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.

FINAL REPLY BRIEF OF APPELLANT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

Other Authorities

ARGUMENT

I. THE SOUTH CAROLINA APPORTIONMENT STATUTE IMPOSES A TAX ON MULTI-STATE TAXAPAYERS ON A BASE THAT REASONABLY REPRESENTS THE PROPORTION OF A TAXPAYER'S BUSINESS CARRIED ON IN SOUTH CAROLINA VERSUS ITS TOTAL BUSINESS EVERYWHERE, AND RAC WEST USED THE STANDARD STATUTORY METHOD.

The parties agree that the South Carolina apportionment statute imposes a 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). See SCDOR Brief at p. 16. They disagree on what the phrase "proportion of the trade or business carried on within this State" means. RAC West contends that the phrase means the proportion of the taxpayer's business in South Carolina as compared to the entirety of the taxpayer's business in all states. SCDOR, on the other hand, appears to argue that it means a taxpayer's business line performed in South Carolina compared to its income from that business line in other states. See SCDOR Brief at pp. 16-20.

The starting point in interpreting a statute is the text of the statute itself. Hodges v. Rainey, 341 S.C 79, 85, 533 S.E.2d 578, 581 (2000). Additionally, 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, "statutes dealing with the same subject matter are in *pari materia* and must be construed together, if possible, to produce a single, harmonious result." Brown v. James, 389 S.C. 41, 53, 697 S.E.2d 604, 611 n.13 (Ct. App. 2010).

RAC West's view that the tax base must reasonably represent the proportion of a multi-state taxpayer's business in this state versus its business in all states is supported by the plain language of the statute itself as well as the statutory scheme as a whole, with which this section should be read *in pari materia*. Brown v. James, 389 S.C. 41, 53, 697 S.E.2d 604, 611 n.13 (Ct. App. 2010). The "plain meaning" argument is clearly set forth in RAC West's Initial Brief and will not be repeated herein. See RAC West Brief at p. 12-13. RAC West's Initial Brief also references the various other code sections that should be read in *pari materia*, or in conjunction with, the apportionment statute. Id. at 13 (citing S.C. Code Ann. §12-6-580, which provides that federal taxable income is the starting point for determining a multi-state taxpayer's income, which by definition includes all income streams of a taxpayer, and S.C. Code Ann. §12-6-2290 (2014), the "gross receipts" statute, which apportions net income by dividing "gross receipts from within this State" by "total gross receipts from everywhere").

SCDOR's Brief cites no law in support of its position that the "proportion" referenced in S.C. Code Ann. § 12-6-2210(B) refers only to a taxpayer's business line in South Carolina. Although the alternative apportionment statute does provide separate accounting as a possible option in appropriate circumstances (see S.C. Code Ann. §12-6-2320(A)) (which, as will be discussed below, are not present in this case), the tax base referred to in §12-6-2210(B) is clearly referring to the proportion of the taxpayer's total business that is conducted in South Carolina.

As also discussed in RAC West's Brief, the parties agree that in this case, the single-factor "gross receipts" statute is the correct method to determine the proportion

of the taxpayer's total business that is to be apportioned to South Carolina if the standard statutory method is to be applied. SCDOR Brief at p. 13. S.C. Code Ann. § 12-6-2290 (2014); R. p. 268 at 172:12-18. Despite this fact, SCDOR makes several references in its Brief to the standard statutory method as "Appellant's apportionment method," "the apportionment formula used by Appellant" and even as Appellant's "apples and oranges approach" (see e.g. SCDOR's Brief at p. 16, 20 and 22) and asserts that this method "dilutes [RAC West's] net income within South Carolina" and "distorts the tax base." Id. at 18 and 22.

It should be emphasized that RAC West did not create its own novel method in an attempt to distort or manipulate its income. Instead RAC West used the standard method that it was ***required*** by statute to use. The retail sales from western states that SCDOR claims RAC West included to "inflate" the denominator of the apportionment ratio and "dilute" the ratio are specifically ***required*** to be included in the denominator by statute. RAC West followed the requirements of the statutorily dictated method as written and did not attempt to "inflate" or "dilute" the formula in any way. The only way RAC West could have avoided using the standard method is if it had petitioned to SCDOR for an exception under S.C. Code Ann. §12-6-2320(A), which it had no reason under the existing law to think would be appropriate. See S.C. Code Ann. §12-6-2320(A) (2014).

II. SCDOR PRESENTED NO PROOF THAT THE STANDARD FORMULA DID NOT REASONABLY REFLECT RAC WEST'S ACTIVITIES IN SOUTH CAROLINA.

As discussed at greater length in RAC West's Initial Brief, SCDOR failed to present any evidence at trial that the standard formula did not reasonably reflect RAC

West's activities in South Carolina. See RAC West Brief at pp. 15-22. In response, SCDOR makes various conclusory statements and arguments but fails to point to any proof presented at trial that would show that the standard formula was not working.

As the Supreme Court recently confirmed, SCDOR, as the party seeking to deviate from the standard statutory formula, bears the burden of proving, among other things, that the standard method does not fairly represent the taxpayer's in-state business activities. CarMaxAuto Superstores West Coast, Inc. v. S.C. Dept. of Rev., 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014); see also S.C. Code Ann. §12-6-2320(A) (2014). Moreover, this proof may not be conclusory allegations that SCDOR satisfied this element or a description of what SCDOR did, and showing that SCDOR's method yields a higher tax is likewise insufficient. CarMax, 411 S.C. at 89-91, 767 S.E.2d at 200-201 (stating that neither a description of what SCDOR did nor conclusory allegations of SCDOR's witnesses that they proved an element are sufficient and citing St. Johnsbury Trucking Co. v. State, 385 A.2d 215, 217 (N.H. 1978) for the proposition that "[m]erely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula"). See also S.C. Rev. Ruling 15-5 (stating that "[t]he party seeking an alternative method must factually identify why the use of the standard statutory apportionment method does not fairly represent the taxpayer's business activity in South Carolina).

The primary basis asserted by SCDOR as to why the standard formula could not be used is its naked assertion that "Appellant's retail sales had 'nothing to do' with Appellant's trademark business in South Carolina." SCDOR Brief at pp. 24-25.

SCDOR cites to no factual support whatsoever for this conclusory statement, and, in fact, although not its burden to do so, RAC West presented evidence to the contrary. For example, a RAC West witness testified to the very obvious fact that as more retail sales are made, the value of the RAC IP increases, and as the value of the RAC IP increases and the brand becomes more well-known, this leads to increased retail sales. See R. p. 130 at 102:9-25; p. 131 at 108:18-25; p. 155 at 203:10-19. How anyone could take the position that income from the sale of a product is not related to income from the brand name of that product is, frankly, incredulous. See also RAC West Initial Brief at pp. 4-5 (for full discussion of ways in which the retail business and the IP business are related).

The only other argument made in SCDOR's brief in support of its contention that the standard formula does not work is that RAC West's retail sales revenues are larger than its trademark revenues such that the inclusion of both in the denominator of the standard formula would result in much less tax. SCDOR Brief at pp. 25-26. This is insufficient as a matter of law under CarMax, 411 S.C. at 89, 767 S.E.2d at 200. Thus, this Court should reverse the ALC's decision because SCDOR has failed to carry its burden of showing that the standard formula did not work.

III. SCDOR PRESENTED NO PROOF THAT ITS ALTERNATIVE METHOD WAS REASONABLE.

As discussed in detail in RAC West's Brief, SCDOR failed to present any evidence at trial that its alternative method, which simply levied a flat tax on RAC West's gross receipts, was reasonable. See RAC West Brief at pp. 22-28. In response, SCDOR asserts that its method "imposes an income tax on Appellant's corporate net

income on a base which reasonably represents the proportion of trade or business carried on within South Carolina." SCDOR Brief at p. 16, Heading A. It also suggests that the reason the tax looks like a flat tax on gross receipts is because RAC West failed to supply substantiation for its expenses. Id. at 21. These statements are simply not accurate and indicate a misunderstanding of the tax imposed on RAC West as well as the impossibility of RAC West reconstructing expense information for one part of its unitary business years later.

First, the tax imposed by SCDOR on RAC West looks like a flat tax on gross receipts because it completely ignores RAC West's *corporate net income* (the base upon which the South Carolina income tax is devised). SCDOR did not multiply RAC West's corporate net income by an apportionment fraction but rather levied a flat tax on gross receipts. The remedy that the ALC alludes to, and also implies in its Order as the SCDOR "solution"--- removing the retail sales from the denominator and then multiplying that fraction by the company's corporate net income-- is the method used in the Microsoft case.[1] It is not the method used by SCDOR in this case.

The danger of using SCDOR's alternative method is that it can result in the imposition of an income tax on a multi-state company even when that company is losing money and has no profits. That is, in fact, exactly what happened to RAC West in 2005 when SCDOR's alternative method levied a tax based on $844,438.13 in royalty receipts when, in fact, RAC West suffered a loss that year of -$9,905,982. See Order, R. p. 7. SCDOR's Brief does not even acknowledge this fact much less make an effort to explain or justify such an absurd result.

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[1] Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178-79 (Cal. 2006).

The only evidence pointed to by SCDOR, and adopted by the ALC, in support of its contention that its formula was reasonable is that RAC West entered into a royalty agreement that attempted to value the use of the RAC trademarks. SCDOR Brief at p. 29. However, licensing agreements that set a price for the use of a trademark, or any product for that matter, have nothing to do with and are not a substitute for a tax formula. See RAC West Brief at pp. 26 and 37-38.[2] The other support offered by SCDOR regarding its method consists of arguments and conclusory statements made by SCDOR and its expert; not one shred of evidence via a document or a fact witness is cited. In sum, this Court should reverse the ALC's decision because SCDOR failed to carry its burden of proof to show that its method was reasonable. CarMax, 411 S.C. at 89, 767 S.E.2d at 200.

Finally, the reasons why RAC West did not supply information on its IP related expenses are fully set forth in its Initial Brief and will not be repeated herein. See RAC West Initial Brief at pp. 24-26. However, RAC West would note that the testimony of Hugh Tollack, its Director of Tax Audits, which is cited by SCDOR in its Brief as showing that one could "determine whether any of their individual retail stores is profitable" could be misunderstood. SCDOR Brief at p. 8. Mr. Tollack goes on to

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[2] See also Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983)(holding that inter-company transfer of value pricing is not controlling for a unitary business); 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" 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.'").

explain that one could determine the direct expenses at the store level but not the "real expenses." R. p. 152 at 192:1-8. See also R. pp. 155-156 at 204:3-205:8 (Mr. Tollack's testimony 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).

In sum, the ALC should also be reversed because SCDOR has failed to carry its burden of showing that its alternative formula is reasonable.

IV. SOUTH CAROLINA LAW IS CLEAR THAT IF A TAXPAYER HAS UNITARY OR RELATED INCOME, SEPARATE ACCOUNTNG IS PROHIBITED.

Both the ALC and SCDOR appear to believe that it makes no difference whether a business is unitary and that separate accounting may be used even if a business is unitary. SCDOR Brief at p. 31-32 (stating that even assuming that RAC West's business was unitary, the trademark business is separable and thus could be subject to separate accounting); Order, R. pp. 16-17. This is simply incorrect and contrary to all income tax apportionment law in this state and in this country. The unitary business concept is the linchpin of the allocation and apportionment statutes, and a court must first determine whether the income of a business is unitary or non-unitary before it can properly apply these statutes.

As the U.S. Supreme Court has stated many times, the whole reason behind the enactment of allocation and apportionment statutes is to properly allocate and apportion the income of unitary businesses that conduct their business partly within and partly without a particular state. See Mobil Oil Corp. v. Comm. of Taxes of Vermont, 445

U.S. 425, 439 (1980) (stating that "the linchpin of apportionability in the field of state income taxation is the unitary business principle"); Butler Bros. v. McColgan, 315 U.S. 501, 508-509 (1942). Allocation and apportionment statutes are generally used to define income that can and should be taxed separately (i.e., income that is not unitary or is unrelated to the business of the taxpayer) and income that is taxed under an apportionment formula (i.e., income that is unitary or is related to the business of the taxpayer). See Mobil Oil, 445 U.S. at 439. South Carolina has three cases, which are all discussed in depth in RAC West's Brief, which stand for this same proposition. See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 258 S.E.2d 93 (1979)(holding that Exxon was a unitary business and thus it could not separate out the income generated by its oil exploration and production activities in other states from its retail sales income from gas stations in South Carolina); Eastman Kodak v. S.C. Tax Comm'n, 308 S.C. 414, 418 S.E.2d 542 (1992)(finding that safe harbor lease transactions were part of Kodak's unitary business and thus separate accounting was not appropriate); and Lowenstein v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989)(rejecting taxpayer's request to apply separate accounting to interest income when the Court found it to be part of the taxpayer's unitary income).

South Carolina employs a system that is consistent with these U.S. Supreme Court and South Carolina cases. First, South Carolina allocates certain specified non-unitary income that is "not connected with the taxpayer's business" either to South Carolina or to other states. See S.C. Code Ann. §12-6-2220 (2014). Next, the balance of the taxpayer's income (i.e., that which is "connected with its business") is apportioned based on the applicable apportionment statute, which in this case is S.C.

Code Ann. §12-6-2290 (i.e., the "gross receipts" apportionment formula). Thus, before one can determine how to allocate and apportion income under South Carolina's statutory scheme, one **must** determine whether the income at issue is part of the taxpayer's unitary income (i.e. connected with its business) or whether it is non-unitary income that is not connected with the taxpayer's business.

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. Reg. § 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."). Amazingly, this regulation is not even mentioned in SCDOR's Brief.

SCDOR contends that a unitary business can be separated because the three South Carolina unitary business cases pre-date the alternative apportionment statute. SCDOR Brief at p. 37. It argues that the Legislature could have specified that unitary businesses are not subject to the separate accounting option if that was its intent. Id. First, the list of possible methods in the alternative apportionment statute is simply that, a list of all possible options; if the Legislature had to address every scenario for each option that would not work, the statute would have spanned hundreds of pages. Instead, it mandated that any formula used must be reasonable. Where a business has unrelated or non-unitary income, then separate accounting could be reasonable and appropriate. However, where unitary income is at issue, under U.S. Supreme Court

and South Carolina case law and statutes as well as SCDOR's own regulations, separate accounting is prohibited and thus cannot be reasonable.

SCDOR also states that the evidence indicates that RAC West's "trademark and retail businesses are not unitary" and asserts that that is not even the relevant inquiry; "[w]hat is relevant is whether the financial activities of Appellant's trademark business can be separately identified." SCDOR Brief at pp. 37-38. Under SCDOR's economist's theory, there is no such thing as a unitary business; all businesses can be carved up and separately accounted. Id. at p. 38 (citing Dr. Harrison's testimony that it would be wrong from both an economic and an accounting perspective to assume that a business cannot separate its accounts if is determined to be part of a unitary business).

First, RAC West addressed in detail in its Initial Brief the evidence supporting that its trademark and retail businesses are unitary and will not repeat that herein. See RAC West Brief at pp. 28-33. Second, SCDOR's framing of the relevant question would turn unitary business law on its head. Of course, any economist or state auditor *could* apply an alleged separate accounting method to a unitary business and attempt to separate it. Economics aside, this is simply not the law. The key question is not whether it is *possible* to separate the business but whether it is accurate and therefore *reasonable*. If a business is unitary, then the income generated by the various components of the unitary business cannot be accurately accounted for individually (or worse, be "subject to manipulation and imprecision") as it is "attributable to all incidents of the business and not to any single activity," and, thus, separate accounting of a unitary business is prohibited under the relevant South Carolina and U.S. Supreme Court cases and thus cannot be reasonable under S.C. Code Ann. §12-6-2320 (A)

(2014). Mobil Oil, 445 U.S. at 439; Butler Bros., 315 U.S. at 508-509; Container Corp., 463 U.S. 164-65 (1983); Exxon, 273 S.C. at 599, 258 S.E.2d at 96; 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; S.C. Code Ann. §12-6-2320 (A) (2014). See also, RAC West Brief, Argument, § II at pp. 28-33.

Therefore, RAC West respectfully requests that this Court enter a finding based on the uncontested evidence at trial that its royalty income and retail sales income are part of its unitary income, and it should reverse the ALC's decision allowing separate accounting to be applied to a unitary business.

CONCLUSION

Based on the foregoing as well as its Initial Brief, RAC West respectfully requests that this Court reverse the ALC's decision and dismiss the assessment at issue.

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

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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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