

DEC 22 2014

**THE STATE OF SOUTH CAROLINA
In The Supreme Court****S.C. Supreme Court**

APPEAL FROM THE ADMINISTRATIVE LAW COURT**Ralph K. Anderson III, Administrative Law Judge**

Opinion No. 5274 (S.C. Ct. App. filed October 8, 2014)

Duke Energy Corporation.....Petitioner,**v.****South Carolina Department of Revenue.....Respondent.**

APPENDIX FOR PETITION FOR A WRIT OF CERTIORARI**VOLUME III**

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1 service if Duke went ahead and sold it on a single
2 charge, you know, \$40 per month for all the
3 electricity?

4 A. All you can eat.

5 Q. That's a service?

6 A. All you can eat. For example, a good example
7 at a restaurant because I brought it up.

8 Q. Yeah.

9 A. Okay. Normally, you would think that's a
10 material transfer. But if it's just a matter of you
11 sit there and eat all you want and I'll charge you 10
12 bucks, that's transformed into a service.

13 Q. The manner in which you bill for something
14 changes its --

15 A. Sure.

16 Q. -- characteristic?

17 A. For example, my garbage pickup. I pay them
18 once a month. They take as little or as much as I
19 produce. That's a service. No question.

20 Q. Okay.

21 A. And by the way, a lot of garbage companies
22 will charge their commercial clients on a ton basis.
23 Tons transfer. Okay. Well, that's different. Then it
24 is a transfer of a commoditized product.

25 MR. TRESH: Can we take like a five-minute

EXHIBIT T

1 STATE OF SOUTH CAROLINA

2 ADMINISTRATIVE LAW COURT

3

4 DUKE ENERGY CORPORATION,

5 Petitioner(s),

6 vs.

Case No: 10-ALJ-17-0270-CC

7 SOUTH CAROLINA DEPARTMENT OF REVENUE,

8 Respondent(s).

9

10 D E P O S I T I O N

11 WITNESS: SARAH G. MAJOR

12 DATE: Wednesday, March 14, 2012

13 TIME: 1:23 p.m.

14 LOCATION: Willoughby & Hoefer, P.A.
930 Richland Street
15 Columbia, South Carolina

16 TAKEN BY: Attorneys for the Petitioner

17 REPORTED BY: SHERI L. BYERS
Registered Professional Reporter

18

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17 ALSO PRESENT:

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19 T. COOPER MONROE

19

20

21 (INDEX AT REAR OF TRANSCRIPT)

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23

24

25

1 administrative policy that occurred before this case
2 that said that we were going to look at net gains
3 instead of gross because the gross is going to
4 distort -- is going to distort your apportionment
5 factor. And it doesn't make sense. It leads to absurd
6 results.

7 So we're going to interpret it in a way so
8 that it reasonably -- we interpret gross receipts in a
9 way that will make it reasonably represent, which is
10 what the statute says you're supposed to be doing, the
11 amount of income that should be taxed to the state.

12 Q. That's what I was getting at. So the
13 reason -- so the Department's policy behind including
14 sales of securities at net would be that to include
15 them at gross would be distortive; is that correct?

16 A. It's not just distortive. It's not -- it's
17 that when you're looking at that term in terms of what
18 it is that you're doing, that the best way to interpret
19 gross receipts for that is to do it at net. That
20 that's going to give you the most reasonable answer.
21 Otherwise, it's going to result in a -- it can lead to
22 absurd results, so we're going to interpret it in that
23 manner.

24 Q. Can lead to absurd results or will? I other
25 words, would it lead to absurd results in all cases or

EXHIBIT U

SUBJECT: TAX LEGISLATIVE UPDATE FOR 2007, 2007 WL 2702166 (2007)

2007 WL 2702166 (S.C.Tax.Com.)

Tax Commission

State of South Carolina

SUBJECT: TAX LEGISLATIVE UPDATE FOR 2007

SC Information Letter No. 07-16

DATE: August 31, 2007

AUTHORITY:

*1 S.C. Code Ann. Section 12-4-320 (Supp. 2000)

S.C. Code Ann. Section 1-23-10(4) (Supp. 2000)

SC Revenue Procedure # 05-2

SCOPE:

An Information Letter is a written statement issued to the public to announce general information useful in complying with the laws administered by the Department. An Information Letter has no precedential value.

Attached is a brief summary of most of the significant changes in tax and regulatory laws and regulations enacted during the past legislative session. The summary is divided into four categories, by subject matter, as indicated below.

CATEGORY OF LEGISLATION & REGULATIONS	PAGE #
1. Income Taxes, Corporate License Fees, and Withholding	
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There are several instances where more than one bill with related subject matters was ratified by the General Assembly. In such cases, these summaries are cross referenced. In addition, there are several instances of apparent inconsistencies in some legislation which will be considered and may be resolved by the Code Commissioner.

Code Section 12-6-2280(0) - As Amended. The following provision was added: Sales of tangible personal property to the United States Government are not included in the numerator or the denominator of the sales factor. Only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government.

2. Code Section 12-6-2280(D) was added to cross reference new Code Section 12-6-2295. For purposes of Code Section 12-6-2280, items included in sales are as provided in Section 12-6-2295.

Code Section 12-6-2295 - Examples of "Sales" and "Gross Receipts" - New Statute

Code Section 12-6-2295 was added to provide examples of items that the terms "sales" and "gross receipts" do and do not include. The amendments are explained below.

Examples of Items Included in Sales or Gross Receipts - Code Section 12-6-2295(A) -Code Section 12-6-2295(A) provides that the terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:

1. receipts from the sale or rental of property maintained for sale or rental to customers in the ordinary course of the taxpayer's trade or business including inventory;
2. receipts from the sale of accounts receivable acquired in the ordinary course of trade or business for services rendered or from the sale or rental of property maintained for sale or rental to customers in the ordinary course of the taxpayer's trade or business if the accounts receivable were created by the taxpayer or a related party. For purposes of this item, a related person includes a person that bears a relationship to the taxpayer as described in Section 267 of the Internal Revenue Code;
3. receipts from the use of intangible property in this State including, but not limited to, royalties from patents, copyrights, trademarks, and trade names;
4. net gain from the sale of property used in the trade or business. For purposes of this subsection, property used in the trade or business means property subject to the allowance for depreciation, real property used in the trade or business, and intangible property used in the trade or business which is:
 - *7 a. not property of a kind that properly would be includible in inventory of the business if on hand at the close of the taxable year; or
 - b. held by the business primarily for sale to customers in the ordinary course of the trade or business;
5. receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State;
6. receipts from the sale of intangible property which are unable to be attributed to any particular state or states are excluded from the numerator and denominator of the factor.

Examples of Items Not Included in Sales or Gross Receipts - Code Section 12-6-2295(B) -Code Section 12-6-2295(B) provides that the terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 do not include:

1. repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
2. the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
3. proceeds from the issuance of the taxpayer's stock or from sale of treasury stock;

4. damages and other amounts received as the result of litigation;
5. property acquired by an agent on behalf of another;
6. tax refunds and other tax benefit recoveries;
7. pension reversions;
8. contributions to capital, except for sales of securities by securities dealers;
9. income from forgiveness of indebtedness; or
10. amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code.

Code Section 12-6-2290 - Gross Receipts Apportionment Method - Amended

Code Section 12-6-2290 provides a gross receipts apportionment method for taxpayers not dealing in tangible personal property. It was amended to add a cross reference to Code Section 12-6-2295 (see above) which provides examples of items that the term "gross receipts" does and does not include.

Code Section 12-6-2290 now provides: If the principal profits or income of a taxpayer are derived from sources other than those described in Section 12-6-2250 or Section 12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.

Related Amendments Effective Upon Final Phase in of Single Sales Factor Apportionment Method

The following amendments, effective for tax years beginning after 2010, update cross references from Code Section 12-6-2250 (the three factor apportionment method with double weighted sales and phase in provisions of the single sales factor) to Code Section 12-6-2252 (the single sales factor apportionment method) for the following code sections:

- *8 1. Code Section 12-6-1130(6) dealing with computation of the depletion deduction;
2. Code Section 12-6-2240 dealing with apportionment of income; and
 3. Code Section 12-6-2290 dealing with gross receipts factor.

The following code sections will be repealed once the sales factor is fully phased in effective for tax years beginning after 2010:

1. Code Section 12-6-2250 (the three factor apportionment method with double weighted sales and phase in provisions of the single sales factor);
2. Code Section 12-6-2260 (three factor apportionment method property factor definition); and
3. Code Section 12-6-2270 (three factor apportionment method payroll factor definition).

Effective Date: Tax years beginning after 2006, except where otherwise indicated for tax years beginning after 2010.

House Bill 3820, Section 2 (Act No. 78)

Catastrophe Savings Accounts - New Deduction

Overview. Article 11, Chapter 6 of Title 12, has been added to allow individuals an income tax deduction for certain contributions to a Catastrophe Savings Account. Code Section 12-6-1620(B)(1) provides that a Catastrophe Savings Account is a regular savings account or money market account established by (1) an insurance policyholder for residential property to cover an insurance deductible under an insurance policy for the taxpayer's legal residence in South Carolina that covers

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

Docket No.: 10-ALJ-17-0270-CC

DUKE ENERGY'S POST-HEARING MEMORANDUM OF LAW

Duke Energy Corporation ("Duke Energy") respectfully submits this Post-Hearing Brief in opposition to the South Carolina Department of Revenue's Motion for Summary Judgment (the "Department's Motion").

BACKGROUND

The Department seeks summary judgment on three issues: (1) whether Duke Energy may not file refund claims for the tax years 1978-1993 even though the Department agreed in writing, *prior to the expiration of the limitations period*, to extend the time period for Duke Energy to file such refund claims ("Waiver Issue"); (2) whether Duke Energy may use the single-factor gross-receipts apportionment formula to apportion its income to South Carolina ("Apportionment Method Issue"); and (3) whether Duke Energy should include the proceeds from sales of securities in the calculation of its South Carolina corporate income tax apportionment formula ("Gross Receipts Issue"). This Post-Hearing Memorandum law is limited to the first issue.

FILED

JUN 28 2012

SC ADMIN. LAW COURT

Duke Energy respectfully requests that this court deny the Department's Motion because there are genuine issues of material fact with regard to the Waiver Issue.

A hearing on the Department's Motion and Duke Energy's Cross-Motion was held before this Court on June 26, 2012. At the hearing, this Court permitted the parties to file post-hearing briefs on issues presented during oral arguments. Duke Energy respectfully submits this Post-Hearing Brief to address arguments raised by the Department associated with executed written agreements ("Waiver agreements") signed by Duke Energy and the Department prior to the expiration of the statute of limitations. Additionally, this Brief addresses the applicability of a Kentucky case cited by the Court to the present case, *Dep't of Conservation v. Co-De Coal Co.*, 388 S.W.2d 614 (Ky. Ct. App. 1964). Finally, this Brief describes facts in the record that demonstrate the Department's actions conclusively show that it believed the executed Waiver agreements were valid and kept open the statute of limitations.

ARGUMENT

The Waiver agreements for the tax years at issue in this case (1978-2001) can be grouped into two categories.

Both parties agree that the Waiver agreements for the tax years 1994-2001 are valid and Duke Energy's amended returns for those years are timely.¹

First, the Waiver agreements for the tax years 1978-1993 are valid because they were executed within the time period allowed by South Carolina Code section 12-54-80. Duke Energy's refund claims for these tax years were filed within the time frame

¹ The Department has challenged the validity of the Waiver agreements that the Department and Duke executed, and the timeliness of Duke Energy's refund claims, only for tax years ending prior to 1994. Department's Memorandum in Support of the Motion for Summary Judgment (the "Department's Memorandum") at 2, 9.

provided for in the Waiver agreements and are therefore, timely. In fact, in 2002, the Department issued assessments and refunds to Duke Energy for corporate income taxes for the tax years 1978 through 1994. (Monroe Aff. ¶¶ 8, 9, Exhibit A.)

Second, for the tax years 1978-1984, the limitations period for claims for refund should be tolled under the doctrine of equitable tolling or alternatively, the Department should be estopped from claiming the Waivers for those years are invalid.

I. Waiver Agreements for the Tax Years 1978-1993

South Carolina Code section 12-54-80 (eff. for tax years prior to 1995) provides that: (1) "the amount of taxes due on a return which has been filed ... must be *determined* or assessed within thirty-six months from the date the return was filed *or due to be filed*, whichever occurs later;" (2) in the case of an adjustment made by the IRS to the taxpayer's federal income tax return, "the commission *may determine and assess income taxes* after the thirty-six months limitation if it makes the determination and assessment within one hundred eighty days of receiving notice from the Internal Revenue Service of a final determination of an income adjustment ...,"² and (3) "[i]f before the expiration of the time prescribed in this section for the mailing of the notice of assessment, the taxpayer has consented in writing to the mailing of the notice after the time, notice of assessment may be mailed at any time prior to the expiration of the period agreed upon." See S.C. Code Ann. § 12-54-80.

Section 12-54-80 provides that South Carolina corporate income taxes were required to be "determined" within the later of the thirty six months from the extended

² South Carolina Code section 12-54-80 was repealed and recodified effective for tax years after 1994. See S.C. Code Ann. § 12-54-85. Effective for years after 1994, a refund claim resulting from an IRS adjustment must be limited to the overpayment of taxes resulting from the IRS adjustment. S.C. Code Ann. § 12-54-85(D)(3). Such a limitation was not in place prior to 1995.

due date of the tax return, or 180 days from the receipt of a notice from the Internal Revenue Service of a final determination of an income adjustment ("Final IRS Adjustment"). The thirty six month time period and the 180-day time period are collectively referred to as the "statute of limitations" for purposes of determining a taxpayer's tax liability. Because Duke Energy filed its amended returns (refund claims) within the statute of limitations, the Department is required to "determine" the correct amount of tax due. A "determination" is not limited to an assessment of additional tax. Rather, a "determination" also contemplates correcting a taxpayer's overpayment of tax.

South Carolina Code section 12-54-80 also provides that the parties could agree to extend the time period of the statute of limitations. This is exactly what happened in this case. The Waiver agreements for the periods 1978-1993 were executed prior to the expiration of the statute of limitations.

The Department argued at the hearing that the statute of limitations contained in South Carolina Code section 12-54-80 does not apply to refund claims. However, the Department's argument is belied by the plain language of the statute, the plain language of its Waiver agreement and its own actions.

Under the plain language of the statute, the Department must determine the amount of taxes due within a defined period. A determination of the amount of taxes due may produce an amount that is higher or lower than the amount reported on a taxpayer's return filing. This determination reflects information obtained from the receipt of supplemental information, including amended tax returns, provided by a taxpayer. Taxpayers regularly seek refunds of tax overpayments but yet the Department has not identified one instance where a taxpayer's refund claim was rejected because of the

claimed inapplicability of South Carolina Code section 12-54-80. In fact, the Department has paid Duke Energy other corporate income tax refunds for the years at issue in this case many years after the expiration of the limitations period that the Department argues controls in this case but within the extended time frame provided for in the waivers. (See *infra* II; Monroe Aff. ¶¶ 8, 9, Exhibit A.)

Duke Energy's position is further supported by the plain language of the Waiver agreements executed by Duke Energy and the Department for over two decades. For periods prior to 1995, the Waiver agreements provided: "This agreement extends the time for mailing the notice of assessment or refund of the above tax pursuant to the provisions of Section 12-54-80 of the 1976 South Carolina Code of Laws, as amended." The Department has recognized for years that a waiver agreement executed within the time frames provided for in South Carolina Code section 12-54-80 extends the period of time to file refunds and for the Department to make assessments. (Davant Aff. ¶¶ 6, 14, 19, Exhibit B.)

The Department's actions also support the view that South Carolina Code section 12-54-80 extended the time for refunds. In 2002, the Department issued assessments of corporate income, license and sales taxes for the tax years 1978 through 1994 and determined that for these same years, Duke Energy was owed refunds for corporate income taxes. On August 13, 2002, the Department and Duke Energy agreed to offset the refunds of South Carolina corporate income taxes against the assessments of South Carolina corporate income, license and sale taxes for the tax years 1978 through 1994 resulting in a net refund to Duke Energy in the amount of \$3,067,703. (Monroe Aff. ¶¶ 8, 9, Exhibit A.) In granting Duke Energy's refund, the Department respected the Waiver

agreements that it and Duke Energy executed. The Department applied the statute of limitations contained in 12-54-80 in honoring the open statute of limitations.

On August 8, 2003, this Court issued a Consent Order memorializing an agreement between Duke Energy and the Department to settle the amount of interest owed to Duke Energy relative to the corporate income tax refund Duke Energy was issued in 2002. The Court order recognized that the statute of limitations for the tax years at issue in this case remained open. (Consent Order, Exhibit C.³)

In *Co-De Coal Co.*, the Kentucky Court of Appeals opined that the statute of limitations provision "creates a condition precedent to the statutory right of refund." 388 S.W.2d at 617. Duke Energy has satisfied the condition precedent for its right to file a refund claim by executing the Waiver agreements *prior* to the expirations of the statute of limitations for refund claims provided under South Carolina law. Therefore, *Co-De Coal Co.* is entirely consistent with Duke Energy's position in this case.

A. Waiver Agreements for the Tax Years 1978-1989

During the tax years 1985 through 1989, South Carolina Code section 12-54-80 was the sole statute of limitations that authorized the filing of claims for refund. Duke Energy and the Department executed multiple Waiver agreements extending the statute of limitations period to allow Duke Energy to file refund claims or the Department to issue assessments. All of those Waiver agreements were timely executed prior to the expiration of the statute of limitations (see Return File Date Chart, Exhibit D) and thus, the statute of limitations for filing refund claims or issuing assessments for the years 1985

³ "The Parties further acknowledge and agree that the Petitioner has certain refund claims pending before the Department which also relate to tax years prior to September 1, 1985. The settlement of this matter shall not ... be binding on either party with respect to Petitioner's pending claims."

through 1989 did not close until the expiration of the last applicable Waiver agreement in 2002.

Additionally, the IRS made adjustments to Duke Energy's tax returns for the tax years 1984 and 1986 through 1989. The IRS made a final determination with respect to those adjustments on September 23, 1992. (Monroe Aff. ¶ 5, Exhibit A; September 23, 1992 Determination, Exhibit E.) The Waiver agreements for those years were executed long before the expiration of one hundred eighty days from the date the IRS notified the Department of those IRS final adjustments. (Exhibit D; Waiver Schedule, Exhibit F).

The Department's argument that South Carolina Code sections 12-47-210 and 12-47-220 "were the exclusive remedy for obtaining a refund of income taxes" is misplaced. Department's Memorandum at 24. Those sections offered a different procedural mechanism. If South Carolina Code sections 12-47-210 and 12-47-220 were the sole remedial procedures available to taxpayers seeking refund claims, then every taxpayer would have been required to pay the tax under protest and file an action in circuit court within 30 days of filing of its original tax returns. This interpretation of South Carolina law is not only inconsistent with the plain reading of the relevant provisions, but it produces an unfair result that implicates Due Process Clause concerns. In contrast, the refund claim procedure provided by South Carolina Code section 12-54-80 offered taxpayers the opportunity to correct an error - a tax overpayment - within a reasonable period of time - a period of time that the Department universally accepted prior to articulating its litigation position in this case.

The Department's assertion that prior to 1995, South Carolina Code sections 12-47-210 and 12-47-220 provided the only procedure for obtaining a refund of income

taxes is also erroneous because, in fact, South Carolina Code section 12-54-30, which contained no statute of limitations or a condition precedent, also provided a mechanism for filing refund claims.

B. Waiver Agreements for the Tax Years 1990-1993

For the years 1990 through 1993, the IRS made adjustments to Duke Energy's tax returns. The IRS made a final determination (1) on May 11, 2001 relative to the adjustments for the tax years 1990 and 1991; and (2) on July 17, 2001 relative to the adjustments for the tax years 1992 and 1993. (Monroe Aff. ¶¶ 6, 7; Exhibit A; May 11, 2001 and July 17, 2001 Final Determination, Exhibit G.) The Waiver agreements for those years were executed long before the expiration of one hundred eighty days from the date the IRS notified the Department of those final federal adjustments. (Exhibit D; Exhibit F)

Accordingly, the Waiver agreements for the tax years 1985 through 1993 were timely as they were executed prior to the expiration of the limitations periods for filing refund claims. The statute of limitations periods did not expire until the dates contained in the Waiver agreements. Because Duke Energy filed its refund claims prior to the Waiver agreements' expiration dates, its refund claims for 1985 through 1993 are timely.

II. Waiver Agreements for the Tax Years 1978 through 1984

Duke Energy has not located executed Waiver agreements for tax years 1978 through 1983. However, the evidence at trial will show that the Department agreed to extend the time to allow Duke Energy to file refund claims for those years. For example, on August 13, 2002, the Department and Duke Energy agreed to offset, for tax years 1978 through 1994, certain assessments made by the Department of additional corporate

income tax against corporate income taxes refunds owed to Duke Energy, resulting in a total tax refund of approximately \$1.9 million. (Monroe Aff. ¶¶ 8, 9, Exhibit A.) If the Waiver agreements for tax years 1978 through 1993 were invalid - as the Department now claims - those years were closed at the time the Department granted Duke Energy a refund claim.

Furthermore, Duke Energy restates and incorporates by reference its claims that the Department should be estopped from arguing that the Waiver agreements for the 1978-1984 tax years are invalid and that the limitations period for filing refund claims should be considered tolled under the doctrine of equitable tolling. Duke Energy's Memorandum of Law in Opposition to the South Carolina Department of Revenue's Motion for Summary Judgment and in Support of Duke Energy's Cross-Motion for Partial Summary Judgment at 21-23.

CONCLUSION

For the foregoing reasons, *Co-De Coal Co.* is entirely consistent with Duke Energy's position in the instant action. Therefore, Duke Energy respectfully requests that this Court deny the Department's Motion for Summary Judgment with respect to the Waiver Issue.

Respectfully submitted this 28 day of June 2012.



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Exhibit A

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

DUKE ENERGY CORPORATION,

Petitioner,

vs.

**SOUTH CAROLINA
DEPARTMENT OF REVENUE,**

Respondent.

Docket No.: 10-ALJ-17-0270-CC

AFFIDAVIT OF T. COOPER MONROE, III

Appeared before the undersigned officer duly authorized to administer oaths, T. Cooper Monroe, who deposed and stated as follows:

1.

My name is Thomas Cooper Monroe, III. I am over the age of 18 years, and I am not under any disability that would impair my competency to provide an affidavit.

2.

This affidavit is given from my personal knowledge.

3.

During the period 1978-2001 ("Period at Issue"), Duke Energy Corporation ("Duke Energy") was a North Carolina corporation engaged principally in the business of selling electric service, with principal offices located at 526 S. Church Street, Charlotte, North Carolina 28285.

4.

Since 1997, I have been at various times the Tax Manager and the Managing Director of State and Local Tax of Duke Energy. In those roles, I have had the opportunity to review and become familiar with Duke Energy's tax files and its correspondence related to its South Carolina and federal corporate income tax issues for the tax years 1978 through 2001.

5.

The Internal Revenue Service ("IRS") made certain adjustments to Duke Energy's federal corporate income tax returns for the tax years 1978 through 1983. The IRS made a final determination with regard to those adjustments on September 23, 1992.

6.

The Internal Revenue Service ("IRS") made certain adjustments to Duke Energy's federal corporate income tax returns for the tax years 1984 and 1986 through 1991. The IRS made a final determination with regard to those adjustments on May 11, 2001.

7.

The Internal Revenue Service ("IRS") made certain adjustments to Duke Energy's federal corporate income tax returns for the tax years 1992 through 1994. The IRS made a final determination with regard to those adjustments on July 17, 2001.

8.

On August 13, 2002, Duke Energy and the South Carolina Department of Revenue ("Department") agreed to offset certain assessments of additional South Carolina corporate income tax made by the Department for the tax years 1978 through 1994 against refunds of South Carolina corporate income tax owed to Duke Energy for the same tax years.

9.

On August 16, 2002, Duke Energy received a refund check for overpaid corporate income taxes from the Department attributable to the tax years 1978 through 1994.

Further affiant sayeth not, this 28th day of June, 2012.


T. Cooper Monroe, III

Subscribed before me this
28 day of June, 2012.

Natalie W Polk

Notary Public

My commission expires: 4-28-2013



Exhibit B

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Duke Energy Corporation)

Petitioner,)

vs.)

South Carolina Department of Revenue,)

Respondent.)

Docket No. 10-ALJ-17-0270-CC

**AFFIDAVIT OF
MARVIN N. DAVANT**

STATE OF SOUTH CAROLINA)

COUNTY OF RICHLAND)

PERSONALLY APPEARED BEFORE ME, Marvin N. Davant, who first being
duly sworn, deposes and says as follows:

1. I am over the age of eighteen (18) years old.
2. I was employed by the South Carolina Department of Revenue (formerly known as the South Carolina Tax Commission) (hereinafter referred to as the "Department") for thirty-seven (37) years beginning in 1964 as an auditor with the Estate & Gift Division, an assistant director of the Estate & Gift Division and then the combined Estate & Gift and Income Tax Divisions, and as Director, Field Services Division, until my retirement in 2001. After I retired, I acted as a consultant to the Director of the Department.
3. The Department authorized the Director of its Field Services Division to fill out, execute and issue Form FS-43 to taxpayers.
4. In the performance of my services as Director, I was authorized to issue and execute, and did routinely issue and execute, the Department's Form FS-43, Consent to Extend the Time to Assess Tax.

5. Form FS-43 was a commonly utilized form, to such extent that I, with approval of the Department, allowed my audit deputy to sign the form in the interests of time.

6. It was common practice for the Department to seek an extension of time to make an assessment and request that taxpayer's sign Form FS-43. For example, if auditors were on a short time frame to audit a file, they would request that the taxpayers sign Form FS-43 as an agreement with the Department to extend the time for both assessments and refunds.

7. The Department promulgated and issued Form FS-43 as an official Department form document. To the best of my knowledge, information and belief, the Department has utilized this form since at least the 1960s, as the form was in use prior to the time I became employed with the Department.

8. Form FS-43 was an official form issued by the Department and provided to the Field Services Division for use in its operations.

9. To the best of my knowledge, information and belief, the Department did not issue forms that had not been properly reviewed or approved.

10. The Department's forms identified which division used the form by including the division's name or initial on the form.

11. To the best of my knowledge, information and belief, no individual division of the Department promulgated its own forms, and every form used by any division was an official form provided to it by the Department.

12. The Field Services Division did not review or question Form FS-43 because it was instructed to use the form by the Department.

13. To the best of my knowledge, information and belief, the use of Form FS-43 by the Department was never questioned.

14. To the best of my knowledge, information and belief, the Department historically intended, believed and understood that Form FS-43 not only extended the time to assess additional tax, but also authorized or extended the time for a taxpayer to file a claim for refund within the time stated in the Form FS-43.

15. Prior to enactment of the South Carolina Revenue Procedures Act in 1995, the Department believed that after the execution of the FS-43 by the DOR and the taxpayer that it was authorized and permitted to issue refunds of overpaid tax even if a claim for refund by the taxpayer would not otherwise be timely under the applicable statutory limitations period for filing a refund claim and regardless of whether the period of time initially prescribed for filing a claim for refund had expired.

16. Prior to enactment of the South Carolina Revenue Procedures Act, it was my intent, belief and understanding as Director of Field Services that an executed Form FS-43 constituted the Department's agreement to issue a refund -- whether resulting from a review of the taxpayer's records commenced by the Department's on its own initiative, upon consideration of a claim for refund filed by the taxpayer prior to the time stated in the Form FS-43, or otherwise -- pursuant to its authority to issue refunds of overpaid tax even if a claim for refund would otherwise be untimely.

17. After enactment of the South Carolina Revenue Procedures Act, there was no difference in how Form FS-43 was interpreted by Department, and the content of the form remained the same.

18. To the best of my knowledge, information and belief, I had the same authority to sign Form FS-43 before and after enactment of the South Carolina Revenue Procedures Act.

19. Both before and after enactment of the South Carolina Revenue Procedures Act, the purpose of Form FS-43 was to allow the Department and the taxpayer by agreement to extend the time for assessment or refund, whether discovered on audit or a refund claim filed by the taxpayer. The form was specifically used for purposes of recording the agreement to extend the time limitations for both the Department and the taxpayer.

20. It was my intent, belief and understanding as Director of Field Services that a refund claim filed after the statute of limitations had expired would be treated differently than a refund claim filed during the extended period of time agreed to by the Department and the taxpayer by executing Form FS-43. The Department would not consider a refund claim filed in the former situation, but would, in accordance with its agreement, in the latter.

FURTHER AFFIANT SAYETH NOT.



Marvin N. Davant

SWORN and subscribed to before me
this 16th day of May, 2012.

Marjorie W. Rish (L.S.)
Notary Public for South Carolina
My Commission Expires: 11-4-2020



Exhibit C

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW JUDGE DIVISION

Anonymous Taxpayer,

Petitioner,
vs.

South Carolina Department of Revenue,
Respondent.

CONSENT ORDER

DOCKET NO. 03-ALJ-17-0094-CC

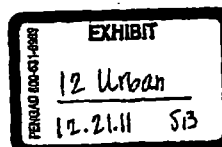
This matter came before the Court from an appeal by the Petitioner, Anonymous Taxpayer, of a final agency determination of the Respondent, the South Carolina Department of Revenue (the "Department") regarding the calculation of interest on an agreed refund of corporate income tax due to Petitioner for periods prior to September 1, 1985.

A hearing was initially scheduled in this matter for December 18, 2003. This hearing date and all discovery deadlines were postponed at the request of both parties upon their notification to the Court that settlement negotiations were underway. The parties have now reached an agreement resolving this matter on the following terms and conditions:

1. The Department agrees to allow tax credits against the South Carolina corporate income tax and license fees of Petitioner in the amount of \$554,244 for the tax year ending 2002, \$554,244 for the tax year ending 2003, and \$554,244 for the tax year ending 2004. In the event the tax credits are not fully utilized in any one year, they may be carried forward to future years until fully utilized.

2. The parties further acknowledge and agree that the Petitioner has certain refund claims pending before the Department which also relate to tax years prior to September 1, 1985. The settlement of this matter shall not constitute a resolution of the substantive issue of the

FILED



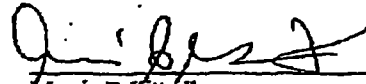
AUG 08 2003

DE00009356

calculation of interest for pre-September 1, 1985 tax periods and shall not be binding on either party with respect to Petitioner's pending claims.

Having reviewed this Agreement in Settlement and Compromise, I hereby order its adoption and dismiss the Petition in this matter with prejudice.

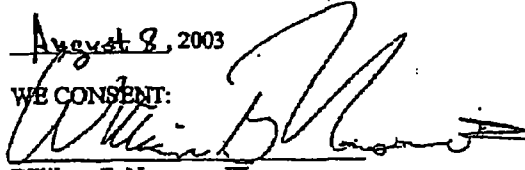
IT IS SO ORDERED.


Marvin F. Kittrell
Chief Administrative Law Judge

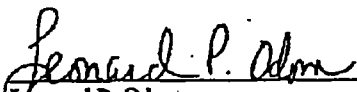
Columbia, South Carolina

August 8, 2003

WE CONSENT:

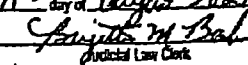

William G. Newsome III
Nexsen Pruet Jacobs & Pollard, LLC
1441 Main Street, Suite 1500
Columbia, SC 29201
(803) 771-8900

pr
Attorney for Petitioner


Leonard P. Odom
Counsel for Revenue Litigation
State of South Carolina
Department of Revenue
Law & Compliance Division
301 Gervais Street
Columbia, SC 29214

Attorney for Respondent

CERTIFICATE OF SERVICE
This is to certify that the undersigned has this date
served this order in the above entitled action upon all
parties to this cause by depositing a copy hereof,
in the United States mail, postage paid, or in the Interagency
Mail Service addressed to the party(ies) or their attorney(s).

This 11th day of August 2003
By: 
Judicial Law Clerk

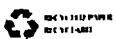


Exhibit D

Tax Year	Original Tax Return File Date	Federal Adjustment Final Determination
1978	9/14/1979	9/23/1992
1979	9/15/1980	9/24/1992
1980	9/15/1981	9/25/1992
1981	9/14/1982	9/26/1992
1982	9/15/1983	9/27/1992
1983	9/17/1984	9/28/1992
1984	9/15/1985	5/11/2001
1985	9/15/1986	
1986	9/15/1987	5/11/2001
1987	9/14/1988	5/11/2001
1988	9/15/1989	5/11/2001
1989	9/15/1990	5/11/2001
1990	9/15/1991	5/11/2001
1991	9/15/1992	7/17/2001
1992	9/14/1993	7/17/2001
1993	9/10/1994	7/17/2001
1994	9/15/1995	
1995	9/16/1996	
1996	9/15/1997	
1997	9/15/1998	
1998	9/14/1999	
1999	9/11/2000	
2000	9/17/2001	
2001	9/13/2002	



Exhibit E

1983) 370 Department of the Treasury, Internal Revenue Service
 7. December Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment
 1983) Internal Revenue Service

Names and Address of taxpayers Duke Power Company
 P.O. Box 33189
 422 South Church Street
 Charlotte, N. C. 28242-0001
 Social security or employer identification number 56-0205520

Increase (Decrease) in Tax and Penalties

Tax year ended	Amount of Tax	Penalty	Penalty
12/31/79	\$ (557,034)	N/A	N/A
12/31/80	\$ (1,381,339)	N/A	N/A
12/31/81	\$ (628,783)	N/A	N/A
12/31/82	\$ (235,305)	N/A	N/A
12/31/83	None	N/A	N/A
	\$	\$	\$

Other Information:

Restricted Interest:

Since \$135,954 of the decrease in tax for the year 1980 results from the carryback of Research Credit from 1983, interest is due on that amount from the due date of the 1983 income tax return (March 15, 1984) under the provisions of Section 6611(f)(2) of the Internal Revenue Code. For the remaining decrease in tax for 1980, interest begins March 16, 1981, the due date of the return.

INTERNAL REVENUE SERVICE
 RECEIVED

SEP 24 1992

District Director - Greensboro District
 CHARLOTTE, N. C.
 100423

Consent to Assessment and Collection

I consent to the immediate assessment and collection of any deficiencies (increase in tax and penalties) and accept any overassessment (decrease in tax and penalties) shown above, plus any interest provided by law. I understand that by signing this waiver, I will not be able to contest these years in the United States Tax Court, unless additional deficiencies are determined for these years.

DUKE POWER COMPANY
 Signatures: _____
 By *John P. O'Keefe* *VP Taxes* Date *9/23/92*

NUCLEAR FUEL DEPRECIATION
1978 - 1987 ADJUSTMENT

	VINTAGE 1978	VINTAGE 1979	VINTAGE 1980	VINTAGE 1981	VINTAGE 1982	VINTAGE 1983	TOTAL
INCREASE (DECREASE)							
DEPRECIABLE BASE	5,117,968	12,000,282	20,302,606	(197,690)	(1,525,103)	31,467	35,729,530
INCREASE (DECREASE)							
DEPRECIATION EXPENSE							
1978	1,023,594						1,023,594
1979	1,637,750	2,400,056					4,037,806
1980	1,074,773	3,840,090	4,060,521				8,975,384
1981	767,756	2,520,060	6,496,834	(29,654)			9,754,996
1982	460,571	1,800,186	4,263,547	(43,492)	(228,765)		6,252,047
1983	153,524	1,079,918	3,045,635	(41,515)	(335,523)	4,720	3,906,759
1984		359,972	1,827,052	(41,515)	(320,272)	6,923	1,832,160
1985			609,017	(41,514)	(320,272)	6,608	253,839
1986					(320,271)	6,608	(313,663)
1987						6,608	6,608
TOTAL	5,117,968	12,000,282	20,302,606	(197,690)	(1,525,103)	31,467	35,729,530

INCREASE (DECREASE)							
ITC GENERATED	392,337	920,022	1,556,533	(19,769)	(152,510)	2,517	2,699,130

NOTES:

SYSTEM LIFE METHOD

1978-1980	ADR	5	DOB-2 YEARS	
			SYD-3RD YEAR	.4375
			4TH YEAR	.5556
			5TH YEAR	.7500
			6TH YEAR	BALANCE
1981-1983	ACRS	5	TABLE 1ST YEAR	.15
			2ND YEAR	.22
			3RD YEAR	.21
			4TH YEAR	.21
			5TH YEAR	.21

Form **2297**
(Rev. March 1982)

Department of the Treasury Internal Revenue Service

WAIVER OF STATUTORY NOTIFICATION
OF CLAIM DISALLOWANCE

I, Duke Power Company (56-0205520) of P.O. Box 33189, 422 South Church Street
(Name, SSN or EIN) (Number, Street, City or Town, State, Zip Code)
Charlotte, North Carolina 28242-0001

waive the requirement under the Internal Revenue Code section 6532(a)(1) that a notice of claim disallowance be sent to me by certified or registered mail for the claims for credit or refund shown in column (d), below.

I understand that the filing of this waiver is irrevocable and it will begin the 2-year period for filing suit for refund of the claims disallowed as if the notice of disallowance had been sent by certified or registered mail.

CLAIMS			
(a) TAXABLE PERIOD ENDED:	(b) KIND OF TAX	(c) AMOUNT OF CLAIM	(d) AMOUNT OF CLAIM DISALLOWED
December 31, 1979	Income	\$ 557,034.00	\$ None
December 31, 1980	Income	1,245,385.00	None
December 31, 1981	Income	777,581.00	148,798.00
December 31, 1982	Income	290,505.00	55,200.00
December 31, 1983	Income	None	None
INTERNAL REVENUE SERVICE RECEIVED			
SEP 24 1992			

If you file this waiver for a joint return, both you & your spouse must sign the original & duplicate of this form. Sign your name exactly as it appears on the return. If you are acting under power of attorney for your spouse, you may sign as agent for him or her.

For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

For a partnership with excise or employment tax liability, all partners must sign. However, one partner may sign with appropriate evidence of authorization to act for the partnership.

For a person acting in a fiduciary capacity (executor, administrator, trustee) file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed.

For a corporation, enter the name of the corporation followed by the signature and title of the officer(s) authorized to sign.

District Director - Greensboro District
CHARLOTTE, N.C.
100423
(Date Signed)

Spouse's Signature If
A Joint Return Was
Filed
(Date Signed)

Taxpayer's Representative
Sign Here
(Date Signed)

Partners/
Corporate
Officers
Sign
Here
(Date Signed)

DUKE POWER COMPANY
9/23/92
(Title)
(Date Signed)

NOTE - Filing this waiver within 6 months from the date the claim was filed will not permit filing a suit for refund before the 6-month period has elapsed unless a decision is made by the Service within that time disallowing the claims.

Form **2297**

Form 3363
(Rev. November 1983)

Department of the Treasury — Internal Revenue Service

ACCEPTANCE OF PROPOSED DISALLOWANCE OF CLAIM
FOR REFUND OR CREDIT

Name(s), SSN or EIN, and address of taxpayer(s) (Number, Street, City or Town, State, ZIP Code)

DUKE POWER COMPANY
P. O. BOX 33189
422 SOUTH CHURCH STREET
CHARLOTTE, NC 28242-0001

56-0205520

INTERNAL REVENUE SERVICE
RECEIVED

SEP 24 1992

District Director, Greensboro District

Year or Period	Date Claim Filed	Kind of Tax	Amount of Claim	Amount of Claim Disallowed	Amount of Claim Allowed
12/31/79	12/30/91	Income	\$ 557,034.	\$ -0-	\$ 557,034.
12/31/80	12/30/91	Income	1,245,385.	-0-	1,245,385.
12/31/81	12/30/91	Income	777,581.	148,798.	628,783.
12/31/82	12/30/91	Income	290,505.	55,200.	235,305.
12/31/83	12/30/91	Income	N/A	N/A	N/A

I accept the proposal of the Internal Revenue Service to disallow the claim(s) to the extent described above. This means only that I do not want the Service to consider the claim(s). It does not waive my right to file suit on the disallowance.

If you file this acceptance for a joint return, both you & your spouse must sign the original & duplicate of this form. Sign your name exactly as it appears on the return. If you are acting under power of attorney for your spouse, you may sign as agent for him or her.

For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

For a partnership with excise or employment tax liability, all partners must sign. However, one partner may sign with appropriate evidence of authorization to act for the partnership.

For a person acting in a fiduciary capacity (executor, administrator, trustee) file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed.

For a corporation, enter the name of the corporation followed by the signature and title of the officer(s) authorized to sign.

YOUR SIGNATURE → _____ (Date Signed) _____

Spouse's Signature If A Joint Return Was Filed → _____ (Date Signed) _____

Taxpayer's Representative Sign Here → _____ (Date Signed) _____

Partners/Corporate Name: DUKE POWER COMPANY

Partners/Corporate Officers Sign Here → _____ (Date Signed) _____

Signature: [Signature] (Title) _____ (Date Signed) 9/23/92

Form 3363 (Rev. 11-83)



Exhibit F

**DUKE ENERGY CORPORATION
SOUTH CAROLINA WAIVERS SCHEDULE
INCOME/ LICENSE TAX**

WAIVER EXPIRATION	WAIVER PERIODS
12/31/02	INCOME: 12/31/78 - 12/31/99 LICENSE: 12/31/84 - 12/31/00
06/30/02	INCOME: 12/31/78 - 12/31/98 LICENSE: 12/31/84 - 12/31/99
12/31/01	INCOME: 12/31/78 - 12/31/97 LICENSE: 12/31/84 - 12/31/98
12/31/00	INCOME: 12/31/78 - 12/31/96 LICENSE: 12/31/84 - 12/31/97
12/31/99	INCOME: 12/31/78 - 12/31/95 LICENSE: 12/31/84 - 12/31/96
12/31/98	INCOME: 12/31/78 - 12/31/94 LICENSE: 12/31/84 - 12/31/95
06/30/98	INCOME: 12/31/78 - 12/31/94 LICENSE: 12/31/84 - 12/31/95
12/31/97	INCOME: 12/31/78 - 12/31/93 LICENSE: 12/31/84 - 12/31/94
06/30/97	INCOME: 12/31/78 - 12/31/92 LICENSE: 12/31/84 - 12/31/93
06/30/96	INCOME: 12/31/83 - 12/31/91 LICENSE: 12/31/84 - 12/31/92
11/30/95	INCOME: 12/31/83 - 12/31/90 LICENSE: 12/31/84 - 12/31/91
05/30/95	INCOME: 12/31/83 - 12/31/90 LICENSE: 12/31/84 - 12/31/91
12/31/94	INCOME: 12/31/83 - 12/31/89 LICENSE: 12/31/84 - 12/31/90
12/31/93	INCOME: 12/31/83 - 12/31/89 LICENSE: 12/31/84 - 12/31/90
12/31/92	INCOME: 12/31/83 - 12/31/88 LICENSE: 12/31/84 - 12/31/89
12/31/91	INCOME: 12/31/83 - 12/31/87 LICENSE: 12/31/84 - 12/31/88
12/31/90	INCOME: 12/31/83 - 12/31/86 LICENSE: 12/31/84 - 12/31/87
12/31/89	INCOME: 12/31/83 - 12/31/85 LICENSE: 12/31/84 - 12/31/86
06/30/89	INCOME: 12/31/83 - 12/31/84 LICENSE: 12/31/84 - 12/31/85
03/31/89	INCOME: 12/31/83 - 12/31/84 LICENSE: 12/31/84 - 12/31/85
12/31/88	INCOME: 12/31/83 - 12/31/84 LICENSE: 12/31/84 - 12/31/85

Exhibit G

Form 870-AD
(rev. 04/1992)

Department of the Treasury-Internal Revenue Service

Offer to Waive Restrictions on Assessment and Collection
of Tax Deficiency and to Accept Overassessment

Symbols: AP LMSB GBO TM	Name of Taxpayer: Duke Energy Corporation and Affiliates: Formerly, Duke Power Company and Affiliates	SSN or EIN : 56-0205520

Under the provisions of section 6213(d) of the Internal Revenue code of 1986 (the Code), or corresponding provisions of prior internal revenue laws, the undersigned offers to waive the restrictions provided in section 6213(a) of the Code or corresponding provisions of prior internal revenue laws, and to consent to the assessment and collection of the following deficiencies and additions to tax, if any, with interest as provided by law. The undersigned offers also to accept the following overassessments, if any, as correct. Any waiver or acceptance of an overassessment is subject to any terms and conditions stated below and on the reverse side of this form.

Deficiencies (Overassessments)
and Additions to Tax

Year Ended	Kind of Tax	Tax				
December 31, 1984	Income	\$12,335.00				
December 31, 1986	Income	(\$4,458,182.00)				
December 31, 1987	Income	\$11,276,912.00				

Accepted as of the date the Joint Committee on Taxation completes its review without objection or the date accepted for the Commissioner, whichever is later.

This offer must be accepted for the Commissioner of Internal Revenue and will take effect on the date it is accepted. Unless and until it is accepted, it will have no force or effect.

If this offer is accepted, the case will not be reopened by the Commissioner unless there was:

- fraud, misfeasance, concealment or misrepresentation of a material fact
- an important mistake in mathematical calculation
- a deficiency or overassessment resulting from adjustments made under Subchapters C and D of Chapter 63 concerning the tax treatment of partnership and subchapter S items determined at the partnership and corporate level
- an excessive tentative allowance of a carryback provided by law

No claim for refund or credit will be filed or prosecuted by the taxpayer for the years stated on this form, other than for amounts attributable to carrybacks provided by law. See exceptions on back.

The proper filing of this offer, when accepted, will expedite assessment and billing (or overassessment, credit or refund) by adjusting the tax liability. This offer, when executed and timely submitted, will be considered a claim for refund for the above overassessment(s), if any.

Signature of Taxpayer:	Date:

Signature of Taxpayer:	Date:

Signature of Taxpayer's Representative:	Date:

Corporate Name: Duke Energy Corporation and Affiliates: Formerly, Duke Power Company and Affiliates	Date:

By Corporate Officer:	Title:	Date:

For
Internal
Revenue
Use Only

Date Accepted for Commissioner:
May 11, 2001
Office: AP LMSB GBO TM

Signature: Thomas M. Cuietow
Title: Appeals Team Case Leader

(See second page for signature instructions)

Form 870-AD-c (Rev. 4/1992)

This offer may be executed by the taxpayer's attorney, certified public accountant, or agent provided this is specifically authorized by a power of attorney which, if not previously filed, must accompany this form. If this offer is signed by a person acting in a fiduciary capacity (for example: an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, must accompany this form, unless previously filed.

If this offer is executed for a year for which a joint return was filed, it must be signed by both spouses unless one spouse, acting under a power of attorney, signs as agent for the other.

If this offer is executed by a corporation, it must be signed with the corporate name followed by the signature and title of the officer(s) authorized to sign. If the offer is accepted, as a condition of acceptance, any signature by or for a corporate officer will be considered a representation by that person and the corporation, to induce reliance, that such signature is binding under law for the corporation to be assessed the deficiencies or receive credit or refund under this agreement. If the corporation later contests the signature as being unauthorized on its behalf, the person who signed may be subject to criminal penalties for representing that he or she had authority to sign this agreement on behalf of the corporation.

Notwithstanding any of the preceding terms and conditions to which this offer is subject, the taxpayer reserves the right to timely file and prosecute a claim or claims for refund or credit for the years stated in this form, based solely upon any or all of the grounds specified in the subparagraphs immediately following this paragraph. This offer is not to be construed as a claim for refund or credit, formal or informal, concerning the matters for which the right to file a claim or claims is reserved.

(a) The entitlement of Duke Power Company to claim additional 1986 and 1987 research and experimentation credits and related adjustments made to reflect changes in depreciation expense, as well as any adjustments to section 174 deductions related to these additional claims for research and experimentation credits (specifically including the taxpayer's Form 1120-X for 1986 and 1987 filed on or about September 23, 1999).

RECEIVED

MAY 10 2001

APPEALS OFFICE - GREENSBORO
SOUTHEAST REGION

Form 870-AD- (Rev. 4/1992)

Form 870-AD (rev. 04/1992)	Department of the Treasury-Internal Revenue Service Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment		
Symbols: AP LMSB GBO TM	Name of Taxpayer: Duke Energy Corporation and Affiliates: Formerly, Duke Power Company and Affiliates		SSN or EIN: 56-0205520
Under the provisions of section 6213(d) of the Internal Revenue code of 1986 (the Code), or corresponding provisions of prior internal revenue laws, the undersigned offers to waive the restrictions provided in section 6213(a) of the Code or corresponding provisions of prior internal revenue laws, and to consent to the assessment and collection of the following deficiencies and additions to tax, if any, with interest as provided by law. The undersigned offers also to accept the following overassessments, if any, as correct. Any waiver or acceptance of an overassessment is subject to any terms and conditions stated below and on the reverse side of this form.			
Deficiencies (Overassessments) and Additions to Tax			
Year Ended	Kind of Tax	Tax	
December 31, 1988	Income	(\$2,547,134.00)	
December 31, 1989	Income	\$14,865,822.00	
December 31, 1990	Income	(\$19,042,352.00)	
December 31, 1991	Income	(\$2,864,975.00)	
Accepted as of the date the Joint-Committee on Taxation completes its review without objection or the date accepted for the Commissioner, whichever is later.			
This offer must be accepted for the Commissioner of Internal Revenue and will take effect on the date it is accepted. Unless and until it is accepted, it will have no force or effect.			
If this offer is accepted, the case will not be reopened by the Commissioner unless there was: • fraud, malfeasance, concealment or misrepresentation of a material fact • an important mistake in mathematical calculation • a deficiency or overassessment resulting from adjustments made under Subchapters C and D of Chapter 63 concerning the tax treatment of partnership and subchapter S items determined at the partnership and corporate level • an excessive tentative allowance of a carryback provided by law			
No claim for refund or credit will be filed or prosecuted by the taxpayer for the years stated on this form, other than for amounts attributed to carrybacks provided by law. See exceptions on back.			
The proper filing of this offer, when accepted, will expedite assessment and billing (or overassessment, credit or refund) by adjusting the tax liability. This offer, when executed and timely submitted, will be considered a claim for refund for the above overassessment(s), if any.			
Signature of Taxpayer:			Date:
Signature of Taxpayer:			Date:
Signature of Taxpayer's Representative:			Date:
Corporate Name: Duke Energy Corporation and Affiliates: Formerly, Duke Power Company and Affiliates			Date:
By Corporate Officer:			Date:
Title: Vice President Signature: Thomas Mc Criston			2/6/2001
For Internal Revenue Use Only		Date Accepted for Commissioner: Mar. 11, 2001 Office: AP LMSB GBO TM	Signature: Title: Appeals Team Case Leader
(See second page for signature instructions)			

Form 870-AD-c (Rev. 4/1992)

This offer may be executed by the taxpayer's attorney, certified public accountant, or agent provided this is specifically authorized by a power of attorney which, if not previously filed, must accompany this form. If this offer is signed by a person acting in a fiduciary capacity (for example: an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, must accompany this form, unless previously filed.

If this offer is executed for a year for which a joint return was filed, it must be signed by both spouses unless one spouse, acting under a power of attorney, signs as agent for the other.

If this offer is executed by a corporation, it must be signed with the corporate name followed by the signature and title of the officer(s) authorized to sign. If the offer is accepted, as a condition of acceptance, any signature by or for a corporate officer will be considered a representation by that person and the corporation, to induce reliance, that such signature is binding under law for the corporation to be assessed the deficiencies or receive credit or refund under this agreement. If the corporation later contests the signature as being unauthorized on its behalf, the person who signed may be subject to criminal penalties for representing that he or she had authority to sign this agreement on behalf of the corporation.

Notwithstanding any of the preceding terms and conditions to which this offer is subject, the taxpayer reserves the right to timely file and prosecute a claim or claims for refund or credit for the years stated in this form, based solely upon any or all of the grounds specified in the subparagraphs immediately following this paragraph. This offer is not to be construed as a claim for refund or credit, formal or informal, concerning the matters for which the right to file a claim or claims is reserved.

(a) The entitlement of Duke Power Company to claim additional 1988 through 1991 research and experimentation credits and related adjustments made to reflect changes in depreciation expense, as well as any adjustments to section 174 deductions related to these additional claims for research and experimentation credits (specifically including the taxpayer's Form 1120-X for 1988 through 1991 filed on or about September 23, 1999).

(b) The entitlement of Duke Power Company to claim diesel fuel tax credits under the mobile machinery exception as defined in Treasury Regulations 48.4061(a)-1(d)(2)(i) for 1988 through 1991.

Form 870-AD
(rev. 04/1992)

Department of the Treasury-Internal Revenue Service

Offer to Waive Restrictions on Assessment and Collection
of Tax Deficiency and to Accept Overassessment

Symbols:
AP LMSB GBO TM

Name of Taxpayer: Duke Energy Corporation and Affiliates:
Formerly, Duke Power Company and Affiliates

SSN or EIN :
56-0205520

Under the provisions of section 6213(d) of the Internal Revenue code of 1986 (the Code), or corresponding provisions of prior internal revenue laws, the undersigned offers to waive the restrictions provided in section 6213(a) of the Code or corresponding provisions of prior internal revenue laws, and to consent to the assessment and collection of the following deficiencies and additions to tax, if any, with interest as provided by law. The undersigned offers also to accept the following overassessments, if any, as correct. Any waiver or acceptance of an overassessment is subject to any terms and conditions stated below and on the reverse side of this form.

Deficiencies (Overassessments)
and Additions to Tax

Year Ended	Kind of Tax	Tax				
December 31, 1992	Income	(\$12,158,532.00)				
December 31, 1993	Income	\$3,624,671.00				
December 31, 1994	Income	\$2,677,953.00				

Accepted as of the date the Joint Committee on Taxation completes its review without objection or the date accepted for the Commissioner, whichever is later.

This offer must be accepted for the Commissioner of Internal Revenue and will take effect on the date it is accepted. Unless and until it is accepted, it will have no force or effect.

If this offer is accepted, the case will not be reopened by the Commissioner unless there was:

- fraud, malfeasance, concealment or misrepresentation of a material fact
- an important mistake in mathematical calculation
- a deficiency or overassessment resulting from adjustments made under Subchapters C and D of Chapter 63 concerning the tax treatment of partnership and subchapter S items determined at the partnership and corporate level
- an excessive tentative allowance of a carryback provided by law

No claim for refund or credit will be filed or prosecuted by the taxpayer for the years stated on this form, other than for amounts attributed to carrybacks provided by law. See exceptions on back.

The proper filing of this offer, when accepted, will expedite assessment and billing (or overassessment, credit or refund) by adjusting the tax liability. This offer, when executed and timely submitted, will be considered a claim for refund for the above overassessment(s), if any.

Signature of Taxpayer:

Date:

Signature of Taxpayer:

Date:

Signature of Taxpayer's Representative:

Date:

Corporate Name: Duke Energy Corporation and Affiliates: Formerly, Duke Power Company and Affiliates

Date:

By Corporate Officer:

Title

Date:

For
Internal
Revenue
Use Only

Date Accepted for Commissioner:

Signature:

July 17, 2001
Office: AP LMSB GBO TM

Thomas McQuiston
Appeals Team Case Leader

(See second page for signature instructions)

Form 870-AD-c (Rev. 4/1992)

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Duke Energy Corporation,	)	Docket No. 10-ALJ-17-0270-CC
	)	
Petitioner,	)	
	)	
vs.	)	
	)	
South Carolina Department of	)	
Revenue,	)	
	)	
Respondent,	)	
	)	

Response to Duke Energy's Post-Hearing Memorandum of Law

Duke Energy erroneously contends that Section 12-54-80 provided a taxpayer with an alternative refund claim procedure. Post-Hrg. Br. at 7. This argument is unsupported by the applicable case law or the governing statutory provisions. The Department contended that South Carolina Code Sections 12-47-210 and 12-47-220 "were the exclusive remedy for obtaining a refund of income taxes" because that is what the Supreme Court said. *Bass v. State*, 307 S.C. 113, 116, 414 S.E.2d 110, 112 (1992) ("This Court has previously stated that the exclusive remedy for contesting an alleged erroneous assessment of income taxes [is] by payment under protest of the tax claimed as illegal and a suit at law for recovery of the sum so paid, in accordance with Sections 65-2661 and 65-2662 of the Code. [predecessors of §§ 12-47-210 and 12-47-220].") (internal quotation marks omitted) (emphasis added), *cert. granted, judgment vacated on other grounds by Bass v. S. Carolina*, 509 U.S. 916 and *abrogated by Harper v.*

Virginia Dept. of Taxation, 509 U.S. 86 (1993); *Perpetual Bldg. & Loan Ass'n of Columbia v. S. Carolina Tax Comm'n*, 255 S.C. 523, 527, 180 S.E.2d 195, 197 (1971) (same). Thus, until amendment of Section 12-47-440 by the General Assembly in 1994, "every taxpayer [was] required to pay the tax under protest and file an action in circuit court within 30 days of filing of its original tax returns." Post-Hrg. Br. at 7.¹

Under Duke Energy's erroneous theory, the taxpayers in *Bass* could have filed a claim for refund within 36 months after their return was filed. See S.C. Code Ann § 12-54-80 ("[T]he amount of taxes due on any return ... must be determined and assessed within [36] months from the date the return was filed"). There are several flaws in this theory. Most importantly, the Supreme Court expressly held that, at that time, section 12-47-210 and 12-47-220 were the "exclusive remedy" for contesting allegedly erroneously paid taxes. Following Duke Energy's theory, the taxpayers would have won if they had invoked the 36-month period codified by section 12-54-80 for assessments instead of the three-year period codified by section 12-47-440 for refunds. Similarly, the General Assembly need not have amended section 12-47-440 in 1994 to make the three-

¹ For the first time in any of its briefing on the Department's summary judgment motion, Duke Energy references "Due Process Clause concerns." The Court should not consider that argument because it could have been but was not raised previously by Duke Energy in its memorandum in opposition. In any event, the Supreme Court rejected the argument that limiting taxpayers to proceeding under section 12-47-210 and 12-47-220 constitutes a due process violation. *Bass*, 307 S.C. at 116, 414 S.E.2d at 112.

year refund period available to taxpayers if section 12-54-80 provided the same remedy with its 36-month period.

Duke Energy now contends that the Department is required to address its refund claims because it granted a refund of corporate income taxes in 2002. There are several problems with this argument, not the least of which is Duke Energy's submission after the hearing of a new affidavit from Cooper Monroe. Mr. Monroe's affidavit should not be accepted because it was not served at least two days before the hearing. *See* S.C. R. Civ. P. 56(c). In any event, that refund as applicable to the years before 1994 was granted based on IRS adjustments and the Department's exercise of its statutorily required duty and discretion. *See* S.C. Code Ann. §12-54-30 ("If the commission discovers on examination of a return or otherwise that the tax ... paid ... is in excess of the amount legally due, the commission may order a refund"). But as explained in the Department's memorandum, there was no further review of the Department's determination under this statute. *See* DOR Supp. Mem. pp.11-12; DOR Reply Mem. pp.6, 22-25. That is because section 12-54-30 was not a substitute for the refund procedures set forth in sections 12-47-210, 12-47-220, and 12-47-440. S.C. Tax Comm'n Decision 88-162, 1988 WL 409374 (June 30, 1988) [DOR Supp. Mem. Exhibit J, Tab 5] (concluding that section 12-54-30 did not modify the provisions of the applicable refund statutes). The Department's consideration and granting of a refund based on IRS adjustments and existing legal principles does not

translate into a blanket right for Duke Energy to file amended returns based on a novel legal theory not contemplated prior to 1994.

Duke Energy also argues that the extension provisions of section 12-54-80 modified the provisions of the refund statutes. Again, however, section 12-54-80 deals with assessments, not refunds. It is quite a leap to conclude that an assessment statute modified the time restrictions of a refund statute without ever using the word "refund," especially in view of the fact that the refund statutes contain absolutely no provision for an extension of time. *Cf. TNS Mills, Inc. v. S. Carolina Dept. of Rev.*, 331 S.C. 611, 620, 503 S.E.2d 471, 476 (1998) ("[I]f 12-4-730 is interpreted as allowing retroactive exemptions, the mandatory deadlines set by the General Assembly are rendered meaningless."). Moreover, it is clear that establishing time periods for refund claims is a legislative function that must be accomplished by statute. *Guar. Bank & Trust Co. v. S. Carolina Tax Comm'n*, 254 S.C. 82, 90-91, 173 S.E.2d 367, 371 (1970) (holding that circuit court erred in extending the time periods under the statute because that is a legislative and not a judicial function). When compared to the absence of any provision for extensions in sections 12-47-210, 12-47-220, or 12-47-440, the presence of that language in section 12-54-80 undermines Duke Energy's argument. Given the "exclusive remedy" provided by these refund statutes, it would be remarkable for the General Assembly to have established a separate taxpayer remedy in a statute governing the Department's duties and responsibilities without ever using the term "refund."

Thus, prior to 1995, a taxpayer was permitted to file a claim for refund only under sections 12-47-210 and 12-47-220 or, after 1990, under section 12-47-440. Depending upon the year at issue, these statutes required the taxpayer to "pay such taxes ... under protest in writing," S.C. Code Ann. §12-47-210, and to institute an action in circuit court within 30 days, S.C. Code Ann. § 12-47-220, or to file and "application ... to abate or refund ... such license fee or tax," S.C. Code Ann. §12-47-440. But a taxpayer's right to file a refund claim for income taxes was limited to proceeding under these statutes. *Bass*, 307 S.C. at 116, 414 S.E.2d at 112. An examination within the time period of section 12-54-80 or the grant of a refund of section 12-54-30 does not change this result. Nor does the execution of Forms FS-43, at least for the years prior to 1994. Rather, taxpayers could file their own refund claims only within the time periods set forth in sections 12-47-210, 12-47-220, or 12-47-440. Because Duke Energy did not comply with this condition precedent for the years prior to 1994, *see Dep't of Conservation v. Co-De Coal Co., Inc.*, 388 S.E.2d 614, 617 (1965), Duke Energy's refund claims are untimely for the years prior to 1994.

The IRS adjustments also do not separately provide a portal through which Duke Energy can file amended returns on issues wholly separate from those at issue in the IRS adjustments. South Carolina Code Section 12-54-140, enacted in 1985, addressed the process by which the Department could address changes made by the IRS. In pertinent part, the statute expressly notes that the time limitation for assessment or refund of taxes does not apply to

underpayments and overpayments “resulting from changes in income made by the [IRS].” S.C. Code Ann. § 12-54-140.² In other words, the time periods reopened only based on the changes made by the IRS, and the taxpayer received the benefit of those changes through the refund of more than \$9 million in 2002. Section 12-54-140 and its predecessor do not afford the taxpayer the benefit of reopening years for filing a refund claim based on any item set forth in the original return, which stands to reason given that a taxpayer would not want the Department to have the ability to assess taxes on items other than those encompassed within the federal adjustments.

Duke Energy closes with a reference to unlocated “Waiver agreements” for the years 1978-1983. There is no evidence that any such forms exist, no evidence about such forms presented to the Court at the hearing, and no evidence that this Court can consider in determining whether to grant summary judgment. To survive summary judgment, the non-moving party is not entitled to simply rest on the pleadings, but “must offer some evidence that a genuine issue of material fact exists for each element of the claim at issue except for those elements that are either uncontested or agreed to by stipulation.” *Kase v. Ebert & DMX Transp.*, 392 S.C. 57, 707 S.E.2d 456, 458 (Ct. App. 2011). That burden must be met on or before the hearing, as evidenced by the fact that Rule 56

² Section 12-7-2230 likely applied to years prior to 1985, but contained provisions similar to section 12-54-140 and, as such, also did not provide a portal for reopening the period for filing a refund claim. See generally DOR Reply Mem. pp.22-25.

requires submission of affidavits before the hearing. *See* S.C. R. Civ. P. 56(c); *see also Singleton v. Sherer*, 377 S.C. 185, 197-98, 659 S.E.2d 196, 203 (Ct. App. 2008) (party opposing summary judgment has affirmative duty “[o]nce the party moving for summary judgment meets the initial burden of showing an absence of evidentiary support for the opponent’s case”). In any event, any such forms or agreements would not modify the pertinent refund statutes for the reasons set forth by the Department above and in its supporting and reply memoranda previously submitted to the Court.

Finally, Duke Energy renews its arguments concerning estoppel and equitable tolling. Those arguments should be rejected for the reasons previously argued by the Department. *See* DOR Supp. Mem. pp.18-20; DOR Reply Mem. pp.15-22.

Conclusion

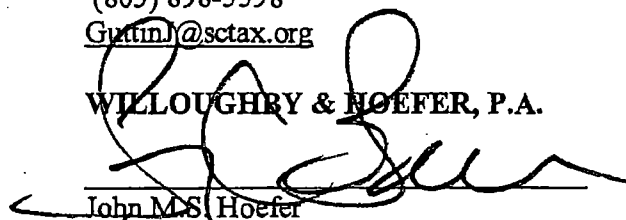
For the reasons set forth above and in the memoranda previously submitted by the Department, Duke Energy’s refund claims prior to 1994 should be denied as untimely.

Respectfully submitted,

**SOUTH CAROLINA DEPARTMENT
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Attorneys for South Carolina Department
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Columbia, South Carolina
July 9, 2012

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Duke Energy Corporation,	)	Docket No. 10-ALJ-17-0270-CC
	)	
Petitioner,	)	
	)	
vs.	)	
	)	
South Carolina Department of	)	
Revenue,	)	
	)	
Respondent,	)	

Response to Questions Presented by Court on July 13, 2012

The Court requested a response to the issues of whether Duke Energy's sales of securities is connected with Duke Energy's business for purposes of S.C. Code Ann. § 12-6-2220(5) and whether this issue constitutes a potential question of fact. This is the Department's response to those issues.

- I. Duke Energy's short-term investment transactions are "connected" with Duke Energy's business for the sole purpose of determining whether the gains or interest from these transactions should be allocated pursuant to S.C. Code Ann. § 12-6-2220(5).**

In denying Duke Energy's refund claims, the Department made no change to the apportionment of the gain or interest from short-term securities transactions as reported by Duke Energy on its original South Carolina corporate income tax returns for the years 1978 – 1999. The Department has previously taken the position that under the broad language of Section 12-6-2220(5), transactions like those entered into by Duke Energy are considered "connected" with the taxpayer's

business. See S.C. Tax Comm'n Decision I-D-389, 1986 WL 221855 (Nov. 14, 1986); S.C. Tax Comm'n Decision 89-87, 1989 WL 433795 (July 6, 1989); S.C. Tax Comm'n Decision 90-33, 1990 WL 512023 (July 23, 1990). Accordingly, it is the long-standing administrative position of the Department that the gain or interest resulting from these transactions is "connected" with a taxpayer's business as such term is used in Section 12-6-2220(5), and thus, should be apportioned rather than allocated.¹ Thus, the Department has historically concluded that the gain or interest from the short-term investment transactions like those at issue in this case should be apportioned, but the return of principal from those transactions should not be included in the apportionment factor. The Department recognizes that the Court has reached a different determination with respect to the inclusion of the principal of those transactions in the apportionment formula.

Moreover, the language of Section 12-6-2220(5) states that the "gains and losses from sales of intangible personal property" not connected with the business of the taxpayer must be allocated. As such, under a plain meaning interpretation, this section would not apply to many, if not all, of Duke Energy's short-term investment transactions because these transactions are not "*sales* of intangible property." Rather, Duke Energy typically holds the securities until the pertinent

¹ The determination that Duke Energy's short-term investment transactions are "connected" with the business of Duke Energy for purposes of Section 12-6-2220(5) does not change the Department's position that the return of principal from these transactions should be excluded from the calculation of Duke Energy's apportionment formula as the inclusion is distortive and does not represent the extent of Duke Energy's business activity in South Carolina.

maturity date or, in the case of "repo" transactions, simply returns the security to the true owner in exchange for more cash than was provided to the owner at the outset of the transaction.

II. Based on the Department's prior decisions, the Department does not believe that there is a question of fact regarding this issue.

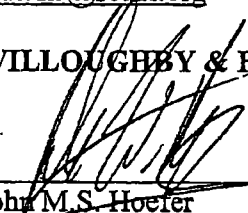
In light of the preceding analysis and the Department's previous decisions on the issue, it does not appear that there is a question of fact regarding the application of Section 12-6-2220(5) to the interest and gains from Duke Energy's short-term investment transactions.

Respectfully submitted,

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July 17, 2012

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

Docket No.: 10-ALJ-17-0270-CC

DUKE ENERGY'S MOTION FOR
RECONSIDERATION OF THE
COURT'S ORDER GRANTING THE
SOUTH CAROLINA DEPARTMENT
OF REVENUE'S MOTION FOR
SUMMARY JUDGMENT AS TO THE
WAIVER AND GROSS RECEIPTS
ISSUES

Pursuant to Rule 29(D) of the Rules of Procedure for the South Carolina Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, Duke Energy Corporation ("Duke Energy") respectfully submits this Motion for Reconsideration in connection with the Court's Order of August 9, 2012, ruling *inter alia* that, as a matter of law, (1) Duke Energy's refund claims for the tax periods 1978-1993 were untimely, and (2) Duke Energy is not permitted to include its gross receipts from sales of securities in the denominator of its apportionment formula ("Gross Receipts Issue").

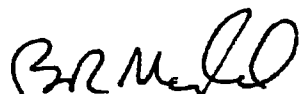
As more fully set out in the attached Memorandum of Authorities filed contemporaneously herewith, Duke Energy respectfully submits that the Court should reconsider its ruling with respect to (1) the Waiver Issue because an evidentiary hearing is necessary to resolve the material facts in dispute with respect to that issue, and (2) Gross Receipts Issue because Duke Energy is entitled to a judgment as a matter of law on

FILED

AUG 20 2012

that issue as South Carolina law requires Duke Energy to include all of its receipts from sales of securities in apportioning its income to South Carolina.

Respectfully submitted this 20 day of August 2012.



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Attorneys for Petitioner Duke Energy Corporation.

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

Docket No.: 10-ALJ-17-0270-CC

DUKE ENERGY'S MEMORANDUM
OF AUTHORITIES IN SUPPORT OF
ITS MOTION FOR
RECONSIDERATION OF THE
COURT'S ORDER GRANTING THE
SOUTH CAROLINA DEPARTMENT
OF REVENUE'S MOTION FOR
SUMMARY JUDGMENT AS TO THE
WAIVER AND GROSS RECEIPTS
ISSUES

INTRODUCTION

Pursuant to Rule 29(D) of the Rules of Procedure for the South Carolina Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, Duke Energy Corporation ("Duke Energy") respectfully requests that the Court reconsider its Order of August 9, 2012, ruling that, as a matter of law, Duke Energy's refund claims for the tax years 1978 through 1993 are untimely ("Waiver Issue"), and Duke Energy is not permitted to include its gross receipts from sales of securities in the denominator of its apportionment formula ("Gross Receipts Issue").

FACTUAL AND PROCEDURAL BACKGROUND

The South Carolina Department of Revenue ("Department") filed a Motion for Summary Judgment ("Department's Motion") asking this Court to rule, *inter alia*, that, as

a matter of law, (1) Duke Energy's refund claims for the tax years 1978 through 1993 are untimely, and (2) Duke Energy was permitted to include only the net proceeds from sales of securities in its South Carolina corporate income tax apportionment formula. Duke Energy filed a Reply and Cross-Motion for Partial Summary Judgment (Duke Energy's Cross-Motion) opposing the Department's Motion and asking this Court to rule, *inter alia*, that (1) genuine issues of material fact exist regarding the Waiver Issue that necessitate an evidentiary hearing, and (2) Duke Energy was required to include the entire proceeds from such sales of securities in its apportionment formula.

A hearing on the Department's Motion and Duke Energy's Cross-Motion was held on June 26, 2012. At the hearing, each party presented arguments in support of its position regarding the Waiver and Gross Receipts Issues.

On June 29, 2012, this Court held a telephone conference and informed the parties of the Court's decision (1) to grant the Department's Motion with regard to the Waiver Issue and to deny the Duke Energy's Cross-Motion with respect to the same issue, and (2) to grant Duke Energy's Cross-Motion with regard to the Gross Receipts Issue and to deny the Department's Motion with respect to the same issue. With regard to the Gross Receipts Issue, the Court further informed the parties that at the evidentiary hearing currently scheduled for September 4-10, 2012, the Department will have an opportunity to argue that South Carolina's alternative apportionment provision may apply and will have an opportunity to present evidence to support its position that the inclusion of the principal in Duke Energy's apportionment formula was distortive.

However, on August 9, 2012, this Court entered the Order in this summary judgment proceeding *granting* the Department's Motion with regard to the Gross Receipts Issue. The Order provided the following bases for its decision:

1. The inclusion of the principal from sales of securities in the standard apportionment formula would encourage excessive distortion or inevitably result in distortion.
2. The inclusion of the principal from sales of securities in the standard apportionment formula would produce an absurd result because it would lead to inevitable distortion and thus an increased application of the alternative apportionment statute.
3. "Gross Receipts," as used in the gross-receipts formula, does not include the principal from sales of securities because such amounts are not included in "gross income"/"taxable income."
4. "Sales," as used in the sales factor under the multi-factor apportionment formula, does not include the principal from sales of securities because "net income" excludes such amounts.

In the transmittal electronic mail of this Court's Order, the clerk of the Court noted:

Though Judge Anderson requested Duke Energy to submit a Proposed Order granting summary judgment to Duke Energy regarding the gross receipts issue, after further research and consideration he decided that the proper decision was to grant summary judgment to the Department.

For the reasons discussed below, Duke Energy respectfully moves this Court to vacate its Order and issue an order denying the Department's Motion with respect to the

Waiver Issue and granting Duke Energy's Cross-Motion with regard to the Gross Receipts Issue.

STANDARD OF REVIEW

Rule 29(D) of the Rules of Procedure for the South Carolina Administrative Law Court and Rule 59(e) of the South Carolina Rules of Civil Procedure, provide that the Court may grant a motion for reconsideration as a means to correct alleged errors, reconsider a possible misapprehension of an earlier argument, or revisit a previously raised argument. *Elam v. S. Carolina Dep't of Transp.*, 361 S.C. 9, 22, 602 S.E.2d 772, 779 (2004). As set forth below, this motion should be granted.

ARGUMENT AND CITATION OF AUTHORITY

I. The Court Erred in Concluding that Duke Energy's Refund Claims for the Tax Periods 1978-1993 Are Untimely as a Matter of Law.

The Department entered into an agreement with Duke Energy to extend the statutory period of time that the Department could assess tax and Duke Energy could seek a refund. The agreement between the Department and Duke Energy to waive the statute of limitations was reached verbally and in writing. Whether the Department agreed to extend the time for Duke Energy to file refund claims is a question of fact. *City of N. Myrtle Beach v. Lewis-Davis*, 360 S.C. 225, 235, 599 S.E.2d 462, 466-67 (Ct. App. 2004). Form FS-43 authorizes the Department to extend the statute of limitations for assessments *and* refunds. Thus, the existence of the Waivers, their effect, and their impact on the arguments raised by the Department are all factual issues that need to be determined as part of an evidentiary hearing before this Court.

Furthermore, the Department is estopped from arguing that Form FS-43 has no effect. Moreover, the statute of limitations was tolled during the tax years at issue and

Duke Energy's refund claims for the tax years 1978 -1993 should be allowed as timely. Accordingly, for these reasons and the reasons stated in Duke Energy's Cross-Motion, Duke Energy respectfully request that the Court amend its Order with regard to the Waiver Issue and conduct an evidentiary hearing to resolve the material facts in dispute with regard to that issue.

- II. The Court Erred in Concluding that Duke Energy Is Not Permitted to Include the Principal from Sales of Securities in Its Apportionment Formula.**
- 1. The Court Erred in Concluding that the Inclusion of the Principal from Sales of Securities in the Standard Apportionment Formula Would Encourage Distortion or Inevitably Result in Distortion.**

In determining the meaning of the term "gross receipts" and "sales," the Order stated that including the principal from sales of securities in the sales factor denominator or the gross-receipts factor denominator is improper because, in part, it would "inevitably" result in "distortion," "distortion of business activity representation," and "continuous underestimation of taxes due to distortions." ALC Order at 29-30. The Court reasoned that if all of the receipts from sales of securities were includable in the standard apportionment formula, "a corporation would have nothing to lose and everything to gain by adding return of principal to the denominator and thereby reducing the amount of taxes owed to South Carolina," which the Order qualified was a "potential for abuse by corporations." *Id.*

This analysis is misplaced. The only issue before the Court was whether, as a matter of law, the principal realized from sales of securities was included in the standard apportionment formula. Whether the inclusion of the principal results in distortion is an entirely separate and inherently factual question, to be addressed only after the standard

apportionment formula results have been determined. *See generally Media Gen.*

Commc'ns., Inc. v. South Carolina Dep't of Revenue, 388 S.C. 138, 147-48, 694 S.E.2d 525, 529 (2010). In other words, distortion falls under the second part of a two-part analysis. Under part one, if a transaction is a "sale"/"gross receipt" for purposes of the sales factor/gross-receipts factor of the standard apportionment formula, then it must be included in the taxpayer's apportionment formula. If such an inclusion is found to distort the revenue generating activities of the taxpayer, then part two of the analysis - the alternative apportionment statute - provides a specific mechanism for parties to deviate from the standard apportionment provision. *See CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, 397 S.C. 604, 611, 725 S.E.2d 711, 714 (S.C. Ct. App. 2012).

Notably, the Court itself recognized this two-part analysis during the summary judgment hearing:

The Court: Well, when you say it does not provide a reasonable basis, is that analysis more one that should be made in the **second stage** of - by this case or is that one that is more - I know you're going to say "yes," so it's more proper in determining what the statute says.

...

The Court: Because if it does result in something that's absurd, then you would find that the apportionment - the standard apportionment formula is one that should not be used and it would invoke the statute to allow you to use the more appropriate formula, is that not ...

...

Mr. Greene: If - yeah. If you - for instance, if you reach that conclusion, that gross receipts covers these types of transaction, the return of somebody's principal within 30 days is a gross receipt, it has to be added to the apportionment basis, then yes, we would go to the **next step**.

(Testimony Trans. 141:17-:23; 143:15-:18; 143:23-144:4; 144:5-:11, Exhibit A (emphasis added).)

In its Order, however, the Court subsumed distortion arguments (part two of the inquiry) into its analysis of the standard apportionment formula (part one of the inquiry) and held that “distortion [would] inevitably result[] from the inclusion of principal in the standard apportionment formula.” ALC Order at 29.

Not only is the Court’s analysis in direct conflict with South Carolina law, but it also renders South Carolina’s alternative apportionment statute set forth in S.C. Code Ann. section 12-6-2230 meaningless. The alternative apportionment statute is a “relief mechanism,” which authorizes a party to apply an alternative method to “effectuate an equitable apportionment of the taxpayer’s income” when the standard apportionment formula does not fairly represent the taxpayer’s business activities in the State. *Media Gen. Commc’ns*, 388 S.C. at 151, at 531. The Court’s reasoning presumes that the inclusion of principal is inherently distortive and the Court’s remedy of that distortion was its limited construction of the standard apportionment formula. The Court, thus, imputed an alternative apportionment mechanism into the standard apportionment provision. That was not, and could not have been, the intent of the Legislature in enacting both statutes.

South Carolina canons of statutory construction mandate that a statute must be construed in a manner that “no word, clause, sentence, provision or part shall be rendered surplusage, or superfluous, for the General Assembly obviously intended the statute to have some efficacy, or the Legislature would not have enacted it into law.” *CFRE, LLC v. Greenville County Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) (internal

quotations omitted). The standard apportionment formula statutes are intended to provide a reasonable representation of taxpayers' business activities in South Carolina. S.C. Code Ann. § 12-6-2210. The alternative apportionment statute is intended to provide a remedy for any inequities that may result from the application of the standard apportionment statute. Contrary to the Court's suggestion, the application of alternative apportionment cannot be said to constitute mere "futility of going through this extra-step process needlessly." ALC Order at 29. The Court is required by South Carolina law to apply the standard apportionment statute in a manner that gives full effect to the legislative intent of enacting the alternative apportionment statute and does not render it meaningless. *CFRE*, 395 S.C. 67, 716 S.E.2d 877. Therefore, the Court should reconsider and amend its holding.

2. The Court Erred in Holding that the Inclusion of the Principal from Sales of Securities in the Standard Apportionment Formula Would Produce an Absurd Result.

i. The Order erroneously determined that the inclusion of the principal in the standard apportionment formula produces an absurd result because it is inherently distortive.

The Court's Order determined that the inclusion of the principal from sales of securities in sales factor or gross-receipts factor denominator would produce an absurd application of the standard apportionment formula because it would lead to inevitable distortion of business activity representation. ALC Order at 28. The Order appears to conflate the "absurd result" analysis under the standard apportionment method and the distortion analysis under the alternative apportionment method.

As discussed above, a determination of distortion is inherently a factual issue to be addressed only after the standard apportionment formula results are determined. *Media*

Gen. Commc'ns, 388 S.C. 138, 694 S.E.2d 525; *CarMax Auto Superstores*, 397 S.C. at 611, 725 S.E.2d at 714. The Court must first apply South Carolina's apportionment provisions – including a calculation of the sales factor. Distortion is determined only after the apportionment results are calculated. See *CarMax Auto Superstores*, 397 S.C. at 611, 725 S.E.2d at 714.

This Court's application of its view of statutory construction – that a statute should not be interpreted to produce an “absurd result” – presupposes that the inclusion of the gross receipts in the apportionment factor is absurd. Concluding that inclusion of all of the receipts from the sales of securities produces an absurd result requires a factual inquiry of the nature of the taxpayer's activities in South Carolina, a comparison of that activity to the apportionment results (with and without gross receipts), and a factual finding that such a comparison produces an absurd result in most if not all cases. None of these steps were followed by this Court.

Duke Energy's inclusion of all of its gross receipts does not produce an absurd result or otherwise contradict the purpose of the standard apportionment statute. And certainly there is no evidence that including all of the receipts from sales of securities in the sales factor or gross-receipts factor denominator produces an absurd result in most, if not all, cases. The purpose of the standard apportionment formula is to reasonably represent the proportion of taxpayers' business carried on within South Carolina. S.C. Code Ann. § 12-6-2210; *Eastman Kodak Co. v. South Carolina Tax Comm'n*, 308 S.C. 415, 419, 418 S.E.2d 542, 544 (1992). In fact, the standard apportionment formula is intended to only provide a “rough approximation” of the income attributable to business activity in each state. *Covington Fabrics Corp. v. South Carolina Tax Comm'n*, 264 S.C.

59, 66-67, 212 S.E.2d 574, 577-78 (1975). This Order contains no analysis regarding why including all receipts from sales of securities in the gross-receipts/sales factor denominator is distortive or at a minimum does not (or could not) roughly approximate a taxpayers' business activity in South Carolina.

Duke Energy's sales of securities were conducted as part of its ordinary business operations. And as Duke Energy can prove at trial, and its experts have testified during depositions, including all of its receipts in its sales factor denominator using the standard apportionment formula reasonably represents the proportion of its business carried on in South Carolina. Thus far, there has been no evidence whatsoever to show that including all of the receipts from sales of securities in the sales factor denominator produces an absurd result for Duke Energy or any other taxpayer.

A court is permitted to deviate from a statute's plain language only when "the result would be so patently absurd that it is clear that the Legislature could not have intended such a result." *Harris v. Anderson County Sheriff's Office*, 381 S.C. 357, 363, 673 S.E.2d 423, 426 (2009) (internal citations and quotations omitted). The South Carolina Supreme Court has cautioned that "[a] merely conjectural absurdity is not enough; the result must be so patently absurd that it is clear that the General Assembly could not have intended such a result." *South Carolina Dep't of Revenue v. Blue Moon of Newberry*, 397 S.C. 256, 261, 725 S.E.2d 480, 484 (2012); *see also South Carolina Coastal Conservation League v. South Carolina Dep't of health & Envrtl. Control*, 2003 SC ENV LEXIS 12 (S.C. Admin. L. Ct. 2003) ("To justify a departure from the letter of the law ... the absurdity must be so gross as to shock the general moral or common sense. And there must be something to make plain the intent ... that the letter of the statute is

not to prevail.' Indeed, an adjudicating body should be less than quick to depart from the meaning of literal language when the controversy between the parties arises from differing views on policy. A provision 'is not absurd merely because it does not comport with one's notion of what constitutes good policy.'" (citing *Crooks v. Harrelson*, 282 U.S. 55, 59-60 (1930), and *Chapman v. Higbee Co.*, 319 F.3d 825 (6th Cir. 2003)).

In *Blue Moon of Newberry*, the South Carolina Supreme Court refused to adopt the Department's restricted interpretation of the plain language of a regulation promulgated by the Department, which permitted the sale of alcoholic beverages by nonprofit organizations only to "bona fide guests of members of such organizations." 397 S.C. at 258, 725 S.E.2d at 482. The regulation provided that "bona fide guests" are those "who accompany a member onto the premises or for whom the member has made prior arrangements with the management of the organization." *Id.* The Department took the position that the term "bona fide implies that the guest have some degree of familiarity or camaraderie with the member." *Id.* at 263, 484. The court rejected the Department's view on the grounds that "the plain language of the regulation contains no support of this, and the ordinary definition of bona fide does not require it." *Id.* at 264, 485. The court opined that to adopt the Department's position would constitute an "improper narrowing of the regulatory definition based on some notion of what a bona fide guest *should* be, not what the regulation actually provides. For us to do so therefore would require the abdication of our role as the interpreter of a regulation and the assumption of the position of a drafter." *Blue Moon of Newberry*, 397 S.C. at 264, 725 N.E.2d at 485 (emphasis original; internal citations omitted). Similarly in the instant

case, the Court should not restrict the meaning of "gross receipts" and "total sales" when the language of the statute does not contain or require any limitations.

The Department further argued that a broad interpretation of the term "bona fide guest" would "'eviscerate' the purpose of the regulation, which is to limit those who may consume alcohol on the premises of private clubs," and produce "an absurd result as it [will] effectively allow[] a private club to be open to the public." *Id.* at 265, 485. The court acknowledged that the plain language of the regulation "may permit some organizations to push the envelope on what it means to be 'private,'" but it nevertheless concluded that "we are not convinced the result is so absurd that we can ignore the regulation's plain language." *Id.* The court agreed with the lower court's dissent:

If the Department of Revenue has an issue with how the regulation itself defined "bona fide guest," then it may promulgate a new regulation as appropriate upon proper notice to the public. Until then, other businesses which follow the unambiguous language of the regulation should not be punished as a result.

Id. at 265, at 485.

Corporate treasury departments that sell securities on a regular basis are not a new phenomenon. And the Department has not argued that Duke Energy's sales of securities are in any way special or unique. Instead, the Department (and this Court) takes issue with the fact that the inclusion of principal from Duke Energy's sales of securities in its apportionment formula "does nothing more than artificially inflate the denominator of either the sales factor or gross receipt factor and thereby decrease the amount of income subject to tax in South Carolina." Resp. Mem. In Supp. of Motion for Sum. Judg. At 34; ALC Order at 28. Not only is there no requirement that taxpayers pay the *most* taxes as discussed in section 2.iii below, but the South Carolina's highest court has rejected this

reasoning. In *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 420 (1992), the South Carolina held that in apportioning its general business income from photography equipment and film processing to South Carolina, Kodak properly included receipts from safe harbor leasing transactions¹ in the denominator of its apportionment formula. Similar to Duke Energy's treasury function transactions, the safe harbor leasing "was a means of gaining working capital and increasing cash flow for all of plaintiff's business operations." *Id.* at 418-9 (quoting *National Service Industries v. Powers*, 98 N.C.App. 504, 391 S.E.2d 509 (N.C. App. 1990)). The South Carolina Tax Commission (now the Department) pointed out that "[t]he result is that Kodak, despite having virtually no safe harbor presence in South Carolina seeks to reduce its South Carolina taxable income by over 33% in 1984 and by over 90% in 1985." Tax Comm'n Brief. at 21 (Exhibit B); *see also* Richland County Ct. of Common Pleas at 25 (Exhibit C). The South Carolina Supreme Court disagreed with the Tax Commission (and the lower court) and held that:

This Court has held that the apportionment formula is a reasonable basis for establishing the income tax of corporations which, like Kodak, do business on a multistate level. *Covington Fabrics v. S. C. Tax Comm'n*, 264 S.C. 59, 212 S.E.2d 574 (1975). Since the safe harbor lease transactions were a part of Kodak's general business, they were properly included in the denominator of the apportionment formula in computing Kodak's national net income from payroll, property, and sales. The fact that a very small percentage of the leased assets are located in South Carolina is accounted for in the numerator of the apportionment formula in which Kodak's payroll, property,

¹ "These transactions ... allowed one corporation to transfer tax benefits to another corporation in the following scenario: One corporation (the lessee) needs special assets, generally equipment, but cannot utilize the related investment tax credits and depreciation deductions. The lessee corporation seeks a relationship with another corporation (the lessor, here Kodak), who makes an initial payment on the asset, then leases it back to the lessee. The lessee makes all other payments on the asset and retains legal title; however, the lessor utilizes the tax benefits associated with the asset." *Eastman Kodak*, 308 S.C. at 417.

and sales in this state are computed. Therefore, the apportionment formula reflects a "reasonable representation" of Kodak's business in this state.

Id. at 419.

Similarly, Duke Energy's sales of securities are connected with its trade or business and the Department has not argued otherwise. Thus, the inclusion of the principal from sales of securities in Duke Energy's apportionment formula does not produce a result that is so absurd to require the Court to ignore the plain meaning of the apportionment statutes. *See Capco of Summerville, Inc. v. J.H. Gayle Constr. Co.*, 368 S.C. 137, 144, 628 S.E.2d 38, 42 (2006) ("However, although we are troubled by this result, we are not at liberty to rewrite the statutes, and any amendment must come from the Legislature.")

Presumably, the South Carolina Legislature was troubled by the inclusion of the principal in the sales factor, which led to its changing the statute to exclude receipts. In 2007, the South Carolina Legislature substantially changed the apportionment formula by defining, for the first time, the terms "gross receipts" and "sales" and statutorily providing a list of transactions that are included in the gross-receipts/sales factor at gross, at net, or not at all. S.C. Code Ann. § 12-6-2295. This legislative change made clear that the sales of securities are excluded from the factor entirely. This Court's conclusion that "it is evident that the Legislature intended Section 12-6-2295 to clarify the existing law" cannot withstand a challenge as the Department (and this Court) allowed the sales of Duke Energy securities to be included at net – not excluded all together as the statutory regime now requires.

- ii. The Order erroneously determined that the inclusion of the principal in the standard apportionment formula would lead to an increased

application of the alternative apportionment formula and thus an absurdity.

The Order reasoned that the inclusion of the principal from sales of securities in the standard apportionment formula would produce an absurd result because the alternative apportionment statute would “become a standard follow-up to the application of the standard apportionment statute.” ALC Order at 28. The Order’s reasoning is misapplied. Whether the inclusion of the principal in the **standard apportionment formula** produces an absurd result does not require evaluation of the **alternative apportionment statute**.

The Order’s reasoning was also based on the mistaken presumption that the inclusion of the principal in the apportionment formula would always result in distortion. As discussed above, the determination of distortion is a factual inquiry which cannot be presumed to exist as a matter of law. Thus, the alternative apportionment provision would come into play only in unusual circumstances when, after conducting a factual analysis, the inclusion of the principal in the standard apportionment formula does not fairly represent (or is not a rough approximation of) the in-state business activities of a specific taxpayer, for a specific period.

Not only is the Order’s analysis misapplied, but it is impermissibly based on grounds not raised by the parties. The South Carolina Supreme Court has held that a trial court lacks authority to grant relief *sua sponte* on a ground not raised by a party. *See, e.g., State v. Dicapua*, 383 S.C. 394 (2009); *Southern Ry. Co. v. Coltex, Inc.*, 285 S.C. 213 (1985). The South Carolina Supreme Court allows courts to act *sua sponte* in very limited circumstances, typically involving the propriety of a court’s subject matter jurisdiction: “It is well settled that, but for a very few exceptional situations not present

here, an appellate court cannot address an issue unless it was raised to, and ruled upon by, the trial court." *Smith v. Phillips*, 318 S.C. 453, 455 (1995); *Lewis v. Local 382, IBEW*, 335 S.C. 562 (1999); *see also Lake v. Reeder Constr. Co.*, 330 S.C. 242, 248 (Ct. App. 1998) ("[L]ack of subject matter jurisdiction can be raised at any time, can be raised for the first time on appeal, and can be raised *sua sponte* by the court.").

The alternative apportionment argument contained in the Order (i.e., the function of the alternative apportionment provision and the effect of the inclusion of the principal in the standard apportionment formula on the alternative apportionment provision), a factual inquiry, was not raised by either party during the extensive briefing or at the summary judgment hearing. ALC Order at 26-30. In its Order, the Court devoted more than three pages to a discussion focusing on the notion that including the principal from sales of securities in Duke Energy's standard apportionment formula would lead to an increased application of the alternative apportionment statute and thus result in an absurdity. ALC Order at 28. This Court's line of reasoning is *sua sponte* decision-making and thus, Duke Energy respectfully asks the Court to vacate this portion of the Order.

- iii. **The Order erroneously determined that the inclusion of the principal in the standard apportionment formula would produce an absurd result because it would have negative impact the State's revenue collection and threaten administrative convenience.**

In reaching its decision that including all receipts in the standard apportionment formula leads to an "absurd result," the Court stated that a holding to the contrary would produce "continuous underestimation of taxes" and "equate to a rather sizeable sum lost to the State." ALC Order at 29-30. The Court also stated that the Department might not be able to detect [lost revenue] due to its "limited resources." *Id.* The Court further

engaged in a cost benefit analysis and held that “any benefits from this principal-inclusion method seem to be vastly outweighed by the great cost of revenue that this State would face through continuous underestimation of taxes due to distortions.” ALC order at 30. Each of these bases by the court are inappropriate and irrelevant in determining the meaning of the statute.

First, the Department has not submitted any evidence to this court that including the gross receipts from the sales of securities in the sales factor denominator would produce a continuous underestimation of taxes. Indeed, in many cases, depending on the size of the taxpayer, the location of its business operations, the type of industry it is in, and a variety of other factors, including all of the taxpayer’s gross receipts will fairly reflect its business activities. The plain meaning of a statute is not absurd simply because it results in less tax being paid. There is simply no rule of statutory construction that requires that taxpayers pay the *most* taxes. In fact, the Fourth Circuit has cautioned that:

“It cannot be said that giving effect to the plain meaning of the language would bring a result that is irrational or absurd, however much we may disagree with its necessity or wisdom. We have no right to fetter a broad provision with conditions not expressed and not essential to the execution of the law, for courts are not free to rewrite legislative enactments to give effect to the judges’ ideas of policy and fitness or the desirability of symmetry in statutes.”

United States v. Shirah, 253 F.2d 798, 800 (4th Cir. 1958).

With regard to the Department’s “limited resources”, it is unclear why the Department’s resources to test for distortion as part of its standard audit processes should be relevant when interpreting a statute. This is especially true in cases where there has been no showing that simply applying the standard apportionment formula and including

a taxpayers gross receipts produces anything but a fair reflection of most taxpayers' business activities in the State.

Furthermore, none of the above arguments were raised by the parties in their briefs or at the hearing and thus, it was improper for the Court to consider the administrative convenience and revenue implications to the State *sua sponte*.

3. The Court Erred in Interpreting the Meaning of "Gross Receipts" Based on the Definition of "Gross Income."

The Court erroneously determined that "gross receipts" excluded the principal from sales of securities because "gross income, and thus taxable income, necessarily exclude principal." ALC Order at 32. "Gross receipts" as used in the apportionment statutes and gross income/taxable income discussed by the Court relate to two entirely different tax concepts. A taxpayer's "gross income"/"taxable income" determines the total amount of money that can be subject to tax. *Media Gen. Commc'ns*, 388 S.C. at 145, 694 S.E.2d at 528. In contrast, "gross receipts" as used in the South Carolina income apportionment provisions determines the portion of that "gross income"/"taxable income" upon which the taxpayer would be subject to tax in South Carolina where business income is generated. *Id.* To describe the concepts colloquially, if gross income/taxable income is a cake, the gross-receipts apportionment provision would determine how many slices of the cake South Carolina is entitled to.

The South Carolina apportionment formula is designed to represent the extent of Duke Energy's business activities in South Carolina. The Court's reliance on the definition of "gross income"/"taxable income" in construing "gross receipts" results in a construction not intended by the Legislature.

As the Court correctly notes, "gross income" equals gross receipts expenses and other deductions, and "taxable income" equals gross income less any deductions allowed by state law. If "gross receipts" for purposes of the apportionment statute were interpreted to exclude expenses and all deductions granted by the State, then the apportionment formula would not be a reasonable representation of a taxpayer's business activities in the State as two identical businesses may be entitled to different deductions (e.g., economic development deduction). Accordingly, the Court's reliance on "gross income"/"taxable income" to limit the definition of "gross receipts" as used in the apportionment statute was an error.

Additionally, this chain of reasoning was not advanced by the parties in their briefs or during the summary judgment hearing and thus, it was improper for the Court to raise this issue *sua sponte*.

4. The Court Erred in Interpreting the Meaning of "Sales" Based on the Principle of "Income-Producing Activity."

The Court concluded that the principal from sales of securities was excluded from the term "sales" because the definition of the term contained the following language: "[i]f the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State." ALC Order at 33. The Court focused on the term "income" from the phrase "income-producing activity" and held that because income means "an actual gain or actual increase of wealth," then sales must mean "net" sales. ALC Order at 33.

At the outset, "income-producing," as used in the sales factor statute, is a cost-based sourcing principle applied in sourcing receipts to South Carolina for purposes of determining the numerator of the apportionment factor. The concept of income-producing activity has no bearing on the definition of "total sales" and whether the principal from sales of securities should be included in the sales factor denominator.

The Court cited to *Texaco* in support of its holding. Once again, however, the Court appears to conflate the concept of taxable income with the concept of apportioning income. The *Texaco* court was clear that "a corporation's entire net income is apportioned to this state by applying to that entire net income a percentage based on the 'three-factor formula' of property, payroll, and sales in this state to the corporation's total property, payroll, and sales." *Texaco, Inc. v. Wasson*, 269 S.C. 255, 259, 237 S.E.2d 75, 76 (1977). The *Texaco* court's reference to "net income" is a reference to the cake, and not how much of the cake South Carolina is entitled to. It is the "percentage" the court referenced that would actually determine how much of the cake would be attributed to South Carolina. The definition of "sales" in the instant case is only relevant for purposes of determining the apportionment "percentage," and not the taxable "net income." In other words, net income is the base to which the apportionment formula is applied to, to determine the portion of the base South Carolina is entitled to tax. Therefore, the concept of "net income" has no relevance to the issue before the Court here, i.e., the definition of "sales" for purposes of the apportionment statute.

The Court also relies on *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 418 S.E.2d 542 (1992). However, this case is simply irrelevant. The issue before the *Eastman Kodak* court was whether receipts from certain transactions were business

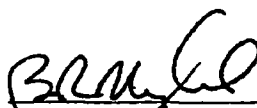
income and thus includable in the apportionment formula denominator, or non-business income and thus allocable. The court held that the receipts at issue constituted business income and were properly includable in the apportionment formula. The Court correctly noted the use of the phrase "net sales, payroll, and property" by the *Eastman Kodak* court. However, the court used the same phrase two additional times without the term "net." *Id.* at 419. Moreover, the issue of whether the receipts from the transactions were included at "gross" or "net" was not before the Court.

Further, this argument was not raised in the briefs of either party or during the hearing and therefore, it was improper for the Court to raise this issue *sua sponte* and rely on it in making its decision.

CONCLUSION

For all of the above reasons, the Court should grant Duke Energy's Motion for Reconsideration and vacate its prior opinion as reflected in its Order with respect to the Waiver and Gross Receipts Issues.

Respectfully submitted this 20 day of August 2012.



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Exhibit A

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1 MR. GREEN: Thank you, Your Honor.

2 THE COURT: All right.

3 REPLY ARGUMENT BY MR. GREEN:

4 MR. GREEN: Thank you, Your Honor. I just have a
5 few points.

6 You've obviously heard and read a lot for this,
7 so I will not going into great detail on the
8 issues. I'll just try to respond to a few
9 things that I noted. I think I'll go in
10 reverse order.

11 There's been some discussion about the nature
12 of the agency precedent here. It didn't deal
13 with this precise issue. I mean, that's
14 readily apparent. It did, however, deal with
15 intangibles. We're dealing with intangible
16 transactions here and, more particularly, we're
17 dealing with products that are essentially
18 loans, they're repos, or loan in exchange
19 for -- secured by a security.

20 As found by the General Motors case, commercial
21 paper really is a short-term loan. A municipal
22 bond is a loan. It is a loan and it is an
23 agreement to pay money in the future. They may
24 have a security nature, but it is a loan to pay
25 an amount and those are the type of

1 transactions that we're dealing with here.
2 The taxpayer's argument is to include the
3 principal from the return of that loan here,
4 which is the same as the type of transaction
5 the intangibles address in the prior agency
6 rulings,
7 So we'd submit, Your Honor -- and we'd submit
8 that even aside from the agency precedent,
9 frankly, by applying the material -- or the
10 authorities and sources we've referenced in our
11 brief, it would lead you to the same
12 conclusion, which is that including principal
13 in transactions such as these is inappropriate
14 and does not provide a reasonable basis on
15 which to determine income properly reported in
16 South Carolina.
17 THE COURT: Well, when you say it doesn't provide a
18 reasonable basis, is that analysis more one
19 that should be made in the second stage of --
20 by this case or is that one that is one that is
21 more -- I know you're going to say "yes," so
22 it's more proper in determining what the
23 statute says.
24 MR. GREEN: Admittedly, Your Honor, they're probably
25 a pretty similar analyses, frankly. I think

1 the reason that you can consider it here partly
2 is the agency precedent. Partly is -- and, in
3 fact, I think we cited -- I'm sorry, Your
4 Honor?

5 THE COURT: If I find agency precedent, I have to
6 find compelling reasons to go otherwise.

7 MR. GREEN: Yes, sir.

8 THE COURT: But if the statute is clear on its face,
9 then that would be compelling reasons.

10 MR. GREEN: If you --

11 THE COURT: If it's plain, plainly says "gross" ...

12 MR. GREEN: Gross receipts.

13 THE COURT: Receipts, yeah.

14 MR. GREEN: Yes, Your Honor. Yes, if you found the
15 statute plain on its face, that is true. I
16 would submit, however, that your interpretation
17 is not to take the gross receipts in isolation
18 from that statute, but interpret along that
19 statutory framework, which is determining a
20 factor, a factor to determine the amount of
21 income to be reported to South Carolina that
22 under 2210 provides a reasonable basis. I
23 forget exactly the language. We've obviously
24 quoted it ad nauseum in our brief.

25 THE COURT: Yeah.

1 MR. GREEN: That provides a reasonable -- I think
2 the cases that we've cited that I mentioned in
3 my earlier presentation is that you interpret
4 it in light of the framework and not just take
5 that term out in isolation. And I think you're
6 also not supposed to do interpretations that
7 lead to absurd results.

8 THE COURT: Okay.

9 MR. GREEN: We submit that it would be an absurd
10 result that making short-term securities
11 transactions, which it's undisputed there's
12 never been a loss, and then getting that money
13 back and that goes in the denominator, that is
14 an absurd result.

15 THE COURT: It is a result, though, for which the
16 existing statutory framework provides a remedy
17 for if it would be an absurd result. Is it
18 not, though?

19 MR. GREEN: There --

20 THE COURT: Are you following what I'm getting at?

21 MR. GREEN: I am following, yes, sir. I think I am,
22 Your Honor.

23 THE COURT: Because if it does result in something
24 that's absurd, then you would find that the
25 apportionment -- the standard apportionment

1 formula is one that should not be used and it
2 would invoke the statute to allow you to use
3 the more appropriate apportioning formula, is
4 that not ...

5 MR. GREEN: If -- yeah. If you -- for instance, if
6 you reach that conclusion, that gross receipts
7 covers these types of transactions, the return
8 of somebody's principal within 30 days is a
9 gross receipt, it has to be added to the
10 apportionment basis, then yes, we would go to
11 the next step.

12 THE COURT: Well, what I'm getting at is, you're
13 asking me to look at the statute as a whole.
14 They could equally be asking me to look at the
15 statute as a whole to accomplish their result,
16 too. So that's what I'm trying to figure: Who
17 gets the whole?

18 MR. GREEN: Understood, Your Honor. And we
19 obviously think we're entitled to the whole --

20 THE COURT: And who falls in it?

21 MR. GREEN: We obviously think we're entitled to
22 that.

23 THE COURT: I guess one side gets W-H-O-L-E and the
24 other falls into H-O-L-E.

25 MR. GREEN: Yes, Your Honor. Yes, Your Honor.

1 But determining -- we would submit that
2 determining the definition of that term in the
3 first place, because you're doing it in the
4 context of a factor. The alternative
5 apportionment deals with what happens if that
6 factor's applied. So we submit that you're
7 interpreting in the context of the factor in
8 light of 2210.

9 THE COURT: And not?

10 MR. GREEN: And then based on agency precedent,
11 obviously.

12 THE COURT: And why would 22...

13 MR. GREEN: I think 10, which provides a reasonable
14 basis for determining income in this state.
15 Isn't it 2210?

16 THE COURT: Well, make sure you got the right one,
17 so I can go back and look at all this.

18 MR. GREEN: Yes, 12-6-2210: If a taxpayer's
19 transacting or conducting business within or
20 without the State, income tax is imposed upon
21 a base which reasonably represents the
22 proportion of the trade or business carried on
23 within this state.

24 And I submit to Your Honor, you know, it's more
25 than just me saying, "Oh, that's a great

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Exhibit B

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STATEMENT OF ISSUES ON APPEAL¹

I.

Did the Trial Court correctly conclude that Kodak's inclusion in its apportionable income of the losses from safe harbor leasing activities was improper when the Court found such losses are allocated by S.C. Code Ann. § 12-7-1120(3) (Supp. 1990) to the states in which the property is located since the losses resulted from rental property not connected with Kodak's business?

¹ Not all issues addressed by the Trial Court are on appeal. Three have been abandoned. The Trial Court found (Tr., pp. 18-20) a portion of the 1984 refund claim was untimely and thus improper. Kodak's Brief (ftn. 2, pp. 6-7) states its 1984 claim is abandoned for the additional loss of \$230 million. Additionally, the Trial Court ruled (Tr., pp. 36-40) that its holdings did not violate Interstate Commerce, Equal Protection or Due Process. Kodak, in its Statement of Issues on Appeal, does not identify any of these issues as being appealed. Rule 207(b)(1)(B), SCACR, states no point will be considered on appeal which is not set forth in the statement of issues on appeal. Likewise, no argument on such issues is made in the Brief. Matters which are neither identified as an issue nor argued in the brief are deemed abandoned and are not before this Court. Gold Kist, Inc. v. Citizens & Southern National Bank of S. C., 286 S.C. 272, 333 S.E.2d 67, 70 (App. 1985). Finally, the Trial Court (Tr., pp. 16-18) held subject matter jurisdiction was present since the matter was a payment under protest suit under § 12-47-220 rather than a claim for refund under § 12-47-440. The Tax Commission does not challenge this determination, and makes no argument on this ruling.

II.

Did the Trial Court correctly conclude that Kodak's application of the apportionment method is improper where it leads to a result that is contrary to the legislative intent established by the reasonableness test of S.C. Code Ann. § 12-7-250 (1976) and where such method improperly joins the non-unitary safe harbor leasing activities with other unitary activities of Kodak?

III.

Did the Trial Court correctly conclude that Kodak's alternative view that it is allowed to claim the depreciation resulting from the safe harbor rental property is incorrect where the depreciation deduction is a related expense to the rental losses and must be treated in the same manner as all other related income and expenses?

STATEMENT OF THE CASE.

In this action, commenced on July 6, 1989, Eastmar Kodak Company (Kodak or taxpayer) seeks a refund under South Carolina Code Ann. § 12-47-440 (1976) of income tax in the amount of \$1,202,639 under one theory of the case and \$1,090,624 under an alternative theory. The taxes in dispute result from an audit of and subsequent claims for refund on the 1984 and 1985 tax years of Kodak. The taxpayer claimed losses from rental activity resulting from what are commonly called "safe harbor leases." The Tax Commission found that the losses could not be used as a part of Kodak's apportionable income, but rather, that such losses were allocated to the states where the rental properties were located. Additionally, the Tax Commission found that even if the losses were apportionable, only an inconsequential portion of the loss was attributable to South Carolina so that the refund sought must be denied.

The matter was heard by Judge Lockemy in a non-jury trial in Richland County on June 6, 1990, with additional arguments heard on October 17, 1990. In the Trial Court, the taxpayer advanced its view that the losses were part of Kodak's apportionable income and in the alternative that it should be allowed to deduct the depreciation associated with the leases. The Tax Commission asserted the rental losses were not apportionable, but rather, should be allocated to

the states where the property was located. Further, the Tax Commission asserted that even if apportionment of the rental losses were proper, the rental activity was not part of Kodak's unitary business and thus such losses were not apportioned to South Carolina. Finally, as to Kodak's alternative argument, the Tax Commission asserted the depreciation deductions were not allowable in South Carolina since they were required to be allocated or apportioned in the same manner as the rental losses.

Judge Lockemy's Order, issued and filed on December 12, 1990, denied the taxpayer's refund request. The Court held the rental losses were allocated to the place where the rental property was located, the depreciation was treated in the same manner, and even if apportionment were proper for the rental losses such did not result in a refund to the taxpayer since the safe harbor rental activity was not unitary with Kodak's other activities.

On January 9, 1991, the taxpayer appealed the Order of Judge Lockemy. On that same date, the taxpayer served its Notice of Appeal on the Tax Commission.

ARGUMENT I

KODAK'S INCLUSION OF THE LOSSES FROM ITS SAFE HARBOR LEASING ACTIVITIES IN ITS APPORTIONABLE INCOME IS IMPROPER SINCE SUCH LOSSES ARE ALLOCATED BY S.C. CODE ANN. § 12-7-1120(3) (SUPP. 1990) TO THE STATES IN WHICH THE PROPERTY IS LOCATED SINCE THE LOSSES RESULT FROM RENTAL PROPERTY NOT CONNECTED WITH KODAK'S BUSINESS.

South Carolina does not tax all of the income of a taxpayer. Rather, after determining that a taxpayer is subject to South Carolina's taxing statutes, the concern becomes one of deciding how much of the taxpayer's income is taxable in South Carolina. For a taxpayer like Kodak, the first applicable statute in addressing this problem is § 12-7-1120. That Section and its subsections identify designated classes of income less related expenses which are assigned or allocated to locations specified in the statute. In the instant case, the parties have disagreed on the application of one of the subsections, § 12-7-1120(3).

The following items of income shall be specifically and directly allocated in accordance with the following provisions before apportionment of the remaining net income and such items shall not be included in any factor of the apportionment formula:

(3) Rents received from the lease or rental of real estate or tangible personal property, royalties received from tangible property, where the property leased or rented was not used in or was not connected with the trade or business of the taxpayer during the income year, less all related expenses, shall be allocated to the state in which the property was located at the time the income was derived.

That provision allocates rental income less related expenses to the "state in which the property was located" as long as the rental property is "not used in . . . or connected with the business." The Trial Court correctly found the elements of this statute are satisfied and that allocation of the safe harbor rental losses is proper.

A. The Losses In Dispute Are Due to Rental Income From Property Located Outside of South Carolina.

Subsection (3) of the statute is applicable if rental income is in issue. The Trial Court found that both the 1984 and 1985 tax returns show rental income and related expenses resulting in a rental net loss from the safe harbor activities. (Tr., p. 26) Additionally, Kodak, at page 2, Statement of the Case, Initial Brief of the Appellant, states that:

[d]uring the years in question, expenses associated with the leases exceeded the rental income thereby producing a loss from these transactions.

Thus Kodak agrees that the first element of the statute is satisfied in that it states that the income is rental income and expense, and further, it makes no argument that the income here in dispute is anything other than rental income and related rental expenses yielding a rental loss.

Additionally, the Trial Court factually held that both the rental property and the rental income were located outside the state except for a minute amount having no real impact on the refund sought by Kodak. The cost of the property used to generate the safe harbor rental income for the 1984 and 1985 tax years was over \$2 billion with all property located outside the state except for only \$32,000 having a physical location in South Carolina. (Tr., pp. 14, 24) In the same vein, the rental income from the safe harbor leasing was over \$200 million, all of which, was outside the state except for approximately \$10,000 in South Carolina. (Tr., pp. 14, 24)

Finally, the Trial Court in an effort to clearly establish this point asked counsel for Kodak the following:

In other words, we're dealing with lease income received by Eastman Kodak from property located outside of the State?

The response by counsel was: "That is correct." (Tr., p. 43)

B. The Rental Property Is Not Connected With The Business Of The Taxpayer.

Having determined the income is rental and is from property located outside the state, the statute requires that the rental property not be used in or connected with the business of the taxpayer. The Trial Court applied the proper legal standard and factually made a correct determination that the rental properties were not used in or connected with Kodak's business.

1. The Application of the Phrase "Not Connected With the Business" Is Based on a Common Sense Approach Applied To The Facts Of Each Case On A Case By Case Basis.

- a. The Development Of The Legal Standard.

The legal standard for applying the phrase "not connected with the business" has been established in Texaco, Inc. v. Wasson, 269 S.C. 255, 266, 237 S.E.2d 75, 80 (1977), and reiterated in M. Lowenstein Corp. v. South Carolina Tax Commission, 298 S.C. 93, 378 S.E.2d 272, 275 (S.C. App. 1989).

Texaco, [supra] sets forth a common sense approach which, [is to be] applied to the facts of the instant case, . . .

This common-sense approach has been applied on a case by case basis, and thus far, two opinions of the appellate courts have addressed the issue. A third case, Dalton v. South Carolina Tax Commission, ___ S.C. ___, 367 S.E.2d 459, 464 (S.C. App. 1988), raises the issue, but there the court found:

. . . the taxpayers have asserted to this Court that none of the properties are in or connected with a business.

Accordingly, the Court was not required to examine the factual background, but rather, relied upon the taxpayers' admission in finding there was no connection of the assets with the business.

The common-sense approach as applied in Texaco, supra, found that royalties from salt and sulfur deposits were connected with Texaco's business, and thus such income was not allocated, but rather was apportioned. The facts demonstrated that the properties upon which the deposits were found were acquired for Texaco's exploration process. Rather than discovering oil and gas, Texaco discovered salt and sulfur. Since the properties were part of the exploration properties, i.e., a part of the exact business in which Texaco was engaged, the Court had no trouble finding the properties were connected with the business.

The application of the common-sense test was more involved in M. Lowenstein, supra, since the property that was tested for the "not connected with" phrase was an intangible. There the court had to establish what factors could "connect" the intangibles (the demand notes) to a business. The court first reviewed the facts concerning demand notes and found numerous instances where the business activities were coordinated to both create the notes and to utilize the note repayments and note income in the day-to-day business of the taxpayer. Under such circumstances, the Court was again correct in finding the common-sense approach required the income from the intangibles to be apportioned on the basis that the intangibles (the demand notes) were connected to the business. Thus

the common sense test is a factual one to be applied on a case by case basis.

b. The Adoption Of I.R.C. Section 168
Did Not Nullify The Common-Sense
Connection Standard Of § 12-7-1120(3).

Kodak argues in its Brief at pages 19-21 that the adoption of § 168(f)(8) of the Internal Revenue Code (I.R.C.) makes § 12-7-1120(3) inapplicable to rental income from safe harbor leasing. It first bases this view on asserting there is a conflict between S.C. Code Ann. § 12-7-700(8) (1976) and § 12-7-1120(3) (Kodak's Brief, pp. 19-20), and second, it argues § 12-7-1120(3) is inapplicable since as a matter of law the adoption of I.R.C. § 168(f)(8) makes the safe harbor assets connected with the business of Kodak. (Kodak's Brief pp. 20-21) Kodak is incorrect in both assertions.

It is settled that the deduction sections of S.C. Code Ann. § 12-7-700 are not in conflict with the provisions of § 12-7-1120(3). Dalton v. South Carolina Tax Commission, supra. There a taxpayer claimed a deduction for interest paid and ignored the allocation provisions of § 12-7-1120(3). The court held that the interest deduction claimed by the taxpayer was improper and that § 12-7-1120(3) allocated the interest deduction to the state where the rental property related to the interest expense was located. Thus the court clearly established that there was no con-

flict between § 12-7-700 and § 12-7-1120(3), and if there were a conflict, it would be § 12-7-1120(3) that controlled over § 12-7-700.

The adoption by South Carolina of I.R.C. § 168(f)(8) did not make safe harbor assets "connected with the business." This position advanced by Kodak shows a fundamental misunderstanding of the apportionment and allocation system in South Carolina. Kodak believes that as a matter of law, the mere adoption of I.R.C. § 168 requires the apportionment of safe harbor income. It does not offer any legislative history to support this conclusion but instead relies upon the view that I.R.C. § 168 placed Kodak in the shoes of the lessee. Kodak reasons that since the federal tax attributes are attributed to Kodak, then it is proper to make "the assumption that the assets are used in Kodak's business." (Kodak's Brief, p. 21) The fallacy of this "assumption" is that the I.R.C. has no requirement that assets be used in the business for purposes of allocating income. Rather, there is no requirement that income be allocated or apportioned under the I.R.C. to decide in what state the taxpayer's income was earned. The I.R.C. has no concept relevant to whether assets are connected with a business or not for purposes of finding where the income is earned. Thus the mere adoption of a federal statute that is unconcerned with "connected" or "not connected" can be no ba-

sis for an "assumption" that the assets are used in a business. In fact, the better assumption is to recognize that the General Assembly knows quite well how the allocation and apportionment statutes operate. Had the Legislature wanted all safe harbor activities apportioned it could have easily stated its desire in the statute. The fact that there is no mention of a method is reason enough to believe the General Assembly intended to apply the normal rules of allocation and apportionment without establishing an assumption of apportionment.

2. The Factual Findings Of The Trial Court Are Decisive Of This Issue And Establish That The Rental Properties Are Not Connected With The Taxpayer's Business.

a. The Standard Of Review Is The "Any Evidence" Standard Used For Actions At Law.

Before reviewing the factual basis for the court's conclusion, it is significant to note the standard of review to be exercised by an appellate court. In actions at law, the appellate court may not find facts in accordance with its own view of the preponderance of the evidence, but rather, the Lower Court must be affirmed where there is "any evidence" to support its findings. Townes Associates, Ltd. v. City of Greenville, 266 S.C. 81, 221 S.E.2d 773 (1976). The current action seeks the recovery of taxes. In South Carolina an action to recover taxes is not in the same nature as a common law action, but rather:

[t]he right to recover taxes from the State was created by statute [with] the statutory recovery of taxes paid to the government [being] a unique proceeding.

C. W. Matthews Contracting v. South Carolina Tax Commission, 267 S.C. 548, 230 S.E.2d 223, 226 (1976).

The Trial Court held that the instant case was before the court as a payment under protest since the taxpayer was audited and its funds involuntarily withheld. These actions prompted Kodak to protest the retention and to bring this suit to recover the funds. Such actions for recovery of taxes paid under protest have been held to be actions at law and subject to the "any evidence" standard of review. Citadel Foundation v. South Carolina Tax Commission, 279 S.C. 443, 308 S.E.2d 797 (1983); and M. Lowenstein, supra, at fn. 1, p. 273.

b. The Evidence Before The Court Was Sufficient To Conclude The Assets Were Not Connected With The Business.

When the Trial Court examined the evidence presented to it, it applied the common-sense approach of Texaco, supra, and found there was insufficient proof to show the safe harbor rental properties were connected to the business, and thus, found that allocation was the proper result. The Trial Judge found evidence of a lack of a connection in that when the annual reports described Kodak's business there was no mention of the safe harbor leases, not-

[REDACTED]

withstanding the fact that the safe harbor assets represented over 16% of Kodak's total assets. (Tr., p. 27) Surely such an activity of this magnitude would be described in the annual report as part of Kodak's business. Additionally, the Trial Judge found further lack of connections to the business in that the testimony and evidence established that Kodak had inconsequential management duties and that it had no maintenance duties over the rental properties. (Tr., p. 27) Significantly, the court found that Kodak did not even have legal title to the property and that the lessee could sell the property without permission from or notice to Kodak. (Tr., p. 27) Based on the totality of the evidence and testimony, the Trial Court correctly found the safe harbor rental property was not connected with the business of Kodak.

c. Kodak Incorrectly Asserts That As A Factual Matter The Safe Harbor Assets Are Connected With Kodak's Business.

Kodak argues in its Brief that the evidence before the court was sufficient to show the safe harbor assets here in dispute are connected to Kodak's business. (Kodak's Brief, pp. 22-29) Kodak, however, has avoided the analysis required to determine if the safe harbor assets are connected with its business. Instead of examining the real issue of whether the safe harbor assets themselves are connected with Kodak's business, Kodak has created an issue that is

not before the court by analyzing whether the tax benefits resulting from the assets have been of assistance to Kodak. This misconception by Kodak is discussed in this section.

Kodak asserts the test of M. Lowenstein Corp. v. South Carolina Tax Commission, supra, is satisfied and that such test can be used to determine when its safe harbor assets are connected with a business. (Kodak's Brief, pp. 22-26) Such a view is incorrect.

While Lowenstein, supra, does set forth a view of when an asset is connected with a business it is important to note that Lowenstein dealt with determining when an intangible asset was connected with a business. There the court was concerned with notes and bonds that generated interest and gains. In determining whether the intangible was "connected" to the business or not, the court found six indirect evidences of connection to the ordinary business. These connections established the intangibles were used as an integral part of the regular business. The court's attention is called to the fact that the cases cited by Kodak at pp. 24-26 in its Brief deal with a court determining whether an item is sufficiently integrated with the taxpayer's ordinary business so as to be a part of that business. The cases cited by Kodak, of which the following are representative, deal with determining if an asset is an integral part of the normal business so as to be included in the

[REDACTED]

income of that business. None address the issue of whether rental property is part of a business: Great Lakes Pipe Line Co. v. Com. of Taxation, 138 N.W.2d 612 (1965), interest income from securities used regularly in the business; Montgomery Ward & Co. v. Com. of Taxation, 151 N.W.2d 294 (1967), interest from intangibles with the interest regularly placed in ordinary activities of the business; Xerox Corp. v. Comptroller of Treasury, 428 A.2d 1208 (1981), loans to a subsidiary used in the furtherance of the parents' business; Holiday Inns, Inc. v. Olsen, 692 S.W.2d 850 (1985), interest from notes and short term investments used in the normal business; Champion Int. Corp. v. Bureau of Rev., 540 P.2d 1300 (1975), the income from intangibles was used for future business needs; Qualls v. Montgomery Ward, 585 S.W.2d 18 (1979), income from intangibles in form of notes was used for business inventory purchases; Atlantic Richfield Co. v. State, 601 P.2d 628 (1979), gain on sale of stock; W. R. Grace and Co. v. Com. of Revenue, 393 N.E.2d 330 (1979), gain on a stock sale; People ex rel. Cone v. Graves, 5 N.Y.S.2d 621 (1938), gain on sale of stock exchange Membership; District of Columbia v. Pierce, 462 A.2d 1129 (1983), insurance proceeds from plant facility integral to the business; Welded Tube Co. v. Commonwealth, 515 A.2d 988 (1986), gain on sale of plant integral to the business.

The Lowenstein test is not satisfied in Kodak's case. The regular business of Lowenstein was the manufacture of textile products and the testimony in that case was that the intangibles (the bonds) were issued "because the company needed the funds to put into their operations." Thus the intangibles were part of the operations and integral to the regular business of the taxpayer. Likewise, as to the business of Clark-Schwebel, the notes were repaid on intervals to coincide with the need for cash in the regular business of making fiberglass. The situation present in Lowenstein is not present in this case since the court here is not dealing with either an intangible or assets that are integral to Kodak's business.

First, this action does not deal with intangibles. Kodak's focus on the intangibles of the tax benefits does not answer the question. The question in the instant case is whether the rental assets are connected to Kodak's business and not whether the intangible tax benefits are connected. If the Court were asked to decide the right of South Carolina to tax the gain on the sale of the tax benefits as was the court in Portland General Electric v. Dept. of Revenue, 11 Or. Tax 78 (1988), then it would be relevant how those intangible tax benefits were connected with Kodak's business. But here the question is the right of South Carolina to tax the rental income generated by tangi-

ble assets. Lowenstein's test of deciding when an intangible is connected to the business has very little relevance to deciding when rental assets are connected to Kodak's business.

Second, if it is assumed that the Lowenstein test does apply to the determination of whether tangible property is connected to a business, it is important to understand how the intangibles in Lowenstein, unlike the instant matter, were connected to the business of the taxpayer. There the notes were part of a virtually daily transaction scheme under which the notes were used to cover the daily cash needs of Clark-Schwebel. Clearly, the notes were integral to the business of Clark-Schwebel, and thus, there was no other logical decision than to find the notes were connected with the business. Likewise, the bonds were integral to the operations of Lowenstein.

In the instant case, the same conclusion cannot be reached. Here Kodak has no daily contact with the leased property, and in fact, as the testimony showed by both the witnesses for Kodak and the South Carolina Tax Commission, there is no contact with the assets. Rather, the "lessee" is the owner of the asset and can sell the property without any consent or permission of Kodak. This lack of involvement is underscored by the uncontradicted fact that the leases are pure fictions.

[REDACTED]

In summary as to Kodak's argument that it has factually shown the connections necessary to defeat the allocation of § 12-7-1120(3), the Court is aware that factual determinations are within the province of the Trial Court, not the Appellant Court. Kodak, in the view of the Trial Court, was unable to show the necessary connection between the rental assets and the business of Kodak. Because of such determinations by the Trial Court, Kodak may not now retry the facts. Further, the issue here is not one of showing that the tax benefits (pure intangibles) are connected with its business. Rather, the issue in this case is one of showing when tangible rental property is connected with a business.

It cannot be stated too forcefully. The property that is in dispute is rental property producing a rental loss. It is not some intangible tax benefit that South Carolina seeks to tax. It is rental income. The income that Kodak reported on its returns is rental income. It is rental property that Kodak must show is connected to its business. It has not done so and its refund claim must be denied.

ARGUMENT II

KODAK'S APPLICATION OF THE APPORTIONMENT METHOD IS IMPROPER SINCE IT LEADS TO A RESULT THAT IS CONTRARY TO THE LEGISLATIVE INTENT ESTABLISHED BY THE REASONABLENESS TEST OF S.C. CODE ANN. § 12-7-250 (1976) AND SINCE KODAK'S METHOD IMPROPERLY JOINS THE NON-UNITARY SAFE HARBOR LEASING ACTIVITIES WITH OTHER UNITARY ACTIVITIES OF KODAK.

A. The Legislative Intent of S.C. Code Ann. § 12-7-250 (1976) To Tax A Reasonable Base Of the Taxpayer's Activities In South Carolina Is Defeated By Kodak's Apportionment Method Since An Excessively Large Reduction In The Tax Base Is Created By A Negligible Degree of Safe Harbor Activity In South Carolina.

1. The Facts Of This Action Demonstrate That The Trial Court Correctly Adopted An Approach That Carries Out The Legislative Intent and Rejected The Approach That Defeated That Intent.

The Court's attention is directed to what is most likely obvious but perhaps has not been clearly stated. The bedrock question in this appeal is which party's theory of the case best carries out the intent of the General Assembly. It is established that the intent of South Carolina's allocation and apportionment statutes is to tax a reasonable portion of the taxpayer's income. Hertz Corp. v. South Carolina Tax Commission, 246 S.C. 92, 142 S.E.2d 445, 446 (1965); and Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (1987). It is the Tax Commission's belief that no matter how persuasive a position appears there can be no correct decision that does not embody this intent.

Kodak's theory of this case leads to untenable and artificial results. The facts show that Kodak is a taxpayer with a multi-billion dollar business generating extensive income from the use in this state of millions of dollars of payroll, property and sales. (Tr., pp. 12, 24) It has generated losses through the legal fiction of owning billions

of dollars of assets under nonexistent leases. (Tr., pp. 14, 15; pp. 24, 25) Under these leases there is virtually no safe harbor presence in South Carolina since there is less than \$10,000 of rental income and less than \$32,000 of rental property in this state. (Tr., pp. 14-15; 24) The result is that Kodak, despite having virtually no safe harbor presence in South Carolina seeks to reduce its South Carolina taxable income by over 33% in 1984 and by over 90% in 1985. (Tr., pp. 25) It is the Trial Court's conclusion that Kodak's theory of this case does not tax a reasonable portion of the taxpayer's income in South Carolina. In light of the unreasonable result reached by Kodak, the Trial Court correctly applied a theory that taxed Kodak only on the activity actually present in the state. Based on the factual findings from the evidence and testimony produced in this matter, the decision of the Trial Court to deny the refund of 1.2 million dollars is proper and should be upheld. The answer to the issue of what result best accomplishes the intent of the General is one that can be reached by quantifying and categorizing the evidence as we have outlined above. However, an even more basic approach is just as reliable in a case such as this one where the total picture is so easily seen. When faced with defining obscenity, Justice Potter Stewart wrote in Jacobellis v. State of Ohio, 84 S.Ct. 1676, 1683 (1964) " . . . I know it when I see it . .

" We suggest that this court is able to use the same test in determining whether a 90% reduction in taxable income due to nonexistent leases violates the legislative intent to tax a reasonable portion of a taxpayer's income. Having presented this background, the arguments raised by Kodak in its Brief are addressed in the remainder of this section.

2. The Trial Court Correctly Found Kodak's Application Of The Apportionment Formula Created An Unreasonable Result Inconsistent With The Intent of § 12-7-250.

Kodak argues that the inclusion of the safe harbor rental losses as a part of Kodak's apportionable income does not produce an unreasonable result within the meaning of § 12-7-250. (Kodak's Brief, pp. 12-18) Kodak appears to base its argument on two positions with one being legal in nature and the other factual. First, and as a legal position, Kodak argues that § 12-7-250 cannot create a new method of apportionment. (Kodak's Brief, pp. 12-14) Second, and as a factual position, Kodak argues the Trial Court incorrectly analyzed the evidence to conclude Kodak's apportionment method leads to an unreasonable result. (Kodak's Brief, pp. 14-18) Each of these positions is addressed below.

a. The Trial Court Did Not Hold That § 12-7-250 Creates A Method Of Apportionment Different From That Established By The Apportionment Formula.

Kodak argues the Trial Court held § 12-7-250 gives ". . . authorization for a computation other than that produced by specific application of the terms of the income tax apportionment formula . . ." (Kodak's Brief, p. 12) Kodak then argues this holding by the Trial Court is incorrect since the three-factor formula has been shown to produce a reasonable result in such cases as Covington Fabrics Corp. v. South Carolina Tax Commission, 264 S.C. 59, 212 S.E.2d 579 (1975); and Moorman Manufacturing Co. v. Blair, 437 U.S. 267 (1978), (Kodak's Brief, pp. 12-14)

The Tax Commission does not argue that the three-factor formula gives an unreasonable result. Rather, the Tax Commission asserts that a reasonable result is reached only when the allocation and apportionment statutes are correctly applied. The fallacy with Kodak's argument is that the Trial Court did not hold that § 12-7-250 established a method different from the terms of the apportionment formula. Rather, the Trial Court tested the approaches suggested to it by the parties and determined that Kodak's method was inconsistent with the intent of the statutes. This holding of the Court is explained below.

The Trial Court was faced with two methods of determining Kodak's base of income subject to tax. The method advanced by the Tax Commission was based on allocating the rental losses to the state where the property was located un-

der § 12-7-1120(3) and then apportioning the remaining income. The taxpayer's method denied that the allocation section was applicable and instead argued that all of Kodak's income should be apportioned. In response to Kodak's view, the Tax Commission asserted that even if the allocation sections were not applicable, Kodak was incorrectly applying the apportionment method since the safe harbor rental income was a separate non-unitary activity which was required to be apportioned separately.

In light of these differing views, the Court held that the General Assembly clearly intended to tax a reasonable base of income and that such intent was embodied in the language of § 12-7-250. (Tr., p. 22) After hearing testimony and receiving evidence on the activities of Kodak and the activities of the safe harbor lease transactions, the Court held the approach advanced by Kodak was inconsistent with the legislative intent and thus rejected Kodak's analysis of South Carolina's allocation and apportionment system. The Court did not create a new method for computing South Carolina's tax liability. It did not ignore existing statutes or disregard or rewrite the three-factor formula. Rather, it simply applied the existing statutory framework consistent with the intent of the General Assembly.

When a taxpayer's approach leads to a result that does not tax a reasonable portion of the taxpayer's activity, then that approach is not consistent with the

[REDACTED]

very purpose of the taxing statutes and must be rejected. The legislative intent must prevail. Peoples National Bank of Greenville v. South Carolina Tax Commission, 250 S.C. 187, 156 S.E.2d 769 (1967). (Tr., p. 22)

No new computation was created. Rather, Kodak's computation was rejected.

b. The Factors Relied Upon By The Trial Court Are Appropriate Indicators of Reasonableness.

Kodak at pages 14-18 of its Brief seems to argue that the Trial Court was incorrect in its analysis of what is necessary to show Kodak's approach gave an unreasonable base upon which to impose South Carolina's tax. Before demonstrating the Trial Court's analysis is correct, it must be noted that the Trial Court was not attempting to arrive at a precise mathematical model. Rather, its objective was general in nature and sought only to review the activities of the taxpayer with a view toward determining the extent to which those activities were carried on in South Carolina. From this general understanding, the Court then determined if the reduction in Kodak's tax liability due to the safe harbor activities was reasonable.

The approach used by the Trial Court involved a comparison. First, the court determined the extent of Kodak's non-safe harbor activities in the State and found the evidence showed Kodak had extensive payroll, property, and sales in South Carolina. (Tr., pp. 23, 24) Second, the

court determined the extent of the safe harbor activities in South Carolina by using the same measuring tool, i.e., the payroll, property, and sales of such activities. However, this time the court found the evidence showed there was virtually no safe harbor activity in South Carolina. (Tr., p. 24)

Having concluded that the safe harbor activities were minimal in South Carolina, the Trial Court then sought to determine the extent to which the safe harbor activities affected the tax and thus the "base" upon which South Carolina imposed its tax. The Court found the evidence established that the safe harbor activities caused a 33% reduction of Kodak's income in 1984 and a reduction of over 90% in 1985. (Tr., p. 25) Such large reductions were not consistent with the minimal safe harbor activities within the state. Based upon this analysis, the Trial Court held that Kodak's apportionment method violated the intent of the apportionment law since it did not tax a reasonable base of Kodak's activities in this state.

Such an approach is entirely proper since our apportionment statutes are premised on the basis that the income of a taxpayer is deemed earned in South Carolina to the extent that its payroll, property, and sales are in this state. Since the safe harbor payroll, property, and sales were minimal in South Carolina, it was reasonable to expect

that such would cause only a minimal affect on South Carolina's taxable base. When Kodak's method of apportionment created a tremendous reduction in the base as a result of only a minimal activity, the Court properly concluded Kodak's method was improper.

B. The Apportionable Income Of Kodak Cannot Include The Rental Losses From The Safe Harbor Leases Since The Safe Harbor Leasing Activities Are Not Unitary With Kodak's Other Activities.

Kodak asserts the apportionment formula includes the losses from the safe harbor activities in its total income and thus allows the safe harbor losses to offset the normal business income of Kodak. (Kodak's Brief, pp. 30-32) The law is well-settled that the apportionment formula is only proper for a multi-state taxpayer when the businesses of that taxpayer are unitary.

[F]ormulary apportionment . . . is constitutionally permissible only in the case of a unitary business.

ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 320 N. 14 (1982). If the activity is a separate and distinct activity, then the apportionment formula may not be applied to the combined activities but rather the separate activity must be taxed separately, as the condition implies. F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico, 458 U.S. 354, 372 (1982). Kodak as-

serts the safe harbor activity is combined with Kodak's business activity since "[s]imply put there was no separate [safe harbor leasing] business." (Kodak's Brief, p. 31) Kodak is mistaken. The Trial Court correctly held the safe harbor transactions do in fact constitute a separate non-unitary activity.

1. Kodak Incorrectly Argues That Common Management Makes The Safe Harbor Activities Unitary With Kodak's Business.

As the following statement shows, Kodak argues in its Brief at pages 30 and 31 that common management is present in relation to the safe harbor activities.

The Director of State and Local Taxes of Kodak stated that there was absolutely no corporate or business separateness with regard to the [safe harbor activities]. . . ., the same corporate employees who performed other corporate duties (such as accounting, legal, and tax) also performed all duties associated with safe harbor leasing.

Kodak apparently seeks to show that the presence of this minimal common management creates a unitary relationship. Kodak is incorrect for at least two significant reasons.

First, as the Trial Court correctly stated (Tr., p. 32) the mere presence of common management is insufficient to create a unitary relationship. See Jaffe v. Department of Treasury, 431 N.W.2d 416 (1988), where the court held

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that the mere showing of common ownership of an advertising business and a cattle operation was insufficient to demonstrate a unitary business. Here the Trial Court found there was only inconsequential commonality insufficient to constitute a unitary operation.

Second, the very idea that Kodak exercised mutual management over both the safe harbor activities and over Kodak's business operations is incorrect. The Trial Court, after hearing the evidence and testimony, found the following:

The only role Kodak had in the safe harbor activities was the nominal duties of administrative tasks such as accounting and financial matters. Such minor tasks do not rise to the level of management necessary to find a unitary relationship. (Tr., p. 33)

The Trial Court was correct in finding there was insufficient management activities to constitute a unitary business.

2. Kodak Incorrectly Argues There Is a Unitary Relationship Between The Safe Harbor Activities And Kodak's Business Based On An Alleged Flow Of Value From The Rental Activities By Virtue Of The Tax Benefits Being Used By The Corporation As A Whole.

Kodak asserts that the safe harbor activities and Kodak's business operations are unitary since:

The record is clear that the deferred federal income taxes and tax credits which resulted from the safe harbor leases in

[REDACTED]

question were used by the company as a whole and that no separate division or department of Kodak benefited. (Kodak's Brief, p. 31)

The mere showing of a benefit to Kodak from the tax savings does not convert the safe harbor rental activity into a unitary activity with Kodak's other operations. The Trial Court correctly held the taxpayer must show there is an interdependence between one activity and the other so that one is dependent upon the other. (Tr., p. 34) Such is the second test of contribution/dependency in Exxon v. South Carolina Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979). The mere showing of a benefit is insufficient and would result in virtually every activity of a taxpayer being unitary and thus proves far too much to be an acceptable test.

In fact it seems that Kodak is saying that since the tax benefits were helpful to the overall business, such should be enough to create a unitary relationship. This view has been specifically rejected by the United States Supreme Court in ASARCO, Inc. v. Idaho State Tax Commission, supra. There the state sought to tax a certain class of income by arguing the income was part of the unitary business. The state sought to prove a unitary business existed since the assets generating the income

contribute to or relate to or are some way in furtherance of the taxpayer's own trade or business.

ASARCO, supra, at p. 3114. The Court disagreed.

This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the corporation's business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all. When less ambitious interpretations are employed, the result is simply arbitrary.

* * * *

In this case, it is plain that the five dividend-paying subsidiaries "add to the riches" of ASARCO. But it is also true that they are "discrete business enterprises" that--in "any business or economic sense"--have "nothing to do with the activities" of ASARCO in Idaho.

ASARCO, supra, at p. 3115. Thus showing the tax benefits "add to the riches" of Kodak is not sufficient to create a unitary relationship. Here Kodak did not prove the existence of a dependency relationship between the safe harbor activities and Kodak's other activities other than "add[ing] to the riches" of Kodak. Accordingly, the Trial Court properly held no unitary relationship was established and the safe harbor losses could not be included in Kodak's apportionable income.

C. The North Carolina Case Of National Services Industries, Inc. v. Powers, 98 N.C. App. 504, 391 S.E.2d 509 (1990) Is Distinguishable

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From the Instant Case.

In Kodak's Brief at pp. 27-30, 31, it is submitted that the North Carolina case of National Service Industries v. Powers, supra, is authority for holding that Kodak is entitled to apportion its losses from the safe harbor rental activity. There are at least two reasons that the result reached in North Carolina should not be applied in South Carolina. First, the case turned on the meaning of business income as used in the North Carolina statute which meaning South Carolina has specifically declined to adopt. Second, the issue of whether the safe harbor lease activity was unitary with the taxpayer's other activities, which issue was strenuously argued by both parties in the instant case, was not litigated in the North Carolina case but rather was stipulated. These two points are briefly discussed below.

First, the North Carolina case was based on the meaning of a statute that defined business income as:

. . . income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.

G.S. 105-130.4(a)(1), N.C. Corporate Income Tax Act. Based on this statute the court stated:

Here, the lease arrangement was a means of gaining working capital and increasing cash flow for all of plaintiff's business operations. This is certainly an "integral part" of plaintiff's business operations.

[REDACTED]

National Service Industries, supra, at p. 512. Under South Carolina law, there is no such definition of business income. In fact, the definition of business income used by North Carolina comes from a model act called the Uniform Division of Income for Tax Purposes Act (see Vol. 7A Uniform Laws Ann. 91 (1978)), and our Supreme Court has specifically denied that South Carolina applies the literal language of that Act:

Appellant urges application of the broad definition of business income contained in the Uniform Division of Income for Tax Purposes Act. While the General Assembly elected to incorporate some of the language from the Uniform Act into Code § 12-7-1120(6), it did not adopt the Act's definition of business income.

Boyle Utilities, Inc. v. South Carolina Tax Commission, 273 S.C. 93, 254 S.E.2d 308, 309 (1979).

Since South Carolina has not adopted the business income test used by North Carolina, a case such as National Service Industries, supra, which is based on that test, is not proper authority for this court. Rather, this court must apply South Carolina's law which asks whether "... the property that produced the income is or is not connected with the business." M. Lowenstein Corp. v. South Carolina Tax Commission, supra. Under such a test, the focus is on the actual use of the property which produces the income in

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dispute. As fully discussed in Argument I, B., the rental property is not connected with the business.

Because of such, the rental loss under § 12-7-1120(3), must be allocated to the place where the rental property is located and may not be apportioned.

A second reason that the decision in National Services Industries, Inc., supra, should not be applied in Kodak's case is that the critical issue of whether the safe harbor activities were unitary with the taxpayer's other activities was not addressed. Rather, in the North Carolina case, the parties stipulated that issue. The court stated:

The parties have stipulated that the several operating arms of plaintiff's business are joined by a highly-centralized cash management and business operation. From this record we conclude that plaintiff's conglomerate corporation is a unitary business for tax purposes.

National Services Industries, Inc., supra, at p. 512. Obviously, no such stipulation is present in the Kodak case. Rather, a major disagreement between the parties is whether the safe harbor rental activity is unitary with Kodak's other activities. The Tax Commission believes that the facts of the case before this court show that the unitary tests of Exxon, supra, were not met. Thus even if the North Carolina case is of some relevance to South Carolina law, the case is still of little help since the facts in Kodak demonstrate that there was no satisfaction of the uni-

tary requirements established by Exxon, supra. Thus even if Kodak could apportion the rental losses, it could do so only as a separate activity which again would not allow the losses claimed by Kodak.

In summary, the North Carolina case is of no support to Kodak's position for two reasons. That case is based on a "business income" test which South Carolina has expressly declined to adopt; and second, that case assumed by stipulation that the safe harbor activities were unitary with the rest of the taxpayer's activities. Accordingly, the North Carolina case is distinguishable from the matter now before this court.

ARGUMENT III

KODAK'S ALTERNATIVE VIEW THAT IT IS ALLOWED TO CLAIM THE DEPRECIATION RESULTING FROM THE SAFE HARBOR RENTAL PROPERTY IS INCORRECT SINCE THE DEPRECIATION DEDUCTION IS A RELATED EXPENSE TO THE RENTAL LOSSES AND MUST BE TREATED IN THE SAME MANNER AS ALL OTHER RELATED INCOME AND EXPENSES.

Kodak asserts the Tax Commission has authorized taxpayer's to claim depreciation on safe harbor leases without concern for the allocation statutes and with no requirement to report the rental income or any other expense associated with the safe harbor transactions. Kodak asserts the South Carolina Tax Commission has allowed taxpayers to simply claim the depreciation deduction as a part of apportionable income. (Kodak's Brief, pp. 33-35) Kodak bases its view upon S.C. Code Ann. Regs. 117-63 (1976), and an article from

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Commerce Clearing House which explains the South Carolina Tax Commission's view on taxing safe harbor leases. Kodak's view ignores the plain language of S.C. Code Ann. § 12-7-700(8) (1976), the plain language of the regulation, the plain language of the Commerce Clearing House publication and the uncontradicted testimony of the South Carolina Tax Commission's witness.

First the statute which started the safe harbor treatment was § 12-7-700(8). That Section granted "... the same depreciation as allowed by Federal Internal Revenue Code Section 168(f)(8) and applicable regulations ...". The "applicable federal regulations" are found at 50.168(f)(8)-7 of the federal regulations. There the regulations are specific that the lessor must include the rental income and the lessee must include any interest income. Further, the lessor claims the interest deduction and the lessee deducts the rental payment. Thus it is clear the General Assembly was not enacting a provision that limited safe harbor transactions to depreciation only.

South Carolina Tax Commission Regulation 117-63 is also no support for Kodak's view. The regulation plainly contemplates rental payments as income to one and an expense to the other by the following: "... the lessee will be entitled to a deduction for the lease payments ...". While it cannot be established for certain, it is reasonable to be-

lieve that the language "... for purposes of depreciation only ..." found in the regulation is intended to mean that safe harbor leases are not to be treated as real leases for any other purposes than for income tax purposes. For example, leases are subject to sales tax on the gross proceeds from the rental of tangible personal property. Edisto Fleets, Inc. v. South Carolina Tax Commission, 256 S.C. 350, 182 S.E.2d 713 (1971). The "for purposes of depreciation only" language would prevent the possible application of a sales tax to the artificial lease payments. Why the language is in the regulation has not been established by any evidence presented by Kodak, nor is any legislative history available to explain the wording. However, it must be remembered that in any event the regulation could not limit to depreciation only the scope of § 12-7-700(8) when that statute had adopted the full extent of safe harbor leases as established by the I.R.C. To so limit the statute would create an invalid regulation. Heyward v. South Carolina Tax Commission, 240 S.C. 347, 126 S.E.2d 15 (1962).

Further, the Commerce Clearing House publication has been grossly misconstrued by Kodak to support Kodak's position that it is allowed depreciation deductions against its apportionable income. That document explicitly says that interest income and expense and rental income and expense are to be claimed by the lessee and the lessor. To

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read such statements as support for Kodak's conclusion that only depreciation deductions are allowed by the South Carolina Tax Commission is a gross disregard of the full statements made in the Commerce Clearing House document.

Finally, the testimony of the South Carolina Tax Commission's witness proves there has never been a time when the Tax Commission only provided for depreciation on safe harbor assets. Ms. Law testified that the safe harbor leases had been construed since their beginning in 1983 as requiring the inclusion of rental income and interest income as well as allowing rental expense and interest expense. All safe harbor taxpayers in South Carolina have filed in this manner. In fact, Kodak filed its returns in this very manner and presented no evidence of instances when the South Carolina Tax Commission had required taxpayers to only include the depreciation generated by safe harbor leasing.

Based on the above, Kodak is incorrect in its view that it is allowed a deduction for the depreciation on the safe harbor leases. In addition, the Trial Court correctly held that the depreciation is a related expense to the rental income and must be allocated to the state where the property is located. (Tr., p. 41) Further, the Trial Court was correct in finding that even if apportionable such expense must be apportioned separately with the safe harbor rental income rather than applied to Kodak's apportionable income.

(Order, p. 41) In summary, the allowance of depreciation only as a deduction for safe harbor leases is improper and should be denied.

CONCLUSION

Based on the foregoing, this Court should affirm the Trial Court on all grounds. As a result, no refund should be ordered to Kodak in any amount.

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Columbia, South Carolina
July 3, 1991.

THE STATE OF SOUTH CAROLINA

IN THE SUPREME COURT

DOCKET NO.

APPEAL FROM RICHLAND COUNTY

HONORABLE JAMES E. LOCKEMY, CIRCUIT COURT JUDGE

CASE NO. 89-CP-40-3213

Eastman Kodak Company,

Appellant,

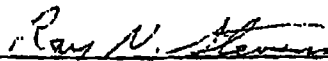
vs.

South Carolina Tax Commission,

Respondent.

CERTIFICATE OF COUNSEL

The undersigned certifies that this final Brief
complies with Rule 210(b), SCACR.


RAY N. STEVENS
Deputy Attorney General

July 3, 1991.

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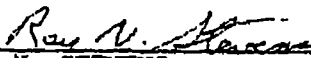
vs.

South Carolina Tax Commission,

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CERTIFICATE OF MAILING

I, Ray N. Stevens, hereby certify that I have mailed, postage prepaid, three copies each of the Brief of Respondent, South Carolina Tax Commission, to John C. von Lehe, Jr., Esquire, and Stephen F. Groves, Esquire, Post Office Box 993, Charleston, South Carolina 29402, this 3 day of July, 1991.


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Deputy Attorney General

THE STATE OF SOUTH CAROLINA

IN THE SUPREME COURT

DOCKET NO.

APPEAL FROM RICHLAND COUNTY

HONORABLE JAMES E. LOCKEMY, CIRCUIT COURT JUDGE

CASE NO. 89-CP-40-3213

Eastman Kodak Company,

Appellant,

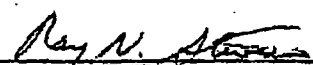
vs.

South Carolina Tax Commission,

Respondent.

CERTIFICATE OF MAILING

I, Ray N. Stevens, hereby certify that I have mailed, postage prepaid, three copies each of the Brief of Respondent, South Carolina Tax Commission, to John C. von Lehe, Jr., Esquire, and Stephen F. Groves, Esquire, Post Office Box 993, Charleston, South Carolina 29402, this 3 day of July, 1991.


RAY N. STEVENS
Deputy Attorney General

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JUL 13 1991

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The undersigned certifies that this final Brief
complies with Rule 210(b), SCACR.


RAY N. STEVENS
Deputy Attorney General

July 3, 1991.

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S. C. SUPREME COURT

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S. C. SUPREME COURT



Exhibit C

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS
Case No. 89-CP-40-3213

Eastman Kodak Company,

Plaintiff,

vs.

South Carolina Tax Commission,

Defendant.

O R D E R

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This court held an evidentiary non-jury trial in this matter on June 6, 1990 followed by a briefing period in which extensive briefs were filed by both parties. In an effort to fully clarify the positions developed at the trial and in the briefs, the court held an additional hearing on October 17, 1990. After considering the evidence produced and the arguments presented, the court finds the dispute raises two procedural issues and several substantive issues. The two procedural issues involve the subject matter jurisdiction of the court provided under S.C. Code Ann. Section 12-47-440 (1976) and the substantive issues involve a disagreement on what is the correct application of South Carolina's taxing scheme to the plaintiff, Kodak, for the tax years 1984 and 1985. After a review of the facts in this matter, the procedural issues are addressed followed by the court's address of the substantive issues.

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FACTUAL BACKGROUND

Kodak is a multinational corporation involved in the business of producing a variety of products including films, papers, chemicals, plastics, fibers, magnetic media, equipment for photographic and electronic imaging and for information management. It conducts its business worldwide including significant operations in South Carolina. Among other activities in South Carolina, Kodak has a manufacturing plant which is part of Kodak's Chemical Division. Kodak's business utilizes property located in South Carolina, which property in 1984 had a cost of almost \$384 million and in 1985 of over \$401 million. Expenditures were made for payroll in South Carolina for 1984 of almost \$39 million and for 1985 of over \$46 million. Further, the sale of products delivered to South Carolina customers for 1984 was over \$127 million and for 1985 was slightly over \$107 million.

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Kodak also reports income and expenses from an activity commonly referred to as "safe harbor leasing." A safe harbor lease is the creation of the Economic Recovery Act of 1981 and is codified within the Internal Revenue Code (I.R.C.) at Section 168(f)(8). There Congress sought to stimulate capital investment by allowing one company to use a lease "in form only" to transfer certain federal tax benefits to another taxpayer. During the trial of this case,

the evidence showed that a safe harbor lease involved three steps.

The first step in a safe harbor lease involves the purchase and nominal sale of qualifying property. A party (XYZ) which, for various reasons, is unable to utilize the federal tax benefits resulting from ownership of qualifying property, purchases the qualified property and takes legal title. (Assume the purchase price is \$1 million.) XYZ then "sells" the property to a party (in this case Kodak) who is able to utilize the federal tax benefits. At the time of the "sale" no legal title passes to Kodak and in fact no physical transfer of the property occurs. The purchase price paid by Kodak is \$1 million (the same amount that XYZ paid) which amount is paid as \$100,000 in money and a promissory note to pay \$900,000 in level payments over a fixed period. This gives rise to the second step in the transaction.

At the time of the "sale" of the property to Kodak, Kodak and XYZ enter into a "lease" in which Kodak leases the property back to XYZ in an amount and for a period which is exactly the amount and the period covered by the \$900,000 promissory note. Thus, no payments are required on the note and no payments are required on the lease since they cancel out each other. As a result of the sale and lease-back, for

federal tax purposes Kodak is treated as the "owner" of the property. As such it is entitled to claim deductions for depreciation, interest expense on the "note payments", and to receive a federal investment tax credit based on the "purchase price" of the property. Since Kodak is now the lessor of the property it also has rental income from the lease agreement. XYZ, as the lessee, has a deduction for the lease payment "paid" to the lessor and XYZ has interest income from the note.

The third and final step occurs at the end of the "lease." At that time XYZ "repurchases" the property from Kodak for the nominal sum of \$1 or in some cases for no consideration at all. As a result the "lease" is concluded, the note is paid in full, and XYZ, which never relinquished legal title in the first place, now takes "ownership" of the property from Kodak.

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Kodak entered into 34 safe harbor leases and the assets over which Kodak became the "lessor" consisted of such diverse property as power plants, railroad rolling stock, and paper mills. The assets involved in the safe harbor leasing were over \$2 billion with less than \$32,000 of the safe harbor assets located in South Carolina. Additionally, the safe harbor leases resulted in rental income of over \$200 million with less than \$10,000 derived from property in

South Carolina. Due to the deductible expenses of the safe harbor leases exceeding the rental income, Kodak had a loss from the activity in both 1984 and 1985. The losses gave rise to the dispute which is now before this court.

On its 1984 South Carolina tax return Kodak claimed a loss from its safe harbor rental activities and later filed a claim for refund seeking to show that its loss was even larger. Kodak's 1984 loss from safe harbor leases of \$426 million was used in 1984 to reduce its apportionable income¹ from \$1.3 billion to \$980 million. In 1985 Kodak's return reflected a safe harbor loss of \$326 million which was used to reduce its 1985 apportionable income from \$474 million to \$48 million. The Tax Commission has asserted the safe harbor losses can not be used to reduce the apportionable income. It is this dispute that has resulted in the issues alluded to previously in this Order.

¹Apportionable income is the remaining net income after special classes of the taxpayer's income have been allocated to and taxed at specified locations. South Carolina then only taxes a portion of the apportionable income. That portion is found by determining the percentage of the taxpayer's total payroll, property and sales which are in South Carolina. That percentage is then multiplied against the total apportionable income to arrive at South Carolina's share of the apportionable income.

ISSUES

I. Subject Matter Jurisdiction Under
Section 12-47-440

A. The Impact of Bass, et al. v.
South Carolina Tax Commission
South Carolina Supreme Court
Op. No. 23216

On July 31, 1990 our South Carolina Supreme Court
issued a decision which stated the following:

Even were we to examine state law, the federal retirees would be barred from receiving a refund. The proper refund statutes under which the federal retirees should have proceeded are S.C. Code Ann. Sections 12-47-210 and 12-47-220 (1976), which require the taxpayer to pay under protest before bringing a refund action. [Footnote 5] We have previously stated that the exclusive remedy for the recovery of the erroneous assessment of income taxes is through these "pay under protest" statutes. See Perpetual Bldg. & Loan Ass'n. of Columbia v. South Carolina Tax Commission, 255 S.C. 523, 180 S.E.2d 195 (1971).

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[Footnote 5] Section 12-47-440 under which the federal retirees proceeded, deals only with the recovery of license fees and taxes. See City of Columbia v. Glens Falls Insurance Company, 245 S.C. 119, 139 S.E.2d 529 (1964).

It is certainly true that the complaint in this matter alleges jurisdiction under Section 12-47-440.² It likewise seems clear that the court in Bass states that the refund route of Section 12-47-440 is not available for the recovery of income tax but rather that the "exclusive remedy for the recovery of the erroneous assessment of income taxes is through the 'pay under protest' statutes." This court holds that under the facts of the instant case this action is a "pay under protest" action.

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The returns of Kodak were filed with the assertion that the safe harbor losses were properly used to reduce apportionable income. Kodak had paid estimated payments throughout the year and, according to its calculation of its tax liability, was entitled to a refund. However, before the overpayment of estimated taxes could be refunded to Kodak, the Tax Commission audited the returns and found that Kodak actually had a tax liability much greater than Kodak had calculated. Based on the Tax Commission's position Kodak's overpayments of estimated tax were not nearly so large as Kodak had calculated. Consequently, the Tax Commission

²The Amended Complaint at paragraph 3 alleges subject matter jurisdiction under Section 12-47-440.

retained the vast majority of the estimated tax and refunded only a small portion. Kodak protested the audit adjustments and after exhausting its administrative remedies brought this action in a timely manner. Since the "refund" involved in this action resulted from an audit adjustment, there was no "voluntary payment" but rather such were payments under protest for which this court has jurisdiction.

B. The Timeliness Of The Claim For
Refund Under Section 12-47-440

While the audit adjustments by the Tax Commission were responsible for the entire tax dispute for the 1985 tax year, those adjustments were not responsible for the entire dispute for the 1984 tax year. For the 1984 tax year, Kodak filed a claim for refund when it learned that the Tax Commission recognized the validity of safe harbor leases entered into prior to January 1, 1983.³ Kodak filed its claim for

³The Tax Commission had held that safe harbor leases entered into prior to January 1, 1983 were not recognized by South Carolina since the adoption of the safe harbor provisions of I.R.C. Section 168(f)(8) was not until January 1, 1983. However, on March 2, 1988, the Tax Commission, through its Policy Division, issued Technical Advice Memorandum #88-9 which advised that safe harbor leases were within South Carolina's adoption of I.R.C. Section 168(f)(8) even if entered prior to January 1, 1983.

refund on May 26, 1988 for the tax year 1984. In that claim it asserted that safe harbor leases entered into prior to January 1, 1983 created an additional loss from safe harbor leasing of approximately \$230 million. The Tax Commission denied the claim.

While it is arguable that the Bass decision precludes the assertion of this refund claim, the court finds it unnecessary to address this point since the court concludes it lacks subject matter jurisdiction over this claim even assuming Section 12-47-440 is an available remedy. It is well settled that the moving party has the burden of satisfying the jurisdictional requirements of a statute. Here Section 12-47-440 states:

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The provisions of this section . . . shall only be available where the application provided for here is made in writing to the Commission within a period of three years from the date the license fee or tax was due to have been paid.

The return for 1984 for Kodak was due on March 15, 1985. Thus, the refund claim was due by March 15, 1988 in order to be timely filed. The facts in the instant case show the claim was not filed until May 26, 1988. Since the refund claim for 1984 was not timely filed, Kodak has failed to satisfy the jurisdictional requirements of Section 12-47-440. This court holds that there is no subject matter jurisdiction.

tion over that portion of this action which seeks a refund due to the \$230 million safe harbor lease losses of 1984.

II. The Application Of South Carolina's Taxing Method To Kodak's Safe Harbor Leasing

The application of South Carolina's taxing method to Kodak has raised a number of issues for this court to address. These issues involve a dispute over the interpretation of South Carolina's tax statutes and a challenge to the constitutionality of such statutes.

There are essentially three statutory interpretation issues raised in this action. First, the Tax Commission argues the losses here involved can not be used to reduce the apportionable income of Kodak since to do so violates the reasonableness test of S.C. Code Ann. Section 12-7-250 (Supp. 1989). Second, the losses are rental losses that must be allocated under S.C. Code Ann. Section 12-7-1120(3) (Supp. 1989), rather than apportioned as Kodak asserts. Finally, the Commission argues that even if neither the reasonableness test of Section 12-7-250 nor the allocation section of Section 12-7-1120(3) applies, the losses still cannot be used to reduce Kodak's apportionable income. The basis for this third argument is that the safe harbor leasing activity is not a unitary activity with Kodak's other activities. Accordingly, the safe harbor leas-

ing activity must be apportioned as a separate activity rather than combined with Kodak's other activities.

There are basically three constitutional issues raised. First, Kodak argues that allocating the losses under Section 12-7-1120(3) discriminates against interstate commerce by allowing the loss if the asset is in South Carolina but denying the loss if the asset is in another state. Second, Kodak argues that Equal Protection is violated by Section 12-7-1120(3) since Kodak asserts there is no rational basis for allowing the losses when the safe harbor assets are located within South Carolina, but excluding the losses when the assets are located outside South Carolina. Finally, Kodak argues that a failure to include Kodak's safe harbor losses in total apportionable income is a violation of Due Process.

After considering the evidence and argument the court agrees with the three positions advanced by the Tax Commission and further finds there is no constitutional violation as presented by Kodak. These views are more fully explained below.

A. Statutory Interpretations

1. The Requirements of Section 12-7-250

Section 12-7-250 (enacted as part of Act 731 in 1959) requires that the tax paid by a taxpayer be made ". . . upon a base which reasonably represents a portion of the trade or business carried on within the State." The purpose of Act 731 is to obtain the objective of reasonable allocation of income. Hertz Corp. v. South Carolina Tax Commission, 246 S.C. 92, 142 S.E.2d 445, 446 (1965) and Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (1987). When a taxpayer's approach leads to a result that does not tax a reasonable portion of the taxpayer's activity, then that approach is not consistent with the very purpose of the taxing statutes and must be rejected. The legislative intent must prevail. Peoples National Bank of Greenville v. South Carolina Tax Commission, 250 S.C. 187, 156 S.E.2d 769 (1967).

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The reasonableness rule of Section 12-7-250 is demonstrated in Hercules, Inc. v. South Carolina Tax Commission, 279 S.C. 177, 304 S.E.2d 815 (1983). There the taxpayer sold a South Carolina manufacturing plant and generated a gain on the sale. The South Carolina Tax Commission taxed the gain as South Carolina income since Section 12-7-1120(4) states that gains from the sale of real property located in this State are allocated to South Carolina. However, the taxpayer objected and argued that to tax the entire gain vi-

olated Section 12-7-250. The argument, agreed to by the Court, was that since the gain resulted entirely from depreciation deductions which were only partially deducted in South Carolina, it was proper to tax only a portion of the gain. In other words, the gain was taxed only to the extent of the representative business carried on in the State.

Here, Kodak's treatment of the safe harbor leasing activities does not set a fair base which reasonably represents the taxpayer's business in South Carolina. Rather, the taxpayer's treatment distorts Kodak's business in South Carolina by inappropriately reducing the share of business carried on in South Carolina. This distortion was supported by the evidence presented to this court.

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In the 1984 and 1985 annual reports for Kodak, essentially two divisions are represented as carrying on Kodak's business: The Photographic and Information Management Division (PIMD) and Eastman Chemical Division (ECD). PIMD produces products such as films, papers, chemicals, magnetic media and equipment for photographic/electronic imaging and information management. The marketing and distribution of these products are made throughout the United States including South Carolina. ECD produces a diversity of chemicals, fibers, and plastics with one of Kodak's manufacturing plants located in Columbia, South Carolina. In fact, Ko-

dak's presence in South Carolina is extensive. Kodak had assets in South Carolina of \$384,000,000 in 1984 and \$401,000,000 in 1985. In addition, Kodak had gross receipts on sales delivered to customers in South Carolina of \$127,000,000 in 1984 and \$107,000,000 in 1985. The payroll of Kodak to its South Carolina employees is also significant. In 1984, Kodak's South Carolina payroll was \$39,000,000 and in 1985 was \$46,000,000. While the above activities show a significant involvement in South Carolina, by contrast, South Carolina's safe harbor activities are not significant.

In 1984, Kodak had over \$1.8 billion of property for which it was the purported lessor under safe harbor leases. That amount grew to over \$2 billion in 1985. Of this amount only \$31,416 was in South Carolina for 1984 and \$31,399 for 1985. The same minute presence in South Carolina of the safe harbor activity is demonstrated by the rental receipts from South Carolina. In 1984 there was only \$4,887 of rental income in South Carolina; in 1985 there was only \$4,801.

These findings demonstrate the safe harbor lease activity in South Carolina was minimal. To allow such minimal activity to greatly reduce Kodak's income from its other activities would exceed the bounds of the "reasonable base" re-

gured by Section 12-7-250. The extent of the reduction is shown by a comparison of the tax liability when the safe harbor lease transactions are included in Kodak's income with the tax liability when the safe harbor activities are not included.

Without the safe harbor losses, Kodak's income tax liability for 1984 is \$1,867,000. However, if the losses are allowed, Kodak reduces its tax liability by 33%. Without the safe harbor lease losses, Kodak's South Carolina tax liability is \$654,000 for 1985. However, Kodak's use of the safe harbor loss reduces South Carolina's tax liability to only \$59,000 and represents a decrease in its tax liability of over 90%. Such a reduction of Kodak's income by the minimal lease activities is a gross distortion of the true business activities of Kodak in South Carolina. Such must be avoided in order to comply with Section 12-7-250's requirement that South Carolina tax a reasonable portion of Kodak's income. Kodak's method of including the safe harbor lease losses in apportionable income does not satisfy Section 12-7-250 and this Court holds Kodak's request for a refund of \$1.2 million is denied.

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2. The Requirements of Section 12-7-1120(3)

[REDACTED]

The South Carolina Code identifies several classes of income that are taxed in a specified manner. One of these classes is income from the rental of tangible personal property. Under Section 12-7-1120(3), the following income is allocated:

Rents received from the lease or rental of . . . property, . . . where the property leased or rented was not used in or was not connected with the trade or business of the taxpayer during the income year, less all related expenses, shall be allocated to the state in which the property was located at the time the income was derived.

Under this statute, the income is allocated if: 1) the income (less related expenses) is rental income and 2) the rental property is not used in or connected with Kodak's business.

a. Rental Income Is Involved.

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The first requirement is established. The income in dispute is rental income from property since the 1984 and 1985 tax returns both show rental receipts from the safe harbor activities. It is further established that the rental income has related expenses of depreciation and interest and that these expenses are responsible for the losses from the safe harbor activities. The final requirement is that the rental property not be used in or connected with the business of Kodak.

b. The Property Is Not Used In Or
Connected With Kodak's Business.

The safe harbor property is neither used in nor connected with the business of Kodak. The test for determining when property is connected with a business is a "common sense" approach. M. Lowenstein Corp. v. South Carolina Tax Commission, 298 S.C. 93, 378 S.E.2d 272 (1989). Here, the annual reports of Kodak establish that the business of Kodak is the production of films, papers, chemicals, plastics, fibers, magnetic media, equipment for photographic and electronic imaging and the service of information management. No mention of safe harbor leases is found anywhere in the annual reports' description of Kodak's business. Such lack of mention is especially noteworthy when the alleged safe harbor assets represent over 16% of Kodak's assets.

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Kodak's business as discussed previously in this Order has virtually no involvement with the property covered by the safe harbor leases. It has no management responsibilities over the property and it has no maintenance duties. The property can be sold by the lessee without permission or notice to Kodak. In fact, the property here in dispute is not even owned by Kodak. The common sense test of Lowenstein, supra, requires that a party at least own the property it is trying to say is connected with its business. Fur-

ther, the property is not used by Kodak in its business but rather is always in use by the party who is the nominal lessee.

In addition, this court finds that it is unreasonable to believe the General Assembly intended to find a "connection" to a business where the connection is based on a fiction. Here the safe harbor leases are fictitious transactions created by federal law under the Economic Recovery Tax Act of 1981. The legislative history to this Act as shown in the Senate Report to The Tax Equity and Fiscal Responsibility Act of 1982, which act substantially amended the safe harbor rules, stated:

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Under the [safe harbor] rules certain transactions involving tangible personal property are treated as leases for Federal income tax purposes regardless of their nontax economic substance Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who has acquired and will use the property can, in effect, sell some of the tax benefits associated with the property to a corporation, while retaining all other economic benefits and burdens of ownership. 1982 U.S. Code Cong. & Admin. News, p. 894.

Commentators who have examined safe harbor leases have reached the same conclusion.

This transaction [safe harbor leases] need be a sale only for federal income tax purposes: no attribute of ownership need pass to the lessor under local law. Ownership status for the lessor and characterization of the transaction as a lease are thus fictitious . . . Warren and Aurbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harvard Law Review 1752, 1762-1763 (1982).

Judicially the same result has been reached:

. . . a review of both the legislative history and the various commentators on this subject leads this Court to the conclusion that the reference to the term "lease" is illusory. In re Chateaugay Corporation, 102 B.R. 335, 343 (1989).

Except for the safe harbor leasing rules, such a transaction would have been laughed out of a tax forum. Even the safe harbor leasing provisions recognize that such a lease is treated as such "solely" for federal income tax purpose. Portland General Electric Co. v. Department of Revenue, 11 Or. Tax 78 (1988).

Thus, this court is convinced that the safe harbor "leases" of Kodak are purely fictional and cannot provide a connection to the business of Kodak.

c. Allocation Is Required

The evidence shows allocation is required. The income in dispute is rental income and is from property not connected with the business of Kodak. The result of the court's determination is that the rental loss is allocated to the place where the property is located. The property un-

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der the safe harbor leases is located outside South Carolina except for a small amount. In the instant case, in 1984, \$4,887 of rental income is from safe harbor property located in South Carolina and \$4,801 in 1985. Even assuming that the cost of these rental properties of \$31,400 is fully written off as a deduction over the two tax years (i.e., \$15,700 deduction each year), the loss from safe harbor activity allocated to South Carolina would be \$10,813 in 1984 (\$15,700 - \$4,887 = \$10,813) and \$10,899 for 1985 (\$15,700 - \$4,801 = \$10,899). All other losses from the safe harbor properties are allocated away from South Carolina. Thus, under the allocation requirement of Section 12-7-1120(3) the court finds the refund of \$1.2 million must be denied.

3. The Requirements of Sections 12-7-250
And 12-7-1140 For Apportionment

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While this court has found that allocation is required under Section 12-7-1120(3), the court is also convinced that even if Section 12-7-1120(3) were not applicable and even if Section 12-7-250 were not violated, Kodak would still be unable to apply its losses against its apportionable income. Instead, the apportionable income from the safe harbor activity would need to be computed separately:

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The South Carolina income tax is imposed upon that part of "the trade or business carried on within this state." See Section 12-7-250. A single taxpayer, however, may carry on more than one business. In such a case, it is necessary to determine whether the income to be taxed is the income from all of the businesses or whether one or more of the businesses is separate. See for example, Exxon Corp. v. South Carolina Tax Commission, supra. Exxon establishes that the income from several businesses operated by the same taxpayer is subject to South Carolina taxation only where the businesses are part of a combined unitary business.

The Court established a two part test for finding a combined unitary business as follows:

. . . the proper answer to the question of whether or not a business is unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business. Exxon at p. 96.

Kodak argued to this court that its losses from its safe harbor activities are unitary with its other business activities and thus should be combined with Kodak's income from other operations. Under such a view, the loss is used to reduce Kodak's income and thus reduce its tax liability.

The law is well settled that the apportionment formula is only proper for a multistate taxpayer when the businesses of that taxpayer are unitary.⁴ If the activity is a separate and distinct activity, then the apportionment formula may not be applied to the combined activities but rather the separate activity must be taxed, as the condition implies, separately. F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico, 458 U.S. 354, 372, 102 S.Ct. 3128 (1982).

Kodak argued there was a minimal common management sufficient to create a unitary relationship. This court finds Kodak is incorrect for at least two significant reasons.

First, the mere presence of common management is insufficient to create a unitary relationship. In Jaffe v. Department of Treasury, 431 N.W.2d 416 (1988), the Court was faced with a taxpayer operating two activities: an advertising business and a cattle operation. The taxpayer wanted to

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. . . "[F]ormulary apportionment . . . is constitutionally permissible only in the case of a unitary business." ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 320 n. 14, 102 S.Ct. 3103 (1982).

reduce his Michigan advertising income by the losses from the cattle operation on the basis that the two activities were unitary. In denying the taxpayer's position, the Court held the management was of no significance.

. . . there was substantial evidence on the record that Jaffe's advertising and cattle operations were not functionally integrated or interdependent, and did not share economies of scale. This was evidenced by their only common denominator being Jaffe's control and operation of both businesses. Jaffe, supra, at 431.

Here the only element of commonality is that Kodak had limited duties in the safe harbor leases and that such duties were carried out by some of the same officials of Kodak. Such a limited role was insufficient in Jaffe, supra, and is also insufficient for South Carolina.

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Second, the view that Kodak exercised mutual management over the safe harbor activities and over Kodak's business operations is not supported by the evidence. The activity that is under review is the rental activity. That rental activity imposes no management duties upon Kodak. The evidence established that the leases are a fiction. The only role Kodak had in the safe harbor activities was the nominal duties of administrative tasks such as accounting and financial matters. Such minor tasks do not rise to the level of management necessary to find a unitary relationship.

Kodak asserted that the safe harbor activities and Kodak's business operations were unitary since the tax benefits were used by the company as a whole. The mere fact that Kodak benefited from the tax savings does not make the safe harbor rental activity unitary with Kodak's other activities. What is required is a showing of an interdependence that has one activity dependent upon the other activity. This is the meaning of the second test of contribution/dependency used by our Supreme Court in Exxon v. South Carolina Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979). If the requirement were to show only a "benefit" to another activity, then virtually every activity of a taxpayer would be unitary. The tests used by Kodak prove far too much and cannot stand in light of Exxon, supra.

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Kodak is unable to show ownership of the rental property. Kodak is also unable to show management in that it does not manage any of the safe harbor properties since the "lessee" has total responsibility for management. Kodak is unable to show how its operations of the chemical and photographic businesses are coordinated with or dependent upon the safe harbor rental activities. In fact, it appears to this court that Kodak essentially asserted that since the tax benefits were helpful to the overall business, such should be enough to create a unitary relationship. Not

only does Exxon, supra, disagree with this view but such has been rejected by the United States Supreme Court.

In ASARCO Inc. v. Idaho State Tax Com'n., supra, the state sought to tax a certain class of income by arguing the income was part of the unitary business of the taxpayer. The state argued that a unitary business is shown where the assets generating the income:

. . . contribute to or relate to or are some way in furtherance of the taxpayer's own trade or business. . . ASARCO, supra, at 3114.

The Court rejected this definition of "unitary" by stating the following:

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This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all. When less ambitious interpretations are employed, the result is simply arbitrary. (ASARCO, Ibid.)

Under ASARCO, the mere showing that the tax benefits would "add to the riches" of Kodak is insufficient to create a unitary relationship. Kodak has failed to show that there is any real dependency between the safe harbor activities and

Kodak's business other than "add[ing] to the riches" of Kodak. The Dependency Test of Exxon, supra, is not satisfied, no unitary relationship is established, and thus the safe harbor rental losses are computed as a separate activity unavailable for offsetting Kodak's apportionable income.

B. Constitutional Interpretations

Kodak raised three constitutional challenges. Two challenges were to the Tax Commission's view that the safe harbor rental losses are allocated to the state where the rental property is located. Kodak asserted that such a view discriminates against Interstate Commerce in violation of the United States Constitution and violates the Equal Protection Clause as not having any rational basis to support the classification. Kodak also argued that Due Process was violated by not including the safe harbor losses in apportionable income. The court holds Kodak is mistaken in its constitutional views.

1. Interstate Commerce

Kodak asks this Court to declare the allocation section of Section 12-7-1120 in violation of the Interstate Commerce Clause on the ground that the statute on its face discriminates against interstate commerce. Kodak asserted the discrimination occurs since the statute gives "preferential taxation . . . to taxpayers who lease assets . . . located

within South Carolina" since the loss is available only when the asset is in South Carolina. (Kodak's brief, pp. 24-25)

Kodak has misconstrued the context of the statute. The statute is not a device for denying a deduction. Rather it is a means for determining where rental income is earned. The state has chosen to base its decision of where that income is earned by looking to the location of the asset that produced the rental income. The United States Supreme Court has explained that a statute like Section 12-7-1120(3) does not violate the Commerce Clause as long as the statute is "internally consistent."

In Armco Inc. v. Hardesty, 104 S.Ct. 2620 (1984), the Court struck down a West Virginia tax statute as discriminatory against interstate commerce over the state's view that there had to be a clear showing of actual discrimination. The Court said the following:

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. . . This [the state's test of actual discrimination] is not the test. In Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 169, 103 S.Ct. 2933, 2942, 77 L.Ed.2d 545 (1983), the Court noted that a tax must have "what might be called internal consistency--that is the [tax] must be such that, if applied by every jurisdiction," there would be no impermissible interference with free trade . . . A similar rule applies where the allegation is that a tax on its face discriminates against interstate commerce. A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce. . .

Section 12-7-1120(3) is internally consistent since if every state adopted the same statute there would be no more than all of the income taxed, i.e., there would not be any double taxation. Container Corp., supra, 103 S.Ct. 2933 at 2942. Here, Section 12-7-1120(3) does not allow for double taxation since the tax is due only in the state where the physical rental property is located. Intangible property can be located in only one state, there is no possibility that the same rental income could be taxed twice. Thus, there is no discrimination against Interstate Commerce.

2. Equal Protection

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Kodak also charged that the allocation statute is unconstitutional as a violation of the Equal Protection Clause on the ground there is no rational basis for the classification of taxing rental property based on where the property is located. The court finds Kodak is incorrect since the taxing of income at the place where the income is earned is a very rational basis for classification.

The law in our State concerning discrimination as to equal protection in a tax statute was stated in State v. Byrnes, 219 S.C. 485, 66 S.E.2d 33 (1951).

To invalidate a tax statute for discrimination, in the absence of specific constitutional inhibition, exemption from

its terms must be purely arbitrary, . . .
. It was said in Marshall v. Tax Comm.,
supra, (178 S.C. at page 62, 182 S.E. at
page 98) upon the authority of numerous
cited decisions of the U.S. Supreme
Court: "The plaintiff must be able to
satisfy the court that the classifica-
tion (of income for State taxation) has
its origin in nothing better than whim
and fantasy and tyrannical exercise of
arbitrary power, before the tax in ques-
tion will be stricken down." . . .

Here the rational basis is that it is always proper to tax
income based on where that income is earned since a state
cannot tax income earned outside its borders. Lowenstein,
supra at p. 276. If the income is earned by the rental of
property located in another state, then it is proper to have
that income taxed in that state and obviously income earned
by property located in South Carolina is taxable here. Such
a rational basis is a valid reason for the classification
based on the location of the property. In fact,

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. . . it has long been settled that a
classification, though discriminatory,
is not arbitrary nor violative of the
Equal Protection Clause . . . if any
state of facts reasonably can be con-
ceived that would sustain it . . . Allied Stores of Ohio, Inc. v. Bowers, 358
U.S. 522, 528, 79 S.Ct. 437 (1959).

Based on the above, there is no violation of the Equal Pro-
tection Clause by Section 12-7-1120(3).

3. Due Process

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The court finds there is no Due Process violation by not including Kodak's safe harbor losses with Kodak's apportionable income. The Due Process Clause allows taxing multistate income under a three-factor formula method where the income is unitary income. Mobil Oil Corp. v. Com. of Taxes of Vermont, 445 U.S. 425 (1980). Here the income of the safe harbor activities is multistate income and is thus subject to fair apportionment on the income of that activity. Likewise, the separate income from Kodak's other multistate activities are subject to fair apportionment. The court merely concludes that the safe harbor activities are not unitary with Kodak's other activities so that the two activities may not be combined. Under this view, fair apportionment is not violated since each activity is still apportioned based on the extent of the payroll, property, and sales which are incurred in South Carolina as compared to those incurred everywhere. The use of such an apportionment formula has been commonly upheld as a fair method of apportionment within the meaning of the Due Process Clause. See Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); Mobil Oil, supra. Because of such, this court finds no violation of Due Process by not combining the safe harbor lease losses with Kodak's apportionable income from its other activities.

III. No Refund Results From The Alternative
Position That Depreciation Deductions Are
Allowed On The Safe Harbor Assets.

The Amended Complaint asserts in the alternative that the taxpayer is entitled to a refund of \$1,090,624 due to depreciation deductions on the safe harbor property involved in this action. There is no basis for granting such a refund.

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The deductions for depreciation are related expenses to the rental income from the safe harbor transactions. As such, the depreciation deductions form part of the rental losses allocated to the state where the rental property is located. Since the rental property is located outside of South Carolina, the depreciation deductions are likewise outside of South Carolina and thus are not deductions against South Carolina income.

Further, as explained previously in this Order, to allow the depreciation deductions would violate the reasonableness test of Section 12-7-250. Finally, and as also explained previously in this Order, the depreciation deductions are not deductible against South Carolina taxable income since the safe harbor leasing activity is not part of Kodak's unitary business. Because of such, the depreciation deductions would only be deductible against the safe harbor activities which essentially are all outside of South Carolina. Accordingly, Kodak's alternative position for a refund of \$1,090,624 is denied.

CONCLUSION

Based on the foregoing, this Court holds Kodak is denied the recovery of the taxes paid of \$1,202,639 and is denied a refund of \$1,090,624 on its alternative position.

AND IT IS SO ORDERED.

James E. Lockemy
JAMES E. LOCKEMY, JUDGE
Fourth Judicial District, N.J.

December 12, 1990

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Duke Energy Corporation,	)	Docket No. 10-ALJ-17-0270-CC
	)	
Petitioner,	)	
	)	
vs.	)	
	)	
South Carolina Department of	)	
Revenue,	)	
	)	
Respondent,	)	

Pretrial Memorandum

The South Carolina Department of Revenue (the "Department" or "DOR") submits this pretrial memorandum supporting its position that Duke Energy Corporation ("Duke Energy" or the "Company") is a manufacturer under South Carolina Code Section 12-6-2250 for the years 1994-2001 (the "Periods at Issue") and required to apportion its income using the sales, property, and payroll factors.

Background

Duke Energy is engaged in the generation, transmission, distribution, and sale of electricity in portions of North Carolina and South Carolina. Its predecessor entity, Duke Power Company, was incorporated, *inter alia*, "[t]o manufacture, generate, buy, sell, accumulate, store, transmit, furnish and distribute electric current for light, heat and power." [E.g., Restated Arts. Inc. Duke Pwr. Co. (July 26, 1977) [Mem. Supp. DOR Mot. Sum. J. Exhibit B].] During the Periods at

Issue, Duke Energy timely filed its South Carolina corporation income tax returns, in which the Company calculated the income apportioned to South Carolina using the three-factor formula of property, payroll, and sales that must be applied by entities "whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State or (b) selling, distributing, or dealing in tangible personal property within this State." S.C. Code Ann. § 12-6-2250;¹ see Dep't Am. Prehr'g Stmt. § 5.b., p.2 (filed Nov. 30, 2010).

Duke Energy's Refund Claims

In December 2002, Duke Energy filed amended corporate income tax returns for the income tax years 1978-2001 seeking a substantial refund of income taxes. Dep't Det'n p.2 (Feb. 4, 2010).² By Order dated August 9, 2012, this Court determined that the Duke Energy's refund claims for the income tax years 1978-1993 are untimely. This Court also ruled that Duke Energy is not entitled to include the return of principal from short-term securities transactions in the denominator of its South Carolina apportionment formula. Thus, the sole issue for consideration in the hearing beginning September 5, 2012 is whether Duke Energy

¹ Section 12-6-2250 as applicable during the Periods at Issue requires that the sales factor be double-weighted in calculation of the apportionment formula. This section was previously designated as section 12-7-1140, which was repealed in 1995. Prior to June 12, 1995, section 12-7-1140 provided a three-factor formula without the double-weighted sales factor.

² These amended returns followed the initial round of amended returns submitted to the Department on or about September 24, 2002.

is required to apportion its income to South Carolina based on the three-factor formula pursuant to section 12-6-2250.

Manufacturing Electricity

In the amended returns, Duke Energy abandoned the method of apportioning income it had employed since at least 1978. The Company now seeks to apportion income to South Carolina using the single factor gross receipts formula that must be applied by entities whose "principal profits or income ... are derived from sources other than those described in Section 12-6-2250" S.C. Code Ann. § 12-6-2290.³ Duke Energy asserts that this change is required because it "erroneously computed its South Carolina income tax liability by incorrectly apportioning business income to South Carolina using a three-factor apportionment formula" Duke Energy 2nd Am. Prehr'g Stmt., p.3. In other words, the Company contends that it "was not a 'manufacturer' of electric power during the tax periods 1978 through 2001 for South Carolina income tax purposes," *id.* pp.8-9, and therefore must use the single-factor gross receipts formula in lieu of the three-factor formula.

Pertinent to the issue of manufacturing electricity, the Department cited to and applied Supreme Court precedent holding that entities engaged in producing and generating electricity are manufacturers. *See* Dep't Det'n, pp.2-3. The

³ The predecessor of section 12-6-2290, S.C. Code § 12-7-1190, was repealed in 1995, but the language remained substantially the same. Section 12-6-2290 also excludes sources described in Section 12-6-2310, but that statute references income earned by railroad companies, motor carriers, telephone service companies, pipeline companies, airline companies, and shipping lines, none of which are applicable in this case.

Department thus determined that the Company is a manufacturer and is required to use the three-factor formula. *See id.* The amount at issue, based on information provided by Duke Energy in discovery, is approximately \$21,747,297, excluding interest.⁴ [See Mem. Supp. DOR Mot. Sum. J., Exhibit F.⁵]

Analysis

1. Duke Energy has the burden of proof.

Duke Energy is challenging a determination by the Department that it must apportion its income as a manufacturer under section 12-6-2250. Therefore, Duke Energy has the burden of proof in this case. R. Proc. ALC 29.B.; *Ford v. Atl. Coast Line R. Co.*, 169 S.C. 41, 168 S.E. 143, 167 (1932) (“The general rule is, in the absence of valid statutory enactment to the contrary, that the burden of proof rests upon him who has the affirmative of the issue and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption.”), *aff’d*, 287 U.S. 502 (U.S. 1933); *Anon. Taxpayer v. S. Carolina Dep’t of Rev.*, No. 01-ALJ-17-0056-CC, 2001 WL 1107817 (S.C. Admin. L.J. Div. Sept. 4, 2001) (Geathers) (“Generally, the burden of proof is on the party asserting the

⁴ At this point, the amount would be offset by the underpayments for the tax years 2000 and 2001 resulting from this Court’s August 9, 2012 ruling that gross receipts and sales factors do not include the return of a taxpayer’s principal. Duke Energy’s originally-filed returns for these tax years included the return of principal from its short-term securities transactions, whereas the originally-filed returns for the years 1994-1999 did not include the return of principal in the apportionment formula.

⁵ Exhibit F is a spreadsheet produced by Duke Energy during discovery that displays the refund amounts at issue based on certain amended returns filed by Duke Energy in September 2002. This Court granted the Department’s motion to treat the document as confidential. A brief explanation of the spreadsheet is included with Exhibit F.

affirmative in an adjudicatory administrative proceeding.”); Burnet R. Maybank, III & The Honorable Marvin F. Kittrell, *The Revenue Procedures Act*, in SOUTH CAROLINA ADMINISTRATIVE PRACTICE & PROCEDURE 221 (Randolph R. Lowell, ed. 2d ed. 2008) (burden of proof is on the party requesting the contested case hearing).

Duke Energy’s standard in this regard is to prove by a preponderance of the evidence that the Department erred in determining that it is a manufacturer within section 12-6-2250. *See* S.C. Code Ann. § 1-23-600(A)(5) (“Unless otherwise provided by statute, the standard of proof is by a preponderance of the evidence.”); S.C. Code Ann. § 12-60-3340 (“Contested case hearings ... must be held in accordance with Chapter 23 of Title 1 ...”). This burden requires Duke Energy to prove that the Department’s determination is wrong based on the greater weight of the evidence. *See, e.g., Janasik v. Fairway Oaks Villas Horizontal Prop. Regime*, 307 S.C. 339, 346, 415 S.E.2d 384, 388 (1992) (“Findings of fact based upon a ‘preponderance’ of the evidence are those supported by the greatest ‘weight, amount, credibility or truth’ as reflected by the whole of the evidence before the court, or ‘evidence which convinces as to its truth.’”).

2. The ultimate definition of the statutory terms is a question of law for the Court.

The definition of the terms “manufacturing,” “goods and materials,” and “tangible personal property” are undefined statutory terms and, thus, the ultimate meaning is a question of law for the Court. *E.g., Town of Summerville v. City of*

North Charleston, 378 S.C. 107, 109, 662 S.E.2d 40, 41 (2008) (statutory interpretation is a question of law). Under this analysis, this Court is to determine the meaning of the terms “manufacturing,” “goods and materials,” and “tangible personal property” as used in section 12-6-2250. Necessarily, that involves a legal determination. The parties can establish an evidentiary record regarding the facts pertinent to that analysis, and the parties can introduce opinion testimony regarding certain aspects of those facts. But the ultimate legal definition of these statutory terms is a question of law for this Court.

3. In 1926 and again in 1930, the Supreme Court held that, as a matter of law, the production and generation of electricity is manufacturing for purposes of a tax statute and that Duke Energy is a manufacturer.

In 1926, the South Carolina Supreme Court held that a corporation engaged in the business of generating electricity was engaged in the business of manufacturing and thereby subject to a tax imposed on manufacturers. *Columbia Ry., Gas & Elec. Co. v. Query*, 134 S.C. 319, 132 S.E. 611 (1926) (“We do not think that there is any doubt that the appellant is engaged in the business of manufacturing gas and electricity”).⁶ In that case, the Court considered the nature of the entity by reference to its articles of incorporation, which in pertinent

⁶ The Department recognizes and accepts for purposes of this hearing that this Court has ruled that “genuine issues of material fact exist necessitating an evidentiary hearing as to whether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a “manufacturer[er].” Order Granting Sum. J. in Part & Denying Sum. J. in Part (Aug. 9, 2012). However, the Department respectfully continues to maintain for purposes of preserving the record that the South Carolina Supreme Court previously has determined as a matter of law that power companies like Duke Energy are engaged in the business of manufacturing.

part provided that the company was authorized to "manufactur[e] light, heat and power ... by electricity or any other agent or agents whatsoever." *Id.* Based on the authorization in the corporate charters for the company "to manufacture gas and electricity," the Court held that the company fell within the provisions of the Manufacturer's Tax Act. *Id.* The Court concluded that "[w]e do not think that there is any doubt that the [company] is engaged in the business of manufacturing gas and electricity, and it is clearly within the provisions of [the Manufacturer's Tax Act]." *Id.*; see also *State v. Broad River Power Co.*, 157 S.C. 1, 153 S.E. 537, 539 (1929) (noting that the Columbia Railway company built "a large plant for the *manufacture* of gas and *electricity* for sale to the public generally") (emphasis added).

When the holding of *Columbia Railway* is considered in light of the pertinent language from the Manufacturer's Tax Act at issue in that case, the applicability of that decision to this case becomes evident. Specifically, the statute at issue required that "every person, firm or corporation engaged in the business of manufacturing" was subject to the tax imposed on manufacturers. 1923 S.C. Acts 12, No. 21 §11-A [DOR Mem. Reply to Duke Energy Mot. Sum. J., Exhibit P]. And, although the tax at issue was a license tax on "the entire receipts," it was specifically imposed on "the business of manufacturing." Thus, the *Columbia Railway* decision is based on a 1923 Act directed at manufacturers and using the same language as the apportionment statute at issue in this case. Compare S.C. Code Ann. § 12-6-2250 (applying to "a taxpayer whose principal business in this

State is ... manufacturing") with 1923 S.C. Acts 12, No. 21 §11-A (applying to a taxpayer "engaged in the business of manufacturing").

The Supreme Court held in 1930 that Duke Power Co., a predecessor of Duke Energy, was entitled to claim an exemption for manufactories—defined as a physical plant, or a place or building, where manufacturing is carried on—because it was a manufacturer. *Duke Power Co. v. Bell*, 156 S.C. 299, 152 S.E. 865 (1930) (citing *Columbia Ry., Gas & Elec. Co.*). Again, the Court referenced the pertinent corporate charters. *Id.*, 152 S.E. at 867 (referencing charter granting authorization to Duke Power Company to "manufacture, generate, buy, sell, accumulate, store, transmit, furnish, and distribute electric current for light, heat, and power"). The tax assessor contended that Duke was not operating a manufactory, but the Court rejected that contention based on the *Columbia Railway* decision. *Id.*, 152 S.E. at 868. In pertinent part, the Court held that "[i]f a company engaged in the generation of electricity is a 'manufacturer' for the purposes of a Statute imposing a tax, the plan or structure wherein the process of generating such electricity is carried on is a manufactory for the purposes of a tax exempting statute." *Id.*

Thus, the Supreme Court, on two different occasions and regarding two different statutes between 1926 and 1930, held that electric utilities in general and Duke Energy in particular are engaged in manufacturing electricity as that term is applied in a tax statute. *Id.* Duke Energy's corporate charter for the Periods at Issue retained the same language used in its original charter, authorizing the company "[t]o manufacture, generate, buy, sell, accumulate, store, transmit,

furnish and distribute electric current for light, heat and power.” [See, e.g., Restated Arts. Inc. Duke Energy. Co. (June 18, 1997) [Mem. Supp. DOR Mot. Sum. J., Exhibit B].] The Supreme Court already has determined that the factual process of generating electricity employed in 1926 and 1930 constitutes manufacturing, and the Department expects that the evidence will show that the current process of generating electricity is substantially the same as that employed in 1926 and 1930. Therefore, based on Supreme Court precedent, Duke Energy is a manufacturer of electricity for purposes of a tax statute and is required to use the three-factor apportionment formula set forth in section 12-6-2250.

4. Department policy has regularly and consistently applied the determination that an electric utility is a manufacturer for purposes of a tax statute.

As reflected above, it has been the law of this State since at least 1926 that a corporation engaged in generating or producing electricity—and, indeed, Duke Energy specifically—is a manufacturer of electricity. In 1985, the South Carolina Tax Commission determined that “X” Electric and Gas” was a manufacturer because the Supreme Court had held that its predecessor was a manufacturer in the *Columbia Railway* decision. S.C. Tax Comm’n Decision P-D-532, 1985 WL 192777 (Apr. 11, 1985) [Mem. Supp. DOR Mot. Sum. J., Exhibit J, Tab 6] Although this ruling was rendered in the context of property taxes, it reflects the Department’s policy to apply the plain language of the *Columbia Railway* and *Duke Power* decisions in all instances involving the question of whether an electric utility is a manufacturer. Moreover, in P-D-532, the Department gave the

electric utility the benefit of being a manufacturer by determining that its property tax assessment ratio should be 6% as opposed to the 10.5% applicable to non-manufacturing entities.

The Department further expects that Joseph Southard, a former auditor for the Department, will testify that the Department's policy and position as he understood it was that electric utilities are to be treated as manufacturers for purposes of apportionment. The Department further expects to introduce through Mr. Southard the audit manual prepared by the Department with respect to examinations of foreign corporations with respect to the issue of how electric utilities are to be treated as manufacturers for purposes of apportionment.

In short, the available materials and evidence to be presented reflect the Department's historical position that generating electricity constitutes manufacturing. Given the existence of the *Columbia Railway* and *Duke Power* cases regarding this subject, it is not surprising that the Department has not issued numerous publications on that issue.

5. Other agencies in South Carolina and other courts have concluded that the *Columbia Railway* and *Duke Power* decisions determined that electric utilities are engaged in manufacturing.

Recognizing the Supreme Court precedent, the South Carolina Attorney General opined in 1970 that South Carolina Electric & Gas Company was a manufacturer and any plant it used to produce electricity was a manufactory eligible for property tax exemptions. 1970 S.C. Op. Att'y Gen. 154, Op. No. 2909, 1970 WL 12192 (June 2, 1970) [Mem. Supp. DOR Mot. Sum. J., Exhibit M.] The

basis for this ruling was the *Columbia Railway* and *Duke Power* decisions referenced above. The point of this document is not to illustrate directly Department policy, but to reflect that other agencies have held the same view of the *Columbia Railway* and *Duke Power* decisions as that asserted by the Department in this proceeding.

Similarly, courts in other states have referenced the *Columbia Railway* and *Duke Power* decisions as holding that generating electricity is manufacturing and that a building in which electricity is generated is a manufactory. *Curry v. Alabama Power Co.*, 243 Ala. 53, 59, 8 So.2d 521, 525 (Ala. 1942) (citing *Columbia Railway* and *Duke Power* decisions in holding that generating electricity is manufacturing); *State ex rel. Winterfield v. Hardin County Rural Elec. Co-op.*, 285 N.W. 219, 226 (Iowa 1939) (same). Again, although these decisions are not binding on this Court, they do reflect the common view that the *Columbia Railway* and *Duke Power* decisions hold that generating electricity is manufacturing.

Numerous other states have also held that generating or producing electricity is manufacturing. Although cases from other states are not binding on this Court, they do indicate that it is common to view the generation of electricity as manufacturing and to view electricity as tangible personal property. The Supreme Court itself engaged in this consideration, recognizing in *Duke Power* that a number of other states at that time had concluded that generating and producing electricity is manufacturing. *See Duke Power* (1930), 156 S.C. at 299, 152 S.E. at 865 (citing cases from New Jersey, Kentucky, and New York). Since

that time, other states have concluded that the production of electricity is manufacturing. *E.g.*, *Pub. Serv. Co. v. Dep't of Rev.*, 10CA1026, 2011 WL 4089971 (Colo. Ct. App. Sept. 15, 2011) (generating electricity is manufacturing); *Davis v. Gulf Power Corp.*, 799 So. 2d 298, 301 (Fla. Dist. Ct. App. 2001) (generation of electricity is a manufacturing process and electricity is tangible personal property); *Minnesota Power & Light Co. v. Pers. Prop. Tax, Taxing Dist., City of Fraser, Sch. Dist. No. 695*, 182 N.W.2d 685, 692 (Minn. 1970) (producing electricity is manufacturing); *Bd. of Assessors of Holyoke v. State Tax Comm'n*, 244 N.E.2d 287, 289 (Mass. 1969) (same); *Boston Gas Co. v. Assessors of Boston*, 137 N.E.2d 462, 469 (Mass. 1956) (same); *City of Ames v. State Tax Comm'n*, 71 N.W.2d 15, 22 (Iowa 1955) (same); *Morley v. Brown & Root*, 219 Ark. 82, 87, 239 S.W.2d 1012, 1015 (Ark. 1951); (same); *City of Louisville ex rel. v. Howard*, 306 Ky. 687, 694-95, 208 S.W.2d 522, 526 (Ky. 1947) ("The generation of electricity is manufacturing."); *Chicago, M., St. P. & P.R. Co. v. Custer County*, 32 P.2d 8, 9 (Mont. 1934) (holding that "the electricity which exists in nature is not subject to use; the current which will cause the wheels of industry to turn, or will light a city, must be produced by the employment of labor and machinery and is, therefore, generally said to be manufactured").

6. The apportionment statute at issue is a tax statute involving the term manufacturing and, thus, is governed by the *Columbia Railway* and *Duke Power* decisions.
 - a. The statute applies to manufacturing.

Section 12-6-2250 requires apportionment using the property, payroll, and sales factors and applies to the following:

A taxpayer whose principal business in this state is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State; or (b) selling, distributing, or dealing in tangible personal property.

S.C. Code Ann. § 12-6-2250.

Therefore, section 12-6-2250 applies to entities engaged in "manufacturing." It also applies to entities engaged in "any form of collecting, buying, assembling, or processing goods and materials within this State." And it applies to entities "selling, distributing, or dealing in tangible personal property." If any of these descriptions apply, the taxpayer must apportion its income in accordance with section 12-6-2250.⁷ Because the Supreme Court already has held that electric utilities in general and Duke Energy in particular are engaged in "manufacturing," section 12-6-2250 applies to the taxpayer in this case.

The statutory history supports the conclusion that the term "manufacturing" in section 12-6-2250 stands alone and is not modified by the clause "or any form of collecting, buying, assembling, or processing goods and materials within this State." South Carolina first adopted an apportionment statute in 1927, which applied to corporations "engaged in the business of manufacturing." 1927 S.C.

⁷ Duke Energy contends that the applicable test to determine whether Duke Energy files under section 12-6-2250 or under section 12-6-2290 is to determine whether "over 50 percent of [its] gross receipts are from providing services." [Duke Mem. Opp. DOR Mot. Sum. J., p. 26 (citing S.C. Rev. Rul. 87-5 (Sept. 16, 1987)).] This test does not assist in determining whether Duke Energy is a manufacturer.

Acts 1, No. 1 § 15(1). This language remained the same in section 2451 of both the 1932 Code and the 1942 Code. In 1946, the General Assembly amended section 2451 of the 1942 Code to apply to taxpayers whose "principal business ... in this State is manufacturing, or if it is any form of collecting, buying, selling, assembling or processing goods and materials within this State." 1946 S.C. Acts 1491, No. 553 § 3. In other words, the statutory history reflects that the second part of the clause was added as a separate and independent component at a date subsequent to the initial adoption of the statute and, thus, that the latter part does not modify the manufacturing language located at the beginning of the clause and enacted as part of the original statute. Therefore, as indicated above, it is not necessary for this Court to resolve the question of whether electricity constitutes "goods and materials" or "tangible personal property" in view of the holdings of *Columbia Railway* and *Duke Power*. Rather, those cases conclusively hold that generating electricity is manufacturing. Because section 12-6-2250 applies to companies engaged in manufacturing, the statute also applies to companies generating electricity, and Duke Energy was required to apportion its income pursuant to the provisions of that statute during the Periods at Issue.

b. The definition of manufacturing encompasses the activities of Duke Energy.

The apportionment statute does not define the term "manufacturing." However, as indicated above, the Supreme Court has held that the process of generating electricity constitutes manufacturing. Other statutes refer to electric

utilities as manufacturing electricity. For example, Title 12, Chapter 23 of the South Carolina Code of Laws imposes a license tax on the sale of electric power in certain defined instances. S.C. Code Ann. § 12-23-10. However, certain matters are exempt from the tax, such as “*electric power manufactured* or generated in another state,” “any person owning and operating an *electric manufacturing* or generating *plant* of ten horsepower or less;” and a “municipality *manufacturing* or generating *electricity* for the use of its customers.” S.C. Code Ann. § 12-23-20 (emphasis added). And a power company is required to submit a “showing the exact amount of *electric power manufactured*, generated, or sold” S.C. Code Ann. § 12-23-60 (emphasis added). These statutes were adopted in the 1930s and, thus, are indicative of the understanding of manufacturing and the use of the term manufacturing as a description of the process of generating electricity during the time of the *Columbia Railway* and *Duke Power* decisions.

Moreover, other statutes adopted and existing at around the same time define the process of generating electricity as manufacturing. Specifically, South Carolina prohibits the theft of electricity by any “person who ... has no contract, agreement, license, or permission with or from any person authorized to *manufacture*, sell, or use *electricity* for the purpose of light, heat, or power.” S.C. Code Ann. § 16-13-380 (emphasis added). Thus, this statute defines the generation of electricity as the manufacture of electricity. Interestingly, although the statute first appeared in 1904, it was amended in 1996 to enhance the penalties for stealing electric current, yet the General Assembly did not change the statutory

formulation regarding the manufacture of electricity. *See* 1996 S.C. Acts 369. This demonstrates a legislative intent to treat the generation of electricity as manufacturing. A related statute prohibits the wrongful use of electricity by a person who has a "contract, agreement, license or permission, oral or written, with or from any person authorized to manufacturer, sell or use electricity for the purpose of light, heat or power." S.C. Code Ann. § 16-13-390 (emphasis added). In contrast, South Carolina law prohibits a person from avoiding or attempting to avoid payments for any "telecommunications *service*." S.C. Code Ann. § 16-13-400 (emphasis added).

In fact, a comparison of current and prior dictionary definitions emphasize the ongoing validity of these Supreme Court decisions. For example, Merriam-Webster presently defines "manufacture" as "the process of making wares by hand or by machinery especially when carried on systematically with division of labor." It further defines the term to include "productive industry using mechanical power and machinery." [<http://www.merriam-webster.com/dictionary/manufacture>] (accessed August 26, 2012).] By comparison, the 1927 Century Dictionary defined manufacture as "the making of goods or wares by ... machinery, esp. on a large scale" [Exhibit A.] These definitions are substantially the same, thus leading to the conclusion that the *Columbia Railway* and *Duke Power* decisions remain binding.

Moreover, in 1939, in holding that the generation of electricity is manufacturing, the Iowa Supreme Court referenced Webster's definition of

manufacturing, which was "to make by hand, by machinery, or by other agency; to work raw materials into forms for use; to produce mechanically." *Winterfield*, 285 N.W. at 224-25 ("The great preponderance of authority as evidenced by the decisions of the courts supports the proposition that one engaged in the generation of electricity is engaged in a manufacturing or mechanical business."). Applying this definition, the Court held that generating electricity is manufacturing. *Id.* (referencing Webster's dictionary, which stated that the term "generate" means "to beget, produce, or cause to be, to produce an electric current"). Although this decision obviously is not binding on this Court, it does illustrate the definition being applied by the courts during the same decade that the South Carolina Supreme Court rendered the *Duke Power* decision. Evaluating that decision and the *Columbia Railway* decision in light of this dictionary definition leads to the conclusion that Duke Energy was and is a manufacturer when that term appears in a taxing statute.

Whatever the definition used, and aside from the decisions of the Supreme Court on this issue, the evidence to be produced at trial will reflect that the Department correctly treats the generation of electricity as manufacturing for purposes of tax statutes employing that term. The Department anticipates that the testimony of Duke Energy's fact and expert witnesses will reflect a process of manufacturing. In addition, the Department's expert witness, Glenn Robinson, will testify that the generation of electricity constitutes manufacturing electricity. The

Department further anticipates that Duke Energy will not meet its burden to prove by a preponderance of the evidence that the Department's determination is wrong.

7. Duke Energy also falls within the other provisions of section 12-6-2250.

a. Processing goods and materials.

Although the Department contends that it is not necessary to reach the second prong of 12-6-2250(a), the evidence will reflect that manufacturing or generating electricity involves "any form of processing goods and materials." Specifically, the evidence will show that generating electricity is a form of processing inputs such as coal, water, or nuclear rods, then using the energy derived from those sources to generate electricity that is then transmitted and distributed to customers. The use of "any form" in the statute reflects a legislative intent that the language be applied as broadly as possible and, concomitantly, a legislative preference for using the three-factor formula whenever possible. *Hertz Corp. v. S. Carolina Tax Comm'n*, 246 S.C. 92, 96, 142 S.E.2d 445, 447 (1965) (identifying "any form" in predecessor to section 12-6-2250 as "broad language"). In fact, the Supreme Court stated that treating a taxpayer involved in renting tangible personal property as falling within the predecessor to section 12-6-2250 that "the legislative classification ... should be liberally construed in favor of the inclusion of business to which the formula is appropriate." *Id.* Applied here, that rule of liberally construing section 12-6-2250 leads to the conclusion that Duke Energy falls within its provisions, especially in light of the Supreme Court's prior rulings on this issue.

Moreover, electricity itself is a good. Duke Energy contests this assertion, contending that a consideration of the nature of electricity leads to the conclusion that it is not tangible. However, it reaches this contention based on a strict evaluation of the science regarding electricity. Duke Energy extends this contention to assert that providing electricity is a service. But as one court said, “[f]rom the strictly scientific point of view, the subject is highly technical; but in considering the case, we must not lose sight of the fact that taxation is a practical matter, and that what constitutes commerce, manufacture, or production is to be determined upon practical considerations.” *Texas E. Transmission Corp. v. Benson*, 480 S.W.2d 905, 908 (Tenn. 1972). Moreover, as one bankruptcy court noted, “[w]hether or not electricity is a good, [the provider] is in the business of selling that electricity and not providing a *service*.” *In re Erving Industries, Inc.*, 432 B.R. 354, 363 (2010) (emphasis in original).

In this vein, courts in other states have concluded that electricity is a good or is tangible personal property for taxation purposes. *See, e.g., Pub. Serv. Co.*, 10CA1026, 2011 WL 4089971, **7-8 (holding that generating electricity is manufacturing for purposes of an exemption from sales taxes for machinery “used in Colorado directly and predominantly in manufacturing tangible personal property, for sale or profit”); *Davis*, 799 So. 2d at 301 (electricity is tangible personal property); *Texas E. Transmission*, 480 S.W.2d at 908 (holding that electricity has characteristics of tangible personal property.”); *S. Natural Gas Co. v. State*, 261 Ala. 222, 229, 73 So. 2d 731, 738 (Ala. 1953) (electricity is tangible

personal property); *Curry*, 8 So.2d at 525 (same); see also *Minn. Power & Light Co.*, 182 N.W.2d at 692 (generating electricity involves producing a product);

Recently, several bankruptcy courts also have concluded that electricity is a good for purposes of Article 2 of the Uniform Commercial Code. These courts have avoided engaging in a hypertechnical analysis of electricity to determine whether the characteristics of electricity render it a good. Thus, one bankruptcy court determined that electricity is tangible because it “really is some *thing*, something that can be felt (although we are loathe to) and something that can be created, measured and stored.” *In re Erving Industries, Inc.*, 432 B.R. at 367-69 (emphasis in original) (finding that, for purposes of Article 2 of the Uniform Commercial Code, “electricity is tangible and *does* possess physical properties”). The court rendered this analysis in rejecting an argument that electricity is not tangible because it is “‘simply the movement of electrical charges’ and the ‘physical phenomena arising from the behavior of electrons and protons,’ but does not have actual physical form or physical attributes.” *Id.* at 368. The Court determined that electricity is tangible because “customers rely on the specific physical properties of electricity to fulfill their needs—anything deviating from those properties simply will not do.” *Id.* In that case, the Court also distinguished electricity from television, radio, telephone, and [I]nternet signals” because those are “mechanisms by which other non-goods—intellectual property, ideas, sounds, music, images, and words—are sent from one location to another.” *Id.* The Court rejected the effort to analogize electricity to those mediums, stating that

"[e]lectricity, in contrast, is not merely a medium of delivery, but is the thing the customer seeks to purchase." *Id.* Thus, the proposition that electricity is a good and is tangible is not unique to the South Carolina Department of Revenue. *See also GFI Wisconsin, Inc. v. Reedsburg Utility Comm'n*, 440 B.R. 791 (W.D. Wisc.) (electricity is a good under Article 2), *aff'g In re Grede Foundries, Inc.*, 435 B.R. 593 (Bankr. W.D. Wisc. 2010) (same); *In re Pac. Gas & Elec. Co.*, 271 B.R. 626, 640 (Bankr. N.D. Cal. 2002) (same).

As recently as June of this year, the United States Court of Appeals for the Sixth Circuit held that the electricity Duke Energy produces and sells is a commodity. *Williams v. Duke Energy, Inc.*, 681 F.3d 788, 800 (6th Cir. 2012). The court held that "[E]lectricity is a commodity as it is 'produced, sold, stored in small quantities, transmitted, and distributed in discrete quantities'" *Id.* (quoting *Metro Commc'ns Co. v. Ameritech Mobile Commc'ns, Inc.*, 984 F.2d 739, 745 (6th Cir. 1993)). In contrast, the *Williams* court stated that "cellular telephone service was not a commodity because it is 'very different from electricity. It cannot be produced, felt, or stored, even in small quantities.'" *Id.* (quoting *Metro*, 984 F.2d at 745). The *Williams* court also cited favorably to two district court decisions from Massachusetts and Florida finding that "electricity is a commodity because...electrical energy is a thing bought and sold in the market place" and "electricity is a commodity because it is a product manufactured from other forms of energy, similar to commodities such as coal and gasoline, and is valued for its physical characteristics rather than legal meaning or ability to provide a service,"

respectively. *Id.* (citing *Town of Concord, Mass. V. Bos Edison Co.*, 676 F.Supp. 396, 397-98 (D.Mass.1988); *City of Gainesville v. Fla Power & Light Co.*, 488 F.Supp. 1258, 1280-83 (S.D.Fla.1980).

The Department anticipates that the evidence to be produced at the hearing will reflect that electricity is indeed tangible and that it has unique physical properties, rendering it a good within the meaning of section 12-6-2250. As the *Erving Industries* court determined, electricity can be sensed, created, measured, and stored and, thus, is a tangible good. The Department further anticipates that Duke Energy cannot meet its burden of establishing by a preponderance of the evidence that the Department's determination is wrong.

b. Selling, distributing, or dealing in tangible personal property.

For the reasons stated above, the Department also contends that it is not necessary to reach section 12-6-2250(b). However, should this Court find it necessary to do so, the Department contends that the evidence will reflect that Duke Energy is "selling, distributing or dealing in tangible personal property." For the same reasons set forth with respect to the definition of electricity as a good, it also constitutes tangible personal property.

As referenced above, the evidence will reflect that electricity is tangible personal property with physical properties. Moreover, the Department anticipates that Duke Energy cannot meet its burden to prove by a preponderance of the evidence that the Department's position is erroneous.

Trial Issues

The Department anticipates that the hearing on the issues in this case should take no more than two days, and probably less. Based on information informally exchanged by the parties, Duke Energy is expected to call Cooper Monroe and Dhiaa Jamil as fact witnesses and Dr. Ioannis Papapolymerou as an expert witness. The Department expects to call Joseph Southard, formerly an auditor with the Department during the Periods at Issue, and Glenn Robinson, an electrical engineer, as an expert witness.

From its vantage point, the Department does not anticipate an extensive documentary record will be necessary. It is likely that some demonstrative exhibits may be used by both parties, but the Department believes there is little to no documentary evidence pertinent to the question of whether Duke Energy is a manufacturer for purposes of section 12-6-2250. The Department does not anticipate any unusual evidentiary questions for the Court's consideration. The Department anticipates that a motion for an involuntary non-suit pursuant to South Carolina Rule of Civil Procedure 41(b) will be appropriate at the conclusion of Duke Energy's case in chief.

Conclusion

The Department contends that the pertinent legal principles and evidence to be introduced will require a conclusion that Duke Energy is required by section 12-6-2250 to use the three-factor apportionment formula just as the Company reported on its originally filed returns for the Periods at Issue. Because this is the

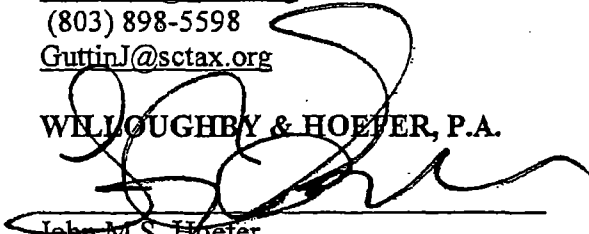
only issue for consideration at the hearing⁸ and affecting the amended returns for the Periods at Issue, this Court should grant judgment in favor of the Department.

Respectfully submitted,

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Columbia, South Carolina
August 27, 2012

⁸ The parties have agreed to hold in abeyance all matters involving Crescent Resources pending the resolution of all issues presented to this Court.

EXHIBIT A

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The New
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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

Docket No.: 10-ALJ-17-0270-CC

DUKE ENERGY CORPORATION'S PRE-TRIAL BRIEF

Duke Energy Corporation ("Duke Energy") respectfully submits this Pre-Hearing Brief for the Court's consideration and states as follows:

INTRODUCTION

This is an appeal by Duke Energy from the Determination of the South Carolina Department of Revenue (the "Department") denying Duke Energy's claims for refund of South Carolina corporate income taxes for the tax years 1994 through 2001.¹ See Department's Determination (Exhibit A). Duke Energy asserts that it is a service provider and thus is required to apportion its income on the basis of the single-factor gross-receipts apportionment formula. The Department concedes that Duke Energy is a service provider, but it nevertheless claims that Duke Energy is a manufacturer and should apportion its income based on the multi-factor apportionment method prescribed for manufacturers under South Carolina law. The Department's theory that Duke Energy

¹ Duke Energy originally sought refunds for the tax years 1978 through 2001. On August 9, 2012, this Court ruled that Duke Energy's refund claims for the tax years 1978 through 1993 are untimely. Duke Energy's refund claims for 1978-1993 are not before the Court at this time.

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can be a service provider and still be a manufacturer is not supported by South Carolina law or the facts. Indeed, the evidence at trial will show that Duke Energy provides services to its customers and is not a manufacturer. This Court² and both the Department's and Duke Energy's experts agree that a service provider³ cannot be a manufacturer. Therefore, Duke Energy respectfully requests that this Court rule that the Department's Determination is illegal and erroneous, and that Duke Energy is entitled to a refund of South Carolina corporate income taxes in the amount of \$21,747,312, plus applicable interest.

STATEMENT OF THE CASE

The testimony and exhibits that will be introduced at the hearing of this matter, scheduled for September 5-7, 2012, before this Court, will provide evidence of the following facts:

I. Duke Energy's Business Operations

Duke Energy (f/k/a Duke Power Company) is, and was during all relevant tax periods, a multi-state energy services enterprise with operations in South Carolina. Duke Energy's primary operations in South Carolina consisted of its franchise electric service business, real estate business, and fiber optics and telecommunications business. Duke Energy's 10-K for the Fiscal Year Ended 2000 at 3 (**Exhibit C**); Duke Energy's 10-K for the Fiscal Year Ended 1997 at 1 (**Exhibit D**); Franchised Electric & Gas Service dated

² In the Order issued by the Court on August 9, 2012 ("ALC Order"), the Court ruled: "Based on the record, I find that genuine issues of material facts exist necessitating an evidentiary hearing as to whether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a "manufactur[er]," or whether Duke Energy is a seller of service, or otherwise falls under none of the above categories, and is therefore required to apportion its income to South Carolina based on the single-factor gross-receipts apportionment formula pursuant to Section 12-6-2290" ALC Order at 23 (emphasis added) (**Exhibit B**).

³ Duke Energy's primary business is the sale of electric service. And the Department has not explained how Duke Energy can manufacture a service. Further, the Department has not claimed thus far, that Duke Energy manufactures any other form of tangible personal property.

July 27, 2010, *available at* www.duke-energy.com/about-us/businesses/francised-electric-and-gas.asp ("Duke Energy offers electric service to approximately 7 million customers in the Carolinas, Ohio, Kentucky, and Indiana) (emphasis added) (Exhibit E).

Duke Energy is, and was during all relevant tax periods, subject to the jurisdictions of the Federal Energy Regulatory Commission ("FERC") and South Carolina Public Service Commission ("SCPSC"). The FERC is an independent federal agency "responsible for regulating interstate transmission rates and services, wholesale energy rates and services, corporate transactions, mergers, and securities issues by public utilities." FERC Industries, *available at* <http://www.ferc.gov/industries/industries.asp> (emphasis added) (Exhibit F). The SCPSC "regulates the rates and service of investor own public utilities in the state of South Carolina and establishes just and reasonable standards for their rates and services." SCPSC Accountability Statement 2011-12 at 1-2, *available at* <http://www.psc.sc.gov/publications/accountabilityreport.asp> (emphasis added) (Exhibit G).

II. Duke Energy's Tax Overpayments

In December 2002, Duke Energy timely filed amended South Carolina corporate income tax returns for the 1994 through 2001 tax periods ("Tax Periods at Issue") to correct errors it had made on its original South Carolina tax returns. Pet'r Preh'g Stmt. § 5.A, pp. 3-4 (filed Apr. 1, 2010). Duke Energy's amended returns constituted refund claims.

The errors on Duke Energy's originally filed South Carolina tax returns related to the computation of Duke Energy's apportionment formula – which is the mechanism for determining how much income is associated with Duke Energy's South Carolina's

business activities. On its original South Carolina tax returns, Duke Energy apportioned its income to South Carolina based on a multi-factor apportionment formula consisting of sales, property and payroll factors. However, because Duke Energy was primarily engaged in the business of selling electric service to its customers, it was required to apportion its income using the single-factor gross-receipts apportionment method rather than the multi-factor method required for companies that manufacture tangible personal property. (Pet'r Preh'g Stmt. § 5.A, p. 4.) Therefore, on its amended returns, Duke Energy applied the single-factor formula applicable to enterprises engaged in the provision of services. (Pet'r Preh'g Stmt. § 5.A, p. 4.)

III. The Department's Denial of Duke Energy's Refund Claims

In 2003, the Department denied Duke Energy's refund claims. Duke Energy timely protested the denial soon thereafter. (Pet'r Preh'g Stmt. § 5.A, p. 4.) The Department reviewed Duke Energy's refund claims and took no action on Duke Energy's protest for approximately seven years. In February 2010, and in response to multiple requests from Duke Energy to rule on its protest, the Department issued the Determination denying Duke Energy's protest and its refund claims. (Pet'r Preh'g Stmt. § 5.A, p. 4.) In its Determination, the Department stated, *inter alia*, that "while the taxpayer [Duke Energy] is correct that it provides a service, its service is statutorily defined [for sales tax purposes] as tangible personal property." Determination at 3 (emphasis added) (Exhibit A).

In March 2010, Duke Energy timely appealed from the Department's Determination by filing a request for a contested case hearing before this Court. Subsequently, the parties filed pre-hearing statements and amended pre-hearing

statements. In its Amended Pre-Hearing Statement dated November 30, 2010, the Department stated as follows: "Because petitioner is a manufacturer of electricity and a **power service provider**, it is required to use the three factor apportionment formula in computing its South Carolina taxable income." Resp. Am. Preh'g Stmt. at 1 (emphasis added) (Exhibit H).

In April 2012, the Department sought a summary judgment asking this Court to rule that, as a matter of law, Duke Energy is a manufacturer. In May 2012, Duke Energy opposed the Department's request for summary judgment on the grounds that Duke Energy is a service provider and an evidentiary hearing is necessary to resolve the material facts in dispute. On August 9, 2012, the Court denied the Department's summary judgment motion and issued an Order concluding as follows:

Based on the record, I find that genuine issues of material facts exist necessitating an evidentiary hearing as to whether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a "manufactur[er]," or whether Duke Energy is a seller of service, or otherwise falls under none of the above categories, and is therefore required to apportion its income to South Carolina based on the single-factor gross-receipts apportionment formula pursuant to Section 12-6-2290"

ALC Order at 23 (emphasis added) (Exhibit B).

As indicated by the Court's ALC Order, the issue for trial is whether Duke Energy is a manufacturer under S.C. Code Ann. section 12-6-2250, or whether it is a seller of a service, or otherwise falls under none of the above categories, under S.C. Code Ann. section 12-6-2290. As set forth by the ALC Order, one cannot be engaged in the business of selling services and be a manufacturer. The analysis of this issue at trial is binary. Because Duke Energy will provide evidence that it is a seller of services, and the

Department concedes that Duke Energy sells services, the Court should rule that Duke Energy is required to file its South Carolina income tax returns using the single-factor gross-receipts method.

ARGUMENT

I. Description of South Carolina's Income Apportionment Regime.

During the Tax Periods at Issue, taxpayers whose principal business in South Carolina was the "manufacturing or a form of collecting, buying, assembling, or processing goods and materials within the state" were required to apportion their income based on a multi-factor apportionment formula, consisting of property, sales, and payroll factors. S.C. Code Ann. § 12-6-2250 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1120 (applicable to tax years prior to 1996). All other taxpayers (except certain specific industries not relevant here) had to apportion their income using a single-factor gross-receipts apportionment formula. S.C. Code Ann. § 12-6-2290 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1190 (applicable to tax years prior to 1996).

This Court has previously explained that the multi-factor apportionment method, based on property, payroll, and sales, "is used for taxpayers whose principal business in South Carolina is dealing in tangible personal property (typically used by businesses that manufacture, sell, or rent tangible personal property)," whereas the gross-receipts apportionment method is "normally used by taxpayers who do not deal with tangible personal property, such as financial businesses and service businesses...). *Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev.*, 2009 S.C. Tax LEXIS 56, *48, *58 (S.C. Admin. L. Ct. May 4, 2009) (emphasis added) (Kittrell, Chief A.L.J.) (Exhibit D), *upheld on appeal*, 388 S.C. 138, 694 S.E.2d 525 (2010).

Similarly, the Department has historically required the multi-factor apportionment formula to be used by taxpayers who manufacture tangible personal property, whereas it has viewed the gross-receipts formula to apply to service providers. *See, e.g.,* S.C. Rev. Proc. No. 09-1, 2009 S.C. LEXIS 84, *2-3 (S.C. Dep't of Rev. 2009) ("South Carolina generally requires the use of one of the following apportionment methods: (1) (a) A 'three factor' apportionment method (based on property, payroll, and double-weighted sales) or (b) [after 2006,] a 'single factor' apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in **tangible personal property**. This method is typically used by businesses that **manufacture, sell, distribute, or rent tangible personal property**. (2) A 'gross receipts' apportionment method for taxpayers **not dealing in tangible personal property**. This method is typically used in the financial businesses and **service businesses**") (Emphasis added) (**Exhibit J**). *See also* Private Letter Ruling No. PLR-03-1, 2003 S.C. Tax LEXIS 263 (S.C. Dep't of Rev. March 10, 2003) ("South Carolina generally requires the use of one of the following apportionment methods: 1. A "three factor" apportionment method (based on property, payroll, and double weighted sales) for taxpayers whose principal business in South Carolina is **dealing in tangible personal property**. Code Section 12-6-2250. 2. A 'gross receipts' apportionment method for taxpayers **not dealing in tangible personal property**, such as financial and service businesses. Code Section 12-6-2290.) (Emphasis added) (**Exhibit K**); Private Letter Ruling No. PLR-95-9, 1995 S.C. Tax LEXIS 325 (S.C. Dep't of Rev. Aug. 14, 1995) (same) (**Exhibit L**); Technical Advice Memorandum No. TAM-94-2, 1994 S.C. LEXIS 162, *4 (S.C. Dep't of Rev. Sept. 20, 1994) (same) (**Exhibit M**); *In Re: A Finding Concerning The Income Tax Liability Of XXX, Inc.*, 1993

S.C. Tax LEXIS 113 (1993) ("We note here that ZZ is in the business of providing services. We have no indication that it is dealing in tangible personal property. Accordingly, ZZ must report on the gross receipts method of Section 12-7-1190.") (Exhibit N); Information Letter No. IL-11-13, 2011 S.C. Tax LEXIS 20 (S.C. Dep't of Rev. Aug. 19, 2011) ("Effective for tax years beginning after 2006, Act No. 384 of 2006 amended Code Section 12-6-2250 to enact a single factor apportionment factor for **businesses dealing in tangible personal property using the 3 factor** (with double weighted sales) **apportionment method**. The single factor apportionment factor is being phased in and will replace the 3 factor (with double weighted sales) apportionment method for tax years beginning in 2011.") (Emphasis added) (Exhibit O); Information Letter No. IL-10-9, 2010 S.C. Tax LEXIS 42 (S.C. Dep't of Rev. Sept. 14, 2010) (same) (Exhibit P).

"Manufacturer" or "manufacturing" is not defined for South Carolina corporate income apportionment tax purposes.⁴ However, the South Carolina Income Tax Code, set forth in section 12-6-10 *et seq.*, defines "tangible property" as "real property and corporeal personal property but does not include money, bank deposits, shares of stock, bonds, credits, evidences of debt, choses in action, or evidences of an interest in property." S.C. Code Ann. § 12-6-30(11). "Intangible property" means "all property other than tangible property. S.C. Code Ann. § 12-6-30(12).

While there is no South Carolina judicial or administrative authority defining "manufacturer," "manufacturing" or "service" for South Carolina income tax purposes, a

⁴ As discussed below, "manufacturing" is defined in other sections of the Income Tax Act, such as for purposes of the Job Income Tax Credit and Renewable Energy Income Tax Credit. See p. 16 below.

plain reading of these terms are instructive. The South Carolina Supreme Court has cited to the following definition of "service" from the Webster Dictionary:

Any result of useful labor which does not produce a tangible commodity. In economics, such business concerns as railroads, telephone companies, or laundries, and such persons as physicians, are regarded as performing services.

Fennell v. S.C. Tax Comm'n, 233 S.C. 43, 46, 103 S.E.2d 424, 426 (1958) (Emphasis added).

Moreover, the Department has previously ruled that:

[W]hether a business is a service related industry can be made by comparing the gross receipts of the business derived from providing services to total gross receipts of the business. If over 50 percent of the gross receipts are from providing services, then the business would be service related. This method has been utilized by the [South Carolina Tax] [C]ommission in determining whether a multistate taxpayer is providing services and thus would utilize the gross receipts ratio to apportion its income.

Rev. Rul. No. RR-87-5, 1987 S.C. Tax LEXIS 15, at *3 (S.C. Tax Comm'n Sept. 16, 1987) (emphasis added) (**Exhibit Q**). Thus, the Department has explicitly adopted a test whereby "if over 50 percent of the gross receipts are from providing services, then the business would be service related" and the taxpayer would be required to apportion its income to South Carolina using the single-factor gross-receipts apportionment method.

II. Duke Energy Is Primarily Engaged in the Provision of Electrical Service and Is Thus Required to Apportion Its Income to South Carolina Based on the Single-Factor Gross-Receipts Apportionment Formula.

1. Duke Energy Does Not Sell "Tangible Personal Property" Because Electricity Is Not "Tangible Personal Property."

The Department agrees that Duke Energy provides a service. In its Determination denying Duke Energy's refund claims, the Department stated that "while the taxpayer

[Duke Energy] is correct that it provides a service, its service is statutorily defined as tangible personal property." Determination at 3 (Exhibit A); *see also* Resp. Am. Preh'g Stmt. at 1 ("Because Petitioner [Duke Energy] is a manufacturer of electricity and a power service provider"). The Department is correct in that Duke Energy sells electric service and that Duke Energy is a service provider. The Department is incorrect, however, in asserting that "its service is statutorily defined as tangible personal property" because the Department relies on the definition of "tangible personal property" for South Carolina sales and use tax purposes.

In fact, the term "tangible property" is specifically defined in the South Carolina Income Tax Act and its definition has no mention of terms such as "electric," "electricity" or "power." Specifically, "tangible property," as set forth in Article 1 of the Income Tax Act, is defined to include "real property and corporeal personal property but does not include money, bank deposits, shares of stock, bonds, credits, evidence of debt, choses in action, or evidence of an interest in property." S.C. Code Ann. § 12-6-30(11). In the Determination, the Department refuses to apply the statutory definition of the term for income tax purposes and instead relies upon the sales tax definition of the term set forth in S.C. Code Ann. § 12-36-60, which specifically provides:

"Tangible personal property" means personal property which may be seen, weighed, measured, felt, touched, or which is in any other manner perceptible to the senses. **It also includes services and intangibles, including communications, laundry and related services, furnishing of accommodations and sales of electricity**

Unlike the definition of "tangible personal property" under the Sales and Use Tax Act, it is clear that the definition of the term as set forth in the Income Tax Act does not include any services or intangibles.

If the South Carolina Legislature wanted to include the service of selling electricity in the definition of "tangible personal property" for South Carolina income tax purposes, it would have done that. "The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature.' Where the statute's language is plain, unambiguous, and conveys a clear, definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." *Travelscape, LLC v. S.C. Dep't of Rev.*, 391 S.C. 89, 98, 705 S.E.2d 28, 33 (2011) (internal citations omitted). Here, based on the plain language of the term "tangible property" as defined in the Income Tax Act, that the South Carolina Legislature did not intend to include in the term's definition the service of providing electricity, in the same manner as it had done so in the Sales and Use Tax Act.

While Duke Energy maintains that the term "tangible personal property" as codified in the Income Tax Act is clear and unambiguous, if the Court determines that ambiguities exist, such ambiguities must be resolved in favor of Duke Energy. In a case decided only three weeks ago by the South Carolina Supreme Court, the Court applied these principles to determine the meaning of the undefined term "telephone company." See, e.g., *Alltel Commc'ns. Inc. v. S.C. Dep't of Rev.*, 2012 S.C. LEXIS 151, *12-13 (S.C. 2012). The court held: "Generally, a court must apply the rules of statutory construction to resolve the ambiguity and discover the intent of the legislature. However, in the enforcement of tax statutes, the taxpayer should receive the benefit in case of doubt. *Id.* (Internal citations omitted).

Moreover, while the legislature chose to include the service of selling electricity in the definition of tangible personal property for sales and use tax purposes, it does not

follow that electricity stops being a service in other tax type contexts, as the Department has suggested. In fact, the Department's line of reasoning was previously rejected by this Court in the context of South Carolina's license tax. In *Consolidated Hydro*, the taxpayer company owned and operated several hydro-electric power generation facilities in South Carolina and it was engaged in the business of production and sale of electricity. *Consolidated Hydro S.E., Inc. v. S.C. Dep't of Rev. & Taxation*, No. 95-ALJ-17-0634, 1996 WL 909155 (S.C. Admin. L.J. Div. May 13, 1996) (Lee, A.L.J.) (**Exhibit R**). The company contended that it did not provide or sell a "service" and thus was not subject to additional license taxes. In so contending, the company relied upon the definition of "tangible personal property" set forth in S.C. Code Ann. § 12-36-60 for sales and use tax purposes. The Court disagreed with the company and reasoned:

While electricity is included in [12-36-60] discussing the application of sales tax on the sale of tangible personal property, the sale of electricity is specifically recognized and defined as a service.

Id. at *4 (emphasis added). The Court then concluded that sale of power by the company was a sale of services. Therefore, in the instant case, the Department's reliance on the definition of "tangible personal property" under the Sales and Use Tax Act is misplaced because the Income Tax Act defines the very same term differently.

Moreover, the Department has not presented any facts that would establish that electricity is tangible personal property. To the contrary, the Department's own expert agreed during depositions that Duke Energy provides services. Robinson Dep. 72:19-73:20 (**Exhibit S**).⁵ Duke Energy will show at trial, through its expert and factual

⁵ Q: So in your view, electricity – the electricity that Duke sells, the electric energy that Duke sells, it would change from material to a service if Duke went ahead and sold it on a single charge, you know, \$40 per month for all the electricity? ...

witnesses, that electricity is not tangible personal property and that Duke Energy's activities in South Carolina constitute services that cannot be qualified as tangible personal property.

2. Duke Energy Is Not A Manufacturer

Both parties' experts and this Court agree that if the provision of electricity is a service, then Duke Energy cannot be classified as a manufacturer, contrary to the Department's suggestion. ALC Order at 23⁶; I. Papapolymerou Dep. 43:4-14 (Exhibit T); Robinson Dep. 72:19-73:20 (Exhibit U). Furthermore, the Department has traditionally viewed manufacturers and service providers as two separate and distinct categories of taxpayers, subject to entirely different apportionment regimes (manufacturers were subject to a multi-factor apportionment method, whereas service providers used a single-factor apportionment method). See SC Rev. Proc. No. 09-1, 2009 S.C. LEXIS 84, *2-3 ("South Carolina generally requires the use of one of the following apportionment methods: (1) (a) A 'three factor' apportionment method (based on property, payroll, and double-weighted sales) or (b) [after 2006,] a 'single factor' apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in tangible personal property. This method is typically used by businesses that manufacture, sell, distribute, or rent tangible personal property. (2) A 'gross receipts' apportionment method for taxpayers not dealing in tangible personal

A: That's a service. No question."

⁶ "Based on the record, I find that genuine issues of material fact exist necessitating an evidentiary hearing as to whether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a "manufacturer," or whether Duke Energy is a seller of services, or otherwise falls under none of the above-categories, and is therefore required to apportion its income to South Carolina based on the single-factor gross-receipts apportionment formula pursuant to Section

property. This method is typically used in the financial businesses and service businesses") (Emphasis added) (Exhibit V).

Interestingly, the Department appears to now claim (in addition to its claim discussed in Section II.1 above) that "Petitioner is a manufacturer of electricity and a power service provider" and thus it is required to apportion its income to South Carolina based on the apportionment formula for manufacturers. Resp. Am. Preh'g Stmt. at 1 (emphasis added) (Exhibit H). The Department provides no explanation what portion of Duke Energy's business constitutes manufacturing and cites to no authority that would require a taxpayer that is allegedly a manufacturer and a service provider simultaneously, to apportion its income based on the multi-factor apportionment method used by manufacturers. In fact, there is no such authority and in any event, the Department's analysis is fundamentally flawed. To be subject to the multi-factor apportionment formula under South Carolina law, a taxpayer cannot be a service provider and instead, it must be "dealing in tangible personal property." See, e.g., S.C. Rev. Proc. No. 09-1, 2009 S.C. LEXIS 84, *2-3 (emphasis added). In fact, this Court recognized that and ruled in the ALC Order that an evidentiary hearing is necessary to determine whether Duke Energy "falls under Section 12-6-2250 as a 'manufacture[er]' or whether Duke Energy is a seller of services, or otherwise falls under none of the above categories, and is therefore required to apportion its income pursuant to Section 12-6-2290 ..." ALC Order at 23 (emphasis added). The Department has conceded in its Determination and in its Amended Prehearing Statement that Duke Energy provides a service. Therefore, the Department cannot require Duke Energy to apportion its income based on the apportionment method for manufacturers, in violation of South Carolina law.

Even assuming, *arguendo*, that Duke Energy could be primarily a manufacturer and a service provider at the same time, which it cannot, the Department has adopted a more-than-50-percent test in determining whether a taxpayer is deemed to be a service provider. Rev. Rul. No. RR-87-5, 1987 S.C. Tax LEXIS 15, at *3 (“[W]hether a business is a service related industry can be made by comparing the gross receipts of the business derived from providing services to total gross receipts of the business. If over 50 percent of the gross receipts are from providing services, then the business would be service related.”). The Department has not asserted, as it cannot, that more than 50 percent of Duke Energy’s gross receipts are from manufacturing activities. Duke Energy’s primary business operations are the provision of electrical services to its customers and most, if not all, but certainly over 50 percent, of its receipts are derived from the provision of such services.

The Department further argues that Duke Energy is a manufacturer because it claims that the generation of electricity is manufacturing. Determination at 3 (Exhibit A); Resp. Preh’g Stmt. at 1 (Exhibit H). The Department’s mischaracterization of Duke Energy as a manufacturer is premised on a decision of the South Carolina Supreme Court issued in another tax context. Resp. Preh’g Stmt. at 1 (Exhibit H). Further, that court did not examine the taxpayer’s activities in the State, and simply relied on a single statement in the company’s charter.

However, this Court ruled in the ALC Order that whether Duke Energy is a manufacturer or a service provider depends on its activities in South Carolina. ALC Order at 23. The evidence at trial will show that Duke Energy is a service provider and

does not manufacture any tangible materials, objects or personal property. See Expert Report of Prof. Papapolymerou (Exhibit W).

While the term “manufacturer” or “manufacturing” is not specifically defined for corporate income apportionment tax purposes, definitions of those terms in other sections of the Income Tax Act are instructive. For example, “manufacturing” is defined for the South Carolina Renewable Energy Income Tax Credit purposes as “fabricating, producing, or manufacturing raw or unprepared materials into usable products, imparting new forms, qualities, properties, and combinations. Manufacturing does not include generating electricity for off-site consumption.” See S.C. Code Ann. § 12-6-3588(B)(2). For purposes of the South Carolina Job Income Tax Credit, a “manufacturing facility” is defined as “an establishment where tangible personal property is produced or assembled,” and “processing facility” is defined as “an establishment that prepares, treats, or converts tangible personal property into finished goods or another form of tangible personal property.” See S.C. Code Ann. § 12-6-2260(M)(5),(6). As the evidence at trial would show, Duke Energy is not engaged in the business of manufacturing any materials or tangible personal property, and is primarily engaged in the business of providing electricity services to its customers. In fact, the Department’s expert agreed during deposition that Duke Energy provides a service by selling electricity in South Carolina. Robinson Dep. 72:19-73:20 (Exhibit S). Any ambiguities in determining whether Duke Energy is a manufacturer or a service provider must be resolved in favor of Duke Energy. *Alltel Commc’ns. Inc.*, 2012 S.C. LEXIS 151, *12-13 (“Generally, a court must apply the rules of statutory construction to resolve the ambiguity and discover the intent of the

legislature. However, in the enforcement of tax statutes, the taxpayer should receive the benefit in case of doubt." (Internal citations omitted))

Moreover, this Court has previously held that the provision of electricity constitutes a service for license tax purposes. *Consolidated Hydro*, 1996 WL 909155 (Exhibit X).

Similarly, other states treat the provision of electricity as a service. Recently, South Carolina's sister-state North Carolina opined as follows:

For corporate income tax purposes, North Carolina does not consider the sales of electricity as the sale of tangible personal property. Receipts from the sale of electricity by a generator are sourced for corporate income apportionment purposes as receipts from sales of a service. Although the Department is on record in some non-Department of Revenue publications as treating electricity as tangible personal property for corporate income tax purposes, this position is incorrect. The correct apportionment methodology, which treats the sale of electricity as a sale of service, will apply.

...
[I]f the Company qualifies as a public utility under GS. Section 105-130, 4(a)(6) and has a filing requirement then it would be required to utilize a single sales factor apportionment formula.

See, e.g., Request for Private Letter Ruling – Nexus Issues (N.C Dep't of Rev. Feb. 9, 2007) (Exhibit Y).

Similarly, in *In re Appeal of PacifiCorp*, 2002-SBE-005-A, 2002 Cal. Tax LEXIS 469 (Cal. SBE Sept. 12, 2002) (Exhibit Z), the California State Board of Equalization ("SBE") concluded that electricity is intangible rather than tangible, and that the sale of electricity is properly characterized as the sale of a service rather than a product, and thus does not qualify as tangible personal property for California corporate income tax

purposes. The SBE noted that both the Multistate Tax Commission⁷ and the Federation of Tax Administrators⁸ categorize the sale of electricity as a service, rather than the sale of tangible personal property for corporate income tax purposes. *Id.* at *11. See also *Westinghouse Broad. Co. v. Comm'r of Rev.*, 382 Mass. 354, 357, 416 N.E.2d 191, 193 (1981) (**Exhibit AA**); *Comm'r of Rev. v. Houghton Mifflin Co.*, 423 Mass. 42, 45, 666 N.E.2d 491, 493-94 (1996) (**Exhibit BB**); *EUA Ocean State Corp. v. Comm'r of Rev.*, Mass. App. Tax Bd., Nos. C-258405-406, C258424-425; C258882-833; C259158-159; C259563; C262566-568 (Mass. App. Tax Bd. Apr. 24, 2006) (**Exhibit CC**); *Miller v. City of Los Angeles*, 185 Cal. 440, 197 P. 342 (1921) (**Exhibit DD**); *State of La. v. New Orleans Ry. & Light Co.*, 116 La. 144, 150, 40 So. 597, 598 (1906) (**Exhibit EE**); *Williams v. Park*, 72 N.H. 305, 56 A. 463, 464-65 (1903) (**Exhibit FF**); *Commonwealth of Pa. v. Northern Elec. Light & Power Co.*, 145 Pa. 105, 119-20, 22 A. 839, 840-41 (1891) (**Exhibit GG**).

The evidence at trial will show that Duke Energy's sales of electricity constitute the provision of a service. Expert Report of Prof. Ioannis Papapolymerou (**Exhibit W**); I. Papapolymerou Dep. 43:4-14 (**Exhibit T**); Deposition of Dhiaa Jamil 50:1-51:11, (**Exhibit HH**); Franchised Electric & Gas Service dated July 27, 2010, available at www.duke-energy.com/about-us/businesses/francised-electric-and-gas.asp ("Duke Energy offers electric service to approximately 7 million customers in the Carolinas,

⁷ The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. See About the Multistate Tax Commission, available at <http://www.mtc.gov/About.aspx?id=40>. South Carolina is a sovereignty member of the Commission. Sovereignty members are states that support the purposes of the Multistate Tax Compact through regular participation in, and financial support for, the general activities of the Commission. See Member States available at <http://www.mtc.gov/AboutStateMap.aspx>.

⁸ The Federation of Tax Administrators is an organization of state tax officials. See <http://www.taxadmin.org/>.

Ohio, Kentucky, and Indiana) (emphasis added) (Exhibit E). Duke Energy is subject to the jurisdictions of the FERC and SCPSC, both of which regulate electricity service providers, not manufacturers. The SCPSC has determined that:

Duke provides retail services in two states as well as wholesale service to certain municipalities and electric membership cooperatives; therefore it is necessary to allocate the cost of service among jurisdictions and among customer classes within each jurisdiction

Service Commission of South Carolina, Proposed Order of Duke Power Company at 10 (Oct. 25, 1991) (Exhibit II).

Further, Duke Energy's annual reports filed with the U.S. Securities and Exchange Commission specifically state:

Duke Energy Corporation (Collectively with its subsidiaries, "Duke Energy") is an integrated energy and energy services provider with the ability to offer physical delivery and management of both electricity and natural gas throughout the U.S. and abroad. Duke Energy provides these and other services through seven business segments."

Duke Energy 10-K for the Fiscal Year Ended December 31, 2000 at 3 (Exhibit C).

Moreover, both the Department and the Department's expert have already agreed that Duke Energy provides a service. Determination at 3 (Exhibit A); Robinson Dep. 72:19-73:20 (Exhibit S).

CONCLUSION

Duke Energy was a service provider during the Tax Periods at Issue and thus was required to apportion its income to South Carolina based on the single-factor gross-receipts apportionment method. Therefore, for all of the above reasons, Duke Energy respectfully requests that the Court (1) rule that the Department's Determination denying

Duke Energy's refund claims for the tax years 1994 through 2001 is erroneous and illegal; (2) grant Duke Energy's refund claims and enter a judgment in favor of Duke Energy in the amount of \$21,747,312, plus applicable interest; and (3) determine that Duke Energy is entitled to such other and further relief as may be just and proper.

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

Docket No.: 10-ALJ-17-0270-CC

CERTIFICATE OF SERVICE

The undersigned, being an employee of Nexsen Pruet, LLC, hereby certify that on the 27th day of August, 2012 the following document was served upon the following by hand delivery:

DUKE ENERGY CORPORATION'S PRE-TRIAL BRIEF WITH EXHIBITS A-II.

Harry Hancock, Esquire
Milton Kimpson, Esquire
J. Abraham Gutting
S.C. Department of Revenue
PO Box 12265
Columbia, SC 29211

John M.S. Hoefer, Esquire
Tracey C. Green, Esquire
John Roberts, Esquire
Willoughby & Hoefer, P.A.
Post Office Box 8416
Columbia, SC 29202


Shelley H. Paradise
Legal Assistant

August 27, 2012
Columbia, South Carolina

A



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EXHIBIT A

State of South Carolina
Department of Revenue
Office of General Counsel for Litigation
301 Gervais Street, P.O. Box 12265, Columbia, South Carolina 29211
Telephone (803) 898-5136 Telecopier (803) 898-5147

February 4, 2010

Burnet R. Maybank, III, Esquire
James F. Reames, III, Esquire
Nexsen Pruet, LLC
PO Drawer 2426
Columbia, SC 29202

Re: Department Determination
Duke Energy Corporation

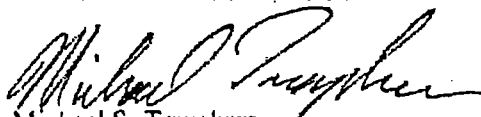
Dear Messrs. Maybank and Reames:

Enclosed is the South Carolina Department of Revenue's Determination in the above-referenced matter. If you disagree with the Determination, you may request a contested case hearing before an Administrative Law Judge. If you choose to pursue such remedy, you must do so within 30 days of the date of this letter. If you fail to respond within this time limitation, you will lose your right to appeal the Department Determination and your protest will be ended. Should you desire a contested case hearing, you must complete the enclosed request form and mail it, along with a \$100 filing fee, to the Administrative Law Court at the address stated on the form's instruction sheet.

The Administrative Law Court rules require that you also send me a copy of your request. My address is as follows: PO Box 12265, Columbia, SC 29211.

Yours truly,

OFFICE OF GENERAL COUNSEL FOR LITIGATION


Michael S. Traynham
Counsel for Litigation

MST:lbc
Enclosures

DEPARTMENT DETERMINATION

Taxpayer:

Duke Energy Corporation
PO Box 1642
Houston, TX 77251-1642

Periods Involved:

Corporate Income Tax Years 1978 through 2001

Matters in Dispute:

1. Is the taxpayer entitled to utilize a single gross receipts factor apportionment formula in the calculation of its South Carolina corporate income tax?
2. Is the taxpayer entitled to include return of principal from the sale of short-term financial instruments in the denominator of its gross receipts factor?
3. Is the taxpayer's claim for refund timely?

Refund amount at issue:

Duke Income Tax:	\$125,142,447.
Crescent Income Tax:	<u>1,098,198.</u>
Total:	\$126,240,645.*

*Total is exclusive of interest. Any refund owed would be subject to a statutory interest rate pursuant to S.C. Code Ann. § 12-54-25 (Supp. 2008)

Determinations:

1. The taxpayer is not entitled to utilize a single-factor formula for apportioning its taxable income.
2. The taxpayer may not include its return of principal from the sale of short-term investments in calculating its gross receipts factor.
3. The taxpayer's claim for refund is untimely for some of the periods in question.

Relevant Facts:

1. Duke Energy Corporation (Duke or taxpayer), formerly known as Duke Power Company, is a multi-state power provider with operations in South Carolina.

2. In December 2002, Duke filed amended South Carolina corporate income tax returns for income tax years 1978 through 2001 requesting a substantial refund.
3. The taxpayer relied on waivers of the statutory time limit for filing amended returns (taxpayer's claim for refund). These waivers were provided by an employee of the Department of Revenue (Department) due to ongoing audit issues. The first of these waivers was issued on August 16, 1988.
4. The taxpayer raised three primary arguments in support of its claim for refund: (A) the taxpayer is not required to calculate its income tax on a three-factor formula pursuant to S.C. Code Ann. § 12-6-2250 (2008); (B) the taxpayer is entitled to include sales of short-term investments in the denominator of its gross receipts factor; and (C) the income and expense of Crescent Resource Corporation was not properly allocated in the original return.
5. The Department denied the requested refunds by letter dated February 12, 2003.
6. The taxpayer filed a timely protest of this denial by letter dated March 12, 2003.

Analysis:

I. The taxpayer is not entitled to use a single-factor gross receipts formula.

Pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2008), "[i]f the principal profits or income of a taxpayer are derived from sources other than those described in Section 12-6-2250 or Section 12-6-2310,"¹ the taxpayer must utilize a single factor apportionment ratio (gross receipts formula). The taxpayer argues it is entitled to utilize this formula because it is not a taxpayer described in either of the other code sections referenced by § 12-6-2290.

Section 12-6-2250(A) provides as follows:

A taxpayer whose principal business in this State is (i) manufacturing or a form of collecting, buying, assembling, or processing goods and materials within this State, or (ii) selling, distributing or dealing in tangible personal property within this State, shall make returns and pay annually an income tax that includes its income apportioned to this State. Its income apportioned to this State is determined by multiplying the net income remaining after allocation pursuant to Sections 12-6-2220 and 12-6-2230 by a fraction, the numerator of which is the property ratio, plus the payroll ratio, plus twice the sales

¹S.C. Code Ann. § 12-6-2310 (2000) is not relevant to the facts of this case.

ratio, and the denominator of which is four. However, where the sales ratio does not exist, the denominator of the fraction is the number of existing ratios, and where the sales ratio exists but the payroll ratio or the property ratio does not exist, the denominator of the fraction is the number of existing ratios plus one. The property, payroll, and sales ratios must be determined in accordance with Sections 12-6-2260, 12-6-2270, and 12-6-2280, respectively.

(Emphasis added). The taxpayer's contention that it is not described by § 12-6-2250 is incorrect. The taxpayer is a manufacturer within the meaning of the statute, and must apportion its income according to the prescribed three-factor formula.² It has long been held in South Carolina that "a company engaged in the business of generating electricity is a 'manufacturer within the meaning of a Statute imposing a tax upon a 'corporation engaged in the business of manufacturing.'" Duke Power Co. v. Bell, 156 S.C. 299, 152 S.E. 865, 868 (1930). South Carolina is hardly alone in this assessment. See, e.g., Hetherington v. Camp Bird Co., 202 P. 1087, 1088, (Colo. 1922); Curry v. Alabama Power Co., 8 So.2d 521 (Ala. 1942); Minn. Power & Light Co. v. Pers. Prop. Tax, Taxing Dist., City of Fraser, Sch. Dist. No. 695, 182 N.W.2d 685, 691 (Minn. 1970). The taxpayer's statements to the public are replete with references to its power generating assets, and its focus on generating power more efficiently. See, e.g., Duke Energy 2008 Summary Annual Report. Put plainly, South Carolina law has long recognized that electricity is something that must be "manufactured" within the meaning of our tax laws, and the generating entity – the taxpayer, in this instance – is the electricity manufacturer. The taxpayer's argument that it is entitled to use a single-factor formula must be rejected.

II. The taxpayer is not entitled to include gross receipts from the sale of short-term investments in calculating its gross receipts or sales factor.

If the Department is correct, and the taxpayer must use the three-factor formula provided by § 12-6-2250, there remains the issue of how it must then calculate its apportionment ratio. The taxpayer argues that it may include all proceeds from short-term investments, including the return of principal, in the denominator of its gross receipts ratio. This argument would apply to the sales factor of the three-factor formula as well. In calculating the sales factor, S.C. Code Ann. § 12-6-2280 (2000) provides that:

(A) The sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the

²Moreover, the taxpayer's contention that it does not sell tangible personal property should also fail. "Tangible personal property" is specifically defined to include "services [such as] sales of electricity." S.C. Code Ann. § 12-36-60 (2000). Thus, while the taxpayer is correct that it provides a service, its service is statutorily defined as tangible personal property.

taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year.

(B) The term "sales in this State" includes sales of goods, merchandise, or property received by a purchaser in this State other than the United States Government. The place where goods are received by the purchaser after all transportation is completed is considered the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person designated by a purchaser constitutes delivery to the purchaser in this State.

(C) The word "sales" includes, but is not limited to:

(1) rentals from tangible personal property located in this State which are not separately allocated; and

(2) sales of intangible personal property and receipts from services if the entire income producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State.

Based on the calculation of the sales factor, the higher the denominator (total sales from everywhere) results in a lower sales factor which, in turn, results in less income tax owed the state.

The taxpayer has diluted its sales factor by including in its denominator (total sales from everywhere) the return of principal from its short-term investments. As part of its treasury and cash management program, the taxpayer invested in short-term investments for which it received a gain on the investments plus the return of principal. In so doing, taxpayer properly included the interest and gains related to the return from these investments in the denominator of the sales factor. However, by also including the return of principal in the denominator of its sales ratio, the ratio is diluted.

The following language was added to this section effective for tax years beginning after 2006:³

³Subsection (c) was also rewritten to discuss sales made to the United States Government.

(D) For purposes of this section, items included in sales are as provided in Section 12-6-2295. Section 12-6-2295 provides in part:

(B) The terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 do not include:

(1) repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;

While the statute did not directly speak to the issue prior to 2006, the Department had implemented the long standing administrative practice to include only the net proceeds from investment activities. Income Tax Decision I-D-309 (June 30, 1982) addressed the issue and concluded:

The commission has included royalties and sales of business connected tangible and intangible property in the sales factor. However, sales of tangible and intangible business connected property have been included only to the extent that the sale resulted in a gain. To include the gross sales price tends to distort the sales factor. Thus, through prudent administrative practice, this procedure has been developed.

All that is required of an apportionment formula is that is [sic] provide a reasonable approximation. Covington Fabrics v. South Carolina Tax Commission, 264 S.C. 59, 212 S.E.2d 574 (1975). The Income Tax Division's computation provides a reasonable basis for apportioning income and is thus valid . . .

Again in 1988 in Income Tax Decision I-D-88-11, the practice was reaffirmed. The taxpayer in that matter sought to include the entire proceeds from the sale of foreign exchange contracts. The finding concluded:

The Division has included in the denominator of the sales factor gain resulting from the disposition of the exchange contracts. We find such to be proper. This position has been the practice of the Tax Commission since 1977 and is a longstanding administrative position. Such should not be overturned unless cogent reasons for doing so are found. Emerson Electric Co. v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986). We find no cogent reasons to change the practice. It must be noted that the apportionment formula

need not be an exact measure of the taxpayer's business activity but rather must only provide a reasonable approximation. Covington Fabrics v. South Carolina Tax Commission, 264 S.C. 59, 212 S.E.2d 574 (1975). Here inclusion of the gain from the foreign exchange contracts provides a reasonable apportionment approach.

Perhaps the leading case addressing this issue is American Telephone and Telegraph Company v. Director, Division of Taxation, 476 A.2d 800 (1984), cert. denied, 97 NJ 627, 483 A.2d 157 (1984) (AT&T). In AT&T, the court was concerned with the proper treatment of revenues received by AT&T from "investments made with its idle cash" under the New Jersey receipts fraction for its apportionment formula.⁴ The New Jersey receipts fraction divides "New Jersey related receipts from sales, services, etc." by the "total receipts of taxpayer from sales, services, etc." AT&T argued that all revenues from its sale of short-term investments, including returns of principal, should be included in the sale of its short-term obligations, in the receipts fraction.⁵ The court concluded that the term "receipts" for apportionment purposes was limited to the net gain from the sale or redemption of investment paper stating:

We uphold as a general matter the exclusion of gross revenues received by plaintiff from the sale or maturity of investment paper. As Judge Crabtree observed, idle cash can be turned over repeatedly by investment in short term securities. It is no true reflection of the scope of AT&T's business done within and without New Jersey to allocate to the numerator or the denominator of the receipts fraction the full amount of money returned to AT&T upon the sale or redemption of investment paper. To include such receipts in the fraction would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account. The bulk of funds flowing back to AT&T from investment paper was simply its own money. Whatever other justification there is for excluding such revenues from the receipts fraction, it is sufficient to say that to do otherwise produces an absurd interpretation of § 6(B). "It is axiomatic that a statute will not be construed to lead to

⁴The court gave the following explanation of "idle cash": "AT&T maintained a pool of funds which it received primarily as dividends from its subsidiary corporations and from the sale of stock and debt obligations. Money not needed for immediate business use was placed in certificates of deposit or invested in short term obligations of various types."

⁵The New Jersey Division of Taxation took the position that only interest owed on the investments should be included in the receipts fraction.

absurd results. All rules of construction are subordinate to that obvious proposition. [Even the rule of strict construction] does not mean that a ridiculous result shall be reached because some ingenious path may be found to that end." State v. Provenzano, 34 N.J. 318, 322, 169 A.2d 135 (1961).

Of particular significance is the AT&T court's observation that including the full amount of money returned on the sale of short-term investments without the exclusion of principal would be comparable to "measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account." Given that a return of principal on an investment is simply a return of the taxpayer's own money, to allow a taxpayer to recognize the return of principal in the gross receipts factor creates the anomaly that the taxpayer is being allowed to reduce its state taxable income not because of a decrease in business activity in the state but because of the amount of its own money the taxpayer has turned over during the tax period. See also, Sherwin-Williams Company v. Indiana Department of State Revenue, 673 N.E.2d 849 (1996) ("[T]his Court holds that 'gross receipts' for the purposes of the sales factor includes only interest income, and not the rolled over capital or return of principal, realized for the sale of investment securities.").

In Walgreen Arizona Drug Company v. Arizona Department of Revenue, 97 P.3d 896 (2004), the Arizona Court of Appeals cited with favor the opinion of an Arizona Tax Court, which had ruled that the return of principal on short-term investments did not qualify as gross receipts for the state's sales factor:

[D]aily revenue from Walgreen's sales would be considered gross receipts when received. Any excess revenue after payment of debt or other disbursements remains a part of those gross receipts and should be counted as such. However, once that excess revenue is invested in securities or other interest bearing mediums, it loses its characterization as gross receipts and may not be counted a second time as gross receipts simply because the money was withdrawn from an investment in a marketable security or interest bearing account. This is akin to someone taking the \$100 left from their [sic] weekly paycheck[,] which is considered income when it was received, depositing it into an interest bearing account[,] then withdrawing the \$100 one month later and claiming it as income a second time. That \$100 is not income.

In affirming the ruling of the tax court, the Walgreen court, quoting extensively from the N.J. AT&T case, held that "the return of principal from the type of short-term

investments at issue here is not includable in the sales factor denominator calculated pursuant to A.R.S. Section 43-1145." Walgreen, 97 P.3d at 902.⁶

The taxpayer has argued that the term "sales" includes "sales of intangible personal property . . ." and, thus, would include the proceeds from the sale of short-term investments. However, when the effect of including the return on principal in the gross receipts factor is considered, there is room to go beyond the language. In Kiriakides v. United Artists Communications, Inc., 312 S.C. 271, 440 S.E.2d 364 (1994), the Supreme Court commented thusly on the strict construction of statutes:

However plain the ordinary meaning of the words used in a statute may be, the courts will reject that meaning when to accept it would lead to a result so plainly absurd that it could not possibly have been intended by the Legislature or would defeat the plain legislative intention . . . If possible, the court will construe the statute so as to escape the absurdity and carry the intention into effect.

Based upon the reasoning employed by the New Jersey AT&T and Walgreen courts and the Department's longstanding administrative practice, a taxpayer's return of principal should not be included in the sales factor. Inasmuch as the principal "sales" at issue here are nothing more than an exchange of the taxpayer's own money, they have no substance other than to artificially inflate the denominator of the gross receipts formula, which in turn serves to decrease South Carolina income tax owed. To allow the return on principal to be included in the sales factor, when to do so lessens the South Carolina income subject to tax, and as a consequence unreasonably represents the amount of business done in South Carolina, is plainly absurd as contemplated by the Kiriakides court.⁷ Thus, the return of principal is not properly includable in calculating the taxpayer's South Carolina sales factor.⁸

⁶The Walgreen court also cited a regulation promulgated by the Multi-State Tax Commission (MTVC), which defines "gross receipts" to exclude the return of principal on short-term investments. Walgreen, 97 P.3 at 901. See MTC Reg. 1V.2(a)(5).

⁷Even in those several cases wherein the deciding court has found that the return of principal is included in "sales" or "gross receipts", those courts have determined that the use of an alternative apportionment formula is appropriate in order to fairly represent the extent of the taxpayer's business within that state. Thus, the return on principal was ultimately excluded from the sales or gross receipts under an alternative apportionment methodology.

⁸In the alternative, the Department could argue that the return of principal should be excluded from the sales factor based on an alternative apportionment formula found in § 12-21-2320(A) as this would more fairly represent the taxpayer's business in South

III. Timeliness of the taxpayer's claim for refund.

A. The waivers provided to the taxpayer are not intended to extend the time for filing a claim for refund.

The taxpayer's refund claim extends over a period of more than 20 years, from 1978 to 2001. In support of its claim, the taxpayer provided numerous copies of waivers provided by a Department employee periodically during that period. These waivers are titled "Consent to Extend the Time to Assess Tax." The language of the waivers state that the agreement "extends the time for mailing the notice of assessment or refund of the above tax pursuant to the provisions of [the South Carolina Code]." The waivers cite different code provisions depending on when they were issued, but all cited code provisions refer to the Department authority, with a taxpayer's consent, to extend the time for assessing a tax. See S.C. Code Ann. § 12-54-85(C)(4) (Supp. 2008). The waivers are not intended to extend the time in which a taxpayer can file a claim for refund. If the Department's examination of a taxpayer reveals that a refund is due, it will be paid, but nothing in the waiver itself grants the taxpayer an extension of time to file a refund claim. Thus, the taxpayer is still constrained by the time limitations for filing a refund contained in § 12-54-85(F), discussed more fully below. Thus, the only years for which the taxpayer's refund claim is timely are 2001, 2000, and 1999.

B. The Department had no authority to extend the time for filing a refund claim before the passage of the Revenue Procedures Act in 1995.

South Carolina law prescribes strict time limitations on the filing of a claim for refund. "Except [in cases involving Internal Revenue Service adjustments,] claims for credit or refund must be filed within three years from the time the return was filed, or two years from the date the tax was paid, whichever is later." Section 12-54-85(F)(1). The General Assembly granted the Department the authority to "extend time limitations provided by [Title 12]" with the passage of the Revenue Procedures Act (RPA) in 1995. S.C. Code Ann. § 12-60-40 (Supp. 2008). Prior to the passage of the RPA, the Department had no statutory authority to extend the time for a taxpayer to claim a refund - only the authority to extend the time for assessing a tax. See, e.g., S.C. Code Ann. § 12-54-80 (Supp. 1988).

Since the Department had no authority to extend the period for filing a refund until 1995, those periods which expired prior to that time could not have been extended by the Department even if the waivers operate as the taxpayer claims. Thus, regardless of what was intended by the Department's waivers, the taxpayer's refund claims for years prior to 1992 cannot be considered timely by the Department.

Carolina. This is the approach that some state courts have taken upon declining to rule that gross receipts do not include the return on short-term investments.

C. The Department cannot extend a filing period which has already expired.

Even if the waivers operate as the taxpayer believes, and the Department's authority to extend the time to assess tax permits it to also extend the time for the filing of a claim for refund by a taxpayer, the Department cannot extend a time period which has already expired. Extensions may only occur, with the taxpayer's consent, only within the period the Department is statutorily authorized to assess tax. See § 12-54-85(C)(4); see also § 12-54-80. The earliest waiver produced by the taxpayer was issued in August of 1988. That waiver could only extend the period for assessing taxes for any period still open under the three year statute of limitations.⁹ Thus, the Department could not extend the time for assessing tax years 1978 through 1983. As a result, the claim for refund as to these years is not timely.

D. The taxpayer's 1998 claim for refund for Crescent Resources is not timely.

The taxpayer filed a claim for refund on behalf of Crescent Resources Corporation for tax years 1998 and 1999. Crescent was a separate entity at this time and apparently received no waivers to extend its time to file refunds, thus a claim for refund for Crescent is subject to the standard statute of limitations. Section 12-54-85(F). Based on the three year statutory look back period, the claim for 1998 is not timely, and cannot be granted by the Department.

February 4, 2010

⁹Moreover, the 1988 waiver only purported to extend the periods for tax years ending December, 31, 1983 and later. The prior years were not referenced in a Department waiver until the mid 1990s.

B



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EXHIBIT B

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Duke Energy Corporation,

Petitioner,

vs.

South Carolina Department of Revenue,

Respondent.

Docket No. 10-ALJ-17-0270-CC

**ORDER GRANTING SUMMARY
JUDGMENT IN PART AND DENYING
SUMMARY JUDGMENT IN PART**

Appearances:

For the Petitioners: Burnet R. Maybank, III, Esq.; Eric S. Tresh, Esq.; Jeffrey A. Friedman, Esq.; and Maria M. Todórova, Esq.

For the Respondent: Tracey C. Green, Esq.; John W. Roberts, Esq.; Harry Hancock, Esq.; and J. Abraham Gutting, Esq.

This matter is before the Administrative Law Court (ALC or Court) upon a Motion for Summary Judgment filed by Respondent Department of Revenue (Department) and a Cross-motion for Partial Summary Judgment filed by Petitioner Duke Energy Corporation (Duke Energy). The underlying case arises from the Department's denial of amended corporate income tax returns filed by Duke Energy in 2002 for income tax years 1978-2001.¹ In its Motion for Summary Judgment, the Department contends that prior to the effective date of the Revenue Procedures Act (RPA), August 1, 1995, it lacked authority to extend the limitation period during which a taxpayer could file a refund claim and therefore, as a matter of law, the Forms FS-43 executed by Duke Energy and the Department prior to that time were ineffective in extending the refund-claim filing periods, rendering Duke Energy's filing of amended corporate income tax returns for tax years ending 1978-1993 untimely.² The Department also contends that Duke Energy, as a matter of law, is a "manufacturer" under the applicable apportionment statute and must therefore use a multi-factor apportionment formula, consisting of property, sales, and

¹ These are the tax periods at issue in this case.

² Both parties stipulate that Duke Energy's amended return for tax year 1994 was timely filed.

FILED

August 9, 2012

SC ADMIN. LAW COURT

payroll factors, not a single-factor gross-receipts formula.³ The Department further contends that as a matter of law, Duke Energy cannot, in its calculation of corporate income tax owed to South Carolina, include in the apportionment formula the return of principal from its sales of securities and other investment transactions. Finally, Duke Energy, in its Cross-Motion for Summary Judgment, argues that it was required to include in the apportionment formula the return of principal from its sales of securities and other investment transactions.

A hearing regarding these motions was held before this Court on June 26, 2012, in Columbia, South Carolina. For the reasons set forth below, I conclude that the Department's Motion for Summary Judgment as to the timeliness of Duke Energy's amended refund claims for tax years ending 1978-1993 must be granted; that the Department's Motion for Summary Judgment as to whether Duke Energy is considered a "manufacturer" under the applicable apportionment statute must be denied; and that the Department's Motion for Summary Judgment as to Duke Energy's inclusion of the return of principal in its apportionment formula must be granted and Duke Energy's Cross-Motion for Partial Summary Judgment on this issue must be denied.

FACTUAL BACKGROUND

The Department began auditing Duke Energy's corporate income taxes for income tax year ending 1978. That audit was extended a number of times, over a period of years due to the pending results of an audit of Duke Energy by the Internal Revenue Service (IRS), and also due to the health issues experienced by the Department's auditor and changes in the Department's personnel. These extensions were approved by Forms FS-43, each entitled "Field Services Division – Consent to Extend the Time to Assess Tax." The first Form FS-43, executed in August 1988, pertained to the income tax years ending December 31, 1983 and 1984. Significantly, the income tax years ending December 31, 1978 through December 31, 1982 were incorporated into the executed Forms FS-43 in May 1996. Additional Forms FS-43 periodically

³ Between the tax years ending 1978-1993, taxpayers whose principal business in South Carolina was "(a) manufacturing or a form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State," were required to apportion their income based on a multi-factor apportionment formula, consisting of property, sales, and payroll factors. S.C. Code Ann. § 12-6-2250 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1120 (applicable to tax years prior to 1996). In this case, no party argued that Duke Energy engaged in collecting, buying, assembling, or processing of goods and materials within South Carolina, or that Duke Energy engaged in selling, distributing, or dealing in tangible personal property within South Carolina. Therefore, the Court will only focus its discussion on whether Duke Energy was a manufacturer for purposes of Section 12-6-2250.

were executed and additional income tax years added until the execution of the final Form FS-43 in June 2002.

In December 2002, Duke Energy filed amended corporate tax returns for the income tax years 1978-2001 seeking a total refund of \$126,240,645 plus interest.⁴ Duke Energy sought to change the apportionment formula – the mechanism for determining how much income is associated with Duke Energy’s South Carolina’s business activities – to the single-factor gross-receipts apportionment formula instead of the three-factor formula that it had previously used. It also sought to include the gross receipts, including the return of principal, from its sales of securities and other capital investments in the denominator of the gross-receipts formula for tax years 1978-1999.⁵ However, on February 4, 2010, the Department denied Duke Energy’s refund claims, after which Duke Energy filed a request for a contested case hearing with this Court on March 3, 2010.

STANDARD OF REVIEW

Rule 68 of the Administrative Law Court Rules provides that “[t]he South Carolina Rules of Civil Procedure . . . may, in the discretion of the presiding administrative law judge, be applied in proceedings before the Court to resolve questions not addressed by these rules.” ALC Rule 68. Rule 56(c) of the South Carolina Rules of Civil Procedure states that summary judgment is properly granted when the “pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that any party is entitled to a judgment as a matter of law.” Rule 56(c), SCRPC.

“The purpose of summary judgment is to expedite disposition of cases which do not require the services of a fact finder.” George v. Fabri, 345 S.C. 440, 452, 548 S.E.2d 868, 874 (2001). “In determining whether summary judgment is proper, the court must construe all ambiguities, conclusions, and inferences arising from the evidence against the moving party. Byers v. Westinghouse Elec. Corp., 310 S.C. 5, 7, 425 S.E.2d 23, 24 (1992). Because it is a

⁴ This is the amount set forth by the Department. However, Duke Energy stated in its Memorandum in Opposition to the Department’s Motion for Summary Judgment and in Support of Duke Energy’s Cross-Motion for Partial Summary Judgment that the Department’s refund calculations in its Memorandum were incorrect, and that damages would need to be resolved should the Court find in the Department’s favor on any issue.

⁵ For 2000 and 2001, Duke Energy’s original tax returns included receipts from sales of securities in the sales factor in the denominator of the three-factor formula.

drastic remedy, summary judgment should be cautiously invoked to ensure that a litigant is not improperly deprived of a trial on disputed factual issues. Helena Chem. Co. v. Allianz Underwriters Ins. Co., 357 S.C. 631, 644, 594 S.E.2d 455, 462 (2004). However, "when plain, palpable, and indisputable facts exist on which reasonable minds cannot differ, summary judgment should be granted." Bayle v. S.C. Dep't of Transp., 344 S.C. 115, 120, 542 S.E.2d 736, 738 (Ct. App. 2001).

S.C. Code Ann. § 1-23-600(A) (Supp. 2010) grants jurisdiction to the ALC to hear contested cases under the Administrative Procedures Act. Additionally, Section 12-60-460 grants the ALC the authority to conduct contested case hearings in matters concerning tax assessment and refunds.

DISCUSSION

I. Timeliness of Duke Energy's Amended Income Tax Return Filings

The Department asserts that Duke Energy did not timely file its request for tax refunds for tax years ending 1978-1993, and therefore this case should be summarily dismissed. Undisputedly, in every instance Duke Energy's amended tax returns for tax years ending 1978-1993 do not meet the statutory deadline to file its amended tax returns. Duke Energy nevertheless argues that its amended tax returns for the disputed tax years were timely filed because the Forms FS-43 extended the statutory deadlines for filing claims for tax refunds and waived any refund limitation periods. In this case, there is no dispute that both parties executed a number of Forms FS-43 periodically between the years 1988 and 2002. The parties also stipulated in their respective memoranda regarding the motions for summary judgment and in the hearing held before this Court on June 26, 2012 that the Form FS-43 executed on December 19, 1997 for the tax year ending 1994 effectively extended the period for filing a refund claim.⁶

Duke Energy argues that the execution of the Forms FS-43 covering the income tax years ending 1978-1993 extended the deadlines for filing claims for tax refunds and waived any refund limitation periods. Duke Energy also argues that because the Department could order a refund if

⁶ Pursuant to S.C. Code Ann. § 12-47-440 (****), which applied to the tax years ending 1990-1994, the period for filing a refund claim was three years. Moreover, S.C. Code Ann. § 12-6-4970(B), which was also applicable during these years, allowed a three-year time period for filing a refund claim for the tax year ending 1994 which would have begun on March 15, 1995. Therefore, because the filing of the Form FS-43 for the year 1994 was executed on December 19, 1997 - after the enactment of the RPA and, and thus before March 15, 1998 - the period for filing a refund claim was still open. Consequently, the extension of the deadline was effective.

it discovered that a taxpayer had overpaid a tax, a penalty, or interest, even after a refund limitation period, this allows Duke Energy to file a claim for a refund after the limitation period. The analysis of Duke Energy's arguments is addressed in three parts: A) Did S.C. Code Ann. § 12-54-80 grant authority to the Department to extend the time to file an amended tax return; B) did S.C. Code Ann. § 12-54-30 authorize Duke Energy to file an amended tax return requesting a refund beyond the statutorily-prescribed timeframe; and C) did the language in the Form FS-43 executed by the Department extend the time for Duke Energy to file an amended tax return?

A. Statutory Authority to Extend the Time to File an Amended Tax Return

Duke Energy contends that Section 12-54-80 authorizes a taxpayer to request a refund once an extension is granted pursuant to that provision. Section 12-54-80, which applied to the tax periods prior to August 1, 1995 (the enactment date of the Revenue Procedures Act (RPA)), provided:

If, before the expiration of the time prescribed in this section for the mailing of a notice of assessment, the taxpayer has consented in writing to the mailing of the notice after the time, notice of assessment may be mailed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

S.C. Code Ann. § 12-54-80 (1978) (repealed in 1995) (emphasis added).

In general, 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 Utils., Inc., 354 S.C. 100, 110, 580 S.E.2d 100, 105 (2003). In interpreting the text, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "[w]here the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." Hodges, 341 S.C. at 85, 533 S.E.2d at 581.

Moreover, in considering this issue, this Court is further bound by the rules of statutory construction relating to tax law. For instance "[a] refund of taxes is solely a matter of governmental grace, . . . and any person seeking such relief must bring himself clearly within the

terms of the statute authorizing the same. . . .” Asmer v. Livingston, 225 S.C. 341, 344, 82 S.E.2d 465, 466 (1954) (internal citations omitted); Guar. Bank & Trust Co. v. S. Carolina Tax Comm’n, 254 S.C. 82, 173 S.E.2d 367 (1970) (“A refund of taxes is solely a matter of governmental or legislative grace and any person seeking such relief must bring himself clearly within the terms of the statute authorizing the same.”). The Court’s analysis in Guaranty Bank, also offers guidance in this case. In Guaranty Bank, the taxpayer claimed it was entitled to recover income tax paid on gain from an involuntary conversion of property. However, the law at the time prescribed a specific timeframe in which the proceeds from the converted property must be reinvested. In construing whether the taxpayer’s claim was timely the Court held that the “statutory language creating exemption from taxation will not be strained or liberally construed in favor of the taxpayer claiming an exemption, and he must, in order to be entitled to such exemption, clearly bring himself within the exemption on which he relies.” 254 S.C. at 89, 173 S.E.2d at 370.⁷ Furthermore, in making that determination, the Court recognized its previous holding that “a taxpayer who seeks to take advantage of a tax deduction must meet the conditions of the statute creating such.” Id.

Here, the plain language of Section 12-54-80 does not establish any authority to extend a taxpayer’s right to seek a refund but rather allowed the Department, with the taxpayer’s consent, to extend the time for it to mail its assessment of the tax owed by the taxpayer. Clearly, when speaking of mailing an assessment, the statute is speaking to an action by the Department. Thus, the plain language of the form extends the timeframe for the Department to mail an assessment to the taxpayer.

Moreover, Section 12-54-80 does not use the word “refund” anywhere within that provision. As explained below, the legislature set forth specific provisions expressing the timeframe to seek a refund for tax years ending 1978-1993. In Spectre, LLC v. S.C. Dep’t of Health & Envtl. Control, 386 S.C. 357, 372, 688 S.E.2d 844, 852 (2010), the South Carolina Supreme Court held that: “Where there is one statute addressing an issue in general terms and another statute dealing with the identical issue in a more specific and definite manner, the more specific statute will be considered an exception to, or a qualifier of, the general statute and given

⁷ The court in Guaranty Bank, likewise held that “in order for a taxpayer to avail himself of a deduction in the calculation of a tax, he must bring himself squarely within the terms of the statute expressly authorizing it.” 254 S.C. at 89-90, 173 S.E.2d at 370.

such effect.” Here, it is incredulous that the legislature intended to grant an exception to the timeframe to seek a refund without even mentioning the term.

The Court nevertheless recognizes that the application of Section 12-54-80 could result in a refund of taxes paid by the taxpayer, but clearly such a refund would occur within the context of fulfilling the purpose of the statute. The purpose of Section 12-54-80 is to provide an option for the Department to extend the time during which the “notice of assessment may be mailed.” If, after the extension of time to make its determination, the Department decided that a taxpayer owed additional taxes, it would notify the taxpayer of that assessment and seek payment based upon that assessment. Conversely, if the Department’s assessment of the taxes owed was less than the taxes proffered by the taxpayer, the taxpayer would be refunded the difference.⁸ However, there is simply no language in Section 12-54-80 that provides that if the Department requests to extend its time to mail a notice of assessment—or determination of the taxes owed—this request, in turn, creates a right for a taxpayer to amend its previous filing and seek a refund upon its revised request.

This Court cannot simply by implication extend the time to file a refund request. Duke Energy must establish a statutory right to make that claim. To the contrary, Duke Energy failed to meet the required timeframes to request a refund for tax years 1978 to 1993. The timeframes for making those refund requests fell into two distinct regulatory periods: 1) 1978 to 1989; and 2) 1990 to 1993.

1. Income Tax Years Ending 1978-1989

The South Carolina Supreme Court set forth in Bass v. State that Section 12-47-440 only applied to property taxes and that “the exclusive remedy for contesting an alleged erroneous assessment of *income taxes* [is] by payment under protest of the tax claimed as illegal and a suit at law for recovery of the sum so paid, in accordance with Sections 65-2661 and 65-2662 of the Code. [predecessors of §§ 12-47-210 and 12-47-220].” 307 S.C. 113, 117, 414 S.E.2d 110, 112 (1992), (internal quotation marks omitted) (emphasis in the original), cert. granted, judgment vacated on other grounds by Bass v. South Carolina, 509 U.S. 916 and abrogated by Harper v. Virginia Dep’t of Taxation, 509 U.S. 86 (1993); see also Perpetual Bldg. & Loan Ass’n of Columbia v. S.C. Tax Comm’n, 255 S.C. 523, 527, 180 S.E.2d 195, 197 (1971). Thus, the

⁸ As addressed more fully below, S.C. Code Ann. § 12-54-30 (****) granted the Department the authority to issue a refund under those circumstances.

timeliness of Duke Energy's refund claims for the years 1978-1989 is governed by S.C. Code Ann. §§ 12-47-210 and 12-47-220 (****).⁹

Sections 12-47-210 and 12-47-220 required a taxpayer who sought to receive a refund of amounts paid to the state to expressly pay the taxes under protest and then institute an action in circuit court within 30 days after payment of the taxes. See S.C. Nat. Bank v. S.C. Tax Comm'n, 297 S.C. 279, 282, 376 S.E.2d 512, 514 (1989). Failure to pay the taxes under protest was fatal to a refund claim. See, e.g., City of Columbia v. Glens Falls Ins. Co., 245 S.C. 119, 139 S.E.2d 529 (1964). Here, there is no evidence that any of the payments for these years were made under protest. And even if the payments were made under protest, no action was filed in circuit court within 30 days after the payment was made. Rather, the refund claims were filed in the ALC well after the 30-day period expired.¹⁰ Therefore, none of the refund claims filed for Duke Energy's 1978-1989 tax years were timely. I thus conclude that the refund claims for the tax years 1978-1989 also are barred from consideration by this Court.

2. Income Tax Years Ending 1990-1994

As explained above, in 1992 the South Carolina Supreme Court in Bass held that Section 12-47-440 only applied to property taxes and that the exclusive remedy for obtaining a refund of income taxes was Sections 12-47-210 and 12-47-220 (****). Id. However, the General Assembly thereafter amended Section 12-47-440 to expressly apply to income tax refund claims, but only for tax years beginning in 1990 and later. See Act No. 464, 1994 S.C. Acts, Section 3(B).

⁹ (****) is used in this order in lieu of statutory years because this case involves numerous tax years, and therefore the years of the applicable statutes are equally numerous and varying, and the law applicable during many years was unchanged. The statutory law can be divided into two yearly ranges: 1978-1995 and 1996-2001, as the law regarding this issue did not change during the first range, and then did not change during the second range after the RPA changes in 1995.

¹⁰ There is also an additional reason for concluding the purported extensions of the corporate income tax years 1978-1982 are untimely. These years appeared for the first time on the face of the executed Form FS-43 effective May 30, 1996. Obviously, under either the modern era provisions or the pre-1995 provisions, these extensions were executed well after the refund periods had closed. See S.C. Code Ann. § 12-54-85 (three years from date return filed or two years after date of payment); S.C. Code Ann. §§ 12-47-210, -220 (pay under protest and file claim for refund within 30 days). The only available avenue for reviewing the taxable income of the years 1978-1982 therefore would have been the statutory provisions regarding an assessment based on a determination issued by the IRS. See S.C. Code Ann. § 12-54-85(D)(1); cf. S.C. Code Ann. § 12-54-80 (prior law). However, Duke Energy did not establish that the IRS issued a final determination within 180 days of May 30, 1996. Moreover, any extension attributable to an IRS determination in that circumstance would have been limited to the tax issues raised by the IRS. Because the allocation and apportionment issues raised by the taxpayers could not have been at issue in an IRS determination, the purported extensions of the 1978-1982 tax years are untimely for purposes of the issues before this Court.

Section 12-47-440 provides for a three-year period of limitation in which to file a refund claim. Therefore, for the 1990-1994 tax years, Duke Energy was required to file its claims for refund within three years after its corporate income tax return was originally due. It is undisputed that Duke Energy filed its corporate income tax returns based on a calendar year. Thus, the returns and payment originally were due without regard to any extension on March 15th of the following year. S.C. Code Ann. §§ 12-6-4970(B) (effective for tax years beginning after 1995); 12-7-1640 (effective for tax years prior to 1996). The refund periods applicable to Duke Energy under Section 12-47-440 for the income tax years 1990-1994 were therefore as follows:

Income Tax Years	Return Originally Due	Close of Refund Period
1990	March 15, 1991	March 15, 1994
1991	March 15, 1992	March 15, 1995
1992	March 15, 1993	March 15, 1996
1993	March 15, 1994	March 15, 1997
1994	March 15, 1995	March 15, 1998

B Section 12-54-30

In its Post-Trial Brief, Duke Energy nevertheless argues that during the tax years at issue S.C. Code Ann. § 12-54-30 (****) provided a different "mechanism" by which it could file an amended tax return requesting a refund. Section 12-54-30 provided in relevant part that: "If the commission discovers on examination of a return or otherwise that the tax, penalty, or interest paid by any person is in excess of the amount legally due, the commission may order a refund or give credit for the overpayment." The plain language of Section 12-54-30 permitted the Department to refund amounts discovered on examination of a return. See Anders v. S.C. Parole & Cmty. Corr. Bd., 279 S.C. 206, 305 S.E.2d 229 (1983) ("[T]he Court's primary function in interpreting a statute is to ascertain the intention of the legislature, and when the terms of the statute are clear and unambiguous, the Court must apply them according to the literal meaning."). Section 12-54-30 does not reference whatsoever the timeframe for a taxpayer to file a request for a refund. To the contrary, as set forth above, there were specific statutes that articulated the timeframe in which a taxpayer could file for a refund for tax years 1978 to 1993. As aforementioned, the statute which deals with an issue in a more specific and definite manner prevails over a statute which addresses the issue in general terms, Spectre, 688 S.E.2d 844. Furthermore, "[w]hen construing statutory language, the statute must be read as a whole, and sections which are part of the same general statutory law must be construed together and each

one given effect." Duvall v. S.C. Budget and Control Bd., 377 S.C. 36, 42, 659 S.E.2d 125, 127 (2008).

Thus, Section 12-54-30 allowed the Department to grant relief to a taxpayer if it discovered an overpayment on examination of a return or otherwise, even if a claim for refund would be untimely. It did not, however, change the fact that the taxpayer had to strictly comply with the provisions of the refund statutes if it wanted to file a claim for refund that would be subject to judicial review. See Hodges v. Rainey, 341 S.C. 79, 533 S.E.2d 578 (2000) ("The canon of construction '*expressio unius est exclusio alterius*' or '*inclusio unius est exclusio alterius*' holds that 'to express or include one thing implies the exclusion of another, or of the alternative.'"). The logic of this interpretation of Section 12-54-30 was reflected in Argent Lumber Co. v. Query, 178 S.C. 1, 182 S.E. 93 (1935), overruled on other grounds by McCall by Andrews v. Batson, 285 S.C. 243, 329 S.E.2d 741 (1985). The Court in Argent Lumber held that under a statute similar to the one in the present case, the taxpayer had no right to judicial review of the Tax Commission's refusal to grant the taxpayer a refund notwithstanding the Commission's discovery of overpaid taxes and the Commission's authority to grant refunds at the time of the tax periods at issue. The reason for this, aside from a lack of statutory authority at the time to compel the Commission to issue a refund of overpaid taxes, was that the taxpayer had failed to comply with the refund statute but instead waited more than ten years after the overpayment and almost four years after the amount of the claim was ascertained to bring suit. Id. at 94-95.

C. Form FS-43

In light of the statutory timeframes for filing an amended return requesting a refund, Duke Energy's case centers upon the implications of the Department's Form FS-43. Duke Energy contends that the Forms FS-43 executed in this case allowed it additional time to file a claim for a refund, an extension that would run for more than twenty years in some cases. At the outset, I do not find that the Forms FS-43 authorized a party to seek a refund after the statutory time for filing such a request.

The language contained in the Form FS-43 prior to August 1, 1995 was as follows:

This agreement extends the time for mailing the notice of assessment or refund of the above tax pursuant to the provisions of Section 12-54-80 of the 1976 South Carolina Code of Laws, as amended.

(Emphasis added).

Clearly, when referencing the mailing of the notice of an assessment or refund, Form FS-43 is speaking to an action by the Department. Thus, the plain language of the form extends the timeframe for the Department to mail the notice of a refund or assessment to the taxpayer in keeping with Section 12-54-80. That purpose is reflected by the title of the Form FS-43: "Consent to Extend the Time to Assess Tax." The purpose also logically flows from the operation of the tax laws. Because a notice of assessment is issued and mailed by the Department, it necessarily follows that Form FS-43 applies only to extend the time in which the Department may issue and mail a notice of assessment or refund that it determines is due. Thus, the refund language in Form FS 43 refers not to allowing a taxpayer additional time in which to file a claim for a refund—which, as explained above, the statutory provisions did not permit—but to affording the Department additional time to review the taxpayer's records and issue a notice of assessment or refund, as it determines appropriate based on a review of the taxpayer's records.

Furthermore, Form FS-43 does not infer that a taxpayer has a right to amend its previous tax filing and seek a refund upon alternative grounds. Duke Energy's proposition is not supported by a specific statutory grant of the authority to extend the timeframe to file an amended request for a refund. Rather, Duke Energy reasons that the use of the term "refund" in the Form FS-43 language infers the grant of an extension to file its request for a refund. However, Form FS-43 reflects its limited purpose by referencing the time an assessment or refund is allowed "pursuant to the provisions of Section 12-54-80." As explained above, Section 12-54-80 does not authorize a taxpayer to file a request for a refund outside of the statutes that specifically set forth that timeframe.

Duke Energy nonetheless contends that since the Department agrees that Form FS-43 had that effect for 1995 and later, it must have had that effect before 1995. Duke Energy avers that since the "refund" language is absent in S.C. Code Ann. § 12-54-85(C)(5) (****) – the section with which the RPA supplanted Section 12-54-80 as of August 1, 1995 – that indeed Section 12-54-80 must have also have granted it the right to file an amended tax return seeking a refund.¹¹

¹¹ Duke Energy also pointed out that the Forms FS-43 executed by the Department and Duke Energy from 1996 to 1999, well after the redesignation of Section 12-54-80 as Section 12-54-85, continued to make reference to Section 12-54-80, a statute that no longer existed. And the Forms FS-43 executed by the Department and Duke Energy from 2000 through 2002 incorrectly cited to subsection (C)(5) of S.C. Code Ann. § 12-54-85 instead of subsection (C)(4). Those arguments carry no legal value, but are probative as to the apparent shoddy fashion in which the Forms FS-43 were executed.

Indeed, Form FS-43 now operates to extend the time for both assessment and refunds for 1995 and later. The language contained in the Form FS-43 following August 1, 1995 is the same except that instead of reference to "Section 12-54-80," it makes reference to "Section 12-54-85(C)(5)." The language contained in Section 12-54-85(C)(5) provides the following:

Taxes may be determined after the thirty-six month limitation if:

* * *

(5) the person liable for any taxes consents in writing, before the expiration of the time prescribed in this section for assessing taxes due, to the assessment of the taxes after the time prescribed by this section.

Duke Energy's argument, however, ignores the substantial and wholesale changes that were enacted as part of the RPA. As with Section 12-54-80, the provisions addressing the authority and timeframes within which to seek a refund were addressed in separate statutory provisions. The RPA added S.C. Code Ann. § 12-60-470 (****), which states that "[a] taxpayer may seek a refund of any state tax by filing a written claim for refund with the [D]epartment. . ." and that a "claim for refund is timely filed if filed within the period specified in Section 12-54-85" The RPA also added S.C. Code Ann. § 12-60-40 (****), which allows the Department to grant extensions of any tax-related time limitations. "It will be presumed that the Legislature in adopting an amendment to a statute intended to make some change in the existing law." Vernon v. Harleyville Mut. Cas. Co., 244 S.C. 152, 155, 135 S.E.2d 841, 844 (1964). It is therefore clear that the General Assembly intended to grant the Department, through the RPA, the authority to extend the period for filing of refund claims, an extension of power which the General Assembly had theretofore limited to the deadline for mailing notices of assessment.

Moreover, "[a]n administrative agency has only the powers conferred on it by law and must act within the authority created for that purpose." SGM-Moonglo, Inc. v. S.C. Dep't of Revenue, 378 S.C. 293, 295, 662 S.E.2d 487, 488 (Ct. App. 2008). In fact, "[a]ny action taken by [the Department] outside of its statutory and regulatory authority is null and void." Triska v. Dep't of Health & Envtl. Control, 292 S.C. 190, 194, 355 S.E.2d 531, 533 (1987). Thus, even if Form FS-43 inferred that a taxpayer has a right to extend the timeframe to request for refund, the Department cannot exceed its statutory authority based upon that form.

In its Memorandum of Law in opposition to the Department's Motion for Summary Judgment, Duke Energy further argues that because Form FS-43 does not reference Section 12-54-30, that statute does not apply to the Department's determination in this matter. Putting aside

the application of Section 12-54-30 in this case, the fallacy of Duke Energy's assertion is referred to as "the fallacy of denying the antecedent" and is illustrated in a hypothetical syllogism as:

If A, then B.

Not A.

Therefore, not B.

Ruggero J. Aldisert, Logic for Lawyers: A Guide to Clear Legal Thinking 160 (National Institute for Trial Advocacy 3d ed. 1997); see also Irving M. Copi, Introduction to Logic 295 (5th ed. 1978).

Stated in terms of syllogism, Duke Energy's arguments proceed as follows:

If Form FS-43 had referenced Section 12-54-30, then that section would be applicable to determining the timeframe for a refund pursuant to Form FS-43.

Form FS-43 did not reference Section 12-54-30.

Therefore, Section 12-54-30 is not applicable to determining the timeframe for a refund pursuant to Form FS-43.

Other courts have also found this reasoning to be faulty. For instance, in Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 703 (2d Cir. 1980), the court held that:

The proposition that "A implies B" is not the equivalent of "non-A implies non-B," and neither proposition follows logically from the other. The process of inferring one from the other is known as "the fallacy of denying the antecedent."

634 F.2d at 703 (cited in Logic for Lawyers).

Moreover, logic dictates a conclusion contrary to Duke Energy's assertion. The failure to reference a provision that governs when the Department may issue a refund upon its own initiative does not suggest it is inapplicable. Nevertheless, the failure to reference any statute (including Section 12-54-30) that addresses the authority of the Department to issue refunds profoundly suggests that Form FS-43 was not addressing a taxpayer's authority to amend its tax returns and seek a refund, or the Department's authority to extend the timeframe within which a refund claim could be filed. If Form FS-43 was granting the authority to extend the time to make refund claims, it would not only reference the statute upon which that authority was granted, but would presumably do so with clarity rather than making the reference: "mailing of notice of assessment or refund." To the contrary, Form FS-43 was based upon Section 12-54-80, which governs the time period in which the Department could assess taxes — a provision that says nothing about refunds or extensions of time to file refund claims.

Waiver of a Statute of Limitations

Duke Energy also contends that the Department “waived” the “statute of limitations” for filing a refund. Duke Energy bases its contention upon the language of Form FS-43; upon the alleged grant by Department employees of an extension of the time during which to file a request for a refund; and upon Duke Energy’s belief that the Department’s Revenue Procedures reflected that right. Duke Energy contends that “[f]or years, the Department advised taxpayers that it had in place a policy to execute waiver agreements extending the statute of limitations for both assessments and refunds.”¹²

However, the phrase “statute of limitations” invokes specific case law that is not applicable to this matter. Obviously, this case does not involve a “cause of action” in which the Court must first determine when the statute of limitations begins to run. In other words, it does not involve parties who possess the discretion to control when a cause of action may properly accrue. Rather, this case involves a determination of when the State of South Carolina grants a right to seek a refund pursuant to the existing tax laws. In Dep’t of Conservation v. Co-De Coal Co., 388 S.W.2d 614 (Ky. 1965), the court aptly explained the distinction between a statute of limitations and a statutory timeframe for filing a request for refund from a state. The court noted: “whereas a statute of limitations neither creates nor extinguishes any rights, but merely places a limitation upon the remedy (which can be waived or tolled), a limitation such as the one in question is a condition essential to the existence of the right.” Co-De Coal, 388 S.W.2d at 617 (internal citations omitted). The court added: “The bringing of the action within the limited time is a condition to the exercise of the right, and, if the condition is not complied with, there is neither right nor remedy.” Id. (internal citation and quotation marks omitted).

Indeed, this concept is supported by South Carolina case law. In Labruce v. City of N. Charleston, 268 S.C. 465, 234 S.E.2d 866 (1977), the appellants instituted an action to recover business license taxes paid under protest. The Court recognized that at that time, Section 65-2661 et seq., Code of Laws, 1962, provided the exclusive remedy for the recovery of contested taxes and held that “[s]trict compliance with the conditions precedent is prescribed when one

¹² In its post-hearing brief, Duke Energy alleges that the Department had respected the “waiver” agreements it had with Duke Energy for tax years 1978-1994 by agreeing, in 2002, to offset refunds of its South Carolina corporate income tax for tax years 1978-1994 against the corporate income, license, and sales taxes for those same years, resulting in a net refund owed to Duke Energy. However, this allegation was based on an affidavit referred to as the “Monroe Affidavit,” designated as “Exhibit A,” that was not submitted prior to, or during, the hearing. Therefore, this Court will not consider this information in rendering its decision.

invokes the statutory remedy.” 234 S.E.2d at 867. See also 4 S.C. Jur. Action § 13 (“One who invokes a statutory remedy must bring himself within the statute and comply with the conditions prescribed therein. Moreover, the Court of Appeals recently reiterated this principle, noting that a nonclaim statute (the sort at issue in the present case)¹³ differs from a statute of limitations in that a nonclaim statute creates no enforceable right of action “[u]nless the claim is filed within the prescribed time set out in the statute,” whereas a statute of limitations “creates a defense to an action brought after the expiration of the time allowed by law for the bringing of such an action.” Phillips ex rel. Barnett v. Quick, Op. No. 5003, 2012 WL 2913296 (S.C. Ct. App. filed July 18, 2012) (citing Estate of Decker v. Farm Credit Servs. Of Mid-Am. ACA, 684 N.E.2d 1137, 1138-39 (Ind. 1997).

As a general rule, when a statute creates a new right and at the same time prescribes a remedy for enforcing the right, the prescribed statutory course must be followed by anyone claiming the right.”); 72 Am. Jur. 2d State and Local Taxation § 996 (“Strict compliance with conditions precedent is required to invoke the statutory remedy for recovery of contested taxes.”). When a statute both creates a cause of action and includes a time limit for its commencement, compliance with the time limit is a condition precedent to the maintenance of the action. 54 C.J.S. Limitations of Actions § 31 (updated October 2010). “Such a statutory time limit conditions the existence of the right of action, thereby creating a substantive, rather than procedural, limitation on the right. Bringing suit within the prescribed time is a condition of liability itself, not of the remedy alone.” Id.

Thus, the statutes that grant a South Carolina taxpayer a right to seek a refund are not statutes of limitations but rather conditions precedent to obtain a right to a refund. Accordingly, the courts have not adopted the doctrine of waiver involving tax claims. To the contrary, a refund of taxes is considered “solely a matter of governmental grace, . . . and any person seeking such relief must bring himself clearly within the terms of the statute authorizing the same.” Asner v. Livingston, 225 S.C. 341, 344, 82 S.E.2d 465, 466 (1954) (internal citations omitted); see also C.W. Matthews Contracting Co., Inc. v. S.C. Tax Comm’n, 267 S.C. 548, 554, 230 S.E.2d 223, 226 (1976); Guar. Bank & Trust Co. v. S.C. Tax Comm’n, 254 S.C. 82, 173 S.E.2d

¹³ A nonclaim statute is one that creates a right of action and provides a time limit on exercising that right. It imposes a condition precedent, as the time element is part of the right of action. 54 C.J.S. Limitation of Actions §33 (updated May 2012).

367 (1970) (holding that the circuit court erred in extending the time periods under the statute because that is a legislative and not a judicial function). Therefore, the South Carolina Supreme Court held in TNS Mills, Inc. v. S.C. Dep't of Revenue, 331 S.C. 611, 623, 503 S.E.2d 471, 478 (1998) that the Department employee's erroneous interpretation of a statute was not binding on the courts, and that Department employees cannot make changes in the refund procedure established by the General Assembly or exceed the authorization granted by a statute. See also Argent Lumber Co., 182 S.E. at 95 ("[T]he agent of the tax commission could not alter, amend, or change the statute law of this state, either orally or by written agreement . . ."). The United States Supreme Court further explained that an employee of the government has no authority to waive or extend a refund period except to the extent authorized by the governing statute. U.S. v. Garbutt Oil Co., 302 U.S. 528 (1938) (Officers of the government have no power to waive statutes of limitations; and Commissioner cannot consider untimely filed returns); see also Dickow v. United States, 740 F. Supp. 2d 231, 237 (D. Mass. 2010) aff'd, 654 F.3d 144 (1st Cir. 2011) cert. denied, 132 S. Ct. 1046 (2012) ("The Executor cannot rely upon the IRS' failure to advise him of the denial to justify his purported conclusion that his second request had been granted where, as here, the IRS clearly did *not* have the authority to issue such extension.").

The only case cited by Duke Energy that involved a refund claim was Anonymous Taxpayer v. S.C. Dep't of Revenue, 377 S.C. 425, 661 S.E.2d 73 (2008). However, the relief sought by the taxpayer in that case was based on the contention that the taxpayer's right to retirement benefits was in the nature of a contract. The Supreme Court's discussion of the statute of limitations in Anonymous Taxpayer was predicated upon the taxpayer's argument that there "was a contract providing for continuing performance, thus the limitations period began anew each year." The Court noted long ago that statutes of limitations could be waived with respect to actions based on contract. See Heyward v. S.C. Tax Comm'n, 240 S.C. 347, 351, 126 S.E.2d 15, 17 (1962) ("We have held that the State may be subject to the doctrine of estoppel in its contractual relations."). Nevertheless, the Court did not hold that refund claims are in the nature of a contract and, in fact, has held the opposite. See id.; see also C. W. Matthews Contracting Co., 267 S.C. at 554, 230 S.E.2d at 226 (a tax refund claim is created by statute and is not in the nature of a debt collection claim).

In sum, since no employee or agent of the Department has any authority to waive the authorization granted by Section 12-54-80, Form FS-43 could grant no more rights than those

permitted by this statute. Thus, any statement made by a Department employee, either verbally or in writing, agreeing to waive the time to request a refund, which was inconsistent with Section 12-54-80, was outside of that employee's authority. Consequently, I conclude that the Forms FS-43 executed before August 1, 1995, and any other statements, written or oral, given by DOR's employees, were ineffective in extending the statutory filing period for Duke Energy's refund claims or in waiving that period.

Moreover, even under section 12-54-85(F)(1), with the exception of situations where there are changes made to taxable income reported to the IRS, or when the IRS changes a corporation's taxable income, "claims for . . . refund must be filed within three years of the time the return was filed, or two years from the date of payment, whichever is later. If no return was filed, a claim for refund must be filed within two years from the date of payment." S.C. Code Ann. § 12-54-85(F)(1) (1995). Also, "[a] claim for refund can be amended prior to, but not after, the expiration of the time for filing the claim for refund under Section 12-54-85(F)." *Id.* § 12-60-470(H). Read together, these sections lead to the conclusion that once a refund period expires under the terms set forth by the legislature, that period of time cannot be revived by the consent of the Department or otherwise; rather, any amendments must be made prior to the expiration of the statutory period for filing refund claims. See Am. Legion Post 15 v. Horry County, 381 S.C. 576, 582, 674 S.E.2d 181, 183-84 (Ct. App. 2009) (holding in part that the three-year limitations period under section 12-54-85(F)(1) barred a taxpayer's action seeking a refund). Thus, even after the RPA took effect on August 1, 1995, and the Department received its new power to extend the period for filing refund claims, the Department was unable to use this power to revive refund claims periods that had expired due to the close of the three-year limitations period applicable to the income tax years ending 1990 through 1994 or due to failure to pay under protest and file a claim for a refund within thirty (30) days for the tax years ending prior to 1990.

Equitable Estoppel

Duke Energy similarly asserts that the Department should be estopped from asserting its "statute of limitations." The basis for this contention is that the Department employees purportedly viewed Form FS-43 as waiving the statutory refund limitations period, and that Duke Energy "agreed to the waivers because the Department represented verbally and in writing that the statute of limitations was extended for both tax assessments and tax refund claims."

As with waiver of a statute of limitations, the courts have recognized that the estoppel doctrine is limited in reviewing tax claims. As a general rule, "the doctrine of estoppel will not be applied to deprive the government of the due exercise of its police power, or to effect public revenues or property rights, or to frustrate the purpose of its laws or thwart its public policy." Heyward v. S.C. Tax Comm'n, 240 S.C. 347, 351, 126 S.E.2d 15, 17 (1962) (emphasis added). In the only South Carolina appellate decision touching upon taxation issues and equitable estoppel, the Court of Appeals held that equitable estoppel did not apply to bar a county from asserting the statute of limitations as a defense to refunding admissions fees paid in connection with bingo games. Am. Legion Post 15, 381 S.C. at 583, 674 S.E.2d at 184.

Also, to invoke estoppel in this case, the Department employees must be authorized to change the procedure for obtaining a refund. However, in Texaco, Inc. v. Wasson, the South Carolina Supreme Court explained that the Department was not estopped from assessing additional taxes based on the use of an improper accounting method even though Department employees had expressly and in writing authorized the taxpayer to use that method "until such time as the South Carolina Tax Commission grants permission to change such method." 269 S.C. 255, 264-65, 237 S.E.2d 75, 79 (1977). Similarly, in TNS Mills, Inc., the taxpayer contended that the Department had the authority to grant a property tax exemption retroactively. Its contention was based in part on a memorandum prepared and issued by a Department employee opining that a recently-enacted statute gave the Department authority to accept exemption applications at any time. The South Carolina Supreme Court rejected that contention, holding instead that "[a]lthough [the employee] believed the Department had the authority to grant retroactive exemptions, and exemptions may have been granted under this erroneous view, neither the Commission nor the courts are bound by his erroneous interpretation." 331 S.C. at 621-22, 503 S.E.2d at 477; see also S.C. Coastal Council v. Vogel, 292 S.C. 449, 357 S.E.2d 187 (Ct. App. 1987) ("The public cannot be estopped ... by the unauthorized or erroneous conduct or statements of its officers or agents which have been relied on by a third party to his detriment.").

In addition, the authority that Duke Energy itself cited supports a conclusion that the Department is not estopped from rejecting actions taken by its employees that are not authorized by statute. Duke Energy cited Quail Hill, LLC v. County of Richland and quoted the following language from that case: "A governmental body is not immune from the application of the doctrine of estoppel where its officers or agents act within the proper scope of their authority."

387 S.C. 223, 236, 692 S.E.2d 499, 506 (2010) (italics omitted). However, Duke Energy only quoted the first part of the pertinent language. The entire relevant passage was quoted by the Court as follows:

A governmental body is not immune from the application of the doctrine of estoppel *where its officers or agents act within the proper scope of their authority ... The public cannot be estopped, however, by the unauthorized or erroneous conduct or statements of its officers or agents which have been relied on by a third party to his detriment.*

Quail Hill, 387 S.C. at 236, 692 S.E.2d at 506 (italics in original) (quoting DeStefano v. City of Charleston, 304 S.C. 250, 257-58, 403 S.E.2d 648, 653 (1991)). That passage followed the Court's recognition at the beginning of the paragraph: "As a general rule, estoppel does not lie against the government to prevent the due exercise of its police power or to thwart the application of public policy." Id. (quotation marks omitted).

Following the above precedents, the Court ultimately held that: "For reasons ... discussed [in the opinion], we believe the Court of Appeals erred in reversing the circuit court's grant of summary judgment to County as to Quail Hill's claim of equitable estoppel." Id., 387 S.C. at 237, 692 S.E.2d at 506. In other words, the Supreme Court in Quail Hill affirmed that the government was not estopped from contesting erroneous statements made by its staff. See id., 387 S.C. at 238, 692 S.E.2d at 507 ("[W]e agree with County's argument that the RU zoning classification was a mistaken statement of law and, thus, could not be used to estop County from enforcing it."). That holding is entirely consistent with the holdings of Texaco, Heyward, and TNS Mills and, in fact, relies on the same rationale stated by the Court in Heyward – that the government cannot be estopped from exercising its police power. Compare id., 387 S.C. at 236, 692 S.E.2d at 506 (discussing police power rationale for not applying estoppel to governmental entities) with Heyward, 240 S.C. at 351, 126 S.E.2d at 17 (holding that "estoppel will not be applied to deprive the government of the due exercise of its police power, or to effect public revenues or property rights").

Thus, I conclude that the Department is not estopped from invoking the correct refund limitations period, even if Department employees believed they had the authority to allow the taxpayer to extend the time in which a claim for refund could be filed. This court clearly does not wish to shield a governmental agency from the doctrine of equitable estoppel where its agents act within the scope of their authority. Rather, this Court recognizes that however

Duke Energy seeks to characterize the evidence presented in response to the Department's summary judgment motion, the Department's employees did not have the authority to create an unauthorized refund procedure. Moreover, execution of Forms FS-43 by Department employees can provide the taxpayer with no greater remedies than those provided by the governing statutes for refund claims and the like. It is upon these principles that the court in Phillips held that "[w]hile equitable principles may extend the time for commencing an action under statutes of limitation, nonclaim statutes impose a condition precedent to the enforcement of a right of action and are not subject to equitable exceptions." Supra. (citing Estate of Decker, 684 N.E.2d at 1139) (emphasis added).

In fact, even if estoppel was applicable here, Duke Energy failed to set forth a genuine issue of material fact as to its meeting those requirements. "To prove estoppel against the government, the relying party must prove: (1) the lack of knowledge and of the means of knowledge of the truth of the facts in question; (2) justifiable reliance upon the government's conduct; and (3) a prejudicial change in position." S.C. Dep't of Transp. v. Horry County, 391 S.C. 76, 83, 705 S.E.2d 21, 25 (2011). Furthermore, "[o]nce the party moving for summary judgment meets the initial burden of showing the absence of a genuine issue as to any material fact, the nonmoving party may not simply rest on the mere allegations contained in the pleadings." Grant v. Mount Vernon Mills, Inc., 370 S.C. 138, 142, 634 S.E.2d 15, 17 (Ct. App. 2006). "Rather, the nonmoving party must come forward with specific facts showing there is a genuine issue for trial." Id. (quoting Peterson v. W. Am. Ins. Co., 336 S.C. 89, 94, 518 S.E.2d 608, 610 (Ct.App.1999)). Here, there is no dispute that Duke Energy could have referenced the governing refund statutes and learned that Department employees cannot extend the time periods set forth in the applicable refund statutes. See Am. Legion Post 15, 381 S.C. at 583, 674 S.E.2d at 184. Moreover, I do not find that the Form FS-43 misinformed Duke Energy that it could file an amended tax return requesting a refund after the statutory timeframe.

Equitable Tolling

Duke Energy contends that the Department should be equitably tolled from requiring Duke Energy to comply with the statutory time frame within which to file a refund because the Department's employees induced Duke Energy to file belatedly. In support of this remedy, Duke Energy contends that it agreed to the waivers because the Department represented that the statute of limitations was extended for both tax assessments and tax refund claims.

"[T]he doctrine of equitable tolling may be applied to toll the running of the statute of limitations." Hooper v. Ebenezer Sr. Servs. & Rehab. Ctr., 386 S.C. 108, 115, 687 S.E.2d 29, 32 (2009) (quoting 54 C.J.S. Limitations of Actions § 115 (2005)). As explained above, however, the statute requiring that refunds be filed within specific timeframes creates a condition precedent to seeking that remedy and thus is not subject to the equitable remedies for statutes of limitations. See Phillips, supra. Thus, equitable tolling is not a proper remedy in this case. Cf. United States v. Brockamp, 519 U.S. 347 (1997) (holding that the statutory limitations period on tax refund claims under the applicable provision of the Internal Revenue Code does not authorize equitable tolling).

Even if, *arguendo*, equitable tolling could apply here, in Hooper, the South Carolina Supreme Court explained that "equitable tolling is a doctrine that should be used sparingly and only when the interests of justice compel its use." 386 S.C. at 117, 687 S.E.2d at 33. Here, however, in an attempt to invoke this extraordinary remedy, Duke Energy submitted affidavits and deposition testimony that reference the belief by Department employees that Duke Energy could seek a "refund" based upon extensions granted by the executed Forms FS-43. However, those affidavits do not contain an averment by any Department employee that he or she specifically stated to a Duke Energy representative that Duke Energy's time to seek a "refund" was extended by Form FS-43. More importantly, there is no reference that any Department employee stated that Duke Energy could file an amended tax return seeking a refund based upon a new basis. Nor is there any sworn testimony by a Duke Energy representative that he or she was misdirected by a Department employee.

Therefore, I conclude that equitable tolling does not lie in this case.

Conclusion

Finally, the context of Duke Energy's request is important in recognizing the proper resolution of this issue. Duke Energy asserts that there are disputed facts regarding this issue because some of the Department's employees viewed Form FS-43 as extending the period during which a taxpayer could seek a refund. However, statements to that effect do not answer the issue in this case. This case is not simply about whether Duke Energy can seek a refund based upon a tax review that had been held open pending the Department's determination of the proper tax to assess. Rather, Duke Energy originally filed as a manufacturer using the three-factor formula. Now, it seeks a refund, not based upon the initial filing, but based upon an amended tax return

using the single-factor gross-receipts apportionment formula – an entirely different basis. Duke Energy's amended return also now includes the gross receipts from the sale of its securities and other capital investments, which further includes the principal.

Duke Energy interprets Form FS-43 as not only allowing it to question its initial filing but as allowing it to file a new (amended) tax return and claim an entirely new basis for a refund. The plain reading of the tax statutes and review of the affidavits and deposition testimony submitted by Duke Energy fail to establish a genuine issue of material fact regarding the request of Duke Energy. In other words, though there are statements regarding the right of Duke Energy to seek a refund, no evidence was presented that any Department employees interpreted Form FS-43 as allowing a taxpayer to file an amended return on an entirely different basis than the original return and then seek a refund based on that amended return.¹⁴ Therefore, the Department's Motion for Summary Judgment as to the issue of the timeliness of Duke Energy's amended income tax return filings is granted.

II. Apportionment Method

The next issue is whether Duke Energy is a "manufacturer" and therefore required to use the multi-factor apportionment formula pursuant to S.C. Code Ann. § 12-6-2250 (****) (applicable to tax years after 1995)/ Section 12-7-1140 (applicable to tax years prior to 1996); or whether Duke Energy was required to use the single-factor gross-receipts formula pursuant to Section 12-6-2290 (****) (applicable to tax years after 1995)/ Section 12-7-1190 (applicable to tax years prior to 1996). Duke Energy argues that it is not a manufacturer, even though it filed its original corporate income tax returns under this status. Duke Energy contends that it is actually a seller of services, and therefore amended its tax return filing using the single-factor gross receipts formula.

During the tax periods at issue, taxpayers whose principal business in South Carolina was "(a) manufacturing . . . goods and materials within this State . . ." had to apportion their income using a three-factor formula composed of property, payroll, and sales. S.C. Code Ann. § 12-6-2250 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1140 (applicable to tax years prior to 1996). All other taxpayers (except certain specific industries not relevant here) had to

¹⁴ Review of the record does not even establish the validity of the Form FS-43 agreements for tax years 1978 through 1983. In fact, Duke Energy has even conceded that it has not located the executed Form FS-43 agreements for tax years 1978 through 1983.

apportion their income using a single-factor gross-receipts apportionment formula. S.C. Code Ann. § 12-6-2290 (applicable to tax years after 1995); Id. § 12-7-1190 (applicable to tax years prior to 1996). "Manufacturing" is not, and was not during the tax periods at issue, statutorily defined for South Carolina apportionment law purposes.¹⁵

Based on the record, I find that genuine issues of material fact exist necessitating an evidentiary hearing as to whether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a "manufactur[er]," or whether Duke Energy is a seller of services, or otherwise falls under none of the above-categories, and is therefore required to apportion its income to South Carolina based on the single-factor gross-receipts apportionment formula pursuant to Section 12-6-2290 (applicable to tax years after 1995)/ Section 12-7-1190 (applicable to tax years prior to 1996). Accordingly, the Court denies the Department's Motion for Summary Judgment with respect to this issue.

III. Gross Receipts

The final issue is whether Duke Energy was allowed, in its calculation of corporate income tax owed to South Carolina, to include in the apportionment formula the return of principal from its sales of securities and other capital investments. Duke Energy argues that "gross receipts" in the gross receipts factor of the denominator of the single-factor gross-receipts apportionment formula and "sales" in the sales factor of the denominator of the three-factor apportionment formula include the entire amount of return capital from a sale of securities or other capital investments, including the return of principal. The Department, however, argues that gross receipts and sales include only the net proceeds from sales of securities or other capital investments.

South Carolina law provides that a taxpayer required to apply the single-factor gross-receipts apportionment formula must do so "using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year." See S.C. Code Ann. § 12-6-2290 (****) (applicable for tax years beginning after 1995); see also id. § 12-7-1190 (****) (applicable for tax years

¹⁵ "Manufacturing" is not statutorily defined, but it is discussed in Columbia Ry., Gas & Elec. Co. v. S.C. Tax Comm'n, 134 S. C. 319, 132 S.E. 611 (1926), a case in which the South Carolina Supreme Court held that a company engaged in the business of generating electricity was properly considered a "manufacturer" for purposes of a particular statute that imposed a corporate income tax on "a corporation engaged in the business of manufacturing."

prior to 1996).¹⁶ "Gross receipts" was not defined for South Carolina apportionment law purposes during the tax periods at issue.

For purposes of the multi-factor apportionment formula¹⁷ the sales factor consists of "[t]he ratio of sales made by such taxpayer during the income year which are attributable to this State to the total sales made by such taxpayer everywhere during the income year" S.C. Code Ann. § 12-7-1170 (****) (for tax years prior to 1996).¹⁸ The term "sales" includes: "(1) rentals from tangible personal property located in this State which are not separately allocated; and (2) sales of intangible personal property and receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State." *Id.*¹⁹

"The language of a tax statute must be given its plain ordinary meaning in the absence of an ambiguity therein. . . . [I]f a legislative intent is clearly apparent from the language of the statute there is no occasion for resort to the rule of statutory construction." Beach v. Livingston, 248 S.C. 135, 139, 149 S.E.2d 328, 330 (1996) (internal citation omitted). "If the statute is ambiguous, however, courts must construe the terms of the statute." S.C. Energy Users Comm. v. S.C. Pub. Serv. Comm'n, 388 S.C. 486, 491, 697 S.E.2d 587, 590 (2010) (internal citation omitted). "A statutory provision should be given a reasonable and practical construction consistent with the purpose and policy expressed in the statute." Lockwood Greene Eng'rs, Inc. v. S.C. Tax Comm'n, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987). "When faced with an undefined statutory term, the term must be interpreted in accordance with its usual and customary meaning." *Id.* at 492, 697 S.E.2d at 590 (internal citation omitted). "Courts should

¹⁶ Even though the Court finds as a matter of law that Duke Energy's filings of tax refund claims for tax years ending 1978-1993 were untimely, and thus will not be considered here, the filing for tax year 1994 was timely, and thus statutes applicable to tax years prior to 1996 will be discussed.

¹⁷ Section 12-6-2250 (applicable to tax years after 1995) and Section 12-7-1140 (applicable to tax years prior to 1996).

¹⁸ For tax years after 1995, S.C. Code Ann. § 12-6-2280 (****) similarly provides that: "The sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year."

¹⁹ For tax years after 1995, S.C. Code Ann. § 12-6-2280 (B) (****) similarly provides that the term "sales in this State" includes sales of goods, merchandise, or property received by a purchaser in this State. The place where goods are received by the purchaser after all transportation is completed is considered the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person designated by a purchaser constitutes delivery to the purchaser in this State."

not merely consider the language of the particular clause being construed, but the undefined word and its meaning in conjunction with the purpose of the whole statute and the policy of the law.” Id. Finally, “[s]tatutes should not be construed so as to lead to an absurd result.” Kennedy v. S.C. Ret. Sys., 345 S.C. 339, 351, 549 S.E.2d 243, 249 (2001) (internal citation omitted).

Here, there is no genuine issue of material fact with regard to the Gross Receipts Issue. The sole question of law is whether Duke Energy could include the return of principal from its sales of securities and other investment transactions as part of the sales or gross receipts factors in the apportionment formula. This is a novel question in South Carolina, but is not unprecedented in some of our sister States.

The first approach to this issue was taken by New Jersey in Am. Tel. and Tel. Co. v. Dir., Div. of Taxation, 194 N.J. Super. 168, 476 A.2d 800 (App. Div. 1984). In that case, the New Jersey Supreme Court concluded that the inclusion of gross or full revenues from the short-term sale or redemption of investment paper in the denominator of the receipts fraction of the apportionment formula would lead to “absurd results” in that such inclusion would greatly distort the amount of business the taxpayer did within and without New Jersey and would thus defeat the intent and purpose of the apportionment statute. Id. at 172, 476 A.2d at 802. Both Indiana and Arizona have adopted similar rationales to the one used by the New Jersey court. See Sherwin-Williams Co. v. Ind. Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax 1996) (holding that “‘gross receipts’ for the purpose of the sales factor includes only the interest income, and not the rolled over capital or return of principal, realized from the sale of investment securities”); Walgreen Ariz. Drug Co. v. Ariz. Dep’t of Revenue, 209 Ariz. 71, 97 P.3d 896 (App. 2004) (holding that the return of principal from the type of short-term investments at issue was not includable in the sales factor denominator).

The other approach to this issue was taken by Tennessee and California.²⁰ In Sherwin-Williams Co. v. Johnson, 989 S.W.2d 710 (Tenn. App. 1998), the chancellor had followed the same reasoning employed by the New Jersey and Indiana courts (and later the Arizona court), holding that “to include the principal in the sales factor denominator would distort the extent of Sherwin-Williams’ business activities in Tennessee and other states in which it does business

²⁰ South Carolina’s apportionment provisions, like those in New Jersey, Indiana, Arizona, Tennessee, and California, are based on the Uniform Division of Income for Tax Purposes Act (UDITPA).

and defeat the intent and purpose of the [apportionment] statute. . .” and that “the amount of return of principal on the sale or redemption of interest bearing securities related to its, [sic] working capital investments should not be included in the denominator of the sales factor.” *Id.* at 714. The Tennessee Court of Appeals, though finding the chancellor’s holding “logical and appealing,” nevertheless decided not to follow the “absurd result standard.” The court instead concluded that:

An absurd result is not necessary, for in spite of the plain language of the [sales factor statute], the commissioner may opt for a different scheme of assessment whenever the resulting apportionment does not fairly represent the taxpayer’s business in this state. The very absurdity of the result sought . . . lays a sound basis for the implementation of [the alternative apportionment method statute].

Id. at 714-15.

The California Supreme Court, in *Microsoft Corp. v. Franchise Tax Bd.*, quoted this passage with approval as it went on to hold that “gross receipts” is not limited to net proceeds. 39 Cal.4th 750, 763, 139 P.3d 1169, 1177 (2006). Referencing California’s alternative apportionment method, the court concluded that “[t]he UDITPA contains an equitable relief provision so that, in cases where application of the statutory sales definition results in excessive distortion, an ‘absurd result’ may be avoided.”

After considering the two lines of reasoning set forth by our sister States, I conclude that the law of South Carolina favors the view expressed by the courts in New Jersey, Indiana, and Arizona.

As the Tennessee Court of Appeals correctly noted, “[i]f the words of a statute plainly mean one thing they cannot be given another meaning by judicial construction.” *Johnson*, 989 S.W.2d at 714-15 (internal citation omitted); see also *Denman v. City of Columbia*, 387 S.C. 131, 138, 691 S.E.2d 465, 468 (2010) (“Under the plain meaning rule, it is not the Court’s place to change the meaning of a clear and unambiguous statute.”). However, to rearrange the order of the court’s sentences, “This sound rule . . . is met by the equally well settled rule that: . . . ‘It is presumed that the legislature enacting a statute did not intend an absurdity, and such a result will be avoided by this court if the terms of the statute admit of it by reasonable construction.’” *Johnson*, 989 S.W.2d at 714 (internal citations omitted).

Alternative Apportionment Method

The Tennessee and California opinions rely upon the presupposition that “an absurd result is not necessary” because the Department “may opt for a different scheme of assessment

whenever the resulting apportionment does not fairly represent the taxpayer's business in this State." Microsoft, 39 Cal.4th at 763, 139 P.3d at 1177 (quoting Johnson, 989 S.W.2d at 715). South Carolina indeed has a similar provision. S.C. Code Ann § 12-6-2320(A) (2002) provided that:

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable: separate accounting;

- (1) the exclusion of one or more of the factors;
- (2) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (3) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(Emphasis added).

I nevertheless find that the California and Tennessee cases, in relying upon this statutory option, miss an important distinction between the court's roles of statutory construction and application of the alternative apportionment provision. Though the alternative relief provision exists as a mechanism to correct problems caused by the application of the standard apportionment statutes (see Media Gen. Commc'ns v. S.C. Dep't of Revenue, 388 S.C. 138, 694 S.E.2d, 525 (2010)), the standard application statutes should not be so construed as to encourage excessive distortion simply because the alternative relief provision exists to remedy that distortion. In applying the principles of statutory construction, the court's function is, in part, to construe statutory law to avoid an absurd result. Ventures S.C., LLC v. S.C. Dep't of Revenue, 378 S.C. 5, 9, 661 S.E.2d 339, 341 (2008) ("[T]he Court will reject the plain meaning of the words used in a statute if it would lead to an absurd result. . ."). If, as here, the proposed construction of a statute reaches an absurd result, our courts should recognize that absurdity and end the inquiry.

On the other hand, the function of the alternative apportionment provision is quite different. The alternative apportionment provision should be utilized only when the standard apportionment statute does not operate sensibly in a given case. As the Florida Supreme Court pointed out in Roger Dean Enters, Inc. v. State, "[t]here is a very strong presumption in favor of normal three-factor apportionment and against the applicability of the relief provisions. . . Departures from the basic formula should be avoided except where reasonableness requires."

387 So.2d 358, 363 (internal citations omitted). Further, in St. Johnsbury Trucking Co. v. New Hampshire, the New Hampshire Supreme Court, in addressing very similar statutory language, held that:

The statutory provisions require that the three-factor formula will be used for apportioning business profits, and an alternative formula may be used if the statutory method of apportionment "does not fairly reflect the extent of the business activities of a business organization within this state." The legislature has, therefore, specified that an alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of showing that the alternative is appropriate.

118 N.H. 209, 212, 385 A.2d 215, 217 (1978) (emphasis added).²¹

In this case, to interpret the standard apportionment formula to include the return of principal in either the sales factor or gross-receipts factor of the denominator would engender an absurd application of the standard apportionment statute simply because another statute exists which allows for another means of accounting when the standard apportionment statute does not "fairly represent the extent of the taxpayer's business activity in this State." In other words, such an interpretation would create the very absurdity that courts are to avoid in their statutory construction. Rather than having Section 12-6-2320(A) available as a remedial back-up, a corporation would have nothing to lose and everything to gain by adding the return of principal to the denominator and thereby reducing the amount of taxes owed to South Carolina, regardless of whether the numbers accurately reflected the corporation's business activity within and without the State. As a result, the alternative apportionment statute, which was intended to be a remedy held in reserve for the relatively infrequent occasion that the standard formula did not result in a fair representation, would then become a standard follow-up to the application of the standard apportionment statute. Indeed, both statutes would become standard, because distortion of business activity representation would be fostered on the front end (through the principal-inclusive standard apportionment formula) so that it could, and necessarily would, be dealt with on the back end (through the alternative apportionment formula).²²

²¹ The following states have followed the holding in St. Johnsbury Trucking: Idaho - Union Pac. Corp. v. Idaho State Tax Comm'n, 83 P.3d 116, 120 (Idaho 2004); and Kentucky - Ruby Const. Co., Inc. v. Dep't of Revenue, 578 S.W.2d 248, 253 (Ky. Ct. App. 1978).

²² In its Memorandum in Opposition to the Department's Motion for Summary Judgment and in Support of its Cross-Motion for Partial Summary Judgment, Duke Energy argues that the definitions of "sales" and "gross receipts" set forth in S.C. Code Ann. § 12-6-2295 (2007) (effective for tax years beginning after 2006), shows the Legislature's intent to make a "drastic" change to the existing law based on its various inclusions in, and exclusions

Of course, this “best-case scenario” assumes that the Department will be able to detect when a business is including principal in the standard apportionment formula and will be able to pursue those cases. In reality, however, limited resources would dictate the exercise of more discretion in the application of the alternative apportionment method. Consequently, much, if not all, of the smaller amounts of tax revenue that the State would have received would become avoidable by including principal in the standard formula and hiding behind the newly-targeted “bigger fish” that would be including more principal in their formulas. In the aggregate, these small amounts, which the State would otherwise have gained but would instead lose through undetected inflation of the denominator and consequent underestimation of the taxes owed to the State, will equate to a rather sizeable sum lost to the State. Thus, the distortion that inevitably results from the inclusion of principal in the standard apportionment formula will pose problems for the Department and South Carolina, regardless of the size of the distortion. This potential for abuse by corporations and the futility of going through this extra-step process needlessly is reflected in a finding by the Arizona Court of Appeals that in most of the cases that the taxpayer cited to support the inclusion of the return of principal in the sales factor denominator of the standard apportionment formula, the courts “nonetheless approved exclusion of the principal from the sales factor denominator pursuant to their states’ version of UDITPA’s ‘relief provision’ [i.e., alternative apportionment method].” Walgreen, 209 Ariz. at 901-02, 97 P.3d 896 at 76-77 (citing Union Pac. Corp. v. Idaho State Tax Comm’n, 139 Idaho 572, 83 P.3d 116, 122 (2004); Am. Tel. & Tel. Co. v. State Tax Appeal Bd., 241 Mont. 440, 787 P.2d 754, 757-58 (1990); Johnson, 989 S.W.2d at 715). Microsoft, which was decided two years after Walgreen, can be added to this list, as it applied California’s alternative apportionment method statute to

from, the definitions of “sales” and “gross receipts” that had previously not existed. According to Duke’s argument, therefore, these inclusions and exclusions did not apply prior to the enactment of Section 12-6-2295. One of the inclusions would be “net gain from the sale of property used in the trade or business[, such as] intangible property used in the trade or business . . .” (Section 12-6-2295(A)(4) (emphasis added)), and one of the exclusions is the “repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument . . .” Id. (B)(1) (emphasis added). According to the Supreme Court in Duvall, 377 S.C. at 46, 659 S.E.2d at 130: “When the Legislature adopts an amendment to a statute, th[e] Court recognizes a presumption that the Legislature intended to change the existing law. Nonetheless, a subsequent statutory amendment may also be interpreted as clarifying original legislative intent.” (Internal citations omitted) (emphasis added). In this case, the inclusion and exclusion quoted above demonstrate that the Legislature intended to exclude the return of principal from the sale of securities and other capital investments in the apportionment formula. In light of all of the reasons discussed above as to why the return of principal was excluded from the apportionment formula prior to the enactment of Section 12-6-2295, it is evident that the Legislature intended Section 12-6-2295 to clarify the existing law.

“fairly represent the extent of the taxpayer’s business activity in this state” after the court included principal in the sales denominator of its standard apportionment formula.²³ Thus, any benefits from this principal-inclusion method seem to be vastly outweighed by the great cost of revenue that this State would face through continuous underestimation of taxes due to distortions.

Logical Definition of Gross Receipts

The term “gross receipts” does not plausibly include the return of principal from the sale of securities and other capital investments. “Gross income”, at least in the context of self-employment or self-owned businesses, is defined as “gross receipts minus ordinary and necessary expenses required for self-employment or business operation. . . .” Spreeuw v. Barker, 385 S.C. 45, 65, 682 S.E.2d 843, 853 (Ct. App. 2009) (citing S.C. Code Ann. Regs. 114-4720(A)(4) (Supp. 2008)). This definition would logically apply to other types of businesses, too. According to this definition, gross receipts equal gross income plus ordinary and necessary expenses of business operations. The South Carolina Supreme Court in Roper v. S.C. Tax Comm’n, Title 65-Section 251 of the 1952 Code of Laws of South Carolina also defined “gross income” as: “the income of a taxpayer derived from . . . interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit” 231 S.C. 587, 598, 99 S.E.2d 377, 382 (1957) (emphasis added); see also S.C. Code Ann. § 12-7-415 (****) (adopting the Internal Revenue Code’s (I.R.C.) determination of gross income with modifications specified in Section 12-7-430 (which are not relevant here)); I.R.C. § 61(a) (****) (generally defining corporate gross income as “all income from whatever source derived” and covering many of the same categories mentioned in Roper)²⁴; S.C. Code Ann. § 12-6-1110 (****). The Court went on

²³ Paradoxically, the court went on to justify this decision to apply the alternative method statute because it was “unable to accept, even for a moment, the notion that more than 11 percent of [taxpayer’s] entire unitary business activities should be attributed to *any* single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America’s largest, and most widespread, businesses.” This rationale highlights the precise reason why principal from the sale of securities and other capital investment activities should not be included in the standard apportionment formula in the first place: the inclusion of principal causes distortions as to the amount of business activity actually performed in a State, which, in turn, have to be remedied.

²⁴ Nowhere in South Carolina’s statutory law or in the federal statutory law adopted by South Carolina is principal from investments listed as part of gross income. In fact, principal would later be excluded in S.C. Code Ann. § 2295(B)(1) (2007), which became effective for tax years after 2006. Also, it is worth noting that even in the context of child support, gross income does not include principal in the return from the sale of investments. Indeed, the inclusion of “capital gains” in the list of items considered part of gross income for child support purposes

to point out that "the word 'income' as used in a tax statute, is to be taken in its ordinary sense of gain or profit." *Id.* (reaffirmed as "well-settled" in *Scott v. S.C. Tax Comm'n*, 262 S.C. 144, 148, 202 S.E.2d 854, 856 (1974)). Because gross income includes "all income," and income, being gain or profit, excludes principal, then gross income necessarily excludes principal. Therefore, the only remaining question is whether "ordinary and necessary expenses of business operations" includes principal.

Principal, by definition, cannot be an expense of a business operation. Since ordinary and necessary business expenses are subtracted from gross receipts to yield gross income, and neither business expenses nor gross income include principal, it is impossible for gross receipts to include principal. Put another way, because gross receipts are equivalent to gross income plus ordinary and necessary business expenses, and neither gross income nor business expenses include principal, gross receipts, being the sum of those two parts, cannot include principal.²⁵ Inversely, Duke Energy contends that the principal is a component of the gross receipts it received. If gross receipts were also a component of gross income, then, according to Duke Energy's argument, gross income must include principal. However, inclusion of principal in gross income would create an absurd result. Generally, the taxable income of a business is its gross income minus any deductions that are allowed by state law.²⁶ Principal is not an item that is specifically excluded from gross income. *See* 26 U.S.C.A. Subt. A, Ch. 1, Subch. B, Pt. III. Thus, the logical extension of Duke Energy's argument is that taxable income includes the

necessarily implies the exclusion of principal from the return of investment sales. *See* S.C. Code Ann. Regs. 114-4720(A)(2) (2012).

²⁵ For examples in the I.R.C. of exclusion of principal from gross receipts, *see* I.R.C. § 165(g)(3)(B) (****) (in the context of determining whether a corporation is affiliated with a taxpayer, "in computing gross receipts for purposes of [calculating the percentage of gross receipts that have come from particular sources], gross receipts from sales or exchanges of stocks and securities shall be taken into account *only to the extent of gains* therefrom.") (emphasis added); *id.* § 1362(d)(3) (in the context of a small business corporation's termination of its election to be an S corporation, where its passive investment income exceeds twenty-five percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits at the close of each of those years, when capital assets (other than stocks or securities) are disposed of, "gross receipts from such dispositions shall be taken into account *only to the extent of the capital gain net income* therefrom[;] and in the case of sales or exchanges of stock or securities, gross receipts shall be taken into account *only to the extent of the gains* therefrom.") (emphasis added); and *id.* § 1244 (in the context of calculating the percentage of gross receipts from particular sources for determining whether "stock" means stock in a domestic corporation for determining losses on small business stocks, "gross receipts from the sales or exchanges of stock or securities shall be taken into account *only to the extent of gains* therefrom.") (emphasis added).

²⁶ I.R.C. § 63(a) (****).

principal and the gain. Consequently, taxpayers would be taxed not only upon the specific gains from the principal but upon the return of the principal itself.²⁷

Furthermore, a corporation's South Carolina gross income and taxable income is computed as determined under the I.R.C. with the modifications as provided in the South Carolina Tax Code. See S.C. Code Ann. §§ 12-6-580 (****) and 12-7-415 (****). The I.R.C. provides that except in the case of individuals who do not itemize deductions, "taxable income" is defined as "gross income minus the deductions allowed by this chapter (other than the standard deduction)." I.R.C. § 63(a) (****); see also U.S. v. Foster Lumber Co., 429 U.S. 32, 36-37 (1976) (recognizing this definition for taxable income as applicable to the corporate respondent in that case). For the reasons given above, gross income does not include principal. Consequently, principal cannot be included in taxable income, the remainder of gross income following deductions (other than the standard deduction). Indeed, because principal is also not a deduction allowed by state law, principal cannot even be included in the calculation of taxable income.²⁸

Therefore, because income is the gain or profit realized from principal, gross income, and thus taxable income, necessarily exclude principal.

Logical Definition of Sales

It is equally implausible to include principal from the sale of securities and other capital investments in the definition of "sales" for purposes of the standard apportionment formula. A major difference between the Tennessee case and the present case is that Tennessee's standard apportionment statute defined "the term 'sales' to include all gross receipts of the taxpayer not otherwise allocated under the Excise Tax Law." Johnson, 989 S.W.2d at 713 (emphasis in original). Likewise, the California standard apportionment statute included "all gross receipts" in the definition of "sales." South Carolina's standard apportionment statute defines the term

²⁷ In light of the above analysis, the application of the holding in Roper v. S.C. Tax Comm'n, 231 S.C. 587, 99 S.E.2d 377 (1957) is even more pertinent.

²⁸ It is worth noting that in Foster Lumber Co., the U.S. Supreme Court reasoned that the inclusion of "gains derived from dealing in property" as part of "all income from whatever source derived" in the definition of gross income under I.R.C. Section 61(a) meant that taxable income, which includes gross income according to Section 63(a), also therefore included capital gains as well as ordinary income, in the absence of a specific exclusion of capital gains. 429 U.S. at 37. The Court's inclusion of capital gains impliedly excludes principal from gross income and thus taxable income.

“sales,” but this definition does not include “gross receipts.”²⁹ Instead, under its definition of “sales,” “[i]f the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the **income-producing** activity is performed within this State.” (Emphasis added). This phrase “income-producing” is used to modify “activity” several other times in the definition of “sales.” “Income” means “an actual gain or actual increase of wealth.” See Scott v. S.C. Tax Comm’n, 262 S.C. 144, 148-49, 202 S.E.2d 854, 856 (1974) (Bussey, J., dissenting) (citing 85 C.J.S. Taxation 1096, p. 730). This emphasis on income production suggests that principal is excluded from the definition of “sales.”³⁰ Moreover, this limitation of “sales” to the net income derived therefrom is not a novel interpretation. Indeed, our own Supreme Court has approved of an apportionment formula “whereby [a business’s] sales, payroll, and property in South Carolina were divided by its national net sales, payroll, and property.” See Eastman Kodak Co. v. S.C. Tax Comm’n, 308 S.C. 415, 416, 419, 418 S.E.2d 542, 542, 544 (1992) (holding in part that safe harbor lease transactions that were part of a corporation’s business “were properly included in the denominator of the apportionment formula in computing [that corporation’s] national net income from payroll, property, and sales.”) (emphasis added). The Supreme Court in Texaco, Inc. v. Wasson, referring to S.C. Code Ann. § 12-7-1140 (****), the immediate predecessor to Section 12-6-2250 (****), further noted that “[u]nder the [three-factor] apportionment method, a corporation’s entire net income is apportioned to this state by applying to that entire net income a percentage based on the ‘three-factor formula’ of property, payroll, and sales in this state to the corporation’s total property, payroll, and sales.” 269 S.C. 255, 259, 237 S.E.2d 75, 76 (1977) (emphasis added). The Court also noted that this apportionment was of the “net income” remaining after the direct allocation of certain items listed under Section 12-7-1120 (****) (currently Section 12-6-2220 (****)). Id. at 266, 237 S.E.2d at 80 (emphasis added). Using this

²⁹ “Sales” and “gross receipts” were later further defined together by S.C. Code Ann. § 12-6-2295 (2007) (effective for tax years beginning after 2006). However, the years at issue here are 1978-2001. Further, because the Court finds as a matter of law that the refund claims filed for tax years ending 1978-1993 are untimely, the only years that will be considered for the gross receipts issue will be tax years ending 1994-2001.

³⁰ Though Duke Energy is a nonresident corporation, it is worth noting that South Carolina taxable income for nonresident individuals, nonresident trusts, nonresident estates, and nonresident beneficiaries include only amounts attributable to, among other things, “income from intangible personal property, including annuities, dividends, interest, and gains that is derived from property employed in a trade, business, profession, or occupation carried on in this State.” It is interesting that nowhere is “principal” mentioned as an inclusion in taxable income.

interpretation and limiting the sales factor in the denominator of the three-part apportionment formula to net income is the more sound application of the apportionment formula.

The conclusion in this case is further supported by the fact that in the context of consolidated returns filed by multiple corporations conducting business within and without the State, the returns included in the sales factor of the standard apportionment formula must "contain such other information necessary to compute the net income of each taxpayer properly attributable to the state so that South Carolina can impose a tax on the taxpayers concerned." Emerson Elec. Co. v. Wasson, 287 S.C. 394, 396-97, 339 S.E.2d 118, 120 (1986) (discussing S.C. Code Ann. § 12-7-1570 (****) (for tax years prior to 1996), the predecessor of § 12-6-5020 (****) (for tax years after 1996)) (emphasis altered). This infers that when a single corporation also conducts business within and without the State, its net income only, and not principal, is included in the sales factor for purposes of apportioning the amount of corporate income taxes the State could impose on that corporation. See, e.g., Eastman Kodak Co., 308 S.C. at 416, 418 S.E.2d at 542 (Kodak included only the net income in the sales factor in the denominator of the apportionment formula).

Criticism of the "Absurd Results Standard"

The California Supreme Court in Microsoft criticized the proponents of the "absurd results standard," in part, because "[i]n each case, the same language governs both sales of off-the-shelf products and sales of securities. AT&T [(the New Jersey case)] and its progeny offer no explanation why in one instance that language should require inclusion of gross proceeds and in the other require inclusion of only net proceeds." 39 Cal.4th at 763, 139 P.3d at 1177.³¹ Nevertheless, the resolution of this issue has been clarified in South Carolina by the Supreme Court's holding in Hay v. Leonard, 212 S.C. 81, 46 S.E.2d 653 (1948).

Hay involved a challenge to the validity of Charleston County's levying an annual license tax for the privilege of engaging in each and every business and occupation in Charleston County, except in the City of Charleston. In reaching its decision, the South Carolina Supreme Court explained the reason why merchandise, or "off-the-shelf products," includes gross proceeds in its taxation, and the Court's reasoning suggests why the sale of securities would not include gross proceeds. The Court explained: "the [license] tax is not on the property itself; it is

³¹ This is the first of the "two problems" that the California Supreme Court had with the "absurd results" cases. The second problem will be discussed in the immediately-following paragraph.

on the privilege of dealing with it. The value of such privilege is measured by the gross receipts therefrom, and this is a familiar and valid method of ascertaining such value." Id. at 97, 46 S.E.2d at 660 (emphasis added). A merchant is required to possess a license in order to have the privilege of dealing in merchandise; and the tax is on this privilege, not on the merchandise. This is why "[t]he sale of all merchandise includes previous taxation" Id.; see also State ex rel. Roddey v. Byrnes, 219 S.C. 485, 514, 66 S.E.2d 33, 45 (1951) ("In general, the sales tax [a form of excise tax], is [like a license tax], an imposition upon the privilege of the business of selling at retail and measured by the amount of business done"). The sale of securities is altogether different in that a license is not required to purchase or sell securities,³² and no sales tax is imposed upon the sale of securities.³³ Therefore, here there exist no "privilege" grounds upon which to include principal in the gross receipts, as the value received from the sales of the securities for tax purposes would be measured by the capital gains, not by the principal. The principal would consist of the business's "idle cash" that would presumably have been taxed already.

Conclusion

This Court hereby follows New Jersey, Indiana, and Arizona in adopting the "absurd results" approach to interpreting South Carolina's standard apportionment statute and therefore rejects Duke Energy's attempt to include the return of principal in the denominator of the standard apportionment formula. In sum, the alternative apportionment formula exists to remediate any nonsensical application of the standard apportionment formula. However, that remediation should not be the result of a court's addition, through its failure to apply the rules of statutory interpretation, of a component to the standard apportionment formula that neither exists in the statute nor was intended by the Legislature. The absurdity that the alternative apportionment formula is intended to remediate is when a taxpayer follows the standard apportionment formula but the result is nevertheless an unfair representation of the extent of the taxpayer's business activity in the State. Construing the purpose of the alternative provision to avoid an absurd use of the standard apportionment statute clearly could open the door to the abuse of the standard apportionment statute and an excessive need to apply Section 12-6-

³² This statement does not include securities brokering.

³³ Capital gains tax is imposed upon the sale of securities (assuming a profit is made from the sale). This tax is imposed on the profit, or "gains," made on the capital originally invested, not on the returned principal.

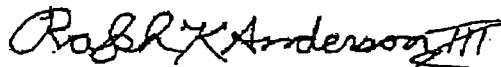
2320(A). Furthermore, to use the alternative apportionment provision as a means to avoid absurdity resulting from an interpretation of the standard apportionment provision that is not envisioned by the tax laws places upon the State a burden of policing tax returns that simply should not exist.

Importantly, it is not the amount of distortion that determines absurdity here. If it was, then there would exist an issue of material fact in this case, and indeed in every such case, as to the amount of distortion that would result from the inclusion of principal, and a hearing would be necessary to obtain facts whereby the degree of distortion could be measured so as to determine whether the results of principal inclusion would be absurd in this case. But such a case-by-case determination is not necessary where, as here, principal cannot, as a matter of law, be included in sales or gross receipts for purposes of the standard apportionment formula. Thus, no hearing is necessary on the gross receipts issue, and the Department's Motion for Summary Judgment as to this issue is therefore granted for the reasons set forth above.

ORDER

THEREFORE, IT IS HEREBY ORDERED that: (1) the Department's Motion for Summary Judgment with respect to the Timeliness Issue is **GRANTED**; (2) the Department's Motion for Summary Judgment with respect to the Apportionment Method Issue is **DENIED**; and (3) the Department's Motion for Summary Judgment with respect to the Gross Receipts Issue is **GRANTED**, and Duke Energy's Cross-Motion for Partial Summary Judgment as to this same issue is therefore **DENIED**.

IT IS SO ORDERED.



Ralph K. Anderson, III
Chief Administrative Law Judge

August 9, 2012
Columbia, South Carolina

CERTIFICATE OF SERVICE

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

E. Harvin Belser Fair

E. Harvin Belser Fair
Judicial Law Clerk

August 9, 2012
Columbia, South Carolina

C



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EXHIBIT C

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the fiscal year ended December 31, 2000 or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934

For the transition period from to

Commission file number 1-4928

DUKE ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

56-0205520

North Carolina
(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification
No.)

526 South Church Street, Charlotte,
North Carolina
(Address of principal executive
offices)

28202-1904
(Zip Code)

704-594-6200

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, without par value	New York Stock Exchange, Inc.
6.375% Preferred Stock A, 1993 Series, par value \$25	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 5 7/8% Due 2001	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 5 7/8% Series C Due 2003	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 1/4% Series B Due 2004	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 3/8% Due 2008	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 5/8% Series B Due 2003	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 3/4% Due 2025	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 7/8% Series B Due 2023	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7% Due 2033	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7 1/2% Series B Due 2025	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7 7/8% Due 2024	New York Stock Exchange, Inc.
7.20% Quarterly Income Preferred Securities issued by Duke Energy Capital Trust I and guaranteed by Duke Energy Corporation	New York Stock Exchange, Inc.
7.20% Trust Preferred Securities issued by Duke	

Energy Capital Trust II and guaranteed by Duke
Energy Corporation
Preference Stock Purchase Rights
Series C 6.60% Senior Notes Due 2038
Corporate Units

New York Stock Exchange, Inc.
New York Stock Exchange, Inc.
New York Stock Exchange, Inc.
New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

Title of class

Preferred Stock, par value \$100

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No []

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

Estimated aggregate market value of the voting stock held by nonaffiliates of the registrant at February 28, 2001..... \$30,197,000,000
Number of shares of Common Stock, without par value, outstanding at February 28, 2001..... 742,000,590

Documents incorporated by reference:

The registrant is incorporating herein by reference certain sections of the proxy statement relating to the 2001 annual meeting of shareholders to provide information required by Part III, Items 10, 11, 12 and 13 of this annual report.

DUKE ENERGY CORPORATION

FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2000

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SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

From time to time, Duke Energy may make statements regarding its assumptions, projections, expectations, intentions or beliefs about future events. These statements are intended as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. Duke Energy cautions that assumptions, projections, expectations, intentions or beliefs about future events may and often do vary from actual results, and the differences between assumptions, projections, expectations, intentions or beliefs and actual results can be material. Accordingly, there can be no assurance that the actual results will not differ materially from those expressed or implied by the forward-looking statements. For a discussion of some factors that could cause actual achievements and events to differ materially from those expressed or implied in such forward-looking statements, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Forward-Looking Statements."

PART I.

Item 1. Business.

GENERAL

Duke Energy Corporation (collectively with its subsidiaries, "Duke Energy") is an integrated energy and energy services provider with the ability to offer physical delivery and management of both electricity and natural gas throughout the U.S. and abroad. Duke Energy provides these and other services through seven business segments.

Franchised Electric generates, transmits, distributes and sells electric energy in central and western North Carolina and the western portion of South Carolina. Its operations are conducted primarily through Duke Power and Nantahala Power and Light. These electric operations are subject to the rules and regulations of the Federal Energy Regulatory Commission (FERC), the North Carolina Utilities Commission (NCUC) and the Public Service Commission of South Carolina (PSCSC).

Natural Gas Transmission provides interstate transportation and storage of natural gas for customers primarily in the Mid-Atlantic, New England and southeastern states. Its operations are conducted primarily through Duke Energy Gas Transmission Corporation. The interstate natural gas transmission and storage operations are subject to the rules and regulations of the FERC.

Field Services gathers, processes, transports, markets and stores natural gas and produces, transports, markets and stores natural gas liquids (NGLs). Its operations are conducted primarily through Duke Energy Field Services, LLC (DEFS), a limited liability company that is approximately 30% owned by Phillips Petroleum. Field Services operates gathering systems in western Canada and 11

contiguous states that serve major natural gas-producing regions in the Rocky Mountain, Permian Basin, Mid-Continent, East Texas-Austin Chalk-North Louisiana, as well as onshore and offshore Gulf Coast areas.

North American Wholesale Energy's (NAWE's) activities include asset development, operation and management, primarily through Duke Energy North America, LLC (DENA), and commodity sales and services related to natural gas and power, primarily through Duke Energy Trading and Marketing, LLC (DETM). DETM is a limited liability company that is approximately 40% owned by Exxon Mobil Corporation. NAWE also includes Duke Energy Merchants (DEM), which develops new business lines in the evolving energy commodity markets. NAWE conducts its business throughout the U.S. and Canada. The operations of the previously segregated Trading and Marketing segment were combined by management into NAWE during 2000.

International Energy conducts its operations through Duke Energy International, LLC. International Energy's activities include asset development, operation and management of natural gas and power facilities and energy trading and marketing of natural gas and electric power. This activity is targeted in the Latin American, Asia-Pacific and European regions.

Other Energy Services is a combination of businesses that provide engineering, consulting, construction and integrated energy solutions worldwide, primarily through Duke Engineering & Services, Inc. (DES), Duke/Fluor Daniel (D/FD) and DukeSolutions, Inc. (DukeSolutions). D/FD is a 50/50 partnership between Duke Energy and Fluor Enterprises, Inc.

Duke Ventures is comprised of other diverse businesses, primarily operating through Crescent Resources, Inc. (Crescent), DukeNet Communications, LLC (DukeNet) and Duke Capital Partners (DCP). Crescent develops high-quality commercial, residential and multi-family real estate projects and manages land holdings primarily in the southeastern U.S. DukeNet provides fiber optic networks for industrial, commercial and residential customers. DCP, a newly formed, wholly owned merchant finance company, provides financing, investment banking and asset management services to wholesale and commercial energy markets.

1

Certain terms used to describe Duke Energy's business are explained below.

British Thermal Unit (Btu). A standard unit for measuring thermal energy or heat commonly used as a gauge for the energy content of natural gas and other fuels.

Cubic Foot (cf). The most common unit of measurement of gas volume; the amount of natural gas required to fill a volume of one cubic foot under stated conditions of temperature, pressure and water vapor.

Distribution. The system of lines, transformers and switches that connect the electric transmission system to customers.

Federal Energy Regulatory Commission (FERC). The agency that regulates the transportation of electricity and natural gas in interstate commerce and authorizes the buying and selling of energy commodities at market-based rates.

Gathering System. Pipeline, processing and related facilities that access production and other sources of natural gas supplies for delivery to mainline transmission systems.

Generation. The process of transforming other forms of energy, such as nuclear or fossil fuels, into electricity. Also, the amount of electric energy produced, expressed in megawatt-hours.

Greenfield Development. The development of a new power generating facility on an undeveloped site.

Independent System Operator (ISO). Ensures non-discriminatory access to a regional transmission system, providing all customers access to the power exchange and clearing all bilateral contract requests for use of the electric transmission system. Also responsible for maintaining bulk electric system reliability.

Liquefied Natural Gas (LNG). Natural gas that has been converted to a liquid by cooling it to -260 degrees Fahrenheit.

Local Distribution Company (LDC). A company that obtains the major portion of its revenues from the operations of a retail distribution system for the delivery of electricity or gas for ultimate consumption.

Natural Gas. A naturally occurring mixture of hydrocarbon and non-hydrocarbon gases found in porous geological formations beneath the earth's surface, often in association with petroleum. The principal constituent is methane.

Natural Gas Liquids (NGLs). Liquid hydrocarbons extracted during the processing of natural gas. Principal commercial NGLs include butanes, propane, natural gasoline and ethane.

Peak Load. The amount of electricity required during periods of highest demand. Peak periods fluctuate by season, generally occurring in the morning hours in winter and in late afternoon during the summer.

Throughput. The amount of natural gas or natural gas liquids transported through a pipeline system.

Transmission System (Electric). An interconnected group of electric transmission lines and related equipment for moving or transferring electric energy in bulk between points of supply and points at which it is transformed for delivery over a distribution system to customers, or for delivery to other electric transmission systems.

Transmission System (Natural Gas). An interconnected group of natural gas pipelines and associated facilities for transporting natural gas in bulk between points of supply and delivery points to industrial customers, local distribution companies, or for delivery to other natural gas transmission systems.

Watt. A measure of real power production or usage equal to one joule per second.

A discussion of the current business and operations of each of Duke Energy's segments follows. For further discussion of the operating outlook of Duke Energy and its segments, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Introduction--Business Strategy." For financial information concerning Duke Energy's business segments, see Note 3 to the Consolidated Financial Statements, "Business Segments."

Duke Energy is a North Carolina corporation with its principal executive offices located at 526 South Church Street, Charlotte, NC 28202-1904. The telephone number is 704-594-6200.

2

FRANCHISED ELECTRIC

Service Area and Customers

Franchised Electric generates, transmits, distributes and sells electricity over a service area which covers about 22,000 square miles with an estimated population of 5.3 million people in central and western portions of North Carolina and the western portion of South Carolina. Franchised Electric supplies electric service directly to approximately two million residential, commercial and industrial customers over 92,000 miles of distribution lines and a 12,700 mile transmission system. Electricity is sold at wholesale to incorporated municipalities and to several public and private utilities. In addition, sales are made through contractual agreements to municipal or cooperative customers who purchased portions of the Catawba Nuclear Station. For statistics related to gigawatt-hour sales by customer type, see "Operating Statistics." For further discussion of the Catawba Nuclear Station joint ownership, see Note 5 to the Consolidated Financial Statements, "Joint Ownership of Generating Facilities."

Franchised Electric's service area is undergoing increasingly diversified industrial and commercial development. The textile industry, machinery and equipment manufacturing, and chemical and chemical-related industries are of major significance to the economy of the area. Other industrial activities include rubber and plastic products, paper and allied products, and various

other light and heavy manufacturing and service businesses. The largest industry served is the textile industry, which accounted for approximately \$419 million of Franchised Electric's revenues for 2000, representing 9% of total electric revenues and 35% of industrial revenues. Franchised Electric normally experiences seasonal peak loads in summer and winter.

[MAP]

3

Capacity and Resources of Energy

Electric energy required to supply the needs of Franchised Electric's customers is primarily generated by three nuclear generating stations with a combined net capacity of 5,409 megawatts (MW), eight coal-fired stations with a combined capacity of 7,572 MW, 31 hydroelectric stations with a combined capacity of 2,693 MW and six combustion turbine stations with a combined capacity of 2,081 MW. Energy and capacity are also supplied through contracts with other generators of electricity and purchased on the open market. Franchised Electric has interconnections and arrangements with its neighboring utilities, which are considered adequate for planning, emergency assistance, exchange of capacity and energy and reliability of power supply. Future increased energy requirements of Franchised Electric's customers are expected to be supplied through additional construction, purchased power contracts and open market purchases. For statistics regarding sources of electric energy, see "Operating Statistics."

Fuel Supply

Franchised Electric presently relies principally on coal and nuclear fuel for the generation of electric energy. Franchised Electric's reliance on oil and gas is minimal. Information regarding the utilization of sources of power and cost of fuels for each of the three years in the period ended December 31, 2000 is set forth in the following table:

	Generation by Source (Percent)			Cost of Fuel per Net Kilowatt-hour Generated (Cents)		
	2000	1999	1998	2000	1999	1998
Coal.....	50.9	50.4	50.7	1.29	1.33	1.32
Nuclear(a).....	48.1	48.0	46.2	0.42	0.43	0.44
Oil and gas(b).....	0.5	0.8	1.0	7.32	4.51	4.01
All fuels (cost based on weighted average)(a).....	99.5	99.2	97.9	0.91	0.92	0.93
Hydroelectric(c).....	0.5	0.8	2.1			
	100.0	100.0	100.0			

- (a) Statistics related to nuclear generation and all fuels reflect Franchised Electric's 12.5% ownership interest in the Catawba Nuclear Station.
 (b) Cost statistics include amounts for light-off fuel at Franchised Electric's coal-fired stations.
 (c) Generating figures are net of output required to replenish pumped storage units during off-peak periods.

Coal. Franchised Electric meets its coal demand through purchase supply contracts and spot agreements. Large amounts of its coal supply are obtained under supply contracts with mining operators utilizing both underground and surface mining. Franchised Electric has an adequate supply of coal to fuel its current operations. Its supply contracts, all of which have price adjustment provisions, have expiration dates ranging from 2001 to 2003. Duke Energy believes that it will be able to renew such contracts as they expire or to enter into similar contractual arrangements with other coal suppliers for the quantities and qualities of coal required. The coal purchased under these

supply contracts is produced from mines located in eastern Kentucky, southern West Virginia and southwestern Virginia. Coal requirements not met by supply contracts have been and are expected to be fulfilled with spot market purchases.

The average sulfur content of coal being purchased by Franchised Electric is approximately 1%. Such coal satisfies the current emission limitation for sulfur dioxide for existing facilities. See also "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental, Air Quality Control" for additional information regarding particulate matter.

Nuclear. Generally, the process for developing nuclear generating fuel supply involves the mining and milling of uranium ore to produce uranium concentrates, the conversion of uranium concentrates to uranium hexafluoride, enrichment of that gas and fabrication of the enriched uranium hexafluoride into usable fuel assemblies. Franchised Electric has contracted for uranium materials and services required to fuel the Oconee.

McGuire and Catawba Nuclear Stations. Based upon current projections, these contracts will meet Franchised Electric's requirements through the following years:

Nuclear Station	Uranium Conversion Enrichment Fabrication			
	Material	Service	Service	Service
Oconee.....	2002	2002	2002	2006
McGuire.....	2002	2002	2002	2009
Catawba.....	2002	2002	2002	2009

Uranium material requirements will be met through various supplier contracts, with uranium material produced primarily in the U.S. and Canada. Duke Energy believes that it will be able to renew contracts as they expire or to enter into similar contractual arrangements with other suppliers of nuclear fuel materials and services. Requirements not met by long-term supply contracts have been and are expected to be fulfilled with unfabricated uranium spot market purchases.

Duke Energy owns and operates the McGuire and Oconee Nuclear Stations with two and three nuclear reactors, respectively, and operates and has a partial ownership interest in the Catawba Nuclear Station with two nuclear reactors. Nuclear insurance coverage is maintained in three program areas: liability coverage; property, decontamination and decommissioning coverage; and business interruption and/or extra expense coverage. Certain expenses associated with nuclear insurance premiums paid by Duke Energy are reimbursed by the other joint owners of the Catawba Nuclear Station. Pursuant to the Price-Anderson Act, Duke Energy is required to insure against public liability claims resulting from nuclear incidents to the full limit of liability of approximately \$9.5 billion. See Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- Nuclear Insurance" for further information.

Estimated site-specific nuclear decommissioning costs, including the cost of decommissioning plant components not subject to radioactive contamination, total approximately \$1.9 billion stated in 1999 dollars based on decommissioning studies completed in 1999. This amount includes Duke Energy's 12.5% ownership in the Catawba Nuclear Station. The other joint owners of Catawba Nuclear Station are responsible for decommissioning costs related to their ownership interests in the station. See Note 11 to the Consolidated Financial Statements, "Nuclear Decommissioning Costs" for further information.

Duke Energy entered into a contract with the Department of Energy (DOE) to use mixed oxide fuel at its McGuire and Catawba nuclear stations. The mixed oxide fuel is fabricated from plutonium from the government's surplus and is similar to conventional uranium fuel. Before using the fuel, Duke Energy must apply for and receive amendments to the respective facility operating licenses from the Nuclear Regulatory Commission (NRC). Mixed oxide fuel is scheduled to be used at McGuire and Catawba nuclear stations in 2007.

After spent fuel is removed from a nuclear reactor, it is placed in temporary storage for cooling in a spent fuel pool at the nuclear station site. Under provisions of the Nuclear Waste Policy Act of 1982, Duke Energy has entered into contracts with the DOE for the disposal of spent nuclear fuel. The DOE failed to begin accepting the spent nuclear fuel on January 31, 1998, the date provided by the Nuclear Waste Policy Act and by Duke Energy's contract with the DOE. On June 8, 1998, Duke Energy filed with the U.S. Court of Federal Claims a claim against the DOE for damages in excess of \$1 billion arising out of the DOE's failure to begin accepting commercial spent nuclear fuel by January 31, 1998. Damages claimed in the suit are intended to recover costs that Duke Energy is incurring and will continue to incur as a result of the DOE's partial material breach of its contract with Duke Energy, including costs associated with securing additional spent fuel storage capacity. Duke Energy will continue to safely manage its spent nuclear fuel until the DOE accepts it.

Competition

Electric industry restructuring is being addressed in all 50 states and in the District of Columbia, which is resulting in changes in the industry. Duke Energy continues to monitor progress toward a more competitive environment and has actively participated in regulatory reform deliberations in North Carolina and South Carolina. Currently, however, movement toward retail deregulation in these states seems to be slowing as a consequence of recent developments related to deregulation of the electric industry in California. For further discussion, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Electric Competition and Current Issues--California Issues."

5

Franchised Electric is currently subject to competition in some areas from government owned power systems, municipally owned electric systems, rural electric cooperatives and, in certain instances, other private utilities. Currently, statutes in North Carolina and South Carolina provide for the assignment by the NCUC and the PSCSC, respectively, of all areas outside municipalities in such States to regulated electric utilities and rural electric cooperatives. Substantially all of the territory comprising Franchised Electric's service area has been so assigned. The remaining areas have been designated as unassigned and in such areas Franchised Electric remains subject to competition. A decision of the North Carolina Supreme Court limits, in some instances, the right of North Carolina municipalities to serve customers outside their corporate limits. In South Carolina there continues to be competition between municipalities and other electric suppliers outside the corporate limits of the municipalities, subject, however, to the regulation of the PSCSC. In addition, Franchised Electric is engaged in continuing competition with various natural gas providers.

Regulation

The NCUC and the PSCSC approve rates for retail electric sales within their respective states. The FERC approves Franchised Electric's rates for certain electric sales to wholesale customers. For further discussion of rate matters, see Note 4 to the Consolidated Financial Statements, "Regulatory Matters -- Franchised Electric." The FERC, the NCUC and the PSCSC also have authority over the construction and operation of Franchised Electric's facilities. Franchised Electric holds certificates of public convenience and necessity issued by the FERC, the NCUC and the PSCSC, authorizing it to construct and operate the electric facilities now in operation for which certificates are required, and to sell electricity to retail and wholesale customers. Prior approval from the NCUC and the PSCSC is required to issue securities.

The NCUC, PSCSC and FERC have implemented regulations governing access to regulated electric customer data by non-regulated entities and services provided between regulated and non-regulated affiliated entities. These regulations affect the activities of NAWES and Other Energy Services with Franchised Electric.

The Energy Policy Act of 1992 (EPACT) and the FERC's subsequent rulemaking activities permit the FERC to order transmission access for third parties to transmission facilities owned by another entity. EPACT does not, however, permit the FERC to issue orders requiring transmission access to retail customers. The FERC has issued orders for third-party transmission service and a number of rules of general applicability, including Orders 888 and 889.

Pursuant to the FERC's final rules, Franchised Electric obtained from the FERC open-access rule the rights to sell capacity and energy at market-based rates from its own assets. For further discussion, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues--Electric Competition."

On December 20, 1999 and February 25, 2000, the FERC issued its Order 2000 and Order 2000-A regarding Regional Transmission Organizations (RTOs). In these orders, the FERC stressed the voluntary nature of RTO participation by utilities and set minimum characteristics and functions that must be met by utilities that participate in an RTO, including exclusive and independent authority to propose rates, terms and conditions of transmission service provided over the facilities it operates. The order provides for an open, flexible structure for RTOs to meet the needs of the market and provides for the possibility of incentive ratemaking and other benefits for utilities that participate in an RTO.

As a result of these rulemakings, on October 16, 2000, Duke Energy and two other investor-owned utilities, Progress Energy and South Carolina Electric & Gas, filed with the FERC to establish GridSouth Transco, LLC (GridSouth), as an RTO. If approved, GridSouth will be a for-profit, independent transmission company, responsible for operating and planning the companies' combined transmission systems. The target date for formation of GridSouth is December 15, 2001. However, the actual date that GridSouth becomes operational will depend upon the resolution of all necessary regulatory approvals and resolving all technical issues. Management believes that the establishment of GridSouth will not have a material adverse effect on Duke Energy's future consolidated results of operations, cash flows or financial position.

6

The Franchised Electric segment is subject to the jurisdiction of the NRC as to the design, construction and operation of its nuclear stations.

The hydroelectric generating facilities of Franchised Electric are licensed by the FERC under Part I of the Federal Power Act, with license terms expiring from 2001 to 2036. The nuclear generating facilities of Franchised Electric are licensed by the NRC with license terms expiring from 2021 through 2034. The FERC has authority to grant extensions of hydroelectric generating licenses, and the NRC has authority to grant extensions of nuclear generating licenses. During 2000, the NRC renewed the operating license for Duke Energy's three Oconee nuclear units through 2033 to 2034. Duke Energy also initiated the license renewal process for the McGuire and Catawba Nuclear Stations in 2000. Duke Energy has filed a license application for one of its hydroelectric facilities for which it expects to receive a new license by the end of 2001. Duke Energy is also in various stages of relicensing other hydroelectric facilities whose licenses expire between 2005 and 2008.

The Franchised Electric segment is subject to the jurisdiction of the Environmental Protection Agency (EPA) and state environmental agencies. For a discussion of environmental regulation, see "Environmental Matters."

7

NATURAL GAS TRANSMISSION

Natural Gas Transmission provides interstate transportation and storage of natural gas through its operating subsidiaries, which include Texas Eastern Transmission Corporation (TETCO) and Algonquin Gas Transmission Company (Algonquin), East Tennessee Natural Gas Company (East Tennessee) and Market Hub Partners (MHP). East Tennessee and MHP were acquired in March 2000 and September 2000, respectively. Panhandle Eastern Pipe Line Company and Trunkline Gas Company, were also a part of Natural Gas Transmission until their sale to CMS Energy Corporation (CMS) in March 1999. See further discussion of the sale and acquisitions in Note 2 to the Consolidated Financial Statements, "Business Acquisitions and Dispositions."

Investments include a 37.5% ownership interest in Maritimes & Northeast Pipeline, which has a design capacity of 530 million cubic feet per day (MMcf/d) in Canada and 400 MMcf/d in the U.S. Maritimes & Northeast Pipeline was placed in service and received the first delivery of natural gas from the Sable Offshore Energy Project near Nova Scotia in December 1999. Duke Energy

operates the U.S. portion of the Maritimes & Northeast Pipeline.

For 2000, consolidated natural gas deliveries by Natural Gas Transmission's interstate pipelines totaled 1,717 trillion British thermal units (Tbtu), compared to 1,565 Tbtu in 1999, a 10% increase from last year. The pipelines that were sold to CMS during 1999 also delivered 328 Tbtu in 1999 prior to the sale. A majority of Natural Gas Transmission's contracted volumes are under long-term firm service agreements with local distribution company (LDC) customers in the pipelines' market areas. Firm transportation services are also provided to gas marketers, producers, other pipelines, electric power generators and a variety of end-users. In addition, the pipelines provide both firm and interruptible transportation to various customers on a short-term or seasonal basis. See natural gas deliveries statistics under "Operating Statistics." Demand for gas transmission on Natural Gas Transmission's interstate pipeline systems is seasonal, with the highest throughput occurring during the colder periods in the first and fourth quarters. Natural Gas Transmission's major pipeline customers are located in Pennsylvania, New Jersey, Connecticut, Virginia, Tennessee, Rhode Island and New York.

[MAP]

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Natural Gas Transmission's interstate pipeline systems consist of approximately 12,000 miles of pipe, which includes 830 miles related to the partial ownership interest in Maritimes & Northeast Pipeline. The pipeline systems receive natural gas from many major North American producing regions for delivery to markets primarily in the Mid-Atlantic, southeastern and New England states. Consistent with its growth strategy, Duke Energy and The Williams Companies, Inc. announced the closing on February 1, 2001 of their joint purchase of Coastal Corporation's Gulfstream Natural Gas System LLC. The planned 744-mile Gulfstream gas pipeline will originate near Mobile, Alabama, and cross the Gulf of Mexico to Manatee County, Florida.

MHP owns natural gas salt cavern facilities in south Texas and Louisiana with a total storage capacity of 23 billion cubic feet (Bcf). Utilizing these facilities, MHP provides high deliverability firm storage services, real-time title tracking and other interruptible storage hub services to producers, end-users, LDCs, pipelines and natural gas marketers. TETCO and East Tennessee also provide firm and interruptible open-access storage services. Storage is offered as a stand-alone unbundled service or as part of a no-notice bundled service with transportation. TETCO's storage services utilize two joint venture storage facilities in Pennsylvania and one wholly owned and operated storage field in Maryland. TETCO's certificated working capacity in these three fields is 75 Bcf. East Tennessee's storage services utilize a liquefied natural gas (LNG) storage facility in Tennessee which has a certificated working capacity of 1.2 Bcf. Algonquin owns no storage fields.

Competition

Duke Energy's interstate pipeline and storage subsidiaries compete with other interstate and intrastate pipeline and storage facilities in the transportation and storage of natural gas. The principal elements of competition are rates, terms of service, and flexibility and reliability of service.

Natural Gas Transmission competes directly with other interstate pipelines serving the Mid-Atlantic, northeastern and southeastern states, and various storage facilities in south Texas and Louisiana.

Natural gas competes with other forms of energy available to Duke Energy's customers and end-users, including electricity, coal and fuel oils. The primary competitive factor is price. Changes in the availability or price of natural gas and other forms of energy, the level of business activity, conservation, legislation and governmental regulations, the capability to convert to alternative fuels, and other factors, including weather, affect the demand for natural gas in the areas served by Duke Energy.

Regulation

The FERC has authority to regulate rates and charges for natural gas transported in or stored for interstate commerce or sold by a natural gas company in interstate commerce for resale. For further discussion of rate matters, see Note 4 to the Consolidated Financial Statements, "Regulatory

Matters--Natural Gas Transmission." The FERC also has authority over the construction and operation of pipeline and related facilities utilized in the transportation, storage and sale of natural gas in interstate commerce, including the extension, enlargement or abandonment of such facilities. TETCO, Algonquin, East Tennessee and MHP hold certificates of public convenience and necessity issued by the FERC, authorizing them to construct and operate the pipelines, facilities and properties now in operation for which such certificates are required, and to transport and store natural gas in interstate commerce.

As required by FERC Order 636, Natural Gas Transmission's pipelines operate as open-access transporters of natural gas, providing unbundled firm and interruptible transportation and storage services on an equal basis for all gas supplies, whether purchased from the pipeline or from another gas supplier.

The FERC has implemented regulations governing access to regulated natural gas transmission customer data by non-regulated entities and services provided between regulated and non-regulated affiliated entities. These regulations affect the activities of NAWT with Natural Gas Transmission.

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Natural Gas Transmission is subject to the jurisdiction of the EPA and state environmental agencies. For a discussion of environmental regulation, see "Environmental Matters." Natural Gas Transmission is also subject to the Natural Gas Pipeline Safety Act of 1968, which regulates gas pipeline and LNG plant safety requirements, and to the Hazardous Liquid Pipeline Safety Act of 1979, which regulates oil and petroleum pipelines.

FIELD SERVICES

Field Services gathers, processes, transports, markets and stores natural gas and produces, transports, markets and stores NGLs. Field Services owns and operates approximately 57,000 miles of natural gas gathering systems, including intrastate pipelines, and 68 natural gas processing plants in the U.S. and Canada. Field Services also has ownership interests in 11 other natural gas processing plants in the U.S.

Field Services gathers natural gas from production wellheads through gathering systems in western Canada and 11 contiguous states that serve major gas-producing regions in the Rocky Mountain, Permian Basin, Mid-Continent, East Texas-Austin Chalk-North Louisiana, as well as onshore and offshore Gulf Coast areas. Field Services' operations also include several intrastate pipeline systems and one high-deliverability natural gas storage facility.

The map below includes Field Services' natural gas gathering systems, intrastate pipelines, region offices and supply areas. The map also shows the interstate systems of the Natural Gas Transmission segment.

[MAP]

Field Services' NGL processing operations involve the extraction of NGLs from natural gas and, at certain facilities, the fractionation of the NGLs into their individual components (ethane, propane, butane and natural

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gasoline). The natural gas used in Field Services' processing operations is generally gathered on its own gathering system. NGLs are sold by Field Services to a variety of customers ranging from large, multi-national petrochemical and refining companies to small, family-owned retail propane distributors. Most NGL sales are based upon current market-related prices. Field Services also produces helium at the National Helium Corporation facility in Liberal, Kansas and the Ladder Creek facility in Colorado.

Field Services' operating results are significantly impacted by changes in NGL prices, which increased approximately 56% in 2000 compared to 1999. See "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk" for a discussion of Field Services' exposure to changes in commodity prices.

In March 2000, Duke Energy, through a wholly owned subsidiary, completed the

approximately \$1.7 billion transaction that combined Field Services' gas gathering and processing business with Phillips Petroleum's Gas Gathering, Processing and Marketing unit (Phillips) to form a new midstream company, named DEFS. In addition to this transaction, Duke Energy transferred its interest in Texas Eastern Products Pipeline Company (TEPPCO), the general partner of TEPPCO Partners, L.P., to the newly formed company, DEFS. For further discussion of the Phillips transaction see Note 2 to the Consolidated Financial Statements, "Business Acquisitions and Dispositions."

On March 31, 1999, Field Services completed the \$1.35 billion acquisition of the natural gas gathering, processing, fractionation and NGL pipeline business from Union Pacific Resources (UPR), as well as UPR's natural gas and NGL marketing activities (collectively, "the UPR acquisition"). For further discussion of the UPR acquisition see Note 3 to the Consolidated Financial Statements, "Business Acquisitions and Dispositions."

See certain operating statistics of Field Services under "Operating Statistics." Activities of Field Services can fluctuate in response to the seasonality affecting natural gas.

Competition

Field Services competes with major integrated oil companies, major interstate pipelines, national and local natural gas gatherers, brokers, marketers and distributors for natural gas supplies, in gathering and processing natural gas and in marketing and transporting natural gas and NGLs. Competition for natural gas supplies is primarily based on the efficiency and reliability of operations, the availability of transportation to high demand markets and the ability to obtain a satisfactory price for the producer's natural gas. Competition for sales customers is based primarily upon reliability and price of delivered natural gas and NGLs.

Regulation

The intrastate pipelines owned by Field Services are subject to state regulation and, to the extent they provide services under Section 311 of the Natural Gas Policy Act of 1978, are also subject to FERC regulation. However, the majority of the natural gas gathering activities of Field Services are not subject to regulation by the FERC.

Field Services is subject to the jurisdiction of the EPA and state environmental agencies. For a discussion of environmental regulation, see "Environmental Matters." Certain operations of Field Services are subject to the jurisdiction of the Department of Transportation and certain similar state agencies whose regulations have incorporated certain provisions of the Natural Gas Pipeline Safety Act of 1968, the Hazardous Liquid Pipeline Safety Act of 1979, and subsequent amendments.

NAWE

NAWE's business activities include asset development, operation and management of merchant generation facilities, primarily through DENA, and commodity sales and services related to natural gas and power, primarily through DETM, a limited liability company that is approximately 40% owned by Exxon Mobil Corporation. NAWE also includes DSM, which develops new business lines in the evolving energy commodity markets. NAWE conducts its business throughout the U.S. and Canada.

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DENA is an integrated energy business that develops, owns and manages a portfolio of merchant generation facilities. To capture the greatest value, DENA, through its portfolio management strategy, seeks opportunities to invest in markets that have capacity needs and to divest assets, in whole or in part, when significant value can be realized. DENA captures additional value by combining its project development, commercial and risk management expertise with the technical and operational skills of other Duke Energy business units to build and manage its projects with maximum efficiency. DENA also supplies competitively priced energy, integrated logistics and asset optimization services, as well as risk management products, to wholesale energy customers.

DENA currently owns, operates or has substantial interests in approximately 6,200 MW of gross operating generation and has approximately 7,300 MW of

projects under construction, which are slated for completion to meet summer peak demand: 3,200 MW in 2001 and 4,100 MW in 2002. In addition to the facilities in operation or under construction, DENA has approximately 13,500 MW in advanced development scheduled to begin operation between 2002 and 2004.

The following map includes DENA's power generation facilities.

[MAP]

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DETM markets natural gas, electricity and other energy-related products to a wide range of customers across North America. Duke Energy owns a 60% interest in DETM's natural gas and electric power trading operations, with Exxon Mobil Corporation owning a 40% minority interest. Duke Energy and Exxon Mobil Corporation are in arbitration regarding the ownership of DETM. See

"Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- "Litigation and Contingencies, Exxon Mobil Corporation Arbitration" and Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- Litigation."

DETM markets natural gas primarily to LDCs, electric power generators (including DENA's generation facilities), municipalities, large industrial end-users and energy marketing companies. DETM markets electricity to investor owned utilities, municipal power generators and other power marketers. DETM also provides energy management services, such as supply and market aggregation, peaking services, dispatching, balancing, transportation, storage, tolling, contract negotiation and administration, as well as energy commodity risk management products and services. Operations are primarily in the U.S. and, to a lesser extent, in Canada, and are serviced through three operating centers.

Natural gas marketing operations encompass both on-system and off-system supplies. With respect to on-system supplies, DETM generally purchases natural gas from producers who are connected to Field Services' facilities and delivers the gas to an intrastate or interstate pipeline for redelivery to another customer. Natural Gas Transmission's pipelines are utilized for deliveries when prudent. With respect to off-system supplies, DETM purchases natural gas from producers, pipelines and other suppliers not connected with Duke Energy's facilities for resale to customers. Substantially all of Mobil's U.S. and Canadian natural gas production is committed to be marketed by DETM through 2006.

With respect to electricity marketing operations, DETM purchases electricity from third-party suppliers and from DENA's domestic generation facilities for resale to customers.

DETM has a portfolio of short-term and long-term sales agreements with customers, the vast majority of which incorporate market-sensitive pricing terms. Long-term gas purchase agreements with producers, principally entered into in connection with on-system supplies, also generally include market-sensitive pricing provisions. Purchase and sales commitments involving significant price and location risk are generally hedged with offsetting commitments and commodity futures, swaps and options. For information concerning DETM's risk-management activities, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk -- Commodity Price Risk" and Note 7 to the Consolidated Financial Statements, "Risk Management and Financial Instruments -- Commodity Derivatives -- Trading."

DEM conducts physical and financial marketing and trading in evolving global energy commodity markets, and provides energy, financial and asset management services to producers, transporters and users of energy commodities and derivative products. Additionally, DEM invests capital in limited hydrocarbon exploration and production prospects through non-operating working interests.

See certain operating statistics of NAWA under "Operating Statistics." Activities of DETM and DEM can fluctuate in response to the seasonality affecting electricity, natural gas and other energy-related commodities.

Competition

DETM and DEM compete with major integrated oil companies, major interstate pipelines and their marketing affiliates, brokers, marketers and distributors.

and electric utilities and other electric power marketers for natural gas supplies and in marketing natural gas, electricity and other energy-related commodities. Competition in the energy marketing business is driven by the price of commodities and services delivered, along with the quality and reliability of services provided.

DENA experiences substantial competition from existing utility companies as well as other merchant electric generation companies in the U.S.

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Regulation

The energy marketing activities of NAME may, in certain circumstances, be subject to the jurisdiction of the FERC. Current FERC policies permit NAME's trading and marketing entities to market natural gas, electricity and other energy-related commodities at market-based rates, subject to FERC jurisdiction.

Most of DENA's operations are not subject to rate regulation. However, to the extent that DENA's generating stations in California sell electricity under "reliability must run" agreements to the California Independent System Operator, such sales are made at FERC regulated rates.

As described in Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- California Issues," a number of investigations have commenced to determine the causes of higher wholesale electric prices in California in 2000. During March 2001, the FERC ordered several electricity suppliers, including DETM, to (i) refund or offset prices that were paid for power in California during Stage 1 emergencies in January and February 2001, to the extent such prices exceeded a FERC-approved market-clearing price or (ii) submit information supporting the prices that were bid. During the months of January and February 2001, DETM's bids included a commercially-based credit premium to cover the substantial risk of nonpayment that existed at the time. The credit premiums were responsible for the bids of DETM exceeding the FERC-approved market-clearing prices for January and February 2001. Although DETM believes that the credit premiums were appropriate, in a compliance filing with the FERC on March 23, 2001, DETM elected to offset the credit premium amounts against the bid prices, provided it was paid what it was owed based on the FERC-approved market-clearing price. Pursuant to such filing, the amount that DETM will offset totals approximately \$20 million in the aggregate. It is expected that the FERC will issue additional orders with respect to sales in California covering the period from October 2 through December 31, 2000, and periods following February 2001. Various parties have expressed differing views on the FERC's actions in this area, and such actions may be subject to reconsideration or appeal. Although this matter is in its earliest stage, management believes this matter will not have a material effect on Duke Energy's consolidated results of operations, cash flows or financial position.

NAME is subject to federal, state and local environmental regulations. For a discussion of environmental regulation, see "Environmental Matters."

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INTERNATIONAL ENERGY

International Energy develops, owns and operates energy-related facilities worldwide. These facilities provide natural gas and power development and operations, as well as energy trading and marketing. International Energy conducts its operations primarily in Latin America, Asia Pacific and Europe, through Duke Energy International (DEI).

Liberalization of energy markets abroad is providing substantial opportunities for International Energy to grow through acquisitions, construction of greenfield projects and expansion of existing facilities. International Energy is an active participant in international competitive energy-related markets, which include natural gas pipelines, power generation, energy trading and marketing and other services. International Energy owns, operates or has substantial interests in approximately 5,000 MW of generation and approximately 1,100 miles of pipeline systems.

International Energy continues to focus on its regional target areas in Asia Pacific, Latin America and Europe for further expansion opportunities. In January 2000, DEI completed a series of transactions to purchase, for approximately \$1.03 billion, an approximate 95% interest in Companhia de Geracao de Energia Eletrica Paranapanema (Paranapanema), an electric generating company in Brazil. From August 1999 through April 2000, DEI acquired Dominion Resources, Inc.'s portfolio of hydroelectric, natural gas and diesel power generation businesses in Argentina, Belize, Bolivia and Peru for approximately \$405 million. Also, during 2000, DEI acquired 100% of Mobil Europe Gas Inc. (MEGAS) from Mobil Corporation. MEGAS is a gas marketing company located in the Netherlands. For additional information on significant business acquisitions, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Liquidity and Capital Resources -- Investing Cash Flows" and Note 2 to the Consolidated Financial Statements, "Business Acquisitions and Dispositions."

The following map illustrates the locations of International Energy's worldwide energy facilities, including projects under construction or under contract.

[MAP]

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Competition and Regulation

International Energy's operations are subject to country and region-specific market and competition regulations enacted by various regulatory authorities. Regulatory issues that are commonly addressed in various international regions include: rules governing open and competitive access to the gas and power transmission grids, dispatch rules for merchant power plant dispatch and remuneration, and rules that support the emergence of competitive gas and power trading and marketing.

International Energy's operations are subject to international environmental regulations. For a discussion of environmental regulation, see "Environmental Matters."

OTHER ENERGY SERVICES

Other Energy Services provides engineering, consulting, construction and integrated energy solutions worldwide, primarily through DE&S, D/FD and DukeSolutions.

DE&S specializes in energy and environmental projects and provides comprehensive engineering, quality assurance, project and construction management and operating and maintenance services for all phases of hydroelectric, nuclear and renewable power generation, transmission and distribution projects worldwide.

D/FD, operating through several entities, provides full service siting, permitting, licensing, engineering, procurement, construction, start-up, operating and maintenance services for fossil-fired plants, both domestically and internationally. Subsidiaries of Duke Energy and Fluor Enterprises, Inc. each own 50% of D/FD.

DukeSolutions provides energy consulting services to large end users of energy by first identifying and then affecting points in a customer's operations where energy related costs are incurred, including procurement, production and disposal. The scope of services involves providing strategic solutions to reduce costs when customers buy energy, convert it into a usable form, use it to manufacture products and dispose of any waste.

Other Energy Services experiences substantial competition from utilities and other independent companies in the U. S. and abroad.

Other Energy Services is subject to the jurisdiction of the EPA and international, state and local environmental agencies. For a discussion of environmental regulation, see "Environmental Matters."

DUKE VENTURES

Duke Ventures is comprised of other diverse businesses, primarily operating through Crescent, DukeNet and DCP.

Crescent develops high quality commercial, residential and multi-family real estate projects and manages land holdings primarily in the southeastern U.S. At December 31, 2000, Crescent owned 3.8 million square feet of commercial and industrial space, with an additional 2.3 million square feet under construction. This portfolio included 2.9 million square feet of office space, 0.8 million square feet of warehouse space and 0.1 million square feet of retail space. ~~Crescent's residential developments include high-end, country club and golf course communities with individual lots sold to custom builders and tract developments with sales to national builders.~~ In 2000, Crescent began development of two multi-family communities in Florida. At December 31, 2000, Crescent also had approximately 175,000 acres of land under its management.

DukeNet provides fiber optic networks for industrial, commercial and residential customers and plans to enable networks for energy services applications. It owns and operates a 700-mile fiber optic communications network centered in the Carolinas that is interconnected with a 15,500-mile fiber optic communications network, through affiliate agreements with third parties, that stretches from Maine to Texas. DCP, a merchant finance company, provides financing, investment banking and asset management services to ~~wholesale and commercial energy markets.~~ During September 2000, DukeNet sold its 20% interest in BellSouth Carolina PCS to BellSouth Corporation. See further discussion of this sale in Note 2 of the Consolidated Financial Statements, "Business Acquisitions and Dispositions."

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ENVIRONMENTAL MATTERS

Duke Energy is subject to international, federal, state and local regulations with regard to air and water quality, hazardous and solid waste disposal and other environmental matters. Certain environmental regulations affecting Duke Energy include:

- The Clean Air Act and the 1990 amendments to the Act, as well as state laws and regulations impacting air emissions that impose responsibilities on owners, operators or both of air emissions sources including obtaining permits and annual compliance and reporting obligations;
- State Implementation Plans, which were issued by the EPA to 22 states, including North and South Carolina, and the District of Columbia related to existing and new national ambient air quality standards for ozone;
- The Federal Water Pollution Control Act Amendments of 1987, which require permits for facilities that discharge treated wastewater into the environment; and
- The Comprehensive Environmental Response, Compensation and Liability Act, which can require any individual or entity which may have owned or operated a disposal site, as well as transporters or generators of hazardous wastes which were sent to such site; to share in remediation costs for the site.

For further discussion of environmental matters involving Duke Energy, including possible liability and capital costs, see "Item 3--Legal Proceedings," "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental" and Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies --

Environmental." Compliance with international, federal, state and local provisions regulating the discharge of materials into the environment, or otherwise protecting the environment, is not expected to have a material adverse effect on the competitive position, consolidated results of operations, cash flows or financial position of Duke Energy.

GEOGRAPHIC REGIONS

Duke Energy's significant geographic regions are as follows:

	Latin	Other
U.S.	Canada	America Foreign Consolidated

In millions

2000					
Consolidated revenues.....	\$43,282	\$4,964	\$ 512	\$ 560	\$49,318
Consolidated long-term assets.....	31,074	906	2,823	1,222	36,019
1999					
Consolidated revenues.....	\$19,336	\$2,007	\$ 171	\$ 252	\$21,766
Consolidated long-term assets.....	22,995	250	2,708	901	26,854
1998					
Consolidated revenues.....	\$16,589	\$ 996	\$ 31	\$ 46	\$17,662
Consolidated long-term assets.....	20,982	140	207	632	21,961

For a discussion of Duke Energy's foreign operations and the risks associated with them, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk -- Foreign Currency Risk" and Notes 3 and 7 to the Consolidated Financial Statements, "Business Segments" and "Risk Management and Financial Instruments," respectively.

EMPLOYEES

At December 31, 2000, Duke Energy had approximately 23,000 employees. Approximately 1,580 operating and maintenance employees are represented by unions. Of these, approximately 1,400 are represented by the International Brotherhood of Electrical Workers (IBEW) at two operating units. During 2000, a new agreement was reached with the IBEW for the larger of these units. Negotiations are underway with the IBEW for the other unit, with a new contract anticipated in early 2001. An additional 65 employees are represented by the United Steelworkers and Rubberworkers of America. Approximately 37 employees are represented by the Paper, Allied, Chemical and Energy Workers Union (PACSE) and 13 employees are represented by the PACSE International Unit. A new labor agreement was reached with the PACSE International Unit in 2000. Approximately 64 employees are represented by the International Union of Operating Engineers.

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RECENT FINANCINGS

In late March 2001, Duke Energy completed an offering of 25 million shares of common stock, at a price of \$38.98 per share, before underwriting discount and other offering expenses. In addition, Duke Energy completed an offering of approximately 31 million units of mandatorily convertible securities (Equity Units) at a price of \$25 per unit before underwriting discount and other offering expenses. The Equity Units consist of senior notes of Duke Energy's wholly owned subsidiary, Duke Capital Corporation and purchase contracts obligating the investors to purchase shares of Duke Energy's common stock in 2004. Also in late March 2001, the underwriters exercised options granted to them to purchase an additional 3.75 million shares of common stock and 4 million Equity Units at the original issue prices, less underwriting discounts, to cover over-allotments made during the offerings. Total net proceeds from the offerings were approximately \$1.94 billion and were used to repay short-term debt and for other corporate purposes.

OPERATING STATISTICS

	Years Ended December 31,				
	2000	1999	1998	1997	1996
Franchised Electric					
Sources of Electric Energy, GWh(a)					
Generated--net output:					
Coal.....	43,526	41,306	42,164	45,234	40,649
Nuclear.....	41,073	39,263	38,366	29,569	33,177
Hydro.....	394	638	1,714	1,633	1,802
Oil and gas.....	459	662	846	301	199
Total generation.....	85,452	81,869	83,090	76,737	75,827
Purchased power and net interchange....	4,497	3,617	2,659	3,781	3,885
Total output.....	89,949	85,486	85,749	80,518	79,712
Plus: Purchases from other Catawba					

joint owners.....	150	1,233	1,656	2,316	2,662
Total sources of energy.....	90,099	86,719	87,405	82,834	82,374
Less: Line loss and company usage.....	5,333	5,171	5,394	4,899	4,827
Total GWh sales.....	84,766	81,548	82,011	77,935	77,547
Electric Energy Sales, GWh					
Residential.....	22,884	21,897	22,002	20,483	21,484
General service.....	22,845	21,607	21,093	19,687	19,593
Industrial					
Textile.....	10,819	11,201	11,981	11,955	11,603
Other.....	18,952	18,704	18,668	18,376	18,131
Other energy and wholesale.....	8,671	7,715	8,933	7,029	6,781
Total GWh sales billed.....	84,171	81,324	82,677	77,530	77,592
Unbilled GWh sales.....	595	224	(666)	405	(45)
Total GWh sales.....	84,766	81,548	82,011	77,935	77,547

Natural Gas Transmission					
Throughput Volumes TBtu(b)(c).....	1,717	1,565	1,459	1,641	1,676
Field Services					
Natural Gas Gathered and					
Processed/Transported, TBtu/d(d).....	7.6	5.1	3.6	3.4	2.9
NGL Production, MBbl/d(e).....	358.5	192.4	110.2	108.2	78.5
Average Natural Gas Price per MMBtu(f) ..	\$ 3.89	\$ 2.27	\$ 2.11	\$ 2.59	\$ 2.59
Average NGL Price per Gallon.....	\$ 0.53	\$ 0.34	\$ 0.26	\$ 0.35	\$ 0.39
Natural Gas Marketed, TBtu/d.....	0.7	0.5	0.4	0.4	0.5
NGL					
Natural Gas Marketed, TBtu/d.....	11.9	10.5	8.0	6.9	5.5
Electricity Marketed, GWh.....	275,258	109,634	98,991	84,650	4,425

(a) Gigawatt-hour.

(b) Trillion British thermal units.

(c) Excludes throughput of pipelines sold in March 1999 to CMS Energy: 328 TBtu (1999); 1,141 TBtu (1998); 1,279 TBtu (1997); 1,319 TBtu (1996).

(d) Trillion British thermal units per day.

(e) Thousand barrels per day.

(f) Million British thermal units.

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EXECUTIVE OFFICERS OF DUKE ENERGY

Richard B. Priory, 54, Chairman of the Board, President and Chief Executive Officer. Mr. Priory served as President and Chief Operating Officer from 1994 until he assumed his present position in 1997 following the merger with PanEnergy Corp (PanEnergy).

William A. Coley, 57, Group President, Duke Power. Mr. Coley served as President of Duke Energy's Associated Enterprises Group from 1994 to 1997 when he assumed his present position following the PanEnergy merger.

Fred J. Fowler, 55, Group President, Energy Transmission. Mr. Fowler served as Group Vice President of PanEnergy from 1996 until the PanEnergy merger, when he assumed his present position.

Harvey J. Padewer, 51, Group President, Energy Services. Mr. Padewer assumed his present position on January 1, 1999. From 1995 through 1998, he served as Senior Vice President and General Manager of Utilicorp Energy Group.

Richard W. Blackburn, 58, Executive Vice President, General Counsel and Secretary. Mr. Blackburn was named to his present position in 1997. Prior to joining Duke Energy, he served as President and Group Executive of NYNEX Corporation's Worldwide Communications and Media Group from 1995 to 1997.

Richard J. Osborne, 50, Executive Vice President and Chief Risk Officer. Mr. Osborne assumed his present position in May 2000. Prior to his present position, Mr. Osborne served as Executive Vice President and Chief Financial Officer from 1997, following the PanEnergy merger. Prior to the merger, Mr. Osborne was the Senior Vice President and Chief Financial Officer beginning in

1994.

Ruth G. Shaw, 53, Executive Vice President and Chief Administrative Officer. Ms. Shaw served as Senior Vice President, Corporate Resources, from 1994 until she assumed her present position following the PanEnergy merger.

Robert F. Brace, 51, Executive Vice President and Chief Financial Officer. Mr. Brace joined Duke Energy in 2000. He had served as Group Finance Director of British Telecommunications plc from 1993 until joining Duke Energy.

Michael S. Tuckman, 56, Executive Vice President, Nuclear Generation, Duke Power. Mr. Tuckman assumed his present position in 1997. He had been Senior Vice President, Nuclear Generation, Duke Power, since 1993.

Sandra P. Meyer, 46, Senior Vice President and Corporate Controller. Ms. Meyer assumed her present position in September 1999. Prior to her present position, Ms. Meyer served as Vice President, Duke Power Planning and Finance from 1997, following the PanEnergy merger. She served as Vice President and Controller of PanEnergy in 1994 and was named to the additional position of Treasurer in October 1996.

David L. Hauser, 49, Senior Vice President and Treasurer. Mr. Hauser held various positions, including Controller, at Duke Power before being named Senior Vice President, Global Asset Development, in 1997 and to his current position in 1998.

Executive officers are elected annually by the Board of Directors and serve until the first meeting of the Board of Directors following the annual meeting of shareholders and until their successors are duly elected.

There are no family relationships between any of the executive officers nor any arrangement or understanding between any executive officer and any other person pursuant to which the officer was selected.

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Item 2. Properties.

FRANCHISED ELECTRIC

At December 31, 2000, Franchised Electric operated three nuclear generating stations with a combined net capacity of 5,409 MW (which includes 12.5% ownership in the Catawba Nuclear Station), eight coal-fired stations with a combined capacity of 7,572 MW, 31 hydroelectric stations with a combined capacity of 2,693 MW and six combustion turbine stations with a combined capacity of 2,081 MW, all of which are located in North Carolina or South Carolina.

In addition, Franchised Electric owned, as of December 31, 2000, approximately 13,000 conductor miles of electric transmission lines, including 600 conductor miles of 525 kilovolts, 2,600 conductor miles of 230 kilovolts, 6,500 conductor miles of 100 kilovolts, and 3,300 conductor miles of 13 to 66 kilovolts. Franchised Electric also owned approximately 92,300 conductor miles of electric distribution lines, including 62,300 conductor miles of rural overhead lines, 15,500 conductor miles of urban overhead lines, 7,900 conductor miles of rural underground lines and 6,600 conductor miles of urban underground lines. At December 31, 2000, the electric transmission and distribution systems comprised approximately 1,600 substations.

Substantially all electric plant is mortgaged under the indenture relating to First and Refunding Mortgage Bonds.

NATURAL GAS TRANSMISSION

TETCO's gas transmission system extends approximately 1,700 miles from producing fields in the Gulf Coast region of Texas and Louisiana to Ohio, Pennsylvania, New Jersey and New York. It consists of two parallel systems, one consisting of three large-diameter parallel pipelines and the other consisting of from one to three large-diameter pipelines over its length. TETCO's system consists of approximately 9,000 miles of pipeline and has 70 compressor stations.

TETCO also owns and operates two offshore Louisiana pipeline systems, which extend over 100 miles into the Gulf of Mexico and include 469 miles of TETCO's pipeline system.

Algonquin's transmission system connects with TETCO's facilities in New Jersey, and extends approximately 250 miles through New Jersey, New York, Connecticut, Rhode Island and Massachusetts. The system consists of 1,066 miles of pipeline with six compressor stations.

East Tennessee's transmission system crosses TETCO's system at two points in Tennessee and consists of two mainline systems totaling 1,100 miles of pipeline in Tennessee and Virginia with 18 compressor stations.

For additional information and a map concerning natural gas transmission and storage properties, see "Business, Natural Gas Transmission."

FIELD SERVICES

For information and a map regarding the properties of Field Services, see "Business, Field Services."

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NAME

The DENA generation portfolio includes:

Name	Gross MW	Fuel	Location	Ownership Interest (percentage)
Moss Landing	1,478	Natural gas	CA	100
Morro Bay.....	1,002	Natural gas	CA	100
South Bay.....	700	Natural gas	CA	100
Madison.....	640	Natural gas	OH	50
Vermillion.....	640	Natural gas	IN	50
Maine Independence.....	520	Natural gas	ME	100
Bridgeport.....	480	Natural gas	CT	67
American Ref-Fuel.....	286	Waste-to-energy	CT, MA, NJ, NY	37
St. Francis.....	247	Natural gas	MO	50
Oakland.....	165	Oil	CA	100
Fort Drum.....	50	Coal	NY	10
Total.....	6,208			

DENA has approximately 7,300 MW under construction in various high-growth markets, which are slated for completion to meet summer peak demand: 3,200 MW in 2001 and 4,100 MW in 2002. In addition to its facilities in operation or under construction, DENA has approximately 13,500 MW in advanced development scheduled to begin operation between 2002 and 2004.

For additional information and a map regarding the properties of NAME, see "Business, NAME."

INTERNATIONAL ENERGY

The International Energy generation portfolio in operation includes:

Name	Gross MW	Fuel	Location	Approximate Ownership Interest (percentage)
Paranapanema.....	2,307	Hydro	Brazil	95
Hidroelectrica Cerros Colozados...	547	Thermal/Hydro	Argentina	91
Egenor.....	529	Hydro/Thermal	Peru	90
Acajutla.....	400	Thermal	El Salvador	88
Puncakjaya Power.....	389	Thermal	Indonesia	43
Western Australia.....	280	Thermal	Australia	100

Electroquil.....	169 Thermal	Ecuador	52
Aguaytia.....	160 Thermal	Peru	22
Empressa Electrica Corani.....	126 Hydro	Bolivia	50
New Zealand.....	112 Thermal	New Zealand	100
Mollejon.....	25 Hydro	Belize	95

Total.....	5,044		

DEI has approximately 562 and 43 gross MWh under construction in Latin America and Australia, respectively. DEI owns approximately 1,320 miles of pipeline systems in Australia, including 434 miles under development. Additionally, DEI has an 11.84% ownership interest in 855 miles of pipeline systems in Australia and a 21.9% ownership interest in 190 miles of pipeline systems in Peru. Also as of December 31, 2000, DEI had a 25% indirect interest in National Methanol Company, which owns and operates a methanol and MTBE (methyl tertiary butyl ether) business in Jubail, Saudi Arabia.

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For additional information and a map regarding the properties of International Energy, see "Business, International Energy."

DUKE VENTURES

For information regarding the properties of Duke Ventures, see "Business, Duke Ventures."

OTHER

None of the properties used in connection with Duke Energy's other business activities are considered material to Duke Energy's operations as a whole.

Item 3. Legal Proceedings.

Duke Energy's subsidiaries, DENA and DETM, have been named among 16 defendants in a class action lawsuit (the Gordon lawsuit) filed against companies identified as "generators and traders" of electricity in California markets. DETM also was named as one of numerous defendants in four additional lawsuits, including two class actions (the Hendricks and Pier 23 Restaurant lawsuits), filed against generators, marketers and traders and other unnamed providers of electricity in California markets. These suits were brought either by or on behalf of electricity consumers in the State of California. The Gordon and Hendricks class action suits were filed in the Superior Court of the State of California, San Diego County, in November 2000. The other three suits were filed in January 2001, one in the Superior Court of the State of California, San Diego County, and the other two in the Superior Court of the State of California, County of San Francisco. These suits generally allege that the defendants manipulated the wholesale electricity markets in violation of state laws against unfair and unlawful business practices and state antitrust laws. Plaintiffs in the Gordon suit seek aggregate damages of over \$4 billion, and the plaintiffs in the other suits, to the extent damages are specified, allege damages in excess of \$1 billion. The lawsuits each seek the disgorgement of alleged unlawfully obtained revenues for sales of electricity and, in three suits, an award of treble damages. For further information related to this lawsuit, see Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- California Issues," and "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- California Issues."

On December 22, 2000, the U.S. Justice Department, acting on behalf of the EPA, filed a complaint against Duke Energy in the U.S. District Court in Greensboro, North Carolina, for alleged violations of the New Source Review (NSR) provisions of the Clean Air Act (CAA). The EPA is claiming that 29 projects performed at 25 of Duke Energy's coal-fired units were major modifications as defined in the CAA and that Duke Energy violated the CAA's NSR requirements when it undertook those projects without obtaining permits and installing emission controls for sulfur dioxide, nitrogen oxide and particulate matter. The complaint requests, among other things, that the court enjoin Duke Energy from operating the coal-fired units identified in the complaint, and order Duke Energy to install additional emission controls and pay unspecified civil penalties. This complaint appears to be part of the EPA's NSR enforcement initiative, in which the EPA claims that utilities and others have committed widespread violations of the CAA permitting requirements for the past 25 years.

The EPA has sued or issued notices of violation of investigative information requests to at least 48 other electric utilities and cooperatives.

The EPA's allegations run counter to previous EPA guidance regarding the applicability of the NSR permitting requirements. Duke Energy, along with other utilities, has routinely undertaken the type of repair, replacement, and maintenance projects that the EPA now claims are illegal. Duke Energy believes that all of its electric generation units are properly permitted and have been properly maintained, and intends to defend itself.

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vigorously against these alleged violations. However, because these matters are in a preliminary stage, management cannot estimate the effects of these matters on Duke Energy's future consolidated results of operations, cash flows or financial position. The CAA authorizes civil penalties of up to \$27,500 per day per violation at each generating unit. Civil penalties, if ultimately imposed by the court, and the cost of any required new pollution control equipment, if the court accepts the EPA's contentions, could be substantial.

For further information related to this lawsuit, see Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- Environmental," and "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental."

In December 2000, three subsidiaries of Duke Energy initiated binding arbitration against three subsidiaries of the Exxon Mobil Corporation (collectively, the "Exxon Mobil entities") concerning the parties' joint ownership of DETM and certain related affiliates (collectively, the "ventures"). At issue is a buy-out right provision in the parties' agreement. The agreements governing the ownership of the Ventures contain provisions giving Duke Energy the right to purchase the Exxon Mobil entities' 40% interest in the Ventures in the event material business disputes arise between the Ventures' owners. Such disputes have arisen, and consequently, Duke Energy exercised its right to buy the Exxon Mobil entities' interest. Duke Energy claims that refusal by the Exxon Mobil entities to honor the exercise is a breach of the buy-out right provision, and seeks specific performance of the provision. Duke Energy also complains of the Exxon Mobil entities' lack of use of, and contributions to, the Ventures.

In January 2001, the Exxon Mobil entities asserted counterclaims in the arbitration and claims in a separate Texas state court action alleging that Duke Energy breached its obligations to the Ventures and to the Exxon Mobil entities. The Exxon Mobil entities also claim that Duke Energy violated a Guaranty Agreement. While this matter is in its early stages, management believes that the final disposition of this action will not have a material adverse effect on Duke Energy's consolidated results of operations, cash flows or financial position.

The Illinois Environmental Protection Agency has initiated an environmental enforcement proceeding against a former subsidiary of Duke Energy relating to alleged air quality permit violations at a natural gas compressor station. Duke Energy has agreed to indemnify the purchaser of this former subsidiary against liability for any penalty or fines resulting from these alleged violations. This proceeding could result in a penalty in excess of \$100,000. Management believes that the resolution of this matter will not have a material adverse effect on consolidated results of operations, cash flows or financial position.

Duke Energy's subsidiary, DEFS, is presently resolving non-compliance issues with the Texas Natural Resources Conservation Commission associated with the timing of air permit annual compliance certifications submitted to the agency in 1998 and 1999. This matter, the bulk of which was voluntarily self-disclosed to the agency, involves approximately 115 of DEFS' facilities that did not meet specific administrative filing deadlines for required air permit paperwork. Additionally, DEFS is actively resolving, with the New Mexico Environment Department, alleged non-compliance of various air permit requirements at four facilities in New Mexico. These matters, the majority of which were also voluntarily self-disclosed to the agency, generally involve document preparation and submittal as required by permits, compliance testing requirements at two facilities and compliance with permit emissions limits at one facility. DEFS believes that these apparent non-compliance issues being addressed with Texas and New Mexico agencies, under relevant air programs, will result in total penalty assessments of less than \$500,000. Management believes that the resolution of this matter will not have a material adverse effect on

consolidated results of operations, cash flows or financial position.

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Duke Energy's subsidiary, DEFS, has been in discussions with the Colorado Air Pollution Control Division regarding various asserted non-compliance issues arising from agency inspections of DEFS' Colorado facilities in 1999 and 2000, as well as non-compliance issues either disclosed to the agency pursuant to permit requirements or voluntarily disclosed to the agency in 2000. These items relate to various specific and detailed terms of the Title V Operating Permits at seven gas plants and two compressor stations in Colorado, including, for example, record keeping requirements, parametric monitoring requirements, delayed filings, and operations inconsistent with throughput limits on particular pieces of equipment. As a result of these discussions, DEFS received from the agency in March 2001 a comprehensive proposed settlement agreement to resolve all of these various items related to air permit compliance at the nine facilities. Although DEFS is still discussing the appropriate resolution of these apparent instances of non-compliance with the Colorado Air Pollution Control Division, management believes that the comprehensive resolution for all nine facilities will result in a total penalty assessment of less than \$575,000.

For additional information concerning litigation and other contingencies, see Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies," and "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental and Current Issues -- California Issues and Current Issues -- Litigation and Contingencies."

Item 4. Submission of Matters to a Vote of Security Holders.

No matters were submitted to a vote of Duke Energy's security holders during the last quarter of 2000.

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PART II.

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.

The common stock of Duke Energy is listed for trading on the New York Stock Exchange. At February 28, 2001, there were approximately 148,000 holders of record of such common stock.

Common Stock Data by Quarter (a)

	2000			1999		
	Dividends Per Share	Stock Price Range		Dividends Per Share	Stock Price Range	
		High	Low		High	Low
First Quarter.....	\$0.275	\$28.94	\$23.19	\$0.275	\$32.34	\$27.41
Second Quarter.....	0.55	31.25	26.16	0.55	30.59	26.06
Third Quarter.....	--	42.88	28.31	--	29.25	26.22
Fourth Quarter.....	0.275	44.97	40.22	0.275	28.44	23.53

(a) Restated to reflect the two-for-one common stock split effective January 26, 2001.

On December 17, 1998, Duke Energy's Board of Directors adopted a shareholder rights plan. Under the terms of the plan, one preference stock purchase right was distributed for each share of common stock outstanding on February 12, 1999 and for each share issued thereafter, subject to adjustment as specified therein. The distribution was approved by the NCUC and PSCSC. The plan is intended to assure the fair treatment of all shareholders in the event of a

hostile takeover attempt and to encourage a potential acquirer to negotiate with the Board of Directors a fair price for all shareholders before attempting a takeover. The adoption of the plan was not in response to any takeover offer or threat.

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Item 6. Selected Financial Data.

	2000	1999(a)	1998	1997(b)	1996(b)
In millions, except per share amounts					
Income Statement					
Operating revenues	\$48,318	\$21,766	\$13,662	\$16,368	\$12,302
Operating expenses	45,505	19,947	15,177	14,339	10,143
Operating income	3,813	1,819	2,485	1,970	2,159
Other income and expenses	201	224	162	138	135
Earnings before interest and taxes	4,014	2,043	2,647	2,108	2,294
Interest expense	911	601	514	472	499
Minority interest expense	307	142	96	23	6
Earnings before income taxes	2,796	1,300	2,037	1,613	1,789
Income taxes	1,020	451	777	639	698
Income before extraordinary item	1,776	849	1,260	974	1,091
Extraordinary gain (loss), net of tax	--	660	(8)	--	(17)
Net income	1,776	1,507	1,252	974	1,074
Dividends on preferred and preference stock	19	20	21	72	44
Earnings available for common stockholders	\$ 1,757	\$ 1,487	\$ 1,231	\$ 902	\$ 1,030
Common Stock Data (c)					
Shares of common stock outstanding					
Year-end	739	733	726	720	718
Weighted average	736	729	722	720	722
Earnings per share (before extraordinary item)					
Basic	\$ 2.39	\$ 1.13	\$ 1.72	\$ 1.26	\$ 1.45
Diluted	2.38	1.13	1.71	1.25	1.44
Earnings per share					
Basic	\$ 2.39	\$ 2.04	\$ 1.70	\$ 1.26	\$ 1.43
Diluted	2.38	2.01	1.70	1.25	1.42
Dividends per share	1.10	1.10	1.10	0.95	0.79
Balance Sheet					
Total assets	\$58,176	\$33,409	\$26,806	\$24,029	\$22,366
Long-term debt, less current maturities	11,019	8,683	6,272	6,510	5,485

- (a) Financial information reflects a pre-tax \$800 million charge for estimated injury and damages claims. The earnings per share effect of this charge was \$0.67 per share. See Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies -- Injury and Damages Claims," for additional information.
- (b) Financial information reflects accounting for the 1997 merger with PanEnergy as a pooling of interests. As a result, the financial information gives effect to the merger as if it had occurred January 1, 1996.
- (c) Restated to reflect the two-for-one common stock split effective January 26, 2001.

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Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition.

INTRODUCTION

Management's Discussion and Analysis should be read in conjunction with the Consolidated Financial Statements.

Business Segments. Duke Energy Corporation (collectively with its subsidiaries, "Duke Energy") is an integrated energy and energy services provider with the ability to offer physical delivery and management of both electricity and natural gas throughout the U.S. and abroad. Duke Energy provides these and other services through seven business segments.

Franchised Electric generates, transmits, distributes and sells electric energy in central and western North Carolina and the western portion of South Carolina. Its operations are conducted primarily through Duke Power and Nantahala Power and Light. These electric operations are subject to the rules and regulations of the Federal Energy Regulatory Commission (FERC), the North Carolina Utilities Commission (NCUC) and the Public Service Commission of South Carolina (PSCSC).

Natural Gas Transmission provides interstate transportation and storage of natural gas for customers primarily in the Mid-Atlantic, New England and southeastern states. Its operations are conducted primarily through Duke Energy Gas Transmission Corporation. The interstate natural gas transmission and storage operations are subject to the rules and regulations of the FERC.

Field Services gathers, processes, transports, markets and stores natural gas and produces, transports, markets and stores natural gas liquids (NGLs). Its operations are conducted primarily through Duke Energy Field Services, LLC (DEFS), a limited liability company that is approximately 30% owned by Phillips Petroleum. ~~Field Services operates gathering systems in western Canada and 11~~ contiguous states that serve major natural gas-producing regions in the Rocky Mountain, Permian Basin, Mid-Continent, East Texas-Austin Chalk-North Louisiana, as well as onshore and offshore Gulf Coast areas.

North American Wholesale Energy's (NAWE's) activities include asset development, operation and management, primarily through Duke Energy North America, LLC (DENA), and commodity sales and services related to natural gas and power, primarily through Duke Energy Trading and Marketing, LLC (DETM). DETM is a limited liability company that is approximately 40% owned by Exxon Mobil Corporation. NAWE also includes Duke Energy Merchants, which develops new business lines in the evolving energy commodity markets. NAWE conducts its business throughout the U.S. and Canada. The operations of the previously segregated Trading and Marketing segment were combined by management into NAWE during 2000. Previous periods have been restated to conform to current period presentation.

International Energy conducts its operations through Duke Energy International, LLC. International Energy's activities include asset development, operation and management of natural gas and power facilities and energy trading and marketing of natural gas and electric power. This activity is targeted in the Latin American, Asia-Pacific and European regions.

Other Energy Services is a combination of businesses that provide engineering, consulting, construction and integrated energy solutions worldwide, primarily through Duke Engineering & Services, Inc. (DE&S), Duke/Fluor Daniel (D/FD) and DukeSolutions, Inc. (DukeSolutions). D/FD is a 50/50 partnership between Duke Energy and Fluor Enterprises, Inc.

Duke Ventures is comprised of other diverse businesses, primarily operating through Crescent Resources, Inc. (Crescent), DukeNet Communications, LLC (DukeNet) and Duke Capital Partners (DCP). Crescent develops high-quality commercial, residential and multi-family real estate projects and manages land holdings primarily in the southeastern U.S. DukeNet provides fiber optic networks for industrial, commercial and residential customers. DCP, a newly formed, wholly owned merchant finance company, provides financing, investment banking and asset management services to wholesale and commercial energy markets.

Business Strategy. Duke Energy is one of the world's leading integrated energy companies. The company's business strategy is to develop integrated

energy businesses in targeted regions where Duke Energy's extensive capabilities in developing energy assets, operating electric power, natural gas and NGL plants, optimizing commercial operations and managing risk can provide comprehensive energy solutions for customers and create superior value for shareholders. The growth in and restructuring of global energy markets are providing opportunities for Duke Energy's competitive business segments to capitalize on their comprehensive capabilities. Domestically, Duke Energy is aggressively investing in new merchant power plants throughout the U.S., expanding its natural gas pipeline infrastructure in the eastern U.S., rapidly increasing its leading position in natural gas gathering and processing and NGL marketing, and developing its trading and marketing structured origination expertise across the energy spectrum. Internationally, Duke Energy is currently focusing on integrated electric and natural gas opportunities in Latin America, Asia Pacific and Europe.

Franchised Electric continues to add customers, maintain low costs and deliver high-quality customer service. Franchised Electric is expected to grow moderately, consistent with historical trends. Expansion will primarily result from continued economic growth in its service territory.

Natural Gas Transmission has increased its earnings growth rate by executing a comprehensive strategy of selected acquisitions and expansions and by developing expanded services and incremental projects that meet changing customer needs.

Field Services has developed market-leading size, scope and reliability of supply in natural gas gathering, processing and NGL marketing. Field Services plans to make additional investments in gathering, processing and NGL infrastructure. Field Services' interconnected natural gas processing operations provide an opportunity to capture fee-based investment opportunities in certain NGL assets, including pipelines, fractionators and terminals.

NAME plans to continue increasing earnings through acquisitions, divestitures, construction of greenfield projects and expansion of existing facilities as regional opportunities are identified, evaluated and realized throughout the North American marketplace. To capture the greatest value in the U.S., DENA, through its portfolio management strategy, seeks opportunities to invest in energy assets in markets that have capacity needs and to divest other assets, in whole or in part, when significant value can be realized. Commodity sales and services related to natural gas and power continue to expand as NAME provides energy supply, structured origination, trading and marketing, risk management and commercial optimization services to large energy customers, energy aggregators and other wholesale companies.

International Energy plans to continue expanding through acquisitions, divestitures, construction of greenfield projects and expansion of existing facilities in selected international regions. International Energy's combination of assets and capabilities and close working relationships with other subsidiaries of Duke Energy allow it to efficiently deliver natural gas pipeline, power generation, energy marketing and other services.

Other Energy Services plans to grow by providing an expanding customer base with a variety of engineering and energy efficiency services that allow customers to more effectively deal with rapidly changing conditions in the energy marketplace.

Duke Ventures plans to expand earnings capabilities in its real estate, telecommunications and capital financing business units by developing regional opportunities and by applying extensive experience to new project development.

Duke Energy's business strategy and growth expectations can vary significantly depending on many factors, including, but not limited to, the pace and direction of industry restructuring, regulatory constraints, acquisition opportunities, market volatility and economic trends. However, Duke Energy's growth expectations do not rely on industry restructuring in North Carolina and South Carolina.

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RESULTS OF OPERATIONS

In 2000, earnings available for common stockholders were \$1,757 million, or \$2.39 per basic share, including a pre-tax gain of \$407 million, or an after-tax gain of \$0.34 per basic share, on the sale of Duke Energy's 20% interest in

BellSouth Carolina PCS (BellSouth PCS). In 1999, earnings available for common stockholders were \$1,487 million, or \$2.04 per basic share, including an after-tax extraordinary gain of \$660 million, or \$0.91 per basic share resulting from the sale of the Panhandle Eastern Pipe Line Company (PEPL), Trunkline Gas Company (Trunkline) and additional storage related to those systems, which substantially comprised the Midwest Pipelines along with Trunkline LNG Company. The increase in earnings available for common stockholders in 2000 was primarily due to a 96% increase in segment earnings as described below, including the BellSouth PCS gain. Partially offsetting this increase was the 1999 extraordinary gain and higher interest and minority interest expense in the current year.

Earnings available for common stockholders increased \$256 million in 1999 from 1998 earnings of \$1,231 million, or \$1.70 per basic share. The increase in earnings available for common stockholders was primarily due to the 1999 extraordinary gain resulting from the sale of the Midwest Pipelines. This gain, along with the factors described below that affect segment earnings, was partially offset by a pre-tax \$800 million charge for estimated injury and damages claims (see Note 14 to the Consolidated Financial Statements) and higher interest and minority interest expense.

Earnings per share information provided above has been restated to reflect the two-for-one common stock split effective January 26, 2001. See Note 15 to the Consolidated Financial Statements for additional information.

Operating income for 2000 was \$3,811 million compared to \$1,819 million in 1999 and \$2,485 million in 1998. Earnings before interest and taxes (EBIT) were \$4,014 million, \$2,043 million and \$2,647 million for 2000, 1999 and 1998, respectively. Management evaluates each business segment based on an internal measure of EBIT, after deducting minority interests. Operating income and EBIT are affected by the same fluctuations for Duke Energy and each of its business segments. The only notable difference between operating income and EBIT is the inclusion in EBIT of certain non-operating activities. See Note 3 to the Consolidated Financial Statements for additional information on business segments. EBIT is summarized in the following table and is discussed by business segment thereafter.

EBIT by Business Segment

	Years Ended December 31,		
	2000	1999	1998
	In millions		
Franchised Electric.....	\$ 1,704	\$ 856	\$ 1,513
Natural Gas Transmission.....	534	627	702
Field Services.....	296	144	75
North American Wholesale Energy.....	418	209	133
International Energy.....	331	42	12
Other Energy Services.....	(61)	(94)	10
Duke Ventures.....	563	162	122
Other Operations.....	(2)	5	22
EBIT attributable to minority interests.....	231	92	57
Consolidated EBIT.....	\$ 4,014	\$ 2,043	\$ 2,647

Other Operations primarily include certain unallocated corporate costs. Included in the amounts discussed hereafter are intercompany transactions that are eliminated in the Consolidated Financial Statements.

Franchised Electric

Years Ended December 31,		
2000	1999	1998

In millions, except where noted

Operating revenues.....	\$ 4,946	\$ 4,700	\$ 4,626
Operating expenses.....	3,316	3,966	3,228
Operating income.....	1,630	734	1,398
Other income, net of expenses.....	74	122	115
EBIT.....	\$ 1,704	\$ 856	\$ 1,513
Sales--GWh(a).....	84,766	81,548	82,011

(a) Gigawatt-hours.

Franchised Electric's EBIT increased \$848 million in 2000 when compared to 1999, primarily due to an \$800 million charge in 1999 for estimated injury and damages claims (see Note 14 to the Consolidated Financial Statements). Overall favorable weather and growth in customers, partially offset by increased operating costs, also contributed to this increase in EBIT. The average number of customers in Franchised Electric's service territory increased 2.5% during 2000. Total gigawatt-hour sales to customers increased by 3.9% for 2000. Sales to general service and residential customers increased 4.7% and 4.4%, respectively, while total industrial sales decreased 0.5%.

In 1999, Franchised Electric's EBIT decreased \$657 million compared to 1998, primarily due to the above-mentioned charge for estimated injury and damages claims. Partially offsetting this decrease was a 2.8% increase in the number of customers in Franchised Electric's service territory during 1999, and the absence of 1998 severance and other costs related to closing Franchised Electric's merchandising business.

Natural Gas Transmission

Years Ended December 31.

	2000	1999	1998
In millions, except where noted			
Operating revenues.....	\$ 1,131	\$ 1,230	\$ 1,542
Operating expenses.....	609	615	864
Operating income.....	522	615	678
Other income, net of expenses.....	12	12	24
EBIT.....	\$ 534	\$ 627	\$ 702
Throughput--Tbtu(a).....	1,717	1,893	2,593

(a) Trillion British thermal units.

In 2000, EBIT for Natural Gas Transmission decreased \$93 million compared to 1999, primarily due to \$132 million of EBIT in 1999 that did not reoccur in 2000. These items consisted of \$70 million of EBIT related to the Midwest Pipelines, which were sold to CMS Energy Corporation (CMS) in March 1999; a \$24 million gain resulting from the sale of Duke Energy's interest in the Alliance Pipeline project; and benefits totaling \$38 million related to the completion of certain environmental cleanup programs below estimates. These items were partially offset by increased earnings from market-expansion projects and joint ventures such as the Maritimes & Northeast Pipeline, which was placed into service in December 1999, and earnings from East Tennessee Natural Gas Company and Market Hub Partners (MHP), which were acquired in March and

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September 2000, respectively. See Note 2 to the Consolidated Financial Statements for additional information on the sale of the Midwest Pipelines and the acquisitions of East Tennessee Natural Gas Company and MHP.

EBIT for Natural Gas Transmission decreased \$75 million in 1999 compared to

1998. As a result of the sale of the Midwest Pipelines in March 1999, EBIT for the Midwest Pipelines decreased \$156 million compared to 1998's full year of operation. For the remainder of Natural Gas Transmission, EBIT increased \$81 million compared to 1998, primarily as a result of increased earnings from market-expansion projects and joint ventures, higher throughput and lower operating expenses. A \$24 million gain resulting from the sale of Duke Energy's interest in the Alliance Pipeline project and benefits totaling \$38 million related to the completion of certain environmental cleanup programs below estimates also increased EBIT in 1999. Partially offsetting these contributions to EBIT were the favorable impacts in 1998 in connection with the resolution of regulatory issues related to natural gas supply realignment costs and a refund from a state property tax ruling.

Field Services

Years Ended December 31,			
	2000	1999	1998
In millions, except where noted			
Operating revenues.....	\$ 9,060	\$ 3,590	\$ 2,677
Operating expenses.....	8,635	3,444	2,598
Operating income.....	425	146	79
Other income, net of expenses.....	6	(2)	(3)
Minority interest expense.....	135	--	--
EBIT.....	\$ 296	\$ 144	\$ 76
Natural gas gathered and processed/transported, TBtu/d(a).....	7.6	5.1	3.6
NGL production, MBbl/d(b).....	358.5	192.4	110.2
Natural gas marketed, TBtu/d.....	0.7	0.5	0.4
Average natural gas price per MMBtu(c).....	\$ 3.89	\$ 2.27	\$ 2.11
Average NGL price per gallon(d).....	\$ 0.53	\$ 0.34	\$ 0.26

- (a) Trillion British thermal units per day.
 (b) Thousand barrels per day.
 (c) Million British thermal units.
 (d) Does not reflect results of commodity hedges.

Field Services' EBIT increased \$152 million in 2000 from 1999. The increase in EBIT and volume activity was primarily due to the combination of Field Services' natural gas gathering, processing and marketing business with Phillips Petroleum's Gas Gathering, Processing and Marketing unit (Phillips) in March 2000; the acquisition of the natural gas gathering, processing, fractionation and NGL pipeline business from Union Pacific Resources (UPR) (collectively, the "UPR acquisition") in April 1999, and other recent acquisitions and plant expansions. For additional information on the Phillips combination and the UPR acquisition, see Note 2 to the Consolidated Financial Statements. Improved average NGL prices, which increased 56% over 1999 prices, also contributed significantly to the increase in EBIT.

In 1999, Field Services' EBIT increased \$68 million compared to 1998. A significant portion of the increase resulted from earnings from the UPR acquisition. Improved average NGL prices, which were up 31% from the prior year, also contributed to the increase in EBIT. Partially offsetting these increases were \$34 million of asset sale gains in 1998.

North American Wholesale Energy

Years Ended December 31,		
	2000	1999
In millions, except where noted		

Operating revenues.....	\$ 33,874	\$ 11,801	\$ 8,783
Operating expenses.....	33,386	11,591	8,619
Operating income.....	488	210	164
Other income, net of expenses.....	3	60	20
Minority interest expense.....	73	61	51
EBIT.....	\$ 418	\$ 209	\$ 133
Natural gas marketed, TBtu/d.....	11.9	10.5	8.0
Electricity marketed, GWh.....	275,258	109,634	98,991
Proportional megawatt capacity owned(a).....	8,984	5,799	5,098

(a) Includes under construction or under contract.

NAWE's EBIT increased \$209 million in 2000 compared to 1999. The increase was the result of increased earnings from asset positions, increased trading margins due to price volatility in natural gas and power and a \$47 million increase in income from the sale of interests in generating facilities as a result of NAWE executing its portfolio management strategy. Operating revenues and expenses increased as the volumes of natural gas and power marketed increased 13% and 151%, respectively. These increases were partially offset by a \$110 million charge related to receivables for energy sales in California, and increased operating and development costs associated with business expansion. See the Current Issues, California Issues section of Management's Discussion and Analysis, and Note 14 to the Consolidated Financial Statements for further information.

In 1999, EBIT for NAWE increased \$76 million from 1998. The increase included \$99 million in income from the sale of partial interests in four generating facilities as a result of NAWE executing its portfolio management strategy. Partially offsetting these increases were lower natural gas trading margins, partially offset by higher power trading margins as well as margins associated with other trading activities and sales of natural gas interests associated with drilling activities. Higher operating expenses and increased development costs associated with business expansion also partially offset the earnings increases.

International Energy

	Years Ended December 31,		
	2000	1999	1998
In millions, except where noted			
Operating revenues.....	\$ 1,067	\$ 357	\$ 159
Operating expenses.....	755	292	145
Operating income.....	312	65	14
Other income, net of expenses.....	42	8	4
Minority interest expense.....	23	31	6
EBIT.....	\$ 331	\$ 42	\$ 12
Proportional megawatt capacity owned(a).....	4,876	2,974	943
Proportional maximum pipeline capacity(a), MMcf/d(b).....	416	321	124

(a) Includes under construction or under contract.

(b) Million cubic feet per day.

International Energy's EBIT increased \$289 million in 2000 when compared to 1999. The increase was primarily attributable to increased earnings in Latin America, mainly resulting from new investments (see Note 2 to the Consolidated Financial Statements for a discussion of significant acquisitions). The

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EXHIBIT D

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 1997 or

☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 1-4928

DUKE ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

56-0235520

(I.R.S. Employer Identification No.)

422 South Church Street, Charlotte, North Carolina
(Address of principal executive offices)28202-1904
(Zip Code)

704-594-6200

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, without par value	New York Stock Exchange, Inc.
6.375% Preferred Stock A, 1993 Series, par value \$25	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 5 7/8% Due 2001	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 5 7/8% Series C Due 2003	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 1/4% Series B Due 2004	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 3/8% Due 2005	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 5/8% Series B Due 2003	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 3/4% Due 2025	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 6 7/8% Series B Due 2023	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7% Due 2000	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7% Series B Due 2000	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7% Due 2005	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7% Due 2033	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7 3/8% Due 2023	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7 1/2% Series B Due 2025	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 7 7/8% Due 2024	New York Stock Exchange, Inc.
First and Refunding Mortgage Bonds, 8% Series B Due 1999	New York Stock Exchange, Inc.
7.20% Quarterly Income Preferred Securities issued by Duke Energy Capital Trust I and guaranteed by Duke Energy Corporation	New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

Title of class

Preferred Stock, par value \$100

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item

405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this form 10-K. []

Estimated aggregate market value of the voting stock held by nonaffiliates of the registrant at February 27, 1998 \$20,010,800,000
 Number of shares of Common Stock, without par value, outstanding at February 27, 1998 360,149,391

Documents incorporated by reference:

The registrant is incorporating herein by reference certain sections of the proxy statement relating to the 1998 annual meeting of shareholders to provide information required by Part III, Items 10, 11, 12 and 13 of this annual report.

DUKE ENERGY CORPORATION

FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 1997

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PART I.

Item 1. Business.

GENERAL

On June 18, 1997, Duke Power Company (Duke Power) changed its name to Duke Energy Corporation (the Corporation) in accordance with the terms of a merger agreement with PanEnergy Corp (PanEnergy), pursuant to which the Corporation issued 159.3 million shares of its common stock in exchange for all of the outstanding common stock of PanEnergy (the merger). PanEnergy was involved in

the gathering, processing, transportation and storage of natural gas, the production of natural gas liquids and the marketing of natural gas, electricity, liquefied petroleum gases and related energy services. Pursuant to the merger, each share of PanEnergy common stock outstanding was converted into the right to receive 1.8444 shares of the Corporation's common stock. In addition, each outstanding option to purchase PanEnergy common stock became an option to purchase common stock of the Corporation, adjusted accordingly. The merger was accounted for as a pooling of interests.

As a result of the merger, the Corporation is an integrated energy and energy services provider with the ability to offer physical delivery and management of both electricity and natural gas throughout the United States and abroad. The Corporation provides these services through four business segments: Electric Operations, Natural Gas Transmission, Energy Services, and Other Operations.

The Electric Operations segment is engaged in the generation, transmission, distribution and sale of electric energy in central and western North Carolina and the western portion of South Carolina. These electric operations are subject to the rules and regulations of the Federal Energy Regulatory Commission (FERC), the North Carolina Utilities Commission (NCUC) and the Public Service Commission of South Carolina (PSCSC).

The Natural Gas Transmission segment is involved in interstate transportation and storage of natural gas for customers primarily in the Mid-Atlantic, New England and Midwest states. The interstate natural gas transmission and storage operations are also subject to the rules and regulations of the FERC.

The Energy Services segment is comprised of several separate business units: Field Services gathers and processes natural gas, produces and markets natural gas liquids (NGLs) and transports and trades crude oil; Trading and Marketing markets natural gas, electricity and other energy-related products; Global Asset Development develops, owns and operates energy-related facilities worldwide; and Other Energy Services provides engineering consulting, construction and integrated energy solutions.

Other Operations include the real estate operations of Crescent Resources, Inc. (Crescent Resources) and communications services. Corporate costs and intersegment eliminations are also reflected in the financial results of this segment.

A discussion of the current business and operations of each of the Corporation's segments follows. The Corporation expects moderate growth in its Electric Operations segment, consistent with historical trends. In the Natural Gas Transmission segment, relatively slow growth is expected due to increased competition. The Corporation is seeking to significantly grow its Energy Services segment through acquisition, construction and expansion opportunities. For further discussion of the operating outlook of the Corporation and its segments, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Operations Outlook." For financial information concerning the Corporation's business segments, see Note 4 to the Consolidated Financial Statements, "Business Segments."

The Corporation is a North Carolina corporation with its principal executive offices located at 422 South Church Street, Charlotte, NC 28202-1904. The telephone number is 704-594-6200.

ELECTRIC OPERATIONS

Service Area and Customers

The Electric Operations service area, approximately two-thirds of which lies in North Carolina, covers about 29,000 square miles with an estimated population of 5.1 million and includes a number of cities, of which the largest are Charlotte, Greensboro, Winston-Salem and Durham in North Carolina and Greenville and Spartanburg in South Carolina. Electric Operations supplies electric service directly to approximately two million residential, commercial and industrial customers in more than 200 cities, towns and unincorporated communities. Electricity is sold at wholesale to incorporated municipalities and to several public and private utilities. In addition, sales are made through contractual agreements to municipal or cooperative customers who purchased portions of the Catawba Nuclear Station. For statistics related to gigawatt-hour sales

1

by customer type, see "Business, Operating Statistics." For further discussion of the Catawba Nuclear Station joint ownership, see Note 5 to the Consolidated Financial Statements, "Joint Ownership of Generating Facilities."

The Electric Operations service area is undergoing increasingly

diversified industrial development. The textile industry, machinery and equipment manufacturing, and chemical and chemical-related industries are of major significance to the economy of the area. Other industrial activities include rubber and plastic products, paper and allied products, and various other light and heavy manufacturing and service businesses. The largest industry served is the textile industry, which accounted for approximately \$457 million of the revenues of the Electric Operations segment for 1997, representing 10% of electric revenues and 38% of industrial revenues. Electric Operations normally experiences seasonal peak loads in summer and winter which are relatively in balance.

Shown below is the Electric Operations service area, in which business is conducted under the name "Duke Power" and by Nantahala Power and Light Company, a subsidiary of the Corporation.

[Map of North and South Carolina depicting
Electric Operations Service Area appears here]

Capability and Resources of Energy

Electric energy required to supply the needs of the customers of Electric Operations is primarily generated through three nuclear generating stations with a combined net capability of 5,078 MW (Oconee Nuclear Station -- 2,538 MW, McGuire Nuclear Station -- 2,258 MW and Catawba Nuclear Station -- 282 MW, which represents Electric Operations' 12.5% ownership share in the Catawba Nuclear Station), eight coal-fired stations with a combined capability of 7,699 MW, twenty hydroelectric stations with a combined capability of 2,685 MW and six combustion turbine stations with a combined capability of 1,784 MW. Energy and capacity are also supplied through contracts with other generators of electricity and purchased on the open market. Electric Operations has interconnections and arrangements with its neighboring utilities, which are considered adequate for planning, emergency assistance, exchange of capacity and energy and reliability of power supply. Future increased energy requirements of Electric Operations' customers are expected to be supplied through open market purchases. For statistics regarding sources of electric energy see "Business, Operating Statistics."

Fuel Supply

Electric Operations presently relies principally on coal and nuclear fuel for the generation of electric energy. Electric Operations reliance on oil and gas is minimal. Information regarding the utilization of sources of power and cost of fuels for each of the three years in the period ended December 31, 1997 is set forth in the following table:

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	Generation by Source (Percent)			Cost of Fuel per Net Kilowatt-hour Generated (Cents)		
	1997	1996	1995	1997	1996	1995
Coal	59.3	54.0	43.7	1.30	1.40	1.56
Nuclear (a)	38.8	44.0	51.7	0.48	0.53	0.57
Oil and gas (b)	.4	.3	.3	5.58	6.74	5.06
All fuels (cost based on weighted average) (a)	98.5	98.3	97.7	0.99	1.02	1.03
Hydroelectric (c)	1.5	1.7	2.3			
	100.0	100.0	100.0			

(a) Statistics related to nuclear generation and all fuels reflect the Electric Operations' 12.5% ownership interest in the Catawba Nuclear Station.

(b) Cost statistics include amounts for light-off fuel at the Electric Operations' coal-fired stations.

(c) Generating figures are net of output required to replenish pumped storage units during off-peak periods.

Coal. Electric Operations obtains a large amount of its coal under supply

contracts with mining operators utilizing both underground and surface mining. Electric Operations currently has an adequate supply of coal. Electric Operations' supply contracts, all of which have price adjustment provisions, have expiration dates ranging from 1998 to 2003. The Corporation believes that it will be able to renew such contracts as they expire or to enter into similar contractual arrangements with other coal suppliers for the quantities and qualities of coal required. The coal purchased under these supply contracts is produced from mines located in eastern Kentucky, southern West Virginia and southwestern Virginia. Coal requirements not met by supply contracts have been and are expected to be fulfilled with spot market purchases.

The average sulfur content of coal being purchased by Electric Operations is approximately 1%. Such coal satisfies the current emission limitation for sulfur dioxide for existing facilities. See also "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental, Air Quality Control" for additional information regarding particulate matter.

Nuclear. Generally, the supply of fuel for nuclear generating units involves the mining and milling of uranium ore to produce uranium concentrates, the conversion of uranium concentrates to uranium hexafluoride, enrichment of that gas and fabrication of the enriched uranium hexafluoride into useable fuel assemblies. After a region (approximately one-third of the nuclear fuel assemblies in the reactor at any time) of spent fuel is removed from a nuclear reactor, it is placed in temporary storage for cooling in a spent fuel pool at the nuclear station site. Electric Operations has contracted for uranium materials and services required to fuel the Oconee, McGuire and Catawba Nuclear Stations. Based upon current projections, these contracts will meet Electric Operations' requirements through the following years:

Nuclear Station	Uranium Material	Conversion Service	Enrichment Service	Fabrication Service
Oconee	1998	1998	2000	2006
McGuire	1998	1998	2000	2009
Catawba	1998	1998	2000	2009

Uranium material requirements will be met through various supplier contracts, with uranium material produced primarily in the United States and Canada. The Corporation believes that it will be able to renew contracts as they expire or to enter into similar contractual arrangements with other suppliers of nuclear fuel materials and services. Requirements not met by long-term supply contracts have been and are expected to be fulfilled with uranium spot market purchases.

Under provisions of the Nuclear Waste Policy Act of 1982, the Corporation entered into contracts with the Department of Energy (DOE) for the disposal of spent nuclear fuel. The DOE delayed in accepting the waste materials on the contract date of January 31, 1998. The Corporation has joined with 35 other utilities in a lawsuit attempting to force the DOE to meet its obligations as called for in the contract. The Corporation has satisfactory plans in place to provide storage of spent nuclear fuel if the DOE cannot accept it.

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Competition

Competition for retail electric customers is not generally allowed in the Electric Operations' service territory. However, there are discussions and events at the national level and within certain states regarding retail competition which are resulting in changes in the industry. For further discussion, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Electric Competition."

Electric Operations is subject to competition in some areas from government-owned power systems, municipally-owned electric systems, rural electric cooperatives and, in certain instances, from other private utilities. Currently, statutes in North Carolina and South Carolina provide for the assignment by the NCUC and the PSCSC, respectively, of all areas outside municipalities in such states to regulated electric utilities and rural electric cooperatives. Substantially all of the territory comprising the Electric Operations' service area has been so assigned. The remaining areas have been designated as unassigned and in such areas Electric Operations remains subject to competition. A decision of the North Carolina Supreme Court limits, in some instances, the right of North Carolina municipalities to serve customers outside their corporate limits. In South Carolina there continues to

be competition between municipalities and other electric suppliers outside the corporate limits of the municipalities, subject, however, to the regulation of the PSCSC. In addition, Electric Operations is engaged in continuing competition with various natural gas providers.

Regulation

The NCUC and the PSCSC approve rates for retail electric sales within their respective states. The FERC approves the Electric Operations' rates for electric sales to wholesale customers. For further discussion of rate matters and fuel and purchased power cost adjustment procedures, see Note 5 to the Consolidated Financial Statements, "Regulatory Matters -- Electric Operations." The FERC, the NCUC and the PSCSC also have authority over the construction and operation of the Electric Operations' facilities. Electric Operations holds certificates of public convenience and necessity issued by the FERC, the NCUC and the PSCSC, authorizing it to construct and operate the electric facilities now in operation for which certificates are required, and to sell electricity to retail and wholesale customers.

The Energy Policy Act of 1992 (EPACT) and the FERC's subsequent rulemaking activities permit the FERC to order transmission access for third parties to transmission facilities owned by another entity. EPACT does not, however, permit the FERC to issue orders requiring transmission access to retail customers. The FERC has issued orders for third-party transmission service and a number of rules of general applicability, including Orders 888 and 889. Pursuant to the FERC's final rules, Electric Operations obtained from the FERC open-access rights to sell at market-based rates up to 2,500 megawatts (MW) of capacity and energy from its own assets. For further discussion, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Electric Competition."

The Electric Operations segment is subject to the jurisdiction of the Nuclear Regulatory Commission (NRC) as to the design, construction and operation of its nuclear stations. For discussions of nuclear decommissioning costs and nuclear insurance regulatory requirements and coverages, see Note 12 to the Consolidated Financial Statements, "Nuclear Decommissioning Costs & Spent Nuclear Fuel" and Note 15 to the Consolidated Financial Statements, "Commitments and Contingencies -- Nuclear Insurance," respectively.

The hydroelectric generating facilities of Electric Operations are licensed by the FERC under Part I of the Federal Power Act, with license terms expiring from 2008 to 2036. The nuclear generating facilities of the Electric Operations are licensed by the NRC with license terms expiring from 2013 to 2026. The FERC has authority to grant extensions of hydroelectric generating licenses, and the NRC has authority to grant extensions of nuclear generating licenses.

The Electric Operations segment is subject to the jurisdiction of the Environmental Protection Agency (EPA) and state environmental agencies. For a discussion of environmental regulation, see "Business, Environmental Matters."

NATURAL GAS TRANSMISSION

During 1997, the Natural Gas Transmission segment completed the organization of its operations into the Northeast Pipelines, which includes Texas Eastern Transmission Corporation (TETCO) and Algonquin Gas Transmission Company (Algonquin), and the Midwest Pipelines, which includes Panhandle Eastern Pipe Line Company (PEPL) and Trunkline Gas Company (Trunkline).

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In 1997, consolidated natural gas deliveries by the Natural Gas Transmission segment's interstate pipelines totaled 2.862 Tbtu (trillion British thermal units), compared to 2.939 Tbtu in 1996, which represented approximately 12% of the natural gas consumed in the United States. A substantial majority of the delivered volumes of the Natural Gas Transmission segment's interstate pipelines represents gas transported under long-term firm service agreements with local distribution company (LDC) customers in the pipelines' market areas. Firm transportation services are also provided under contract to gas marketers, producers, other pipelines, electric power generators and a variety of end-users. In addition, the pipelines offer interruptible transportation to customers on a short-term or seasonal basis. See natural gas deliveries statistics under "Business, Operating Statistics." Demand for gas transmission of the Natural Gas Transmission segment's interstate pipeline systems is seasonal, with the highest throughput occurring during the colder periods in the first and fourth quarters.

The Natural Gas Transmission segment's 37,500 mile interstate pipeline system is fully interconnected and can receive natural gas from most major North American producing regions for delivery to markets throughout the Northeast and Midwest states, as shown in the map below.

[Map of United States depicting the Natural Gas Transmission segment Interstate Pipelines and Storage Fields appears here]

Northeast Pipelines

TETCO's major customers are located in Pennsylvania, New Jersey and New York, and include LDCs serving the Pittsburgh, Philadelphia, Newark and New York City metropolitan areas. Algonquin's major customers include LDCs and electric power generators located in the Boston, Hartford, New Haven, Providence and Cape Cod areas.

TETCO also provides firm and interruptible open-access storage services. Since the implementation of the FERC Order 636 restructuring, storage is offered as a stand-alone unbundled service or as part of a no-notice bundled service. TETCO's storage services utilize two joint venture storage facilities in Pennsylvania and one wholly owned and operated storage field in Maryland. TETCO also leases storage capacity. TETCO's certificated working capacity in these three fields is 70 Billion cubic feet (Bcf), and the combined working gas in storage was 55 Bcf on December 31, 1997. Algonquin owns no storage fields. For further discussion of Order 636, see "Business, Natural Gas Transmission -- Regulation."

Midwest Pipelines

FEPL's market volumes are concentrated among approximately 30 utilities located in the Midwest market area that encompasses large portions of Michigan, Ohio, Indiana, Illinois and Missouri. Trunkline's major customers include eight utilities located in portions of Tennessee, Missouri, Illinois, Indiana and Michigan.

FEPL also owns and operates three underground storage fields located in Illinois, Michigan and Oklahoma. Trunkline owns and operates one storage field in Louisiana. The combined maximum working gas capacity of the four fields is 44

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Bcf. Additionally, FEPL, through a subsidiary, Pan Gas Storage Company (Pan Gas), is the owner of a storage field in Kansas with an estimated maximum capacity of 26 Bcf. FEPL is the operator of the field. Since the implementation of Order 636, each of FEPL, Trunkline and Pan Gas offer firm and interruptible storage on an open-access basis. In addition to owning and operating storage fields, FEPL also leases storage capacity. FEPL and Trunkline have retained the right to use up to 15 Bcf and 10 Bcf, respectively, of their storage capacity for system needs. See further discussion of Order 636 in "Business, Natural Gas Transmission -- Regulation."

Competition

The Corporation's interstate pipeline subsidiaries compete with other interstate and intrastate pipeline companies in the transportation and storage of natural gas. The principal elements of competition among pipelines are rates, terms of service and flexibility and reliability of service. The Corporation's pipelines continue to offer selective discounting to maximize revenues from existing capacity and to advance projects that provide expanded services to meet the specific needs of customers.

In the Mid-Atlantic and New England markets, TETCO competes directly with Transcontinental Gas Pipe Line Corporation, Tennessee Gas Pipeline Company (TGPC), Iroquois Gas Transmission System (Iroquois), CNG Transmission Corporation and Columbia Gas Transmission Corporation. Algonquin competes directly in certain market areas with TGPC and Iroquois. FEPL and Trunkline compete directly with ANR Pipeline Company, Natural Gas Pipeline Company of America and Texas Gas Transmission Corporation in the Midwest market area.

Natural gas competes with other forms of energy available to the Corporation's customers and end-users, including electricity, coal and fuel oils. The primary competitive factor is price. Changes in the availability or price of natural gas and other forms of energy, the level of business activity, conservation, legislation and governmental regulations, the capability to convert to alternative fuels, and other factors, including weather, affect the demand for natural gas in the areas served by the Corporation.

Regulation

The FERC has authority to regulate rates and charges for natural gas transported in or stored for interstate commerce or sold by a natural gas

company in interstate commerce for resale. For further discussion of rate matters, see Note 3 to the Consolidated Financial Statements, "Regulatory Matters -- Natural Gas Operations." The FERC also has authority over the construction and operation of pipeline and related facilities utilized in the transportation and sale of natural gas in interstate commerce, including the extension, enlargement or abandonment of such facilities. TERC, Algonquin, PEPL, Trunkline and Pan Gas hold certificates of public convenience and necessity issued by the FERC, authorizing them to construct and operate the pipelines, facilities and properties now in operation for which such certificates are required, and to transport and store natural gas in interstate commerce.

The Natural Gas Transmission segment's pipelines operate as open-access transporters of natural gas. In 1992, the FERC issued Order 636, which requires open-access pipelines to provide firm and interruptible transportation services on an equal basis for all gas supplies, whether purchased from the pipeline or from another gas supplier. To implement this requirement, Order 636 provided, among other things, for mandatory unbundling of services that have historically been provided by pipelines into separate open-access transportation, sales and storage services. Order 636 allows pipelines to recover eligible costs, known as "transition costs," resulting from the implementation of Order 636. For further discussion of Order 636, see Note 5 to the Consolidated Financial Statements, "Regulatory Matters -- Natural Gas Operations."

The Natural Gas Transmission segment is subject to the jurisdiction of the EPA and state environmental agencies. For a discussion of environmental regulation, see "Business, Environmental Matters." The Natural Gas Transmission segment is also subject to the Natural Gas Pipeline Safety Act of 1968, which regulates gas pipeline safety requirements, and to the Hazardous Liquid Pipeline Safety Act of 1979, which regulates oil and petroleum pipelines.

ENERGY SERVICES

The Energy Services segment is comprised of several separate business units: Field Services, Trading and Marketing, Global Asset Development and Other Energy Services. See certain operating statistics of the Energy Services segment under "Operating Statistics." Activities of the Energy Services segment can fluctuate in response to the seasonality affecting both electricity and natural gas.

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Field Services

Field Services owns and operates approximately 17,000 miles of natural gas gathering systems, including intrastate pipelines, and 27 natural gas processing plants in the United States. Field Services also has ownership interests in 11 other natural gas processing plants in the United States.

Field Services' gathering systems are located in 10 states, which serve major gas-producing regions in the Rocky Mountain, Permian Basin, Mid-Continent and Gulf Coast (offshore and onshore) areas. Field Services' gathering operations also include several intrastate pipeline systems and two natural gas storage facilities.

Field Services' NGL processing operations involve the extraction of NGLs from natural gas and, at certain facilities, the fractionation of the NGLs into their individual components (ethane, propane, butane and natural gasoline). The natural gas used in Field Services' processing operations is generally gathered on its own gathering system or from the natural gas stream on the Corporation's transmission system. Field Services also operates approximately 450 miles of NGL pipelines in the Texas Gulf Coast area which transport NGLs received from 12 processing plants in South Texas. NGLs are sold by Field Services to a variety of customers ranging from large multi-national petrochemical and refining companies to small family-owned retail propane distributors. NGL sales are based upon current market-related prices. Field Services also provides, on a more limited basis, processing services to producers and others for a stipulated fee and produces helium at the National Helium facility.

Field Services also operates approximately 1,500 miles of intrastate crude oil pipelines in the Mid-Continent and South Texas areas. The crude oil pipeline system provides gathering and mainline transportation service, for a volumetric fee, based on published tariffs. Crude oil is also purchased from producers and sold to end users.

Trading and Marketing

The Corporation's energy marketing operations are conducted through Duke Energy Trading and Marketing L.L.C. in the United States, Duke Energy Marketing Limited Partnership in Canada (collectively, DETM) and Duke/Louis Dreyfus L.L.C. (D/LD).

DETH was formed in August 1996 as a natural gas and power marketing joint venture with Mobil Corporation (Mobil). All of Mobil's United States and Canadian natural gas production is committed to be marketed through DETH for at least a 10-year period. The Corporation, through its affiliates, operates the joint venture and owns a 50% interest, with Mobil owning a 40% minority interest.

In June 1997, a wholly owned subsidiary of the Corporation acquired the remaining 50% ownership interest in D/LD not already owned from affiliates of Louis Dreyfus Corp. A substantial portion of the Corporation's trading and marketing of electricity is conducted through D/LD.

Trading and Marketing markets natural gas primarily to LDCs, electric power generators, municipalities, industrial end-users and energy marketing companies and markets electricity to investor owned utilities, municipal power generators and other power marketers. Operations are primarily in the United States and, to a lesser extent, in Canada, and are serviced through 13 offices or operating centers.

Natural gas marketing operations encompass both on-system and off-system sales. With respect to on-system sales, Trading and Marketing generally purchases natural gas from the Corporation's Field Services facilities and delivers the gas to an intrastate or interstate pipeline for redelivery to another customer. The Corporation's Natural Gas Transmission pipelines are utilized for deliveries when prudent. With respect to off-system sales, Trading and Marketing purchases natural gas from producers, pipelines and other suppliers not connected with the Corporation's facilities for resale to customers.

Trading and Marketing has a portfolio of short-term and long-term sales agreements with customers, the vast majority of which incorporate market-sensitive pricing terms. Long-term gas purchase agreements with producers, principally entered into in connection with on-system sales, also generally include market-sensitive pricing provisions. Purchases and sales of off-system gas and electricity supply are normally made under short-term contracts. Purchase and sales commitments involving significant price and location risk are generally hedged with commodity futures, swaps and options. For information concerning the Corporation's risk-management activities, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Information About Market Risk -- Commodity Price Risk" and Note 8 to the Consolidated Financial Statements, "Financial Instruments and Risk Management -- Commodity Derivative Instruments."

Trading and Marketing also provides energy management services, such as supply and market aggregation, peaking services, dispatching, balancing, transportation, storage, tolling, contract negotiation and administration, as well as energy commodity risk management products and services.

Global Asset Development

Global Asset Development is an active participant in competitive power markets worldwide and has ownership interests in more than 6,500 megawatts of generation worldwide, including projects under construction and under contract. Global Asset Development is comprised of three units: Duke Energy Power Services (DEPS), Duke Energy Industrial Asset Development, and Duke Energy International.

DEPS develops, owns and operates electric generation projects for customers in the United States and Canada. DEPS focuses on acquisitions of existing energy production facilities, greenfield opportunities and operating energy assets. Domestic investments include a 32.5% indirect ownership interest in American Ref-Fuel Company, which owns five waste to energy facilities in New York, New Jersey, Massachusetts and Connecticut. Such facilities process about 4 million tons of municipal solid waste per year and have an aggregate generating capacity of 286 megawatts. DEPS projects under construction include an ownership interest in the Bridgeport Energy Project, a 520 megawatt combined cycle natural gas fired merchant generation plant which will be Connecticut's largest non-nuclear power plant.

On November 18, 1997, DEPS entered into an agreement with Pacific Gas & Electric Company (PG&E) for the purchase of three electric generating plants in California for approximately \$500 million. The plants have a combined net operating capacity of 2,645 megawatts. The sale is expected to close during 1998. Pursuant to California's electric restructuring law, DEPS must contract with PG&E to operate and maintain the facilities for two years following the sale. Energy and capacity from the plants will be sold into the California power exchange and under separate contracts.

Duke Energy Industrial Asset Development was formed in July 1997 to develop, own, manage and operate on-site, inside-the-fence electric generation and energy conversion facilities for industrial customers. Its market focus is the United States and Canada. This unit is currently working with prospective customers from the textile, pulp and paper, petrochemical, agricultural, food and automotive industries and the federal privatization sector.

Duke Energy International develops, owns and operates energy projects worldwide. This unit focuses on projects involving natural gas exploration, production, processing, transportation and supply. Additionally, projects include generation, delivery and marketing of electric power and thermal energy. Its ownership interests include investments in Argentina, Chile, Peru, Indonesia and Saudi Arabia.

Other Energy Services

Other Energy Services provides engineering consulting, construction and integrated energy solutions, primarily through Duke Engineering & Services, Inc. (DE&S), Duke/Flour Daniel and DukeSolutions, Inc. (DukeSolutions).

DE&S specializes in energy and environmental projects and provides comprehensive engineering, quality assurance, project and construction management and operating and maintenance services for all phases of hydroelectric, nuclear and renewable power generation projects worldwide.

Duke/Flour Daniel, operating through several entities, provides full service siting, permitting, licensing, engineering, procurement, construction, start-up, operating and maintenance services for fossil-fired plants, both domestically and internationally.

DukeSolutions provides integrated energy solutions to industrial, commercial, institutional, governmental and wholesale customers and focuses on increasing customers' efficiency, productivity and profitability through energy cost savings.

Competition

Field Services and Trading and Marketing compete with major integrated oil companies, major interstate pipelines and their marketing affiliates, national and local natural gas gatherers, brokers, marketers and distributors and electric utilities and other electric power marketers for natural gas supplies, in gathering and processing natural gas and in marketing and transporting natural gas, electricity, NGLs and crude oil. Competition for natural gas supplies is primarily based on efficiency, reliability, availability of transportation and the ability to obtain a satisfactory price for the producer's natural gas. Competition for customers is based primarily upon reliability and price of delivered natural gas, NGLs and crude oil. Competition in the energy marketing business is driven by the price of commodities and services delivered, along with the quality and reliability of services provided.

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The Global Asset Development and Other Energy Services business units experience substantial competition in their fields from utility companies in the United States or abroad and from independent companies.

Regulation

The intrastate pipelines owned by the Field Services group are subject to state regulation and, to the extent they provide services under Section 311 of the Natural Gas Policy Act of 1978 (NGPA), are also subject to FERC regulation. The natural gas gathering activities of the Field Services group are generally not subject to regulation by the FERC, but are subject to state regulation.

The energy marketing activities of the Trading and Marketing group may, in certain circumstances, be subject to the jurisdiction of the FERC. Current FERC policies permit the Trading and Marketing entities subject to the FERC jurisdiction to market natural gas and electricity at market-based rates.

The NERC, FERC and FERC have implemented regulations governing access to regulated electric customer data by non-regulated entities and services provided between regulated and non-regulated affiliated entities. These regulations affect Energy Services' activities with the Corporation's Electric Operations segment.

The Energy Services segment is subject to the jurisdiction of the EPA and state environmental agencies. For a discussion of environmental regulation, see "Business, Environmental Matters." The Energy Services segment is also subject to the Natural Gas Pipeline Safety Act of 1968, which regulates gas pipeline

and LNG plant safety requirements, and to the Hazardous Liquid Pipeline Safety Act of 1979, which regulates oil and petroleum pipelines.

OTHER OPERATIONS

The Other Operations segment includes the Corporation's non-energy related subsidiaries, including Crescent Resources and DukeNet Communications, Inc. (DukeNet).

Crescent Resources develops high quality commercial and residential real estate projects and manages substantial forest holdings. At December 31, 1997, Crescent Resources owned 3.5 million square feet of commercial space, of which 75% of the operating space was leased. Crescent Resources' portfolio included 2.1 million square feet of warehouse space, 1.1 million square feet of office space and .3 million square feet of retail space. In 1997, Crescent Resources sold 884 residential developed lots compared to 869 lots in 1996. At December 31, 1997, Crescent Resources also had approximately .2 million acres of land under its management.

DukeNet develops and manages communications systems, including fiber optic and wireless digital network services. DukeNet provides a network for communications and other services to commercial, industrial and residential markets.

ENVIRONMENTAL MATTERS

The Corporation is subject to federal, state and local regulations with regard to air and water quality, hazardous and solid waste disposal and other environmental matters. Certain environmental regulations affecting the Corporation include:

- o The Clean Air Act Amendments of 1990, which require a two-phase reduction by electric utilities in aggregate annual emissions of sulfur dioxide and nitrogen oxide by 2000;
- o State Implementation Plans (SIP), which were issued by the EPA to 22 states related to existing and new national ambient air quality standards for ozone;
- o The Federal Water Pollution Control Act Amendments of 1987, which require permits for facilities that discharge treated wastewater into the environment; and
- o The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), which can require any individual or entity which may have owned or operated a disposal site, as well as transporters or generators of hazardous wastes which were sent to such site, to share in remediation costs for the site.

For further discussion of environmental matters involving the Corporation, including possible liability and capital costs, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues - -- Environmental" and Note 15 to the Consolidated Financial Statements, "Commitments and Contingencies - -- Environmental." Except as set

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forth therein, compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise protecting the environment, is not expected to have a material adverse effect on the consolidated results of operations or financial position of the Corporation.

OTHER MATTERS

The Corporation is exempt from regulation as a holding company under the Public Utility Holding Company Act of 1935 (PUHCA), except with respect to the acquisition of the securities of other public utilities. The issuance of debt or equity securities by the Corporation is subject to the regulation of the NCUC and the PSCSC.

Foreign operations and export sales are not material to the Corporation's business as a whole. For a discussion of risks associated with the Corporation's foreign operations, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk - -- Foreign Operations Risk."

At December 31, 1997, the Corporation had approximately 23,000 employees.

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

From time to time, the Corporation may make statements regarding its expectations, intent or beliefs about future events. These statements are intended as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. The Corporation cautions that assumptions, projections and expectations about future events may and often do vary from actual results, the differences between assumptions, projections and expectations and actual results can be material, and there can be no assurance that the forward-looking statements will be realized. For a discussion of some factors that could cause actual achievements and events to differ materially from those expressed or implied in such forward-looking statements, see "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Forward-Looking Statements."

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OPERATING STATISTICS

	Years Ended December 31				
	1997	1996	1995	1994	1993
Electric Operations					
Sources of Electric Energy, GWh (a)					
Generated -- net output:					
Coal	45,234	40,649	32,389	32,714	34,097
Nuclear	29,569	33,177	19,836	35,587	34,390
Hydro	1,129	1,319	1,685	1,460	1,582
Oil and gas	301	199	255	35	43
Total generation	76,233	75,344	74,165	69,796	70,112
Purchased power and net interchange	1,776	3,587	1,175	1,276	1,750
Total output	80,009	78,931	75,340	71,072	71,862
Plus: Purchases from other Catawba joint owners	2,316	2,662	6,070	9,046	8,810
Total sources of energy	82,325	81,593	81,410	80,118	80,672
Less: Line loss and company usage	4,784	4,741	4,673	4,555	4,614
Total GWh sales	77,541	76,852	76,737	75,563	76,058
Electric Energy Sales, GWh					
Residential	20,005	20,992	19,669	18,870	19,465
General service	19,368	19,269	18,160	17,289	16,904
Industrial					
Textile	11,950	11,599	12,151	12,285	11,954
Other	7,555	7,028	8,330	10,274	11,337
Other energy and wholesale	7,555	7,028	8,330	10,274	11,337
Total GWh sales billed	77,131	76,909	75,941	75,723	75,904
Unbilled GWh sales	410	(57)	796	(160)	154
Total GWh sales	77,541	76,852	76,737	75,563	76,058
Natural Gas Transmission					
Throughput Volumes, TBtu (b)					
Northeast Pipelines					
ETCO	1,300	1,349	1,234	1,194	1,115
Algonquin	341	327	331	288	245
Total Northeast Pipelines	1,641	1,676	1,565	1,482	1,360
Midwest Pipelines					
EPPL	659	687	663	626	607
Trunkline	620	632	519	560	633
Total Midwest Pipelines	1,279	1,319	1,182	1,186	1,240
Intercompany eliminations	(58)	(56)	(44)	(91)	(125)
Total Natural Gas Transmission	2,862	2,939	2,703	2,577	2,475
Energy Services					
Field Services Natural Gas Gathered/Processed, TBtu/d (c)	3.4	2.9	1.9	1.6	1.4

Field Services NGL Production, MBbl/d (d)	103.9	76.5	54.8	49.4	42.0
Trading and Marketing Natural Gas Marketed, Tbtu/d	6.9	5.5	3.6	2.7	2.1
Trading and Marketing Electricity Marketed, GWh	64,650	4,229	513	--	--

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- (a) Gigawatt-hour
 (b) Trillion British thermal units
 (c) Trillion British thermal units per day
 (d) Thousand barrels per day

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Executive Officers of the Corporation

RICHARD B. PRIORY, 51, Chairman of the Board and Chief Executive Officer. Mr. Priory served as President and Chief Operating Officer from 1994 until he assumed his present position in 1997. He was Executive Vice President, Power Generation Group, from 1991 to 1994.

PAUL M. ANDERSON, 52, President and Chief Operating Officer. Mr. Anderson served as Chairman of the Board, President and Chief Executive Officer of PanEnergy prior to the merger, when he assumed his present position. Mr. Anderson was elected Chairman of the Board of PanEnergy in 1997, Chief Executive Officer in 1995 and President in 1993. He was Executive Vice President of PanEnergy from 1991 to 1993.

WILLIAM A. COLBY, 54, Group President, Duke Power. Mr. Colby served as President, Associated Enterprises Group, from 1994 to 1997 when he assumed his present position following the merger. Mr. Colby served as Executive Vice President, Customer Group, from 1991 to 1994.

FRED J. FOWLER, 52, Group President, Energy Transmission. Mr. Fowler served as Group Vice President of PanEnergy from 1996 until the merger, when he assumed his present position. He was President of TETCO from 1994 to 1996, President of ISource Corporation from 1993 to 1994 and President of Trunkline Gas Company from 1991 to 1993.

JAMES T. HACKETT, 44, Group President, Energy Services. Mr. Hackett served as Executive Vice President of PanEnergy from 1996 until the merger, when he assumed his present position. Prior to joining PanEnergy, Mr. Hackett served as Senior Vice President of NGC Corporation (formerly Natural Gas Clearinghouse) from 1990 to 1995.

RICHARD W. BLACKBURN, 55, Executive Vice President and General Counsel. Mr. Blackburn was named to his present position in October 1997. Prior to joining the Corporation, he served as President and Group Executive of NYNEX Corporation's Worldwide Communications and Media Group from 1995 to 1997. He was Chief Operating Officer, Worldwide Communications and Media Group, of NYNEX from 1993 to 1995 and Senior Vice President for Business Development and General Counsel of NYNEX from 1991 to 1993.

RICHARD J. OSBORNE, 46, Executive Vice President and Chief Financial Officer. Mr. Osborne served as Senior Vice President and Chief Financial Officer from 1994 until he assumed his present position in 1997 following the merger. Mr. Osborne served as Vice President and Chief Financial Officer from 1991 to 1994.

RUTH G. SHAW, 50, Executive Vice President and Chief Administrative Officer. Ms. Shaw served as Senior Vice President, Corporate Resources, from 1994 until she assumed her present position following the merger. Ms. Shaw was Vice President, Corporate Communications, from 1992 to 1994, and prior to joining the Corporation, she served as President of Central Piedmont Community College from 1986 to 1992.

JEFFREY L. BOYER, 41, Vice President and Corporate Controller. Mr. Boyer served as Controller from 1994 to 1997, when he assumed his present position following the merger. He was Director of Corporate Accounting from 1992 to 1994.

Executive officers are elected annually by the Board of Directors and serve until the first meeting of the Board of Directors following the annual meeting of shareholders and until their successors are duly elected.

There are no family relationships between any of the executive officers nor any arrangement or understanding between any executive officer and any other person pursuant to which the officer was selected.

Item 2. Properties.

ELECTRIC OPERATIONS

At December 31, 1997, the Corporation's Electric Operations segment operated three nuclear generating stations with a combined net capability of

5,078 MW (which includes Electric Operations' 12.5% ownership share in the Catawba Nuclear Station), eight coal-fired stations with a combined capability of 7,699 MW, twenty hydroelectric stations with a combined capability of 2,685 MW and six combustion turbine stations with a combined capability of 2,125 MW, all of which are located in North Carolina or South Carolina.

In addition, the Corporation owned, as of December 31, 1997, approximately 12,800 conductor miles of electric transmission lines, including 600 conductor miles of 500 kilovolts, 2,600 conductor miles of 220 kilovolts, 6,400 conductor miles of 100 kilovolts, and 3,200 conductor miles of 13 to 66 kilovolts. The Corporation also owned approximately 75,000 conductor miles of electric distribution lines, including 47,300 conductor miles of rural overhead lines, 15,000 conductor miles of urban overhead lines, 7,000 conductor miles of rural underground lines and 5,700 conductor miles of urban underground

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lines. At December 31, 1997, the Corporation's electric transmission and distribution systems comprised approximately 1,600 substations with an installed transformer capacity of approximately 84,100,000 kVA (kilovolt-amperes).

Substantially all electric plant is mortgaged under the indenture relating to the First and Refunding Mortgage Bonds of the Corporation.

NATURAL GAS TRANSMISSION

TETCO's gas transmission system extends approximately 1,700 miles from producing fields in the Gulf Coast region of Texas and Louisiana to Ohio, Pennsylvania, New Jersey and New York. It consists of two parallel systems, one consisting of three large-diameter parallel pipelines and the other consisting of from one to three large-diameter pipelines over its length. TETCO's system, including its gathering systems, has 73 compressor stations. The TETCO system connects with the WEPN and Trunkline systems in Lebanon, Ohio.

TETCO also owns and operates two offshore Louisiana gas supply systems, which extend over 100 miles into the Gulf of Mexico and consist of 490 miles of pipeline.

Algonquin's transmission system connects with TETCO's facilities in New Jersey, and extends through New Jersey, New York, Connecticut, Rhode Island and Massachusetts. The system consists of approximately 250 miles of pipeline with 6 compressor stations.

FERL's transmission system, which consists of four large-diameter parallel pipelines and 13 mainline compressor stations, extends a distance of approximately 1,300 miles from producing areas in the Anadarko Basin of Texas, Oklahoma and Kansas through the states of Missouri, Illinois, Indiana and Ohio into Michigan.

Trunkline's transmission system extends approximately 1,400 miles from the Gulf Coast areas of Texas and Louisiana through the states of Arkansas, Mississippi, Tennessee, Kentucky, Illinois and Indiana to a point on the Indiana-Michigan border. The system consists principally of three large-diameter parallel pipelines and 16 mainline compressor stations.

Trunkline also owns and operates two offshore Louisiana gas supply systems consisting of 337 miles of pipeline extending approximately 81 miles into the Gulf of Mexico.

For information concerning natural gas storage properties, see "Business, Natural Gas Transmission."

ENERGY SERVICES

For information regarding the properties of Field Services, see "Business, Energy Services -- Field Services."

Global Asset Development owns two liquid natural gas (LNG) ships, each with a transportation capacity of 125,000 cubic meters of LNG. Both vessels have been chartered to Nigeria LNG Limited (Nigeria LNG) for 22 years starting in 1999. Under the terms of the charter, Nigeria LNG will have the right to purchase the vessels.

Global Asset Development also owns a marine terminal, storage and regasification facility for LNG located in Louisiana. This LNG facility has a design output capacity of approximately 700 million cubic feet per day (MMcf/d) and a storage capacity of approximately 1.8 million barrels, which approximates 6 Bcf.

Other generation, transmission and distribution properties of Global Asset

Development are owned primarily through joint ventures in which the Corporation's ownership interest is 50% or less.

Properties of Trading and Marketing and Other Energy Services are not considered material to the Corporation's operations as a whole.

OTHER OPERATIONS

None of the other properties used in connection with the Corporation's other business activities are considered material to the Corporation's operations as a whole.

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Item 3. Legal Proceedings.

See Note 15 to the Consolidated Financial Statements, "Commitments and Contingencies" and "Management's Discussion and Analysis of Results of Operations and Financial Condition, Current Issues -- Environmental" for a discussion of legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders.

No matters were submitted to a vote of the Corporation's security holders during the last quarter of 1997.

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PART II.

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.

The common stock of the Corporation is listed for trading on the New York Stock Exchange. At February 27, 1998, there were approximately 155,619 holders of record of such common stock.

The following table sets forth for the periods indicated the dividends paid per share of common stock and the high and low sales prices of such shares reported by the New York Stock Exchange Composite Transactions:

1997	Dividends Per Share (a)	Stock Price Range	
		High	Low
First Quarter ..	\$.40	\$ 48	\$ 43 1/8
Second Quarter ..	.40	48	42 1/8
Third Quarter ..	.55	51 1/8	47 11/16
Fourth Quarter ..	.55	56 3/16	45 3/4

1996	Dividends Per Share (a)	Stock Price Range	
		High	Low
First Quarter ...	\$.38	\$53	\$45 7/8
Second Quarter ..	.39	51 1/2	45 3/4
Third Quarter ...	.40	51 3/8	45 3/4
Fourth Quarter ..	.40	49 1/8	43 3/8

(a) Financial information reflects accounting for the merger with PanEnergy Corp as a pooling of interests. As a result, the financial information gives effect to the merger as if it had occurred January 1, 1996.

Item 6. Selected Financial Data.

	1997 (a)	1996 (a)	1995 (a)	1994 (a)	1993 (a)
In Millions (except per share amounts)					
Income Statement					
Operating Revenues	\$ 16,308.9	\$ 12,302.4	\$ 9,694.7	\$ 9,115.0	\$ 8,784.3
Operating Expenses	14,338.9	10,143.8	7,626.4	7,309.0	7,068.6
Operating Income	1,970.0	2,158.6	2,068.3	1,806.0	1,715.7
Other Income and Expenses	138.1	135.6	122.2	101.0	137.5
Earnings Before Interest and Taxes	2,108.1	2,294.2	2,190.5	1,907.0	1,853.2
Interest Expense	471.8	499.2	508.2	484.5	526.2
Minority Interests	23.0	6.2	--	--	--
Earnings Before Income Taxes	1,613.3	1,788.8	1,682.3	1,422.5	1,326.9
Income Taxes	638.9	697.8	664.2	558.4	528.9
Income Before Extraordinary Item	974.4	1,091.0	1,018.1	864.1	798.0
Extraordinary Item	--	16.7	--	--	--
Net Income	974.4	1,074.3	1,018.1	864.1	798.0
Dividends and Premiums on Redemptions of Preferred and Preference Stock	72.8	44.2	48.9	49.7	52.4
Earnings for Common Stockholders	\$ 901.6	\$ 1,030.1	\$ 969.2	\$ 814.4	\$ 745.6
Common Stock Data					
Shares of common stock					
Year-end	359.8	359.4	361.8	360.6	359.1
Average	359.8	361.2	361.2	360.2	353.6
Basic earnings per share (before extraordinary item)	\$ 2.51	\$ 2.90	\$ 2.68	\$ 2.26	\$ 2.11
Basic earnings per share	\$ 2.51	\$ 2.85	\$ 2.68	\$ 2.26	\$ 2.11
Dividends per share	\$ 1.90	\$ 1.57	\$ 1.50	\$ 1.44	\$ 1.39
Balance Sheet					
Total Assets	\$ 24,028.8	\$ 22,366.2	\$ 20,867.9	\$ 20,254.2	\$ 19,717.4
Long-term Debt	\$ 6,530.0	\$ 5,485.1	\$ 5,801.0	\$ 5,930.8	\$ 5,370.9
Preferred Stock with Sinking Fund Requirements	\$ 149.0	\$ 234.0	\$ 214.0	\$ 279.5	\$ 281.0

(a) Financial information reflects accounting for the merger with PanEnergy Corp as a pooling of interests. As a result, the financial information gives effect to the merger as if it had occurred January 1, 1993.

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Item 7. Management's Discussion and Analysis of Results of Operations and Financial Condition.

INTRODUCTION

On June 18, 1997, Duke Power Company (Duke Power) changed its name to Duke Energy Corporation (the Corporation) in accordance with the terms of a merger agreement with PanEnergy Corp (PanEnergy), pursuant to which the Corporation issued 158.3 million shares of its common stock in exchange for all of the outstanding common stock of PanEnergy (the merger). PanEnergy was involved in the gathering, processing, transportation and storage of natural gas, the production of natural gas liquids and the marketing of natural gas, electricity, liquefied petroleum gases and related energy services. Pursuant to the merger, each share of PanEnergy common stock outstanding was converted into the right to receive 1.0444 shares of the Corporation's common stock. In addition, each outstanding option to purchase PanEnergy common stock became an option to purchase common stock of the Corporation, adjusted accordingly.

As a result of the merger, the Corporation is an integrated energy and energy services provider with the ability to offer physical delivery and management of both electricity and natural gas throughout the United States and abroad. The Corporation provides these services through four business segments: Electric Operations, Natural Gas Transmission, Energy Services, and Other Operations.

The Electric Operations segment is engaged in the generation, transmission, distribution and sale of electric energy in central and western North Carolina and the western portion of South Carolina. These electric

operations are subject to the rules and regulations of the Federal Energy Regulatory Commission (FERC), the North Carolina Utilities Commission (NCUC) and The Public Service Commission of South Carolina (PSCSC).

The Natural Gas Transmission segment is involved in interstate transportation and storage of natural gas for customers primarily in the Mid-Atlantic, New England and Midwest states. The interstate natural gas transmission and storage operations are also subject to the rules and regulations of the FERC.

The Energy Services segment is comprised of several separate business units: Field Services gathers and processes natural gas, produces and markets natural gas liquids and transports and trades crude oil; Trading and Marketing markets natural gas, electricity and other energy-related products; Global Asset Development develops, owns and operates energy-related facilities worldwide; and Other Energy Services provides engineering consulting, construction and integrated energy solutions.

Other Operations include the real estate operations of Crescent Resources, Inc. (Crescent Resources), communications services, corporate costs and intersegment eliminations.

The merger was accounted for as a pooling of interests and, accordingly, the Consolidated Financial Statements included in this Annual Report are presented as if the merger was consummated as of the beginning of the earliest period presented. Portions of the following discussion provide information related to material changes in the Corporation's consolidated results of operations and financial condition between the periods presented, based on the combined historical information of Duke Power and PanEnergy.

Management's Discussion and Analysis should be read in conjunction with the Consolidated Financial Statements of the Corporation.

RESULTS OF OPERATIONS

Earnings available for common stockholders of the Corporation decreased 12% in 1997 as compared to 1996, from \$1,030.1 million or \$2.85 per share in 1996 to \$901.6 million or \$2.51 per share in 1997. The decrease was due primarily to increases in non-recurring merger related costs, a provision for non-recurring severance costs associated with the work force reduction in Electric Operations, premiums associated with the redemption and tender offer for ten issues of preferred stock and higher expenses as a result of increased outages at the Electric Operations' nuclear stations. Partially offsetting the decrease were lower expenses in 1997 as compared to 1996 when major storms affected the Electric Operations' distribution costs.

In 1996, earnings available for common stockholders increased 6% over 1995, from \$969.2 million or \$2.68 per share in 1995 to \$1,030.1 million or \$2.85 per share in 1996. Contributing to the increase were Electric Operations' customer growth, business expansion projects placed in service in both the Natural Gas Transmission and the Energy Services segments and increased volumes in Energy Services due primarily to the joint venture formed with Mobil Corporation (Mobil).

In August 1996, partially offsetting the increase were expenses related to major storms in 1996, which affected the Electric Operations' distribution costs, non-recurring merger related costs and an extraordinary item related to the early retirement of debt in 1996.

Operating income of the Corporation for 1997 was \$1,970 million compared to \$2,158.5 million in 1996 and \$2,068.3 million in 1995. Earnings before interest and taxes (EBIT) were \$2,108.1 million, \$2,294.2 million and \$2,190.5 million for 1997, 1996 and 1995, respectively. Operating income and earnings before interest and taxes are not materially different, and are affected by the same fluctuations for the Corporation and each of its business segments. Earnings before interest and taxes by business segment are summarized below, and the explanation of these results by business segment are discussed thereafter.

Earnings Before Interest and Taxes by Business Segment is as follows:

	1997	1996	1995
	In Millions		
Electric Operations			

Duke Power	\$ 1,266.1	\$ 1,404.8	\$ 1,370.9
Nantahala Power and Light Company	15.7	14.7	10.3
Total Electric Operations	1,281.8	1,419.5	1,381.2
Natural Gas Transmission			
Northeast Pipelines	420.5	399.4	370.5
Midwest Pipelines	203.9	196.1	197.1
Total Natural Gas Transmission	624.4	595.5	567.6
Energy Services			
Field Services	157.0	151.6	106.1
Trading and Marketing	44.4	57.9	17.1
Global Asset Development	4.5	--	26.8
Other Energy Services	18.2	20.0	23.7
Total Energy Services	224.1	229.5	173.7
Crescent Resources	97.6	87.7	64.0
Other Operations	(119.8)	(38.0)	4.0
Consolidated EBIT	\$ 2,108.1	\$ 2,294.2	\$ 2,190.5

Net income for 1997 is net of a full year of the minority interests associated with the August 1996 joint venture with Mobil in the Trading and Marketing operations of the Energy Services segment (see Note 3 to the Consolidated Financial Statements).

Included in the amounts discussed below are intercompany transactions that do not have a material impact on consolidated earnings before interest and taxes.

Electric Operations

	1997	1996	1995
	Dollars in Millions		
Revenue	\$ 4,401.7	\$ 4,498.4	\$ 4,512.4
Operating Expenses	3,221.4	3,194.8	3,203.7
Operating Income	1,180.3	1,303.6	1,308.7
Other Income, Net of Expenses	101.5	115.9	72.5
EBIT	\$ 1,281.8	\$ 1,419.5	\$ 1,381.2
Volumes, GWh Sales (a)	77,541	76,952	76,737

(a) Gigawatt-hour sales

In 1997, earnings before interest and taxes for the Electric Operations segment declined 10% as compared to 1996 primarily as a result of the provision for non-recurring severance costs associated with the work force reduction and the increase in nuclear expenses, due primarily to increased outage days. Also contributing to the decrease were lower electric revenues.

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which were due primarily to mild weather and to the South Carolina rate reduction, which was effective June 1, 1996. Partially offsetting the decrease in earnings were lower expenses in 1997 as compared to 1996 when major storms affected distribution costs.

Although the unusually mild weather reduced residential sales during the year, general service and industrial sales continued to show strong growth. Residential kilowatt-hour sales, the most sensitive to weather, declined 4.7% during the year. Textile sales increased 3.0% and other industrial sales were up 1.3%, for a total growth in industrial sales of 2.0%. Sales to general service customers increased 0.5%. The number of customers in the Electric Operations' service territory increased 2.7% over 1996.

In 1996, earnings before interest and taxes for Electric Operations increased 3% over 1995 due to growth in the number of residential and general

service customers and increased retail kilowatt-hour sales to weather-sensitive customer classes. Increased retail sales were partially offset by the South Carolina rate reduction, which was effective June 1, 1996 and by a 16% decrease in wholesale sales primarily due to a decrease of 24% in supplemental sales requirements to the other joint owners of the Catawba Nuclear Station (Catawba). The effect on earnings before interest and taxes of the decrease in supplemental sales was partially offset by declines in purchased power expense from the other joint owners.

For more information on the Catawba joint ownership, see Note 6 to the Consolidated Financial Statements.

Natural Gas Transmission

	1997	1996	1995
	Dollars in Millions		
Revenue	\$ 1,572.1	\$ 1,556.3	\$ 1,533.4
Operating Expenses	964.4	972.5	971.1
Operating Income	607.7	583.8	562.3
Other Income, Net of Expenses	16.7	11.7	5.3
EBIT	\$ 624.4	\$ 595.5	\$ 567.6
Volumes, Tbtu (a)	2,862	2,939	2,703

(a) Trillion British Thermal Units

During 1997, the Natural Gas Transmission segment completed the organization of its operations into the Northeast Pipelines, which includes Texas Eastern Transmission Corporation (TETCO) and Algonquin Gas Transmission Company (Algonquin), and the Midwest Pipelines, which includes Panhandle Eastern Pipe Line Company (PEPL) and Trunkline Gas Company (Trunkline). Earnings before interest and taxes for the Natural Gas Transmission segment increased 5% in 1997 over the prior year, with increases in earnings at Northeast Pipelines and Midwest Pipelines of 5% and 4%, respectively. Earnings before interest and taxes increased primarily due to market-expansion projects placed in service and the favorable resolution of regulatory matters in 1997 in amounts in excess of those resolved in 1996. The resolution of regulatory matters was reflected as additional revenue and other income. The increases were partially offset by certain litigation expenses recorded in 1997.

In 1996, earnings before interest and taxes for the Natural Gas Transmission segment increased 5% over 1995. This was primarily due to a 9% increase in throughput resulting from new pipeline expansion projects placed in service in late 1995 and due to colder weather, which increased revenues. Operating expenses in 1995 included a charge for higher Order 636 transition cost estimates, partially offset by the benefit of lower than projected PCB (polychlorinated biphenyl) clean-up costs (see Note 5 to the Consolidated Financial Statements).

Energy Services

Earnings before interest and taxes for the Energy Services segment in 1997 decreased slightly as compared to 1996, which was 32% higher than 1995 earnings before interest and taxes. During 1997, 1996 and 1995, these fluctuations were driven primarily by the results of operations of Field Services and Trading and Marketing.

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Field Services

	1997	1996	1995
	Dollars in Millions		
Revenue	\$ 3,054.6	\$ 2,636.5	\$ 1,791.4
Operating Expenses	2,897.9	2,487.1	1,694.6

Operating Income	156.7	149.4	96.8
Other Income, Net of Expenses	0.3	2.2	9.3
EBIT	\$ 157.0	\$ 151.6	\$ 106.1
Volumes			
Natural Gas Gathered/Processed, TBtu/d (a)	3.4	2.9	1.9
NGL Production, MBbl/d (b)	103.9	76.5	54.8

(a) Trillion British thermal units per day

(b) Thousand barrels per day

Field Services' earnings before interest and taxes increased 4% for 1997 over 1996 primarily due to higher volumes as a result of acquisitions in 1996. Natural gas gathered and processed volumes increased 17% and natural gas liquids (NGL) production increased 36%. Partially offsetting these increases were higher natural gas prices, which increased operating expenses, and a decrease in NGL prices of 8%, which decreased revenues.

Earnings before interest and taxes for Field Services increased 43% in 1996 as compared with 1995. Strong processing margins and increased gathering and processing volumes related to expansion projects and asset acquisitions, primarily the acquisition of assets from Mobil, contributed to the increase in revenues. Average NGL prices increased 30%, while NGL production increased 40%. These improvements were partially offset by increased operating expenses and depreciation as a result of the Mobil asset acquisition and other projects placed in service. A gain on the sale of an investment in Seagull Shoreline System in 1995 caused a comparative reduction in other income.

Trading and Marketing

	1997	1996	1995
	Dollars in Millions		
Revenue	\$ 7,488.7	\$ 3,814.0	\$ 1,866.7
Operating Expenses	7,446.0	3,757.7	1,846.7
Operating Income	42.7	56.3	20.0
Other Income, Net of Expenses	1.7	1.6	(2.9)
EBIT	\$ 44.4	\$ 57.9	\$ 17.1
Volumes			
Natural Gas Marketed, TBtu/d	6.9	5.5	3.6
Electricity Marketed, GWh (a)	64,650	4,229	513

(a) Gigawatt-hours

A wholly owned subsidiary of the Corporation acquired the remaining 50% ownership interest in the Duke/Louis Dreyfus, L.L.C. (D/LD) joint venture in June 1997. This acquisition, coupled with a full year of operations of the joint venture with Mobil formed in August 1996, accounted for the significant increases in Trading and Marketing revenues, related operating expenses and volumes in 1997 over 1996. Natural gas marketed volumes increased 25%, in addition to increases in natural gas margins from trading activities, which were largely offset by the emerging electric power trading and marketing activities. Higher operating expenses, driven mainly by increased personnel levels and system development costs to provide the necessary infrastructure for growth in the trading and marketing business, resulted in a decrease in earnings before interest and taxes in 1997 as compared to 1996.

In 1996, Trading and Marketing's earnings before interest and taxes increased \$40.8 million as compared to 1995 primarily as a result of expanded operations due to the joint venture with Mobil formed in August 1996. The increase resulted primarily from higher gas volumes, improved margins resulting from colder weather and gas price volatility, and higher trading margins. Total gas volumes marketed increased 53%. The increase in margins was partially offset by higher operating expenses related to the joint venture with Mobil.

Other Operations

Earnings before interest and taxes for Crescent Resources increased 11% in 1997 over 1996. The increase is primarily due to gains associated with bulk land sales in 1997. In 1996, earnings before interest and taxes for Crescent Resources increased 37% over 1995 resulting from increased developed lot sales as well as bulk land sales.

Earnings before interest and taxes for Other Operations, excluding Crescent Resources, declined \$81.8 million in 1997 as compared to 1996. Contributing to the decrease were merger related expenses of \$71.2 million in 1997, compared to 1996 merger expenses of \$13.9 million, and the 1997 amortization of goodwill associated with the purchase of the remaining 50% ownership interest of the D/LD joint venture. This decline was partially offset by the sale of the Corporation's ownership interest in the Midland Cogeneration Venture in 1997.

In 1996, earnings before interest and taxes for Other Operations, excluding Crescent Resources, decreased \$42 million as compared to 1995 primarily as a result of 1996 expenses related to the merger and losses related to the start-up activities of a wireless communications joint venture.

Other Impacts on Earnings Available for Common Stockholders

In 1997, interest expense decreased \$27.4 million, or 5%, as compared to 1996 as a result of lower interest rates. Interest expense in 1996 decreased 2% compared with 1995 as a result of lower average interest rates and lower average debt balances outstanding.

Minority interests in 1997 and 1996 relate primarily to the joint venture with Mobil formed in August 1996.

On October 1, 1996, a subsidiary of the Corporation redeemed its \$150 million, 10% debentures and its \$100 million, 10 1/8% debentures both due 2011. The Corporation recorded a non-cash extraordinary item of \$16.7 million (net of income tax of \$10.3 million) related to the unamortized discount on this early retirement of debt.

In December 1997, the Corporation redeemed four issues of preferred stock and commenced a tender offer to purchase a portion of an additional six issues of preferred stock. Premiums related to these redemptions were included in Dividends and Premiums on Redemptions of Preferred and Preference Stock in the Consolidated Statements of Income.

LIQUIDITY AND CAPITAL RESOURCES

OPERATING CASH FLOW. Operating cash flows decreased \$195.1 million from 1996 to 1997. This decrease primarily reflects the cash impact of costs associated with the merger and natural gas transition cost recoveries.

Operating cash flows increased \$503 million from 1995 to 1996. This increase primarily reflects the cash impact of purchased capacity levelization and natural gas transition cost recoveries. Additionally, improved working capital caused cash flows from operations to increase in 1996.

Assets and liabilities recorded in the Consolidated Balance Sheets related to purchased capacity levelization and the natural gas transition cost recoveries and the related cash flow impacts are affected by state and federal regulatory initiatives and specific agreements. For more information on the purchased capacity levelization and the natural gas transition cost recoveries, see Notes 6 and 5, respectively, to the Consolidated Financial Statements.

INVESTING CASH FLOW. Capital and investment expenditures were approximately \$2.0 billion in 1997 compared with approximately \$1.6 billion in 1996. Increased capital and investment expenditures were partially due to the acquisition of the remaining 50% ownership interest in the D/LD joint venture and the acquisition of an ownership interest in American Ref-Fuel Company. Additionally, increased Electric Operations' construction costs, primarily due to steam generator replacement at certain of the Corporation's nuclear plants and increased distribution line construction and business expansion for the Natural Gas Transmission segment caused expenditures to increase. These increases were partially offset by the 1996 acquisition of certain assets from Mobil.

The Corporation participated in the marketing of electric power and natural gas through its 50% ownership interest in D/LD. On June 17, 1997, the Corporation, through one of its subsidiaries, acquired the remaining 50% ownership interest in D/LD from affiliates of Louis Drayfus Corp. for \$247 million. The purchase price substantially represents goodwill, which will be amortized over 10 years.

Also in June 1997, the Corporation signed a letter of intent to build a \$265 million, 520-megawatt combined cycle natural gas fired merchant generation plant in Bridgeport, Connecticut. The Corporation will be majority owner, with the first phase of the project scheduled to provide power in mid-1998. The

project is currently under construction.

During December 1997, a wholly owned subsidiary of the Corporation formed a joint venture with UAE Ref-Fuel L.L.C. (UAF), a wholly owned subsidiary of United American Energy Corp. The Corporation owns a 65% interest in the joint venture, with UAE owning a 35% minority interest. The joint venture acquired a 50% ownership interest in American Ref-Fuel Company, a waste-to-energy firm, with operations primarily in New York and New Jersey. Thus, the Corporation has an indirect 32.5% ownership interest in American Ref-Fuel Company and provided \$237 million of investment and financing to the venture.

During 1997, the Corporation sold its ownership in trading and marketing operations in the United Kingdom and its equity interest in certain affiliates. Proceeds from these sales were \$87 million.

Capital and investment expenditures in 1996 included the acquisition of certain assets of Mobil for approximately \$300 million by Field Services. The increase in capital and investment expenditures in 1996 over 1995 was a result of this acquisition and other Energy Services expansion projects, partially offset by decreased Electric Operations' construction costs as a result of the completion of certain generating facilities in 1995.

The Corporation plans to maintain its regulated facilities and pursue business expansion of its regulated operations as opportunities arise. Projected 1998 capital and investment expenditures for the Electric Operations and the Natural Gas Transmission segments, including allowance for funds used during construction, are approximately \$700 million and \$300 million, respectively. These projections are subject to periodic review and revisions. Actual expenditures incurred may vary from such estimates due to various factors, including revised electric load estimates, business expansion opportunities, environmental matters and cost and availability of capital.

The Energy Services segment plans to spend approximately \$100 million in 1998 for required capital expenditures at its existing facilities. In addition, the Corporation is seeking to significantly grow its Energy Services businesses, primarily through the Global Asset Development business unit. One expansion opportunity includes the 520-megawatt combined cycle natural gas fired merchant generation plant in Bridgeport, Connecticut already under construction. Another growth opportunity includes the recently announced agreement to purchase from Pacific Gas & Electric Company three power plants in California. The power plants have a combined capacity of 2,645 megawatts. The purchase price is estimated at approximately \$500 million and the transaction is expected to close during 1998. Other similar initiatives in 1998 will likely require significant capital and investment expenditures, which will be subject to periodic review and revision and may vary significantly depending on the value-added opportunities presented.

Projected capital and investment expenditures for 1998 of the Other Operations segment are approximately \$200 million. These projected capital and investment expenditures are subject to periodic review and revision and may vary significantly depending on the value-added opportunities presented.

FINANCING CASH FLOW. The Corporation's consolidated capital structure at December 31, 1997, including short-term debt, was 45% debt, 3% preferred stock, 50% common equity and 2% other capitalization. Fixed charges coverage, using the SEC method, was 4.1 times for 1997 compared to 4.3 and 4.0 times for 1996 and 1995, respectively.

Subsequent to the merger, several rating agencies reviewed and in some cases revised their debt ratings for the Corporation and its subsidiaries PanEnergy, PEEL, and IBTCO. As of December 31, 1997, Duke Energy Corporation's senior indebtedness ratings were as follows: AA- by Standard & Poor's Group and Fitch Investors Service; Aa3 by Moody's Investors Service; and AA by Duff & Phelps. The Corporation's intent is to maintain these current credit ratings.

During August 1997, the Corporation instituted a new commercial paper program, increasing its available commercial paper facilities to \$2.5 billion. The commercial paper facilities consist of \$1.25 billion for the Corporation and \$1.25 billion for Duke Capital Corporation (Duke Capital), a wholly owned subsidiary of the Corporation. Duke Capital serves as the parent for the Corporation's business segments except the Electric Operations and certain other operations. The Corporation's total commercial paper facilities were \$780 million at December 31, 1996. These facilities are supported by various bank credit agreements which totaled \$2.7 billion and \$1.5 billion at December 31, 1997 and 1996, respectively. As a result of the revised commercial paper program and the related credit facilities, the Corporation terminated the prior commercial paper program and related bank facilities held by the Corporation and PanEnergy. At December 31, 1997, \$1.7 billion of commercial paper and \$93 million of bank borrowings were outstanding.

On December 8, 1997, Duke Energy Capital Trust I (the Trust), a business

trust which is treated as a subsidiary of the Corporation for financial reporting purposes, issued \$350 million of its 7.2% trust preferred securities, at an \$11 million discount, representing preferred undivided beneficial interests in the assets of the Trust. Payment of distributions on such preferred securities is guaranteed by the Corporation, but only to the extent the Trust has funds legally and immediately available to make such distributions.

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Since December 31, 1996, \$647.6 million of the Corporation's first and refunding mortgage bonds and \$114.5 million of the Corporation's medium term notes matured or were redeemed. These retirements were funded primarily through the Corporation's commercial paper facilities.

During July 1996, the Corporation began purchasing shares of its common stock. In 1996, the Corporation repurchased approximately 3.3 million shares of common stock for \$159 million. On January 28, 1997, the Board of Directors amended the program to expressly limit the number of shares authorized for repurchase under the program, from the initiation of the program through a date two years after the consummation of the merger, to an amount not to exceed 15 million shares. No repurchases of common stock were made in 1997, and none are anticipated in the future.

The Corporation plans to use authorized but unissued shares of its common stock to meet 1998 employee benefit plan contribution requirements instead of purchasing shares on the open market.

The Corporation and its subsidiaries have authority to issue up to \$1.3 billion aggregate principal amount of debt and other securities under shelf registration statements filed with the Securities and Exchange Commission. Such securities may be issued as First and Refunding Mortgage Bonds, Senior Notes, Subordinated Debentures, or Preferred Stock.

Dividends and debt repayments, along with operating and investing requirements, are expected to be funded by cash from operations, debt and commercial paper issuances and available credit facilities. As noted previously, the Corporation is seeking to significantly grow its Energy Services businesses, which will likely require significant additional financing.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK. The Corporation is exposed to changes in interest rates as a result of significant financing through its issuance of variable-rate debt, fixed-rate debt, commercial paper and auction market preferred stock, as well as fixed-to-floating interest rate swaps. The Corporation manages its interest rate exposure by limiting its variable-rate exposure to a certain percentage of total capitalization, as set by policy, and by monitoring the effects of market changes in interest rates. (See Notes 11 and 14 to the Consolidated Financial Statements.)

If market interest rates average 1% more in 1998 than in 1997, the Corporation's interest expense, after considering the effect of the interest rate swap agreements, would increase, and income before taxes would decrease by approximately \$23.6 million. This amount has been determined by considering the impact of the hypothetical interest rates on the Corporation's variable-rate debt balances, commercial paper balances, auction market preferred stock balances and interest rate swap agreements as of December 31, 1997. These analyses do not consider the effects of the reduced level of overall economic activity that could exist in such an environment. In the event of a significant change in interest rates, management would likely take actions to further mitigate its exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, the sensitivity analysis assumes no changes in the Corporation's financial structure.

COMMODITY PRICE RISK. The Corporation, substantially through its subsidiaries, is exposed to the impact of market fluctuations in the price and transportation costs of natural gas, electricity and petroleum products marketed and employs established policies and procedures to manage its risks associated with these market fluctuations using various commodity derivatives, including futures, swaps and options. (See Note 8 to the Consolidated Financial Statements.) The Corporation measures the risk in its commodity derivative portfolio on a daily basis utilizing a Value-at-Risk (VAR) model to determine the maximum potential one-day favorable or unfavorable impact on its earnings and monitors its risk in comparison to established thresholds. The Corporation also utilizes other measures to monitor the risk in its commodity derivative portfolio on a monthly, quarterly and annual basis. The VAR computations are based on an historical simulation, which utilizes price movements over a specified period to simulate forward price curves in the energy markets to estimate the favorable or unfavorable impact of one-day's price movement on the

existing portfolio. The VAR computations utilize several key assumptions, including the confidence level for the resultant price movement and the holding period chosen for the calculation. The Corporation's calculation includes commodity derivative instruments held for trading purposes and excludes the effects of written and embedded physical options in the trading portfolio. At December 31, 1997, the Corporation's estimated potential one-day favorable or unfavorable impact on income before taxes, as measured by VAR, related to its commodity derivatives held for trading purposes was approximately \$2 million. Changes in markets inconsistent with historical trends could cause actual results to exceed predicted limits. Market risks associated with commodity derivatives held for purposes other than trading were not material at December 31, 1997.

Subsidiaries of the Corporation are also exposed to market fluctuations in the price of natural gas liquids (NGLs) related to their ongoing gathering and processing operating activities. Because the Corporation generally does not maintain an

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inventory of NGLs or actively trade commodity derivatives related to NGLs, the Corporation was not exposed to this risk at December 31, 1997. However, the Corporation closely monitors the risks associated with NGL price changes on its future operations.

EQUITY PRICE RISK. The Corporation maintains trust funds, as required by the Nuclear Regulatory Commission, to fund certain costs of nuclear decommissioning. (See Note 12 to the Consolidated Financial Statements.) As of December 31, 1997, these funds were invested primarily in domestic and international equity securities, fixed-rate, fixed income securities and cash and cash equivalents. By maintaining a portfolio that includes long-term equity investments, the Corporation is maximizing the returns to be utilized to fund nuclear decommissioning, which in the long-term will better correlate to inflationary increases in decommissioning costs. However, the equity securities included in the Corporation's portfolio are exposed to price fluctuation in equity markets, and the fixed-rate, fixed income securities are exposed to changes in interest rates. The Corporation actively monitors its portfolio by benchmarking the performance of its investments against certain indexes and by maintaining, and periodically reviewing, established target allocation percentages of the assets in its trusts to various investment options. Because the accounting for nuclear decommissioning recognizes that costs are recovered through the Corporation's Electric Operations' rates, fluctuations in equity prices or interest rates do not affect the earnings of the Corporation.

FOREIGN OPERATIONS RISK. The Corporation has investments in several international operations, many of which are joint ventures. At December 31, 1997, the Corporation had investments in international affiliates of \$236.1 million. These investments represent primarily investments in affiliates which own energy-related production, generation and transmission facilities.

The Corporation is exposed to foreign currency risk, sovereign risk and other foreign operations risks, primarily through investments in affiliates of \$115.5 million in Asia and \$100.7 million in South America. In order to mitigate risks associated with foreign currency fluctuations, the majority of contracts entered into by the Corporation or its affiliates are denominated in or indexed to the U.S. dollar. Other exposures to foreign currency risk, sovereign risk or other foreign operations risk are periodically reviewed by management and were not material to the Corporation's consolidated results of operations or financial position during the period.

CURRENT ISSUES

OPERATIONS OUTLOOK. The Electric Operations segment is expected to grow moderately, consistent with historical trends. Expansion will be primarily as a result of continued economic growth in its service territory. In 1997, as a result of the merger, the Corporation signed various agreements with the NRC, FERC and the FERC in which the Corporation agreed to cap base rates to retail and wholesale electric customers at existing levels through 2000. In addition, the Corporation signed agreements with the other joint owners of Catawba providing for a cap on certain rates charged under interconnection agreements. In response to these rate agreements and competitive pressures, the Electric Operations segment is striving to maintain low costs and competitive rates for its customers and to provide high quality customer service. The Corporation does not expect a negative impact as a result of such agreements on its results of operations or financial position. (See further discussion in the Electric Competition section below.)

Due to increased competition, especially for the Midwest Pipelines, relatively slow growth is expected for future operations of the Corporation's Natural Gas Transmission segment. The Natural Gas Transmission segment continues to offer selective discounting to maximize revenues from existing capacity and to advance projects that provide expanded services to meet the

specific needs of customers. Several projects have been announced that position the Natural Gas Transmission segment to meet increasing demand for gas in northeast markets by providing continuous paths from new supplies in both western and eastern basins in addition to traditional domestic supply basins.

The Corporation is seeking to significantly grow its Energy Services segment. Deregulation of energy markets in the U.S. and abroad is providing substantial opportunities for the Energy Services business units to capitalize on their broad capabilities. Growth is expected to be achieved through acquisitions, construction of greenfield projects and expansion of existing facilities as value-added opportunities present themselves.

The strong real estate market in the southeast continues to present substantial growth opportunities for Crescent Resources. In 1997, Crescent Resources initiated development of significant office and industrial facilities in each of its established markets to capitalize on market conditions.

ELECTRIC COMPETITION. The Energy Policy Act of 1992 (EPACT) and the FERC's subsequent rulemaking activities are major drivers towards a more competitive market for electric operations. EPACT amended provisions of the Public Utility

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Holding Corporation Act of 1935 (FONCA) and Part II of the Federal Power Act to remove certain barriers to electric competition. EPACT permits utilities to participate in the development of independent electric generating plants for sales to wholesale customers, and also permits the FERC to order transmission access for third parties to transmission facilities owned by another entity. It does not, however, permit the FERC to issue an order requiring transmission access to retail customers. The FERC, responsible in large measure for implementation of the EPACT, has moved vigorously to implement its mandate, interpreting the statute broadly and issuing orders for third-party transmission service and a number of rules of general applicability, including Orders 888 and 889.

Open-access transmission for wholesale customers as defined by the FERC's final rules provides energy suppliers, including the Corporation, with opportunities to sell and deliver capacity and energy at market-based prices. The Corporation and several of the Corporation's non-regulated subsidiaries were granted authority by the FERC to act as power marketers in late 1995. The Electric Operations obtained from the FERC open-access rights to sell at market-based rates up to 2,500 megawatts of capacity and energy from its own assets. Open-access provides another supply option through which the Corporation can purchase at attractive rates a portion of capacity and energy requirements resulting in lower overall costs to customers and thus improving the Corporation's competitive position. Open-access also provides the Corporation's existing wholesale customers with competitive opportunities to seek other suppliers for their capacity and energy requirements.

Wholesale sales represented approximately 9.4 percent of the Corporation's total gigawatt-hour sales for the Electric Operations segment in 1997. Supplemental sales to the other joint owners of Catawba comprised the majority of wholesale sales. Such supplemental sales will continue to decline in 1998 as a result of the retention of larger portions of ownership entitlement by the other joint owners. Two of the Catawba joint owners gave notice of their intent to end their supplemental capacity requirements on January 1, 2001 and January 1, 2002, respectively. In addition, as a result of the merger, the other joint owners have the right to end their supplemental capacity requirements as of January 1, 2001 with written notice to the Corporation due by December 31, 1999. Another joint owner gave notice of its intent to end its interconnection agreement with the Corporation effective January 1, 2006 (see Note 6 to the Consolidated Financial Statements).

Competition for retail electric customers is not generally allowed in the Corporation's service territory. However, there are discussions and events at the national level and within certain states regarding retail competition which are resulting in changes in the industry. Such changes will impact all entities owning electric generating assets. During 1997, both North and South Carolina have taken steps to address retail competition among electric utilities.

In May 1997, North Carolina passed a bill that created a study commission to assess deregulation of electric utilities in the state. The commission's report to the state General Assembly is expected to be completed by early 1999. Members of the study commission include legislators, utility representatives, customers and a member of an environmental group.

South Carolina has considered several proposals during 1997 to restructure the electric industry, the most significant of which would have provided retail customers with a choice of suppliers by January 1, 1998. None of these proposals has been approved. However, in May 1997, the PSCSC requested interested parties to file restructuring proposals for the electric industry. On June 30, 1997, the Corporation filed its proposal for introducing electric competition in South Carolina with the PSCSC. The Corporation's plan proposes

that electric generation be deregulated while transmission and distribution continue to be regulated by the FERC and the PSCSC, respectively, providing for an orderly transition to competition that takes all stakeholders into consideration. The Corporation's plan also provides for recovery of stranded investment. The PSCSC held hearings on August 19, 1997 on the various restructuring proposals it received and presented its report to the state legislature on February 3, 1998. The report proposes a five year transition period before starting full-fledged electric competition. In addition, customers could receive two separate electric bills, one from the distribution company, and one from the generator or supplier of electricity. The report leaves the final decisions to the General Assembly of South Carolina.

Currently, the electric utility industry is predominantly regulated on a basis designed to recover the cost of providing electric power to its customers. If cost-based regulation were to be discontinued in the industry, for any reason, including competitive pressure on the cost-based prices of electricity, profits could be reduced and electric utilities might be required to reduce their asset balances to reflect a market basis less than cost. Discontinuance of cost-based regulation would also require affected utilities to write off their associated regulatory assets. The regulatory assets of the Corporation are included in the Consolidated Balance Sheets. The portion of these regulatory assets related to electric operations is \$1.7 billion, including primarily purchased capacity costs, debt expense, and deferred taxes related to regulatory assets. Currently, the Corporation is recovering substantially all of these regulatory assets through its wholesale and retail electric rates and would attempt to continue to recover these assets should cost-based regulation be discontinued. In addition, the Corporation would seek to recover the costs of its electric generating facilities in excess of the market price of power at the time of transition.

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The Corporation seeks to move toward an orderly transition to retail competition that provides for consideration of the interests of all stakeholders in the retail electric sales arena. Management cannot predict the potential impact, if any, of these competitive forces on the Corporation's future financial position and consolidated results of operations.

NUCLEAR DECOMMISSIONING COSTS. The Corporation's estimated site-specific nuclear decommissioning costs, including the cost of decommissioning plant components not subject to radioactive contamination, total approximately \$1.3 billion stated in 1994 dollars based on decommissioning studies completed in 1994. In order to fund these costs, the Corporation contributes to an external decommissioning trust fund and maintains an internal reserve.

The balance of the external funds as of December 31, 1997 and 1996, was \$471.1 million and \$362.6 million respectively. The balance of the internal reserve as of December 31, 1997 and 1996, was \$210.8 million and \$207.8 million, respectively, and is reflected in Accumulated Depreciation and Amortization in the Consolidated Balance Sheets.

Both the NCUC and the PSCSC have granted the Corporation recovery of estimated decommissioning costs through retail rates over the expected remaining service periods of the Corporation's nuclear plants. Management is of the opinion that funding of the decommissioning costs will not have a material adverse effect on the consolidated results of operations and financial position of the Corporation. (See Note 12 to the Consolidated Financial Statements.)

ENVIRONMENTAL. The Corporation is subject to federal, state and local regulations regarding air and water quality, hazardous and solid waste disposal and other environmental matters.

Manufactured Gas Plants and Superfund Sites. The Corporation was an operator of manufactured gas plants until the early 1950s. The Corporation has entered into a cooperative effort with the State of North Carolina and other owners of certain former manufactured gas plant sites to investigate and, where necessary, remediate these contaminated sites. The State of South Carolina has expressed interest in entering into a similar arrangement. The Corporation is considered by regulators to be a potentially responsible party and may be subject to future liability at nine federal Superfund sites and one state Superfund site. While the cost of remediation of the remaining sites may be substantial, the Corporation will share in any liability associated with remediation of contamination at such sites with other potentially responsible parties. Management is of the opinion that resolution of these matters will not have a material adverse effect on the consolidated results of operations or financial position of the Corporation.

PCB (Polychlorinated Biphenyl) Assessment and Clean-up Programs. TETCO, a wholly owned subsidiary of the Corporation, is currently conducting PCB assessment and clean-up programs at certain of its compressor station sites under conditions stipulated by a U.S. Consent Decree. The programs include on- and off-site assessment, installation of on-site source control equipment and groundwater monitoring wells, and on- and off-site clean-up work. TETCO expects

to complete these clean-up programs during 1998. Groundwater monitoring activities will continue at several sites beyond 1998.

In 1987, the Commonwealth of Kentucky instituted a suit in state court against TETCO, alleging improper disposal of PCBs at TETCO's three compressor station sites in Kentucky. This suit is still pending. In 1996, TETCO completed clean-up of these sites under the U.S. Consent Decree.

The Corporation has also identified environmental contamination at certain sites on the FEPL and Trunkline systems and is undertaking clean-up programs at these sites. The contamination resulted from the past use of lubricants containing PCBs and the prior use of wastewater collection facilities and other on-site disposal areas. Soil and sediment testing, to date, has detected no significant off-site contamination. The Corporation has communicated with the Environmental Protection Agency (EPA) and appropriate state regulatory agencies on these matters. Environmental clean-up programs are expected to continue until 2002.

At December 31, 1997 and 1996, the Corporation had accrued liabilities for remaining estimated clean-up costs on the TETCO, FEPL and Trunkline systems, which were included in Environmental Clean-up Liabilities in the Consolidated Balance Sheets. These cost estimates represent gross clean-up costs expected to be incurred, have not been discounted or reduced by customer recoveries and do not include fines, penalties or third-party claims. Costs expected to be recovered from customers are included in the Consolidated Balance Sheets as of December 31, 1997 and 1996, as Regulatory Assets and Deferred Debits.

The federal and state clean-up programs are not expected to interrupt or diminish the Corporation's ability to deliver natural gas to customers. Based on the Corporation's experience to date and costs incurred for clean-up operations, management believes the resolution of matters relating to the environmental issues discussed above will not have a material adverse effect on the consolidated results of operations or financial position of the Corporation.

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Air Quality Control. The Clean Air Act Amendments of 1990 require a two-phase reduction by electric utilities in aggregate annual emissions of sulfur dioxide and nitrogen oxide by 2000. The Corporation currently meets all requirements of Phase I. The Corporation supports the national objective of protecting air quality in the most cost-effective manner, and has already reduced emissions by operating plants efficiently, using nuclear and hydroelectric generation and implementing various compliance strategies. To meet Phase II requirements by 2000, the Corporation's current strategy includes using low-sulfur coal, purchasing sulfur dioxide emission allowances, and installing low-nitrogen oxide burners and emission monitoring equipment. Construction activities needed to comply with Phase II requirements are substantially complete, and future one-time capital costs associated with meeting Phase II requirements range from \$14 million to \$24 million. Additional annual operating expenses of approximately \$25 million for low-sulfur coal premiums, emission allowance purchases and other compliance activities will occur after 2000. This strategy is contingent upon developments in future markets for emission allowances, low-sulfur coal, future regulatory and legislative actions, and advances in clean air technologies.

Additionally, the Corporation would be affected by a proposed call for new State Implementation Plans (SIP) issued by the EPA to 22 states related to existing and new national ambient air quality standards for ozone. Costs to the Corporation related to the SIP call may range from \$123 million to \$517 million, depending on final EPA implementation plans and schedules.

In 1994, the State of Missouri issued a Notice of Violation to FEPL alleging violations of Missouri air pollution regulations at the Corporation's Houstonia compressor station. The Corporation is in negotiations with the State to resolve this matter. The State is seeking a penalty and correction of the alleged violations.

In December 1997, the United Nations held negotiations in Kyoto, Japan to determine how to achieve worldwide stabilization of greenhouse gas emissions, including carbon dioxide emissions from fossil-fired generating facilities. Because this matter is in the early stages of discussion, the Corporation cannot estimate the effects on future consolidated results of operations or financial position of the Corporation.

LITIGATION AND CONTINGENCIES. For information concerning litigation and other commitments and contingencies, see Note 15 to the Consolidated Financial Statements.

COMPUTER SYSTEMS CHANGES FOR THE YEAR 2000. The Corporation is incurring incremental costs to modify existing computer systems to accommodate the year 2000 and beyond. The Corporation is currently making modifications to its programs and is of the opinion that remaining modifications will be completed

before they become problematic. Management is of the opinion that the costs associated with these modifications will not have a material adverse effect on the consolidated results of operations or financial position of the Corporation.

FORWARD-LOOKING STATEMENTS. From time to time, the Corporation may make statements regarding its expectations, intent or beliefs about future events. These statements are intended as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. The Corporation cautions that assumptions, projections and expectations about future events may and often do vary from actual results, the differences between assumptions, projections and expectations and actual results can be material, and there can be no assurance that the forward-looking statements will be realized. The following are some of the factors that could cause actual achievements and events to differ materially from those expressed or implied in such forward-looking statements: state and federal legislative and regulatory initiatives that effect cost and investment recovery, have an impact on rate structures, and affect the speed and degree to which competition enters the electric and natural gas industries; industrial, commercial and residential growth in the service territories of the Corporation and its subsidiaries; the weather and other natural phenomena; the timing and extent of changes in commodity prices and interest rates; changes in environmental and other laws and regulations to which the Corporation and its subsidiaries are subject or other external factors over which the Corporation has no control; the results of financing efforts; growth in opportunities for the Corporation's subsidiaries and diversified operations; and the effect of the Corporation's accounting policies, in each case during the periods covered by the forward-looking statements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

See "Management's Discussion and Analysis of Results of Operations and Financial Condition, Quantitative and Qualitative Disclosures About Market Risk."

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Item 8. Financial Statements and Supplementary Data.

DUKE ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31		
	1999	1998	1997
	(In Millions, except per share amounts)		
Operating Revenues			
Natural gas and petroleum products (Notes 2 and 5)			
Sales, trading and marketing of natural gas and petroleum products	\$ 8,150.7	\$ 5,848.0	\$ 3,397.2
Transportation and storage of natural gas	1,503.5	1,522.9	1,500.6
Electric (Notes 2 and 5)			
Generation, transmission and distribution	4,334.5	4,436.6	4,454.6
Trading and marketing of electricity	1,664.9	77.8	9.8
Other (Note 9)	655.3	417.1	332.5
Total operating revenues	16,308.9	12,302.4	9,694.7
Operating Expenses			
Natural gas and petroleum products purchased (Note 2)	7,705.2	5,416.3	3,119.3
Fuel used in electric generation (Note 2)	742.8	758.5	744.2
Net interchange and purchased power (Notes 3, 5 and 6)	1,960.2	456.8	480.2
Other operation and maintenance (Notes 5, 12 and 15)	2,720.9	2,382.8	2,209.0
Depreciation and amortization (Notes 2 and 6)	841.0	789.4	737.1
Property and other taxes	368.8	342.0	336.6
Total operating expenses	14,338.9	10,143.8	7,626.4
Operating Income	1,970.0	2,158.6	2,068.3
Other Income and Expenses			
Deferred returns and allowance for funds used during construction (Note 2)	109.4	104.8	113.9
Other, net	28.7	30.8	8.1

Total other income and expenses	138.1	135.6	122.2
Earnings Before Interest and Taxes	2,108.1	2,294.2	2,190.5
Interest Expense (Notes 8 and 11)	471.8	499.2	508.2
Minority Interests (Note 3)	23.0	6.2	--
Earnings Before Income Taxes	1,613.3	1,788.8	1,682.3
Income Taxes (Notes 2 and 7)	638.9	697.8	664.2
Income Before Extraordinary Item	974.4	1,091.0	1,018.1
Extraordinary Item (net of tax)	--	16.7	--
Net Income	974.4	1,074.3	1,018.1
Dividends and Premiums on Redemptions of Preferred and Preference Stock (Note 14)	72.8	44.2	48.9
Earnings Available for Common Stockholders	\$ 901.6	\$ 1,030.1	\$ 969.2
Common Stock Data (Note 2)			
Average shares outstanding	359.8	361.2	361.2
Earnings per share (before extraordinary item)			
Basic	\$ 2.51	\$ 2.90	\$ 2.68
Dilutive	\$ 2.50	\$ 2.88	\$ 2.67
Earnings per share			
Basic	\$ 2.51	\$ 2.85	\$ 2.68
Dilutive	\$ 2.50	\$ 2.83	\$ 2.67
Dividends per share	\$ 1.90	\$ 1.57	\$ 1.50

See Notes to Consolidated Financial Statements.

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DUXIE ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31		
	1997	1996	1995
	(In Millions)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 974.4	\$ 1,074.3	\$ 1,018.1
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	982.5	964.9	953.8
Deferred income taxes and investment tax credit amortization	109.7	74.7	115.2
Purchased capacity levelization	56.4	73.5	(33.1)
Transition cost recoveries	(35.6)	90.9	(85.2)
(Increase) Decrease in			
Receivables	(266.5)	(645.6)	(286.0)
Inventory	(6.6)	45.1	(26.2)
Other current assets	(18.4)	16.7	90.5
Increase (Decrease) in			
Accounts payable	(72.1)	576.7	53.5
Taxes accrued	50.0	(31.0)	25.7
Interest accrued	(13.1)	(18.5)	5.6
Other current liabilities	326.2	(10.0)	17.7
Other, net	57.2	103.5	(17.4)
Net cash provided by operating activities	2,140.1	2,335.2	1,832.2
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(1,323.2)	(1,393.9)	(1,223.0)
Investment expenditures	(704.4)	(256.1)	(67.7)
Decommissioning, retirements and other	33.9	(18.2)	(26.9)
Net cash used in investing activities	(1,993.7)	(1,568.2)	(1,317.6)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from the issuance of			
Long-term debt	1,617.6	362.8	421.5
Guaranteed preferred beneficial interests in Corporation's subordinated notes	339.8	--	--
Common stock and stock options	14.9	11.8	16.5
Payments for the redemption of			

Long-term debt	(868.5)	(527.0)	(480.9)
Common stock	(25.4)	(159.0)	--
Preferred stock	(223.6)	--	(100.5)
Net change in notes payable and commercial paper	(290.2)	159.3	193.2
Dividends paid	(726.4)	(609.3)	(590.5)
Other	(40.4)	(12.1)	(4.8)
Net cash used in financing activities	(203.0)	(773.5)	(545.5)
Net decrease in cash and cash equivalents	(56.6)	(6.5)	(30.9)
Cash and cash equivalents at beginning of year	166.0	172.5	203.4
Cash and cash equivalents at end of year	\$ 109.4	\$ 166.0	\$ 172.5
Supplemental Disclosures			
Cash paid for interest (net of amount capitalized)	\$ 475.9	\$ 493.1	\$ 481.6
Cash paid for income taxes	\$ 469.8	\$ 549.9	\$ 519.9

See Notes to Consolidated Financial Statements.

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DUKE ENERGY CORPORATION

CONSOLIDATED BALANCE SHEETS

	December 31	
	1997	1996
	(In Millions)	
ASSETS		
Current Assets (Note 2)		
Cash and cash equivalents (Note 8)	\$ 109.4	\$ 166.0
Receivables (Note 8)	2,280.8	1,888.0
Inventory	440.1	433.5
Current portion of natural gas transition costs	66.9	67.9
Current portion of purchased capacity costs	76.2	51.3
Unrealized gains on mark to market transactions (Note 8)	551.3	397.2
Other (Note 8)	160.5	142.1
Total current assets	3,685.2	3,146.0
Investments and Other Assets		
Investments in affiliates (Notes 9 and 15)	685.9	502.9
Nuclear decommissioning trust funds (Notes 8 and 12)	471.1	362.6
Pre-funded pension costs (Note 15)	177.2	277.2
Goodwill, net (Notes 2, 3 and 7)	503.6	222.1
Notes receivable	239.6	63.5
Other	209.9	108.0
Total investments and other assets	2,447.6	1,629.7
Property, Plant and Equipment (Notes 2, 6, 10, 11, 12 and 15)		
Cost	25,448.1	24,468.2
Less accumulated depreciation and amortization	9,712.2	9,199.1
Net property, plant and equipment	15,735.9	15,269.1
Regulatory Assets and Deferred Debits (Note 2)		
Purchased capacity costs (Note 6)	759.4	840.7
Debt expense	253.1	244.0
Regulatory asset related to income taxes	511.0	493.5
Natural gas transition costs	193.7	250.0
Environmental clean-up costs	103.6	153.2
Other	339.3	350.0
Total regulatory assets and deferred debits	2,160.1	2,331.4
Total Assets	\$ 24,028.8	\$ 23,366.2

See Notes to Consolidated Financial Statements.

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DUKE ENERGY CORPORATION

CONSOLIDATED BALANCE SHEETS -- (Continued)

	December 31	
	1997	1996
	(In Millions)	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	\$ 1,358.7	\$ 1,286.5
Notes payable and commercial paper (Notes 8 and 11)	169.5	459.7
Taxes accrued (Note 2)	124.8	74.8
Interest accrued	111.2	124.1
Current portion of natural gas transition liabilities (Note 2)	35.0	84.4
Current portion of environmental clean-up liabilities (Notes 2 and 15)	26.4	32.4
Current maturities of long-term debt (Note 11)	77.3	350.6
Unrealized losses on mark to market transactions (Notes 2 and 8)	937.8	388.5
Other (Note 2)	834.5	508.3
Total current liabilities	3,275.2	3,309.5
Long-term Debt (Notes 8 and 11)	6,530.0	5,485.1
Deferred Credits and Other Liabilities (Note 2)		
Deferred income taxes (Note 7)	3,706.5	3,568.5
Investment tax credit (Note 7)	238.9	250.1
Nuclear decommissioning costs externally funded (Notes 8 and 12)	471.1	362.6
Natural gas transition liabilities	78.4	121.9
Environmental clean-up liabilities (Note 15)	157.6	188.9
Other	1,035.1	971.0
Total deferred credits and other liabilities	5,687.6	5,463.0
Minority Interests (Note 3)	168.3	83.4
Guaranteed Preferred Beneficial Interests in Corporation's Subordinated Notes (Notes 8 and 13)	339.0	-
Preferred and Preference Stock (Notes 8 and 14)		
Preferred and preference stock with sinking fund requirements	149.0	234.0
Preferred and preference stock without sinking fund requirements	340.0	450.0
Total preferred and preference stock	489.0	684.0
Commitments and Contingencies (Notes 6, 12 and 15)		
Common Stockholders' Equity (Notes 16 and 17)		
Common stock, no par, 500 million shares authorized; 359.8 million and 359.4 million shares outstanding at December 31, 1997 and 1996, respectively	4,283.7	4,289.3
Retained earnings	3,256.0	3,051.9
Total common stockholders' equity	7,539.7	7,341.2
Total Liabilities and Stockholders' Equity	\$ 24,028.8	\$ 22,366.2

See Notes to Consolidated Financial Statements.

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DUKE ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF COMMON STOCKHOLDERS' EQUITY

Years Ended December 31		
1997	1996	1995

(In Millions)

Common Stock			
Balance at beginning of year	\$ 4,283.3	\$ 4,296.0	\$ 4,275.8
Stock issued for purchase of assets	--	--	2.5
Stock repurchased (Note 16)	--	(30.8)	--
Dividend reinvestment and employee benefits	(9.9)	23.3	18.5
Other capital stock transactions, net	4.3	--	--
Balance at end of year	4,283.7	4,289.3	4,296.8
Retained Earnings			
Balance at beginning of year	3,051.9	2,715.7	2,292.2
Net income	974.4	1,074.3	1,018.1
Common stock dividends	(682.2)	(569.6)	(542.2)
Preferred and preference stock dividends and premiums on redemptions (Note 14)	(72.8)	(64.2)	(48.9)
Other capital stock transactions, net	(15.3)	(128.3)	(3.5)
Balance at end of year	3,256.0	3,051.9	2,715.7
Total Common Stockholders' Equity	\$ 7,539.7	\$ 7,341.2	\$ 7,012.5

See Notes to Consolidated Financial Statements.

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DUKE ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For The Years Ended December 31, 1997, 1996 and 1995

NOTE 1. NATURE OF OPERATIONS

On June 18, 1997, Duke Power Company (Duke Power) changed its name to Duke Energy Corporation (the Corporation) in accordance with the terms of a merger agreement with PanEnergy Corp (PanEnergy), pursuant to which the Corporation issued 158.3 million shares of its common stock in exchange for all of the outstanding common stock of PanEnergy (the merger). PanEnergy was involved in the gathering, processing, transportation and storage of natural gas, the production of natural gas liquids, and the marketing of natural gas, electricity, liquefied petroleum gases and related energy services. Pursuant to the merger, each share of PanEnergy common stock outstanding was converted into the right to receive 1.0444 shares of the Corporation's common stock. In addition, each outstanding option to purchase PanEnergy common stock became an option to purchase common stock of the Corporation, adjusted accordingly. The merger was accounted for as a pooling of interests and, accordingly, the consolidated financial statements for periods prior to the combination were restated to include the operations of PanEnergy.

Operating revenues and net income previously reported by the separate companies and the combined amounts presented in the accompanying consolidated financial statements for the years ended December 31, 1996 and 1995 are as follows:

	Duke Power	PanEnergy	Adjustments	Combined
In Millions				
1996				
Operating revenues	\$ 4,758.0	\$ 7,505.6	\$ 38.8	\$ 12,302.4
Net income before extraordinary item	\$ 729.9	\$ 361.2	--	\$ 1,091.0
Net income	\$ 729.9	\$ 344.4	--	\$ 1,074.3
1995				
Operating revenues	\$ 4,676.6	\$ 4,967.5	\$ 50.6	\$ 9,694.7
Net income	\$ 714.5	\$ 303.6	--	\$ 1,018.1

The adjustment to operating revenues reflects a reclassification of PanEnergy's equity in earnings of unconsolidated affiliates from other income to revenues to be consistent with the Corporation's financial statement presentation.

The Corporation is an integrated energy and energy services provider with

the ability to offer physical delivery and management of both electricity and natural gas throughout the United States and abroad. The Corporation provides these services through its four business segments:

Electric Operations -- Generation, transmission, distribution and sale of electric energy in central and western North Carolina and the western portion of South Carolina. Duke Energy Corporation (doing business as Duke Power) and its wholly owned subsidiary Nantahala Power and Light Company serve this area. These electric operations are subject to the rules and regulations of the Federal Energy Regulatory Commission (FERC), the North Carolina Utilities Commission (NCUC) and The Public Service Commission of South Carolina (PSCSC).

Natural Gas Transmission -- Interstate transportation and storage of natural gas for customers in the Mid-Atlantic, New England and Midwest states. The interstate natural gas transmission and storage operations of the Corporation's wholly owned subsidiaries Texas Eastern Transmission Corporation (TETCO), Algonquin Gas Transmission Company (Algonquin), Panhandle Eastern Pipe Line Company (PEPL), and Trunkline Gas Company (Trunkline) are also subject to the rules and regulations of the FERC.

Energy Services -- Comprised of several separate business units: Field Services -- gathers and processes natural gas, produces and markets natural gas liquids and transport and trades crude oil; Trading and Marketing -- markets natural gas, electricity and other energy-related products; Global Asset Development -- develops, owns and operates energy-related facilities worldwide; and Other Energy Services -- provides engineering consulting, construction and integrated energy solutions.

Other Operations -- Real estate operations of Crescent Resources, Inc., communications services, corporate costs and intersegment eliminations.

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DUKE ENERGY CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CONSOLIDATION. The consolidated financial statements reflect consolidation of all of the Corporation's majority-owned subsidiaries after the elimination of intercompany transactions. Investments in other entities that are not majority owned and where the Company has significant influence over operations are accounted for using the equity method.

The consolidated financial statements are prepared in conformity with generally accepted accounting principles appropriate in the circumstances to reflect in all material respects the substance of events and transactions which should be included. In preparing these statements, management makes informed judgments and estimates of the expected effects of events and transactions that are currently being reported. However, actual results could differ from these estimates.

CASH AND CASH EQUIVALENTS. All liquid investments with maturities at date of purchase of three months or less are considered cash equivalents.

INVENTORY. Inventory consists primarily of materials and supplies, gas held for transmission, processing and sales commitments and coal held for electric generation. Inventory is recorded at the lower of cost or market, primarily using the average cost method.

COMMODITY DERIVATIVE INSTRUMENTS. The Corporation, primarily through its subsidiaries, holds and issues instruments that reduce exposure to market fluctuations in the price and transportation costs of natural gas, petroleum products and electric power marketed. The Corporation uses futures, swaps and options to manage and hedge price and location risk related to market exposures. In order to qualify as a hedge, the price movements in the commodity derivatives must be highly correlated with the underlying hedged commodity. Gains and losses related to commodity derivatives which qualify as hedges of commodity commitments are recognized in income when the underlying hedged physical transaction closes (the deferral method) and are included in Natural Gas and Petroleum Products Purchased or Net Interchange and Purchased Power in the Consolidated Statements of Income. Gains and losses related to such instruments, to the extent not yet settled in cash, are reported as Current Assets or Liabilities, as appropriate, in the Consolidated Balance Sheets until recognized in income. If the derivative instrument is no longer sufficiently correlated to the underlying commodity, or if the underlying commodity transaction closes earlier than anticipated, the deferred gains or losses are recognized in income.

In addition to non-trading activities, the Corporation also engages in the trading of commodity derivatives and therefore experiences net open positions. Gains and losses on derivatives utilized for trading are recognized in income

on a current basis (the mark to market method) and are also included in Natural Gas and Petroleum Products Purchased or Net Interchange and Purchased Power.

GOODWILL AMORTIZATION. The Corporation amortizes goodwill related to the purchases of Duke/Louis Dreyfus, L.L.C. (D/LD) and Texas Eastern Corporation (TEC), and certain other natural gas gathering, transmission and processing facilities and engineering consulting businesses on a straight-line basis over 10 years, 40 years, and 15 years, respectively. Accumulated amortization of goodwill at December 31, 1997 and 1996 was \$123.6 million and \$99.7 million, respectively.

PROPERTY, PLANT AND EQUIPMENT. Property, plant and equipment is stated at original cost. The Corporation capitalizes all construction-related direct labor and materials, as well as indirect construction costs. Indirect costs include general engineering, taxes and the cost of money. The cost of renewals and betterments that extend the useful life of property is also capitalized. The cost of repairs and replacements is charged to expense. Depreciation is generally computed using the straight-line method. The Corporation's composite weighted-average depreciation rates, excluding nuclear fuel, were 3.67, 3.77 and 3.97 percent for 1997, 1996, and 1995, respectively.

At the time property, plant and equipment maintained by the Corporation's regulated operations are retired, the original cost plus the cost of retirement, less salvage, is charged to accumulated depreciation and amortization. When entire regulated operating units are sold or non-regulated properties are retired or sold, the property and related accumulated depreciation and amortization accounts are reduced and any gain or loss is recorded in income, unless otherwise required by the FERC.

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DUKE ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- Continued

UNAMORTIZED DEBT PREMIUM, DISCOUNT AND EXPENSE. Expenses incurred in connection with the issuance of presently outstanding long-term debt, and premiums and discounts relating to such debt, are amortized over the terms of the respective issues. Also, any call premiums or unamortized expenses associated with refinancing higher-cost debt obligations used to finance regulated assets and operations are amortized consistent with regulatory treatment of these items.

ENVIRONMENTAL EXPENDITURES. Expenditures that relate to an existing condition caused by past operations, and do not contribute to current or future revenue generation, are expensed. Environmental expenditures relating to current or future revenues are expensed or capitalized as appropriate. Liabilities are recorded when environmental assessments and/or clean-ups are probable and the costs can be reasonably estimated. Certain of these environmental assessments and clean-up costs have been deferred and are included in Regulatory Assets and Deferred Debits as they are expected to be recovered from Natural Gas Transmission customers.

COST-BASED REGULATION. The regulated operations of the Corporation are subject to the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." Accordingly, the Corporation records certain assets and liabilities that result from the effects of the ratemaking process that would not be recorded under generally accepted accounting principles for non-regulated entities. The regulatory assets and regulatory liabilities of the Corporation are classified as Regulatory Assets and Deferred Debits and Deferred Credits and Other Liabilities, respectively, in the Consolidated Balance Sheets. The Corporation regularly evaluates the continued applicability of SFAS No. 71, considering such factors as regulatory changes and the impact of competition. Discontinuance of cost-based regulation or increased competition might require entities to reduce their asset balances to reflect a market basis less than cost and would also require entities to write off their associated regulatory assets. Management cannot predict the potential impact, if any, of discontinuance of cost-based regulation or increased competition on the Corporation's future financial position and results of operations. However, the Corporation continues to position itself to effectively meet these challenges by maintaining prices that are competitive.

COMMON STOCK OPTIONS. The Corporation follows the intrinsic value method of accounting for common stock options and awards issued to employees.

REVENUES. The Corporation recognizes revenues on sales of electricity and transportation and storage of natural gas as service is provided and on sales of natural gas and petroleum products in the period of delivery. Receivables on the Consolidated Balance Sheets included \$231.6 million and \$210 million as of December 31, 1997 and 1996, respectively, for electric service that has been

provided but not yet billed to customers. When rate cases associated with the transportation of natural gas are pending final FERC approval, a portion of the revenues collected by the interstate natural gas pipelines is subject to possible refund. The Corporation has established reserves where required for such cases.

NUCLEAR FUEL. Amortization of nuclear fuel is included in Fuel Used in Electric Generation in the Consolidated Statements of Income. The amortization is recorded using the units-of-production method.

DEFERRED RETURNS AND ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC). Deferred returns represent the estimated financing costs associated with funding certain regulatory assets. These regulatory assets primarily arose from the Corporation's funding of purchased capacity costs above levels collected in rates. Deferred returns are non-cash items and are primarily recognized as an addition to Purchased Capacity Costs with an offsetting credit to Other Income and Expenses.

AFUDC represents the estimated debt and equity costs of capital funds necessary to finance the construction of new regulated facilities. AFUDC is a non-cash item and is recognized as a cost of Property, Plant and Equipment, with offsetting credits to Other Income and Expenses and to Interest Expense. After construction is completed, the Corporation is permitted to recover these costs, including a fair return, through their inclusion in rate base and in the provision for depreciation.

Rates used for capitalization of deferred returns and AFUDC by the Corporation's regulated operations are calculated in compliance with FERC rules.

DERIVATIVE FINANCIAL INSTRUMENTS. The Corporation uses interest rate swaps to manage the interest rate characteristics of its outstanding debt. Interest rate differentials to be paid or received as interest rates change are accrued and recognized

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DUKE ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- Continued

as an adjustment of interest expense related to the designated debt (the accrual method). The amount payable to or receivable from counterparties related to the interest rate differential is included in Regulatory Assets and Deferred Debits in the Consolidated Balance Sheets. The fair values of interest rate swaps are not recognized in the financial statements.

INCOME TAXES. Prior to the merger, Duke Power and PanEnergy filed separate consolidated federal income tax returns. Subsequent to the merger, the Corporation and its subsidiaries file a consolidated federal income tax return. Federal income taxes have been provided by the Corporation on the basis of its separate company income and deductions in accordance with established practices of the consolidated group.

Deferred income taxes have been provided for temporary differences. Temporary differences occur when events and transactions recognized for financial reporting result in taxable or tax-deductible amounts in different periods. Duke Power's investment tax credits have been deferred and are being amortized over the estimated useful lives of the related properties.

EARNINGS PER COMMON SHARE: The Financial Accounting Standards Board issued SFAS No. 128, "Earnings per Share" which replaces the presentation of primary and fully diluted earnings per share with basic and diluted earnings per share. Basic earnings per share is computed by dividing net earnings available for common stockholders by the weighted average number of common shares outstanding for the year. Basic earnings per share in the Consolidated Statements of Income is identical to the primary earnings per share previously presented for all periods. Diluted earnings per share reflects the potential dilution that could occur if securities or other agreements to issue common stock were exercised or converted into common stock. Dilutive earnings per share is computed based upon the weighted average number of common shares and dilutive common equivalent shares outstanding. Common stock options, which are common stock equivalents, had a dilutive effect on earnings per share and increased the weighted average number of common shares by 1.9 million, 2.1 million and 2.6 million shares for 1997, 1996, and 1995, respectively. The weighted average number of common shares, for dilutive purposes, was 361.7 million, 363.5 million and 363.8 million shares for 1997, 1996 and 1995, respectively.

RECLASSIFICATIONS. Certain amounts have been reclassified in the consolidated financial statements to conform to the current presentation.

NOTE 3. BUSINESS COMBINATIONS AND ACQUISITIONS

DUKE/LOUIS DREYFUS, S.A.C. (D/LD). On June 17, 1997, a wholly owned subsidiary of the Corporation acquired the remaining 50% ownership interest in D/LD from affiliates of Louis Dreyfus Corp. for \$247 million. D/LD markets electric power, natural gas and energy-related services to utilities, municipalities and other large energy users in North America. The acquisition was accounted for by the purchase method, and the assets and liabilities and results of operations of D/LD have been consolidated in the Corporation's financial statements since the date of purchase. The purchase price substantially represents goodwill.

DUKE/UAE L.L.C. During December 1997, a wholly owned subsidiary of the Corporation formed a joint venture with UAE Ref-Fuel L.L.C. (UAE), a wholly owned subsidiary of United American Energy Corp. The Corporation owns a 65% interest in the joint venture, with UAE owning a 35% minority interest. The joint venture acquired a 50% ownership interest in American Ref-Fuel Company, a waste-to-energy firm with operations primarily in New York and New Jersey. Thus, the Corporation has an indirect 32.5% ownership interest in American Ref-Fuel Company and provided \$237 million of investment and financing to the venture.

DUKE ENERGY TRADING AND MARKETING, L.L.C. On August 1, 1996, a wholly owned subsidiary of the Corporation formed a natural gas and power marketing joint venture with Mobil Corporation (Mobil) affiliates. The marketing company (DETM) conducts business as Duke Energy Trading and Marketing, L.L.C. (formerly PanEnergy Trading and Market Services, L.L.C.) in the United States and as Duke Energy Marketing L.P. (formerly PanEnergy Marketing L.P.) in Canada. The Corporation operates the joint venture and owns a 50% interest, with Mobil owning a 40% minority interest.

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DUKE ENERGY CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 4. BUSINESS SEGMENTS

Business segment financial information follows for each of the three years in the period ended December 31, 1997. Other Operations include intersegment eliminations.

	Unaffiliated Revenues	Intersegment Revenues	Total Revenues
	In Millions		
1997			
Electric Operations	\$ 4,401.7	\$ --	\$ 4,401.7
Natural Gas Transmission	1,467.8	104.3	1,572.1
Energy Services			
Trading and Marketing	7,411.0	77.7	7,488.7
Field Services	2,480.5	574.1	3,054.6
Global Asset Development	109.2	34.2	123.4
Other Energy Services	342.8	32.8	375.6
Energy Services' Eliminations	--	(655.1)	(655.1)
Total Energy Services	10,343.5	43.7	10,387.2
Other Operations	95.9	(148.0)	(52.1)
Total Consolidated	\$ 16,308.9	\$ --	\$ 16,308.9
1996			
Electric Operations	\$ 4,498.4	\$ --	\$ 4,498.4
Natural Gas Transmission	1,470.2	86.1	1,556.3
Energy Services			
Trading and Marketing	3,773.5	40.5	3,814.0
Field Services	2,315.6	420.9	2,736.5
Global Asset Development	65.0	6.6	71.6
Other Energy Services	182.8	21.4	204.2
Energy Services' Eliminations	--	(456.5)	(456.5)
Total Energy Services	6,236.9	32.9	6,269.8
Other Operations	96.9	(119.0)	(22.1)
Total Consolidated	\$ 12,302.4	\$ --	\$ 12,302.4
1995			

Electric Operations	\$ 4,512.6	\$ --	\$ 4,512.4
Natural Gas Transmission	1,480.3	53.1	1,533.4
Energy Services			
Trading and Marketing	1,818.3	28.4	1,866.7
Field Services	1,607.1	184.3	1,791.4
Global Asset Development	75.3	4.0	79.3
Other Energy Services	94.5	0.8	95.3
Energy Services' Eliminations	--	(216.9)	(216.9)
Total Energy Services	3,615.2	0.6	3,615.8
Other Operations	86.8	(53.7)	33.1
Total Consolidated	\$ 9,694.7	\$ --	\$ 9,694.7

	Operating Income	Earnings Before Interest & Taxes	Depreciation & Amortization
In Millions			
1997			
Electric Operations	\$ 1,180.3	\$ 1,281.8	\$ 497.8
Natural Gas Transmission	507.7	624.4	229.6
Energy Services			
Trading and Marketing	42.7	44.4	7.0
Field Services	156.7	157.0	71.4
Global Asset Development	(5.4)	4.5	8.7
Other Energy Services	23.2	18.2	5.9
Energy Services' Eliminations	--	--	--
Total Energy Services	216.2	224.1	92.9
Other Operations	(34.2)	(22.2)	20.7
Total Consolidated	\$ 1,970.0	\$ 2,108.1	\$ 841.0
1996			
Electric Operations	\$ 1,303.6	\$ 1,419.5	\$ 481.1
Natural Gas Transmission	583.8	595.5	228.2
Energy Services			
Trading and Marketing	56.3	57.9	3.8
Field Services	149.4	151.6	58.7
Global Asset Development	(1.2)	--	6.9
Other Energy Services	19.9	30.0	3.5
Energy Services' Eliminations	--	--	--
Total Energy Services	224.4	229.5	72.9
Other Operations	46.8	49.7	7.2
Total Consolidated	\$ 2,158.6	\$ 2,294.2	\$ 789.4
1995			
Electric Operations	\$ 1,398.7	\$ 1,381.2	\$ 451.2
Natural Gas Transmission	562.3	567.6	228.5
Energy Services			
Trading and Marketing	30.0	17.1	2.3
Field Services	96.8	106.1	40.3
Global Asset Development	24.9	26.8	6.8
Other Energy Services	23.6	23.7	8.8
Energy Services' Eliminations	--	--	--
Total Energy Services	185.3	173.7	50.2
Other Operations	32.0	68.0	7.2
Total Consolidated	\$ 2,068.3	\$ 2,190.5	\$ 737.1

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DUKE ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 4. BUSINESS SEGMENTS -- Continued

Capital and Investment Expenditures			Identifiable Assets	
1997	1996	1995	1997	1996

In Millions

Electric Operations	\$ 742.5	\$ 609.8	\$ 704.0	\$ 12,958.5	\$ 12,644.8
Natural Gas Transmission	247.3	194.0	230.5	5,088.9	5,216.4
Energy Services					
Trading and Marketing	17.9	6.6	15.3	1,857.3	1,403.5
Field Services	156.5	530.8	187.2	1,979.8	1,769.4
Global Asset Development	348.3	34.8	53.5	987.6	522.3
Other Energy Services	47.2	39.1	1.0	223.2	130.1
Energy Services' Eliminations	--	--	--	(169.1)	(247.0)
Total Energy Services	569.9	611.3	257.0	4,878.8	3,578.3
Other Operations	467.8	134.9	99.2	1,102.6	946.3
Total Consolidated	\$ 2,027.6	\$ 1,550.0	\$ 1,290.7	\$ 24,028.8	\$ 22,366.2

NOTE 5. REGULATORY MATTERS

Electric Operations. The NCUC and the PSCSC approve rates for retail electric sales within their respective states. The FERC approves the Corporation's rates for electric sales to wholesale customers. Electric sales to the other joint owners of the Catawba Nuclear Station (Catawba), which represent a substantial majority of the Corporation's electric wholesale revenues, are set through contractual agreements.

In 1997, the Corporation signed stipulation agreements with the NCUC and the PSCSC as a result of the merger in which the Corporation agreed to cap the base electric rates at existing levels through 2000, with very limited exceptions, for retail customers. The Corporation also signed an agreement with the FERC to freeze rates, except for the market-based rates, for the Corporation's transmission and wholesale electric sales. In addition, the Corporation signed agreements with the other joint owners of Catawba providing for a cap on the rates charged under interconnection agreements and on the reimbursement of certain costs related to administration and general expenses and general plant costs under operation and fuel agreements. Management is of the opinion that these agreements will not have a material adverse effect on the consolidated results of operations or financial position of the Corporation.

Fuel costs are reviewed semiannually in the wholesale jurisdiction and annually in the South Carolina retail jurisdiction, with provisions for changing such costs in base rates. In the North Carolina retail jurisdiction, a review of fuel costs in base rates is required annually and during general rate case proceedings. All jurisdictions allow the Corporation to adjust electric rates for past over- or under-recovery of fuel costs. Therefore, the Corporation reflects in revenues the difference between actual fuel costs incurred for electric operations and fuel costs recovered through rates. The stipulation agreements related to the merger do not apply to the fuel cost adjustments.

The PSCSC, on May 7, 1996, ordered a rate reduction in the form of a decrement rider of 0.432 cents per kilowatt-hour, or an average of approximately 8 percent, affecting South Carolina retail customers. South Carolina retail sales represent approximately 30 percent of the Corporation's total regulated electric sales. The rate reduction was reflected on bills rendered on or after June 1, 1996. This net decrement rider reflects an interim true-up decrement adjustment associated with the levelization of Catawba purchased capacity costs and an interim true-up increment associated with amortization of the demand-side management deferral account. The rate adjustment was made because, in the South Carolina retail jurisdiction, cumulative levelized revenues associated with the recovery of Catawba purchased capacity costs had exceeded purchased capacity payments and accrual of deferred returns, and certain demand-side costs had exceeded the level reflected in rates.

Certain of the Corporation's electric wholesale customers, excluding the other Catawba joint owners, initiated proceedings in 1995 before the FERC concerning rate related matters. The Corporation and nine of its eleven wholesale customers entered into a settlement in July 1996 which reduced the customers' electric rates by approximately 9 percent and renewed their contracts with the Corporation through 2000. Both of the customers that did not enter into the settlement have signed

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DUKE ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 5. REGULATORY MATTERS -- Continued

agreements and have begun purchasing electricity from other suppliers in 1997. Early in 1998, the Corporation reached agreements, subject to FERC approval, with both of these former customers to recover the stranded costs incurred to serve these customers. Management is of the opinion that these agreements will not have a material adverse impact on the consolidated results of operations or financial position of the Corporation.

Natural Gas Operations.

FERC Order 636 and Natural Gas Transition Costs. The Corporation's interstate natural gas pipelines primarily provide transportation and storage services pursuant to FERC Order 636. Order 636 allows pipelines to recover eligible costs resulting from implementation of the order (transition costs). In 1994, the FERC approved TETCO's settlement resolving regulatory issues related primarily to Order 636 transition costs and a number of other issues related to services prior to Order 636. TETCO's liability for transition costs is estimated based on the amount of producers' natural gas reserves and other factors. TETCO's final and nonappealable settlement provides for the recovery of certain of these transition costs from customers through volumetric and reservation charges through 2002 and beyond, if necessary. Pursuant to the settlement, TETCO will absorb a certain portion of the transition costs, the amount of which continues to be subject to change dependent upon natural gas prices and deliverability levels. In 1995, based upon producers' discoveries of additional natural gas reserves, TETCO increased the estimated liabilities for transition costs by \$125.8 million. Under the terms of the existing settlement, regulatory assets were increased \$85.8 million for amounts expected to be collected from customers and TETCO recognized a \$40 million charge to operating expenses (\$26 million after tax).

On July 16, 1996, the U.S. Court of Appeals for the District of Columbia upheld, in general, all aspects of Order 636 and remanded certain issues for further explanation. One of the issues remanded for further explanation is whether pipelines should be entitled to recover 100% of gas supply realignment (CSR) costs. This matter is substantially mitigated by TETCO's transition cost settlements.

The Corporation believes the exposure associated with gas purchase contract commitments is substantially mitigated by transition cost recoveries pursuant to customer settlements, Order 636 and other mechanisms, and that this issue will not have a material adverse effect on consolidated results of operations or financial position of the Corporation.

Jurisdictional Transportation and Sales Rates. On April 1, 1992 and November 1, 1992, PEPL placed into effect, subject to refund, general rate increases. On February 26, 1997, the FERC approved PEPL's settlement agreement which provided final resolution of refund matters and established prospective rates. The agreement terminated other actions relating to these proceedings as well as PEPL's restructuring of rates and transition cost recoveries related to FERC Order 636. The settlement will not have a material impact on future operating revenues or financial position of the Corporation.

As a result of the resolution of these and certain other proceedings, PEPL recorded earnings before interest and taxes of \$12.7 million, \$8 million, and \$20.6 million in 1997, 1996, and 1995, respectively.

NOTE 6. JOINT OWNERSHIP OF GENERATING FACILITIES

The Corporation previously sold interests in both units of Catawba. The other owners of portions of Catawba and supplemental information regarding their ownership are as follows:

Owner	Ownership Interest in the Station
North Carolina Municipal Power Agency Number 1 (NCMPA)	17.5%
North Carolina Electric Membership Corporation (NCEMC) ..	28.125%
Piedmont Municipal Power Agency (PMPA)	12.5%
Saluda River Electric Cooperative, Inc. (Saluda River) ..	9.375%

Each owner has provided its own financing for its ownership interest in Catawba.

The Corporation retains a 12.5 percent ownership interest in Catawba. As of December 31, 1997, \$507.8 million of Property, Plant and Equipment represented the Corporation's investment in Units 1 and 2. Accumulated depreciation and

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- Continued

NOTE 6. JOINT OWNERSHIP OF GENERATING FACILITIES -- Continued

amortization of \$198.3 million associated with Catawba was recorded as of year-end 1997. The Corporation's share of operating costs of Catawba is included in the Consolidated Statements of Income.

In connection with the joint ownership, the Corporation has entered into contractual interconnection agreements with the other joint owners to purchase declining percentages of the generating capacity and energy from the plant. These purchased power agreements were effective beginning with the commercial operation of each unit. Units 1 and 2 began commercial operation in June 1985 and August 1985, respectively. The purchased power agreements were established for 15 years for NCMPA and PMPA and 10 years for NCEMC and Saluda River. While the purchased power agreements with NCMPA and PMPA extend for 15 years, a significant decrease in the percentage of capacity and energy the Corporation is obligated to purchase occurs in the 11th calendar year of operation for each unit. This significant decrease occurred in 1995 for Unit 1 and 1996 for Unit 2.

The interconnection agreements also provide for supplemental power sales by the Corporation to the other joint owners. Such power sales are to satisfy capacity and energy needs of the other joint owners beyond the capacity and energy which they retain from Catawba or potentially acquire in the form of other resources. The agreements further provide the other joint owners the ability to secure such supplemental requirements outside of these contractual agreements following an appropriate notice period. NCEMC and Saluda River have given appropriate notice that they intend to acquire their supplemental capacity requirements outside of these agreements effective January 1, 2001 and January 1, 2002, respectively, thus relieving the Corporation of the obligation to serve this portion of load. In addition, as a result of the merger, the other joint owners of Catawba have the right to end their supplemental capacity requirements as of January 1, 2001 with written notice to the Corporation due by December 31, 1999. As the joint owners retain more capacity and energy from Catawba or a third party, supplemental power sales are expected to decline. Management is of the opinion that this will not have a material adverse effect on the consolidated results of operations or the financial position of the Corporation.

The interconnection agreements with each of the other joint owners include provisions that the Corporation will provide generating reserves to backstand the other joint owners' retained capacity in the Catawba plant at the system average cost of installed capacity. Additionally, the agreements include certain reliability exchanges designed to manage outage-related risks by exchanging energy entitlements between Catawba and the McGuire Nuclear Station, impacting the Corporation as well as all the other joint owners. The agreements also provide the other joint owners the ability to terminate the interconnection agreements in their entirety upon eight years written notice to the Corporation. PMPA has rendered such notice effective January 1, 2006. This termination will relieve the Corporation of the obligation to serve this portion of load as well as provide the reserves associated with PMPA's retained capacity. Management is of the opinion that this will not have a material adverse effect on the consolidated results of operations or the financial position of the Corporation.

Purchased energy cost payments are based on variable operating costs and are a function of the generation output of Catawba. Purchased capacity payments are based on the fixed costs of the plant and include the capital costs and fixed operating and maintenance costs. Actual purchased capacity costs for 1997 and projected obligations through 2000, the last year of the purchase buy-backs, are \$99.8 million, \$72 million, \$52.9 million and \$6.6 million, respectively.

Effective in its November 1991 rate order, the NRCU reaffirmed the Corporation's recovery from retail electric customers, on a levelized basis, of the capital costs and fixed operating and maintenance costs of capacity purchased from the other joint owners. The PSCSC in its November 1991 rate order reaffirmed the Corporation's recovery on a levelized basis of the capital costs of capacity purchased from the other joint owners. Levelization was reaffirmed through inclusion in rates approved in March 1992 by the FERC. The portion of purchased capacity subject to levelization not currently recovered in rates is being deferred, and the Corporation is recording a deferred return on the accumulated balance. The Corporation is recovering the accumulated balance, including the deferred return, when the sum of the declining purchased capacity payments and accrual of deferred returns for the current period drops below the levelized revenues. Jurisdictional levelizations are intended to recover total costs, including deferred returns, and are subject to adjustments, including final true-ups. The Corporation recovers the costs of purchased energy and the non-levelized portion of purchased capacity on a current basis.

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EXHIBIT E



Franchised Electric & Gas Service

Duke Energy offers electric service to approximately 7 million customers in the Carolinas, Florida, Ohio, Kentucky and Indiana, including retail gas service to approximately 500,000 customers in Ohio and Kentucky. Our service area covers approximately 104,000 square miles in the Southeast and Midwest.

Our fleet of power plants generates approximately 49,600 megawatts of electricity from a variety of fuel sources – from hydroelectric to coal, oil and natural gas to nuclear. Learn more about our different operations in the states that we serve.

Duke Energy North Carolina	Duke Energy South Carolina	Duke Energy Ohio	Duke Energy Kentucky	Duke Energy Indiana	Progress Energy Carolinas	Pr
<u>Residential</u> <u>(/north- carolina.asp)</u>	<u>Residential</u> <u>(/south- carolina.asp)</u>	<u>Residential</u> <u>(/ohio.asp)</u>	<u>Residential</u> <u>(/kentucky.asp)</u>	<u>Residential</u> <u>(/indiana.asp)</u>	<u>Residential (https://www.progress- energy.com/carolinas/home/index.page?)</u>	<u>Reside</u> <u>energy.cc</u>
<u>Business</u> <u>(/north- carolina- business.asp)</u>	<u>Business</u> <u>(/south- carolina- business.asp)</u>	<u>Business</u> <u>(/ohio- business.asp)</u>	<u>Business</u> <u>(/kentucky- business.asp)</u>	<u>Business</u> <u>(/indiana- business.asp)</u>	<u>Business (https://www.progress- energy.com/carolinas/business/index.page?)</u>	<u>Busin</u> <u>energy.com</u>
<u>Large</u> <u>Business /</u>	<u>Large</u> <u>Business /</u>	<u>Large</u> <u>Business /</u>	<u>Large</u> <u>Business /</u>	<u>Large</u> <u>Business /</u>	<u>Large Commercial, Industrial & Government (https://www.progress- energy.com/carolinas/business/commercial- industrial-governmental/index.page?)</u>	<u>Large</u> <u>Govern</u> <u>energy.com</u>
<u>Commercial /</u> <u>Industrial</u> <u>(/north- carolina-large- business.asp)</u>	<u>Commercial /</u> <u>Industrial</u> <u>(/south- carolina-large- business.asp)</u>	<u>Commercial /</u> <u>Industrial</u> <u>(/ohio-large- business.asp)</u>	<u>Commercial /</u> <u>Industrial</u> <u>(/kentucky- large- business.asp)</u>	<u>Commercial /</u> <u>Industrial</u> <u>(/indiana- large- business.asp)</u>		

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EXHIBIT F

**FERC**

FEDERAL ENERGY REGULATORY COMMISSION

Electric

FERC is responsible for regulating interstate transmission rates and services, wholesale energy rates and services, corporate transactions, mergers, and securities issued by public utilities.

Hydropower

FERC is responsible for licensing of nonfederal hydroelectric projects, overseeing related environmental matters, and inspecting nonfederal hydropower projects for safety conditions and compliance with license terms and conditions.

Natural Gas

FERC is responsible for regulating interstate transportation rates and services for natural gas pipelines, the construction of natural gas pipelines, and overseeing related environmental matters.

Oil

FERC is responsible for regulating interstate transportation rates and services of crude oil and petroleum products.

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G



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EXHIBIT G



Public Service Commission of South Carolina

Accountability Report

Fiscal Year 2010-2011

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Section I – Executive Summary

- **Mission and values:**

The Public Service Commission of South Carolina regulates the rates and services of investor owned public utilities in the state of South Carolina and establishes just and reasonable standards for their rates and services.

The mission of the Public Service Commission is to serve the public by providing fair, open, and effective regulation of the state's public utilities through the faithful administration of the law and the regulatory process.

- **Major achievements for 2010-2011**

A main focus for the Commission during the 2010-2011 fiscal year was identifying emerging issues within the regulated industries and engaging in discussions with members of the regulated community on these issues. With new developments on the federal level concerning transmission and renewable energy sources, and proposed new EPA regulations and FCC rulings on the horizon, the Commission desires to be proactive in response to issues that affect the entities they regulate. Over the course of the year, the Commission held over twenty-seven allowable ex parte meetings and workshops to stay abreast of emerging issues. Topics included "Emerging and Foundational Issues in the Electric Utility Sector," "Settlement Policy and Procedure," "South Carolina Natural Gas Research and Development Essentials," and "Issues Related to Renewable Energy Sources" (Table 7.2-1, pages 23 and 24). These hearings were open to the public, and notices were posted on the Commission's website.

The Commission also desired to provide consumers with more information concerning the regulatory process to aid in fulfillment of its mission in providing a forum for fair, open, and effective regulation. In collaboration with practitioners, the Commission developed an online form for use by the public to file a letter of protest against a utility. The form standardizes the process, and ensures that the necessary information is included with the protest. Also, in collaboration with its customers and stakeholders, the Commission made enhancements to its website to improve the display of information and functionality. In addition, the Commission's website was updated to add educational information for consumers on the regulatory process, energy efficiency and demand side management, and net metering.

The Commission continued to attain leadership positions on the national level furthering the professional development of the Commission. PSC commissioners held chairmanships of three National Association of Regulatory Utility Commissioners (NARUC) committees and one subcommittee this year, and four commissioners served on the NARUC Board of Directors. Commissioner David Wright was elected as the First Vice President of NARUC. He will assume the presidency of the organization in the fall of 2011. Several commissioners were appointed to key strategic federal panels and committees. These positions ensure that South Carolina and the Southeast's positions are represented on national issues such as transmission in the Eastern Interconnection, smart grid, gas pipeline safety, and broadband expansion (Table 1.7-1, pages 11 and 12).

During the 2010-2011 fiscal year, the Commission presided over and ruled on several significant cases in the telecommunications and electric industries. These cases involved

rulings on the federal and state universal service funds and expenses related to the expansion of nuclear energy production at Duke Energy Carolinas, LLC and South Carolina Electric & Gas Company facilities.

The following paragraphs are summaries of the Commission's most significant cases for FY 2010-2011:

- In accordance with the Base Load Review Act, South Carolina Electric & Gas Company (SCE&G) sought approval for updates and revisions to schedules related to the construction of Units 2 and 3 at the V.C. Summer Nuclear Station near Jenkinsville, SC. The revisions included the removal of approximately \$438 million in owner's contingency funds that were included in the cost schedules previously approved by the Commission, but reversed on appeal by the South Carolina Supreme Court, and the addition of \$174 million for construction of the units. As a result of these updates and revisions, the capital cost of the units in 2007 dollars was reduced to approximately \$4.3 billion, and gross capital costs were reduced to approximately \$5.8 billion.
- Duke Energy Carolinas, LLC (Duke) filed for approval to incur additional pre-construction costs of \$229 million through December 31, 2013, for the Lee Nuclear Station in Cherokee County, SC. In an amended application, Duke sought approval of nuclear generation preconstruction expenditure of no more than \$75 million during the period January 1, 2011 through June 30, 2012. All parties, with the exception of one, agreed that this was the minimum amount estimated to be necessary to keep the nuclear option available and signed a settlement agreement. The Commission concurred and approved the settlement agreement.
- AT&T filed complaints against several competing telecommunications companies. These complaint cases centered on the interpretation and application of Sections 251 and 252 of the Telecommunications Act of 1996. At issue is how promotional programs and discounts are to be treated. The resolution of these complaints will establish criteria for interpreting a significant portion of the remedies contained in Sections 251 and 252 and the FCC regulations regarding those sections. A ruling is pending in these cases.
- Allied Wireless Communications Corporation d/b/a Alltel filed its application for designation as an Eligible Telecommunications Carrier (ETC) to serve both rural and nonrural areas in South Carolina. The FCC is currently revising the federal Universal Service Fund (USF) and plans to have these revisions completed by the end of 2011. Any revisions to the existing federal USF could have a great impact on how much federal USF funding will be available to South Carolina, how many ETCs are to be designated, the criteria upon which ETC designation will be determined, and what services the federal USF will support. The Commission ruled to hold in abeyance a ruling on Alltel's application until at least the end of 2011 to allow time for the FCC to finalize its revision of the federal USF.
- The South Carolina Cable Television Association (SCCTA) filed a petition seeking to transition the Interim Local Exchange Carrier (ILEC) Fund into the South Carolina Universal Service Fund (SCUSF). At oral arguments, the SCCTA argued that the ILEC Fund must transition into the SCUSF when funding for the SCUSF is

finalized and adequate to support the obligations of the ILEC Fund. Other parties argued that the SCUSF must be consistent with the federal USF which is currently being revised by the FCC. The Commission denied the petition of the SCCTA finding that the SCUSF, at this time, was neither finalized nor sufficient to support the obligations of the ILEC Fund, and, thus, the ILEC Fund should not be transitioned into the SCUSF.

- **Key strategic goals for present and future years:**

The Commission must be alert to and anticipate emerging issues in the industries it regulates, including federal regulatory developments. Maintaining effective communications with its customers and participation in national organizations integrated into the utility sectors will aid in achieving this goal.

The Commission will continue to improve its hearing procedures so as to provide the public with accessible, transparent, and effective regulation of public utilities and provide the public with clear information about the regulatory process and its decisions.

An on-going goal of the Commission is to improve its operations through technological advances. As opportunities are identified, the Commission will investigate the costs and benefits and take the appropriate actions.

- **Key strategic challenges:**

The nation's electric and gas industries are subject to a broad range of regulatory models across the country, and regulators have taken a number of measures to increase competition and investment. And with growing pressure for the generation of energy using alternative energy sources, the Commission must effectively regulate these industries, safeguarding the ratepayers, without unduly burdening the industries or stifling competition.

The public relies on the Commission's online systems to access information related to its operations. The Commission must budget funds to support maintenance and development of the systems.

The water and sewer industries are also faced with stricter environmental regulations, as well as the rising cost of water itself, which is often purchased from third party providers and distributed to the customer by the utilities, and can lead to increased operating expenses.

Another key strategic challenge that faces the Commission is the need to maintain an effective regulatory environment without unnecessarily impeding change in a dynamic marketplace.

- **How the accountability report is used to improve performance:**

The Accountability Report is used in conjunction with the agency's strategic plan, which is developed under the guidance of the State Regulation of Public Utility Review Committee (PURC), to measure organizational performance and gauge overall progress in fulfilling the organization's mission and objectives.

Section II – Organizational Profile

- **Main products and services and primary methods by which these are delivered:**

The PSC serves as a quasi judicial body charged with the adjudication of cases involving the state's investor owned utilities that provide electric, gas, telecommunications, water, sewer, and various transportation services to the citizens of South Carolina. As such, it is the Commission's duty to accept all filings, pleadings, testimony, etc. that are associated with cases presented before the Commission and to rule on such cases in the form of issuance of orders. These orders put into full force and effect rulings on:

- Rates and schedules
- Certificates of operation for telecommunications companies and transportation carriers
- Consumer complaints
- Service issues
- Territorial assignments of regulated utilities
- Telecommunications interconnection agreements
- Prudency reviews of electric and gas utilities' fuel purchasing practices
- Arbitration of disputes involving certain federal statutes, such as the Federal Telecommunications Act of 1996
- Reviews of allowable costs for Chem-Nuclear Systems, LLC
- Standards under the federal Energy Policy Act of 2005
- Siting and financing for generating facilities

The Commission's Docket Management System (DMS), an on-line case management system (<http://dms.psc.sc.gov>), maintains the documents and events associated with a case. Hearings on cases are held before the commissioners (below), and decisions are issued from the bench at the weekly public Commission Agenda Meetings. Orders are subsequently issued to the parties of record in the cases (Chart 7.1-1, page 21).



Commission Bench During a Hearing

- **Key customers and their key requirements/expectations:**

As a regulatory agency, the key customers of the Public Service Commission are the utilities subject to the jurisdiction of the Commission and the public who are served by these regulated utilities. The statutory mandate of the Public Service Commission is to ensure that the rates charged by the utilities are just and reasonable. The Commission also ensures that service quality standards are maintained and that utility customers are treated fairly.

- **Key stakeholders:**

The regulations and rulings of the Commission directly impact other state agencies such as the Office of Regulatory Staff (ORS). In addition, NARUC, the Southeastern Association of Regulatory Utility Commissioners (SEARUC), the Federal Energy Regulatory Commission (FERC), the North American Electric Reliability Council (NERC), the Eastern Interconnection Planning Council (EIPC), and the Universal Service Administrative Company (USAC) benefit from the Commission's involvement with these organizations. The State Regulation of Public Utility Review Committee is the joint legislative committee charged with the oversight of the Commission as a result of Act 175.

- **Key suppliers and partners:**

The Commission employs the services of software designers to develop, enhance, and maintain its online systems, and a network support specialist to maintain its network software in conjunction with the Commission's information technology staff.

- **Operation location:**

The Public Service Commission's office is located on the first floor of the Saluda Building in the Synergy Business Park in Lexington County. The street address is 101 Executive Center Drive, Suite 100, Columbia, SC 29210.

- **Employment statistics:**

In FY 2010-2011, the Public Service Commission had thirty-eight classified full time equivalent positions, one temporary employee, one grant position, and one contract position.

- **Regulatory environment under which organization operates:**

The Commission regulates investor-owned electric, natural gas, telecommunications, water, and wastewater utilities for which numerous federal, state and local regulations exist. The Commission also regulates the transportation of passengers, household goods, and hazardous waste, which must conform to various safety and market regulations in order to obtain certificates of public convenience and necessity allowing them to operate in South Carolina. Finally, the Commission determines the allowable costs for Chem-Nuclear Systems, LLC, a regional low-level radioactive waste disposal facility located in Barnwell, South Carolina.

Most Commission orders may be appealed to the state Supreme Court. In addition, the Commission has some overlapping jurisdiction with federal entities such as the FCC, FERC, and NERC.

- **Performance improvement systems:**

The Commission currently records and monitors on a monthly basis several key inputs and outputs in its docket processing system. These key identifiers such as new dockets, hearings, directives, orders and electronic filings assist management in allocating resources to meet demands (Charts 7.1-1 thru 7.1-4, and 7.2-2 thru 7.2-4, pages 21-26).

Activity related to agency Hearing Officers and Hearing Examiners is also tracked to ensure that this component of the Commission is utilized whenever possible to improve the timeliness of proceedings. For the past several years, there has been a steady increase in the number of rulings made through these Commission Staff appointments – one indicator of the increasing efficiency with which the Commission resolves complaints and applications (Chart 7.1-5, page 23).

The State Regulation of Public Utilities Review Committee serves as the joint legislative committee that oversees the operations of the Commission as a result of Act 175. The committee is chaired by Senator Thomas Alexander, with Representative William Sandifer serving as vice chairman. Other legislative members are Senators Bradley Hutto and Luke Rankin, and Representatives Michael Forrester and Harry Ott. In addition, there are four members from the public sector, namely, Elizabeth Atwater, Erik Ebersole, John Simmons, and Helen Zeigler that also serve on the committee. Each year the Commission develops objectives and action plans and reports on the results to the committee. These objectives are in line with the Commission's strategic plan and goals and are the framework against which the agency's performance is evaluated.

An external system is also employed which features customer satisfaction surveys to identify areas of concern and improvement with respect to operations, timeliness, and quality of service. This year, members of the practicing legal community that participate in hearings at the Commission and members of the public sector were surveyed on a variety of topics, including satisfaction with the Commission's online systems, prefile testimony guidelines, and the role of hearing examiners and officers at the Commission. Results of the surveys are studied to determine areas of improvement.

At least twice a year, the Commission has meetings with its Advisory Committee, which consists of more than thirty members from the legal community who regularly practice before the Commission (Figure 3.6-2, page 15). Discussions center on operations and regulations, suggestions for improvement, and feedback on the Commission's priorities and objectives.

Organizational structure:

The Public Service Commission is comprised of a seven member board elected by the General Assembly for four year terms, representing each congressional district plus an at-large member.

Public Service Commission of South Carolina

	Commissioner John E. "Butch" Howard Charleston, SC Representing District 1 Term Expires June 30, 2012		Commissioner David A. Wright Columbia, SC Representing District 2 Term Expires June 30, 2014
	Commissioner Randy Mitchell Saluda, SC Representing District 3 Term Expires June 30, 2012		Commissioner Elizabeth B. "Lib" Fleming Spartanburg, SC Representing District 4 Term Expires June 30, 2014
	Commissioner G. O'Neal Hamilton Bennettsville, SC Representing District 5 Term Expires June 30, 2012		Commissioner Nikiya "Nikki" Hall Columbia, SC Representing District 6 Term Expires June 30, 2014
	Commissioner Swain E. Whitfield Blythewood, SC At-Large Representative Term Expires June 30, 2012		Chief Clerk/Administrator Jocelyn G. Boyd Columbia, SC

The Chief Clerk and Administrator manages the day-to-day operations of the Commission. Four departments, Administrative, Clerk's Office, Legal, and Advisory Staff, perform the daily duties of the Commission. All departments have a manager reporting directly to the Chief Clerk.

• **Expenditures/Appropriations Chart:**

Actual expenditures for fiscal years 2009-2010 and 2010-2011, and appropriations for 2011-2012 are shown in the following chart. The utilities regulated by the Public Service Commission are assessed to provide funding for the Commission. The Commission was the recipient of a grant from the American Recovery and Reinvestment Act of 2009 (ARRA). The grant will be used to fund activities at the Commission, ORS, and PURC.

Major Budget Categories	FY 09-10 Actual Expenditures		FY 10-11 Actual Expenditures		FY 11-12 Appropriations Act	
	Total Funds	General Funds	Total Funds	General Funds	Total Funds	General Funds
Personal Service	\$ 2,693,903		\$ 2,685,526		\$ 3,045,395	
Other Operating	\$ 698,686		\$ 913,120		\$ 902,545	
Special Items						
Permanent Improvements						
Case Services						
Distributions to Subdivisions						
Fringe Benefits	\$ 683,722		\$ 747,666		\$ 846,368	
Non-recurring						
Total	\$ 4,076,311		\$ 4,346,312		\$ 4,792,308	

• Major Program Areas Chart:

Program Number and Title	Major Program Area Purpose (Brief)	FY 09-10 Budget Expenditures	FY 10-11 Budget Expenditures	Key Cross References for Financial Results
Administrative Department	Provides administrative support and direction to ensure consistency, compliance, financial integrity and fulfillment of the agency's mission.	State: Federal: Other: \$ 2,326,523 Total: \$ 2,326,523 % of Total Budget: 57%	State: Federal: Other: \$ 2,116,143 Total: \$ 2,116,143 % of Total Budget: 49%	Chart 7.2-3 Chart 7.2-4 Chart 7.5-1
Clerk's Office	Processes all legal documents that are filed with the Commission. Creates and mails all notices of filings. Processes public inquiries. Prepares and maintains all hearing documents.	State: Federal: Other: \$ 694,479 Total: \$ 694,479 % of Total Budget: 17%	State: Federal: Other: \$ 675,089 Total: \$ 675,089 % of Total Budget: 15%	Chart 7.1-1 Chart 7.1-4 Chart 7.2-2 Chart 7.2-3 Chart 7.5-1 Table 7.6-1
Legal Department	Advises the Commission regarding pending cases. Drafts legal documents.	State: Federal: \$ 5,445 Other: \$ 581,517 Total: \$ 586,962 % of Total Budget: 14%	State: Federal: \$ 339,646 Other: \$ 660,712 Total: \$ 1,000,358 % of Total Budget: 23%	Chart 7.1-1 Chart 7.1-2 Chart 7.1-3 Chart 7.1-5 Table 7.4-1 Table 7.6-1
Office of Advisory Staff	Provides technical advice to the commissioners and staff.	State: Federal: \$ 6,882 Other: \$ 461,465 Total: \$ 468,347 % of Total Budget: 12%	State: Federal: Other: \$ 554,724 Total: \$ 554,724 % of Total Budget: 13%	Chart 7.1-1 Table 7.4-1 Chart 7.4-2
Below: List any programs not included above and show the remainder of expenditures by source of funds.				
	Remainder of Expenditures:	State: Federal: Other: Total: % of Total Budget:	State: Federal: Other: Total: % of Total Budget:	

Section III – Elements of Malcolm Baldrige Award Criteria

Category 1 – Senior Leadership, Governance, and Social Responsibility

The Public Service Commission performs an annual exercise of developing performance measures in the areas that are critical to the successful operation of the agency. Under direction of PURC, key performance goals and action items are identified. These goals and action items translate into the Commission's performance measurement system which guides the agency in the management of its processes.

Senior leaders (i.e. the Commission and its professional staff) set, deploy, and ensure two-way communication for short and long term direction and organizational priorities through the performance measurement process described above. Senior leaders regularly review the progress on the action items established in the performance measurement process. PURC reviews the performance measures on a yearly basis as well.

The goals developed in the performance measurement process reflect the values by which the Commission operates: fairness in its decision-making, aspiring to professional excellence, and providing value and accountability to the citizens of South Carolina.

The Commission encourages individual contribution to performance and operations improvements and rewards such contributions through its newly restructured Employee Recognition Program (Shout Out!). Developmental and agency training needs are identified by senior management, and as deficiencies are identified, solutions are developed to provide the necessary instruction.

Senior leadership fosters ethical behavior by attending an annual ethics seminar, publishing a periodic newsletter that addresses ethics issues, and the designation of in-house personnel to resolve issues that arise in the day to day operations. The Commission adheres to the SC Code of Judicial Conduct, the State Ethics Laws, and Title 58 of the South Carolina Code of Laws in its operations. This year's annual ethics training featured a distinguished panel including Senator Bradley Hutto, Cathy Hazelwood, General Counsel of the State Ethics Commission, Dean Robert Wilcox from the University of South Carolina School of Law, and The Honorable Thomas Cooper, Jr., a retired circuit court judge.

Senior leaders promote a focus on customers and other stakeholders by utilizing the Commission's Advisory Committee in a series of forums that address operations and procedures at the Commission, independent surveys of parties that practice before the Commission, and soliciting customer feedback through online surveys. The Commission also desires to provide consumers with more information concerning the regulatory process to aid in fulfillment of its mission in providing a forum for fair, open, and effective regulation.

The Commission addresses the current and potential impact on the public with respect to its services, facilities, and operations by conducting hearings that are open to the public. In these hearings, public comment is both requested and desired. In addition, the companies that are under jurisdiction of the Commission must publish notices in local media concerning changes to their operations as mandated by the Commission's regulations.

Public hearings and workshops are also held to inform the public of emerging utility issues in the industries regulated by the Commission. Some of the topics from this year's workshops include "Hazardous Waste Transportation in the United States," "Issues Related to Renewable Energy

Sources," "An Update on Construction of New Nuclear Units at V.C. Summer Nuclear Station," and "Improvements Within Regulated Water Companies in South Carolina."

Senior leaders maintain fiscal, legal, and regulatory accountability through regular communication with PURC. The Commission's budget must be reviewed by PURC prior to submission for approval from the General Assembly.

Senior leaders regularly review the progress on the action items that were established in the performance measures development process. In addition, key statistics related to operations are reported and tracked on a monthly basis.

The performance measurement process defines the organizational values for the Commission, and the developed action items provide a means to meet the goals established for the Commission. Senior leadership improves its own effectiveness by identifying areas where additional knowledge and skills are required in order to meet the objectives in the performance measurement system.

The commissioners of the Public Service Commission are elected by the General Assembly. The chairman and the senior staff work to promote and educate future organizational leaders by identifying programs that will cultivate the skills necessary to lead the agency. PSC commissioners held chairmanships of three NARUC committees and one subcommittee this year, and as a result of their leadership positions, organized and led many of the NARUC national meetings. Commissioner David Wright was elected as the First Vice President of NARUC. He will assume the presidency of the organization in the fall of 2011. Four PSC commissioners served on the NARUC Board of Directors during this past year. Several commissioners were appointed to key strategic federal panels and committees. Below is a listing of the positions held by the Commission:

Commissioner Leadership Positions 2010-2011

Commissioner Howard District 1	Chairman Board Member Director Member Member	NARUC Committee on Water NARUC Board of Directors NARUC Utility Rate School Water Research Foundation's Public Council on Drinking Water Research Department of Homeland Security/EPA Water Sector Government Coordinating Council
Commissioner Wright District 2	First Vice President Chairman Member Member Chairman Board Member Board Member Member	NARUC Executive Committee and Board of Directors NARUC Subcommittee on Nuclear Issues and Waste Disposal NARUC Washington Action Committee NARUC Committee on Electricity Nuclear Waste Strategy Coalition Advisory Board of the Institute of Public Utilities at Michigan State University Electric Power Research Institute (EPRI) Keystone Energy Board

Commissioner Mitchell District 3	Member Member Vice Chairman Vice Chairman Board Member	NARUC Committee on Telecommunications FCC & NARUC Advanced Services Conference NARUC Special Access Study Committee NARUC Committee on Critical Infrastructure Universal Service Administrative Company (USAC)
Commissioner Fleming District 4	Chair Board Member Member Secretary Member Member Member	NARUC Committee on Critical Infrastructure NARUC Board of Directors NARUC Committee on Electricity Eastern Interconnection States Planning Council Executive Committee Eastern Interconnection Planning Council Stakeholders Steering Council White House Smart Grid Working Group Advisory Council for the Center for Public Utilities at New Mexico State University
Commissioner Hamilton District 5	Chairman Board Member Member Member Member	NARUC Committee on Gas NARUC Board of Directors NARUC Subcommittee on Nuclear Issues and Waste Disposal National Petroleum Council Advisory Board Gas Technology Institute
Commissioner Hall District 6	Member Member	NARUC Committee on Energy Resources and the Environment NARUC Utility Marketplace Access Subcommittee
Commissioner Whitfield At-Large	Member Member Member	NARUC Committee on Critical Infrastructure NARUC Committee on Gas NARUC Pipeline Safety Task Force

Table 1.7-1 Commissioner Leadership

Senior leaders use the performance measurement process to create an environment for performance improvement and accomplishment of strategic objectives.

Senior leadership recognizes the importance of staying up to date in all areas of the regulatory process in this fast changing and volatile environment. Members of the Commission and staff regularly attend training sessions (conferences, workshops, webinars, etc.) on emerging issues within the industries regulated by the Commission (Table 7.2-1, page 24 and Table 7.4-1, page 27). They encourage the workforce to seek additional knowledge and training when required.

Senior leadership interacts with the entire workforce through the work processes. High performance is recognized and rewarded using an employee recognition program, which was restructured during this past year to allow more opportunities for recognition at all organizational levels. Formal recognition by senior management is made on a quarterly basis, with informal recognition taking place on an as needed basis.

The Commission's senior leadership actively supports and strengthens the communities in which the agency operates by volunteering their time and donating their resources to numerous civic organizations. Some of the recipients are the Harvest Hope Food Bank, the United Way, Rotary Clubs, Ruritan Clubs, the Irmo-Chapin Recreation Commission, the American Red Cross, the American Cancer Society, and the Colorectal Cancer Action Committee.

Category 2 - Strategic Planning

The regulatory climate today is dynamic and can be best addressed through a proactive regulatory process that reflects the increased competitive nature of the companies within the nation and the state, while seeking to best serve the needs of all of the citizens of the state.

PURC serves as the joint legislative committee that oversees the operations of the Commission as a result of Act 175. Senior management, with input from the Commission's Advisory Committee, develops the strategic plan and implementation process, which is presented to PURC for final approval.

Our strategic planning process addresses our organization's strengths, weaknesses, opportunities, and threats by identifying those areas that are critical to the successful operation of the agency and the systems that must be in place and function at optimum performance to achieve our goals. Those critical operations are functions performed by the clerk's office related to filings of matters and service of orders, hearings conducted by the commissioners, and the legal and advisory staff's advice to the Commission and assistance in drafting orders. Senior management is involved in the day to day operations of these functions and is able to make necessary adjustments to meet goals. PURC oversees the operations at the Commission and recommends objectives that need to be met in order to comply with regulations.

The public utility arena has become increasingly competitive over the last decade with the introduction of deregulation on both the federal and state levels. With new developments on the federal level concerning transmission and renewable energy sources, and proposed new EPA regulations and FCC rulings on horizon, the Commission desires to be proactive in response to issues that affect the entities they regulate. This is done through the Commission's affiliation with NARUC and SEARUC and their partnered organizations, and attendance at educational functions (conferences, seminars, webinars, etc.). To keep informed of potential legislation or court rulings on the federal or state level that would impact the Commission, an alert system is in place to notify senior leadership and includes an internal electronic discussion board (blog).

The Commission is continually striving to maintain cutting edge technology with respect to its operations. As new technology becomes available, the information technology staff investigates its potential benefits and makes recommendations to senior management.

With the guidance of PURC and input from the Commission's Advisory Committee, action plans are identified and developed by senior management so that the critical operations of the Commission will have the necessary resources to function at optimum performance. These resources may be human, systematic or technological. Senior management oversees the day to day critical operations of the Commission and is able to allocate resources to meet the demands.

Strategic objectives, action plans, and related performance measures are communicated and deployed throughout the agency through senior management at weekly, monthly, and quarterly meetings.

Progress is measured on action plan items by means of periodic update sessions with senior management. New tasks and additional resources are assigned, if necessary, at these meetings to ensure that the action item continues on track.

Evaluation and improvement of the strategic planning process requires senior management's knowledge of the short and long term goals for the agency coupled with the results from the performance measurement program and input from customers and key stakeholders.

Key strategic objectives and action plans are outlined in the following chart:

Strategic Planning

Program Number and Title	Supported Agency Strategic Planning Goal/Objective	Related FY 10-11 and beyond Key Agency Action Plan/Initiative(s) and Timeline for Accomplishing the Plan	Key Cross References for Performance Measures
Administrative Department	The Administrative Department provides administrative support and direction to ensure consistency, compliance, financial integrity, and fulfillment of the agency's mission.	Maintain all personnel-related records; record and file annual reports from regulated companies; provide a variety of information technology support services; handle internal mail distribution, photocopying, and central supplies; publish newsletters and reports; conduct training sessions for staff; develop agency budget; perform financial functions related to the agency such as payroll and general ledger accounting. [2011-2012]	Chart 7.2-3 Chart 7.2-4 Chart 7.5-1
Clerk's Office	The Clerk's Office processes all legal documents that are filed with the Commission. Creates and mails all notices of filings and directives. Schedules hearings before the Commission. Prepares and maintains all hearing documents.	Process all legal documents filed with the agency; prepare notices; maintain accurate and complete files of the Commission's dockets; provide copies of recent and historical Commission orders through the agency's online docket management system (DMS); provide court reporter services and transcripts, provide copies of matters filed in dockets to the public on the DMS; maintain company tariffs; maintain the Order Index System. [2011-2012]	Chart 7.1-1 Chart 7.1-4 Chart 7.2-2 Chart 7.2-3 Chart 7.5-1 Table 7.6-1
Legal Department	The Legal Department provides legal advice to the commissioners and staff, and drafts the oral decisions of the Commission.	Properly set out in writing the decisions of the Commission; provide appropriate consultation to the Commission staff on all laws and regulations pertaining to the utility and transportation industries; attend national and regional conferences related to laws and regulations; review and revise regulations. [2011-2012]	Chart 7.1-1 Chart 7.1-2 Chart 7.1-3 Chart 7.1-5 Table 7.4-1 Table 7.6-1
Office of Advisory Staff	The Office of Advisory Staff provides technical advice to commissioners and staff.	Provide policy input to the commissioners regarding changing and evolving regulations in reference to jurisdictional utilities; develop and present educational seminars to commissioners and staff; attend national and regional conferences related to laws and regulations; interact with external groups such as NARUC, FERC, NRRI, EIPC, etc. via electronic communication and conference calls. Assist in preparation and review of commission's rulings. [2011-2012]	Chart 7.1-1 Table 7.4-1 Chart 7.4-2

Category 3 - Customer Focus

Through strategic planning, our customer and stakeholder groups have been identified as individuals and businesses acquiring the services provided by our regulated utilities, citizens of our state who would be affected by the unsafe operation of utility services, and utilities authorized to operate within the state of South Carolina.

A variety of procedures are employed to determine customer needs, expectations, and satisfaction. These include:

- Workshops/Training Classes
- Generic Proceedings
- Advisory Focus Groups
- Publications/Public Service Announcements/Websites
- Performance Surveys (formal and informal)
- Formal Proceedings



Figure 3.6-1 Attendees at "The Rate Case Experience" Ex Parte Briefing

Through the Commission's formal hearings and meetings and its online public information systems, customers are able to access the information concerning proceedings before the Commission.



Figure 3.6-2 Webmaster Bret Stenhouse discussing new procedure.

The Commission meets with its Advisory Committee to address issues related to its operations and procedures. As in previous meetings, working groups are assembled to assist the Commission in developing solutions to new regulations, procedures, and operations. Members of the Advisory Committee contribute helpful suggestions, and their input is valued and taken into account when changes to operations or procedures are required (Figure 3.6-2).

The Commission developed surveys for use in evaluating and improving its website (www.psc.sc.gov) and online systems (DMS and ETariff). Electronic surveys were sent to members of the public who have made contact with the Commission, and a more detailed electronic survey was sent to members of the Commission's Advisory Committee. Eighty-four percent of the respondents stated that the information on the Commission's website was current and up to date. Results of the survey will be used to identify areas for improvement.

By responding to our customers in a timely fashion and meeting their expectations with respect to service received, whether it is from one of our online systems or direct communication with a staff member, the Commission continually strives to improve its operations. Because the Commission must operate under the Code of Judicial Conduct, the agency is limited in its direct contact with its

customers, but will continue to make improvements to its operations and procedures to provide an environment that leads to healthy customer relations.

Category 4 - Measurement, Analysis, and Knowledge Management

Key performance measures are identified as those functions that are critical to the successful operation of the agency to achieve its goals. Those critical operations are functions performed in the filings of matters and service of orders, hearings conducted by the Commission, and preparation and issuance of orders. Weekly meetings with senior management are held to discuss upcoming filings, hearings, and issues and allocate resources to meet them.

Monthly totals (number of new dockets, filings, hearings, directives, orders, etc.) are collected, analyzed, and reported to senior management. Senior management is involved in the day to day operations of these functions and can adjust workloads to ensure deadlines are being satisfied.

Where available, measures are compared to past trends to assist management in planning future workloads.

Whenever possible, data is collected and reported automatically to ensure its integrity, reliability, and accuracy. In cases where manual collection is required, data is validated to ensure accuracy.

Although job functionality is specific to industry and workload is structured by industry, general cross training of duties does occur to handle the instances of vacations, sick leave, training, etc. Additionally, standardization of operations is performed when applicable. Internal "Best Practices" documents have been developed to assist in this standardization.

Category 5 - Workforce Focus

Workloads are organized and managed according to function. From the time a docket is created, every department at the Commission is actively involved in its filing and disposition. A high level of cooperation exists between departments because of the interdependence in processing a docket. Because of this interdependence, senior management meets weekly to ensure that all departments are working on the same set of short term goals and sharing critical information.

The Commission fills agency vacancies utilizing existing personnel if possible. For recruitment from outside the agency, the Commission partners with the SC Office of Human Resources' E-Recruitment System. A member of senior management is involved in the hiring, orientation, and training of new hires.

In order to adapt to the changing regulatory market, the Commission requires a knowledgeable staff to assist the Commission in adjudicating cases. Developmental and agency training needs are identified by senior management. As deficiencies are identified, solutions are developed to provide the necessary instruction. Individual training requests can be made to develop expertise or knowledge in an area of an employee's job description. Informal evaluations are recorded for training that is performed off-site. Internal "Best Practices" documents have been developed to standardize functions where possible.

The Commission received a grant from the American Recovery and Reinvestment Act of 2009 (ARRA) to ensure that staff has the appropriate technical expertise to process regulatory activities pertaining to ARRA electricity related initiatives such as energy efficiency, demand response management, renewable energy, smart grid, and transmission. The Commission sponsored two seminars in which commissioners and staff members attended. The seminars featured presenters from the Institute of Public Utilities at Michigan State University and the National Regulatory Research Institute (NRRI). Sessions were held on the basics of utility regulation and electricity's current challenges (Figure 5.6-1). The NRRI seminar was open to the public, and nearly one hundred people from the regulatory and legal community, as well as representatives from the electric utility industry, were present. A follow-up seminar on transmission is planned for later in the year.

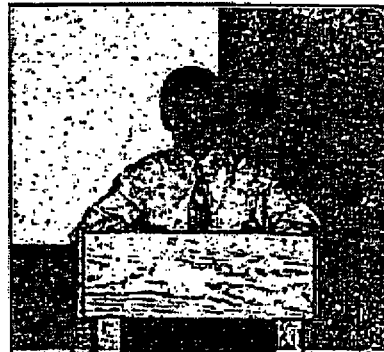


Figure 5.6-1 – NRRI Director Scott Hempling

Senior management is involved in leadership on the national level with numerous affiliated organizations and stays informed of current issues within the industries regulated by the Commission (Table 7.4-3, page 29). Involvement in these organizations ensures that South Carolina and the Southeast's positions are represented on national issues such as transmission in the Eastern Interconnection, smart grid, gas pipeline safety, and broadband expansion. These leadership positions assist in fulfilling one of the main goals of the Commission for the year, namely, "To strive for excellence such that it will be recognized for its achievements."

The mission of the Commission is to provide fair, open, and effective regulation of the state's public utilities. In order to be effective, the Commission must be engaged and informed. This is accomplished through involvement in national organizations (NARUC, FERC, Nuclear Waste Strategy Coalition, etc.) and attendance at conferences, seminars, and webinars (Table 7.4-1, page 27).

Members of the Commission receive training in ethical practices through seminars and newsletters. This year a diverse panel consisting of a state legislator, the State Ethics Commission General Counsel, the USC School of Law dean, and a retired circuit judge conducted seminars for commissioners and staff. (Figures 5.6-2 and 5.6-3)



Figure 5.6-2 – Senator Brad Hutto conducts ethics training for the PSC.



Figure 5.6-3 – Dean Robert Wilcox, from the USC School of Law, engages PSC staff during training.

Additional technology and appropriate tools required to perform job functions are utilized when resources are available. The Commission encourages individual contribution to performance and operations improvements and rewards such contribution utilizing its restructured Employee Recognition Program (Shout Out!). The Commission recognizes members of its workforce for years of service.

The Synergy Business Park is a safe and secure workplace. Coded entrances provide security to employees. The Commission has a prevention and wellness program in place to educate its workforce on good health practices for the home and workplace. Activities include cholesterol and blood pressure screening, speaker's bureau, stress management, weekly health tips, and flu shots (Figures 5.14-1 and 5.14-2).



Figure 5.14-1 – Staff Attorney Josh Minges (r)

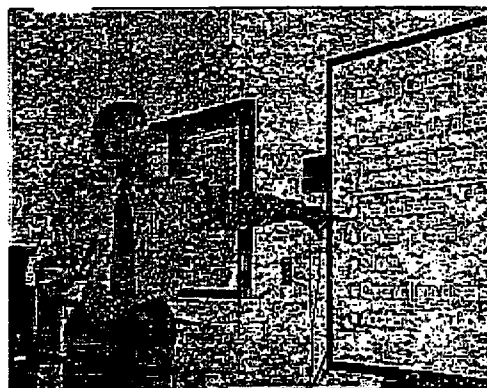


Figure 5.14-2 – John Leech of Lexington Medical Center Cardiovascular Rehab Center

Category 6 - Process Management

Most of the processes utilized by the Commission are dictated by statute or regulation. Whenever a party desires a hearing before the Commission, the party must file a formal application requesting a hearing. The Clerk's Office reviews the application to ensure that it complies with all legal requirements. Once the Clerk's Office accepts the application, it is noticed on the Commission's agenda as an advised item to begin the notification process.

In most cases, public notice must be given, often in bill inserts and notices published in newspapers of the affected areas. Deadlines are set for intervention and the filing of testimony, and a hearing date is scheduled. Discovery, information requests, and interrogatories follow the procedures set forth in the Code of Laws of South Carolina. A hearing is held, and a court reporter transcribes the proceeding (Figure 6.2-1).

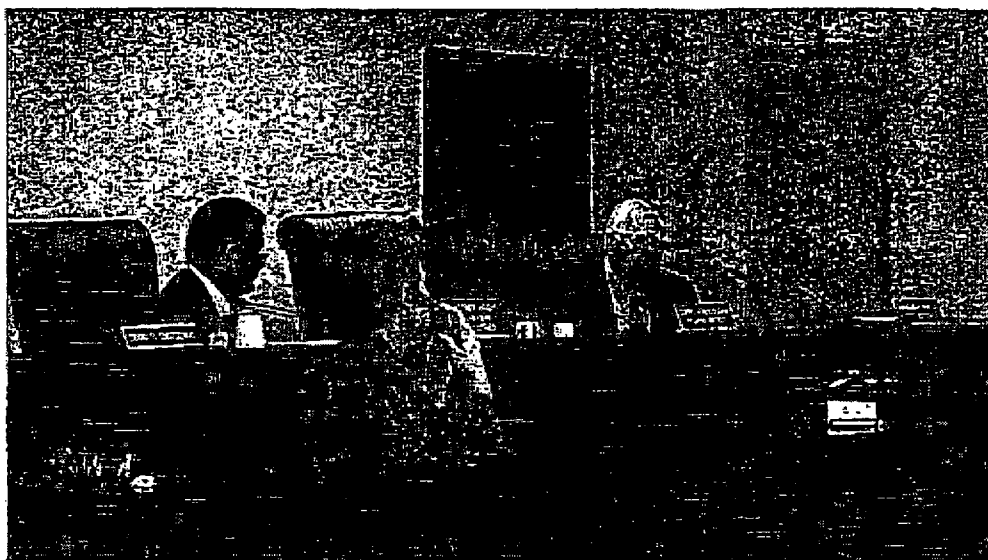


Figure 6.2-1 – Commission Hamilton (r) questions the witness during hearing.

Parties generally file legal briefs or proposed orders shortly after the hearing transcripts are released. The commissioners render their decision at a Commission Meeting, and the Legal Department drafts an order, which is then made available for the commissioners' review. Any input from commissioners is incorporated before the order is finalized, and the Clerk's Office mails a copy of the order to the parties of record. Any party to the hearing can ask the commissioners to reconsider their decision and can appeal the decision to the Appellate Court. This process most often applies to our jurisdictional utilities.

The DMS is used extensively in the process management of these tasks. Since it is an online system, the parties of record and the general public can monitor the activity of a case. Daily reports are generated from the DMS that list activity on the system with respect to process management (new dockets, filing of matters, issuance of orders, etc.). In addition, the Commission's main website contains the latest information on current issues and cases.

Weekly meetings with senior management are held to discuss upcoming filings, hearings, and issues and allocate resources to meet them. Because senior management is involved in the day to day operations, adjustments can be made to the processes when demand requires.

Meeting statutory deadlines for hearings, orders, etc. allows the Commission to appraise the effectiveness of its operations and institute changes to operations to improve the regulatory process. The Commission recently implemented changes to its order drafting process to allow the use of issuance of orders in the form of directives issued from the bench in many routine procedural matters. This operational change improves productivity and yields timelier results for the parties. In addition, the Commission meets at least twice a year with its Advisory Committee to evaluate the Commission's operations. With input from staff, senior leadership, the Commission's Advisory Committee, and customer feedback, improvements and updates to processes are identified in order to improve performance.

Key support processes include information management, financial and accounting, personnel, and office management functions. Through the performance measures plan approved by PURC, objectives and action items are reviewed on a regular basis to determine if adjustments need to be made to processes and workforce to meet the objectives of the plan.

Senior management regularly reviews the agency's budgetary status and makes adjustments where necessary based on developed contingency plans. Prior to the beginning of the fiscal year, departmental managers submit budgets for education, equipment, training and other budgetary needs for their areas. Throughout the year, managers update their requirements and budget revisions are made.

Category 7 - Business Results

Key business results for the 2010-2011 year include improvements in customer communications and customer education, and professional development of commissioners and staff.

7.1 The Commission's primary duty is to adjudicate cases involving the state's investor owned utilities.

- The Commission held 94 hearings this past fiscal year and issued over 850 orders (Chart 7.1-1). Fiscal year 2010-2011 did not see the activity generated from the multiple electric and water rate cases that were adjudicated in 2009-2010, in which 15 additional public hearings were held across the state.

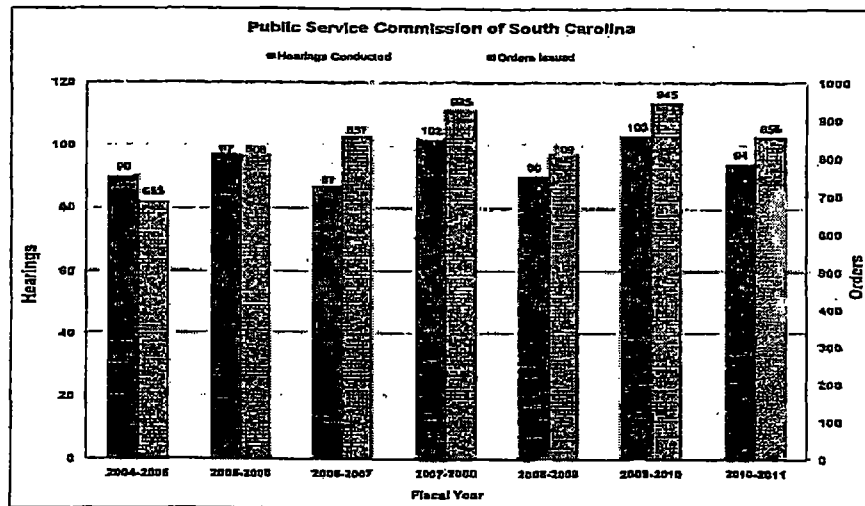


Chart 7.1-1 PSC Hearings and Orders

- The Commission's hearings encompass the telecommunications, electric, gas, water/wastewater, and transportation industries (Chart 7.1-2).

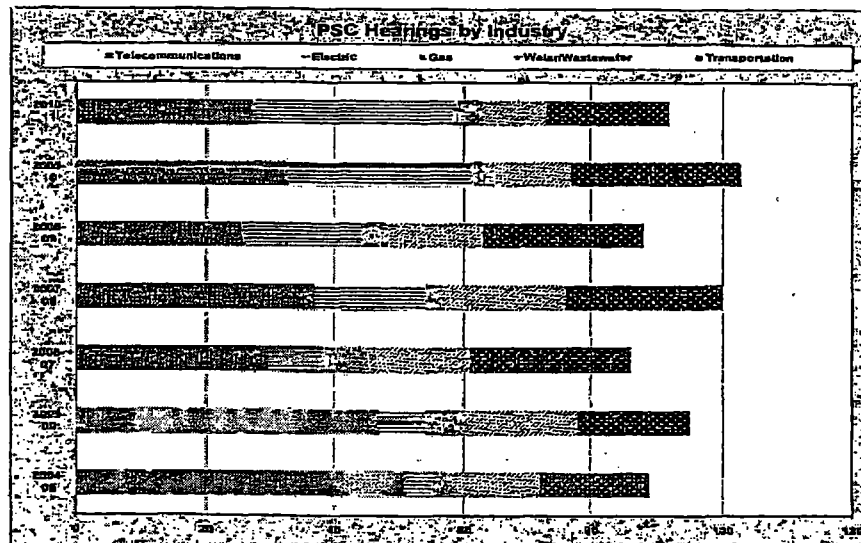


Chart 7.1-2 Hearings by Industry

- The number of cases in the electric industry heard by the Commission has been steadily increasing over the past few years as shown in Charts 7.1-2 and Chart 7.1-3. This is due to the impact of new issues that must be addressed from a regulatory standpoint. Some of these issues are energy efficiency and demand side management, renewable energy, plug-in electric vehicles, the expansion of nuclear generating facilities, FERC and state authority issues, and new EPA regulations. This trend is expected to continue.

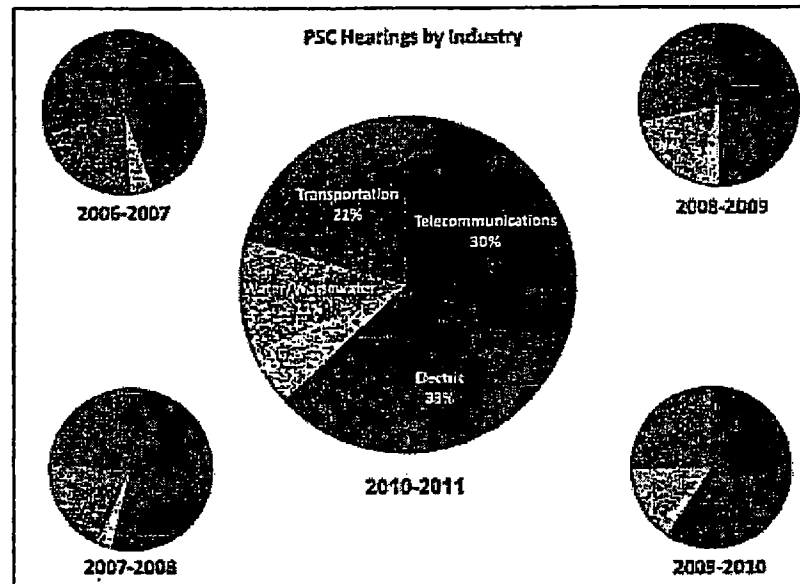


Chart 7.1-3 Hearings by Industry

- The Commission opened 454 new dockets during the fiscal year. A new docket is opened whenever an application is submitted to the Commission, a complaint, petition, or agreement is filed, or a rulemaking or fuel case proceeding comes before the Commission (Chart 7.1-4). This figure is on par with recent years' new dockets.

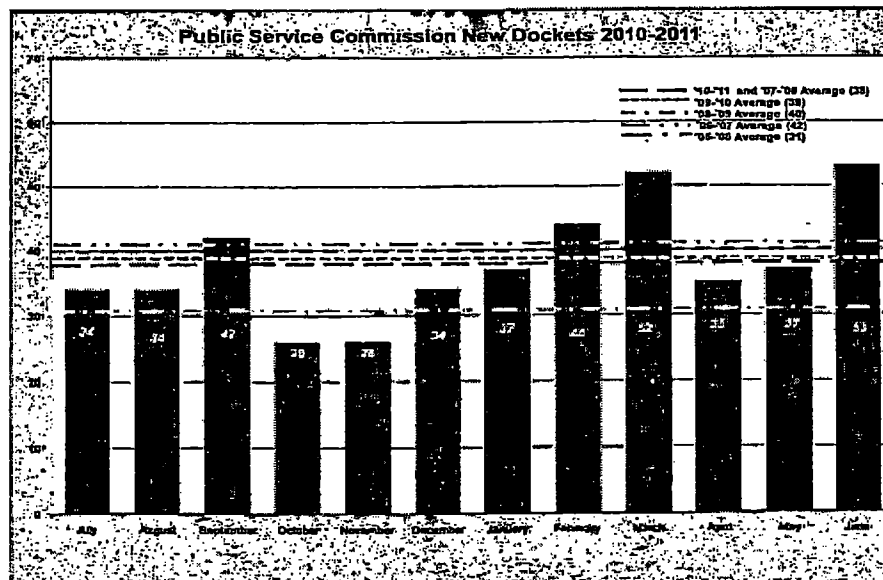


Chart 7.1-4 New Dockets

- Hearing examiners and officers are appointed to dispose of procedural matters and report findings of fact in appropriate cases. Each year has shown a steady increase in the number of rulings made through these Commission staff appointments – one indicator of the increasing efficiency with which the Commission resolves complaints and applications (Chart 7.1-5).

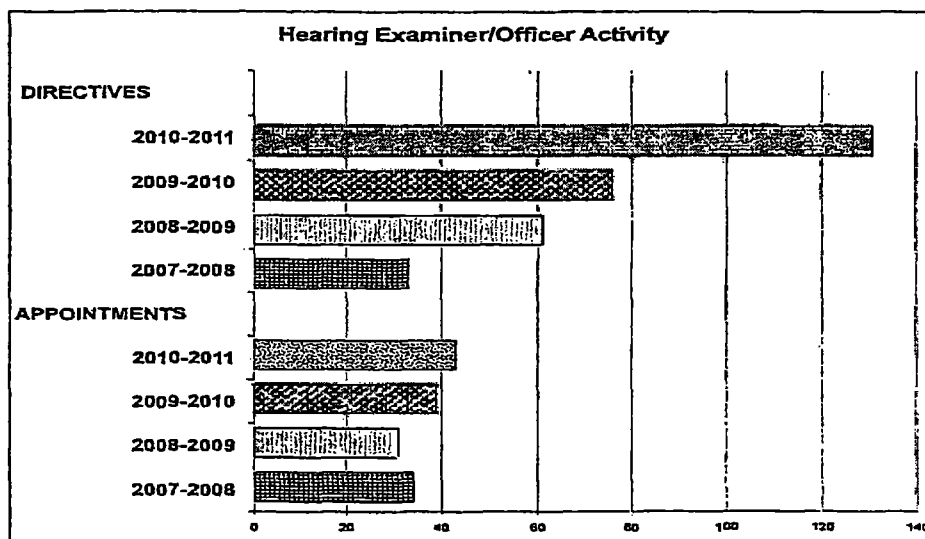


Chart 7.1-5 Hearing Examiner/Officer Activity

7.2 This year, the Commission heavily engaged in activities to increase customer awareness and education. In addition, the Commission also concentrated on effective dialogue with customers and stakeholders on emerging issues in the industries regulated by the Commission.

- The Commission conducted a series of public workshops to foster a better understanding of regulatory developments in the industries it regulates (Table 7.2-1). Topics included “Emerging and Foundational Issues in the Electric Utility Sector,” “Settlement Policy and Procedure,” “South Carolina Natural Gas Research and Development Essentials,” and “Issues Related to Renewable Energy Sources.” These workshops allowed the Commission to continue to provide a transparent regulatory process while maintaining effective communications with its customers and stakeholders.

Date	Topic
July 16, 2010	Fundamentals of Electricity Regulation in South Carolina
August 18, 2010	Emerging and Foundational Issues in the Electric Utility Sector
August 25, 2010	Financial Conditions and Future Generation and Infrastructure Projects – Progress Energy Carolinas, Inc.
September 8, 2010	Hazardous Waste Transportation in the United States – US Nuclear Infrastructure Council

Date	Topic
September 9, 2010	Commissioner NARUC Activities and Involvement
September 29, 2010	Settlement Policy and Procedure
October 8, 2010	Educational, Foundational, and Emerging Issues in the Gas Utility Sector
October 21, 2010	Update on Construction Progress of New Nuclear Units at V.C. Summer Nuclear Station – South Carolina Electric & Gas Company
October 25, 2010	The Rate Case from the Financial Officer's Perspective
November 8, 2010	Tour of Chem-Nuclear Systems, LLC
November 9, 2010	Integrated Resource Plan – Duke Energy Carolinas, LLC Integrated Resource Plan – Progress Energy Carolinas, Inc.
December 2, 2010	The Telecommunications Network
December 15, 2010	Issues Related to Renewable Energy Sources – Progress Energy Carolinas, Inc.
December 15, 2010	South Carolina Natural Gas Research and Development Essentials
January 20, 2011	Merger of Progress Energy, Inc. and Duke Energy Corporation
January 27, 2011	Duke Energy Carolinas' Economic Development Activities and 2010 Successes
February 22, 2011	Update on Transition with Emphasis on Broadband Future Plans for 2011 – Frontier Communications of the Carolinas, Inc.
March 25, 2011	Duke Energy Carolinas, LLC's Look Ahead at 2011 and Review of Nuclear Operations
April 6, 2011	South Carolina Emergency Preparedness – SC Office of Regulatory Staff and SC Energy Office
April 18, 2011	Actions Taken to Maintain and Improve Service – Alpine Utilities, Inc.
April 19, 2011	Pilot Weather Normalization Adjustment Mechanism – South Carolina Electric & Gas Company
April 20, 2011	Energy Issues from an Industrial Customer Perspective – Nucor Steel – South Carolina Gas Pipeline Safety – Office of Regulatory Staff
April 28, 2011	2011 Integrated Resource Plan and Update on Demand Side Management Program – South Carolina Electric & Gas Company
May 24, 2011	Proposed Plug-in Electric Vehicle Charging Station Pilot Program – Duke Energy Carolinas, LLC
June 1, 2011	South Carolina Electric & Gas Company's 2011 Integrated Resource Plan – South Carolina Coastal Conservation League, the Southern Alliance for Clean Energy, and Upstate Forever
June 7, 2011	Actions Taken to Maintain and Improve Service – Harbor Island Utilities, Inc.
June 21, 2011	Update Concerning Proposed EPA Regulations – Progress Energy Carolinas, Inc.

Table 7.2-1 2010-2011 Public Workshops

- In collaboration with practitioners, the Commission developed an online form for use by the public to file a letter of protest against a utility. The form standardizes the process and ensures that the necessary information is included with the protest. This form is being highly utilized.
- Enhancements to the agency's website www.psc.sc.gov and its online docket management system (<http://dms.psc.sc.gov>) allowed the public more access to information related to the Commission's operations. The Commission's homepage is used to inform the public of upcoming hearings and announcements, proposed regulations, and consumer information.
- The Commission made enhancements to its website to improve the display of information and functionality. In addition, the Commission's website was updated to add educational information for consumers on the regulatory process, energy efficiency and demand side management, and net metering.
- The Commission's online tariff system (ETariff) (<http://etariff.psc.sc.gov>) allows users to view and search tariffs online, and allows organizations to file promotions and revisions to tariffs electronically using the web based system. Currently, there are over 630 tariffs in the database, with most telecommunications companies and all electric and gas company tariffs available online. The percentage of returning visitors to the site is increasing as the system becomes established.
- Posting of matters related to docketed cases on DMS is a vital function of the Clerk's Office (Chart 7.2-2). Once the information is in DMS, it is available for public access over the internet. This information consists of applications, testimony, exhibits, notices, correspondence, orders, etc.

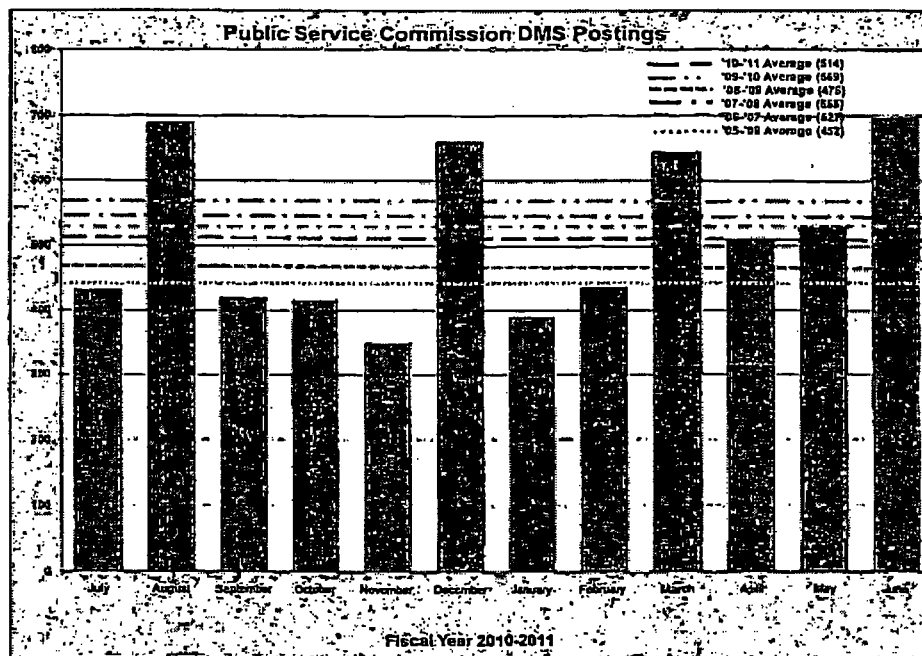


Chart 7.2-2 DMS Postings

- The DMS's database was expanded to include orders dating back to 1952. Although the number of pageviews has dropped off somewhat from the previous year, the chart below (Chart 7.2-3) shows the activity level on the DMS website year after year and reinforces the usefulness of the system and the public's dependence on the information contained in the system.

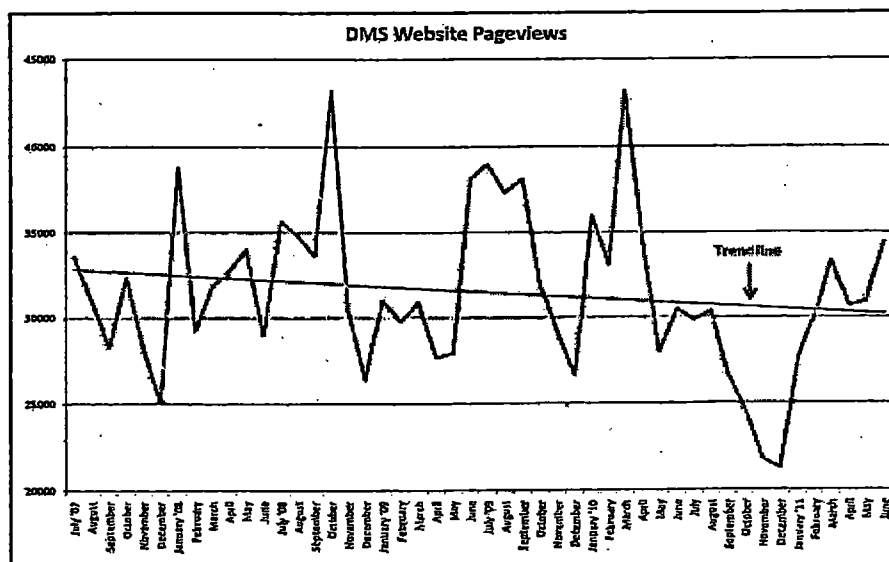


Chart 7.2-3 DMS Website Activity

- As shown in Chart 7.2-4, the Commission's website is very accessible using internet search engines. As new information is added to the site, such as details on the significant cases and consumer information, search engines are able to direct people to the site.

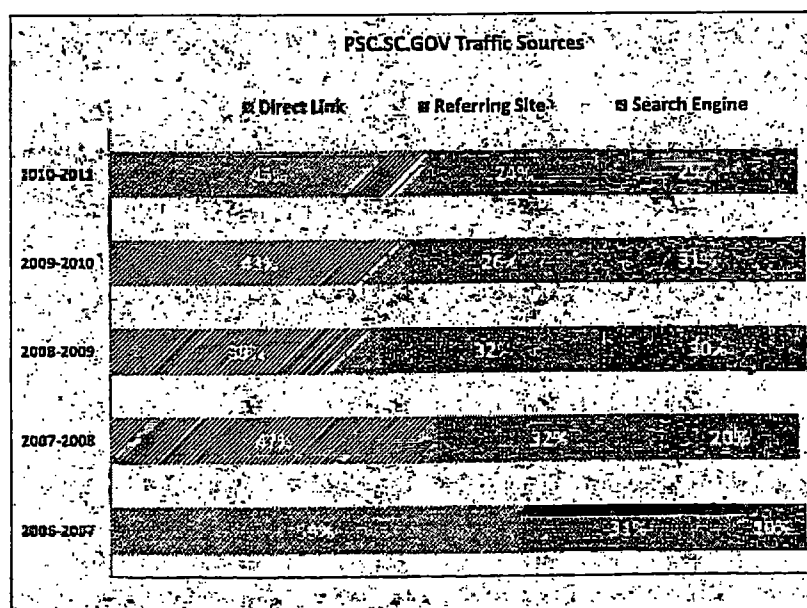


Chart 7.2-4 PSC Website Traffic

- 7.3 The Commission completed the 2010-2011 fiscal year within its operating budget, despite uncollected revenues of \$80, 005. The FY 11-12 budget was submitted in a timely manner.
- 7.4 The Commission aspires to professional excellence and, in a readily changing environment, must be alert to and anticipate emerging issues in the industries it regulates.
- Public workshops and allowable ex parte briefings were held to develop a better understanding of regulatory developments and issues that affect the industries regulated by the Commission (Table 7.2-1).
 - Members of the Commission attended numerous forums, workshops and meetings to stay informed of emerging issues within the regulated industries. As technological advances are made in the industries regulated by the Commission (e.g. renewable energy, shale gas drilling, and smart grid), the Commission must learn how the integration of these technologies will impact industries (Table 7.4-1).

Emerging Issues Educational Sessions

National Electricity Forum
Eastern Interconnection States Planning Council Meetings
Eastern Interconnection Planning Council Sector Steering Committee Meetings
Institute of Public Utilities at Michigan State University Grid School
Transmission Business School
Transmission Technologies Workshop
South Carolina Biomass Council Meetings
Blue Ribbon Commission Meeting
Governor's Conference on Energy
White House Smart Grid Subcommittee Meeting
Electric Infrastructure Security Summit
South Carolina Energy Users Committee Meeting
Bonbright Center Electric and Natural Gas Conference
National Petroleum Council Public Interest Advisory Council Meetings
Gas Technology Institute Public Interest Committee Meeting
American Gas Association Centerpoint Technology Lab Tour
National Association of Water Companies (NAWC) Annual Conference
NAWC Water Policy Forum
Water Research Foundation Advisory Council Meetings
Society of Utility and Regulatory Financial Analysts Forum
Government Coordinating Council's Critical Infrastructure Partnership Advisory Council Water Sector Committee Meetings
South Carolina Telephone Association Conferences
Utility Wall Street Dialogue
Emerging Issues Policy Forum
Critical Consumer Issues Forum
Department of Energy Southern Regional Energy Assurance Exercise
Center for Public Utilities at New Mexico State University Current Issues 2011
Public Utilities Research Center Annual Conference

Table 7.4-1 Emerging Issues Educational Sessions

- A system to alert the Commission to upcoming legislation, court ruling or federal entity ruling is in place to provide senior leadership with timely information to assist the Commission with its duties, as well as alerts related to happenings within the regulated industries. A total of nearly 900 alerts was issued during 2010-2011. These alerts are in the form of blog postings and emails. With new developments on the federal level concerning transmission, and proposed new EPA regulations and FCC rulings on horizon, the Commission desires to be proactive in response to issues that affect the entities they regulate (Chart 7.4-2).
- The Office of Advisory Staff and the Legal Department identified areas where the Commission needed additional training and conducted seminars on Act 175 of 2004, Perspectives on Water and Waste Water, and Proposed New EPA Regulations (Chart 7.4-2).
- In order to provide quality analysis, members of the Commission participated in webinars that featured outside experts [National Regulatory Research Institute (NRR), Water Research Foundation, American Gas Association, Energy Central, EPA, FERC, and others] who addressed emerging utility issues (Chart 7.4-2).
- Participation in national and regional regulatory conferences (NARUC, SEARUC, NERC, IPU, etc.) and involvement in associated committees and related organizations benefited the commissioners and staff by keeping them informed of current and emerging issues within regulated industries (Chart 7.4-2).

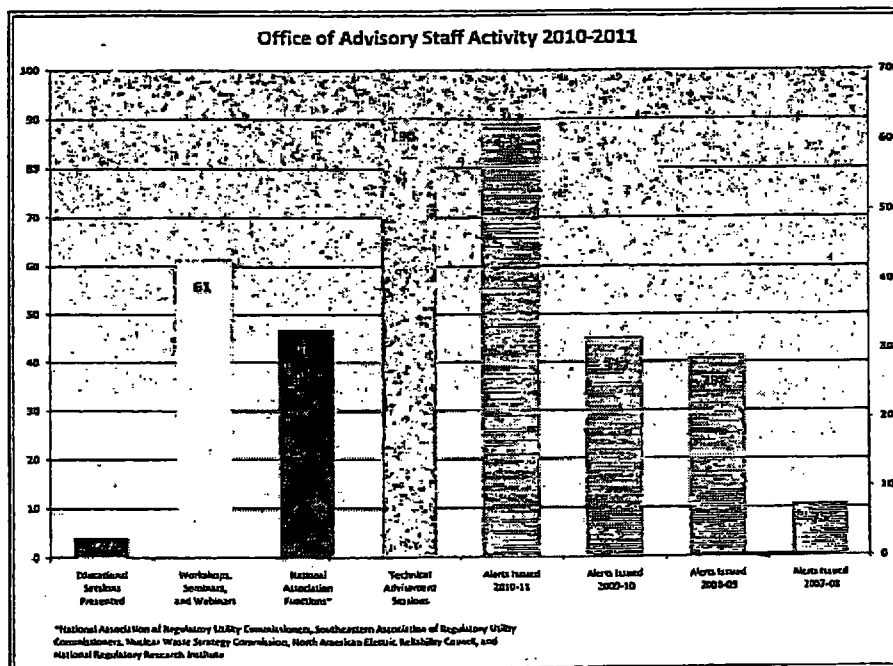


Chart 7.4-2 Office of Advisory Staff

- The commissioners and staff received training on ethics issues in the form of seminars and newsletters to ensure compliance with the Code of Judicial Conduct and Titles 8 and 58 of the South Carolina Code of Law.

- Commissioners and staff continued to achieve positions of leadership on the national level furthering the professional development of the Commission (Table 7.4-3). These positions cultivate the leadership of the Commission while ensuring that South Carolina and the Southeast's positions are represented on national issues such as transmission in the Eastern Interconnection, smart grid, gas pipeline safety, and broadband expansion.

First Vice President - NARUC Executive Committee*
Chairman - NARUC Committee on Gas*
Chairman - NARUC Committee on Water*
Chairman - NARUC Committee on Critical Infrastructure*
Chairman - NARUC Nuclear Issues and Waste Disposal Subcommittee
Chairman - Nuclear Waste Strategy Coalition
Chairman - NARUC Staff Subcommittee on Information Services
Secretary - Eastern Interconnection States Planning Council Executive Committee
Board Member - Universal Service Administrative Company
Board Member - Electric Power Research Institute
Voting Member - NERC Compliance and Certification Committee

* Additionally Serve on NARUC Board of Directors.

Table 7.4-3 Leadership Positions

7.5 The Commission continued to identify improvements to operations and procedures that resulted in increased productivity.

- Electronic filing (E-Filing) of documents increases the timeliness of the information and improves productivity for the users and the Commission staff (Chart 7.5-1). As more users realize the benefits of E-Filing, the percentage of documents filed electronically will increase as the trend shows. E-Filing of documents on the ETariff System increased from 82% last year to nearly 90% this year.

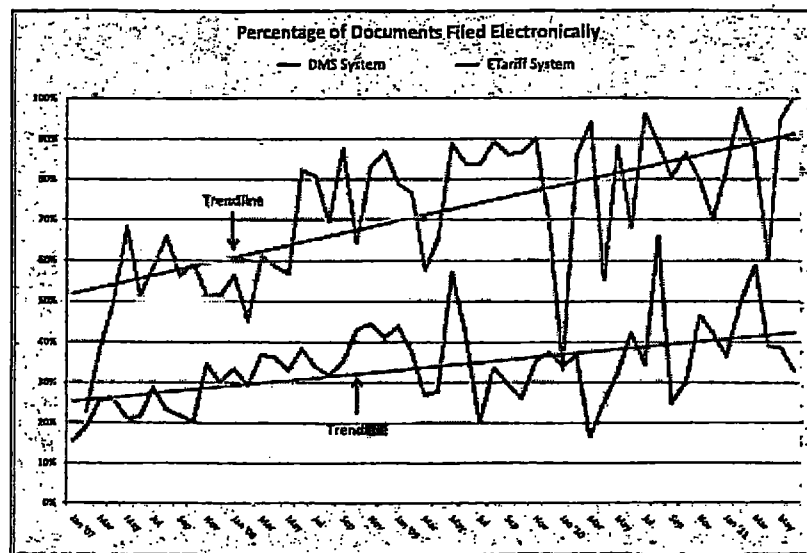


Chart 7.5-1 E-Filing

7.6 The process of revising the regulations that govern the practices and procedures of the Commission and its regulated industries is on-going (Table 7.6-1). In its 119th Session, the General Assembly approved the following revisions:

- Article 3 addresses customer deposits and retention of deposits for electric companies. The changes to Regulation 103-331 allow an electrical utility to require a deposit from a non-residential customer when the customer or its parent company is experiencing financial difficulties. With respect to Regulation 103-336, the revisions state an electrical utility is not required to refund a deposit if a non-residential customer or its parent company is experiencing financial difficulties. These revisions help electric utilities avoid losses and subsequent write-offs to uncollectible accounts.
- Article 6 revises bond requirements for local exchange telecommunications carriers. Revisions to Article 6 expand the present regulation of providers of prepaid local telephone service to all telephone utilities who provide retail residential local exchange services, but who have not invested at least five million dollars in telecommunications facilities in the State of South Carolina. The amendments also delete references to advance payments and prepaid payments and require bonds or other security mechanisms to be filed with the Commission and a copy provided to the Office of Regulatory Staff. These revisions will protect customers in the event a telephone company ceases to provide service.

A Notice of Drafting has been filed with the General Assembly's Legislative Council, and a public hearing has been scheduled for the following proposed regulation:

- Article 8 to create a new regulation to specify the information that must be submitted with electric utility financing applications filed with the Commission. Such additional information includes, but is not limited to, the effect of the proposed financing on the utility's income statement, balance sheet, and capital structure, and information on the possible impact on the utility if the proposed financing is not approved or if approval is delayed.

2010-2011 PSC Regulation Revision Status							
Article	Description	Notice of Drafting	Proposed Regulations Filed	Public Hearing Held	Final Regulations Filed	Approved by General Assembly	Published in State Register
3	Customer Deposits and Deposit Retention for Electric Utilities	✓	✓	✓	✓	✓	✓
6	Bond Requirements for Local Exchange Carriers	✓	✓	✓	✓	✓	✓
8	Requirements for Financing Applications for Regulated Electric Utilities	✓	✓				

Table 7.6-1 PSC 2010-2011 Regulation Review Process

***** END OF REPORT *****

H



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Department of Revenue
Office of General Counsel for Litigation
301 Gervais Street, P.O. Box 125, Columbia, South Carolina 29214
Phone: (803) 898-5598 Fax: (803) 898-5907

November 30, 2010

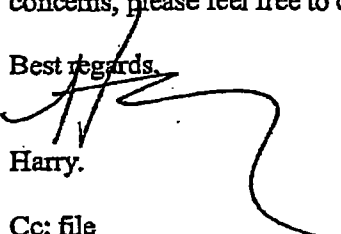
Burnet R. Maybank, III
J. Frederick Reames, III
1230 Main Street, Suite 700
Columbia, SC 29202

RE: Duke Energy Corporation v. SC DOR.
Case No.: 10-ALJ-17-0270-CC

Dear Burnie and Rick,

Enclosed please find the Department's Amended Prehearing Statement. If you have any questions or concerns, please feel free to contact me or Milton at any time.

Best regards,



Harry.

Cc: file
Cc: Milton Kimpson, and Abe Gutting.

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

Duke Energy Corporation,	)	Docket No. 10-ALJ-17-0270-CC
	)	
Petitioner,	)	
	)	RESPONDENT'S AMENDED
vs.	)	PREHEARING STATEMENT
	)	
South Carolina Department of Revenue,	)	
	)	
Respondent.	)	

1. The Nature of This Proceeding:

This proceeding is requested by Petitioner, a manufacturer/producer and distributor of electric power, to challenge Respondent's denial of Petitioner's tax refund claim for periods from 1978 through 2001.

2. Statutory Provisions Conferring Subject Matter Jurisdiction To The Court And Other Applicable Statutes And Regulations:

Subject matter jurisdiction is conferred by S.C. Code Ann. § 12-60-460 (Supp. 2008). Other relevant provisions: S.C. Code Ann. §§ 12-6-2250(A); 12-6-2290; 12-54-85 (Supp. 2008).

3. The Issues Presented For Determination, Including Any Claims Or Defenses Expected To Be Raised:

A. Is Petitioner entitled to utilize a single-factor apportionment formula to calculate its South Carolina taxable income?

Because Petitioner is a manufacturer of electricity and a power service provider, it is required to use the three factor apportionment formula in computing its South Carolina taxable income. See S.C. Code § 12-6-2250.

Alternatively, because the utilization of the standard statutory gross receipts apportionment method would unfairly represent Petitioner's business activities in the State, the use of the combined entity apportionment method is appropriate to effectuate an equitable apportionment of Petitioner's South Carolina taxable income. See Media Gen. Comm., Inc. v. South Carolina Dep't Rev., 388 S.C. 138, 694 S.E.2d 525 (2010); see also Microsoft Corp. v.

Franchise Tax Bd., 139 P.3d 1169 (Cal. 2006).

- B. Is Petitioner entitled to include the return of principal from short-term investments in calculating its receipts factor?

Petitioner should be prohibited from including the return of any principal of a short-term marketable security or instrument, including, but not limited to, municipal bonds, loan repurchase agreements, commercial paper, or the like, regardless of the apportionment formula utilized to calculate Petitioner's South Carolina taxable income. See S.C. Code Ann. §§ 12-6-2280, -2290, and -2295.

- C. Is Petitioner's refund claim timely for all periods involved?

The timeliness of Petitioner's refund claims is based solely on the agreements between the Respondent and Petitioner. However, such agreements merely extended the respective assessment periods, not the statute of limitations for Petitioner to change its apportionment method, thereby filing a refund claim. In addition, Respondent lacked the authority to extend the statute of limitations for filing a refund claim until 1995; thus, all refund claims related to any agreements that were executed prior to such authority being granted are invalid. Moreover, Respondent and Petitioner executed a settlement in 2002 for the corporate and sales taxes during the 1978-1994 tax periods; thus, any claim for refund during such period is invalid.

4. The Action Requested Of The Court, If Any:

Affirm the Department Determination and deny Petitioner's requested refund.

5. A Brief Summary of The Facts To Be Presented At The Hearing:

- a. Petitioner, formerly known as Duke Power Company, is a multi-state electricity manufacturer and power provider with operations in South Carolina. In addition, Petitioner's operations include a Treasury Department that invests Petitioner's excess capital in marketable securities, including municipal bonds, loan repurchase agreements, and commercial paper, thereby maximizing Petitioner's return and providing for Petitioner's short-term and long-term cash necessities.
- b. Petitioner timely filed its South Carolina corporate income tax returns (including license fee returns) for the 1978-2001 tax periods, whereby the Petitioner accurately computed its South Carolina taxable income by using the three factor apportionment method and properly included only the net gain from the sale of securities in its sales factor.

- c. Between August 16, 1988 and June 21, 2002, Petitioner and Respondent annually executed a South Carolina Department of Revenue and Taxation (formerly South Carolina Tax Commissions) Form FS-43, Consent to Extend the Time to Assess Tax ("Waivers of Assessment Period"), thereby extending the respective assessment periods.
- d. In December 1991, Petitioner filed amended South Carolina corporate income tax returns for the 1978-1983 tax periods, which reflected federal audit adjustments.
- e. In 2002, Respondent and Petitioner executed a settlement agreement for which Petitioner's corporate income tax and sales tax liabilities were settled for the 1978-1994 tax periods.
- f. Petitioner, believing that the Waivers of Assessment Period extended the statute of limitations, filed amended South Carolina corporate income tax returns for 1978 through 2001 requesting a substantial refund in December 2002.
- g. Petitioner raised three primary arguments in support of its claim for refund: (1) Petitioner is not required to calculate its income tax on a three-factor formula pursuant to S.C. Code Ann. § 12-6-2250 (Supp. 2008); (2) Petitioner is entitled to include sales of short-term investments in the denominator of its gross receipts factor; and (3) the income and expense of Crescent Resource Corporation was not properly allocated in the original return.
- h. In February 2003, Respondent denied Petitioner's adjustments for the 1978-2001 tax periods.
- i. Petitioner appealed Respondent's denial of the refund claims for the 1978-2001 tax periods.
- j. In June 2007, Petitioner filed amended South Carolina corporate income tax returns for the 1986-1998 tax periods, which reflected federal audit adjustments, seeking a refund based on the same arguments as above.
- k. In February 2008, Respondent denied Petitioner's adjustments for the 1986-1998 tax periods.
- l. Petitioner appealed Respondent's denial of the refund claims for the 1986-1998 tax periods.¹

¹ In its original Prehearing Statement, Petitioner asserted that because Respondent has not acted on Petitioner's appeal of the denied adjustments for the 1986-1998 tax periods, such returns are not before the Court. Respondent, however, firmly believes that because such returns and refund claims are encompassed in the 1978-2001 tax periods and predicated on the same facts and arguments as those tax periods, the returns for the 1986-1998 tax periods are properly before the Court.

- m. In a related sales tax audit, Duke has stated that it is entitled to claim a sales tax exemption pursuant to SC Code Ann. § 12-36-2120(17). As such, it has taken a position which is at odds with its position that it is not a "manufacturer" of electricity in this case.

6. A Summary Of Any Motions Expected To Be Raised At The Hearing And The Appropriate Authority Underlying The Motion:

Respondent anticipates submitting a motion for summary judgment or partial summary judgment to the extent there is no genuine issue of material facts underlying the legal questions in this case.

7. A List Of Proposed Witnesses And Exhibits:

Witnesses:

Respondent's Employee(s) will testify to the examination of the Petitioner's refund request and the Respondent's communications with the Petitioner (if testimony is deemed necessary).

Glenn J. Robinson will testify as to the definition of electricity, including the principles of the manufacturing of electricity, its scientific and technical intricacies, and industry standards.

The Respondent reserves the right to name additional witnesses, including a possible expert witness.

Exhibits:

Taxpayer's Refund Request
Department's Response to Refund Request
Taxpayer's Protest
Department's Determination

The Respondent reserves the right to name additional exhibits after discovery.

8. A Statement Regarding The Necessity For Discovery, If Any:

The Respondent and the Petitioner will submit a consent order to the Court with the express intent of limiting discovery and stipulating to the facts of the case to the extent possible. The consent order will address the need for discovery should an agreement as to all or part of the facts not be reached.

9. **The Estimated Time Required For The Hearing:**

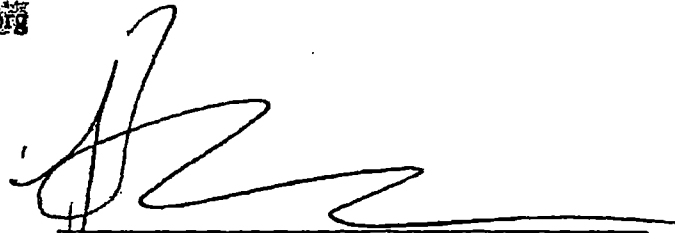
Respondent anticipates 2-3 days for the Hearing.

10. **Any dates in the next 120 days when you will not be available for a hearing:**

~~May 26, 27, June 24, July 27-29~~

11. **An email address where you can be reached:**

~~hancoch@sctax.org~~



Harry A. Hancock (Bar No. 065233)

Counsel for Litigation

PO Box 12265

Columbia, SC 29211

Phone: 803-898-5598

Fax: 803-898-5147

Hancoch@sctax.org

Attorney for South Carolina

Department of Revenue

Columbia, South Carolina

~~November 10, 2010~~



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EXHIBIT I

Westlaw.

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C

Supreme Court of South Carolina.
 MEDIA GENERAL COMMUNICATIONS, INC.,
 and Media General Broadcasting of South Carolina
 Holdings, Inc., Respondents,

v.

SOUTH CAROLINA DEPARTMENT OF REV-
 ENUE, Appellant.

Media General, Inc., Respondent,

v.

South Carolina Department of Revenue, Appellant.

No. 26828.

Heard March 16, 2010.

Decided June 14, 2010.

Background: Multistate corporations sought review of decision of Department of Revenue to use standard income apportionment method in determining corporations' State tax liabilities. The Administrative Law Court, Richland County, Marvin F. Kittrell, Administrative Law Judge, granted corporations' motion for summary judgment. Department appealed.

Holding: The Supreme Court, Beatty, J., held that Department was authorized to use combined entity apportionment method to effectuate equitable apportionment of income.

Affirmed.

West Headnotes

[1] Taxation 371 ⇨ 3477

371 Taxation

371VIII Income Taxes

371VIII(C) Income Taxable

371k3472 Sources of Income Outside State

371k3477 k. Apportionment of income. Most Cited Cases

Department of Revenue was authorized to use

combined entity method in apportioning multistate corporations' income based on intangible business assets in order to determine corporations' State corporate income tax liability, rather than standard statutory apportionment method based on gross receipts, under statute permitting taxpayers to petition Department for use of any other methods of income allocation and apportionment to effectuate equitable apportionment of income; Department stipulated that combined entity apportionment method would result in fair computing of corporations' business activities in State. Code 1976, § 12-6-2320(A)(4).

[2] Statutes 361 ⇨ 181(1)

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k180 Intention of Legislature

361k181 In General

361k181(1) k. In general. Most

Cited Cases

The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature.

[3] Statutes 361 ⇨ 176

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k176 k. Judicial authority and duty.

Most Cited Cases

The determination of legislative intent, for purposes of statutory construction, is a matter of law.

[4] Statutes 361 ⇨ 188

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k187 Meaning of Language

361k188 k. In general. Most Cited

Statutes 361 ⇨ 190

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361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k187 Meaning of Language

361k190 k. Existence of ambiguity.

Most Cited Cases

Where 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.

[5] Statutes 361 ⇨181(1)

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k180 Intention of Legislature

361k181 In General

361k181(1) k. In general. Most

Cited Cases

Statutes 361 ⇨188

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k187 Meaning of Language

361k188 k. In general. Most Cited

The best evidence of intent is in the statute itself, that is, what a legislature says in the text of a statute is considered the best evidence of the legislative intent or will; therefore, the courts are bound to give effect to the expressed intent of the legislature when interpreting a statute.

[6] Statutes 361 ⇨188

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k187 Meaning of Language

361k188 k. In general. Most Cited

If a statute's terms are clear and unambiguous,

they must be taken and understood in their plain, ordinary and popular sense, unless it fairly appears from the context that the legislature intended to use such terms in a technical or peculiar sense.

[7] Statutes 361 ⇨219(3)

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k213 Extrinsic Aids to Construction

361k219 Executive Construction

361k219(3) k. Long continuance of construction, and approval or acquiescence. Most Cited Cases

Statutes 361 ⇨219(4)

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k213 Extrinsic Aids to Construction

361k219 Executive Construction

361k219(4) k. Erroneous construction; conflict with statute. Most Cited Cases

An agency's long-standing interpretation of a statute is usually entitled to be given deference and should not be overruled by a reviewing court in the absence of cogent reasons, but the interpretation will not be sustained if it contradicts a statute's plain language.

****525** Lynn M. Baker, Managing Counsel, and Ronald W. Urban, Chief Counsel, both of South Carolina Department of Revenue, of Columbia, for Appellant.

Burnet R. Maybank, III, of Nexsen Pruet, of Columbia, for Respondents.

****526** Justice BEATTY.

***140** The appellant, the South Carolina Department of Revenue ("Department"), contends the Administrative Law Court ("ALC") erred in construing S.C.Code Ann. § 12-6-2320(A)(4) as allowing the three multistate corporations named herein to

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use the combined entity method in apportioning their income and determining their South Carolina corporate income tax liability. We affirm.

I. FACTS

This taxation case involves three corporations that are challenging the accounting procedure applied by the Department in calculating their corporate income taxes due in South Carolina. The taxes were based on income earned from intangible assets used in this state-royalty receipts from the use of trademarks, trade names, and licenses. The parties stipulated to the following facts.

Media General, Inc. ("Media General"), a Virginia corporation, is an independent, publicly-owned communications company headquartered in Richmond, Virginia. Media General *141 maintains its commercial domicile in Virginia and is subject to income tax there. Media General is the parent company in a consolidated group of communications companies situated primarily in the Southeast with interests in newspapers, television stations, and interactive media.

Media General owns all of the stock of Media General Communications, Inc. ("MG Communications"), a Delaware corporation that is domiciled in, and subject to income tax in, Virginia. MG Communications owns Media General Operations, Inc. ("MGO"), a Delaware corporation, which, in turn, owns Media General Broadcasting of South Carolina Holdings, Inc. ("MG Broadcasting"), a Delaware corporation domiciled in, and subject to income tax in, Virginia.^{FN1}

FN1. MGO is not a party to the current action.

Media General and its affiliates comprise a "unitary group," which as used herein is defined as a business in which there is a high degree of interrelationship and interdependence among related entities so that the value of the business as a whole exceeds the sum of its individual elements. Unitary groups generally share a unity of management,

ownership, and control of operations resulting in unquantifiable flows of value among the related entities of the business. Media General and its affiliates operate converged media operations where television, newspaper, and online products and information are merged and leveraged off of each other.

The Department conducted a corporate income tax audit of Media General, MG Communications, and MG Broadcasting. During the audit period, both MG Broadcasting and MG Communications owned intangible assets utilized in MGO's multistate operations, including those operations conducted in South Carolina. These intangibles included licenses and other authorizations issued by the Federal Communications Commission ("FCC") for the operation of various television broadcasting affiliates, as well as trademarks for the stations and a Florence daily newspaper.

MG Communications and MG Broadcasting each licensed their intangible assets to Media General and charged Media General a flat royalty fee. Media General then sublicensed the intangibles to MGO and charged MGO a royalty fee. The *142 revenues generated by MGO from its South Carolina broadcasting and publishing operations consisted mostly of advertising sales revenue.

Media General also had an Administrative Services Agreement with MG Communications and MG Broadcasting. The license agreements, sublicense agreements, and the Administrative Services Agreement were all signed on behalf of each entity by the same individual who is a corporate officer for each company.

After evaluating the effects of the royalty income generated by the intangible assets, the Department issued assessments for the three taxpayers at issue in this case, Media General, MG Communications, and MG Broadcasting (collectively, "Taxpayers").

In determining these assessments, the Depart-

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ment utilized the separate entity apportionment method, which is the standard apportionment**527 method used in South Carolina for apportioning income among multistate, related business entities. The ALC noted that this method "considers each entity having nexus with the taxing state as a separate and distinct entity, even if it is part of a unitary business."

This is in contrast to the combined entity apportionment method, which the parties have stipulated is defined for this matter as an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income attributable to activities in South Carolina by taking a portion of the combined net income of the group through the utilization of combined apportionment factors. The combined income of the unitary group is not computed for the purpose of taxing such income, but rather as a basis for determining the portion of income from the entire unitary business attributable to sources within South Carolina that is derived by members of the group subject to South Carolina's taxing jurisdiction. One of the purposes of this method is to capture the many subtle and largely unquantifiable transfers of value that take place among related companies of a single business enterprise.

South Carolina's statutory apportionment methodology as utilized in the Department's assessments and the calculation of taxes on returns filed during the audit period results in income *143 taxes and license fees for Media General, MG Broadcasting, MG Communications, and MGO in the amount of \$3,758,320. In contrast, the combined apportionment methodology results in income taxes and license fees for these same entities in the amount of \$863,179.

The Department's application of South Carolina's standard apportionment formula utilized in its proposed assessments does not fairly represent petitioners' business activities in South Carolina, thus resulting in a statutory distortion of petitioners' activities within South Carolina.

The corporations timely filed protests to the assessments and asked the Department to use the combined entity apportionment methodology as an alternative method to the separate entity apportionment method to fairly represent their business activities in South Carolina pursuant to S.C.Code Ann. § 12-6-2320(A)(4). This statute provides that if the allocation and apportionment provisions do not fairly represent the taxpayer's business activities in South Carolina, the taxpayer may petition for, or the Department may require, if reasonable, the employment of any other method to effectuate the equitable allocation and apportionment of the taxpayer's income.

The Department issued a Final Agency Determination upholding the proposed assessments. Although the Department agreed that the combined apportionment methodology fairly represents the corporations' business activities in South Carolina during the audit period, as compared to South Carolina's standard apportionment methodology, the Department declined the group's petition to use the combined apportionment method pursuant to section 12-6-2320(A)(4) on the ground that the Department has no authority to either grant a petition for, or require, the use of the combined apportionment method.

Media General filed this matter for a contested case hearing before the ALC. The parties filed cross-motions for summary judgment. The ALC granted Media General's motion for summary judgment, and denied the Department's motion. The ALC found the allowance of the use of "any other method" as provided by section 12-6-2320(A)(4) of the South Carolina Code encompasses the combined entity apportionment*144 method advocated by Media General and that this method should be applied in this case. The Department appeals from the ALC's ruling.

II. STANDARD OF REVIEW

Rule 56(c) of the South Carolina Rules of Civil Procedure provides a motion for summary judgment shall be granted "if the pleadings, depositions,

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answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Rule 56(c), SCRCP; *see also* ALC Rule 68 (stating the South Carolina**528 Rules of Civil Procedure may be applied in proceedings before the ALC to resolve questions not addressed by the ALC rules). A reviewing court may reverse the decision of the ALC where it is in violation of a statutory provision or it is affected by an error of law. S.C.Code Ann. § 1-23-610(B)(a), (d) (Supp.2009).

III. LAW/ANALYSIS

[1] On appeal, the Department contends the ALC erred in construing section 12-6-2320(A)(4) of the South Carolina Code as allowing Taxpayers to use the combined entity method in apportioning their South Carolina corporate income tax. The Department asserts the ALC ignored South Carolina case law when it determined that combined entity apportionment was contemplated by section 12-6-2320(A)(4), there is a split of authority in other states that have adopted similar provisions, and the Department's longstanding administrative interpretation and application of the statute is entitled to deference.

A. South Carolina Corporate Income Tax Provisions

In South Carolina, "[a]n income tax is imposed annually at the rate of five percent on the South Carolina taxable income of every corporation ... transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C.Code Ann. § 12-6-530 (2000).

*145 A corporation's taxable income in South Carolina is computed using the Internal Revenue Code with modifications as provided by South Carolina law, and this amount is "subject to allocation and apportionment as provided in Article 17 of this chapter." Id. § 12-6-580.

Article 17, entitled "Allocation and Apportionment," provides certain income that is not related to business activity in South Carolina must be directly allocated to a taxpayer and is not subject to apportionment. *See id.* §§ 12-6-2220, -2230 (2000 & Supp.2009). All income remaining after allocation is apportioned in accordance with the general apportionment statute, section 12-6-2250, or one of the special apportionment formulas. *Id.* § 12-6-2240 (Supp.2009).

"If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." *Id.* § 12-6-2210(B) (2000) (emphasis added).

In the current appeal, the Department utilized a standard statutory apportionment method based on gross receipts since the income in question was from intangible business assets. The gross receipts method requires the taxpayer to "apportion its ... net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year." *Id.* § 12-6-2290 (Supp.2009).

The statute in contention here, section 12-6-2320(A), provides for alternative methods of allocation and apportionment when the standard provisions in the South Carolina Code do not fairly represent the taxpayer's business activity in South Carolina:

(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;

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(3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or

*146 (4) *the employment of any other method* to effectuate an equitable allocation and apportionment of the taxpayer's income.

Id. § 12-6-2320(A) (2000) (emphasis added). Section 12-6-2320(A) of the South Carolina Code is identical to the Uniform Division of Income for Tax Purposes Act (UDITPA), section 18, Equitable Adjustment of Formula,**529 and was passed by the South Carolina General Assembly in 1995.

Taxpayers petitioned under section 12-6-2320 (A)(4) for the use of "any other method" of apportionment, and they have specifically requested that the Department apply the combined entity method in apportioning their income for South Carolina tax purposes. The Department stipulated that the standard statutory method it used did not fairly represent Taxpayers' income, and that the combined entity apportionment method did fairly measure Taxpayers' business activity in South Carolina, but it denied the petition based on its determination that it was not authorized under South Carolina law to apply the combined entity apportionment method.

B. Combined Entity Versus Single Entity Apportionment Methods

The ALC observed that the states typically apply one of two apportionment methods for multistate businesses. The first is the separate entity apportionment method, which considers each entity having some nexus with the taxing state as a separate entity, even if it is part of a unitary business. The second method, known as the combined entity apportionment method, considers the entities that are part of the unitary business such that the numerator represents all of the unitary entities' gross receipts from within the taxing state and the denominator consists of all of the unitary entities' gross receipts from everywhere.

The ALC compared the use of the separate en-

tity apportionment method with the use of the combined entity apportionment method in calculating a corporation's income tax due in South Carolina:

To determine the tax of a related entity of a multistate corporation in South Carolina using the separate entity apportionment method, each individual entity must determine*147 a ratio to apply against its taxable income in South Carolina to arrive at a net taxable income. The ratio is determined by dividing each individual entity's gross receipts in this State or the sum of each individual entity's property, payroll and sales within this State, by each individual entity's gross receipts everywhere or the sum of each individual entity's property, payroll and sales everywhere. It then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income. The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

To determine the tax of a related entity or related entities of a multistate corporation in South Carolina by using the combined entity apportionment method, the individual entity or all related entities (if more than one taxpayer is transacting business in this state), must determine a ratio to apply against its/their taxable income to arrive at its/their net taxable income in South Carolina. The ratio is determined by dividing the gross receipts of all the related entities of the multistate corporation in South Carolina or all the related entities[] property, payroll, and sales from within South Carolina, by all the related entities[] gross receipts from everywhere or the related entities[] property, payroll, and sales from everywhere. The taxpayer (individual entity) then applies this ratio to the entity's taxable income in South Carolina to determine its net taxable income. The corporate tax rate (5%) is then applied to ascertain the tax owed this State.

The parties have stipulated that South Carolina uses the separate entity apportionment method as its standard method to determine the taxable income related to intangible property of multistate busi-

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nesses transacting or doing business in South Carolina. The parties have further stipulated that the standard apportionment formulas do not fairly represent the South Carolina income of Taxpayers; therefore, section 12-6-2320(A) is applicable and the only question is the interpretation of the statute and whether it permits the combined entity apportionment method that Taxpayers request here.

[2][3] "The cardinal rule of statutory construction is to ascertain and effectuate the intent of the legislature." *148*Charleston County Sch. Dist. v. State Budget & Control Bd.*, 313 S.C. 1, 5, 437 S.E.2d 6, 8 (1993). "The determination of legislative intent is a matter of law." **530*Eagle Container Co. v. County of Newberry*, 379 S.C. 564, 568, 666 S.E.2d 892, 894 (2008) (quoting *Charleston County Parks & Recreation Comm'n v. Somers*, 319 S.C. 65, 67, 459 S.E.2d 841, 843 (1995)).

[4][5] "Where 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 v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The best evidence of intent is in the statute itself. "What a legislature says in the text of a statute is considered the best evidence of the legislative intent or will. Therefore, the courts are bound to give effect to the expressed intent of the legislature." *Id.* (quoting Norman J. Singer, *Sutherland Statutory Construction* § 46.03, at 94 (5th ed.1992)).

[6] If a statute's "terms are clear and unambiguous, they must be taken and understood in their plain, ordinary and popular sense, unless it fairly appears from the context that the Legislature intended to use such terms in a technical or peculiar sense." *Etiwan Fertilizer Co. v. South Carolina Tax Comm'n*, 217 S.C. 354, 360, 60 S.E.2d 682, 684 (1950). "The prime object, of course, in the construction of a statute is to ascertain and give effect to the legislative intent." *Id.*

The ALC found section 12-6-2320(A)(4) was

clear on its face and that the legislative intent expressed therein was to allow the use of "any other method" to apportion income where the standard statutory formulas resulted in an unfair apportionment of a taxpayer's business income in South Carolina.

The Department disagrees and argues section 12-6-2320(A)(4) should not be construed to allow the combined entity apportionment method based on the legislative intent expressed in the corporate tax statutes requiring the filing of tax returns by a single entity. Specifically, the South Carolina Code defines "taxpayer" as including "an individual, trust, estate, partnership, association, company, corporation, or any other entity subject to the tax imposed by this chapter or required to file a return." S.C.Code Ann. § 12-6-30(1) (2000) (emphasis added). The Department notes the definition refers *149 to a single corporation as a taxpayer and thus to separate filing requirements for each entity. Consequently, this definition must be used for the meaning of "taxpayer" as it appears in section 12-6-2320(A) and it limits the statute's application to a separate entity.

In *Coca Cola Co. v. Department of Revenue*, 271 Or. 517, 533 P.2d 788 (1975), the Supreme Court of Oregon rejected a similar argument, finding the use of "taxpayer" in the singular did not prevent the Department of Revenue from applying combined reporting. The court stated: "While it is true, as plaintiff points out, that the statute speaks of taxpayer in the singular, this is no bar. We note that the prior statute also spoke in the singular. Yet in [*Zale-Salem, Inc. v. Tax Comm'n*, 237 Or. 261, 391 P.2d 601 (1964)] we approved combined reporting." *Id.* at 793. The court observed that "the fact that the Uniform Act does not specifically require (the combined method of reporting for a multicorporate business) constitutes no barrier to its adoption by the Multistate Tax Commission and the various member states." *Id.* at 793 n. 4 (alteration in original) (citation omitted).

The Department also contends the combined

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entity apportionment method should not be allowed because it is not expressly provided for in section 12-6-2320 and the Department has never applied the combined entity apportionment method. The Department contends the ALC erred in failing to give deference to the agency's own interpretation. The Department further contends that use of the method is contrary to existing South Carolina law.

The ALC acknowledged that a court generally gives deference to an administrative agency's interpretation of an applicable statute or regulation. However, the ALC found the Department's interpretation was contrary to the plain language of the statute and was not entitled to deference.

[7] An agency's long-standing interpretation of a statute is usually entitled to be given deference and should not be overruled by a reviewing court in the absence of cogent reasons, but the interpretation will not be sustained if it contradicts a statute's plain **531 language. *Etiwan Fertilizer Co.*, 217 S.C. at 359, 60 S.E.2d at 684. We find the ALC was not required to defer to the Department's interpretation in this instance because it was contrary to the plain language of the *150 statute. See *Brown v. Bi-Lo, Inc.*, 354 S.C. 436, 440, 581 S.E.2d 836, 838 (2003) ("We recognize the Court generally gives deference to an administrative agency's interpretation of an applicable statute or its own regulation. Nevertheless, where, as here, the plain language of the statute is contrary to the agency's interpretation, the Court will reject the agency's interpretation." (citation omitted)).

The Department also asserts the ALC's ruling ignored existing South Carolina case law. The Department cites to *NCR Corp. v. South Carolina Tax Commission*, 304 S.C. 1, 402 S.E.2d 666 (1991) (*NCR I*) and to *NCR Corp. v. South Carolina Tax Commission*, 312 S.C. 52, 439 S.E.2d 254 (1993) (*NCR II*), arguing these cases "remain good [law] for the proposition that South Carolina is a separate entity taxing state."

In *NCR I*, we noted that "[e]ach of the statutory

sections defining the ratios of property, payroll, and sales use the singular word 'taxpayer.'" *NCR I*, 304 S.C. at 5, 402 S.E.2d at 669. We held that "subsidiary payroll, sales, and property ... should generally not be considered under our statutory scheme." *Id.* at 6, 402 S.E.2d at 669.

In *NCR II*, *NCR* "contend[ed] the royalties and interest income paid by all of its forty-four foreign subsidiaries should be combined and then divided by the combined income of all the subsidiaries to determine the proportionate contribution of sales, property, and payroll by foreign subsidiaries." *NCR II*, 312 S.C. at 56, 439 S.E.2d at 256. Under this calculation, the gains of the various subsidiaries would be offset by the losses of others. *Id.* In contrast, the Tax Commission asserted "the trial court correctly made the calculation separately for each subsidiary and added each separate amount to the denominator of the apportionment formula." *Id.* This Court stated that "[s]ubsidiaries are treated as separate entities for tax purposes," and held the "Tax Commission's method of calculation is the better approach since it is consistent with general tax principles." *Id.*

The ALC found these cases were not controlling as they were decided prior to the enactment of section 12-6-2320, which clearly and specifically allows for the use of "any other method" to fairly represent a taxpayer's income when the standard apportionment formulas provided by statute do not *151 fairly represent the taxpayer's business activity in South Carolina. The ALC determined this was a "relief provision" enacted by the South Carolina General Assembly that authorizes the use of the combined entity apportionment method. The ALC concluded "[t]he Department's interpretation would thwart legislative intent clearly expressed in the general allocation and apportionment statutes, would deny Taxpayers the equitable relief intended by the legislature when it enacted § 12-6-2320(A), and would leave Taxpayers with an unreasonable and arbitrary apportionment of their taxable income in this state."

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The Department acknowledges that the standard apportionment statutes result in statutory distortion of Taxpayers' incomes and taxes. However, the Department asserts that other methods, such as changing the factors to be considered in the apportionment ratios, may be used to correct the problems caused by application of the standard apportionment statutes. Despite its argument, to date the Department has not recalculated Taxpayers' income and taxes using any alternative method that it believes would fairly apportion Taxpayers' income from business activities in South Carolina.

We agree with the ALC that the legislature enacted section 12-6-2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) clearly authorizes the Department to use "any other method" to effectuate an equitable apportionment of the taxpayer's income, including the combined entity apportionment method. The authority cited by the Department predates the legislative enactment and therefore is not controlling on this issue.

We emphasize that, as a general rule, the Department need not automatically use the method requested by a taxpayer, as it has **532 the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina. In this case, however, the Department never recalculated Taxpayers' incomes using any other alternative method, and the Department stipulated that use of the combined entity apportionment method proposed by Taxpayers does result in a fair computing of Taxpayers' business activities in South Carolina. Accordingly, we uphold the ALC's determination that the combined entity apportionment method should be utilized by the Department for the tax period in question. The combined entity *152 apportionment method is merely a mechanism for approximating the income attributable to the corporations that comprise a unified business, but this does not change the fact that the entities will be reporting the taxes due for each entity.

V. CONCLUSION

The Department concedes the standard apportionment formulas allowed under South Carolina law result in a statutory distortion of Taxpayers' incomes and that the combined entity apportionment method would fairly represent their business activities in South Carolina. We agree with the ALC that the legislature has placed no explicit limitation on the alternative methods that may be used under section 12-6-2320(A)(4), and consequently we affirm the ALC's ruling that the Department is authorized to use the combined entity apportionment method. Although the Department has the discretion to select an alternative method, the ALC has ordered in this case that the method be applied and we affirm this determination as the Department has not established that another method would be more appropriate. This ruling is limited to the tax period in question, and the Department may employ any other appropriate alternative method for future tax years.

AFFIRMED.

TOAL, C.J., PLEICONES, KITTREDGE and HEARN, JJ., concur.

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South Carolina Revenue Procedure

2009

South Carolina Revenue Procedure No. 09-1, 01/13/2009

South Carolina Revenue Procedure No. 09-1, 01/13/2009**Date Issued:** 01/13/2009**Tax Type(s):** Personal Income Tax, Corporate Income Tax**SUBJECT:** Applying for an Alternative Allocation/Apportionment Method (Income Tax) ..**EFFECTIVE DATE:** January 13, 2009**SUPERSEDES:** SC Revenue Procedure #95-4 and all previous documents and any oral directives in conflict herewith.**REFERENCES:** S.C. Code Ann. Section 12-6-2320 (2000)**AUTHORITY:** S.C. Code Ann. Section 12-4-320 (Supp. 2000)

S.C. Code Ann. Section 1-23-10(4) (2000)

SC Revenue Procedure #05-2

SCOPE: The purpose of a Revenue Procedure is to provide procedural guidance to the public and Department personnel. It is an advisory opinion issued to assist in the administration of laws and regulations by providing guidance that may be followed in order to comply with the law. It is effective until superseded or modified by a change in statute, regulation, court decision, or another Departmental advisory opinion.

INTRODUCTION

Code Section 12-6-2210 provides for the determination of taxable income of a business. A taxpayer whose entire business is transacted or conducted in South Carolina is subject to income tax based on the entire taxable income of the business for the taxable year. A taxpayer that transacts or conducts its business partly within and partly outside of South Carolina is subject to income tax based on the portion of its business

carried on in South Carolina. This portion is determined through allocation and apportionment of income. The sum of these amounts is South Carolina taxable income.

Code Sections 12-6-2220 and 12-6-2230 provide that certain classes of income, less related expenses, are allocated. Items directly allocated include nonbusiness interest, nonbusiness dividends, nonbusiness rents and royalties from the lease or rental of real estate or tangible personal property, gains (not subject to depreciation recapture) and losses from the sale of real property, and nonbusiness gains and losses from sales of intangible property.

The income remaining after allocation is apportioned in accordance with South Carolina Code Section 12-6-2240. South Carolina generally requires the use of one of the following apportionment methods:

1. (a) A "three factor" apportionment method (based on property, payroll, and double-weighted sales) or (b) a "single factor" ¹ apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in tangible personal property. This method is typically used by businesses that manufacture, sell, distribute, or rent tangible personal property. See Code Sections 12-6-2250, 12-6-2252, and 12-6-2295.
2. A "gross receipts" apportionment method for taxpayers not dealing in tangible personal property. This method is typically used by financial businesses and service businesses, including doctors, architects, businesses that install or repair tangible personal property, and contractors. See Code Sections 12-6-2290 and 12-6-2295.
3. A "special" apportionment method for certain companies, such as railroad companies, telephone companies, pipeline companies, airline companies, and shipping lines. See Code Section 12-6-2310.
4. An individualized apportionment method tailored to a particular business because the normally required method would not fairly represent the extent of the taxpayer's business in South Carolina. See Code Section 12-6-2320(A).
5. An individualized apportionment method tailored to a particular business as an economic incentive. See Code Section 12-6-2320(B).

The purpose of this advisory opinion is to provide a procedure for a taxpayer to request use of an alternative allocation/apportionment method set forth in Code Section 12-6-2320(A) if the taxpayer believes that the statutory formula does not fairly represent the extent of the taxpayer's business activities in South Carolina. This request will be referred to as an Application for Modification of an Allocation/Apportionment Method ("Application"). ²

WHERE TO FILE THE APPLICATION

The Application must be filed separately and not attached to a tax return being filed. Mail the Application to the following address:

Department of Revenue

Attn: Administrator of Audit Services

301 Gervais Street
P.O. Box 125
Columbia, S.C. 29214

CONTENT OF APPLICATION

The Application must set forth a complete statement of the facts and reasons relating to the request to change the allocation/apportionment method currently used by the taxpayer (or any affiliated corporation included in filing a South Carolina consolidated return with the taxpayer that is requesting to change its allocation/apportionment method under this procedure) or would be required to be used if the taxpayer is not yet operating in South Carolina, including the following:

1. Full name and address, and as applicable, taxpayer identifying number or social security number of the taxpayer applying for the change in allocation or apportionment method.
2. The taxpayer's tax year.
3. The tax year the taxpayer proposes the change to be effective.
4. The present allocation/apportionment method used in South Carolina. If the taxpayer currently has no operations in South Carolina, the method that would be the method required to be used under South Carolina law if the taxpayer had been operating in this State.
5. If applicable, the approximate number of years that the present allocation and apportionment method has been used in South Carolina.
6. A complete and precise statement of the reasons for the modification requested, including why the present method does not fairly represent the activities of the taxpayer within this State.
7. Evidence supporting the taxpayer's Application including any court decisions on the matter, copies of all contracts, deeds, agreements, instruments or other documents which evidence the necessity for the modification. Do not send originals.
8. Projected net income of the taxpayer attributable to South Carolina in the tax year the new allocation/apportionment method would commence and for five years thereafter. Please provide these projections using the current (or currently required) method of allocation/apportionment and the alternative method proposed by the taxpayer. These projections should be as complete as possible and should include income allocated as well as the computations of each of the factors in question.
9. Any other relevant information that the taxpayer believes may have a bearing on the Department's decision about whether to grant the allocation/apportionment method requested.

The Application must also answer the following questions:

10. Is the proposed allocation/apportionment method to be used solely by the taxpayer or is the request to

change the allocation/apportionment method to be applicable to all affiliated corporations that join with the taxpayer in filing a South Carolina consolidated return?

11. Is the taxpayer currently being audited by the Department?

12. In the past five years, has the taxpayer been audited by the Department and adjustments made to its allocation and/or apportionment method or to specific items that the taxpayer allocated or apportioned to South Carolina?

13. During the past five years, has the taxpayer or any of its affiliates applied to the Department to use a different method of allocating or apportioning income or to use separate accounting to determine its net income attributable to South Carolina?

14. Has the taxpayer made requests to any other states to use an alternative method of allocating/apportioning income? What was the result?

REVIEW OF THE APPLICATION

The Department's Field Operations Division, Audit Services Department will review the information submitted and will issue a decision as to whether the taxpayer may adopt the alternative method of allocation/apportionment requested. With its decision, Audit Services will issue a letter setting forth its reasons for approving or denying the taxpayer's request to change its allocation or apportionment method. Written approval of the new method must be received prior to using the new method to determine income allocated or apportioned to South Carolina.

APPEAL OF A DECISION

If the taxpayer disagrees with the decision of Audit Services, the taxpayer may appeal the denial of the Application. Any appeal will follow the procedures established in South Carolina Revenue Procedure #06-2 for a proposed assessment.

FOR MORE INFORMATION

If you have questions regarding the Application, please call the Administrator of Audit Services at 803-898-5604.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Ray N. Stevens

Ray N. Stevens, Director

Columbia, South Carolina

January 13, 2009

1

Effective for tax years beginning after 2006, a single factor apportionment method for businesses dealing in tangible personal property using the three factor (with double weighted sales) apportionment method is being phased in and will replace the three factor (with double weighted sales) apportionment method for tax years beginning in 2011.

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The procedure for a taxpayer to request approval of an economic development incentive based on alternative allocation or apportionment under Code Section 12-6-2320(B) is provided in a separate advisory opinion. It is available on the Department's website at www.sctax.org.

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EXHIBIT K

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South Carolina Private Letter Ruling

2003

South Carolina Private Letter Ruling No. 03-1, 03/10/2003

South Carolina Private Letter Ruling No. 03-1, 03/10/2003

Date Issued: 03/10/2003

Tax Type(s): Corporate Income Tax

SUBJECT: Allocation and Apportionment of ABC Licensee Income
(Income Tax)

REFERENCES: S. C. Code Ann. Section 12-6-2220 (Supp. 2000)

S. C. Code Ann. Section 12-6-2230 (Supp. 2000)

S. C. Code Ann. Section 12-6-2290 (Supp. 2000)

AUTHORITY: S. C. Code Ann. Section 12-4-320 (Supp. 2000)

S. C. Code Ann. Section 1-23-10(4) (Supp. 2000)

SC Revenue Procedure #03-1

SCOPE: A Private Letter Ruling is a written statement issued to a specific taxpayer by the Department to apply principles of law to a specific set of facts or a particular tax situation. A Private Letter Ruling is an advisory opinion; it does not have the force and effect of law and is not binding on the person who requested it or the public. It is, however, the Department's opinion limited to the specific facts set forth, and is binding on agency personnel only with respect to the person to whom it was issued and only until superseded or modified by a change in statute, regulation, court decision, or advisory opinion, providing the representations made in the request reflect an accurate statement of the material facts and the transaction was carried out as proposed.

Questions:

1. What South Carolina apportionment method should ABC Licensee, a newly formed corporation domiciled in South Carolina that is a subsidiary of ABC Company, use and where is its income related to the licensing of FCC licenses apportioned?
2. Does ABC Company's ownership in W-TV, a single member limited liability company operating solely in South Carolina and treated as a division of ABC Company, affect ABC Licensee's South Carolina apportionment factor?

Conclusions:

1. ABC Licensee's income related to the licensing of intangibles is apportioned using the single factor gross receipts apportionment method under Code Section 12-6-2290. ABC Licensee's income related to the licensing of the FCC licenses is apportioned outside of South Carolina since the use of the X-TV and NewsChannel * FCC licenses do not generate royalties from South Carolina, but generate royalties from H, I, and J.
2. ABC Company's (*i.e.*, the parent corporation's) ownership in W-TV, a single member limited liability company operating solely in South Carolina and treated as a division of ABC Company, does not affect ABC Licensee's (*i.e.*, a corporate subsidiary's) South Carolina apportionment factor.

Facts:

ABC Company is a Delaware corporation that is headquartered in H. ABC Company owns and operates network television broadcast properties. ABC Company operates in H, I, and J via X-TV (a commercial television station that serves the H market) and, upon approval by the FCC, via NewsChannel * (a 24 hour news and information service that provides content to H area cable operators for distribution to cable broadcast facilities.)

ABC Company holds FCC licenses related to its X-TV operations and NewsChannel *'s fleet of electronic and satellite news gathering vehicles. ABC Company is the single member in three limited liability companies: W, LLC, operating solely in South Carolina; Y, LLC, operating solely in K; and Z, LLC, operating solely in L. These three limited liability companies are disregarded for federal income tax purposes and are treated as divisions of ABC Company. Each LLC holds and will continue to hold a separate FCC license for broadcast operations conducted in its respective state.

ABC Company recently formed ABC Licensee, a wholly owned C corporation subsidiary, for a legitimate non-tax business purpose. ABC Licensee is an operating corporation, not a sham corporation, incorporated in Delaware and having its principal place of business in South Carolina. Effective October 1, 2002, ABC transferred its FCC licenses related to X and NewsChannel * to ABC Licensee. ABC Licensee will charge ABC Company an arm's length royalty for the use of these FCC licenses; its only business in South Carolina will be the licensing of intangibles and the receipt of royalty income from those intangibles.

Discussion:

Code Section 12-6-530 imposes a corporate income tax on the South Carolina taxable income of every corporation, other than those otherwise described in Code Sections 12-6-540 and 12-6-550, transacting, conducting, or doing business within South Carolina or having income within South Carolina, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce. The terms "transacting," "conducting," or "doing business" include transacting or engaging in any activity for the purpose of financial profit or gain.

In *Geoffrey v South Carolina Tax Comm.*, 437 S.E. 2nd 13 (S.C. 1993), *cert.denied*, 114 S.Ct.550 (1993), the South Carolina Supreme Court concluded that in order for a corporation to be taxed in South Carolina the corporation must be "transacting, conducting, doing business, or having an income within this state." The court construed this language as extending South Carolina's authority to tax foreign corporations to the limits of the Constitution. In *Geoffrey*, the South Carolina Supreme Court determined that the licensing of trademarks and trade names to a South Carolina retailer and the maintaining of accounts receivable in South Carolina by a nonresident taxpayer create nexus for South Carolina income tax purposes even though the taxpayer lacked physical presence in South Carolina.

The Court determined that Geoffrey purposely directed its activities toward South Carolina, and that Geoffrey owned and used business intangible property in South Carolina. Each of these activities was held to be sufficient to satisfy the nexus requirements of the Due Process Clause and the Commerce Clause.

Based upon the facts presented above, ABC Licensee is conducting business in South Carolina and, therefore, is subject to South Carolina income tax.

Next, it must be determined how ABC Licensee will allocate and apportion its income for South Carolina tax purposes. Code Section 12-6-2210 provides for the determination of taxable income of a corporation. Code Section 12-6-2210(B) provides that if a taxpayer is transacting or conducting business partly within and partly outside of South Carolina, then South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State. South Carolina taxable income for a multistate taxpayer is determined by combining income allocated to South Carolina with income apportioned to South Carolina. After allocation, South Carolina apportions remaining business income. Based upon the facts, ABC Licensee is conducting business partly within and partly outside South Carolina; it would be subject to a net income tax in other taxing jurisdictions if South Carolina's net income tax laws were in effect in such jurisdictions. Accordingly, ABC Licensee may apportion its income. See Code Section 12-6-2210(B).

Code Sections 12-6-2220 and 12-6-2230 provide that certain classes of income less related expenses are allocated. Items directly allocated include dividends, nonbusiness interest, and nonbusiness gains and losses from sales of intangible property. Based upon the facts, ABC Licensee income from the licensing of intangibles is not allocable; it is apportionable.

In accordance with Code Section 12-6-2240, South Carolina generally requires the use of one of the following apportionment methods:

1. A "three factor" apportionment method (based on property, payroll, and double weighted sales) for taxpayers whose principal business in South Carolina is dealing in tangible personal property. Code Section 12-6-2250.
2. A "gross receipts" apportionment method for taxpayers not dealing in tangible personal property, such as financial and service businesses. Code Section 12-6-2290 .
3. A "special" apportionment factor provided in Code Section 12-6-2310 for certain companies, such as railroad or telephone companies.

Based upon the facts presented, ABC Licensee will apportion income using a single factor formula based upon "gross receipts" since they are not dealing in tangible personal property and they are not one of the particular types of industries required to use a special formula. The gross receipts formula in Code Section 12-6-2290 provides that the taxpayer apportion its income using a fraction in which the numerator is gross receipts from within South Carolina during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.

In *Geoffrey*, the taxpayer earned its income by licensing trademarks and trade names for a percentage of sales made by its retail licensees. The South Carolina Supreme Court determined that it was proper for South Carolina to tax its apportioned share of the royalty income. The court held that intangibles and their income could be taxed at their business situs and that the real source of *Geoffrey's* income was South Carolina's customers. *Geoffrey's* South Carolina apportioned income was determined under the single factor, gross receipts, apportionment formula; *i.e.*, gross receipts from royalty payments from South Carolina sales divided by gross receipts from everywhere.

Based upon the above discussion and *Geoffrey*, ABC Licensee's income related to the licensing of the FCC licenses is apportioned outside of South Carolina since the use of the X-TV and NewsChannel * FCC licenses do not generate royalties from South Carolina, but generate royalties from H, I, and J. Note: ABC Company's (*i.e.*, the parent corporation) ownership in W-TV, a single member limited liability company operating solely in South Carolina and treated as a division of ABC Company, does not affect ABC Licensee's (*i.e.*, a corporate subsidiary's) South Carolina apportionment factor.

CAVEAT: This advisory opinion is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting the advisory opinion may not rely on it. If the taxpayer relies on this advisory opinion, and the Department discovers, upon examination, that the facts and circumstances are different in any material respect from the facts and circumstances given in this advisory opinion, then the advisory opinion will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this advisory opinion, changes in a statute, a regulation, or case law could void the advisory opinion.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Burnet R. Maybank III

Burnet R. Maybank III, Director

March 10, 2003

Columbia, South Carolina

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EXHIBIT L

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South Carolina Private Letter Ruling No. 95-9, 08/14/1995

South Carolina Private Letter Ruling No. 95-9, 08/14/1995

Date Issued: 08/14/1995

Tax Type(s): Corporate Income Tax

SC PRIVATE LETTER RULING #95-9 (TAX)

TO: XYZ

SUBJECT: Apportionment Factor (Income Tax)

DATE: August 14, 1995

Question:

Based upon the facts, what apportionment ratio should XYZ use in determining its South Carolina income?

Conclusion:

XYZ should use the gross receipts formula provided in Code Section 12-7-1190 with the numerator including royalties earned from sales that occur in South Carolina, and the denominator including royalties earned from sales that occur everywhere. Since, under the facts of this case, sales occur at the point of destination, the numerator of XYZ's gross receipts formula will include royalty receipts earned from the licensees' sales delivered to customers in South Carolina, and the denominator will include royalty receipts earned from licensees' sales delivered to customers everywhere.

Facts:

ABC is a Delaware corporation domiciled in South Carolina. ABC manufactures X products in South Carolina and North Carolina. ABC, also, operates a loading dock in Texas.

Once the X products are manufactured, the majority are shipped to ABC's loading dock in Texas and then shipped to a subsidiary, DEF, for assembly. (A small percentage of the X products are shipped directly to the customer.) DEF is a non U.S. corporation with manufacturing facilities in X country. After assembly, the X products are shipped back to ABC's loading dock in Texas for repackaging and distribution to customers.

ABC has set up a new subsidiary, XYZ, a Delaware corporation domiciled in South Carolina. XYZ owns title and rights to trademarks and tradenames. The trademarks and tradenames are used by ABC to generate sales of tangible personal property in numerous states, including South Carolina. The activities that generate the sales occur in the marketing and distribution process as the ABC name, mark, and reputation is presented to customers.

XYZ conducts its business in South Carolina, but does not engage in manufacturing or any form of collecting, buying, assembling, or processing goods or materials, or selling or distributing or dealing in tangible personal property. All of its property is located in South Carolina. All of its payroll is paid to employees in South Carolina.

XYZ's only business is licensing and protecting the use of the trademarks and tradenames. Under the terms of the contract, XYZ requires that ABC maintain quality specifications are instructed by XYZ related to all products sold under the licensed intellectual property. Based upon a proposed Royalty and Licensing Agreement, to be finalized and executed after this ruling is resolved, XYZ will receive from ABC a royalty fee of 1.5% of the net customer billings (gross billings of customers less related returns and sales credits) from the operations. Sales occur when and at the place they are received by the licensee's customers.

Discussion:

Code Section 12-7-230 imposes an income tax on corporations transacting or conducting business in South Carolina, and reads, in part:

...every corporation organized under the laws of this State, doing or transacting business partly within and partly without this State...shall pay annually an income tax equivalent to five percent of a proportion of its entire net income to be determined as provided in this chapter...

Therefore, XYZ is subject to tax in South Carolina. Next, we must determine how much of its income is subject to tax by South Carolina. XYZ is transacting business partly within and partly without South Carolina. See *Geoffrey v. South Carolina Tax Commission*, 437 SE 2d 13 (1993). Code Section 12-7-250 provides that "the income tax...is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State". The base upon which South Carolina imposes income tax is determined by an allocation and apportionment process. The allocation process under Code Section 12-7-1120 is applied first, then any remaining income is apportionable. To determine how much of XYZ's income is apportionable to South Carolina, we must determine the correct apportionment factor to be used by XYZ.

Code Section 12-7-1140 provides for the three-factor apportionment formula to apportion the income of corporations whose principal business in South Carolina is manufacturing, selling, distributing or dealing in

tangible personal property within South Carolina. Based upon the facts presented, this statute is inapplicable to XYZ. Therefore, XYZ must use the gross receipts method of apportionment provided in Code Section 12-7-1190 . Pursuant to this section, a taxpayer using the gross receipts method shall:

...make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

Next, we must determine what is included in the numerator and the denominator of the gross receipts factor used by XYZ. In *Lockwood Greene Engineers v. South Carolina Tax Commission*, 361 SE 2d 346 (1987) , the court looked to the place where the income-producing activity occurred in order to satisfy the statutory requirement of identifying the "gross receipts from within this State". In *Geoffrey*, supra, the court determined that the activity that produced the royalty is the sale in South Carolina. It is the use of the trademark in each state that produces the gross receipts.

Based on the facts presented and the above analysis of recent court decisions, the numerator of XYZ's gross receipts ratio will include royalties earned from sales that occur in South Carolina, and the denominator will include royalties earned from sales that occur everywhere. XYZ's South Carolina apportioned income is then added to income specifically allocated to South Carolina, if any, under Code Section 12-7-1120 . This sum results in South Carolina taxable income.

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M



EXHIBIT M



301 Gervais Street, P.O. Box 125, Columbia, South Carolina 29214

SC Technical Advice Memorandum #94-2 (TAX)

TO: JKL, Inc.

SUBJECT: Apportionment Ratio
(Income Tax)

DATE: September 20, 1994

SCOPE: This Technical Advice Memorandum is Policy's official advisory opinion on how laws administered by the Department of Revenue are to be applied to a specific audit of a particular person. It may only be relied upon by the person to whom it is issued and only for the transaction or transactions to which it relates. This Technical Advice Memorandum has no precedential value.

Question:

Based upon the facts, what apportionment ratio should be used by JKL, Inc., in determining its South Carolina income?

Conclusion:

Based upon the facts, JKL, Inc., should use the gross receipts formula provided in Code Section 12-7-1190 in determining its South Carolina income.

Facts:

JKL, Inc., (JKL), began doing business in November 1991 in Delaware. JKL's principal asset is the ownership of the "ABC" tradename and associated trademarks. It performs functions related to the licensing of the ABC tradename and trademarks and the receipt and investment of royalties from the exploitation of the ABC tradename and trademarks.

Over 90% of the royalties which JKL receives are generated pursuant to its licensing agreements with its parent company, XYZ Company, (XYZ). XYZ is a manufacturer of industrial and consumer packaging products and is headquartered in South Carolina.

JKL also licenses trademarks to affiliated domestic companies for use on JKL's and its subsidiaries associated products. The royalties which are paid by JKL's licensees are based on each licensee's sales of licensed products throughout the United States and foreign countries.

The licenses in question are licenses for the exclusive use of trademarks or tradenames under which products are sold by JKL and its subsidiaries. No manufacturing or any form of collecting, buying, assembling, or processing goods or materials, or selling, distributing or dealing in tangible personal property is performed by JKL.

Discussion:

Code Section 12-7-230 imposes an income tax on corporations transacting or conducting business in South Carolina, and reads, in part:

...every foreign corporation transacting, conducting, doing business, or having an income within the jurisdiction of this State, whether or not the corporation is engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income, to be determined as provided in this chapter...

Based upon the facts and Geoffrey v. South Carolina Tax Commission, 437 SE 2d 13 (1993), SPCR is taxable under Code Section 12-7-230. The base upon which South Carolina imposes income tax is determined by an allocation and apportionment process. The allocation process under Code Section 12-7-1120 is applied first, then any remaining income is apportionable. We have received no facts that indicate any of JKL's income is allocable under Code Section 12-7-1120, therefore, for purposes of this document, we will assume that all of its income must be apportioned. To determine how much of JKL's income is apportionable to South Carolina, we must determine the correct apportionment factor to be used by JKL.

Code Section 12-7-1140 provides for the three-factor apportionment formula to apportion the income of corporations whose principal business in South Carolina is manufacturing, selling, distributing or dealing in tangible personal property within South Carolina. This statute is inapplicable to JKL.

Therefore, JKL must use the gross receipts apportionment ratio provided in Code Section 12-7-1190. Pursuant to this section, a taxpayer using the gross receipts method shall:

...make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

Based on this analysis, JKL is subject to South Carolina income tax and the gross receipts method of apportionment should be used to determine its South Carolina taxable income. The numerator of the gross receipts ratio will include royalties earned from South Carolina sales, and the denominator will include royalties earned from sales everywhere.

The interpretation is consistent with Geoffrey v. South Carolina Tax Commission, 437 SE 2d 13 (1993) and Lockwood Green Engineers v. South Carolina Tax Commission, 361 SE 2d 346 (1987).

NOTE: Since JKL has not filed a South Carolina income tax return, the guidelines set forth in SC Information Letter #94-5 for voluntary and non-voluntary filers should be reviewed by JKL.

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IN RE: A FINDING CONCERNING THE INCOME TAX LIABILITY OF XXX, INC. AND YYY
SUBSIDIARIES FOR AUDIT YEARS 1985, 1986, AND 1987., COMMISSION DECISION 93-51, 05/06/1993

IN RE: A FINDING CONCERNING THE INCOME TAX LIABILITY OF XXX, INC. AND YYY SUBSIDIARIES FOR AUDIT YEARS 1985, 1986, AND 1987.

Case Information:

Docket/Court: COMMISSION DECISION 93-51, South Carolina Dept. of Rev. Commission Decisions

Date Issued: 05/06/1993

Tax Type(s): Corporate Income Tax

References: (Cite as: 1993 WL 460614 (S.C.Tax.Com.))

OPINION

FINDINGS OF FACT

This matter results from an audit and a proposed assessment issued to "ABC and YYY Subsidiaries" as the taxpayer. The taxpayer's current name is XXX, Inc. It is the successor to ABC, Inc. (hereinafter "ABC"), which is the name of the taxpayer's predecessor corporation during the period under audit. Both ABC and XXX, Inc., will hereafter be referred to as "taxpayer". Taxpayer has protested the additional income tax assessment of \$2,205,564 plus interest for tax years 1985, 1986, and 1987.

Taxpayer is a member of an affiliated group as defined by Internal Revenue Code Section 1504. The parent of the affiliated group is ABC Sons', Inc. (ABCS), which, before the acquisition of The XXXG, Inc., was the parent of an affiliated group of multistate corporations engaged in the construction and mining businesses. A subsidiary of ABCS joined with an unrelated third-party corporation to form ABC in 1984 for the purpose of acquiring The XXXG, Inc. (XXXG). XXXG was the parent of an affiliated group of multistate corporations

engaged in the packaging, insurance, oil and gas, and timber businesses.

The 1984 acquisition by ABC of XXXG was financed by capital infusion and borrowings. The borrowings totalled \$ billion and the capital infusion was \$ million. Prior to the acquisition, ABC incorporated 52 mirror companies to purchase the stock of ZZ, Inc. (ZZ), a subsidiary of ZZ which was the timber- holding company. The timber mirror companies were capitalized by an \$ million cash contribution by ABC. The timber mirrors purchased the shares of ZZ, and, through a series of corporate liquidations, acquired the timber assets.

Prior to the acquisition of XXXG by ABC, the South Carolina timber operations and properties acquired by the mirrors were contained in two corporations known as XAX, Inc., and XSX, Inc., which did business both within and without South Carolina. After a series of liquidations and asset transfers, XDX, Inc., XCX, Inc., XGX, Inc., and ZZ were the timber companies which held title to the South Carolina timber operations and property. The South Carolina mirrors had no employees, equipment, nurseries, cutting contracts, offices or bank accounts. All tangible and intangible personal property was held by ZZ. ZZ operated both inside and outside South Carolina.

ZZ (formerly known as YZZ, Inc.) performed certain administrative functions for XDX, XCX, and XGX, including payment of accounts payable, collection of receivables, engineering and construction services, general financial and cash management, income tax planning and compliance, and legal services pursuant to the terms of a series of "Management Agreements".

ABC, incorporated under the laws of Delaware, is authorized to do business in this State. ABC borrowed the money used to capitalize ZZ, XCX, XDX, XGX, and the remaining 48 foreign mirror corporations so the subsidiaries could purchase The XXXG. ABA provided cash management, tax, and legal services for ZZ and the timber mirrors.

CONCLUSIONS

There are four broad issues raised by this dispute. Each is addressed in the following discussions.

A. Filing Of A Consolidated Return

ABC filed a consolidated South Carolina income tax return for 1985, 1986, and 1987 which included ABC, ZZ, XCX, XDX, and XGX. ABC has been removed from the consolidation as have XCX, XDX, and XGX. The consolidation question is addressed below.

1. Introduction

Determining taxable income in South Carolina for a corporate taxpayer involves at least three determinations. The first determination a taxpayer must make is whether it is taxable in South Carolina. It is taxable if it is within S.C. Code Ann. Section 12-7-230 (Supp.1992). That section imposes an income tax on corporations that are conducting business in the State. The second determination concerns taxing a base which is that portion of the income "as provided in this chapter". The base upon which the tax is imposed is found in

Chapter 7, Article 9 of Title 12.

The base upon which South Carolina imposes its income tax is determined in two steps, both of which are identified in Chapter 7, Article 9 of Title 12, which Article is entitled "Allocation or Apportionment of Income". The first step is allocation. S.C.Code Ann. Section 12-7-1120 (Supp.1992) explains that certain classes of income less related expenses are allocated, i.e., taxed at a designated location. For example, Section 12-7-1120(4) allocates a taxpayer's gain on the sale of real property to "the state in which the real property is located ..."

The second step in the determination of the base is that of apportionment. Apportionment is required by S.C.Code Ann. Section 12-7-1140 (1976), which states the following:

Net income of the above classes [12-7-1120] having been separately allocated, a taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling or processing goods and materials within this State, or (b) selling, distributing or dealing in tangible personal property within this State, shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the arithmetical average of the three ratios stated in Sections 12-7-1150 to 12-7-1170 .

Thus, after allocating specific classes of income less related expenses, a taxpayer is subject to a formula to determine the "proportion of its remaining net income" which is taxable in South Carolina. The formula is the average of three ratios: property in South Carolina as a percentage of property everywhere, see S.C.Code Ann. Section 12-7-1150 (Supp.1992); payroll in South Carolina as a percentage of payroll everywhere, see S.C.Code Ann. Section 12-7-1160 (1976); and sales in South Carolina as a percentage of sales everywhere, see S.C.Code Ann. Section 12-7-1170 (Supp.1992). The average of these three percentages is then multiplied by the remaining net income to give South Carolina apportioned income. If a taxpayer is not "dealing in tangible personal property" within the classification of Section 12-7-1140 , then its income is apportioned under S.C.Code Ann. Section 12-7-1190 (Supp.1992). That section apportions income based upon gross receipts within South Carolina to total gross receipts within and without South Carolina. The South Carolina apportioned income is then added to income specifically allocated to South Carolina, if any, under Section 12-7-1120 . This sum results in South Carolina taxable income.

The final determination is how the income is reported. Generally, corporate taxpayers file separate returns and report their income separately. In some instances, however, a consolidated return is permitted. S.C.Code Ann. Section 12-7-1570 (1976) states the following:

Any taxpayer capable of exercising, directly or indirectly, substantially the entire control of the business of another taxpayer, either by ownership or control of substantially the entire capital stock (if a corporation) of such other taxpayer or otherwise, may, under regulations prescribed by the Commission, be permitted to make a consolidated return, showing the consolidated net income and such other information as the Commission may require in order to compute the net income properly attributable to the State and to impose the tax upon the taxpayers concerned.

For the years here in dispute, the regulatory guidance for filing such returns is prescribed at 27 S.C. Code Ann. Regs. 117-77. During the time of the instant matter, the pertinent part of that regulation provided as follows:

II. All corporations included in a consolidated return must be subject to tax under Section 12-7-230.

III. A corporation doing business entirely within this State may not consolidate with a corporation doing a multistate business. The South Carolina net income must be computed separately for each corporation and then combined into one return.

IV. Two or more corporations doing a multistate business may file a consolidated return provided all corporations in the consolidation are subject to the same method of apportionment. Corporations not subject to the same method of apportionment must compute the South Carolina net income of each corporation separately and then combine the South Carolina net income of each into one return.

V. A corporation establishing a new business or industry in this State and seeking to avail to itself the benefits of Section 12-7-700(12) may not consolidate or combine such new business or industry with its other business until the benefits of Section 12-7-700(12) have been exhausted.

VI. All corporations included in a consolidated return or a combined return must use the same accounting year.

VII. The election to file a consolidated return, combined return or separate returns shall be made on an original and timely filed return and may not be changed after the return is filed.

VIII. Once an election is made to file a consolidated return, such election must be adhered to until permission is granted by the Tax Commission to file separate returns.

Regulation 117-77, for the years in question here, allowed corporations two methods of filing a South Carolina consolidated return. When all the corporations included in the consolidated return are subject to the same method of apportionment, the net income of each corporation is added and a single ratio including all payroll, property, and sales is computed. Then this total net income is multiplied by the single ratio to determine South Carolina consolidated net income (single method). If the corporations included in the consolidated return are subject to different methods of apportionment, the net income of each corporation is multiplied by the ratio of that corporation, then the South Carolina net incomes separately computed are added together to arrive at South Carolina consolidated net income (separate method).

2. Application Of Consolidation Rules To The Taxpayer

ABC, ZZ, XCX, XDX, and XGX all filed as part of a consolidated group using the single method. The Field Services Division found that XCX, XDX, and XGX could not consolidate under the single method with ZZ and ABC. Further, Field Services concluded that ABC could not be part of a consolidation in any event since ABC did no business in South Carolina. We address these views below.

A corporation doing business entirely within South Carolina may not consolidate under the single method with a corporation doing a multistate business. Rather, the South Carolina net income must be computed separately and then combined under the separate method. Regulation 117-77 III. Further, all corporations in a consolidated return must be subject to tax in South Carolina. Regulation 117-77 II.

There is no dispute that ZZ conducts a multistate business. It had equipment and employees in Georgia and South Carolina and derived income from at least those two states. Thus, ZZ may not consolidate under the single method with corporations that are entirely conducting business in South Carolina. Thus, the dispute initially turns upon whether the three mirror corporations of XCX, XDX, and XGX are conducting a multistate business.

We find and conclude ZZ may not consolidate under the single method with XGX and XDX for 1985, 1986, and 1987. We find, however, that ZZ may consolidate under the single method with XCX for 1986 and 1987, but not 1985.

XGX and XDX owned no property in any state except South Carolina. XCX likewise owned no property in any state other than South Carolina, but in 1986, XCX acquired timberland in Georgia. In 1987, XCX sold its Georgia timberland. For all three corporations, ZZ negotiated the sale of timber to various buyers and was paid a fee for its services. The fee was pursuant to a service agreement. Such service agreement is insufficient to place the companies receiving the services into another taxing jurisdiction. If a South Carolina landowner hired a New York real estate agent to sell its land to a California buyer, there is no basis for finding the South Carolina landowner is doing business in New York or California. The same is true here. We conclude the service agreement does not place the three mirror corporations as doing business in another state, and in the absence of other factors, no consolidation under the single method of ZZ with the three mirrors would be allowed.

Other factors, however, are present as to XCX for the tax years 1986 and 1987. As mentioned above, XCX owned timberland in Georgia in 1986 and sold the property in 1987. Accordingly, for 1986 and 1987, XCX was conducting business in South Carolina and Georgia and was thus a multistate taxpayer. Accordingly, ZZ and XCX may file single method consolidated returns for 1986 and 1987. 1

We note here that ZZ is in the business of providing services. We have no indication that it is dealing in tangible personal property. Accordingly, ZZ must report on the gross receipts method of Section 12-7-1190. In ZZ's consolidation with XCX for 1986 and 1987, the consolidation is under the single method if the corporations "are subject to the same method of apportionment". Regulation 117-77 IV. If they are not under the same method, the corporations must consolidate under the separate method. Thus, we reach the question of whether the mirror corporation of XCX is subject to the gross receipts apportionment method as is ZZ.

Under Section 12-7-1190, a taxpayer apportions its income (not otherwise allocated by Section 12-7-1120) based upon the percentage of total gross receipts that are South Carolina gross receipts. This method is used if the taxpayer is not dealing in tangible personal property. We find and conclude XCX, like the other mirrors of XGX and XDX, is subject to the gross receipts method since it is not dealing in tangible personal property.

In South Carolina for the years in question, the sale of standing timber constituted the sale of an interest in realty. *Alexander v. Hemdon*, 84 S.C. 181, 65 S.E. 1048 (1909) ; *Graham v. Prince*, 293 S.C. 77, 358 S.E.2d 714, 717 (S.C.App.1987) ; *Hamilton Ridge Lumber Corporation v. Southern Cotton Oil Co.*, 271 F. 934 (1921) . Only in 1988 for years beginning in 1989 did the General Assembly make "timber to be cut" a contract for the sale of goods. See 1988 Act No. 494, Section 3. Accordingly, timber for the 1985, 1986, and 1987 tax years is an interest in realty. Thus, since the mirrors do not deal in tangible personal property, any income which is apportionable is apportioned under the gross receipts method of Section 12-7-1190 . Since ZZ and XCX are multistate for 1986 and 1987, and since ZZ and XCX are under the same apportionment method, consolidation is allowed for these two corporations under the single method of consolidation.

The issue of whether ABC is allowed to consolidate under either the single method or the separate method with XCX, XDX, and XGX or ZZ turns upon ABC satisfying the requirement that it is a corporation subject to tax under Section 12-7-230 . See Regulation 117-77 II. If ABC is subject to South Carolina tax, it may consolidate under the single method with other multistate corporations, but if it is not subject to South Carolina tax, it may not consolidate under any method.

We find and conclude ABC is not subject to South Carolina taxation and thus may not join in the consolidation under any method. ABC, a holding company, provides an array of administrative services for its subsidiary corporations that are typical of most holding companies. Services provided include cash management, income tax planning and compliance, and legal services. None of these services, however, was performed in South Carolina. This is evidenced by the fact that on the returns filed with the Commission, ABC has no property, payroll, or sales in this State.

ABC has been unable to provide the Commission with documentation showing that any of these administrative services were actually performed in this State. During the three year audit period, ABC employees entered this State on only one occasion. On September 23, 1986, the "ZZ Woodlands Field Trip" was held. During this trip, a group of individuals, many of whom served as directors of ABC, ZZ, XCX, XDX, and XGX, toured the mirror company's timber operations in South Carolina and Georgia. Other than this contact, we find no activity that places ABC within the taxability of South Carolina's law.

B. Allocation Of Gain On Sales Of Timberlands

The corporations of XGX, XDX, and XCX sold substantial timberland and standing timber. The Field Services Division held the gains or losses from such sales were allocated under Section 12-7-1120(4) . That section states the following:

Gains and losses from the sale of real property located in this State are allocable to this State, and the gains and losses from the sale of real property located outside this State shall be allocated to the state in which the real property is located. The taxpayer has advanced three positions. First, it asserts the gain is incorrectly computed since it does not follow *Hercules, Inc. v. South Carolina Tax Commission*, 279 S.C. 177 , 304 S.E.2d 815 (S.C.1983) . Second, it asserts the standing timber is inventory and is not apportioned. Finally, it asserts Section 12-7-1120(4) is unconstitutional.

1. Application Of Hercules, supra.

Hercules, supra, states the following:

We, therefore, hold that the gain which is allocable to South Carolina under Section 12-7-1120(4) is gain represented by a true and actual profit as contrasted with a profit brought into being by reason of recapturing depreciation. In addition, the gain would, of course, include the recapture of depreciation actually allocated to South Carolina. Hercules, supra at 818.

In Hercules, supra, the Tax Commission attempted to tax a gain based upon the difference between the basis of the property and the sales price of the property. The Court disagreed and required that the basis must be adjusted upward to account for the fact that depreciation reduced the basis even when the depreciation deduction was apportioned, and thus Hercules did not receive the full benefit of the deduction that reduced its basis. Thus, the basis was required to be cost less the depreciation deduction applied in South Carolina which result gives the South Carolina adjusted basis for gain or loss.

We agree that Hercules, supra, controls the sales here in dispute. The basis must be adjusted to reflect any items that reduced the basis in the property where those items were apportioned in arriving at South Carolina taxable income. The evidence presented to us does not demonstrate what that adjustment, if any, might be. Accordingly, we remand the matter to the Field Services Division for consideration of this adjustment.

2. Inventory

The taxpayer also asserts the standing timber is inventory and is thus not within Section 12-7-1120(4). We disagree. As we have previously stated in this decision, standing timber is realty. Whether it is inventory or crops or some other designation does not remove it from being realty. Section 12-7-1120(4) allocates the gain or loss on the sale of realty. Here, the gain is allocated.

3. Constitutionality

Finally, the taxpayer asserts Section 12-7-1120(4) is unconstitutional. As a state agency, we are unable to make such a finding, but rather we are required to enforce the plain and unambiguous statutes since only a court may declare a statute unconstitutional. South Carolina Tax Commission v. South Carolina Tax Board of Review, 278 S.C. 556, 299 S.E.2d 489 (1983). However, in our view, the statute is constitutional. We decline to disregard the plain language of the statute and until the statute is shown to be improper, we will continue to enforce it.

C. Basis In The Timberland

The taxpayer filed both its federal and South Carolina income tax returns using a "carry-over" basis for the timberland assets of XDX, XCX, and XGX. To insure that the mirror companies were entitled to use the "carry-over" instead of "stepped-up" basis in the timber assets, ABC filed a protective carry-over election with the IRS in 1984 to prevent the application of Section 338. It was not advantageous for federal purposes for

ABC to elect Section 338 treatment.

The taxpayer now seeks to argue that it did not intend to elect a carry-over basis for South Carolina, but rather intended to use a stepped-up basis. If a stepped-up basis is used, the gain from the sale of the timber assets is reduced.

Under Act 101, Acts of 1985, Section 7, the General Assembly stated the following:

Any election for federal income tax purposes automatically applies for South Carolina income tax purposes and a taxpayer may not elect differently for South Carolina income tax purposes.

In order to ensure uniformity between state and federal income, the General Assembly required that elections already existing or elections to be made in the future were to be consistent between state and federal income. The very purpose of the Act was set out in the Title as the "Federal Conforming Amendments of 1985". To ensure conformity, federal elections carried over to South Carolina. When the General Assembly desired to let a taxpayer change for state purposes a federal election already in existence, the Act allowed specific exceptions. See for example S.C.Code Ann. Section 12-7-455(c) (Supp.1992) which states a taxpayer's federal election made before January 1, 1985 as to IRC Section 83(b) will not be effective unless certain conditions are met. In fact, the 1986 supplement to the Code of Laws for Title 12 (which supplement was adopted by the General Assembly as official) sets forth the title to Section 12-7-455 as "Effect of transactions occurring prior to January 1, 1985". Thus, in our view, it is clear that the federal elections made prior to South Carolina's conforming act were to become binding elections under South Carolina law.

Section 338 of the IRC became law under the Tax Equity and Fiscal Responsibility Act of 1982. Under that section, a purchasing corporation could make an irrevocable election to treat purchases of stock in a target corporation as if the target corporation had sold and purchased its assets in a complete stock liquidation on the very day of the stock purchase. In other words, the election allows the purchaser to obtain a basis in the assets premised on the amount paid for the stock. While the election is voluntary under Section 338(e), the election is deemed to be made automatically under certain circumstances involving affiliated corporations.

In the instant matter, the taxpayer was concerned that it might be deemed to have chosen the benefits of IRC Section 338. Accordingly, it filed an election in which it specifically stated it did not want the stepped-up basis of Section 338. In our view, the taxpayer intentionally chose the carry-over basis. It has not and did not choose the stepped-up basis of Section 338. Thus, we find and conclude it is bound by its federal decision.

Further, we do not believe the doctrine of Kimbell-Diamond compels a finding that the basis in the assets must be the stock purchase price. Kimbell-Diamond to a large extent is based upon effectuating the intent of the parties. It is certainly relevant that here the parties reflected their intent by establishing a carry-over basis in the assets. We do not find sufficient reason in 1993 to alter the manner in which the parties in 1984 recorded their acquisition.

D. Debt And Expenses Associated With The Sale Of Timber And Timberlands

The 1984 acquisition by ABC of XXXG was financed by utilizing \$ million of cash and loans totalling \$ billion. The timber mirrors were then capitalized by a \$ million cash contribution by ABC. The timber mirrors, three of which operated in South Carolina, were created by ABC to effectuate the purchase of ZZ, Inc. The timber mirrors purchased the shares of ZZ, Inc., and through a series of corporate liquidations, acquired the timber assets. The South Carolina timber assets were held by XCX, XGX, and XDX.

The loan of \$ billion generated interest expense. That interest expense is one incurred by ABC since ABC was liable on the debt. The interest expense of one party cannot be shifted to another. Even under the provisions of IRC Section 482, only the taxing authority is authorized to redistribute income and expenses between related parties. We find no reason for shifting such expenses to the timber sales made by the three South Carolina timber companies. Such is especially true in light of our finding that ABC does no business in South Carolina. We conclude that interest expenses are those of ABC and may not be shifted to the timber sales.

Further, the interest expense was incurred by ABC to enable it to acquire stock in the timber corporations. Accordingly, in any event, the interest expense is not appropriate as a reduction for the sale of timber. Rather, the interest expense is allocated to ABC's receipt of dividends. *Avco Corp. v. Wasson*, 267 S.C. 581, 230 S.E.2d 614 (1976). Thus, there is no basis upon which the ABC expenses can be applied to offset the timber sales.

Based on all of the above, we find and conclude ZZ may consolidate under the single method with XCX for tax years 1986 and 1987. We find and conclude ABC may not consolidate under any consolidation method. We also find the mirror corporations are to allocate the sales of timber and timberland as realty under Section 12-7-1120(4). We find the basis for determining the gain on the sale of the timber and timberland is the carry-over basis and not the stepped-up basis. Further, the basis must be adjusted in accordance with our directions in light of *Hercules*, supra. We find that any income from the sale of timber and timberland cannot be reduced by interest and other expenses incurred by ABC. Finally, we find that any apportionable income of XCX, XGX, XDX, and ZZ must be apportioned under the gross receipts method of Section 12-7-1190.

AND IT IS SO FOUND AND ORDERED.

A. Crawford Clarkson, Jr.

Chairman

T.R. McConnell

Commissioner

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Even under single method consolidation, however, income must be allocated in accordance with Section 12-7-1120. Thus, realty sold must be allocated to the appropriate location.

END OF DOCUMENT -

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EXHIBIT O

State of South Carolina
Department of Revenue
301 Gervais Street, P. O. Box 12265, Columbia, South Carolina 29211
Website Address: <http://www.sctax.org>

SC INFORMATION LETTER #11-13

SUBJECT: Tax Legislative Update for 2011

DATE: August 19, 2011

AUTHORITY: S.C. Code Ann. Section 12-4-320 (2000)
S.C. Code Ann. Section 1-23-10(4) (Supp. 2010)
SC Revenue Procedure #09-3

SCOPE: An Information Letter is a written statement issued to the public to announce general information useful in complying with the laws administered by the Department. An Information Letter has no precedential value.

Attached is a brief summary of most of the significant changes in tax and regulatory laws enacted during the past legislative session. The summary is divided into categories, by subject matter, as indicated below.

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DISCLAIMER:

This is intended to be a summary of the main points of the legislation; it is not an interpretation by the Department. Please refer to the full text of the legislation for specific details and requirements.

There may be instances where some tax or incentive related legislation briefly summarized is under the jurisdiction of another state agency or political subdivision, and not the Department. In such cases, questions concerning these provisions should be made directly to the agency or political subdivision having primary responsibility for the administration of these acts. Legislation regarding distribution of funds is not summarized.

TEXT OF LEGISLATION:

A complete copy of the legislation discussed in this publication can be obtained from the South Carolina Legislative Council's website at <http://www.scstatehouse.net/html-pages/legpage.html>.

LIST OF BILLS BY SUBJECT CATEGORY

A list of significant changes in tax and regulatory laws (both permanent and temporary) enacted during the 2011 legislative session is provided below. Temporary provisos are enacted in the State budget and are only effective for the State fiscal year (July 1 – June 30); unless re-enacted they expire on June 30, 2012.

This list is divided by subject matter with the bills listed in numeric order. The list of bills with a link to the full text of each act is on the Department's website at:
<http://www.sctax.org/Tax+Policy/Legislation+for+2010.htm>.

INCOME TAXES, WITHHOLDING & CORPORATE LICENSE FEES

BILL #	ACT #	SUBJECT
522	5	Income Tax Conformity
592 – Sec. 6	46	Military Corporation – Filing Requirement
3700 – Proviso 1A.16	73	Teacher Supplies – Reimbursement Not Taxable – Reenacted Temporary Proviso
3700 – Proviso 81.8	73	No Estimated Tax Penalty when following IRC 6654(d)(1)(D) – Reenacted Temporary Proviso

PROPERTY TAXES and FEES IN LIEU OF PROPERTY TAXES

BILL #	ACT #	SUBJECT
628		Dorchester County School Districts Millage
3700 – Proviso 1.99	73	DOR Computation of Index of Taxpaying Ability – New Temporary Proviso
3700 – Proviso 89.45	73	Personal Property Tax Relief Fund – Reenacted Temporary Proviso
3713 – Sec. 1	57	Alternative Valuation for Assessable Transfer of Interest
– Sec. 2		Cap on Millage Increase Revised
– Sec. 3		Rollback Millage
3806		Property Tax Credit in Lexington County School Districts 1 and 4

SALES AND USE TAXES

BILL #	ACT #	SUBJECT
36 – Sec. 1	32	Durable Medical Equipment
– Sec. 2		Warranty & Maintenance Contracts
– Sec. 3		Distribution Facility Nexus
3700 – Proviso 89.44	73	Private Schools – Use Tax Exemption – Reenacted Temporary Proviso
3700 – Proviso 89.67	73	Respiratory Syncytial Virus Medicine – Reenacted Temporary Proviso
3700 – Proviso 89.72	73	Viscosupplementation Therapy – Tax Suspended – Reenacted Temporary Proviso

MISCELLANEOUS

BILL #	ACT #	SUBCATEGORY	SUBJECT
		Administrative & Procedural	
<u>20</u>	69		Immigration Reform – Suspension or Revocation of licenses
3700 – <u>Proviso 72.17</u>	73		2% Interest Rate Reduction on Refunds for Guardian Ad Litem – Reenacted Temporary Proviso
3700 – <u>Proviso 81.6</u>	73		Political Candidate Tax Return Inquiry – Reenacted Temporary Proviso
3700 – <u>Proviso 89.116</u>	73		1% Interest Rate Reduction on Refunds for Joint Citizens and Legislative Committee on Children and the Department of Juvenile Justice – Reenacted Temporary Proviso
3700 – <u>Proviso 90.21</u>	73		Interpretation of Tax Statutes – Report to General Assembly – New Temporary Proviso
		Miscellaneous Taxes	
<u>584</u>			Lexington County Property Relief – 1¢ Special Sales Tax Extended
3700 – <u>Proviso 1.17</u>	73		Motor Fuel Tax Exemption for School Buses – Reenacted Temporary Proviso
3700 – <u>Proviso 21.16</u>	73		Nursing Home Bed Franchise Fee Suspended – Reenacted Temporary Proviso
3700 – <u>Proviso 81.7</u>	73		Athletic Booster Organizations Season Tickets – Admissions Tax Exemption – Reenacted Temporary Proviso
3700 – <u>Proviso 90.23</u>	73		Motorsports Entertainment Complex Facility – New Temporary Proviso
		Regulatory	
<u>3178</u>	66		Tastings at Liquor Store
<u>3278</u>			Special Permits for Nonprofits
<u>3295</u>	67		ABL Permits

INCOME TAXES, WITHHOLDING, and CORPORATE LICENSE FEES

Senate Bill 522 (Act No. 5)

Internal Revenue Code Conformity

Code Section 12-6-40(A)(1)(a) has been amended, except as otherwise provided, to update South Carolina's income tax laws to conform to the Internal Revenue Code of 1986, as amended through December 31, 2010, and includes the effective date provisions contained therein.

Effective Date: April 12, 2011

Senate Bill 592, Section 6 (Act No. 46)

Military Corporation Filing Requirements Clarified

Code Section 25-1-120, dealing with the incorporation of certain military organizations, has been amended to add subsection (C) to exempt these military organizations from filing returns with the Department to the same extent they are exempt from filing returns with the Internal Revenue Service.

These military organizations may include: (1) enlisted, officer or all-ranks clubs, (2) family support groups, (3) auxiliary organizations, (4) service branch organizations, (5) battalion, brigade, or unit fund organizations, or (6) other such organizations that provide support to personnel and their families. The incorporation of these organizations must be approved by the Adjutant General and the State Judge Advocate. These corporations cannot engage in business and are not required to pay the corporate license fee.

Effective Date: June 7, 2011

REMINDER

The following provisions were enacted in 2010, but are effective in 2011. They are summarized below for informational purposes.

House Bill 4478, Section 23 (Act No. 290)

Manufacturers of Renewable Energy Systems and Components - New Credit

Code Section 12-6-3588 has been added to provide an income tax credit to companies in the solar, wind, geothermal, and other renewable energy industries who are expanding or locating in South Carolina. To qualify, a company must: (1) manufacture renewable energy systems and components in South Carolina for solar, wind, geothermal, or other renewable energy uses; (2) invest at least \$500 million in new qualifying plant and equipment in the year the tax credit is claimed; and (3) create one and one-half full time jobs for every \$500,000 of qualifying capital investment that each pays at least 125% of the State's average annual median wage as defined by the Department of Commerce. A taxpayer may separately qualify for new facilities in separate locations or for separate expansions at existing facilities in South Carolina.

Expenditures qualifying for this credit must be certified by the State Energy Office. To obtain the amount of credit available to a taxpayer, each taxpayer must submit a request for the credit to the State Energy Office by January 31st for qualifying expenditures incurred in the previous calendar year. By March 1st, the State Energy Office must notify the taxpayer of the qualifying expenditures and the allocated credit amount. The credit is claimed for the tax year which contains December 31st of the previous calendar year.

The credit is equal to 10% of the cost of the company's total qualifying investment in plant and equipment in South Carolina for renewable energy operations. A taxpayer's total credit for all expenditures allowed must not exceed \$500,000 for any year and \$5 million total for all years. Unused credits can be carried forward 15 years after the tax year in which a qualified expenditure was made. This credit is in lieu of any other applicable income tax credits or abatements allowed by state law. In the event of an overlap or conflict in available credits or abatements, the taxpayer may select the credit or abatement desired in the manner prescribed by the Department.

Note Expiration: "The income tax credit program is for a five-year period beginning January 1, 2010, and ending December 31, 2015."

Effective Date: January 1, 2011

House Bill 4478, Sections 20, 21, and 38 (Act No. 290)

Capital Investment Tax Credit - Replacing Economic Impact Zone Investment Tax Credit. Repeal of Certain Code Sections in Economic Impact Zone Act in Chapter 14 of Title 12 and Repeal of Credit for Hiring Displaced Workers in Code Section 12-6-3450

Chapter 14 of Title 12 contains the Economic Impact Zone Community Development Act of 1995. Chapter 14 has been substantially amended. Among the changes are the following:

1. Code Section 12-14-20, containing the purpose of the Economic Impact Zone Community Development Act of 1995, is amended to provide that the purpose of Chapter 14 is to establish a program of providing tax incentives for the creation of capital investment in order to revitalize capital investment in South Carolina, primarily by encouraging the formation of new businesses and the retention and expansion of existing businesses; and to promote meaningful employment. Previously, the Act's purpose was to provide for the establishment of economic impact zones on or in the vicinity of closed or realigned military installations in which various tax incentives may apply to businesses and individuals located in the economic impact zone in order to economically revitalize the area.

2. Code Section 12-14-60, providing for the economic impact zone investment tax credit, has been amended to delete all references to "economic impact zone" and to provide for a capital investment tax credit as follows:

0.5% of total aggregate bases of all qualifying 3 year manufacturing and productive equipment property;

1.0% of total aggregate bases of all qualifying 5 year manufacturing and productive equipment property;

1.5% of total aggregate bases of all qualifying 7 year manufacturing and productive equipment property;

2.0% of total aggregate bases of all qualifying 10 year manufacturing and productive equipment property; and

2.5% of total aggregate bases of all qualifying 15 year or greater manufacturing and productive equipment property.

The definition of qualified manufacturing and productive equipment property in Code Section 12-14-60(B) was amended to replace references to "economic impact zone" with "this State."

3. To repeal the following code sections in Chapter 14 of Title 12:

- a. Code Section 12-14-30. This section contained definitions of the terms "economic impact zone," "applicable federal military installation," "applicable federal facility," and "internal revenue code."
- b. Code Section 12-14-40. This section provided for the designation and revocation of an area as an economic impact zone.
- c. Code Section 12-14-50. This section provided for an individual income tax deduction for 20% of the purchase price of economic impact zone stock.
- d. Code Section 12-14-70. This section contained definitions of the terms "economic impact zone business," "qualified business," and "nonqualified financial property" relating to the individual income tax deduction.

In a related amendment, Code Section 12-6-3450, providing a tax credit to employers who hire persons who were employed in an economic impact region and whose job was terminated as a result of the closing or realignment of an applicable federal military installation or applicable federal facility, has been repealed.

Effective Date: January 1, 2011, except the repeal of Code Sections 12-14-30, 12-14-40, 12-14-50, 12-14-70, and 12-6-3450 are effective June 23, 2010.

House Bill 4478, Sections 16 and 38 (Act No. 290)

Job Tax Credit – Amended

Code Section 12-6-3360, dealing with the job tax credit, has been amended by this Act. Among the changes are the following:

1. The county rankings have been changed from five designations to four designations. Counties will now be ranked as "Tier I," "Tier II," "Tier III," and "Tier IV" counties. "Tier I" counties are the 11 counties with a combination of the lowest unemployment rate and highest per capita income. "Tier IV" counties are the 12 counties with a combination of the highest unemployment rate and lowest per capita income. Previously, counties were ranked as "developed," "moderately developed," "underdeveloped," "least developed," and "distressed" counties. Code Section 12-6-3360(B).
2. The dollar amount of the basic job tax credit for each new job created based on the new county designations of Tier I, II, III, and IV are:

\$1,500 per year for each new full time job created in a Tier I county,

\$2,750 per year for each new full time job created in a Tier II county,

\$4,250 per year for each new full time job created in a Tier III county, and

\$8,000 per year for each new full time job created in a Tier IV county.

Note: The credit is one-half of the dollar amount listed above for a taxpayer with 99 or fewer employees claiming the small business job tax credit under Section 12-6-3360(C)(2) for jobs with gross wages less than 120% of the county's or state's average per capita income.

Previously, the annual basic credit amount for each new, full time job was \$1,500 in a developed county, \$2,500 in a moderately developed county, \$3,500 in an underdeveloped county, \$4,500 in a least developed county, and \$8,000 in a distressed county. Code Section 12-6-3360(C).

3. Several types of businesses qualifying for the credit have been added or changed as follows:
 - a. A taxpayer that operates an "agribusiness operation" can now qualify for the job tax credit. Code Section 12-6-3360(A).
 - b. A taxpayer that operates a retail facility or service-related industry can qualify for the job tax credit only in a Tier IV county. Previously, a retail facility or service related industry in an underdeveloped county not traversed by an interstate highway, least developed county, or distressed county could qualify for the job tax credit. Code Section 12-6-3360(A).
 - c. The definition of "processing facility" has been expanded to include "meat, poultry, and any other variety of food processing operations." Processing facility continues to mean an establishment that prepares, treats, or converts tangible personal property into finished goods or another form of tangible personal property. The term includes a business engaged in processing agricultural, aquacultural, or maricultural products and specifically includes meat, poultry, and any other variety of food processing operations. It does not include an establishment in which retail sales of tangible personal property are made to retail customers. Code Section 12-6-3360(M)(6).
4. Special provisions have been deleted that qualify certain areas and counties for an increased credit designation. The restriction that a county's designation cannot be lowered in credit amount more than one tier in the following calendar year has also been deleted. Previously, rankings were done with equal weight given to unemployment rate and per capita income and then adjusted in accordance with special rules in Code Sections 12-6-3360(B) and (L), as applicable. Code Section 12-6-3360(B) and former Code Section 12-6-3360(L).

5. Section 38 of the Act repealed Code Section 12-6-3450 concerning a tax credit for persons terminated as a result of closing or realignment of federal military installations. Code Section 12-6-3450(A)(1)(b) was referenced in Code Section 12-6-3360(F)(2)(d) and Code Section 12-6-3360(M)(3). The general definition of "new job" in Code Section 12-6-3360(M)(3) continues to provide that "this exclusion of a new job created by an employee shifting does not extend to a job created at a new or expanded facility located in a county in which is located an 'applicable federal facility' as defined in Section 12-6-3450(A)(1)(b)."

Effective Date: January 1, 2011, except the repeal of Code Section 12-6-3450 is effective June 23, 2010.

House Bill 4478, Section 17 (Act No. 290)

Port Cargo Volume Increase Credit - Amended

Code Section 12-6-3375 provides a tax credit to a taxpayer engaged in manufacturing, warehousing, or distribution that uses a South Carolina port facility and that increases its port cargo volume at these facilities by at least 5% in a calendar year over its base year port cargo volume. The amount of the credit is determined by the Coordinating Council for Economic Development ("Council") upon application by the taxpayer. The changes to the credit include:

1. The credit has been expanded to allow it to be used against employee withholding taxes. The total amount of credit available for all taxpayers continues to be \$8 million a calendar year. Only \$4 million of the \$8 million may be used against withholding. Previously, the credit could only be used against income taxes.
2. The time for the taxpayer to submit an application to the Council for certification of the credit amount has changed. The taxpayer may now submit the application after the calendar year in which the increase occurs. Prior to amendment, a taxpayer had to submit the application by March 1st of the calendar year following the year of the increase.
3. The Council continues to have the sole discretion in allocating the credit and may now make allocations on a monthly, quarterly, or yearly basis. Previously, credits were allocated on a yearly basis.
4. The provisions in subitems (A)(2) and (B)(2) that provided that a taxpayer could not receive more than \$1 million in credit a year unless the total \$8 million credit had not been allocated have been deleted.
5. The Council may annually award up to \$1 million in credit to a new warehouse or distribution facility which commits to spending at least \$40 million at a single site and creating 100 new full-time jobs, without regard to base year cargo requirements.

The Council can award the credit in the year the facility is announced, but cannot tender the credit certificate until the taxpayer has provided proof that the capital investment and job requirements have been, or will be, satisfied. Any credit certificate expires 3 years after issuance if satisfactory proof has not been received.

Effective Date: January 1, 2011

House Bill 4478, Section 22 (Act No. 290)

Alternative Fuels Research and Development Credit - Extended to Waste Grease Derived Biodiesel

Code Section 12-6-3631, providing an income tax credit for qualified expenditures a taxpayer incurs for research and development of certain alternative energy sources, has been amended to include certain expenditures to develop feedstocks and processes for waste grease derived biodiesel in the definition of "qualified expenditures for research and development." The amendment also provides that the credit for research and development for waste grease derived biodiesel is 10% of the qualified expenditures.

Effective Date: January 1, 2011

House Bill 4478, Section 19 (Act No. 290)

Job Development Credit Amended

Code Section 12-10-80 provides a credit against employee withholding taxes to new or expanding businesses making qualifying investments and creating a minimum number of new jobs in South Carolina and entering into a revitalization agreement with the Coordinating Council for Economic Development ("Council"). Code Section 12-10-80 has been amended as follows:

1. A provision has been added to provide that a company's job development credits are suspended during any quarter the company fails to maintain 100% of the minimum job requirement set forth in the revitalization agreement. A company can only claim credits on jobs, including a range of jobs approved by the Council, as set forth in the company's final revitalization agreement. This codifies an existing guideline of the Council. Code Section 12-10-80(A)(6).
2. A provision has been added to clarify that credits may be claimed beginning with the withholding quarter after the Council's approval of the company's documentation that the minimum job and capital investment requirements have been met. This codifies an existing guideline of the Council. Code Section 12-10-80(A)(7).

3. Subsection (C)(3), which provides for the eligible expenditures that can be reimbursed from job development credits has been amended: (a) to clarify that real property acquired by capital or operating lease with at least a 5 year term, may qualify as an eligible expenditures if approved by the Council and (b) to provide only employee relocation expenses for those employees to whom the company is paying gross wages of at least twice the lower of the per capita income of the state or the county in which the project is located, qualify as eligible expenditures.

Effective Date: January 1, 2011

House Bill 4478, Section 18 (Act No. 290)

Credit against License Fee on Utilities and Electric Cooperatives for Eligible Infrastructure Projects - Amended

Code Section 12-20-105, which provides a credit for amounts paid in cash for qualifying infrastructure for an eligible project against the license fee imposed on utilities and electric cooperatives in Code Section 12-20-100, has been amended as follows:

1. Subsection (B)(2), which formerly allowed an office, business, commercial, or industrial park or combination of these parks to be considered an eligible project for purposes of the credit, has been amended to allow a project located in an office, business, commercial, or industrial park or combination of these parks to be considered an eligible project. The amendment also expands who can own or construct a project to include agencies of the State.
2. Subsection (C)(4) has been amended to allow incubator buildings owned by the county, political subdivision, or agency of the State to qualify as eligible infrastructure.
3. Section (H) was added to provided that by March 1 of each year the Department will issue a report to the Chairman of the Senate Finance Committee, the Chairman of the House Ways and Means Committee, and the Secretary of the Department of Commerce outlining the history of the credit including the amount of credit allowed and the types of infrastructure provided to eligible projects.

Effective Date: January 1, 2011.

The following provision was enacted in 2006, but is effective for tax years beginning after 2010. It is summarized below for informational purposes.

Senate Bill 91, Sections 50 through 55 (Act No. 110)

(See also House Bill 3749, Sections 55 through 60 (Act No. 116))

Single Factor Apportionment - Related Amendments Effective Upon Final Phase In of Single Sales Factor Apportionment Method

Effective for tax years beginning after 2006, Act No. 384 of 2006 amended Code Section 12-6-2250 to enact a single factor apportionment factor for businesses dealing in tangible personal property using the 3 factor (with double weighted sales) apportionment method. The single factor apportionment factor is being phased in and will replace the 3 factor (with double weighted sales) apportionment method for tax years beginning in 2011.

The following amendments, effective for tax years beginning after 2010, update cross references from Code Section 12-6-2250 (the 3 factor apportionment method with double weighted sales and phase in provisions of the single sales factor) to Code Section 12-6-2252 (the single sales factor apportionment method) for the following code sections:

1. Code Section 12-6-1130(6) dealing with computation of the depletion deduction;
2. Code Section 12-6-2240 dealing with apportionment of income; and
3. Code Section 12-6-2290 dealing with gross receipts factor.

The following code sections will be repealed once the single sales factor is fully phased in effective for tax years beginning after 2010:

1. Code Section 12-6-2250 (the 3 factor apportionment method with double weighted sales and phase in provisions of the single sales factor);
2. Code Section 12-6-2260 (3 factor apportionment method property factor definition); and
3. Code Section 12-6-2270 (3 factor apportionment method payroll factor definition).

Effective Date: Tax years beginning after 2010.

PROPERTY TAXES and FEES IN LIEU OF PROPERTY TAXES

House Bill 3713, Section 1 (Act No. 57)

Valuation of 6% Real Property When an Assessable Transfer of Interest Occurs

Background. The South Carolina Real Property Valuation Reform Act, Article 25, Chapter 37, Title 12 was enacted in 2006. Code Section 12-37-3140 of the Act provides for valuation of real property at fair market value as of December 31st of the year in which an assessable transfer of interest (ATI) has occurred. This new valuation becomes the basis for property tax assessment in the property tax year following the year in which the ATI occurred. During that property tax year, the new valuation is not subject to the 15% cap imposed on valuation increases attributable to the periodic countywide appraisal and equalization program implemented pursuant to Code Section 12-43-217.

New Law. Code Section 12-37-3135 has been enacted to exempt a portion of the value of certain property that undergoes an ATI after 2010. If eligibility requirements are met, the alternate valuation derived using the exemption will become the basis for property tax assessment.

Eligibility Requirements - Assessment Ratio and Notice. When property subject to the 6% assessment ratio provided pursuant to Code Section 12-43-220(e) and which is currently subject to property tax undergoes an ATI after 2010, such property may be eligible for the exemption. The property owner or his agent must notify the assessor that the property will be subject to the 6% assessment ratio before January 31st of the property tax year for which the owner first claims eligibility. No further notifications are necessary from the current owner while the property remains subject to the 6% assessment ratio.

Eligibility Requirement - ATI Valuation. Even if the assessment ratio and notice requirements are met, the exemption and alternate valuation allowed under Code Section 12-37-3135 will not apply if the "ATI fair market value" of the parcel is less than "current fair market value." (See definitions below.) If the ATI fair market value is less than current fair market value, valuation will be determined as provided in Code Section 12-37-3140.

Definitions. Definitions are provided for the following terms used in Code Section 12-37-3135.

- "ATI fair market value" means the fair market value of a parcel of real property and any improvements thereon as determined by appraisal at the time the parcel last underwent an assessable transfer of interest.
- "Current fair market value" means the fair market value of a parcel of real property as reflected on the books of the property tax assessor for the current property tax year.
- "Exemption value" means the ATI fair market value when reduced by the exemption allowed by this section.
- "Fair market value" means the fair market value of a parcel of real property and any improvements thereon as determined by the property tax assessor by an initial appraisal, by an appraisal at the time the parcel undergoes an assessable transfer of interest, and as periodically reappraised in a countywide reassessment program pursuant to Code Section 12-43-217.
- "Property tax value" means the fair market value as it may be adjusted downward to reflect the limit, imposed pursuant to Code Section 12-37-3140(B), on increases in value resulting from a periodic reappraisal pursuant to Code Section 12-43-217.

Applicability of the Exemption. If all eligibility requirements are met, a parcel of real property undergoing an ATI after 2010 will be subject to an exemption equal to 25% of ATI fair market value. The resulting exemption value must not be less than current fair market value. Calculation of property tax value for such parcels is based on exemption value. The exemption allowed by this section applies at the time the ATI fair market value first applies.

Effective Date: Applies to assessable transfers of interest after 2010.

House Bill 3713, Section 2.A (Act No. 57)

Millage Increase Limit – Revised

Code Section 6-1-320(A) authorizes a local governing body, in years in which no reassessment program is implemented, to increase the millage it imposes for general operating purposes only to the extent of the increase in the average consumer price index for the most recent 12 month period and the percentage increase in the previous year in the local entity's population. Code Section 6-1-320(A) has been amended to authorize the local governing body to further increase its operating millage by any such increase

allowed but not previously imposed for the three property tax years preceding the year to which the current limit applies.

Effective Date: June 14, 2011

House Bill 3713, Sections 3.A and C (Act No. 57)

Rollback Millage Calculation - Revised

Code Section 12-37-251(E) provides a formula for calculating rollback millage. Rollback millage is the millage imposed in the year a county implements a reassessment program, as provided in Code Sections 6-1-320 and 12-43-217. The rollback millage formula consists of a numerator and a denominator. Code Section 12-37-251(E) has been amended to provide the following:

1. The numerator is the amount of property taxes levied in the prior year as adjusted by abatements and additions. Previously, the numerator was an amount equivalent to the prior year property tax revenues.
2. With respect to the denominator, which is derived from the total assessed value applicable in the reassessment year adjusted by certain deductions, there is a new deduction for assessments attributable to increases in value due to an assessable transfer of interest (ATI).

Effective Date: June 14, 2011

House Bill 3713, Section 2.B (Act No. 57)

Millage Increase Limit and Special Tax Districts - Clarified

Code Section 6-1-320, which limits increases in millage imposed for general operating purposes, has been amended. New subsection (F) clarifies that the restrictions contained in Code Section 6-1-320 do not apply to millage imposed to pay bonded indebtedness or operating expenses of a special tax district established pursuant to Code Section 4-9-30(5), but the special tax district is subject to the millage rate limitations set forth in Code Section 4-9-30(5).

Effective Date: June 14, 2011

House Bill 3713, Sections 3.B and C (Act No. 57)

Uniform Millage Imposition for Municipalities Extending into Multiple Counties that Implement Reassessment Programs in Different Years

Code Section 12-37-251, which provides a formula for calculating rollback millage, has been amended. New subsection (G) applies to a municipality with boundaries extending into multiple counties that implement reassessment programs in different years. Such a municipality's governing body must set an equivalent millage to be used to compute municipal property taxes. This equivalent millage must be determined by methodology established by the respective county auditors which must be consistent with the methodology for calculating equivalent millage to be established by the Department for use in these situations for the purpose of equalizing the municipal property tax on real property situated in different counties.

Effective Date: June 14, 2011

Senate Bill 628 (Act No. Unassigned)

Dorchester County School Districts Millage and Cash Reserves

For the school year 1992-1993 and for all school years thereafter, the annual millage for the operating budgets for Dorchester School Districts 2 and 4 must not, without the approval of the Dorchester County Council, be increased beyond the millage cap imposed by Section 6-1-320 for the reasons stated in that section notwithstanding the supermajority vote requirement contained therein, plus a limited cash reserve.

Pursuant to Senate Bill 628, the cash reserve may not exceed 15% of the total operating budget for that school district for the year in which the cash reserve is maintained and must be funded only by an accumulation of revenue in excess of budgeted amounts and not by the levy of additional taxes as part of the budget. Monies in the cash reserve may not be used to fund any expenditure for which any general obligation bond may be issued.

This provision amends Act 593 of 1992, which in turn, amended Act 267 of 1987, both of which originally imposed limits on the millage imposed by these school districts. Act 593 originally allowed a 5% cash reserve for these school districts.

Effective Date: March 16, 2011

House Bill 3700, Part IB, Section 1, Proviso 1.99 (Act No. 73)

Index of Taxpaying Ability – Imputed Value for Owner-Occupied Residential Property

The index of taxpaying ability is used to determine state funding for education under the Education Finance Act of 1977, Chapter 20, Title 59. This index, prepared by the Department, shows a local school district's relative fiscal capacity in relation to that of all other districts in the state based on the full market value of all taxable property of the district assessed for ad valorem taxes for the second completed property tax year preceding the fiscal year in which the index is used.

For property tax years beginning after 2006, Code Section 12-37-220(B)(47) exempts 100% of the fair market value of owner-occupied residential property receiving a 4% assessment ratio from all property taxes imposed for school operating purposes. School districts are reimbursed for lost revenue based on a 3 tier formula set forth in Code Section 11-11-156.

This temporary proviso clarifies that, for fiscal year 2011-2012, an index value for the exempt owner-occupied residential property must be imputed by adding the second preceding taxable year total school district reimbursements for Tiers 1, 2 and 3(A) of the 3 tier formula and not to include the supplement distribution. The Department shall not include sales ratio data in its calculation of the index of taxpaying ability. The methodology for the calculation of value for classes of property other than exempt owner-occupied residential property is not affected by this temporary proviso.

Effective Date: This temporary proviso is effective for State fiscal year July 1, 2011 through June 30, 2012. It will expire June 30, 2012, unless reenacted by the General Assembly in the next legislative session.

House Bill 3806 (Act No. Unassigned)

Property Tax Credit – Lexington County School Districts 1 and 4

This joint resolution provides a credit for property tax millage imposed in 2007 and 2008 on owner-occupied residential property in Lexington County School District Numbers 1 and 4 to repay construction lease-purchase obligations (the debt service millage). Code Section 12-37-220(B)(47) exempts 100% of the fair market value of owner-occupied residential property receiving a 4% assessment ratio from all property taxes imposed for school operating purposes. In July 2009, the South Carolina Supreme Court clarified that the debt service millage was millage imposed for a school operating purpose and thus subject to the exemption. See *Berkeley County School District v South Carolina Department of Revenue* 383 S.C. 334, 679 S.E. 2d 913 (2009).

The joint resolution specifies the method by which the debt service millage is to be calculated and applied as a credit against property taxes on affected parcels for tax year 2011. The credit is the sole remedy with respect to property taxes attributable to the debt service millage. The credit is refundable to the extent it exceeds actual property tax liability for tax year 2011. Ownership of affected parcels is determined as of July 1, 2011.

Effective Date: April 12, 2011

REMINDER

The following provisions were enacted in 2010, but are effective in 2011. They are summarized below for informational purposes.

House Bill 4478, Section 13 (Act No. 290)

Manufacturers' Real Property Used for Warehousing and Wholesale Distribution - Changes to Requirements for Alternative Classification

Code Section 12-43-220(a) concerns the classification of real and personal property owned by, or leased to, manufacturers and utilities and generally provides for an assessment ratio of 10.5% on property used in the conduct of the business. Item (4) has been amended to provide that real property owned by or leased to a manufacturer and used primarily for warehousing and wholesale distribution is not considered used in the conduct of the manufacturing business. Previously, this exception was available only for property used exclusively for warehousing and wholesale distribution. Real property that falls outside the manufacturers and utilities classification is generally taxed based on a 6% assessment ratio.

The amendment further clarifies that real property subject to this exclusion must not be physically attached to the manufacturing plant unless the warehousing and wholesale distribution area is separated by a permanent wall.

Effective Date: January 1, 2011

House Bill 4478, Sections 2 - 5 (Act No. 290)

Little Fee - Revised for Time Limits, Valuation, and Qualifications

1. Code Section 4-12-30(B)(4)(b) has been amended to provide that if a project consists of a manufacturing, research and development, corporate office, or distribution facility, each sponsor or sponsor affiliate is not required to invest \$2.5 million, if the total investment in the project exceeds \$5 million. Previously, the total investment had to exceed \$10 million.

Effective Date: Agreements executed after January 1, 2011. However, a taxpayer and a county may amend an existing agreement at any time prior to the expiration of the fee to incorporate this change into the agreement.

2. Code Section 4-12-30(C)(4) has been amended to provide that a single piece of property may be subject to the fee for no more than 30 years. Previously, the statute provided that a single piece of property could be subject to the fee for up to 20 years. By resolution on a finding of substantial public benefit, the county may agree to

extend this period for another 10 years. Corresponding amendments provide that if a county allows the additional 10 year extension, a single piece of property can be subject to the fee for up to 40 years, and the project itself can be subject to the fee for up to 50 years. For the super fee, a single piece of property can be subject to the fee for up to 40 years (with the extension) and the project itself can be subject to the fee for up to 53 or 55 years depending on the specifics of the project. Previously, the super fee time limits were 30 years and 43 or 45 years, respectively.

Effective Date: Effective for agreements executed after January 1, 2011. However, a taxpayer and a county may amend an existing agreement at any time prior to the expiration of the fee to incorporate this change into the existing agreement.

3. Code Section 4-12-30(D)(2)(a)(i), which provides that real property is generally valued at original cost for the life of the fee, has been amended to provide that a county and a sponsor or sponsor affiliate may agree (initially or by amendment) that the value of real property subject to the fee will be determined by an appraisal completed by the Department. If the county and the sponsor or sponsor affiliate agree to appraisal by the Department, the property will be subject to reappraisal no more than once every 5 years.

Effective Date: Effective in each county in the first property tax year in which a county reassessment program is implemented after December 31, 2010.

4. Code Section 4-12-30(J)(1)(b) has been amended to provide that property that has been subject to South Carolina property taxes is eligible for the fee if it was placed in service in the State pursuant to an inducement agreement or other preliminary county approval before the execution of a lease agreement. Before this amendment, previously taxed property would qualify only if it had not been placed in service.

Effective Date: January 1, 2011

House Bill 4478, Section 6 (Act No. 290)
(See also Senate Bill 1131 (Act No. 161))

Big Fee - Extended Time Periods and Valuation

1. Code Section 4-29-67(C)(3) has been amended to provide that a single piece of property may be subject to the fee for no more than 30 years. Previously, the statute provided that a single piece of property could be subject to the fee for up to 20 years. By resolution on a finding of substantial public benefit, the county can agree to extend this period for another 10 years. Corresponding amendments provide that if a county allows the additional 10 year extension provided for in the statute, a single piece of property can be subject to the fee for up to 40 years, and the project itself can be subject to the fee for up to 50 years. For the super fee, a single piece of property

can be subject to the fee for up to 40 years (with the extension) and the project itself can be subject to the fee for up to 53 or 55 years depending on the specifics of the project. Previously, the super fee time limits were 30 years and 43 or 45 years, respectively.

Effective Date: January 1, 2011. However, a county may amend an existing agreement at any time prior to the expiration of the fee to incorporate this change into the agreement.

2. Code Section 4-29-67(D)(2)(a)(iii)(A) which provides that real property is generally valued at original cost for the life of the fee, has been amended to provide that a county and a sponsor or sponsor affiliate may agree (initially or by amendment) that the value of real property subject to the fee will be determined by an appraisal completed by the Department. If the county and the sponsor or sponsor affiliate agree to appraisal by the Department, the property will be subject to reappraisal no more than once every 5 years.

Effective Date: Effective in each county in the first property tax year in which a county reassessment program is implemented after December 31, 2010.

House Bill 4478, Sections 8 - 12 (Act No. 290)
(See also Senate Bill 1131, Sections 1 - 2 (Act No. 161))

Simplified Fee - Extended Time Period, Valuation and Qualification

1. Code Section 12-44-30(21) has been amended to provide that the "termination date" is the last day of the property tax year that is the 29th year following the first property tax year in which an applicable piece of economic development property is placed in service. By resolution or a finding of substantial public benefit, the county may agree to extend this period for another 10 years. Previously, the termination date was the 19th year after the economic development property is placed in service or the 29th year for property subject to an enhanced investment fee, and a single piece of property could be subject to the fee for a total of 30 years.

Effective Date: January 1, 2011. However, a county and a sponsor may amend an existing fee agreement any time before the expiration of the fee to incorporate this change.

2. Section 12-44-50(A)(1)(c)(i) which provides that real property is generally valued at original cost for the life of the fee, has been amended to provide that a county and a sponsor or sponsor affiliate may agree (either initially or by amendment) that real property subject to the fee will be determined by an appraisal completed by the Department. If the county and the sponsor or sponsor affiliate agree to appraisal by the Department, the property will be subject to reappraisal no more than once every 5 years.

Effective Date: Effective in each county in the first property tax year in which a countywide reassessment program is implemented after December 31, 2010.

3. Code Section 12-44-110(2) has been amended to provide that property that has been subject to South Carolina property taxes, is eligible for the fee if it was placed in service in the State pursuant to an inducement agreement or other preliminary county approval before the execution of a lease agreement. Before this amendment, previously taxed property would qualify only if it had not been placed in service.

Effective Date: January 1, 2011

House Bill 4478, Section 7 (Act No. 290)

Special Source Revenue Bonds or Credits - Eligible Uses Expanded

Code Section 4-29-68 allows a county to issue special source revenue bonds to pay for, among other things, improved or unimproved real property associated with a manufacturing or commercial project. Code Section 4-29-68(A)(2) has been amended to provide that bonds may be issued, or a credit against the fee may be given, to pay for the cost of personal property including machinery and equipment used in the operation of such a project.

If the bonds, or monies from a credit allowed against the fee due on the property, are used to pay for personal property, and the personal property is removed from the project during the time the fee is in effect and the removed property is not replaced with qualifying replacement property, the amount of the fee due for that property must be paid for the year it is removed and for the 2 years following its removal from the project. If any bond funds or credit funds are used to pay for both real and personal property, or infrastructure and personal property, all of the funds will be presumed to have first been used to pay for personal property. The fee amounts described above will be remitted to the county in which the project is located.

Effective Date: January 1, 2011