony at trial identified a number of factors that might have been considered in making a negligence determination. Among them: the use by the taxpayer of a tax minimization business structure, the use by the taxpayer of an incorrect statutory formula (the three-factor formula), and the disregard of the requirement that tax be reported on a basis that "fairly represent the extent of the taxpayer's business in this State" pursuant to § 12-6-2320. Thus the application of the negligence penalty was appropriately applied to this taxpayer.

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

##### A. Commerce Clause.

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).<sup>13</sup> 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.<sup>14</sup> Notwithstanding, this Court finds that a ratio

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<sup>13</sup>Originally, 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.

<sup>14</sup>The 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 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.

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**

Based on the foregoing, I find the following:

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 Petitioner's business activities in this State;
3. The penalties applied to the Petitioner by the Department are 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.

**IT IS THEREFORE ORDERED** that Petitioner's requested relief is **DENIED**.

**AND IT IS SO ORDERED.**

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Carolyn C. Matthews  
Administrative Law Judge

\_\_\_\_\_, 2010  
Columbia, South Carolina

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

# ADMINISTRATIVE LAW COURT

**Respondent.**

For the Respondent: Michael S. Traynham, Esquire  
Lynn M. Baker, Esquire

## STATEMENT OF THE CASE

This matter comes before the Administrative Law Court (ALC or Court) pursuant to the request of Petitioner CarMax Auto Superstores West Coast, Inc. ("CarMax West" or the "Taxpayer") for a contested case hearing under S.C. Code Ann. § 12-60-460 (Supp. 2008). CarMax West is protesting an assessment of corporate income taxes from the South Carolina Department of Revenue ("SCDOR" or the "Department") for the income tax years ending in 2002, 2003, 2004, 2005, 2006 and 2007. A hearing was held before me on February 18 and 19, 2010, at the offices of the ALC.

The following chart appears in SCDOR's amended audit report in this matter and summarizes the amounts in dispute:

ROA\_000946

*INCOME TAX: Schedule A*

| PERIOD ENDED: | INCOME TAX       | INTEREST        | PENALTY         | TOTALS           |
|---------------|------------------|-----------------|-----------------|------------------|
| Feb-02        | \$59,517         | \$32,997        | \$34,354        | \$126,868        |
| Feb-03        | \$72,706         | \$34,123        | \$38,873        | \$145,702        |
| Feb-04        | \$68,703         | \$27,795        | \$34,508        | \$131,006        |
| Feb-05        | \$36,133         | \$12,209        | \$16,944        | \$65,286         |
| Feb-06        | \$94,544         | \$23,842        | \$40,284        | \$158,670        |
| Feb-07        | <u>\$107,924</u> | <u>\$16,984</u> | <u>\$40,869</u> | <u>\$165,777</u> |
| TOTALS:       | \$439,526        | \$147,950       | \$205,832       | \$793,308        |

See Tr. Ex. 29, Amended SCDOR Audit Report at 14. SCDOR audited the returns at issue and issued an additional assessment, which the Taxpayer timely protested. See Tr. Ex. 2, CarMax West Notice of Protest. Following a conference, SCDOR issued a Department Determination upholding the additional assessment. See Tr. Ex. 3, SCDOR Department Determination. The Taxpayer timely requested a contested case hearing before this Court.

**LEGAL ISSUES RAISED**

The following legal issues have been presented to this Court: (1) whether SCDOR can properly change the statutorily mandated income tax apportionment method used by the Taxpayer and instead impose an "alternative method," which is a form of separate accounting that is not based on the Taxpayer's total net income; (2) whether SCDOR properly sourced financing receipts to South Carolina where the business activities related to those receipts were performed in another state; (3) whether SCDOR properly assessed penalties against the Taxpayer; (4) whether the alternative method proposed by SCDOR or its assessment of a penalty against Taxpayer in this case violated Taxpayer's constitutional rights.

In addition, the primary legal issue in the case regarding whether SCDOR can properly change the statutorily mandated income tax apportionment method used by the Taxpayer (issue (1) above) involves the following sub-issues: (a) whether the Taxpayer

operated a unitary business; (b) whether the standard apportionment formula fairly reflects the in-state business activities of the Taxpayer; and (c) whether the alternative method proposed by SCDOR is reasonable.

### **FINDINGS OF FACT**

Having taken evidence and observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of persuasion and the credibility of witnesses, I make the following findings of fact, most of which were uncontested, by a preponderance of the evidence.

#### **I. Formation of CarMax**

CarMax, Inc. ("CarMax") was formed in 1996 and is the nation's largest specialty retailer of used cars and light trucks. Tr. at 37:18-19; 39:8. Its primary business is to purchase, recondition, market, sell and finance used cars and trucks. It was originally formed as a subsidiary of Circuit City Stores, Inc. ("Circuit City"). Id. at 37:12-17. In 2002, Circuit City's shareholders approved the separation of CarMax from Circuit City. Id. at 39:18-21. CarMax is now a separately held, publicly traded holding company. Id.

#### **II. Corporate Structure of CarMax Group**

CarMax was created with and inherited upon its spin-off a corporate structure that mirrored Circuit City's structure: CarMax operated as a holding company and wholly owned two operating entities, CarMax West, the Taxpayer, which sold used vehicles in the western United States and owned substantially all of CarMax's intellectual property, and CarMax Auto Superstores, Inc. ("CarMax East"), which sold used vehicles in the eastern and mid-western states (where most of CarMax's retail operations were at the time) and provided the group's corporate, back office support and finance functions. Tr. at 40:16- 41:4

The inherited corporate structure was not common to the car sales industry and began to cause numerous problems, particularly on the financing side, ranging from creating confusion amongst regulatory agencies and potential investors of the retail installment contracts to licensing issues. See id. at 47:8- 50:10. Thus, in 2004, CarMax management determined that certain changes to the corporate structure/organization would be beneficial to the business, and it created CarMax Business Services, LLC ("CBS") to: (1) house the financing functions/operations (CarMax Auto Finance or "CAF") for the CarMax business group; and (2) own the intellectual property and provide certain shared services to the companies in the group. Id. at 43:2-15. The first change, which separated the financing functions from the retail operations, made the sale and/or securitization process for vehicle financing contracts less cumbersome, lessened confusion for regulators, simplified the regulatory compliance process and provided greater liability protection for the separate businesses. Id. at 47:8- 50:10. The second change brought about greater efficiencies and cost savings across all of the CarMax entities by centralizing general management functions, including human resources, information systems, finance and accounting; retail functions, including real estate support services, strategic analysis, advertising and marketing (including the CarMax website); and intangible asset management for various intellectual property, trademarks and trade names, marketing programs, customer data, etc. Id. at 51:18- 53:14. The above evidence presented at trial showed that CBS was formed for valid business reasons, and there was no evidence presented to the contrary. SCDOR has attempted to suggest or create a presumption that the primary purpose of CarMax's restructuring was to create a tax advantage and further suggested that CarMax West realized significant tax savings as a result, but there is no actual evidence in the record to support either finding.

CBS was created as a multi-member limited liability company (taxed as a partnership) between CarMax West and CarMax East, with CarMax West contributing the intellectual property and CarMax East contributing the financing operations and certain other corporate assets. Tr. at 42:14-21 and 46:23-25. An independent study was performed by an accounting firm to determine the value of the contributions to CBS (see id. at 43:19-25), which in turn determined their respective ownership interests in CBS-- CarMax West owns 93.5% while CarMax East owns 6.5%. Id. at 44:8-10.

CBS then charged CarMax West and CarMax East a per vehicle management services fee, also determined by an independent study, which includes an intellectual property royalty component. The revenues from the management fees flowed up to CarMax West and CarMax East as a result of their interests in CBS. CBS also generated financing income through CAF. Id. at 46:15-20.

### III. CarMax West's Connection to South Carolina

As the CarMax West representative testified at trial, CarMax West sells cars in the western United States and does no business in South Carolina. Tr. at 56:24-57:8. It has no employees, no facilities and no tangible property in South Carolina. Id. at 57:2-6. Due to the absence of a physical presence in the state, it receives no real services or benefits from the State of South Carolina. See id. at 57:9-11. Its only connection to South Carolina is the payments it has received from CarMax East for the use of the CarMax intellectual property that is used by CarMax East to sell cars in South Carolina (via payments directly to CarMax West from 2002-2004 and, subsequently, via its partnership interest in CBS which received such payments from CarMax East). Id. at 57:12-58:6.

#### **IV. Unitary Facts Regarding CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization)**

A review of the organization, systems and operations of CarMax West shows that it was a unitary business pre-reorganization (2002-2004) and that CarMax West and CBS together were a unitary business post-reorganization (2005-2007). The companies have shared ownership and management. Tr. at 58:20-60:9; Ex. 8, CarMax FY 2005 Officers and Directors List. They also have a number of shared services and systems that create efficiencies and cost savings across the companies, including centralized general management functions (such as human resources, information systems, finance and accounting), retail functions (including real estate support services, strategic analysis, advertising and marketing), and intangible asset management (for various intellectual property, trademarks and trade names, marketing programs and customer data). Tr. at 51:18-53:14; see also Ex. 7, Sample CarMax, Inc. Annual Report. The various activities of the CarMax companies, including retail sales, financing, marketing and intellectual property management, contribute to and depend upon one another. Id. at 61:19-24; see also Ex. 7, Sample CarMax, Inc. Annual Report. For example, as CarMax sells more cars, the value of its intellectual property increases, and as the value of the intellectual property increases and the brand becomes more well-known, CarMax sells more cars. Id. at 61:1-17. Similarly, because CarMax can offer financing options to customers through CAF, it is able to sell more cars, and CAF is able to make loans because it has access to the CarMax customers. Id. at 61:18-62:19.

Furthermore, the centralization and integration of the companies is apparent both in how the companies hold themselves out to the public-- all are known simply as "CarMax"-- (id. at 56:11-17; Ex. 7, Sample CarMax, Inc. Annual Report) and how the

companies share the fruits of their labors— all income earned by CarMax entities is placed in a general account and is used for the benefit of the entire CarMax group of companies. Tr. 60:21-61:7.

Finally, CarMax West's expert in state and local tax, tax accounting and tax policy testified that from a tax accounting standpoint, CarMax West pre-reorganization and CarMax West and CBS post-reorganization were unitary businesses. Id. at 138:8- 139:9. Similarly, CarMax West's expert economist testified that from an economic standpoint, CarMax West pre-reorganization and CarMax West and CBS post-reorganization were unitary businesses. Id. at 182:11- 183:14 (citing common ownership and management, vertical integration, economies and efficiencies, and interdependence among business units in support of his conclusion) and 184:7-21. SCDOR provided no testimony or evidence to refute that the businesses were unitary.<sup>1</sup>

#### V. Financing Receipts Income

As previously mentioned, CBS generates income through the financing activities of CAF. When a vehicle is sold in South Carolina, all income from that sale (in the form of cash and a retail installment contract generated at the store and immediately sold/assigned to CBS (CAF) or a third party finance company) is reported in South Carolina by CarMax East and is taxed by South Carolina. See Tr. at 86:6-11. To use a simple example, if CarMax East sells a car in South Carolina for \$20,000, with \$5,000 down and \$15,000 financed, CarMax East records and reports \$20,000 in revenue in South Carolina. Subsequent activity related to handling and servicing these loans *after* the initial sale takes place *outside the state of South*

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<sup>1</sup> SCDOR's witness testified that he thought that the entire CarMax group of companies was a unitary business (Tr. 277:20-24 and 280:18- 281:1), and SCDOR's expert economist refused to answer whether or not the businesses were unitary as he believed this question was irrelevant. Id. at 395:19- 396:7.

*Carolina*. Id. at 89:15-22. As noted above, CarMax East immediately assigns all retail installment contracts for financed vehicles to a third party finance company or to CBS. CBS associates located in Georgia then service and securitize the contracts assigned to CBS. Id. at 86:20- 88:5 and 89:15-21. I find that these employees provide added value, which, in turn, produces additional revenue, all of which is earned out-of-state. Id. at 90:12-15.

#### VI. Tax Returns, Audit and Determination

CarMax West filed the tax returns at issue using the standard apportionment method for multi-state taxpayers. CarMax West's witness testified that she reviewed and supervised the preparation of the subject tax returns. Id. at 64:17-19. She further testified that CarMax West followed the tax return instructions and the guidance in the returns themselves in applying the statutorily mandated standard apportionment formula. Id. at 68:4-9, 69:14- 25 and 70:16-21; see also Ex. 4, CarMax West Amended Tax Returns, 2002-2007; Ex. 5 Sample SCDOR Corporate Tax Return Instructions. More specifically, CarMax West started with its *federal taxable income*. Tr. at 64:20-25. This is dictated by the tax return (on line 1) and the instructions, which both provide that the starting point for determining taxable income in South Carolina is federal taxable income. See Ex. 6, Sample SCDOR Corporate Tax Return Instructions, at p. 5, line 1; Ex. 4, CarMax West Amended Tax Returns 2002-2007. CarMax West then made South Carolina adjustments to derive its net income as reconciled (also known as apportionable net income). Tr. at 65:1-22. CarMax West then used the statutory apportionment formula to calculate an apportionment fraction of South Carolina receipts over total everywhere receipts. Id. at 65:24-66:17. Id. The fraction was then multiplied by the net income as reconciled (or apportionable net income). Id. at 66:19-23. The result was the South

Carolina net income, which was then multiplied by the tax rate to arrive at the amount of income tax due. Id. at 66:25-67:2.

SCDOR rejected the statutory method and instead applied what it calls an "alternative method," which is not based on federal taxable income as a starting point. Ex. 1, SCDOR Report of Field Audit; Tr. at 75:4-9. The alternative method seeks to separate and tax only the Taxpayer's royalty receipts. Tr. at 75:4-9 and 75:20- 76:10. The impetus for using the alternative method appears to be that the auditor noticed that the CarMax group of companies had an East Coast/West Coast structure. See id. at 245:16- 246:12. The audit supervisor testified that sometimes other taxpayers employ organizational structures like this in order to distort income and, thus, this raises "red flags" for SCDOR. Id. However, before performing any investigation into the actual reasons for CarMax West's organizational structure, the auditor concluded that CarMax was operating a "royalty scheme" and sent out a draft audit report so stating, assessing additional taxes and imposing penalties. See Ex. 1, SCDOR Report of Field Audit, at 5; Tr. 72:21- 73:15. As part of the report, SCDOR created a "distortion" example, which allegedly shows that the inclusion of western car sales in the denominator of the gross receipts formula (i.e. Taxpayer's unitary gross income) distorts the Taxpayer's South Carolina income. Ex. 1, SCDOR Report of Field Audit, at 8. However, SCDOR presented no substantive evidence to show that the South Carolina income actually was distorted.<sup>2</sup> Moreover, the proposed audit adjustment imposes a tax on CarMax West of

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<sup>2</sup> The only arguable evidence SCDOR produced consisted of two examples: The first was a hypothetical that I found inadmissible because it was not related to the facts of the case and its relevance was not shown and the second was a copy of the separate accounting calculation that was used as the basis of the audit report. I find this separate accounting to be precluded by established South Carolina tax law. Exxon Corporation v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979). However, even if it were not, it amounts to nothing more than a tax on royalties during the pre-reorganization years and a tax on the partnership income of CBS during the post-reorganization years. If South Carolina wishes to impose a royalty or partnership tax, it can do so through the legislative process, but SCDOR lacks the constitutional authority to do so through S.C. Code Ann. §12-6-2320.

\$102,303, which is greater than the tax imposed on CarMax East (\$94,452), the entity that is actually operating a substantial business in South Carolina. See Ex. 31, SCDOR Distortion Example for FY 2006.

In addition, after the corporate reorganization in December 2004, via its ownership interest in CBS, CarMax West received income from financing operations performed by CAF. Tr. at 43:2-15; 46:15-47:7. It included the financing income only in the total net income in the subject returns but did not source any to South Carolina because all CAF operations related to financing were performed outside the state of South Carolina. Tr. at 67:13-24. In the audit report, SCDOR assessed additional taxes on CarMax West based on SCDOR's position that the financing income should be sourced to the state where the customer making payments on the loan resides. Tr. at 262:9-12; see also Ex. 1, SCDOR Report of Field Audit; Ex. 29, Amended SCDOR Audit Report.

#### **VII. Penalties Assessed by SCDOR**

SCDOR assessed penalties against CarMax West based on both negligence and substantial understatement, which totaled \$205,832. Ex. 29, Amended SCDOR Audit Report, at 14. 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, and, in fact, SCDOR's witness at trial believed SCDOR had no ability under the law *not* to assess a substantial understatement penalty. Tr. 263: 3-6 (testifying that the statute says "must" and, thus, SCDOR has no discretion).

In addition, as previously stated, 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. Tr. at 91:10-13. 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. 2007); Ex. 5, Sample SCDOR Corporate Income Tax Instruction; Ex. 4, CarMax West Amended Tax Returns 2002-2007. 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. Tr. at 91:14-17.

### **CONCLUSIONS OF LAW**

#### **General Conclusions**

S.C. Code Ann. § 1-23-600 grants jurisdiction to this Court to hear contested cases under the Administrative Procedures Act. Additionally, S.C. Code Ann. § 12-60-470(f) and 12-60-460 grant the Administrative Law Court the authority to conduct contested case hearings in matters concerning claims for refunds and assessments.

#### **Burden of Proof**

Ordinarily it is the taxpayer's burden to rebut an assessment; however, in this case, SCDOR bears the burden of showing why the standard apportionment formula should not be followed. Although S.C. Code Ann. § 12-6-2320 and South Carolina case law are silent on who has the burden of proof in regard to the use of an alternative apportionment formula, there is "universal authority" amongst other states that have adopted the Uniform Division of Income for Tax Purposes Act's alternative apportionment provision, which is identical to the South

Carolina provision, requiring the party seeking an alternative apportionment method to show by clear and convincing evidence that the standard formula is not a fair representation and that its proposed alternative is reasonable. See Union Pacific Corp. v. Tax Commission, 83 P.3d 116 (Id. 2004); St. Johnsbury Trucking Co. v. New Hampshire, 385 A.2d 215 (N.H. 1978); Amaco v. Arnold, 518 P.2d 453 (Kan. 1974); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041 (Or. 1972); Kennecott Copper Corp. v. State Tax Comm'n., 493 P.2d 632 (Utah 1972); The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4<sup>th</sup> 1491 (Cal. Ct. App. 2007). The parties were in agreement at trial that this is the appropriate burden of proof. See Tr. at 443:3-9. Thus, the Department must establish by clear and convincing evidence that the standard apportionment formula is not a fair reflection of CarMax West's business activities in South Carolina and that the alternative apportionment method it proposes is reasonable.

#### **Preliminary Conclusions of Law**

1. Clear and convincing evidence has been presented that (a) pre-reorganization (2002-2004), the Taxpayer was a unitary business and the royalty income from CarMax East was unitary income to CarMax West; and (b) post-reorganization (2005-2007), CarMax West and CBS were unitary and the income paid by CBS to CarMax West was unitary income. Moreover, SCDOR presented no evidence that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) were not unitary. Thus, I find the business of CarMax West prior to the reorganization to have been a unitary business and the income from the royalty payments a part of that unitary income. After the reorganization, CarMax West, the Taxpayer, and CBS were unitary with respect to each other and the income received by CarMax West from CBS was unitary income to CarMax West.

2. SCDOR has presented no credible evidence, much less clear and convincing evidence, that the income tax apportionment formula does not fairly reflect the Taxpayer's business activities in South Carolina. The only evidence presented by SCDOR was its alternative calculation. It gave no reason to substantiate or support why it was correct except to say that it derived more tax revenue for the State of South Carolina than the statutory method. Moreover, the Taxpayer presented compelling evidence that the standard tax apportionment method it used does fairly reflect its business activities in South Carolina.

3. SCDOR presented no credible evidence, and certainly not clear and convincing evidence, that its alternative method is reasonable, and, to the contrary, the Taxpayer presented compelling evidence that the alternative method is not reasonable and does not fairly reflect its business activities in South Carolina.

4. It was uncontested that the business activities of CBS post-initial sale of CarMax East vehicles are performed by CBS employees located outside the state of South Carolina. Pursuant to Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), post-sale receipts should also go to the state where the activities took place (in this case Georgia) because that is where the value was added.

5. SCDOR has provided no basis to impose either a substantial understatement penalty or a negligence penalty on the Taxpayer. CarMax West acted in good faith and with reasonable cause and substantial authority in following the tax return instructions, the tax return forms themselves and the mandatory statutory apportionment method in preparing and submitting its returns, and, therefore, a substantial understatement penalty cannot be applied. SCDOR has produced no guidance for determining when an alternate apportionment formula should be used. Therefore, CarMax West could not have

determined that it should use the alternative method SCDOR now proposes, and, thus, it could not have acted negligently.

6. SCDOR's alternative method (which is unpublished and has no standards or criteria as to when it applies) as applied to this taxpayer taxes CarMax West out of all proportion to its income and to its business activities in the state of South Carolina and therefore violates CarMax West's constitutional rights under the Commerce Clause of the United States Constitution. In addition, the imposition of penalties under the circumstances in this case violates CarMax West's due process rights under both the United States and South Carolina Constitutions.

### Discussion

#### **I. Proper Income Tax Apportionment Method**

The central issue in this case is the proper method to use in determining the share of CarMax West's unitary income that should be taxed by this state during the audit period (tax years ending 2002 through 2007). Taxpayer asserts that under South Carolina law, the standard statutory method of income tax apportionment as applied to its unitary corporate net income, which consists of a portion of its total multi-state net income, should be applied. CarMax West filed the subject returns based on its federal taxable income as adjusted and using the single factor gross receipts formula contained in S.C. Code Ann. § 12-6-2290 (Supp. 2007).<sup>3</sup> More specifically, CarMax West's South Carolina receipts, which included income from royalties for all audit years, were divided by CarMax West's total receipts, and this

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<sup>3</sup> CarMax initially filed its returns using the three factor method but amended them prior to trial to use the single factor method. Thus, whether CarMax should use the three factor versus single factor method is not at issue in this case.

statutorily defined fraction was applied against its unitary apportionable net income. See S.C. Code Ann. § 12-6-2290 (Supp. 2007).

SCDOR has rejected this statutory apportionment method in favor of what it terms an "alternative method" of apportionment of income. This customized method, which seeks to separate a portion of the Taxpayer's income and tax only a portion of it (thereby ignoring its total unitary income), is an unprecedented action by the Department. A similar method was attempted by a taxpayer in Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); however, the Department opposed the method and the South Carolina Supreme Court held that the multi-state oil corporation taxpayer could not divide its unitary income producing activities and exclude from taxation in South Carolina all income related to its exploration and production activities. Id. Now, in this case, it is the Department who seeks to isolate and tax only a portion of this taxpayer's unitary income, in contravention of its predecessor's position in Exxon and the well-established law in this State.<sup>4</sup>

Under South Carolina law, an alternative method of apportionment is only authorized when the standard method does not properly reflect the extent of a taxpayer's income-producing activities in South Carolina. See S.C. Code Ann. § 12-6-2320(A) (2000 and West Supp. 2009). As the United States Supreme Court has explained, formulary apportionment is presumed to be fair and reasonable (see Butler Bros. v. McColgan, 315 U.S. 501 (1942)), while separate or formal accounting is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Container Corp. of

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<sup>4</sup> See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989).

America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983). This is particularly true when the taxpayer operates a unitary business. The income generated by the various components of a unitary business cannot be accurately accounted for individually as it is "attributable to all incidents of the business and not to any single activity." See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 599, 258 S.E.2d 93, 96 (1979), quoting Covington Fabrics v. S.C. Tax Comm'n, 264 S.C. 59, 212 S.E.2d 574, appeal dismissed, 423 U.S. 805 (1975).<sup>5</sup> See also Tr. at 187:13-18 (testimony of CarMax West's expert economist that because of the interdependence of the business units, applying separate accounting to a unitary business is likely to lead to errors in calculating income and tax); Id. at 132:13- 133:15 (testimony of CarMax West's tax accounting expert that errors in accounting for the various individual components of a unitary business result because of "the interrelationships between the members of the unitary group," which can result in the sum of all the parts being greater than the whole).<sup>6</sup>

Moreover, an alternative formula should only be used in "unique and non-recurring" circumstances. See Tr. Ex. 6, Uniform Division of Income for Tax Purposes Act ("UDITPA") (and related regulations); Donald M. Drake Co. v. Department of Revenue of

<sup>5</sup> The holding in Exxon is established law in South Carolina and is in accord with SCDOR's own regulations. See S.C. Code Ann. Regs. § 117-710.1 (West Supp. 2009) (providing that a "taxpayer operating a unitary or homogenous business within and without the state and an unrelated business either entirely within or without is subject to apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business").

<sup>6</sup> While some of the flows of value between and among CarMax West and CBS may be quantified in the amount of the management fee, there are inevitably many more "subtle and largely unquantifiable transfers of value" that are not. Container Corp., 463 U.S. at 164-65. See also Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 603-604, 258 S.E.2d 93, 98 (S.C. 1979) (quoting Butler Bros. v. McCollgan, 315 U.S. 501, 507 (1942)) (finding arguments of the Tax Commission that "transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income" persuasive and stating that "[a]ccounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.").

State of Oregon, 500 P.2d 1041, 1043 (Or. 1972) (stating that "the apportionment method is now the general rule and any other system, including the segregated method, is the exception"); St. Johnsbury Trucking Co., Inc v. State of New Hampshire, 385 A.2d. 215, 217 (N.H. 1978), quoting William J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747, 781 (1957) (stating that an alternative method is the exception and "departures from the basic formula should be avoided except where reasonableness requires").<sup>7</sup>

Finally, the alternative method proposed by the Department must be reasonable. S.C. Code Ann. § 12-6-2320. Thus, in this matter, the Court must consider whether SCDOR established by clear and convincing evidence that the statutory method did not fairly reflect the business activities of the Taxpayer in South Carolina as well as whether SCDOR established by clear and convincing evidence that its alternative method is reasonable. Because both of these issues are impacted by the issue of whether the Taxpayer operated a unitary business, the Court will consider that issue first.

#### A. Unitary Business

In determining whether a business is unitary, South Carolina courts apply two main tests: (1) the three unities test; and (2) the contribution-dependence test. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. These tests are not mutually exclusive, and the courts often apply both. Id.; see also Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 789 (1992) (discussing unitary business tests of "functional integration, centralization of management, and economies of scale"). Under the three unities test, courts look at whether the business or businesses have unity of ownership, unity of management and unity of

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<sup>7</sup> See also Tr. at 145:9-16 (testimony of CarMax West's state and local tax and tax accounting expert stating that UDITPA limits the use of an alternative formula to "unique and non-recurring situations" and should be done on an "exception basis").

operation. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. Under the contribution-dependence test, the court considers whether the "activities of the business in question contribute to or depend on the other activities of the business." Exxon, 273 S.C. at 600, 258 S.E.2d at 96. The courts do not require that it be "necessary" or "essential" that the business or businesses be operated together; cost savings or increased profits gained by operating together are acceptable reasons. Exxon, 273 S.C. at 599-601, 258 S.E.2d at 96-97.

For example, in Exxon, the court found that the taxpayer operated a unitary business where, among other things, it held itself out to the public as one company; it employed central staff on which all companies were dependent; it used centralized purchasing techniques that resulted in cost savings throughout company; it had strong, centralized management over all segments of company; the structure provided profit stability, reduced risk and insured full capacity utilization of company's facilities; it made no attempt to segregate earnings or funds of the various segments; and the various operating activities of the company of exploration, production, refining and marketing contributed to and depended upon each other. The Court held that the taxpayer satisfied both the three unities test and the contribution-dependence test. Exxon, 273 S.C. at 602, 258 S.E.2d at 97.<sup>8</sup>

In the case at hand, the income of CarMax West (pre-reorganization) and CarMax West and its share of CBS income (post-reorganization) are unitary. The following

<sup>8</sup> See also Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992) (finding that multinational camera and film corporation that was also doing safe harbor lease transactions involving tangible personal property was a unitary business not capable of separation where only a small portion of leased assets were in South Carolina, the funding for the leasing came from the general corporate treasury and the income benefited the company as a whole); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977) (finding multi-state oil and gas company that also contracted on a royalty basis with third parties to mine salt and sulphur discovered on prospective oil lands was a unitary business where salt and sulphur was discovered during oil exploration process, which was an integral part of the business); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Cl. App. 1989) (finding affiliated New York textile manufacturing companies that also earned interest income from inter-company loans and from repurchasing own bonds on open market were unitary where funding for leasing came from general corporate treasury, interest income and loan payments were deposited in general company accounts and used for normal business operations, and income benefited company as a whole).

facts presented at trial through the testimony of CarMax's witness support this conclusion: the companies have shared ownership and management; the companies have a number of shared services and systems that create efficiencies and cost savings across the companies, including centralized general management functions (such as human resources, information systems, finance and accounting), retail functions (including real estate support services, strategic analysis, advertising and marketing), and intangible asset management (for various intellectual property, trademarks and trade names, marketing programs, customer data); CarMax entities hold themselves out to the public as simply "CarMax;" all income is placed in a general account and is used for the benefit of the CarMax group of companies as a whole; the various activities of the companies, including retail sales, financing, marketing and intellectual property management contribute to and depend on one another; and the company is functionally integrated. See Tr. at 51:18- 53:14; 58:20- 60:9; 61:1- 62:19; see also Ex. 8, CarMax FY 2005 Officers and Directors List; Ex. 7, Sample CarMax, Inc. Annual Report.

In addition, both CarMax West's expert economist and expert tax accountant testified that from an economic standpoint and a tax accounting standpoint respectively, the businesses at issue were unitary. See Tr. at 138:8- 139:9 (testimony of expert tax accountant) and 182:11- 183:14; 184:7-21 (testimony of expert economist). Moreover, the above evidence and testimony regarding the unitary nature of the businesses was un rebutted.<sup>9</sup>

Therefore, based on the overwhelming and uncontested evidence, I find that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) are

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<sup>9</sup> As previously stated, SCDOR's witness testified that he thought that the entire CarMax group of companies was a unitary business (Tr. 277:20-24 and 280:18- 281:1), and SCDOR's expert economist refused to answer whether or not the businesses were unitary as he believed this question was irrelevant. Id. at 375:15-22 and 395:19-396:7.

unitary businesses, and the royalty and financing income produced thereby constitutes unitary income of the Taxpayer.

### **B. The Standard Apportionment Formula**

As previously stated, SCDOR bears the burden of establishing by clear and convincing evidence that the standard apportionment formula does not fairly reflect the business activities of the Taxpayer in South Carolina.<sup>10</sup> Not only does SCDOR fail to carry this burden, but I find that the Taxpayer established that the standard method does fairly reflect its business activities in South Carolina.

In order to determine whether the standard formula fairly reflects a taxpayer's in-state business activities, one would expect to find a test or criteria to apply to this question. No such guidance exists. SCDOR presented no evidence of any criteria (published or unpublished) that exists for SCDOR, taxpayers or this Court to follow on how to determine whether the standard formula fairly reflects a taxpayer's in-state business activities. Instead, it appears to be done on a case-by-case basis with the auditors making their own subjective determinations.

In this case, SCDOR's witness testified that auditors are instructed to look for companies that have East Coast/West Coast structures. See Tr. 242:20- 243:13. He further testified that SCDOR believes that sometimes other taxpayers employ organizational structures like this in order gain tax savings and, thus, this structure raises "red flags." Id. at 245:16- 246:12. However, before visiting CarMax or performing any investigation into the reasons for

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<sup>10</sup> See supra, Burden of Proof Section, citing Union Pacific Corp. v. Tax Commission, 83 P.3d 116 (Id. 2004); St. Johnsbury Trucking Co. v. New Hampshire, 385 A.2d 215 (N.H. 1978); Amaco v. Arnold, 518 P.2d 453 (Kan. 1974); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041 (Or. 1972); Kennecott Copper Corp. v. State Tax Comm'n., 493 P.2d 632 (Utah 1972); The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491 (Cal. Ct. App. 2007).

CarMax West's organizational structure, the auditor immediately concluded that CarMax was operating a "tax scheme." See Ex. 1, Report of Field Audit. In support of his conclusion, he created a "distortion" example, which allegedly shows that the inclusion of western car sales in the denominator of the gross receipts formula distorts CarMax West's South Carolina income. Id. The auditor then sent proposed assessments of additional taxes owed as well as penalties owed to the Taxpayer in "audit papers" *prior to* the actual field audit being performed. See Tr. 72:21- 73:15.

Had the auditor performed an investigation prior to reaching the aforementioned conclusion, he could have learned that CarMax West had valid business reasons for its structure. See Tr. at 47:8- 50:10. Additionally, SCDOR presented no substantive evidence to show that the Taxpayer's South Carolina income was distorted. Its only support for the alternative formula appears to be the distortion example, which simply shows that CarMax East, which does substantial business in South Carolina, has a higher income in South Carolina. SCDOR did not explain how this comparison was meaningful, and, in fact, one would expect CarMax East to have significantly higher income (and thus higher tax revenue) in South Carolina because it has a much greater level of business activity in South Carolina. Nothing about the fact or amount of this difference in income strikes this Court as meaningful or provides a legal basis for SCDOR to deviate from the standard formula.

In addition, despite the South Carolina Supreme Court's ruling in Exxon that the income of a unitary business is not subject to apportionment, the auditor does not appear to have considered whether the Taxpayer operated a unitary business; in fact, its expert economist stated that whether the Taxpayer was unitary was irrelevant. Tr. at 395:19- 396:7. SCDOR's position appears to be that Exxon is merely instructive and does not create any bright line rule

that unitary businesses are not subject to alternate methods under S.C. Code Ann. § 12-6-2320. SCDOR misunderstands the nature and effect of the Exxon holding, which permits a unitary business to be subjected to an alternate method but prohibits the use of a method that separates the units or activities of an otherwise unitary business. SCDOR presented no evidence to support its theory that isolated portions of the Taxpayer's unitary income should be separated or can be accurately separated or to show that the receipts at issue are produced solely by the Taxpayer's activities in South Carolina.<sup>11</sup> In addition, although it attempted to insinuate throughout the trial that the Taxpayer realized significant tax savings from its business structure, it offered no evidence to support this contention.

On the other hand, the Taxpayer presented substantial evidence that the standard formula does fairly reflect its activities in South Carolina. First, it presented evidence that its in-state activities are minimal and that it receives minimal benefits from the State of South Carolina. As CarMax West's expert economist testified, an important tax policy goal is that the taxpayers who are benefiting from government services are the ones helping to pay for those services. Tr. 186:21- 186:4. For example, the gasoline tax is used to help build more roads, bridges, etc.; those using the roads more buy more gas and thus pay a larger share of those taxes, which they then benefit from via new roads and bridges. Id. at 186: 5-15. CarMax West's tax burden should have some relation to the benefits received from South Carolina, and because it receives few benefits, its tax burden should be correspondingly low.

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<sup>11</sup> Although not evidence, SCDOR's expert economist attempted to justify separation of the Taxpayer's activities (and thus income) through an "apples and oranges" metaphor with the apples in this case being the royalty payments and the oranges being the retail car sales. He contended that you should not mix the apples with the oranges, i.e. the royalty income with the retail sales income. Tr. 330:9- 331:9. This reasoning is flawed and is contrary to South Carolina law on unitary businesses. Similar arguments were made in the Exxon case with the apples being the oil production and refineries and the oranges being the gas pumps and stations. The South Carolina Supreme Court rejected this type of reasoning and held that the income of a unitary business cannot be separated in this manner. Exxon Corp. v. S.C. Tax Comm'n., 273 S.C. 594, 258 S.E.2d 93 (1979).

In addition, the testimony and evidence presented by CarMax West showed that the income at issue was produced by its total unitary business activities and not solely attributable to its limited activities in South Carolina. See Tr. 51:18- 53:14; 56:11-17 and 58:20- 62:19 (testimony of CarMax representative regarding unitary business and minimal contact with South Carolina); Id. at 187:6-18 (testimony of CarMax West's expert economist that the Taxpayer's unitary income could not be accurately accounted for separately); Id. at 185:6- 187:2 (testimony of CarMax West's expert economist that the statutory apportionment method used by CarMax accurately reflected its low-level of business activities in South Carolina).

The absence of specific criteria for the Department to use in rejecting the statutory apportionment formula (either internally or externally) and in its place proposing a method that has not been published to the outside world is disturbing to this Court. Moreover, SCDOR's audit process in this case appears to ignore the factual circumstances of this taxpayer (in particular, the valid business reasons for its structure, the unitary nature of its business, the minimal activities in South Carolina and the minimal benefits provided to CarMax West by South Carolina) as well as the established law in this State regarding unitary businesses. See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979). Accordingly, I find that SCDOR has failed to meet its burden of establishing that the statutory method does not fairly reflect the Taxpayer's business activities in South Carolina and further find that the Taxpayer has established by a preponderance of the evidence that the statutory method does fairly reflect its business activities in South Carolina.

### C. SCDOR's Alternative Method

Even assuming that SCDOR could establish that the standard apportionment formula does not fairly reflect the business activities of the Taxpayer in South Carolina, it has not shown that its proposed alternative formula is reasonable. Moreover, as with the preceding section, not only does SCDOR fail to carry this burden by clear and convincing evidence, but I find that the Taxpayer has established that the alternative method is unreasonable.

As with the question of whether the standard formula fairly reflects the business activities of a taxpayer, SCDOR's witness testified that there were no criteria (published or unpublished) that would provide SCDOR, taxpayers or this Court with any guidance on how to determine an appropriate alternative formula or whether any particular formula was reasonable or fairly reflected the in-state business activities of a taxpayer. Tr. 281:20- 282:12. SCDOR offered no evidence to substantiate why the alternative formula was appropriate and reasonable except to show that it derived more tax revenue than the statutory method. SCDOR's only other argument, which was advanced through its expert economist, appears to be that the alternative formula is appropriate because it is *possible* to separate CarMax West's South Carolina income from its total income. Tr. at 390:23- 391:19. However, SCDOR's expert never explained why the unitary nature of the Taxpayer's income should be ignored or showed that such a separation would be accurate.

This Court first finds that the fact that the alternative formula would derive more income is not justification for this method. See St. Johnsbury Trucking Co., Inc v. State of New Hampshire, 385 A.2d. 215, 217 (N.H. 1978) (stating that "[m]erely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively

mandated formula"). Furthermore, although SCDOR contends that it is possible to separate the South Carolina royalty income from CarMax West's total income, because the Taxpayer was operating unitary businesses (see supra Section I(A)), this Court concludes that it cannot accurately separate the royalty income from the rest of the Taxpayer's unitary income and that doing so would be in contravention of well-established South Carolina law. Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989). See also Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 783 (1992).

Additionally, to the extent that a tax is to be viewed as compensatory for services rendered, the proposed separate accounting method employed in the audit report produces gross distortion. The distortion is evident by comparing CarMax East (whose tax liability is not in dispute) with CarMax West. Under SCDOR's alternative method, CarMax East, which operates CarMax Superstores (large car dealerships) in South Carolina and reaps significant benefits from this state, would owe less in taxes (\$94,452) than would CarMax West, which has virtually no presence in South Carolina (\$102,303). See Ex. 31, SCDOR Distortion Example for FY 2006. I find no reasonable explanation in the audit report, the Department Determination, or the evidence produced at trial that could justify a tax on the limited in-state activities of CarMax West of this magnitude. The State of South Carolina has not provided sufficient benefits or services for which it could reasonably exact a return of this size. Exxon, 273 S.C. at 606, 258 S.E.2d at 99 (stating that "[t]he simple but controlling question is whether the state has given anything for which it can ask return").

Finally, the lack of any criteria or standards for SCDOR, taxpayers and courts to follow is not comforting to this Court. If this Court was to approve SCDOR's use of this "alternative method," the result would likely be chaos. No multi-state taxpayer filing in this state would have any certainty about how to file because there is nothing in the instructions to the tax return or the published position of SCDOR that would indicate to even the most careful multi-state taxpayers what is expected of them and under what circumstances. Moreover, when disputes arise, as they most certainly will, courts will still have no clear basis on which to evaluate SCDOR's alternative method in any given case.

Based on the above, the Court concludes that SCDOR has failed to establish by clear and convincing evidence that its alternative formula is reasonable. Additionally, although not the Taxpayer's burden, I find that the Taxpayer proved by a preponderance of the evidence that the alternative method used by SCDOR was unreasonable. SCDOR's method is simply an arbitrary tax on receipts, it ignores the unitary income of the Taxpayer, and it attempts to tax the income of a partnership (i.e. CBS, a pass-through entity) which SCDOR lacks the legal authority to do. The tax bears no relationship to the Taxpayer's business activities in South Carolina.

## **II. Sourcing of Financing Receipts**

Another issue in this matter is the state to which certain financing receipts of the Taxpayer should be sourced. In Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), the South Carolina Court of Appeals examined two views regarding the use of the term "receipts": (1) the origin of payment view; and (2) the place of activity view. Under the "origin of payment" view, the term "receipts" is defined by reference to the location of the taxpayer's customers making the payments. Lockwood Greene,

293 S.C. at 448, 361 S.E.2d at 347. On the other hand, the "place of activity" view looks to the place where the services are performed. Id. The taxpayer in Lockwood Greene was an engineering firm with employees in South Carolina and customers in and out-of-state. Lockwood Greene argued that the Court should look to the location of its customers, but SCDOR contended and the Court held that the appropriate method of sourcing the firm's income was the "place of activity" test. Id. The Court reasoned that an out-of state client is paying the firm for the expertise and time of the employees who were located in South Carolina. Lockwood Greene, 293 S.C. at 449, 361 S.E.2d at 347.

Turning to the case at hand, all income from the initial vehicle sales are reported in South Carolina by CarMax East and taxed by South Carolina. Tr. at 86:6-11. Thus, the financing income at issue here is related only to the subsequent activity of servicing or handling the loans after the initial sale. It was uncontested that all such activity takes place outside the state of South Carolina (id. at 90:12-15), and I have previously found that such activity added value. See supra Findings of Fact, Section V. As CarMax West's expert economist testified, sourcing to the state where value is added is justified from an economic perspective. Tr. 190:6- 191:2. Because CBS associates are located in Georgia and add value during the servicing and securitizing stage, he believed these revenues should not be sourced to South Carolina. Id. (explaining that this concept is the same one used in computing national gross domestic product, which looks at the addition in value at each stage of production). Sourcing to Georgia also comports with the economic principle of matching income to expenses. Id. at 191:3-13. See also Tr. at 150:11-22 (testimony of CarMax West's expert on state and local tax, tax accounting and tax policy explaining that matching income and expenses

is good tax policy<sup>12</sup> and that most states would tax this type of financing income on a cost of performance or income-producing activity basis).

SCDOR's position is that all receipts from financing activities related to vehicles sold in South Carolina should be sourced to South Carolina because that is where the initial transaction takes place; as SCDOR's expert testified, "but for" the initial sale in South Carolina, there would be no financing receipts. Tr. at 402:14-21. The "but for" test is flawed; under this test, income from commercial paper initially sold in South Carolina would always be traced to South Carolina no matter where the sale or assignment of that paper took place, no matter where the purchaser of that paper was located and no matter how much work was performed in order to handle the servicing, selling, factoring or securitization of that paper. Indeed, it would make no difference whether the purchaser of the vehicle moved out of South Carolina and began paying CBS in Georgia from, for example, North Carolina; under SCDOR's theory, those payments would not be made "but for" the initial transaction in South Carolina, and, therefore, the receipts should be taxed by South Carolina. This makes no sense and is contrary to sound economic policy, tax policy and accounting principles, including the cost or performance or place of activity concept and the matching principle.

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<sup>12</sup> SCDOR's point raised at trial that the financing receipts have already been matched against financing expenses in CBS is not a reason to trace the receipts away from the activities that produced them. The matching principal is just as viable in the sourcing of receipts as it is in the fact that the receipts are first off-set by the expenses that produced them in CBS; one should still match income with activities.

Based on the above and under the "place of activity" test in Lockwood Greene,<sup>13</sup>

I find that CarMax West has established by a preponderance of the evidence that it should not source any income from the financing services activities that take place after the initial sale to South Carolina because the economic activity that produces these additional revenues (thereby adding value to the process) and the sales or securitizations of the initial contract take place out-of-state. Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

### III. Penalties

SCDOR assessed penalties totaling \$205,832 against the Taxpayer based on two statutory grounds: (1) negligence and (2) substantial understatement. See Ex. 29, Amended SCDOR Audit Report, at 14. First, 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

<sup>13</sup> SCDOR pointed to dicta in Lockwood Greene stating that the place of activity test might not apply to a finance company and notes that Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993), which addressed royalty income earned by a holding company, supports a different result. None of these arguments are sustainable as to financing activity that takes place *after* the initial sale. Unlike a lender such as a credit card company making loans in South Carolina to which the dicta in Lockwood Greene might be thought to apply, there is no nexus or connection to South Carolina for these subsequent sales/securitizations in this matter, and all activity related thereto is performed outside South Carolina.

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. Tr. 156:22- 157:22. 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. Additionally, I find by a preponderance of the evidence that assessing a negligence penalty under the circumstances of this case would violate this Taxpayer's due process rights under both the South Carolina and United States Constitutions, and, thus, the penalty cannot be sustained on this ground as well.

In addition, 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 West Supp. 2008) (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 West Supp. 2008) (emphasis added).

While SCDOR focuses on the mandatory nature of the penalty provisions, these exceptions are no less mandatory.

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 evidence 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 must conclude that CarMax West has established by a preponderance of the evidence that the substantial understatement penalty should not apply and must be dismissed.<sup>14</sup> Additionally, assessing a substantial understatement penalty under the circumstances of this case would violate this Taxpayer's due process rights under both the South Carolina and United States Constitutions, and, thus, the penalty cannot be sustained on this ground as well.

#### IV. Violation of Petitioner's Constitutional Rights

The final issue in this matter is whether CarMax West's constitutional rights have been violated if the "alternative method" of apportionment asserted in the audit report is applied. Petitioner believes that SCDOR has erroneously applied the South Carolina income

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<sup>14</sup> 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.

tax laws to CarMax West in such a way as to reach an unconstitutional result.<sup>15</sup> I have concluded that the method of taxation employed by SCDOR violates the Interstate Commerce Clause of the U.S. Constitution because; *inter alia*, it taxes income with no connection to South Carolina, taxes income out of all proportion to CarMax West's activities in South Carolina, subjects CarMax West to the risk of multiple taxation, is not fairly apportioned, is not fairly related to the services provided by the taxing state and discriminates against interstate commerce.

The Commerce Clause "prohibits economic protectionism- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." Fulton Corp. v. Faulkner, 516 U.S. 325, 330 (1996) (internal quotations omitted). As the Supreme Court has explained, the purpose of such a rule is "to preven[t] a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within its borders would not bear." Id. at 330-31 (internal quotations omitted).

The four-part test for determining whether a state taxing statute violates the commerce clause is set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). To be sustained, a tax must (1) be applied to an activity with a substantial nexus to the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the taxing state. Id. at 279. In evaluating the fairness prong, one of the tests the courts apply is an external consistency test. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983) (discussing fairness issue under both

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<sup>15</sup> I am mindful of the fact that although this Court does not have the authority to declare a statute facially unconstitutional, it has the authority to declare the application of a statute unconstitutional. Evans v. State of South Carolina, 344 S.C. 60, 543 S.E.2d 547 (2001); Video Gaming Consultants, Inc. v. SCDOR, 342 S.C. 34, 535 S.E.2d 642 (2000).

Commerce Clause and Due Process Clause). External consistency requires that the factors used by the state in the apportionment formula "must actually reflect a reasonable sense of how income is generated." Id. A formula will not satisfy this test if it attributes income to the state that is "out of all appropriate proportions to the business transacted . . . in that State" (id. at 170 (quoting Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931))) or has "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. at 267, 274 (1978)).

As applied to CarMax West in this case, the tax at issue fails the Complete Auto test because it taxes income with no connection to South Carolina (as to financing income only), is not fairly apportioned, discriminates against interstate commerce and is not fairly related to the services provided by the taxing state. More specifically, as to the fairness and discrimination prongs, the alternative formula invoked by SCDOR in this case fails the external consistency test because it does not actually reflect a reasonable sense of how income is generated by CarMax West, a unitary business, in South Carolina. Finally, the formula applied by SCDOR is not fairly related to the services provided by South Carolina, which are de minimus in this case. The irrationality and unfairness of the proposed assessment on CarMax West is further illustrated by the fact that SCDOR would be imposing a greater tax liability on CarMax West (\$102,303), which has virtually no contact with South Carolina, than CarMax East (\$94,452), which performs substantial business in South Carolina. See Ex. 31, SCDOR Distortion Example for FY 2006. Thus, I find that CarMax West has established by a preponderance of the evidence that SCDOR's assessment results in liability that is distortive and taxes CarMax West out of all proportion to and does not fairly represent its business conducted in South Carolina. See Container Corp., 463 U.S. at 170; Hans Rees', 283 U.S. at 135.

## V. Remedy

In its closing argument, SCDOR raised for the first time the argument that if the Court determines that SCDOR's proposed assessment is unreasonable, then the appropriate remedy would be for the Court to remand this matter back to the Department to determine a reasonable alternative. Tr. at 441:13-21. I have serious procedural concerns about SCDOR first raising this question at the conclusion of the case and not complying with the basic provisions of the Revenue Procedures Act under which this matter is being adjudicated before me.

The Revenue Procedures Act (the Act) is contained in Chapter 60 of Title 12, S. C. Code Ann § 12-60-10, et. seq. The purpose of the Act is to provide an efficient method of assessing, protesting and adjudicating tax questions. The Act requires adequate notice to taxpayers. A remand remedy was not requested in the Pre-Hearing Statement or the Pre-Trial Brief in this matter. In my judgment, the fact that the question of remand was not presented at any time to the Taxpayer prior to closing statements at the trial of this matter is in violation of the procedures set forth in the Act and prevents the Department from raising the question before me at the conclusion of the trial of the case. However, even if the matter of remand was properly before me, I do not find the Department's argument that the proper remedy would be to remand this matter to be persuasive.

Final Conclusion of Law

This Court holds that Taxpayer is entitled to have the proposed assessment dismissed in its entirety.

**ORDER**

And it is so ordered this \_\_\_\_\_ day of \_\_\_\_\_, 2010.

\_\_\_\_\_  
The Honorable Carolyn Matthews

STATE OF SOUTH CAROLINA  
ADMINISTRATIVE LAW COURT

|                                              |   |                                       |
|----------------------------------------------|---|---------------------------------------|
| CarMax Auto Superstores West Coast,<br>Inc., | ) | Civil Action No. 09-ALJ-17-0160-CC    |
|                                              | ) |                                       |
|                                              | ) |                                       |
| Petitioner,                                  | ) |                                       |
|                                              | ) |                                       |
| vs.                                          | ) | <u>MOTION FOR RECONSIDERATION</u>     |
|                                              | ) | <u>UNDER ALC RULE 29(D) AND/OR TO</u> |
| South Carolina Department of Revenue,        | ) | <u>ALTER OR AMEND UNDER SCRCP</u>     |
|                                              | ) | <u>RULE 59(E)</u>                     |
| Respondent.                                  | ) |                                       |
|                                              | ) |                                       |

Pursuant to South Carolina Rule of Civil Procedure 59(e) and Rule 29(D) of the Rules of Procedure for the Administrative Law Court, Petitioner CarMax Auto Superstores West Coast, Inc. ("CarMax West") respectfully requests that this Court reconsider and alter or amend its Final Order and Decision dated April 22, 2010 ("Order"), a copy of which is attached hereto as Ex. A, finding in favor of Respondent South Carolina Department of Revenue ("SCDOR") in this matter. This motion is based upon the grounds that the Court overlooked, misinterpreted or failed to apply South Carolina law and/or failed to consider certain evidence and arguments presented, which, when considered, necessitate a finding in favor of CarMax West.

A. The Court Applied the Wrong Standard and Burden of Proof.

The Order sets forth the general standard and burden of proof in cases involving challenges to tax assessments, i.e. that the standard of proof is preponderance of the evidence and that the burden of proof is upon the taxpayer challenging the proposed assessment. See Ex. A, Order, at 6. At trial, CarMax West asserted that an exception to the general rule

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applies where a tax assessor deviates from the standard apportionment formula. In such a case, the burden shifts to the taxing authority to show why the standard apportionment formula should not be followed and that its alternative formula is reasonable. CarMax West cited to universal authority amongst other states that have adopted the Uniform Division of Income for Tax Purposes Act's alternative apportionment provision, which is identical to the South Carolina provision, in support of this change in the burden of proof. The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4<sup>th</sup> 1491, 1498 (Ct. App. 2007) (stating that the party asserting alternative apportionment bears the burden of proof); Union Pacific Corp. v. Tax Commission, 83 P.3d 116, 119 (Id. 2004) (stating that "[t]he party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate"); St. Johnsbury Trucking Co. v. New Hampshire, 385 A.2d 215, 217 (N.H. 1978) (holding that "an alternative formula is the exception, and the party who wants to use an alternative formula has the burden of showing that the alternative is appropriate"); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041, 1044 (Or. 1972) (stating that "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof); Kmart Properties, Inc. v. Taxation and Revenue Dep't of N.M., 131 P.3d 27 (N.M. 2001); writ of cert. quashed by Kmart Corp. v. Taxation and Revenue Dep't of N.M., 131 P.3d 22, 50 (2005) (applying burden of proof to Department "to justify any modification of the UDITPA formula"); In the matter of the Protest of Wal-Mart Stores, Inc. ID No. 02-344332-00-4, No. 06-07 (N.M. Hearing Officer of Taxation and Revenue Dep't. 2006) (holding Department had burden of proof [a]s the party who wishes to depart from the standard three-factor formula under UDITPA).<sup>1</sup> CarMax knows of no case holding otherwise.

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<sup>1</sup> See also Tr. 413:19- 415:21; Ex. B, CarMax West's Proposed Order, at 11-12.

Indeed, the parties were in agreement at trial that this was the appropriate burden of proof. See Tr. at 443:3-9 (wherein SCDOR's attorney stated, "Your Honor, we do not disagree with Mr. von Lehe's discussion of our burden in this case. We welcome that burden. If we cannot show that they have not fairly represented their business in South Carolina, we should not be allowed to apply this statute."). CarMax also asserted that the proper standard was the "clear and convincing" standard. See The Limited Stores, 152 Cal. App. 4<sup>th</sup> at 1498 (stating that the party asserting alternative apportionment bears the burden of showing by "clear and convincing evidence" that alternative apportionment is appropriate). However, the Order summarily cites the standard rule as to both burden and standard with no discussion of the universally accepted exception as to the burden of proof or the fact that both parties agreed at trial that the standard rule did not apply.

Thus, CarMax West respectfully requests that the Court (1) reconsider the overwhelming authority in support of the exception to the general rule; (2) alter or amend its Order to place the burden of proof on SCDOR to show by clear and convincing evidence that the standard formula does not fairly represent CarMax West's in-state business activities and that SCDOR's alternative formula is reasonable and to conclude that SCDOR has failed to meet that burden; and (3) dismiss the assessments.

**B. The Court Failed to Expressly Find that CarMax West is a Unitary Business.**

One of the undisputed facts in this case, which was central to CarMax West's legal arguments, is that CarMax West (pre-reorganization) and CarMax West and CarMax Business Services, LLC ("CBS") (post-reorganization) are unitary businesses. CarMax West's witnesses testified at length as to the fact that the businesses are unitary, and CarMax West

introduced several exhibits in further support of this testimony. See Ex. B, CarMax West Proposed Order, at 6-7 (summarizing CarMax West employee's testimony regarding unitary aspects of businesses and CarMax exhibits on the same); 19 (summarizing testimony of CarMax West's experts who testified that the subject businesses are unitary). SCDOR presented no testimony or evidence to refute that the businesses are unitary.<sup>2</sup> Under South Carolina law, courts apply two tests to determine whether a business is unitary: the three unities test and the contribution and dependence test. CarMax West clearly established that the subject businesses are unitary under both tests, and SCDOR made no arguments to the contrary. See Ex. B, CarMax West's Proposed Order, at 17-20 (for full discussion of South Carolina law on the tests for determining whether a business is unitary and application of CarMax West's facts to that law). In the Order, the Court does not appear to consider or rule upon this issue; therefore, CarMax respectfully requests that the Court consider this issue and alter or amend its Order to make both factual and legal findings that the subject businesses are unitary.

**C. The Court Misapplied the Relevant Tests and Contradicted Established Precedent in Approving SCDOR's Deviation from the Standard Apportionment Formula.**

The Court appears to misconstrue CarMax West's position in this case regarding SCDOR's ability to employ an alternative method with respect to a unitary business. See generally, Ex. A, Order, at 9 (citing as inconsistent with CarMax West's position its expert's testimony that a unitary taxpayer whose business cannot be fairly represented by a standard formula is still subject to the provisions of an alternate apportionment formula under § 12-6-

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<sup>2</sup> SCDOR's witness testified that the entire CarMax group of companies constitutes a unitary business (Tr. 277:20-24 and 280:18- 281:1), and SCDOR's expert economist refused to answer whether or not the businesses are unitary as he believed this question was irrelevant. Id. at 395:19- 396:7.

2320). CarMax West does not contend that SCDOR may never deviate from the standard formula where a unitary business is involved. Rather, CarMax West argued at trial, and its expert witnesses so testified, that with respect to any deviation by SCDOR from the statutory apportionment formula: (1) § 12-6-2320 requires SCDOR to prove that a taxpayer's in-state activities are not fairly reflected by the standard formula and that its alternative method is reasonable; and (2) the Exxon case prohibits the use of separate accounting (the method employed by SCDOR) as an alternative method for a unitary business. See generally Tr. at 158:19- 159:12 and 171:16-25 (testimony of CarMax West's expert witness that alternative method must be reasonable and that separate accounting is not appropriate for a unitary business).

CarMax West respectfully requests that the Court (1) reconsider CarMax West's arguments and evidence regarding SCDOR's deviation from the statutory apportionment formula; (2) alter or amend its Order to conclude that SCDOR's method is prohibited in this case by § 12-6-2320 and Exxon; and (3) dismiss the assessment.

1. The Statutory Apportionment Formula Fairly Reflects CarMax West's In-State Business Activities.

Considerable evidence was introduced at trial, the majority of it uncontroverted, to support the conclusion that the standard apportionment formula fairly reflects CarMax West's business activities in South Carolina. It is not clear from the Order, however, whether the Court considered and ruled upon much of that evidence (which is summarized in Ex. B, CarMax West Proposed Order, at 20-23), including the following:

- The absence of any test or criteria employed by SCDOR to determine whether the standard apportionment formula fairly reflects a taxpayer's activity within the State and the resulting subjective and arbitrary nature of SCDOR's determination with respect to CarMax West;

- The failure by SCDOR to investigate the actual business activities and purpose of CarMax West and CBS, including whether they are unitary;
- The fact that CarMax West has a limited connection to and no presence in South Carolina;
- The fact that CarMax West receives no services and minimal benefits from the State of South Carolina;
- The fact that SCDOR's alternative formula results in CarMax West bearing a greater South Carolina tax burden than CarMax Auto Superstores, Inc. ("CarMax East"), the entity that actually has a substantial presence in South Carolina;
- The fact that CarMax West's disproportionate South Carolina tax burden contravenes the economic benefit principle, i.e., that those who receive greater benefits from public expenditures should have a higher tax burden than those who receive fewer benefits; and
- The irrelevance of SCDOR's "distortion example" in light of the very different relationships that CarMax West and CarMax East have to South Carolina.

In addition, in its Findings of Fact number 11, the Court found that "[t]he proposed alternative apportionment formula divided 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." Ex. A, Order, at 4-5 (emphasis added). CarMax West respectfully submits that the Court misunderstood what SCDOR's proposed alternative apportionment formula did. SCDOR did not determine a ratio (percentage) of the taxpayer's "apportionable income." Instead, it ignored the taxpayer's "apportionable income" as that term is generally used for tax purposes. That term is synonymous with corporate net income with appropriate South Carolina adjustments, which are not in issue in this case. A taxpayer's "apportionable income" is line two on the South Carolina corporate income tax return.

SCDOR did not impose a tax on a percentage of this income. It instead imposed a tax that had no relationship to the taxpayer's apportionable income by performing a separate accounting that attempted to divide the taxpayer's income sources and tax only what SCDOR believed to be a profitable portion of the business. By concluding that SCDOR imposed a tax on "the ratio of taxpayer's apportionable income which is taxable in South Carolina," the Court misunderstood what the SCDOR assessment has done.

CarMax West asks that the Court (1) reconsider the above discussed evidence; (2) alter or amend its Order to find that SCDOR failed to establish by clear and convincing evidence that the standard formula did not fairly reflect the in-state activities of CarMax West; and (3) dismiss the assessment.

2. SCDOR's Alternative Formula Is Unreasonable.

Considerable evidence was also introduced at trial to support the conclusion that SCDOR's alternative method is not reasonable, but it is not clear from the Order whether the Court considered and ruled upon much of that evidence (which is summarized in Ex. B, CarMax West Proposed Order, at 24-26), including the following:

- The absence of any test or criteria employed by SCDOR to determine an appropriate alternative formula and the resulting subjective and arbitrary nature of SCDOR's selection with respect to CarMax West;
- The lack of any evidence supporting SCDOR's alternative formula other than that it derives more tax revenue and that it is *possible* to identify which portion of CarMax West's unitary income is received from South Carolina;
- The lack of any benefits provided by the State that would justify a tax of this magnitude on a business with in-state activities as limited as those of CarMax West; and
- The gross distortion caused by separate accounting, which is reflected in the fact that SCDOR's alternative formula results in CarMax West bearing a

greater South Carolina tax burden than CarMax East, the entity that actually has a substantial presence in South Carolina.

Based on the above, CarMax West respectfully requests that this Court (1) reconsider these facts; (2) alter or amend its Order to find that SCDOR failed to establish by clear and convincing evidence that SCDOR's alternative formula was reasonable; and (3) dismiss the assessment.

3. The Exxon Case Prohibits SCDOR's Assessment.

CarMax West asserted at trial that South Carolina law prohibits separate accounting for the different income producing activities of a unitary business under Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979). As stated above, the Court may have misunderstood CarMax West's position on this point. To clarify, while separate accounting may be an option under the statute for some businesses, the Exxon case prohibits separate accounting as to unitary businesses. Id. Stated differently, SCDOR could propose any number of other alternatives under the statute as to a unitary business whose in-state activities are not fairly reflected by the standard formula; it simply cannot apply separate accounting. This proscription is independent of but entirely consistent with the second element of § 12-6-2320: it cannot be reasonable to undertake a separate accounting of one piece of a unitary business.

Although the Order quotes the key language from the Exxon case describing a unitary business as one that is comprised of components parts that are "too closely connected and necessary to each other to justify division or separate consideration as independent units" (see Ex. A, Order, at 10 (emphasis omitted)), it then does precisely what Exxon forbids by allowing SCDOR to apply separate accounting to unitary businesses. Thus, CarMax West respectfully requests that the Court (1) reconsider the holding and applicability of Exxon; (2)

alter or amend its Order to find that Exxon prohibits SCDOR's assessment; and (3) dismiss the assessment.

**D. Lockwood Green's "Place of Activity" Test Requires that CarMax West's Financing Receipts be Sourced Outside of South Carolina.**

In determining the state to which certain financing receipts should be sourced, this Court applied an "origin of payment" or "source of the borrower" test. In doing so, the Court rejected Lockwood Green Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), which adopted the "place of activity" test in a case involving an engineering firm. This Court appears to have relied on dicta of the South Carolina Court of Appeals in Lockwood Green stating that it was not convinced that a financing company would be comparable to an engineering firm. Ex. A, Order, at 12. CarMax West respectfully requests that the Court reconsider the appropriate test. The dicta regarding finance companies is not a compelling basis upon which to reject the "place of activity" test set forth in Lockwood Green because (a) the issue was not before the Court of Appeals and so was not thoroughly considered, and (b) neither CarMax West nor CBS is a finance company (CarMax West is a vehicle retailer and CBS is a management services company that includes a financing division).

When reconsidering this issue, CarMax West would also respectfully request that the Court consider and rule upon the following evidence and arguments presented at trial (which are set forth more fully in Ex. B, CarMax West Proposed Order, at 7-8 and 26-29):

- The fact that all activity related to servicing and handling of the retail installment contracts takes place outside South Carolina;
- The fact that this out-of-state activity by CBS associates provides added value; and

- The fact that sourcing to South Carolina income that is generated out-of-state contravenes the matching principle, i.e., that income should be matched to expenses.

Based on the above, CarMax West respectfully requests that this Court (1) reconsider the above facts and arguments; (2) alter or amend its Order to find that CarMax West established by a preponderance of the evidence that the financing receipts at issue should not be sourced to South Carolina; and (3) dismiss the assessment.

**E. SCDOR's Assessment Is Unconstitutional.**

In ruling in SCDOR's favor regarding the constitutional issues in this case, the Court does not appear to have considered or ruled upon the following Commerce Clause arguments made by CarMax West:

- SCDOR's alternative formula is unconstitutional because it taxes income with no connection to South Carolina;
- SCDOR's alternative formula is unconstitutional because it taxes income out of all proportion to CarMax West's business activities in South Carolina; and
- SCDOR's alternative formula is unconstitutional because it fails to fairly apportion CarMax West's South Carolina income.

In addition, the Court does not appear to have considered or ruled upon the following evidence supporting the above arguments:

- The fact that CarMax West has a limited connection to and presence in South Carolina;
- The fact that CarMax West receives no services and minimal benefits from State of South Carolina;
- The fact that SCDOR's alternative formula results in CarMax West bearing a greater South Carolina tax burden than CarMax East, the entity that actually has a substantial presence in South Carolina;
- The fact that CarMax West's disproportionate South Carolina tax burden contravenes the benefit principle, i.e., that those who receive greater

benefits from public expenditures should have a higher tax burden than those who receive fewer benefits; and

- The fact that the income at issue was produced by CarMax West's total unitary business activities and not solely attributable to its limited activities in South Carolina.

Based on the above, CarMax West respectfully requests that the Court (1) reconsider the above facts and arguments; (2) alter or amend its Order to find that CarMax West established by a preponderance of the evidence that the subject assessment results in an application of the alternate apportionment statute that is in violation of its constitutional rights; and (3) dismiss the assessment.

#### CONCLUSION

Based on the foregoing, CarMax West respectfully requests that this Court reconsider its rulings and alter or amend its Order to find in favor of CarMax West on all issues and dismiss SCDOR's proposed assessment in its entirety.

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: Bryson M. Geer

John C. von Lehe, Jr.

SC Bar No. 5719

E-Mail: [john.vonlehe@nelsonmullins.com](mailto:john.vonlehe@nelsonmullins.com)

Bryson M. Geer

SC Bar No. 13606

E-Mail: [bryson.geer@nelsonmullins.com](mailto:bryson.geer@nelsonmullins.com)

151 Meeting Street / Sixth Floor

Post Office Box 1806 (29402-1806)

Charleston, SC 29401-2239

(843) 853-5200

Attorneys for CarMax Auto Superstores West Coast, Inc.

Charleston, South Carolina  
May 3, 2010

CERTIFICATE OF SERVICE

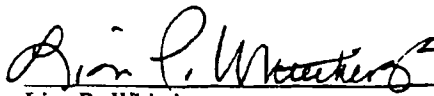
I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for CarMax Auto Superstores West Coast, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by having hand delivered, to the following address(es):

Pleadings:

MOTION FOR RECONSIDERATION UNDER ALC RULE  
29(D) AND/OR TO ALTER OR AMEND UNDER SCRCP  
RULE 59(E)

Counsel Served:

Michael Traynham, Counsel for Litigation  
Ray N. Stevens, Director  
Harry T. Cooper, Jr., Chief of Staff  
Nicholas P. Sipe, General Counsel for Litigation  
South Carolina Department of Revenue  
P.O. Box 12265  
Columbia, SC 29211



Lisa P. Whitehurst  
Administrative Assistant

May 3, 2010

**FILED**

MAY 03 2010

SC ADMIN. LAW COURT

FILED

APR 22 2010

STATE OF SOUTH CAROLINA  
ADMINISTRATIVE LAW COURT

SC 10-17-0160-CC

Carmax Auto Superstores West Coast, Inc., )  
 )  
Petitioner. )  
 )  
vs. )  
 )  
South Carolina Department of Revenue, )  
 )  
Respondent. )  
\_\_\_\_\_ )

Docket No.: 09-ALJ-17-0160-CC

FINAL ORDER AND DECISION

The Honorable Carolyn C. Matthews  
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 18<sup>th</sup> and 19<sup>th</sup>, 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?

EXHIBIT A

ROA\_000993

### 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.<sup>1</sup> 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.

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<sup>1</sup>The 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,<sup>2</sup> 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.

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<sup>2</sup>The 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 ratio<sup>3</sup> 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

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<sup>3</sup>The 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.<sup>4</sup> 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

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<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup>

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

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<sup>5</sup>The 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).

<sup>6</sup>The 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.<sup>7</sup> 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.<sup>8</sup> The term "unitary" is itself subject to a multitude of definitions and nuances – a taxpayer may be "unitary" in one sense, and yet be

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<sup>7</sup>The 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)).

<sup>8</sup>The 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.<sup>9</sup> 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.

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<sup>9</sup>Under § 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.<sup>10</sup> 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

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<sup>10</sup>The 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. McCannless, 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.**<sup>11</sup>

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.<sup>12</sup> 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.

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<sup>11</sup>The 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."

<sup>12</sup>The 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.<sup>13</sup>

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

##### **A. Commerce Clause.**

<sup>13</sup> 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).<sup>14</sup> 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.<sup>15</sup> Notwithstanding, this Court

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<sup>14</sup>Originally, 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.

<sup>15</sup>The 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:

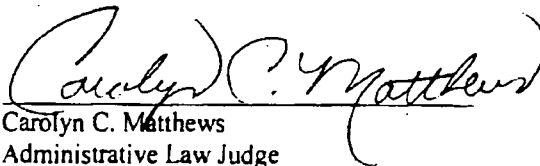
Turning to the question of multiple taxation and the Commerce Clause, the prevention of double taxation is, of course, the whole reason for apportioning income. . . . The record does not disclose what portion of Humble's income was taxed by all states

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

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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:*  
10. 10. 75 B. 10-1-75

STATE OF SOUTH CAROLINA  
ADMINISTRATIVE LAW COURT

|                                              |   |                                    |
|----------------------------------------------|---|------------------------------------|
| CarMax Auto Superstores West Coast,<br>Inc., | ) | Civil Action No. 09-ALJ-17-0160-CC |
|                                              | ) |                                    |
|                                              | ) |                                    |
| Petitioner,                                  | ) |                                    |
|                                              | ) |                                    |
| vs.                                          | ) | <b><u>FINAL ORDER</u></b>          |
|                                              | ) |                                    |
| South Carolina Department of Revenue,        | ) |                                    |
|                                              | ) |                                    |
| Respondent.                                  | ) |                                    |
| <hr/>                                        |   |                                    |

**APPEARANCES:** For the Petitioner: John C. von Lehe, Jr., Esquire  
Bryson M. Geer, Esquire

For the Respondent: Michael S. Traynham, Esquire  
Lynn M. Baker, Esquire

**STATEMENT OF THE CASE**

This matter comes before the Administrative Law Court (ALC or Court) pursuant to the request of Petitioner CarMax Auto Superstores West Coast, Inc. ("CarMax West" or the "Taxpayer") for a contested case hearing under S.C. Code Ann. § 12-60-460 (Supp. 2008). CarMax West is protesting an assessment of corporate income taxes from the South Carolina Department of Revenue ("SCDOR" or the "Department") for the income tax years ending in 2002, 2003, 2004, 2005, 2006 and 2007. A hearing was held before me on February 18 and 19, 2010, at the offices of the ALC.

The following chart appears in SCDOR's amended audit report in this matter and summarizes the amounts in dispute:

**EXHIBIT B**

ROA\_001011

APP\_01021

*INCOME TAX: Schedule A*

| PERIOD ENDED: | INCOME TAX       | INTEREST        | PENALTY         | TOTALS           |
|---------------|------------------|-----------------|-----------------|------------------|
| Feb-02        | \$59,517         | \$32,997        | \$34,354        | \$126,868        |
| Feb-03        | \$72,706         | \$34,123        | \$38,873        | \$145,702        |
| Feb-04        | \$68,703         | \$27,795        | \$34,508        | \$131,006        |
| Feb-05        | \$36,133         | \$12,209        | \$16,944        | \$65,286         |
| Feb-06        | \$94,544         | \$23,842        | \$40,284        | \$158,670        |
| Feb-07        | <u>\$107,924</u> | <u>\$16,984</u> | <u>\$40,869</u> | <u>\$165,777</u> |
| TOTALS:       | \$439,526        | \$147,950       | \$205,832       | \$793,308        |

See Tr. Ex. 29, Amended SCDOR Audit Report at 14. SCDOR audited the returns at issue and issued an additional assessment, which the Taxpayer timely protested. See Tr. Ex. 2, CarMax West Notice of Protest. Following a conference, SCDOR issued a Department Determination upholding the additional assessment. See Tr. Ex. 3, SCDOR Department Determination. The Taxpayer timely requested a contested case hearing before this Court.

**LEGAL ISSUES RAISED**

The following legal issues have been presented to this Court: (1) whether SCDOR can properly change the statutorily mandated income tax apportionment method used by the Taxpayer and instead impose an "alternative method," which is a form of separate accounting that is not based on the Taxpayer's total net income; (2) whether SCDOR properly sourced financing receipts to South Carolina where the business activities related to those receipts were performed in another state; (3) whether SCDOR properly assessed penalties against the Taxpayer; (4) whether the alternative method proposed by SCDOR or its assessment of a penalty against Taxpayer in this case violated Taxpayer's constitutional rights.

In addition, the primary legal issue in the case regarding whether SCDOR can properly change the statutorily mandated income tax apportionment method used by the Taxpayer (issue (1) above) involves the following sub-issues: (a) whether the Taxpayer

operated a unitary business; (b) whether the standard apportionment formula fairly reflects the in-state business activities of the Taxpayer; and (c) whether the alternative method proposed by SCDOR is reasonable.

### **FINDINGS OF FACT**

Having taken evidence and observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of persuasion and the credibility of witnesses, I make the following findings of fact, most of which were uncontested, by a preponderance of the evidence.

#### **I. Formation of CarMax**

CarMax, Inc. ("CarMax") was formed in 1996 and is the nation's largest specialty retailer of used cars and light trucks. Tr. at 37:18-19; 39:8. Its primary business is to purchase, recondition, market, sell and finance used cars and trucks. It was originally formed as a subsidiary of Circuit City Stores, Inc. ("Circuit City"). Id. at 37:12-17. In 2002, Circuit City's shareholders approved the separation of CarMax from Circuit City. Id. at 39:18-21. CarMax is now a separately held, publicly traded holding company. Id.

#### **II. Corporate Structure of CarMax Group**

CarMax was created with and inherited upon its spin-off a corporate structure that mirrored Circuit City's structure: CarMax operated as a holding company and wholly owned two operating entities, CarMax West, the Taxpayer, which sold used vehicles in the western United States and owned substantially all of CarMax's intellectual property, and CarMax Auto Superstores, Inc. ("CarMax East"), which sold used vehicles in the eastern and mid-western states (where most of CarMax's retail operations were at the time) and provided the group's corporate, back office support and finance functions. Tr. at 40:16- 41:4

The inherited corporate structure was not common to the car sales industry and began to cause numerous problems, particularly on the financing side, ranging from creating confusion amongst regulatory agencies and potential investors of the retail installment contracts to licensing issues. See id. at 47:8- 50:10. Thus, in 2004, CarMax management determined that certain changes to the corporate structure/organization would be beneficial to the business, and it created CarMax Business Services, LLC ("CBS") to: (1) house the financing functions/operations (CarMax Auto Finance or "CAF") for the CarMax business group; and (2) own the intellectual property and provide certain shared services to the companies in the group. Id. at 43:2-15. The first change, which separated the financing functions from the retail operations, made the sale and/or securitization process for vehicle financing contracts less cumbersome, lessened confusion for regulators, simplified the regulatory compliance process and provided greater liability protection for the separate businesses. Id. at 47:8- 50:10. The second change brought about greater efficiencies and cost savings across all of the CarMax entities by centralizing general management functions, including human resources, information systems, finance and accounting; retail functions, including real estate support services, strategic analysis, advertising and marketing (including the CarMax website); and intangible asset management for various intellectual property, trademarks and trade names, marketing programs, customer data, etc. Id. at 51:18- 53:14. The above evidence presented at trial showed that CBS was formed for valid business reasons, and there was no evidence presented to the contrary. SCDOR has attempted to suggest or create a presumption that the primary purpose of CarMax's restructuring was to create a tax advantage and further suggested that CarMax West realized significant tax savings as a result, but there is no actual evidence in the record to support either finding.

CBS was created as a multi-member limited liability company (taxed as a partnership) between CarMax West and CarMax East, with CarMax West contributing the intellectual property and CarMax East contributing the financing operations and certain other corporate assets. Tr. at 42:14-21 and 46:23-25. An independent study was performed by an accounting firm to determine the value of the contributions to CBS (see id. at 43:19-25), which in turn determined their respective ownership interests in CBS-- CarMax West owns 93.5% while CarMax East owns 6.5%. Id. at 44:8-10.

CBS then charged CarMax West and CarMax East a per vehicle management services fee, also determined by an independent study, which includes an intellectual property royalty component. The revenues from the management fees flowed up to CarMax West and CarMax East as a result of their interests in CBS. CBS also generated financing income through CAF. Id. at 46:15-20.

### **III. CarMax West's Connection to South Carolina**

As the CarMax West representative testified at trial, CarMax West sells cars in the western United States and does no business in South Carolina. Tr. at 56:24-57:8. It has no employees, no facilities and no tangible property in South Carolina. Id. at 57:2-6. Due to the absence of a physical presence in the state, it receives no real services or benefits from the State of South Carolina. See id. at 57:9-11. Its only connection to South Carolina is the payments it has received from CarMax East for the use of the CarMax intellectual property that is used by CarMax East to sell cars in South Carolina (via payments directly to CarMax West from 2002-2004 and, subsequently, via its partnership interest in CBS which received such payments from CarMax East). Id. at 57:12-58:6.

**IV. Unitary Facts Regarding CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization)**

A review of the organization, systems and operations of CarMax West shows that it was a unitary business pre-reorganization (2002-2004) and that CarMax West and CBS together were a unitary business post-reorganization (2005-2007). The companies have shared ownership and management. Tr. at 58:20-60:9; Ex. 8, CarMax FY 2005 Officers and Directors List. They also have a number of shared services and systems that create efficiencies and cost savings across the companies, including centralized general management functions (such as human resources, information systems, finance and accounting), retail functions (including real estate support services, strategic analysis, advertising and marketing), and intangible asset management (for various intellectual property, trademarks and trade names, marketing programs and customer data). Tr. at 51:18-53:14; see also Ex. 7, Sample CarMax, Inc. Annual Report. The various activities of the CarMax companies, including retail sales, financing, marketing and intellectual property management, contribute to and depend upon one another. Id. at 61:19-24; see also Ex. 7, Sample CarMax, Inc. Annual Report. For example, as CarMax sells more cars, the value of its intellectual property increases, and as the value of the intellectual property increases and the brand becomes more well-known, CarMax sells more cars. Id. at 61:1-17. Similarly, because CarMax can offer financing options to customers through CAF, it is able to sell more cars, and CAF is able to make loans because it has access to the CarMax customers. Id. at 61:18-62:19.

Furthermore, the centralization and integration of the companies is apparent both in how the companies hold themselves out to the public-- all are known simply as "CarMax"-- (id. at 56:11-17; Ex. 7, Sample CarMax, Inc. Annual Report) and how the

companies share the fruits of their labors-- all income earned by CarMax entities is placed in a general account and is used for the benefit of the entire CarMax group of companies. Tr. 60:21-61:7.

Finally, CarMax West's expert in state and local tax, tax accounting and tax policy testified that from a tax accounting standpoint, CarMax West pre-reorganization and CarMax West and CBS post-reorganization were unitary businesses. Id. at 138:8- 139:9. Similarly, CarMax West's expert economist testified that from an economic standpoint, CarMax West pre-reorganization and CarMax West and CBS post-reorganization were unitary businesses. Id. at 182:11- 183:14 (citing common ownership and management, vertical integration, economies and efficiencies, and interdependence among business units in support of his conclusion) and 184:7-21. SCDOR provided no testimony or evidence to refute that the businesses were unitary.<sup>1</sup>

#### V. Financing Receipts Income

As previously mentioned, CBS generates income through the financing activities of CAF. When a vehicle is sold in South Carolina, all income from that sale (in the form of cash and a retail installment contract generated at the store and immediately sold/assigned to CBS (CAF) or a third party finance company) is reported in South Carolina by CarMax East and is taxed by South Carolina. See Tr. at 86:6-11. To use a simple example, if CarMax East sells a car in South Carolina for \$20,000, with \$5,000 down and \$15,000 financed, CarMax East records and reports \$20,000 in revenue in South Carolina. Subsequent activity related to handling and servicing these loans *after* the initial sale takes place *outside the state of South*

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<sup>1</sup> SCDOR's witness testified that he thought that the entire CarMax group of companies was a unitary business (Tr. 277:20-24 and 280:18- 281:1), and SCDOR's expert economist refused to answer whether or not the businesses were unitary as he believed this question was irrelevant. Id. at 395:19- 396:7.

*Carolina*. Id. at 89:15-22. As noted above, CarMax East immediately assigns all retail installment contracts for financed vehicles to a third party finance company or to CBS. CBS associates located in Georgia then service and securitize the contracts assigned to CBS. Id. at 86:20- 88:5 and 89:15-21. I find that these employees provide added value, which, in turn, produces additional revenue, all of which is earned out-of-state. Id. at 90:12-15.

#### **VI. Tax Returns, Audit and Determination**

CarMax West filed the tax returns at issue using the standard apportionment method for multi-state taxpayers. CarMax West's witness testified that she reviewed and supervised the preparation of the subject tax returns. Id. at 64:17-19. She further testified that CarMax West followed the tax return instructions and the guidance in the returns themselves in applying the statutorily mandated standard apportionment formula. Id. at 68:4-9, 69:14- 25 and 70:16-21; see also Ex. 4, CarMax West Amended Tax Returns, 2002-2007; Ex. 5 Sample SCDOR Corporate Tax Return Instructions. More specifically, CarMax West started with its *federal taxable income*. Tr. at 64:20-25. This is dictated by the tax return (on line 1) and the instructions, which both provide that the starting point for determining taxable income in South Carolina is federal taxable income. See Ex. 6, Sample SCDOR Corporate Tax Return Instructions, at p. 5, line 1; Ex. 4, CarMax West Amended Tax Returns 2002-2007. CarMax West then made South Carolina adjustments to derive its net income as reconciled (also known as apportionable net income). Tr. at 65:1-22. CarMax West then used the statutory apportionment formula to calculate an apportionment fraction of South Carolina receipts over total everywhere receipts. Id. at 65:24-66:17. Id. The fraction was then multiplied by the net income as reconciled (or apportionable net income). Id. at 66:19-23. The result was the South

Carolina net income, which was then multiplied by the tax rate to arrive at the amount of income tax due. Id. at 66:25-67:2.

SCDOR rejected the statutory method and instead applied what it calls an "alternative method," which is not based on federal taxable income as a starting point. Ex. 1, SCDOR Report of Field Audit; Tr. at 75:4-9. The alternative method seeks to separate and tax only the Taxpayer's royalty receipts. Tr. at 75:4-9 and 75:20- 76:10. The impetus for using the alternative method appears to be that the auditor noticed that the CarMax group of companies had an East Coast/West Coast structure. See id. at 245:16- 246:12. The audit supervisor testified that sometimes other taxpayers employ organizational structures like this in order to distort income and, thus, this raises "red flags" for SCDOR. Id. However, before performing any investigation into the actual reasons for CarMax West's organizational structure, the auditor concluded that CarMax was operating a "royalty scheme" and sent out a draft audit report so stating, assessing additional taxes and imposing penalties. See Ex. 1, SCDOR Report of Field Audit, at 5; Tr. 72:21- 73:15. As part of the report, SCDOR created a "distortion" example, which allegedly shows that the inclusion of western car sales in the denominator of the gross receipts formula (i.e. Taxpayer's unitary gross income) distorts the Taxpayer's South Carolina income. Ex. 1, SCDOR Report of Field Audit, at 8. However, SCDOR presented no substantive evidence to show that the South Carolina income actually was distorted.<sup>2</sup> Moreover, the proposed audit adjustment imposes a tax on CarMax West of

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<sup>2</sup> The only arguable evidence SCDOR produced consisted of two examples: The first was a hypothetical that I found inadmissible because it was not related to the facts of the case and its relevance was not shown and the second was a copy of the separate accounting calculation that was used as the basis of the audit report. I find this separate accounting to be precluded by established South Carolina tax law. Exxon Corporation v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979). However, even if it were not, it amounts to nothing more than a tax on royalties during the pre-reorganization years and a tax on the partnership income of CBS during the post-reorganization years. If South Carolina wishes to impose a royalty or partnership tax, it can do so through the legislative process, but SCDOR lacks the constitutional authority to do so through S.C. Code Ann. §12-6-2320.

\$102,303, which is greater than the tax imposed on CarMax East (\$94,452), the entity that is actually operating a substantial business in South Carolina. See Ex. 31, SCDOR Distortion Example for FY 2006.

In addition, after the corporate reorganization in December 2004, via its ownership interest in CBS, CarMax West received income from financing operations performed by CAF. Tr. at 43:2-15; 46:15-47:7. It included the financing income only in the total net income in the subject returns but did not source any to South Carolina because all CAF operations related to financing were performed outside the state of South Carolina. Tr. at 67:13-24. In the audit report, SCDOR assessed additional taxes on CarMax West based on SCDOR's position that the financing income should be sourced to the state where the customer making payments on the loan resides. Tr. at 262:9-12; see also Ex. 1, SCDOR Report of Field Audit; Ex. 29, Amended SCDOR Audit Report.

#### **VII. Penalties Assessed by SCDOR**

SCDOR assessed penalties against CarMax West based on both negligence and substantial understatement, which totaled \$205,832. Ex. 29, Amended SCDOR Audit Report, at 14. 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, and, in fact, SCDOR's witness at trial believed SCDOR had no ability under the law *not* to assess a substantial understatement penalty. Tr. 263: 3-6 (testifying that the statute says "must" and, thus, SCDOR has no discretion).

In addition, as previously stated, 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. Tr. at 91:10-13. 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. 2007); Ex. 5, Sample SCDOR Corporate Income Tax Instruction; Ex. 4, CarMax West Amended Tax Returns 2002-2007. 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. Tr. at 91:14-17.

### **CONCLUSIONS OF LAW**

#### **General Conclusions**

S.C. Code Ann. § 1-23-600 grants jurisdiction to this Court to hear contested cases under the Administrative Procedures Act. Additionally, S.C. Code Ann. § 12-60-470(f) and 12-60-460 grant the Administrative Law Court the authority to conduct contested case hearings in matters concerning claims for refunds and assessments.

#### **Burden of Proof**

Ordinarily it is the taxpayer's burden to rebut an assessment; however, in this case, SCDOR bears the burden of showing why the standard apportionment formula should not be followed. Although S.C. Code Ann. § 12-6-2320 and South Carolina case law are silent on who has the burden of proof in regard to the use of an alternative apportionment formula, there is "universal authority" amongst other states that have adopted the Uniform Division of Income for Tax Purposes Act's alternative apportionment provision, which is identical to the South

Carolina provision, requiring the party seeking an alternative apportionment method to show by clear and convincing evidence that the standard formula is not a fair representation and that its proposed alternative is reasonable. See Union Pacific Corp. v. Tax Commission, 83 P.3d 116 (Id. 2004); St. Johnsbury Trucking Co. v. New Hampshire, 385 A.2d 215 (N.H. 1978); Amaco v. Arnold, 518 P.2d 453 (Kan. 1974); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041 (Or. 1972); Kennecott Copper Corp. v. State Tax Comm'n., 493 P.2d 632 (Utah 1972); The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491 (Cal. Ct. App. 2007). The parties were in agreement at trial that this is the appropriate burden of proof. See Tr. at 443:3-9. Thus, the Department must establish by clear and convincing evidence that the standard apportionment formula is not a fair reflection of CarMax West's business activities in South Carolina and that the alternative apportionment method it proposes is reasonable.

#### Preliminary Conclusions of Law

1. Clear and convincing evidence has been presented that (a) pre-reorganization (2002-2004), the Taxpayer was a unitary business and the royalty income from CarMax East was unitary income to CarMax West; and (b) post-reorganization (2005-2007), CarMax West and CBS were unitary and the income paid by CBS to CarMax West was unitary income. Moreover, SCDOR presented no evidence that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) were not unitary. Thus, I find the business of CarMax West prior to the reorganization to have been a unitary business and the income from the royalty payments a part of that unitary income. After the reorganization, CarMax West, the Taxpayer, and CBS were unitary with respect to each other and the income received by CarMax West from CBS was unitary income to CarMax West.

2. SCDOR has presented no credible evidence, much less clear and convincing evidence, that the income tax apportionment formula does not fairly reflect the Taxpayer's business activities in South Carolina. The only evidence presented by SCDOR was its alternative calculation. It gave no reason to substantiate or support why it was correct except to say that it derived more tax revenue for the State of South Carolina than the statutory method. Moreover, the Taxpayer presented compelling evidence that the standard tax apportionment method it used does fairly reflect its business activities in South Carolina.

3. SCDOR presented no credible evidence, and certainly not clear and convincing evidence, that its alternative method is reasonable, and, to the contrary, the Taxpayer presented compelling evidence that the alternative method is not reasonable and does not fairly reflect its business activities in South Carolina.

4. It was uncontested that the business activities of CBS post-initial sale of CarMax East vehicles are performed by CBS employees located outside the state of South Carolina. Pursuant to Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), post-sale receipts should also go to the state where the activities took place (in this case Georgia) because that is where the value was added.

5. SCDOR has provided no basis to impose either a substantial understatement penalty or a negligence penalty on the Taxpayer. CarMax West acted in good faith and with reasonable cause and substantial authority in following the tax return instructions, the tax return forms themselves and the mandatory statutory apportionment method in preparing and submitting its returns, and, therefore, a substantial understatement penalty cannot be applied. SCDOR has produced no guidance for determining when an alternate apportionment formula should be used. Therefore, CarMax West could not have

determined that it should use the alternative method SCDOR now proposes, and, thus, it could not have acted negligently.

6. SCDOR's alternative method (which is unpublished and has no standards or criteria as to when it applies) as applied to this taxpayer taxes CarMax West out of all proportion to its income and to its business activities in the state of South Carolina and therefore violates CarMax West's constitutional rights under the Commerce Clause of the United States Constitution. In addition, the imposition of penalties under the circumstances in this case violates CarMax West's due process rights under both the United States and South Carolina Constitutions.

### Discussion

#### **I. Proper Income Tax Apportionment Method**

The central issue in this case is the proper method to use in determining the share of CarMax West's unitary income that should be taxed by this state during the audit period (tax years ending 2002 through 2007). Taxpayer asserts that under South Carolina law, the standard statutory method of income tax apportionment as applied to its unitary corporate net income, which consists of a portion of its total multi-state net income, should be applied. CarMax West filed the subject returns based on its federal taxable income as adjusted and using the single factor gross receipts formula contained in S.C. Code Ann. § 12-6-2290 (Supp. 2007).<sup>3</sup> More specifically, CarMax West's South Carolina receipts, which included income from royalties for all audit years, were divided by CarMax West's total receipts, and this

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<sup>3</sup> CarMax initially filed its returns using the three factor method but amended them prior to trial to use the single factor method. Thus, whether CarMax should use the three factor versus single factor method is not at issue in this case.

statutorily defined fraction was applied against its unitary apportionable net income. See S.C. Code Ann. § 12-6-2290 (Supp. 2007).

SCDOR has rejected this statutory apportionment method in favor of what it terms an "alternative method" of apportionment of income. This customized method, which seeks to separate a portion of the Taxpayer's income and tax only a portion of it (thereby ignoring its total unitary income), is an unprecedented action by the Department. A similar method was attempted by a taxpayer in Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); however, the Department opposed the method and the South Carolina Supreme Court held that the multi-state oil corporation taxpayer could not divide its unitary income producing activities and exclude from taxation in South Carolina all income related to its exploration and production activities. Id. Now, in this case, it is the Department who seeks to isolate and tax only a portion of this taxpayer's unitary income, in contravention of its predecessor's position in Exxon and the well-established law in this State.<sup>4</sup>

Under South Carolina law, an alternative method of apportionment is only authorized when the standard method does not properly reflect the extent of a taxpayer's income-producing activities in South Carolina. See S.C. Code Ann. § 12-6-2320(A) (2000 and West Supp. 2009). As the United States Supreme Court has explained, formulary apportionment is presumed to be fair and reasonable (see Butler Bros. v. McColgan, 315 U.S. 501 (1942)), while separate or formal accounting is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Container Corp. of

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<sup>4</sup> See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989).

America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983). This is particularly true when the taxpayer operates a unitary business. The income generated by the various components of a unitary business cannot be accurately accounted for individually as it is "attributable to all incidents of the business and not to any single activity." See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 599, 258 S.E.2d 93, 96 (1979), quoting Covington Fabrics v. S.C. Tax Comm'n, 264 S.C. 59, 212 S.E.2d 574, appeal dismissed, 423 U.S. 805 (1975).<sup>5</sup> See also Tr. at 187:13-18 (testimony of CarMax West's expert economist that because of the interdependence of the business units, applying separate accounting to a unitary business is likely to lead to errors in calculating income and tax); Id. at 132:13- 133:15 (testimony of CarMax West's tax accounting expert that errors in accounting for the various individual components of a unitary business result because of "the interrelationships between the members of the unitary group," which can result in the sum of all the parts being greater than the whole).<sup>6</sup>

Moreover, an alternative formula should only be used in "unique and non-recurring" circumstances. See Tr. Ex. 6, Uniform Division of Income for Tax Purposes Act ("UDITPA") (and related regulations); Donald M. Drake Co. v. Department of Revenue of

<sup>5</sup> The holding in Exxon is established law in South Carolina and is in accord with SCDOR's own regulations. See S.C. Code Ann. Regs. § 117-710.1 (West Supp. 2009) (providing that a "taxpayer operating a unitary or homogenous business within and without the state and an unrelated business either entirely within or without is subject to apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business").

<sup>6</sup> While some of the flows of value between and among CarMax West and CBS may be quantified in the amount of the management fee, there are inevitably many more "subtle and largely unquantifiable transfers of value" that are not. Container Corp., 463 U.S. at 164-65. See also Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 603-604, 258 S.E.2d 93, 98 (S.C. 1979) (quoting Butler Bros. v. McCollgan, 315 U.S. 501, 507 (1942)) (finding arguments of the Tax Commission that "transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income" persuasive and stating that "[a]ccounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.").

State of Oregon, 500 P.2d 1041, 1043 (Or. 1972) (stating that "the apportionment method is now the general rule and any other system, including the segregated method, is the exception); St. Johnsbury Trucking Co., Inc v. State of New Hampshire, 385 A.2d. 215, 217 (N.H. 1978), quoting William J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747, 781 (1957) (stating that an alternative method is the exception and "departures from the basic formula should be avoided except where reasonableness requires").<sup>7</sup>

Finally, the alternative method proposed by the Department must be reasonable. S.C. Code Ann. § 12-6-2320. Thus, in this matter, the Court must consider whether SCDOR established by clear and convincing evidence that the statutory method did not fairly reflect the business activities of the Taxpayer in South Carolina as well as whether SCDOR established by clear and convincing evidence that its alternative method is reasonable. Because both of these issues are impacted by the issue of whether the Taxpayer operated a unitary business, the Court will consider that issue first.

#### A. Unitary Business

In determining whether a business is unitary, South Carolina courts apply two main tests: (1) the three unities test; and (2) the contribution-dependence test. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. These tests are not mutually exclusive, and the courts often apply both. Id.; see also Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 789 (1992) (discussing unitary business tests of "functional integration, centralization of management, and economies of scale"). Under the three unities test, courts look at whether the business or businesses have unity of ownership, unity of management and unity of

<sup>7</sup> See also Tr. at 145:9-16 (testimony of CarMax West's state and local tax and tax accounting expert stating that UDITPA limits the use of an alternative formula to "unique and non-recurring situations" and should be done on an "exception basis").

operation. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. Under the contribution-dependence test, the court considers whether the "activities of the business in question contribute to or depend on the other activities of the business." Exxon, 273 S.C. at 600, 258 S.E.2d at 96. The courts do not require that it be "necessary" or "essential" that the business or businesses be operated together; cost savings or increased profits gained by operating together are acceptable reasons. Exxon, 273 S.C. at 599-601, 258 S.E.2d at 96-97.

For example, in Exxon, the court found that the taxpayer operated a unitary business where, among other things, it held itself out to the public as one company; it employed central staff on which all companies were dependent; it used centralized purchasing techniques that resulted in cost savings throughout company; it had strong, centralized management over all segments of company; the structure provided profit stability, reduced risk and insured full capacity utilization of company's facilities; it made no attempt to segregate earnings or funds of the various segments; and the various operating activities of the company of exploration, production, refining and marketing contributed to and depended upon each other. The Court held that the taxpayer satisfied both the three unities test and the contribution-dependence test. Exxon, 273 S.C. at 602, 258 S.E.2d at 97.<sup>8</sup>

In the case at hand, the income of CarMax West (pre-reorganization) and CarMax West and its share of CBS income (post-reorganization) are unitary. The following

<sup>8</sup> See also Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992) (finding that multi-national camera and film corporation that was also doing safe harbor lease transactions involving tangible personal property was a unitary business not capable of separation where only a small portion of leased assets were in South Carolina, the funding for the leasing came from the general corporate treasury and the income benefited the company as a whole); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977) (finding multi-state oil and gas company that also contracted on a royalty basis with third parties to mine salt and sulphur discovered on prospective oil lands was a unitary business where salt and sulphur was discovered during oil exploration process, which was an integral part of the business); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989) (finding affiliated New York textile manufacturing companies that also earned interest income from inter-company loans and from repurchasing own bonds on open market were unitary where funding for leasing came from general corporate treasury, interest income and loan payments were deposited in general company accounts and used for normal business operations, and income benefited company as a whole).

facts presented at trial through the testimony of CarMax's witness support this conclusion: the companies have shared ownership and management; the companies have a number of shared services and systems that create efficiencies and cost savings across the companies, including centralized general management functions (such as human resources, information systems, finance and accounting), retail functions (including real estate support services, strategic analysis, advertising and marketing), and intangible asset management (for various intellectual property, trademarks and trade names, marketing programs, customer data); CarMax entities hold themselves out to the public as simply "CarMax;" all income is placed in a general account and is used for the benefit of the CarMax group of companies as a whole; the various activities of the companies, including retail sales, financing, marketing and intellectual property management contribute to and depend on one another; and the company is functionally integrated. See Tr. at 51:18- 53:14; 58:20- 60:9; 61:1- 62:19; see also Ex. 8, CarMax FY 2005 Officers and Directors List; Ex. 7, Sample CarMax, Inc. Annual Report.

In addition, both CarMax West's expert economist and expert tax accountant testified that from an economic standpoint and a tax accounting standpoint respectively, the businesses at issue were unitary. See Tr. at 138:8- 139:9 (testimony of expert tax accountant) and 182:11- 183:14; 184:7-21 (testimony of expert economist). Moreover, the above evidence and testimony regarding the unitary nature of the businesses was un rebutted.<sup>9</sup>

Therefore, based on the overwhelming and uncontested evidence, I find that CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization) are

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<sup>9</sup> As previously stated, SCDOR's witness testified that he thought that the entire CarMax group of companies was a unitary business (Tr. 277:20-24 and 280:18- 281:1), and SCDOR's expert economist refused to answer whether or not the businesses were unitary as he believed this question was irrelevant. Id. at 375:15-22 and 395:19-396:7.

unitary businesses, and the royalty and financing income produced thereby constitutes unitary income of the Taxpayer.

**B. The Standard Apportionment Formula**

As previously stated, SCDOR bears the burden of establishing by clear and convincing evidence that the standard apportionment formula does not fairly reflect the business activities of the Taxpayer in South Carolina.<sup>10</sup> Not only does SCDOR fail to carry this burden, but I find that the Taxpayer established that the standard method does fairly reflect its business activities in South Carolina.

In order to determine whether the standard formula fairly reflects a taxpayer's in-state business activities, one would expect to find a test or criteria to apply to this question. No such guidance exists. SCDOR presented no evidence of any criteria (published or unpublished) that exists for SCDOR, taxpayers or this Court to follow on how to determine whether the standard formula fairly reflects a taxpayer's in-state business activities. Instead, it appears to be done on a case-by-case basis with the auditors making their own subjective determinations.

In this case, SCDOR's witness testified that auditors are instructed to look for companies that have East Coast/West Coast structures. See Tr. 242:20- 243:13. He further testified that SCDOR believes that sometimes other taxpayers employ organizational structures like this in order gain tax savings and, thus, this structure raises "red flags." Id. at 245:16-246:12. However, before visiting CarMax or performing any investigation into the reasons for

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<sup>10</sup> See supra, Burden of Proof Section, citing Union Pacific Corp. v. Tax Commission, 83 P.3d 116 (Id. 2004); St. Johnsbury Trucking Co. v. New Hampshire, 385 A.2d 215 (N.H. 1978); Amaco v. Arnold, 518 P.2d 453 (Kan. 1974); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041 (Or. 1972); Kennecott Copper Corp. v. State Tax Comm'n., 493 P.2d 632 (Utah 1972); The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491 (Cal. Ct. App. 2007).

CarMax West's organizational structure, the auditor immediately concluded that CarMax was operating a "tax scheme." See Ex. 1, Report of Field Audit. In support of his conclusion, he created a "distortion" example, which allegedly shows that the inclusion of western car sales in the denominator of the gross receipts formula distorts CarMax West's South Carolina income. Id. The auditor then sent proposed assessments of additional taxes owed as well as penalties owed to the Taxpayer in "audit papers" *prior to* the actual field audit being performed. See Tr. 72:21- 73:15.

Had the auditor performed an investigation prior to reaching the aforementioned conclusion, he could have learned that CarMax West had valid business reasons for its structure. See Tr. at 47:8- 50:10. Additionally, SCDOR presented no substantive evidence to show that the Taxpayer's South Carolina income was distorted. Its only support for the alternative formula appears to be the distortion example, which simply shows that CarMax East, which does substantial business in South Carolina, has a higher income in South Carolina. SCDOR did not explain how this comparison was meaningful, and, in fact, one would expect CarMax East to have significantly higher income (and thus higher tax revenue) in South Carolina because it has a much greater level of business activity in South Carolina. Nothing about the fact or amount of this difference in income strikes this Court as meaningful or provides a legal basis for SCDOR to deviate from the standard formula.

In addition, despite the South Carolina Supreme Court's ruling in Exxon that the income of a unitary business is not subject to apportionment, the auditor does not appear to have considered whether the Taxpayer operated a unitary business; in fact, its expert economist stated that whether the Taxpayer was unitary was irrelevant. Tr. at 395:19- 396:7. SCDOR's position appears to be that Exxon is merely instructive and does not create any bright line rule

that unitary businesses are not subject to alternate methods under S.C. Code Ann. § 12-6-2320. SCDOR misunderstands the nature and effect of the Exxon holding, which permits a unitary business to be subjected to an alternate method but prohibits the use of a method that separates the units or activities of an otherwise unitary business. SCDOR presented no evidence to support its theory that isolated portions of the Taxpayer's unitary income should be separated or can be accurately separated or to show that the receipts at issue are produced solely by the Taxpayer's activities in South Carolina.<sup>11</sup> In addition, although it attempted to insinuate throughout the trial that the Taxpayer realized significant tax savings from its business structure, it offered no evidence to support this contention.

On the other hand, the Taxpayer presented substantial evidence that the standard formula does fairly reflect its activities in South Carolina. First, it presented evidence that its in-state activities are minimal and that it receives minimal benefits from the State of South Carolina. As CarMax West's expert economist testified, an important tax policy goal is that the taxpayers who are benefiting from government services are the ones helping to pay for those services. Tr. 186:21- 186:4. For example, the gasoline tax is used to help build more roads, bridges, etc.; those using the roads more buy more gas and thus pay a larger share of those taxes, which they then benefit from via new roads and bridges. Id. at 186: 5-15. CarMax West's tax burden should have some relation to the benefits received from South Carolina, and because it receives few benefits, its tax burden should be correspondingly low.

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<sup>11</sup> Although not evidence, SCDOR's expert economist attempted to justify separation of the Taxpayer's activities (and thus income) through an "apples and oranges" metaphor with the apples in this case being the royalty payments and the oranges being the retail car sales. He contended that you should not mix the apples with the oranges, i.e. the royalty income with the retail sales income. Tr. 330:9- 331:9. This reasoning is flawed and is contrary to South Carolina law on unitary businesses. Similar arguments were made in the Exxon case with the apples being the oil production and refineries and the oranges being the gas pumps and stations. The South Carolina Supreme Court rejected this type of reasoning and held that the income of a unitary business cannot be separated in this manner. Exxon Corp. v. S.C. Tax Comm'n., 273 S.C. 594, 258 S.E.2d 93 (1979).

In addition, the testimony and evidence presented by CarMax West showed that the income at issue was produced by its total unitary business activities and not solely attributable to its limited activities in South Carolina. See Tr. 51:18- 53:14; 56:11-17 and 58:20- 62:19 (testimony of CarMax representative regarding unitary business and minimal contact with South Carolina); Id. at 187:6-18 (testimony of CarMax West's expert economist that the Taxpayer's unitary income could not be accurately accounted for separately); Id. at 185:6- 187:2 (testimony of CarMax West's expert economist that the statutory apportionment method used by CarMax accurately reflected its low-level of business activities in South Carolina).

The absence of specific criteria for the Department to use in rejecting the statutory apportionment formula (either internally or externally) and in its place proposing a method that has not been published to the outside world is disturbing to this Court. Moreover, SCDOR's audit process in this case appears to ignore the factual circumstances of this taxpayer (in particular, the valid business reasons for its structure, the unitary nature of its business, the minimal activities in South Carolina and the minimal benefits provided to CarMax West by South Carolina) as well as the established law in this State regarding unitary businesses. See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979). Accordingly, I find that SCDOR has failed to meet its burden of establishing that the statutory method does not fairly reflect the Taxpayer's business activities in South Carolina and further find that the Taxpayer has established by a preponderance of the evidence that the statutory method does fairly reflect its business activities in South Carolina.

### C. SCDOR's Alternative Method

Even assuming that SCDOR could establish that the standard apportionment formula does not fairly reflect the business activities of the Taxpayer in South Carolina, it has not shown that its proposed alternative formula is reasonable. Moreover, as with the preceding section, not only does SCDOR fail to carry this burden by clear and convincing evidence, but I find that the Taxpayer has established that the alternative method is unreasonable.

As with the question of whether the standard formula fairly reflects the business activities of a taxpayer, SCDOR's witness testified that there were no criteria (published or unpublished) that would provide SCDOR, taxpayers or this Court with any guidance on how to determine an appropriate alternative formula or whether any particular formula was reasonable or fairly reflected the in-state business activities of a taxpayer. Tr. 281:20- 282:12. SCDOR offered no evidence to substantiate why the alternative formula was appropriate and reasonable except to show that it derived more tax revenue than the statutory method. SCDOR's only other argument, which was advanced through its expert economist, appears to be that the alternative formula is appropriate because it is *possible* to separate CarMax West's South Carolina income from its total income. Tr. at 390:23- 391:19. However, SCDOR's expert never explained why the unitary nature of the Taxpayer's income should be ignored or showed that such a separation would be accurate.

This Court first finds that the fact that the alternative formula would derive more income is not justification for this method. See St. Johnsbury Trucking Co., Inc v. State of New Hampshire, 385 A.2d. 215, 217 (N.H. 1978) (stating that "[m]erely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively

mandated formula"). Furthermore, although SCDOR contends that it is possible to separate the South Carolina royalty income from CarMax West's total income, because the Taxpayer was operating unitary businesses (see supra Section I(A)), this Court concludes that it cannot *accurately* separate the royalty income from the rest of the Taxpayer's unitary income and that doing so would be in contravention of well-established South Carolina law. Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989). See also Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 783 (1992).

Additionally, to the extent that a tax is to be viewed as compensatory for services rendered, the proposed separate accounting method employed in the audit report produces gross distortion. The distortion is evident by comparing CarMax East (whose tax liability is not in dispute) with CarMax West. Under SCDOR's alternative method, CarMax East, which operates CarMax Superstores (large car dealerships) in South Carolina and reaps significant benefits from this state, would owe less in taxes (\$94,452) than would CarMax West, which has virtually no presence in South Carolina (\$102,303). See Ex. 31, SCDOR Distortion Example for FY 2006. I find no reasonable explanation in the audit report, the Department Determination, or the evidence produced at trial that could justify a tax on the limited in-state activities of CarMax West of this magnitude. The State of South Carolina has not provided sufficient benefits or services for which it could reasonably exact a return of this size. Exxon, 273 S.C. at 606, 258 S.E.2d at 99 (stating that "[t]he simple but controlling question is whether the state has given anything for which it can ask return").

Finally, the lack of any criteria or standards for SCDOR, taxpayers and courts to follow is not comforting to this Court. If this Court was to approve SCDOR's use of this "alternative method," the result would likely be chaos. No multi-state taxpayer filing in this state would have any certainty about how to file because there is nothing in the instructions to the tax return or the published position of SCDOR that would indicate to even the most careful multi-state taxpayers what is expected of them and under what circumstances. Moreover, when disputes arise, as they most certainly will, courts will still have no clear basis on which to evaluate SCDOR's alternative method in any given case.

Based on the above, the Court concludes that SCDOR has failed to establish by clear and convincing evidence that its alternative formula is reasonable. Additionally, although not the Taxpayer's burden, I find that the Taxpayer proved by a preponderance of the evidence that the alternative method used by SCDOR was unreasonable. SCDOR's method is simply an arbitrary tax on receipts, it ignores the unitary income of the Taxpayer, and it attempts to tax the income of a partnership (i.e. CBS, a pass-through entity) which SCDOR lacks the legal authority to do. The tax bears no relationship to the Taxpayer's business activities in South Carolina.

## **II. Sourcing of Financing Receipts**

Another issue in this matter is the state to which certain financing receipts of the Taxpayer should be sourced. In Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), the South Carolina Court of Appeals examined two views regarding the use of the term "receipts": (1) the origin of payment view; and (2) the place of activity view. Under the "origin of payment" view, the term "receipts" is defined by reference to the location of the taxpayer's customers making the payments. Lockwood Greene,

293 S.C. at 448, 361 S.E.2d at 347. On the other hand, the "place of activity" view looks to the place where the services are performed. Id. The taxpayer in Lockwood Greene was an engineering firm with employees in South Carolina and customers in and out-of-state. Lockwood Greene argued that the Court should look to the location of its customers, but SCDOR contended and the Court held that the appropriate method of sourcing the firm's income was the "place of activity" test. Id. The Court reasoned that an out-of state client is paying the firm for the expertise and time of the employees who were located in South Carolina. Lockwood Greene, 293 S.C. at 449, 361 S.E.2d at 347.

Turning to the case at hand, all income from the initial vehicle sales are reported in South Carolina by CarMax East and taxed by South Carolina. Tr. at 86:6-11. Thus, the financing income at issue here is related only to the subsequent activity of servicing or handling the loans after the initial sale. It was uncontested that all such activity takes place outside the state of South Carolina (id. at 90:12-15), and I have previously found that such activity added value. See supra Findings of Fact, Section V. As CarMax West's expert economist testified, sourcing to the state where value is added is justified from an economic perspective. Tr. 190:6- 191:2. Because CBS associates are located in Georgia and add value during the servicing and securitizing stage, he believed these revenues should not be sourced to South Carolina. Id. (explaining that this concept is the same one used in computing national gross domestic product, which looks at the addition in value at each stage of production). Sourcing to Georgia also comports with the economic principle of matching income to expenses. Id. at 191:3-13. See also Tr. at 150:11-22 (testimony of CarMax West's expert on state and local tax, tax accounting and tax policy explaining that matching income and expenses

is good tax policy<sup>12</sup> and that most states would tax this type of financing income on a cost of performance or income-producing activity basis).

SCDOR's position is that all receipts from financing activities related to vehicles sold in South Carolina should be sourced to South Carolina because that is where the initial transaction takes place; as SCDOR's expert testified, "but for" the initial sale in South Carolina, there would be no financing receipts. Tr. at 402:14-21. The "but for" test is flawed; under this test, income from commercial paper initially sold in South Carolina would always be traced to South Carolina no matter where the sale or assignment of that paper took place, no matter where the purchaser of that paper was located and no matter how much work was performed in order to handle the servicing, selling, factoring or securitization of that paper. Indeed, it would make no difference whether the purchaser of the vehicle moved out of South Carolina and began paying CBS in Georgia from, for example, North Carolina; under SCDOR's theory, those payments would not be made "but for" the initial transaction in South Carolina, and, therefore, the receipts should be taxed by South Carolina. This makes no sense and is contrary to sound economic policy, tax policy and accounting principles, including the cost or performance or place of activity concept and the matching principle.

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<sup>12</sup> SCDOR's point raised at trial that the financing receipts have already been matched against financing expenses in CBS is not a reason to trace the receipts away from the activities that produced them. The matching principal is just as viable in the sourcing of receipts as it is in the fact that the receipts are first off-set by the expenses that produced them in CBS; one should still match income with activities.

Based on the above and under the "place of activity" test in Lockwood Greene,<sup>13</sup>

I find that CarMax West has established by a preponderance of the evidence that it should not source any income from the financing services activities that take place after the initial sale to South Carolina because the economic activity that produces these additional revenues (thereby adding value to the process) and the sales or securitizations of the initial contract take place out-of-state. Lockwood Greene Engineering v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

### III. Penalties

SCDOR assessed penalties totaling \$205,832 against the Taxpayer based on two statutory grounds: (1) negligence and (2) substantial understatement. See Ex. 29, Amended SCDOR Audit Report, at 14. First, 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

<sup>13</sup> SCDOR pointed to dicta in Lockwood Greene stating that the place of activity test might not apply to a finance company and notes that Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993), which addressed royalty income earned by a holding company, supports a different result. None of these arguments are sustainable as to financing activity that takes place *after* the initial sale. Unlike a lender such as a credit card company making loans in South Carolina to which the dicta in Lockwood Greene might be thought to apply, there is no nexus or connection to South Carolina for these subsequent sales/securitizations in this matter, and all activity related thereto is performed outside South Carolina.

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. Tr. 156:22- 157:22. 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. Additionally, I find by a preponderance of the evidence that assessing a negligence penalty under the circumstances of this case would violate this Taxpayer's due process rights under both the South Carolina and United States Constitutions, and, thus, the penalty cannot be sustained on this ground as well.

In addition, 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 West Supp. 2008) (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 West Supp. 2008) (emphasis added).

While SCDOR focuses on the mandatory nature of the penalty provisions, these exceptions are no less mandatory.

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 evidence 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 must conclude that CarMax West has established by a preponderance of the evidence that the substantial understatement penalty should not apply and must be dismissed.<sup>14</sup> Additionally, assessing a substantial understatement penalty under the circumstances of this case would violate this Taxpayer's due process rights under both the South Carolina and United States Constitutions, and, thus, the penalty cannot be sustained on this ground as well.

#### **IV. Violation of Petitioner's Constitutional Rights**

The final issue in this matter is whether CarMax West's constitutional rights have been violated if the "alternative method" of apportionment asserted in the audit report is applied. Petitioner believes that SCDOR has erroneously applied the South Carolina income

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<sup>14</sup> 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.

tax laws to CarMax West in such a way as to reach an unconstitutional result.<sup>15</sup> I have concluded that the method of taxation employed by SCDOR violates the Interstate Commerce Clause of the U.S. Constitution because, *inter alia*, it taxes income with no connection to South Carolina, taxes income out of all proportion to CarMax West's activities in South Carolina, subjects CarMax West to the risk of multiple taxation, is not fairly apportioned, is not fairly related to the services provided by the taxing state and discriminates against interstate commerce.

The Commerce Clause "prohibits economic protectionism- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." Fulton Corp. v. Faulkner, 516 U.S. 325, 330 (1996) (internal quotations omitted). As the Supreme Court has explained, the purpose of such a rule is "to preven[t] a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within its borders would not bear." Id. at 330-31 (internal quotations omitted).

The four-part test for determining whether a state taxing statute violates the commerce clause is set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). To be sustained, a tax must (1) be applied to an activity with a substantial nexus to the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the taxing state. Id. at 279. In evaluating the fairness prong, one of the tests the courts apply is an external consistency test. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983) (discussing fairness issue under both

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<sup>15</sup> I am mindful of the fact that although this Court does not have the authority to declare a statute facially unconstitutional, it has the authority to declare the application of a statute unconstitutional. Evans v. State of South Carolina, 344 S.C. 60, 543 S.E.2nd 547 (2001); Video Gaming Consultants, Inc. v. SCDOR, 342 S.C. 34, 535 S.E.2nd 642 (2000).

Commerce Clause and Due Process Clause). External consistency requires that the factors used by the state in the apportionment formula "must actually reflect a reasonable sense of how income is generated." Id. A formula will not satisfy this test if it attributes income to the state that is "out of all appropriate proportions to the business transacted . . . in that State" (id. at 170 (quoting Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931))) or has "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. at 267, 274 (1978)).

As applied to CarMax West in this case, the tax at issue fails the Complete Auto test because it taxes income with no connection to South Carolina (as to financing income only), is not fairly apportioned, discriminates against interstate commerce and is not fairly related to the services provided by the taxing state. More specifically, as to the fairness and discrimination prongs, the alternative formula invoked by SCDOR in this case fails the external consistency test because it does not actually reflect a reasonable sense of how income is generated by CarMax West, a unitary business, in South Carolina. Finally, the formula applied by SCDOR is not fairly related to the services provided by South Carolina, which are de minimus in this case. The irrationality and unfairness of the proposed assessment on CarMax West is further illustrated by the fact that SCDOR would be imposing a greater tax liability on CarMax West (\$102,303), which has virtually no contact with South Carolina, than CarMax East (\$94,452), which performs substantial business in South Carolina. See Ex. 31, SCDOR Distortion Example for FY 2006. Thus, I find that CarMax West has established by a preponderance of the evidence that SCDOR's assessment results in liability that is distortive and taxes CarMax West out of all proportion to and does not fairly represent its business conducted in South Carolina. See Container Corp., 463 U.S. at 170; Hans Rees', 283 U.S. at 135.

## V. Remedy

In its closing argument, SCDOR raised for the first time the argument that if the Court determines that SCDOR's proposed assessment is unreasonable, then the appropriate remedy would be for the Court to remand this matter back to the Department to determine a reasonable alternative. Tr. at 441:13-21. I have serious procedural concerns about SCDOR first raising this question at the conclusion of the case and not complying with the basic provisions of the Revenue Procedures Act under which this matter is being adjudicated before me.

The Revenue Procedures Act (the Act) is contained in Chapter 60 of Title 12, S. C. Code Ann § 12-60-10, et. seq. The purpose of the Act is to provide an efficient method of assessing, protesting and adjudicating tax questions. The Act requires adequate notice to taxpayers. A remand remedy was not requested in the Pre-Hearing Statement or the Pre-Trial Brief in this matter. In my judgment, the fact that the question of remand was not presented at any time to the Taxpayer prior to closing statements at the trial of this matter is in violation of the procedures set forth in the Act and prevents the Department from raising the question before me at the conclusion of the trial of the case. However, even if the matter of remand was properly before me, I do not find the Department's argument that the proper remedy would be to remand this matter to be persuasive.

**Final Conclusion of Law**

This Court holds that Taxpayer is entitled to have the proposed assessment dismissed in its entirety.

**ORDER**

And it is so ordered this \_\_\_\_\_ day of \_\_\_\_\_, 2010.

\_\_\_\_\_  
The Honorable Carolyn Matthews

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

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

CERTIFICATE OF COUNSEL

The undersigned certifies that the Record on Appeal contains all material  
proposed to be included by any of the parties and not any other material.

NELSON MULLINS RILEY & SCARBOROUGH, L.L.P.

By: Bryson M. Geer  
John C. von Lehe, Jr.  
SC Bar no. 5719  
Bryson M. Geer  
SC Bar no. 13606  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402)  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for CarMax Auto Superstores West Coast,  
Inc.

Charleston, South Carolina  
December 29, 2010

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THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT of Appeals  
Carolyn C. Matthews, Administrative Law Judge

Case No. 09-ALJ-17-01560-CC

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

PROOF OF SERVICE

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

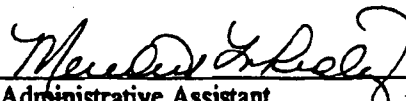
Pleadings:

RECORD ON APPEAL

Counsel Served:

Milton G. Kimpson, Esq.  
Harry A. Hancock, Esq.  
Counsel for Litigation  
South Carolina Department of Revenue  
P.O. Box 12265  
Columbia, SC 29211

Burnet R. Maybank, III  
Nexsen Pruet, LLC  
PO Drawer 2426  
Columbia, SC 29202

  
Administrative Assistant

December 29, 2010

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT COUNTY

Carolyn C. Matthews, Administrative Law Judge

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

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

South Carolina Department of Revenue.....Respondent

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FINAL BRIEF OF APPELLANT

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John C. Von Lehe  
Bryson M. Geer  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200  
*Attorneys for Appellant*

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## STATEMENT OF ISSUES

- I. Did the ALC err in failing to place the burden of proof on SCDOR to establish by clear and convincing evidence that the standard statutory apportionment method used by CarMax West does not reflect the extent of CarMax West's business in South Carolina and that SCDOR's alternative separate accounting method is reasonable?
- II. Did the ALC err in failing to consider and find that CarMax West operates a unitary business?
- III. Did the ALC err in concluding that the activities of CarMax West in South Carolina are not fairly represented by the standard statutory apportionment method?
- IV. Did the ALC err in allowing SCDOR to apply separate accounting to a unitary business when doing so is prohibited by Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979) and S.C. Code Ann. § 12-6-2320(A)(4) (2000 and West Supp. 2009) because it produces an unreasonable result, or, alternatively, because separate accounting produces an unreasonable result in this case?
- V. Did the ALC err in failing to apply the "place of activity" test set forth in Lockwood Greene Eng'g v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987) and in concluding that CarMax West's financing receipts should be sourced to South Carolina when all services related to producing that income are performed out-of-state?
- VI. Did the ALC err in concluding that SCDOR is not violating CarMax West's constitutional rights by applying separate accounting to a unitary business and by sourcing financing receipts to South Carolina?

## STATEMENT OF THE CASE

This case involves a protest by CarMax Auto Superstores West Coast, Inc. ("CarMax West") of an assessment of corporate income taxes by the South Carolina Department of Revenue ("SCDOR") for the income tax years ending in 2002, 2003, 2004, 2005, 2006 and 2007.

SCDOR audited CarMax West's returns for these years and issued an additional assessment, which CarMax West timely protested. See R. p.p. 480-489, CarMax West Notice of Protest. Following a conference, SCDOR issued a Department Determination upholding the additional assessment. See R. p.p. 490-496, SCDOR Department Determination. The following chart, which appears in SCDOR's amended audit report in this matter, summarizes the amounts in dispute:

### *INCOME TAX: Schedule A*

| PERIOD ENDED: | INCOME<br>TAX    | INTEREST        | PENALTY         | TOTALS           |
|---------------|------------------|-----------------|-----------------|------------------|
| Feb-02        | \$59,517         | \$32,997        | \$34,354        | \$126,868        |
| Feb-03        | \$72,706         | \$34,123        | \$38,873        | \$145,702        |
| Feb-04        | \$68,703         | \$27,795        | \$34,508        | \$131,006        |
| Feb-05        | \$36,133         | \$12,209        | \$16,944        | \$65,286         |
| Feb-06        | \$94,544         | \$23,842        | \$40,284        | \$158,670        |
| Feb-07        | <u>\$107,924</u> | <u>\$16,984</u> | <u>\$40,869</u> | <u>\$165,777</u> |
| TOTALS:       | \$439,526        | \$147,950       | \$205,832       | \$793,308        |

See R. p. 910, Amended SCDOR Audit Report.

CarMax West timely requested a contested case hearing before the Administrative Law Court ("ALC") pursuant to S.C. Code Ann. § 12-60-460 (Supp. 2009). The ALC held a hearing on February 18 and 19, 2010 and issued a Final Order ("Order") finding for SCDOR on all issues except the penalty, which the ALC

dismissed, on April 22, 2010. See R. p.p. 1-18, Order. CarMax West received written notice of the Order on April 23, 2010 and subsequently filed a motion for reconsideration on May 3, 2010. See R. p.p. 981-1045, CarMax West's Motion for Reconsideration. The ALC denied this motion on May 26, 2010, and CarMax West received that order on May 28, 2010. CarMax West timely filed a Notice of Appeal on June 25, 2010.<sup>1</sup>

### STATEMENT OF FACTS

#### **I. Formation of CarMax**

CarMax, Inc. ("CarMax") was formed in 1993 and is the nation's largest specialty retailer of used cars and light trucks. R. p. 55, lines 18-19 and p. 57, line 8. Its primary business is to purchase, recondition, market, sell and finance used cars and trucks. It was originally formed as a subsidiary of Circuit City Stores, Inc. ("Circuit City"). R. p. 57, lines 12-17. In 2002, Circuit City's shareholders approved the separation of CarMax from Circuit City. R. p. 57, lines 18-21. CarMax is now a separately held, publicly traded holding company. Id.

#### **II. Corporate Structure of CarMax Group**

CarMax was created with and inherited upon its spin-off a corporate structure that mirrored Circuit City's structure: CarMax operated as a holding company and wholly owned two operating entities, CarMax West, the taxpayer in this case, which sold used vehicles in the western United States and owned substantially all of CarMax's intellectual property, and CarMax Auto Superstores, Inc. ("CarMax East"), which sold

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<sup>1</sup> In accordance with S.C. Code Ann. § 12-60-3370 (Supp. 2009), CarMax West has posted an appeal bond with the ALC.

used vehicles in the eastern and mid-western states (where most of CarMax's retail operations were at the time) and provided the group's corporate, back office support and finance functions. R. p. 58, line 16- p. 59, line 4; see also R. p. 655, Chart Regarding Organizational Structure of CarMax (Pre-Reorganization). During the early years of the audit period (2002-2004), CarMax East paid CarMax West a royalty for its use of the intellectual property.

The inherited corporate structure is not common to the car sales industry and began to cause numerous problems, particularly on the financing side, ranging from confusion amongst regulatory agencies and potential investors of the retail installment contracts to licensing issues. See R. p. 65, line 8- p. 68, line 10. Thus, in 2004, CarMax management determined that certain changes to the corporate structure/organization would be beneficial to the business, and it created CarMax Business Services, LLC ("CBS") to: (1) house the financing functions/operations (CarMax Auto Finance or "CAF"); (2) provide certain shared services to the companies in the group; and (3) own the intellectual property. R. p. 61, lines 2-15; see also R. p. 656, Chart Regarding Organizational Structure of CarMax (Post-Reorganization). The first change, which separated the financing functions from the retail operations, made the securitization process for vehicle financing contracts less cumbersome, lessened confusion for regulators, simplified the regulatory compliance process and provided greater liability protection for the separate businesses. R. p. 65, line 8- p. 68, line 10. The second and third changes brought about greater efficiencies and cost savings across all of the CarMax entities by centralizing general management functions, including human resources, information systems, finance and accounting; retail functions,

including real estate support services, strategic analysis, advertising and marketing (including the CarMax website); and intangible asset management for intellectual property, trademarks and trade names, marketing programs, customer data, etc. R. p. 69, line 18- p. 71, line 14.

The above evidence presented at trial showed that CBS was formed for valid business reasons, and there was no evidence presented to the contrary. SCDOR attempted to suggest that a purpose of CarMax's restructuring was to create a tax advantage, but the evidence in the record does not support this, and the ALC made no finding to that effect.

CBS was created as a multi-member limited liability company (taxed as a partnership) between CarMax West and CarMax East, with CarMax West contributing the intellectual property and CarMax East contributing the financing operations and certain other corporate assets. R. p. 60, lines 14-21; p. 64, lines 23-25. An accounting firm performed an independent study to determine the value of CarMax West's and CarMax East's respective contributions to CBS (R. p. 61, lines 19-25), which in turn determined their respective ownership interests in CBS -- CarMax West owns 93.5% while CarMax East owns 6.5%. R. p. 62, lines 8-10.

Since the restructuring, CBS has charged CarMax West and CarMax East a per vehicle management services fee, also determined by an independent study, which includes an intellectual property royalty component. The income from the management fees flows up to CarMax West and CarMax East as a result of their interests in CBS. CBS also generates financing income through CAF, which also flows up to CarMax West and CarMax East. R. p. 64, lines 15-20.

### **III. CarMax West's Connection to South Carolina**

As CarMax West's Tax Director testified at trial, CarMax West sells cars in the western United States and does no business in South Carolina. R. p. 74, line 24- p. 75, line 8. It has no employees, no facilities and no tangible property in South Carolina. R. p. 75, lines 2-6. Due to the absence of a physical presence in the state, it neither requires nor receives any substantive services or benefits from the State of South Carolina. R. p. 75 lines 9-11. Its only connection to this State is the payments it has received from CarMax East for the use of the CarMax intellectual property that is used by CarMax East to sell cars in this state (via payments directly to CarMax West from 2002-2004 and, subsequently, via its partnership interest in CBS, which has received such payments from CarMax East since 2004). R. p. 75, line 12- p. 76, line 6.

### **IV. Unitary Facts Regarding CarMax West (pre-reorganization) and CarMax West and CBS (post-reorganization)**

The evidence presented at trial regarding the integrated organization, systems and operations of CarMax West shows that it was a unitary business pre-reorganization (2002-2004) and that CarMax West and CBS (the "pass-through" entity in which CarMax West held a 93.5% interest) together are a unitary business post-reorganization (2005-2007).

The CarMax companies and their operations are highly integrated and interrelated. They have shared ownership and management. R. p. 76, line 20- p. 78, line 9; R. p.p. 651-654, CarMax FY 2005 Officers and Directors List. As discussed above, they also have a number of shared services and systems that create efficiencies and cost savings across the companies, including the centralized management functions,

retail functions and intangible asset management. See supra Statement of Facts, Section II; see also R. p. 69, line 18- p. 71, line 14; R. p. 599-650, Sample CarMax, Inc. Annual Report. All income earned by CarMax entities is placed in a general account and is used for the benefit of the entire CarMax group of companies. R. p. 78, line 21- p. 79, line 7. All entities hold themselves out to the public simply as "CarMax." R. p. 74, lines 11-17; R. p.p. 599-650, Sample CarMax, Inc. Annual Report.

In addition, the various activities of the CarMax companies, including retail sales, financing, marketing and intellectual property management, contribute to and depend upon one another. R. p. 79, lines 19-24; see also R. p.p. 599-650, Sample CarMax, Inc. Annual Report. For example, as CarMax sells more cars, the value of its intellectual property increases, and as the value of the intellectual property increases and the brand becomes more well-known, CarMax sells more cars. R. p. 80, lines 1-17. Similarly, because CarMax can offer financing options to customers through CAF, it is able to sell more cars, and CAF is able to provide financing because it has access to CarMax customers. R. p. 80, line 18- p. 81, line 19.

CarMax West's expert witnesses also provided testimony supporting the conclusion that the CarMax businesses are unitary. CarMax West's expert in state and local tax, tax accounting and tax policy testified that from a tax accounting standpoint, CarMax West pre-reorganization was and CarMax West and CBS post-reorganization are unitary businesses. R. p. 156, line 8- p. 157, line 9. Similarly, CarMax West's expert economist testified that from an economic standpoint, CarMax West pre-reorganization was and CarMax West and CBS post-reorganization are unitary businesses. R. p. 200, line 11- p. 201, line 14 (citing common ownership and

management, vertical integration, economies and efficiencies and interdependence among business units in support of his conclusion) and R. p. 202, lines 7-21.

SCDOR provided no testimony or evidence to refute that the businesses are unitary. Indeed SCDOR's lone fact witness testified that he thought that the entire CarMax group of companies is a unitary business (R. p. 295, lines 20-24 and p. 298, line 18- p. 299, line 1), while SCDOR's expert economist refused to answer whether or not the businesses are unitary as he believed this question was irrelevant. R. p. 393, lines 15-22 and 413, line 19- p. 414, line 7. The ALC's Order, however, did not make any findings as to whether CarMax operated a unitary business stating that it was "not outcome determinative." See R. p. 10, Order; R. p.p. 983-984, CarMax West's Motion for Reconsideration (section B).

#### V. Financing Receipts Income

In addition to the management fee income, CBS generates income through the financing activities of CAF, its car financing division. When a vehicle is sold in South Carolina, all income from that sale is reported to South Carolina by CarMax East and is taxed by South Carolina. To use a simple example, if CarMax East sells a car in South Carolina for \$20,000, with \$5,000 down and \$15,000 financed, CarMax East records and reports \$20,000 in revenue to South Carolina. See R. p. 104, lines 6-11.

Subsequent activity related to servicing and securitizing these retail installment contracts *after* the initial sale takes place *outside the state of South Carolina*. R. p. 107, lines 15-22; p. 108, lines 12-15. Specifically, CBS associates located in Georgia service the contracts assigned to CBS by, for example, receiving interest payments from customers, answering questions from customers regarding payments and

collecting on amounts due and unpaid. These associates also do the work of converting pools of the contracts into asset-backed securities that are then sold to third party investors. R. p. 104, line 20- p. 106, line 5 and p. 107, lines 15-22. It is these activities that produce the revenue that SCDOR seeks to tax through its assessment.

#### VI. Tax Returns, Audit and Determination

CarMax West filed the tax returns at issue using the standard apportionment method for multi-state taxpayers. CarMax West's Tax Director testified that she reviewed and supervised the preparation of the subject tax returns. R. p. 82, lines 17-19. She further testified that CarMax West followed the tax return instructions and the guidance in the returns themselves in applying the statutorily mandated standard apportionment formula. R. p. 86, lines 4-9; p. 87, lines 14-25; and p. 88, lines 16-21; see also R. p.p. 497-537, CarMax West Amended Tax Returns, 2002-2007; R. p. 538-554, Sample SCDOR Corporate Tax Return Instructions. Specifically, and critically, CarMax West started with its *federal taxable income*. R. p. 82, lines 20-25. This is dictated by the tax return (on line 1) and the instructions, both of which provide that the starting point for determining taxable income in South Carolina is federal taxable income. See R. p. 543, Sample SCDOR Corporate Tax Return Instructions (Basis of Return section); R. p. 497-537, CarMax West Amended Tax Returns 2002-2007 (page 1, line 1 of each return). CarMax West then made South Carolina adjustments to derive its net income as reconciled (also known as apportionable net income). R. p. 83, lines 1-22. CarMax West then applied a standard apportionment formula, which, in this case, was the single

factor gross receipts formula contained in S.C. Code Ann. § 12-6-2290 (Supp. 2007).<sup>2</sup>

This formula created a fraction with the numerator being CarMax West's South Carolina receipts (including income from South Carolina royalties for all audit years but excluding CAF financing revenue as all of the financing operations were performed outside of South Carolina) and the denominator being CarMax West's total receipts in all states. R. p. 83, line 24- p. 84, line 17. This statutorily defined fraction was then multiplied by CarMax West's apportionable net income to determine the taxable income (R. p. 84, lines 19-23), which in turn was multiplied by the tax rate to arrive at the amount of taxes owed. R. p. 84, line 25- p. 85, line 2. The following illustrates the above-described calculations:

$$\begin{array}{l} \text{Federal taxable income} \\ + / - \text{South Carolina adjustments} \\ \hline \text{Apportionable net income} \\ \times \text{Apportionment formula (South Carolina receipts/total receipts)} \\ \hline \text{South Carolina taxable income} \\ \times \text{South Carolina tax rate} \\ \hline \text{Income tax due to South Carolina} \end{array}$$

SCDOR rejected CarMax West's use of the standard statutory method claiming that it does not fairly reflect CarMax West's activity in this State because CarMax's business structure distorts CarMax West's income under that method. SCDOR instead applied what it calls an "alternative method." R. p. 93, lines 4-9. This alternative method is not based on using federal taxable income (i.e. apportionable net income) as a starting point (see R. p. 471-479, SCDOR Report of Field Audit), but rather

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<sup>2</sup> CarMax initially filed its returns using the three factor method but amended them prior to trial to use the single factor method. Thus, whether CarMax should use the three factor versus the single factor method was not an issue at trial.

separates and taxes only CarMax West's royalty receipts and thus is a separate accounting. R. p. 93, lines 4-9 and p. 93, line 20- p. 94, line 10.

As SCDOR's audit supervisor testified at trial, SCDOR used this alternative method because its auditor noticed that CarMax has what SCDOR refers to as an "East Coast/West Coast" structure, which SCDOR believes is sometimes employed by other taxpayers in order to distort income. R. p. 263, line 16- p. 264, line 12. On that basis alone, and before performing any investigation into the actual reasons for CarMax West's organizational structure, the auditor concluded that CarMax West was operating a "[r]oyalty scheme" and sent out a draft audit report so stating, assessing additional taxes and imposing penalties. See R. p. 474, SCDOR Report of Field Audit; R. p. 90, line 21- p. 91, line 15. The only attempt at analysis or proof of distortion offered by SCDOR is an alleged "distortion" example created by SCDOR as part of the draft audit report and later modified for trial. R. p.p. 478, SCDOR Report of Field Audit (Distortion Example) and R. p.p. 924-926, SCDOR Distortion Example for FY 2006. SCDOR argues that distortion results from CarMax West's inclusion of all its western vehicle sales in its apportionment formula denominator, as directed by the statute. The "distortion" example, however, simply shows that CarMax West's apportionment ratio differs significantly from CarMax East's and that not including car sales in CarMax West's formula produces more taxable income than including them, *i.e.*, that a smaller denominator produces a larger result.

SCDOR also rejected CarMax West's exclusion of the CAF financing income from its apportionment factor numerator. CarMax West did not source this income to South Carolina because the activity producing this income occurred out-of-state.

SCDOR took the position in the audit and at trial that the financing income should be sourced to the state where the customer making payments on the retail installment contract resides rather than the place where the activity producing the income occurs. R. p. 279, lines 9-12; see also R. p.p. 471-479, SCDOR Report of Field Audit; R. p.p. 897-922, Amended SCDOR Audit Report.

### STANDARD OF REVIEW

The Administrative Procedures Act provides the appropriate standard of review in an appeal related to the decision of an administrative agency. S.C. Code Ann. § 1-23-610 (Supp. 2009); see also Original Blue Ribbon Taxi Corp. v. S.C. Dep't of Motor Vehicles, 380 S.C. 600, 604, 670 S.E.2d 674, 676 (Ct. App. 2008). Under S.C. Code Ann. § 1-23-610(B), the Court of Appeals may reverse or modify a decision of the ALC "if the substantive rights of the petitioner have been prejudiced because the finding, conclusion, or decision is: (a) in violation of constitutional or statutory provisions; . . . (d) affected by other error of law; [or] (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record. . . ." S.C. Code Ann. § 1-23-610 (Supp. 2009); Original Blue Ribbon Taxi, 380 S.C. at 604, 670 S.E.2d at 676 (addressing subsection (C) of the 2007 version of this code section, which is substantially similar to the current subsection (B)); Brownlee v. S.C. Dep't of Health and Envtl. Control, 382 S.C. 129, 136, 676 S.E.2d 116, 119-120 (2009) (holding ALJ may be reversed based on error of law or if his findings were not supported by substantial evidence).

## ARGUMENT

**I. THE ALC ERRED IN FAILING TO PLACE THE BURDEN OF PROOF ON SCDOR TO ESTABLISH BY CLEAR AND CONVINCING EVIDENCE THAT THE STANDARD STATUTORY APPORTIONMENT METHOD DOES NOT REFLECT THE EXTENT OF THE TAXPAYER'S BUSINESS IN SOUTH CAROLINA AND THAT THE ALTERNATIVE SEPARATE ACCOUNTING METHOD IS REASONABLE.**

In ruling for SCDOR, the ALC improperly placed the burden of proof on CarMax West to establish by a preponderance of the evidence that the standard statutory apportionment method fairly represents its business activities in this State and that the separate accounting method used by SCDOR is not reasonable. See R. p. 6, Order. Although this is the appropriate standard and burden of proof in tax assessment cases generally, as CarMax West asserted at trial, an exception to this general rule applies when a party wishes to deviate from the standard method of apportionment. In such a case, the burden shifts to the party attempting to deviate to show by clear and convincing evidence why the standard method should not be followed and that the alternative method is reasonable.

CarMax West cited to universal authority amongst other states that have adopted the Uniform Division of Income for Tax Purposes Act's alternative apportionment provision, which is identical to the South Carolina provision, in support of placing the burden of proof on SCDOR. Limited Stores, Inc. v. Franchise Tax Board, 62 Cal. Rptr. 3d 191, 196 (Ct. App. 2007) (stating that the party asserting alternative apportionment bears the burden of proof); Union Pac. Corp. v. Tax Comm., 83 P.3d 116, 119 (Id. 2004) (stating that "[t]he party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate"); St. Johnsbury

Trucking Co. v. N.H., 385 A.2d 215, 217 (N.H. 1978) (stating that "an alternative formula is the exception, and the party who wants to use an alternative formula has the burden of showing that the alternative is appropriate"); Donald M. Drake Co. v. Dept. of Revenue, 500 P.2d 1041, 1044 (Or. 1972) (stating that "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof); Kmart Props., Inc. v. Taxation and Revenue Dep't of N.M., 131 P.3d 27 (N.M. 2001) (applying burden of proof to Department "to justify any modification of the UDITPA formula"), writ of cert. quashed by Kmart Corp. v. Taxation and Revenue Dep't of N.M., 131 P.3d 22, 41 (N.M. 2005); In the matter of the Protest of Wal-Mart Stores, Inc. ID No. 02-344332-00-4, No. 06-07 (N.M. Hearing Officer of Taxation and Revenue Dep't. 2006) (holding Department had burden of proof as the party who wanted to depart from the standard three-factor formula under UDITPA).<sup>3</sup> Not only did SCDOR fail to cite any authority to the contrary, but it agreed at trial that it bore the burden. See R. p. 461, lines 3-9 (wherein SCDOR's attorney states: "Your Honor, we do not disagree with Mr. von Lehe's discussion of our burden in this case. We welcome that burden. If we can't show that they have not fairly represented their business in South Carolina, we should not be allowed to apply this statute.").

In addition to bearing the burden, SCDOR should have been required to carry that burden with "clear and convincing" evidence. See Limited Stores, 62 Cal. Rptr. at 196 (stating that the party asserting alternative apportionment bears the burden of showing by "clear and convincing evidence" that alternative apportionment is

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<sup>3</sup> See also R. p. 431, line 19- 433, line 21; R. p.p. 956-957, CarMax West's Proposed Order (Burden of Proof section).

appropriate). Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978) (stating that in case where taxpayer asserts that separate accounting method was appropriate, taxpayer must establish by clear and cogent evidence that standard method's resulting assessment is out of all proportion to business transacted in the state or leads to a grossly distorted result).

Thus, the ALC improperly placed the burden of proof on CarMax West when the burden of proof should have been placed on SCDOR to show by clear and convincing evidence that the standard apportionment method does not fairly represent CarMax West's in-state business activities and that SCDOR's alternative formula is reasonable. Accordingly, CarMax West respectfully requests that the Court conclude that SCDOR failed to meet its burden and standard of proof and reverse the ALC and dismiss the assessment. Alternatively, CarMax West requests that the Court remand this matter to the ALC so that it may apply the correct burden and standard of proof on these two critical issues.

## **II. THE ALC ERRED IN FAILING TO CONSIDER AND FIND THAT CARMAX WEST OPERATES A UNITARY BUSINESS.**

The ALC erred in failing to consider and find that CarMax West operates a unitary business. SCDOR argued at trial and the ALC agreed that whether CarMax West operates a unitary business was irrelevant in this matter. See R. p. 10, Order (stating that the "question of whether a taxpayer is 'unitary' or 'non-unitary' is not outcome determinative" and making no finding as to whether CarMax West was unitary). To the contrary, this factual and legal issue is critical to determining two key issues in this case: (1) whether the standard apportionment method is a fair reflection of CarMax West's

activities in South Carolina; and (2) whether the separate accounting method applied by SCDOR to CarMax West, a unitary business, is reasonable. CarMax West presented substantial and uncontested evidence that it does, in fact, operate a unitary business.

**A. The ALC Should Have Considered Whether CarMax West Operates a Unitary Business.**

The decisions of the United States Supreme Court, the South Carolina Supreme Court and this Court firmly establish that a determination of whether a business is unitary is critical to identifying and applying the proper apportionment method. As the United States Supreme Court has explained:

[When] a unitary business exists, "separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'"

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 181 (1983) (quoting, Mobil Oil Corp. v. Comm. of Taxes of Vt., 445 U.S. 425, 438 (1980)). Once the determination is made that a business is unitary, "a State must then apply a formula apportioning the income of that business within and without the State." Id. at 169 (emphasis added).

Consistent with this analysis, the South Carolina Supreme Court has definitively held that a unitary business cannot be subject to a separate accounting like the one imposed by SCDOR here, which seeks to isolate and tax only CarMax West's royalty income derived from the use of its trademarks and trade names in South Carolina. In

the seminal unitary business case in this State, the South Carolina Supreme Court rejected the taxpayer's argument to separate out and exclude from taxation income from certain out-of-state business activities citing an earlier decision for the proposition that the income of a unitary business "is attributable to all incidents of the business and not to any single activity." Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 599, 258 S.E.2d 93, 96 (1979), quoting Covington Fabrics v. S.C. Tax Comm'n, 264 S.C. 59, 68, 212 S.E.2d 574, 578 (1975). The taxpayer in Exxon sought to separate income generated by its oil exploration and production activities in other states from its retail sales income from gas stations in South Carolina. The Department opposed this separate accounting method, and the South Carolina Supreme Court agreed holding that the taxpayer could not divide its unitary income producing activities. Id.

Indeed, the South Carolina Supreme Court has also previously rejected an attempt by SCDOR's predecessor to do precisely what SCDOR has done here: compute a portion of a unitary business separately. See Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992). In Eastman Kodak, the Department argued and the trial court found that including safe harbor lease transactions involving properties in other states "distort[ed] Kodak's business in South Carolina by inappropriately reducing the share of business carried on in South Carolina" and held that the safe harbor lease transactions should be computed separately. Id. at 419-20, 418 S.E.2d at 544 (internal quotations omitted). The Supreme Court disagreed, finding that the safe harbor lease transactions were part of Kodak's unitary business and thus that the standard formula reflected a "reasonable representation" of Kodak's business in this state. Id. at 419, 418 S.E.2d at 544

(internal quotations omitted). The Court then concluded that based on Exxon and the evidence in the case, "the safe harbor lease transactions cannot be segregated from Kodak's general business operations." Id. at 420, 418 S.E.2d at 544.

This Court has previously applied these principles in Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989). In Lowenstein, this Court rejected the taxpayer's request to apply separate accounting to interest income when the Court found the interest income to be part of the taxpayer's unitary income. Id. at 298 S.C. at 103-107, 378 S.E.2d at 277-79. The Court cited to the United States Supreme Court's approval of the unitary business analysis:

"[U]nitary business/formula apportionment" rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form just one part, and then apportioning the total income of that "unitary business" between one taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.

Lowenstein, 298 S.C. at 101, 378 S.E.2d at 276.

In this case, SCDOR seeks to isolate and tax only a portion of CarMax West's unitary income (*i.e.*, the royalty income). To do so, it must determine that the standard apportionment method is not a fair reflection of CarMax West's in-state business activities and then it must establish that the separate accounting method it chose is reasonable. Under the well-established law of this State, neither determination can be made without considering whether CarMax West operated a unitary business. Therefore, the ALC erred in accepting SCDOR's argument that the existence of a unitary business was irrelevant and in declining to consider and rule on this issue.

**B. CarMax West Presented Substantial and Uncontested Evidence that It Operates a Unitary Business, and the ALC Should Have Found Accordingly.**

CarMax West presented substantial, uncontested evidence at trial that it operates a unitary business. Based on this evidence, this Court can and should find that CarMax West is a unitary business and should reverse the ALC's Order accordingly. In determining whether a business is unitary, South Carolina courts apply two main tests: (1) the three unities test; and (2) the contribution-dependence test. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. These tests are not mutually exclusive, and the courts often apply both. Id.; see also Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 789 (1992) (discussing unitary business tests of "functional integration, centralization of management, and economies of scale"). Under the three unities test, courts look at whether the business or businesses have unity of ownership, unity of management and unity of operation. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. Under the contribution-dependence test, the court considers whether the "activities of the business in question contribute to or depend on the other activities of the business." Id. at 600, 258 S.E.2d at 96. The courts do not require that it be "necessary" or "essential" that the business or businesses be operated together; cost savings or increased profits gained by operating together are acceptable reasons. Id. at 599-601, 258 S.E.2d at 96-97.

The Exxon case provides a model for how to analyze whether a taxpayer operates a unitary business. The Court noted the following regarding Exxon's operations: it held itself out to the public as one company; it employed central staff on which all companies were dependent; it used centralized purchasing techniques that

resulted in cost savings throughout the company; it had strong, centralized management over all segments of the company; the structure provided profit stability, reduced risk and insured full capacity utilization of the company's facilities; it made no attempt to segregate earnings or funds of the various segments; and the various operating activities of the company (exploration, production, refining and marketing) contributed to and depended upon each other. Exxon, 273 S.C. at 601, 258 S.E.2d at 96-97. Based on these findings, the Court held that the taxpayer satisfied both the three unities test and the contribution-dependence test. Id. at 602, 258 S.E.2d at 96-97.<sup>4</sup>

The following facts presented at trial through the testimony of CarMax West's Tax Director support the conclusion that CarMax West (pre-reorganization) was and CarMax West and CBS (post-reorganization) are unitary: the companies have shared ownership and management; the companies have a number of shared services and systems that create efficiencies and cost savings across the companies, including centralized general management functions (such as human resources, information systems, finance and accounting), retail functions (including real estate support services, strategic analysis, advertising and marketing), and intangible asset

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<sup>4</sup> See also Eastman Kodak, 308 S.C. 415, 418 S.E.2d 542 (finding that multi-national camera and film corporation that was also doing safe harbor lease transactions involving tangible personal property was a unitary business not capable of separation where only a small portion of leased assets were in South Carolina, the funding for the leasing came from the general corporate treasury and the income benefited the company as a whole); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977) (finding multi-state oil and gas company that also contracted on a royalty basis with third parties to mine salt and sulphur discovered on prospective oil lands was a unitary business where salt and sulphur was discovered during oil exploration process, which was an integral part of the business); Lowenstein, 298 S.C. 93, 378 S.E.2d 272 (finding affiliated New York textile manufacturing companies that also earned interest income from inter-company loans were unitary where funding for leasing came from general corporate treasury, interest income and loan payments were deposited in general company accounts and used for normal business operations and income benefited company as a whole).

management (including intellectual property, trademarks and trade names, marketing programs and customer data); CarMax entities hold themselves out to the public as simply "CarMax;" all income is placed in a general account and is used for the benefit of the CarMax group of companies as a whole; the various activities of the companies, including retail sales, financing, marketing and intellectual property management contribute to and depend on one another; and the company is functionally integrated. See R. p. 69, line 18- p. 71, line 14; p. 76, line 20- p. 78, line 9; p. 79, line 1- p. 81, line 19; see also R. p.p. 651- 654, CarMax FY 2005 Officers and Directors List; R. p. 599-650, Sample CarMax, Inc. Annual Report.

In addition, both CarMax West's expert economist and expert tax accountant testified that from an economic standpoint and a tax accounting standpoint respectively, the CarMax businesses at issue are unitary. See R. p. 156, line 8- p. 157, line 9 (testimony of expert tax accountant); and p. 200, line 11- p. 201, line 14 and p. 202, lines 7-21 (testimony of expert economist). Moreover, the above evidence and testimony regarding the unitary nature of the businesses was un rebutted.<sup>5</sup>

Therefore, the overwhelming and uncontested evidence establishes that CarMax West (pre-reorganization) was and CarMax West and CBS (post-reorganization) are unitary businesses, and the royalty and financing income produced thereby constitutes CarMax West's unitary income, and CarMax West respectfully requests that the Court enter such a finding. In the alternative, CarMax West requests that the Court remand

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<sup>5</sup> As previously stated, SCDOR's witness testified that he thought that the entire CarMax group of companies was a unitary business (R. p. 295, lines 20-24 and p. 298, line 18- p. 299, line 1); SCDOR's expert economist refused to answer whether or not the businesses were unitary as he believed this question was irrelevant (R. p. 393, lines 15-22 and 413, line 19- p. 414, line 7); and SCDOR presented no evidence that CarMax West did not operate a unitary business.

this matter to the ALC so that it may make a finding under Exxon as to whether or not CarMax West operates a unitary business, and if the Court finds that it does, to reconsider the following two issues in light of that finding: (1) whether the standard apportionment method is a fair reflection of CarMax West's activities in South Carolina; and (2) whether the separate accounting method applied to CarMax West is reasonable.

**III. THE ALC ERRED IN CONCLUDING THAT THE ACTIVITIES OF CARMAX WEST IN THIS STATE ARE NOT FAIRLY REPRESENTED BY THE STANDARD STATUTORY APPORTIONMENT METHOD.**

The ALC erred in concluding that the standard apportionment method for multi-state taxpayers, which CarMax West used in filing the tax returns at issue, does not fairly reflect the business activities of CarMax West in South Carolina. In reaching this conclusion, the ALC applied the incorrect burden and standard of proof. See supra Argument, section I. Even if the ALC was correct in applying the burden of proof to CarMax West, it failed to apply the proper legal test as to a unitary business and its finding was not supported by substantial evidence in the record, and, therefore, its decision should be reversed. S.C. Code Ann. § 1-23-610(B)(e) (Supp. 2009); Brownlee, 382 S.C. at 136, 676 S.E.2d at 119-120 (holding ALJ may be reversed "based on an error of law or if his findings were not supported by substantial evidence").

As set forth in detail in section VI of the Statement of Facts, CarMax West followed the tax return instructions and the guidance in the returns themselves in applying the standard statutory method of income tax apportionment by starting with its federal taxable income as adjusted and then performing the following calculations:

Apportionable net income  
 x Apportionment formula (South Carolina receipts/total receipts)  
 South Carolina taxable income  
 x South Carolina tax rate  
 Income tax due to South Carolina

Under South Carolina law, an alternative method of apportionment is only authorized when the above-described standard method does not properly reflect the extent of a taxpayer's income-producing activities in South Carolina. See S.C. Code Ann. § 12-6-2320(A) (2000 and West Supp. 2009). Moreover, an alternative formula should only be used in "unique and non-recurring" circumstances. See R. p.p. 555-598, Uniform Division of Income for Tax Purposes Act ("UDITPA") (and related regulations); Donald M. Drake Co., 500 P.2d at 1043 (stating that "the apportionment method is now the general rule and any other system, including the segregated method, is the exception"); St. Johnsbury Trucking Co., 385 A.2d. at 217, quoting William J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747, 781 (1957) (stating that an alternative method is the exception and "departures from the basic formula should be avoided except where reasonableness requires").<sup>6</sup>

Furthermore, under South Carolina law, the activities of a unitary business are fairly reflected when the net income of all of its business activities is apportioned and not by applying separate accounting to one business line or geographic location of income. As the South Carolina Supreme Court explained in Exxon, the income of a unitary business "is attributable to all incidents of the business and not to any single activity" and, thus, taxing one line of income-producing activity separately would not

<sup>6</sup> See also R. p. 163, lines 9-16 (testimony of CarMax West's state and local tax and tax accounting expert stating that UDITPA limits the use of an alternative formula to "unique and non-recurring situations" and should be done on an "exception basis").

be appropriate. Exxon, 273 S.C. at 602, 258 S.E.2d at 97 (holding that the taxpayer could not divide its unitary income producing activities and exclude from taxation in South Carolina all income related to its out-of-state oil exploration and production activities); Lowenstein, 298 S.C. at 103-107, 378 S.E.2d at 277-79 (rejecting taxpayer's request to apply separate allocation of income to interest income when court found it to be part of taxpayer's unitary income). See also supra Argument, Section II(A). Moreover, including income resulting from a unitary company's out-of-state business activities does not distort that company's in-state income. Eastman Kodak, 308 S.C. at 419-420, 418 S.E.2d at 544 (rejecting SCDOR's argument that including the portion of Kodak's unitary business done primarily out-of-state in the formula distorted Kodak's in-state income and holding that based on Exxon and the testimony in the case, "the safe harbor lease transactions cannot be segregated from Kodak's general business operations").

CarMax West presented substantial evidence that the standard formula fairly reflects its activities in South Carolina under the principles set forth in Exxon, Eastman Kodak and Lowenstein. Specifically, CarMax West presented testimony and evidence at trial showing that the income at issue is produced by its total unitary business activities and is not solely attributable to its limited activities in South Carolina. See R. p. 69, line 18- p. 72, line 9; p. 74, lines 11-17 and p. 76, line 20- p. 80, line 17 (testimony of CarMax Tax Director regarding unitary nature of business and interrelationship of different parts of the business such that each contributed to the success of others); R. p. 205, lines 6-18 (testimony of CarMax West's expert economist that the Taxpayer's unitary income could not be accurately accounted for separately).

Additionally, in order to satisfy due process concerns, a tax must fairly reflect the relationship between the taxpayer's activities in this State and the benefits provided by the State. As the South Carolina Supreme Court has explained, a proposed tax must have "a fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask [something in] return." Exxon, 273 S.C. at 606, 258 S.E.2d at 99.

CarMax West presented evidence at trial that its in-state activities are minimal and that it receives minimal benefits from the State of South Carolina. CarMax West's Tax Director testified that CarMax West has no physical presence in South Carolina (see R. p. 74, line 24- p. 75, line 8 (testifying that it sells cars in the western United States and does no business in South Carolina); R. p. 75, lines 2-6 (testifying that CarMax West has no employees, no facilities and no tangible property in South Carolina)), and that its only connection to the State is the payments it has received from CarMax East for the use of the CarMax intellectual property that is used by CarMax East to sell cars in this state. R. p. 75, line 12- p. 76, line 6. She also testified that due to the absence of a physical presence in the state, CarMax West neither requires nor receives any substantive services or benefits from the State of South Carolina. See R. p. 75, lines 9-11.

CarMax West's expert economist also testified that the statutory apportionment method used by CarMax accurately reflects its low-level of business activities in South Carolina in light of two economic principles: the "matching" principle and the "benefit" principle. Under the "matching" principle, revenue should be matched with the expenses incurred to produce it, and because the overwhelming majority of CarMax

West's operations and expenses take place outside of South Carolina, it is appropriate that its South Carolina tax burden be low. R. p. 203, line 6- p. 205, line 2. Under the "benefit" principle, an important tax policy goal is that the taxpayers who are benefiting from government services are the ones helping to pay for those services. R. p. 203, line 21- p. 204, line 4. For example, the gasoline tax is used to help build more roads and bridges; those using these roads and bridges more buy more gas and thus pay a larger share of those taxes, which they then benefit from via new roads and bridges. R. p. 204, lines 5-15. CarMax West's tax burden must have some relation to the benefits received from South Carolina, and because it receives few benefits, its tax burden should be correspondingly low. Exxon, 273 S.C. at 606, 258 S.E.2d at 99. The tax assessment computed under the standard apportionment method is directly proportionate to CarMax West's limited activities in this State and the minimal benefits received.

Not only does SCDOR ignore the above law as to unitary businesses, but it presented no evidence of any criteria (published or unpublished) that exists for its auditors, taxpayers or the ALC to follow to determine whether the standard method fairly reflects a taxpayer's in-state business activities. Instead, this determination is done on a case-by-case basis with the auditors making their own subjective determinations. SCDOR's approach and the ALC's endorsement of it, therefore, significantly undermine the predictability that is essential to a properly functioning tax system.

Indeed, SCDOR's assessment in this case is premised entirely on a false assumption. SCDOR's witness testified that auditors have been instructed to look for companies that have East Coast/West Coast structures because SCDOR believes that

sometimes other taxpayers employ organizational structures like this in order gain tax savings and, thus, this structure raises "red flags." R. p. 260, line 20- p. 261, line 13; p. 263, line 16- p. 264, line 12. Based on this assumption and before visiting CarMax West or performing any investigation (much less a thorough field audit), the auditor immediately concluded that CarMax was operating a "[r]oyalty scheme," and he sent CarMax West "audit papers" with proposed assessments of additional taxes and penalties owed. See R. p. 474, Report of Field Audit (assessment section); R. p. 90, line 21- p. 91, line 15.

The uncontested evidence presented at trial directly contradicted SCDOR's assumption and conclusively establishes that CarMax West had valid business reasons for its structure. See R. p. 65, line 8- p. 68, line 10. These reasons, outlined previously, include lessening confusion for regulators, simplifying the regulatory compliance process, providing greater liability for the separate businesses and centralizing general, retail and intangible asset management functions. See supra Statement of Facts, Section II.

Beyond its assumption, SCDOR presented no substantive evidence to show that CarMax West's South Carolina income was distorted. Its only support for the alternative formula is the alleged distortion example created by the auditor after already having reached his conclusion. The "example" compares the amount of income made by CarMax East versus CarMax West (it divides the federal net income of each by the federal gross receipts of each) and arguably shows two things: that CarMax West had a lower apportionment ratio and therefore lower taxable income than CarMax East and

that CarMax West paid less tax under the standard formula than it would under separate accounting - neither of which suggests, much less establishes, distortion.

The simple fact that CarMax West and CarMax East have different apportionment ratios and therefore different taxable income in South Carolina does not, standing alone, establish anything, and SCDOR failed to explain how this comparison was meaningful. In fact, one would expect CarMax East to have significantly higher income and thus higher tax revenue in South Carolina because it has a much greater level of business activity in South Carolina. Nothing about the fact or amount of this difference in taxable revenue provides a legal basis for SCDOR to deviate from the standard formula. Furthermore, SCDOR introduced no evidence to suggest much less establish that the additional income at issue upon which the assessment is based is generated solely by CarMax West's in-state activities.

In addition, the fact that an alternative method such as separate accounting produces higher taxable revenue does not and cannot justify the use of such a method. See St. Johnsbury Trucking Co., 385 A.2d. at 217 (stating that "[m]erely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire is not in and of itself a sufficient reason for deviating from the legislatively mandated formula").

Finally, SCDOR's alternative method has ultimately created rather than remedied a distortion by assessing a tax on CarMax West out of all proportion to its relationship to South Carolina and in excess of the tax paid by CarMax East. As previously explained, CarMax West operates no stores, owns no tangible property and employs no associates in South Carolina. R. p. 75, lines 2-6. Its only connection to

the state is through its ownership interest in CBS. Conversely, CarMax East owns and operates three auto superstores in the state. Yet, under the assessment for fiscal year 2006, CarMax West owes \$102,303 in tax while CarMax East paid only \$94,452.

In sum, SCDOR has no standards or criteria in place to use in rejecting the standard statutory apportionment method. Moreover, SCDOR's audit process in this case appears to have ignored the factual circumstances of CarMax West (in particular, the valid business reasons for its structure, the unitary nature of its business, the minimal activities in South Carolina and the minimal benefits provided to it by South Carolina) as well as the established law in this State regarding unitary businesses.<sup>7</sup> CarMax West presented substantial and un rebutted evidence that it operates a unitary business, and, thus, under Exxon, Eastman Kodak and Lowenstein, its in-state business activities are fairly reflected by the standard apportionment method. Accordingly, CarMax West respectfully requests that this Court conclude that the ALC erred in finding that the standard statutory method does not fairly reflect CarMax West's business activities in South Carolina and reverse the ALC and dismiss the assessment.

**IV. THE ALC ERRED IN ALLOWING SCDOR TO APPLY SEPARATE ACCOUNTING TO A UNITARY BUSINESS WHEN DOING SO IS PROHIBITED UNDER EXXON CORP. V. S.C. TAX COMM'N, 273 S.C. 594, 258 S.E.2d 93 (1979) AND S.C. CODE ANN. § 12-6-2320(A)(4) (2000 and West Supp. 2009) BECAUSE IT PRODUCES AN UNREASONABLE RESULT; ALTERNATIVELY, SEPARATE ACCOUNTING DOES NOT PRODUCE A REASONABLE RESULT IN THIS CASE.**

Even if one assumes that the statutory apportionment formula does not fairly reflect the business activities of CarMax West in South Carolina, the ALC erred in finding

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<sup>7</sup> See Exxon, 273 S.C. 594, 258 S.E.2d 93; Eastman Kodak, 308 S.C. 415, 418 S.E.2d 542; Texaco, 269 S.C. 255, 237 S.E.2d 75; Lowenstein, 298 S.C. 93, 378 S.E.2d 272.

that SCDOR correctly applied separate accounting to a unitary business in contradiction to Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979) and S.C. Code Ann. § 12-6-2320(A)(4) (2000 and West Supp. 2009) because this method cannot and does not produce a reasonable result. In the alternative, should the Court determine that Exxon and § 12-6-2320(A)(4) do not strictly prohibit separate accounting in all cases involving a unitary business, separate accounting does not produce a reasonable result in this case. As previously discussed, in reaching its conclusions, the ALC applied the incorrect burden and standard of proof (see supra, Argument, section I). Even if the ALC correctly applied the burden of proof to CarMax West, it made errors in applying the law and making findings and conclusions that were not supported by substantial evidence in the record, and, therefore, these findings and conclusions should be reversed. S.C. Code Ann. § 1-23-610(B)(e) (Supp. 2009); Brownlee, 382 S.C. at 136, 676 S.E.2d at 119-120 (holding ALJ may be reversed based on error of law or if findings were not supported by substantial evidence).

- A. Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979) and S.C. Code Ann. § 12-6-2320(A)(4) (2000 and West Supp. 2009) Prohibit Separate Accounting as to a Unitary Business Because this Method Cannot and Does Not Produce a Reasonable Result.

SCDOR's alternative method seeks to separate CarMax West's royalty income from its other income (related to retail car sales) and, thus, is a separate accounting. The only basis given in the Order as to why separate accounting is reasonable in this case is that the statute provides this option and that this method considers only the business done by CarMax West in this State. See R. p. 11, Order. The ALC is correct that separate accounting is one method identified under the statute as a possible

alternative (as is "any other method"); however, the method chosen must be reasonable and must fairly reflect the taxpayer's activities in this State.<sup>8</sup> While separate accounting might very well be reasonable in some cases, the South Carolina and United States Supreme Court case law prohibit this option for a unitary business precisely because it cannot be reasonable.

As the United States Supreme Court has explained, formulary apportionment is presumed to be fair and reasonable (see Butler Bros. v. McColgan, 315 U.S. 501 (1942)), while separate or formal accounting is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Container Corp., 463 U.S. at 164-65. Thus, once a court determines that a business is unitary, "a State must then apply a formula apportioning the income of that business within and without the State." Id. at 169 (emphasis added). In other words, a state must apportion the entire net income received from the in-state and out-of-state activities of a unitary business and cannot pick and choose certain items of income and expenses to be included in or excluded from taxation in certain states even if the discrete components of a state income tax, when viewed in isolation, might appear susceptible to geographic designation.

Similarly, the South Carolina Supreme Court has held that because the income generated by the various components of a unitary business cannot be accurately

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<sup>8</sup> See Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue, Op. no. 26828 (June 14, 2010) (affirming ALC's decision that S.C. Code Ann. § 12-6-2320 allows "any other method" even if not generally used in South Carolina (combined reporting generally not allowed in this State) but only if the standard method does not fairly reflect the taxpayer's in-state business activities and the alternative method is reasonable and does fairly measure the taxpayer's in-state activities).

accounted for individually as it is "attributable to all incidents of the business and not to any single activity," separate accounting of a unitary business is prohibited. Exxon, 273 S.C. at 599, 258 S.E.2d at 96. See also Eastman Kodak, 308 S.C. at 419-20, 418 S.E.2d at 544; Lowenstein, 298 S.C. at 101-107, 378 S.E.2d at 276-279. See also, supra, Argument, Section II(A).

This reading of Exxon is consistent with both SCDOR's own regulations and economic and tax accounting principles. SCDOR's regulations clearly state that a "taxpayer operating a unitary or homogenous business within and without the state and an unrelated business either entirely within or without is subject to apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business." See S.C. Code Ann. Regs. § 117-710.1 (West Supp. 2009) (emphasis added). CarMax West's expert economist and expert tax accountant provided compelling economic and tax policy rationales in support of this rule. See R. p. 205, lines 13-18 (testimony of CarMax West's expert economist that because of the interdependence of the business units, applying separate accounting to a unitary business is likely to lead to errors in calculating income and tax); R. p. 150, line 13- p. 151, line 15 (testimony of CarMax West's tax accounting expert that errors in accounting for the various individual components of a unitary business result because of "the interrelationships between the members of the unitary group," which can result in the sum of all the parts being greater than the whole).

SCDOR nonetheless argued at trial and the ALC found that Exxon is not an "all or nothing" proposition, that unitary is a descriptive term that implies "a range, at one end of which is a business too interconnected to be separated" and that "whether or not

a division or separate consideration is possible or can be justified depends on the purpose of that division or separation." R. p. 10, Order. CarMax West believes that the ALC misunderstands the nature and effect of Exxon and the related cases discussed above. No Court has interpreted Exxon this way. Moreover, even if the ALC was correct that there is a range of unitary businesses, it cites no law for the proposition that the purpose of the division is relevant, fails to consider the purpose in this case and fails to determine where CarMax West falls within this supposed unitary "range." The ALC simply concluded that "whether a taxpayer is unitary or non-unitary is not outcome determinative." Id. To the contrary and as discussed above, nothing is more critical to the analysis in this case because under Exxon, if a business is unitary, then its income is attributable to all incidents of the business and attempts to segregate this income along geographic or business lines cannot and will not produce a reasonable result as S.C. Code Ann. § 12-6-2320(A)(4) requires.

In sum, under South Carolina law, which is consistent with economic and tax accounting principles, separate accounting is prohibited as to a unitary business because it cannot produce reasonable results. Accordingly, SCDOR may not separate one portion of CarMax West's business (*i.e.* the royalty income) from the rest of the business (*i.e.* the retail sales income) because CarMax West operates a unitary business just as the taxpayers in Exxon, Eastman Kodak and Lowenstein did.

**B. Separate Accounting Is Not Reasonable in this Case.**

Even if this Court finds that separate accounting is not strictly prohibited as to all unitary businesses, it is not reasonable in this case for numerous reasons. Several of these reasons have been addressed previously: (1) CarMax presented substantial and

unrebutted evidence that it operates a highly unitary business (see supra, Argument, Section II(B)); (2) SCDOR presented no evidence to support its theory that what it perceived as isolated portions of CarMax West's unitary income should be separated or can be accurately separated or to show that the receipts at issue are produced solely by CarMax West's activities in South Carolina, and, indeed, CarMax West presented substantial and unrebutted evidence that its royalty income was not produced solely by its in-state activities but rather was part of its unitary income (see R. at p. 71, line 16- p. 72, line 9 and supra, Argument, Section II(B)); and (3) imposing a separate accounting on a unitary business contradicts SCDOR's own regulations. See supra Argument, Section IV(A).

Moreover, SCDOR's separate accounting constitutes an attempt to effectively isolate and tax the income of a partnership (*i.e.*, CBS, a pass-through entity). Under South Carolina law, however, a partnership is not a taxable entity, and the Department therefore lacks any authority to tax it.

Additionally, to the extent that a tax is to be viewed as compensatory for services rendered, the proposed separate accounting method employed in the audit report produces gross distortion in this case. The distortion is evident by comparing CarMax East (whose tax liability is not in dispute) with CarMax West. Under SCDOR's alternative method, CarMax East, which operates three CarMax superstores in South Carolina and reaps significant benefits from this state, paid less in taxes (\$94,452) than would CarMax West (\$102,303), which has virtually no presence in South Carolina and receives minimal benefits from the State. See R. p.p. 924-926, SCDOR Distortion Example for FY 2006. There is no reasonable explanation in the

audit report, the Department Determination or the evidence produced at trial that could justify a tax on the limited in-state activities of CarMax West of this magnitude. The State of South Carolina has not provided sufficient benefits or services for which it could reasonably exact a return of this size. Exxon, 273 S.C. at 606, 258 S.E.2d at 99 (stating that "[t]he simple but controlling question is whether the state has given anything for which it can ask return").

Finally, SCDOR's separate accounting is not based on any criteria or standards for SCDOR, taxpayers and courts to follow when selecting an alternative method. If this Court approves SCDOR's use of this "alternative method," the result would likely be chaos. No multi-state taxpayer filing in this state would have any certainty about how to file because there is nothing in the instructions to the tax return, revenue rulings or any other published position of SCDOR that would indicate to even the most careful multi-state taxpayers what is expected of them and under what circumstances. Moreover, when disputes arise, as they most certainly will, courts will still have no clear basis on which to evaluate SCDOR's alternative method in any given case.

In response to the above, SCDOR argued at trial that CarMax West's royalty income should not be "mixed" with its retail car sales income because no retail car sales income was earned in South Carolina and that the ALC need not be concerned with separating these two types of income because the amount of the royalty payments accounted for the flows of value between the companies or divisions. In further support of this notion, SCDOR's expert economist offered an "apples and oranges" metaphor with the apples in this case being the royalty payments and the oranges being the retail car sales. He contended that one should not mix the apples with the oranges,

*i.e.* the royalty income with the retail sales income (R. p. 348, line 9- p. 349, line 9) because only apples (royalty income) are in South Carolina. Additionally, SCDOR argued and the Order states that the main concern with separate accounting, *i.e.* that "it may fail to account for the flows of values among the components of a unitary business" (see R. p. 11, Order), is not present in this case because "the various activities and flows of value are clearly delineated by the inter-company flow of funds from one legal entity to another." R. p. 11-12, Order.

Just as they underestimated the effect of Exxon, SCDOR and the ALC also underestimate the obstacles encountered in applying separate accounting to a unitary business. First, just because a company generates only one type of income in one state (*i.e.* royalty income here) and another type of income in another state (*i.e.* retail car sales income here) does not mean that they should never be combined for tax purposes. Similar arguments were made in the Exxon case with the apples being the oil production and refineries and the oranges being the gas pumps and stations. The South Carolina Supreme Court rejected this type of reasoning and held that the income of a unitary business cannot be separated in this manner. Exxon, 273 S.C. 594, 258 S.E.2d 93. Second, the fact that royalty payments are made only shows that CarMax West has *attempted* to value the *use* of the CarMax intellectual property and does not show that CarMax West has *determined* the value of the management of the intellectual property's *contribution to the business as a whole*, and SCDOR presented no evidence to the contrary. Inter-company transfer of value pricing is not controlling for a unitary business. Container Corp., 463 U.S. at 164-65. See also Exxon, 273 S.C. at 603-604, 258 S.E.2d at 98 (quoting Butler Bros., 315 U.S. at 507) (finding arguments of the Tax

Commission that "transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income" persuasive and stating that "[a]ccounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.").

In sum, under Exxon and related cases, separate accounting is prohibited for a unitary business, which CarMax West clearly is (see supra Argument, section II(B) and IV(A)). Alternatively, if this Court determines that separate accounting is not strictly prohibited as to all unitary businesses, it is still not reasonable in this case because (1) CarMax West operates a highly unitary business; (2) the royalty income at issue was created by the unitary business activities of the company and not just its activities in South Carolina and therefore cannot be accurately separated; (3) imposing a separate accounting on a unitary business contradicts SCDOR's own regulations; (4) SCDOR lacks the legal authority to separately tax a partnership; (5) CarMax West's level of business activity in South Carolina is very low; (6) the services and benefits provided to CarMax West by South Carolina are minimal; (7) this tax is higher than that paid by CarMax East, which does substantial business in South Carolina; and (8) SCDOR has used no established standards or criteria to depart from the standard formula and invoke its alternative method authority. Under S.C. Code Ann. §12-6-2320(A)(4), because SCDOR's separate accounting method was unreasonable, this Court should reverse the ALC's findings and dismiss the assessment.

V. THE ALC ERRED IN FAILING TO APPLY THE "PLACE OF ACTIVITY" TEST SET FORTH IN LOCKWOOD GREENE ENGINEERING V. S.C. TAX COMM'N, 293 S.C. 447, 361 S.E.2d 346 (CT. APP. 1987) AND IN CONCLUDING THAT CARMAX WEST'S FINANCING RECEIPTS SHOULD BE SOURCED TO SOUTH CAROLINA WHEN ALL SERVICES RELATED TO PRODUCING THAT INCOME ARE PERFORMED OUT-OF-STATE.

The ALC erred in sourcing financing receipts of CarMax West to South Carolina when all of the services related to producing that income are performed out-of-state. In Lockwood Greene Engineers v. S.C. Tax Commission, 293 S.C. 447, 448, 361 S.E.2d 346, 347 (Ct. App. 1987), this Court adopted the "place of activity" test, under which, for purposes of South Carolina's apportionment statutes, "receipts" are sourced to the state where the services are performed. The taxpayer in Lockwood Greene was an engineering firm with employees in South Carolina and customers in and out-of-state. Lockwood Greene argued that the Court should apply the "origin of payment" test and source the receipts to the location of its customers, but SCDOR and the Court rejected this test in favor of the "place of activity" test. Id. The Court reasoned that out-of-state clients were paying the firm for the expertise and time of the employees who were located in South Carolina. Id. at 449, 361 S.E.2d at 347.

Under the Lockwood Greene "place of activity" test, CBS's financing receipts should be sourced outside of South Carolina. It was uncontested that all of the activity producing these receipts takes place outside of the state (R. p. 108, lines 12-15), and that such activity adds value. R. p. 207, line 24- p. 209, line 2. Moreover, sourcing the receipts outside of South Carolina does not deprive South Carolina of a fair share of the tax revenue from the transactions that actually occur within the state. As explained above, all income from the initial vehicle sales is reported in South Carolina by

CarMax East and taxed by South Carolina. R. p. 104, lines 6-11. The financing income at issue here is related only to the subsequent activity of servicing and securitizing the loans after the initial sale, all of which occurs in Georgia.

As CarMax West's expert economist testified, applying the "place of activity" test produces the correct economic result under the "value added" and "matching" principles. The "value added" principle essentially holds that income should be sourced to the location where the value producing the income is added. R. p. 208, line 6- p. 209, line 2. Because CBS associates are located in Georgia and add value during the servicing and securitizing stage, he believed these revenues should not be sourced to South Carolina. Id. (explaining that this concept is the same one used in computing national gross domestic product, which looks at the addition in value at each stage of production). As previously discussed, the matching principle provides that income should be matched to the expenses that produce it. R. p. 209, lines 3-13. Because CBS incurs its servicing and securitizing expenses in Georgia, that is where the income they produce should be sourced. See also R. p. 168, lines 11-22 (testimony of CarMax West's expert on state and local tax, tax accounting and tax policy explaining that matching income and expenses is good tax policy<sup>9</sup> and that most states would tax this type of income on a cost of performance or income-producing activity basis).

The alternative "but for" test proposed by SCDOR is unsupported, is flawed, would produce irrational results and should be rejected. SCDOR's position is that all

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<sup>9</sup> SCDOR's point raised at trial that the financing receipts have already been matched against financing expenses in CBS is not a reason to trace the receipts away from the activities that produced them. The matching principal is just as viable in the sourcing of receipts as it is in the fact that the receipts are first off-set by the expenses that produced them in CBS; one should still match income with activities.

receipts from post-sale financing activities related to vehicles sold in South Carolina should be sourced to South Carolina because that is where the initial transaction takes place; as SCDOR's expert testified, "but for" the initial sale in South Carolina, there would be no financing receipts. R. p. 420, lines 14-21. Neither SCDOR nor its expert supplied any basis for this test in the law or economic literature. A more persuasive application of the "but for" test is that "but for" the activities of the out-of-state employees who service and securitize the loans, there would be no income to source. SCDOR's expert failed to even address much less explain why the activities that directly cause the income to be earned should be ignored.

This test is also flawed and produces illogical results. Under SCDOR's "but for" test, income from financing contracts initially sold in South Carolina would always be traced to South Carolina no matter where the sale or assignment of those contracts takes place, no matter where the purchaser of those contracts is located and no matter how much work is performed in order to service or securitize those contracts. Indeed, it would make no difference whether the purchaser of the vehicle moves out of South Carolina and begins paying CBS in Georgia from, for example, North Carolina; under SCDOR's theory, those payments would not be made "but for" the initial transaction in South Carolina, and, therefore, the receipts should be taxed by South Carolina. This makes no sense and is contrary to sound economic policy, tax policy and accounting principles, including the cost or performance or place of activity concept and the matching principle.

As support for its ruling, the ALC references dicta in Lockwood Greene stating that the "place of activity" test might not apply to a finance company. That language

obviously does not constitute binding precedent and should not guide resolution of this issue. The principles supporting the sourcing of the engineering services revenue to the place of activity in Lockwood Greene apply equally to the finance employees in this case.

The ALC also cites Geoffrey, Inc. v. S.C. Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (1993) in support of its decision on this issue, but that case simply has no bearing on where CarMax West's financing receipts should be sourced. In Geoffrey, the South Carolina Supreme Court held that the royalty income earned by an out-of-state holding company affiliate had a sufficient nexus to the state to support the assessment of income tax. CarMax West does not contest its economic nexus to South Carolina, as evidenced by its years of income tax return filings and payments to the state. But Geoffrey provides no guidance whatsoever as to where financing revenue generated out-of-state after an in-state sale should be sourced, and it does not displace the "place of activity" test adopted in Lockwood Greene.<sup>10</sup>

Based on the above and under the "place of activity" test in Lockwood Greene, CarMax West established by a preponderance of the evidence that it should not source any income from the financing services activities that take place after the initial sale to South Carolina because the economic activity that produces these additional revenues (thereby adding value to the process) and the securitizations of the initial contracts take place out-of-state, and the ALC erred in finding otherwise. CarMax West therefore

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<sup>10</sup> Additionally, Geoffrey provides further support to CarMax West's argument above that separate accounting is inappropriate (see supra, Argument, section IV) as the tax assessed in Geoffrey was based on Geoffrey's total unitary net income as measured by its sales activities (the exploitation of trademarks) that took place in this State and not by separate geographical accounting as SCDOR has imposed here.

respectfully requests that this Court reverse the ALC on this issue and dismiss the portion of the assessment related to sourcing of financing receipts.

**VI. THE ALC ERRED IN CONCLUDING THAT SCDOR DOES NOT VIOLATE CARMAX WEST'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS AND SOURCING FINANCING RECEIPTS TO SOUTH CAROLINA.**

The ALC erred in concluding that SCDOR does not violate CarMax West's constitutional rights by applying separate accounting to a unitary business and by sourcing the finance receipts at issue to South Carolina. SCDOR has erroneously applied the South Carolina income tax laws to CarMax West in such a way as to reach an unconstitutional result.<sup>11</sup> The method of taxation employed by SCDOR violates the Due Process Clause of the South Carolina and United States Constitutions and the Interstate Commerce Clause of the United States Constitution because, *inter alia*, it taxes income with no connection to South Carolina, taxes income out of all proportion to CarMax West's activities in South Carolina, is not fairly apportioned and is not fairly related to the services provided by the taxing state.

The four-part test for determining whether a state taxing statute violates the commerce clause is set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). To be sustained, a tax must: (1) be applied to an activity with a substantial nexus to the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the taxing state. *Id.* at 279. In evaluating the fairness prong, one of the tests the courts apply is an external

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<sup>11</sup> Although the ALC does not have the authority to declare a statute facially unconstitutional, it has the authority to declare the application of a statute unconstitutional. Evans v. State of South Carolina, 344 S.C. 60, 543 S.E.2d 547 (2001); Video Gaming Consultants, Inc. v. S.C. Dep't of Revenue, 342 S.C. 34, 535 S.E.2d 642 (2000).

consistency test. See Container Corp., 463 U.S. at 169 (discussing fairness issue under both Commerce Clause and Due Process Clause). External consistency requires that the factors used by the state in the apportionment formula "must actually reflect a reasonable sense of how income is generated." Id. A formula will not satisfy this test if it attributes income to the state that is "out of all appropriate proportions to the business transacted . . . in that State" (id. at 170 (quoting Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell, 283 U.S. 123, 135 (1931))) or has "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978)). See also Amerada Hess Corporation v. Director, Division of Taxation, 490 U.S. 66 (1989) (applying Complete Auto test and due process analysis and holding that expenses and income associated with the taxpayer's crude oil production activities were part of the taxpayer's unitary business and accordingly were not assignable out-of-state but rather were properly subject to apportionment); Trinova Corp. v. Michigan Department of Treasury, 498 U.S. 358 (1991); Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 607 258 S.E.2d 93, 99 (1979) (stating that due process clause requires there be some fiscal relation to the protections, opportunities and benefits provided by the state).

As applied to CarMax West in this case, the tax assessment at issue fails the Complete Auto test and runs afoul of the law as set forth in Container Corp., Exxon and similar cases because it taxes income with no connection to South Carolina (as to financing income only), is not fairly apportioned, and is not fairly related to the services provided by the taxing state. More specifically, as to the fairness prong, the alternative formula invoked by SCDOR in this case fails the external consistency test because it does not actually reflect a reasonable sense of how income is generated by CarMax West, a unitary

business, in South Carolina. Finally, the formula applied by SCDOR is not fairly related to the services provided by South Carolina, which are de minimus in this case. The irrationality and unfairness of the proposed assessment on CarMax West is further illustrated by the fact that SCDOR would be imposing a greater tax liability on CarMax West (\$102,303), which has virtually no contact with South Carolina, than CarMax East (\$94,452), which performs substantial business in South Carolina. See R. p. 924-926, SCDOR Distortion Example for FY 2006. CarMax West established by a preponderance of the evidence that SCDOR's assessment results in liability that is distortive and taxes CarMax West out of all proportion to and does not fairly represent its business conducted in South Carolina (see Container Corp., 463 U.S. at 170; Hans Rees', 283 U.S. at 135), and the ALC's finding to the contrary is in error and should be reversed.

### CONCLUSION

Based on the foregoing, CarMax West respectfully requests that this Court:

- I. Reverse the ALC and dismiss the assessment based on separate accounting because the ALC improperly placed the burden of proof on CarMax West. Alternatively, CarMax West requests that this Court remand this case to the ALC to enter an order consistent with the correct burden and standard of proof.
- II. Enter a finding based on the uncontested evidence that CarMax West is a unitary business. In the alternative, CarMax West requests that this Court remand this matter to the ALC so that it may make a finding under Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979) as to whether or not CarMax West operates a unitary business, and if the ALC finds that it did, to reconsider the following two issues: (1) whether the standard apportionment method is a fair reflection of CarMax West's activities in South Carolina; and (2) whether the separate accounting method applied to CarMax West is reasonable.

- III. Reverse the ALC and dismiss the assessment based on separate accounting because the standard statutory method fairly reflects CarMax West's business activities in South Carolina.
- IV. Reverse the ALC and dismiss the assessment based on separate accounting because SCDOR's separate accounting method is unreasonable.
- V. Reverse the ALC and dismiss the assessment as to CarMax West's financing receipts because those receipts should not be sourced to South Carolina when the services related to the production of that income were performed out-of-state.
- VI. Reverse the ALC and dismiss the entire assessment because SCDOR does violate CarMax West's constitutional rights by applying separate accounting to a unitary business and sourcing financing receipts to South Carolina.

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: Bryson M. Geer

John C. von Lehe, Jr.  
SC Bar no. 5719  
Bryson M. Geer  
SC Bar no. 13606  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for CarMax West

Charleston, South Carolina  
January 12, 2011

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

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

CERTIFICATE OF COUNSEL

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

NELSON MULLINS RILEY & SCARBOROUGH, L.L.P.

By: Bryson M. Geer  
John C. von Lehe, Jr.  
SC Bar no. 5719  
Bryson M. Geer  
SC Bar no. 13606  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402)  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for CarMax Auto Superstores West Coast,  
Inc.

Charleston, South Carolina  
January 12, 2011

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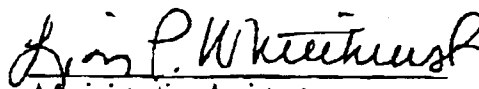
I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for CarMax Auto Superstores West Coast, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by hand delivering a copy of the same via courier, to the following address(es):

Pleadings: Final Brief of Appellant

Counsel Served:

Milton G. Kimpson  
Harry A. Hancock  
Counsel for Litigation  
South Carolina Department of Revenue  
301 Gervais Street, 3<sup>rd</sup> Floor  
Columbia, SC 29201

Burnet R. Maybank, III  
Nexsen Pruet, LLC  
1230 Main Street, Suite 700  
Columbia, SC 29201

  
Administrative Assistant

January 14, 2011

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THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Carolyn C. Matthews, Administrative Law Judge

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

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

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FINAL BRIEF OF RESPONDENT

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Harry A. Hancock  
Counsel for Litigation  
Milton G. Kimpson  
General Counsel for Litigation  
PO Box 12265  
Columbia, SC 29211  
(803) 898 5598  
Fax (803) 898-5147  
Attorneys for Respondent

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### STATEMENT OF ISSUES ON APPEAL

- I. Did the ALC err in finding the Department's use of an alternative apportionment method pursuant to § 12-6-2320 was reasonable and that the taxpayer failed to meet its burden challenging the Department's assessment?
- II. Did the ALC err in finding that the taxpayer's west coast retail operations were not a part of the taxpayer's business activity within South Carolina pursuant to § 12-6-2320?
- III. Did the ALC err in finding that the extent of the taxpayer's business activity in South Carolina was fairly represented by the application of an alternative method of apportionment pursuant to § 12-6-2320?
- IV. Does South Carolina case law prohibit the use of an alternative method of apportionment pursuant to § 12-6-2320?
- V. Did the ALC err in sourcing the taxpayer's royalty income within South Carolina and by finding that its retail auto sales in California, Nevada, and Utah were not sourced to South Carolina?
- VI. Did the taxpayer fail to carry its burden of proof that the Department's alternative method of apportionment violated its rights under the Due Process and Commerce Clauses of the United States Constitution?

### STATEMENT OF THE CASE

CarMax Auto Superstores West Coast, Inc., (Appellant or taxpayer) is a multi-state corporation which owns a 93.5% interest in Carmax Business Services, LLC (CBS) which manages intangibles and enters into car financing (secured transactions) within South Carolina. CBS then securitizes the consumer finance contracts and sells them to third party investors. The other owner of CBS is CarMax Auto Superstores, Inc., (East) which owns 6.5% of CBS. East operates retail auto sales locations within South Carolina. East pays a royalty fee to CBS, which it takes as a deduction against its South Carolina taxable income. CBS is treated as a pass-through entity for tax purposes and pays no taxes in this State. CBS then makes distributions of income to East and the taxpayer based on the percentage of ownership interest. The taxpayer filed amended returns for the tax years 2002-2007 employing its chosen method of apportionment, and their methods yielded the following taxable income:<sup>1</sup>

|        |                 |
|--------|-----------------|
| 2002:  | \$14,717        |
| 2003:  | \$11,532        |
| 2004:  | \$7,840         |
| 2005:  | \$6,883         |
| 2006:  | \$3,879         |
| 2007:  | <u>\$3,670</u>  |
| Total: | <b>\$48,523</b> |

The Department of Revenue (Department) audited the taxpayer for the corporate income tax years of 2002, 2003, 2004, 2005, 2006, and 2007. The total assessment, including penalties and interest, was \$829,490.00.<sup>2</sup> This was summarized as follows:

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<sup>1</sup>See Tr. Ex.4, CarMas West Amended Tax Returns, 2002-2007 (R., p. 497).

<sup>2</sup>See Department Determination (R., p. 490).

|                   |                     |
|-------------------|---------------------|
| <b>Income Tax</b> | <b>\$488,300.00</b> |
| <b>Interest*</b>  | <b>\$129,828.00</b> |
| <b>Penalty</b>    | <b>\$211,362.00</b> |
| <b>Total</b>      | <b>\$829,490.00</b> |

The Department's auditor employed an alternative apportionment formula under the provisions of S.C. Code Ann. § 12-6-2320(A)(4) (Supp. 2009) as he found that the taxpayer's use of the standard apportionment formula failed to accurately reflect income producing activity within this State. The alternative method of apportionment essentially denied the taxpayer's efforts to inflate its apportionment ratio denominator by including the sales of autos from its retail operations in California, Utah, and Nevada. The auditor also included the income from the sale of securitized consumer lending contracts in the taxpayer's South Carolina income. The taxpayer protested the Department's proposed assessment and the Department issued its Determination upholding the proposed assessment. The taxpayer timely protested the Determination by filing for a contested case hearing before the Administrative Law Court (ALC).

The ALC issued its ruling after a full hearing of all issues. In its Order, the ALC upheld the Department's audit findings. However, the ALC did not award the penalties as assessed.

### **FACTS**

CarMax Auto Superstores West Coast, Inc. is the Appellant/taxpayer, and a subsidiary of Carmax, Inc. Taxpayer is a retailer of used light trucks and automobiles, and operates retail locations in California, Utah, and Nevada.<sup>3</sup> Prior to 2004, the taxpayer

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<sup>3</sup>ALC Order, p. 2, para. 1; Tr., p. 96, lines 9-12, p. 98, line 13 (R., p. 2, para. 1; R., p. 114, lines 9-12; R., p. 116, line 13).

also 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 and from retailers in other states.<sup>4</sup>

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 personal 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 royalties and other payments for South Carolina tax purposes.<sup>5</sup>

Carmax Business Services, LLC (CBS) is another Carmax, Inc. subsidiary that was formed in 2005 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 income distributions. East also contributed certain assets and turned over the Carmax financing operations to CBS in exchange for a 6.5% interest in CBS.<sup>6</sup> And, after the restructuring, CBS provided various services to all Carmax entities and retailers. These services included managing the intangibles and 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

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<sup>4</sup>ALC Order, p.2 (R., p. 2).

<sup>5</sup>ALC Order, p. 2 (R., p. 2).

<sup>6</sup>ALC Order p. 2 (R., p. 2).

Carmax customers who financed their purchases. Some income was received from the sale of the securitized financing contracts to third party investors. The value of the securitized investment offerings, in part was attributable to regular payment of installments by the end-consumers.<sup>7</sup>

CBS is a "pass through" entity for South Carolina tax purposes, and is not directly taxed on the income it received from South Carolina. CBS's net income is distributed to the taxpayer (93.5%) and East (6.5%). Thus, the taxpayer received South Carolina sourced income in the post restructuring audit years despite its lack of retail operations in this State.<sup>8</sup>

The 2005 restructuring was undertaken with consultation from Ernst and Young, which simultaneously provided state tax advice on the restructuring to Carmax, Inc.<sup>9</sup>

The taxpayer originally filed timely South Carolina corporate income tax returns for years 2002-2007 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 taxpayer's total property, payroll, and sales.<sup>10</sup>

The Department audited the taxpayer for the tax years 2002 through 2007, and issued a proposed assessment on June 19, 2008, adjusting the taxpayer's apportionment formula and imposing additional taxes, penalties, and interest. After the audit, the

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<sup>7</sup>ALC Order p. 3 (R., p. 3).

<sup>8</sup>ALC Order p. 3 (R., p. 3).

<sup>9</sup>ALC Order p. 4 (R., p. 4).

<sup>10</sup>ALC Order p. 4 (R., p. 4).

taxpayer filed amended returns in September 2009, utilizing a different statutory formula - S.C. Code Ann. § 12-6-2290 (Supp. 2009) - also referred to as the gross receipts formula. This formula calculated the taxpayer's apportionment ratio by dividing its gross receipts from financing and intangibles in South Carolina by the taxpayer's receipts from financing, intangible, and retail sales everywhere the taxpayer does business.<sup>11</sup>

The ALC agreed that the taxpayer's tax returns failed to fairly reflect the extent of its business in South Carolina, even using the gross receipts formula in the amended returns. The auditor's proposed alternative apportionment formula relied on the authority in § 12-6-2320(A). The alternative apportionment formula divided the taxpayer's income from royalties and financing receipts from within South Carolina by its royalties and financing receipts from everywhere it does business to determine its ratio of apportionable income which is attributable to this State. The ALC found the Department's alternate formula to be reasonable and upheld its use. The ALC did not agree that penalties were in order and denied this portion of the assessment.<sup>12</sup>

The Administrative Procedures Act standards announced in S.C. Code Ann. § 1-23-610 (Supp. 2009) provide the standard of review in appeals from the ALC. Appellate review of an ALC order must be confined to the record. Section 1-23-610(B). The State Supreme Court, in Carroll v. S.C. Department of Public Safety, 388 S.C. 39, 693 S.E.2d 430 (2010), has found:

This court may not substitute its judgment for that of the ALC as to the weight of the evidence on questions of fact. . . . This court may affirm the decision, remand the case for

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<sup>11</sup>ALC Order p. 4 (R., p. 4).

<sup>12</sup>ALC Order p. 18 (R., p. 18).

further proceedings, or "reverse or modify the decision if the substantive rights of the petitioner have been prejudiced . . . ." The petitioner suffers prejudice when the ALC's finding, conclusion, or decision is:

- (a) in violation of constitutional or statutory provisions;
- (b) in excess of the statutory authority of the agency;
- (c) made upon unlawful procedure;
- (d) affected by other error of law;
- (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or
- (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

### ARGUMENTS

I. THE ALC DID NOT ERR IN FINDING THE DEPARTMENT'S USE OF AN ALTERNATIVE APPORTIONMENT METHOD, PURSUANT TO § 12-6-2320, WAS REASONABLE, AND THAT THE TAXPAYER FAILED TO MEET ITS BURDEN CHALLENGING THE DEPARTMENT'S ASSESSMENT.

A. Two Burdens.<sup>13</sup>

The taxpayer fails to clearly explain that this case involves two issues which are resolved by two different, but conjunctive, requirements of proof. First, the Department is required to show that the taxpayer's chosen method of apportionment is not reasonable. Second, once the Department meets its burden, the taxpayer has the burden of showing, by clear and convincing evidence, that under the Department's method "the income attributed to that State is in fact 'out of all appropriate proportions to the business

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<sup>13</sup>It is important to note that the ultimate burden of proof in the case, as correctly found by the ALC, is preponderance of the evidence and rests with the taxpayer, the party challenging the Department's assessment. (ALC Order p. 6;(R., p. 6) see also S.C. Code Ann. § 1-23-600(5) (Supp. 2009) ("Unless otherwise provided by statute, the standard of proof in a contested case is by the preponderance of the evidence")). The burdens of proof the taxpayer challenges here are what may more aptly be described as intermediate burdens. The Department must meet an intermediate burden of proof to show that the taxpayer's chosen apportionment method does not fairly reflect its business activity in South Carolina.

transacted . . . in that State,' [citation], or has 'led to a grossly distorted result.'"<sup>14</sup> A review of the record reveals ample legal and factual evidence that the Department met its burden; however, the taxpayer did not.

B. The Department Met Its Burden Of Proof.

The Department clearly met its initial burden to show that the taxpayer's chosen apportionment formula did not fairly represent its business activities in the State of South Carolina. At page 8 of the Order (R., p. 8), the ALC judge notes that in 2006, the calculation using the taxpayer's method which included the taxpayer's unrelated retail sales to inflate the denominator to be divided into the numerator made up of intangible income received from South Carolina resulted in an apportionment ratio of .0972%. The Department's alternate apportionment formula, which included South Carolina intangible income divided by intangible income from everywhere (thus excluding retail sales), produced an apportionment ratio of .2537% for royalty receipts and 1.0054% for other intangible receipts such as financing receipts.

Nevertheless, the taxpayer cites numerous nonbinding decisions to support its argument that there exists a duty upon the Department to show by clear and convincing evidence that the taxpayer's chosen method of apportionment failed to meet the standards set by this State's General Assembly in S.C. Code Ann. § 12-6-2210(B) (Supp. 2009):

If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.

Moreover, no such standard of proof is found in the plain language of § 12-6-2320(A):

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<sup>12</sup>Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 170 (1983).

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.

Contrary to the taxpayer's insistence, there is no requirement in this statute, or any South Carolina statute, that the Department must prove, by clear and convincing evidence, that the taxpayer's chosen method of statutory apportionment does not reflect the extent of its business activity in this State, and thereby failing to comply with the underlying purpose of South Carolina corporate income tax law cited above.

C. The Taxpayer Misplaces Its Reliance Upon Nonbinding Legal Authority.

The taxpayer incorrectly argues that the Department must first prove, by clear and convincing evidence, that its chosen method of accounting does not accurately reflect its business activities in the State. And, only then can the Department apply an alternative method of apportionment pursuant to § 12-6-2320(A). However, in arguing that the ALC did not apply the "clear and convincing" standard, the taxpayer confuses two distinct issues with one line of reasoning. For instance, in the California case of Limited Stores, Inc. v. Franchise Tax Board, 62 Cal. Rptr. 3d 191 (Ct. App. 2007), the Court's full quote reads:

As the party invoking section 25137, the FTB "has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is

not a fair representation, and (2) its proposed alternative is reasonable. [Citations.]” (Microsoft, *supra*, 39 Cal4th at p. 765 . . . .)

The Limited court is applying a ruling by the California Supreme Court in Microsoft Corp. v. Franchise Tax Board, 39 Cal. 4<sup>th</sup> 750 (2006). The basis for this quote is the higher court’s holding that under the California statute § 25137,<sup>15</sup> the Franchise Tax Board was invoking the alternative method of allocation and apportionment, and therefore had the burden of showing by clear and convincing evidence that “(1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable.”<sup>16</sup> Then, in footnote 16, the California Supreme Court makes a significant clarification that was lost upon the taxpayer here:

Both Microsoft and amicus curiae General Motors Corporation erroneously suggest the Board must show “the income attributed to that State is in fact ‘out of all appropriate proportions to the business transacted ... in that State,’ [citation], or has ‘led to a grossly distorted result’ [citation].” (Container Corp., *supra*, 463 U.S. at p. 170, 103 S. Ct. 2933.) This is the *constitutional* standard for striking down a tax under the due process and commerce clauses. However, section 25137’s application is not confined to correcting unconstitutional distortions. (See Twentieth Century-Fox Film Corp. v. Department of Revenue (1985) 299 Or. 220, 700 P.2d 1035, 1039-1040 [interpreting identical UDITPA relief provision].) The Board need only satisfy the lesser statutory standard quoted in the text.

To that end, the standard cited is limited to clear and convincing evidence as applied to the two-factor analysis above. Given that this ruling is confined to the courts

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<sup>15</sup>Note that California statute § 25137, is identical to South Carolina’s § 12-6-2320(A).

<sup>16</sup>Microsoft at p. 765.

of California, the only standard applicable to the ALC would be that announced by Federal Courts when a constitutional challenge is brought against a state income based tax, which is alleged to violate the Due Process and Commerce Clauses of the United States Constitution.<sup>17</sup> And, in such cases, the taxpayer is clearly bringing the challenge against the government, and therefore always has this burden. This was not alleged. Therefore, when the taxpayer fuses the state court decisions with the case of Moorman Mfg. Co. v. Bair,<sup>18</sup> 437 U.S. 267, 274 (1978), it does so incorrectly. Consequently, the "clear and convincing" standard is nonbinding upon the ALC and the "out of all proportions to the business transacted" attendant to a constitutional challenge was not invoked by the taxpayer.<sup>19</sup>

Although it had no binding duty to do so, ALC did exactly what the taxpayer wished as stated on p. 7 of its Order (R., p. 7). The Court ruled:

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 taxpayer's business in South Carolina. Second, whatever method the Department proposes, it must be reasonable.

The remainder of the ALC's Order is replete with factual and legal findings to support a

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<sup>17</sup>Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 164 (1983).

<sup>18</sup>Taxpayer's Initial Brief at p. 14, para. 2.

<sup>19</sup>Although the taxpayer raised the issue of a violation of the constitutional provisions of Due Process and the Commerce Clauses in a separate argument, it does so distinctively in that the issue discussed under this section is clearly related to the appropriateness of the alternative method of apportionment under § 12-6-2320(A). Further, when the issue of a constitutional challenge is raised, it is done so without legal support and mentions no factual basis in the record.

finding by clear and convincing evidence. Although it should be noted that the ALC was not bound by this standard under South Carolina legal authority, to the extent the taxpayer's assertions have any validity, the ALC's rulings satisfy even this higher standard.

D. The South Carolina Supreme Court Has Not Adopted The "Clear And Convincing" Standard In Applying § 12-6-2320(A).

The South Carolina Supreme Court recently discussed the application of alternative apportionment methods in Media General Communications, Inc. and Media General Holdings, Inc. v. South Carolina Department of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010). In that matter, the taxpayer filed income taxes relying upon an alternative method of apportionment known as combined reporting. The Department made an assessment by applying the standard apportionment formula under a separate entity approach. The procedure stated by the court was:

This statute provides that if the allocation and apportionment provisions do not fairly represent the taxpayer's business activities in South Carolina, the taxpayer may petition for, or the Department may require, if reasonable, the employment of any other method to effectuate the equitable allocation and apportionment . . . .<sup>20</sup>

The Supreme Court made no mention of the need for a showing of clear and convincing evidence. And since none of the case law cited by the taxpayer is binding and is not based on a constitutional requirement, the ALC was not constrained to apply the clear and convincing evidence standard. Nevertheless, as the ALC's findings are supported by the clear and convincing evidence standard, the taxpayer's contentions on this issue must fail.

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<sup>20</sup>Id. at p. 143.

E. The Taxpayer Failed To Meet Its Burden Of Proof.

The taxpayer correctly cites the authority of Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), but has clearly failed to discredit the Department's assessment. In this segment of the action, the appellant avers to a violation of its rights under the Due Process and Commerce Clauses of the United States Constitution. Again, the High Court has ruled that such a challenge can only be vindicated if the appellant proves by clear and convincing evidence that "the income attributed to that State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' [citation], or has 'led to a grossly distorted result.'"<sup>21</sup> This is the constitutional standard for striking down a tax under the Due Process and Commerce Clauses.

The Department's showing was that the taxpayer had earned royalty income from within South Carolina. It also demonstrated that the taxpayer had retail auto sales income which was not earned within the State. In giving consideration to the taxpayer's argument, the ALC noted that "[t]he taxpayer has offered only vague arguments and assertions in its pretrial brief, and has failed to meet its burden of proof of establishing that a violation of a constitutional right occurred."<sup>22</sup> Specifically, the taxpayer had every opportunity to prove that more than 100% of its income was taxed under the Department's alternative apportionment method and failed to do so. Now, it is asking this Court to find ample evidence in the record to support its claims; however, the evidence is nonexistent. To that end, the record was considered and found lacking in factual substantiation. And, in resurrecting this issue for this Court, the taxpayer offers

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<sup>21</sup>Container Corp., at p. 170.

<sup>22</sup>ALC Order p. 16, para. 1 (R., p. 16, para. 1).

no definitive evidence of any kind. The taxpayer clearly failed to meet its burden before the ALC, and likewise, cannot do so on appeal.

II. THE ALC DID NOT ERR IN FINDING THAT THE TAXPAYER'S WEST COAST RETAIL OPERATIONS WERE NOT A PART OF THE TAXPAYER'S BUSINESS ACTIVITY WITHIN SOUTH CAROLINA PURSUANT TO § 12-6-2320.

"Ours is a global economy. In contrast, government and the taxing authority used to fund it are national and local. This geographic disparity generates difficulties when each jurisdiction seeks its piece of the economic pie, a pie generated by economic activity that knows no borders."<sup>23</sup>

The taxpayer incorrectly confuses the unitary business definition with the Department's mandate to impose the South Carolina corporate income tax provisions in a way that reasonably represents the portion of a taxpayer's trade or business carried on within this State. Indeed, the taxpayer urges this Court to sanctify its definition of a "unitary business" model, even if it violates the letter and spirit of South Carolina law. There is no realistic means to allow the taxpayer to deprive the State General Assembly of its constitutional duty to determine what income it may lawfully tax, and the taxpayer is incorrect in asserting that there is but one means to judge the unitary structure of an endeavor for State income tax purposes. The United States Supreme Court has noted:

A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach. For example, a State might decide to respect formal corporate lines and treat the ownership of a corporate subsidiary as per se a passive investment. In Mobile Oil Corp., 445 U.S. at 440-441, 100

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<sup>23</sup>Microsoft, at p. 754.

S. Ct., at 1233, however, we made clear that, as a general matter, such a per se rule is not constitutionally required: "Superficially, intercorporate division might appear to be a[n]... attractive basis for limiting apportionability. But the form of a business organization may have nothing to do with the underlying unity or diversity of business enterprise" ....<sup>24</sup>

In essence, what the taxpayer believes is a unitary business is not relevant to the questions of whether or not the income of the entity, or groups of entities, is representative of the portion of trade or business carried on within this State.

The taxpayer also urged the ALC to accept its reading of Exxon Corporation v. S.C. Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979). The ALC recounted in paragraph 1 of its Order, that the taxpayer operates a retail business for the sale of autos in California, Utah, and Nevada. And, the ALC recognized as significant that the taxpayer received a distribution from the payment of royalties from a subsidiary CBS, which included royalties paid by its affiliate East. It is not disputed that the royalty income at issue was generated in South Carolina as East took a deduction from its South Carolina income tax for this expense. The Exxon opinion states:

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

The taxpayer shows it misapprehends this language when it insists that all of its operations were "homogenous." The factual issue of whether or not the taxpayer's retail

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<sup>24</sup>Container Corp., at pp. 167-168.

sales are homogenous with its collection of royalties and financing income from South Carolina was answered definitively in the negative by the ALC. In Exxon the court's decision was supported by the fact that a vertically integrated activity defined it as "unitary." The significance of this finding is that the exploration and extraction of the natural resources were costs directly related to the retail sale of gasoline in South Carolina. And, in that sense, all activities were interrelated and interdependent. The record firmly supports the ALC's findings that the royalty income and financing income from CBS was not homogenous with the taxpayer's retail income from auto sales. To that end, the Department was not isolating the royalty income; it was preventing the taxpayer from distorting its true income from within South Carolina by diluting it with income from distinct sources outside of South Carolina.<sup>25</sup> Lastly, Exxon does not prohibit the use of an alternative method of apportionment inasmuch as that opinion predated the enactment of § 12-6-2320, which, if nothing more, shows the taxpayer simply misapprehends the issues raised.

The taxpayer also urges this Court to find all of its activities as a unitary business by relying upon the decision of Eastman Kodak Corporation v. S.C. Dept. of Revenue, 308 S.C. 415, 418 S.E.2d 542 (1992). In that case, the Court found that the taxpayer's use of short term investments, which accounted for up to 10% of its net worth, were unitary with its business purpose in South Carolina. The taxpayer had invested in "safe harbor lease transactions" which were common at the time, and the taxpayer's investment

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<sup>25</sup>See ALC Order p. 9, fn 7 (R., p. 9, fn. 7).

and returns were of such "magnitude and frequency"<sup>26</sup> that it made a significant contribution to the taxpayer's general business. The Court specifically found:

Based on Exxon and the testimony of record here, the safe harbor lease transactions cannot be segregated from Kodak's general business operations since: (1) the funding for the safe harbor leases came from the general corporate treasury; (2) no separate staff supervised the transactions; and (3) the magnitude of the transactions and resulting tax benefits suggest a significant contribution to Kodak's general business.<sup>27</sup> (emphasis added).

In the case at bar, the taxpayer seems to mistake corporate structure with the taxpayer's business activity in South Carolina. Moreover, the ALC had substantial evidence before it that the taxpayer's retail auto sales in western states were discernable from income received from South Carolina sources<sup>28</sup> and were indeed subject to separate consideration under the provisions of § 12-6-2320.<sup>29</sup> As such, the Department has much more flexibility in determining a more accurate apportionment of a taxpayer's true South Carolina income which is subject to taxation.<sup>30</sup> To that end, what is "unitary" from a corporate structural standpoint, may be in direct conflict with activities that are "unitary" in terms of reaching a fair assessment of a taxpayer's business activity in this State. And, § 12-6-2320 allows the Department to disregard a corporate unitary structure in order to focus on the more imminent and constitutional issue of what activity is conducted in

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<sup>26</sup>Id. at p. 418.

<sup>27</sup>Id. at p. 420.

<sup>28</sup>ACL Order p. 9, fn 7 (R., p. 9, fn. 7).

<sup>29</sup>Section 12-6-2320 was enacted in 1995, after the Court's Kodak and Exxon decisions.

<sup>30</sup>Media General at p. 152, "conclusion" section.

South Carolina.

III. THE ALC DID NOT ERR IN FINDING THAT THE EXTENT OF TAXPAYER'S BUSINESS ACTIVITY IN SOUTH CAROLINA WAS FAIRLY REPRESENTED BY THE APPLICATION OF AN ALTERNATIVE METHOD OF APPORTIONMENT PURSUANT TO § 12-6-2320.

The taxpayer's arguments that the application of the standard apportionment formula was proper for its business activities in South Carolina is a reassertion of its argument that its alleged unitary business structure must be honored. Given, all of the foregoing, this argument is misdirected. Further, the taxpayer makes generalized allegations that the use of the alternative method of apportionment assessed was "out of all proportion to its relationship to South Carolina." Yet, this portion of the taxpayer's brief is comprised of a mix of prose and references to the record. The Department has responded to the taxpayer's position that a finding of unitary business structure is not determinative to the application of § 12-6-2320, and its claim of violations of the Due Process and Commerce Clauses is rebutted in the ensuing sections of this brief. In sum, the taxpayer offers no cogent evidence or arguments to rebut the findings of the ALC that the Department's alternative method of apportionment more accurately defines and taxes the income related to its business in this State. And, the taxpayer offers no explanation as to why its attempt to dilute the apportionment denominator under the standard apportionment formula is a better representation of its activities in South Carolina. To that end, the taxpayer's arguments must fail.

First, standard apportionment, as provided for in §§ 12-6-2250 and 12-6-2290, was challenged by the Department as its audit determined that neither method fairly reflected the true nature of the taxpayer's business in South Carolina. As such, the

auditor proposed an alternative apportionment method pursuant to § 12-6-2320(A).<sup>31</sup> As has been held by the South Carolina Supreme Court in Media General, the Department has latitude to do so. Further, as the discussion involving the burden of proof shows, the Department was justified in doing so.

Specifically, the taxpayer, as 93.5% owner of CBS, received a distribution which was comprised of a royalty payment to CBS by East. East took a deduction in South Carolina for paying the royalty to CBS. CBS is a pass through entity, so it paid no taxes. This leaves the taxpayer receiving income generated in this State. Instead of paying tax on this income in a manner which reasonably reflected its true business activity in this State, the taxpayer then inflated the denominator of its standard apportionment ratio by including its auto retail sales income from western states. The effect being that the numerator portion of the apportionment ratio, being comprised of royalty payments deducted by East in South Carolina, was made a smaller portion than if had just been compared to royalty income earned nationwide by the taxpayer.<sup>32</sup>

The taxpayer then intimates that despite this dilution of the denominator, "the apportionment is now the general rule and any other system, including the segregated method, is the exception."<sup>33</sup> As the authority cited for this proposition was issued in 1957, it is most difficult to see why it should withstand the application of § 12-6-2320, enacted in South Carolina in 1995. A more relevant, and authoritative comment on the matter can be found in Container Corp, when the Court noted that "separate accounting"

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<sup>31</sup>ALC Order p. 6 (R., p. 6).

<sup>32</sup>ALC Order p. 8 (R., p. 8; R., p. 923; R., p. 245).

<sup>33</sup>Taxpayer's Initial Brief, p. 23, para. 1.

or other alternative methods of apportionment have been allowed when total formula apportionment, would "not fairly represent the extent of the taxpayer's business activity in the state."<sup>34</sup> Indeed, the taxpayer's position of defending the inclusion of its distinct business activity of retail auto sales in its apportionment denominator must yield to the principle that its business activity in this State must be fairly representative of the extent of its true activity in South Carolina. This is mandated by § 12-6-2320.

The taxpayer regenerates its position that its alleged unitary corporate structure must be honored, and its retail operations cannot be considered separately. In lieu of reaffirming the Department's analysis of the "unitary" requirement pursuant to § 12-6-2320, it shall suffice to summarize that there is overwhelming evidence in the record to support the ALC's finding that § 12-6-2320 eliminates the need to honor the taxpayer's corporate reorganization strategy. Additionally, even if a finding was required, the taxpayer's retail auto sales activities were not homogenous with its business carried on in this State and in no way vertically integrated with the royalty income it received.

The taxpayer next argues that it received a diminished modicum of government services in South Carolina, which ostensibly, is a surrogate argument that its South Carolina income tax assessment is "out of all reasonable proportion to the business transacted . . . in that State."<sup>35</sup> Here, the taxpayer intimates that a reciprocal tax burden and public benefit analysis would support its position. The assertion is that its in-state activities are minimal and it receives minimal benefits from this State. The point then goes without factual support of examples, there is no list of benefits other taxpayers

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<sup>34</sup>Id. at p. 167, fn 3.

<sup>35</sup>Moorman Mfg. Corp. v. Bair, 473 U.S. 267, 267 (1978).

receive that are denied to this taxpayer, there is no showing of what government services should be properly offered to this taxpayer for the amount of tax it proposes is fair versus what it would receive under the Department's assessment and it cannot be demonstrated that the taxpayer could not enforce its agreements in the State court system. This is all problematic. Essentially, this is an issue without significance.

Finally, the taxpayer attests to several arguments which intimate constitutional issues, but fails to present its arguments in terms announced in the pertinent case law. For instance, on p. 26 of its Initial Brief, the taxpayer states that the Department's auditors are not guided by any fixed criteria for assessing income tax reporting, with the implied conclusion being that there was no basis for rejecting the taxpayer's use of the standard apportionment formula. Then, the taxpayer undertakes a discussion of the comparison of its tax burden versus that of East. The evidence presented is that it has no employees in South Carolina, operates no stores in South Carolina, and owns no tangible personal property. What the taxpayer failed to mention was that the income at issue was a distribution from CBS, which had its basis in royalties generated in part by payments by East, for which it took a deduction against its South Carolina taxable income. The end result of this discussion is to be measured against the taxpayer's burden of proving, by clear and convincing evidence that the Department's assessment was "out of all appropriate proportions to the business transacted . . . in that State," [citation], or has "led to a grossly distorted result."<sup>36</sup>

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

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<sup>36</sup>Container Corp., at p. 170

taxing state and taxed activity; (2) the tax is fairly apportioned to income; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the benefits the state provides.<sup>37</sup> The taxpayer is ostensibly alleging that the assessment discriminates against interstate commerce.

The taxpayer complains that its tax burden is heavier than East, which does have retail operations in South Carolina. The evidence clearly shows that East only receives a flow through distribution from CBS of 6.5%, while the taxpayer receives a 93.5% distribution. Moreover, East benefits from a deduction for royalties paid to CBS. If that deduction were not taken, East would pay the entire tax burden at issue.

Since Complete Auto was decided, the Supreme Court has increasingly employed the "internal consistency test" to determine whether a taxing scheme creates unconstitutional discrimination. See, e.g., Armco, Inc. v. Hardesty, 467 U.S. 638 (1984); Tyler Pipe Industries v. Washington Dep't. of Revenue, 483 U.S. 232 (1987). Simply put, this test asks whether the taxing scheme, if applied in every jurisdiction, would subject more than 100% of a taxpayer's income to taxation. The taxpayer offers no evidence on this point. Again, this argument must fail.

IV. SOUTH CAROLINA CASE LAW DOES NOT PROHIBIT THE USE OF AN ALTERNATIVE METHOD OF APPORTIONMENT PURSUANT TO § 12-6-2320.

Again, the taxpayer restates its earlier arguments. In this instance, the taxpayer alleges that the application of a "separate accounting" method produced an unreasonable result. Again, Exxon does not forbid the application of § 12-6-2320(A) for all the same reasons stated in this Brief previously. Again, the taxpayer raises the argument that its

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<sup>37</sup>Complete Auto, at p. 279.

business was "unitary." And, again, the Department would aver to its discussions in this Brief to counter this position. And, again, the taxpayer raises the issue that the Department's alternative method of apportionment produces an unreasonable result. And, again, the Department asserts that the taxpayer has not met its burden of challenging the assessment pursuant to the Complete Auto and Container Corp. rulings by the United States Supreme Court. And, again, the taxpayer argues its tax burden is distorted when compared to that of its affiliate, East. Again, the Department would aver to its positions stated in this Brief which deny the taxpayer's allegations.

The Media General decision clearly holds that the Department may employ an alternative method of apportionment when it is determined that the taxpayer has employed a method that fails to do so. The taxpayer has ignored the import and significance of Media General in this case. In Media General the court noted that the "separate entity apportionment method" is the standard apportionment method used in South Carolina for apportioning income among multistate, related business entities. However, under the facts of Media General the separate accounting method did not accurately reflect the taxpayer's income and business activity in the State.<sup>38</sup> Most significantly, the Court stated:

The ALC observed that the states typically apply one of the two apportionment methods for multistate businesses. The first is the separate entity apportionment method, which considers each entity having some nexus with the taxing state as a separate entity, even if it is part of a unitary business.<sup>39</sup>

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<sup>38</sup>Media General Communications v. South Carolina Dept. of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010).

<sup>39</sup>Id. at p. 146.

After the Court noted that the use of this method would not provide for the most accurate determination of taxable income in the State, it upheld the ruling of the ALC that section 12-6-2320(A)(4) "clearly authorized the Department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income . . ."<sup>40</sup> This ruling seems to fully discredit the Taxpayer's argument.

Undaunted, the taxpayer makes an argument that its inter-company transfer pricing study somehow is not an indication that its royalty business can be separated from its retail operations in the west. It then cites language of the United States Supreme Court to fortify its point. However, the High Court in Butler Bros. v. McCollgan, 315 U.S. 501 (1942), ruled in favor of the California State taxing authority in separating the taxpayer's in-state and out-of-state activities to tax only the income raised in California. This case does not support the taxpayer's position. The taxpayer prefaces its citation to Butler Bros. by stating "[i]nter-company transfer of value pricing is not controlling for a unitary business." At this point, it expected that this case would somehow fortify the taxpayer's argument. To the contrary, it supports the Department's use of an alternative method of apportionment in this case. For instance, the quote used by the taxpayer reads: "[a]ccounting practices for income statements may vary considerably according to the problem at hand . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders."<sup>41</sup> In Butler Bros., the taxpayer complained to the High Court that California's use of a separate accounting method against its interstate

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<sup>40</sup>Id. at p. 151.

<sup>41</sup>Taxpayer's Initial Brief p. 36, para. 1.

business converted a loss to a profit. "Appellant maintains that the use of the formula in question resulted in converting a loss of \$82,851 into a profit of over \$93,500 and that the difference of some \$175,000 has either been created out of nothing or has been appropriated by California from other states."<sup>42</sup> The Court's response to this position of the taxpayer was: "We take a different view. We read the statute as calling for a method of allocation which is 'fairly calculated' to assign to California that portion of the net income 'reasonably attributable' to the business done there."<sup>43</sup>

The taxpayer is arguing that 1) allowing the Department to apply separate accounting to a unitary business is prohibited because it produces an unreasonable result, or 2) alternatively, separate accounting does not produce a reasonable result in this case. It has failed however, to make an adequate showing on either front.

Butler Bros. stands for the principle that a state's method for determining an interstate corporation's income earned within that state, can differ from the taxpayer's financial statement's position using the same income and remain constitutional. Here, not only has the taxpayer failed to show that the Department's alternative method of apportionment fails the "internal consistency" test, but contradicts its own argument by citing Butler Bros. Indeed, a clear reading of all cases cited by the taxpayer is either neutral authority or fortifies the Department's case.

In summary, the taxpayer cannot merely state that the Department's alternative method of apportionment is unreasonable, it must meet its burden of proving its case by clear and convincing evidence that the result is a violation of the Due Process and

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<sup>42</sup>Butler Bros. v. McColgan, at p. 506.

<sup>43</sup>Id.

Commerce Clauses of the United States Constitution.

V. THE ALC DID NOT ERR IN SOURCING THE TAXPAYER'S ROYALTY INCOME WITHIN SOUTH CAROLINA AND BY FINDING THAT ITS RETAIL AUTO SALES IN CALIFORNIA, NEVADA, AND UTAH WERE NOT SOURCED TO SOUTH CAROLINA.

The facts of this case are that the financing contracts are entered into by CBS. CBS then "bundled" or securitized the financing contracts for sale to third parties. CBS would then realize income from the sale of the securitized contracts. Then, CBS would make distributions to the taxpayer, as 93.5% owner, and to East as 6.5% owner.

The ALC found that the taxpayer's business of financial services was distinguishable from engineering services. The ALC, relying upon Lockwood Greene v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), noted that the Court's holding was concerned "upon a base which reasonably represents the portion of the trade or business carried on within this State."<sup>44</sup> To that end, the sourcing rule announced by this Court is aligned with the alternative apportionment method permitted by § 12-6-2320(A)(4).

The record is strongly supportive of the ALC's ruling and substantial evidence was abundant. The taxpayer's income flowed from intangibles, not professional services. The base value of the intangible income was the South Carolina borrower's good faith adherence to the contractual obligations which are enforced by the courts of this State. In Lockwood Greene, the engineering services performed within this State were the commodity which attracted the income. The taxpayer's own witness testified that the value, in part, of the securitized instruments to third party investors, was the borrowers'

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<sup>44</sup>Lockwood Greene, at p. 449.

faithful payments on the financing agreements.<sup>45</sup> Therefore, the ALC was correct in distinguishing the taxpayer's case from that of a professional engineering firm located and licensed within the State of South Carolina.

As the taxpayer seeks to disassociate its case from Geoffrey, Inc. v. S.C. Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (1993), it must make the critical admission that its financing division has nexus to the State. Like the taxpayer in Geoffrey, the taxpayer here collects payments from an intangible asset from a captive subsidiary. If the taxpayer had sold the securitized financing contracts to third party investors directly, it would still find itself with nexus and liability of taxation to this State. By inserting CBS as a pass through entity, the taxpayer must fully expect the value of its contracts is the payment of monies from South Carolina residents, and enforcement is also sourced in this State. Therefore, the ALC committed no error of fact or law in finding the taxpayer's income from the intangible assets was identical to the royalty agreements of Geoffrey.

VI. THE TAXPAYER FAILED TO CARRY ITS BURDEN OF PROOF THAT THE DEPARTMENT'S ALTERNATIVE METHOD OF APPORTIONMENT VIOLATED ITS RIGHTS UNDER THE DUE PROCESS AND COMMERCE CLAUSES OF THE UNITED STATES CONSTITUTION.

The taxpayer states, in the broadest terms possible, that its rights of Due Process, as well as the protections of the Commerce Clause were violated. The cites, not legal, standard or factual recitations, are necessary for this Court to evaluate the claims. Indeed, if such had occurred, the taxpayer would have specifically notified this Court of

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<sup>45</sup>ALC Order p. 13, fn 12; Tr., pp. 103-104, 105 (R., p. 13, fn. 12; R., pp. 121-123).

the instances and errors committed. The taxpayer's brief is conspicuously silent on both counts.

The proper legal standard for evaluating the taxpayer's constitutional claims was announced by the United States Supreme Court in ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982). The High Court under both the Due Process and Commerce Clauses of the United States Constitution, a state may not, when imposing an income based tax, "tax value earned outside of its borders."<sup>46</sup> The taxpayer has the "distinct burden of showing by 'clear and convincing evidence' that the state tax results in extraterritorial values being taxed."<sup>47</sup> Further, what must be shown by clear and convincing evidence is that the income attributed to this State is in fact "out of all reasonable proportion to the business transacted . . . in that State."<sup>48</sup> However, the Court also noted that the United States Constitution does not "invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State."<sup>49</sup>

A reading of the taxpayer's brief finds no allegations that the ALC's Order imposed an income based tax on any of its income earned outside of South Carolina. Although the taxpayer argues that the ALC misapplied the sourcing of income rules as announced in Lockwood Greene, this position does not make the requisite showing that the Department's assessment, as upheld by the ALC, taxes income earned outside of this

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<sup>46</sup>Id. at p. 307.

<sup>47</sup>Norfolk & Western Rail Co. v. North Carolina Ex Rel Maxwell, 297 U.S. 682, 688 (1936).

<sup>48</sup>Moorman Mfg. Corp. v. Bair, at p. 267.

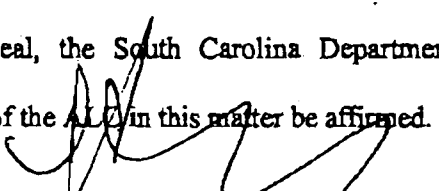
<sup>49</sup>Id. at p. 272.

State. Also, the taxpayer challenged the ALC's failure to make findings of a "unitary business" segment, but failed to invoke the challenge that it was being taxed on income earned outside of South Carolina. Without such a showing, the taxpayer does not discharge its duty of leveling a specific constitutional challenge to the ALC's findings or the Department's use of an alternative method of apportionment. And, the mere possibility of this occurrence is not sufficient to invalidate the Department's assessment or the ALC's ratification of it.

When the taxpayer fails to make any specific legal or factual arguments, it leaves the Department in a position to make assumptions about its position. The concise resolution of this issue is that the taxpayer has not made the requisite showing that any of its income from outside South Carolina has been taxed by the Department. To that end, the taxpayer's position is unfounded.

#### CONCLUSION

For the foregoing reasons, and pursuant Rule 220, SCRCP, for any other reason appearing in the Record on Appeal, the South Carolina Department of Revenue respectfully requests that the ruling of the ALC in this matter be affirmed.



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Harry A. Hancock (Bar No. 65233)  
Counsel for Litigation  
Milton G. Kimpson (Bar No. 7917)  
General Counsel for Litigation  
PO Box 12265  
Columbia, SC 29211  
Phone: 803-898-5598  
Fax: 803-898-5147  
Attorneys for Respondent

Columbia, South Carolina  
January 14, 2011

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Carolyn C. Matthews, Administrative Law Judge

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

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

v.

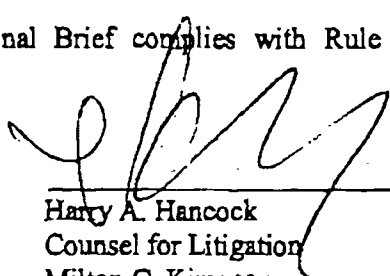
South Carolina Department of Revenue, .....Respondent.

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CERTIFICATE OF COUNSEL

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



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Harry A. Hancock  
Counsel for Litigation  
Milton G. Kimpson  
Managing Counsel for Litigation  
PO Box 29211  
Columbia, SC 29211  
(803) 898 5598  
Attorneys for Respondent

Columbia, South Carolina  
January 14, 2011

STATE OF SOUTH CAROLINA  
COURT OF APPEALS

Carmax Auto Superstores West Coast, Inc. )

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

Appellant, )

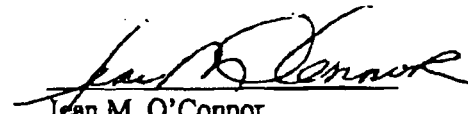
vs. )

PROOF OF SERVICE

South Carolina Department of Revenue, )

Respondent. )

I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, postage pre-paid, the Department of Revenue's Final Brief in the above mentioned matter to Bryson M. Geer, Esquire and John C. von Lehe, Jr., Esquire, Nelson Mullins Riley & Scarborough, LLP, PO Box 1806, Charleston, SC 29402 this 18<sup>th</sup> day of January 2011.

  
Jean M. O'Connor

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

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

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

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FINAL REPLY BRIEF OF APPELLANT

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John C. von Lehe, Jr.  
Bryson M. Geer  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200  
*Attorneys for Appellant*

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| <u>Lowenstein Corp v. S.C. Tax Comm'n,</u><br>298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989).....        | 4, 8                 |
| <u>Media Gen. Commc'ns v. S.C. Dep't of Revenue,</u><br>Op. no. 26828 (June 14, 2010).....            | 6, 7                 |
| <u>Mobil Oil Corp. v. Comm. of Taxes of Vt.,</u><br>445 U.S. 425 (1980).....                          | 8                    |
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**Statutes**

S.C. Code Ann. § 12-6-2320 (2000 West and Supp. 2009)..... 3, 4, 5, 10

## INTRODUCTION

The South Carolina Department of Revenue's ("SCDOR" or "Respondent") brief in this matter ("Respondent's Brief") asks this Court to ignore controlling law, the facts in the record or both on the four key issues in this case regarding the tax assessed on CarMax Auto Superstores West Coast, Inc. ("CarMax West" or "Appellant"). First, SCDOR attempts to distract the Court from the overwhelming, universal authority that the burden of proof is on the party seeking to diverge from the standard apportionment formula and that the proper standard of proof is clear and convincing evidence. Second, SCDOR ignores or misapplies controlling case law and ignores the evidence in the record in attempting to convince the Court to allow it to segregate one portion of a unitary business's income and tax it separately. Third, SCDOR ignores controlling case law in favor of non-binding and inapplicable dictum in support of its position that receipts from the servicing and securitization of retail installment contracts should be sourced to South Carolina even though the economic activity generating those receipts takes place out-of-state. Finally, SCDOR asks the Court to determine that the tax it assessed, which is out of all proportion to CarMax West's activities in South Carolina and contrary to controlling law, does not violate CarMax West's constitutional rights.

While the legal precedents and underlying tax and economic policies relevant to this case are complex, the critical issues are simple and straightforward. CarMax West has done nothing more than report its revenue exactly the way the statute requires. The CarMax corporate structure is neither unique nor improper but is in fact common among national retailers with financing operations. South Carolina has not been

deprived of its fair share of tax revenue from the CarMax group of companies as it has received such revenue not only from CarMax West's royalty receipts but also from all of CarMax Auto Superstores, Inc.'s ("CarMax East") vehicle sales. The unreasonableness and impropriety of SCDOR's assessment in this case is made plain by the fact that it increases CarMax West's tax burden almost fivefold and produces a greater tax burden for CarMax West than is imposed on CarMax East.

Therefore, for the reasons set forth in Appellant's Brief and below, CarMax West respectfully requests that this Court reverse the ALC's decision and grant the relief requested in Appellant's Brief.

#### **ARGUMENT**

**I. SCDOR CONCEDES THAT IT BEARS THE BURDEN OF PROOF, WHICH IT HAS FAILED TO MEET.**

SCDOR explicitly concedes that it bears the burden of showing that the standard apportionment formula does not fairly reflect CarMax West's income from its activities in South Carolina before it can apply an alternative method. See Respondent's Brief at 7 ("First, the Department is required to show that the taxpayer's chosen method of apportionment [i.e. the standard statutory method] is not reasonable"). SCDOR implicitly concedes that it bears the burden of proving that its alternative method is reasonable as well. These concessions are consistent with the decisions of all courts that have applied the alternative apportionment provision of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which is identical to South Carolina's, that the burden of proof should be borne by the party attempting to diverge from the

standard formula. Appellant's Brief at 12-15 (citing numerous cases approving of this universal holding).

SCDOR has attempted to minimize the effect of these concessions by creating the idea of a so-called "intermediate burden" (Respondent's Brief at n. 13) and attempting to import and apply a stricter constitutional burden to all issues in the case (id. at 10-11), but these are red herrings. The cases cited in the parties' briefs provide no support for the notion of an intermediate burden, and constitutional burdens have no bearing on the non-constitutional issues in the case, i.e., whether SCDOR's separate accounting meets the requirements of S.C. Code Ann. § 12-6-2320(A) and whether it is prohibited by Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 358 S.E.2d 93 (1979).

While it is unclear from SCDOR's brief whether it agrees that the standard applicable to its burden is "clear and convincing evidence," the relevant case law and underlying principles support such a standard here. Although fewer courts have addressed this issue, those that have require this heightened standard, and SCDOR cites no cases to the contrary. See Limited Stores, Inc. v. Franchise Tax Board, 62 Cal. Rptr. 3d 191, 196 (Cal. Ct. App. 2007); Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978); see also Appellant's Brief at 14. Because of the sound policy underpinning the standard apportionment formula and the intent of the UDITPA drafters that any departures from the standard formula be used sparingly, this Court should follow the applicable precedent and apply the stricter standard.

II. SCDOR HAS IGNORED OR MISAPPLIED CONTROLLING CASE LAW, WHICH PROHIBITS SEPARATE ACCOUNTING FOR A UNITARY BUSINESS, AND HAS DISREGARDED THE RECORD, WHICH ESTABLISHES THAT CARMAX WEST IS UNITARY AND THAT SCDOR CANNOT JUSTIFY ITS SEPARATE ACCOUNTING.

- A. Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 358 S.E.2d 93 (1979) and Related South Carolina and United States Supreme Court Cases Prohibit Separate Accounting of a Unitary Business.

Simply put, Exxon and related South Carolina and United States Supreme Court cases prohibit separate accounting of a unitary business. More specifically, and as set forth more fully in Appellant's Brief, these courts have explained that when a multi-state taxpayer operates a unitary business, its entire unitary net income must be both considered and apportioned under the relevant apportionment statute because unitary income cannot be accurately subjected to separate accounting. See Exxon, 273 S.C. at 599, 358 S.E.2d at 96 (holding that separate accounting is not appropriate for a unitary business because the income of a unitary business "is attributable to all incidents of the business and not to any single activity"); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983) (stating that once a taxpayer has been determined to be unitary, "a State must then apply a formula apportioning the income of that business within and without the State") (emphasis added). See also Appellant's Brief at 15-18.<sup>1</sup>

SCDOR's error in this case is that it applies and interprets its statutory authority in isolation and in ignorance of Exxon. SCDOR asks this Court to allow it to disregard the net income of CarMax West and instead levy a tax on only a portion of its unitary income based on S.C. Code Ann. §12-6-2320(A). This section states that where the

<sup>1</sup> See also Lowenstein Corp. v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Cl. App. 1987); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207 (1980); and Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

standard apportionment formula does not fairly represent the business activities of a taxpayer in this State, SCDOR may use "any method" that does reasonably reflect the activities, including "separate accounting." See S.C. Code Ann. § 12-6-2320(A) (2000 West and Supp. 2009). The parties agree that in order to invoke this statutory authority, SCDOR must first establish two prerequisites: (a) that the standard formula does not fairly represent a taxpayer's business activities in this state, and (b) that the alternative method applied by SCDOR does. Where the parties disagree is the effect of Exxon. Appellant contends that Exxon provides an additional but consistent limit on SCDOR's authority under § 12-6-2320(A). Specifically, under Exxon, for a unitary business, the standard apportionment formula **does** fairly represent its business activities and a separate accounting **cannot** be reasonable. SCDOR's attempts to evade this natural reading are unpersuasive.

SCDOR focuses on irrelevant distinctions and terminology that find no support in, and, in fact, contradict, the relevant precedent. For example, SCDOR attempts to distinguish what is "unitary" from a corporate structural standpoint from what is "unitary" from a business activities standpoint. However, SCDOR fails to show how that distinction applies in this case, and, in fact, the evidence in the record clearly establishes that CarMax West's business activities were unitary. SCDOR also focuses on terms like "discernible" and "homogenous" in asserting that CarMax West's income streams can be separated while failing to address the more important question of whether the income streams **should** be separated. Exxon and Eastman Kodak establish that they should not. For example, in Exxon, an effort was made to separately compute the income earned from oil exploration activities versus retail sale activities, and in

Eastman Kodak, the income from the "safe harbor" leases could have been separated from the income from the sale of cameras. However, in both cases, the South Carolina Supreme Court found these different business activities and the income derived therefrom to be unitary with each taxpayer's other activities and income and therefore upheld the result reached by the standard apportionment formula.<sup>2</sup> See Exxon, 273 S.C. at 599, 358 S.E.2d at 96; Eastman Kodak, 308 S.C. at 420, 418 S.E.2d at 544.

SCDOR also mistakenly focuses on the facts that the apportionment statute was enacted after Exxon (in 1986) and that the statute expressly lists separate accounting as an optional method. With respect to the effect of § 12-6-2320(A) on Exxon, the Supreme Court's subsequent decision in Eastman Kodak (in 1992) confirms that Exxon remains a valid and critical check on SCDOR's statutory authority. As to the argument on separate accounting being listed by the statute as an option, SCDOR misguidedly relies on Media Gen. Communication, Inc. v. S.C. Dept. of Revenue, Op. No. 262828 (S.C. June 14, 2010) and overstates its applicability to this case. In Media General, all parties stipulated that the standard method of taxation (separate entity reporting) did not fairly reflect the taxpayer's in-state activities and that the proposed alternative method (combined entity reporting) did, leaving only the question whether combined reporting was permitted as "any other method," which the Court held that it was. Beyond applying the same statute, Media General has no bearing on this case for several reasons. First, CarMax West does not concede (as the parties in Media General did)

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<sup>2</sup> Similarly, SCDOR attempts to distinguish or minimize Exxon by quoting an SCDOR (then South Carolina Tax Commission) regulation cited in Exxon providing that if a taxpayer operates a business in South Carolina that is "unrelated" to its multi-state "unitary" or "homogenous" business, then the income from the unrelated business can be separately assigned and taxed separately in the state where it is operated. Again, the issue is whether the taxpayer's activities and income are unitary or not, and this regulation is consistent with that.

the inapplicability of the statutory formula but instead has provided compelling evidence and arguments that it fairly reflects CarMax West's activities in South Carolina. Second, CarMax West does not concede (as the parties in Media General did) that the proposed alternative method is reasonable but instead has provided compelling evidence and arguments that it is not. Finally, Media General involved the issue of whether SCDOR could accept a particular alternative method when the statutory requirements were conceded and no applicable precedent prohibited it. This case involves the very different issue of whether SCDOR can force a particular alternative method when the statutory requirements are disputed and existing South Carolina Supreme Court precedent prohibits it.

Finally, SCDOR has not cited a single decision that has invoked the alternative apportionment statute provision to allow a portion of a unitary business to be separately taxed. The ALC's decision stands alone in that regard and should be overturned.

**B. The Record Establishes that CarMax West Operates a Unitary Business.**

The ALC stated that the question of whether CarMax West's income was unitary was "not outcome determinative," and, therefore, notwithstanding SCDOR's suggestions to the contrary (see Respondent's Brief at 14-16), declined to make any factual findings or legal conclusions as to whether CarMax West's business was unitary.<sup>3</sup> Had the ALC considered this issue, the undisputed evidence presented at trial establishes that CarMax West operates a unitary business and that the income in question was part of its unitary income. Appellant's Brief at 18-21.

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<sup>3</sup> In addition, following the decision, CarMax West moved that the ALC consider and rule upon whether CarMax West was unitary, and the ALC denied that motion.

As set forth in detail in Appellant's Brief, CarMax West's income includes receipts derived from the provision of management services and the licensing of intellectual property to a related entity, CarMax East, and from the servicing and securitization of retail installment contracts originally created by CarMax East in South Carolina.<sup>4</sup> Under any and all tests that the South Carolina courts have enunciated<sup>5</sup> following a number of United States Supreme Court decisions,<sup>6</sup> this income is part of CarMax West's unitary income. All accounting and economic testimony in the record as well as common sense support the conclusion that the income derived from the royalty and financing activities is unitary income, and SCDOR presented no credible evidence to the contrary. See Appellant's Brief at 18-21.<sup>7</sup>

**C. The Record Establishes that the Standard Apportionment Formula Fairly Represents CarMax West's Business Activities in South Carolina.**

The evidence at trial establishes that the standard apportionment formula fairly represents CarMax West's business activity in this State, and there is no contrary evidence. As set forth in Appellant's Brief, because CarMax West operates a unitary business, the standard formula, which is based on CarMax West's net income from all

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<sup>4</sup> These services were provided directly by CarMax West during the early part of the audit period (2002-2004), and through a partnership, CarMax Business Services, LLC ("CBS"), in which it was a 93.5% owner, during the later audit years (2005-2007). CBS also performed financing functions.

<sup>5</sup> These tests include the three unities test, the contribution and dependence test and the functional integration test. See Exxon, 273 S.C. at 598-600, 358 S.E.2d at 95-96; Eastman Kodak, 308 S.C. at 420, 418 S.E.2d at 544; and Lowenstein, 298 S.C. at 102-104, 378 S.E.2d at 277-278.

<sup>6</sup> See Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207 (1980); Mobile Oil Corp. v. Comm. of Taxes of VI., 445 U.S. 425 (1980); and Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

<sup>7</sup> See also R. p. 69, line 18- p. 71, line 14; p. 76, line 20- p. 78, line 9; p. 79, line 1- 81, line 19; p. 156, line 8- p. 157, line 9; p. 200, line 11- p. 201, line 14; p. 202, lines 7-21; R. p. 651-654, CarMax FY 2005 Officers and Directors List; R. p. 599-650, Sample CarMax, Inc. Annual Report.

its unitary activities, fairly represents its South Carolina business activities, which are virtually non-existent.<sup>8</sup> CarMax West presented substantial tax accounting and economic evidence in support of this. See Appellant's Brief at 24-26.

SCDOR's "distortion" argument ultimately relies on two assertions: (1) CarMax West paid less tax using the standard apportionment formula than it would have paid using a separate accounting; and (2) CarMax West paid less tax using the standard apportionment formula than CarMax East paid. As explained in Appellant's Brief, these facts are unsurprising and uncontroversial in light of CarMax West's limited connection to South Carolina, do not prove distortion and should not provide a basis for disregarding Exxon and imposing a separate accounting on a unitary business. In an apparent attempt to suggest some culpable intentionality, SCDOR repeatedly claims that CarMax West has "inflated the denominator of the sales factor." See Respondent's Brief at 3, 8 and 19. This unfounded and uncalled for allegation is simply not true. CarMax West has done nothing more than follow the law and apply the denominator precisely as the standard apportionment formula requires (i.e., by applying the formula to its entire corporate net income and apportioning that income based on its "gross receipts from within this state" to "total gross receipts from everywhere"). It is SCDOR that has inflated or distorted the measurement of CarMax West's income in South Carolina by ignoring its net income and imposing a separate accounting method to a segment of that income.

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<sup>8</sup> SCDOR does not dispute that CarMax West had no physical presence in South Carolina and that all relevant activities were performed out-of-state. The parties agree that the only connection with this State is the economic presence derived from the out-of-state ownership of intangibles, which, as previously stated, were licensed to and used in this state by CarMax East. The financing activities were performed out-of-state.

**D. The Record Establishes that SCDOR's Alternative Method Does Not Reasonably Reflect CarMax West's In-State Activities.**

The evidence presented at trial establishes that SCDOR's alternative separate accounting method does not reasonably reflect CarMax West's in-state activities, and SCDOR failed to present credible evidence to the contrary. As previously stated, controlling case law provides that separate accounting is not appropriate for a unitary business. See supra Argument (II)(A). Moreover, CarMax West introduced extensive tax accounting and economic testimony as well as other evidence at trial that established that SCDOR's alternative method does not fairly reflect CarMax West's in-state activities. See Appellant's Brief at 33-37.

Particularly telling are the facts that the tax attempted to be imposed by SCDOR here (\$488,300 for the six audit years)<sup>9</sup> is almost five times larger than the tax imposed by the standard formula (\$97,024)<sup>10</sup> and is more than the tax imposed on CarMax East,<sup>11</sup> which operated two superstores and had a substantial investment and physical presence as well as many employees in this state. This is clear and convincing evidence that the separate accounting method imposed by SCDOR is taxing income far in excess of CarMax West's miniscule activities in this State. Any alternative method SCDOR seeks to apply must "effectuate an equitable apportionment of the taxpayer's income," and the isolation and taxation of only royalty and financing income does not do this. See S.C. Code Ann. § 12-6-2320(A) (2000 West and Supp. 2009).

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<sup>9</sup> See R. p.p. 490-496, Department Determination.

<sup>10</sup> See R. p.p. 497-537, CarMax West Amended Tax Returns 2002-2007.

<sup>11</sup> See R. p.p. 471-479, SCDOR Report of Field Audit.

III. SCDOR HAS IGNORED THE HOLDING OF LOCKWOOD GREENE, WHICH ADOPTS THE "PLACE OF ACTIVITY" TEST, IN FAVOR OF NON-BINDING AND INAPPLICABLE DICTUM.

The undisputed evidence in the record establishes that all of the activities producing CarMax West's financing income took place in Georgia. SCDOR has nevertheless taxed those receipts based solely on non-binding and inapplicable dictum in the seminal South Carolina case on sourcing, Lockwood Greene Eng'g v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). As discussed more fully in Appellant's Brief, the South Carolina Court of Appeals held in that case that the income of a multi-state taxpayer should be sourced to the state where the activities that created that income were performed, which the Court refers to as the "place of activity" test. See Appellant's Brief at 37-38. As CarMax West's experts testified at trial, this test is consistent with sound accounting and economic principles. Id. at 38-39.

SCDOR claims that this Court should nonetheless apply the "origin of payment" test (which would look to the location of the buyers of cars in this case) based on dictum stating that the "place of activity" test *might not* apply to finance companies. Lockwood Greene, 293 S.C. at 450, 361 S.E.2d at 348. As noted above, the "place of activity" test is the law in this State and is supported by sound accounting and economic principles. However, even if this Court considered the dictum in Lockwood Greene, the same reasoning that led the Court to source receipts to the location of the engineers supports sourcing the CarMax West receipts to the location of the employees who service the retail installment contracts in this case. These employees service the accounts, package bundles of the receivables into asset-backed securities, actively market the securities to outside investors and continue to manage the accounts

throughout their lifecycles, all the while creating value and producing the receipts at issue. Appellant's Brief at 8-9. All of this occurs outside of South Carolina. Id. at 8. There is no rational reason to except such a scenario from the place of activity test.

#### IV. SCDOR HAS VIOLATED CARMAX WEST'S CONSTITUTIONAL RIGHTS.

SCDOR's Brief claims that CarMax West failed to make specific factual or legal arguments as to its claim that the taxes assessed by SCDOR are unconstitutional. Respondent's Brief at 29. To the contrary, Appellant's Brief details the basis for its claim that the tax at issue violates both the Due Process and Commerce Clauses. Appellant's Brief at 41-44. More specifically, CarMax West asserts that the tax fails to satisfy the test set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) in that it taxes income with no connection to this state (as to financing income only); does not actually reflect a reasonable sense of how income is generated; attributes income to the state that is out of all proportion to the business transacted therein and has led to a grossly distorted result; is not fairly apportioned; and does not relate to the services provided by South Carolina. Appellant's Brief at 41-44; see also Complete Auto, 430 U.S. 274; Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983). CarMax West showed that it has only minimal activities in this state but has been confronted with a tax of shocking magnitude based on a segment of its unitary business. See Appellant's Brief at 44. As previously stated, under SCDOR's alternate method, CarMax West faces a tax that is almost five times the tax produced by the standard formula.<sup>12</sup>

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<sup>12</sup> See supra Argument at II(D).

Moreover, the tax at issue flies in the face of every South Carolina and United States Supreme Court case that has considered the proper apportionment of a multi-state, unitary taxpayer's income. See Butler Bros. v. McColgan, 315 U.S. 501 (1942) (holding that separate accounting is not applicable to a unitary business); Container Corp., 463 U.S. at 169 (holding that separate accounting is unconstitutional when applied to a unitary business); Exxon, 273 S.C. at 599, 358 S.E.2d at 96. See also supra Argument (II)(A). Under these circumstances, it is clear that the tax assessed against CarMax West violates its constitutional rights and should not be upheld.

#### CONCLUSION

For the reasons set forth above and in its Brief, CarMax West respectfully requests that this Court reverse the ALC and grant the relief requested in Appellant's Brief.

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: Bryson M. Geer  
John C. von Lehe, Jr.  
SC Bar No. 5719  
E-Mail: john.vonlehe@nelsonmullins.com  
Bryson M. Geer  
SC Bar No. 13606  
E-Mail: bryson.geer@nelsonmullins.com  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for CarMax Auto Superstores West Coast,  
Inc.

Charleston, South Carolina  
January 12, 2011

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

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

CERTIFICATE OF COUNSEL

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

NELSON MULLINS RILEY & SCARBOROUGH, L.L.P.

By: Bryson M. Geer

John C. von Lehe, Jr.

SC Bar no. 5719

Bryson M. Geer

SC Bar no. 13606

151 Meeting Street / Sixth Floor

Post Office Box 1806 (29402)

Charleston, SC 29401-2239

(843) 853-5200

Attorneys for CarMax Auto Superstores West Coast,  
Inc.

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PROOF OF SERVICE

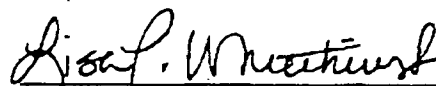
I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for CarMax Auto Superstores West Coast, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified, by hand delivering a copy of the same via courier, to the following address(es):

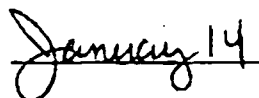
Pleadings: Final Reply Brief of Appellant

Counsel Served:

Milton G. Kimpson  
Harry A. Hancock  
Counsel for Litigation  
South Carolina Department of Revenue  
301 Gervais Street, 3<sup>rd</sup> Floor  
Columbia, SC 29201

Burnet R. Maybank, III  
Nexsen Pruet, LLC  
1230 Main Street, Suite 700  
Columbia, SC 29201

  
Administrative Assistant

 . 2011

1. The first step in the process of creating a new product is to identify a market need. This involves conducting market research to understand what consumers want and what problems they are facing. Once a need is identified, the next step is to develop a concept that addresses this need. This is often done through brainstorming sessions with a team of designers and engineers. The concept is then refined through prototyping and testing. The final step is to launch the product into the market and monitor its performance. This involves tracking sales, customer feedback, and market trends to ensure the product remains competitive and relevant.

Westlaw.

Page 1

--- S.E.2d ---, 2012 WL 832985 (S.C.App.)  
(Cite as: 2012 WL 832985 (S.C.App.))

Only the Westlaw citation is currently available.

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Court of Appeals of South Carolina.  
CARMAX AUTO SUPERSTORES WEST  
COAST, INC., Appellant,  
v.

SOUTH CAROLINA DEPARTMENT OF REVENUE, Respondent.

No. 4953.

Heard Jan. 26, 2012.

Decided March 14, 2012.

**Background:** Taxpayer, the nation's largest retailer of used cars and light trucks, filed contested case hearing challenging assessment of corporate income taxes by Department of Revenue. The Administrative Law Court, Carolyn C. Matthews, J., upheld Department's alternate method for calculating tax liability, determined alternate method was reasonable and did not violate the Commerce Clause, and dismissed penalties imposed by Department. Taxpayer appealed.

**Holding:** The Court of Appeals, Lockemy, J., held that Department, rather than taxpayer, had burden of proving its alternative accounting method was reasonable and more fairly represented taxpayer's business activity in state.

Reversed and remanded.

West Headnotes

[1] Administrative Law and Procedure 15A 791

15A Administrative Law and Procedure

15AV Judicial Review of Administrative Decisions

15AV(E) Particular Questions, Review of

15Ak784 Fact Questions

15Ak791 k. Substantial Evidence.

Most Cited Cases

As to factual issues, judicial review of administrative agency orders is limited to a determination whether the order is supported by substantial evidence.

[2] Taxation 371 3544

371 Taxation

371VIII Income Taxes

371VIII(G) Assessment

371k3543 Evidence

371k3544 k. In General. Most Cited

Cases

Department of Revenue had burden of proving gross receipts formula did not fairly represent business activity of taxpayer in state, in proceeding in which taxpayer, the nation's largest retailer of used cars and light trucks, filed contested case hearing challenging assessment of corporate income taxes.

[3] Taxation 371 3544

371 Taxation

371VIII Income Taxes

371VIII(G) Assessment

371k3543 Evidence

371k3544 k. In General. Most Cited

Cases

Department of Revenue, rather than taxpayer, had burden of proving its alternative accounting method was reasonable and more fairly represented taxpayer's business activity in state, in proceeding in which taxpayer, the nation's largest retailer of used cars and light trucks, filed contested case hearing challenging assessment of corporate income taxes; Department, as proponent of alternative apportionment method, was required to establish that its alternative method was not only appropriate, but

-- S.E.2d --, 2012 WL 832985 (S.C.App.)  
(Cite as: 2012 WL 832985 (S.C.App.))

more appropriate than any competing methods.

[4] Taxation 371  3545

371 Taxation

371VIII Income Taxes

371VIII(G) Assessment

371k3543 Evidence

371k3545 k. Weight and Sufficiency.

Most Cited Cases

Preponderance of evidence, rather than clear and convincing evidence, was standard of proof applicable to Department of Revenue in proving its alternative accounting method fairly represented taxpayer's business activity in state, in proceeding in which taxpayer, the nation's largest retailer of used cars and light trucks, filed contested case hearing challenging assessment of corporate income taxes.

John C. von Lehe, Jr., and Bryson M. Geer, both of Charleston, for Appellant.

Milton G. Kimpson and Harry A. Hancock, both of Columbia, for Respondent.

Alexandra E. Sampson, of Washington, D.C., and Burnet R. Maybank, III, of Columbia, for Amicus Curiae Council on State Taxation.

Robert L. Widener and Erick P. Doerring, both of Columbia, for Amicus Curiae South Carolina State Chamber of Commerce.

LOCKEMY, J.

\*1 This appeal arises out of CarMax Auto Superstores West Coast, Inc.'s (CarMax West) protest of an assessment of corporate income taxes by the South Carolina Department of Revenue (the Department). CarMax West alleges the Administrative Law Court (ALC) erred in: (1) failing to place the burden of proof on the Department to establish by clear and convincing evidence that the standard statutory apportionment method used by CarMax West does not reflect the extent of CarMax West's business in South Carolina and that the

Department's alternative accounting method is reasonable; (2) failing to consider and find that CarMax West operates a unitary business; (3) concluding that the activities of CarMax West in South Carolina are not fairly represented by the standard statutory apportionment method; (4) allowing the Department to apply separate accounting to a unitary business; (5) failing to apply the "place of activity" test set forth in *Lockwood Greene Engineers v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (Ct.App.1987) and concluding that CarMax West's financing receipts should be sourced to South Carolina; and (6) concluding that the Department did not violate CarMax West's constitutional rights by applying separate accounting to a unitary business and by sourcing financing receipts to South Carolina. We reverse and remand.

FACTS/PROCEDURAL BACKGROUND

1. Formation and Corporate Structure of CarMax, Inc.

CarMax, Inc. (CarMax) was formed in 1993 and is the nation's largest retailer of used cars and light trucks. From 2002–2004, CarMax operated as a holding company with two wholly owned subsidiaries: (1) CarMax West, which sold used vehicles in the western United States and owned substantially all of CarMax's intellectual property; and (2) CarMax Auto Superstores, Inc. (CarMax East), which sold used vehicles in the eastern and mid-western United States, including South Carolina, and handled financing and corporate overhead/management. Prior to 2004, CarMax East paid CarMax West a royalty for its use of the intellectual property. In 2004, CarMax's corporate structure was reorganized. CarMax Business Services, LLC (CBS) was created to: (1) house CarMax's financing operations (CarMax Auto Finance (CAF)); (2) provide certain shared services to the companies in the group; and (3) own the intellectual property. CBS was created as a multi-member limited liability company between CarMax West and CarMax East, with CarMax West owning a 93.5% interest in CBS and CarMax East owning a 6.5% interest in CBS. CBS charges CarMax West and CarMax

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East a per vehicle management services fee, which includes an intellectual property royalty component. The income from the management fee, in addition to the financing income generated through CAF, is distributed to CarMax West (93.5%) and CarMax East (6.5%).

## 2. Income Tax Returns, Audit, and Department Determination

CarMax West filed South Carolina corporate income tax returns for the years 2002–2007 utilizing the standard apportionment formula for multi-state taxpayers outlined in section 12–6–2250 of the South Carolina Code (2000). This formula calculates a taxpayer's taxable income in South Carolina by computing a ratio of the taxpayer's total property, payroll, and sales. The Department audited CarMax West for the tax years 2002–2007 and issued an audit report on June 19, 2008, adjusting the apportionment formula used by CarMax West and issuing a proposed assessment totaling \$829,490. On October 20, 2008, CarMax West submitted a Notice of Protest. On March 11, 2009, the Department issued a Final Agency Determination upholding the proposed assessment. The Department found neither the standard formula nor the gross receipts formula fairly represented the extent of CarMax West's business in South Carolina. The Department applied an alternative method to calculate CarMax West's taxable income in South Carolina. The alternative apportionment formula divided CarMax West's income from royalties and financing receipts from within South Carolina by its royalties and financing receipts from everywhere CarMax West does business to determine its ratio of apportionable income taxable in South Carolina. The Department's method did not include the retail income earned by CarMax West in other states. After the audit and the Department's Determination, CarMax West filed amended tax returns in September 2009, utilizing the gross receipts formula. To calculate taxable income using gross receipts, a fraction is created with the numerator being the taxpayer's South Carolina receipts and the denominator being the taxpayer's total receipts in

all states. This fraction is multiplied by the taxpayer's apportionable net income to determine the taxable income. Here, CarMax West included income from South Carolina royalties but excluded financing revenue in the numerator.

## 3. ALC Determination

\*2 CarMax West filed this matter for a contested case hearing before the ALC. Following a hearing on February 18 and 19, 2010, the ALC issued its final order on April 22, 2010. The ALC upheld the Department's alternate method for calculating CarMax West's tax liability, and determined the alternate method was reasonable and did not violate the Commerce Clause. According to the ALC, "the significance of considering [CarMax West'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.' " The ALC noted that "[w]here 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 taxpayer's business is represented in this State for tax purposes." The ALC also determined CarMax West was not negligent in reporting its tax liability and dismissed the penalties imposed by the Department. The ALC denied CarMax West's motion for reconsideration. This appeal followed.

## STANDARD OF REVIEW

[1] Appeals from the ALC are governed by the Administrative Procedures Act (APA). S.C.Code Ann. §§ 1–23–310 to –400 (2005 & Supp.2011). Pursuant to the APA, this court may reverse or modify the ALC's decision if the appellant's substantial rights have been prejudiced because the administrative decisions are:

- (a) in violation of constitutional or statutory provisions; (b) in excess of the statutory authority of the agency; (c) made upon unlawful procedure; (d) affected by other error of law; (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or (f)

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arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

S.C.Code Ann. § 1-23-380(5) (Supp.2011). “As to factual issues, judicial review of administrative agency orders is limited to a determination whether the order is supported by substantial evidence.” *MRI at Belfair, LLC v. S.C. Dep’t of Health & Envtl. Control*, 379 S.C. 1, 6, 664 S.E.2d 471, 474 (2008).

#### LAW/ANALYSIS

**CarMax West** argues the ALC erred in failing to place the burden of proof on the Department to establish by clear and convincing evidence that the standard statutory apportionment method used by **CarMax West** did not reflect the extent of **CarMax West**’s business in South Carolina and that the Department’s alternative accounting method is reasonable.

The ALC held:

[t]he standard of proof is a preponderance of the evidence. *Anonymous v. State Bd. of Med. Examiners*, 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.

\*3 **CarMax West** argues that although this is the appropriate standard in tax assessment cases generally, an exception to the rule applies when a party wishes to deviate from the standard method of apportionment. In such a case, **CarMax West** contends, the burden shifts to the party attempting to deviate to show by clear and convincing evidence why the standard method should not be used and the alternative method is reasonable. **CarMax West** cites several decisions from other jurisdictions applying similar shifts in the burden of proof. See

*Limited Stores, Inc. v. Franchise Tax Bd.*, 152 Cal.App.4th 1491, 1498, 62 Cal.Rptr.3d 191, 196 (Cal.App. 1 Dist.2007) (holding the party asserting alternative apportionment bears the burden of showing by clear and convincing evidence that alternative apportionment is appropriate); *Union Pacific Corp. v. Idaho State Tax Comm’n*, 139 Idaho 572, 575, 83 P.3d 116, 119 (Idaho 2004) (holding “[t]he party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate”); *St. Johnsbury Trucking Co. v. State*, 118 N.H. 209, 212, 385 A.2d 215, 217 (N.H.1978) (holding “an alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of showing that the alternative is appropriate”); *Donald M. Drake Co. v. Dep’t of Revenue*, 263 Or. 26, 32, 500 P.2d 1041, 1044 (Or.1972) (holding “the use of any method other than apportionment should be exceptional” and the party seeking to use an alternative method bears the burden of proof); *Kmart Properties, Inc. v. N.M. Taxation & Revenue Dep’t*, 139 N.M. 177, 191, 131 P.3d 27, 41 (N.M.App.2001) (holding the Department of Revenue had the burden of proof “to justify any modification of the [Uniform Division of Income for Tax Purposes Act] formula”), rev’d on other grounds, 139 N.M. 172, 131 P.3d 22 (N.M.2005). **CarMax West** also contends the Department failed to cite any authority to the contrary and agreed at trial that the Department bore the burden.

The Department maintains: (1) no such standard of proof is found in the plain language of section 12 -6-2320(A); (2) the cases cited by **CarMax West** are non-binding; and (3) our supreme court has not adopted the clear and convincing standard. The Department contends there is a shifting burden of proof. First, the Department argues it bears the burden of proving **CarMax West**’s chosen method of apportionment is not reasonable. Thereafter, once the Department meets its burden, **CarMax West** bears the burden of proving by clear and convincing evidence that under the Department’s alternate method the income attributed to South Caro-

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lina is "out of all appropriate proportions to the business transacted" in South Carolina or has led to a "grossly distorted result."

[2][3] We find the ALC erred in finding CarMax West had the burden of proving the Department's alternate accounting method was not reasonable. There are two burdens of proof which must be met in this case. First, we note both the Department and CarMax West agree the Department bears the burden of proving the gross receipts formula does not fairly represent CarMax West's business activity in South Carolina. Second, the Department bears the burden of proving its alternative accounting method is reasonable and more fairly represents CarMax West's business activity in South Carolina.

\*4 In *Media General Communications, Inc. v. South Carolina Department of Revenue*, 388 S.C. 138, 146, 694 S.E.2d 525, 529 (2010), it was undisputed that the gross receipts apportionment statute "did not fairly represent [the multi-state] Taxpayers' income." It was also undisputed that the alternative method proposed by the Taxpayer "did fairly measure the Taxpayers' business activity in South Carolina." *Media General*, 388 S.C. at 146, 694 S.E.2d at 529. Our supreme court upheld the Taxpayers' alternative method, because "the Department has not established that another method would be more appropriate." *Id.* at 152, 694 S.E.2d at 532. Thus, based on *Media General*, the Department, as the proponent of an alternative apportionment method, must establish that its alternative method is not only appropriate, but more appropriate than any competing methods.

[4] Furthermore, although the statutes do not provide a standard of proof, we find they evidence intent by the General Assembly to require proponents of alternate apportionment methods to prove their method fairly represents the extent of the taxpayer's business activity in South Carolina. It is only logical that a party seeking to override the legislatively determined apportionment method bears the burden of proving that method is not ap-

propriate and an alternative method more accurately reflects the taxpayer's business activity within the state. Additionally, we disagree with CarMax West's assertion that the standard of proof is clear and convincing evidence. CarMax West has failed to cite any South Carolina authority supporting its position and the statutes do not indicate a legislative intent to apply the clear and convincing standard. Accordingly, we reverse the ALC's determination that CarMax West had the burden of proof, and remand for a reconsideration of all issues applying the preponderance of the evidence burden of proof.

#### CONCLUSION

We find the ALC erred in determining CarMax West had the burden of proving the Department's alternate accounting method was not reasonable, and therefore, we reverse the ALC and remand for a reconsideration of all issues.

#### REVERSED AND REMANDED.

HUFF and PIEPER, JJ., concur.

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CarMax Auto Superstores West Coast, Inc. v. South Carolina Dept. of Revenue

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**SC 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

**PETITION FOR REHEARING**

Pursuant to Rules 219(a) and 221(a) of the South Carolina Appellate Court Rules, Appellant, CarMax Auto Superstores West Coast, Inc. ("CarMax West"), hereby files this petition for rehearing of the above-referenced matter, which resulted in Opinion number 4953 filed March 14, 2012 (the "Opinion"). This Petition for Rehearing is based on the ground that the Court overlooked and/or failed to rule upon some of the issues in this case.

**FACTUAL BACKGROUND**

The Court correctly identified the basic issues raised by Appellant in this appeal as that the ALC erred in: (1) failing to place the burden of proof on the South Carolina Department of Revenue (the "Department") to establish by clear and convincing evidence that the standard statutory apportionment method used by CarMax West does not reflect the extent of CarMax West's business in South Carolina and that

the Department's alternative accounting method is reasonable (the "Burden of Proof Issue"); (2) failing to consider and find that CarMax West operates a unitary business (the "Unitary Business Issue"); (3) concluding that the activities of CarMax West in South Carolina are not fairly represented by the standard statutory apportionment method (the "Factual Finding on CarMax West Activities Issue"); (4) allowing the Department to apply separate accounting to a unitary business (the "Separate Accounting Issue")<sup>1</sup>; (5) failing to apply the "place of activity" test set forth in Lockwood Greene Engineers v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987) and concluding that CarMax West's financing receipts should be sourced to South Carolina (the "Sourcing Issue"); and (6) concluding that the Department did not violate CarMax West's constitutional rights by applying separate accounting to a unitary business and by sourcing financing receipts to South Carolina (the "Constitutional Issue"). Opinion at p. 1. See also Appellant's Brief at p. 1 (statement of issues).

The Court then thoroughly considered the Burden of Proof Issue (Issue no. 1), and correctly concluded that the burden should have been placed on the Department to establish by a preponderance of the evidence that the standard statutory apportionment method used by CarMax West did not reflect the extent of CarMax West's business activities in South Carolina and that the Department's alternative accounting method is reasonable. See Opinion at p. 4-5. The Court then reversed and

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<sup>1</sup> CarMax West would clarify that as to the Separate Accounting Issue, it asserted two bases for finding that separate accounting was inappropriate: (1) because it is prohibited by Exxon and S.C. Code Ann. 12-6-2320(A)(4) because it produces an unreasonable result, or (2) because it produces an unreasonable result in this case. Appellant's Brief at p. 1.

remanded this matter "for reconsideration of all issues" in light of this ruling. Opinion at p. 5. However, the Court did not consider or rule upon the remaining issues in the case, which (1) would support a final and dispositive ruling by this Court such that remand is not necessary, (2) are entirely independent of the Burden of Proof Issue, or (3) would be instructive to the ALC when reconsidering the issues in the case on remand.

### LEGAL ARGUMENT

**I. The Court Did Not Consider or Rule upon Certain Issues, which when Considered Would Support a Final and Dispositive Ruling by this Court such that Remand is Not Necessary.**

First, CarMax West would ask that the Court reconsider and rule upon the Factual Finding on CarMax West Activities Issue (3<sup>rd</sup> issue). CarMax West submits that based on the evidence in the record, SCDOR could not meet its burden of proof in this case as it put forth no substantive evidence to show that the standard statutory apportionment method used by CarMax West did not reflect the extent of its business activities in South Carolina or that the Department's alternative accounting method is reasonable.<sup>2</sup> Under S.C. Code Ann. § 1-23-610(B), this Court may reverse a decision of the ALC if it is "clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record." See S.C. Code Ann. § 1-23-610(B); Sierra Club v.

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<sup>2</sup> The only factual evidence submitted by the Department was its "distortion" example that arguably showed two things: (1) that CarMax West had a lower apportionment ratio and thus lower taxable income than CarMax East, and (2) that CarMax West paid less tax under the standard formula than under the Department's alternative method. Neither of these facts has anything to do with the extent of CarMax West's activities in South Carolina or the income derived from those activities. One would expect CarMax East to have a significantly higher income and thus higher tax revenue in this State because it has a much greater level of business activity here than does CarMax West. To the contrary, it is the method used by the Department that produces a distorted result by imposing a tax on the minimal activities of CarMax West that was greater than the tax on CarMax East, the entity with substantial activities in South Carolina. See Appellant's Brief at p. 27-28.

South Carolina Dep't of Environmental Control, 387 S.C. 424, 431, 693 S.E.2d 13, 16 (2011). "Substantial evidence" is defined as evidence "that would allow reasonable minds to reach the same conclusion as the [ALC] and is more than a mere scintilla of evidence." Id. Because there is no evidence in the record upon which the ALC could base a decision in favor of SCDOR on this issue no matter which party has the burden of proof, this Court can and should reverse the decision of the ALC as the record can only support a ruling in favor of CarMax West.

Similarly, the Court should also rule upon the Unitary Business Issue (2<sup>nd</sup> issue). The evidence was uncontested that CarMax West operated a unitary business (see Appellant's Brief at p. 19-22 and Reply Brief at p. 7), and thus, this Court should reconsider this issue and rule that CarMax West is a unitary business. Furthermore, this Court should rule that as a matter of law, SCDOR's method of apportionment was not proper as SCDOR's regulation requires a unitary business to be apportioned in its entirety and not subdivided (see S.C. Code Ann. Regs. 117-710.1 (West Supp. 2009); Appellant's Brief at p. 32) and because South Carolina law prohibits separate accounting as to a unitary business. See Appellant's Brief at 29-33; Reply Brief at 4-7. See also S.C. Code. Ann. 1-23-610(B) (providing that an appellate court may reverse or modify a decision of the ALC if it is affected by an error of law).

**II. The Court Did Not Consider or Rule upon Certain Issues That are Independent of the Burden of Proof Issue.**

The parties agreed in their briefing that the ALC applied the proper burden and standard of proof (i.e. CarMax West bore the burden of proof) as to the Sourcing Issue (5<sup>th</sup> issue) and the Constitutional Issue (6<sup>th</sup> issue). CarMax argued that

the ALC erred in finding in favor of SCDOR based on other reasons as set forth in its Briefs. See Appellant's Brief at 38-42 (as to Sourcing Issue) and 42-44 (as to Constitutional Issue); Reply Brief at 11-12 (as to Sourcing Issue) and 12-13 (as to Constitutional Issue). The Court does not appear to have addressed these issues in the Opinion, and, thus, CarMax West would respectfully request that the Court reconsider and rule upon these issues.

**III. In the Alternative, if the Court Believes that Remand is Necessary, then the Court Should Consider and Rule upon Certain Issues That it Did Not Address as This Would be Instructive to the ALC.**

In the alternative, if the Court believes a remand is necessary in this case, then it would be instructive for the Court to further rule upon the Unitary Business Issue (2<sup>nd</sup> issue) and the Separate Accounting Issue (4<sup>th</sup> issue) such that the ALC can properly consider all relevant facts and law on remand. CarMax West respectfully suggests that South Carolina law requires the ALC to consider if CarMax is unitary because this impacts (1) whether the standard apportionment method accurately reflects its unitary business activities, and (2) whether the Department's alternative separate accounting method is reasonable. See Appellant's Brief at 30-37; Reply Brief at 4-6 and 8-10. Thus, CarMax West would ask that this Court instruct the ALC that it should consider this issue and rule upon whether CarMax West is unitary, and, if it is unitary, then the ALC should consider this fact when evaluating whether the standard apportionment method accurately reflects CarMax West's unitary business activities and whether the Department's alternative separate accounting method is reasonable.

**IV. Also in the Alternative and if the Court Believes that Remand is Necessary, then the Court Should Clarify Whether the Remand will be on the Record in the Case.**

CarMax West would ask for clarification from this Court regarding the nature of the remand. As previously stated, the Court indicated that this matter should be reversed and remanded to the ALC for "for reconsideration of all issues" in light of this ruling. Opinion at p. 5. CarMax West assumes this reconsideration should be based on the facts in the record but requests that the Court confirm that the ALC should simply apply the proper burden of proof and the law to the facts already in the record. The Department's position at trial was that it should bear the burden of proof. See Appellant's Brief at p. 14 (citing Tr. at 443:3-9). Thus, it should have presented any and all evidence it needed to meet this burden. It would be fundamentally unfair to now require the parties to bear the burden and expense of another trial and to give the Department a second bite at the apple. See Lewis v. Lewis, 392 S.C. 381, 709 S.C. 650 (2011) (reversing Court of Appeals decision, which found that the value of the marital home was not supported by the record and which remanded the case with instructions that invited the lower court to accept additional evidence, and noting that "Given Respondent's incomplete presentation at trial, it would be fundamentally unfair to Petitioner to give Respondent a second bite at the apple"); Sierra Club v. South Carolina Dep't of Environmental Control, 387 S.C. 424, 693 S.E.2d 13 (2011) (remanding case to ALC with instructions to apply its factual findings to the proper regulations, which the ALC had not addressed in its order).

## CONCLUSION

CarMax West respectfully requests that this Court have a rehearing in this matter for the purpose of considering and ruling upon the foregoing issues. Specifically, CarMax West would ask that the Court reconsider and rule as follows:

- I. Reverse the ALC and dismiss the entire assessment because, regardless of which party bears the burden of proof:
  - A. The record does not contain substantial evidence to support a ruling by the ALC that the standard statutory method does not fairly reflect CarMax West's business activities in South Carolina or that SCDOR's separate accounting method is reasonable, and, therefore, the ALC's decision must be reversed; and
  - B. Based on the uncontested evidence, CarMax West is a unitary business and under S.C. Code Ann. Regs. 117-710.1 (West Supp. 2009), a unitary business may not be subdivided as the Department seeks to do but rather must be apportioned in its entirety, and, therefore, the ALC's decision must be reversed.
- II. Reverse the ALC and dismiss the assessment as to CarMax West's financing receipts because those receipts should not be sourced to South Carolina when the services related to the production of that income were performed out-of-state.
- III. Reverse the ALC and dismiss the entire assessment because SCDOR violated CarMax West's constitutional rights by applying separate accounting to a unitary business and sourcing financing receipts to South Carolina.
- IV. In the alternative to I, remand the case to the ALC with the following instructions:
  - A. Reconsider the evidence in the record made at trial applying the preponderance of evidence standard under which the Department must show that (1) the standard apportionment method does not fairly reflect CarMax West's activities in South Carolina; and (2) the separate accounting method applied to CarMax West is reasonable.
  - B. In conducting this reconsideration, the ALC should also consider the following:

1. The uncontested evidence that CarMax West is a unitary business (or, in the alternative remand for consideration under Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979) as to whether CarMax West operates a unitary business);
2. The discussion in Exxon and related cases of the nature of a unitary business's income as being attributable to all of the business's operations;
3. The prohibition on applying separate accounting to a unitary business discussed in Exxon and related cases; and
4. The SC regulation requiring that a unitary business be apportioned in its entirety and not subdivided (S.C. Code Ann. Regs. 117-710.1 (West Supp. 2009)).

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: John C. von Lehe, Jr.  
John C. von Lehe, Jr.  
SC Bar No. 5719  
E-Mail: john.vonlehe@nelsonmullins.com  
Bryson M. Geer  
SC Bar No. 13606  
E-Mail: bryson.geer@nelsonmullins.com  
151 Meeting Street / Sixth Floor  
Post Office Box 1806 (29402-1806)  
Charleston, SC 29401-2239  
(843) 853-5200

Attorneys for Carmax Auto Superstores  
West Coast, Inc.

Charleston, South Carolina  
March 28, 2012

CERTIFICATE OF SERVICE

I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for Carmax Auto Superstores West Coast, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by delivering a copy of the same, via Federal Express, to the following address(es):

Pleadings:

APPELLANT'S PETITION FOR REHEARING

Counsel Served:

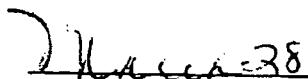
Milton Kimpson, Esq.  
Harry A. Hancock, Esq.  
Counsel for Litigation  
South Carolina Department of Revenue  
301 Gervais Street, 3<sup>rd</sup> Floor  
Columbia, SC 29201

Burnet R. Maybank, III  
Nexsen Pruet, LLC  
1230 Main Street, Ste 700  
Columbia, SC 29201

Erik P. Doerring  
McNair Law Firm, P.A.  
1221 Main Street, Ste. 1800  
Columbia, SC 29211

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THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Carolyn C. Matthews, Administrative Law Judge

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

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

v.

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

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**SOUTH CAROLINA DEPARTMENT OF REVENUE'S  
PETITION FOR REHEARING**

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Pursuant to Rules 221 and 224, SCACR, the Respondent, South Carolina Department of Revenue (Department), hereby files this Petition for Rehearing. The Department respectfully submits that rehearing and/or issuance of a new opinion denying the relief sought by the Appellant is warranted. The grounds for the petition are that the Court's March 14, 2012 decision misapprehends the correct burden of proof for the employment of an alternative apportionment method under S.C. Code Ann. § 12-6-2320(A) (2000) and overlooks the substantial evidence in the record that the Department satisfied the correct burden.

## INTRODUCTION

The areas in contention are relatively narrow. Initially, the Department agrees with the Court that the preponderance of evidence is the correct standard of proof. (Opinion, p. 5) Further, the Department agrees with the Court's conclusion that a sufficient showing under § 12-6-2320(A) entails a two pronged burden of proof. Id. As the proponent of an alternative apportionment method, the Department bore the initial burden to prove that the standard gross receipts formula chosen by the taxpayer "does not fairly represent CarMax West's business activity in South Carolina." Id. It is the Court's characterization of the second prong of the burden of proof, however, that is problematic and ultimately inconsistent with the plain language of the governing statute and the South Carolina Supreme Court's formulations in Media General v. SC Department of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010). Instead of being required to show that the alternative apportionment formula it chooses is "not only appropriate, but more appropriate than any other competing methods," the Department submits that it must show only that the selected alternative apportionment formula is "reasonable." Moreover, the Department further submits that the Administrative Law Court's (ALC) order and the evidence in the record show that its burden was satisfied in this case such that any error in the ALC's characterization of the applicable burden of proof is harmless.

## LEGAL ANALYSIS

- I. The Plain Language Of § 12-6-2320(A) Requires The Proponent Of An Alternate Apportionment Formula To Show That The Standard Apportionment Formula Does Not Fairly Reflect The Taxpayer's Business In South Carolina And That The Chosen Alternative Apportionment Formula Is "Reasonable."

Section 12-6-2320(A) provides as follows:

(A) 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).

According to the statute, once there is an adequate showing that standard allocation and apportionment formulas ["the allocation and apportionment provisions of this chapter"] do not fairly represent the extent of the taxpayer's business in this State, the Department may require any of the accounting methods enumerated in subparagraphs (1) - (5) of § 12-6-2320(A), if "reasonable." The statute does not require that the proponent of an alternative accounting method - whether the Department or even the taxpayer - show that the proffered method is more appropriate than any other "competing methods."<sup>1</sup> Instead, in the absence of evidence to the contrary, an alternate accounting method should be upheld if "reasonable."

When construing a statute, the cardinal rule is to ascertain the intent of the Legislature. Georgia-Carolina Bail Bonds, Inc. v. County of Aiken, 354 S.C. 18, 22, 579

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<sup>1</sup>In practice, such evidence could be part of any case the proponent of an alternate apportionment method pursues under the terms of § 12-6-2320, but only in response to the introduction of some competing method by the party opposing alternative apportionment. In the event an opposing party does not come forward with evidence of a competing method, the proponent's showing that the alternative formula is reasonable necessarily satisfies the statute.

S.E.2d 334, 336 (Ct. App. 2003). "All rules of statutory construction are subservient to the one that legislative intent must prevail if it can be reasonably discovered in the language used, and that language must be construed in the light of the intended purpose of the statute." *Id.* at 23, 579 S.E.2d at 336. The words of the statute must be given their plain and ordinary meaning without resorting to subtle or forced construction to limit or expand the statute's operation. Hitachi Data Sys. Corp. v. Leatherman, 309 S.C. 174, 178, 420 S.E.2d 843, 846 (1992).

Here, § 12-6-2320(A) is clear that once the first prong is satisfied - that the standard formula fails to fairly represent the extent of the taxpayer's business activity in this State -- an alternative apportionment formula may be required by the Department if "reasonable." The second prong of the proponent's burden of proof is therefore met once the proponent shows that its alternative method is "reasonable."<sup>2</sup> The statute does not require the proponent to show that the chosen apportionment method is more appropriate than competing methods.<sup>3</sup> With both prongs under § 12-6-2320(A) thus satisfied, the

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<sup>2</sup>It is significant to note that CarMax has characterized the second prong of the burden of proof in similar terms. CarMax urged the Court to require the Department to "establish by clear and convincing evidence that the standard statutory apportionment method does not reflect the extent of the taxpayer's business in South Carolina and that the alternative separate accounting method is reasonable." (Appellant's Final Brief, p. 13). Aside from the taxpayer's use of a clearly incorrect standard of proof, the Department is in agreement with CarMax's characterization of the substantive burden of proof under § 12-6-2320(A).

<sup>3</sup>This interpretation of § 12-6-2320(A)'s two pronged burden of proof is straightforward, logical, and avoids absurd results. By proving that the standard method of apportionment fails to fairly reflect the extent of a taxpayer's business within South Carolina and proposing a "reasonable" alternative, the proponent of any alternative method will have already shown that at least one method of apportionment is not proper. In the absence of specific evidence of competing formulas produced by the party opposing the proffered alternative method, the proponent should not be required to

proponent of the alternative method has met its burden of proof and use of the alternative formula should be upheld.

II. The Media General Case Dictates That The Second Prong Of § 12-6-2320(A)'s Burden Of Proof Is Satisfied By The Showing That Any Alternate Apportionment Formula Is "Reasonable."

Media General is the most recent case issued by the South Carolina Supreme Court interpreting § 12-6-2320. The Court ruled that the language in § 12-6-2320(A)(4) providing for "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income" allowed the taxpayer therein to use a combined entity apportionment method to determine its tax liability. Heretofore, inasmuch as South Carolina had always been a "separate entity" state, combined entity reporting had not been recognized as a proper method for apportionment of income, even as an alternative method under § 12-6-2320. Media General, 388 S.C. at 149-150; 694 S.E.2d at 530-531.

For the purposes of the instant case, it is important to recognize that the taxpayer in Media General was the proponent of the alternative method of apportionment, meaning the taxpayer bore the burden of justifying its use of a formula other than standard apportionment. The taxpayer satisfied its initial burden under § 12-6-2320(A) by virtue of the parties' stipulation that the standard statutory method of apportionment did not fairly measure the taxpayer's business activity in South Carolina. Id., 388 at 146, 694

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speculatively defend against endless permutations of alternate formulas. To hold otherwise would work an absurd result not intended by the General Assembly. State ex rel. McLeod v. Montgomery, 244 S.C. 308, 136 S.E.2d 778 (1964) (A statute must be interpreted so as to avoid absurd results.).

S.E.2d at 529. Secondly, based upon its audit findings, the Department acknowledged that the combined entity apportionment method propounded by the taxpayer "did fairly measure the Taxpayers' business activity in South Carolina." Id.<sup>4</sup> This was tantamount to a showing by the taxpayer that its chosen alternative method of apportionment was "reasonable" within the meaning of § 12-6-2320(A) – the second prong of the burden of proof test to be satisfied by the proponent of an alternative apportionment method.<sup>5</sup>

After the Media General taxpayer satisfied both its initial and second level burdens of proof under § 12-6-2320(A), the burden then shifted to the Department to show that a more appropriate method of apportionment existed. This burden shifting is illustrated by the following excerpt:

We emphasize that, as a general rule, the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina. In this case, however, the Department never recalculated

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<sup>4</sup>The Department's role is to fairly administer the tax laws. S.C. Code Ann. § 12-4-10 (2000). In particular, S.C. Code Ann. § 12-6-2210(B) (2000) provides in pertinent part: "[i]f a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State" (emphasis added).

<sup>5</sup>The Court's language underscores that reasonableness is the touchstone for use of an alternative formula:

[t]his statute [§ 12-6-2320(A)(4)] provides that if the allocation and apportionment provisions do not fairly represent the taxpayer's business activities in South Carolina, the taxpayer may petition for, or the Department may require, if reasonable, the employment of any other method to effectuate the equitable allocation and apportionment of the taxpayer's income.

Id., 388 SC at 143; 694 S.E.2d at 527 (emphasis added).

Taxpayers' incomes using any other alternative method, and the Department stipulated that use of the combined entity apportionment method proposed by Taxpayers does result in a fair computing of Taxpayers' business activities in South Carolina. Accordingly, we uphold the ALC's determination that the combined entity apportionment method should be utilized by the Department for the tax period in question.

\* \* \*

The Department concedes the standard apportionment formulas allowed under South Carolina law result in a statutory distortion of Taxpayers' incomes and that the combined entity apportionment method would fairly represent their business activities in South Carolina. We agree with the ALC that the legislature has placed no explicit limitation on the alternative methods that may be used under section 12-6-2320(A)(4), and consequently we affirm the ALC's ruling that the Department is authorized to use the combined entity apportionment method. Although the Department has the discretion to select an alternative method, the ALC has ordered in this case that the method be applied and we affirm this determination as the Department has not established that another method would be more appropriate. This ruling is limited to the tax period in question, and the Department may employ any other appropriate alternative method for future tax years.

Id., 388 S.C. at 151-152; 694 S.E.2d at 531-532 (emphasis added).

Once the taxpayer in Media General met the requirements of § 12-6-2320(A) by showing that the standard apportionment method did not "fairly represent the extent of the taxpayer's business activity in this State" and that the chosen apportionment method resulted in a fair measure of its in state business activities, i.e., the method was "reasonable," the Department then had the further opportunity as the party opposing use of the proffered method to show that a more appropriate alternative existed. In Media General, the Department did not make such a showing and thus, the Court determined that the combined entity apportionment method, because it was reasonable, was the

method to be used to calculate the taxpayer's South Carolina income tax liability. Id.<sup>6</sup> In the instant case, once the Department demonstrated that the standard apportionment method used by CarMax did not fairly reflect the taxpayer's business activity within South Carolina and that the proffered alternative method was reasonable, the burden then lay with CarMax, the opponent of the proffered alternative method, to show that a more appropriate alternative method existed. CarMax failed to make such a showing.<sup>7</sup> In the absence of evidence propounded by the taxpayer that the reasonable alternative apportionment method selected by the Department was not as well suited to measure the taxpayer's business activity as some competing formula, the Department's proffered method of apportionment should be upheld.

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<sup>6</sup>In such cases, in the event the Department responds to the taxpayer's proffer of an alternative formula with an alternative equally as reasonable, arguably the Department's method may enjoy some presumption of correctness based on § 12-6-2210(B) and the Media General Court's observation that "the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina." Id. (emphasis added).

<sup>7</sup>In fact, the ALC order recites that CarMax raised:

... 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.

(ALC Order, p. 11). These counter arguments appear to fall woefully short of the kind of specific evidentiary challenges to reasonableness contemplated by the Media General Court.

III. The ALC Order And The Record Show That The Department Satisfied The Applicable Burden Of Proof Under § 12-36-2320(A) Such That Any Error Of The ALC Is Harmless.

A careful review of the ALC Order and the Record indicate that the Department met its two pronged burden of proof regarding use of the alternative apportionment method. As such, any error of the ALC in the characterization of the Department's burden of proof under § 12-6-2320(A) in the context of this case was harmless.

As the Court observed, the ALC noted in its General Findings that "the burden of proof is generally upon the party asserting the affirmative in an adjudicatory administrative proceeding. . . . 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." (ALC Order, p. 6). While this is not an incorrect statement of law as it relates to the overall burden of proof in tax cases under the Revenue Procedures Act, the statement does not address the specific burdens under § 12-6-2320(A). Nevertheless, at a later point in its Order, the ALC outlined the two pronged burdens under this statute:

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 [ALC] discusses each of these requirements in turn below.

(ALC Order, p. 7)<sup>8</sup>

The ALC thereafter made findings concerning the burdens, and significantly, relied on evidence adduced by the Department on these issues:

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.

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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 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. The Department described this as a dilution of apportionment ratio, and described the consequent reduction of the taxpayer's tax liability as a distortion of the tax owed.

[5]The 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 tangible receipts (i.e.

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<sup>8</sup>The phrasing of the Order in this regard indicates that the ALC looked to the Department to invoke the two "triggers" authorizing the use of an alternative apportionment formula under § 12-6-2320(A).

financing receipts).

(ALC Order, pp. 7-8).

In deciding that the use of an alternative apportionment formula was warranted in this case, the ALC concluded its analysis of the first prong of burden of proof under § 12-6-2320 by quoting the testimony of a Department witness:

The 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 oranges company, that's - that leaps out at you. ...[T]he apples here are the franchise payment, 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.

(ALC Order, p. 9, fn. 7).

The ALC relied on this same body of Department evidence in reaching its decision that the second prong of the § 12-6-2320 test - that the alternative apportionment method was reasonable -- had been satisfied:

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.

(ALC Order, p. 11) (emphasis in original).

As such, to the extent the ALC committed error in its characterization of the respective burdens of proof borne by the taxpayer and the Department, the Department submits that such error was harmless as the ALC relied extensively on evidence the Department produced at trial to make the required findings under § 12-6-2320.

#### CONCLUSION

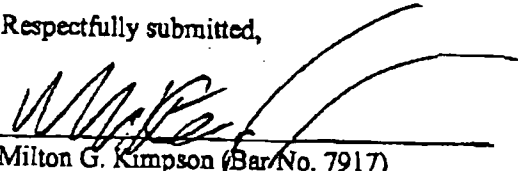
For the reasons specified herein, the South Carolina Department of Revenue respectfully requests that this Court grant its Petition for Rehearing and/or issue a decision denying the relief requested by CarMax and affirming the judgment of the ALC.<sup>9</sup>

[Remainder of Page Blank]

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<sup>9</sup>In the event the Court denies the Department's motion, the Department requests that the Court make clear that the matter is to be remanded to the ALC for trial on all issues.

Respectfully submitted,



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Milton G. Kimpson (Bar No. 7917)  
General Counsel for Litigation  
Harry H. Hancock (Bar No. 65233)  
Managing Counsel for Litigation  
PO Box 12265  
Columbia, SC 29211  
(803) 898-5130  
Attorneys for  
South Carolina Department of Revenue

Columbia, South Carolina  
March 29, 2012

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Carolyn C. Matthews, Administrative Law Judge

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

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

v.

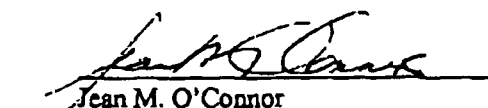
South Carolina Department of Revenue, .....Respondent.

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PROOF OF SERVICE

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I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, by United States Postal Service, first class mail postage prepaid, a copy of the Department of Revenue's Petition for Rehearing in the above-referenced matter to John C. von Lehe, Jr., Esquire, 151 Meeting Street, Sixth Floor, Charleston, SC 29401 this 29<sup>th</sup> day of March, 2012.

  
Jean M. O'Connor

THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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**SC 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

**CARMAX AUTO SUPERSTORES WEST COAST, INC.'S  
RESPONSE TO RESPONDENT'S  
PETITION FOR REHEARING**

Appellant CarMax Auto Superstores West Coast, Inc. ("CarMax West") hereby files this Response to the South Carolina Department of Revenue's (the "Department") Petition for Rehearing pursuant to Rules 221 and 224, SCACR. CarMax West submits for the reasons discussed herein that the Petition for Rehearing should be denied.

**ARGUMENT**

**I. The Standard Statutory Apportionment Method is the "Competing Method."**

In the Introduction to its Petition for Rehearing (the "Petition"), the Department states that it agrees with this Court's conclusion that when an alternative apportionment is in question under S.C. Code Ann. § 12-6-2320 (A), the party challenging the standard statutory apportionment method has the burden of proving that the statutory method "does not fairly represent the taxpayer's business activity in South Carolina"

and that "the Department must show that its selected alternative apportionment is reasonable." CarMax West submits that this ends the matter so far as the burden of proof is concerned as no other burden of proof issue was before this Court. However, the Department appears to believe otherwise. Although agreeing with the Court and CarMax West that it bore the burden of proof, the Department attempts to convince the Court that it erred on the burden of proof issue by objecting to certain language in the Court's decision regarding a "competing" apportionment method. The Department finds fault with the Court's statement that the alternative formula chosen by the Department must "not only (be) appropriate, but more appropriate than any other competing methods." However the "competing method" referenced in the Court's decision in this case is the standard apportionment method. There is no other "competing method" as CarMax West has relied on the standard apportionment method. Its position concerning the alternate apportionment issue (evidence and argument) is and has been that the statutory apportionment method does fairly represent its business activity in South Carolina. It has not proposed any other "competing method" nor, as will be discussed below, is it required to do so. Because the "competing method" was the standard method, this Court correctly stated that the Department had the burden of showing that its alternative method must be more appropriate than the statutory method. The Department's assignment of error to the Court's reference to a "competing method" is irrelevant to this adjudication.

**II. The Burden of Proof Issue Has Been Decided With Finality.**

The parties agree that the Department, as the proponent of an alternative method authorized by § 12-6-2320(A), had the burden of proving that (1) the standard

apportionment formula did not fairly represent the taxpayer's business activity in this state, and (2) the method chosen by the Department did fairly reflect those activities. These are the only burden of proof questions before this Court. This Court correctly stated the law when it said: "there are two burdens of proof which must be met in this case. First, we note both the Department and CarMax agree the Department bears the burden of proving the gross receipts formula does not fairly represent CarMax's business activity in South Carolina. Second, the Department bears the burden of proving its alternative accounting method is reasonable and more fairly represents CarMax's business activity in South Carolina." It is therefore clear that the statutory formula is presumed to be correct and the Department agreed that the party seeking to deviate from it must show that it does not fairly reflect the taxpayer's business activity and that the alternative method it proposes does fairly reflect those activities.

The Administrative Law Court ("ALC") erroneously found that CarMax West had the burden of proof. At oral argument before this Court, the Department supported that faulty conclusion submitting that the ALC was correct and that the taxpayer had the burden of proving that the statutory apportionment formula fairly represented the extent of the taxpayer's business activities in this State. This Court disagreed and in its decision correctly found that the burden was on the Department as the party seeking to deviate from the statutory method to show that the standard statutory formula did not fairly represent the extent of the taxpayer's business activities and that the Department's alternative method did. In its Petition, the Department now agrees that it and the ALC were wrong. The burden of proof question is decided.

The Department's protracted argument concerning a competing method appears to imply that CarMax West had a duty to derive a third formula. It did not. The taxpayer obviously had a perfect right to rely on the standard apportionment method provided by the legislature. The Department then had the burden to show that the standard method did not fairly represent the extent of the taxpayer's business activities in this state and that its alternative did. As previously stated, the Department now agrees that it had this burden and this issue is resolved. Even if the Court's reference to a "competing method" can be construed to mean a third method (one other than the statutory method and the SCDOR's alternative method), it is irrelevant to the burden of proof question before this Court because there are only two methods and no third competing method. Because there are only two methods, the concept of a third competing method and the burden of proof related to this hypothetical method is irrelevant.

Furthermore, the Department's argument concerning the sequence of burdens of proof is erroneous. It apparently would have this Court adopt a sequence in which: (1) the taxpayer files using the standard formula; (2) the Department objects and proposes an alternative method; (3) the taxpayer must then come forward with a third "competing" method. But there is no such sequence in the alternative apportionment statute, none is required. That statute requires that if the Department objects to the standard method it must not only show that the standard method does not fairly represent the extent of the taxpayer's business activities in this state, it must also propose a method that does. There is no requirement that the taxpayer propose a third competing method.

The Department's reliance on the case of Media General Communications v. SC Department of Revenue, 388 S.C. 138, 694, S.E.2d 525 (2010) is misplaced. The SCDOR quotes from the Media General case in an effort of convince this Court that CarMax West had a duty to propose a third "competing" method. The clear difference is that in Media General both the taxpayer and the Department agreed that the standard apportionment formula did not fairly represent the extent of the taxpayer's business activities in South Carolina and further that the method proposed by the taxpayer (the combined method) did fairly represent those activities. Because the Department did not propose a method of calculation, the Court adopted the taxpayer's method. In the case at hand, had both parties agreed (as they did in Media General) that the statutory method was not appropriate, then CarMax may have had the burden of proposing a competing method. But in this case, CarMax submits that the standard statutory method does fairly represent its activities in South Carolina. There is simply no similarity in the cases. In fact, there was not even a burden of proof issue in Media General. That case has no bearing on the burden of proof issue before the Court in this case.

**III. The ALC's Error Concerning the Burden of Proof is Not Harmless.**

The Department argues that it submitted evidence sufficient to satisfy the burden of proof it had to show that the statutory formula did not fairly represent the extent of the taxpayer's business activity in this state and that the alternate formula which it proposed did so, and, thus, it claims that the ALC's error is harmless. First, the Department did not satisfy its burden of proof. Second, it is impossible to know this unless the ALC applied the proper standard and it is agreed that this proper standard

was not applied. The ALC weighed the evidence assuming that CarMax West bore the burden. Both parties and this Court agree that this was an error.

In support of its argument that it met the burden of proof (which burden the ALC did not believe it had), the Department on page 11 of its Petition repeats a quote from the ALC Order quoting the Department's expert witness who testified that the taxpayer was conducting two separate businesses consisting of franchising and retail sales, which he referred to as "apples and oranges." But this statement about the separateness of the brand names and trademarks from the sales of a retail business was clearly contradicted by CarMax West's fact and expert witnesses. They testified to the obvious, which is that the franchising (trade names and trademarks) and retail functions (car sales) were not factually or economically separable and were instead parts of a unitary or related business. (See Testimony of Eileen Yost, Transcript p. 55, l. 1 - p. 54, l. 9; testimony of Phil Zimm, p. 158, l. 22 - p. 159, l. 12; and testimony of Prof. Ron Wilder p. 183, l. 8 - p. 184, l. 6). This evidence must be weighed under the proper burden of proof standard. This was not done. This is the key question in this case as it pertains to the use of an alternative formula, *i.e.*, can this business be separated? The taxpayer's experts testified that it cannot and should not be separated and that the two functions (franchising and retailing) were interdependent and contributed to and depended upon each other. The South Carolina established case law such as Exxon Corp v. South Carolina Tax Comm., 273 S.C. 594, 258, S.E.2d 93 (1979); Lowenstein Corp. v. South Carolina Tax Comm., 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989); and Eastman Kodak Co. v. South Carolina Tax Comm., 308 S.C. 415, 418 S.E.2d 542 (1992) clearly support the testimony and opinion of CarMax

West' witnesses, not the opinion of the Department's witness. The issue is whether or not this taxpayer's business is unitary or, put another way, do the functions of franchising and retail sales contribute to and depend upon each other. These cases clearly set forth the facts to be considered in making this determination and those facts conclusively weigh in CarMax West's favor. In addition, the Department's own regulation, Reg. 117-710.1, which has been completely ignored by the Department, is consistent with this case law. That regulation states that if a corporation operates two businesses, the question of whether these two businesses should be separately apportioned (as the Department has done here) depends on whether they are related or unrelated; in other words, whether they are "unitary or homogeneous" with each other or, alternatively, have no direct bearing on each other. It appears obvious that the franchising functions (trademarks and trade names) are related to retail sales. The interrelationship of franchising (trade name and trademarks) and retail sales, contrary to the "apples and oranges" example relied upon by the Department and the ALC, obviously establishes a unitary or homogeneous business. However, in any case, this evidence must be weighed under the proper standard in which the burden is upon the Department to separate the functions of franchising and retail sales and show them to be unrelated.

In attempting to show that the ALC's erroneous understanding of the burden of proof was harmless, the Department quotes from the ALC's decision that "The mixing of the royalty payments (from franchising) with retail income (from car sales) produced a significantly lower apportionment ratio than that of the taxpayer's royalty income considered alone." It then reproduces footnote 5 from the opinion that shows that the

apportionment ratio under the standard formula that the taxpayer used is much lower than the formula that the Department proposed. This proves only that the Department's method produces a higher apportionment formula and therefore a higher tax. It has nothing to do with whether the standard formula fairly represents the extent of the taxpayer's business activities in this state. The Department did not meet its burden of proof and the application of the proper standard makes this clear. In any case, in the absence of the use of the proper standard of proof, it is impossible to determine what conclusion the ALC would have reached had it applied the proper standard.

#### CONCLUSION

There is only one "competing" method to the Department's alternate method in this case and that is the standard statutory gross receipts method. In addition, this Court was correct in its description of the burden of proof, and the ALC's application of the wrong burden of proof standard was not harmless. Therefore, CarMax requests that this Court deny the Department's Petition for Rehearing.

*[SIGNATURE BLOCK ON FOLLOWING PAGE]*

Respectfully submitted,

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: Bryson M. Geer by AUB u/pamerson

John C. von Lehe, Jr.

SC Bar No. 5719

E-Mail: john.vonlehe@nelsonmullins.com

Bryson M. Geer

SC Bar No. 13606

E-Mail: bryson.geer@nelsonmullins.com

151 Meeting Street / Sixth Floor

Post Office Box 1806 (29402-1806)

Charleston, SC 29401-2239

(843) 853-5200

Attorneys for CarMax Auto Superstores  
West Coast, Inc.

Charleston, South Carolina

April 9, 2012

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CERTIFICATE OF SERVICE

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I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for CarMax Auto Superstores West Coast, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by delivering a copy of the same via U.S. mail to the following address(es):

Pleadings:

CARMAX SUPERSTORES WEST COAST, INC.'S  
RESPONSE TO PETITION FOR REHEARING

Counsel Served:

Milton Kimpson, Esq.  
Harry A. Hancock, Esq.  
Counsel for Litigation  
South Carolina Department of Revenue  
PO Box 12265  
Columbia, SC 29211

Burnet R. Maybank, III  
Nexsen Pruet, LLC  
PO Drawer 2426  
Columbia, SC 29202

Erik P. Doerring  
McNair Law Firm, P.A.  
PO Box 11390  
Columbia, SC 29211

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SC Court of Appeals

  
\_\_\_\_\_  
Administrative Assistant

April 9, 2012

# The South Carolina Court of Appeals

Carmax Auto Superstores West Coast,  
Inc.,

Appellant,

v.

South Carolina Department of  
Revenue,

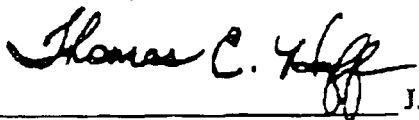
Respondent.

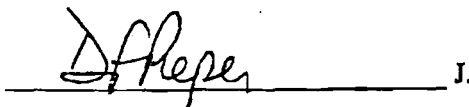
The Honorable Carolyn C. Matthews  
Richland County  
Trial Court Case No. 2009-AL-17-00160

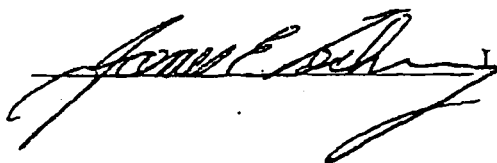
## ORDER DENYING PETITION FOR REHEARING

PER CURIAM: After a careful consideration of Appellant's Petition for Rehearing, the Court is unable to discover that any material fact or principle of law has been either overlooked or disregarded and hence, there is no basis for granting a rehearing.

It is, therefore, ordered that the Petition for Rehearing be denied.

 I.

 I.

 I.

Columbia, South Carolina

cc: Allen Mattison Bogan, Esquire  
John C. von Lehe, Jr., Esquire  
Bryson M. Geer, Esquire  
Milton G. Kimpson, Esquire  
Harry A. Hancock, Esquire  
Alexandra Eikner Sampson, Esquire  
Burnet R. Maybank, III, Esquire  
Robert L. Widener, Esquire  
The Honorable Jana E. Shealy

**FILED**

7 May 2012

# The South Carolina Court of Appeals

Carmax Auto Superstores West Coast,  
Inc.,

Appellant,

v.

South Carolina Department of  
Revenue,

Respondent.

The Honorable Carolyn C. Matthews  
Richland County  
Trial Court Case No. 2009-AL-17-00160

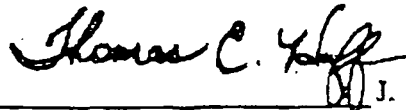
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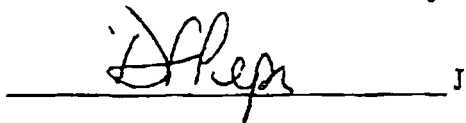
## ORDER DENYING PETITION FOR REHEARING

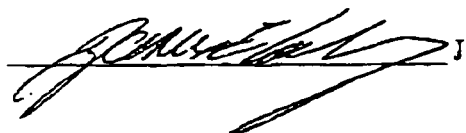
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PER CURIAM: After a careful consideration of Respondent's Petition for Rehearing, the Court is unable to discover that any material fact or principle of law has been either overlooked or disregarded and hence, there is no basis for granting a rehearing.

It is, therefore, ordered that the Petition for Rehearing be denied.

  
\_\_\_\_\_  
J.

  
\_\_\_\_\_  
J.

  
\_\_\_\_\_  
J.

Columbia, South Carolina

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The Honorable Jana E. Shealy

**FILED**

*May 2012*