

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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APPEAL FROM ADMINISTRATIVE LAW COURT

SC Court of Appeals

Ralph King Anderson, III, Administrative Law Judge

Case No. 09-ALJ-17-0204-CC

Appellate Case No. 2012-208608

Rent-A-Center West, Inc., Appellant,
v.
South Carolina Department of Revenue Respondent.

**RECORD ON APPEAL
VOLUME I**

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

Sean G. Ryan
William J. Condon, Jr.
South Carolina Department of Revenue
300A Outlet Pointe Blvd. (29210)
P.O. Box 12265
Columbia, SC 29211
(803) 898-5278
Attorneys for Respondent

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Background

The Rent-A-Center (RAC) business is a rent-to-own business that rents and sells appliances, furniture, electronics, computers, televisions, etc. RAC stores are located in all 50 states. The ownership of these stores is split between three entities:

- Rent-A-Center East (RAC East) owns and operates retail stores in eastern states (including South Carolina),
- The taxpayer in this case, RAC West, owns and operates retail stores in western states and
- Rent-A-Center Texas (RAC Texas) owns and operates retail stores in Texas.

The Department audited RAC West's 2003-2005 initial returns, which were filed using the three factor apportionment formula set forth in S.C. Code Ann. § 12-6-2250 (Supp. 2000),¹ and issued an assessment finding that RAC West owed an additional \$144,971 in corporate income tax, \$35,086 in interest, and \$36,243 in penalties for the period of 2003 through 2005.² At issue in this case is the proper method of reporting RAC West's royalty income earned in South Carolina as a result of its licensing of intellectual property to RAC East for use in RAC East's South Carolina stores.

Rent-A-Center Trademark

RAC West, a Delaware corporation, does not operate any retail stores in South Carolina. While RAC West does not operate any retail stores in this State, it owns and licenses the "Rent-A-Center" intellectual property, which primarily consists of Rent-A-Center trademarks/trade names (trademarks), to all Rent-A-Center companies. One of those operating entities is RAC East which owns and operates retail stores in South Carolina.³

Pursuant to licensing agreements between RAC West and the operating entities, each entity pays a royalty of 3% of its "Net Sales of Licensed Services" to RAC West for use of Rent-A-Center related trademarks. RAC West's only activity in South Carolina is its receipt of those

¹ In July of 2011, two years after the Department issued its Determination, and after this matter was before this Court, RAC West filed amended tax returns for the period in dispute. In its amended returns, the taxpayer changed its method of apportionment from three factor apportionment to gross receipts apportionment pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2010).

<u>Period Ended:</u>	<u>Income Tax</u>	<u>Interest</u>	<u>Penalty</u>	<u>Totals</u>
12/31/03	\$44,887	\$14,016	\$11,222	\$70,125
12/31/04	\$46,607	\$11,748	\$11,652	\$70,007
12/31/05	\$53,477	\$9,322	\$13,369	\$76,168
Totals	\$144,971	\$35,086	\$36,243	\$216,300

³ As will be discussed later, RAC West also owns and operates retail stores in other states.

royalties for use of the Rent-A-Center related trademarks by the operating entities. Inversely, RAC East claimed the royalty payment as an expense on their tax returns, thereby reducing their income, including their income in South Carolina.

Royalty Income Attributable to South Carolina

When this matter began, RAC West filed South Carolina corporate income tax returns reporting a portion of its royalty income attributable to South Carolina. In determining its South Carolina income, RAC West utilized three factor apportionment, consisting of property, payroll, and (double weighted) sales. After this matter was filed with this Court, RAC West filed amended tax returns for the period in dispute. In its amended returns, RAC West changed its method of apportionment from three factor apportionment to gross receipts apportionment pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2010).

Pursuant to Section 12-6-2290, a taxpayer apportions its net income by using a ratio in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. Here, however, RAC West's only business in South Carolina is its trademark business. As noted above, RAC West operates retail stores in other states, but not in South Carolina. The revenue from those retail store operations are unrelated to the trademark business RAC West operates in South Carolina.

The Department thus chose to deviate from standard apportionment methods, determining that RAC West's South Carolina taxable income should be apportioned using an alternative accounting method pursuant to S.C. Code Ann. § 12-6-2320(A) (2000). The alternative method the Department chose was to calculate RAC West's South Carolina income based upon the three percent (3%) each entity pays to the taxpayer for use of Rent-A-Center related trademarks. Significantly, this method calculates RAC West's South Carolina income in accordance with the licensing agreements that RAC West entered into with the retail entities operating in South Carolina – thus, it is a formula created by RAC West itself. Therefore, for each of the three South Carolina entities, the Department apportioned 3% of the amounts listed as South Carolina sales and rental revenue to RAC West. The amounts determined for each of the three entities were then combined to determine RAC West's South Carolina income.

This method of apportionment both fairly and accurately reflects RAC West's South Carolina income in accordance with the licensing agreements created by the taxpayer. Importantly, the Department's method does not include the retail income earned by RAC West

from its retail operations which are not connected to South Carolina. Furthermore, applying the Department's method of apportionment to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. It thus treats each state equally and consistently.⁴ Moreover, the Department's method does not tax more than 100% of the income generated in South Carolina.

Conversely, RAC West's chosen apportionment formula did not fairly represent its business activities in South Carolina. For instance, in 2004, RAC West had gross receipts from South Carolina in the amount of \$861,437.00 and total gross receipts from all sources in the amount of \$424,004,077.00. Additionally, RAC West had total trademark royalty receipts of \$55,221,912.35. Given that RAC West's gross receipts from trademark royalties totaled \$55,221,912.35, then its trademark business was only 13% of its total gross receipts. The other 87% of RAC West's total gross receipts came from its out-of-State retail operations.⁵ Clearly, RAC West's retail business brought in substantially more gross receipts than its trademark operations did, thereby diluting the impact of RAC West's royalty income on its net income.

Moreover, despite the fact that RAC West's retail stores generated \$368,782,164.65 in gross receipts in 2004, RAC West's total adjusted net income was only \$19,840,800. As a result of the large difference in these two figures, under the gross receipts apportionment method used by RAC West, only \$40,317 (or 4.7%) of the \$861,437 in gross receipts that RAC West received from South Carolina was deemed taxable, as the following table reflects:⁶

2004 S.C. Gross Receipts	2004 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2004 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$861,437	\$424,004,077	0.2032%	\$19,840,800	\$40,317	4.68%

⁴ The federal tax filings for each operating entity provide a state by state breakdown of the amount of sales and rental revenue received by each entity.

⁵ The percentage split of 13% royalties gross receipts and 87% retail gross receipts occurred in all tax years covered by the audit.

⁶ The results were even more dramatic when RAC West used the three factor apportionment method. Under that method, RAC West calculated that its 2004 taxable income in South Carolina was only \$20,158, or 2.34% of its South Carolina gross receipts.

The results were even more striking for the 2003 and 2005 tax years, as the tables below demonstrate:

2003 S.C. Gross Receipts	2003 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2003 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$830,247	\$411,403,419	0.2018%	\$6,303,906	\$12,721	1.53%

2005 S.C. Gross Receipts	2005 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2005 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$844,348.13	\$426,296,541	0.1981%	-\$9,905,982	-\$19,624	0%

Although RAC West stresses that the "gross receipts" figures do not account for expenses, RAC West failed to adequately establish that it incurred expenses in conducting its trademark business, which was the only economic activity it performed in South Carolina. Certainly, there is no evidence showing that RAC West's trademark-related expenses constituted more than 95% of its gross receipts, as the gross receipts apportionment method would suggest. For these reasons, I find that including the gross receipts from RAC West's retail operations in determining its taxable South Carolina income would so dilute the gross receipts received from South Carolina as to extensively distort RAC West's actual economic activity in this State.

RAC West nevertheless argues that an alternative method of apportionment is not appropriate in this case because RAC West is a "unitary business" and, consequently, no portion of its business can be separately considered. According to RAC West's expert, there is an "inextricable link" between the retail operations and the trademark operations. He further testified that there are flows of value and interdependencies between its retail operations and its trademark operations which make them dependant on each other. In his estimation, if the retail stores do well, the trademarks are more valuable, and if the retail stores do not do well, the trademark's value declines. Stated another way, the retail sales activities and the intellectual

property activities of RAC West contribute to and depend on one another, and there is a flow of value between the two activities.⁷

However, RAC West simply failed to establish that the retail to trademark relationship is “inextricable” in this case. It is clear that a value can be placed on the trademark business as evidenced in the transfer pricing study which RAC West asserts provides an arms-length amount for use of the trademarks. The fact that each Rent-A-Center entity specifically pays a three percent (3%) royalty of its revenue to RAC West for use of Rent-A-Center related trademarks negates RAC West’s contention from a taxing perspective of an “inextricable” relationship. The proportioning of the revenues via the set royalty payment allocates the revenue influences of the trademark upon the Rent-A-Center companies. Clearly, other subsidiaries of Rent-A-Center, including RAC East and RAC Texas operate retail stores in other parts of the United States and utilize the very same trademarks. The retail operations of those subsidiaries depend upon the trademarks exactly the same way that RAC West’s retail operations depend upon the trademarks. The retail to trademark relationship is exactly the same between the other subsidiaries and RAC West as it is between its retail business and its trademark business. Yet, RAC West provided no explanation as to why the trademark to retail relationship could be separated as to these other subsidiaries, but cannot be separated with respect to itself.

Similarly, RAC West argues that its retail operations and its trademark operations share common management thereby making them unitary and not subject to separation. The facts do not support this assertion. For instance, no evidence reflected that RAC West actually manages the trademarks that it owns. Rather, RAC Texas manages RAC West’s trademarks and RAC West’s employees manage its retail operations. Based upon the evidence, I find that RAC West is reasonably able to separate the management retail business from the trademark business.

In conclusion, the allocation and apportionment methods proposed by RAC West and in particular the provisions of Sections 12-6-2250 and 12-6-2290 do not fairly represent the extent of RAC West’s business activity in this State. Because RAC West has no South Carolina property or payroll, the use of Section 12-6-2250 significantly diluted its South Carolina taxable

⁷ RAC West also argued that all income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole and that it did not separately track the costs of the intellectual property alone. The fact that RAC West chooses to place sales and the royalties in the same account and not track the intellectual property cost does not establish that the Department’s proposed method of apportioning income is flawed or that RAC West’s method is preferable. It simply reflects that RAC West currently chooses to consolidate its accounts and not obtain the data.

income. Moreover, because RAC West's gross receipts from its retail stores are substantially larger than its gross receipts from its trademark business, the use of 12-6-2290 also caused a distorting result. On the other hand, the alternative accounting method used by the Department fairly reflects RAC West's activities in South Carolina. I therefore find the Department met its burden of establishing that the standard formulas of Title 12, Chapter 6 failed to fairly represent RAC West's business in South Carolina and that the Department's allocation method fairly and accurately reflected RAC West's activity in this State.

Penalties

In its Determination, the Department included \$36,243.00 in substantial understatement penalties because RAC West's use of the three factor apportionment method (rather than the separate accounting method utilized by the Department) resulted in a substantial understatement of taxes in an amount greater than \$10,000 and in excess of 10% of the tax owed.

However, at the hearing, the Department's auditor testified that he was not aware of anything in the tax return's instructions that would have indicated to RAC West that it should have used the Department's separate accounting method. He further testified that it would have made a difference in his decision to assess a penalty if RAC West had used the gross receipts formula initially (rather than the three factor formula) because the gross receipts formula "would have been the correct method."

A comparison of the results under the three factor method and the gross receipts method demonstrates that the difference in taxes under these two methods was \$318.00 for tax year 2003 and \$1,008.00 for tax year 2004, and that there was no difference for tax year 2005.

CONCLUSIONS OF LAW

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

General Conclusions

S.C. Code Ann. § 1-23-600 (Supp. 2010) grants jurisdiction to the ALC 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 administrative proceedings is generally a preponderance of the evidence. Anonymous v. State Bd. of Med. Exam'rs, 329 S.C. 371, 496 S.E.2d 17 (1998). RAC West nonetheless argued in its Pre-Trial Brief that in this case the Department must first prove,

by clear and convincing evidence, that its chosen method of accounting does not accurately reflect its business activities in this State. RAC West cited The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491 (Ct. App. 2007) as supporting that proposition. Quite to the contrary, S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2010) provides that: "Unless otherwise provided by statute, the standard of proof in a contested case [before the ALC] is by a preponderance of the evidence." No statute in the South Carolina Income Tax Act sets forth the standard of proof as clear and convincing. See S.C. Code Ann. §§ 12-6-10 et. al. (2000 & Supp. 2010). In fact, only two statutes in all of Title 12 set forth that standard and both of those statutes are clearly not applicable to this case. See S.C. Code Ann. §§ 12-22-740 (2000) and 12-45-185 (Supp. 2010).

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). Nevertheless, in this case the Department seeks to deviate from the standard apportionment formula established by the General Assembly. In St. Johnsbury Trucking Co. v. New Hampshire, 118 N.H. 209, 385 A.2d 215 (N.H. 1978), the New Hampshire Supreme Court addressed whether under a similar law the burden of proof is placed upon the party seeking to invoke an alternative formula. The Court held that:

The statutory provisions require that the three-factor formula will be used for apportioning business profits, and an alternative formula may be used if the statutory method of apportionment "does not fairly reflect the extent of the business activities of a business organization within this state." The legislature has, therefore, specified that 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.

118 N.H. at 212, 385 A.2d at 217.⁸ Therefore, in this case, the burden shifted to the Department to show why the standard apportionment formula should not be followed and that its alternative formula is reasonable. For all other issues, RAC West bore the burden of proof.

⁸ The following states have followed the holding in St. Johnsbury Trucking: Idaho - Union Pac. Corp. v. Idaho State Tax Comm'n, 83 P.3d 116, 120 (Idaho 2004); Tennessee - Am. Tel. & Tel. Co. v. Huddleston, 880 S.W.2d 682, 692 (Tenn. Ct. App. 1994); and Kentucky - Ruby Const. Co., Inc. v. Dep't of Revenue, 578 S.W.2d 248, 253 (Ky. Ct. App. 1978). See also Deseret Pharm. Co., Inc. v. State Tax Comm'n, 579 P.2d 1322, 1327 (Utah 1978); Donald M. Drake Co. v. Dep't of Revenue, 500 P.2d 1041, 1044 (Or. 1972) (en banc); and Larry D. Scheafer, Annotation, Construction and Application of Uniform Division of Income for Tax Purposes Act, 8 A.L.R. 4th 934 (originally published in 1981).

Apportionment of RAC West's Income

Application of S.C. Statutory Provisions

The central issue in this case is the proper method to use in determining RAC West's taxable income in this State during the audit period (tax years ending 2003 through 2005). The dispute between the parties boils down to whether in computing a reasonable representation of the proportion of RAC West's business done within this State, the income from its retail sales should be included in the denominator of the apportionment formula along with its royalty income (RAC West's position) or whether the denominator should be limited to only income from royalty receipts (the Department's position). I find that the statutory scheme and the evidence presented at trial support the Department's position.

When interpreting a statute, the sole function of the Court is to determine and give effect to the intent of the legislature. Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The starting point in doing so should always be the text of the statute itself. Id. (holding that "[w]hat a legislature says in the text of a statute is considered the best evidence of the legislative intent or will"); Wigfall v. Tideland Utilities, Inc., 354 S.C. 100, 110, 580 S.E.2d 100, 105 (2003). In interpreting the text, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "[w]here the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." Hodges, 341 S.C. at 85, 533 S.E.2d at 581.⁹

RAC West utilized standard apportionment formulas delineated by statutes in both its original and amended returns for the years at issue to reflect the extent of RAC West's business in South Carolina. Specifically, it utilized S.C. Code Ann. § 12-6-2250 (2000) in its original return and S.C. Code Ann. § 12-6-2290 (2000) in its amended returns. I find that neither method fairly reflected the extent of RAC West's business in South Carolina.

Section 12-6-2250 is not applicable to the revenue emanating from RAC West's business in this State. Section 12-6-2250 pertains to taxpayers "whose principal business in this State is

⁹ See also State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002) (holding when the language of the statute is clear, "a court cannot rewrite the statute and inject matters into it which are not in the legislature's language. . . ."); Rosmer v. Pfizer, 263 F.3d 263 (4th Cir. 2001) (holding that when a statute is plain on its face, the court's inquiry is at an end).

(a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State.” As explained above, RAC West’s only business within South Carolina is its licensing of trademarks to the operating entities. Since RAC West’s principal business in South Carolina is not manufacturing, selling, or distributing tangible personal property, Section 12-6-2250 is simply not applicable.

Section 12-6-2290 thus appears on its face to be applicable to the income RAC West receives from this State. Section 12-6-2290 provides that:

If the principal profits or income of a taxpayer are **derived from sources other than** those described in Section 12-6-2250 or Section 12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.

(emphasis added). As explained above, the source of RAC West’s income was from sources other than those identified in Sections 12-6-2250.¹⁰ Nevertheless, apportioning RAC West’s income using a ratio in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year would not accurately reflect RAC West’s business in South Carolina.

S.C. Code Ann § 12-6-2210(B) (2000) sets forth that: “If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.” (emphasis added). Furthermore, 27 S.C. Code Ann. Regs. 117-710.1 (Supp. 2010) provides:

The phrase “transacting or conducting his business partly within and partly without this State” as used in Section 12-6-2210, is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. A taxpayer operating two or more unrelated businesses, each of which is entirely within and without the State, is not subject to the provisions of this section, but each business determines its South Carolina net income separately. 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 the apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the

¹⁰ It is also indisputable and uncontested that the provisions of S.C. Code Ann. § 12-6-2310 (2000) do not apply to this case.

unrelated business is allocated and apportioned separately as appropriate to the State where such business is conducted.

Here, RAC West's only business in South Carolina is its trademark business. In other states, RAC West's operates retail stores. Though Petitioner attempted to interrelate the revenue from the operation of those stores and its trademark business, the facts clearly reflect the revenue from the operation of those stores is unrelated to the trademark business RAC West operates in South Carolina.

Moreover, when Section 12-6-2290 is utilized, the unrelated revenue from the retail operations increases the denominator of the apportionment ratio, but adds nothing to the numerator. The evidence in this matter clearly shows that RAC West's business is predominantly its retail operations and the taxpayer brings in significantly more revenue from its retail operations than it does from its trademark operations. Additionally, the evidence does not show that RAC West's retail operations, which generate a very large portion of its gross receipts, contribute a comparable amount to RAC West's net income. Accordingly, inclusion of RAC West's gross receipts from its retail operations in the denominator of the apportionment ratio would so dilute the gross receipts received from South Carolina as to distort the taxpayer's actual economic activity in this State. Cf. Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178-79 (Cal. 2006) (finding that including the taxpayer's investment income from short-term securities distorted the results of the standard formula's apportionment method because the investments produced less than 2% of the company's business income, but 73% of its gross receipts).

In instances in which the facts establish that the standard formulas do not accurately reflect a business's South Carolina income, the Department may utilize an alternative formula in limited circumstances. S.C. Code Ann. §12-6-2320(A) (2000 and Supp. 2009) provides

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.

Under Section 12-6-2320(A), 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. This Court further recognizes the significance of permitting such a deviation. As noted by the United States Supreme Court, separate 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 America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983).¹¹

Obviously, the tax laws of South Carolina are concerned with the taxpayer's business in this State. See, e.g., S.C. Code Ann. § 12-6-2320. However, as explained previously, the evidence in this case demonstrates that the standard formulas for apportionment (and, in particular, use of Section 12-6-2290) did not reasonably represent the proportion of trade or business that RAC West carried on in South Carolina. Furthermore, the facts established that the Department's method of apportionment is reasonable. In fact, the Department's method calculates RAC West's South Carolina income in accordance with a formula created by the taxpayer itself through its licensing agreements. The method is also fair because it treats each state equally and consistently. Applying the Department's method of apportionment to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. Moreover, the Department's method does not tax more than 100% of the income generated in South Carolina, whereas RAC West's method includes income from its retail operations which is not connected to South Carolina in any way. In sum, application of the Department's method of apportionment pursuant to Section 12-6-2320 is fair and accurate.

¹¹ RAC West also asserted that an alternative apportionment method should only be used in unique and non-recurring circumstances. Contrary to that assertion, South Carolina law does not limit application of its alternative apportionment provisions to "unique and non-recurring" circumstances. Though that view was propounded in proposed regulations to the Uniform Division of Income For Tax Purposes Act, it was never adopted by South Carolina. To the contrary, Section 12-6-2320(A) was enacted after the proposed regulations were issued and "unique and non-recurring" circumstances language is not included in § 12-6-2320(A). However, even if this were the law of South Carolina, the facts of this case (a business which operates distinct retail operations in other states but none in this state, yet has income occurring from intellectual property in all States) reflect unique circumstances which are unlikely to reoccur.

Unitary Business

Although taxpayers have traditionally used separate accounting to challenge State division-of-income determinations based on formulary apportionment,¹² RAC West takes the opposite position in this case. It argues that separate accounting is not appropriate here because it is a unitary business. The Department, however, contends that South Carolina does not expressly disallow separate accounting for unitary businesses and that separate accounting is appropriate under Section 12-6-2320. As discussed below, I find that the use of separate accounting is proper here.

“Separate accounting” is a technique of carving out of the overall business of the taxpayer the income derived from sources within a single State and ascertaining the profits attributable to that portion of the business. See, Hellerstein, supra, at ¶ 8.03. It is a “geographically oriented method which is analytically suited to the case of a single taxable entity carrying on separate and distinct businesses in each taxing jurisdiction.” Citizens Utilities Co. of Illinois v. Dep’t of Revenue, 488 N.E.2d 984, 986 (1986).

“Unitary business,” on the other hand, is a concept that functions as a tool in determining whether a taxpayer may be subject to income tax on a formulary apportionment basis. 71 Am. Jur. 2d State and Local Taxation § 511 (updated Nov. 2011). Under the unitary business principle, “a State need not ‘isolate the intrastate income-producing activities from the rest of the business’ but ‘may tax an apportioned sum of the corporation’s multistate business if the business is unitary.’” MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep’t of Revenue, 553 U.S. 16, 25 (2008) (quoting Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 772 (1992)). In contrast to separate accounting, the formulary apportionment method authorized under the unitary business principle “rejects geographical or transactional accounting.” Lowenstein, 298 S.C. at 101, 378 S.E.2d at 276 (quoting Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 165 (1983)). Instead, it “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 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

¹² 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 8.03[1] (2d. ed. 1993); see also Exxon Corp. v. S.C. Tax Comm’n, 273 S.C. 594, 258 S.E.2d 93 (1979); 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).

account objective measures of the corporation's activities within and without the jurisdiction." Id. at 101, 378 S.E.2d at 276.

As the Department correctly points out, Section 12-6-2320 does not expressly prohibit separate accounting for unitary businesses. Rather, it allows separate accounting whenever "the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State." § 12-6-2320. Nonetheless, courts and legal commentators have generally recognized that separate accounting can have drawbacks when applied to unitary businesses. See, e.g., Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438 (1980) ("[T]he Court has noted that separate 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."); Hellerstein, supra, at 8.10[1][a] (stating that separate accounting is vulnerable on its merits when applied to unitary businesses because "the essence of the separate accounting technique of dividing the income of a unitary business is to ignore interdependence and integration of the business operations conducted in the various taxing jurisdictions").

The issue of the appropriateness of applying separate accounting to a unitary business was addressed by the South Carolina Supreme Court in Eastman Kodak Co. v. South Carolina Tax Commission, 308 S.C. 415, 418 S.E.2d 542 (1992). In that case, the Tax Commission argued, and the trial court found, that Kodak's income from safe harbor lease transactions involving properties in other states should have been computed separately from its camera and film income because it was not part of Kodak's unitary business. Id. at 419-20, 418 S.E.2d at 544. On appeal, the Supreme Court disagreed, finding that the safe harbor lease transactions were part of Kodak's unitary business. Id. at 420, 418 S.E.2d at 544. In making that determination, the court set forth the following test:

[W]hether or not a business in unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business.

Id. at 420, 418 S.E.2d at 544 (quoting Exxon, 273 S.C. at 600, 258 S.E.2d at 96). It then held:

[W]e find the safe harbor lease transaction to be part of Kodak's unitary business. 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.

Id. at 420, 416 S.E.2d at 544.

Applying the factors quoted above to the facts of this case, I find that Eastman Kodak is distinguishable. Unlike in Eastman Kodak, RAC West's retail operations are not funded by the trademark operations, nor are the trademark operations funded by the retail operations. To the contrary, each line of business generates its own distinct income from different sources. RAC West's income from its retail stores is derived from the customers of those stores, none of which are located in South Carolina. On the other hand, RAC West's income from its trademark business comes from licensing agreements it has entered into with other Rent-a-Center affiliates. The customers of those affiliates are thus ultimately the source of RAC West's trademark revenues. See Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 22, 437 S.E.2d 13, 18 (1993) (finding that the "real source" of a foreign corporation's income from licensing "Toys R Us" trademarks to South Carolina stores was "South Carolina's Toys R Us customers.>"). Furthermore, unlike in Eastman Kodak, RAC West's trademark business and retail business have separate staffs handling the different lines of business. A separate subsidiary, Rent-A-Center Texas, L.P., manages RAC West's royalty operations. Although RAC West receives revenue from the royalty operations, it is the staff of Rent-A-Center Texas, L.P. that actually operates the trademark business. For these reasons, I find that Eastman Kodak is distinguishable from the present case.

Just as Eastman Kodak is distinguishable from the present case, many of the drawbacks that usually accompany separate accounting are not present here. The evidence does not demonstrate the existence of any "centralization of management" or "economies of scale" between RAC West's retail operations and its trademark business. Moreover, it is clear that a value can be placed on the trademark business. RAC West's income transfer pricing study and the trademark agreements show how the income of the trademarks is determined and that such reflects an arms-length value for the trademarks. For these reasons, I find that the separate accounting method employed by the Department here is appropriate.

RAC West's Constitutional Rights

RAC West argues that the tax imposed by the Department violates its rights under the Commerce Clause of the United States Constitution because it fails the four-part test set forth in Complete Auto Transit v. Brady, 430 U.S. 274 (1977). I disagree.

In Complete Auto Transit, the U.S. Supreme Court held that a tax will survive challenge under the Commerce Clause so long as it (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State. Id. at 279. In the present case, RAC West contends that the tax at issue here fails the Complete Auto Transit test because it is not fairly apportioned, discriminates against interstate commerce, and is not fairly related to the services provided by the taxing state.¹³

A. Fairly Apportioned

The purpose of the apportionment requirement is to “ensure that each state taxes only its fair share of an interstate transaction.” Travelscape, LLC v. S.C. Dep’t of Revenue, 391 S.C. 89, 107, 705 S.E.2d 28, 37-38 (2011) (quoting Goldberg v. Sweet, 488 U.S. 252, 260–61 (1989)). To be fairly apportioned, a tax must be both internally and externally consistent. Id. An income tax is internally consistent where it is structured such that if it were applied by every State, it would result in no more than all of the business’s income being taxed. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). To meet the external consistency test, “the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.” Id. In other words, the State’s tax must not reach “beyond that portion of value that is fairly attributable to economic activity within the taxing State.” Oklahoma Tax Comm’n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995); see also Goldberg, 488 U.S. at 262 (“The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed.”).

Here, the tax is internally consistent because only the royalties paid by the South Carolina stores are being taxed. If every State imposed a similar tax, no multiple taxation would occur.¹⁴

¹³ Although RAC West does not appear to argue that it lacks substantial nexus with South Carolina, it should be noted that in Geoffrey, 313 S.C. at 23-24, 437 S.E.2d at 18, the South Carolina Supreme Court held that a foreign corporation with no property or employees in South Carolina had a substantial nexus with the State because it licensed trademarks and trade names for use in the State and derived income from their use there. Consequently, because RAC West, like the foreign corporation in Geoffrey, derives income from licensing trademarks for use in South Carolina, there is little doubt that a substantial nexus exists between RAC West and South Carolina.

¹⁴ Although it is possible that multiple taxation could occur if other states did not use the same apportionment method utilized by the Department, such “speculative concerns with multiple taxation” are insufficient to invalidate the tax on Commerce Clause grounds. See Moorman Mfg. Co. v. Bair, 437 U.S. 267, 277-280 (1978).

As to external consistency, because the tax is assessed only on income derived from South Carolina stores, it “reasonably reflects” the South Carolina component of RAC West’s economic activity. Accordingly, I find that the tax is both internally and externally consistent.

B. Discrimination Against Interstate Commerce

Discrimination against interstate commerce occurs where a tax favors local businesses or the activity taxed lends itself to repeated taxes in other states. See Int’l Harvester Co. v. Wasson, 281 S.C. 458, 461, 316 S.E.2d 378, 380 (1984). With respect to the interstate commerce context, “the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment.” Container Corp., 463 U.S. at 171.

In this case, RAC West failed to establish that it was treated differently than a similarly situated taxpayer doing business in this State. Moreover, as discussed above, the tax is internally consistent, and thus it does not lend itself to repeated taxes in other states. Although RAC West contends that the tax is discriminatory because it does not reflect a reasonable sense of how income is generated by RAC West, as discussed above, I find that the tax is externally consistent. For these reasons, I do not find that the tax unconstitutionally discriminates against interstate commerce.

C. Fairly Related To Services Provided By The State

The purpose of the “fairly related” prong of the Complete Auto Transit test is “to ensure that a State’s tax burden is not placed upon persons who do not benefit from services provided by the State.” Goldberg, 488 U.S. at 266-67. In Geoffrey, the Supreme Court held that a foreign corporation which received royalty income by licensing trademarks and trade names to a South Carolina corporation benefitted from the services of South Carolina and that South Carolina’s tax on the royalty income was “rationally related” to those benefits. Geoffrey, 313 S.C. at 21-22, 437 S.E.2d at 17. It explained:

By providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement. That Geoffrey has received protection, benefits, and opportunities from South Carolina is manifested by the fact that it earns income in this state. That the tax is rationally related to these protections, benefits, and opportunities is evidenced by the fact that the State seeks to tax only that portion of Geoffrey’s income generated within its borders.

Id. at 22, 437 S.E.2d at 18.

Although, in Geoffrey, the South Carolina Supreme Court was addressing the taxpayer's due process challenge to the tax, the same reasoning applies here.¹⁵ RAC West is able to earn royalty income from the South Carolina stores because of the sales that those stores make to South Carolina customers. Moreover, the stores are able to make those sales because of the "orderly society" provided by South Carolina. Furthermore, there is a "fair" relationship between the tax and the services provided by South Carolina because the tax is imposed only on income generated within this State. Accordingly, I find that the tax fairly relates to the services provided by South Carolina.

For the foregoing reasons, I find that the Department's method of taxing RAC West's South Carolina income is not barred by the Commerce Clause. Cf. Geoffrey, 313 S.C. at 22-24, 437 S.E.2d at 18-19 (finding that the Commerce Clause did not bar South Carolina from taxing the royalty income of a Delaware corporation that was not physically present in South Carolina but earned income from licensing intangible assets to its parent corporation, a retailer which conducted business in South Carolina).

Expenses or Deductions

The Department's calculation of RAC West's liability did not include any deduction for expenses. During the audit and during the pending litigation, the Department requested documentation to substantiate RAC West's claimed expenses. RAC West did not provide the Department with any documentation supporting any expenses. In the absence of proper substantiation, the Department properly denied any expenses for the taxpayer.

Furthermore, RAC West requested this contested case hearing to challenge the Department's Determination, including challenging the Department's denial of any expenses. Because RAC West is the party asserting the affirmative, it bears the burden of proof in this matter. 2 Am. Jur. 2d Administrative Law § 354 (2004). RAC West thus bore the burden of proving, by a preponderance of the evidence, that it was entitled to expenses. Despite bearing the burden, RAC West did not put forth evidence sufficient to substantiate any expenses. Though RAC West's witnesses claimed that it incurred expenses, no specific details of the types or amounts of expenses were given. In sum, RAC West did not bring forth any books, records, receipts, or other documentary evidence to substantiate any expenses.

¹⁵ In addressing the taxpayer's Commerce Clause arguments in Geoffrey, the Supreme Court stated that "[o]ur Due Process analysis of the benefits conferred upon Geoffrey applies with equal force here and need not be repeated." Geoffrey, 313 S.C. at 24, 437 S.E.2d at 18.

It is well established that bare assertions by a taxpayer as to the amount claimed, or that a return is correct as filed, are not sufficient to overcome the presumption of correctness which attaches to the tax authority's determinations. Jackson v. Commissioner, 1953 WL 10532, 12 T.C.M. 778 (1953); Halle v. Commissioner, 7 T.C. 245 (1946). As the Eighth Circuit has recognized:

The cases are legion which state that the burden of proof is on the taxpayer; that the Commissioner's assessment is prima facie or presumptively correct and that such presumption is not overcome by mere book entries, mere statements in the tax returns, the mere unsupported testimony of the taxpayer, (or) mathematical calculations involving uncertain facts.

Cleveland Chiropractic College v. Comm'r, 312 F.2d 203, 206 (1963). RAC West did not substantiate its expenses and thus, it is not entitled to deduct any expenses.

Penalties

The Department's auditor applied penalties for substantial understatement as provided for by S.C. Code Ann. § 12-54-155 (Supp. 2010), which states in pertinent part:

(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.

While Section 12-54-155 provides for penalties where a taxpayer substantially understates amounts owed, it also sets forth several exceptions or "safe-harbor" type provisions. Section 12-54-155(B)(2)(b) provides that the amount of the understatement "must be reduced by that portion of the understatement which 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." § 12-54-155(B)(2)(b) (emphasis added). Additionally, Section 12-54-155(D)(1) 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." § 12-54-155(D)(1).

Here, RAC West initially filed its returns using the three factor apportionment method set forth in Section 12-6-2250.¹⁶ Under its plain terms, Section 12-6-2250 does not apply to the licensing of intangible property like trademarks. Therefore, I find that RAC West did not have substantial authority to use the three factor apportionment method in calculating its taxes.

Nevertheless, I do not find that the amount of penalties imposed by the Department in this case is appropriate. The Department based the penalty on the difference between the results under the three-factor formula and the separate accounting method. However, there is nothing in the regulations, policy statements or instructions that would have provided notice to RAC West that it should have filed its return using the separate accounting method. In fact, the tax return form dictates that a taxpayer use a standard apportionment method.

Moreover, Section 12-6-2320(A) does not state that a taxpayer has an affirmative duty to use separate accounting in cases such as this one. Rather, it provides that the taxpayer “may petition for” a variety of alternative methods, including separate accounting, when the standard apportionment formulas do not fairly represent the taxpayer’s business activities in this State. § 12-6-2320(A).

For these reasons, I find that the penalty should not be based on the difference in results between the three-factor formula and the separate accounting method. Rather, I find that the penalty should be calculated based upon a comparison of the different results under the three-factor method and the gross receipts method. Significantly, the Department’s auditor testified the gross receipts method “would have been the correct method.” He further indicated that had RAC West initially filed using the gross receipts method, he likely would not have assessed a penalty.

Comparing the results under the three factor method and the gross receipts method reveals that in none of the applicable years was the difference in taxes under these two methods greater than \$5,000, and that, in fact, the aggregate difference in taxes for all three tax years was only \$1,326.00. Therefore, I find that RAC West did not substantially understate the taxes it owed and that no penalties should therefore be assessed. See § 12-54-155(B)(1)(a) (“For purposes of this section, there is a substantial understatement of tax for a taxable period if the

¹⁶ While RAC West later amended its returns and applied the gross receipts method, it did not do so until July 11, 2011, which was two years after the Department issued its Determination and only a month before the administrative hearing in this matter.

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.).

ORDER

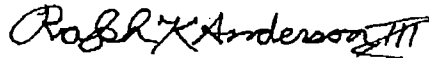
Based on the foregoing, I find the following:

1. The Department demonstrated that RAC West'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 RAC West's business activities in this State;
3. The imposition of an alternative method in this case does not violate the Constitution;
4. RAC West did not substantiate any expenses, therefore it is not entitled to any expenses; and
5. RAC West is not liable for substantial understatement penalties.

IT IS THEREFORE ORDERED that the Department's assessment of an additional \$144,971 in corporate income taxes and \$35,086 in interest is upheld; and

IT IS FURTHERED ORDERED that the Department's assessment of \$36,243 in substantial understatement penalties imposed is dismissed.

AND IT IS SO ORDERED.



Ralph King Anderson, III
Chief Administrative Law Judge

January 6, 2012
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, E. Harvin Belser Fair, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof, in the United States mail, postage paid, in the Interagency Mail Service, or by electronic mail to the address provided by the party(ies) and/or their attorney(s).

E. Harvin Belser Fair

E. Harvin Belser Fair
Judicial Law Clerk

This 6th day of January, 2012
Columbia, South Carolina

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Rent-A-Center West Inc.,)	Docket No. 09-ALJ-17-0204-CC
)	
Petitioner,)	
)	ORDER DENYING MOTION
vs.)	FOR RECONSIDERATION
)	
South Carolina Department of Revenue,)	
)	
Respondent.)	
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APPEARANCES: For the Petitioner: John C. von Lehe, Esquire and Bryson M. Geer, Esquire
For the Respondent: Sean G. Ryan, Esquire

A hearing was held in this matter on August 10 and 11, 2011, at the Administrative Law Court. This Court thereafter upheld the Department's assessment of an additional \$144,971 in corporate income taxes and \$35,086 in interest. Petitioner thereafter filed timely a Motion for Reconsideration of that decision. I generally find that the Petitioner's arguments are without merit or are a reiteration of the arguments made in the hearing into this matter. See 11 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 2810.1 (2d ed. 1995) (While Rule 59(e) motions may be appropriate to preserve an issue raised in a contested case for appellate review or to ask the court to decide an issue which has been raised but not ruled upon, they "may not be used to relitigate old matters."). Nevertheless, I do briefly address the following:

Petitioner asserts that it would be difficult to track the different lines of business and it is unfair to expect the taxpayer to prove its expenses for each line of business because no other State ever requested such information. Petitioner's Motion cites to the Department's expert economist Dr. Glenn Harrison to support its position. To the contrary, Dr. Harrison testified that there are various ways for accountants to determine the expenses associated with different businesses within the same corporation. His testimony demonstrates that methods exist whereby the taxpayer could have shown the expenses incurred for each business it operates and is in direct

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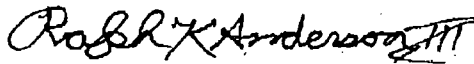
February 1, 2012

SC ADMIN. LAW COURT

contradiction to the Petitioner's assertion that it is not able to separate the expenses of its different businesses. There were options available at the hearing through which the taxpayer could have put forth evidence of its expenses, but the taxpayer chose not to utilize any of those options. Instead, the taxpayer chose not to put forth any records of any expenses and relied solely on the assertion that it does not track expenses independently for each of the businesses. Simply stated, there are no documents in the record to support the taxpayer's assertion that its expenses cannot be separated.

IT IS THEREFORE ORDERED that Petitioner's Motion for Reconsideration is DENIED.

AND IT IS SO ORDERED.



Ralph King Anderson, III
Chief Administrative Law Judge

February 1, 2012
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, E. Harvin Belser Fair, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof, in the United States mail, postage paid, in the Interagency Mail Service, or by electronic mail to the address provided by the party(ies) and/or their attorney(s).

E. Harvin Belser Fair

E. Harvin Belser Fair
Judicial Law Clerk

February 1, 2012
Columbia, South Carolina

RECEIVED

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The Supreme Court of South Carolina vs. MULLINS

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

v.

South Carolina Department of Revenue,
Petitioner/Respondent.

Appellate Case No. 2012-212203

ORDER

The request by South Carolina Department of Revenue for an extension to file the Petition for Rehearing in the above matter is hereby granted and should be served and filed no later than 5:00 pm on January 22, 2015.


C.J.
FOR THE COURT

Columbia, South Carolina

January 7, 2015

cc:

John C. Von Lehe, Jr., Esquire
Bryson Moore Geer, Esquire
Milton Gary Kimpson, Esquire
Robert L. Widener, Esquire
Erik P. Doerring, Esquire
Burnet Rhet Maybank, III, Esquire
Alexandra Eikner Sampson, Esquire
Adam Nicholas Marinelli, Esquire
Roxanna Marshall Tinsley, Esquire

DEPARTMENT DETERMINATION

Taxpayer:

Rent-A-Center West, Inc.
5501 Headquarters 2nd Fl.
Plano, TX 75024

Periods Involved:

Corporate Income Tax Years 2003 through 2005

Matters in Dispute:

1. Can Rent-A-Center West, Inc. (taxpayer) utilize three factor apportionment pursuant to S.C. Code Ann. § 12-6-2250 (2000) to determine its South Carolina income?
2. Is it proper for the South Carolina Department of Revenue (Department) to use an alternative formula to determine the taxpayer's South Carolina income?
3. Is the taxpayer subject to substantial understatement penalties?

Amount in Original Proposed Assessment:

	Income Tax
Tax	\$144,971.
Interest*	35,086
Penalty	36,243
Total	\$216,300

*Interest as computed through April 15, 2008.

Determinations:

1. The taxpayer cannot utilize three factor apportionment pursuant to § 12-6-2250 to determine its South Carolina income.
2. It is proper for the Department to use an alternative formula to determine the taxpayer's South Carolina income. The Department utilized an alternative formula to determine the amount listed above as "Amount in Original Proposed Assessment." Subsequent to the issuance of the proposed assessment, the Department determined it would utilize a different alternative formula to determine the taxpayer's South Carolina income. Use of this new formula

reduced the amount of the proposed assessment to \$204,183, consisting of \$130,194 in tax, \$41,440 in interest, and 32,549 in penalties.

3. The taxpayer is subject to substantial understatement penalties.

Relevant Facts:

1. The taxpayer is a Delaware corporation, with its principal place of business in Plano, Texas. The taxpayer is a subsidiary of Rent-A-Center, East, Inc., a Delaware corporation, that operates retail stores that rent and sell tangible personal property in several states, including South Carolina.
2. The taxpayer does not operate any retail stores in South Carolina, but the taxpayer does own and operate retail stores in other states.
3. While the taxpayer does not operate any retail stores in South Carolina, the taxpayer does own and license "Rent-A-Center" related trademarks to Rent-A-Center, related entities, including Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc., which each operate retail stores in South Carolina.
4. Pursuant to licensing agreements between the taxpayer and Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc., each entity pays a royalty of 3% of its "Net Sales of Licensed Services" to the taxpayer for use of Rent-A-Center related trademarks. As a result of these licensing agreements, the taxable income of the South Carolina operating entities is reduced and the income of the taxpayer is increased by that amount.
5. The taxpayer filed South Carolina corporate income tax returns reporting the portion of its royalty income attributable to South Carolina. In determining its South Carolina income, the taxpayer utilized three factor apportionment, consisting of property, payroll, and (double weighted) sales. Because the taxpayer has no South Carolina property or payroll, the use of the three factor formula ratio significantly diluted its South Carolina taxable income.
6. The Department conducted a corporate income tax and license fee audit of the taxpayer for years 2003 through 2005. The Department determined that the taxpayer should be apportioning its South Carolina taxable income using an alternative accounting method since its income from South Carolina is only from intangibles yet its income from other states includes the sale of tangible personal property.
7. The taxpayer's South Carolina income consists solely of royalty fees received from Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc. The Department utilized an alternative formula to determine the amount of royalty fees generated in South Carolina. The alternative method utilized in determining the

proposed assessment consisted of dividing the royalty expenses taken by Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc., by the gross rental income of each entity. This resulted in a royalty expense percentage for each entity. The Department applied that royalty expense percentage to the South Carolina sales of each entity as listed on the SC1120. Pursuant to this formula, on March 12, 2008, the Department issued the taxpayer a proposed assessment for the amount list above as Amount In Original Proposed Assessment.

8. The taxpayer submitted a protest to the proposed assessment on June 6, 2008.
9. After issuing the proposed assessment, the Department decided to utilize a different formula for determining the taxpayer's South Carolina income. The new formula determines the taxpayer's South Carolina income in accordance with the licensing agreements that the taxpayer entered into with the retail entities operating in South Carolina. Pursuant to the licensing agreements, Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc., pay royalties to the taxpayer in an amount equal to 3% of its sales of rental services. The federal tax filings for each entity contain documents detailing the revenue received from the activities of each entity. Specifically, these documents provide a state by state breakdown of the amount of sales and rental revenue received by each entity. Pursuant to the licensing agreements, 3% of those revenues were paid to the taxpayer. Therefore, for each of the three entities, the Department apportioned 3% of the amounts listed as South Carolina sales and rental revenue to the taxpayer. The amounts determined for each of the three entities were then combined to determine the taxpayer's South Carolina income. Use of the new formula reduced the amounts listed under "Determination."
10. The Amount In Original Proposed Assessment includes substantial understatement penalties because the taxpayer failed to pay more than 10% of the amount of tax due, and the amount of tax due exceeds \$10,000.

Analysis:

I. The Taxpayer Cannot Utilize Three Factor Apportionment to Determine Its South Carolina Income.

The taxpayer filed South Carolina corporate income tax returns reporting a portion of its royalty income to South Carolina. The taxpayer determined its South Carolina income pursuant to the three factor apportionment formula found at § 12-6-2250. The taxpayer argues it is entitled to utilize three factor apportionment because it deals in tangible personal property. Contrary to the taxpayer's assertions, the facts in this matter demonstrate that three factor apportionment is not appropriate for this taxpayer for it does not accurately reflect the taxpayer's South Carolina income.

When a taxpayer's principal business in South Carolina is manufacturing, selling, or distributing tangible personal property, such taxpayer's South Carolina income is determined pursuant to § 12-6-2250(A) which states:

A taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State, shall make returns and pay annually an income tax which includes its income apportioned to this State. Its income apportioned to this State is determined by multiplying the net income remaining after allocation under Sections 12-6-2220 and 12-6-2230 by a fraction, the numerator of which is the property ratio, plus the payroll ratio, plus twice the sales ratio, and the denominator of which is four. However, where the sales ratio does not exist, the denominator of the fraction is the number of existing ratios, and where the sales ratio exists but the payroll ratio or the property ratio does not exist, the denominator of the fraction is the number of existing ratios plus one. The property, payroll, and sales ratios must be determined in accordance with Sections 12-6-2260, 12-6-2270, and 12-6-2280, respectively.

(Emphasis added) In this matter, the three factor apportionment is not applicable, as the taxpayer is not engaged in selling or distributing tangible personal property in South Carolina, nor is it involved in manufacturing or any other activity in South Carolina which would implicate § 12-6-2250. On the contrary, the taxpayer's only business within South Carolina is its licensing of trademarks to Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc. Because the taxpayer's principal business in South Carolina is not manufacturing, selling, or distributing tangible personal property, three factor apportionment pursuant to § 12-6-2250 is not applicable.

The taxpayer argues that it is entitled to use three factor apportionment pursuant to § 12-6-2250 because it "was dealing in tangible personal property." The facts in this matter demonstrate that the taxpayer's business in South Carolina consists solely of receiving royalty fees from the various Rent-A-Center Inc. retail entities. Contrary to the taxpayer's argument, licensing trademarks do not constitute dealing in tangible personal property. On the contrary, as the South Carolina Supreme Court recognized in Geoffrey, Inc. v. South Carolina Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993), cert denied, 510 U.S. 992 (1993), trademarks are intangible property. Because trademarks are intangible property, the taxpayer's assertion that it was dealing in tangible personal property is not supported by the facts in this case.

To the extent the taxpayer deals in tangible personal property in other states, such is not determinative of the apportionment method applicable to the taxpayer in South Carolina. The taxpayer operates retail stores in the western United States, but does not operate any such stores in South Carolina. On the contrary, the taxpayer's activities in South Carolina consist entirely of receiving royalty fees from Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc. Pursuant to § 12-6-2250(A), the business transacted within South Carolina determines the method of apportionment to be used. Therefore, because the business transacted by the taxpayer in South Carolina deals only with intangibles, three factor apportionment is not applicable. Moreover, the taxpayer's dealings in tangible personal property in other states does not bring the taxpayer within § 12-6-2250(A).

The South Carolina three factor formula described in § 12-6-2250, is based on the Uniform Division of Income for Tax Purposes Act's (UDITPA) own three factor formula. The United States Supreme Court has called the UDITPA formula "something of a benchmark against which other apportionment formulas are judged." Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 170 (1983). Container Corp. also recognized that the assumption underlying the three factor formula is that the three factors—sales, property, and payroll—"appear in combination to reflect a very large share of the activities by which value is generated." Id. at 183.

As noted above, UDITPA's drafter indicated that manufacturing and mercantile businesses made up the vast majority of the national economy when the UDITPA three factor formula was drafted. W.J. Pierce, UDITPA 35 Taxes at 747. South Carolina drafted apportionment statutes which reflect the underlying principles of the UDITPA formula, in which retailers and manufacturers employ a multi-factor formula and most other businesses use a gross receipts formula. Despite the fact that the taxpayer's South Carolina income does not arise from retail activities, and the fact that the taxpayer has little or no South Carolina sales or payroll from which its income is generated, the taxpayer maintains that it should be entitled to employ the three factor formula of § 12-6-2250. Clearly, this result is in conflict with the intent of the Legislature.

In addition, applying three factor apportionment to the taxpayer's business causes a dilution of the taxpayer's South Carolina income. The taxpayer has little to no payroll and/or property in South Carolina. Therefore, two out of the three factors would be zero, thereby diluting the sales factor. The dilution caused by use of three factor apportionment results in an inaccurate representation of the taxpayer's South Carolina income. Because three factor apportionment does not accurately represent the taxpayer's South Carolina income, and because the taxpayer's principal business in South Carolina is not manufacturing, selling, or distributing tangible personal property, the taxpayer cannot use § 12-6-2250 to determine its South Carolina income.

II. An Alternative Formula Is Necessary To Determine The Taxpayer's South Carolina Income.

A. Gross Receipts Apportionment Is Not Accurate.

S.C. Code Ann. § 12-6-2290 (2000) provides a method of determining income for businesses which are not described by § 12-6-2250. This method requires the taxpayer to divide gross receipts received in South Carolina by gross receipts received everywhere to determine taxable income. The same distortion which occurs when applying the three factor formula to this taxpayer occurs in the context of the gross receipts method. Because the taxpayer engages in significantly different types of businesses in states other than South Carolina, which bring in far greater revenues than the intangible fees received from South Carolina, the gross receipts denominator would so dilute the gross receipts received from South Carolina as to distort the taxpayer's actual economic activity in the state.

In states other than South Carolina, the taxpayer's business includes renting and selling tangible personal property. Therefore, the taxpayer's gross receipts include amounts received from the renting and selling of tangible personal property, as well as the taxpayer's royalty income. On the other hand, the taxpayer's gross receipts from South Carolina only include royalty fees. Therefore, apportioning the taxpayer's income in accordance with § 12-6-2290 would not be accurate, as the South Carolina royalty income would be diluted by the denominator that includes not only royalty fees, but also amounts received from the sales and rentals of tangible personal property. Because use of § 12-6-2290 results in such dilution, it is not an accurate means of determining the taxpayer's South Carolina income.

B. Use Of An Alternative Formula Is Necessary For This Taxpayer.

Through S.C. Code Ann. § 12-6-2320(A) (2000), South Carolina adopted statutory provisions substantially similar to UDITPA § 18 for those instances where §§ 12-6-2250 and 12-6-2290 do not accurately reflect a taxpayer's South Carolina activities. Section 12-6-2320(A) provides:

(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.

The taxpayer's returns do not delineate the amount of royalty revenue it received from each state. Therefore, pursuant to § 12-6-2320(A)(4), the Department utilized an alternative formula to determine the taxpayer's activities within South Carolina. Accurately determining the taxpayer's South Carolina activities requires calculating the amount of royalty fees the taxpayer received from South Carolina. The taxpayer receives royalty fees from three entities operating in South Carolina: Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc. Pursuant to licensing agreements, each of these entities paid the taxpayer royalties equal to 3% of its rental income. Each entity deducted the amount of royalties paid to the taxpayer on its federal income tax returns. Accordingly, the amount of royalty expenses claimed by each of the three entities accurately reflects the amount of royalty fees the taxpayer received.

Pursuant to the licensing agreements, Rent-A-Center East, Inc., Rainbow Rentals, and RAC RR, Inc., pay royalties to the taxpayer in an amount equal to 3% of its sales of rental services. The federal tax filings for each of these entities contain documents detailing the revenue received from activities of each entity. Specifically, these documents provide a state by state breakdown of the amount of sales and rental revenue received by each entity. Pursuant to the licensing agreements, 3% of those revenues were paid to the taxpayer. Therefore, for each of the three entities, the Department apportioned 3% of the amounts listed as South Carolina sales and rental revenue to the taxpayer.

The Department's method of apportionment in this matter is both fair and accurate. This method of apportionment is fair in that it operates pursuant to a formula created and agreed upon by the taxpayer through the licensing agreements. Furthermore, it is fair because it treats each state equally and consistently. Applying the Department's method of apportionment to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. The accuracy of the Department's method is demonstrated by applying this formula to each entity's total sales and rental revenue. Taking 3% of each entity's total sales and rental revenue generates amounts very similar to the amount of royalty fees deducted by that entity.

Courts have previously upheld the use of statutory provisions similar to § 12-6-2320(A) to calculate taxable income from intangibles. In Protest of Wal-Mart Stores, Inc., the New Mexico Court ruled that the state was justified in implementing a new formula under the "any other method" branch of New Mexico's substantially identical statute, NMSA 1978 § 7-4-19. In that case, Wal-Mart Stores, Inc., created an intangible holding company known as "WMR," which received royalty fees from Wal-Mart, and other stores, that were equivalent to a specified percentage of gross sales. WMR, despite having no property or payroll to speak of in New Mexico, calculated its New Mexico income by using the standard UDITPA three factor formula, and argued that its royalty income should be sourced to Delaware where WMR was incorporated. The Court upheld

the use of a formula which sourced the royalty income earned in the state to New Mexico, and which compared the royalty income in New Mexico to royalty income everywhere. The Court specifically noted that UDITPA was drafted to allow such flexibility where a business' economic activities were not accurately reflected by applying the three factor formula. Protest of Wal-Mart Stores, Inc., citing Pierce, UDITPA.

C. The Department's Alternative Formula Is Not A Gross Receipts Tax.

The taxpayer's protest rejects the Department's calculation, and argues that it is not an alternative method of apportionment, but a gross receipts tax. The taxpayer argues that the Department must give the taxpayer credit for expenses in determining its South Carolina income. Because the Department did not give the taxpayer credit for expenses, the taxpayer argues that the Department is asserting a "gross receipts tax" rather than an income tax. Contrary to the taxpayer's argument, the Department is not asserting a gross receipts tax, rather it is the taxpayer's own failure to provide documentation that prevented the Department from allowing the taxpayer use of expenses in determining its income. Throughout the audit of this taxpayer, the Department requested documentation to support any expenses or deductions related to the royalty fee arrangement. The taxpayer failed to provide any information related to these expenses which would allow the Department to calculate the true net income from the fee arrangement. Because the taxpayer has not provided the requested documentation, the Department's calculation of the taxpayer's South Carolina income does not include any expenses.

III. The Taxpayer Is Subject to Substantial Understatement Penalties.

The taxpayer argues that the application of substantial understatement penalties is improper. The taxpayer asserts that there should be no penalties because the taxpayer "properly apportioned its income pursuant to the statutory formula under S.C. Code Ann. § 12-6-2250." The Department's position is that the taxpayer intentionally applied the three factor formula of § 12-6-2250 despite the clear inapplicability of that section to the taxpayer. The taxpayer was not principally engaged in manufacturing, selling, distributing, or dealing in tangible personal property within South Carolina. The taxpayer's use of the three factor formula resulted in a substantial understatement in excess of 10% of the tax owed. Furthermore, the taxpayer's use of the three factor formula resulted in an understatement of tax in an amount greater than \$10,000. Therefore, pursuant to S.C. Code Ann. § 12-54-155(B)(1)(a) (2000), the taxpayer is subject to substantial understatement penalties.

The taxpayer argues that any understatement was attributable to substantial authority so as to vitiate the substantial understatement penalty pursuant to § 12-54-155(B)(2)(b). The "substantial authority" standard of § 12-54-155 is judged by reference to Treas. Reg. § 1.6662-4. Pursuant to Treas. Reg. § 1.6662-4, substantial authority is present when the weight of authority in favor of the tax treatment is "substantial" in light of contrary authority. The taxpayer has not provided any evidence demonstrating that weight of

authority supports its position in this matter. On the contrary, it is clear from the facts in this matter that the taxpayer elected to use three factor apportionment despite not qualifying for the use of such apportionment method.

May 6, 2009

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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Rent-A-Center West, Inc.,)	Civil Action No. 09-ALJ-17-0204-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 Rent-A-Center West, Inc. ("RAC West") respectfully requests that this Court reconsider and alter or amend its Final Order and Decision dated January 6, 2012 (the "Order"), a copy of which is attached hereto as Ex. A, which found in favor of Respondent South Carolina Department of Revenue ("SCDOR") in this matter. This motion is based upon the grounds that the Court may have overlooked, misinterpreted or failed to apply South Carolina law and/or overlooked or failed to consider certain evidence and arguments presented, which, when considered, necessitate a finding in favor of RAC West.

- A. **The Court Failed to Find that RAC West is Operating a Unitary Business and that RAC West's Gross Royalty Receipts Should Not Be Segregated from its Total Receipts and Taxed Separately with No Consideration of Expenses Incurred.**

RAC West presented testimony and evidence that its retail store operations and its trademark business were interrelated and part of a unitary business. RAC West argued that under South Carolina law (including Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258

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S.E.2d 93 (1979); Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992); and Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989)), a separate accounting method should not be applied to a unitary business and that SCDOR's attempt to separate out RAC West's trademark business from its other business and tax only the trademark income was improper. Although the Court did not expressly state that RAC West was not operating a unitary business, it implicitly reached this conclusion by finding that "the revenue from the operation of [the retail] stores is unrelated to the trademark business RAC West operates in South Carolina." Order at 11. The Court further held that the facts in this case were distinguishable from those in Eastman Kodak (in which the South Carolina Supreme Court held that separate accounting should not be applied to a unitary business) and concluded that, therefore, SCDOR's separate accounting method was permissible.

First, RAC West respectfully suggests that the Court may have overlooked critical testimony and evidence in reaching its factual finding that RAC West's trademark activities and its retail store activities are unrelated. RAC West presented substantial factual testimony regarding the unitary nature of RAC West's business activities, including, but not limited to, the following:

- The same management is over both business activities. Trial Transcript Day I ("Tr. I") at 107:14-21.
- The two activities share services and systems that create efficiencies and cost savings across both business lines. Id. at 108:4-11.
- All income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole. Id. at 107:22- 108:3.
- The retail stores contribute to the profitability of the IP and vice versa. Id. at 108:12-25.

- More specifically, as the RAC brand name becomes more well-known, it builds brand loyalty, public recognition and goodwill, which increases traffic to the stores and leads to customers being willing to pay more to buy the RAC brand versus another brand. See Tr. I at 102:9-25; 108:20-25; 203:10-19. This, in turn, leads to increased sales and thus higher profitability of RAC East (increased sales revenue) and RAC West (increased royalty payments). Id. Likewise, as the RAC West retail store sales increase, the RAC IP becomes more valuable as it is tied to a more profitable and successful business. Id. at 203:4-8.
- Stated another way, the retail sales activities and the intellectual property activities of RAC West contribute to and depend on one another and there is a flow of value between the two activities. Tr. I at 108:12-25 and 203:20- 204:2.

SCDOR presented no evidence to refute any of the above testimony. In fact, SCDOR's auditor testified he thought the RAC IP owned by RAC West probably contributed to the profitability of the RAC West stores, but he did not consider this fact in his analysis. Trial Transcript Day II ("Tr. II") at 167: 3-11. See also Ex. B, RAC West's Proposed Order, at pp. 3-6.

Expert testimony also supported the conclusion that RAC West was unitary. RAC West's economist testified that the business was unitary from an economic perspective based on the foregoing facts (see Tr. I at 264:10-23), and RAC West's tax policy expert testified that from a tax policy perspective, RAC West was unitary. Tr. II at 65:9-13. Even SCDOR's own expert economist agreed that RAC West had interrelated activities, that there were synergies between them and that there were economies of scope and scale. Tr. II at 259:9-14. See also Ex. B, RAC West's Proposed Order, at p. 22. It is not clear from the Court's Order whether this testimony was considered.

In addition, it is not clear whether the Court considered all the facts regarding expenses in this case. RAC West argued (and the case law so holds) that one reason that applying separate accounting to a unitary business is problematic because expenses are so difficult to

track. Tr. I at 111:11-115:17 and 204:3-205:8. The testimony and arguments presented on this issue included, but were not limited to, the following:

- RAC West did not keep track of its expenses for each business activity (versus RAC West as a whole) because it had no reason to do so. It does business in all 50 states and has never before been asked for this information by any taxing authority. Tr. I at 112:1-4. Thus, RAC West had no notice that it needed to keep records regarding the expenses of one business line versus another.
- Even if RAC West attempted to keep such records, tracking direct costs like overhead or man hours spent on a given task would fail to capture all of the contributions and flows of value between the two business activities. Tr. I at 204:3- 205:8 (RAC West witness discussing that because work performed related to the IP increases the value of the retail operations and vice versa, it is difficult to accurately account for the actual costs of trademark business versus retail store business even if one did attempt to track an employee's time on tasks for the two different operations). Putting a given task all in one bucket versus the other would overstate the cost of one businesses activity while understating the other.
- Because SCDOR's separate accounting method ignores the costs incurred by RAC West to generate the royalty income, it results in an improper gross revenue tax versus a corporate income tax (which is based upon the profits of a corporation). See Tr. I at 268:11-16 (testimony of RAC West's expert economist on same); Trial Ex. 1, Tab 16, Pomp Report on RAC West, pp. 8-9 (testimony of RAC West's tax policy expert on same).
- RAC West's tax policy expert explained that "it makes no sense to talk about what are the expenses that may have generated the components of that unitary business. For all the reasons why we view the unitary business as this organic whole and we take its revenues as the unitary business and we subtract the expenses of the unitary business, and then we come up with a net income which is the amount we then apportion, there is no attempt made in a unitary business apportionment system to segregate out expenses that might be attributable to one component of income versus another. . . . [I]f you are taxing the unitary business income, you are giving a deduction for all of the expenses of generating that unitary business income."). Tr. II at 60:1- 61:7.
- SCDOR's own expert economist acknowledged "there are no generally accepted accounting principles in this area." *Id.* at 266:22-23. He also stated that "[t]here are multiple or there are different ways" a managerial accountant could make an allocation and that "one has to choose between alternative rules for apportionment." *Id.* at 267:8-13. The fact that there are no generally accepted accounting principles in this area and that one has to choose between multiple ways and alternative rules requires many professional judgments and subjectivity depending on the underlying purpose of the allocation. Therefore, it is possible that one allocation method could be reasonable for

cost accounting purposes, but not necessarily reasonable for managerial accounting, financial accounting or tax accounting purposes. That is another reason why separate accounting is so disfavored.

See also Ex. B, RAC West's Proposed Order, at pp. 5-6 and 25-27.

The Court recognized that RAC West had no notice that SCDOR's separate accounting method should have been used in its Order in the section discussing why SCDOR should not have assessed any penalties. See Order at p. 20. However, the Court justified the fact that SCDOR's method imposes a gross receipts tax versus an income tax by stating that RAC West bore the burden of proving its expenses. When a taxpayer has no notice that it needs to track its expenses by business line, it is fundamentally unfair to then penalize the taxpayer when it cannot do so after the fact.

Additionally, while the Court seemed to acknowledge that separate accounting may not be appropriate for some unitary businesses, it approved of SCDOR applying separate accounting here based on its above finding that the two business activities were not related, on its conclusion that the facts in this case were distinguishable from Eastman Kodak and on its conclusion that the typical concerns with applying separate accounting were absent here. Order at p. 15. More specifically, the Court stated that unlike the taxpayer in Eastman Kodak, RAC West's retail operations were not funded by its trademark operations (and vice versa) and separate staffs handled the retail store operations and the trademark operations. Id. It further found no evidence here demonstrating any "centralization of management" or "economies of scale" between the two business activities. Finally, it noted that the transfer pricing study and trademark agreements show that "a value can be placed on the trademark business." Id.

RAC West would respectfully suggest that the Court may have overlooked or misunderstood the testimony and evidence on these issues. As summarized above (see supra

pp. 2-4), RAC West's witnesses testified at length on the fact that these two business activities are related and are parts of a unitary business, that the retail operations and trademark operations were both funded from the same RAC general account, and that there was centralized management and economies of scale between the two business activities. Even SCDOR's own expert economist agreed that RAC West had interrelated activities, that there were synergies between them and that there were economies of scope and scale. Tr. II at 259:9-14. These facts were uncontested and are extremely similar to and aligned with those in Eastman Kodak (as well as the other cases cited in RAC West's Proposed Order), which held that it was inappropriate for SCDOR's predecessor to separate out Eastman Kodak's safe harbor leasing transactions from its general business of camera and film processing and tax said income separately (see Eastman Kodak, 308 S.C. 415, 419-20, 418 S.E.2d 542, 544 (1992)); thus, the results in this case should be aligned with Eastman Kodak as well. See also Ex. B, RAC West's Proposed Order, at pp. 20-27. Additionally, RAC West would note that simply because a value can be placed on the trademark for some purposes does not mean that said value is accurate for accounting or tax purposes.¹ Finally, it is unclear where the Court considered that the prohibition on applying separate accounting to a unitary business in the South Carolina case law is also consistent with SCDOR's own regulations (see S.C. Code. Regs. § 117-710.1 (West Supp. 2009)) and whether it considered the fact that SCDOR's apples and oranges analogy (i.e. appropriate to separate out trademark income (apples) from retail

¹ 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 persuasive the 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" 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.'").

stores income (oranges)) has been rejected by South Carolina courts in Exxon, Eastman Kodak and Lowenstein. See Ex. B, RAC West Proposed Order at pp. 25-27.

Based on the foregoing, RAC West respectfully requests that the Court (1) reconsider the facts discussed above and find that RAC West operates a unitary business; (2) reconsider the holding and applicability of Exxon, Eastman Kodak and Lowenstein; (3) alter or amend its Order to find that under the facts in this case, South Carolina law prohibits SCDOR's assessment; and (4) dismiss the assessment.

B. The Court Does Not Appear to Have Ruled upon Whether the Statutory Scheme Prevents SCDOR from Using an Alternative Method that Revises the Phrase "Total Gross Receipts From Everywhere" in S.C. Code Ann. §12-6-2210 (B) (2000).

The Court does not appear to have ruled upon RAC West's argument that the statutory scheme prevents SCDOR from using an alternative method that revises the phrase "total gross receipts from everywhere " in S.C. Code Ann. 12-6-2210 (B) (2000) to mean "total gross receipts from everywhere for the same business activity as is performed in this State." This argument is summarized in section II(A) of RAC West's Proposed Order. See Ex. B at pp. 9-13. RAC West respectfully requests that the Court (1) reconsider the above-discussed argument; (2) alter or amend its Order to find that the statutory scheme prevents SCDOR from revising the statute as it has done in this case; and (3) dismiss the assessment.

C. The Court May Have Misunderstood the Evidence and Testimony Presented by RAC West Showing that the Statutory Apportionment Formula Fairly Reflects RAC 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 RAC West's business activities in South Carolina, and, thus, SCDOR may not apply an alternative formula.

It is not clear from the Order, however, whether the Court considered and ruled upon some of that evidence (which is summarized in Ex. B, RAC West Proposed Order, at pp. 14-16), including the following:

- The fact that RAC West has a limited connection to and no presence in South Carolina;
- The fact that RAC West receives no services and minimal benefits from the State of South Carolina;
- The fact that the income at issue was produced by its total unitary business activities and not solely attributable to its limited activities in South Carolina;
- The fact that the apportionment formula worked exactly as it is supposed to work by taking a slice of RAC West's total income in all states versus taking only the more profitable royalty income and thus does not prove an improper distortion or dilution of income. Tr. II at 64:21- 65:1; Ex. B, RAC West Proposed Order at pp. 15-16; and
- The fact that the assessment 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. Ex. B, RAC West Proposed Order at p. 14.

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

D. The Court May Have Misunderstood the Evidence and Testimony Presented by RAC West Showing that SCDOR's Alternative Formula Is Unreasonable.

RAC West presented considerable evidence 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 some of that evidence (which is summarized in Ex. B, RAC West Proposed Order, at pp. 17-19), including, but not limited to, the following:

- Fact that RAC West has a limited connection to and no presence in South Carolina;
- Fact that RAC West receives no services and minimal benefits from the State of South Carolina;
- Fact that the income at issue was produced by its total unitary business activities on not solely attributable to its limited activities in South Carolina;
- Fact that the method used by SCDOR fails to take into account the implicit royalty value of the RAC IP, which leads to the denominator (gross receipts from everywhere) being understated. See Trial Ex. 1, Tab 1, Audit Report for RAC West (no consideration given to implicit royalty value); Ex. B, Proposed Order at p. 19 (explaining why this renders SCDOR's formula unreliable and not representative of RAC West's in-state activities).
- 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 RAC West's unitary income is received from South Carolina;
- Lack of any evidence of 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 RAC West;
- Fact that RAC West had no notice that it needed to track expenses by business line and could not do so after the fact (due to interdependencies and contributions between the two business lines), which inability SCDOR then used to justify imposition of a gross receipts tax and not a corporate income tax;
- Argument that SCDOR's apples and oranges analogy has been rejected by South Carolina courts in Exxon, Eastman Kodak and Lowenstein. See Ex. B, RAC West Proposed Order at pp. 25-27.
- Lack of evidence supporting the Court's finding that "the Department's method calculates RAC West's South Carolina income in accordance with a formula created by the taxpayer itself through its licensing agreements" (Order at p. 3) and conclusion that "RAC West's income transfer pricing study and the trademark agreements show how the income of the trademarks is determined. . . .". Id. at p. 15. SCDOR introduced no evidence showing that the amount of the royalty payment calculated by the transfer pricing study and then adopted by the licensing agreements is indicative of the amount of income earned in South Carolina; and
- Argument that SCDOR's separate accounting method is prohibited under South Carolina law under the facts in this case. See supra § A.

Based on the above, RAC West respectfully requests that this Court (1) reconsider these facts and arguments; (2) alter or amend its Order to find that SCDOR failed to establish that its alternative formula was reasonable; 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 may not have considered or ruled upon some of the constitutional arguments made by RAC West as well as some of the evidence presented, including, but not limited to, the following:

- Fact that RAC West has a limited connection to and presence in South Carolina;
- Fact that the income at issue was produced by RAC West's total unitary business activities and not solely attributable to its limited activities in South Carolina;
- Argument that SCDOR's alternative formula is unconstitutional because it taxes income out of all proportion to RAC West's business activities in South Carolina;
- Argument that SCDOR's alternative formula is unconstitutional because it fails to fairly apportion RAC West's South Carolina income;
- Argument that RAC 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
- Argument that imposing a gross receipts tax on RAC West unfairly penalizes it for not being able to track its expenses by business line when it had no notice from SCDOR or the State of South Carolina that it needed to do so.

Based on the above, RAC West respectfully requests that the Court (1) reconsider the above facts and arguments; (2) alter or amend its Order to find that RAC 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, RAC West respectfully requests that this Court reconsider its rulings and alter or amend its Order to find in favor of RAC West on all issues and dismiss SCDOR's proposed assessment in its entirety.

NELSON MULLINS RILEY & SCARBOROUGH LLP

By: John C. von Lehe, Jr. 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 Rent-A-Center West, Inc.

Charleston, South Carolina
January 17, 2012

CERTIFICATE OF SERVICE

I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for Rent-A-Center West, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified via hand delivery to the following address(es):

Pleadings:

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

Counsel Served:

Sean G. Ryan
Counsel for Litigation
South Carolina Department of Revenue
Office of General Counsel for Litigation
301 Gervais Street
Columbia, SC 29201



Administrative Assistant

January 17, 2012

FILED

JAN 17 2012

SC ADMIN. LAW COURT

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Rent-A-Center West Inc.,)	Docket No. 09-ALJ-17-0204-CC
)	
Petitioner,)	
)	FINAL ORDER AND DECISION
vs.)	
)	
South Carolina Department of Revenue,)	
)	
Respondent.)	

APPEARANCES: For the Petitioner: John C. von Lehe, Esquire and Bryson M. Geer, Esquire
For the Respondent: Sean G. Ryan, Esquire

STATEMENT OF THE CASE

This matters comes before the Administrative Law Court (ALC or Court) for a contested case hearing pursuant to S.C. Code Ann. § 12-60-460 (Supp. 2010). The South Carolina Department of Revenue (Department) issued a Department Determination finding that Rent-A-Center West, Inc. (RAC West) owes additional corporate income tax, interest, and penalties for the period of 2003 through 2005. RAC West requested a contested case hearing before this Court to dispute the Department's Determination. After notice of the date, time, place, and nature of this hearing was timely given to all parties, a hearing was held before me on August 10 and 11, 2011, at the offices of the ALC.

ISSUES

1. Did the Department properly determine RAC West's South Carolina income for the period of 2003 through 2005?
2. Is RAC West entitled to expenses or deductions beyond those allowed by the Department?
3. Is RAC West subject to substantial understatement penalties?

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of proof and the credibility of the witnesses, I make the following findings of fact by a preponderance of evidence:

FILED

January 6, 2012

EXHIBIT A

SC ADMIN. LAW COURT

Background

The Rent-A-Center (RAC) business is a rent-to-own business that rents and sells appliances, furniture, electronics, computers, televisions, etc. RAC stores are located in all 50 states. The ownership of these stores is split between three entities:

- Rent-A-Center East (RAC East) owns and operates retail stores in eastern states (including South Carolina),
- The taxpayer in this case, RAC West, owns and operates retail stores in western states and
- Rent-A-Center Texas (RAC Texas) owns and operates retail stores in Texas.

The Department audited RAC West's 2003-2005 initial returns, which were filed using the three factor apportionment formula set forth in S.C. Code Ann. § 12-6-2250 (Supp. 2000),¹ and issued an assessment finding that RAC West owed an additional \$144,971 in corporate income tax, \$35,086 in interest, and \$36,243 in penalties for the period of 2003 through 2005.² At issue in this case is the proper method of reporting RAC West's royalty income earned in South Carolina as a result of its licensing of intellectual property to RAC East for use in RAC East's South Carolina stores.

Rent-A-Center Trademark

RAC West, a Delaware corporation, does not operate any retail stores in South Carolina. While RAC West does not operate any retail stores in this State, it owns and licenses the "Rent-A-Center" intellectual property, which primarily consists of Rent-A-Center trademarks/trade names (trademarks), to all Rent-A-Center companies. One of those operating entities is RAC East which owns and operates retail stores in South Carolina.³

Pursuant to licensing agreements between RAC West and the operating entities, each entity pays a royalty of 3% of its "Net Sales of Licensed Services" to RAC West for use of Rent-A-Center related trademarks. RAC West's only activity in South Carolina is its receipt of those

¹ In July of 2011, two years after the Department issued its Determination, and after this matter was before this Court, RAC West filed amended tax returns for the period in dispute. In its amended returns, the taxpayer changed its method of apportionment from three factor apportionment to gross receipts apportionment pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2010).

² Period Ended:	Income Tax	Interest	Penalty	Totals
12/31/03	\$44,887	\$14,016	\$11,222	\$70,125
12/31/04	\$46,607	\$11,748	\$11,652	\$70,007
12/31/05	\$53,477	\$9,322	\$13,369	\$76,168
Totals	\$144,971	\$35,086	\$36,243	\$216,300

³ As will be discussed later, RAC West also owns and operates retail stores in other states.

royalties for use of the Rent-A-Center related trademarks by the operating entities. Inversely, RAC East claimed the royalty payment as an expense on their tax returns, thereby reducing their income, including their income in South Carolina.

Royalty Income Attributable to South Carolina

When this matter began, RAC West filed South Carolina corporate income tax returns reporting a portion of its royalty income attributable to South Carolina. In determining its South Carolina income, RAC West utilized three factor apportionment, consisting of property, payroll, and (double weighted) sales. After this matter was filed with this Court, RAC West filed amended tax returns for the period in dispute. In its amended returns, RAC West changed its method of apportionment from three factor apportionment to gross receipts apportionment pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2010).

Pursuant to Section 12-6-2290, a taxpayer apportions its net income by using a ratio in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. Here, however, RAC West's only business in South Carolina is its trademark business. As noted above, RAC West operates retail stores in other states, but not in South Carolina. The revenue from those retail store operations are unrelated to the trademark business RAC West operates in South Carolina.

The Department thus chose to deviate from standard apportionment methods, determining that RAC West's South Carolina taxable income should be apportioned using an alternative accounting method pursuant to S.C. Code Ann. § 12-6-2320(A) (2000). The alternative method the Department chose was to calculate RAC West's South Carolina income based upon the three percent (3%) each entity pays to the taxpayer for use of Rent-A-Center related trademarks. Significantly, this method calculates RAC West's South Carolina income in accordance with the licensing agreements that RAC West entered into with the retail entities operating in South Carolina -- thus, it is a formula created by RAC West itself. Therefore, for each of the three South Carolina entities, the Department apportioned 3% of the amounts listed as South Carolina sales and rental revenue to RAC West. The amounts determined for each of the three entities were then combined to determine RAC West's South Carolina income.

This method of apportionment both fairly and accurately reflects RAC West's South Carolina income in accordance with the licensing agreements created by the taxpayer. Importantly, the Department's method does not include the retail income earned by RAC West

from its retail operations which are not connected to South Carolina. Furthermore, applying the Department's method of apportionment to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. It thus treats each state equally and consistently.⁴ Moreover, the Department's method does not tax more than 100% of the income generated in South Carolina.

Conversely, RAC West's chosen apportionment formula did not fairly represent its business activities in South Carolina. For instance, in 2004, RAC West had gross receipts from South Carolina in the amount of \$861,437.00 and total gross receipts from all sources in the amount of \$424,004,077.00. Additionally, RAC West had total trademark royalty receipts of \$55,221,912.35. Given that RAC West's gross receipts from trademark royalties totaled \$55,221,912.35, then its trademark business was only 13% of its total gross receipts. The other 87% of RAC West's total gross receipts came from its out-of-State retail operations.⁵ Clearly, RAC West's retail business brought in substantially more gross receipts than its trademark operations did, thereby diluting the impact of RAC West's royalty income on its net income.

Moreover, despite the fact that RAC West's retail stores generated \$368,782,164.65 in gross receipts in 2004, RAC West's total adjusted net income was only \$19,840,800. As a result of the large difference in these two figures, under the gross receipts apportionment method used by RAC West, only \$40,317 (or 4.7%) of the \$861,437 in gross receipts that RAC West received from South Carolina was deemed taxable, as the following table reflects:⁶

2004 S.C. Gross Receipts	2004 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2004 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$861,437	\$424,004,077	0.2032%	\$19,840,800	\$40,317	4.68%

⁴ The federal tax filings for each operating entity provide a state by state breakdown of the amount of sales and rental revenue received by each entity.

⁵ The percentage split of 13% royalties gross receipts and 87% retail gross receipts occurred in all tax years covered by the audit.

⁶ The results were even more dramatic when RAC West used the three factor apportionment method. Under that method, RAC West calculated that its 2004 taxable income in South Carolina was only \$20,158, or 2.34% of its South Carolina gross receipts.

The results were even more striking for the 2003 and 2005 tax years, as the tables below demonstrate:

2003 S.C. Gross Receipts	2003 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2003 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$830,247	\$411,403,419	0.2018%	\$6,303,906	\$12,721	1.53%

2005 S.C. Gross Receipts	2005 Total Gross Receipts	S.C. Apportionment Ratio	RAC West's 2005 Total Adjusted Net Income	S.C. Taxable Income	Percentage of S.C. Gross Receipts Determined Taxable
\$844,348.13	\$426,296,541	0.1981%	-\$9,905,982	-\$19,624	0%

Although RAC West stresses that the "gross receipts" figures do not account for expenses, RAC West failed to adequately establish that it incurred expenses in conducting its trademark business, which was the only economic activity it performed in South Carolina. Certainly, there is no evidence showing that RAC West's trademark-related expenses constituted more than 95% of its gross receipts, as the gross receipts apportionment method would suggest. For these reasons, I find that including the gross receipts from RAC West's retail operations in determining its taxable South Carolina income would so dilute the gross receipts received from South Carolina as to extensively distort RAC West's actual economic activity in this State.

RAC West nevertheless argues that an alternative method of apportionment is not appropriate in this case because RAC West is a "unitary business" and, consequently, no portion of its business can be separately considered. According to RAC West's expert, there is an "inextricable link" between the retail operations and the trademark operations. He further testified that there are flows of value and interdependencies between its retail operations and its trademark operations which make them dependant on each other. In his estimation, if the retail stores do well, the trademarks are more valuable, and if the retail stores do not do well, the trademark's value declines. Stated another way, the retail sales activities and the intellectual

property activities of RAC West contribute to and depend on one another, and there is a flow of value between the two activities.⁷

However, RAC West simply failed to establish that the retail to trademark relationship is "inextricable" in this case. It is clear that a value can be placed on the trademark business as evidenced in the transfer pricing study which RAC West asserts provides an arms-length amount for use of the trademarks. The fact that each Rent-A-Center entity specifically pays a three percent (3%) royalty of its revenue to RAC West for use of Rent-A-Center related trademarks negates RAC West's contention from a taxing perspective of an "inextricable" relationship. The proportioning of the revenues via the set royalty payment allocates the revenue influences of the trademark upon the Rent-A-Center companies. Clearly, other subsidiaries of Rent-A-Center, including RAC East and RAC Texas operate retail stores in other parts of the United States and utilize the very same trademarks. The retail operations of those subsidiaries depend upon the trademarks exactly the same way that RAC West's retail operations depend upon the trademarks. The retail to trademark relationship is exactly the same between the other subsidiaries and RAC West as it is between its retail business and its trademark business. Yet, RAC West provided no explanation as to why the trademark to retail relationship could be separated as to these other subsidiaries, but cannot be separated with respect to itself.

Similarly, RAC West argues that its retail operations and its trademark operations share common management thereby making them unitary and not subject to separation. The facts do not support this assertion. For instance, no evidence reflected that RAC West actually manages the trademarks that it owns. Rather, RAC Texas manages RAC West's trademarks and RAC West's employees manage its retail operations. Based upon the evidence, I find that RAC West is reasonably able to separate the management retail business from the trademark business.

In conclusion, the allocation and apportionment methods proposed by RAC West and in particular the provisions of Sections 12-6-2250 and 12-6-2290 do not fairly represent the extent of RAC West's business activity in this State. Because RAC West has no South Carolina property or payroll, the use of Section 12-6-2250 significantly diluted its South Carolina taxable

⁷ RAC West also argued that all income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole and that it did not separately track the costs of the intellectual property alone. The fact that RAC West chooses to place sales and the royalties in the same account and not track the intellectual property cost does not establish that the Department's proposed method of apportioning income is flawed or that RAC West's method is preferable. It simply reflects that RAC West currently chooses to consolidate its accounts and not obtain the data.

income. Moreover, because RAC West's gross receipts from its retail stores are substantially larger than its gross receipts from its trademark business, the use of 12-6-2290 also caused a distorting result. On the other hand, the alternative accounting method used by the Department fairly reflects RAC West's activities in South Carolina. I therefore find the Department met its burden of establishing that the standard formulas of Title 12, Chapter 6 failed to fairly represent RAC West's business in South Carolina and that the Department's allocation method fairly and accurately reflected RAC West's activity in this State.

Penalties

In its Determination, the Department included \$36,243.00 in substantial understatement penalties because RAC West's use of the three factor apportionment method (rather than the separate accounting method utilized by the Department) resulted in a substantial understatement of taxes in an amount greater than \$10,000 and in excess of 10% of the tax owed.

However, at the hearing, the Department's auditor testified that he was not aware of anything in the tax return's instructions that would have indicated to RAC West that it should have used the Department's separate accounting method. He further testified that it would have made a difference in his decision to assess a penalty if RAC West had used the gross receipts formula initially (rather than the three factor formula) because the gross receipts formula "would have been the correct method."

A comparison of the results under the three factor method and the gross receipts method demonstrates that the difference in taxes under these two methods was \$318.00 for tax year 2003 and \$1,008.00 for tax year 2004, and that there was no difference for tax year 2005.

CONCLUSIONS OF LAW

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

General Conclusions

S.C. Code Ann. § 1-23-600 (Supp. 2010) grants jurisdiction to the ALC 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 administrative proceedings is generally a preponderance of the evidence. Anonymous v. State Bd. of Med. Exam'rs, 329 S.C. 371, 496 S.E.2d 17 (1998). RAC West nonetheless argued in its Pre-Trial Brief that in this case the Department must first prove,

by clear and convincing evidence, that its chosen method of accounting does not accurately reflect its business activities in this State. RAC West cited The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491 (Ct. App. 2007) as supporting that proposition. Quite to the contrary, S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2010) provides that: "Unless otherwise provided by statute, the standard of proof in a contested case [before the ALC] is by a preponderance of the evidence." No statute in the South Carolina Income Tax Act sets forth the standard of proof as clear and convincing. See S.C. Code Ann. §§ 12-6-10 et. al. (2000 & Supp. 2010). In fact, only two statutes in all of Title 12 set forth that standard and both of those statutes are clearly not applicable to this case. See S.C. Code Ann. §§ 12-22-740 (2000) and 12-45-185 (Supp. 2010).

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). Nevertheless, in this case the Department seeks to deviate from the standard apportionment formula established by the General Assembly. In St. Johnsbury Trucking Co. v. New Hampshire, 118 N.H. 209, 385 A.2d 215 (N.H. 1978), the New Hampshire Supreme Court addressed whether under a similar law the burden of proof is placed upon the party seeking to invoke an alternative formula. The Court held that:

The statutory provisions require that the three-factor formula will be used for apportioning business profits, and an alternative formula may be used if the statutory method of apportionment "does not fairly reflect the extent of the business activities of a business organization within this state." The legislature has, therefore, specified that 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.

118 N.H. at 212, 385 A.2d at 217.⁸ Therefore, in this case, the burden shifted to the Department to show why the standard apportionment formula should not be followed and that its alternative formula is reasonable. For all other issues, RAC West bore the burden of proof.

⁸ The following states have followed the holding in St. Johnsbury Trucking: Idaho - Union Pac. Corp. v. Idaho State Tax Comm'n, 83 P.2d 116, 120 (Idaho 2004); Tennessee - Am. Tel. & Tel. Co. v. Huddleston, 880 S.W.2d 682, 692 (Tenn. Ct. App. 1994); and Kentucky - Ruby Const. Co., Inc. v. Dep't of Revenue, 578 S.W.2d 248, 253 (Ky. Ct. App. 1978). See also Deseret Pharm. Co., Inc. v. State Tax Comm'n, 579 P.2d 1322, 1327 (Utah 1978); Donald M. Drake Co. v. Dep't of Revenue, 300 P.2d 1041, 1044 (Or. 1972) (en banc); and Larry D. Scheafer, Annotation, Construction and Application of Uniform Division of Income for Tax Purposes Act, 8 A.L.R. 4th 934 (originally published in 1981).

Apportionment of RAC West's Income
Application of S.C. Statutory Provisions

The central issue in this case is the proper method to use in determining RAC West's taxable income in this State during the audit period (tax years ending 2003 through 2005). The dispute between the parties boils down to whether in computing a reasonable representation of the proportion of RAC West's business done within this State, the income from its retail sales should be included in the denominator of the apportionment formula along with its royalty income (RAC West's position) or whether the denominator should be limited to only income from royalty receipts (the Department's position). I find that the statutory scheme and the evidence presented at trial support the Department's position.

When interpreting a statute, the sole function of the Court is to determine and give effect to the intent of the legislature. Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The starting point in doing so should always be the text of the statute itself. *Id.* (holding that "[w]hat a legislature says in the text of a statute is considered the best evidence of the legislative intent or will"); Wigfall v. Tideland Utilities, Inc., 354 S.C. 100, 110, 580 S.E.2d 100, 105 (2003). In interpreting the text, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leonard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "[w]here the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." Hodges, 341 S.C. at 85, 533 S.E.2d at 581.⁹

RAC West utilized standard apportionment formulas delineated by statutes in both its original and amended returns for the years at issue to reflect the extent of RAC West's business in South Carolina. Specifically, it utilized S.C. Code Ann. § 12-6-2250 (2000) in its original return and S.C. Code Ann. § 12-6-2290 (2000) in its amended returns. I find that neither method fairly reflected the extent of RAC West's business in South Carolina.

Section 12-6-2250 is not applicable to the revenue emanating from RAC West's business in this State. Section 12-6-2250 pertains to taxpayers "whose principal business in this State is

⁹ See also State v. Leonard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002) (holding when the language of the statute is clear, "a court cannot rewrite the statute and inject matters into it which are not in the legislature's language. . . ."); Rosner v. Pfizer, 263 F.3d 263 (4th Cir. 2001) (holding that when a statute is plain on its face, the court's inquiry is at an end).

(a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State." As explained above, RAC West's only business within South Carolina is its licensing of trademarks to the operating entities. Since RAC West's principal business in South Carolina is not manufacturing, selling, or distributing tangible personal property, Section 12-6-2250 is simply not applicable.

Section 12-6-2290 thus appears on its face to be applicable to the income RAC West receives from this State. Section 12-6-2290 provides that:

If the principal profits or income of a taxpayer are derived from sources other than those described in Section 12-6-2250 or Section 12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.

(emphasis added). As explained above, the source of RAC West's income was from sources other than those identified in Sections 12-6-2250.¹⁰ Nevertheless, apportioning RAC West's income using a ratio in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year would not accurately reflect RAC West's business in South Carolina.

S.C. Code Ann § 12-6-2210(B) (2000) sets forth that: "If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." (emphasis added). Furthermore, 27 S.C. Code Ann. Regs. 117-710.1 (Supp. 2010) provides:

The phrase "transacting or conducting his business partly within and partly without this State" as used in Section 12-6-2210, is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. A taxpayer operating two or more unrelated businesses, each of which is entirely within and without the State, is not subject to the provisions of this section, but each business determines its South Carolina net income separately. 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 the apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the

¹⁰ It is also indisputable and uncontested that the provisions of S.C. Code Ann. § 12-6-2310 (2000) do not apply to this case.

unrelated business is allocated and apportioned separately as appropriate to the State where such business is conducted.

Here, RAC West's only business in South Carolina is its trademark business. In other states, RAC West's operates retail stores. Though Petitioner attempted to interrelate the revenue from the operation of those stores and its trademark business, the facts clearly reflect the revenue from the operation of those stores is unrelated to the trademark business RAC West operates in South Carolina.

Moreover, when Section 12-6-2290 is utilized, the unrelated revenue from the retail operations increases the denominator of the apportionment ratio, but adds nothing to the numerator. The evidence in this matter clearly shows that RAC West's business is predominantly its retail operations and the taxpayer brings in significantly more revenue from its retail operations than it does from its trademark operations. Additionally, the evidence does not show that RAC West's retail operations, which generate a very large portion of its gross receipts, contribute a comparable amount to RAC West's net income. Accordingly, inclusion of RAC West's gross receipts from its retail operations in the denominator of the apportionment ratio would so dilute the gross receipts received from South Carolina as to distort the taxpayer's actual economic activity in this State. Cf. Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178-79 (Cal. 2006) (finding that including the taxpayer's investment income from short-term securities distorted the results of the standard formula's apportionment method because the investments produced less than 2% of the company's business income, but 73% of its gross receipts).

In instances in which the facts establish that the standard formulas do not accurately reflect a business's South Carolina income, the Department may utilize an alternative formula in limited circumstances. S.C. Code Ann. §12-6-2320(A) (2000 and Supp. 2009) provides

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.

Under Section 12-6-2320(A), 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. This Court further recognizes the significance of permitting such a deviation. As noted by the United States Supreme Court, separate 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 America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983).¹¹

Obviously, the tax laws of South Carolina are concerned with the taxpayer's business in this State. See, e.g., S.C. Code Ann. § 12-6-2320. However, as explained previously, the evidence in this case demonstrates that the standard formulas for apportionment (and, in particular, use of Section 12-6-2290) did not reasonably represent the proportion of trade or business that RAC West carried on in South Carolina. Furthermore, the facts established that the Department's method of apportionment is reasonable. In fact, the Department's method calculates RAC West's South Carolina income in accordance with a formula created by the taxpayer itself through its licensing agreements. The method is also fair because it treats each state equally and consistently. Applying the Department's method of apportionment to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. Moreover, the Department's method does not tax more than 100% of the income generated in South Carolina, whereas RAC West's method includes income from its retail operations which is not connected to South Carolina in any way. In sum, application of the Department's method of apportionment pursuant to Section 12-6-2320 is fair and accurate.

¹¹ RAC West also asserted that an alternative apportionment method should only be used in unique and non-recurring circumstances. Contrary to that assertion, South Carolina law does not limit application of its alternative apportionment provisions to "unique and non-recurring" circumstances. Though that view was propounded in proposed regulations to the Uniform Division of Income For Tax Purposes Act, it was never adopted by South Carolina. To the contrary, Section 12-6-2320(A) was enacted after the proposed regulations were issued and "unique and non-recurring" circumstances language is not included in § 12-6-2320(A). However, even if this were the law of South Carolina, the facts of this case (a business which operates distinct retail operations in other states but none in this state, yet has income occurring from intellectual property in all States) reflect unique circumstances which are unlikely to reoccur.

Unitary Business

Although taxpayers have traditionally used separate accounting to challenge State division-of-income determinations based on formulary apportionment,¹² RAC West takes the opposite position in this case. It argues that separate accounting is not appropriate here because it is a unitary business. The Department, however, contends that South Carolina does not expressly disallow separate accounting for unitary businesses and that separate accounting is appropriate under Section 12-6-2320. As discussed below, I find that the use of separate accounting is proper here.

"Separate accounting" is a technique of carving out of the overall business of the taxpayer the income derived from sources within a single State and ascertaining the profits attributable to that portion of the business. See Hellerstein, supra, at ¶ 8.03. It is a "geographically oriented method which is analytically suited to the case of a single taxable entity carrying on separate and distinct businesses in each taxing jurisdiction." Citizens Utilities Co. of Illinois v. Dep't of Revenue, 488 N.E.2d 984, 986 (1986).

"Unitary business," on the other hand, is a concept that functions as a tool in determining whether a taxpayer may be subject to income tax on a formulary apportionment basis. 71 Am. Jur. 2d State and Local Taxation § 511 (updated Nov. 2011). Under the unitary business principle, "a State need not 'isolate the intrastate income-producing activities from the rest of the business' but 'may tax an apportioned sum of the corporation's multistate business if the business is unitary.'" MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 25 (2008) (quoting Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768, 772 (1992)). In contrast to separate accounting, the formulary apportionment method authorized under the unitary business principle "rejects geographical or transactional accounting." Lowenstein, 298 S.C. at 101, 378 S.E.2d at 276 (quoting Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 165 (1983)). Instead, it "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 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

¹² 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 8.03[1] (2d ed. 1993); see also Exxon Corp. v. S.C. Tax Comm'n., 273 S.C. 594, 258 S.E.2d 93 (1979); Texaco v. Wesson, 269 S.C. 255, 237 S.E.2d 75 (1977); Lowenstein Corp. v. S.C. Tax Comm'n., 298 S.C. 91, 378 S.E.2d 272 (Ct. App. 1989).

account objective measures of the corporation's activities within and without the jurisdiction." Id. at 101, 378 S.E.2d at 276.

As the Department correctly points out, Section 12-6-2320 does not expressly prohibit separate accounting for unitary businesses. Rather, it allows separate accounting whenever "the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State." § 12-6-2320. Nonetheless, courts and legal commentators have generally recognized that separate accounting can have drawbacks when applied to unitary businesses. See, e.g., Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438 (1980) ("[T]he Court has noted that separate 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."); Hellerstein, supra, at 8.10[1][a] (stating that separate accounting is vulnerable on its merits when applied to unitary businesses because "the essence of the separate accounting technique of dividing the income of a unitary business is to ignore interdependence and integration of the business operations conducted in the various taxing jurisdictions").

The issue of the appropriateness of applying separate accounting to a unitary business was addressed by the South Carolina Supreme Court in Eastman Kodak Co. v. South Carolina Tax Commission, 308 S.C. 415, 418 S.E.2d 542 (1992). In that case, the Tax Commission argued, and the trial court found, that Kodak's income from safe harbor lease transactions involving properties in other states should have been computed separately from its camera and film income because it was not part of Kodak's unitary business. Id. at 419-20, 418 S.E.2d at 544. On appeal, the Supreme Court disagreed, finding that the safe harbor lease transactions were part of Kodak's unitary business. Id. at 420, 418 S.E.2d at 544. In making that determination, the court set forth the following test:

[W]hether or not a business in unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business.

Id. at 420, 418 S.E.2d at 544 (quoting Exxon, 273 S.C. at 600, 258 S.E.2d at 96). It then held:

[W]e find the safe harbor lease transaction to be part of Kodak's unitary business. 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.

Id. at 420, 416 S.E.2d at 544.

Applying the factors quoted above to the facts of this case, I find that Eastman Kodak is distinguishable. Unlike in Eastman Kodak, RAC West's retail operations are not funded by the trademark operations, nor are the trademark operations funded by the retail operations. To the contrary, each line of business generates its own distinct income from different sources. RAC West's income from its retail stores is derived from the customers of those stores, none of which are located in South Carolina. On the other hand, RAC West's income from its trademark business comes from licensing agreements it has entered into with other Rent-a-Center affiliates. The customers of those affiliates are thus ultimately the source of RAC West's trademark revenues. See Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 22, 437 S.E.2d 13, 18 (1993) (finding that the "real source" of a foreign corporation's income from licensing "Toys R Us" trademarks to South Carolina stores was "South Carolina's Toys R Us customers."). Furthermore, unlike in Eastman Kodak, RAC West's trademark business and retail business have separate staffs handling the different lines of business. A separate subsidiary, Rent-A-Center Texas, L.P., manages RAC West's royalty operations. Although RAC West receives revenue from the royalty operations, it is the staff of Rent-A-Center Texas, L.P. that actually operates the trademark business. For these reasons, I find that Eastman Kodak is distinguishable from the present case.

Just as Eastman Kodak is distinguishable from the present case, many of the drawbacks that usually accompany separate accounting are not present here. The evidence does not demonstrate the existence of any "centralization of management" or "economies of scale" between RAC West's retail operations and its trademark business. Moreover, it is clear that a value can be placed on the trademark business. RAC West's income transfer pricing study and the trademark agreements show how the income of the trademarks is determined and that such reflects an arms-length value for the trademarks. For these reasons, I find that the separate accounting method employed by the Department here is appropriate.

RAC West's Constitutional Rights

RAC West argues that the tax imposed by the Department violates its rights under the Commerce Clause of the United States Constitution because it fails the four-part test set forth in Complete Auto Transit v. Brady, 430 U.S. 274 (1977). I disagree.

In Complete Auto Transit, the U.S. Supreme Court held that a tax will survive challenge under the Commerce Clause so long as it (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State. Id. at 279. In the present case, RAC West contends that the tax at issue here fails the Complete Auto Transit test because it is not fairly apportioned, discriminates against interstate commerce, and is not fairly related to the services provided by the taxing state.¹³

A. *Fairly Apportioned*

The purpose of the apportionment requirement is to "ensure that each state taxes only its fair share of an interstate transaction." Travelscape, LLC v. S.C. Dep't of Revenue, 391 S.C. 89, 107, 705 S.E.2d 28, 37-38 (2011) (quoting Goldberg v. Sweet, 488 U.S. 252, 260-61 (1989)). To be fairly apportioned, a tax must be both internally and externally consistent. Id. An income tax is internally consistent where it is structured such that if it were applied by every State, it would result in no more than all of the business's income being taxed. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). To meet the external consistency test, "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." Id. In other words, the State's tax must not reach "beyond that portion of value that is fairly attributable to economic activity within the taxing State." Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995); see also Goldberg, 488 U.S. at 262 ("The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed.").

Here, the tax is internally consistent because only the royalties paid by the South Carolina stores are being taxed. If every State imposed a similar tax, no multiple taxation would occur.¹⁴

¹³ Although RAC West does not appear to argue that it lacks substantial nexus with South Carolina, it should be noted that in Geoffrey, 313 S.C. at 23-24, 437 S.E.2d at 18, the South Carolina Supreme Court held that a foreign corporation with no property or employees in South Carolina had a substantial nexus with the State because it licensed trademarks and trade names for use in the State and derived income from their use there. Consequently, because RAC West, like the foreign corporation in Geoffrey, derives income from licensing trademarks for use in South Carolina, there is little doubt that a substantial nexus exists between RAC West and South Carolina.

¹⁴ Although it is possible that multiple taxation could occur if other states did not use the same apportionment method utilized by the Department, such "speculative concerns with multiple taxation" are insufficient to invalidate the tax on Commerce Clause grounds. See Moonman Mfg. Co. v. Blair, 437 U.S. 267, 277-280 (1978).

As to external consistency, because the tax is assessed only on income derived from South Carolina stores, it "reasonably reflects" the South Carolina component of RAC West's economic activity. Accordingly, I find that the tax is both internally and externally consistent.

B. Discrimination Against Interstate Commerce

Discrimination against interstate commerce occurs where a tax favors local businesses or the activity taxed lends itself to repeated taxes in other states. See Int'l Harvester Co. v. Wasson, 281 S.C. 458, 461, 316 S.E.2d 378, 380 (1984). With respect to the interstate commerce context, "the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." Container Corp., 463 U.S. at 171.

In this case, RAC West failed to establish that it was treated differently than a similarly situated taxpayer doing business in this State. Moreover, as discussed above, the tax is internally consistent, and thus it does not lend itself to repeated taxes in other states. Although RAC West contends that the tax is discriminatory because it does not reflect a reasonable sense of how income is generated by RAC West, as discussed above, I find that the tax is externally consistent. For these reasons, I do not find that the tax unconstitutionally discriminates against interstate commerce.

C. Fairly Related To Services Provided By The State

The purpose of the "fairly related" prong of the Complete Auto Transit test is "to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State." Goldberg, 488 U.S. at 266-67. In Geoffrey, the Supreme Court held that a foreign corporation which received royalty income by licensing trademarks and trade names to a South Carolina corporation benefitted from the services of South Carolina and that South Carolina's tax on the royalty income was "rationally related" to those benefits. Geoffrey, 313 S.C. at 21-22, 437 S.E.2d at 17. It explained:

By providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement. That Geoffrey has received protection, benefits, and opportunities from South Carolina is manifested by the fact that it earns income in this state. That the tax is rationally related to these protections, benefits, and opportunities is evidenced by the fact that the State seeks to tax only that portion of Geoffrey's income generated within its borders.

Id., at 22, 437 S.E.2d at 18.

Although, in Geoffrey, the South Carolina Supreme Court was addressing the taxpayer's due process challenge to the tax, the same reasoning applies here.¹³ RAC West is able to earn royalty income from the South Carolina stores because of the sales that those stores make to South Carolina customers. Moreover, the stores are able to make those sales because of the "orderly society" provided by South Carolina. Furthermore, there is a "fair" relationship between the tax and the services provided by South Carolina because the tax is imposed only on income generated within this State. Accordingly, I find that the tax fairly relates to the services provided by South Carolina.

For the foregoing reasons, I find that the Department's method of taxing RAC West's South Carolina income is not barred by the Commerce Clause. Cf. Geoffrey, 313 S.C. at 22-24, 437 S.E.2d at 18-19 (finding that the Commerce Clause did not bar South Carolina from taxing the royalty income of a Delaware corporation that was not physically present in South Carolina but earned income from licensing intangible assets to its parent corporation, a retailer which conducted business in South Carolina).

Expenses or Deductions

The Department's calculation of RAC West's liability did not include any deduction for expenses. During the audit and during the pending litigation, the Department requested documentation to substantiate RAC West's claimed expenses. RAC West did not provide the Department with any documentation supporting any expenses. In the absence of proper substantiation, the Department properly denied any expenses for the taxpayer.

Furthermore, RAC West requested this contested case hearing to challenge the Department's Determination, including challenging the Department's denial of any expenses. Because RAC West is the party asserting the affirmative, it bears the burden of proof in this matter. 2 Am. Jur. 2d Administrative Law § 354 (2004). RAC West thus bore the burden of proving, by a preponderance of the evidence, that it was entitled to expenses. Despite bearing the burden, RAC West did not put forth evidence sufficient to substantiate any expenses. Though RAC West's witnesses claimed that it incurred expenses, no specific details of the types or amounts of expenses were given. In sum, RAC West did not bring forth any books, records, receipts, or other documentary evidence to substantiate any expenses.

¹³ In addressing the taxpayer's Commerce Clause arguments in Geoffrey, the Supreme Court stated that "[o]ur Due Process analysis of the benefits conferred upon Geoffrey applies with equal force here and need not be repeated." Geoffrey, 313 S.C. at 24, 437 S.E.2d at 18.

It is well established that bare assertions by a taxpayer as to the amount claimed, or that a return is correct as filed, are not sufficient to overcome the presumption of correctness which attaches to the tax authority's determinations. Jackson v. Commissioner, 1953 WL 10532, 12 T.C.M. 778 (1953); Halle v. Commissioner, 7 T.C. 245 (1946). As the Eighth Circuit has recognized:

The cases are legion which state that the burden of proof is on the taxpayer; that the Commissioner's assessment is prima facie or presumptively correct and that such presumption is not overcome by mere book entries, mere statements in the tax returns, the mere unsupported testimony of the taxpayer, (or) mathematical calculations involving uncertain facts.

Cleveland Chiropractic College v. Comm'r. 312 F.2d 203, 206 (1963). RAC West did not substantiate its expenses and thus, it is not entitled to deduct any expenses.

Penalties

The Department's auditor applied penalties for substantial understatement as provided for by S.C. Code Ann. § 12-54-155 (Supp. 2010), which states in pertinent part:

(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.

While Section 12-54-155 provides for penalties where a taxpayer substantially understates amounts owed, it also sets forth several exceptions or "safe-harbor" type provisions. Section 12-54-155(B)(2)(b) provides that the amount of the understatement "must be reduced by that portion of the understatement which 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." § 12-54-155(B)(2)(b) (emphasis added). Additionally, Section 12-54-155(D)(1) 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." § 12-54-155(D)(1).

Here, RAC West initially filed its returns using the three factor apportionment method set forth in Section 12-6-2250.¹⁶ Under its plain terms, Section 12-6-2250 does not apply to the licensing of intangible property like trademarks. Therefore, I find that RAC West did not have substantial authority to use the three factor apportionment method in calculating its taxes.

Nevertheless, I do not find that the amount of penalties imposed by the Department in this case is appropriate. The Department based the penalty on the difference between the results under the three-factor formula and the separate accounting method. However, there is nothing in the regulations, policy statements or instructions that would have provided notice to RAC West that it should have filed its return using the separate accounting method. In fact, the tax return form dictates that a taxpayer use a standard apportionment method.

Moreover, Section 12-6-2320(A) does not state that a taxpayer has an affirmative duty to use separate accounting in cases such as this one. Rather, it provides that the taxpayer "may petition for" a variety of alternative methods, including separate accounting, when the standard apportionment formulas do not fairly represent the taxpayer's business activities in this State. § 12-6-2320(A).

For these reasons, I find that the penalty should not be based on the difference in results between the three-factor formula and the separate accounting method. Rather, I find that the penalty should be calculated based upon a comparison of the different results under the three-factor method and the gross receipts method. Significantly, the Department's auditor testified the gross receipts method "would have been the correct method." He further indicated that had RAC West initially filed using the gross receipts method, he likely would not have assessed a penalty.

Comparing the results under the three factor method and the gross receipts method reveals that in none of the applicable years was the difference in taxes under these two methods greater than \$5,000, and that, in fact, the aggregate difference in taxes for all three tax years was only \$1,326.00. Therefore, I find that RAC West did not substantially understate the taxes it owed and that no penalties should therefore be assessed. See § 12-54-155(B)(1)(a) ("For purposes of this section, there is a substantial understatement of tax for a taxable period if the

¹⁶ While RAC West later amended its returns and applied the gross receipts method, it did not do so until July 11, 2011, which was two years after the Department issued its Determination and only a month before the administrative hearing in this matter.

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.)

ORDER

Based on the foregoing, I find the following:

1. The Department demonstrated that RAC West'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 RAC West's business activities in this State;
3. The imposition of an alternative method in this case does not violate the Constitution;
4. RAC West did not substantiate any expenses, therefore it is not entitled to any expenses; and
5. RAC West is not liable for substantial understatement penalties.

IT IS THEREFORE ORDERED that the Department's assessment of an additional \$144,971 in corporate income taxes and \$35,086 in interest is upheld; and

IT IS FURTHERED ORDERED that the Department's assessment of \$36,243 in substantial understatement penalties imposed is dismissed.

AND IT IS SO ORDERED.



Ralph King Anderson, III
Chief Administrative Law Judge

January 6, 2012
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, E. Harvin Belser Fair, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof, in the United States mail, postage paid, in the Interagency Mail Service, or by electronic mail to the address provided by the party(ies) and/or their attorney(s).

E. Harvin Belser Fair

E. Harvin Belser Fair
Judicial Law Clerk

This 6th day of January, 2012
Columbia, South Carolina

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Rent-A-Center West, Inc.,) Civil Action No. 09-ALI-17-0204-CC
)
Petitioner,)
)
vs.) FINAL ORDER
)
South Carolina Department of Revenue,)
)
Respondent.)
_____)

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

For the Respondent: Sean G. Ryan, Esquire

STATEMENT OF THE CASE

This matter comes before the Administrative Law Court ("ALC" or the "Court") pursuant to the request of Petitioner Rent-A-Center West, Inc. ("RAC West") for a contested case hearing under S.C. Code Ann. §12-60-460 (Supp. 2008). RAC West is protesting an assessment of corporate income taxes from the South Carolina Department of Revenue ("SCDOR") for the income tax years ending in 2003, 2004 and 2005. SCDOR audited RAC West's initial returns filed for 2003-2005, which were filed using the three-factor apportionment formula, and issued an additional assessment claiming that RAC West owed the following in income tax, interest and penalties:

EXHIBIT B

ROA 0072

<u>Period Ended:</u>	<u>Income Tax</u>	<u>Interest</u>	<u>Penalty</u>	<u>Totals</u>
12/31/03	\$44,887	\$14,016	\$11,222	\$70,125
12/31/04	45,607	11,748	11,652	70,007
12/31/05	53,477	9,322	13,369	76,168
Totals	\$144,971	\$35,086	\$36,243	\$216,300

See Trial Exhibit ("Ex.") 1, Tab 1, Field Audit for RAC West. RAC West timely protested this assessment. See Ex. 1, Tab 3, RAC West Notice of Protest. Following a conference, SCDOR issued a Department Determination upholding the assessment. See Ex. 1, Tab 5, SCDOR Department Determination for RAC West. RAC West then timely requested a contested case hearing before this Court. Thereafter, and prior to this hearing, RAC West filed amended tax returns based on the single-factor apportionment formula and paid \$1,326.00 in additional taxes owed under that method. A hearing was held before me on August 10 and 11, 2011 at the offices of the ALC. Any issue raised in that proceeding but not ruled upon herein is deemed denied pursuant to ALC Rule 29(C).

LEGAL ISSUES RAISED

The following legal issues have been presented to the ALC:

- (1) Whether SCDOR established that the apportionment method used by RAC West does not reasonably reflect its business activities in this State;
- (2) Whether, if SCDOR established that the apportionment method used by RAC West does not reasonably reflect its business activities in this State, it also established that its alternate apportionment method (which is a form of separate accounting) does reasonably reflect the business activities of RAC West in this State;
- (3) Whether SCDOR properly assessed penalties against RAC West; and

- (4) Whether SCDOR's assessment violates RAC West's constitutional rights.

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 by a preponderance of the evidence.

A. General Background on RAC West

The Rent-A-Center ("RAC") business is a rent-to-own business that rents and sells appliances, furniture, electronics, computers, televisions, etc. Trial Transcript Day I ("Tr. I") at 83:24- 84:2. RAC stores are located in all 50 states. Id. at 84:10-12. The ownership of these stores is split between three entities: RAC East owns and operates retail stores in eastern states (including South Carolina), RAC West owns and operates retail stores in western states and RAC Texas owns and operates retail stores in Texas. Id. at 84:18-25.

RAC West is the taxpayer in this case. In addition to owning and operating retail stores, RAC West owns and licenses the RAC intellectual property ("IP"), which primarily includes RAC trademarks and trade names, to all RAC companies. Id. at 84:20-21 and 85:6-8. At issue in this case is the proper method of reporting RAC West's royalty income earned in South Carolina as a result of its licensing of IP to RAC East that is used by the RAC East stores in South Carolina.

RAC West licenses the RAC IP to RAC East pursuant to a licensing agreement. Ex. 1, Tab 11, Trademark License Agreement dated 12/31/2002 (the "License Agreement"). Per this agreement, RAC West charges a royalty fee for this license that is equal to 3% of the net sales of the RAC East stores. Id. RAC West and RAC East set the amount of this fee based upon the analysis and conclusions of a transfer pricing study performed by a Ph.D. economist and

expert in the field of transfer pricing with a third party accounting firm, KPMG, LLP. Tr. I at 104:13-18 and 230:23-231:25 (KPMG economist's testimony regarding how fee was determined). SCDOR stipulated at trial that it did not dispute that the amount of this fee was reasonable. Trial Transcript Day II ("Tr. II") at 134:5-6 and 9-10.

Beyond receiving these royalty payments for the use of the IP by the South Carolina stores, RAC West has no connection to this State. Tr. I at 106:3-6. It has no physical presence in South Carolina as it has no employees, facilities or tangible property in this State. Id. at 105:17-22. RAC West also makes no sales in South Carolina and receives *de minimis*, if any, services or benefits from the State. Id. at 105:23- 106:2.

Additionally, RAC West presented evidence regarding the unitary relationship between its two business activities of owning and licensing IP and owning and operating retail stores in western states. The same management is over both business activities. Tr. I at 107:14-21. The two activities also share services and systems that create efficiencies and cost savings across both business lines. Id. at 108:4-11. All income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole. Id. at 107:22- 108:3. The retail stores contribute to the profitability of the IP and vice versa. See id. at 108:12-25. More specifically, as the RAC brand name becomes more well-known, it builds brand loyalty, public recognition and goodwill, which increases traffic to the stores and leads to customers being willing to pay more to buy the RAC brand versus another brand. See Tr. I at 102:9-25; 108:20-25; 203:10-19. This, in turn, leads to increased sales and thus higher profitability of RAC East (increased sales revenue) and RAC West (increased royalty payments). Id. Likewise, as the RAC West retail store sales increase, the RAC IP becomes more valuable as it is tied to a more profitable and successful business. Id. at 203:4-8. Stated

another way, the retail sales activities and the intellectual property activities of RAC West contribute to and depend on one another and there is a flow of value between the two activities. Tr. I at 108:12-25 and 203:20- 204:2. The evidence regarding these relationships was uncontested as SCDOR presented no evidence to challenge or refute any of the above. In fact, SCDOR's auditor testified that he thought the RAC IP owned by RAC West probably contributed to the profitability of the RAC West stores but that he did not consider this fact in his analysis.¹ Tr. II at 167: 3-11.

Finally, RAC West's witness testified that RAC West kept records of the total costs for its unitary business activities (IP and retail stores), which it reported in its returns, but it did not separately track the costs of the IP alone because there was no reason to do so and it would be very difficult to do with any degree of accuracy or reliability. Tr. I at 111:11-115:17 and 204:3-205:8. In fact, this South Carolina audit was the first time RAC West had ever been asked for this information. Id. at 112:1-4. Separately tracking the IP costs (versus tracking total costs) is difficult because of the interrelated and interdependent nature of the company's business activities. Tr. I at 111:11-115:17 and 204:3-205:8. While SCDOR's economist stated that managerial accountants routinely track costs for companies, tracking direct costs like overhead or man hours spent on one task versus another of a unitary business such as RAC West would fail to capture all of the contributions and flows of value between the two activities. Tr. I at 204:3- 205:8 (RAC West witness discussing that because work performed related to the IP increases the value of the retail operations and vice versa, it is difficult to

¹ SCDOR's auditor was asked whether the IP owned by RAC West contributed to the profitability of the RAC West stores. He responded: "Well, they probably do. When we go and audit, we don't think about that; we're just looking at the numbers; we don't think about whether this whatever (sic) contributes to the profitability." Tr. II at 167: 3-11.

accurately account for the actual costs of the one versus the other even if one could make an effort to track an employee's time on tasks for the two different operations).

B. Tax Returns, Audit, Protest and Determination

RAC West's Tax Director testified that the company followed the instructions and guidance provided in the tax returns in preparing the returns at issue. More specifically, RAC West started with its federal taxable income (which would include the total income less costs of RAC West), made South Carolina adjustments and applied a statutory apportionment formula to determine South Carolina apportionable net income all in accordance with what the statute, tax return and instructions dictate.¹ See Tr. I at 117:17-118:7; S.C. Code Ann. §12-6-2290 (Supp. 2007); Ex. 1, Tab 8, Sample SCDOR Corporate Income Tax Instruction; Ex. 1, Tab 7, RAC West Amended Tax Returns 2003-2005. He also testified that in preparing and submitting these returns he acted in good faith and with substantial authority and made adequate disclosures on the returns. Tr. I at 133:10- 134:9. Finally, he testified that nothing in the instructions or anything else he had seen suggested that RAC West should file its return using the separate accounting method SCDOR now asserts. Id. at 134:17-21.

SCDOR's position in the case is that the single-factor gross receipts method of apportionment used by RAC West, which attempts to compute a reasonable representation of RAC West's in-state business activities via a ratio that compares RAC West's income in South

¹ RAC West initially filed its returns using the three-factor standard apportionment method (i.e. property, payroll and gross revenues). RAC West's Tax Director testified that he completed the return by following its layout, which included a section requesting information related to the three-factor formula. Tr. I at 116:18-23. He also testified that this method is commonly used by RAC West in other states. Id. at 116:24- 117:1. However, when SCDOR's auditor advised him that the single-factor gross receipts method was more appropriate, he offered to amend the returns at that time to resolve the matter. Id. at 117:2-13. SCDOR did not agree to resolve the case, but, thereafter, RAC West determined that it should amend them anyway and so filed amended returns using the single-factor formula. Id. at 117:14-16.

Carolina to its total income in all states, does not accurately reflect its in-state business activities. It bases this position on its assertion that where a multi-state taxpayer has multiple types of income, SCDOR need only look to the type of income the taxpayer has in South Carolina to compute the aforementioned ratio of South Carolina receipts versus receipts from all states. The audit report does not indicate that the auditor considered whether RAC West operated a unitary business even though he conceded that a unitary business would not need to do all business activities in this State in order to be taxed as a unitary business (i.e. not taxed using a separate accounting method to divide up the business). Tr. II at 157:21- 158:3. Instead, SCDOR ignored the interdependencies between the business activities that generate the income streams and the unitary nature of the business and applied a separate accounting method that considered only the income from the business line that operates in this State in purportedly computing a reasonable representation of the proportion of the business done by RAC West within this State. See Ex. 1, Tab 1, SCDOR Audit Report for RAC West, at p. 4 and supra p. 5, n. 1 (quoting auditor's testimony on this point).

SCDOR's separate accounting method also did not offset the revenues by the costs incurred to generate those revenues. This was a point of contention between the parties as SCDOR argued that it was the taxpayer's burden to provide SCDOR with the costs associated with its royalty income, while RAC West argued that nothing under the law required it to track the costs of one business line versus another for a unitary business engaged in multiple business activities and asserted that it would be impossible to do so accurately or reliably. See supra pp. 5-6 (explaining that attempts to allocate costs for IP activities versus retail store activities would not likely be accurate or reliable due to the interrelated and interdependent

nature of these activities and that separate accounting of the costs would fail to capture all of the contributions and flows of value between the two activities).

SCDOR also assessed penalties against RAC West for substantial understatement of taxes owed and negligence even though its auditor testified that he was not aware of anything in the tax return instructions that would have indicated to RAC West that it should use the separate accounting method asserted by SCDOR. Tr. I at 173:10-22. He further testified that had RAC West used the single-factor formula initially (versus the three-factor formula), he may not have imposed a penalty at all as the single-factor formula "would have been the correct method." Tr. II at 172:12-18.

CONCLUSIONS OF LAW

I. BURDEN OF PROOF

The standard of proof in cases involving challenges to tax assessments is the preponderance of evidence standard, and the burden of proof in such cases is normally upon the taxpayer challenging the proposed assessment. However, an exception to this general rule applies where a party seeks to deviate from the standard apportionment formula. In such a case, the burden shifts to that party to show why the standard apportionment formula should not be followed and that its alternative formula is reasonable. The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal. App. 4th 1491, 1498 (Ct. App. 2007) (stating that the party asserting alternative apportionment bears the burden of proof). This rule appears to be universally accepted and applied. Union Pacific Corp. v. Tax Comm'n., 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 Rev., 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 Rev. Dep't of N.M., 131 P.3d 27 (N.M. 2001); writ of cert. quashed by Kmart Corp. v. Taxation and Rev. 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., 2006 WL 2038698 (N.M. Tax. Rev. Dept. 2006) (holding Department had burden of proof as the party wanting to depart from the standard three-factor formula). In this case, SCDOR seeks to deviate from the standard apportionment method, and, therefore, it bears the burden of proof and must show by a preponderance of the evidence that the standard apportionment formula should not be followed and that its alternative formula is reasonable.

II. PROPER INCOME TAX APPORTIONMENT METHOD

The central issue in this case is the proper method to use in determining RAC West's taxable income in this State during the audit period (tax years ending 2003 through 2005).

A. South Carolina Law on the Taxation of a Multi-State Taxpayer Does Not Support SCDOR's Position of Applying Separate Accounting where a Taxpayer Conducts Multiple Business Activities, only some of which are Conducted in South Carolina.

The dispute between the parties boils down to whether in computing a reasonable representation of the proportion of RAC West's business done within this State, the income from its retail sales should be included in the denominator of the apportionment formula along with its royalty income (RAC West's position) or whether the denominator should be limited to

only income from royalty receipts (SCDOR's position). I find that the statutory scheme and the evidence presented at trial support RAC West's position.

When interpreting a statute, the sole function of the Court is to determine and give effect to the intent of the legislature. Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The starting point in doing so should always be the text of the statute itself. Id. (holding that "[w]hat a legislature says in the text of a statute is considered the best evidence of the legislative intent or will"); Wigfall v. Tideland Utilities, Inc., 354 S.C. 100, 580 S.E.2d 100 (2003). In interpreting the text, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "[w]here the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." Hodges, 341 S.C. at 85, 533 S.E.2d at 581.³

Under South Carolina law, a multi-state taxpayer that does business both within and without this State is subject to a 5% tax "upon a base which reasonably represents the proportion of the trade or business done within the State." S.C. Code Ann. § 12-6-2210(B) (2000). The General Assembly's language in this statute focuses on the proportion of a taxpayer's business within South Carolina and makes no mention of the type of income stream that is being taxed. The starting point for determining the "base" referenced in § 12-6-2210(B) is the taxpayer's "federal taxable income" plus or minus certain adjustments under Article 9 of Title 12, which results in the taxpayer's South Carolina apportionable net income. See S.C.

³ See also State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002) (holding when the language of the statute is clear, "a court cannot rewrite the statute and inject matters into it which are not in the legislature's language. . . ."); Rosmar v. Pfizer, 263 F.3d 263 (4th Cir. 2001) (holding that when a statute is plain on its face, the court's inquiry is at an end).

Code Ann. §12-6-580. This net income figure is then adjusted by the amount of income, deductions or credits that should be allocated to another state. The parties agree that there are no allocable items at issue in this matter.

Next, the taxpayer's South Carolina apportionable net income is apportioned under the appropriate statute, which, in this case, the parties agree is the single-factor "gross receipts" statute if the standard statutory method is to be applied. S.C. Code Ann. § 12-6-2290 (2000); Tr. II at 172:12-18 (testimony of auditor that single-factor formula would be the correct method). Under this statute, the taxpayer's "gross receipts from within this State" are divided by the taxpayer's "total gross receipts from everywhere." Id. This statutorily defined fraction is then multiplied by the taxpayer's apportionable net income to arrive at the South Carolina taxable income, i.e. the "base which reasonably represents the proportion of the trade or business done within the State." Finally, the South Carolina taxable income is multiplied by the 5% tax rate resulting in the amount due in taxes.

In this case, RAC West followed the above standard statutory formula by starting with its federal taxable income and making any appropriate adjustments to arrive at its apportionable net income. It then applied the single-factor gross receipts formula to its apportionable net income to determine its South Carolina net income. Thus, RAC West divided its South Carolina gross receipts by its total gross receipts. See S.C. Code Ann. § 12-6-2290. It then multiplied this fraction by its apportionable net income to determine its South Carolina taxable income, which it then multiplied by the South Carolina tax rate of 5%. See supra p. 6.

SCDOR rejected this standard statutory apportionment method in favor of a separate accounting method that substituted the "total gross receipts from everywhere" in the denominator of the gross receipts formula with only gross receipts that were identical to the

type of receipts RAC West had in South Carolina. Apparently, SCDOR believes that where a taxpayer has more than one type of income stream, any income streams that are different from those that arise in South Carolina should be excluded from the "total gross receipts from everywhere." See Tr. II at 154:15-24 (testimony of SCDOR's auditor that "from an auditor point of view, we look to the activity in the State of South Carolina").

A visual comparison of the two methods is as follows:

<u>Standard Method</u>	<u>SCDOR's Method</u>
Gross Receipts from SC Activities	Gross Receipts from SC Activities
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Total Gross Receipts Everywhere	Total Gross Receipts Everywhere from the Same Type of Activity as in SC

First, it is clear that the General Assembly was focused on obtaining a fair measure of the proportion of a multi-state taxpayer's business activity in South Carolina versus other states. S.C. Code Ann. § 12-6-2210(B) (2000) (stating that a multi-state taxpayer that does business in this State as well as others is subject to a 5% tax "upon a base which reasonably represents the proportion of the trade or business done within the State") (emphasis added). Nothing in the statute requires or even suggests that the "proportion" be limited to a comparison of the business done in this State versus the same type of business performed in other states.

Additionally, the General Assembly used federal taxable income as its starting point for determining a multi-state taxpayer's income, which by definition includes all income streams of a taxpayer. See S.C. Code Ann. §12-6-580. The gross receipts method, which SCDOR agrees would be the appropriate standard method if a standard method is to be used (see Tr. II 172:12-18), apportions net income by dividing "gross receipts from within this State" by "total

gross receipts from everywhere." S.C. Code Ann. 12-6-2290.⁴ Had the General Assembly intended the result sought by SCDOR, it could easily have drafted the gross receipts statute to read that net income should be apportioned by dividing "gross receipts from within this State" by "total gross receipts everywhere for the same business activity as is performed in this State." Thus, I find that the plain meaning of the relevant statutes does not support SCDOR's position that gross receipts related to other lines of a taxpayer's business be excluded from the denominator of the apportionment formula.

B. Even if SCDOR's Position Is Acceptable in Certain Circumstances, SCDOR Has Not Established that the Standard Formula Does Not Fairly Reflect RAC West's In-State Business Activities or that SCDOR's Alternative Formula Does.

Even if this Court determined that the relevant statutes do not prevent SCDOR from using an alternative method that revises the gross receipts formula as it proposes, SCDOR must still meet other statutory requirements. An alternative method of apportionment is only authorized in certain circumstances, which are set forth in S.C. Code Ann. §12-6-2320(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.

⁴ See also Tr. II at 38: 12-15 (testimony of RAC West's tax policy expert explaining that the standard apportionment formula under the Uniform Division of Income for Tax Purposes Act is "trying to get a relative measure of the sales occurring in the taxing state as a percentage of the corporation's total sales.").

Thus, an alternative method may only be used where (a) the standard method does not fairly represent the taxpayer's in-state business activities and (b) the alternative method (in this case separate accounting) does fairly reflect these activities. See S.C. Code Ann. §12-6-2320(A) (2000 and West Supp. 2009).

Additionally, an alternative method should be used "only in limited and specific cases . . . where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the [standard] apportionment and allocation provisions" See Ex. 1, Tab 14, Uniform Division of Income for Tax Purposes Act ("UDITPA") and related regulations, at p. 37. As the United States Supreme Court has explained, this approach to using alternative formulas sparingly is based on the belief that formulary apportionment is presumed to be fair and reasonable. See Butler Bros. v. McColgan, 315 U.S. 501 (1942). On the other hand, separate 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 America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983).

1. The Standard Apportionment Formula Fairly Reflects RAC West's Activities in South Carolina.

As previously stated, SCDOR bears the burden of establishing by a preponderance of the evidence that the standard apportionment formula does not fairly reflect the business activities of RAC West in South Carolina. See supra, § I, Burden of Proof Section, at pp. 8-9. Not only does SCDOR fail to carry this burden, but I find that RAC West established that the standard method does fairly reflect its business activities in South Carolina.

First, RAC West has no physical presence in South Carolina, its in-state activities are minimal and it receives minimal benefits from the State. Tr. I at 105:17- 106:2. When a taxpayer has a minimal presence in this State, it does not burden the government services funded by South Carolina tax revenues. RAC 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. See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("The simple but controlling question is whether the state has given anything for which it can ask return").

RAC West also presented testimony and evidence showing that the income at issue was produced by its total unitary business activities and was not solely attributable to its limited activities in South Carolina. See Tr. I at 105:23- 106:2; 107:14- 109:25; 202:9- 204:2 (testimony of RAC West witness regarding unitary nature of business, fact that its retail store operations contributed to the profitability of its IP operations and vice versa and its minimal contact with South Carolina); Id. at 268:4-10 (testimony of RAC West's expert economist that standard apportionment method fairly reflected RAC West's in-state activities based on benefit principle of tax fairness).

Finally, the standard statutory method takes into account RAC West's costs associated with its unitary income and thus is a fair reflection of its activities in South Carolina especially when compared to SCDOR's method, which was not based on net income (because it failed to take costs into account) and thus is not even a corporate income tax. See id. at 268:11-16 (testimony of RAC West's expert economist that a gross receipts tax is not a corporate income tax as it ignores costs or profits).

SCDOR's position as to why the standard method does not fairly reflect RAC West's

in-state activities appears to be that combining the retail store income (apples) with the IP income (oranges) results in a dilution and/or distortion of RAC West's income in South Carolina. SCDOR presented no evidence to support this argument other than to point to the percentage of total revenues of RAC West and imply that because the royalty income is only 13% of that total, there must be something wrong with the formula. See Tr. II at 114:4-25. This proves nothing and could be true of any taxpayer that has multiple income streams but with only one line of business in South Carolina. As the gross receipts statute indicates and as RAC West's tax policy expert testified, that is exactly how formulary apportionment works for multi-state taxpayers. Using a pizza pie analogy, RAC West's tax policy expert explained that formulary apportionment takes the total pizza (total corporate income in all states) and determines the slice of the pizza that the taxing state should get. Tr. II at 64:21- 65:1; Ex. 1, Tab 16, Pomp's RAC West Report, at pp. 3-4 and 6-8; see also Tr. II at 49:3- 53:4 (explaining how formulary apportionment works and stating that "sometimes a state gains from formulary apportionment, sometimes it doesn't. . . [but] you don't reject formulary apportionment because you don't like the results of it.").

Another argument similar to the apples and oranges argument was advanced by SCDOR's auditor who testified that he believed that the retail stores in western states have nothing to do with what goes on in South Carolina (see Tr. II at 115:7-9); thus, SCDOR implied that it would not be appropriate for activities in other states to be considered. First, the auditor's statement is contradicted by all the evidence and testimony presented in the case on the relationship between RAC West's two business activities (owning/licensing IP and operating retail stores), including their interdependencies, synergies, economies of scale and scope, contributions to the profits of each other, etc. SCDOR's own expert conceded these

relationships. Tr. II at 259:9-14 and 263:2-4. Neither he nor SCDOR ever explained why, if these relationships did in fact exist, the standard apportionment formula would not be a fair reflection of RAC West's activities in this State. Additionally, and as previously stated, there is nothing in the statutory scheme that supports SCDOR's re-writing of § 12-6-2290 to exclude different lines of business from the denominator of the apportionment formula.

Based on the foregoing, I find that SCDOR has failed to meet its burden of establishing that the standard apportionment method does not fairly reflect RAC West's business activities in South Carolina and further find that RAC West has established by a preponderance of the evidence that this method, which obtains a proportional measure of the taxpayer's activities (including both income and costs) occurring in the taxing state versus its total activities (again, including income and costs) fairly reflects RAC West's business activities in South Carolina especially where the taxpayer can show such a unitary and symbiotic relationship between the different business activities as RAC West did in this case. Thus, SCDOR's assessments must be dismissed.

2. SCDOR's Alternative Separate Accounting Method Does Not Fairly Reflect RAC West's Activities in South Carolina.

Even assuming SCDOR could establish that the standard apportionment formula does not fairly reflect the business activities of RAC West in South Carolina, it has not shown that its proposed alternative separate accounting method is reasonable. Moreover, I find that RAC West has established that the separate accounting method is unreasonable in this case.

The evidence presented at trial established that excluding the gross receipts related to the income from the retail stores operating in other states produced a result that was not a fair reflection of RAC West's activities in this State. RAC West presented substantial evidence of the relationship between its unitary business activities. It showed that its retail business

activities in other states contributed to the profitability of its IP activities in South Carolina. More specifically, as the retail stores sell more products, the value of the IP increases and the amount of the royalties paid to RAC West increases. SCDOR's auditor admitted that the retail store activities probably increased the profitability of the IP, but he simply chose not to consider this fact before breaking apart the business (Tr. II at 167:3-11), and SCDOR presented no evidence to dispute the interdependencies and flows of value between the two activities. Also, the method used by SCDOR fails to take into account the implicit royalty value of the RAC IP, which leads to the denominator (gross receipts from everywhere) being understated. See Tr. II at 167:15-22 (testimony of auditor agreeing that RAC IP has intrinsic value to RAC West); Ex. 1, Tab 1, Audit Report for RAC West (no consideration given to implicit royalty value). In other words, if RAC West did not own the IP, it would have to license it and pay a fee just as the other RAC companies do. Failing to consider royalties that would result from the revenues generated in states where RAC West owns stores distorts the ratio of its true business activities within and without South Carolina thereby causing SCDOR's method to be unreliable in measuring RAC West's activities in South Carolina. In sum, RAC West established, though not its burden to do so, that the income received as a result of its activities in South Carolina was not solely a result of its activities in this State but was also produced by its retail store activities in other states.

RAC West also presented evidence that because of these interdependencies and contributions that each activity provides to the other, it could not *accurately* separate the royalty costs from the retail store costs. See supra at pp. 5-6. SCDOR attempted to cast blame on RAC West for the fact that SCDOR's method did not consider costs of generating royalty income stating that it was incumbent upon the taxpayer to provide any such information, and it

implied RAC West was being unreasonable or recalcitrant in not doing so. However, as RAC West's tax policy expert explained, such a taxpayer is being neither unreasonable nor recalcitrant; the beauty of the standard apportionment formula is that it does not ask a taxpayer to do something that is inappropriate or impossible to do. See Tr. II 98:5-13. He further explained in his report as follows:

Formulary apportionment recognizes that in a unitary business both the receipts and the expenses are part of an indivisible whole. Consequently, in determining the net income of the business, the aggregate expenses are offset against the aggregate receipts. Just the way it is inappropriate to take apart a unitary business and tax only a subset of its activities, it is inappropriate to try to identify the expenses that generated that subset.

By applying separate accounting rather than formulary apportionment, the Department is requiring RAC West to bifurcate its expenses between two indivisible sources of income: the retail stores and the royalties. RAC West has no reason to do this under GAAP, the Internal Revenue Code, or under its own internal management accounting.

Ex. 1, Tab 16, Pomp Report on RAC West, pp. 8-9. The clear and uncontroverted evidence is that RAC West does not keep its books and records in this fashion and did not have this information to give to SCDOR. See also supra pp. 5-6 and 7-8. It is also telling that RAC West, which does business in all 50 states, has never before been asked for this information by any taxing authority. Tr. I at 112:1-4. Because SCDOR's separate accounting method ignores the costs incurred by RAC West to generate the royalty income, it results in an improper gross revenue tax versus a corporate income tax (which is based upon the profits of a corporation). See Tr. I at 268:11-16 (testimony of RAC West's expert economist on same); Ex. 1, Tab 16, Pomp Report on RAC West, pp. 8-9 (testimony of RAC West's tax policy expert on same).

In addition, I find that applying separate accounting to a unitary business would be in contravention of well-established South Carolina law.⁵ More specifically, despite the South Carolina Supreme Court's ruling in Exxon and other cases as well as SCDOR's own regulations that the income of a unitary business should be subject to the apportionment formulas and not separate accounting,⁶ the auditor failed to consider whether RAC West operated a unitary business. SCDOR presented no evidence to support its theory that isolated portions of RAC West's unitary income should be separated or can be accurately separated or to show that the receipts at issue are produced solely by RAC West's activities in South Carolina, and RAC West presented substantial evidence to the contrary. The evidence presented clearly shows that the royalty income derived from the South Carolina sales was both dependent upon and contributed to the retail operations in the western stores.

The term "unitary business" is a term of art that has been employed by the United States Supreme Court and South Carolina courts to characterize a business that is made up of integrated component parts and functions, the income from which is not capable of accurate separation and measurement. In determining whether a business is unitary, South Carolina courts apply two 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. Under the three unities test, the courts look at whether the

⁵ 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 (Cl. App. 1989). See also Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 783 (1992).

⁶ S.C. Code Ann. Regs. § 117-710.1 (West Supp. 2009)(providing that where a "Taxpayer operates 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").

business or businesses have unity of ownership, unity of management and unity of operation. Id. 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 staffing 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 and 258 S.E.2d at 97.⁷

⁷ See also Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992) (finding that a multi-national camera and film corporation that was also doing safe harbor lease transactions involving tangible personal property was a unitary business 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); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Cl. App. 1989) (finding that affiliated New York textile manufacturing companies that also earned interest income from inter-company loans and from repurchasing their own bonds on the open market were unitary where the funding for the leasing came from the general corporate treasury, the interest income and loan payments were deposited in general company accounts and used for normal business operations, and the income benefited the companies 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

In the case at hand, this Court finds that RAC West is a unitary business based on the following: RAC West has shared ownership (it is one company) and management (same management is over the retail stores operations and the IP operations); it has shared services and systems that create efficiencies and cost savings across the company; all income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole; and the retail sales activities and the intellectual property activities contribute to and depend on one another (including, but not limited to that each contributes to the profitability of the other) and there is a flow of value between the two activities.⁸ See supra, Findings of Fact, Section A, pp. 4-5. Additionally, RAC West's expert economist testified that the business was unitary from an economic perspective based on the foregoing facts (see Tr. I at 264:10-23), and RAC West's expert in tax policy likewise testified that from a tax policy perspective, RAC West was a unitary business. Tr. II at 65:9-13. Even SCDOR's own expert economist agreed that RAC West had interrelated activities, that there were synergies between them and that there were economies of scope and scale. Tr. II at 259:9-14. Accordingly, I find that RAC West is a unitary business, and the income from the RAC West retail sales operations and the royalty income constitute RAC West's unitary income.

In the seminal unitary business case in this State, the South Carolina Supreme Court held that separate accounting was not appropriate for determining the taxable income of a unitary business. Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 599, 258 S.E.2d 93, 96

discovered during oil exploration process, which was an integral part of the business).

⁸ As previously noted by this Court, this evidence was uncontested as SCDOR presented no evidence to refute it. SCDOR's auditor testified that he thought the IP probably contributed to the profitability of the RAC West stores but stated that he did not consider this in his analysis.

(1979). 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 and have only the retail sales income be subject to taxation. The Department's predecessor 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. In support of this holding, the court cited 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).

Similar results were reached in Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992) and Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989). 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 from the camera and film income. 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. Similarly, 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.

RAC West's tax policy expert explained the rationale behind the disfavor of separate accounting for a unitary business. He testified that formulary apportionment views the income of a business as a pizza and then attempts to determine the slice of the pizza that the taxing state should tax by obtaining a relative measure of the activities/income occurring in the taxing state versus the company's total activities/income. Tr. II at 37:20-39:10. In contrast, separate accounting looks only at what a multi-state corporation does in the taxing state. Id. at 46:16-22. It attempts to ignore the pizza as a whole and to tax only the more valuable pepperonis. Id. at 49:3-18. This method has become highly disfavored because it fails to take into account the interdependencies, economics of scope and scale, and flows of value that can take place between the different business activities of a company. See Tr. II 47:17- 49:2; see also Ex. 1, Tab 16, Pomp Report on RAC West, at pp. 4-6. Thus, he explained that "the proper way of taxing it from a policy perspective, would be to take the pizza pie that represents the profits of West and determine the taxing state's slice of that pizza. . . ." Tr. II at 64:21- 65:1; see also Ex. 1, Tab 16, Pomp Report on RAC West, at pp. 4-8.

In this case, SCDOR seeks to isolate RAC West's royalty income from its retail stores income when determining the "reasonable representation" of RAC West's business in South Carolina versus other states. SCDOR appears to base this argument for separate or geographic accounting primarily on its expert economist's testimony to the effect of one should not mix the apples (retail sales income) with the oranges (IP income); thus, because RAC West does not operate retail stores in South Carolina, SCDOR's position is that it should only consider the oranges/IP income and not the apples/retail sales income in other states when determining RAC West's total receipts everywhere (i.e. the denominator in the single-factor apportionment formula). See Tr. II at 193:14-194:9. SCDOR's economist also stated that whether RAC West was unitary was not determinative in his analysis of the case and was "a red herring." Tr. II at 197:4-9. He asserted that the fact that a company operates a unitary business does not mean that one cannot separately apportion costs and divide up that unitary business from an economic point of view (see Tr. II at 263:2-12). Although he was not qualified as an expert in managerial accounting, he testified that managerial accountants do that type of cost accounting routinely. Id. at 265:2-14. In fact, he could not think of a single example of a unitary business that could not be separated. See id. at 264:12-16.

While at first blush, SCDOR's position might appear reasonable, similar apples and oranges arguments were advanced by the parties but rejected by South Carolina appellate courts in Exxon (apples being oil production/refineries income and the oranges being gas station income), Lowenstein (apples being textile manufacturing income and oranges being bond interest income) and Eastman Kodak (apples being camera/film income and oranges being safe harbor lease income). As discussed above, the appellate courts rejected these arguments in all three cases because separate accounting would not take into account the synergies,

economies of scale and scope, interdependencies and contributions between the taxpayers' different business activities. A managerial accountant could have examined the business operations of the taxpayers in Exxon, Lowenstein and Eastman Kodak just as easily as he could RAC West's operations. However, while one could attempt to track how many hours each RAC West employee spends on the two primary business activities (i.e. IP versus retail stores) and arrive at estimated total costs for each, such a determination would fail to take into account the synergies, interdependencies and contributions between the IP and the retail stores. For example, because as the retail sales increase, the value of the IP goes up, ten hours of time spent on retail operations issues, which a managerial accountant would put in the operations bucket, actually also contributes to the value of the IP. Assigning those hours only to retail operations would fail to recognize the value provided to the IP operations; it would overstate the costs of the retail operations and understate the costs of the IP operations. See Tr. I at 270:1-4 (RAC West's expert economist testimony that the component parts of a unitary business cannot be accurately accounted for separately); see also Tr. II at 60:1- 61:7 (testimony of RAC West's tax policy expert explaining that "it makes no sense to talk about what are the expenses that may have generated the components of that unitary business. For all the reasons why we view the unitary business as this organic whole and we take its revenues as the unitary business and we subtract the expenses of the unitary business, and then we come up with a net income which is the amount we then apportion, there is no attempt made in a unitary business apportionment system to segregate out expenses that might be attributable to one component of income versus another. . . . [I]f you are taxing the unitary business income, you are giving a deduction for all of the expenses of generating that unitary business income.").

Additionally, SCDOR's expert economist acknowledged "there are no generally accepted accounting principles in this area." Id. at 266:22-23. He also stated that "[t]here are multiple or there are different ways" a managerial accountant could make an allocation and that "one has to choose between alternative rules for apportionment." Id. at 267:8-13. The fact that there are no generally accepted accounting principles in this area and that one has to choose between multiple ways and alternative rules requires many professional judgments and subjectivity depending on the underlying purpose of the allocation. Therefore, it is possible that one allocation method could be reasonable for cost accounting purposes, but not necessarily reasonable for managerial accounting, financial accounting or tax accounting purposes. That is another reason why separate accounting is so disfavored.

Based on the above, the Court concludes that SCDOR has failed to establish by a preponderance of the evidence that its alternative separate accounting method fairly reflects RAC West's business activities in South Carolina. Additionally, the Court would note that SCDOR has failed to explain why it did not consider whether RAC West operated as a unitary business, and its expert's theory that separate accounting can be applied to any unitary business is simply contrary to South Carolina law. Additionally, although not RAC West's burden, I find that it 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 that ignores the unitary income of RAC West. The tax bears no relationship to RAC West's limited business activities in South Carolina. Thus, SCDOR's assessments must be dismissed.

III. PENALTIES

SCDOR assessed penalties totaling \$36,243.00 against RAC West based on substantial understatement. See Ex. 1, Tab 1, SCDOR Audit Report for RAC West, at 2 (as to amount of

penalty); Ex. 1, Tab 5, Department Determination for RAC West, at 8-9 (as to basis of penalty). Because this Court finds that RAC West used the proper apportionment method, no additional tax is owed and the penalties must be dismissed.

Even if this Court had found in favor of SCDOR on the assessment, it finds that penalties would not be appropriate in this case. The South Carolina Code provides for penalties where a taxpayer substantially understates amounts owed; however, it also sets forth several exceptions or "safe-harbor" type provisions. 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). The Code 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).

In this case, RAC West filed the Amended Returns at issue in accordance with the single-factor statutory method as well as the tax return forms and instructions. The tax returns and the instructions to those returns represent substantial authority, and RAC West acted in good faith in following this authority and submitting RAC West's amended filing. SCDOR's auditor testified that had RAC West filed this way initially, he probably would not have assessed a penalty as the single-factor method "would have been the correct method." Tr. II at

172:12-18. Thus, SCDOR now appears to be basing its penalty solely on the fact that RAC West initially filed using the three-factor formula and, after the audit, changed to the single-factor formula now in contention.

I do not find a penalty to be appropriate under the facts of this case. First, if, as the auditor suggests, SCDOR was basing the penalty only on the fact that the three-factor versus single-factor formula was being used, then the penalty should be reduced to be a reflection of the difference between reporting under those two methods, which was \$1,326.00 (see Ex. 1, Tab 7, RAC West Amended Returns); instead, SCDOR is still basing the penalty on the difference between reporting under the three-factor formula and the separate accounting method (i.e. approximately \$145,000). Additionally, I find that both positions taken by RAC West were supported by substantial authority,⁹ it offered to amend the returns as soon as SCDOR brought the matter of single-factor being appropriate to its attention (Tr. I at 117:2-13), later amended its returns even though that would not resolve the matter (*id.* at 117:14-16), and the difference in the amounts due under the single-factor versus the three-factor formula is *de minimus*. I also find that RAC West made adequate disclosure on its initial returns as conclusively evidenced by the fact that the audit report itself uses only that information that was reported on the return. Finally, I find that there is nothing in the regulations, policy statements or instructions that would provide notice to a taxpayer that it should file its return

⁹ As to the use of the three-factor formula, RAC West's Tax Director testified that he initially filed under that method because he was following the layout of the return, which contained a section asking for information related to the three-factor formula. Tr. I at 116:18-23. He also testified that this method is commonly used by RAC West in other states. *Id.* at 116:24-117:1. As to SCDOR's assertion that separate accounting is appropriate, that method is unpublished and SCDOR has given no notice that such a method exists or should be used. See Tr. I at 134:17-21 (testimony of RAC West Tax Director that there was nothing in the instructions or anything else he had seen that would suggest that RAC West should file its return using the separate accounting method asserted by SCDOR); *Id.* at 173:10-22 (testimony of SCDOR's auditor that he was not aware of anything in the tax return instructions that would have indicated to RAC West that it should use the separate accounting method).

using a separate accounting method as SCDOR contends in this case. In fact, the tax return and the instructions dictate that a taxpayer use a standard apportionment method.

Thus, because RAC West had substantial authority and made complete disclosure on its returns and because there is nothing that would have put RAC West on notice that it should use the separate accounting method asserted by SCDOR, I conclude that even if the Court had found in SCDOR's favor on the assessment, RAC West has established by a preponderance of the evidence that the substantial understatement penalty should not apply. Additionally, assessing such a penalty under the circumstances of this case would violate RAC West's due process rights under both the South Carolina and United States Constitutions, and, thus, the penalty could not be sustained on this ground as well.

IV. RAC WEST'S CONSTITUTIONAL RIGHTS

A final issue in this matter is whether RAC West's constitutional rights have been violated. Although the ALC does not have the authority to declare a statute unconstitutional, it can and should determine whether the application of a statute produces an unconstitutional result. RAC West believes that SCDOR has erroneously applied the South Carolina income tax laws to it in such a way as to reach an unconstitutional result in this case. More specifically, 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 its activities in South Carolina, is not fairly apportioned, discriminates against interstate commerce, and is not fairly related to the services provided by the taxing state.

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, the courts apply both an internal and external consistency test. See Container Corp., 463 U.S. at 169 (discussing fairness issue under both Commerce Clause and Due Process Clause). Internal consistency requires that if the formula was applied by every jurisdiction, "it would result in no more than all of the unitary business' income being taxed." 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. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931)) or has led to "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. at 267, 274 (1978)). Courts also apply the internal consistency test in examining prong three, discrimination against interstate commerce.

As applied to RAC West in this case, the tax at issue fails the Complete Auto test as it 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 tests because it does not actually reflect a reasonable sense of how income is generated by RAC West. Finally, the formula applied by SCDOR is not fairly related to the services provided by South Carolina which are *de minimus* or non-existent in this case.

ORDER

Based on the foregoing, I find the following:

1. SCDOR has failed to establish either (a) that RAC West's single-factor apportionment formula is not a fair reflection of its business activities in this State, or (b) that SCDOR's proposed alternative separate accounting method is reasonable; therefore, the assessment must be dismissed.

2. The penalties imposed by SCDOR are not reasonable under the facts of this case and, therefore, must be dismissed.

3. The imposition of an alternative method in this case would violate RAC West's constitutional rights.

IT IS THEREFORE ORDERED THAT PETITIONER'S REQUESTED RELIEF IS GRANTED.

AND IT IS SO ORDERED.

_____, 2011
Columbia, South Carolina

The Honorable Ralph King Anderson, III

**Transcript of the Testimony of
RAC V. SCDOR - DAY ONE**

Date: August 10, 2011

**CREEL COURT REPORTING, INC.
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1 STATE OF SOUTH CAROLINA
 2 ADMINISTRATIVE LAW COURT
 3 Rent-A-Center West, Inc.,) Docket No.:
 4 Petitioner,) 09-ALJ-17-0204-CC
 5 v.)
 6 South Carolina Department of)
 7 Revenue,)
 8 Respondent.)
 9 Rent-A-Center Texas, L.P.,) Docket No.:
 10 Petitioner,) 09-ALJ-17-0206-CC
 11 v.)
 12 South Carolina Department of)
 13 Revenue,)
 14 Respondent.)

DAY ONE OF TWO

ADMINISTRATIVE HEARING

Wednesday, August 10, 2011
9:59 a.m. - 6:18 p.m.

The hearing before the Honorable Ralph K. Anderson, III, was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 10th day of August, 2011 before Andrea R. Taylor, Court Reporter and Notary Public in and for the State of South Carolina.

EXHIBITS

1
 2
 3 Petitioner's Exhibit Number One. 79
 4 (Notebook containing Joint Trial Exhibits)
 5
 6 (The original exhibits were retained by the Court.)
 7
 8

STIPULATIONS

9
 10
 11 It is stipulated and agreed that this hearing
 12 is being taken pursuant to the rules of the
 13 Administrative Law Judge Division and the South
 14 Carolina Rules of Civil Procedure.

APPEARANCES:

1
 2 John C. von Lehe, Jr., Esquire
 3 Bryson M. Geer, Esquire
 4 NELSON, MULLINS, RILEY & SCARBOROUGH, LLP
 5 Liberty Center, 6th Floor
 6 151 Meeting Street
 7 Charleston, South Carolina 29401-2239
 8 Attorneys for the Petitioners
 9
 10 Sean G. Ryan, Esquire
 11 Office of General Counsel for Litigation
 12 SOUTH CAROLINA DEPARTMENT OF REVENUE
 13 301 Gervais Street
 14 Columbia, South Carolina 29201
 15 Attorney for the Respondent

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 31

1 THE COURT: All right. This is the hearing in the
 2 matter of Rent-A-Center West, Inc. vs. South
 3 Carolina Department of Revenue and Rent-A-
 4 Center Texas, L.P. vs. South Carolina
 5 Department of Revenue. Docket Numbers are --
 6 or somebody wrote on my caption civil action
 7 number. Who would write that? Oh, well. The
 8 document number is 09-ALJ-17-0204-CC, and the
 9 other one is the same except it's 0206. All
 10 right. I've got -- let's see Petitioner's
 11 trial brief, but I've also got a Motion in
 12 Limine. Is that one of the issues that the
 13 parties want to bring up before we proceed?
 14 MR. RYAN: Yes, Your Honor. But before we proceed,
 15 the Petitioners have asked an opportunity to
 16 introduce their clients to the Court.
 17 THE COURT: Okay.
 18 MR. VON LEHE: If we may, Your Honor. Your Honor,
 19 it's good to see you again. I'm John von Lehe.
 20 This is Bryson Geer, my partner. And we'll be
 21 arguing the case before Your Honor. I would
 22 also like to take this opportunity to introduce
 23 you to our clients who are here today with us.
 24 Mr. Rick Cordone, if you would please stand up.
 25 They're all executives, I'll say, with the

1 taxpayer. Dawn Wolverton, Mr. Hugh Tollack.
 2 MR. TOLLACK: Hello, Your Honor.
 3 MR. VON LEHE: And then right in the back this is
 4 John Wells, who is a Ph.D.. He's a witness.
 5 This is Dr. Ron Wilder, who is a Ph.D.
 6 economist. He's a witness. And this is
 7 Professor Rick Pomp who's a proposed witness.
 8 He's a professor at the University of
 9 Connecticut School of Law.
 10 THE COURT: All right.
 11 MR. VON LEHE: Thank you, Your Honor.
 12 THE COURT: With that said.
 13 MR. RYAN: Your Honor, the Department has moved to
 14 exclude Professor Pomp for some simple reasons,
 15 and that is just the unfairness of it all. To
 16 give you some background. This matter started
 17 in 2009. The Department served discovery in
 18 2009 asking for any expert. This matter
 19 proceeded, as you know, for several years,
 20 throughout which in 2010, the Department
 21 notified petitioner's then counsel that it
 22 would be using Dr. Glenn Harrison as an expert.
 23 Petitioner's counsel stated they wouldn't be
 24 using an expert. As their documents show, they
 25 didn't use an expert until we come all the way

1 the whole time.
 2 MR. VON LEHE: Your Honor, if I may, I will be glad
 3 to explain at least -
 4 THE COURT: Yeah. I want to hear that so I'll know
 5 whether to hear you -
 6 MR. VON LEHE: -- those particular facts. As you
 7 know, the case does have a long history in the
 8 court.
 9 THE COURT: Yes, sir.
 10 MR. VON LEHE: And we're delighted to be here today
 11 trying it. But back in 2009 -
 12 THE COURT: And just so you'll understand, I want to
 13 hear from you on this so I'll understand my
 14 position on a continuance down the road.
 15 MR. VON LEHE: Yes, Your Honor. But I think that,
 16 you know, I believe that both of us want to go
 17 forward with the case today. But be that as it
 18 may, I know we do. But back in 2009, Rent-A-
 19 Center brought this action, they -- at that
 20 time they had Morrison and Foerster as their
 21 lawyers.
 22 THE COURT: Who is the attorney that was admitted
 23 pro hac vice so I'll understand that?
 24 MR. VON LEHE: His name was Michael --
 25 MS. GEER: Jesse Miller.

1 up until May of this year when we had our
 2 scheduling conference with Your Honor for yet
 3 another continuance, and you made quite clear
 4 there would be no more continuance, in fact, we
 5 would try it on a Saturday if we needed to to
 6 go forward.
 7 THE COURT: Well, just the thing about that is, and
 8 just to let you know the path to where you may
 9 be headed as far as a continuance is, Rent-A-
 10 Center, you know, they told me that the reason
 11 they needed the case continued was because the
 12 attorney admitted pro hac vice needed time to
 13 prepare. I feel somewhat like I was
 14 manipulated by the petitioners in that -- and
 15 I don't know all of the facts, so I would have
 16 to find that out later. Or not to say -- I
 17 can't say I was manipulated. I could have
 18 potentially been manipulated because I
 19 continued the case solely based on an
 20 assertion that the attorney needs time to
 21 prepare the case, and within just a matter of
 22 weeks, it was a couple of weeks I get a motion
 23 to be relieved as counsel, and all the sudden,
 24 you know, that counsel is out and Nelson
 25 Mullins is back in, and Nelson Mullins was in

1 MR. VON LEHE: Huh?
 2 MS. GEER: Jesse Miller.
 3 MR. VON LEHE: Jesse Miller was yes, at the end. So
 4 it's been a bit of a domino effect here. But
 5 anyhow, and we're -- quite frankly we're glad
 6 to be last the domino in that chain --
 7 THE COURT: Well, they've got good attorneys now, I
 8 know that.
 9 MR. VON LEHE: But we just got the case. We just
 10 got the case in either late May or June. But
 11 we're delighted to have the case.
 12 THE COURT: Okay.
 13 MR. VON LEHE: But it went like this. Yes, we were
 14 involved, but we were involved as local counsel
 15 only.
 16 THE COURT: Yeah.
 17 MR. VON LEHE: So Morrison and Foerster, probably
 18 the leading state and local tax firm in the
 19 country -- they're not here to hear this, but
 20 probably they are -- they had the case. And at
 21 that time, they had one of their partners up
 22 there named Michael McLaughlin, was the head
 23 lawyer on the case. And they filed, they
 24 prepared all the documents and we filed them
 25 for them back in 2009. Then as time went on,

1 of course, we were so called second seed on the
 2 case during those years. I filed what they
 3 sent me to file, advised on what I was asked to
 4 advise on, but it was a very limited role. But
 5 then what happened was Michael McLaughlin, he
 6 changed law firms and went over to another
 7 major firm by the name of Reed and -
 8 MS. GEER: Actually Mike is the one that went to
 9 Verizon.
 10 MR. VON LEHE: He did eventually, but first he went
 11 over to Reed and Smith.
 12 MS. GEER: Oh, that's right.
 13 MR. VON LEHE: Okay. Went over to a law firm called
 14 Reed and Smith in New York City; he took the
 15 case with him. And then very recently, like in
 16 2011, I don't know the date on this, Michael
 17 got a chance to leave the practice of law and
 18 take a job with Verizon in their tax
 19 department. He did that. When he did that,
 20 one of the other lawyers there at Reed and
 21 Smith, Jesse Miller because the lawyer for a
 22 brief period of time. So the clients, I guess
 23 assessing all of this and Mr. Miller's on the
 24 West coast, so they - the clients assessing
 25 all of this said well, you know, we really

1 matters rather than formal pleadings or letters
 2 because it was just simpler to pick up the
 3 phone and say this is what we're going to do.
 4 In April he not - April 2011, he notified me
 5 that he would leaving Reed Smith, and said,
 6 Sean, I know we discussed experts. Send me an
 7 email that says what expert you have so we can
 8 cover your butt in case this becomes an issue
 9 down the line with the lawyers. So I sent that
 10 email. I have an April 11th email saying we're
 11 using Glenn Harrison and this is what he's
 12 going to testify to. That was all before Jesse
 13 Smith - or Jesse Miller came into this matter.
 14 Before petitioner's counsel, current counsel
 15 came onto the matter. And then we go forward.
 16 We have our conference with you and we learn
 17 that we're definitely going forward in August.
 18 We move forward from that May conference to
 19 June 13th when I get an email from counsel
 20 saying, you know, we're a little late in the
 21 game, we're getting - we're going to add these
 22 three witness, all of which are experts, no
 23 designation as to what they're going to testify
 24 to, and do you want to me get dates. I asked
 25 responded with yes, can you get me dates as

1 don't have any continuity of lawyers here. And
 2 I don't know that they knew Jesse Miller. They
 3 probably did not. Glad to fill that in if
 4 necessary. And, you know, they called me up,
 5 and they said, you know, how would you feel
 6 about handling the case? I said I'd be
 7 delighted. And that was either in late May or
 8 June. And that's when we became the counsel
 9 for the case. And Mr. Miller did - we did
 10 file a pro hac vice for him -
 11 THE COURT: Yeah, I understand. I'm just thinking
 12 through this.
 13 MR. VON LEHE: - For them. They say, well, you
 14 know, we want - we want you to handle this.
 15 Fine. So we told Jesse that the clients had
 16 asked us to handle it. Or they told Jesse that
 17 they wanted us to handle it and we exchanged
 18 goodbyes, and that was it.
 19 THE COURT: Okay.
 20 MR. VON LEHE: That's how we got here.
 21 THE COURT: All right.
 22 MR. RYAN: As your Honor - as this matter is going
 23 along, I had a wonderful relationship with Mike
 24 McLaughlin who they just spoke of. Mike and I
 25 often would exchange telephone conversations on

1 soon as possible. We get dates.
 2 Unfortunately, the only date that they can make
 3 Professor Pomp available is July 28th, less
 4 than two weeks before trial. And then as we're
 5 still going along, we get in the middle, about
 6 the middle of July, we get amended returns from
 7 the taxpayer changing their whole theory of
 8 half of this case. Despite all this, the
 9 Department's given its best efforts to address
 10 these amended returns, to address all these
 11 experts they've named. We now get up to July
 12 26th, two weeks before trial. And they saw,
 13 Sean, Professor Pomp is going to be issuing
 14 some reports. I know you're supposed to depose
 15 him in two days. If we get the - you know,
 16 we're going to try and get you the reports
 17 before the deposition. You want to move the
 18 deposition? I said, I'm going to need to see
 19 those reports before I can depose him. I get
 20 the reports the night of the 28th. Again,
 21 we're now within two weeks of today. They move
 22 - the first available deposition for him then
 23 is the 3rd of August. Last week. During that
 24 deposition, I asked Professor Pomp, do you have
 25 any articles that discuss what you're going to

1 -- you know, that are relevant to what you're
 2 going to testify to. He chuckles because he's
 3 a very well published man in the subject. And
 4 he says, well, let's start with the textbook,
 5 which is several hundred pages. He then
 6 proceeds to list over a dozen articles, some of
 7 which are in Japanese, some of which are in
 8 German. Now, petitioners think, or at least
 9 their response is I've now had ample time to
 10 review that report and the materials he's
 11 relied on. Apparently counsel must have a much
 12 better reading ability than I do to read all
 13 those materials and know languages that I don't
 14 know. The Department asked for these experts
 15 years ago. They waited until June to let me
 16 know who he is; July to let me know what his
 17 opinions are going to be. There's no way I
 18 could address all those matters. There's no --
 19 and in time to, (a) go through everything that
 20 he's going to opine about and research whether
 21 that's consistent with what he's said in the
 22 past, with what the law says, or locate an
 23 expert to address it, bring that expert up to
 24 speed, bring that -- have that expert deposed
 25 and bring him here today. It's just not

1 parties can then brief the Court. If they want
 2 to use Professor Pomp in their brief, they can.
 3 That way we both have equal footing; we're both
 4 addressing the exact same thing and no one is
 5 giving a legal conclusion. And if it is, it's
 6 a brief and that's okay rather than testimony
 7 here. Because in addition to the the prejudice
 8 --
 9 THE COURT: He doesn't testify and his report
 10 doesn't come in, but he's only allowed to --
 11 because when you say a brief, I mean that would
 12 be assisting with the brief.
 13 MR. RYAN: He can assist with the Brief.
 14 THE COURT: All right. Well, he can do that now,
 15 couldn't he?
 16 MR. RYAN: I mean, if they wanted to use him, yes.
 17 THE COURT: I mean they could associate him right
 18 now as far as that's concerned.
 19 MR. RYAN: Correct. I think it's just -- Your Honor,
 20 it's a fair way to put both of us on equal
 21 footing and go forward today. And it also
 22 addresses the second half of my motion, which
 23 is I believe Professor Pomp is going to testify
 24 to legal conclusions. He's here to testify
 25 regarding what South -- how South Carolina law

1 possible. I mean, there's no reason for this
 2 delay other than they've changed lawyers
 3 repeatedly, and now at the last minute with a
 4 local firm, a very competent local firm,
 5 they've changed the strategy and now want to
 6 use experts. That prejudices the Department
 7 for no reason for this -- I mean, this matter
 8 has gone on for long enough. I'm not here,
 9 Your Honor, asking for a continuance. I'd ask
 10 for --
 11 THE COURT: Well, I've got to address the issue of
 12 prejudice. So you're arguing that you're
 13 prejudiced.
 14 MR. RYAN: I am.
 15 THE COURT: All right.
 16 MR. RYAN: I have a proposal if you would, Your
 17 Honor.
 18 THE COURT: Yeah, I'd like to hear that.
 19 MR. RYAN: Rather than simply exclude Professor
 20 Pomp, I would propose, and I think this is very
 21 fair, that Professor Pomp doesn't testify and
 22 his reports don't come in, but if when you're
 23 ruling on this matter, if you want tax policy
 24 guidance on an issue, you notify the parties as
 25 to what issue you want to address, then both

1 should be read and how it should be applied and
 2 the intent behind it. Those are all clearly
 3 legal conclusions.
 4 THE COURT: All right.
 5 MR. RYAN: We're not here talking about --
 6 THE COURT: Pretty well tell you, I don't want to
 7 prejudge myself on a ruling, but if he's going
 8 to testify to the intent behind South Carolina
 9 law, especially that one is going to be tough
 10 road to hoe. But I'll have to hear how it came
 11 down. But legislative intent and then he's
 12 going to testify to the intent, that would be
 13 interesting. But go ahead.
 14 MR. RYAN: As I was saying, Your Honor, he is -- I
 15 mean, all he can provide in this matter is
 16 legal conclusions. This isn't a matter about
 17 how do other states do things. This isn't a
 18 matter about an interaction between, say,
 19 federal law and state law. We would need a tax
 20 expert to help us understand those differences.
 21 He's here to tell us this is how -- what the
 22 South Carolina law meant; this is how it's
 23 supposed to be read; this is what if what the
 24 petitioners did was appropriate and whether the
 25 respondent did was appropriate. All of those

1 are legal conclusions.
 2 THE COURT: All right.
 3 MR. RYAN: Thank you.
 4 THE COURT: Okay. Mr. von Lehe.
 5 MR. VON LEHE: Your Honor, I would defer to my
 6 partner.
 7 MS. GEER: Bryson Geer, Nelson Mullins. All right.
 8 So I want to address the -- there's two basic
 9 grounds that we heard. One is the delay and
 10 that that leads to prejudice, and the other one
 11 is the legal conclusions. So I'll address them
 12 in turn. On the first one, you know, the
 13 bottom line is, as you've heard from the time
 14 line, and actually, this part is in our brief
 15 and I don't think Mr. Ryan discussed it so
 16 maybe he's not an issue anymore, but the
 17 initial allegation --
 18 THE COURT: When you say the brief, you mean your --
 19 MS. GEER: I'm sorry, our response.
 20 THE COURT: Response, yeah.
 21 MS. GEER: Yeah.
 22 THE COURT: And I read that.
 23 MS. GEER: The initial accusation about delay was
 24 based on a conversation that Craig Fields, who
 25 was also former counsel in this matter, had

1 holding off on depositions; no one is taking
 2 depositions of any witnesses, fact or expert,
 3 at that time. Once we had the continuance
 4 hearing, and my recollection, which could be
 5 off, I thought that -- because I just got into
 6 the case right on the eve of that hearing, that
 7 Mr. Ryan needed a continuance because of a
 8 hearing that was coming up in front of the
 9 Supreme Court and Mr. Ryan didn't object to it
 10 and said to Your Honor when you were asking
 11 couldn't we just push this -- schedule it, I
 12 think you suggested scheduling it and then if
 13 it ends up at your schedule we would move it.
 14 And at that point, I think Mr. Miller said,
 15 well, it would be better for me as well because
 16 I'm just getting involved due to the departure
 17 of my partner.
 18 THE COURT: Yeah.
 19 MS. GEER: So I don't think he was --
 20 THE COURT: I think I -- the continuance, you were
 21 correct on your version except for the length
 22 of the continuance was --
 23 MS. GEER: That may be correct.
 24 THE COURT: Was due to bringing him up to speed.
 25 MS. GEER: I think that is correct, Your Honor. All

1 with Professor Pomp back in 2009. He
 2 apparently had a very general conversation with
 3 him at the beginning of the case and referenced
 4 that in his deposition. And so the Department
 5 thought that we had sat on Professor Pomp since
 6 the beginning of the case.
 7 THE COURT: Okay. Let's just move on from that.
 8 MS. GEER: All right.
 9 THE COURT: That's not a --
 10 MS. GEER: All right. So --
 11 THE COURT: Because I recognize that.
 12 MS. GEER: Right. And as I understand it from prior
 13 counsel, up until this May time when the
 14 continuance was requested, both parties were
 15 seeking to settle the case versus spending time
 16 and money on discovery. So they did the
 17 initial written discovery, but they held off on
 18 depositions. I don't know -- I know Mr. Ryan
 19 said that he identified Dr. Harrison in April.
 20 I'm not sure how much earlier he had a
 21 telephone conversation. Mr. McLaughlin's
 22 recollection is that it was not much earlier.
 23 But in any event, there was a written
 24 disclosure in April. So some month or two
 25 before we named experts. And so everyone is

1 right. So and then Mr. von Lehe has already
 2 covered the reasons for the shifts in counsel.
 3 But as soon as we got involved, we had
 4 discussions with the client, as are set forth
 5 in the affidavit of Mr. Tollack, about
 6 identifying witnesses. And I let him know
 7 within two days. I think Professor Pomp was
 8 retained on a Saturday and I think I advised
 9 him in an email on Monday that we were naming
 10 Professor Pomp, as well as --
 11 THE COURT: Well --
 12 MS. GEER: I'm sorry.
 13 THE COURT: I don't want to cut you off.
 14 MS. GEER: No, please.
 15 THE COURT: I think I can cut the to the chase on
 16 some of this. Certainly when you became
 17 involved you could select whatever expert
 18 witnesses you want.
 19 MS. GEER: Right.
 20 THE COURT: I have no problem with that.
 21 MS. GEER: Okay.
 22 THE COURT: I have -- the only issue that I need to
 23 come to a better understanding on, or at least
 24 resolve as far as the prejudice is concerned,
 25 is that at a certain point in time --

1 MS. GEER: Yes.
 2 THE COURT: -- the documents upon which Mr., or
 3 Professor Pomp. Is it Dr. Pomp? Professor
 4 Pomp? What are we going on?
 5 MS. GEER: Professor Pomp.
 6 THE COURT: Okay. Professor Pomp is relying was
 7 made known to the Department. That is what
 8 they're presenting to me as their problems.
 9 Now, especially those which aren't even in
 10 English. It would be, to me his testimony, he
 11 was deposed, so --
 12 MS. GEER: Yes.
 13 THE COURT: -- that which he was deposed about could
 14 come into evidence. But if he seeks to --
 15 well, on one hand, if he seeks to rely upon
 16 anything that they were not able to obtain,
 17 they would be prejudiced. But then I think the
 18 further argument they're going to make is that
 19 they can't test his theory without obtaining
 20 the -- or being able to have a thorough review
 21 of that which he's relied upon and to have --
 22 to get an expert to review that which he relied
 23 upon to determine whether or not that theory is
 24 properly supported. So what sayeth you about
 25 that?

1 views things mean and then look at the South
 2 Carolina law and interpret it yourself. As to
 3 Professor Pomp, he would tell you the tax
 4 policy rationales behind the two views and why,
 5 you know, what the rationale behind one view
 6 might be versus the other. So it's just
 7 another perspective of behind the different tax
 8 statutes, and in cases at issue is what's going
 9 on, what could be going on behind these two
 10 views. And then Your Honor looks to see which
 11 view South Carolina follows.
 12 THE COURT: All right. Can I stop you there?
 13 MS. GEER: Yes.
 14 THE COURT: She's presenting two views or two areas
 15 of view of which Professor Pomp will be
 16 testifying to. Were you able to depose him
 17 regarding those views?
 18 MR. RYAN: Yes, I was able to depose him regarding
 19 those views. I was not able to review the
 20 materials which he bases the -- which he's
 21 published about those views. Nor was I able to
 22 recall an expert that might have -- have a
 23 different explanation of these same tax
 24 policies.
 25 THE COURT: All right.

1 MS. GEER: Well, that issue, Your Honor, I have a
 2 couple of thoughts to add to that. One is
 3 Professor Pomp, as we've discussed, is a
 4 renowned expert in this field of tax policy.
 5 And in fact, he's been used by the Department
 6 on a couple of occasions.
 7 THE COURT: I know.
 8 MS. GEER: And so I don't think that his -- you
 9 know, the nature of his testimony, and I'll go
 10 ahead and say here that it's not what the
 11 Department says. He's not trying to interpret
 12 South Carolina, or to say what the
 13 legislature's intent was in enacting it.
 14 THE COURT: Well, that one was the more fun issue.
 15 MS. GEER: Yeah, it would be interesting. But what
 16 his testimony is is as to tax policy, and it's
 17 similar to what their expert, Dr. Harrison, is
 18 doing from an economic point of view is to look
 19 at what are the rationales behind the different
 20 views you could have. For example, on a
 21 sourcing issue. You've got two different views
 22 of where to source income to. What are those
 23 two views and what is the -- for Dr. Harrison,
 24 what's the economic rationale behind those two
 25 views so that the Court can understand what

1 MS. GEER: All right. And so I would also point out
 2 that we were in a similar position -- I mean
 3 the way the attorneys by agreement early on in
 4 the case apparently worked was to try to work
 5 together on these things. Dr. Harrison did not
 6 provide a list to us of what he would be
 7 testifying about. He provided no opinion to
 8 us. He provided nothing to us ahead of the
 9 deposition as to what he would be talking about
 10 and what he based his opinions on. And he also
 11 was only available for -- I think he had two
 12 days, July 13th and 14th, if I remembered
 13 correctly. And we deposed him on the 14th.
 14 So, you know, at that deposition, we too got
 15 for the first time the opinions, what he based
 16 it on and all of that. So I mean, I think the
 17 relationship of counsel in this matter is
 18 important. And that's how the parties worked
 19 together to do things. And neither party has
 20 -- I mean, I guess there's a -- a two week
 21 differential in there.
 22 MR. RYAN: If I may, Your Honor, there's a --
 23 THE COURT: Well, are you through?
 24 MS. GEER: Not with my whole argument. I don't know
 25 if you want to hear specifically on that point.

1 THE COURT: Well, do you mind him -- I interrupted a
 2 while ago. I'll let him respond and then I'll
 3 let you --
 4 MS. GEER: Okay.
 5 MR. RYAN: There's an important distinction here, and
 6 that is, in August 2010, a year ago, Department
 7 notified them of Dr. Glenn Harrison. Again in
 8 April of 2011, we notified them of Dr. Glenn
 9 Harrison. At any point they could have noticed
 10 his deposition or asked for dates. They waited
 11 until June to ask for dates, and they specified
 12 we want dates in July. So they're late in
 13 deposing Dr. Harrison because they waited to
 14 ask for depositions of Dr. Harrison until July.
 15 I couldn't depose Professor Pomp until I did
 16 because that was the first available date
 17 through this entire matter that they've given.
 18 And I asked for it as soon as I heard about
 19 him. There's a big difference between the two.
 20 MS. GEER: Your Honor, one point that Professor Pomp
 21 has passed up to me is that he has a widely
 22 used casebook. He's views are well known on
 23 this. The Department would be aware of them
 24 from the other cases that they have used him
 25 for, and that he's not relying on anything in

1 at this point?
 2 THE COURT: Yes, sir. Yeah, I want to thoroughly --
 3 on one hand, I don't want to drag this out. On
 4 the other hand I want to make the proper
 5 decision on this issue because it's important.
 6 MR. VON LEHE: Well, Your Honor, I think it's -- I
 7 think it's come down, not prejudging anything,
 8 but I think it's come down to the materials
 9 that Professor Pomp might rely upon.
 10 THE COURT: And that for which --
 11 MR. VON LEHE: And that for --
 12 THE COURT: -- he would even have access to to
 13 determine whether or not they would question
 14 him.
 15 MR. VON LEHE: He has, of course, written. His
 16 casebook has been translated into a number of
 17 different languages. I'm assuming they have
 18 his casebook. I don't know that, but if they
 19 didn't, it's readily available. I don't know
 20 what other articles that he might be relying
 21 upon that they would impeach him from. If we
 22 had a more -- we could get a more narrow view
 23 of this from Professor Pomp in asking him to
 24 take the stand now and found out what he's
 25 going to be relying upon. I think it -- that's

1 a foreign language. And in fact, one
 2 suggestion we could make is that we would limit
 3 the materials that he is relying on in giving
 4 his opinions.
 5 THE COURT: Well, now when you say you're going to
 6 limit that, you would have to say that not only
 7 is his opinion limited on that, I would have to
 8 have -- to completely be assured on that
 9 ruling, I would have to have verification that
 10 none of those materials could potentially be
 11 impeaching. And I would have -- I'd have to
 12 rely of Dr. Pomp's assertion that none of
 13 those materials could potentially impeach that
 14 which he's testifying to, which would be
 15 relying on someone who is subject to the
 16 impeachment to verify that they will not
 17 impeached. Do you see my point?
 18 MS. GEER: Yes, Your Honor. I mean, we'd be happy
 19 to allow the Department to respond following
 20 the hearing on anything or to bring him back if
 21 necessary.
 22 THE COURT: Yeah. Well, if I'm going to go there,
 23 I'm going to continue the case. That's why I'm
 24 trying to decide what to do on --
 25 MR. VON LEHE: Your Honor, may I just add something

1 just a -- and if he's not relying upon it,
 2 then I fail to see that they would be
 3 prejudiced by that.
 4 THE COURT: Okay.
 5 MR. RYAN: Two things, Your Honor. This isn't
 6 coming down to just what he's relying upon.
 7 This is coming down to the Department doesn't
 8 have an opportunity to call a witness or an
 9 expert, utilize an expert on it to go against
 10 what Professor Pomp is going to say. It's not
 11 just about his materials. And eliminating what
 12 he's relying on doesn't -- isn't the issue, the
 13 whole issue. Part of the issue is we need to
 14 know what he said and if he's been consistent.
 15 And that requires, we would have to go through
 16 the materials. He said these --
 17 THE COURT: Is this an issue -- because the
 18 Department has used him in the past. Is this
 19 an issue for which the Department has not
 20 utilized him or is not familiar with his
 21 testimony?
 22 MR. RYAN: The straight answer would be I do not
 23 know, Your Honor. When he was used it was in
 24 2005, I believe.
 25 THE COURT: Okay.

1 MR. RYAN: It was involved -- he was used by an
 2 attorney who is no longer with the Department,
 3 Malane Pike. I know you know Malane. So I
 4 couldn't -- and I don't -- I can't confer with
 5 her. I don't know what that subject of that
 6 case was. Any knowledge that she might have,
 7 I do not have about what he might or might not
 8 testify to.
 9 THE COURT: Okay.
 10 MR. RYAN: But I mean, we should have the right or
 11 the -- if they're going to -- we should have
 12 had the chance, Your Honor, to know what he's
 13 going to say and have called experts and say,
 14 hey, can you address this? Can you come in and
 15 be our witness. But because they've done it so
 16 late, we couldn't do that. And again, I don't
 17 want a continuance.
 18 THE COURT: Where I can be clear -- where I can be
 19 clear. At what point were you put on notice of
 20 his report as to the fact or the issues that he
 21 thought were the pertinent issues in this case?
 22 Because you're referencing his deposition. But
 23 what your more salient point appears to me at
 24 this point in time is that he's raised certain
 25 issues that you believe you should have the

1 THE COURT: That's true on both sides.
 2 MR. VON LEHE: That could be --
 3 THE COURT: I get to hear from their biased view and
 4 your biased view and I try to make a decision.
 5 MR. VON LEHE: It is our judgment that when we
 6 noticed Professor Pomp that he was going to be
 7 a witness for us, that's when they knew that we
 8 were going to have A tax policy witness.
 9 THE COURT: Yeah. I --
 10 MR. VON LEHE: And that's when they, if they wanted
 11 one, had ample time to locate one, or
 12 alternatively object --
 13 THE COURT: Well, I guess with that -- I'm sorry.
 14 MR. VON LEHE: Or alternatively object to Professor
 15 Pomp.
 16 THE COURT: At that point in time.
 17 MR. VON LEHE: If they had objected to Professor
 18 Pomp, made this motion then instead of last
 19 Friday, which the motion -- this Motion in
 20 Limine was made on Friday, or made on Saturday.
 21 THE COURT: Yeah. I noticed that was in your Motion
 22 in Limine, or your response.
 23 MR. VON LEHE: I had some conversations over the
 24 weekend with the Professor, by the way, since
 25 that motion was made, but on Saturday and

1 right to challenge, correct?
 2 MR. RYAN: Correct.
 3 THE COURT: And at what point were you aware of
 4 those issues?
 5 MR. RYAN: The night of July 28th.
 6 THE COURT: So you've had how many days?
 7 MR. RYAN: Less than two weeks. That was a Thursday
 8 night.
 9 MR. VON LEHE: And Your Honor, we'd like to add that
 10 the deposition took place after they had his
 11 report in hand.
 12 THE COURT: All right. Well, actually, July 28th is
 13 I think best case scenario for you anyway
 14 because that's -- and I'm backing up to that
 15 point in time as to not just you're aware of
 16 the issue. So at that point in time -- when
 17 I say you, the Department is aware of those
 18 issues. So at that point in time is when they
 19 should start, or have the ability to start
 20 addressing whether or not they need to respond
 21 to those issues and conduct a deposition
 22 afterwards.
 23 MR. VON LEHE: Your Honor, it is my judgment, and I
 24 realize mine is biased. But it is my judgment
 25 that --

1 Sunday. But if they wanted to object to him,
 2 that should have been done when we noticed him.
 3 Then they should have said wait, we don't have
 4 time to -- we're going to make a Motion in
 5 Limine. We're going to move to exclude this
 6 because we don't have time to do it. We can't
 7 find -- they made no effort to find another
 8 expert, to the best of my knowledge. If they
 9 have, they haven't alleged it. So they just
 10 said well, you know, we just -- we will just go
 11 ahead with the kinks. And then on Friday, they
 12 decided well, we want to exclude him.
 13 THE COURT: Okay. Mr. Ryan, I've had to adjust to
 14 the simple side of things. My background was
 15 a prosecutor for the Attorney General's Office
 16 and I didn't have all this time to prepare for
 17 cases. I got a murder case on Tuesday and you
 18 tried it on Thursday. But I understand the
 19 discovery aspects in civil law, obviously,
 20 after 15 years. But the event -- or the time
 21 frame appears to me is on July 28th. At that
 22 point in time, do you see the issues that were
 23 developing before you, and upon reviewing those
 24 issues, determine whether or not at that point
 25 you needed to seek an expert to (a) respond or

1 (b) review Professor Pomp. (A) and (b). There
 2 may be a (c) or (d), but I'll leave it at that
 3 right now. But why could you not in the two
 4 proceeding weeks have sought to obtain an
 5 expert?
 6 MR. RYAN: Frankly, I don't know if that would be
 7 enough time for me to locate an expert and
 8 bring them up to speed and bring them here,
 9 Your Honor. And I'm sure if I had, I'd have
 10 the other side screaming at me that you can't
 11 do this this late in the game. Going back to
 12 what they said that he -- in June when they
 13 told me about Professor Pomp, they didn't tell
 14 me that he was a tax policy expert. And the
 15 man's expertise is broad, to say the least,
 16 because he's very well published on every area.
 17 I shouldn't have to guess as to what areas and
 18 then try and guess as to what expert I should
 19 bring forward. This is defeating the whole
 20 purpose of discovery which we conducted in
 21 2009. I mean, the reason we serve discovery is
 22 so we don't have these problems. But I don't
 23 think, Your Honor, from the 28th until now
 24 would have ever been enough time for me to
 25 locate, bring an expert up to speed, get them

1 THE COURT: Okay.
 2 MS. GEER: I just had one point. The cases that we
 3 cite in our response on whether prejudice is
 4 required and basically, or examining whether a
 5 late named expert witness is prejudicial to a
 6 party and should be excluded, and they all look
 7 at the prejudice. And they basically say look
 8 also at the intent of the party and if there
 9 was a wilful intent in delaying. And if there
 10 was not a wilful intent --
 11 THE COURT: Well, now the wilful intent is --
 12 examination is lower in the area of when the --
 13 when is it excluded. And I'm not looking at
 14 that at this point in time.
 15 MS. GEER: Okay. Well on --
 16 THE COURT: Because I'm either going to let him go
 17 forward or I'm going to continue this case.
 18 MS. GEER: Right.
 19 THE COURT: Reluctantly, y'all may not want it. I
 20 can tell you the judge doesn't want. But I
 21 don't see the mandate for this case to go
 22 forward under the circumstances, that's the way
 23 to resolve the prejudice. If you look at some
 24 of the case law, and I haven't examined it in
 25 this case.

1 here. It just wouldn't be possible, nor was it
 2 necessary with the facts in this case.
 3 THE COURT: Okay.
 4 MR. VON LEHE: I was just going to say as to what
 5 Professor Pomp is going to be testifying about,
 6 which is tax policy as it turns out. He's not
 7 here to testify about South Carolina law. But
 8 the Department is well aware of Professor Pomp
 9 and what he testifies about, that it is tax
 10 policy and I think they, that if they didn't
 11 know definitely, they had a mighty good idea.
 12 THE COURT: Well, at this point I have dualing
 13 opinions as to their knowledge as to what he
 14 would testify to. They're making one
 15 assertion, you're making another.
 16 MR. RYAN: This brings me back to my proposal, Your
 17 Honor. I think I addressed this fairly --
 18 THE COURT: Your proposal -- I'll ask them, but your
 19 proposal is a win win for the Department and a
 20 lose lose for them for them, I think.
 21 MR. VON LEHE: We would agree, Your Honor. We would
 22 like to go forward with Professor Pomp today.
 23 THE COURT: Well --
 24 MR. VON LEHE: And Ms. Geer would like to add one
 25 thing, Your Honor, if she may.

1 MS. GEER: Yes, Your Honor.
 2 THE COURT: I will hear you after I say all this
 3 because is what you have in your hand. But one
 4 of the suggestions that the court has made is
 5 -- in the past is that you allow the parties to
 6 depose -- a continuance to depose a witness.
 7 You allow them to consult with the witness.
 8 Now, in this situation it being -- and I
 9 recognize this case and I -- and I recognize
 10 case law doesn't always take into account the
 11 complexity of the matter. And if this was a
 12 simple case, I would say step outside of the
 13 room and discuss the issue. I've done that in
 14 the past. Give them an hour to consult with
 15 the witness and find out what he's going to
 16 testify to. But this is a matter of which I
 17 see at least the point to them raising it that
 18 they may wish to call a responding expert
 19 witness. And given the complexity of the
 20 matter, I think I'm either at the point of
 21 granting his testimony or continuing the case.
 22 I don't think a proper resolution would be to
 23 just exclude him.
 24 MR. VON LEHE: Your Honor, I wonder if it would be
 25 possible for this, if we could proceed with the

1 case, proceed with Professor Pomp, give him
 2 leave when the case is -- and then after the
 3 case has been tried, if they want to, to bring
 4 an expert before you and have his testimony to
 5 refute Professor Pomp's, we wouldn't have a
 6 problem with that, Your Honor.
 7 THE COURT: That's not a bad --
 8 MR. VON LEHE: If they want to do that.
 9 THE COURT: What do you think about that?
 10 MR. RYAN: I'll accept that, Your Honor.
 11 THE COURT: All right.
 12 MR. VON LEHE: Thank you, Your Honor.
 13 THE COURT: Well, with that said, then we can move
 14 forward.
 15 MR. VON LEHE: Thank you, Your Honor. Your Honor,
 16 then if it please the court, we'll proceed with
 17 the case.
 18 THE COURT: Yes.
 19 OPENING STATEMENT - BY MR. VON LEHE:
 20 MR. VON LEHE: Your Honor, this is a corporate
 21 income tax case. It involves two taxpayers,
 22 Rent-A-Center Texas and Rent-A-Center West.
 23 Rent-A-Center Texas and Rent-A-Center West. In
 24 the trial notebook and manual we have this
 25 exhibit that we'd like to put up for the

1 assessments, and certainly it would be
 2 conceivable you could hold one way on one case
 3 and one way on another. So the two cases are
 4 separate, but for purposes of trying to,
 5 instead of having to go back through two cases
 6 where a whole lot of the testimony is going to
 7 be the same, we agreed with the Department of
 8 Revenue, or they agreed with us, I think we
 9 asked that they be consolidated before you. So
 10 that's been done. The two taxpayers, their
 11 names have been abbreviated and most of what
 12 they are now called, instead of Rent-A-Center
 13 Texas and Rent-A-Center West, we call them RAC
 14 Texas and RAC West. And then the Rent-A-Center
 15 East entity, which is their common parent, we
 16 refer to it throughout most of the arguments as
 17 RAC East. These taxpayers, they operate, each
 18 of them operates a rent to own business where
 19 commonly one who, perhaps for whatever reasons,
 20 but certainly sometimes they can't -- they
 21 don't have good enough credit to go out and buy
 22 something that won't be financed, they can go
 23 to Rent-A-Center and rent it, like television
 24 sets, etcetera. And if they make all their
 25 payments, eventually they will own the

1 purpose of taking a look at it.
 2 MS. GEER: If it's okay, Your Honor, can I put it
 3 on the easel?
 4 MR. VON LEHE: We're going to put it on the easel.
 5 THE COURT: You've got two options. You can do that
 6 or if you have it on a piece of paper, you can
 7 use the Elmo and put it up on the screen.
 8 MR. VON LEHE: Well, if it's all right with you, we
 9 have these made up and we'll put them up there.
 10 THE COURT: Okay.
 11 MR. VON LEHE: So --
 12 MS. GEER: I also have an extra copy if you'd like.
 13 MR. VON LEHE: Here's a copy and counsel has a copy.
 14 So there are two taxpayers involved here, Rent-
 15 A-Center West and Rent-A-Center Texas. And you
 16 see them down at the bottom of his graph.
 17 They've got a common parent, Rent-A-Center
 18 East, which is certainly going to be talked
 19 about during this case, but it's not a taxpayer
 20 in the sense of having an assessment against
 21 it. It's a taxpayer. But it is -- there's no
 22 assessment against Rent-A-Center East. So
 23 these entities, these cases rather, they've
 24 been consolidate for purposes of trial before
 25 you, but they still remain separate

1 particular appliance. But that's the nature of
 2 their business. They operate stores all over
 3 the country. RAC Texas operates stores in
 4 Texas only. RAC West operates stores in the
 5 western states, except for Texas, in the far
 6 West, for example. Their stores are in the
 7 West. And RAC East, which is not a taxpayer
 8 but still very much a part of all of this, it
 9 operates stores in the eastern United States.
 10 It's the larger of the -- of the entities. And
 11 it operates stores in South Carolina. There
 12 were, I believe, 39 of those stores during the
 13 years in controversy here. There are about
 14 3,000 store if you can add up what all the
 15 entities own across the country. RAC Texas
 16 operates, as I mentioned, the retail stores in
 17 Texas. But it also -- it also has one of its
 18 functions is to provide detailed management
 19 services for the stores throughout the country,
 20 including RAC East, which does business in
 21 South Carolina. RAC Texas, through these
 22 management services, does just about everything
 23 on a higher level except for the actual, I
 24 think someone said, turn on the lights. I'm
 25 sure there's more to it than that, but than

1 just the lower levels workings of the
 2 individual store. RAC Texas out in Texas
 3 performs all of these services. RAC West -
 4 THE COURT: So the company that RAC East owns is the
 5 one that provides the management?
 6 MR. VON LEHE: That is correct. That is correct,
 7 Your Honor.
 8 THE COURT: Kind of backwards from what is normally
 9 done, but -
 10 MR. VON LEHE: Well, RAC East is a larger company.
 11 It - but -
 12 THE COURT: Well, I mean, you've got the company
 13 that owns the - the owned company providing
 14 the management services for the parent.
 15 MR. VON LEHE: That is correct. That is correct.
 16 RAC Texas has been where it is, out in Plano,
 17 Texas, for a long, long time. Probably since
 18 the inception of all of this. And sometime
 19 back, and we'll explore that as we go along,
 20 through a reorganization this particular
 21 organization was finally adopted as the best
 22 business plan for this company. But your
 23 observation is correct. Then we - so RAC
 24 Texas operates stores in Texas and it does
 25 management services for the other RAC stores,

1 intend to prove it. And these management
 2 services, for these management services, RAC
 3 East pays a management fee to RAC Texas. The
 4 other hand with the yellow company, which in
 5 this diagram is RAC West, it operates stores in
 6 the western states, as I said. It owns
 7 intellectual property and which it licenses to
 8 RAC East, which pays it royalties for the use
 9 of that intellectual property. So this is
 10 basically the services being performed in
 11 Texas, and the payment coming from RAC East
 12 which does business in South Carolina. And the
 13 - the trademarks and trade names owned by RAC
 14 West being licensed to the company that does
 15 business in South Carolina with the royalty
 16 payment going to RAC West. We will talk about
 17 RAC Texas for a little bit and what it does.
 18 RAC Texas, unlike RAC West, RAC West filed an
 19 income tax return here. RAC Texas did not file
 20 an income tax return. And it did not file an
 21 income tax return purposefully. It wasn't done
 22 as a matter of inadvertence. It didn't file an
 23 income tax return because, in its opinion, it
 24 is not required to file a tax return in South
 25 Carolina. And it bases this on two reasons.

1 including RAC East. What about RAC West? What
 2 about the entity that has stores in the western
 3 states; what does it do? It owns and licenses
 4 intellectual property to the other entities,
 5 and particularly, RAC East, which is in South
 6 Carolina, pays its royalties. So we have RAC
 7 East in South Carolina paying royalties to RAC
 8 West. We also have RAC East in South Carolina
 9 paying a management fee to RAC Texas. And this
 10 is going to eventually be the rub of what's
 11 before you are those two payments. Your Honor,
 12 I want to show you the second demonstrative
 13 which I would to hand up. It's designed to
 14 simplify things. I'm not sure that it does.
 15 But since I drew it up, I guess they can't
 16 complain. But this shows you the stream of
 17 activities and income that occurs. And we'd
 18 like to give you a copy of it and I believe
 19 the Department has one. So here we see RAC
 20 East over on the right which is operating
 21 stores in the East and also in South Carolina,
 22 the blue one over on the right. It, in turn,
 23 is - it receives the management services from
 24 RAC Texas where the management services take
 25 place. That will be a matter of proof, but we

1 First, that the United State Constitution says
 2 that the State of South Carolina can not impose
 3 an income tax on it. Your Honor, I'm sure you
 4 are probably familiar with the term nexus.
 5 There's a term used in state and local taxes.
 6 We tend to use it quite often without
 7 explaining it but it basically means -
 8 THE COURT: I'm very - if you're familiar with
 9 Travelscape and Expedia -
 10 MR. VON LEHE: Your Honor, forgive me, please.
 11 Forgive me Your Honor.
 12 THE COURT: I'm very familiar with that.
 13 MR. VON LEHE: Forgive me, Your Honor. From now on
 14 the term nexus shall be used with comfort. So
 15 we believe that there is no nexus here for RAC
 16 Texas; therefore, it had no responsibility to
 17 file. We also believe that our doing business
 18 statute, which is a requirement to require
 19 someone to - when you're doing business here,
 20 you file a return. We believe our doing
 21 business statute does not cover it; therefore,
 22 even if the Constitution did allow it, which we
 23 believe it does not, we don't think the statute
 24 reaches it on doing business. And the third
 25 reason, which is whether it was required to

1 file a return or whether it did or did not file
 2 a return, we believe its taxable income under
 3 established precedent in South Carolina is
 4 zero. It has no taxable income in South
 5 Carolina. And we're going to base this, Your
 6 Honor, on what is subtle law in South Carolina,
 7 in our opinion, which is the 1987 Court of
 8 Appeals case of Lockwood Greene Engineers vs.
 9 the South Carolina Tax Commission. And that
 10 case held that receipts from a service
 11 business, like this management services
 12 business, are to be assigned to the state where
 13 those activities take place, which here is in
 14 Texas. No activities of RAC Texas take place
 15 in South Carolina. It has no employees here to
 16 render those services. It has nothing here.
 17 Since it has no activities in South Carolina,
 18 we believe the Lockwood Greene case clearly
 19 shows that any income that comes to it here
 20 from RAC East ought to be assigned to Texas,
 21 not to South Carolina. We're going to -- this
 22 is going to be a matter I'm sure that will be
 23 debated before you for the next couple of days.
 24 But in our judgment, the Lockwood Greene
 25 Engineers case is directly on point on this

1 THE COURT: The Geoffrey, that's one I'm not familiar
 2 with. The Geoffrey case.
 3 MR. VON LEHE: Your Honor, in the Geoffrey case --
 4 THE COURT: Is that a South Carolina or --
 5 MR. VON LEHE: Yes, it is.
 6 THE COURT: -- US?
 7 MR. VON LEHE: It's a South Carolina. A very
 8 important South Carolina case that occurred a
 9 number of years ago. What that case held was
 10 that the existence of intangible property in a
 11 state, such as trademarks and trade names, that
 12 that will subject that entity. For example,
 13 RAC West, it licenses trademarks and trade
 14 names to RAC East. And because it does that,
 15 it filed a tax return and paid a tax based on
 16 our apportionment formula. We have an argument
 17 with the Department of Revenue about that also,
 18 obviously, but not about filing it. RAC West
 19 filed because it had intangible property here.
 20 RAC East doesn't have anything here. It has no
 21 intangible property here, just has the services
 22 agreement with the store and it performed
 23 services for it. And then on the doing
 24 business, Your Honor, the doing business
 25 statute, we don't think it reaches it. It

1 saying that for a service function or a service
 2 business, you go to the state where those
 3 services are performed; that is the state where
 4 it is taxable. Of interest is that -- now,
 5 you'll have testimony to this, but if -- the
 6 Department of Revenue's assertion of tax
 7 liability against this company, no state in the
 8 country has ever attempted to tax this company.
 9 This would be a first. But of course, we will
 10 point that out that it's a -- that we believe,
 11 from our experience level, that states and
 12 other states do not attempt to tax us. We talk
 13 about the constitutional issue, fall back to
 14 that for just a moment and the nexus question.
 15 Your Honor, you would know it from your
 16 experiences with the dot.com hotel case that
 17 nexus can be established in a lot of different
 18 -- number of different ways. It could have
 19 been established if RAC Texas had some kind of
 20 facility here, like an office. It could have
 21 been established if we had employees here in
 22 the state. It could also be established
 23 according to the Geoffrey casem which we will
 24 both be relying upon, but it could have been
 25 established under the --

1 talks about any activity in this state for
 2 profit. And we don't have any activity in
 3 South Carolina for profit. So we don't think
 4 the doing business statute reaches it. The
 5 sourcing of receipts. Much will be said about
 6 that, and that is the Lockwood Greene case
 7 again. And I would like to show, Your Honor,
 8 with another demonstrative the sourcing of the
 9 receipts in the Lockwood Greene case. Again,
 10 this is all about RAC Texas. And in Lockwood
 11 Greene, we had engineers performing engineering
 12 services in South Carolina. These engineers
 13 performed engineering services in South
 14 Carolina, but they had customers in other
 15 states. The customers were located elsewhere.
 16 The example given by the court was, well, you
 17 know, if they've got a customer in North
 18 Carolina, for example. But the engineering
 19 work, this is Lockwood Greene up there on the
 20 board without a name on it. We had the taxing
 21 state, which was South Carolina. There was an
 22 engineering firm here named Lockwood Greene and
 23 it performed engineering services. Out of
 24 state, in many states, it had customers and had
 25 received payments from those customers. And

1 Lockwood Greene said look, these payments are
 2 coming from customers in another state.
 3 They're coming -- they're coming from customers
 4 in another state. We shouldn't have to be
 5 taxed on those, or we shouldn't include those
 6 as South Carolina receipts in the apportionment
 7 formula because the customers are located in
 8 other states. But the South Carolina Court of
 9 Appeals in 1987 in Lockwood Greene, the case in
 10 other matters is heavily relied upon by the
 11 Department, which we'll show through some of
 12 their policy documents, the South Carolina
 13 Supreme Court said no. For a service business,
 14 we are going to assign receipts where those
 15 services are performed. This would be the
 16 place of activity view, which I show here.
 17 That is the activity that took place and our
 18 court called it the place of activity view,
 19 where the services are performed. It said
 20 look, we aren't going to adopt this origin of
 21 payment view for a service business. We're not
 22 going to do that. This thing is on all fours
 23 with what we have in front of us insofar as RAC
 24 Texas is concerned. And I'll show you a
 25 picture of what we have before us today. That

1 the court held it's where the services are
 2 performed that counts. So obviously, we will
 3 be relying on Lockwood Greene before Your
 4 Honor, or throughout this trial. The nature of
 5 the assessment for a moment. The nature of the
 6 assessment against RAC Texas, we'll talk about
 7 that for a moment. What has the Department of
 8 Revenue done? It has looked at the management
 9 fee, and it has said through a calculation that
 10 they had made, which we also disagree by the
 11 way, but nevertheless, they have said this --
 12 this management fee, the whole management fee
 13 is taxable in South Carolina, being paid by RAC
 14 East to the Texas company. They say the whole
 15 management fee is taxable. They have not
 16 applied the apportionment formulas at all.
 17 Their judgment, the apportionment formulas
 18 won't work. We say they will work. If Your
 19 Honor decides that there is nexus here, we say
 20 the apportionment formulas do work and they
 21 produce zero income. I also say that the
 22 method that the Department has used have looked
 23 at accurately, that produces a zero income.
 24 Because again, the services are taking place in
 25 Texas. The tax that they have imposed is not

1 was Lockwood Greene, and this is us. Here the
 2 taxing state is South Carolina. Again, and the
 3 customers -- the customer is located here now.
 4 The shoe is on the other foot, in other words.
 5 But the services are being performed, all of
 6 them in Texas. So we say that the receipts for
 7 those services, meaning this management fee,
 8 has got to be allocated to Texas. And this is
 9 Lockwood Greene. Your Honor, I don't know if
 10 you've ever ruled against somebody reading from
 11 a case. I hope not. I would like to read just
 12 a sentence from this. I know the Supreme Court
 13 perhaps does. But where the issue is the
 14 proper determination of gross receipts from
 15 within this state, Lockwood asserts the phrase
 16 is clear, refers to when --
 17 THE COURT: What case are you reading out of?
 18 MR. VON LEHE: Lockwood Greene.
 19 THE COURT: Okay. Go ahead. I've got the case in
 20 front of me, matter of fact.
 21 MR. VON LEHE: Yes, Your Honor. But Lockwood
 22 asserts the term refers to where a taxpayer's
 23 customers are located and payments are made.
 24 Commission asserts the phrase refers to the
 25 place where the services are performed. And

1 even an income tax. We're here to argue about
 2 a corporate income tax. They've imposed a
 3 gross receipts tax on this taxpayer. The
 4 entire gross management fee has just been
 5 taxed. Now, they're going to say well, we gave
 6 you a chance to show what expenses ought to go
 7 against that management fee, and we're going to
 8 talk about that. We don't believe that that
 9 can be done. We believe they've impose a
 10 requirement on a taxpayer which cannot be met.
 11 But they will argue that we told them, tell us
 12 what expenses are associated with it, and you
 13 didn't tell us. What reason would we have to
 14 hold back what expenses? If we had expenses
 15 associated with the management fee, we used it.
 16 We believe probably would have been significant
 17 once you talk about this company. But it's
 18 just not the taxpayer's burden to come up with
 19 cannot be done. This taxpayer, if required to
 20 do anything, ought to be required to file a tax
 21 return, apply an apportionment formula to its
 22 net corporate income and have an income tax.
 23 That's not what we face. We face a tax on its
 24 gross management fees. They've said that this
 25 management fee is a form of separate

1 accounting. They will argue that this is a
 2 form of separate accounting. Given that for a
 3 moment, let's assume it is. We believe it to
 4 be faulty one if it is one. But believing that
 5 it is for a moment, we believe that is
 6 incorrect because separate accounting is not to
 7 be applied to a unitary business. And RAC
 8 Texas --
 9 THE COURT: Say that again.
 10 MR. VON LEHE: Separate accounting should not be
 11 applied to a unitary business.
 12 THE COURT: Okay. I caught that.
 13 MR. VON LEHE: RAC Texas, Your Honor, just to get a
 14 look at it, which performs management services
 15 and also operates stores in Texas, those two
 16 functions are interrelated, highly
 17 interrelated. It manages its own stores, in
 18 addition to managing stores in South Carolina.
 19 Those functions are highly related. We will
 20 attempt to show Your Honor that this is an
 21 integrated business and a highly integrated
 22 business; not a marginally integrated business,
 23 but a highly integrated business, that those
 24 stores in Texas depend on this management and
 25 that this management learns from these stores.

1 considerable testimony. This is one the areas
 2 that Professor Pomp will opine on.
 3 THE COURT: If we follow your line of thinking along
 4 the barbeque restaurant.
 5 MR. VON LEHE: Yes, Your Honor.
 6 THE COURT: In this case, they're only providing a
 7 management model, and that is it. They're not
 8 providing barbeque sauce. I guess the
 9 intellectual aspect of how you would prepare
 10 that would come through RAC West?
 11 MR. VON LEHE: That is correct, Your Honor. At
 12 least the trade name and trademark will come
 13 through RAC West.
 14 THE COURT: Well, how about the --
 15 MR. VON LEHE: The talent?
 16 THE COURT: Is it the sauce? The components of the
 17 business as far as supplying anything to the
 18 business?
 19 MR. VON LEHE: They don't do that.
 20 THE COURT: They don't do that at all? Okay.
 21 That's what I was getting at.
 22 MR. VON LEHE: Your Honor, I think there's some
 23 training manuals. We'll have to get -- when
 24 the first witness gets up here, we'll go
 25 through that in great detail. To the best of

1 I'd like to give you an example. Suppose
 2 somebody developed, for example, a barbeque
 3 restaurant. To make it a Southern example.
 4 Let's say somebody developed a barbeque
 5 restaurant. And he said well, you know, this
 6 is a great looking restaurant, everything works
 7 well here, The barbeque is great, the sauce is
 8 here. Somebody else might be interested in
 9 having a restaurant, and at the risk of having
 10 competitors, he decides I will offer a
 11 management service to other entities, and even
 12 though -- and this service, how to do this, how
 13 to manage this, is learned through the practice
 14 of that barbeque restaurant. Here are these
 15 management services. This management expertise
 16 has been learned to the operation of the
 17 stores. So we believe that it's integrated in
 18 two respects. First, that the management
 19 services are dependent upon these stores; and
 20 secondly, that the stores are dependent upon
 21 the management fee, and they both contribute to
 22 each other. So we think it is a classic example
 23 of a unitary business. And you do not
 24 separately account for a unitary business.
 25 There will be testimony to that effect today,

1 my knowledge, that's where my example would
 2 probably fail to some extent. It's not as much
 3 that relate -- like a franchise, franchise what
 4 we do. We're basically your lower management
 5 services is basically what we do.
 6 THE COURT: Okay.
 7 MR. VON LEHE: Again, with regard to their efforts
 8 to separately account for the unitary business,
 9 which is RAC West, and they have also done --
 10 excuse me, which is RAC Texas. And they've
 11 also done the same thing with regard to RAC
 12 West, and we'll talk about that in a moment.
 13 But insofar as RAC Texas is concerned, the
 14 method that they have used does not even relate
 15 to the fees which are being charged, which they
 16 have taxed. It wouldn't matter. Those fees
 17 are based loosely on income. And the method
 18 which they have chosen, under that method, it
 19 wouldn't make any difference if the 39 South
 20 Carolina stores made income or not. It would
 21 make no difference. It's just a dart thrown up
 22 against the wall as to whether or not it hits
 23 or misses. It is not an accurate separate
 24 accounting method. It's based on the gross
 25 management fee that's paid by RAC East, which

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1 operates many, many stores in all the eastern
 2 states, and paid to RAC Texas. And they then
 3 apportion this through an apportionment method
 4 that they have come with, but it is unrelated
 5 to the income of the South Carolina stores. So
 6 we believe the method that they have chosen, in
 7 addition to the fact it shouldn't be done, that
 8 it fails. They've not chosen an equitable
 9 method to impose on us. We believe the burden
 10 to be on the Department of Revenue on that,
 11 Your Honor. We'll be able to show you some
 12 cases that when they propose an alternate
 13 method --
 14 THE COURT: I saw that California case.
 15 MR. VON LEHE: Yes, Your Honor.
 16 THE COURT: That you're relying on.
 17 MR. VON LEHE: Yes, Your Honor.
 18 THE COURT: I'm not so -- that California case is
 19 based on a statute that dealt with a taxpayer
 20 having the burden. I didn't see anything about
 21 the Department.
 22 MR. VON LEHE: We have in our brief that we forward
 23 to you --
 24 THE COURT: And I think --
 25 MR. VON LEHE: -- we do have a number of --

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1 THE COURT: Well, I want to be clear because on that
 2 one, the California case, because I didn't see
 3 another case. Maybe I missed it.
 4 MS. GEER: There were like a dozen cases.
 5 THE COURT: Okay. I didn't --
 6 MS. GEER: There was one case on clear and
 7 convincing being the standard.
 8 THE COURT: That's the one I was thinking about.
 9 MS. GEER: Okay. And then there's about 15 on who
 10 has the burden of proof.
 11 THE COURT: Well, the burden, I don't want to deal
 12 with the burden, only the clear and convincing
 13 aspect.
 14 MS. GEER: Okay.
 15 THE COURT: That I didn't buy into because it seemed
 16 like that was California's burden in tax
 17 matters. So if you want to shift the burden
 18 argument, I can see that with the shift I think
 19 would be preponderance of evidence --
 20 MR. VON LEHE: Understood, Your Honor.
 21 THE COURT: -- shift, rather than clear and
 22 convincing.
 23 MR. VON LEHE: Understood, Your Honor. We will
 24 reflect on that. We do believe it's clear that
 25 the burden of proof is on the Department of

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1 Revenue when it comes up with an alternate
 2 formula. And we would submit that in every
 3 case in the country, to the best of my
 4 knowledge, and Ms. Geer put together the brief
 5 for me, holds that way, has considered it. So
 6 again, I want to go back for a moment to the
 7 sourcing and say this with regard to the
 8 sourcing. It doesn't matter if it's under this
 9 alternate method that they've come up with or
 10 if it's under the standard apportionment
 11 formula. In either case, Lockwood Greene is
 12 going to say, you're going to source these
 13 management fees to where the activity takes
 14 place that produces them. And that is
 15 unquestionably in Texas. All the management
 16 takes place out there for which they are being
 17 paid. I want to talk about RAC West very
 18 briefly. I realize I've gone a long time. I
 19 want to talk about RAC West very briefly.
 20 Again, RAC West owns the trademarks and trade
 21 names. It licenses the trademarks and trade
 22 names to RAC East. That's what it does so far
 23 as South Carolina is concerned to file a tax
 24 return. It based that tax -- it based its tax
 25 on the standard apportionment formula. It did

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1 file an amended return. Learned counsel
 2 referred to that earlier today. I do take
 3 issue with that being much of a surprise
 4 because it is a -- it is a method that, shall
 5 we say, has been used many times in the past.
 6 Our method is a rather standard method, not an
 7 unusual method. But simply, when we first
 8 looked at the tax returns that RAC West was
 9 filing, it used the three factor formula. We
 10 told them that we thought the proper formula to
 11 file under in South Carolina was a single
 12 factor formula, gross receipts from South
 13 Carolina to total gross receipts. So they
 14 amended their return and filed it like that.
 15 So we will stand on that return, on that
 16 amended return. I believe the Department of
 17 Revenue would say that if a standard formula
 18 applies, if, then it's the one we used. If it
 19 applies. If it applies. They, of course,
 20 would disagree with us with whether or not a
 21 standard formula applies or not. But I do
 22 believe that they would agree that the one that
 23 we filed on our amended return is the correct
 24 one. So we filed it. So RAC West filed on the
 25 standard apportionment formula. They took

1 South Carolina royalties, put those in the
 2 numerator of the apportionment formula. They
 3 took its total receipts, as our statutes says,
 4 and they got a percentage. And they multiplied
 5 that percentage times its net corporate entity.
 6 That is the way all corporations that file in
 7 South Carolina file. There's nothing unusual
 8 about that. That's the way - tax return is
 9 set up like that, the instructions are set up
 10 like that, and that's the way they're filed.
 11 Now the Department of Revenue has argued that
 12 no, that this method is not appropriate; that
 13 it does not properly reflect their income.
 14 I'll leave that argument to them. I don't want
 15 to make their argument for them, but I know
 16 that they will make that argument because
 17 that's - it's in the - it's in the audit
 18 report and it's in the agency determination.
 19 We're going to find that however, Your Honor,
 20 that in this particular case that it does
 21 properly reflect our income because what
 22 they've done is they separated off the royalty
 23 payment and they applied a tax on that royalty
 24 payment. They completely disregarded the
 25 income of RAC West, just like they disregarded

1 mention one case to Your Honor which we believe
 2 is the foundation case for a unitary business
 3 in South Carolina. And that's the Exxon case.
 4 The case is probably about 20 years old. I
 5 don't have it right here in front of me right
 6 this second.
 7 THE COURT: I've got it in front of me.
 8 MR. VON LEHE: Thank you, Your Honor. In the Exxon
 9 case, Exxon, as I think it is generally known,
 10 but it's in the facts of the case, it has an
 11 expiration in production function, it has a
 12 refining function, and then it has a marketing
 13 function, all in the same corporation. Just
 14 like these functions, like this intellectual
 15 property in these stores and like this - this
 16 management group and the stores it operates,
 17 they're all in the same company. Exxon had
 18 these - these three elements I'll call them
 19 for a moment, for lack of a better word. And
 20 it said we're going to file a return in South
 21 Carolina that's going to be based only on our
 22 marketing function. We're going to separate
 23 our business, and we're going to file in South
 24 Carolina only on the marketing function. But
 25 the South Carolina Supreme Court said, no, you

1 the income of RAC Texas. They said well, we
 2 don't care about the income of RAC West is. It
 3 doesn't matter. We're going to apply what we
 4 consider to be an alternate formula. They have
 5 statutory authority for an alternate formula,
 6 but we don't agree that it applies in this
 7 case. We're going to apply an alternate
 8 formula. We're just going to take the entire
 9 royalties and tax them. And that's what they
 10 did. Again, they said look, you show some
 11 expenses to go against those royalties, we'll
 12 deduct them. Because RAC West does two things,
 13 because it is a unitary business in which it
 14 owns intellectual property which it licenses,
 15 and it operates the stores, owns and operates
 16 the stores out West. That intellectual
 17 property is used in those western stores, and
 18 those stores also contribute to that
 19 intellectual property. And we have a witness
 20 and we will prove that. So we believe that
 21 those - that that intellectual property that
 22 that entity owns and those stores that it
 23 operates cannot be effectively separated
 24 because it is a unitary business. While we're
 25 on the subject of a unitary business, I want to

1 are not. You are a unitary business. You
 2 refine - you find oil, you pump oil, you
 3 refine oil and you market it. The fact that
 4 you don't have oil wells in South Carolina and
 5 you don't have refineries in South Carolina,
 6 that doesn't mean that you can simply report to
 7 South Carolina based on your marketing income.
 8 We believe that the Exxon case greatly supports
 9 here that these entities should not be
 10 separated because they, like Exxon, are unitary
 11 businesses. They are also unitary businesses.
 12 Each of them is a unitary business. They ought
 13 to be reporting their entire income. They
 14 should be. That's what RAC West did. But the
 15 Department of Revenue just said no, that
 16 doesn't work in this case because you've got
 17 the stores, you have the - you've got the
 18 operation of the stores in the denominator of
 19 the apportionment formula and you can't do
 20 that. We're not going to allow you to that
 21 because -
 22 THE COURT: Say that again.
 23 MR. VON LEHE: They have the operation of the
 24 stores, whereas the apportionment formula for
 25 RAC West, royalties from South Carolina over

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1 total receipts. That's the way we filed. And
 2 those receipts in the dominator of that
 3 apportionment formula are not just royalties
 4 from everywhere. It also includes the gross
 5 receipts from the operation of the stores. We
 6 put everything into the denominator of the
 7 formula, because it's a unitary business. It
 8 should be in the denominator of the
 9 apportionment formula because those stores are
 10 operated out West. They say it dilutes the
 11 formula. It doesn't dilute the formula. It
 12 makes the formula accurate. If you didn't have
 13 those stores in the denominator of this
 14 formula, you would get an inaccurate view of
 15 how much business is done in South Carolina.
 16 THE COURT: So does Container Corp. analysis enter
 17 into this or not?
 18 MR. VON LEHE: Yes. It's a unitary business. It
 19 does enter into it. Yes, it's a unitary
 20 business. Container Corp., yes. Yes. And it
 21 was given unitary business treatment by the
 22 Supreme Court. We believe that every United
 23 States Supreme Court case, including Container
 24 Corporation, supports us. In every one of
 25 those cases, the taxpayer has -- usually

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1 they're arguing against it, but nevertheless,
 2 the Court has found those businesses are too
 3 closely connected to separate. Too closely
 4 connected to separate that which -- those
 5 functions of that business. And you can't
 6 separate it out and say hey, we're only going
 7 to do -- we're only going to report refining --
 8 excuse me, we're only going to report marketing
 9 in South Carolina. Can't do that based on the
 10 Supreme Court case also. Ours didn't go up.
 11 Wisconsin case on almost identical facts went
 12 up to the Supreme Court. It was basically
 13 identical to ours. And again, Your Honor, so
 14 far as RAC West is concerned, what did they do,
 15 as I said, file an assessment against nothing
 16 but the gross royalty fees that RAC East pays
 17 to RAC West. We say this is not an income tax.
 18 They have chosen a method which is a gross
 19 receipt tax. Again, we're given opportunity to
 20 show expenses. We can't show those expenses in
 21 a meaningful way because it's a unitary
 22 business, and the whole idea of a unitary
 23 business is you can't do that. Now, you're
 24 going hear a good bit today, Your Honor, if not
 25 from the Department, from me, about a case

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1 called Carmax. The Carmax case was decided in
 2 this court April 22nd, 2010. The case is on
 3 appeal, unfortunately by me. But the case is
 4 on appeal to the South Carolina Supreme Court.
 5 THE COURT: Prior opinions of this court aren't
 6 binding on me anyway, but I'll let you know
 7 that.
 8 MR. VON LEHE: Your Honor, that was my
 9 understanding. But I'll be glad to hear that
 10 understanding reinforced.
 11 THE COURT: My own prior decisions aren't binding
 12 on me. I've actually reversed my own self.
 13 MR. VON LEHE: Okay. Well, I'm hoping that -- I'm
 14 hoping that you won't follow Carmax. But
 15 nevertheless, I want to talk about it because
 16 I think we have some distinguishing features
 17 from Carmax. Carmax was very much like RAC
 18 West. They, Carmax operated previously owned
 19 automobile dealerships. There's a superstore
 20 somewhere around here, I believe, is my
 21 recollection, but they're in the state. They
 22 set up, Carmax set up a separate subsidiary,
 23 which is called Carmax West. It operated those
 24 superstores out West. It also owned the
 25 intellectual property. And a tax was proposed

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1 against it. It filed a tax return. It put in
 2 the numerator, just as we did here, royalties
 3 from South Carolina. It put in the denominator
 4 all receipts, royalties from everywhere and of
 5 the operations of its stores, of their stores,
 6 just as we're doing here.
 7 THE COURT: In the state of South Carolina?
 8 MR. VON LEHE: Everywhere. Gross receipts. In
 9 other words, the formula says, the standard
 10 formula says, I think everybody would agree on
 11 the standard formula's language, gross receipts
 12 from South Carolina, which were only
 13 royalties, and they're only royalties here,
 14 over total receipts of the business. Now, our
 15 argument there, just like it is here before
 16 you, is that you've got to include those
 17 receipts out West. If you don't, you get a
 18 very distorted picture of what the entity's
 19 income is in South Carolina. You can't
 20 separate these things. These aren't -- these
 21 aren't separate businesses. These are all part
 22 of one business. This intellectual property is
 23 important to that company. It's not apples and
 24 oranges. It's related. It's related. It's
 25 not different type -- it's not different

1 income. It's all together to compose one
 2 unitary business. Of course, we argued that
 3 here in this Court. In its decision in Carmax,
 4 and in grappling with that, these issues, the
 5 Court noted that Carmax had set up a separate
 6 partnership called Carmax Business Services,
 7 and it had put all the royalties into that
 8 separate partnership and it had expenses there
 9 for those royalties. And then it would all
 10 come out on what we're familiar with as a K1,
 11 out to the business. And the Court said look,
 12 you already isolated your income, and you've
 13 isolated your income. You've got expenses
 14 against it. Even though they didn't say you've
 15 got expenses against it, still it was a fact.
 16 You've isolated your income and so it comes
 17 out. And the Court looked at that and said
 18 look, if you are a unitary business, you're not
 19 very unitary. They said, the Court said in
 20 Carmax it's a range. And you're at the bottom
 21 of this range because you already separated
 22 things out and you wanted -- you did your
 23 business that way, so your flow of value has
 24 already been separated. Where you going into
 25 a partnership and then you're coming back out,

1 conclusion, the penalties have been accessed.
 2 We do not believe penalties should be accessed
 3 against RAC West. RAC West filed a tax return.
 4 They filed the only way it would have been
 5 allowed to file. There is no income tax return
 6 you can file for the method the Department
 7 wants us to use. There's nothing you can file.
 8 If you follow that income tax return, you start
 9 with corporate net income. You don't start
 10 with gross royalties. You start with corporate
 11 net income. You make some adjustments to that
 12 and you apply the standard apportionment
 13 formula. And that's what we did. But they
 14 would post penalties against it. We think
 15 those penalties should be dismissed outright.
 16 So far as -- so far as the penalties against
 17 RAC Texas are concerned. No, we didn't file.
 18 We're in hopes that Your Honor will conclude we
 19 didn't have to file, so obviously penalties
 20 would make no difference. If the assessment
 21 falls, the penalties will, too. But since this
 22 will be, and -- in our research, if Your Honor
 23 were to hold this company taxable, it would be
 24 the first case in the country in which the
 25 rendering of services outside the state was

1 you've already done that. That's not the way
 2 that we do business. So that is a
 3 distinguishing feature. First of all, we would
 4 argue before Your Honor that Carmax is
 5 incorrect. We hope that the case, obviously
 6 since we appealed it, will be reversed in the
 7 Supreme Court based on cases like Exxon, which
 8 is precedent, that a unitary business is not to
 9 be divided. But there are distinguishing
 10 features there that the Court is going to say
 11 well, we're going to look at it and say, you
 12 know, unitary is not all or nothing. There's
 13 a range. This is a much stronger case or a
 14 much stronger unitary relationship than Carmax
 15 had. We hope to prove that before Your Honor.
 16 Your Honor, again, in summation, and I realize
 17 this had gone on, but for summation, I will add
 18 one more thing about Carmax. It didn't have
 19 management fees that they sought to tax. There
 20 were management fees but the Department didn't
 21 seek to tax them. So the case does not discuss
 22 management fees. Neither here nor there. It
 23 is of interest that they did not attempt to
 24 seek that, but it wasn't before the Court, so
 25 obviously it's not precedent. Your Honor, in

1 held to be taxable by the state in which the --
 2 from which payments for those services were
 3 made. This would be a novel decision. And
 4 based on those grounds, we would ask that the
 5 penalty be removed.
 6 THE COURT: All right.
 7 MR. VON LEHE: Thank you, Your Honor.
 8 OPENING STATEMENT - BY MR. RYAN:
 9 MR. RYAN: Your Honor, I'll be rather brief. We're
 10 here today about two taxpayers, which John has
 11 done a wonderful job explaining. I'll refer to
 12 them as RAC West and RAC Texas because that's
 13 what you're going to hear all the witnesses
 14 refer to them as. What these cases are all
 15 about is fairness. First, as to RAC Texas, the
 16 question is, is it fair for a business to
 17 provide services in South Carolina using South
 18 Carolina people, have property in this state,
 19 get compensated for services that take place in
 20 South Carolina, yet not file and not pay taxes
 21 on the compensation for those services that
 22 were in South Carolina.
 23 THE COURT: Well, you just made a -- something that
 24 was a little different than what Mr. von Lehe
 25 has been arguing. You said using -- did you

1 say using people in South Carolina?
 2 MR. RYAN: Yes, Your Honor.
 3 THE COURT: So what you're distinguishing factor in
 4 that regard?
 5 MR. RYAN: I think the evidence will show, Your
 6 Honor, that RAC Texas -- that RAC Texas is
 7 compensated for services that are provided here
 8 through people here.
 9 THE COURT: All right.
 10 MR. RYAN: There's going to be -- there's a dispute
 11 between the parties as to where these things
 12 actually take place.
 13 THE COURT: Okay.
 14 MR. RYAN: The second issue which applies to both
 15 taxpayers is whether the -- how we properly
 16 apportion their taxes. As to RAC West, it does
 17 two things. It owns royalties, which it
 18 doesn't manage. It just owns them. And it
 19 runs retail services. The only thing it has in
 20 this state is income from those royalties. The
 21 Department says the only thing we're trying to
 22 figure out is what is your activity in this
 23 state. And your only activity in this state is
 24 royalties. So to us we think it should be the
 25 amount of royalties you received here or the

1 only do one of them here --
 2 THE COURT: Okay.
 3 MR. RYAN: -- it wouldn't be fair to include both in
 4 the denominator when that adds nothing to the
 5 numerator. All that does is dilute the ratio
 6 and reduce your tax liability. They are
 7 unrelated. The taxpayers used unitary the way
 8 -- I'll relate it to my adorable little nephew.
 9 We'll play and he'll yell force field and you
 10 can't touch him. These guys yell, unitary, we
 11 can't be touched. The facts are going to show
 12 that's not what the statute says. Moreover,
 13 that's not how they -- they don't -- they're
 14 only unitary when they want to be unitary.
 15 They're not unitary when they don't want to be
 16 unitary. I'm glad that John bought up Carmax,
 17 and I wanted the Court to be aware of it
 18 because I believe the Court of Appeal's opinion
 19 will have impact on how this matter comes out.
 20 One of us will be -- probably be appealing or
 21 not appealing based on that. And going back to
 22 these expenses under the --
 23 THE COURT: Well, it's in the Court of Appeals now?
 24 MR. RYAN: That's my -- John said Supreme Court. My
 25 understanding is it's Court of Appeals.

1 amount of royalties you received everywhere.
 2 THE COURT: So are you saying you're trying to
 3 follow the Container Corp's, US Supreme Court's
 4 apportionment under a unitary business? Is
 5 that what you're --
 6 MR. RYAN: I think -- well, Your Honor, you're going
 7 to hear a lot about unitary business. And I
 8 think that --
 9 THE COURT: Are you following that procedure or not?
 10 MR. RYAN: I'm not really -- I'm not, you know,
 11 familiar enough with Container Corp to say
 12 whether or not we are. We've come up with our
 13 own separate accounting method.
 14 THE COURT: Okay.
 15 MR. RYAN: That is provided for in the statute.
 16 THE COURT: The accounting method would be after the
 17 Container Corp analysis, but go ahead.
 18 MR. RYAN: We think the issue comes down to for both
 19 RAC Texas and RAC West, if you don't do that
 20 whole line of business, it has nothing to do
 21 with what goes on here. You shouldn't be able
 22 to include that in the denominator and to
 23 dilute your income tax liability here.
 24 THE COURT: Say that again one more time.
 25 MR. RYAN: If you do two different things, and you

1 THE COURT: Well, I thought he was --
 2 MS. GEER: It got pulled by the Supreme Court.
 3 MR. RYAN: Did it get pulled? Then it's probably in
 4 the Supreme Court now then.
 5 THE COURT: Okay.
 6 MR. RYAN: They seem to like to pull out anything
 7 when they see DOR. As to expenses --
 8 THE COURT: Well, maybe they do it when they see von
 9 Lehe.
 10 MR. RYAN: That could be, too. And, Your Honor, I
 11 would be remiss if I didn't do this on the
 12 record. My motion earlier made assertions that
 13 John von Lehe had conversations in the past.
 14 And I want the Court to know that John said
 15 that didn't happen, and to me, that means it
 16 didn't happen.
 17 THE COURT: Yeah.
 18 MR. RYAN: Because he has an outstanding reputation
 19 and I wouldn't want anything to tarnish that.
 20 Now let's talk about expenses. I don't -- the
 21 taxpayers essentially want you to say well, we
 22 couldn't show you want the expense are, but we
 23 should get credit for them anyway. The
 24 Department can't do that. We can't accept --
 25 we ask you to show us your expense. Show us

1 your books. Tell us how we're -- you know,
 2 what you spent. They won't do it. They just
 3 want us to say we can't show you the expenses,
 4 but you're going to have to live with that,
 5 that we have. And that's just not how the law
 6 is. Your Honor, you're going to hear, as I
 7 said, about the unitary business method and the
 8 force field that it creates. I don't want you
 9 to get bogged down in their phrases like
 10 interdependencies and synergies and functional
 11 integration. The question comes down to is the
 12 Department's -- is the method used accurately
 13 reflecting a taxpayer's activity in this state.
 14 That's the issue. Thank you.
 15 THE COURT: All right. Call your first witness.
 16 We're going to take a short break.
 17 (Break from 11:27 a.m. until 11:32 a.m.)
 18 THE COURT: Mr. von Lehe, or --
 19 MS. GEER: Your Honor, sorry, we would like to call
 20 Hugh Tollack to the stand.
 21 THE COURT: Okay.
 22 HUGH L. TOLLACK, II, having been duly sworn,
 23 testifies as follows:
 24 MS. GEER: And Your Honor, I'm sorry, one other
 25 procedure matter before we start. Sean and I

1 can refer to them by that at that number.
 2 THE COURT: Why don't we just mark it as
 3 Petitioner's One and then refer to tabs 1
 4 through 23.
 5 MS. GEER: That would work as well.
 6 THE COURT: That's more simple. You got that?
 7 COURT REPORTER: Yes, sir.
 8 THE COURT: All right.
 9 (Petitioner's Exhibit Number One was admitted into
 10 evidence.)
 11 MS. GEER: And Your Honor, I'm assuming that based
 12 on your ruling earlier that Professor Pomp's
 13 reports are now in as well?
 14 THE COURT: They aren't in unless they're admitted,
 15 so --
 16 MR. RYAN: The only object the Department would have
 17 to Professor Pomp's reports would be to the
 18 extent they give legal conclusions.
 19 THE COURT: Well, do they give legal conclusions --
 20 MR. RYAN: The Department asserts that they do.
 21 THE COURT: Do you wish to have those redacted?
 22 MR. RYAN: I'd like to have them removed.
 23 MS. GEER: Why don't we do this, Your Honor, if it's
 24 okay with you. Why don't Sean and I get
 25 together after this and he can show me which

1 have talked ahead of time about the exhibits
 2 and except for the objection he had to
 3 Professor Pomp's report, we were agreeable that
 4 all the exhibits would come in.
 5 MR. RYAN: That's correct.
 6 THE COURT: All the exhibits listed as what?
 7 MS. GEER: All the exhibits that are in the exhibit
 8 notebook.
 9 THE COURT: And is that marked as exhibit or
 10 Petitioner's One?
 11 MR. RYAN: It would be Exhibit 1 through 23, I
 12 believe. They're each individual documents.
 13 THE COURT: I need to have it marked. I tell you
 14 what, I will agree to their admission --
 15 MS. GEER: Okay.
 16 THE COURT: -- or accept their admission, but it
 17 needs to be marked so -- it's going to
 18 ultimately be marked as One so the record will
 19 be clear.
 20 MS. GEER: Right. And my suggestion, if it works
 21 for everyone else would be that maybe after
 22 today -- they're all tabbed, you know, 1
 23 through 23, that the court reporter could put
 24 tabs 1 through 23 on them. And then regardless
 25 of the order that they come in, all the parties

1 ones he objects to and then we can do a
 2 redaction and replace it tomorrow.
 3 MR. RYAN: We can do that.
 4 THE COURT: I would just like to think about the
 5 difference between redaction and remove. But
 6 --
 7 MR. RYAN: Well, Your Honor, redaction would be take
 8 parts out.
 9 THE COURT: Remove would be -- I guess remove would
 10 be cutting it out with a pair of scissors and
 11 redacted would be covering over it so that I
 12 can't see it. But either way --
 13 MR. RYAN: I meant remove as in take the whole
 14 document out. That's what I meant.
 15 THE COURT: Oh, oh. You meant the whole document.
 16 Okay.
 17 MS. GEER: All right. So we'll get together on that
 18 after this.
 19 THE COURT: Okay.
 20 MS. GEER: All right.
 21 MR. TOLLACK - DIRECT EXAMINATION BY MS. GEER:
 22 Q: Mr. Tollack, could you tell us what your
 23 current position is?
 24 A: Yes. I'm director of tax audits, planning and
 25 research for Rent-A-Center Texas, LP.

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1 Q: Okay. And just to simplify things, we'll refer
 2 to the entities as we've been referring to them
 3 thus far today with RAC Texas, LP can be RAC
 4 Texas, I'm sorry, Rent-A-Center Texas, LP, and
 5 then RAC West and RAC East for the other two
 6 entities. Is that agreeable?
 7 A: Yes, ma'am.
 8 Q: All right. And tell us a little bit about your
 9 educational background, please.
 10 A: I have a Bachelor of Business Administration
 11 degree from the University of Wisconsin, White
 12 Water, with double majors in accounting and
 13 finance.
 14 Q: And are you a certified CPA?
 15 A: Yes, ma'am, I am.
 16 Q: How long have you been a CPA?
 17 A: I first obtained my license in Wisconsin in
 18 1980. And I'm also licensed in the state of
 19 Texas.
 20 Q: And if you could just briefly summarize for us
 21 your employment background from graduation
 22 forward.
 23 A: Upon graduating from college, I took a job with
 24 a company at that time known as Peat Marwick
 25 Mitchell, a big agency CPA firm, currently

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1 known as KPMG. Worked there for five years.
 2 Left there to work for a client, an insurance
 3 holding company, for over six and a half years.
 4 And then left that position to take a position
 5 with another insurance holding company in
 6 Dallas. Worked there for several years. And
 7 I worked in public accounting, and then took a
 8 position with Rent-A-Center in 2001.
 9 Q: All right. And is one of your job duties
 10 supervising the filing of corporate income tax
 11 returns for all of the RAC entities?
 12 A: Yes, it is.
 13 Q: And were you involved in the preparation of
 14 filing of RAC West's returns in South Carolina
 15 that are at issue in this matter?
 16 A: Yes, I was.
 17 Q: And were you involved in the decision not to
 18 file a return for RAC Texas during the audit
 19 years?
 20 A: Yes, I was.
 21 Q: And were you also involved in the audit process
 22 once the Department issued a notice of audit
 23 for both of these entities?
 24 A: Yes, I was.
 25 Q: All right. So let me put an exhibit for this.

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1 Mr. Tollack, if you could -- this is actually
 2 an exhibit in the case. It is tab -- Exhibit
 3 One, Tab 9. Can you describe for us what this
 4 chart shows.
 5 A: Yes. It's a simplified organizational
 6 structure of the Rent-A-Center organization.
 7 Q: Okay. And can you just run through the
 8 entities for us, please.
 9 A: Yes. The entity at the top is Rent-A-Center,
 10 Inc., which is publically traded on the NASDAQ.
 11 It has a wholly owned subsidiary, Rent-A-Center
 12 East, Inc., which in turn has two wholly-owned
 13 subsidiaries, Rent-A-Center West, Inc. and
 14 Rent-A-Center Texas, LP.
 15 Q: All right. And can you describe for us
 16 generally what the Rent-A-Center business is.
 17 A: Rent-A-Center is the leading provider of rent
 18 to own, rent to own industry. We have about 40
 19 percent of the market share, I believe. We
 20 basically offer consumer goods to customers on
 21 the basis of a rental purchase agreement.
 22 Q: And what types of products do you have in your
 23 stores?
 24 A: It would be all types of consumer or durable
 25 consumer goods, such as appliances, furniture,

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1 electronics, computers, television, DVDs, Blu-
 2 ray players.
 3 Q: How long has the company been around?
 4 A: I believe the company was originally founded in
 5 1986.
 6 Q: How many stores are there today?
 7 A: Today there's approximately 3,000 stores.
 8 Q: And tell us about the geographic locations
 9 where these stores are located.
 10 A: The stores are located in every state of the
 11 country, including the District of Columbia,
 12 Puerto Rico, Canada and Mexico.
 13 Q: I'll get you to look at another exhibit for me.
 14 This one is a demonstrative. It's not a trial
 15 exhibit. Can you walk us through this chart
 16 and tell us what the different entities RAC
 17 West, RAC Texas and RAC East do.
 18 A: Yes. RAC East owns approximately two-thirds of
 19 the stores in the eastern part of the country.
 20 RAC West owns intellectual property, trademarks
 21 and trade names, and operates roughly 400
 22 stores in the western part of the county. RAC
 23 Texas provides management services to the
 24 affiliates and operates all the stores in
 25 Texas, which is roughly ten percent of the

1 store, total stores.
 2 Q: All right. And can you tell us -- also
 3 describe for us these lines going back and
 4 forth between RAC West and RAC East and RAC
 5 Texas and RAC East.
 6 A: Yes. RAC East pays a royalty for the use of
 7 trademarks and trade names it uses to RAC West
 8 who owns those trademarks and trade names. RAC
 9 East also pays management fees to RAC Texas,
 10 which provides management and administrative
 11 services to RAC East.
 12 Q: And both of these entities also have agreements
 13 with other RAC affiliates. These just aren't
 14 reflected on the chart; is that correct?
 15 A: That's correct.
 16 Q: All right. And if you could turn in the
 17 exhibit notebook to Exhibit One, Tab 10. Tell
 18 us what that document is, please.
 19 A: That's a management services agreement.
 20 Q: Okay. And tell us generally what this
 21 management services agreement does.
 22 A: It -- basically, it's an agreement between
 23 Rent-A-Center East, Inc. and Rent-A-Center
 24 Texas, LP that -- for the provision of
 25 management services and payment by RAC East to

1 A: They work at our corporate headquarters located
 2 at 5501 Headquarters Drive, Plano, Texas.
 3 Q: And where do they perform their job duties?
 4 A: At that same location.
 5 Q: All right. I'm going to -- we're going to go
 6 through some of these categories so we can
 7 understand what these services are. Let's
 8 start with leasing. What does the leasing
 9 department do?
 10 A: Leasing department would facilitate the
 11 selection of new store locations. It would
 12 make contacts with landlords. It would review
 13 demographic data from our national databases
 14 that had information on the income level of
 15 people that lived in those areas. It would
 16 have information about competing businesses, or
 17 I would say supportive types of businesses in
 18 the area. Would have information on the
 19 parties that own the properties that were
 20 landlords that they would have to do business
 21 with; would conduct negotiations with the
 22 landlords, negotiate lease terms, which we have
 23 a standardize lease that we prefer to use when
 24 we do execute a lease with a landlord. It
 25 would take care of any issues that came up with

1 RAC Texas for those services.
 2 Q: Okay. And are the categories of management
 3 services that will be provided described or
 4 listed in here?
 5 A: There's a brief explanation, although it's not
 6 a detailed explanation.
 7 Q: Okay. Can you just go through and give us so
 8 that we have a general idea of what the
 9 management services that are provided are.
 10 A: It's information technology services, general
 11 accounting services, payroll services, general
 12 human resource services, maintenance of
 13 insurance policies, maintenance of the
 14 corporate records, advertising services,
 15 purchasing activities, and coordination of
 16 leasing of real property.
 17 Q: All right. And do you have different
 18 departments that do these management services?
 19 A: Yes. We have a number of departments in our
 20 headquarters in Texas.
 21 Q: Are all of the departments located in Texas?
 22 A: Yes, they are.
 23 Q: Where do all the employees that work in these
 24 departments and provide these management
 25 services work?

1 respect to physical maintenance of the
 2 property. It would review all of the lease
 3 charges, the common area maintenance charges,
 4 and would actually pay the monthly rentals.
 5 Q: All right. And tell me again where are all
 6 these services are performed.
 7 A: They're all performed in Texas.
 8 Q: What about under one of the subcategories you
 9 identified was finding store locations. Do you
 10 not ever send somebody from RAC Texas to South
 11 Carolina to look at a potential store site?
 12 A: It's not necessary to send somebody from there.
 13 We do have employees of RAC East, for instance,
 14 in South Carolina that may, in their normal
 15 course of commuting, come across a space that
 16 they think may just have opened up, or a new
 17 facility, or a new strip mall was built. They
 18 recommend that to the home office personnel as
 19 a possible site. But there's really -- all of
 20 the information that our real estate department
 21 needs it can access from our offices in Texas.
 22 Q: Okay. And so that RAC East employee who might
 23 go out and look at a potential store site, who
 24 pays them for doing that?
 25 A: RAC East would pay them. That's just part of

1 their salary.
 2 Q: Okay. And so is RAC East paying -- is any
 3 portion of the management fee that's being paid
 4 by RAC East to RAC Texas in payment for what
 5 that South Carolina employee is doing?
 6 A: No, not at all.
 7 Q: All right. Can you tell us what the training
 8 department does.
 9 A: Training department puts together training
 10 materials on various different topics. It has
 11 training materials for new store employees, as
 12 well as training materials that go over things
 13 like employee relations or gender
 14 discrimination. Those types of things that
 15 make our employees aware of, you know, proper
 16 conduct and policies of the company, and
 17 provides those to RAC East, as well as RAC
 18 West.
 19 Q: And where are those training materials put
 20 together?
 21 A: They're all -- all contents is developed in
 22 Texas. And any videos or anything that helps
 23 to demonstrate that, any written materials are
 24 all prepared in Texas.
 25 Q: Okay. Do you ever send RAC Texas employees to

1 time is entered in computers at the store
 2 locations. It's transmitted to the computer
 3 servers in Texas, and that information, on a
 4 weekly basis, is extracted and the hours are
 5 then applied to the employees' rates to produce
 6 paychecks for them. And we print the paychecks
 7 and send them to them on a weekly basis.
 8 Q: And are all those payroll activities done in
 9 Texas?
 10 A: Yes, they are.
 11 Q: What about if you had an employee, a situation
 12 where an employee got overpaid, so a check was
 13 issued? First of all, who are the checks --
 14 who is the payor on the check to? Who are the
 15 checks issued from?
 16 A: The checks are issued from RAC East.
 17 Q: Okay. So RAC East is the entity that is paying
 18 these employees?
 19 A: That's correct.
 20 Q: In South Carolina?
 21 A: That's correct.
 22 Q: Okay. Well, let's say a South Carolina
 23 employee gets paid too much one week And says,
 24 I'm not giving it back. Who would sue to get
 25 that money back?

1 train the --
 2 A: No.
 3 Q: -- employees in South Carolina?
 4 A: No.
 5 Q: Now, do the store managers provide some
 6 training as well?
 7 A: Yes. They would provide some onsite training.
 8 It's really an ongoing process. There's always
 9 education going on with employees on specific
 10 store examples, customer relations. But -- so,
 11 I mean, there is -- there's basic training
 12 that's offered, but obviously the training is
 13 also day to day. You learn something new every
 14 day that you're an employee.
 15 Q: Right. And who is paying those store managers
 16 to do that training?
 17 A: RAC East pays the store managers for everything
 18 they do.
 19 Q: And is any portion of the management fee that
 20 RAC Texas receives payment for what that store
 21 manager is doing?
 22 A: No.
 23 Q: What about payroll? You have a payroll
 24 department?
 25 A: Yes. All the information for each employee's

1 A: RAC East would.
 2 Q: Can you describe for us what the marketing and
 3 advertisement department does.
 4 A: The marketing department develops strategic
 5 marketing initiatives, would develop the themes
 6 of our advertising. Would select the
 7 spokespersons that are going to appear in our
 8 television and print spots or radio, any other
 9 kind of media. And it would develop the theme
 10 or the content of those -- of those advertising
 11 campaigns.
 12 Q: Who actually implements those plans or
 13 strategies?
 14 A: The actual contracts to run the advertising
 15 spots and to print those materials is all
 16 handled by a third party ad agency.
 17 Q: So does anyone at RAC Texas ever do any direct
 18 -- ever implement these advertising strategies
 19 as to South Carolina?
 20 A: No, they don't.
 21 Q: Anybody from RAC Texas ever call South Carolina
 22 customers?
 23 A: No, they don't.
 24 Q: Anybody from RAC Texas ever send direct
 25 mailings to South Carolina customers?

1 A: No. The direct mailings would be, again, the
 2 contract between the ad agency and the
 3 fulfillment services. And the fulfillment
 4 service would provide that.
 5 Q: What does the -- do you have an information and
 6 technology department?
 7 A: Yes, we do.
 8 Q: What does that department do?
 9 A: They resolve software issues, difficulties with
 10 operating systems. That type of thing.
 11 Q: And where do they perform those services?
 12 A: That's all done in Texas.
 13 Q: Do you ever send IT people to a store in South
 14 Carolina to help?
 15 A: No, we don't.
 16 Q: Tell me about the accounting department.
 17 A: Accounting department receives information
 18 every day. All the transactions that are
 19 entered into the computers in the store are
 20 downloaded to the servers in Texas, and the
 21 accounting department from that information
 22 will input into our general ledger system. We
 23 prepare financial reports. We prepare
 24 management information reports, Other kinds of
 25 reports that capture certain business metrics,

1 A: Yes.
 2 Q: And there's actually two agreements under this
 3 one tab. If you'll flip back, there's an
 4 amendment that's three-fourths of the way back
 5 under that tab. It's just two pages at the
 6 end. Can you tell me who the parties are to
 7 the amendment to the license agreement.
 8 A: Yes. High Touch, Inc. and Rent-A-Center, Inc.
 9 Q: Do you have a risk management department?
 10 A: Yes, we do.
 11 Q: What do they do?
 12 A: They develop safety procedures to try to
 13 minimize injuries and accidents and those type
 14 of things. And they also arrange for insurance
 15 coverage for all workers' comp, general auto,
 16 and general liability for all the stores.
 17 Q: And you named three categories of insurance.
 18 Are those the only types of insurance that
 19 Rent-A-Centers obtain?
 20 A: Yes.
 21 Q: And who is the insured on those policies?
 22 A: The insureds would be the companies that own
 23 the stores.
 24 Q: Okay. So for South Carolina stores, who would
 25 the insured be on their policies?

1 not just financial data, and then transmit
 2 those reports back to the stores, wherever
 3 they're located.
 4 Q: And where does all this data come from?
 5 A: Comes from each individual store.
 6 Q: And from what, a computer?
 7 A: A computer located in each store, yes.
 8 Q: Do you have a special -- any special reference
 9 to what those computers are called? Do y'all
 10 have a special name for them in your business?
 11 A: No.
 12 Q: Is there something called a point of sale?
 13 A: Point of Sale is a software that's used in a
 14 store.
 15 Q: Okay.
 16 A: But that software is owned by a third party
 17 company, High Touch, who's located in Kansas.
 18 Q: And if you would flip for me to Exhibit One,
 19 the notebook, Tab 11. And actually, I'm sorry,
 20 that's not it. Let's see, Tab 12. And tell me
 21 what document is?
 22 A: That's a software license agreement with High
 23 Touch, the company that's referenced.
 24 Q: Okay. So High Touch owns the software and
 25 licenses it to Rent-A-Center to use?

1 A: The insured would be Rent-A-Center East, Inc.
 2 Q: And if there are claims made under those
 3 policies, who works to get those claims settled
 4 or resolved?
 5 A: We contract with a third party claims
 6 administrator. And when a claim is submitted,
 7 it goes to the third party claims
 8 administrator. They gather the information
 9 necessary to assess the claim, negotiate the
 10 claims payments, review the bills and that type
 11 of thing and then actually issue the payments.
 12 Q: Can you describe what the purchasing department
 13 does.
 14 A: The purchasing department selects the -- the
 15 rental merchandise that's going to be offered
 16 in stores. It has contracts and relationships
 17 with various vendors, and it negotiates prices
 18 of all the various types of merchandise we
 19 carry.
 20 Q: And who actually purchases the merchandise?
 21 A: All the purchases are done through Texas.
 22 Q: Okay. Who is actually paying for the
 23 merchandise?
 24 A: The store that actually receives the
 25 merchandise pays for the merchandise. But all

1 the orders are placed from Texas.
 2 Q: Okay. On behalf of a store?
 3 A: On behalf of a store, yes.
 4 Q: And who actually owns the inventory once it's
 5 purchased?
 6 A: The ownership is with the company that owns the
 7 store. So RAC East in this case.
 8 Q: Tell us what the legal department does.
 9 A: Legal department manages and oversees all
 10 litigations, all legal issues, regulatory
 11 issues for all the entities.
 12 Q: Has RAC Texas ever been sued in South Carolina?
 13 A: Not that I'm aware of, no.
 14 Q: Tell me what the human resources department
 15 does.
 16 A: Human resources department assists in hiring
 17 and firing of employees. It provides advice,
 18 maintains the personnel records in Texas. It
 19 also plays a substantial role in reviewing new
 20 employee hire data. It screens applicants. It
 21 conducts full interviews, does background
 22 checks, does criminal checks. And provides
 23 qualified candidates for the store managers to
 24 interview when they have a need or a job
 25 opening.

1 Q: All right. And are any management fees paid by
 2 RAC East for what this person, this employee of
 3 RAC east is doing in South Carolina?
 4 A: No.
 5 Q: Does RAC Texas charge RAC East for these
 6 management services?
 7 A: Yes, they do.
 8 Q: And does the management services agreement
 9 address the amount of the fee that RAC East
 10 will pay?
 11 A: It sets forth the way to compute that fee, yes.
 12 Q: Okay. And how did the parties determine what
 13 that formula should be?
 14 A: It's based upon a transfer pricing study that
 15 was prepared by KPMG.
 16 Q: Okay. Who performed that study?
 17 A: Specifically, Dr. John Wells.
 18 Q: And he's here in the courtroom with us today?
 19 A: Yes, he is.
 20 Q: All right. So we'll hear from him later. But
 21 can you briefly tell us what his study
 22 concluded about the fee that should be charged.
 23 A: He determined the proper -- what we thought was
 24 the proper methodology and then provided a
 25 range of arms length. In other words, what A

1 Q: What about what is your -- what is the human
 2 resources department role in terminating an
 3 employee?
 4 A: Typically, if an employee is going to be
 5 terminated, the store manager will contact the
 6 human resources department, discuss the
 7 implications of the termination or reasons for
 8 that. It will seek advice as to whether it is
 9 appropriate to terminate an employee for those
 10 particular reasons. And then if the answer to
 11 all those questions is yes, then the store
 12 manager will go ahead and terminate an
 13 employee.
 14 Q: All right. So does anyone from RAC Texas ever
 15 go to South Carolina to either hire or fire an
 16 employee in a South Carolina store?
 17 A: No, they don't.
 18 Q: And you talked about that the store managers
 19 have a role in this process in that they
 20 actually make the hires and do the firings; is
 21 that correct?
 22 A: Yes, that's correct.
 23 Q: And who pays them for doing that?
 24 A: RAC East or the store that -- the company that
 25 owns the store that they work in.

1 unrelated party would pay another unrelated
 2 party for similar types of services.
 3 Q: Okay. And why did Rent-A-Center have this
 4 study done?
 5 A: Well, because we wanted to know what the arms
 6 length amount would be or, you know, what an
 7 appropriate reasonable fee would be for
 8 providing services.
 9 Q: All right. And did you say that Dr. Wells
 10 provided a range?
 11 A: Yes.
 12 Q: Okay. And where in that range did you
 13 ultimately decide the fee should be?
 14 A: Approximately right in the middle.
 15 Q: Can you describe the formula to us.
 16 A: It's basically, I guess the shorthand
 17 description is it's a residual profit method.
 18 It first looks at all the operating expenses of
 19 the company, and then guarantees them a profit
 20 of four and a half percent above and beyond all
 21 of their expenses. So then the excess over the
 22 four and half percent then would be what the
 23 management fee would then be calculated to be.
 24 Q: Okay. So what would happen if the store is
 25 operating at a loss?

1 A: The store is operating a loss, RAC Texas would
 2 actually pay the store the difference to make
 3 up the four and a half percent.
 4 Q: So they have a guaranteed rate of return?
 5 A: Yes, they do.
 6 Q: Can you tell us why it's beneficial for RAC
 7 Texas to provide these management services to
 8 its affiliates.
 9 A: Well, there's substantial efficiencies that are
 10 gained by doing this, you know, on a larger --
 11 on a larger scale, as well as efficiencies
 12 from, you know, a common database, knowing --
 13 experiencing all the different operations of
 14 the store, knowing the operations of the store.
 15 So you gain not only efficiencies in scope and
 16 scale, but there's, you know, bulk purchasing
 17 benefits, like having common service provides,
 18 systems, those types of things. And you know,
 19 just the wealth and knowledge over the years of
 20 doing this business.
 21 Q: Are there -- is there any impact on quality
 22 control?
 23 A: Yes. Because we control the, you know, the
 24 look and feel of the stores, that helps to
 25 ensure that they all meet our standards.

1 Q: So would you say that RAC Texas, the services
 2 provided by RAC Texas impact the profitability
 3 of the stores?
 4 A: Yes. Definitely.
 5 Q: In a positive way?
 6 A: Oh, yes.
 7 Q: All right. Well, would it be possible to have
 8 a separate entity? Could it be possible to
 9 have a separate entity provide management
 10 services?
 11 A: It would be possible. I don't know why we
 12 would.
 13 Q: Well, what would the downside be to having it
 14 in a separate entity?
 15 A: Well, it's less efficient. Just more other
 16 administrative costs and expenses in overhead.
 17 Q: What about would the interrelationships and
 18 interdependencies you were just describing,
 19 would they be impacted?
 20 A: They would. The shared expenses would create
 21 more costs and it wouldn't have the same -- I
 22 guess the same benefits of having firsthand
 23 functionality and knowledge of the operations
 24 in the stores.
 25 Q: If you could flip for to Tab 12. I'm sorry.

1 Q: What about, are there competitive advantages?
 2 A: Well, we have unique knowledge in our business
 3 model and in our operating methods.
 4 Q: What would you -- how would you describe the
 5 relationship between the marketing performed by
 6 RAC Texas and the sales that are happening in
 7 the retail stores? Is there a relationship
 8 there?
 9 A: Well, successful marketing builds a brand and
 10 a brand name and brand loyalty, public
 11 recognition, good will. That clearly has an
 12 impact on increasing customer traffic in a
 13 store, number one, so you'll have more
 14 transactions. But number two, once you've
 15 established yourself and your good will and
 16 customers know the service that you provide,
 17 they're willing to pay more for that than they
 18 would somebody else.
 19 Q: And how is the intellectual property impacted
 20 by retail sales?
 21 A: Well, the value of the intellectual property
 22 increases when all those other things occur,
 23 which then again makes all those other things
 24 occur more. So it's -- there's a flow of value
 25 between the two of them.

1 Tab 11. Tell us what this document is.
 2 A: That's a Trademark License Agreement.
 3 Q: Okay. Who is that agreement between?
 4 A: It's between the owner of the intellectual
 5 property, Rent-A-Center West, and in this case,
 6 Rent-A-Center East.
 7 Q: All right. Do RAC East under this agreement
 8 make royalty payments to RAC West for the use
 9 of the intellectual property?
 10 A: Yes, it did.
 11 Q: How did you determine the amount of the
 12 royalties that should be charged?
 13 A: Again, we engaged KPMG to prepare and review
 14 all of the information and prepare a transfer
 15 pricing study. And they came up with a range
 16 that they recommended based upon arms length
 17 amounts, and we selected a number right in the
 18 middle of that range.
 19 Q: Okay. And is this part of the same study that
 20 determined the management fee?
 21 A: Yes, it is.
 22 Q: Okay. And if you would flip for me to Tab 13
 23 and tell me if that's a copy of the transfer
 24 pricing study?
 25 A: Yes, that is.

1 Q: All right. And so -- I'm sorry. Did you just
 2 say the study -- what did the study conclude?
 3 A: The study concluded that an arms length royalty
 4 amount would be in the range of between two and
 5 four percent.
 6 Q: And what did you all select?
 7 A: We selected three percent.
 8 Q: When you say two and four percent, two and four
 9 percent of what?
 10 A: Of gross revenues.
 11 Q: Okay. And so you selected three percent of
 12 gross revenues?
 13 A: That's correct.
 14 Q: All right. I'm going to switch topics now and
 15 talk about RAC West and RAC Texas' connections
 16 to South Carolina. Let's start with RAC West.
 17 Does RAC West have any employees in South
 18 Carolina?
 19 A: No, it does not.
 20 Q: Does it have any facilities or tangible
 21 property in South Carolina?
 22 A: No, it does not.
 23 Q: Does it make any sales in South Carolina?
 24 A: No, it does not.
 25 Q: Does it receive any services or benefits from

1 A: No, it does not.
 2 Q: Does it make any sales in South Carolina?
 3 A: No, it does not.
 4 Q: And does it receive any services or benefits
 5 from the state of South Carolina?
 6 A: No, it does not.
 7 Q: So what is its connection to South Carolina?
 8 A: It has no connection to South Carolina.
 9 Q: And does it have a customer in South Carolina?
 10 A: Yes, it does.
 11 Q: Would that be the only thing that you can think
 12 of that has to do with South Carolina?
 13 A: Yes.
 14 Q: All right. Go back and ask you some questions
 15 about how RAC West is set up. Is the same
 16 management -- do you have the management over
 17 the intellectual property activities as you do
 18 over the retail store activities?
 19 A: Yes.
 20 Q: In RAC West? Yes?
 21 A: Yes. That's correct.
 22 Q: And is the income from RAC West retail sales
 23 placed in the same account as income from
 24 royalty payments?
 25 A: Yes, it is.

1 the state of South Carolina?
 2 A: No, it does not.
 3 Q: So tell us what the connection to South
 4 Carolina is for RAC West.
 5 A: It owns intellectual property in South
 6 Carolina.
 7 Q: And does that result in your having to file a
 8 tax return in South Carolina?
 9 A: Yes.
 10 Q: And why is that?
 11 A: Based on the Geoffrey case, we believe it's
 12 appropriate to file because of the ownership of
 13 intellectual property.
 14 Q: And did you file a return for RAC West prior to
 15 being audited?
 16 A: Yes, we did.
 17 Q: All right. Now, let's go over similar ground
 18 as to RAC Texas. Does RAC Texas have any
 19 employees in South Carolina?
 20 A: No, it does not.
 21 Q: Does it own any facilities or tangible property
 22 in South Carolina?
 23 A: No, it does not.
 24 Q: Does it own or use any intangible property in
 25 South Carolina?

1 Q: And is that income used for the benefit of RAC
 2 West as a whole?
 3 A: Yes, it is.
 4 Q: All right. And you talked about some of these
 5 shared services and systems that these entities
 6 have. Does RAC West depend upon these shared
 7 services and systems?
 8 A: Yes, it does.
 9 Q: Do they create savings or efficiencies for the
 10 companies?
 11 A: Yes.
 12 Q: And do the different activities of the
 13 business, which in the case of RAC West is the
 14 intellectual property licensing and the retail
 15 store sales, does those contribute to depend
 16 upon each other?
 17 A: Yes, most definitely.
 18 Q: Would you say that there's a flow of value
 19 between those two activities?
 20 A: Yes. As I described earlier, the more
 21 successful the stores are, the more value the
 22 trademarks and trade names have, the more
 23 recognizable they are, the more they're used.
 24 And that again, increases traffic in the store
 25 and allows the company to be more profitable.

1 Q: All right. Similar questions as to RAC Texas.
 2 Do you have the same management over the
 3 management services activities as you do over
 4 the retail store activities of RAC Texas?
 5 A: Yes, we do.
 6 Q: And is the income from the retail sales side
 7 put in the same account as the income from the
 8 management services?
 9 A: Yes, it is.
 10 Q: And is that income used for the benefit of RAC
 11 Texas as a whole?
 12 A: Yes, it is.
 13 Q: All right. And going back to the shared
 14 services and systems that you described. Does
 15 RAC Texas depend upon these shared services and
 16 systems?
 17 A: Yes.
 18 Q: Do they create savings or efficiencies for RAC
 19 Texas?
 20 A: Yes, they do.
 21 Q: Do the different activities of the business,
 22 and as to RAC Texas that would be the
 23 management services activities and the retail
 24 sales activities, contribute to and depend upon
 25 each other?

1 having -- having a company that licenses a
 2 trademark or trade name and actually use the
 3 trademark or trade name makes that trademark or
 4 trade name more valuable.
 5 Q: And why is that?
 6 A: Because using it helps to, again, drive traffic
 7 to the store. And then by making the traffic
 8 -- increasing traffic to the store, you
 9 increase the profitability which there again
 10 makes the trademark more valuable.
 11 Q: All right. I'm going to switch to a different
 12 topic and ask you about costs. Does RAC Texas
 13 -- actually I'll ask it for both entities. Do
 14 RAC Texas or RAC West track the costs
 15 separately for the different business
 16 activities? So for RAC Texas that would be by the
 17 management services and the retail stores
 18 operations, and for RAC West it would be the
 19 intellectual property cost versus the retail
 20 store costs.
 21 A: No.
 22 Q: Why not?
 23 A: Well, first of all, it will be very difficult
 24 to do so. But there's really no need to do
 25 that.

1 A: Yes, they do. The management activities make
 2 the stores more profitable. And then the
 3 experience in the stores helps give feedback to
 4 management to develop better procedures more --
 5 you know, that also helps to increase the
 6 profits of the store.
 7 Q: And is there a flow of value between the
 8 management services activities and the retail
 9 store activities?
 10 A: Yes, there is.
 11 Q: And does RAC Texas benefit from certain
 12 economies of scale and scope by doing the
 13 management services and the retail store of
 14 business out of the same entity?
 15 A: Yes, definitely.
 16 Q: All right. We talked earlier about putting you
 17 on a separate entity to provide the management
 18 services. But we didn't talk about whether you
 19 have a separate entity to provide the -- to own
 20 and license the intellectual property. What's
 21 the answer to that question?
 22 A: Well, first of all, we didn't select the
 23 company that owns the intellectual property.
 24 That was already owned by the same company that
 25 owns it now when we acquired the company. But

1 Q: And why don't you need to do that? Why would
 2 that information not be needed?
 3 A: Until this point in time, we've never been
 4 asked for that kind of information.
 5 Q: And can you talk just a little bit more detail
 6 about why it's so difficult, or why it would be
 7 so difficult to track cost. And maybe you can
 8 start with RAC Texas as an example. Why would
 9 it be difficult to track a cost that incurred
 10 in performing the service, the management
 11 services versus the retail stores?
 12 A: Well, we don't keep track of every minute of
 13 every day to determine how we're spending our
 14 time. All the 350, 400 people in the home
 15 office at that point in time go to work every
 16 day and work on numerous things all day long.
 17 So it would be overwhelming to try to account
 18 for every different thing they did during the
 19 day.
 20 Q: Like for you, for example. Let's talk about
 21 your salary, for example. What all do you do
 22 during your day?
 23 A: I could work on 10, 15 different issues in a
 24 given day as the day progresses.
 25 Q: And who would those issues be for?

1 A: It would be for not only RAC Texas but for
 2 support for all the stores and all the -- in
 3 every store.
 4 Q: Are there fixed or overhead costs that would be
 5 difficult to allocate?
 6 A: Yeah. We have all of our overhead costs for
 7 our home office. We have real estate,
 8 operating costs, and there's costs that I
 9 really don't know how you'd go about separating
 10 or allocating.
 11 Q: Okay. And how about -- what about the expense
 12 associated with developing the network of
 13 suppliers that allows you to purchase things at
 14 bulk? How would you allocate that?
 15 A: Again, those activities benefit many different
 16 store, many different companies.
 17 Q: All right. Let's say, you've heard of the term
 18 "managerial accountant"?
 19 A: Yes.
 20 Q: All right. And do you understand what they do?
 21 A: Yes, I do.
 22 Q: What is that?
 23 A: They basically examine different costs and
 24 expenses in an attempt to categorize them in
 25 certain ways for different purposes. It could

1 out how your salary should be apportioned and
 2 the office overhead should be apportioned.
 3 Would there be any other challenges to
 4 determining -- to allocating these costs?
 5 Would there be other problems with allocating
 6 costs, even if you could attribute people's
 7 time?
 8 A: Well, as we mentioned, there's the overhead
 9 general expenses that benefit all activities.
 10 So what, you know, how you determine what --
 11 what the procedure is or what the logic is for
 12 all those different items. And then even if
 13 you did come up with an amount, somebody else
 14 could come up with a completely different set
 15 of rationale and different amounts, and then
 16 you're still faced with the task of determining
 17 who was right.
 18 Q: Right. Let me -- let me walk through an
 19 example with you. What about the contracts
 20 that are developed? Do y'all do contracts for
 21 -- do y'all draft the leases that are entered
 22 into by the stores?
 23 A: We typically have a master lease agreement that
 24 we like to use.
 25 Q: All right. And so who all would benefit from

1 be -- same expense could be categorized
 2 multiple different ways, depending upon what
 3 the objective of the -- of the exercise was.
 4 It obviously entails substantial amount of
 5 judgments and different opinions. But that's
 6 basically what they -- I understand what they
 7 do.
 8 Q: So do you think that there would be various
 9 opinions on how to allocate the expenses of
 10 Rent-A-Center West and Rent-A-Center Texas?
 11 A: I would guess that if you had ten different
 12 managerial accountants, they would have ten
 13 different answers.
 14 Q: Okay. Do you think a resulting -- an
 15 allocation done by a managerial accountant
 16 would be reliable?
 17 A: I don't know how it would be any more reliable
 18 than anything else. I mean, it -- there's no
 19 way to tell how reliable it is under certain --
 20 given set of circumstances and goals and
 21 objective.
 22 Q: All right. Well, let's assume for a minute
 23 that we could get a managerial accountant in
 24 there and we have them track you for the day
 25 and track all the other employees and figure

1 a lease that's drafted by someone in your
 2 department?
 3 A: Well, all the stores that used it would benefit
 4 from it because it wouldn't require a lot of
 5 review, wouldn't require a lot of negotiations.
 6 We already have all the contractual terms and
 7 things that we like to use. We understand
 8 them. So it's much more efficient to use one
 9 standardized lease.
 10 Q: Let's turn to the amended tax returns. They
 11 are Exhibit One, Tab 7. Did you assist in the
 12 preparation of these amended returns?
 13 A: Yes, I reviewed them.
 14 Q: And tell us about, there was some mention in
 15 the opening about that you filed under a
 16 different method to begin with in the original
 17 returns. Can you tell us what happened here?
 18 A: Yeah. When we initially filed the returns, we
 19 basically followed the layout of the return,
 20 and they have a section for a three factor
 21 formula. And so we filled that section out,
 22 which included the payroll and the property, as
 23 well as revenues.
 24 Q: And does RAC West use the three factor method
 25 in other states?

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1 A: Yes, it does commonly.
 2 Q: When did you first learn that that might not
 3 have been the correct method?
 4 A: Well, the auditor mentioned it when he came in
 5 and reviewed the tax return in the audit.
 6 Q: And what did he suggest was the proper method?
 7 A: He suggested the single factor formula which -
 8 and that would have - if we would have
 9 resolved our differences at that point in time,
 10 I offered to change it at that time.
 11 Q: You offered to change it to the auditor at that
 12 time?
 13 A: Yes.
 14 Q: All right. Then eventually did you make the
 15 decision to go ahead and file them?
 16 A: Yes.
 17 Q: All right. So if you could just walk us
 18 through how you did these returns. What did
 19 you start with?
 20 A: Okay. Well, by looking at the form itself,
 21 page 1 line 1 starts with federal taxable
 22 income per Federal Form 1120. And then it has
 23 certain adjustments that are particular to
 24 South Carolina to arrive at an amount of South
 25 Carolina taxable income. From that, then an

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1 apportionment factor is determined in another
 2 section of the return. It's applied to the
 3 South Carolina taxable income line, and then
 4 the tax rate is applied to that number.
 5 Q: All right. And so why did you file that way?
 6 A: Because that's the way the form prescribes and
 7 the instructions in the form support that.
 8 Q: All right. After you filed the original
 9 returns for RAC West, did you receive a notice
 10 of audit?
 11 A: Yes, we did.
 12 Q: And tell us what happened after you received
 13 the notice.
 14 A: Well, the notice of audit was completely
 15 different than what I anticipated in that the
 16 auditor not only used the single factor revenue
 17 formula, but he excluded the revenue from the
 18 stores from the denominator, and then applied
 19 the resulting apportionment percentage against
 20 gross revenues.
 21 Q: All right. And was the notice - let's see.
 22 The notices, I'm not sure we have those. Did
 23 the notice of audit just mention RAC West or
 24 did it also mention RAC Texas?
 25 A: There's a separate notice for each one.

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1 Q: Okay. All right. And I'm sorry. Let's go
 2 back and talk a little about the - did someone
 3 come to Texas from the Department of Revenue?
 4 A: Yes. There were two auditors who came to our
 5 home office facility at 5501 Headquarters
 6 Drive, Plano, Texas.
 7 Q: And what did they do while they were there?
 8 A: I mean, they examined the returns. They asked
 9 for some information, some of which - well,
 10 everything they asked for for RAC West was
 11 provided for them. When they asked for
 12 information relative to RAC Texas, my first
 13 question was why would RAC Texas need to file
 14 a tax return in South Carolina.
 15 Q: Did you get a response?
 16 A: I never received any satisfactory explanation
 17 to that question.
 18 Q: All right. And then you started talking about
 19 the RAC West audit report. Let's look at that
 20 in a little more detail. It is Tab 1 in
 21 Exhibit One. And so tell us again what the
 22 Department's position was. How should RAC West
 23 have filed, according to them?
 24 A: Well, it appears that, you know, they derived
 25 an amount of royalties that are related to

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1 South Carolina. Basically they used that in the
 2 numerator and excluded the store revenues from
 3 the denominator to calculate an alternative
 4 apportionment ratio which they applied to gross
 5 receipts of RAC West, and then calculated the
 6 tax, interest and penalties on those amounts.
 7 Q: Did they take into account your costs, RAC
 8 West's cost?
 9 A: They excluded all expenses.
 10 Q: All right. So does the Department's method
 11 consider the net income of the taxpayer?
 12 A: No.
 13 MS. GEER: Your Honor, if I could just have one
 14 minute to confer.
 15 Q: Let me clear up one thing. I think you
 16 mentioned something about an apportionment
 17 factor earlier. Did what the South Carolina
 18 Department of Revenue's audit do is do a tax,
 19 and you can look at page - where are we -
 20 three it looks like of the audit under the
 21 apportionment income as adjusted and the
 22 percentage and it looks like it's 100 percent
 23 -
 24 A: Yes.
 25 Q: - of the gross revenues; is that correct?

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1 A: Yes.
 2 Q: Okay. So if the taxpayer in this case had lost
 3 ten million dollars, would the tax still have
 4 been the same?
 5 A: Yes.
 6 Q: Because it doesn't take into account anything
 7 but the gross revenues, correct?
 8 MR. RYAN: Objection. Leading.
 9 MS. GEER: I apologize, Your Honor.
 10 THE COURT: Sustained.
 11 Q: Why does it -- why would it not matter if the
 12 company lost ten million? What would happen if
 13 the company lost ten million under the
 14 Department's position?
 15 A: Well, any -- the basis of an income tax return
 16 is that you only pay taxes if you have net
 17 income to begin with. And by assessing a tax
 18 on gross receipts and failing to consider
 19 expenses, you could end up imposing a tax on a
 20 taxpayer that has a loss that has negative
 21 taxable income.
 22 Q: Did the Department assess penalties?
 23 A: Yes, they did.
 24 Q: And do you know what those penalties were based
 25 on?

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1 A: I believe they were based on negligence and
 2 substantial underpayment.
 3 Q: Are you familiar with the South Carolina
 4 Corporate Income Tax Return and instructions
 5 and regulations regarding South Carolina
 6 corporate income taxes?
 7 A: In general, yes.
 8 Q: Is there anything in those returns,
 9 instructions or regulations that would allow
 10 for the method employed by the Department in
 11 this case?
 12 A: No. They're not described anywhere.
 13 Q: All right. Let's move on to the RAC Texas
 14 return. I'm sorry. The RAC Texas audit
 15 report. It is Tab 2 to Exhibit One. Can you
 16 summarize for us what the Department's position
 17 was in the audit as to RAC Texas?
 18 A: Well, first of all, they, for reasons unknown
 19 to me, determined that RAC Texas had nexus in
 20 South Carolina, were doing business in South
 21 Carolina and subject to income tax in South
 22 Carolina. Then they made a calculation, an
 23 estimate of, I guess, what they thought was
 24 management fees that were generated in South
 25 Carolina based on companywide information.

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1 Q: All right. Hold on. Before we go to the
 2 apportionment part. They determined you had
 3 nexus. Then what was their position on where
 4 the receipts should be sourced?
 5 A: They believed they should be sourced to South
 6 Carolina.
 7 Q: And what was the basis for that for that
 8 belief?
 9 A: I later found that they for some reason had the
 10 mistaken impression that the point of sale
 11 software was owned by RAC Texas that was used
 12 in South Carolina.
 13 Q: Did they ever ask you who owned the point of
 14 sale license?
 15 A: No, they didn't.
 16 Q: Do you know why they reached that conclusion?
 17 A: I have no idea.
 18 Q: Were there any other -- well, never mind.
 19 Let's go back to the audit. All right. So
 20 they claimed it should be sourced in South
 21 Carolina. Then if you could please proceed on
 22 what they did next.
 23 A: Instead of actually determining the amount of
 24 management fee that was generated in South
 25 Carolina, they took -- they reviewed the total

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1 management fees paid by RAC East and then came
 2 up with some sort of a formula estimate that
 3 calculated the supposed South Carolina
 4 management fee, and then used that in their
 5 numerator and then disregarded the store
 6 revenues from the denominator, and then used
 7 that factor to apply to, again, gross receipts
 8 and didn't allow any expense deductions.
 9 THE COURT: Go back through that again. Just repeat
 10 it.
 11 MR. TOLLACK: From the very part -- beginning part?
 12 THE COURT: Yes.
 13 MR. TOLLACK: Okay.
 14 A: They looked at the total management fee paid by
 15 RAC East in all the states that it did business
 16 and came up with a methodology or an estimate
 17 of how much they thought was related to South
 18 Carolina without reviewing any of the detailed
 19 information from South Carolina. And then took
 20 the amount and used that in the numerator with
 21 the total management fees collected by RAC
 22 Texas in the denominator. And then that ratio
 23 then they applied to only the gross revenue of
 24 the management fees of RAC Texas. Again,
 25 without allowing for any expenses.

1 Q: All right. And so their formula, did it look
 2 at the actual income earned by RAC Texas from
 3 South Carolina stores?
 4 A: No, it did not.
 5 Q: So if the South Carolina stores -- do your
 6 stores operate at different profit levels?
 7 A: Yes.
 8 Q: And so if the South Carolina stores operated at
 9 a loss, what would the result be under the
 10 Department's method?
 11 A: Well, if the stores were operating at a loss,
 12 they wouldn't pay any management fee.
 13 Q: Okay.
 14 A: At all.
 15 Q: Shouldn't pay any management fee at all?
 16 A: That's correct.
 17 Q: All right. And so how would that impact, if
 18 you used the Department's method, the tax?
 19 A: It would be, even under their method, if they
 20 didn't pay any management fee, there would be
 21 no tax.
 22 Q: But they're not looking at South Carolina
 23 stores, correct?
 24 A: Correct.
 25 MR. RYAN: Objection. Leading, Your Honor.

1 after you got these audit reports. What was
 2 your reaction to the audit reports?
 3 MS. GEER: Your Honor, may I have one moment?
 4 THE COURT: I'm going to give you longer for one
 5 moment.
 6 MS. GEER: Okay.
 7 THE COURT: I'm going to break for lunch at this
 8 point in time. Let's be back at two o'clock?
 9 Is that okay with you?
 10 MR. VON LEHE: Yes, Your Honor.
 11 MR. RYAN: Certainly, Your Honor.
 12 THE COURT: All right.
 13 (Lunch break from 12:41 p.m. until 2:06 p.m.)
 14 MS. GEER: Your Honor, we would like Mr. Tollack to
 15 complete his testimony.
 16 THE COURT: You're still under oath.
 17 Q: Mr. Tollack, when we broke for lunch, we were
 18 just starting to talk about what happened after
 19 you received the audit reports. What did you
 20 do after you received the audit reports from
 21 the Department of Revenue?
 22 A: I called the -- our legal counsel, Mike
 23 McLaughlin at Morrison Foester.
 24 Q: Okay. And without saying anything about what
 25 you and they talked about, what were the next

1 THE COURT: Sustained.
 2 MS. GEER: Apologies, Your Honor.
 3 A: As I said, they were looking --
 4 THE COURT: Well, you've got -- you need to re --
 5 Q: I will rephrase first and then you may answer.
 6 Tell us what the -- what is the problem with
 7 the Department's method?
 8 A: The problem is they're looking at all of RAC
 9 East without looking at state specific
 10 information. And profits vary by state,
 11 profits vary store to store. And so they're
 12 ignoring the reality of the performance of the
 13 stores in South Carolina.
 14 Q: All right. And this is a similar question.
 15 You sort of covered it, but I'll ask it anyway.
 16 Does the Department's method consider the net
 17 income of the taxpayer?
 18 A: No, it does not.
 19 Q: And you stated earlier that you were familiar
 20 with the South Carolina Corporate Tax Return
 21 instructions and regulations regarding that.
 22 Is there anything that allows for the method
 23 employed by the Department as to RAC Texas?
 24 A: No, there isn't.
 25 Q: All right. Let's talk about what happened

1 steps that you took?
 2 A: They filed a protest on our behalf.
 3 Q: Were there any discussions between Rent-A-
 4 Center West -- anyone on behalf of Rent-A-
 5 Center West and Rent-A-Center Texas and the
 6 Department before you filed the protest
 7 letters?
 8 A: I don't recall any further discussions.
 9 Q: Okay. All right. So the protest letters, are
 10 the protest letters that were filed on behalf
 11 of RAC West and RAC Texas located at Tabs 3 and
 12 4 of Exhibit One?
 13 A: Yes.
 14 Q: Thereafter, did you receive Department
 15 determinations for each entity?
 16 A: Yes, we did.
 17 Q: Under Tab 5 and 6 in Exhibit One, are those the
 18 determinations you received?
 19 A: Yes, they are.
 20 Q: Did the determination contain any factual
 21 inaccuracies?
 22 A: Well, it stated that RAC Texas owned the Point
 23 of Sale software and it was using it in South
 24 Carolina stores.
 25 Q: Did it suggest that any other activities --

1 MR. RYAN: Objection. Leading, Your Honor.
 2 THE COURT: Sustained.
 3 Q: If you - you have the Department's
 4 determinations in front of you?
 5 A: Yes.
 6 Q: Can you look at them and see if there are any
 7 other factual inaccuracies. And actually,
 8 which one are you looking at right now?
 9 A: RAC Texas.
 10 Q: Okay. That's the one at Tab 6?
 11 A: Yes. Well, it states here that under item 4 of
 12 relevant facts that, stated differently, four
 13 and a half percent of net profits remain with
 14 RAC East, Rainbow Rentals and RAC RR, Inc., and
 15 the other 95 and a half percent of profit is
 16 shifted to the taxpayer as a management fee.
 17 That's an inaccurate statement.
 18 THE COURT: Say that one more time. I'm sorry.
 19 MR. TOLLACK: Okay. I'm sorry.
 20 THE COURT: You read it and you went fast.
 21 MR. TOLLACK: Okay. Sorry.
 22 A: Under item 4 of relevant facts, which is on
 23 page 2, the second sentence starts, stated
 24 differently, four and a half percent of net
 25 profits remain with RAC East, Rainbow Rentals,

1 MR. TOLLACK: Yes.
 2 Q: All right. Can you flip over to page 4 for me.
 3 A: Yes.
 4 Q: All right. The determination reads, employees
 5 hired for - the taxpayer provides human
 6 resources, or let me go to the three entities,
 7 including the hiring and terminating of
 8 employees. Did you speak earlier on the topic
 9 of hiring and firing?
 10 A: Yes, I did.
 11 Q: Okay. And tell us how - whether that
 12 statement that I just read is accurate or not.
 13 A: I'm still looking for that statement.
 14 Q: I'm sorry. It's subsection (a) under human
 15 resources.
 16 A: Okay.
 17 Q: The first sentence.
 18 A: Oh, I see it. Okay. Well, it fails to
 19 understand the fact that the employees are
 20 actually employees of RAC East, not employees
 21 of RAC Texas.
 22 Q: Does RAC Texas fire employees?
 23 A: No. It only - it's only consulted before the
 24 termination occurs.
 25 Q: All right. Let's look at - let's talk about

1 and RAC RR, Inc., and the other 95.5 percent of
 2 any profit is shifted to the taxpayer as a,
 3 quote, management fee, end of quote, period.
 4 Q: And tell us how that is inaccurate. How does
 5 the fee actually work?
 6 A: Well, the fee is actually calculated based upon
 7 the total operating expenses, and it guarantees
 8 a profit to the stores of four and a half
 9 percent of their operating expenses.
 10 Q: All right.
 11 THE COURT: So how is that different -
 12 MR. TOLLACK: For instance, take an example -
 13 THE COURT: I mean it guarantees four and half. But
 14 they may get more is what you're intimating?
 15 MR. TOLLACK: Yes. The difference between the
 16 actual profit of the store and the four and a
 17 half percent level is the amount that is paid
 18 as a management fee. So let's say, for
 19 instance, total expenses were \$100. They'd be
 20 guaranteed a profit of four and a half dollars.
 21 And if the total profit of the store was ten
 22 dollars, they'd get five and a half dollars of
 23 management fee.
 24 THE COURT: Okay. They get five and a half dollars
 25 - yeah, you said in management fees?

1 the RAC East audit. Was RAC East audited?
 2 A: Yes, it was.
 3 Q: Okay. And did the Department challenge the
 4 methodology or the calculation of the
 5 management fee paid by RAC East?
 6 A: No, they did not.
 7 Q: Did they indicate that there was anything
 8 improper about the amount of the fee?
 9 MR. RYAN: Objection. Leading, Your Honor.
 10 THE COURT: Sustained. That was quite a -- I
 11 sustain it.
 12 Q: What, if anything, did they indicate about
 13 whether the fee was appropriate or not?
 14 A: Well, they allowed the entire amount of fee to
 15 be deducted by RAC East, so I'm assuming they
 16 thought it appropriate.
 17 Q: Did the Department allow RAC East to deduct 100
 18 percent of the management fee it paid to RAC
 19 Texas?
 20 A: Yes, it did.
 21 Q: All right. Let's talk about -- let's see. All
 22 right. We talked earlier about the income from
 23 the management fees. And let's assume that a
 24 court finds that there is nexus over RAC Texas,
 25 just for the purpose of these questions. If a

1 court makes that determination, then where do
 2 you believe the management fees should be
 3 sourced?
 4 A: Well, it should be sourced to Texas where the
 5 activity is performed.
 6 Q: All right. I want to ask you a few questions
 7 about the penalties that were assessed. For
 8 RAC West, it was substantial understatement and
 9 negligence is what you previously testified.
 10 So let's talk about RAC West first. Do you
 11 believe that RAC West had substantial authority
 12 for reporting its income as it did?
 13 A: Yes, I do.
 14 Q: And what authority did it rely upon?
 15 A: Well, it followed the instructions that the tax
 16 return and it followed the form prescribed in
 17 the tax return. Reported all of its income,
 18 attached federal pro forma, which has details
 19 of income and expenses. And it's the same
 20 income and expenses that were reported to the
 21 Internal Revenue Service, and which was, in
 22 fact, audited.
 23 Q: Okay. Was there -- besides the form, was there
 24 any other authority that you relied upon in
 25 filing RAC Texas -- I'm sorry RAC West in that

1 are, they had no business activity in South
 2 Carolina.
 3 Q: And what authority did you rely on?
 4 A: Relied on my knowledge of multi-state income
 5 tax law, as well as my general knowledge of
 6 what constitutes doing business in the state of
 7 South Carolina.
 8 Q: And has -- other than Texas where RAC Texas is
 9 and South Carolina, has any other state
 10 attempted to assert nexus over RAC Texas?
 11 A: No, they have not.
 12 Q: I'm sorry. For the management services, based
 13 on management services?
 14 A: For any services.
 15 Q: Okay.
 16 MS. GEER: Your Honor, that's all the questions I
 17 have for this witness.
 18 THE COURT: All right. Hold on one moment.
 19 Proceed.
 20 MR. TOLLACK - CROSS-EXAMINATION BY MR. RYAN:
 21 Q: Good afternoon, Mr. Tollack. You and I have
 22 spoken over the telephone through these
 23 depositions. But my name is Sean Ryan. I'm
 24 counsel for the Department of Revenue. Would
 25 you mind turning to Exhibit One, Tab 10, the

1 manner?
 2 A: Just general -- my general knowledge of multi-
 3 state tax laws.
 4 Q: All right. Do you believe that RAC West made
 5 adequate disclosure on its income tax returns?
 6 A: Yes. As I said, it attached the federal pro
 7 forma with the detail of income expenses. And
 8 it completed every line of that information was
 9 required be inserted or added to.
 10 Q: And do you believe -- well, let me ask it this
 11 way. Was there any way for RAC West to know
 12 that they were supposed to file the returns
 13 using the method that the Department now
 14 asserts?
 15 MR. RYAN: Objection. Leading, Your Honor.
 16 THE COURT: Sustained.
 17 Q: How would you know? How would you know how to
 18 file in the manner the Department is asserting?
 19 A: There was nothing in the instructions about
 20 this methodology or anything else that I had
 21 ever seen.
 22 Q: Let me ask about RAC Texas. Do you believe
 23 that you had substantial authority to support
 24 RAC Texas not filing in South Carolina?
 25 A: Yes. My understanding of the facts as they

1 Management Services Agreement. I'm going to
 2 ask you about that.
 3 A: Okay.
 4 Q: Now, when the original management services
 5 agreement was entered into, wasn't the
 6 management fee 3.3 percent of each operating
 7 entity's gross monthly revenue?
 8 A: The agreement states that. However, that's
 9 never the amount that was actually paid. It
 10 was an error on the document which was
 11 subsequently corrected when it was amended.
 12 Q: So it was changed because there was an error?
 13 A: That's correct.
 14 Q: Who determined the original -- what was it
 15 supposed to state?
 16 A: Four and a half percent.
 17 Q: Four and a half percent of what?
 18 A: For and a half percent of the residual profits.
 19 It was intended to be four and a half percent.
 20 Q: Now, is the four and a half percent residual
 21 profit based on the pricing study?
 22 A: Yes, it is.
 23 Q: So the amount you're getting that RAC Texas has
 24 paid is based upon the premise put forth in
 25 that pricing study?

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1 A: Yes, it is.
 2 Q: All right. Let's talk about leasing. Now, in
 3 that Management Services Agreement, I believe
 4 it's subpart - it's on the second page,
 5 subpart - what is that?
 6 A: Nine.
 7 Q: Now, it says that you - that RAC Texas will
 8 coordinate the leasing of all real property on
 9 behalf of the company, right?
 10 A: Yes.
 11 Q: Now, when RAC Texas is negotiating a lease for
 12 a South Carolina store, they're negotiating
 13 regarding land here in South Carolina, right?
 14 A: That's correct.
 15 Q: And that property would be protected by South
 16 Carolina law?
 17 A: I assume so.
 18 Q: Now, the condition of a potential shopping
 19 plaza, that's important, right?
 20 A: It's one of the factors that's considered, yes.
 21 Q: Now, how do you evaluate the condition of a
 22 shopping plaza from Texas?
 23 A: You can easily view pictures of almost any
 24 property on line from anywhere in the country,
 25 or the world for that matter.

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1 Q: Now, didn't you tell me at deposition that
 2 before any property is leased, someone from the
 3 RAC entity goes and visits that property?
 4 A: I don't think that's absolute every time. But
 5 it's very common that somebody who lives in a
 6 neighborhood is going to be observing or seeing
 7 property that's within a close proximity either
 8 of where they work or live.
 9 Q: They'll go by and see the site?
 10 A: Yes.
 11 Q: Isn't that part of the leasing process?
 12 A: No. I don't view it as being part of the
 13 leasing process.
 14 Q: What part of the process is it?
 15 A: General observations. Store managers obviously
 16 have an interest in having a store location
 17 that is going to increase the traffic in their
 18 stores.
 19 Q: But it's the - so this is the store manager
 20 for the store that's not open yet?
 21 A: Right. It could be a store manager from a
 22 store that's close by.
 23 Q: And they do this on their own time; is that
 24 what you're saying?
 25 A: It's not - it's not really a time demanding

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1 job. It's just part of a daily routine. They
 2 may be going to the bank to make a deposit and
 3 see a spot where somebody is closed or moved
 4 out. And so they talk to somebody in our real
 5 estate leasing department and say hey, this
 6 location looks like it's available.
 7 Q: Now, let's look back at the agreement. It says
 8 coordination of leasing real property on behalf
 9 of company. Does it - can you show me where
 10 in this agreement it says for leasing it's only
 11 the parts that you do in Texas?
 12 A: I'm sorry. What?
 13 Q: Does the agreement specify that what goes on
 14 only goes on in Texas?
 15 A: It doesn't mention anything about where the
 16 services are performed, no.
 17 Q: Does it mention that the visit of the potential
 18 location by the store manager is not included?
 19 A: I don't see that as relevant, no.
 20 Q: I'm not asking you relevance, sir.
 21 THE COURT: If you can answer his questions.
 22 Q: Does it say that?
 23 A: No, it doesn't say that.
 24 Q: Does it - does it say that you're only
 25 handling part of the leasing process?

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1 A: Since it doesn't have a lot of detail, I
 2 believe it doesn't specify it, how much of the
 3 leasing process is -
 4 Q: In fact all it says is you're just coordinating
 5 the leasing process, correct?
 6 A: That's correct.
 7 Q: Now, the pricing study, does that specify that
 8 in terms of leasing, you're only getting paid
 9 for what goes on in Texas?
 10 A: I don't recall.
 11 Q: So wouldn't you say that part of the leasing
 12 process is you said that store manager visiting
 13 a potential location and you're paid for the
 14 whole process?
 15 A: Well, this doesn't say we're paid for the whole
 16 process. We're paid for what we do.
 17 Q: If it - well, what part of the process does it
 18 say you are paid for?
 19 A: Coordination of leasing of real property on
 20 behalf of the company.
 21 Q: But it doesn't specify the different parts?
 22 A: No, it doesn't.
 23 Q: So there's no way for you to say that that says
 24 whether or not you're being paid for the South
 25 Carolina portion, is it?

1 A: Well, I believe that coordinating the real
 2 property on behalf of the company would include
 3 coordinating real property in South Carolina.
 4 Coordinating and leasing the property in South
 5 Carolina as well.
 6 Q: Now, is the location of the store important to
 7 the success of the store?
 8 A: It's one factor that makes -- can make it
 9 successful. Yes.
 10 Q: And when you choose a store, a location for the
 11 store, aren't you trying to maximize the number
 12 of customers that will come in that store?
 13 A: I think that's a general rule for most of our
 14 operations, yes.
 15 Q: So when you lease real property in South
 16 Carolina, aren't you trying to maximize the
 17 economic market of South Carolina that will
 18 come into that store?
 19 A: RAC East, the store operator is, yes.
 20 Q: But you're the one choosing the location,
 21 correct?
 22 A: Generally choosing the location, correct.
 23 Q: You're the entity that's doing the negotiating
 24 of this lease, correct?
 25 A: Right.

1 correct?
 2 A: Yes. It would be two parties involved in that
 3 discussion. One would be in South Carolina;
 4 one would be in Texas.
 5 Q: And that South Carolina property and that South
 6 Carolina landlord would be in the South
 7 Carolina marketplace, correct?
 8 A: It would be in the real estate marketplace of
 9 South Carolina, yes.
 10 Q: Now, does the landlord have to travel to Texas
 11 to execute the lease?
 12 A: No.
 13 Q: Would it be fair to say that a landlord may
 14 execute his portion here in South Carolina?
 15 A: Yes, that would be fair to say.
 16 Q: Now, if there were a dispute regarding one of
 17 these leases, you said earlier that RAC East
 18 would handle that. Does RAC East have its own
 19 set of lawyers?
 20 A: No. RAC East does not employ any lawyers.
 21 Q: Does RAC Texas employ lawyers?
 22 A: Yes, it does.
 23 Q: Would the RAC Texas lawyers be the ones
 24 handling that dispute?
 25 A: They would manage all litigation normally,

1 Q: But where are you aiming all of those
 2 negotiations? Is it South Carolina?
 3 A: We're aiming them to our client or our
 4 customer, which is RAC East of South Carolina.
 5 Q: But you're not leasing property from yourself,
 6 are you? I mean, you're dealing with landlords
 7 that aren't RAC entities, right?
 8 A: Right. But all the leases are in the name of
 9 RAC East.
 10 Q: But when you're doing the negotiations, it's
 11 RAC Texas talking to the landlord here, right?
 12 A: Correct.
 13 Q: So aren't you aiming your negotiations towards
 14 that landlord?
 15 A: I don't see the correlation, no.
 16 Q: I'm asking -- I'm not asking you to see a
 17 correlation. Do you --
 18 THE COURT: Once again, sir, when he asks a
 19 question, you should answer the question unless
 20 it's objected to.
 21 MR. TOLLACK: Okay. I'm sorry. But I don't
 22 understand your question.
 23 Q: When you're negotiating a lease with a South
 24 Carolina landlord, you're directing your
 25 negotiations at the South Carolina landlord,

1 which would include hiring the local counsel if
 2 needed.
 3 Q: What if local counsel isn't needed? Would it
 4 just be between your in-house lawyer? Can that
 5 in-house lawyers sometimes try to negotiate
 6 directly with the landlord?
 7 A: That I don't know.
 8 Q: Now, if you went to court about a property in
 9 South Carolina, wouldn't that go in a South
 10 Carolina court?
 11 MR. VON LEHE: Your Honor, that calls for a
 12 conclusion of law. This witness is not a
 13 trained lawyer or a judge.
 14 THE COURT: Any response?
 15 MR. RYAN: I'll withdraw, Your Honor.
 16 THE COURT: Okay.
 17 Q: In your experience, if there's been a dispute
 18 with a landlord, is that usually brought in the
 19 state where the property is located?
 20 A: I do not know.
 21 Q: Do you know whether or not the leases you
 22 negotiate are protected by South Carolina law?
 23 MR. VON LEHE: Your Honor, again, calls for a legal
 24 conclusion. He's not a lawyer.
 25 MR. RYAN: Your Honor, I asked him if he knew. He

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1 doesn't know, he can say he doesn't know.
 2 THE COURT: Well, you asked if it's protected by
 3 South Carolina law. I think I'll sustain the
 4 objection as asked.
 5 Q: In your experience, do you know if the leases
 6 you negotiated utilize the courts of those
 7 states to be protected?
 8 A: I do not know.
 9 Q: Let's talk about hiring. Now, part of the
 10 management fee is for hiring and firing,
 11 correct?
 12 A: Correct.
 13 Q: I believe that's item number 4, correct?
 14 A: Yes.
 15 Q: Under the Management Services Agreement?
 16 A: Yes.
 17 Q: Can you read item number 4 out loud, please.
 18 A: "General human resource services for the
 19 Company, including, but not limited to, the
 20 hiring of employees by the Company, termination
 21 of Company employees and the management of the
 22 Company benefit plan."
 23 Q: So it goes into the specifics, doesn't, saying
 24 hiring and firing, correct?
 25 A: Yes.

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1 Q: Now, would you agree that the hiring process
 2 includes attracting people to apply for a job?
 3 A: I'm not sure what you mean by that.
 4 Q: In order to get people to apply, you have to
 5 attract them - how do you get people to apply?
 6 A: People see information on the internet. People
 7 may be walking by a store, and it may be a
 8 customer would like to work for Rent-A-Center.
 9 Q: Is the application process part of hiring and
 10 firing someone?
 11 A: Yes.
 12 Q: Now, as part of the application process, don't
 13 applicants have to come to the store and
 14 complete an application?
 15 A: They can come to a store and complete an
 16 application, but I also know that they can
 17 apply over the internet from any place.
 18 Q: Is that what you testified to in your
 19 deposition?
 20 A: In deposition I testified that they come to the
 21 store. But since then I've found out that they
 22 can also apply just from their own home over
 23 the internet.
 24 Q: Now, if I were a potential employee and I go
 25 into a South Carolina store, is there a

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1 computer there?
 2 A: Yes, there is.
 3 Q: Is that computer dedicated just to hiring and
 4 applications?
 5 A: Yes.
 6 Q: It would it be fair to say applicants don't
 7 have to go to Texas to be hired, do they?
 8 A: That's correct.
 9 Q: And those dedicated computers for taking
 10 applications, those would be here in South
 11 Carolina, correct?
 12 A: Yes, they would.
 13 Q: And would you say applications are an important
 14 part of the hiring process?
 15 A: You can't hire someone without them applying
 16 for it, so yes.
 17 Q: And the information provided through that
 18 application, that's important to the hiring
 19 process, right?
 20 A: Yes.
 21 Q: And now isn't there some dialogue often between
 22 a potential applicant and the store manager
 23 about the job duties and pay and things like
 24 that in the store?
 25 A: I would assume so.

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1 Q: Isn't that part of the hiring process?
 2 A: I think that's part of the information process,
 3 the inquiry process of a prospective employee.
 4 Q: Now, for South Carolina, would that
 5 conversation take place here in South Carolina?
 6 A: Yes, it would.
 7 Q: Now, an applicant doesn't have to contact Texas
 8 to apply, do they?
 9 A: I'm not sure what you mean contact Texas.
 10 Q: Do they have to call someone in the state of
 11 Texas to apply?
 12 A: They would have to talk to somebody over the
 13 phone in Texas before that candidate is
 14 selected to be interviewed.
 15 Q: No, I'm just saying just to get an application
 16 submitted. Do they have to call Texas?
 17 A: No, they don't.
 18 Q: Would it be fair to say that most of the South
 19 Carolina employees live in South Carolina?
 20 A: Yes.
 21 Q: Would it be fair to say that most of the
 22 applications for South Carolina positions are
 23 completed in South Carolina?
 24 A: Yes.
 25 Q: Now, potential employees before they're hired,

1 they're interviewed by a store manager, aren't
 2 they?
 3 A: Yes, they are.
 4 Q: Now, is that interview an important part of the
 5 hiring process?
 6 A: Yes.
 7 Q: So for a potential South Carolina employee,
 8 wouldn't that interview take place in South
 9 Carolina?
 10 A: Yes, it would.
 11 Q: Now, just to be clear. Potential candidates
 12 aren't flown to Texas for that interview, are
 13 they?
 14 A: No, they're not.
 15 Q: Now, part of the hiring process involves what's
 16 called the observation day; is that right?
 17 A: I'm not sure about that.
 18 Q: So you don't know whether or not an employee
 19 has to come in and observe what goes on before
 20 they get hired?
 21 A: No, I don't.
 22 Q: How familiar are you with the hiring process of
 23 Rent-A-Center?
 24 A: I have worked in a store for several weeks at
 25 a time.

1 counsel here.
 2 Q: And the legal department is part of who?
 3 A: RAC Texas.
 4 Q: So let's go over this again. Completing
 5 applications happens in South Carolina,
 6 correct?
 7 A: The information inputted in South Carolina, but
 8 then transmitted to Texas, yes.
 9 Q: It's submitted here, correct, in the store?
 10 A: Correct.
 11 Q: And the discussion with the job, about the job
 12 with the store manager, that takes place here,
 13 correct?
 14 A: Yes.
 15 Q: And the potential interview, that takes place
 16 here, right?
 17 A: The interview takes place here, yes.
 18 Q: And the final decision of who gets hire here is
 19 done by a store manager here, correct?
 20 A: Yes.
 21 Q: And now let's look at that Management Services
 22 Agreement again in section 4. Can you tell me
 23 - what does it - it says that they're
 24 responsible for hiring, doesn't it?
 25 A: No, it says, including, but not limited to

1 Q: Now, isn't it the store manager who makes the
 2 ultimate decision of who gets hired?
 3 A: Yeah. Well, he selects a candidate after
 4 they've been screened. So once - you know, I
 5 mean, there's a lot of individuals who have
 6 applied that never make it to that point. But
 7 then he would select the ones, of the ones who
 8 are qualified, he would select one or two that
 9 would make it that for.
 10 Q: And then he makes the final call, correct? He
 11 or she makes the final call?
 12 A: Yes.
 13 Q: And for a South Carolina store, that South
 14 Carolina manager would be here, right?
 15 A: Yes, he will.
 16 Q: Now, if a potential South Carolina employee is
 17 not hired and they feel wronged because they
 18 weren't hired and they decide to bring an
 19 action, would RAC Texas handle that litigation?
 20 A: No. The litigation would involve RAC East, not
 21 RAC Texas. It's a RAC East employee.
 22 Q: So RAC East would hire its own lawyers?
 23 A: No. If it was litigation, it would be managed
 24 by the legal department as all litigation is.
 25 But they would engage legal counsel, local

1 hiring of employees.
 2 Q: And all those things I just discussed, aren't
 3 those part of the hiring process?
 4 A: Yes.
 5 Q: And they all occur here, don't they?
 6 A: Yes, they do.
 7 Q: And isn't RAC Texas compensated for handling
 8 the hiring process?
 9 A: They're compensated for all the things that
 10 they do in RAC Texas - in Texas.
 11 Q: Can you show me where in the agreement it
 12 specifies only what goes on in Texas?
 13 A: It doesn't say only in Texas, but that's where
 14 the employees that perform those activities are
 15 located.
 16 Q: But you just said the store manager did all of
 17 those parts here in South Carolina that are
 18 part of the hiring process, right?
 19 A: Those are only parts. It says including, but
 20 not limited to, and it doesn't discuss all the
 21 parts - all of the processes that are done in
 22 Texas.
 23 Q: But it doesn't specify that you're only being
 24 paid for the parts in Texas, does it?
 25 A: Well, we're only paid for what we do.

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1 Q: Does it specify that the management fee only
 2 pays you for what goes on in Texas?
 3 A: It specifies that we paid for what we do and
 4 what we do goes on in Texas.
 5 Q: Can you show me in here where it says that?
 6 A: No, I can't.
 7 Q: Because it doesn't say it in here, does it?
 8 A: No, it doesn't.
 9 Q: In the pricing study, does it say does you only
 10 get paid for what goes on in Texas?
 11 A: There is no language in the pricing study that
 12 says that, no.
 13 Q: Does the pricing study say that as to hiring
 14 you're only paid for the portion that goes on
 15 in Texas?
 16 A: It doesn't specify it in those kinds of
 17 details, no.
 18 Q: Does it specify that you're not being paid for
 19 the portions that the store manager does here
 20 in South Carolina?
 21 A: The store manager is paid by the company that
 22 owns the stores in South Carolina.
 23 Q: I'm not asking you if it specifies who pays the
 24 store manager. I'm asking you if it specifies
 25 that the management fee paid to Texas specifies

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1 that it's not compensating you for the portion
 2 that goes on in South Carolina?
 3 A: I guess I'm confused by your question.
 4 MR. VON LEHE: Your Honor, let me object here and
 5 make a -- the basis of objection is the
 6 agreement speaks for itself, the language of
 7 the agreement speaks for itself. I think the
 8 witness has already answered -- or the question
 9 has been asked and answered now a number of
 10 times. I say the agreement speaks for itself.
 11 MR. RYAN: I'll move on, Your Honor.
 12 THE COURT: Okay.
 13 Q: Let's talk about firings. According to the
 14 Management Services Agreement, aren't you
 15 specifically compensated for handling firings?
 16 A: Well, I think we've read that section before.
 17 Q: Does it say termination of company employees?
 18 A: Yes.
 19 Q: Why would an employee be fired?
 20 A: Well, there's -- as with any business, there's
 21 a multitude of reasons that an employee is
 22 terminated.
 23 Q: Can you give me some examples?
 24 A: Could be non-performance by an individual or
 25 not performing job duties as required. Could

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1 be violation of company policies. I mean, the
 2 list is very long.
 3 Q: How would -- just from the examples you just
 4 gave. How would RAC Texas know an employee did
 5 any of those things?
 6 A: Because any time there is an employee issue, a
 7 store manager will discuss that with a human
 8 resource representative in Texas.
 9 Q: So it's the store manager making the
 10 observations?
 11 A: Yes.
 12 Q: And again, for South Carolina, that South
 13 Carolina manager will be here in South
 14 Carolina?
 15 A: That's correct.
 16 Q: And isn't it the store manager who initiates
 17 the firing process?
 18 A: Yes. He would request -- he would contact the
 19 human resource department and ask their advice.
 20 And then once he has listened to their advice
 21 and any suggestions that they would have, he
 22 would have the decision to terminate an
 23 employee.
 24 Q: So he's got the final call?
 25 A: Basically, yes.

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1 Q: Are employees flown to Texas to be fired?
 2 A: No.
 3 Q: Now, is it the store manager who gets the
 4 unfortunate task of sitting down with employees
 5 and letting them know that they've been fired?
 6 A: Generally, yes.
 7 Q: And wouldn't you agree that the observation,
 8 the decision and the notification of firing all
 9 take place in South Carolina for a South
 10 Carolina employee?
 11 A: Yes, they do.
 12 Q: Does the agreement where it speaks of firing,
 13 does it specify that those portions going on in
 14 South Carolina are not being compensated by the
 15 management fee?
 16 A: The agreement doesn't specify.
 17 MR. VON LEHE: Again, objection. The agreement
 18 speaks for itself. The language is there. The
 19 witness has already testified about this.
 20 MR. RYAN: The witness has testified about hiring.
 21 Now I'm into firing, Your Honor.
 22 MR. VON LEHE: Same objection, Your Honor.
 23 THE COURT: He can ask the witness to publish what
 24 the agreement states. You can't ask for an
 25 interpretation of what the agreement means.

1 MR. VON LEHE: Yes, Your Honor.
 2 THE COURT: So at this point in time, it sounded
 3 like his agreement was does it state. I'm
 4 going to overrule your objection on the
 5 question does it state, but if he goes any
 6 further, I'll sustain the objection.
 7 Q: Does the pricing study, does it state that RAC
 8 Texas is not compensated for the portion of the
 9 firing process that goes on in South Carolina?
 10 A: No, it doesn't specify.
 11 Q: Does the pricing study state that RAC Texas is
 12 only compensated for the portions going on in
 13 Texas?
 14 A: It doesn't make any statement about that.
 15 Q: Let's talk about training. Does RAC Texas
 16 handle training for the South Carolina stores?
 17 A: Yes, it does.
 18 Q: Does the management fee that RAC Texas
 19 receives, does it compensate RAC Texas for the
 20 training?
 21 A: Yes, it does.
 22 Q: Now, training is important for the stores'
 23 ability to succeed, isn't it?
 24 A: Yes, it is.
 25 Q: And training for any given store, let's say

1 A: Correct.
 2 Q: So RAC Texas would have video cassettes and
 3 printed materials here?
 4 A: I don't think they -- they're like a supply.
 5 They're basically shipped. Every store goes
 6 through training with every new employee. So
 7 it's like whenever they need more of these
 8 binders or video cassettes, they're sent to the
 9 stores.
 10 Q: Who owns the rights to the training materials?
 11 A: That I don't know.
 12 Q: And during the audit period, did training
 13 include both paper materials and video
 14 cassettes?
 15 A: Yes.
 16 Q: And those paper materials and video cassettes
 17 would be reviewed here in South Carolina?
 18 A: Yes.
 19 Q: So South Carolina employees aren't sent to
 20 Texas for training, are they?
 21 A: No.
 22 Q: Are South Carolina employees trained how to use
 23 the cash registers, computer cash registers?
 24 A: Yes.
 25 Q: Where would that training take place?

1 South Carolina stores, where does that training
 2 actually take place?
 3 A: It's actually in the store.
 4 Q: So for a South Carolina employee, they're
 5 trained in a South Carolina store?
 6 A: Correct.
 7 Q: And who conducts the training in South Carolina
 8 stores?
 9 A: There are training materials that are developed
 10 in Texas and given to the stores for their --
 11 for training.
 12 Q: My question wasn't quite clear enough. Who's
 13 actually the person overseeing or managing the
 14 class?
 15 A: There is no manager in the class.
 16 Q: Who is presenting the class?
 17 A: It's self-contained. It's written materials
 18 and video cassettes.
 19 Q: Oh, it's a self study?
 20 A: Yes.
 21 Q: Oh. That's my confusion. Sorry. So RAC Texas
 22 creates the materials and sends them here,
 23 correct?
 24 A: That's correct.
 25 Q: And those materials stay here, correct?

1 A: In the store.
 2 Q: In South Carolina? For a South Carolina
 3 employee, would that be in South Carolina?
 4 A: Yes.
 5 Q: Now, are South Carolina employees trained on
 6 how to use delivery trucks?
 7 A: I believe that they have to have a driver's
 8 license so they know how to drive before
 9 they're hired. And the truck isn't like a big
 10 semi truck. It's a truck that you or I could
 11 easily get into and drive.
 12 Q: Are they shown how to use -- I'm imagining
 13 there's a lift on the back or something. Are
 14 they shown how to use anything on the truck?
 15 A: I believe that's part of the -- in the training
 16 materials, safety issues.
 17 Q: Are they actually put on a truck itself to
 18 train?
 19 A: Are they put on a truck?
 20 Q: Are they put in front of an actual physical
 21 truck and shown how to do things?
 22 A: That I don't know.
 23 Q: Now, a current South Carolina employee would
 24 use -- go on the computer for training,
 25 correct?

1 A: Yes.
 2 Q: You're no longer using the paper materials as
 3 much; you've now moved to online training?
 4 A: Correct.
 5 Q: And they can be sitting in front of a computer
 6 in South Carolina, correct?
 7 A: Correct.
 8 Q: Do South Carolina store managers train their
 9 employees how to use the computer system?
 10 A: Yes.
 11 Q: Would that training take place in South
 12 Carolina?
 13 A: Yes.
 14 Q: Now, can you show me where in the pricing study
 15 -- would you agree that RAC Texas is
 16 compensated for handling training, correct?
 17 A: Yes.
 18 Q: Can you show me where in the pricing study it
 19 says that you're not paid for the portion that
 20 goes on in South Carolina?
 21 A: There's no language to that effect, no.
 22 Q: Can you show me where in that pricing study it
 23 says you're only paid for the portion of the
 24 training that takes place in Texas?
 25 A: I don't believe there's any language to that

1 their experience with others and have hands-on
 2 experience of how RAC operates. The training
 3 program covers an initial two week program
 4 addressing basic issues. This involves
 5 learning how new customers are added to the MIS
 6 system, how their accounts are set up, and how
 7 RAC manages its customer service and customer
 8 payment process. The intermediate training
 9 program focuses on other areas of the business,
 10 such as internal controls and the use of
 11 computer reports. The final stage teaches
 12 account management in understanding further RAC
 13 operational issues. The following areas are
 14 covered in the training manuals: expectation of
 15 RAC customers and customer relations, rental
 16 payments, rental selling, taking rental orders,
 17 closing the rental agreement, e.g., what
 18 information to collect from customers, vehicle
 19 safety, product delivery, product services and
 20 account management. At the successful
 21 completion of the self-study program, the
 22 market manager awards the staff with a
 23 certificate."
 24 Q: Now, anywhere in those paragraphs you read does
 25 it say that the RAC stores handle training?

1 effect, no.
 2 Q: Okay. Let's look at that pricing study, which
 3 I believe is item 13. Can you go to section --
 4 look over to page 13 of that report.
 5 A: Okay.
 6 Q: Can you see section 4.1.10?
 7 A: Yes.
 8 Q: What is that section labeled?
 9 A: Training.
 10 Q: Can you read through that section.
 11 A: "Training includes the development of training
 12 materials, the distribution of training
 13 material, along with conducting training
 14 sessions."
 15 Q: Keep reading.
 16 A: "RAC Management has developed a sophisticated
 17 three stage training model which requires each
 18 staff to review the self study training manuals
 19 and videos. As the company has a general
 20 policy of recruiting from within the company,
 21 through for example, internal promotions, these
 22 training programs are aimed at developing staff
 23 at various stages of their progress of the
 24 company. Furthermore, these training sessions
 25 are run by internal staff, are able to share

1 A: Well, there's inter -- yes. There is
 2 interaction with store employees. Is that what
 3 you're asking?
 4 Q: No. I'm just saying anywhere in that language
 5 can you show me where it says that the RAC
 6 stores are the ones who handle training?
 7 MR. VON LEHE: Your Honor again, objection. The
 8 agreement speaks for itself. He need not
 9 interpret --
 10 THE COURT: Yeah. I'll sustain your objection on
 11 that one. I think I -- I can't remember the
 12 exact question. But I --
 13 MR. RYAN: Can you show me where, is what I asked
 14 him.
 15 THE COURT: That's kind of getting in a gray area
 16 between --
 17 MR. RYAN: I'll move on, Your Honor.
 18 THE COURT: -- whether states it or, but now you're
 19 semi asking for interpretation. Close enough
 20 for me to sustain the objection.
 21 Q: Can you flip over to page 16 of that agreement,
 22 please. And unfortunately the copy -- my copy
 23 is not clear. I hope yours is clearer. Is it
 24 -- on the top of the chart is it a big black
 25 line that you can't read what's it's in?

1 A: Yes.
 2 THE COURT: What tab are we at?
 3 MR. RYAN: We are still at Tab 13, Your Honor.
 4 Q: And have you seen this chart before?
 5 A: Yes.
 6 Q: Do you think you're familiar enough with it
 7 that we can discuss what's in that black line
 8 if we could read it?
 9 A: I don't recall what that says in it. I can't
 10 read it.
 11 Q: All right. I would have to get the original
 12 out. Well, do you see all those -- there's
 13 four columns, correct?
 14 A: Yes.
 15 Q: Do you know what the columns with all the Xs,
 16 do you know what's on the top of that?
 17 A: I believe it says RAC Management.
 18 Q: Okay. That's good. And next to it, the column
 19 with only three 3 Xs, do you know what that
 20 column is?
 21 A: No, I don't.
 22 Q: All right. If I said that was RAC stores,
 23 would that make sense to you?
 24 A: Yes.
 25 Q: Okay. And if I said I believe the last column

1 A: It's based upon the range that's set forth in
 2 the pricing study, yes.
 3 Q: And this pricing study places all the training
 4 with RAC Texas, right?
 5 A: I don't know that the contract says it places
 6 all training with RAC Texas.
 7 Q: Can you show me where in this pricing study it
 8 places training with anyone other than RAC
 9 Texas?
 10 A: No.
 11 MR. VON LEHE: Your Honor again, objection. This
 12 contact speaks for itself. The repeated
 13 question can you show me in here where this is
 14 otherwise is an -- is a request for
 15 interpretation of a contact that speaks for
 16 itself. Whatever the language is, that's what
 17 the language is.
 18 THE COURT: I thought about your last objection.
 19 And I sustained it. But again, you asked can
 20 you show me where it is in the contract? How
 21 is that an interpretation of a contact? You're
 22 asking -- I know it's -- he's asking if you can
 23 show me where the wording is in the contract.
 24 MR. VON LEHE: Your Honor, my response is everyone
 25 is capable of reading the contract. The

1 is RAC West, would that make sense to you?
 2 Because it places ownerships and trademarks
 3 with RAC West?
 4 A: Yes.
 5 Q: Okay. Now where it says -- would you agree
 6 that says training on here twice, correct?
 7 A: Yes.
 8 Q: And both times the extra training is placed
 9 with management, correct?
 10 A: Yes.
 11 Q: Now, look at customer service. Do you see two
 12 Xs there, one for RAC Management and one for
 13 RAC stores?
 14 A: Yes.
 15 Q: So some things could be split between the two,
 16 correct?
 17 A: Apparently.
 18 Q: As customer service. For training, there's no
 19 split, is there?
 20 A: There's one X.
 21 Q: There's just one X. There's no X in the RAC
 22 stores, correct?
 23 A: Correct.
 24 Q: So that now the amount of your management fee
 25 is based on this pricing study, right?

1 contract stands for itself. It is what it is.
 2 And the question to the witness can you show me
 3 in the contract where something is not there.
 4 Whatever is in the contract --
 5 THE COURT: That, I'll agree with that.
 6 MR. RYAN: I'll move on again.
 7 THE COURT: All right.
 8 Q: Let's talk about payroll. During the period at
 9 issue, RAC Texas was responsible for handling
 10 payroll for South Carolina stores, correct?
 11 A: That's correct.
 12 Q: And RAC Texas was compensated for handling
 13 payroll, correct?
 14 A: Yes.
 15 Q: And where do South Carolina employees enter
 16 their time?
 17 A: In the computers that RAC East owns.
 18 Q: Are those computers located in South Carolina?
 19 A: Yes.
 20 Q: Are those employees located in South Carolina?
 21 A: Yes.
 22 Q: Are the paychecks sent to South Carolina?
 23 A: Yes.
 24 Q: When you're handling payroll in South Carolina,
 25 where do you direct interactions?

1 A: We direct interactions to the employees who
 2 receive paychecks.
 3 Q: So for a South Carolina employee, you're
 4 directing those actions at South Carolina?
 5 A: No. Directing them at -- we're processing
 6 paychecks for RAC East to give to its employees
 7 in South Carolina.
 8 Q: Does a South Carolina employee have to set up
 9 a Texas bank account to get paid?
 10 A: No.
 11 Q: And during the audit period, did employees
 12 receive paychecks?
 13 A: Yes.
 14 Q: And RAC Texas sent those paychecks into South
 15 Carolina?
 16 A: Yes.
 17 Q: If there were litigation over a paycheck, who
 18 would handle that litigation?
 19 A: What type of litigation?
 20 Q: Let's say the paycheck has gone missing and it
 21 turns out that somebody else got it and cashed
 22 it. Who would handle that litigation to get
 23 that money back?
 24 A: I'm not sure it would involve litigation.
 25 Q: If it did, who would handle it?

1 Rent-A-Center, Inc., who would handle it?
 2 A: I mean, litigation would managed by our legal
 3 department.
 4 Q: The legal department is part of RAC Texas?
 5 A: Right.
 6 Q: Now, when Rent-A-Center advertises in South
 7 Carolina, aren't they aiming at the South
 8 Carolina marketplace?
 9 A: Well, the advertising isn't contracted by RAC
 10 Texas. It's contracted by a third party ad
 11 agency.
 12 Q: Can the stores in South Carolina, can they
 13 contract for their own advertising?
 14 A: Generally, no.
 15 Q: Do the stores have to follow the advertising
 16 and marketing scheme that RAC Texas sets forth?
 17 A: Yes.
 18 Q: Now, doesn't the pricing study place all
 19 responsibility for advertising with RAC Texas?
 20 A: I don't know that.
 21 Q: Let's look back at that chart on 16 again.
 22 A: Okay.
 23 Q: Where it says advertising and marketing.
 24 Where's the X?
 25 A: It's under RAC Management.

1 A: Well, it's a matter between RAC East and its
 2 employee.
 3 Q: Would it use the legal team at RAC Texas?
 4 A: If it was -- a lawsuit was filed, RAC Texas
 5 legal department would manage the litigation on
 6 behalf of RAC East.
 7 Q: Let's talk about advertising. Now, Texas --
 8 RAC Texas is responsible for handling
 9 advertising as part of the Management Services
 10 Agreement, right?
 11 A: Correct.
 12 Q: And, in fact, doesn't RAC -- doesn't the
 13 agreement say that it handles advertising
 14 services for the company, all of it, correct?
 15 A: It handles advertising services for the
 16 company.
 17 Q: Now if a lawsuit were bought regarding
 18 advertising in South Carolina, would RAC Texas
 19 handle that lawsuit?
 20 A: Not necessarily.
 21 Q: Who would?
 22 A: The litigation could be directed at the vendors
 23 who actually provided the services. Those have
 24 no affiliation with RAC or RAC Texas.
 25 Q: If the litigation were directed at RAC, not

1 Q: Now, can you -- let's go to page 1 of this
 2 report. Actually, true page 1, not the table
 3 of contents.
 4 MR. VON LEHE: Your Honor, I would like to enter
 5 another objection. This witness did not
 6 prepare this pricing study. He's not the
 7 author of this pricing study. That man happens
 8 to be present in this courtroom as you know
 9 from being told a few minutes ago a little
 10 earlier. He will be a witness before the
 11 Court. I would suggest that any knowledge
 12 about this pricing study that this witness
 13 might have would be no more than anybody else
 14 who reads the report. And the questions about
 15 how this pricing study works, etcetera, it is
 16 my judgment would be better directed at someone
 17 who drew up that pricing statement.
 18 THE COURT: You don't believe that -- well, one, he
 19 can publish the pricing study. But if he is the
 20 person who administers the pricing study, he
 21 can certainly testify about how the corporation
 22 administers that which someone else drew up.
 23 MR. VON LEHE: Very well, Your Honor. In fact he
 24 is the person who administers it.
 25 THE COURT: If he's -- and that needs to be, that

1 groundwork would need to be developed.
 2 MR. VON LEHE: Well, I object because that
 3 groundwork has not been developed.
 4 MR. RYAN: Your Honor, if I may respond. In their
 5 direct questioning they asked him all about
 6 this document. I'm just doing the same thing.
 7 THE COURT: All right. So --
 8 MR. RYAN: They opened that door.
 9 THE COURT: Any response to that?
 10 MR. VON LEHE: No.
 11 THE COURT: Proceed.
 12 Q: Did you find page 1?
 13 A: Yes.
 14 Q: Okay. Can you look down at footnote number 1?
 15 You see footnote number 1?
 16 A: Yes.
 17 Q: Now, right about that is the line, based on the
 18 above analysis. Can you read that sentence for
 19 us, please.
 20 A: "Based on the above analysis, KPMG assessed
 21 that RAC store will be performing functions
 22 that are similar to a limited risk retailer."
 23 Q: And that's where footnote 1 is, correct?
 24 A: Yes.
 25 Q: Can you read footnote 1 out loud, please.

1 A: Yes.
 2 Q: Is that strategy valuable?
 3 A: Yes.
 4 Q: Now, that strategy is -- that advertising
 5 strategy, that's an intangible asset, isn't it?
 6 A: I don't think of an intangible asset, no.
 7 Q: Will you turn to page 15 of the report.
 8 MR. VON LEHE: Your Honor, objection along these
 9 line. I don't believe we asked any questions
 10 along the lines of what nature this asset was.
 11 So I object.
 12 THE COURT: Well, he's already -- that's been asked
 13 and answered. But now his next question was
 14 just can you turn to page 15. And then you
 15 stated an objection.
 16 MR. VON LEHE: Well, I'll wait for the question
 17 then, Your Honor. Excuse me, please.
 18 Q: What is the -- can you see section 4.3.1?
 19 A: Yes.
 20 Q: What does that heading say?
 21 A: Intangible assets.
 22 Q: Can you read the first two paragraphs, please.
 23 A: "Tangible assets include any non-financial
 24 asset developed or owned by a company which
 25 includes internal know how, trademarks, banks,

1 A: "The limited risk retailer in this context is
 2 described as an entity that only performed
 3 retail functions, i.e., displays merchandise on
 4 the shop floor, manages the store, serves
 5 customers and processes customer orders. It
 6 does not have responsibility for vendor or
 7 merchandise selection, marketing, or
 8 advertising or other value added or strategic
 9 management activities. It also bears no
 10 inventory risk. Therefore, the functions
 11 performed by such a retailer bear minimal
 12 risk."
 13 Q: So according to that RAC Texas -- I mean, the
 14 RAC stores don't handle marketing advertising,
 15 correct?
 16 A: Correct.
 17 Q: Now, RAC Texas comes up with the advertising
 18 and marketing strategy that's used by all the
 19 stores, right? I mean RAC West, RAC Texas, RAC
 20 East, they all use them, right?
 21 A: Yes.
 22 Q: And that strategy, is that important?
 23 A: Yes.
 24 Q: Is that strategy key to attracting customers
 25 into your store?

1 suppliers or customer relations. These assets
 2 can be of significant value to a company, can
 3 have a direct impact on the profitability and
 4 success of the firm."
 5 Q: Keep going. Second paragraph, please.
 6 A: "The Rent-A-Center name is recognized -- is a
 7 recognized name and plays a key role in
 8 distinguishing itself from its competitors.
 9 This is extremely important to the rent to own
 10 industry where competitive advantage is gained
 11 through customer service rather than pricing.
 12 Thus the company relies heavily on the positive
 13 trademark recognition as unsuccessful
 14 advertising promotions can significantly impact
 15 the company's product demand. RAC West owns
 16 the group's trademark. RAC Management is
 17 responsible for developing advertising and
 18 marketing strategies to create, maintain, and
 19 expand the brand name of the company. Other
 20 intellectual property such as strategic
 21 management plans, know-how related to customer
 22 service, computer systems and software are
 23 owned by RAC Management."
 24 Q: Are strategic management plans used in South
 25 Carolina?

1 A: Are they used in South Carolina? You mean the
 2 plans are overview. The policies and
 3 procedures are conducted that carry out those
 4 plans. But I don't know that the plans are
 5 used in one place or another. So it's a
 6 concept.
 7 Q: The concept --
 8 THE COURT: Let me stop you one moment so I can be
 9 clear. You just testified that -- I thought I
 10 heard when you were reading the document. You
 11 said the computers are owned by whom?
 12 MR. TOLLACK: The stores. RAC East in this case.
 13 THE COURT: Okay. I misunderstood. Go ahead.
 14 Q: On that -- can you read that last sentence
 15 again please.
 16 A: "Other intellectual property such as strategic
 17 management plans, know-how related to customer
 18 service, computer systems and software are
 19 owned by RAC Management."
 20 Q: So according to that, computer systems are
 21 owned by RAC Management, correct?
 22 A: Yes.
 23 Q: Software is owned by RAC Management, correct?
 24 A: Yes.
 25 Q: Now, going back to the strategic management

1 A: They're compensated for services. They're not
 2 compensated for intangibles, no.
 3 Q: Can you show me where in this agreement it says
 4 that RAC Texas is not compensated for the use
 5 of intangible assets?
 6 MR. VON LEHE: Your Honor, again, the agreement
 7 speaks for itself. The question to the witness
 8 can you show me in here where it says they're
 9 not, anybody can read this agreement. The
 10 agreement stands for itself.
 11 THE COURT: Well, he didn't say not. You added not.
 12 He said can you show me where they are.
 13 MR. VON LEHE: Still, I'll take back the not, Your
 14 Honor.
 15 THE COURT: Well the --
 16 MR. VON LEHE: Anybody can read the agreement. The
 17 agreement speaks for itself.
 18 THE COURT: All right. You're asking him to
 19 interpret it or --
 20 MR. RYAN: I want him to just show me where in the
 21 document it says that.
 22 THE COURT: And again, that's a fine line. I'm
 23 going to sustain the objection at this point in
 24 time.
 25 Q: Now, is RAC Texas responsible for purchasing in

1 plans, to the extent those are policies and
 2 procedures, are those used in South Carolina?
 3 A: Policies and procedures are used in South
 4 Carolina, yes.
 5 Q: Is the know-how related to customer service
 6 utilized in South Carolina?
 7 A: Know-how is used in South Carolina, yes.
 8 Q: Are the computer systems used in South
 9 Carolina?
 10 A: No.
 11 Q: Is the software owned by RAC Management used in
 12 South Carolina?
 13 A: No.
 14 Q: But would you agree that the marketing
 15 strategy, strategic management plans and know-
 16 how related to customer service, those are used
 17 in South Carolina?
 18 A: Well, the procedures that carry out the plans
 19 are used in South Carolina.
 20 Q: And RAC Texas is compensated for those
 21 intangible assets, aren't they?
 22 A: All those intangible assets are located in
 23 Texas.
 24 Q: All right. I'm asking are they compensated for
 25 stores' use of them?

1 South Carolina stores?
 2 A: Yes.
 3 Q: When it purchases things for a South Carolina
 4 store, where is it sending those things?
 5 A: It's not sending them anywhere.
 6 Q: They don't -- they purchase it and then what
 7 happens?
 8 A: The vendor drop ships the item directly to the
 9 store.
 10 Q: So for a South Carolina store that would be
 11 sent to South Carolina?
 12 A: Correct. From the vendor to South Carolina.
 13 Q: Would it be fair to say if there weren't stores
 14 in South Carolina, you wouldn't need inventory
 15 in South Carolina?
 16 A: Whose inventory are you referring to?
 17 Q: Would RAC Texas need -- would RAC East need any
 18 inventory?
 19 A: Could you repeat the question?
 20 Q: Sure. If there weren't any stores in South
 21 Carolina, would there be any need for RAC Texas
 22 to purchase supplies for that store?
 23 A: The store wouldn't exist.
 24 Q: So there wouldn't be any need?
 25 A: Right.

1 Q: Let's talk about legal services. RAC Texas
 2 handles all the legal needs for all their
 3 operating entities, right?
 4 A: It manages all legal activities, yes.
 5 Q: Do any of the operating -- other entities have
 6 their own legal teams?
 7 A: No, they don't.
 8 Q: So to the extent there's a RAC Texas -- Rent-A-
 9 Center legal team, it's RAC Texas?
 10 A: That's correct.
 11 Q: And the management fee compensates RAC Texas
 12 for providing that legal team to all entities,
 13 correct?
 14 A: Yes.
 15 Q: So any claim brought against any of the
 16 operating entities would be handled by RAC
 17 Texas?
 18 A: They would manage, yes, whatever that entails.
 19 Q: Wouldn't RAC Texas need to utilize South
 20 Carolina courts for a matter in South Carolina?
 21 MR. VON LEHE: Your Honor, this calls for a legal
 22 conclusion from the witness. I'm not even sure
 23 of the answer about that myself. I mean, this
 24 calls for a legal conclusion for a witness as
 25 to all the laws of what state would apply or

1 Q: Does RAC Texas handle all the litigation or
 2 legal needs of RAC West in terms of the
 3 trademarks?
 4 A: Yes.
 5 Q: Does RAC -- which entity handles all the
 6 filings in terms of the RAC West trademarks?
 7 A: RAC Texas.
 8 Q: Who's in charge of protecting the RAC West
 9 trademarks?
 10 A: RAC -- RAC West owns them. It's part of the
 11 legal services that are provided by RAC Texas.
 12 Q: And part of the management fee paid by South
 13 Carolina pays RAC Texas for protecting the
 14 trademarks here then?
 15 A: I'm sorry?
 16 Q: Does part of the management fee paid by South
 17 Carolina stores to RAC Texas, does that
 18 compensate RAC Texas for protecting the
 19 management -- the trademarks here?
 20 A: No.
 21 Q: Why not?
 22 A: Because RAC East wouldn't be defending the
 23 trademarks here.
 24 Q: No, no.
 25 A: RAC West would be.

1 where actions would be brought. So I object to
 2 it.
 3 THE COURT: Sustained. Well, do you want to
 4 respond?
 5 MR. RYAN: No, that's fine.
 6 Q: Let's look at page 14 of the study, please.
 7 You see section 4.2.2?
 8 A: Yes.
 9 Q: In the second -- actually it's the third
 10 paragraph, the third paragraph that starts
 11 with, RAC customers typically pay.
 12 A: Yes.
 13 Q: Do you see the sentence starting with the
 14 words, in the event that?
 15 A: Yes.
 16 Q: Can you read that sentence aloud, please.
 17 A: "In the event that a customer does not return
 18 the equipment and/or is not able to make the
 19 payments, any legal proceeding will be managed
 20 by RAC Management."
 21 Q: Thank you. So if a South Carolina customer
 22 does not return equipment and is not able to
 23 make payments, RAC Texas would be handling that
 24 legal proceeding?
 25 A: Yes. We would manage it, yes.

1 Q: Maybe my question wasn't clear. Why RAC East
 2 pays RAC Texas its management fee, is that fee
 3 paying RAC Texas for its work in protecting
 4 trademarks here in South Carolina?
 5 A: No.
 6 Q: But you testified earlier that RAC Texas
 7 protects the trademarks here, correct?
 8 A: Yes.
 9 Q: And they are paid for that through their
 10 management fee, correct?
 11 A: Correct.
 12 Q: So when South Carolina stores pay the
 13 management fee, aren't they paying for the
 14 services for protecting the trademarks here?
 15 A: No.
 16 Q: Let's talk about expenses. You testified on
 17 direct that you're criticizing the Department's
 18 method that they didn't use -- they used a
 19 formula to come up with RAC Texas' income,
 20 correct?
 21 A: Yes.
 22 Q: Did you provide state specific information
 23 about RAC Texas to the auditor?
 24 A: No.
 25 Q: Did you provide information breaking down the

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1 management fee paid by each state to the
 2 auditor?
 3 A: No. The auditor could never tell me why RAC
 4 Texas was subject to tax in South Carolina.
 5 Q: So you didn't provide an explanation?
 6 A: No.
 7 Q: So the Department had to use a formula, didn't
 8 it?
 9 A: Well, RAC East who is a RAC -- who is a South
 10 Carolina taxpayer has books and records. Is it
 11 information, they never asked RAC East for that
 12 information.
 13 Q: RAC East has the information of how much each
 14 state paid in management fees?
 15 A: Well, how much RAC East paid in management
 16 fees.
 17 Q: Does it have it by each state?
 18 A: No.
 19 Q: So in order to determine by state, wouldn't a
 20 formula need to be used?
 21 A: No. You could determine the profitability of
 22 the stores in RAC Texas and then calculate it
 23 that way.
 24 Q: How do you determine the profitability? So you
 25 can determine the profitability of each store?

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1 A: Yes.
 2 Q: And if -- and then you could determine the
 3 profitability of the whole state for --
 4 correct?
 5 A: Yes.
 6 Q: Did you provide that information that they --
 7 A: Never asked RAC East for that information.
 8 Q: Now, the expenses you've -- on your amended --
 9 excuse me. We're still on RAC Texas, so on the
 10 original return. If you were to file here, is
 11 it your position that you would use standard
 12 gross receipts?
 13 A: If we were to file here?
 14 Q: If you were to file here, is it your position
 15 you would file with -- on the denominator would
 16 include both the management fee, revenue, and
 17 store revenue, correct?
 18 A: Are you asking if RAC Texas filed in South
 19 Carolina?
 20 Q: If it did.
 21 A: I would -- I would use an apportionment ratio
 22 based upon what services are performed, if I
 23 did.
 24 Q: Now, how many stores do you have in Texas?
 25 A: Approximately 300.

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1 Q: Do you have that many in any other state?
 2 A: No.
 3 Q: Would you call that your biggest state?
 4 A: Yes.
 5 Q: Is it a lot bigger than the other states?
 6 A: I'm not sure what you mean by a lot.
 7 Q: What's the second largest state for number of
 8 stores?
 9 A: Probably California.
 10 Q: How many states? How many stores?
 11 A: I don't know offhand.
 12 Q: Would it be fair to say that the Texas stores
 13 are ten percent of all Rent-A-Center?
 14 A: Yes.
 15 Q: What do the operations of the Texas retail
 16 stores have to do with what goes on in South
 17 Carolina?
 18 A: Well, Texas retail stores are kind of like a
 19 test market for policies and procedures that
 20 are developed and management services that are
 21 provided to all the companies.
 22 Q: They're a test market?
 23 A: Yes.
 24 Q: How are they test market?
 25 A: Well, the new ideas are tried out in Texas,

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1 stores that are close to our management, and
 2 they can observe how effective those are at
 3 affecting profitability or any other
 4 performance metrics. And if those proved to be
 5 effective, they'll start to instruct other
 6 stores to do the same thing.
 7 Q: Did you provide any documents regarding those
 8 test procedures during discovery?
 9 A: No.
 10 Q: Did you provide any of it -- any documents
 11 regarding those test procedures to the auditor?
 12 A: Nobody asked for them.
 13 Q: Now, at RAC Texas, you know which people work
 14 in the management section and which people work
 15 in the retail section, right?
 16 A: No.
 17 Q: Is there an overlap?
 18 A: Yes.
 19 Q: How is there an overlap?
 20 A: Well, we're doing both functions all the time
 21 every day, basically.
 22 Q: Does someone from corporate headquarters go
 23 work at one of the retail stores?
 24 A: Sometimes, yes.
 25 Q: Who determined that RAC Texas didn't need to

1 file returns in South Carolina?
 2 A: I was involved in that process.
 3 Q: Do you know who made that -- was it an internal
 4 decision?
 5 A: Yes.
 6 Q: Was an accounting firm consulted?
 7 A: No.
 8 Q: Was the Department consulted?
 9 A: No.
 10 Q: Okay. Let's move on to RAC West. Now, RAC
 11 West's only source of income from this state is
 12 royalties, correct?
 13 A: Correct.
 14 Q: And the retail stores that RAC West owns, are
 15 they approximately a third of all of the Rent-
 16 A-Center stores?
 17 A: A little less than a third.
 18 Q: A little less than a third. A fair amount?
 19 A: Yes.
 20 Q: So because there's no retail stores in South
 21 Carolina, would any of the income from those
 22 retail stores be in the numerator of your
 23 amended returns?
 24 A: There would be no -- no, there would be retail
 25 store in the numerator.

1 A: Well, it's their responsibility to protect
 2 their own trademarks, but they use RAC Texas to
 3 provide the services.
 4 Q: Now, which entity did you say we assess -- the
 5 Department assessed negligence penalties
 6 against?
 7 A: RAC West.
 8 Q: What's your basis for that statement?
 9 A: The determination letter, audit report.
 10 Q: Were you aware of the Carmax decision John
 11 talked about in his opening?
 12 A: Recently became aware of it.
 13 Q: Were you aware of that when you filed your
 14 amended return?
 15 A: Yes.
 16 Q: How do you determine if you're going to close
 17 a specific store?
 18 A: I don't have specific knowledge of that, but it
 19 depends upon the store's financial performance.
 20 Q: So they analyze on a store level on whether
 21 they're making money or not making money?
 22 A: Correct.
 23 Q: So you can determine at the store level whether
 24 a store is profitable or not profitable?
 25 A: Yes.

1 Q: So including the retail operations only adds
 2 things to the denominator, right?
 3 A: Yes.
 4 Q: What do the retail operations of the RAC West
 5 stores have to do with the royalties in South
 6 Carolina?
 7 A: Well, a successful operation of the RAC West
 8 stores makes the trademarks and trade names
 9 that are used in South Carolina more valuable.
 10 Q: Would the operation of the RAC East stores make
 11 the trademarks in South Carolina more valuable?
 12 A: Yes.
 13 Q: Now, would you say -- would you agree that
 14 essentially RAC East and RAC West, the retail
 15 stores, are essentially the same in the
 16 services they receive?
 17 A: From?
 18 Q: From RAC Texas.
 19 A: Pretty much, yes.
 20 Q: Would you say the only difference between RAC
 21 West and the RAC East is the fact that RAC West
 22 owns the trademarks?
 23 A: Yes.
 24 Q: And RAC West doesn't actually protect the
 25 trademark, correct? That's RAC Texas?

1 Q: So you would know the revenue and the expenses
 2 at the store level, correct?
 3 A: The direct expenses, yes.
 4 Q: So isn't that kind of a form of separate
 5 accounting to figure out how much each store
 6 does?
 7 A: It doesn't -- it wouldn't include the real
 8 expenses of the store.
 9 Q: Those are all the questions I have for you.
 10 Thank you.
 11 MR. VON LEHE: Your Honor, can we have just a
 12 moment?
 13 THE COURT: Uh-huh (affirmative response). Because
 14 I don't know who the we is anymore because you
 15 started off the direct examination with one
 16 lawyer and objections with the other one. So
 17 I'll let you transition however y'all wish.
 18 MR. VON LEHE: It will be she.
 19 THE COURT: Okay.
 20 (Off the Record)
 21 MS. GEER: We're ready whenever the Court is.
 22 THE COURT: Go ahead.
 23 MR. TOLLACK - REDIRECT EXAMINATION BY MS. GEER:
 24 Q: Mr. Tollack, I just want to clear up a few
 25 things. Whose name is on the leases for the

1 stores in South Carolina?
 2 A: Rent-A-Center East.
 3 Q: Who owns the computers in which the applicants
 4 would apply for jobs in the South Carolina
 5 stores?
 6 A: RAC East.
 7 Q: You talked about a number of the management
 8 services activities performed by RAC Texas
 9 where there's some part of the process that's
 10 done by somebody --
 11 MR. RYAN: Objection, Your Honor. She's leading.
 12 MS. GEER: I'm just summarizing his testimony.
 13 THE COURT: She can -- she can lead somebody in cross
 14 examination if she -- I mean on redirect if
 15 she's directing a witness to the cross-
 16 examination. So I'm going to allow her to
 17 complet the question and then we'll address it.
 18 Q: You spoke in your testimony just now about
 19 activities, certain activities. Let's take one
 20 for example, firing. That's an activity that
 21 RAC Texas plays some role in and that you
 22 testified that a South Carolina manager may
 23 play some in role in. Is that correct?
 24 A: That's correct.
 25 Q: Okay. Now, for that activity that the South

1 responsibility. The more effective and
 2 profitable the store is, the more he is
 3 compensated.
 4 Q: And is RAC East management familiar with the
 5 roles that its store managers play in these
 6 processes?
 7 A: Yes.
 8 Q: And so RAC East, you just testified RAC East
 9 knows what role its employee pay -- play. Does
 10 RAC East pay RAC Texas for doing those roles?
 11 A: No.
 12 Q: Is any portion of the management fee for that
 13 work?
 14 A: No.
 15 MS. GEER: Your Honor, we don't have any other
 16 questions for this witness.
 17 THE COURT: Any recross on any matter raised by
 18 petitioner?
 19 MR. RYAN: No, Your Honor.
 20 THE COURT: You said that -- said that in conducting
 21 the leasing that -- you started the sentence by
 22 saying it could be a store manager who reviews
 23 a location. Do you remember that?
 24 MR. TOLLACK: Yes, sir. Observes a location, yes.
 25 THE COURT: Yes. Who else could it be? When you

1 Carolina store manager plays in that activity
 2 or any of the others that we've talked about
 3 here today, who pays the employee for that
 4 work?
 5 A: RAC East.
 6 Q: Could RAC Texas provide management services to
 7 RAC East without talking to anyone in RAC East
 8 store or getting any information from someone
 9 in a RAC East store?
 10 A: Yes.
 11 Q: They could? And we're talking about the firing
 12 process. Could RAC Texas do the entire firing
 13 process from start to finish without any
 14 involvement from someone in the South Carolina
 15 store?
 16 A: That's possible.
 17 Q: Would it make good business sense?
 18 A: No.
 19 Q: Why not?
 20 A: Well, because the store manager is responsible
 21 for running the store. And he's the one who
 22 has the firsthand knowledge and observation of
 23 all aspects of running the store, customer
 24 relations, employee relations, store
 25 appearance, all those things are part of his

1 say could, that leaves open other possibilities
 2 and I want to know what the other possibilities
 3 are.
 4 MR. TOLLACK: Well, we have a network of landlords
 5 that we deal with. And let's say we have an
 6 existing landlord that we have a good
 7 partnership, business partnership with at a
 8 different location, that landlord may have
 9 another location that he's just acquired or has
 10 opened up, and he may contact RAC Texas
 11 directly and say I've got another store, you
 12 know, would you be interested in leasing this
 13 location. So there's, you know, a number of
 14 different business affiliations of partnerships
 15 that we have with vendors that may refer, make
 16 those similar types of referrals.
 17 THE COURT: And would that be pretty exhaustive of
 18 you use either the store manager or the
 19 affiliations you're discussing, would that be
 20 the exhaustive list of how you would determine
 21 visual observation of whether the location
 22 should be leased?
 23 MR. TOLLACK: Probably. But I mean, I'm sure
 24 there's other databases that they have access
 25 to.

1 THE COURT: I'm talking -- you said the computers,
 2 or looking at a computer. But I'm talking
 3 individual people.
 4 MR. TOLLACK: I can't think of any other at this
 5 time.
 6 THE COURT: All right. You testified concerning
 7 advertising is contracted by a third party ad
 8 agency.
 9 MR. TOLLACK: Yes, sir.
 10 THE COURT: Who executes that contract with the ad
 11 agency?
 12 MR. TOLLACK: RAC Texas would have the contract with
 13 the ad agency.
 14 THE COURT: All right. Any follow-up questions on
 15 what I have asked?
 16 MS. GEER: No, Your Honor.
 17 MR. RYAN: No, Your Honor.
 18 THE COURT: You may step down.
 19 MR. TOLLACK: Thank you, sir.
 20 MS. GEER: Your Honor, we would like to call Dawn
 21 Wolverton to the stand.
 22 DAWN WOLVERTON, having been duly sworn, testifies as
 23 follows:
 24 MS. WOLVERTON - DIRECT EXAMINATION BY MS. GEER:
 25 Q: Ms. Wolverton, who are you currently employed

1 general counsel and secretary.
 2 Q: And how long have you been in that position?
 3 A: I began my career at Rent-A-Center as senior
 4 counsel and assistant secretary and I was
 5 promoted vice president in January of 2007.
 6 And I recently was promoted to the title of
 7 secretary in July of this year.
 8 Q: Is one of your job responsibilities at RAC
 9 Texas maintaining the corporate records of the
 10 RAC entities?
 11 A: Yes, it is.
 12 Q: Do you perform any services regarding managing
 13 the RAC intellectual property?
 14 A: Yes. I am responsible for maintaining the
 15 company's portfolio of trademarks and trade
 16 names.
 17 Q: Okay. All right. Can you summarize for us
 18 what maintaining corporate records entails.
 19 A: A variety of things, ranging from any of the
 20 SEC filings that we're required to make as a
 21 public company, drafting minutes to be adopted
 22 by the board of directors of the various
 23 entities or the shareholders of various
 24 entities, maintain corporate formalities,
 25 maintain state registrations, do trading and

1 by?
 2 A: Rent-A-Center Texas, LP.
 3 Q: And what is your position there?
 4 A: My current role is vice president, assistant
 5 general counsel and secretary.
 6 Q: Tell us a little bit about your educational
 7 background.
 8 A: I went to undergrad at the University of Texas,
 9 graduated in 1987 with BBA in finance and real
 10 estate. I worked in the Dallas area in the
 11 banking and real estate industries for several
 12 years before returning to law school at Texas
 13 Tech University where I graduated in May of
 14 1994.
 15 Q: And summarize for us your work experience from
 16 law school forward.
 17 A: After graduating from law school, I was
 18 licensed in the State of Texas and began
 19 practicing at a Dallas base law firm called
 20 Winstead, Sechrest and Minick. I practiced
 21 there in the corporate securities transactions
 22 group for about ten years before joining Rent-
 23 A-Center.
 24 Q: And you said -- tell us your title again.
 25 A: My current title is vice president, assistant

1 filings. Those kind of things.
 2 Q: All right. And where do you perform your work
 3 to maintain these corporate records?
 4 A: In Plano, Texas.
 5 Q: Do you ever go to South Carolina with regards
 6 to maintaining the corporate records?
 7 A: No.
 8 Q: All right. Let's talk about the maintenance of
 9 the intellectual property. First of all, when
 10 we're talking about the intellectual property,
 11 what does that include?
 12 A: For us it's primarily trademarks and trade
 13 names.
 14 Q: Can you give us a couple of examples just so
 15 we'll have an idea of what you're talking
 16 about.
 17 A: Sure. The primary marks are RAC, Rent-A-
 18 Center, RAC Acceptance, ColorTyme. We also
 19 register some ancillary marks or tag lines or
 20 slogans like "Worry Free Guarantee" or "Try it
 21 before you buy it."
 22 Q: All right. Can you summarize for us what
 23 maintaining these trademarks and trade names
 24 entails.
 25 A: From inception, it would be when marketing

1 advertising identifies a new mark that they're
 2 interested in protecting. We would do
 3 trademark searches to determine whether or not
 4 that name would be available for federal
 5 registration. And once we make that
 6 determination, we'd file the registration,
 7 provide specimens of use, shepherd that process
 8 through to registration, and then maintain that
 9 registration by filing continued use statements
 10 when required and monitoring the use of those
 11 marks by third parties.
 12 Q: If you -- if during the monitoring process you
 13 discovered that there was some infringement,
 14 what would happen next?
 15 A: We would start off by sending a cease and
 16 desist letter, try to get the person to stop
 17 using the mark in what we would consider to be
 18 an infringing way.
 19 Q: Okay. And what about if they didn't stop?
 20 A: We would proceed to litigation to the extent
 21 necessary.
 22 Q: And in whose name would any litigation be
 23 filed?
 24 A: Rent-A-Center West.
 25 Q: Now, where do you perform your work regarding

1 the intellectual property?
 2 A: In Plano, Texas.
 3 Q: Have you ever been to South Carolina with
 4 regards to your work to maintain the
 5 intellectual property?
 6 A: No.
 7 Q: All right. Let me ask you a couple of more
 8 questions about the intellectual property
 9 piece. Tell me what the relationship is
 10 between RAC West's business activities of
 11 operating retail stores and licensing
 12 intellectual property? What relationship is
 13 there between those two activities?
 14 A: Well, RAC West as the owner of that
 15 intellectual properties, those trademarks, is
 16 making direct first person use of those marks,
 17 so is contributing to the increase in value of
 18 that intellectual property.
 19 Q: And why is that? Or how is that?
 20 A: Why is that? As I said, they're making direct
 21 first person use of it so they have more
 22 control over the quality of the mark and as the
 23 -- the control over the quality of the services
 24 that are being provided under those marks. And
 25 so as the quality of the services increase, the

1 value of the marks increases and vice versa.
 2 Q: Okay. What about do the sales at the retail
 3 stores have any impact on IP?
 4 A: Yes. As I just said, as the stores perform
 5 better, that makes the mark more famous; that
 6 makes the association or the good will
 7 associated with that mark that much more
 8 valuable.
 9 Q: All right. And you may have said this and, if
 10 you did, I missed it. How does the
 11 intellectual property affect the sales at the
 12 retail stores?
 13 A: Because the mark is famous, the mark is well
 14 known, the mark is associated with good
 15 services. So now I'm being drawn into the
 16 store because of the mark, whereas I might also
 17 be being drawn into the store because of the
 18 service which enhances the mark, and then it
 19 just kinds of feeds on itself.
 20 Q: Would you say that the activities of operating
 21 the retail stores and the licensing of the
 22 intellectual property contribute to and depend
 23 upon each other?
 24 A: Yes, I would.
 25 Q: Would you say that there's a flow of value

1 between the two activities?
 2 A: Yes, I would.
 3 Q: Does RAC Texas keep track of the costs to
 4 maintain intellectual property?
 5 MR. RYAN: Objection, Your Honor. Leading.
 6 MS. GEER: I don't see how that's leading. Does it
 7 track cost?
 8 THE COURT: Overruled.
 9 A: No.
 10 Q: Would it be difficult to try to do so?
 11 A: With any -- you couldn't do that with 100
 12 percent accuracy.
 13 Q: Can you elaborate on that for us.
 14 A: As I was discussing earlier, to the extent that
 15 I'm doing -- something that's related to the
 16 market is going to increase the value of the
 17 retail operation. To the extent I'm doing
 18 something that's more focused on the retail
 19 operations it's going to increase the value of
 20 the mark, so you can't really split out the
 21 cost.
 22 Q: What about the cost of any individual employee;
 23 would that be possible to do?
 24 A: No. Again, where -- you know, you might be
 25 able to say you spend a certain amount of time

1 on this task and a certain amount of time on
 2 this task, because the tasks are interrelated
 3 because the -- the activity of maintaining the
 4 mark or supporting the store service relates to
 5 each other and contribute back the value back
 6 and forth, you have that a circular cause, or
 7 a chicken and egg. You can't really tell which
 8 is which.
 9 MS. GEER: All right. That's all the questions we
 10 have for this witness.
 11 THE COURT: Cross?
 12 MR. RYAN: No questions, Your Honor.
 13 THE COURT: You may step down.
 14 MS. GEER: Your Honor, would it be possible for us
 15 to take a short break before our next witness?
 16 THE COURT: It'd be possible.
 17 MS. GEER: Would you allow it; how about that?
 18 THE COURT: Would you allow it? There you go. Ding,
 19 ding. Yeah. We'll take a break.
 20 (Break from 3:37 p.m. until 3:49 p.m.)
 21 THE COURT: All right.
 22 MS. GEER: Your Honor, we would call to the stand
 23 Dr. John Wells.
 24 JOHN WELLS, Ph.D., having been duly sworn, testifies
 25 as follows:

1 tell me if that is a copy of your CV or bio?
 2 A: Yes, ma'am, it is.
 3 Q: Okay. Is it current?
 4 A: It is not current. It's a year old, a little
 5 over a year old. January 2010, but if it was
 6 updated it would just have more of the same
 7 sort of things in it.
 8 Q: Okay. And could you summarize for us your
 9 educational background.
 10 A: Yes. I received my undergraduate degree at
 11 Texas Tech University in international trade
 12 economics and my Ph.D. from Texas A&M
 13 University in economics.
 14 Q: Okay. And can you summarize for us your
 15 employment history.
 16 A: I was a university professor at Auburn
 17 University and a took a sabbatical and was a
 18 economic advisor of the Kuwait government for
 19 several years. And then was employed with KPMG
 20 from 2000 onward until 2008, both in their
 21 Washington national tax practice and in Dallas.
 22 And now since 2008, I have been with Deloitte
 23 as the principal in charge or their transfer
 24 pricing services practice for the mid America
 25 region.

1 DR. WELLS - DIRECT EXAMINATION BY MS. GEER:
 2 Q: Dr. Wells, did you prepare the transfer pricing
 3 study that's been discussed today?
 4 A: Yes.
 5 Q: All right. And just tell us what the basic
 6 nature of it is so we can understand. What
 7 does a transfer pricing study do?
 8 A: Well, under the 42 regulations there -- those
 9 are designed to ensure that taxpayers record
 10 income correctly that is attributable to
 11 intercompany transactions. And so these
 12 reports are designed to help companies
 13 structure their intercompany transactions in a
 14 way that is consistent with what third parties
 15 -- the way third parties would structure their
 16 intercompany transactions, what is often known
 17 as the arms length standard.
 18 Q: Okay. All right. Now, before we get into your
 19 opinions, I want to get a little bit of your
 20 background --
 21 A: Okay.
 22 Q: -- before the Court. Do you have the exhibit
 23 notebook in front of you?
 24 A: Yes.
 25 Q: If you could look at Exhibit One, Tab 19, and

1 Q: Okay. Were you selected by Euromoney as one of
 2 the world's leading transfer pricing advisors?
 3 A: Yes, last two years.
 4 MS. GEER: Your Honor, we would move to have Dr.
 5 Wells admitted as an expert in the subfield of
 6 transfer pricing under, I guess, economics. I
 7 don't believe the Department has an objection.
 8 MR. RYAN: No objection, Your Honor.
 9 THE COURT: He's so qualified.
 10 Q: All right. So you talked earlier at the arms
 11 length transaction. Are there any Internal
 12 Revenue Code sections that relate to this?
 13 A: Section 482 primarily.
 14 Q: Okay. If I can go back to my index.
 15 A: It's 23.
 16 Q: Okay. Does that -- is Tab 23 that section?
 17 A: Yes.
 18 Q: What does that section say?
 19 A: In the general thrust of that section is to
 20 impose market conditions on intercompany
 21 transactions to ensure that taxpayers reflect
 22 income associated with controlled transactions.
 23 Q: Okay. Are the studies you performed based on
 24 this section?
 25 A: Yes, ma'am.

1 Q: Do you know what the rationale behind the
 2 section is?
 3 A: Again, to ensure that taxpayers accurately
 4 reflect income associated with controlled
 5 transactions and the appropriate legal
 6 entities.
 7 Q: What would the concern be if they did not?
 8 A: The presumption is that if a taxpayer priced an
 9 intercompany transaction lower than what an
 10 arms length would dictate, it could either
 11 reduce its own income or reduce the income of
 12 a controlled party.
 13 Q: Are there different methods that can be used to
 14 determine the appropriate charge for a
 15 transaction between affiliated companies?
 16 A: Yes. Two broad categories. You can think of
 17 them as transactional methods. And the other
 18 category would be profit based methods. Those
 19 two methods can be aligned most closely to
 20 where they address themselves to an income
 21 statement. Transactional methods typically
 22 focus on the top section of the income
 23 statement, meaning revenues, cost of goods sold
 24 and gross profits, whereas profit based methods
 25 are typically at the operating profit level and

1 oftentimes it is not possible to find
 2 transactional methods for some transactions.
 3 It's very hard for services, for instance, to
 4 find a transactional method that applies. For
 5 tangible transactions, it can be very easy to
 6 find a transactional method, so you would inure
 7 yourself to those methods, particularly for
 8 tangible transactions such as commodities.
 9 Price of oil is often priced using a tangible
 10 method.
 11 Q: A transactional method?
 12 A: A transaction method. Thank you.
 13 Q: Okay.
 14 A: But where you have a number of things coming
 15 together to bundle together to provide a
 16 transaction, often in the case of services this
 17 is what you find. You end up having to defer
 18 to a profits based method.
 19 Q: All right. Let's talk about the transfer
 20 pricing study you did.
 21 A: Okay.
 22 Q: Which is behind Tab 13.
 23 A: Yes.
 24 Q: Will you flip there and first of all confirm
 25 for us that this is your study.

1 are focused on setting prices indicative with
 2 the arms length standard at the operating
 3 profit level. And there's a number of
 4 methodologies within that, such as a comparable
 5 and controlled price or a comparable and
 6 controlled transactions. A transactional
 7 methods that focusing on revenue. And the
 8 comparable profits method, for instance, both
 9 of those were used in this study that we'll
 10 will refer to, is at the operating profit
 11 level.
 12 Q: Well, how about maybe if you can explain for us
 13 why you would use one method versus the other
 14 and what the benefits are of each maybe.
 15 A: Okay. The goal in deciding which method to use
 16 is based on a best method requirement that is
 17 in the regulations.
 18 Q: Okay.
 19 A: So taxpayers are required to look at all the
 20 methods available and choose the best or most
 21 appropriate method. What often dictates which
 22 method you use depends on the transaction
 23 involved, whether it be tangible, intangible
 24 services or intercompany loans, which is a type
 25 of service, and the available data. So

1 A: This is my study.
 2 Q: All right. Can you -- let's take the companies
 3 separately. Let's start with RAC Texas. Can
 4 you walk us through what you did in your study
 5 as to RAC Texas.
 6 A: Would you like the process that built up the
 7 study; is that what you --
 8 Q: Yes.
 9 A: Okay.
 10 Q: Yes.
 11 A: So the first thing that I did with my
 12 colleagues is examine the functions, markets
 13 and risks at -- in the whole company operates
 14 in, and as well as the individual entities.
 15 And this was done through interviews, store
 16 visits, going through the training material.
 17 Quite an intensive process taking, you know,
 18 several months, and gathering financial data on
 19 Rent-A-Center and its related parties, and
 20 examining that and determining which activities
 21 were performed where, how the company made
 22 money, the value drivers of the business, the
 23 market in which the business operated. Those
 24 sorts of things.
 25 Q: Okay. Let me ask you a follow-up question on

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1 the functions part. So is one of the things
 2 you are looking there who does what?
 3 A: Right.
 4 Q: Is that what you're saying?
 5 A: Yeah. The functions are essentially what
 6 activities are undertaken by each entity.
 7 Q: Okay. And so if you could just kind of
 8 summarize for us what your findings were as to
 9 who did what and as between RAC Texas and RAC
 10 East.
 11 A: Okay. It was pretty clear from our interview
 12 processees and store visits that a tremendous
 13 amount of activity and services were being
 14 performed in RAC Texas for the benefit of the
 15 stores. And we analyzed and interviewed
 16 individuals who undertook these functions,
 17 these activities. They were nicely contained
 18 within RAC Texas. And by looking at the stores
 19 and interviewing with the stores, it was clear
 20 that their functions were fairly limited and
 21 that there was a lot of strategic management,
 22 a lot of value creation that took place in RAC
 23 Texas. And the stores were essentially routine
 24 retailers, as we say in the study. And then,
 25 of course, RAC West similar to the East but for

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1 the fact that it owned the Rent-A-Center name
 2 which we also understood from our interviews
 3 and from our analysis provided considerable
 4 value to the stores themselves. We were able
 5 to identify particular that, because of some
 6 controlled experiments that we had available to
 7 us, that when Rent-A-Center would acquire
 8 companies that were either unbranded or branded
 9 with a different name and run a different way,
 10 they would inject their magic and their way of
 11 doing business and almost immediately the
 12 income per store or sales per square foot would
 13 increase. So that was an important driver of
 14 our conclusions.
 15 Q: All right. Could you flip with me over to page
 16 16 of your report.
 17 A: Yes.
 18 Q: All right. Since you prepared this, for the
 19 benefit of everyone else who has a bad copy,
 20 could you identify what's in the black area?
 21 The titles for those columns where the Xs are?
 22 A: Yeah. It looks like -- I have a bad copy too.
 23 But it looks like RAC Management, RAC Stores,
 24 and RAC West.
 25 Q: Okay.

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1 A: And I point out importantly that the title of
 2 this is Functions, Risk and Assets. Not purely
 3 functions.
 4 Q: Right.
 5 A: So it's not purely a description of just
 6 functions and what the stores do versus what
 7 management does, but also the risks that are
 8 involved, which plays a very important part of
 9 this transfer pricing analysis.
 10 Q: Explain that a little bit to us. What do you
 11 mean by the risks? Maybe you can give us a
 12 couple of examples.
 13 A: Well, what's -- I'm leveraging earlier
 14 testimony and questioning obviously. But it's
 15 clear that there was some confusion over the Xs
 16 in the RAC Management column indicating that
 17 there were not activities at the store level
 18 that were similarly performed. Because the
 19 risks were at, as well as the large proportion
 20 of the activities were RAC Management, we -- it
 21 was clear that that's the preponderance of the
 22 Xs there. But indeed, the stores still, we
 23 understood at the time and continue to
 24 understand, were performing, had their role in
 25 training, had their role in implementing

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1 strategic plans, and marketing, advertising,
 2 etcetera. But because the transfer pricing
 3 structure that was -- that was in place as a
 4 result of the study, the stores did not bear
 5 any risks associated with that. And that is
 6 contractually because RAC Management undertook
 7 those activities on behalf of the store and
 8 then ensured that the stores earned a routine
 9 return commensurate with what other comparable
 10 companies would earn. And as a result of that
 11 contractual guarantee, all those risks flowed
 12 back to RAC Management and were not at the
 13 store level. Even though some of those
 14 functions would have been at the store level,
 15 RAC Management was driving the strategy behind
 16 this -- behind these functions and defining
 17 these functions and the stores just had a
 18 routine activity to implement those functions.
 19 Q: And how would you characterize the level of
 20 what the stores were doing for these activities
 21 that have Xs by RAC Texas? For example, let's
 22 look at -- well, you tell me me. What is one
 23 where you saw activity at both RAC Texas and
 24 the RAC stores?
 25 A: Clearly customer service stands out because --

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1 and that's a good example. Because it was
 2 obvious that RAC Management, some of their
 3 magic was defining how customer service would
 4 be performed. That the way that the store
 5 managers and the employees of the store would
 6 interact with customers, was guided by
 7 policies, developed by RAC Management about how
 8 to successfully run and operate a store. And
 9 the market evidence indicated that this was
 10 very effective. But yet it was -- it's -- RAC
 11 Management is not interacting with the customer
 12 ultimately, it's the store managers. So it's
 13 their job to implement that and and was one of
 14 the primary activities that the stores were
 15 involved in.
 16 Q: All right. So once you look at the functions,
 17 market and risks, what's the next step?
 18 A: So the next step is you could easily take this
 19 -- this table, if you will. That would come
 20 out of our interviews as well as all the
 21 narrative about what's done and what's adding
 22 value and what's strategic and what's routine.
 23 And the next step would then be to try to
 24 benchmark the simpler entity.
 25 Q: Okay. And can you hold on one second?

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1 A: Yeah.
 2 Q: I know you mentioned, talked about functions
 3 and risks. I'm not sure if you talked about
 4 market to us. Can you tell us what that piece
 5 is?
 6 A: I'm sorry?
 7 Q: The market piece.
 8 A: Oh, the market.
 9 Q: You talked about functions and risk. I think
 10 we skipped over market.
 11 A: So markets is the rent to own business that
 12 Rent-A-Center operates in, as well as its
 13 competitors which -- some of which would be
 14 rent to own, some of which would be regular
 15 retail operations. So the retail market, in
 16 general, for electronics and consumer hard
 17 goods that are in the store.
 18 Q: Okay. And I apologize for interrupting you.
 19 So you were going on to say what you do after
 20 you've looked at all those three things.
 21 A: Right. So then it becomes, it's a benchmarking
 22 exercise. That's what transfer pricing is pure
 23 and simple, it's an attempt to benchmark. And
 24 as is typical of any transfer pricing
 25 situation, you have complicated entities and

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1 you have less complicated entities. Sometimes
 2 you have equal degrees of complexity on both
 3 sides of the transaction. But in this case it
 4 was pretty clear what the routine activities
 5 were. And the regulations point you to and the
 6 prudence would point you to trying to benchmark
 7 the routine. The easiest to benchmark is going
 8 to be entities that are performing the most
 9 routine functions that don't have intangible
 10 assets. That don't -- aren't peculiarly
 11 capable of undertaking their activities without
 12 assistance from another. And so the next step
 13 is to try to benchmark and figure out which
 14 side in the transaction you're going to
 15 benchmark. And in this case, the stores were
 16 the obvious choice both from a regulatory
 17 perspective and from ease of benchmarking --
 18 Q: Okay.
 19 A: -- so we -- we searched for comparables, both
 20 in the rent to own space and the general retail
 21 space to determine what the appropriate return
 22 should be for the stores. And then by defining
 23 that by residual, you are able to understand
 24 what additional income, if any, is attributable
 25 to the activities undertaken by RAC Management.

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1 Q: All right. So can you flip forward for me to
 2 page 34, which is Appendix 1 and it's titled
 3 Audit Trail of Search for Comparable Retail
 4 Companies.
 5 A: You want me to go to 35, right?
 6 Q: Yes.
 7 A: Yes.
 8 Q: So does this summarize your search for
 9 appropriate an benchmark?
 10 A: Yes.
 11 Q: And just walk us through what all -- what types
 12 of companies you considered, what types of
 13 companies you ruled out.
 14 A: So the companies that we considered are in
 15 these primary SIC codes at the top of this page
 16 35, that was our beginning search string, and
 17 that was based on the functional markets and
 18 risks analysis that we had done. And I don't
 19 have all these SIC codes memorized --
 20 Q: Right.
 21 A: -- but they are easily determined, they're in
 22 the retail space, if you will. And so it --
 23 are you asking me about the process then?
 24 Q: Yeah. Just tell --
 25 A: Okay. So --

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1 Q: -- me about the process. How you ruled things
 2 out and how you selected the ones you used.
 3 A: Then you take -- so you take all companies that
 4 are in these SIC codes, and it essentially
 5 becomes -- think of it as a giant funnel. You
 6 throw all these companies in there and then you
 7 apply various screens to that funnel to weed
 8 out companies that are not comparable. And
 9 several of the important strings would be --
 10 well, first of all, if they don't have three
 11 years of financial data or there's going
 12 concerns, issues, you know, you want to take
 13 those out. So you do those sorts of
 14 quantitative screens. You would look for R&D
 15 expenditures which would be indicative of
 16 intangible assets. You would look at balance
 17 sheet items, etcetera, to get to something that
 18 is routine. And then you would do after --
 19 you'll get a group of companies like that, and
 20 then you would do qualitative screens, which is
 21 searching for brand names and companies that
 22 are easily recognized in the public domain.
 23 Again to try to arrive at a set of comparables
 24 that are stripped of intangible assets to some
 25 extent and to the extent possible and are

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1 performing activities which are similar to what
 2 we would now call the tested party, which was
 3 RAC East or RAC West, in this case.
 4 Q: The stores?
 5 A: The stores. Thank you.
 6 Q: All right. So can you just give us a couple of
 7 examples of ones that you ruled out? They can
 8 be categories, not specific companies, besides
 9 the ones you talked about where they owned
 10 substantial intellectual properties or
 11 something along those lines?
 12 A: Or that didn't have sufficient financial
 13 assets, or that had advertising to sales
 14 amounts that were greater than three percent.
 15 R&D, I mentioned that as a screen. Am I
 16 understanding your question what screens are --
 17 Q: Yeah. You said in your report that you were
 18 looking for retailers of unbranded consumer
 19 products. Tell us what you meant by that.
 20 A: Right. So the -- since the Rent-A-Center name
 21 is owned by RAC West and will have a -- we have
 22 a specific transaction for that, what we wanted
 23 was stripped down stores that were not
 24 leveraging a brand name or developing a brand
 25 name that they owned. So we wanted the most

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1 routine functions possible to benchmark these
 2 stores against because they didn't have -- they
 3 didn't own the brand name. So what you want to
 4 look for is not JC Penneys or Sears or Walmart.
 5 All those have intangible assets.
 6 Q: And sell their own -- do they all sell their
 7 own products?
 8 A: And they also have their own branded products,
 9 which is not the case with Rent-A-Center
 10 stores. So that's a key -- often a key of
 11 misconception in transfer pricing is why do you
 12 look at something without a brand name. Well,
 13 you want to isolate the functions that are
 14 being performed without the benefit of a brand
 15 name when they don't own the brand name. If I
 16 was benchmarking Walmart or Sears, I would use
 17 those comparables with intangible assets in
 18 them. But in this case, that would be
 19 inappropriate.
 20 Q: All right. And does page 30 of your report
 21 summarize the comparables you selected?
 22 A: It summarizes the comparables selected and --
 23 and their return on total costs, which is ROTC.
 24 Q: Okay. So again, we've got not a great copy.
 25 So the headings here are "Company" over the

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1 first column, and what's the heading over the
 2 second column?
 3 A: Average -- period weighted average -- I'm
 4 sorry. Maybe it's adjusted period weighted
 5 average return on total costs.
 6 Q: All right. Adjusted period weighted average --
 7 I can't write very fast.
 8 A: Period weighted average, return on total cost.
 9 Q: Okay.
 10 A: RO -- which is ROTC. So this is taking their
 11 cost of goods sold, plus their operating
 12 expenses and calculating what their operating
 13 profit is relative to those amounts.
 14 Q: Okay. All right. And then -- so tell me what
 15 you do with these numbers once you determine
 16 what their --
 17 A: So these numbers it's -- note that there's a
 18 range here. So we take -- we do a statistical
 19 analysis and essentially end up eliminating 50
 20 percent of the companies in the set from
 21 consideration for an appropriate range. And
 22 that's -- we take out 25 percent of the
 23 comparables on the bottom end of the range and
 24 25 percent on the top of the range. And that
 25 adjustment is meant to eliminate outliers.

1 companies that, for whatever reason, their
 2 results are above or below what would be
 3 dictated by normal or routine. And that is
 4 shown in the bottom part of this table where it
 5 says interquartile range. And the 25th
 6 percentile would be the return on total cost
 7 result that the company earns on average, the
 8 lowest possible routine return. The seven
 9 percent - 75th percentile would be the maximum
 10 possible routine return. And the IRS
 11 regulations, as well as the regulations under
 12 482, as well as the regulations of most other
 13 countries, require that taxpayers be within
 14 this range. Any place in the range is
 15 sufficient for most tax authorities.
 16 Q: Okay.
 17 A: But you want to be somewhere in that range.
 18 That would define the routine returns that the
 19 stores should earn without the intangible
 20 trademarks and trade names that are provided by
 21 RAC West and without the strategic management
 22 services that are provided by RAC Texas.
 23 Q: And it says here that the median was 3.3
 24 percent?
 25 A: Correct.

1 the store receives 3.3 percent of those
 2 operating profits?
 3 A: No.
 4 Q: No. What does it means?
 5 A: What it means is the store would receive -
 6 Q: I'm sorry. The cost.
 7 A: Yes.
 8 Q: I meant to say operating cost.
 9 A: Yes. So the store would receive - whatever
 10 its operating costs are, the store is
 11 guaranteed a 3.3 percent or 4.5 percent return
 12 on those costs. Come hell or high water it's
 13 going to earn that. If it's earning less than
 14 that, then it's, under this structure it's RAC
 15 Texas' role to prop up the store, to bring it
 16 up to that amount. If it's - if it's earning
 17 more than that's indicative of the successful
 18 strategic management and trademark value that
 19 is not owned by the stores, and that excess,
 20 that residual, would be due back to Texas, RAC
 21 Texas for its - for its activities. And so
 22 it's - the management fee is determined
 23 residually in that way. And maybe it's
 24 appropriate to point out here another thing I
 25 gleaned from the conversations previously is

1 Q: And do you know what RAC Texas ended up
 2 charging?
 3 A: Four -
 4 Q: Or what the fee ended up being?
 5 A: The - well, what they - so these are - these
 6 are used as - this is what the routine return
 7 should be. So this is what the stores would be
 8 required to earn.
 9 Q: Right.
 10 A: And I believe what they benchmarked, what they
 11 used was something above the median, 4
 12 percent, 4.5 percent. Something like that.
 13 Q: Okay. And so 4.5 percent would be better or
 14 worse for the stores than 3.3?
 15 A: It's more generous.
 16 THE COURT: More generous to whom?
 17 A: The stores. More - it's compensating the
 18 stores above what would be dictated by the
 19 median result.
 20 Q: So let's just talk through that number so a
 21 non-math person can understand it.
 22 A: Okay.
 23 Q: Non-economist. So if you're getting - if the
 24 store is getting - if the fee is 3.3 percent
 25 of the operating profits, does that mean that

1 that there's some concern over, for instance,
 2 hiring and firing that takes place at the store
 3 level and training that takes place at the
 4 store level and whether or not that is
 5 compensated under this structure. And indeed
 6 it is. Well, all these stores here undertake
 7 hiring and firing activities. All these stores
 8 here would undertake training of their people.
 9 Q: And you're referring, you said all these stores
 10 are you referring -
 11 A: The comparables.
 12 Q: - to the list of the comparables?
 13 A: Sorry.
 14 Q: That's okay.
 15 A: All these comparables would undertake their own
 16 activities to run their stores. They would -
 17 they would be forced, in the normal course of
 18 business, to do the things that RAC stores have
 19 to do to, you know, customer service, hiring,
 20 firing, training, etcetera. And with these
 21 margins they're getting - these comparables
 22 are getting a return on those activities.
 23 Q: Right.
 24 A: So it's not as if that return or that payment
 25 for those activities is not - it is baked into

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1 this -- to these numbers.
 2 THE COURT: Where I can be clear on your -- back to
 3 your pricing. When you said it was more
 4 generous to the stores, that would result in --
 5 and to ultimately to RAC East, that would
 6 thereby lower generosity of, lack for a better
 7 term right now, to RAC West, would it not?
 8 DR. WELLS: Sir --
 9 THE COURT: In other words, it would make the RAC
 10 West, in entering into the agreement for what
 11 they do, be less profitable?
 12 DR. WELLS: I would -- I would argue that it would
 13 necessarily make RAC Texas less profitable from
 14 the management.
 15 THE COURT: I'm sorry, RAC Texas. What did I say?
 16 DR. WELLS: You said RAC West. But I know where
 17 you're going.
 18 THE COURT: All right.
 19 DR. WELLS: Yes, sir. So it's like -- it's like --
 20 THE COURT: So RAC West isn't involved in this at
 21 all?
 22 DR. WELLS: Correct.
 23 THE COURT: Okay.
 24 DR. WELLS: So it's -- it would, by giving 4.5
 25 percent to the stores or guaranteeing their

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1 margin at that level, it would necessarily mean
 2 that the management fee coming back for RAC
 3 Texas' services would be that much less.
 4 THE COURT: All right.
 5 Q: And I apologize if you've already said this.
 6 I don't recall your talking about it. What
 7 happens if a store is not profitable?
 8 A: If the store is not profitable, the other side
 9 of the coin here is that RAC Texas is on the
 10 hook to make them profitable, to give them a
 11 sufficient return to give them 3.3 or whatever
 12 the policy is in order to true them up. So if
 13 their loss making or they're only making one
 14 percent profit, operating profit, then there
 15 would be an outflow of income from RAC Texas to
 16 the stores.
 17 Q: So they have a guaranteed rate of return?
 18 A: Correct.
 19 Q: No matter what happens as far as the
 20 profitability of the business, they get that
 21 return?
 22 A: Correct.
 23 Q: All right. Let me talk briefly about RAC West.
 24 Can you just summarize for us your methodology
 25 and conclusions about the royalty fee and the

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1 amount that should be charged?
 2 A: Yes. We had the benefit of being able to use
 3 the transactional method to benchmark the
 4 trademark value that was owned by RAC West.
 5 And this was due to the fact that Rent-A-Center
 6 had acquired ColorTyme and ColorTyme did not
 7 own all its stores, but actually licensed its
 8 brand name to unrelated parties for between two
 9 and four percent of gross revenue. And this
 10 was -- this would be termed an internal
 11 comparable.
 12 Q: Okay.
 13 A: And it's one of the strongest comparables that
 14 one can find in transfer pricing because it's
 15 licensing the same or very similar brand name
 16 to stores that are performing very similar
 17 services. And so we used that to benchmark the
 18 payment from RAC East to RAC West for use of
 19 the brand name.
 20 Q: All right. And did you provide a range here as
 21 well?
 22 A: Yes. Two to four percent.
 23 Q: And do you know what RAC West ultimately set
 24 the fee to be?
 25 A: Three percent, somewhere in there. And we did

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1 not -- I did not advise on where within the
 2 range the company should be. They chose these
 3 numbers, which is typical for our advice. We
 4 give a range and --
 5 Q: For some reason I thought I saw a
 6 recommendation to use the median?
 7 A: Well, that often is a -- that is often a -- in
 8 a planning report, that is often the -- that is
 9 often the conclusion.
 10 Q: Okay.
 11 A: And I can't remember if that's what we
 12 concluded here or not.
 13 Q: Let's see, 32 it looks like is where your
 14 conclusions are. Yes. If you look at page 32
 15 and the bullet points one, two, three, four
 16 down.
 17 A: Okay.
 18 Q: That doesn't recommend -- I know I wrote it
 19 somewhere. Well, here it is for -- anyway, and
 20 so do sometimes --
 21 A: Well, if I recommended the median on the
 22 stores, they didn't listen to me very well, did
 23 they? But, because they paid them more.
 24 Q: Right.
 25 A: But --

1 Q: All right. Final questions for you on your
2 opinions. Do you have an opinion to a
3 reasonable degree of certainty in the transfer
4 pricing field that the amount that RAC Texas is
5 charging its affiliates for the management
6 services it provides is consistent with the
7 arms length transaction?

8 A: Yes.

9 Q: And do you have an opinion to a reasonable
10 degree of certainty in the transfer pricing
11 field that the amount that RAC West is charging
12 its affiliates for the use of the RAC
13 intellectual property consistent with an arms
14 length transaction?

15 A: Yes.

16 Q: And just so I'm clear. You have an opinion --

17 A: I have a --

18 Q: -- it is --

19 A: I have an opinion and that, yes. And that that
20 is --

21 THE COURT: Thank you for that.

22 A: -- it is reasonable to conclude that they are
23 transacting in an arms length manner consistent
24 with the arms length standard for both
25 transactions.

1 reasons. First of all, the value of the
2 services provided are not routine or pure back
3 office activities. And two, the -- it would
4 not compensate RAC Texas for the risks it was
5 bearing, which are substantial under this
6 arrangement. And so if you're guaranteeing a
7 fixed return to the stores, the cost of the
8 services become irrelevant in that sense
9 because you've also got risks there as well.
10 And those risks are very difficult to price,
11 and they're not at all related to cost. As
12 we've seen from the last few days on the
13 markets, risks are very difficult to price. So
14 cost would be inappropriate for those two
15 reasons. We also, during our interviews, were
16 able to identify the fact that many people were
17 performing integrated functions which both
18 supported the intangibles and were strategic in
19 nature. And it was -- became difficult to try
20 to think about ways to bifurcate people's
21 activities between those various functions. So
22 I guess there's maybe three reasons that a,
23 that cost would not be appropriate, and indeed,
24 the regulations would lead you away from that.

25 Q: All right. And its your opinion that costs

1 Q: Okay. And by both transactions, you mean the
2 RAC Texas transaction regarding management
3 services and the RAC West transaction regarding
4 intellectual property?

5 A: That is correct. That's what I mean.

6 Q: We talked earlier about section 482 and what it
7 says about charging arms length -- at arms
8 length transactions. What would you opinion be
9 as to a company charging its affiliate at cost?
10 Is that proper?

11 A: In many cases it is. But qualifying that, it
12 really depends upon the functions performed and
13 the risks incurred. For some services, such as
14 back office, very routine services, the
15 transfer pricing regulations in effect at the
16 time used -- allowed taxpayers to select a safe
17 harbor that would be cost only. But that is
18 relegated to very routine activities and,
19 indeed, is prohibited for activities that are
20 strategic in nature that are critical to the
21 success of the business where the company or
22 the service provider, the renderer, is
23 peculiarly capable of providing the services.
24 And -- but it is used in some cases. The
25 reason it wouldn't apply here is for two

1 would not be an appropriate method to use in
2 this case. Is it to a reasonable degree of
3 certainty in the transfer pricing field?

4 A: It is reasonable to conclude that cost would
5 not be an appropriate basis for charging out
6 the strategic management services performed by
7 RAC Texas.

8 Q: All right. Let me just make sure I understood
9 what you just said. My question is not just is
10 it reasonable, but can you say to a reasonable
11 degree of certainty in this field of transfer
12 pricing studies that it would be inappropriate
13 in this case for RAC Texas to charge its
14 affiliates at cost?

15 A: I can say that to a reasonable degree with
16 certainty.

17 Q: Okay. Great.

18 THE COURT: You said strategic, what was the phrase?
19 I read it before. Strategic?

20 DR. WELLS: Strategic management.

21 THE COURT: There you go.

22 Q: I'm sorry. And I just want to make sure this
23 was clear. Did you say that the 482
24 regulations would prohibit it in this case?

25 A: Correct.

1 MS. GEER: That's all I have, Your Honor.
 2 THE COURT: Hold on one moment.
 3 MR. RYAN: Did you give me the go ahead, Your Honor?
 4 THE COURT: No.
 5 MR. RYAN: Oh.
 6 THE COURT: He's over there drinking water anyway.
 7 Go ahead.
 8 MR. RYAN: All right. Thank you.
 9 MR. WELLS - CROSS-EXAMINATION BY MR. RYAN:
 10 Q: Dr. Wells, good afternoon.
 11 A: Hi.
 12 Q: We haven't formerly met. I'm Sean Ryan with
 13 the Department of Revenue.
 14 A: Nice to meet you, Sean.
 15 Q: Nice to meet you too. Does your report specify
 16 that RAC Texas is only compensated for what
 17 goes on in Texas?
 18 A: I would say it's implicit, perhaps not
 19 explicit. But it's -- from my perspective,
 20 what we're doing is compensating the stores for
 21 what goes on in the stores. And therefore, it
 22 is, by definition, everything else is what's
 23 being performed in Texas other than the
 24 trademark.
 25 Q: Where does the report recognize that training

1 THE COURT: 4.1.10?
 2 Q: On page 13.
 3 A: 4.1.10.
 4 Q: Yeah. 4.1.10. Can you just read the first
 5 sentence for me, please.
 6 A: "Training includes the development of training
 7 material, the distribution of training
 8 material, along with conducting training
 9 sessions."
 10 Q: So would it be fair to say from here out where
 11 you refer to training, you're referring to the
 12 training materials or distribution of training
 13 materials along with the training sessions?
 14 A: Uh-huh (affirmative response).
 15 Q: Correct?
 16 A: Uh-huh (affirmative response).
 17 Q: Okay. Can you turn to page 16, please.
 18 A: Yes.
 19 Q: And where it says -- so training on there is on
 20 there twice, correct, once as a risk and once
 21 as a function?
 22 A: Yeah. Well, I'd say there's -- it's -- you
 23 could think of it maybe as three times really.
 24 They may be training assets that they have as
 25 well, such as the -- the VCR tapes and training

1 is going on in the stores?
 2 A: I don't know that it does. But as I indicated,
 3 all the stores -- all the comparables are doing
 4 training. So explicitly they'd be -- they
 5 would be undertaking training activity on their
 6 own for their own benefit.
 7 Q: Now, other than putting you on the stand and
 8 asking you that, how would we know that without
 9 reading your report?
 10 A: You could look at the business descriptions of
 11 the companies perhaps. I don't know if any of
 12 them indicate that they are undertaking
 13 training on their on behalf. But clearly they
 14 would be in a situation, Sean, which they'd be
 15 doing advertising training, hiring, firing. It
 16 may even be so obvious that one would not need
 17 to state that because every company would be
 18 undertaking those activities on its on behalf.
 19 So it's unlikely, in most cases, that we would
 20 enumerate every individual activity that would
 21 be taken, undertaken by a set of comparables.
 22 Q: All right. Can you turn to -- let's start at
 23 page 13.
 24 A: Okay.
 25 Q: You see section 4.1.10?

1 materials that I reviewed.
 2 Q: If there had been a line that said training
 3 under the assets, where would you put the X?
 4 A: Well, note that this is a combination, Sean, of
 5 everything. So it's got functions, risks and
 6 assets all together. So under the assets.
 7 Q: And again, if there was an assets line that
 8 said training --
 9 A: Where would I put it?
 10 Q: -- were would the X go? Yeah.
 11 A: To the extent that RAC Management owns the
 12 training materials, it would go under RAC
 13 Management.
 14 Q: So under this example, on your current chart
 15 there is two trainings and both Xs are under
 16 RAC Management, correct?
 17 A: Oh, I see. There is risk down here. Yeah.
 18 Right.
 19 Q: And under the table, if you -- you could have
 20 included an additional training under assets
 21 and that also would have been under RAC
 22 Management, correct?
 23 A: Yeah. I think that's right. Again, I don't
 24 know exactly who owns the training materials,
 25 if the stores pay for them or what.

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1 Q: Now, you earlier testified about how customer
 2 service has two Xs because it was your
 3 understanding that the stores took part of it
 4 and management did part of it.
 5 A: Uh-huh (affirmative response).
 6 Q: Why aren't there two Xs for training?
 7 A: We didn't necessarily view it as a -- for
 8 competency, but indeed, it could have been an
 9 oversight.
 10 Q: You're not sure?
 11 A: I'm not sure.
 12 Q: Does your report say anywhere in there that RAC
 13 Texas is only compensated for generating
 14 training materials?
 15 A: I don't know. Is only compensated for training
 16 materials? No, I don't think so. But it
 17 doesn't say that the stores are not compensated
 18 for training either.
 19 Q: Would you agree that your report places all
 20 risks associated with the training sessions
 21 with RAC Management?
 22 A: All risks -- all risks for training is with RAC
 23 Management.
 24 Q: And the amount of the fee compensates RAC Texas
 25 for that, for its training responsibilities,

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1 correct?
 2 A: Correct.
 3 Q: Let's go over to page 10 of your report if you
 4 would, please.
 5 A: Okay.
 6 Q: You find that page okay?
 7 A: Yes, sir.
 8 Q: Okay. Under section 4.1.5, can you read the
 9 second paragraph please.
 10 A: "RAC stores process orders using the management
 11 information system provided by RAC Management.
 12 RAC Management provide -- RAC Management
 13 provide training and guidance to RAC store
 14 managers on how to process orders, e.g., what
 15 forms to complete, information on rental
 16 payment options, how to make deliveries and
 17 operate the delivery vehicle."
 18 Q: So it was your understanding that these are
 19 things that RAC Management provides to the
 20 stores?
 21 A: Yeah. Training guides.
 22 Q: Is the management information system something
 23 that RAC Texas owns?
 24 A: I don't know. I don't know who owns that. I
 25 would think it's owned by RAC Services -- I

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1 mean RAC Management.
 2 Q: Do you know if RAC Management provides that
 3 management information system to the stores?
 4 A: I do not think they license the management
 5 information systems to the stores. But they
 6 use it to provide services to the stores.
 7 Q: Is the management information system used in
 8 the stores?
 9 A: I do not know.
 10 Q: Okay. Can you turn to page 12, please. Can
 11 you read the first paragraph section 4.1.9?
 12 A: "RAC Management has a licensing agreement with
 13 High Touch, Inc., which provides the integrated
 14 computerized management information and control
 15 system used by the stores. Each store is
 16 equipped with a computer system utilizing point
 17 of sale software. This system tracks
 18 individual components of revenue, each item in
 19 idle and rented inventory, total items on rent,
 20 delinquent accounts and other account
 21 information."
 22 Q: Was it your understanding that RAC Management
 23 had a licensing agreement with High Touch?
 24 A: Yes.
 25 Q: Pursuant to that licensing agreement, are point

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1 of sale computers placed in stores?
 2 A: Yes.
 3 Q: Does the fee -- the management fee compensate
 4 RAC Management for having that license?
 5 A: Yes.
 6 Q: Okay. Will you please turn to page 15.
 7 A: Okay.
 8 Q: Under the heading of 4.3.1 -- what is the
 9 heading 4.3.1 state?
 10 A: Intangible Assets.
 11 Q: Can you read those two paragraphs, please.
 12 A: "Intangible assets include any non-financial
 13 assets developed or owned by a company, which
 14 includes internal know-how, trademarks, bank,
 15 supplier or customer relations. These assets
 16 can be of significant value to a company and
 17 can have a direct impact on the profitability
 18 and success of a firm. The Rent-A-Center name
 19 is a recognized name and plays a key role in
 20 distinguishing itself from its competitors.
 21 This is extremely important in the rent-to-own
 22 industry where competitive advantage is gained
 23 through customer service rather than pricing.
 24 Thus, the company relies heavily on positive
 25 trademark recognition as unsuccessful

1 advertising promotions can significantly impact
 2 the company's product demand. RAC West owns
 3 the group's trademark. RAC Management is
 4 responsible for developing advertising and
 5 marketing strategies to create, maintain, and
 6 expand the brand name for the company. Other
 7 intellectual properties such as strategic
 8 management plans, know-how related to -- know-
 9 how related to customer service, computer
 10 systems and software are owned by RAC
 11 Management."
 12 Q: Thank you. Is it your understanding that RAC
 13 Texas owns the intellectual property described
 14 in that paragraph?
 15 A: Uh-huh (affirmative response).
 16 Q: And any intellectual property value --
 17 A: Yes, I should say.
 18 Q: And I appreciate -- yes? You said yes?
 19 A: Yes.
 20 Q: Thank you. My bad for going so quick. And
 21 that intellectual property is valuable?
 22 A: Yes.
 23 Q: And the management fee compensates RAC Texas
 24 for that intellectual property, correct?
 25 A: Yes.

1 where they should place ads, etcetera.
 2 Q: What if they were told specifically how they're
 3 supposed to do things? Are they then using the
 4 marketing strategy here rather than just
 5 guidance?
 6 A: Potentially. I don't know the ramifications of
 7 that. But that could be possible.
 8 Q: Did you hear Hugh Tollack testify earlier that
 9 stores can't choose their own advertising?
 10 A: I don't recall hearing that.
 11 Q: Now, you used the CUT method, correct?
 12 A: Yeah.
 13 Q: Can you explain what the CUT method is.
 14 A: The CUT method is the -- is called the
 15 Comparable Uncontrolled Transaction method. It
 16 is an effort to benchmark license arrangements
 17 involving intangible property using agreement
 18 or transactions that are available in the
 19 public domain or within a company.
 20 Q: Now, the "U" in CUT is Uncontrolled, right?
 21 A: Uncontrolled.
 22 Q: And your report used ColorTyme as the
 23 uncontrolled, right?
 24 A: Right.
 25 Q: Doesn't Rent-A-Center own ColorTyme?

1 Q: Now, according to that paragraph, isn't
 2 marketing strategy an intangible asset?
 3 A: Yes. It's not an intangible asset like what
 4 you would find on a balance sheet, which is
 5 typically the way we would define intangible
 6 assets for accounting purposes. But it is --
 7 it is IP, yeah.
 8 Q: And --
 9 A: It supports the brand.
 10 Q: And RAC Texas owns that marketing strategy?
 11 A: Uh-huh (affirmative response). Yes, sir.
 12 Q: And part of the fee paid to RAC Texas is for
 13 that marketing strategy?
 14 A: Yes. I think the important distinction may be
 15 that it doesn't license that marketing strategy
 16 to the stores. It uses that marketing strategy
 17 to provide services, and indeed, most of these
 18 intangibles to provide services to the stores.
 19 Q: You don't know if the marketing strategy is
 20 used in South Carolina?
 21 A: It's not -- the services are used, but the --
 22 it's not a license of a marketing strategy to
 23 South Carolina. It uses it to provide guidance
 24 as to how they should market, is my
 25 understanding, what they should market in,

1 A: Yes. But it does not own ColorTyme's third
 2 parties that they transact with and license
 3 their brand name to.
 4 Q: Were there no other uncontrolled entities you
 5 could find that weren't owned by Rent-A-Center?
 6 A: Just to confirm, that doesn't -- that is still
 7 uncontrolled because it's ColorTyme licensing
 8 to third parties. That's what we used. We
 9 used ColorTyme's licensing of its brand name to
 10 parties that are not owned by Rent-A-Center or
 11 ColorTyme, they're third parties. That's the
 12 comparable uncontrolled transaction we used.
 13 Were there not others? Undoubtedly, we could
 14 have found others. But that transaction is
 15 really the gold standard of transfer pricing in
 16 that you can't -- you typically can't go out in
 17 the public domain and find a comparable
 18 uncontrolled transaction between two third
 19 parties which is better than a comparable
 20 uncontrolled transaction which is between the
 21 company you are benchmarking and a third party.
 22 Q: Of the comparables -- comparables, excuse me,
 23 that you selected, are any of them in the rent-
 24 to-own business?
 25 A: I don't believe so. Maybe -- let me look at

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1 them. Some of -- Tweeter may do some rent-to-
 2 own activities, Ultimate Electronics may do
 3 some rent-to-own activities. I'm not sure.
 4 Q: You're speculating?
 5 A: I'm speculating at this point. I could look at
 6 the business descriptions and -- and try to
 7 figure that out if you would like me to.
 8 Q: Now, you -- you don't need to.
 9 A: No?
 10 Q: No. You labeled in your report, I believe you
 11 called Rent-A-Center an unbranded retailer; is
 12 that correct?
 13 A: No, not Rent-A-Center. The stores without the
 14 Rent-A-Center name are unbranded retailers.
 15 Q: Could you explain that to me.
 16 A: They -- the comparables that we benchmark
 17 against, for the most part, have got either not
 18 very valuable brand names or brand names you've
 19 never heard of. So they're not -- they don't
 20 have a lot of brand value associated with them,
 21 whereas Rent-A-Center does have brand names.
 22 If the store is without the Rent-A-Center name,
 23 which is what we're trying to benchmark, a
 24 stripped down versions of the stores are
 25 essentially unbranded retail operations. You

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1 take the -- take the Rent-A-Center name off and
 2 they're Sean's Rent-to-Own.
 3 Q: So we're figuring out what the store would have
 4 been if it had no brand name as opposed to one
 5 that has a brand name?
 6 A: Right.
 7 Q: Okay.
 8 THE COURT: The Sean Rent-to-Own would probably be
 9 one of your outlying things.
 10 DR. WELLS: You ain't on the top end.
 11 MR. RYAN: Thanks, Your Honor.
 12 THE COURT: Well, I didn't say which end.
 13 MR. RYAN: I believe that's all the questions I have
 14 for you. Thank you.
 15 DR. WELLS: Okay. Thank you.
 16 THE COURT: Redirect?
 17 MS. GEER: No, we don't have any further questions.
 18 THE COURT: Okay. You may step down.
 19 DR. WELLS: Thank you.
 20 THE COURT: Are you uncomfortable or you want to say
 21 something?
 22 MR. VON LEHE: We're prepared to call our next
 23 witness depending on what you want done.
 24 THE COURT: Well --
 25 MR. VON LEHE: I will give you this, but as this

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1 witness is on his way out, Your Honor, may he
 2 be excused?
 3 THE COURT: Any objections?
 4 MR. RYAN: No objection, Your Honor.
 5 THE COURT: Call away.
 6 MR. VON LEHE: Proceed, Your Honor? Your Honor, we
 7 would like to call Dr. Ron Wilder.
 8 RONALD P. WILDER, Ph.D., having been duly sworn,
 9 testifies as follows:
 10 THE COURT: All right. My goal is to get through
 11 this case by tomorrow.
 12 MR. RYAN: Understood, Your Honor.
 13 THE COURT: So how late do we need to go today to
 14 accomplish my goal?
 15 MR. VON LEHE: I would think that Dr. Wilder's direct
 16 examination will take approximately half an
 17 hour.
 18 THE COURT: Well, that's his. But my question again
 19 was how late do we need to go today to
 20 accomplish my goal of making sure this case is
 21 concluded by tomorrow?
 22 MS. GEER: Your Honor, after Dr. Wilder, we only
 23 have -- we have one more witness, and then I
 24 understand the Department has two witnesses.
 25 So I think we should be able to.

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1 THE COURT: All right. So if we can get Dr. Wilder
 2 in --
 3 MS. GEER: We would only have three witnesses
 4 tomorrow.
 5 THE COURT: Okay. Well, we're going to start at
 6 nine tomorrow, too.
 7 MR. VON LEHE: Very good, Your Honor.
 8 THE COURT: All right. Let me just take a real
 9 quick break.
 10 MR. VON LEHE: Yes, Your Honor.
 11 (Break from 4:54 p.m. until 4:58 p.m.)
 12 DR. WILDER - DIRECT EXAMINATION BY MR. VON LEHE:
 13 Q: Mr. Wilder, you've been sworn, I believe?
 14 A: Yes, I have.
 15 Q: Please state your full name.
 16 A: My full name is Ronald P. Wilder.
 17 MR. VON LEHE: Your Honor, it's my understanding
 18 that Ms. Geer and Sean Ryan have stipulated
 19 that as to this witness and his later economist
 20 witness, Glenn Harrison, that we will have no
 21 objection to their being accepted by the Court
 22 as experts in the area of economics.
 23 THE COURT: Okay.
 24 Q: I would like to just -- an introductory, I
 25 guess, just a personal matter. I would like to

1 ask one question of him about economics. And
 2 that is, what position did you hold at the
 3 University of South Carolina?
 4 A: I was a Professor of Economics. I was chairman
 5 of the department for about 15 years.
 6 Q: I understand. You're retired from what role,
 7 I believe?
 8 A: Yes. I'm retired from active teaching. I
 9 retain an appointment as a professor emeritus,
 10 which gives me access to the library and
 11 interaction with my colleagues.
 12 Q: Very well. What --
 13 THE COURT: Do they give you access to football
 14 tickets? I was just wondering how valuable a
 15 professor emeritus is?
 16 DR. WILDER: Yes, it does.
 17 THE COURT: All right. Then it's a valuable
 18 commodity to have.
 19 MR. VON LEHE: Yes, it is.
 20 Q: Dr. Wilder, what were you asked to do with
 21 regard to this matter?
 22 A: I was asked to consider some of the economic
 23 aspects of this case and to form my opinion on
 24 about five general areas of the case. First
 25 area would be the issue of where income is

1 written report of Professor Pomp. In addition
 2 to those, I looked -- consulted a public
 3 finance textbook. One of the classics by
 4 Musgrave and Musgrave on the benefit principle
 5 in public finance. I consulted a classic
 6 article by Ronald Coze of the nature of the
 7 firm, and an article by Charles McClure in
 8 which Charles McClure defined the unitary
 9 business from an economics perspective. I
 10 consulted the relevant parts of the state tax
 11 code dealing with corporate income tax. I
 12 reread a couple of articles on my own from the
 13 -- from the earlier days. One dealing with
 14 vertical integration which used the value added
 15 concept that's part of my testimony here, and
 16 a second on profitability and firm size which
 17 considers the importance of economies of scale
 18 as it relates to firm size.
 19 Q: All right. So just the concept of economic
 20 theory and application include the question of
 21 where income is earned?
 22 A: Yes. The study of economics deals with the
 23 earning of income and also where it is earned.
 24 It is my view that the important determination
 25 of the earning of income, where it is earned is

1 earned. The second was the economic aspect of
 2 the unitary business. The third was, from an
 3 economic point of view, could or should a
 4 unitary business be separated. And then the
 5 last two questions were about the apportionment
 6 ratios methods in this case. So the first,
 7 whether the statutory apportionment formula as
 8 applied to RAC West and if applied to RAC
 9 Texas, if it were required to file, would
 10 fairly represent its economic activity in South
 11 Carolina. And alternatively, if -- would a
 12 separate accounting method, an alternate
 13 method, be a fairer representation of its
 14 economic activity in South Carolina.
 15 Q: And in preparing for your testimony today, what
 16 have you done?
 17 A: I've read some of the materials that were sent
 18 to me and consulted some articles in economics.
 19 I read the audit reports and agency
 20 determinations for both taxpayers from the
 21 Department of Revenue. I read the prehearing
 22 statements of both parties. I read depositions
 23 of Mr. Tollack, of the Department of Revenue
 24 agent, Mr. Southard. I read the deposition of
 25 Professor Glenn Harrison, and I read the

1 the value added concept.
 2 Q: And in the case of a service business, how does
 3 that apply?
 4 A: In the case of a service business, value is
 5 added and income is earned in the economic
 6 establishment which employs the labor and
 7 capital used to produce the services. That's
 8 where value is added. That's where income is
 9 earned. And that is where the income should be
 10 assigned if it is a -- if there's a question of
 11 the location.
 12 Q: And what about the view that income is earned
 13 where the customer is located? What about that
 14 view?
 15 A: That view is not consistent with the value
 16 added concept of earning of income. The value
 17 added concept would place the earning of income
 18 at the economic establishment where labor and
 19 capital are employed to produce the goods or
 20 services.
 21 MR. VON LEHE: Your Honor, we would like to bring
 22 back one of our demonstratives.
 23 Q: Dr. Wilder, I would like for you to answering
 24 this question. In the case of an architectural
 25 or engineering firm that -- assume that this

1 firm is located in South Carolina, and assume
 2 that it performs its architectural and
 3 engineering services in South Carolina on
 4 behalf of customers located in, let's say,
 5 North Carolina, what is your opinion concerning
 6 where that income is earned, in what state?
 7 A: In my opinion, the income is earned in South
 8 Carolina where the engineering firm's
 9 establishment is located. That's where the
 10 labor and capital are employed to produce the
 11 value added in the income.
 12 Q: And in this demonstrative which we have in
 13 front of us, you'll see the taxing state is
 14 where the engineering firm is located, the out
 15 of state is where the customers are located.
 16 In the example I just gave would be North
 17 Carolina. Services are performed in this
 18 example in South Carolina on behalf of
 19 customers located out of state. And can you
 20 read the sourcing alternatives in the body from
 21 where you're sitting? I'll read them. They're
 22 a long way off. One is place of activity view
 23 where the services are performed. The other is
 24 origin of payment view where the customers are
 25 located and/or locations from which payment --

1 A: In my -- in my opinion, the income is earned at
 2 the location of the establishment where the
 3 management services are performed. So in the
 4 case of this example, the management services
 5 are performed in Texas. That's where the
 6 income is earned on the basis of the value
 7 added concept.
 8 Q: All right, sir. You said you had read some
 9 materials associated with this case. And I
 10 believe you were here this morning, were you
 11 not?
 12 A: Yes, I was.
 13 Q: All right. Then the question, are you familiar
 14 with management services granted by RAC Texas
 15 or RAC East and the fee paid by RAC East to RAC
 16 Texas? Are you familiar with that?
 17 A: Yes. I have read the Management Services
 18 Agreement and that -- that agreement provides
 19 for management services to be provided by RAC
 20 Texas to the customer, RAC East.
 21 Q: And where is your understanding of where those
 22 services are performed? Where?
 23 A: My concept is that the services are performed
 24 in Texas since that's where the value is added.
 25 Q: And have you an opinion from an economic

1 payments are made. What is your view from the
 2 economic perspective of is the proper state to
 3 assign the income to?
 4 A: My view is that the income should be assigned
 5 to the state where the engineering firm is
 6 located. That would -- that would correspond
 7 to the place of activity view in the chart.
 8 Q: All right, sir. So I'm going to show you the
 9 corollary to this, another demonstrative which
 10 shows, in this case this demonstratives states
 11 on the left it states in the taxing states
 12 where the customer is located this time. On
 13 the right, out of state is where the management
 14 services are being performed. And the sourcing
 15 and the customer in the taxing state this time
 16 is making payments to the management services
 17 company located out of state in exchange for
 18 those services. And then we have the sourcing
 19 alternatives. One, is the place of activity
 20 view is where the services are performed. And
 21 second is the origin of payment view where the
 22 customers are located and/or the location from
 23 which payments are made. Under this fact
 24 scenario, from an economic perspective, what is
 25 your opinion as to where this income is earned?

1 perspective on where the management fee paid by
 2 RAC East to RAC Texas is earned?
 3 A: The management fee paid by RAC East to RAC
 4 Texas, in my opinion, is earned in Texas.
 5 Q: All right, sir. I would ask you some questions
 6 about concept of the unitary business. Does
 7 the term "unitary business" have meaning in the
 8 field of economics?
 9 A: Yes, it does. The concept of the firm goes
 10 back a long way and developed extensively by
 11 Ronald Coze, in his article of "The Nature of
 12 the Firm." Coze's idea of the that it is -- it
 13 is an entity which may choose to produce goods
 14 and services within the firm or purchase them
 15 from outside the firm, depending on which is
 16 more efficient. And so the limit to the size
 17 of the firm is -- is the point at which it
 18 becomes too inefficient to continue growing the
 19 firm. The Coze concept of the firm was
 20 extended by Charles McClure in the article I
 21 mentioned previously about the unitary business
 22 from an economist's view. McClure extended it
 23 to a firm with two or more business activities
 24 where the multiple business activities are
 25 interdependent in some way, such as through

1 economies of scale, economies of scope, or
 2 shared overhead expenses for those sorts of
 3 interdependence.
 4 Q: And in your preparation for your testimony
 5 today, have you had occasion to study the
 6 structure and the business functions of the two
 7 taxpayers, RAC Texas and RAC West, and the
 8 related entity RAC East? And if so, please
 9 comment on their structure.

10 A: Yes. I'll start with RAC Texas. As I
 11 understand the structure of RAC Texas, RAC
 12 Texas has two primary business activities. It
 13 operates its own stores in the state of Texas,
 14 and it also provides management services to
 15 itself, as well as to RAC East and RAC West.
 16 Then RAC West, the second of the taxpayers in
 17 this case, also has two main lines of business
 18 activity. It operates its own stores in the
 19 western region and it owns the intellectual
 20 property in the form of Rent-A-Center
 21 trademarks and trade names. Finally, RAC East,
 22 which is -- which operates stores in the
 23 eastern region of the United States, including
 24 within South Carolina.

25 Q: All right, sir. I'm going to look at this

1 depend upon and support the activities of the
 2 other.

3 Q: And is there an article, and if so, what is it
 4 defining a unitary business?

5 A: Yes. The article by Charles McClure that I
 6 mentioned defines the unitary business from an
 7 economist's point of view.

8 Q: In what ways, if they do, in what ways do the
 9 store operations and management services
 10 contribute to and depend on each other in RAC
 11 Texas?

12 A: The -- their occurrence in the same business
 13 entity means that the operation of the stores
 14 makes use of the management services. And that
 15 operation of the stores in the same firm, as
 16 the production of the management services
 17 allows for mutual support, information flows,
 18 feedback, so that the successful operation of
 19 the stores leads to the improvement of the
 20 management services, the successful operation
 21 of the management services improves the
 22 operation of the stores.

23 Q: All right, sir. What is your conclusion
 24 concerning the question of whether RAC Texas is
 25 a single unitary business?

1 demonstrative for just a second. This
 2 demonstrative, Dr. Wilder, if you can see it
 3 from where you are, it's got three diagrams on
 4 it, RAC West, RAC Texas, RAC East. The diagram
 5 says RAC East operates stores in the
 6 southeastern states of the eastern -- including
 7 South Carolina. That much is right. RAC West
 8 operates stores in the western states, owns and
 9 licenses trademarks and trade names. RAC Texas
 10 operates stores in Texas, performs management
 11 services for RAC Texas, RAC West and RAC East.
 12 Is this consistent with your understanding?

13 A: Yes, it is.

14 Q: And just what, if anything, concerning the
 15 business activities of RAC Texas, I believe you
 16 just testified, operates stores and renders
 17 management services. What, if anything, is the
 18 relationship between those two activities?

19 A: The fact that RAC Texas has both lines of
 20 business activity within the same firm creates
 21 an opportunity for interdependence and mutual
 22 support that we would expect there to be to
 23 economies of scale and economies of scope from
 24 having them both in the same firm, economic
 25 interdependence in that the activities of one

1 A: In my opinion, RAC Texas is a single unitary
 2 business.

3 Q: Please describe the business activities of RAC
 4 West.

5 A: RAC West has two primary business activities.
 6 It operates stores and it owns and licenses the
 7 trademarks and trade names.

8 Q: And what, if anything, is the relationship
 9 between these two activities?

10 A: I believe in a similar way as I described with
 11 RAC Texas, the operation of the two business
 12 activities together within the same firm create
 13 efficiencies and economies. The value of the
 14 trademarks is related to the successful
 15 operation of the stores. The successful
 16 operation of the stores increases the value of
 17 the trademarks. And in that sense, they are
 18 mutually interdependent.

19 Q: What is your conclusion, if you have one,
 20 concerning the question of whether or not RAC
 21 West is a single unitary business?

22 A: I believe that RAC West is a single unitary
 23 business.

24 Q: You've read Dr. Glenn Harrison's deposition in
 25 this case?

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1 A: Yes, I have.
 2 Q: And in that deposition, what does he imply
 3 about RAC Texas and its two business
 4 activities?
 5 A: He implies that the two business activities can
 6 be treated as though they are separate firms,
 7 with no relationship between each other.
 8 That's implied in his conclusion of separate
 9 accounting it is appropriate in that case.
 10 Q: And to your agree, not agree what's that
 11 conclusion?
 12 A: I don't agree with that conclusion because of
 13 my belief that RAC Texas is a unitary business
 14 and that seeking to -- seeking to apply
 15 separate accounting would lead to error and
 16 distortion.
 17 Q: And what about RAC West?
 18 A: Professor -- are we still talking about
 19 Professor Harrison's?
 20 Q: We're talking about his deposition and your
 21 opinion of what he said or did not say about
 22 RAC West.
 23 A: Yes. Thank you. Also in RAC West, the
 24 implication of Professor Harrison's deposition
 25 is that it is reasonable to treat the two

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1 business activities within RAC West as though
 2 they were separate firms so that separate
 3 accounting can be applied and fairly represent
 4 the activities of those entities in South
 5 Carolina.
 6 Q: And do you have an opinion on that conclusion?
 7 And if so, what is it?
 8 A: Again, I disagree with Professor Harrison on
 9 that point because I believe that RAC West
 10 meets the economic definition of a unitary
 11 business as laid out by Charles McClure. And
 12 I believe that it is a unitary business.
 13 Q: All right, sir. I want to ask you some
 14 questions concerning the question of whether or
 15 not the income reported by the taxpayer, RAC
 16 West, using the standard income apportionment
 17 formula, which you may assume that they used,
 18 represents the extent of the taxpayer's
 19 business activity in this state. Whether it
 20 fairly represents the extent of the taxpayer's
 21 business activity in this state. This is what
 22 I'm going to ask you about. Concerning RAC
 23 West, how did RAC West -- what is your
 24 understanding of how RAC West reported its
 25 income?

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1 A: In its amended return, RAC West reported its
 2 taxable income in South Carolina by applying
 3 the gross receipts ratio based on its royalty
 4 receipts from South Carolina divided by its
 5 gross receipts everywhere, and multiplied that
 6 by the total corporate income as adjusted.
 7 Q: All right. What did the South Carolina
 8 Department of Revenue -- what is your
 9 understanding of what the South Carolina
 10 Department of Revenue did in its audit report?
 11 A: In the audit report, the Department of Revenue
 12 rejected that approach and instead applied a
 13 method of separate accounting in which it
 14 looked only at the royalty receipts from South
 15 Carolina as representing the taxable income of
 16 RAC West in South Carolina.
 17 Q: And what did it do about the corporation's net
 18 income, the corporate net income?
 19 A: It did not include the corporation net income
 20 in its computation of taxable income.
 21 Q: All right, sir. Have you been asked, and I'm
 22 going to ask you now to address the question of
 23 whether or not from an economic point of view
 24 the income reported to this state by RAC West
 25 on its amended tax returns, using the standard

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1 apportionment formula, did from an economic
 2 point of view fairly represent the extent of
 3 the taxpayer's activities in this state?
 4 A: Yes, I've been asked to look at that. And I do
 5 believe that the method used by RAC West in its
 6 amended return does fairly represent its
 7 economic activity in South Carolina. I base
 8 that conclusion in part on the fairness -- on
 9 the benefit principle of tax fairness as
 10 discussed by the public finance textbook that
 11 I mentioned. And I also base my conclusion on
 12 the fact that RAC West uses its total
 13 corporation income as what is to be
 14 apportioned. That use of corporation net
 15 income corresponds to the economic concept of
 16 profit on which taxable income should be based.
 17 Q: And what is your opinion of the taxation of
 18 gross royalties with no offsetting expenses
 19 from an economic point of view?
 20 A: The taxes -- the taxation of gross receipts or
 21 gross royalties rather than the taxation of
 22 corporation net income is inconsistent with the
 23 economic concept of profit since a tax on
 24 royalties does not include costs or expenses in
 25 its definition of what's to be taxed as it

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1 should be for corporate income.
 2 Q: What do you understand the major complaint of
 3 the Department of Revenue to be concerning the
 4 use of the standard apportionment formula?
 5 A: I believe that the Department of Revenue
 6 referred to the problem of dilution in the
 7 apportionment ratio of which the total receipts
 8 of the taxpayer are in the denominator. That
 9 produced a ratio which seemed to lead the
 10 Department of Revenue to believe that it was
 11 too low and somehow dilutes the income
 12 associated with South Carolina.
 13 Q: And what is your reaction to that from an
 14 economic standpoint?
 15 A: My reaction is that since -- since the
 16 taxpayer, RAC West, is a unitary business, all
 17 of its receipts should be used in the
 18 denominator of the apportionment formula.
 19 Q: Where are these stores located?
 20 A: The stores for RAC West are located in the
 21 western regions of the United States. They're
 22 not in South Carolina.
 23 Q: What would be the result of the RAC West store
 24 operations if the West were not included in the
 25 denominator of the apportionment formula?

1 to file a return. Please make that assumption.
 2 What is your opinion on what income from an
 3 economic standpoint should have been reported,
 4 and why would you say that?
 5 A: If RAC Texas had filed a return, because I
 6 believe that its income was earned in Texas, I
 7 believe that the numerator of the apportionment
 8 formula should be zero, with no -- with no
 9 taxable income in South Carolina so that its --
 10 its receipts, it's -- the numerator should be
 11 zero leading to a zero taxable income in South
 12 Carolina.
 13 Q: All right, sir. Would that be true under the
 14 method of, the standard apportionment formula
 15 method as well as this alternate method that
 16 the Department of Revenue has used attempting
 17 to tax the gross management fee?
 18 A: Well the -- would you repeat the question,
 19 please?
 20 Q: Yes. Does it change anything under these
 21 methods so far as assigning the income from the
 22 management services? And if so, in what way?
 23 A: I still believe that the management fee income
 24 is earned in Texas and should be assigned to
 25 Texas, not South Carolina.

1 A: Well, the -- my belief that RAC West is a
 2 unitary business leads me to believe that
 3 separate accounting cannot accurately measure
 4 the activities of RAC West. So on that basis,
 5 I believe that all of the receipts of RAC West
 6 should be in the denominator.
 7 Q: All right. I'm going to ask you about RAC
 8 Texas, some questions about RAC Texas. What
 9 did RAC Texas do about reporting its income to
 10 South Carolina? What did it do?
 11 A: My understanding is that RAC Texas did not file
 12 in South Carolina and did not believe that it
 13 had a taxable income in South Carolina.
 14 Q: All right, sir. And what did the Department of
 15 Revenue do in its audit report?
 16 A: In its audit report, the Department of Revenue
 17 concluded that RAC Texas is taxable in South
 18 Carolina and assigned the management fees, an
 19 estimate of the management fees which
 20 originated in South Carolina to be the taxable
 21 income of RAC Texas in South Carolina.
 22 Q: So it imposed the tax on the management fees?
 23 A: Imposed the tax on the management fees rather
 24 than on taxable income in South Carolina.
 25 Q: Assume for a moment that RAC Texas is required

1 Q: All right, sir. Now with regard to RAC Texas.
 2 What has the Department of Revenue taxed? I
 3 believe you just stated it.
 4 A: It is taxed an estimate of the management fees
 5 originated from South Carolina.
 6 Q: And has any allowance been made? And if so,
 7 what for expenses?
 8 A: No inclusion of expenses.
 9 Q: And what effect does that have on the accuracy
 10 of the measurement of economic income?
 11 A: That approach is not consistent with the
 12 economic concept of profit viewed as the
 13 difference between total receipts and total
 14 costs. So it is not an appropriate measure of
 15 corporate income.
 16 Q: A few more questions about the audit report.
 17 Are you aware that the audit report so far as
 18 RAC Texas is concerned talks about distortion
 19 and talks about the fact that the management
 20 fee is between 58 and 60 percent of the income
 21 of RAC Texas. Are you aware of that?
 22 A: Yes. I believe I've seen that wording.
 23 Q: Okay. From an economic standpoint what, if
 24 anything -- what difference does it make, if
 25 anything, as to the size of that management fee

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1 as related to the size of the income from the
 2 stores in RAC Texas?
 3 A: In my opinion, that -- that percentage is not
 4 important, is not relevant because of my belief
 5 that RAC Texas is a unitary business and that
 6 properly it should be viewed as a single
 7 business.
 8 Q: All right, sir.
 9 MR. VON LEHE: May I have just one moment, Your
 10 Honor? Your Honor, that concludes our direct.
 11 DR. WILDER - CROSS-EXAMINATION BY MR. RYAN:
 12 Q: Now, you testified earlier that the value added
 13 concept is the economic concept that defines
 14 where income is earned; is that right?
 15 A: Yes.
 16 Q: Would it be more accurate to say that value
 17 added is a way of defining where income is
 18 valued?
 19 A: No, I don't think so. When the -- when the
 20 economic census measures gross domestic product
 21 by state, the location of income in a
 22 particular state is related to the activities
 23 of physical establishments in that state. And
 24 that's where -- that's where gross domestic
 25 product is assigned to the state based on value

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1 added in the establishments.
 2 Q: Can you define value added for me.
 3 A: Yes. Value added in economics refers to the
 4 increase in value above the value of the
 5 purchased outside inputs into the firm and the
 6 value of the final product of the firm. So
 7 another way to think of it is value added is
 8 the sum of the labor and capital incomes in the
 9 firm.
 10 Q: Let's talk about RAC Texas. You were in the
 11 courtroom today, correct?
 12 A: Yes.
 13 Q: Did you hear that training classes are
 14 conducted in South Carolina stores? Did you
 15 hear that?
 16 A: I heard some discussion of training. Yes.
 17 Q: Now, according to you, is it the labor -- labor
 18 and capital determine where economic activity
 19 takes place?
 20 A: Yes. The location of the labor and capital
 21 used in producing the good or service.
 22 Q: So if the training labor, being the training
 23 classes being conducted here, that's -- if
 24 they're conducted here, isn't the labor here in
 25 South Carolina?

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1 A: It depends on the particulars.
 2 Q: If a South Carolina store manager trains an
 3 employee on how to use a computer system in
 4 South Carolina, where is that labor?
 5 A: That labor is part of RAC East operation in
 6 South Carolina.
 7 Q: So in South Carolina?
 8 A: Yes. For RAC East.
 9 Q: Now, how do you know it's for RAC East?
 10 A: That's where the physical stores are located in
 11 the territory of RAC East's stores.
 12 Q: Now, let's talk about hiring and firing. The
 13 action of hiring and firing is done by a store
 14 manager in South Carolina. Where is that labor
 15 taking place?
 16 A: If it's in South Carolina, it's within a RAC
 17 East store. And that store is physically
 18 located in South Carolina.
 19 Q: Now, if RAC Texas is paid for training and
 20 hiring and firing, doesn't that mean they're
 21 being paid for what's going on in South
 22 Carolina?
 23 A: In my view, they're being paid for the services
 24 that are produced in Texas.
 25 Q: How do you -- who's getting paid for the hiring

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1 and firing and the training in South Carolina?
 2 A: Who or -- my understanding is that some of the
 3 management services of RAC Texas produced in
 4 Texas may oversee hiring and firing in South
 5 Carolina. But those services are produced in
 6 Texas.
 7 Q: Do you know whether the management fee is
 8 compensating RAC Texas for the training and
 9 hiring and firing that goes on in South
 10 Carolina?
 11 A: Well, again, it depends on the particulars. If
 12 you're referring to RAC East store managers in
 13 South Carolina that's one thing. If you're
 14 referring to the services produced in Texas by
 15 RAC Texas, that's a different matter.
 16 Q: In your analysis, if you assume that the
 17 management fee only pays Texas for what goes on
 18 Texas?
 19 A: My view is that the services are produced and
 20 provided in Texas.
 21 Q: How did you address the training, hiring and
 22 firing that goes on in South Carolina?
 23 A: The geographic line between the two activities,
 24 I think, depends on primarily whether we're
 25 talking about what happens in RAC East stores

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1 by RAC East store managers, which is not part
 2 of RAC Texas activity, And what happens in
 3 Texas where some training and hiring and firing
 4 services are produced.
 5 Q: Now, in your analysis, did you consider the
 6 fact that intellectual property owned by RAC
 7 Texas is used in South Carolina?
 8 A: The primary intellectual property that I
 9 considered was the -- was the trademarks and
 10 trade names for RAC West. I'm not sure which
 11 intellectual property relates to RAC Texas.
 12 Q: Did you consider the intellectual property that
 13 is marketing strategies?
 14 A: I did not view that as intellectual property in
 15 the sense that it's talked about in this case.
 16 Q: Talking about intellectual property. Under
 17 your theory of labor and capital for
 18 intellectual property like a trademark, if the
 19 people that manage it or own it are located in
 20 Delaware but it's used in South Carolina, under
 21 your theory, is that income in Delaware?
 22 A: My view is tied to the location of
 23 establishments. And so if -- if the
 24 intellectual property is created in an
 25 establishment in Delaware.

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1 Q: In that instance then the income would be
 2 sourced to Delaware?
 3 A: By the value added concept it would be, yes.
 4 Q: And it wouldn't be taxed in South Carolina?
 5 A: Well, that's the question of tax law. And I'm
 6 not sure where it would be taxed.
 7 Q: Do you know in the sourcing of income you just
 8 described, do you know if that's consist with
 9 South Carolina case law?
 10 A: The Delaware example?
 11 Q: Yes.
 12 MR. VON LEHE: Your Honor, question of law.
 13 Professor Wilder is not here to discuss the
 14 Geoffrey case. He's not here to discuss
 15 questions of law. He's just here to give his
 16 opinion on economic matters. So I object.
 17 MR. RYAN: I asked him if he knows.
 18 THE COURT: All right. You can ask him if he knows.
 19 Do you have a position about whether -- the
 20 question is that is a matter that is proper for
 21 him to answer?
 22 MR. RYAN: I think it's a proper question, Your
 23 Honor.
 24 MR. VON LEHE: Can we ask for what reason?
 25 THE COURT: Yeah. That's what I'm asking.

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1 MR. RYAN: I want to know if he considered South
 2 Carolina law in his analysis.
 3 MR. VON LEHE: I object to that as a question of
 4 law.
 5 THE COURT: I'll overrule that if you ask it that
 6 way.
 7 Q: In your analysis, did you consider South
 8 Carolina case law?
 9 A: Not very much. I have been -- either read or
 10 been told about the Geoffrey case. But I don't
 11 know a great deal about it.
 12 Q: Now, talking about where income is sourced. At
 13 your deposition did you tell me that -- let's
 14 -- we'll give you an example. Say a
 15 corporation sends out employees from Oklahoma
 16 and they send them into South Carolina. South
 17 Carolina, people in South Carolina do work
 18 here, work on project. Where is the income
 19 related to what they did sourced?
 20 A: If the economic establishment out of which they
 21 were is located in Oklahoma, then the value
 22 added concept that I'm using would argue that
 23 the income is earned in Oklahoma.
 24 Q: So under that it matters not where that
 25 employee went to do the work; it matters where

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1 that firm is located?
 2 A: Where an establishment is located. Now, firms
 3 may have many establishments.
 4 Q: Can you explain that for me.
 5 A: Well, let's take RAC East as an example. Each
 6 RAC East store is an economic establishment.
 7 It employs labor and capital produced services.
 8 So RAC East, in my view of where income is
 9 earned, the income generated by RAC East stores
 10 in South Carolina is earned in South Carolina.
 11 Q: Let's take your -- let's use the facts in this
 12 case. Let's say RAC Texas sent employees of
 13 RAC Texas into South Carolina to run a training
 14 class. Where would the income from that
 15 training class be sourced under your theory?
 16 A: Under my view, it would be earned in Texas,
 17 unless RAC Texas decided to open an
 18 establishment in South Carolina.
 19 Q: Now, you testified that the Department's method
 20 is a receipts method, right?
 21 A: My understanding yes, of the -- of the
 22 Department's method is that it views taxable
 23 income as the receipts or the royalties
 24 attributable to South Carolina.
 25 Q: What is your understanding of what proof was

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1 provided regarding expenses to the Department?
 2 A: There was some wording in the audit reports
 3 about that, about how either expenses had not
 4 been provided or that expenses were difficult
 5 to compute. But I don't have a clear
 6 understanding of any specifics about that.
 7 Q: Let's say no proof of expenses was provided.
 8 From an economic perspective, what was the
 9 Department to do to determine their expenses?
 10 A: Well, I don't - I don't think that's an
 11 economics matter. I think it's a matter of
 12 tax, the operational aspects of the tax agency.
 13 I don't have an opinion about that.
 14 Q: Economic doesn't have an opinion? There's no
 15 - is there no economic opinion about
 16 estimating expenses or what you would do in
 17 that situation?
 18 A: I think the economic view is that taxable
 19 income should be based on economic profits and
 20 that that concept includes revenues minus cost,
 21 and they both should be considered.
 22 Q: Is it your testimony that the RAC West retail
 23 operations are interdependent on the RAC West
 24 royalty operations?
 25 A: Yes, it is.

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1 Q: Now, isn't there the exact same connection
 2 between the RAC East retail stores and the RAC
 3 West royalties?
 4 A: Well, the RAC East stores pay royalties to RAC
 5 West for the use of the trademarks and trade
 6 names.
 7 Q: Do they pay royalties in the same amount?
 8 A: In the same amount as?
 9 Q: Based on the same percentage?
 10 A: My understanding of the royalty agreement is
 11 that it's based on three percent of the
 12 revenues, three percent of receipts.
 13 Q: For both - for all entities, correct?
 14 A: I think so, yes.
 15 Q: So wouldn't say the relationship between RAC
 16 West royalties and RAC West retail and RAC East
 17 retail and RAC West royalties is the same?
 18 A: They're the same in the sense that the
 19 royalties are assessed at the same percentage.
 20 Q: Now if they're unitary as to what goes on in
 21 RAC West, why aren't they unitary with RAC
 22 East?
 23 A: Because RAC West and RAC East are not the same
 24 firm. They're two separate firms.
 25 Q: With the same interdependencies?

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1 A: Within each firm. Within RAC West, there's an
 2 interdependency between the operation of the
 3 stores and ownership of the trademarks.
 4 Q: Is there interdependency between RAC East and
 5 RAC West?
 6 A: There may be some. I haven't looked at that.
 7 I haven't considered that.
 8 Q: Let's say they have the same interdependencies.
 9 You have RAC East was in one corporation and
 10 RAC West is in another. Does that mean they're
 11 not unitary?
 12 A: Well, my focus has been on RAC West and RAC
 13 Texas. And I've stated that I believe both of
 14 those firms are unitary. RAC East, I haven't
 15 really looked at from the standpoint of the
 16 unitary business questions.
 17 Q: If the same interdependencies and flows of
 18 value and synergies existed between RAC West
 19 and RAC East as they do between - internally
 20 already amongst RAC West, could they be -
 21 MR. VON LEHE: Asked and answered twice, Your Honor.
 22 The question has been asked and answered twice.
 23 He says he hasn't looked at it, hasn't made a
 24 decision about it. He's been asked.
 25 THE COURT: Well, he wasn't quite through, but he is

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1 heading down the same path. How about let's
 2 let him finish.
 3 MR. VON LEHE: Yes, Your Honor.
 4 THE COURT: And you may be making the same
 5 objection.
 6 MR. VON LEHE: Yes, Your Honor.
 7 MR. RYAN: I'll withdraw, Your Honor. That's fine.
 8 Q: Do you know of any differences between RAC East
 9 and RAC West, other than geography?
 10 A: Well, the primary difference that I understand
 11 is that RAC West owns the trademarks and RAC
 12 East does not.
 13 Q: Would that be the only difference you know of?
 14 A: That's the primary one, other than location.
 15 Q: Now, don't all the RAC entities have the same
 16 management?
 17 A: Well, there are levels of management.
 18 Q: Okay. At the highest level, do they all have
 19 the same management?
 20 A: I believe that's the case. I believe that in
 21 Mr. Tollack's deposition, he said that the same
 22 top statutory officers oversee all of the RAC
 23 entities.
 24 Q: Now, is common management often a quality of a
 25 unitary business?

1 A: Yes. Common control.
 2 Q: Would all the RAC entities have common control?
 3 A: At the highest level.
 4 Q: Now -
 5 MR. VON LEHE: Your Honor, I am not certain - I
 6 want to enter an objection on the grounds of
 7 relevancy. This is not an issue in the case as
 8 to whether or not these entities are unitary
 9 with regard to each other. The only issue in
 10 the case, to the best of my knowledge, and the
 11 only issue in the audit reports, and the only
 12 issue in the agency determination is whether or
 13 not these two entities are themselves unitary
 14 with regard to themselves, not with regard to
 15 the other entities. This is simply not the
 16 matter that we're here to decide. It's not an
 17 issue in the case. So I object on the grounds
 18 of relevancy.
 19 MR. RYAN: The issue in this case, Your Honor, is
 20 how do we fairly apportion these taxpayer's
 21 taxes in South Carolina. And the recent
 22 holding of Media General by our Supreme Court,
 23 which came out after this matter, it is now
 24 possible in this state to have combined
 25 reporting if an entity is a unitary business.

1 They were protested. It came before this court
 2 in pleadings by your positions - the tax
 3 position statements that you asked for. Each
 4 side has given those. I don't know that they
 5 have, we filed our preliminary brief, of
 6 course, based on our understanding of the
 7 issues to be argued today. We prepared a case
 8 based on our understanding of what the issues
 9 are to be argued today. And quite frankly, I'm
 10 shocked that this matter would come up now at
 11 this late date and to be a statement about a
 12 case about combined reporting in South
 13 Carolina.
 14 THE COURT: Well, I'd have to go back and look at
 15 Media General. But if Media General is setting
 16 forth - if that is an option for the Court to
 17 employ, no matter what issues were raised, how
 18 the issues were framed before the Court, then
 19 it would be irrelevant. If that is not the
 20 holding of Media General, then what I'm going
 21 to do is I am going to let him ask the
 22 question, but then, indeed, if it is not proper
 23 to exercise that path, then I would find that
 24 that was - I would ultimately disregard the
 25 testimony.

1 So if they're going to say that all of these
 2 business are unitary, I think if we - our
 3 method is - they keep saying the Department's
 4 method isn't fair, we say their method isn't
 5 fair. It's at - the court has the ability to
 6 offer combined reporting.
 7 MR. VON LEHE: Your Honor, we do not agree with that
 8 because this matter has been going on now for
 9 many years. You have before you the - not
 10 just original pleadings. First of all, you
 11 have the audit reports. They have nothing to do
 12 with the combined reporting. Nothing. You
 13 have these audit reports against these two
 14 individual entities. An alternative method a
 15 computation has been proposed. We're arguing
 16 against that. No one at the Department of
 17 Revenue has ever mentioned a combined
 18 assessment against these entities until this
 19 moment. This is the first time this has been
 20 brought up in this case. And I'm certain that
 21 Mr. Ryan would agree with that. Now, this
 22 matter has been going on for a number of years.
 23 The audit reports are made. The agency
 24 determinations were made. Nothing about
 25 combined reporting mentioned anywhere in there.

1 MR. VON LEHE: Very well, Your Honor. And I would
 2 like to comment on the Media General case for
 3 a moment since it's been raised. It does not
 4 - it does not say it's an option for the
 5 Court. The Media General case - in the Media
 6 General case, the taxpayers said that they
 7 wanted combined reporting, and they brought
 8 that forward to the Court. The Department of
 9 Revenue said well, you can't do that. And the
 10 Supreme Court of South Carolina said you can as
 11 an alternate method of apportionment. But it's
 12 incumbent upon them to propose, or the
 13 taxpayer, one or the other, to propose that
 14 alternate method of apportionment and get it
 15 before the Court. It doesn't come before the
 16 Court in the middle of the case. It's the way
 17 that an audit is set up or the way a taxpayer
 18 brings its position and its - this would be,
 19 Your Honor, a whole different set of
 20 computations. Quite frankly I don't know how
 21 it would come out. But I know this, I know it
 22 is wrong to launch this on the taxpayer at this
 23 particular junction. It violates every -
 24 every due process and notice requirement of the
 25 tax - of the Department of Revenue's own rules

1 and regulations. They always make a proposed
 2 assessment. And the taxpayer then says what
 3 they think about that proposed assessment and
 4 it comes to court. We shouldn't be faced with
 5 some lurking proposed assessment based on
 6 combined reporting at this late date.
 7 THE COURT: Okay. Mr. Ryan, any response to that?
 8 MR. RYAN: Your Honor, I'll let you read Media
 9 General and make your conclusion. I won't tell
 10 you what I think it says. I think what we're
 11 here to do and what the law is asking the
 12 Department to do is determine what the most
 13 fair way to determine their activity is in this
 14 state. We still think what we did in the
 15 determination is the most fair. But they're
 16 going to put up -- they're already putting up
 17 testimony about how unitary they are. And I
 18 think it would only be consistent if they're
 19 going say they're all unitary under these
 20 bases, and the quite evident facts are the same
 21 relationship exist as a whole unit and they're
 22 going to use this unitary business theory, I
 23 think it's fair for the Court to consider all
 24 of the options that are available for
 25 accurately determining their activity in this

1 incorrect. We have not done that. He is
 2 trying to get Dr. Wilder to testify about that.
 3 I don't want Dr. Wilder to testify about that.
 4 I don't want any information in this record.
 5 I'm not bringing forward anything about whether
 6 this group is unitary or not. That is
 7 irrelevant to the Court's decision. It has
 8 nothing to do because it has nothing to do with
 9 the assessment.
 10 THE COURT: I'm going to let him go forward. My
 11 concern is I do recognize the de novo nature of
 12 this proceeding. But the problem about
 13 allowing this -- to read Media General as wide
 14 as you want it read is that the taxpayer should
 15 be put on some notice so that they can prepare
 16 their case. And your introducing an issue for
 17 which they have not -- unless there's
 18 something in your prehearing statement that I
 19 don't know, and I'll have to back and look at
 20 it --
 21 MR. RYAN: There isn't, Your Honor.
 22 THE COURT: -- for which I don't think they can
 23 prepare their case. I mean, I think the issue
 24 is proper before this Court if it was raised,
 25 but there's a fairness issue that I've got to

1 state.
 2 THE COURT: How about their position that this has
 3 not been raised by the Department before, the
 4 notice requirement? And I recognize this is a
 5 de novo hearing.
 6 MR. RYAN: I certainly discussed it with counsel.
 7 THE COURT: With counsel --
 8 MR. RYAN: But I would not say -- I will agree I have
 9 not formally put the taxpayer on notice of it.
 10 THE COURT: All right.
 11 MR. RYAN: I don't know what they would need me to
 12 do to do that.
 13 MR. VON LEHE: Your Honor, discussion with counsel I
 14 believe, according to Ms. Geer, occasioned in
 15 conversation. There was settlement discussions
 16 about it. Of course, settlement negotiations
 17 have absolutely nothing to do what the case is
 18 before this Court.
 19 THE COURT: Well, settlement negotiations can put
 20 you on notice.
 21 MR. VON LEHE: Well, it could, Your Honor, but these
 22 didn't, by the way, because -- but what you
 23 have here, Your Honor, is we have not brought
 24 forward any argument about all these entities
 25 being unitary as a group. So that is

1 deal with, too. But I'm going to let him go
 2 forward and pollute --
 3 MR. VON LEHE: Your Honor, it's --
 4 THE COURT: -- and pollute the record as you would
 5 see it.
 6 MR. VON LEHE: Well, it's probably not a good
 7 reason for objection. But I must tell you I am
 8 shocked at this raising this issue at this
 9 time. Completely shocked at this.
 10 MR. RYAN: Your Honor, if I can address Mr. Von
 11 Lehe's shock. A lot of this goes back to what's
 12 gone on in them changing -- their changing
 13 lawyers. The conversations I referenced were
 14 not strictly with Nelson Mullins. They were
 15 conversations with Michael McLaughlin when he
 16 was with Reed Smith. When the Media General
 17 decision came down, Mike immediately contacted
 18 me and said well, I can see how things are
 19 going to go from here forward. And we
 20 discussed is this how we're going to -- will
 21 this be an option.
 22 THE COURT: All right. Well I --
 23 MR. RYAN: Now, I'm not saying --
 24 THE COURT: I have to take that into consideration,
 25 Mr. von Lehe.

1 MR. VON LEHE: Well, Your Honor, the only thing is,
 2 an assessment has to be proposed --
 3 THE COURT: Well --
 4 MR. VON LEHE: -- under all the rules -- under all
 5 the rules, both the Department of Revenue and
 6 of this Court. An assessment has be proposed.
 7 THE COURT: Well, I'll let you brief that. Because
 8 I'm not -- when you say that, I think you may
 9 be correct. But I don't have the understanding
 10 of tax law as y'all do to know whether or not
 11 that's true. Unless, Mr. Ryan, are you going
 12 to -- would you concede that, that this has to
 13 be raised in an assessment under the tax law?
 14 MR. RYAN: I don't know the answer to that question,
 15 Your Honor.
 16 THE COURT: Okay. Well --
 17 MR. RYAN: I would have to -- alternatively, would I
 18 have to, you know, amend my assessment to
 19 change it? I'm not sure.
 20 THE COURT: Well, now here's another problem. If
 21 you don't know if that's true, then why should
 22 I let this evidence go forward?
 23 MR. VON LEHE: Your Honor, we don't even know --
 24 it's an impossible situation because we don't
 25 even know what that proposed assessment might

1 MR. VON LEHE: Your Honor, one last thing, Your
 2 Honor.
 3 THE COURT: Yes, sir.
 4 MR. VON LEHE: That Ms. Geer properly pointed out to
 5 me. A combined return in this case would be
 6 improper for another reason. But putting aside
 7 notice requirements and the formalities of this
 8 Court, which are being completely overrun by
 9 this effort by the --
 10 THE COURT: Well, they're not being overrun yet.
 11 MR. VON LEHE: Not overrun, but an effort is being
 12 made.
 13 THE COURT: Yeah. Because we're --
 14 MR. VON LEHE: And you're not allowing it.
 15 THE COURT: -- we're in the proffer stage.
 16 MR. VON LEHE: And you're not allowing it. But that
 17 RAC East over there, the blue one over there on
 18 the right --
 19 THE COURT: Is not a party.
 20 MR. VON LEHE: It's not a party because its
 21 assessment -- its already been audited and its
 22 assessment was accepted years ago. So it's not
 23 even in the case. I mean, the statute of
 24 limitations is long run on it for these years.
 25 THE COURT: I understand that.

1 be. Who knows, it might be in our favor. I
 2 don't know. It's never been made; it's never
 3 been done. I seriously doubt it, let me say
 4 that. But we've never seen it so we really
 5 wouldn't know. So it is just -- Your Honor, I
 6 know I've already made my objection, but I want
 7 to just say this. This would be a huge and
 8 grievous departure of anything the South
 9 Carolina Department of Revenue has ever done.
 10 THE COURT: Well, I tell you what. At this point in
 11 time, I'll let it -- on this area, I'll let you
 12 proffer it.
 13 MR. RYAN: Okay.
 14 THE COURT: And then -- but the normal proffer is
 15 preservation for the court above. In this
 16 instance, I'm going to let you proffer it for
 17 me, and thereafter, maybe for the court above.
 18 But proffer, let me research the law after
 19 y'all brief it, and then I'll decide one way or
 20 the other. So at this point in time, if you're
 21 going to ask questions in this regard, we're
 22 entering the proffer arena. So once you step
 23 out of proffer, I want to know so that the
 24 record will be clear.
 25 MR. RYAN: Okay, Your Honor.

1 MR. VON LEHE: So the --
 2 THE COURT: Okay.
 3 MR. VON LEHE: Thank you.
 4 MR. RYAN: If I may, Your Honor, I'd like to say that
 5 discussion of unitary overall as opposed to
 6 just by the entity, I think it's relevant in
 7 that it shows -- as to consistency. Is it
 8 consistent to split yourself up when you want
 9 to for tax advantage -- tax reasons and then
 10 claim unity for other reasons. Not just is it
 11 a form of relief in this case. But it's
 12 relevant to show inconsistency in what they've
 13 done.
 14 THE COURT: Like I said, y'all can brief that. I
 15 think you have a right on the -- if you have
 16 the right to split yourself up under the tax
 17 laws, then you have the right to split yourself
 18 up for whatever reason, as long as it's -- when
 19 you say consistent, as long as it's proper
 20 under the tax laws. But I still -- I'm going
 21 to let you present a proffer. And then I'll
 22 decide whether the evidence is introduced into
 23 the record later.
 24 Q: Let's go back to your understanding of unitary
 25 business theory. You base your understanding

1 of unitary on Charles McClure; is that correct?
 2 A: That's right.
 3 Q: What is McClure's -- does he say if a business
 4 is unitary, separate reporting doesn't apply?
 5 Or does he say a business can't be accurately
 6 separately reported, it's unitary?
 7 A: Well, I believe that he talks -- he talks about
 8 separate accounting and he talks about unitary.
 9 And as I understand his argument, it is that if
 10 the firm is unitary, with the interdependencies
 11 and economies of scale and those factors, then
 12 separate accounting is either impossible or is
 13 likely to be in error.
 14 Q: Under your test, what do you look at first?
 15 You look at separate accounting possible, or do
 16 you look at whether it's unitary?
 17 A: Well, I start with the characteristics of the
 18 firm, and I follow his -- follow his thinking
 19 on that. And the main -- the main
 20 characteristic of the firm that relates to the
 21 unitary business is, are the multiple lines of
 22 business activity operating within the same
 23 firm interrelated, interdependent featuring
 24 economies of scale and scope and those things
 25 such that separate accounting would not be

1 interdependent. What actual evidence have you
 2 seen that shows that interdependence? Did you
 3 actually look at their books and records?
 4 A: The primary evidence I have is the testimony
 5 that I heard this morning from Mr. Tollack.
 6 And then just from the logical -- from the
 7 logical point of view, going back to the -- to
 8 the Ronald Coze and the McClure points about
 9 why firms do, in fact, produce multiple lines
 10 of business within the same firm rather than
 11 having two separate firms do it.
 12 Q: But haven't actually looked at the books and
 13 records of the taxpayers?
 14 A: No, I have not. Other than the tax returns.
 15 Q: Now, you have seen -- you said you looked at
 16 the South Carolina relevant corporate income
 17 tax statutes, right?
 18 A: Yes.
 19 Q: Did you look at 12-6-2320; do you remember?
 20 A: I lost track of what falls under which number.
 21 I looked at them.
 22 MR. RYAN: Your Honor, may I approach the witness?
 23 Q: I put in front of you the South Carolina Code
 24 Title 12. Are you on 12-6-2320?
 25 A: Yes.

1 appropriate; it would be in error?
 2 Q: Did you look in your analysis as to whether,
 3 let's take RAC West, whether the retail portion
 4 of RAC West could survive without the royalty
 5 portion of RAC West?
 6 A: I did not consider that question.
 7 Q: Did you consider that question as to RAC Texas?
 8 A: No, I did not.
 9 Q: Do you know if -- in economics, is it possible
 10 for economists to come in and make such a split
 11 in a company?
 12 A: I don't understand your question.
 13 Q: That means it's a bad a question. Let's say
 14 RAC West wanted to separate its royalty
 15 operations from its retail operations, could it
 16 employ an economist to come in and separate the
 17 two?
 18 A: I know that firms do go through divestitures in
 19 which parts of the company are split out
 20 separately. I don't know that economists do
 21 that, participate in that process and advise
 22 companies or not. But I know that divestiture
 23 does take place and is fairly common.
 24 Q: Now, I heard you testify that both the RAC East
 25 -- excuse me, both RAC West and RAC Texas are

1 Q: Does that statute say that it's not applicable
 2 to unitary business?
 3 A: I don't recall that the code uses the term
 4 unitary business. It does talk about other
 5 things.
 6 Q: How long has the unitary business theory been
 7 around?
 8 A: Well, I believe that Charles McClure pointed
 9 out that it had been mentioned in some court
 10 cases earlier than his article. The article
 11 that I'm relying on from him was published in
 12 1983, I believe. So it's been around a while.
 13 Q: At least 1983, we can say?
 14 A: Yes.
 15 Q: So when that statute was enacted in 1995, the
 16 unitary business theory existed?
 17 A: Yes.
 18 Q: But the statute makes no mention of it?
 19 A: Not to my knowledge.
 20 Q: And under section A of 2320, does it make
 21 separate accounting an option?
 22 MR. VON LEHE: Your Honor, I would like to object to
 23 this line of questioning. Dr. Wilder is here
 24 to testify about economic matters, not matters
 25 of law. Now, he did say in his opening

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1 statement that he looked at some of the --
2 THE COURT: Yeah.
3 MR. VON LEHE: However, what he looked at is what is
4 what he looked it. But nevertheless, he
5 cannot, should not be allowed, Your Honor, to
6 testify as to matters of law. And certainly
7 not to give this Court any type of
8 interpretation about South Carolina laws.
9 THE COURT: Well, when you're asking him does it
10 state, we can publish that or just move on.
11 MR. RYAN: I'll move on.
12 THE COURT: Thank you.
13 MR. RYAN: And I will be done very soon so we can
14 all go home.
15 Q: Can you explain your -- you said the economic
16 concept of profit under which income should be
17 based. Can you explain that?
18 THE COURT: Are we moving out of the unitary issue?
19 MR. RYAN: Yes.
20 THE COURT: Okay. So the proffer is concluded at
21 this point?
22 MR. RYAN: Uh-huh (affirmative response).
23 THE COURT: Okay.
24 A: The economic concept of profit is that profit
25 is total revenues minus total costs.

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1 Q: Now, at your deposition, did you talk about
2 national income? Is that included in your
3 analysis?
4 A: I don't recall that I mentioned that.
5 MR. RYAN: I think those are all the questions I
6 have, Your Honor.
7 THE COURT: All right. Redirect?
8 MR. VON LEHE: No redirect, Your Honor.
9 THE COURT: I was going to give you the choice to
10 redirect in the proffer area or the other area,
11 but since you've chose none, that just takes
12 care of it.
13 MR. VON LEHE: Thank you, Your Honor.
14 THE COURT: All right. You may step down.
15 MR. WILDER: Thank you, Your Honor.
16 THE COURT: All right. I'll conclude it for today
17 then.
18 MR. VON LEHE: Thank you, Your Honor.
19 THE COURT: Be back at nine o'clock tomorrow.
20 MR. VON LEHE: Thank you.
21 THE COURT: Thank y'all.
22 (There being nothing further, the hearing adjourned
23 for the day at 6:18 p.m.)

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1230 Richland Street / Columbia, SC 29201
(803) 252-3445 / (800) 822-0896

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