THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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SC Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

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.

FINAL BRIEF OF APPELLANT

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STATEMENT OF ISSUES

I. DID THE ALC ERR IN FINDING THAT THE STANDARD STATUTORY APPORTIONMENT FORMULA DID NOT FAIRLY REPRESENT RAC WEST'S BUSINESS ACTIVITIES IN SOUTH CAROLINA AND THAT SCDOR'S ALTERNATIVE METHOD WAS REASONABLE?

II. DID THE ALC ERR IN FINDING THAT RAC WEST DID NOT OPERATE A UNITARY BUSINESS WHERE THE UNCONTESTED EVIDENCE ESTABLISHED THAT IT WAS UNITARY?

III. DID THE ALC ERR IN ALLOWING SCDOR TO APPLY SEPARATE ACCOUNTING TO A UNITARY BUSINESS WHEN DOING SO IS PROHIBITED BY EXXON CORP. V. S.C. TAX COMM'N, 273 S.C. 594, 258 S.E.2D 93 (1979) AND S.C. CODE ANN. § 12-6-2320(A)(4) (2014) BECAUSE IT PRODUCES AN UNREASONABLE RESULT, OR, ALTERNATIVELY, BECAUSE SEPARATE ACCOUNTING PRODUCES AN UNREASONABLE RESULT IN THIS CASE?

IV. DID THE ALC ERR IN CONCLUDING THAT SCDOR DID NOT VIOLATE RAC WEST'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS?

STATEMENT OF THE CASE

This case involves a protest by Rent-A-Center West, Inc. ("RAC West") of an assessment of corporate income taxes by 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:

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**

See Field Audit for RAC West, R. pp. 340-350. RAC West timely protested this assessment. See RAC West Notice of Protest, R. pp. 351-360. Following a conference, SCDOR issued a Department Determination upholding the assessment. See SCDOR Department Determination for RAC West. R. pp. 29-37. RAC West then timely requested a contested case hearing before the Administrative Law Court ("ALC") pursuant to S.C. Code Ann. § 12-60-460 (2014). 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.

The ALC held a hearing on August 10 and 11, 2011, and issued a Final Order (the "Order") finding for SCDOR on all issues except the penalty, which the ALC dismissed, on January 6, 2012. See Order, R. pp. 3-24. RAC West received written notice of the Order that same day and subsequently filed a motion for reconsideration on January 17, 2012. See RAC West's Motion for Reconsideration, R. pp. 38-103. The ALC denied this motion on February 1, 2012, and RAC West received that order that same day. RAC West timely filed a Notice of Appeal on February 27, 2012.[1]

Thereafter, because the parties believed that some or all of the issues in this case might be decided by the Court of Appeals' decision in CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue (Appeal from ALC Case No. 09-ALJ-17-0160-CC) (the "CarMax Appeal"), they requested a stay of this matter until the opinion in the CarMax Appeal was issued with the stay to expire upon a decision by the Court of Appeals, including any appeals of that ruling, i.e. until a final decision in that matter. The Supreme Court issued a decision in the CarMax Appeal on December 23,

[1] In accordance with S.C. Code Ann. § 12-60-3370 (2014), RAC West has paid the contested amount.

2013. CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev., 411 S.C. 79, 767 S.E.2d 195 (2014). SCDOR then obtained an extension to file a Petition for Rehearing in the CarMax Appeal making such petition due on or before January 22, 2015. Order for Extension dated 1/7/15. R. p. 28. However, thereafter, the parties resolved that matter, and SCDOR did not file a petition such that the stay in this matter expired on or about January 22, 2015. Accordingly, RAC West's deadline to file its Initial Brief and Designation was February 23, 2015. RAC West then obtained a thirty day extension such that these items were due on or before March 25, 2015 and then requested a second thirty day extension such that they would be due on or before April 24, 2015.

STATEMENT OF FACTS

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. R. p. 125 at 83:24-84-2. RAC stores are located in all 50 states. R. p. 125 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. R. p. 125 at 84:18-25.

RAC West is the taxpayer in this case. In addition to owning and operating retail stores, it owns and licenses the RAC intellectual property ("IP"), which primarily includes RAC trademarks and trade names, to all RAC companies. R. p. 125 at 84:20-21 and p. 126 at 85:6-8. At issue in this case is the proper method of reporting RAC

West's income in South Carolina as a result of its licensing of IP to RAC East for use by the RAC East stores in South Carolina.

RAC West licenses the IP to RAC East pursuant to a licensing agreement. Trademark License Agreement dated 12/31/2002, R. pp. 383-390. Per this agreement, RAC West charges a royalty fee for the 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. R. p. 130 at 104:13-18 and p. 162 at 230:23-231:25. SCDOR stipulated at trial that it did not dispute that the amount of this fee was reasonable. R. p. 259 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 activities in this State. R. p. 131 at 106:3-6. It has no physical presence in South Carolina as it has no employees, facilities or tangible property in this State. R. p. 131 at 105:17-22. It also makes no sales in South Carolina and receives *de minimus*, if any, services or benefits from the State. R. p. 131 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. R. p. 131 at 107:14-21. The two activities also share services and systems that create efficiencies and cost savings across both business lines. R. p. 131 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. R. p. 131 at 107:22-108:3. The retail stores contribute to the profitability of the IP and vice versa. R. p. 131 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. R. p. 130 at 102:9-25 and p. 131 at 108:20-25. This, in turn, leads to increased sales and thus higher profitability of RAC East (via increased sales revenue) and RAC West (via 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. R. p. 155 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. R. p. 155 at 203:20-204:2. In addition to the foregoing factual testimony, RAC West also presented expert testimony regarding the unitary nature of its business. Its expert economist testified that RAC West was a single unitary business based on these facts and the mutual interdependence of the trademark and retail businesses (R. p. 170 at 264:3-23) as did RAC West's tax policy expert, who found an "inextricable link" and "synergy" between the IP and retail store businesses. R. p. 241 at 64:9- p. 242 at 65:1 and p. 242 at 65:17-66:6.

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.[2] R. p. 267 at 167:3-11.

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[2] More specifically, when 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

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. R. p. 132 at 111:11- p. 133 at 115:17 and p. 155 at 204:3- p. 156 at 205:8. In fact, this South Carolina audit was the first time RAC West had ever been asked for this information. R. p.157 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. R. p. 132 at 111:11- p. 133 at 115:17 and p. 155 at 204:3- p. 156 at 205:8.

While SCDOR's economist claimed that managerial accountants routinely track costs for companies, tracking indirect 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. R. p. 155 at 204:3- p. 156 at 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 one versus the other even if one could make an effort to track an employee's time on tasks for the two different operations); R p.163 at 235:15-24 (RAC West's economist and transfer pricing expert, Dr. John Wells, discussing the difficulty of separating costs and explaining that the employees of RAC West were performing "integrated functions which both supported the intangibles and were

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the numbers; we don't think about whether this whatever (sic) contributes to the profitability." R. p. 267 at 167: 3-11.

strategic in nature" such that it "became difficult to try to think about ways to bifurcate people's activities between those various functions."). See also Expert Opinion of Professor Richard D. Pomp at p. 9, R. p. 407 (RAC West's tax policy expert explaining that is "nearly impossible" to divide the costs of RAC West's unitary business between the stores and the royalties and stating that RAC West would have no reason to attempt to do so under GAAP, the Internal Revenue Code or its own internal management accounting); R. p. 240 at 60:11- p. 241 at 61:7 (Professor's Pomp's trial testimony regarding the same).

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 the standard single factor gross receipts statutory apportionment formula set forth in S.C. Code Ann. §12-6-2290 to determine South Carolina apportionable net income all in accordance with what the statute, tax return and instructions dictate.[3] See R. p. 134 at 117:17-118:7; S.C. Code Ann. §12-6-2290 (2014); Sample SCDOR Corporate Income Tax Instruction, R. pp. 479-499; RAC West Amended Tax Returns 2003-2005, R. pp. 361-382. The standard formula computes an income tax by apportioning corporate net

[3] RAC West initially filed its returns using the three-factor standard apportionment method (i.e. property, payroll and gross revenues) but later determined that the single-factor gross receipts method was more appropriate and, accordingly, filed amended returns under that method, which SCDOR agreed would be the correct method if the standard statutory method is applied. R. p. 134 at 117:14-16 and p. 147 at 172:12-18.

income based on a ratio that compares RAC West's receipts in South Carolina to its total receipts in all states.[4] See S.C. Code Ann. §12-6-2290 (2014).

SCDOR rejected RAC West's use of the standard statutory method and instead levied a tax on RAC West based only on its gross royalty receipts (in effect a "flat tax"). This flat tax on gross receipts ignores all of RAC West's receipts except for the royalties derived from the licensing of the RAC IP. In addition, the flat tax method ignores the net income of the royalties as it did not offset these revenues by the costs incurred to generate them.[5] Finally, the flat tax method ignores the unitary nature of RAC West's business. The audit report does not indicate that the auditor even considered whether RAC West operated a unitary business, which cannot be subject to separate accounting, 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. R. p. 265 at 157:21-158:3. Instead, SCDOR ignored the inter-dependencies between the business activities that generate the income streams and the unitary nature of the business and applied a purported separate accounting method that considered only the

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[4] RAC West's Tax Director also testified that in preparing and submitting the returns at issue, he acted in good faith and with substantial authority, that he made adequate disclosures on the returns, and 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. R. p. 138 at 133:10-134:21.

[5] This was a point of contention between the parties as SCDOR argued that it was the taxpayer's burden to provide it with the accurate 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. 6-7 (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).

receipts from the business line that operates in this State to compute a representation of the proportion of the business done by RAC West within this State. See SCDOR Audit Report for RAC West at p. 4, R. p. 344; and supra p. 6, n. 2 (auditor's testimony admitting that the IP business probably contributed to the profitability of the RAC West stores but stating that he did not consider that in the audit).

STANDARD OF REVIEW

The Administrative Procedures Act (the "APA") provides the appropriate standard of review in an appeal related to the decision of an administrative agency. S.C. Code Ann. § 1-23-610 (Supp. 2014); see also CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev., 411 S.C. 79, 85, 767 S.E.2d 195, 198 (2014). Under the APA, the Court of Appeals may reverse or modify a decision of the ALC "if the substantive rights of the petitioner have been prejudiced because the finding, conclusion, or decision is: (a) in violation of constitutional or statutory provisions; . . . (d) affected by other error of law; [or] (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record. . . ." S.C. Code Ann. § 1-23-610(B) (Supp. 2014); CarMax, 411 S.C. at 85, 767 S.E.2d at 198; Brownlee v. S.C. Dep't of Health and Envtl. Control, 382 S.C. 129, 136, 676 S.E.2d 116, 119-120 (2009) (holding ALJ may be reversed based on error of law or if his findings were not supported by substantial evidence).

STATUTORY CONSTRUCTION

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.[6]

ARGUMENT

I. THE ALC ERRED IN FINDING THAT THE STANDARD STATUTORY APPORTIONMENT FORMULA DID NOT FAIRLY REPRESENT RAC WEST'S BUSINESS ACTIVITIES IN SOUTH CAROLINA AND THAT SCDOR'S ALTERNATIVE METHOD WAS REASONABLE.

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). RAC West's position is that the standard statutory method fairly represents its business activities and that SCDOR's alternative separate accounting method does not, while SCDOR claims the opposite is true. Because the ALC's findings in favor of SCDOR on these issues are contrary to all evidence presented and

[6] 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).

the law, this Court should reverse those findings. S.C. Code Ann. § 1-23-610 (B)(a), (d), and (e) (Supp. 2014); CarMax, 411 S.C. at 85, 767 S.E.2d at 198.

A. South Carolina Law Imposes an Income Tax on a Multi-State Taxpayer's Corporate Net Income Based on the Proportion of the Trade or Business Performed within this State Versus other States.

Under South Carolina law, a multi-state taxpayer that does business both within and without this State is subject to a 5% corporate income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). 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. Code Ann. §12-6-580 (2014). This net income figure is then adjusted by the amount of income, deductions or credits that should be allocated (i.e. assigned) to another state. The parties agree that there are no allocable items at issue in this matter.

Next, the taxpayer's "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 (2014); R. p. 268 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." S.C. Code Ann. § 12-6-2290 (2014). 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 carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). Finally, the South Carolina taxable income is multiplied by the 5% corporate income tax rate resulting in the amount due in taxes. S.C. Code Ann. § 12-6-530 (2014).

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. See supra Facts at p. 7. It then applied the single-factor gross receipts formula to its apportionable net income to determine its South Carolina net income. Id. Thus, RAC West divided its South Carolina gross receipts by its total gross receipts. Id. 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 corporate income tax rate of 5%. Id.

SCDOR rejected this standard statutory apportionment method in favor of a tax on gross royalty receipts, which in the absence of any other possible description could be referred to as a failed attempt at separate accounting. Not only did it not include all of RAC West's gross receipts in the denominator of the apportionment factor, but it also did not multiply this fraction by RAC West's net income. Instead, SCDOR simply levied a flat tax on the gross royalty receipts of RAC West. See SCDOR Department Determination for RAC West, R. pp. 29-37.

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) (2014) (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 carried on within this State") (emphasis added). Nothing in the statute 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 as SCDOR has done.

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 (2014). The gross receipts method, which SCDOR agrees would be the appropriate standard method if a standard method is to be used (see R p. 268 at 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 (2014).[7] The General Assembly 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 type of business activity as is performed in this State**" if that was its intention. Thus, the plain meaning of the relevant statutes does not support SCDOR's position in this case that RAC West's gross receipts related to its retail business be excluded from consideration and that gross receipts from royalties be separately taxed.

Finally, South Carolina law requires that the apportionment fraction then be multiplied against a taxpayer's total *net income*. S.C. Code Ann. § 12-6-2290 (2014)

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[7] See also R. p. 234 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.").

(stating taxpayer shall apportion its remaining net income). In this case, SCDOR has completely ignored RAC West's corporate net income and seeks to tax only gross receipts from royalties. There is no support for this in the statutory scheme.

B. If SCDOR Chooses to Deviate from the Standard Formula, It Bears the Burden of Establishing that the Standard Formula Does Not Fairly Represent RAC West's In-State Business Activities and that its Method is Reasonable; it Failed to Prove Either Element.

Even if this Court determines that the relevant statutes do not reflect RAC West's activities in South Carolina and therefore permit SCDOR to propose an alternative method that revises the gross receipts formula as it suggests, SCDOR must still meet all 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.

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 a flat tax on gross receipts) is reasonable. See S.C. Code Ann. §12-6-2320(A) (2014). Additionally, the party seeking to deviate from the standard statutory formula bears the burden of proving both of these elements by a preponderance of the evidence. CarMax, 411 S.C. at 89, 767 S.E.2d at 200. Thus, SCDOR, as the proponent of an alternative method, bears the burden of proof on those two elements in this matter.

1. SCDOR Failed to Establish that the Standard Formula Does Not Fairly Represent RAC West's In-State Business Activities.

SCDOR failed to meet its burden to show that under the first prong, the standard formula does not fairly represent RAC West's in-state business activities. The South Carolina Supreme Court recently examined this prong in the CarMax decision, wherein it held that SCDOR had not met its burden to show that the standard formula did not fairly represent CarMax West's in-state activities. Id., 411 S.C. at 90, 767 S.E.2d at 200. The Court stated that the ALC had relied on testimony from an auditor that the business structure of the taxpayer is often "linked with tax minimization strategies" and the fact that the taxpayer's method yielded a significantly lower tax than that of a related company to support its determination that the taxpayer's income was diluted by the standard statutory apportionment method. Id., 411 S.C. at 90, 767 S.E.2d at 201. The Court noted that "the Department merely 'describe[d] what it did rather than cite any evidence justifying what it did.'" (Id., 411 S.C. at 90, 767 S.E.2d at 200) (citing Amicus Brief of the South Carolina Chamber of Commerce).) It also found that "[t]his was the extent of the evidence offered by the Department to prove the contention that the statutory formula did not fairly represent CarMax West's business activity in South Carolina, other than bald assertions by its witnesses that it satisfied this threshold

question." Id., 411 S.C. at 90-91, 767 S.E.2d at 201. The Court then held that such findings, even if true, "do not provide a sound evidentiary basis to support the conclusion that the statutory formula did not fairly represent CarMax West's business activity in South Carolina." Id., 411 S.C. at 91, 767 S.E.2d at 201 (citing *St. Johnsbury Trucking Co.*, 385 A.2d at 217 ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula")).[8] In other words, simply because SCDOR's chosen method produces a higher income figure than the standard method is not a reason to reject the standard method and adopt SCDOR's alternative method.[9]

Similarly in this case, SCDOR has failed to carry its burden of proving that the standard formula does not fairly reflect RAC West's activities in South Carolina.

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[8] Additionally, RAC West would note that 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 Uniform Division of Income for Tax Purposes Act ("UDITPA") and related regulations at 37, R. pp. 500-543. 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). See also CarMax at p. 10 (citing St. Johnbury's Trucking Co. v. State, 385 A.2d 215, 217 (N.H. 1978) and Donald M. Drake Co. v. Dep't of Revenue, 500 P.2d 1041, 1044 (Or. 1992)(both holding that an alternative formula is the exception and thus party seeking to use bears the burden of proof).

[9] Using this same reasoning, any taxpayer should be able to meet its burden merely by showing an alternative method results in a lower tax and should be allowed to use any reasonable method, including a three factor formula based on revenue, payroll and assets.

SCDOR's position as to why the standard method does not fairly reflect RAC West's in-state activities appears to be that considering all of its net income, which would include both the retail store income and the royalty income, results in a dilution 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 royalty revenues to total revenues of RAC West (royalty receipts are 13% of total revenues) and to show that a greater taxable amount would result with a separate accounting method. See R p. 254 at 114:4-25.

The ALC then based its decision that SCDOR had met its burden on these same types of comparisons. More specifically, a matrix in the ALC's Order compares RAC West's "reported income" in 2004 of $40,317 to SCDOR's method of taxing $861,437 of "income" (actually gross receipts in this case as no costs were deducted). Order, R. pp. 6-7. The ALC then compares these two figures and states that RAC West only deemed 4.68% of the gross receipts to be taxable. Id. at 6. The ALC also observed that RAC West's trademark business was only 13% of its total gross receipts, and it noted that that the standard statutory method produces a tax of only about 5% of the gross receipts number. Id.

These facts are very similar, if not identical, to those in CarMax. The ALC here simply compared RAC West's computation using the standard formula to SCDOR's alternative computation and observed that the latter's method produces a higher tax. If this were a reliable method, then every formula that SCDOR comes up with that shows more tax should be accepted. SCDOR merely showing what it did is not evidence of anything, much less distortion, and showing that its method will produce a higher tax is

insufficient as a matter of law under CarMax to establish that the standard statutory method does not reasonably reflect a taxpayer's business activities in this State. CarMax, 411 S.C. at 91, 767 S.E.2d at 201, citing St. Johnsbury Trucking Co., 385 A.2d at 217 ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.").

Additionally, the fact that RAC West's royalty receipts are a relatively low percentage of its total revenue 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 (i.e. the total corporate income of a business in all states) and determines the slice of the pizza that the taxing state should get. R.p. 238 at 49:3-5; Pomp's RAC West Report, R. pp. 401-402 and 404-406. Separate accounting, on the other hand, "just want[s] to tax the pepperoni." R. p. 238 at 49:5-7. It seeks to tax only the "high profit item" and ignores the entire pizza, which Professor Pomp explained is not appropriate for a unitary business that has interdependencies with "component parts that are too closely connected to each other to merit any kind of division." R. p. 238 at 49:19-22. From a policy perspective, the proper way to tax a unitary business is with an apportionment formula. R. p. 238 at 50:4-7. Assuming a taxpayer's business is profitable and that it expands outside the taxing state, then the pizza pie will get larger (because it has more total profits), and the taxing state's slice

will get smaller (because the gross receipts in the denominator (i.e. gross receipts from everywhere) will get larger while the numerator (i.e. gross receipts in the taxing state) will not change (again, assuming expansion is outside of the taxing state). R. 238 at 50:22-51:20. Professor Pomp then concluded as follows:

> Whether this means more income gets apportioned or less income is an empirical question. We can't talk about that in theory. We don't know. Both happen simultaneously, bigger pizza, smaller slice. But that's the way apportionment is supposed to work. That's not a defect. That's not anything unusual, out of the ordinary. That is exactly the apportionment theory applied to a unitary business.

R. p. 238 at 52:8-18.

As additional support for its finding that the standard statutory method does not reasonably reflect RAC West's business activities in South Carolina, the ALC states that "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" such that including RAC West's income from its retail sales would dilute its gross receipts and distort its economic activity in this State. Order, R. p. 13. The implication appears to be that RAC West's retail business is less profitable than its royalty business. However, the ALC reaches this conclusion not based on any evidence in the record (there was none) but on the basis that the evidence did not show that this conclusion was *not* accurate. Id. The ALC then cites a California case holding that a taxpayer's investment income from short-term securities distorted the results of the standard apportionment formula because the investments produced less than 2% of the company's business income but 73% of its gross receipts. Id., citing Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178-79 (Cal. 2006). Thus, the ALC appears to

conclude that this absence of evidence that the retail business is not more profitable than the royalty business amounts to proof of distortion in this case.

However, as previously stated, it was not RAC West's burden to prove anything; SCDOR bore the burden of showing that the standard formula did not reasonably represent RAC West's business activities in South Carolina. If it wanted to try to establish this by showing that the royalty business was more profitable than the retail business, then it could have chosen to do so; however, SCDOR presented no such evidence.[10] Thus, this factual conclusion by the ALC is not supported by any facts in the record such that Microsoft would not apply here. Additionally, the court in Microsoft based its holding, in large part, on the fact that Microsoft's treasury function was unrelated to its primary business. That is not the case here where RAC West's retail sales business is highly related to and interconnected with its IP business. See Microsoft, 139 P.3d at 1179. Thus, Microsoft is also distinguishable from this matter.

Even if SCDOR had presented evidence showing that the royalty business was more profitable than the retail business and could show that the two business lines were not related, the Microsoft remedy was to take the lower margin portion of the business (the short term investment security sales) out of the denominator of the apportionment formula and then multiply this fraction by the corporate net income. Microsoft, 139 P.3d at 1178-83. However, SCDOR did not do this; instead it abandoned formulary apportionment and taxed only the gross royalty receipts.

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[10] And if evidence that one line was more profitable than another was sufficient to show distortion, then all taxpayers would have to determine the profit margin for each line of business in South Carolina and separately report every line of business with differing profit margins, which would be an administrative nightmare for taxpayers.

Finally, the record contained substantial evidence that the ALC either failed to consider or improperly discounted the evidence showing that the standard statutory method reasonably reflected RAC West's business activities in South Carolina. First, the record contained testimony and evidence showing that the receipts at issue were produced by RAC West's total unitary business activities and were not solely attributable to its limited activities in South Carolina. See R. p. 131-132 at 105:23-106:2 and 107:14-109:25; R.p. 155 at 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); R. p. 171 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). The ALC's findings to the contrary were not supported by any evidence in the record. See infra, Argument, § III, at pp. 33-39 for full discussion.

Additionally, the standard method is reasonable because it is based on corporate net income especially when compared to SCDOR's method, which is not (because it failed to take costs into account) and thus is not even a corporate income tax. See R. p. 171 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).

Finally, the ALC does not appear to have considered RAC West's lack of physical presence in South Carolina, that its in-state activities are minimal and that it receives minimal benefits from the State. R. p. 131 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"). SCDOR's method has produced a shocking result in light of the taxpayer's minimal activities in South Carolina. The taxation of gross receipts from royalties has produced a so-called income of $861,437 in 2004 compared to the income assigned to South Carolina by the standard statutory apportion formula of $40,317, some twenty times the standard formula amount. Similar results occur in other audit years, including taxing income in 2005 when there was a *loss* from corporate operations. Order, R. pp. 106-107.

In sum, SCDOR has presented no evidence to support its contention that the standard statutory method does not reasonably reflect RAC West's business activities in South Carolina, and the record, in fact, contains substantial evidence that it does, and thus the assessment must be dismissed as it was in CarMax for insufficient proof as a matter of law.

2. SCDOR Failed to Establish that its Alternative Method is Reasonable.

Even assuming SCDOR did establish that the standard apportionment formula does not fairly represent the business activities of RAC West in South Carolina, it has not shown that its proposed alternative method is reasonable. Because the ALC's finding that is was reasonable is contrary to all evidence presented and the law, this Court should reverse that finding. S.C. Code Ann. § 1-23-610(B)(a), (d), and (e) (Supp. 2014); CarMax, 411 S.C. at 85, 767 S.E.2d at 198.

SCDOR's position does not apply the standard method with only a modification that retail sales are not included in the denominator of the apportionment fraction (i.e. the method approved in Microsoft and relied upon by the ALC, after erroneously concluding that there was evidence presented to show – as is shown in Microsoft – that the taxpayer's retail expenses were less profitable than its royalty licenses). Instead, SCDOR rejects the use of an apportionment method or formula at all and ignores corporate net income in favor of a flat tax on gross royalty receipts, which on its face is not reasonable.

South Carolina imposes a corporate income tax, not a gross receipts tax. The remedy that the ALC alludes to of removing the retail sales from the denominator is the method used in the Microsoft case. It is not the method used by the SCDOR, which did not multiply RAC West's corporate net income by an apportionment fraction but rather levied a flat tax on gross receipts. The absurdity of this can be seen in the fact that under SCDOR's method, a tax is levied upon RAC West for 2004 based on $844,438.13 in royalty receipts when, in fact, RAC West had a loss of -$9,905,982. See Order, R. p. 107.

Moreover, 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 representation of RAC West's activities in this State. RAC West presented substantial evidence of the relationship between its unitary business activities. See supra Statement of Facts, §A at pp. 4-5. It showed that its retail business activities in other states contributed to the profitability of its IP activities in South Carolina. Id. 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. Id. 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 (R. p. 267 at 167:3-11), and SCDOR presented no evidence to dispute the interdependencies and flows of value between the two activities.

Also, SCDOR's method of taxing only royalty receipts fails to take into account the implicit royalty value of the RAC IP because it does not consider royalties computed on revenues generated in stores that RAC West owns and operates in 13 states. See R. p. 267 at 167:15-22 (testimony of auditor agreeing that RAC IP has intrinsic value to RAC West); Audit Report for RAC West, R. pp. 340-350 (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 royalty licensing activities in this State but was also produced by its retail store activities in other states.

SCDOR and the ALC attempted to cast blame on RAC West for the fact that SCDOR's method did not consider the costs of generating royalty income stating that it was incumbent upon the taxpayer to provide any such information, and SCDOR implied that RAC West was being unreasonable or recalcitrant in not doing so. However, RAC

West presented evidence that because of the 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 Statement of Facts, §A, at p. 6. 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 with reasonable accuracy. See R. p. 250 at 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.
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> ***
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> 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.

Pomp Report on RAC West, R. pp. 406-407. 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. Furthermore, any allocation of expenses would require a system to capture certain nonfinancial information (e.g. hours spent on a specific task) which can only be captured at the time the expense is incurred. See also supra Statement of Facts, §A, at pp. 6-7.

In addition, RAC West's economist and transfer pricing expert, Dr. John Wells, recognized the difficulty of separating these costs back in 2003 and abandoned this

approach. He explained that the employees of RAC West were performing "integrated functions which both supported the intangibles and were strategic in nature" such that it "became difficult to try to think about ways to bifurcate people's activities between those various functions." R. 163 at 235:15-24. See also supra Statement of Facts, §A, at p. 6-7.

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. R. p. 132 at 112:1-4. Because SCDOR's attempt at separate accounting ignores the costs incurred by RAC West to generate the royalty income, it results in an improper gross receipts tax versus a corporate income tax (which is based upon the profits of a corporation), which cannot, on its face, be reasonable. See R. pp. 171-172 at 268:17-269:1 (testimony of RAC West's expert economist on same); Pomp Report on RAC West, R. pp. 406-407 (testimony of RAC West's tax policy expert on same).

Additionally, in further support of its conclusion that SCDOR's method was reasonable, the ALC states that the method is in accordance with a formula created by RAC West itself through its licensing agreements. Order, R.p. 14. This is incorrect. The 3% licensing charge has nothing to do with a tax formula or internal valuation. It is based on an arm's length rate that an unrelated third party would pay to license a comparable trademark. This is a charge for using the trade names and trademarks. It is no different than a price set for the sale of merchandise. For example, assume that a taxpayer engages a consultant to determine the proper charge for sales of goods between related entities or a price for services between those entities. Does this mean

that that the taxpayer has devised a formula for taxation of those goods or services? Of course not.

Moreover, there is no reasonable explanation in the audit report, the Department Determination or the evidence produced at trial that could justify a tax on the limited in-state activities of RAC West of this magnitude. See supra Argument I(B)(1) at p. 21-22. The State of South Carolina has not provided sufficient benefits or services for which it could reasonably exact a return of this size. Id.; Exxon, 273 S.C. at 606, 258 S.E.2d at 99 (stating that "[t]he simple but controlling question is whether the state has given anything for which it can ask return").

The ALC also notes in the Order that S.C. Code Ann. § 12-6-2320 "does not expressly prohibit separate accounting for unitary businesses" and provides it as an option whenever the standard apportionment method does not fairly represent the extent of the taxpayer's business in this State. Order, R. p. 16. The ALC is correct that separate accounting is one method identified under the statute as a possible alternative (as is "any other method"); however, the method chosen must be reasonable and must fairly reflect the taxpayer's activities in this State.[11] While separate accounting might very well be reasonable in some cases, the South Carolina and United States Supreme Court case law prohibit this option for a unitary business precisely because it cannot be reasonable. See, infra, Argument, § III at pp. 33-39.

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[11] See Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010) (affirming ALC's decision that S.C. Code Ann. § 12-6-2320 allows "any other method" even if not generally used in South Carolina (combined reporting generally not allowed in this State) but **only** if the standard method does not fairly reflect the taxpayer's in-state business activities and the alternative method is reasonable and does fairly measure the taxpayer's in-state activities).

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

In sum, SCDOR has failed to meet its burden to show that its alternative method – a flat tax on RAC West's gross royalty receipts in South Carolina – is reasonable. Accordingly, this Court should reverse the ALC's decision.

II. THE ALC ERRED IN FINDING THAT RAC WEST DID NOT OPERATE A UNITARY BUSINESS WHERE THE UNCONTESTED EVIDENCE ESTABLISHED THAT IT WAS UNITARY.

The ALC erred in finding that RAC West did not operate a unitary business. Order, R. p. 17. Because this finding is contrary to all evidence presented and the law, this Court should reverse that finding. S.C. Code Ann. § 1-23-610(B)(d) and (e) (Supp. 2014); CarMax, 411 S.C. at 85 and 91, 767 S.E.2d at 198 and 201.

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. <u>Exxon</u>, 273 S.C. at 598, 258 S.E.2d at 95. These tests are not mutually exclusive, and the courts often apply both. <u>Id.</u> Under the three unities test, the courts look at whether the business or businesses have unity of ownership, unity of management and unity of operation. <u>Id.</u> 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." <u>Id.</u>, 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. <u>Id.</u>, 273 S.C. at 599-601, 258 S.E.2d at 96-97.

For example, in <u>Exxon</u>, the taxpayer argued that only its marketing income should be taxed by South Carolina because it only marketed gasoline here and that it should not be taxed on its exploration and refining income, which took place in other states. However, the court found that the taxpayer operated a unitary business and could not separate its business in South Carolina from its unitary corporate income 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 the company; it had strong, centralized management over all segments of company; the structure provided profit stability, reduced risk and insured full capacity utilization of the company's facilities; it made no attempt to segregate earnings or funds of the various segments; and the various operating activities of the company 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.[12]

In the case at hand, RAC West presented undisputed evidence that it operates a unitary business, including 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. See supra, Statement of Facts, §A at pp. 4-5; R. p. 131 at 107:14-108:25. More specifically as to the contribution/dependency and flow of values elements, as the retail stores sell more products, the value of the IP increases as it is associated with a more profitable brand

[12] 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 (Ct. 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 discovered during oil exploration process, which was an integral part of the business).

and the amount of the royalties paid to RAC West accordingly will increase. See supra, Statement of Facts, §A at pp. 4-5; R. p. 130 at 102:4-25; p. 131 at 108:18-25; and p. 155 at 203:2-19. Likewise, as the IP's value increases, the brand is more visible and the retail stores see increased sales. Id.

Additionally, RAC West's expert economist testified that the business was unitary from an economic perspective based on the foregoing facts (see R. p. 170 at 264:8-23), and RAC West's expert in tax policy likewise testified that from a tax policy perspective, RAC West was a unitary business. R. p. 242 at 65:5-13. Even SCDOR's auditor admitted that the retail store activities probably increased the profitability of the royalty business (R. p. 267 at 167:3-11), and its 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. R. p. 290 at 259:8-14.

The ALC appears to have ignored all of the above evidence and cites to two factors that led it to conclude that RAC West was not a unitary business. First, it states that "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." Order, R. p. 17. It follows this statement with a cite to Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 22, 437 S.E.2d 13, 18 (1993) as standing for the proposition that "the 'real source' of a foreign corporation's income from licensing 'Toys R Us' trademarks to South Carolina stores was 'South Carolina Toys R Us customers.'" Id. The ALC is mistaken as to both its factual conclusions and the applicability of Geoffrey to this case.

First, factually, the issue is not whether each line of business generates its own income, but rather whether the business uses all sources of income to fund all parts of its business. In Exxon, for example, the refinery and retail business lines each produced their own streams of income, but Exxon made no attempt to segregate earnings or funds of the various segments. See Exxon, 273 S.C. at 602 and 258 S.E.2d at 97. See also Eastman Kodak, 308 S.C. at 420, 418 S.E.2d at 544 (finding that the funding for the leasing activities came from the general corporate treasury (which would have included income from other business lines) and the income benefited the company as a whole). Here, similar to both Exxon and Eastman Kodak, the evidence showed 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. R p. 131 at 107:22-108:3.

Additionally, the ALC's reliance on Geoffrey is misplaced. The issue in that case was whether the taxpayer had nexus, i.e. the requisite minimum connection, to South Carolina when its only connection to this State was its receipt of royalty income from the use of Toys R Us trademarks in South Carolina stores. As the ALC correctly states, the court found that the true source of the taxpayer's income in that case was the use of the trademarks in South Carolina stores. Geoffrey, 313 S.C. at 22, 437 S.E.2d at 18. RAC West is not contesting nexus in this case, and Geoffrey has no application whatsoever on the issue of whether RAC West was operating a unitary business— Geoffrey did not address what constitutes a unitary business and did not change the "funding" element of the unitary business test. Indeed, no company with separate lines of business could meet this element of the unitary business as the ALC appears to be interpreting it.

The ALC also notes that "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." However, the question is whether there is *common management* over the business' different lines. See Exxon, 273 S.C. at 601, 258 S.E.2d at 96 (finding "strong centralized management was employed over all segments of the company"). The evidence here clearly showed that there was. R. p. 131 at 107:14-21 (same management is over the retail stores operations and the royalty operations).

Based on the foregoing, this Court should reverse the ALC because its finding that RAC West was not operating a unitary business is contrary to South Carolina law on what constitutes a unitary business and is clearly erroneous in light of the substantial and uncontested evidence in the record showing that RAC West was, in fact, operating a unitary business.

III. THE ALC ERRED IN ALLOWING SCDOR TO APPLY A PURPORTED SEPARATE ACCOUNTING TO A UNITARY BUSINESS WHEN DOING SO IS PROHIBITED UNDER EXXON CORP. V. S.C. TAX COMM'N, 273 S.C. 594, 258 S.E.2d 93 (1979), S.C. CODE ANN. REGS. § 117-710.1 (SUPP. 2011), AND S.C. CODE ANN. § 12-6-2320 BECAUSE IT PRODUCES AN UNREASONABLE RESULT; ALTERNATIVELY, SCDOR'S PURPORTED SEPARATE ACCOUNTING METHOD DOES NOT PRODUCE A REASONABLE RESULT IN THIS CASE.

Even if one assumes that the standard statutory apportionment formula does not fairly represent the business activities of RAC West in South Carolina, the ALC erred in finding that SCDOR could apply a purported form of separate accounting to a unitary business in contradiction to Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979), S.C. Code Ann. § 12-6-2320(A)(4) (2014) and S.C. Code Ann.

Regs. § 117-710.1 (Supp. 2011). In the alternative, should the Court determine that South Carolina law does not prohibit separate accounting in all cases involving a unitary business, SCDOR's purported separate accounting method would not produce a reasonable result in this case (even if properly applied to the taxpayer's net income). The ALC made errors in applying the law and making findings and conclusions that were not supported by substantial evidence in the record as to this issue, and, therefore, these findings and conclusions should be reversed. S.C. Code Ann. § 1-23-610(B)(d) and (e) (2014); CarMax, 411 S.C. at 85 and 91, 767 S.E.2d at 198 and 201.

As previously stated, SCDOR's alternative method levies a flat tax on RAC West's gross royalty receipts and purports to be a form of separate accounting (although because it taxes gross versus net income, it cannot properly be called that). As the United States Supreme Court has explained, formulary apportionment is presumed to be fair and reasonable (see Butler Bros. v. McColgan, 315 U.S. 501 (1942)), while separate or formal accounting for "in-state" activities is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Container Corp., 463 U.S. at 164-65. Thus, once a court determines that a business is unitary, "a State **must** then apply a formula apportioning the income of that business within and without the State." Id. at 169 (emphasis added). In other words, a state must apportion the entire net income received from the in-state and out-of-state activities of a unitary business and cannot pick and choose certain items of income and expenses to be included in or excluded from

taxation in certain states even if the discrete components of a state income tax, when viewed in isolation, might appear susceptible to geographic designation.

Similarly, the South Carolina Supreme Court has held that because the income generated by the various components of a unitary business cannot be accurately accounted for individually as it is "attributable to all incidents of the business and not to any single activity," separate accounting of a unitary business is prohibited. Exxon, 273 S.C. at 599, 258 S.E.2d at 96. See also Eastman Kodak, 308 S.C. at 419-20, 418 S.E.2d at 544; Lowenstein, 298 S.C. at 101-107, 378 S.E.2d at 276-279. See also, supra, Argument, § II at pp. 28-33.

Additionally, SCDOR's own regulations provide that the income of a unitary business is subject to the apportionment formulas and not separate accounting. See S.C. Code Ann. Regs. § 117-710.1 (Supp. 2011)(providing that "[a] taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without is subject to the apportionment formulas with respect to the unitary or homogenous business but not with respect to the unrelated business.").

A prohibition on separate accounting for a unitary business is also consistent with economic and tax policy principles. RAC West's expert economist and tax policy expert provided compelling economic and tax policy rationales in support of the prohibition on separate accounting for a unitary businesses. See R. pp. 170-171 at 264:3-265:16 and p. 172 at 270:1-6 (testimony of RAC West's expert economist that because of the interdependence of its business activities, applying separate accounting to a unitary business is likely to lead to errors and distortion); R. pp. 241-242 at 64-65 (testimony of RAC West's tax policy expert that where have a unitary business, the

proper way of taxing it is to "take the pizza pie that represents the profits of West and determine the taxing state's slice of that pizza [pie]); and Expert Opinion of Professor Richard D. Pomp; R. pp. 402 and 404-405.

Even the ALC acknowledged that "courts and legal commentators have generally recognized that separate accounting can have drawbacks when applied to unitary businesses." Order, R.p. 16. However, the ALC then erroneously found as follows:

> [M]any 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 "economics 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.

See Order, R. p. 17.

SCDOR took a similar position at trial arguing that RAC West's royalty income should not be "mixed" with its retail sales income because no retail sales income was earned in South Carolina and that the ALC should separate these two types of income. R. p. 123 at 74:18-75:22. In further support of this notion, SCDOR's expert economist offered an "apples and oranges" metaphor with the apples in this case being the royalty payments and the oranges being the retail sales. He contended that one should not mix the apples with the oranges, *i.e.* the royalty income with the retail sales income because only apples (royalty income) are in South Carolina. See R. p. 274 at 193:14-194:22.

Although it is correct that the **gross** income from the retail and trademark activities can be accurately measured, it is the expenses (and therefore the **net** income) that cannot be accurately determined due to the unitary nature of RAC West's business.

First, the ALC's factual conclusions that the evidence does not demonstrate the existence of any "centralization of management" or "economics of scale" between RAC West's retail operations and its trademark business are completely contrary to all evidence in the record. See R. pp. 130-131 at 101:6-102:8 and 107:14-21 (testimony of RAC witness that same management is over both business activities and that common management creates efficiencies in scope and scale as well as other benefits); R. p. 131 at 108:4-11 (testimony of RAC witness that the two business activities share services and systems that create efficiencies and cost savings across both business lines); R. p. 290 at 259:9-14 (testimony of SCDOR's economist agreeing that RAC West had interrelated activities, that there were synergies between them and that there were economies of scope and scale).

Moreover, SCDOR and the ALC both appear to misunderstand the law on unitary businesses and to underestimate the obstacles encountered in applying separate accounting to a unitary business. First, just because a company generates only one type of income in one state (*i.e.* royalty income here) and another type of income in another state (*i.e.* retail sales income here) does not mean that they should not be combined for tax purposes. Similar arguments were made in Exxon with the apples being the oil production and refineries and the oranges being the gas pumps and stations. The South Carolina Supreme Court rejected this type of reasoning and held that Exxon's unitary business income could not be separated based on the fact that Exxon had only

marketing activities in this State. Exxon, 273 S.C. 594, 258 S.E.2d 93. The U.S. Supreme Court agreed in Exxon v. Wisconsin Dept. of Rev., 447 U.S. 207, 223-24 (1980) (holding that Exxon failed to establish that its income from its marketing activities in Wyoming was derived from an "unrelated business activity" that constituted "a discreet business enterprise" and thus the marketing income was part of its unitary income).

Additionally, the fact that royalty payments are made only shows that RAC West has *attempted* to value the *use* of the RAC intellectual property and does not show that RAC West has *determined* the value of the management of the intellectual property's *contribution to the business as a whole*, and SCDOR presented no evidence to the contrary. Inter-company transfer of value pricing is not controlling for a unitary business. Container Corp., 463 U.S. at 164-65. See also Exxon, 273 S.C. at 603-604, 258 S.E.2d at 98 (quoting Butler Bros., 315 U.S. at 507) (finding arguments of the Tax Commission that "transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income" persuasive and stating that "'[a]ccounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.'").

In sum, under South Carolina law, which is consistent with economic and tax accounting principles, separate accounting is prohibited for a unitary business because it cannot produce reasonable results. Accordingly, SCDOR may not separate one portion of RAC West's business (*i.e.* the royalty income) from the rest of the business (*i.e.* the

retail sales income) because RAC West operates a unitary business just as the taxpayers in Exxon, Eastman Kodak and Lowenstein did.

Alternatively, even if this Court finds that separate accounting is not prohibited for all unitary businesses, it is not reasonable in this case for numerous reasons that have been previously addressed: (1) RAC West presented substantial and unrebutted evidence that it operates a highly unitary business (see supra, Argument, § II at pp. 30-32); (2) the royalty income at issue was created by the unitary business activities of the company and not just its activities in South Carolina and therefore cannot be accurately separated (id. at pp. 32-41); (3) imposing a separate accounting on a unitary business contradicts SCDOR's own regulations; (4) RAC West's level of business activity in South Carolina is very low (see R. p. 131 at 105:17-106:6; see also supra Argument, §I(B)(1) at pp. 21-22); (5) the services and benefits provided to RAC West by South Carolina are minimal (Id.); and (6) SCDOR has used no established standards or criteria to depart from the standard formula and invoke its alternative method authority. See supra Argument, § I(B)(2) at pp. 27-28.

Based on the foregoing, this Court should reverse the ALC because its application of a purported form of separate accounting to RAC West is contrary to South Carolina law and is clearly erroneous in light of the substantial evidence in the record showing that RAC West was operating a unitary business and that the attempted separate accounting was not reasonable.

IV. THE ALC ERRED IN CONCLUDING THAT SCDOR DID NOT VIOLATE RAC WEST'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS.

The ALC erred in concluding that SCDOR did not violate RAC West's constitutional rights by applying separate accounting to a unitary business. Although the ALC does not have the authority to declare a statute facially unconstitutional, it can and should determine whether the application of a statute produces an unconstitutional result. Evans v. State of South Carolina, 344 S.C. 60, 543 S.E.2d 547 (2001); Video Gaming Consultants, Inc. v. S.C. Dep't of Revenue, 342 S.C. 34, 535 S.E.2d 642 (2000). Because the ALC's findings and conclusions on this issue are in violation of constitutional or statutory provisions, affected by errors of law, clearly erroneous in light of the reliable, probative and substantial evidence in the record, or are arbitrary or capricious or characterized by abuse of discretion, the order must be reversed. S.C. Code Ann. § 1-23-610(B)(a), (d) and (e) (Supp. 2014); CarMax, 411 S.C. at 85 and 91, 767 S.E.2d at 198 and 201.

More specifically, the method of taxation employed by SCDOR in this case violates the Due Process Clause of the South Carolina and United States Constitutions and the Interstate Commerce Clause of the United States Constitution. U.S. Const. amend. XIV, § 1; S.C. Const. art. I, § 3; U.S. Const. art. I, § 8, cl. 3. 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. See also Travelscape, LLC v. S.C. Dept. of Rev., 391 S.C. 89, 705 S.E.2d 28 (2011). In evaluating the fairness prong, the courts apply both an internal and external consistency test. See Container Corp., 463 U.S. at 169; Travelscape, 391 S.C. 89, 705 S.E.2d 28. 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. N.C. ex rel. Maxwell, 283 U.S. 123, 135 (1931)) or has "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978)). See also Amerada Hess Corporation v. Director, Division of Taxation, 490 U.S. 66 (1989) (applying Complete Auto test and due process analysis and holding that expenses and income associated with the taxpayer's crude oil production activities were part of the taxpayer's unitary business and

accordingly were not assignable out-of-state but rather were properly subject to apportionment); Trinova Corp. v. Michigan Department of Treasury, 498 U.S. 358 (1991); Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 607 258 S.E.2d 93, 99 (1979) (stating that due process clause requires there be some fiscal relation to the protections, opportunities and benefits provided by the state).

As applied to 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. First, as to the fairness prong, the alternative formula invoked by SCDOR in this case fails both the internal and external consistency tests. As to the internal consistency test, the ALC states that by using the 3% royalty formula to tax RAC West, SCDOR has used a method that ensures that there will not be more than 100% of the taxpayer's income taxed by all states. Order, R. pp. 18-19. To the contrary, if every state taxed RAC West by using SCDOR's method of taxing gross receipts, it would be assured that more than 100% of the net income from the royalties of RAC West would be taxed. One must take the expenses associated with the royalties into account or the result will be an unfair tax on more than 100% of RAC West's net income. Even if SCDOR had levied a tax on net income from royalties, such a method if employed in all states, would have no relationship to the income of this clearly unitary business and would cause multiple taxation whenever corporate net income was a loss (as it was in this case for the 2004 audit year).

Additionally, the flat tax proposed by SCDOR also fails the external consistency test and the anti-discrimination element because it does not actually reflect a reasonable sense of how income is generated by RAC West. See Container Corp., 463 U.S. at 171

(explaining that with respect to interstate commerce cases, "the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment"). More specifically, SCDOR's purported separate accounting method on gross receipts fails to account for the unitary nature of the RAC West business, including that the retail stores contribute to the profitability of the IP and vice versa and that there is a flow of value between the two activities. See supra, Statement of Facts, at §B.

Finally, SCDOR's alternative tax is not fairly related to the services provided by South Carolina, which are *de minimus* or non-existent in this case. See supra, Argument, at §I(B)(1) at pp. 21-22. The ALC states in its Order that the tax is fairly related to the services provided by the State and cites Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993) in support of this. However, as previously discussed, Geoffrey was a nexus case primarily concerned with whether or not the taxpayer had the requisite minimum connection to South Carolina such that it was subject to paying corporate income tax in this State; it did not address formulary apportionment versus separate accounting for a unitary business and most certainly did not approve of or condone a flat tax on gross receipts.

In sum, the ALC's finding that RAC West's constitutional rights were not violated is an error of law and contrary to the substantial evidence in the case and thus should be reversed.

CONCLUSION

Based on the foregoing, RAC West respectfully requests that this Court reverse the ALC's decision because RAC West's rights have been prejudiced because the administrative findings, inferences, conclusions or decisions are in violation of constitutional or statutory provisions, affected by errors of law, or are clearly erroneous in light of the reliable, probative and substantial evidence in the record, and the assessment against RAC West should be dismissed.

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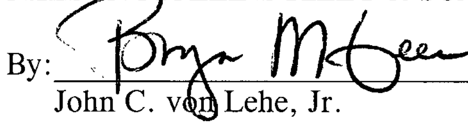
By: 

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September 8, 2015

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

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.

CERTIFICATE OF COUNSEL

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

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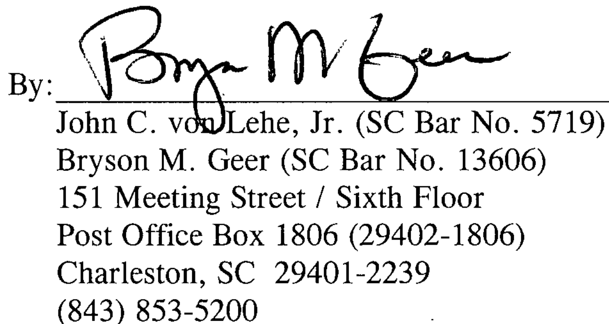
By: 

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PROOF OF SERVICE

I the undersigned Administrative Assistant of the law firm 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 by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

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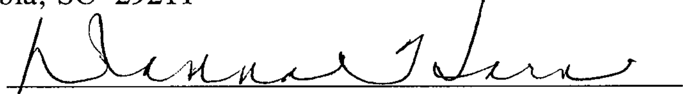

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Sept 9, 2015