

THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT
Ralph King Anderson, III, Chief Administrative Law Judge

Appellate Case No. 2017-000265

Rent-A-Center West, Inc.,Respondent,

v.

South Carolina Department of Revenue,Petitioner.

**PETITIONER'S REPLY TO RESPONDENT'S RETURN TO THE PETITION FOR A
WRIT OF CERTIORARI**

William J. Condon, Jr.
Sean G. Ryan
Milton G. Kimpson
PO Box 12265
Columbia, SC 29211-9979
(803) 898-5278
Attorneys for Petitioner

Other Counsel of Record:

John C. Von Lehe, Jr.
Bryson M. Geer
Nelson Mullins Riley & Scarborough
151 Meeting Street, Sixth Floor
Charleston, SC 29401-8700
(843) 853-5200
Attorneys for Respondent

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S.C. SUPREME COURT

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Pursuant to Rule 242(g) of the South Carolina Appellate Court Rules, Petitioner, South Carolina Department of Revenue (“Department” or “Petitioner”), files Petitioner’s Reply to Respondent’s Return to the Petition for a Writ of Certiorari. For the reasons set in out the Petition for a Writ of Certiorari (“Petition”) and set forth below, this Court should issue a writ of certiorari to review and reverse the decision of the Court of Appeals styled Rent-A-Center West, Inc. v. S.C. Dep’t of Revenue, 418 S.C. 320, 792 S.E.2d 260 (Ct. App. 2016). (Appendix (“App.”) pp. 1-14.) This case involves a novel issue of law and may have a significant limiting effect on the application of Section 12-6-2320(A) and on many multi-state taxpayers doing business both within and without South Carolina. This case is not a replay of Carmax Auto Superstores West Coast, Inc. v. S.C. Dep’t of Revenue, 411 S.C. 79, 767 S.E.2d 195 (2014), and Respondent’s claims in its Return to the Petition for a Writ of Certiorari (“Return”) and the Court of Appeal’s decision do not recognize the critical procedural and factual differences between the two cases.

REPLY TO THE COUNTER-STATEMENT OF THE QUESTIONS PRESENTED FOR REVIEW

- I. Did the Court of Appeals err by finding that the Department failed to meet its burden of proof to show that the statutory apportionment formula used by the Respondent, Rent-A-Center West, Inc., did not fairly reflect the extent of Respondent’s business activity in South Carolina?

- II. Did the Court of Appeals err by not ruling on whether Respondent’s retail and trademark activities are unitary activities and, thereby, allowing Respondent to improperly combine Respondent’s unrelated and non-unitary activities into one gross-receipts formula for apportionment purposes?

REPLY TO THE COUNTER-STATEMENT OF THE CASE

I. Reply to the Summary of Procedural History

In its procedural history, Rent-A-Center West, Inc. (“Respondent” or Taxpayer”) downplayed the extent of the findings of the Administrative Law Court (“ALC”) in this case. The ALC, who was the fact-finder in this case, found that (1) the Department demonstrated that

Respondent's use of a standard apportionment formula failed to fairly represent its business in South Carolina, (2) the Department's proposed alternative method was reasonable in light of Respondent's business activities in South Carolina, (3) the imposition of an alternative method in this case did not violate the Constitution, and (4) Respondent did not substantiate any expenses, so it is not entitled to any deductions from its gross royalty income in South Carolina. (ROA 0023.) Further, the ALC found that Respondent was able to separate its retail business from its trademark business, (ROA 0008), and that Respondent failed to establish that its retail business and its trademark business were inextricably linked, (ROA 0008), all of which supported the ALC's conclusion that the Department's separate accounting method was appropriate in this case, (ROA 0015).

In its Final Brief of Respondent (to the Court of Appeals), the Department made a lengthy argument that the Taxpayer's retail and trademark businesses were not unitary. (APP 124-29.) However, even if the Taxpayer's two business lines were unitary, the Court of Appeals should have affirmed the ALC's decision because the Department also stated that the clear language of the alternative apportionment statute allows the use of separate accounting, an alternative apportionment method, in a unitary business. (App. 130-31.) Accordingly, when the Department's expert testified that the issue of whether the Taxpayer's two lines of business were unitary was a "red herring," the Department's expert stated that he was referencing the fact that a taxpayer can separate the financial activities of a unitary business for accounting and tax purposes. (App. 130-31; ROA 0275-0277, Tr. p. 197, line 1-Tr. p. 206, line 7.)

II. Reply to the Summary of Relevant Facts

In its summary of relevant facts, the Taxpayer stated that it "makes no sales in South Carolina and receives *de minimus*, if any, services or benefits from the State." Although one of its

witnesses testified as such, this statement and the corresponding testimony is incorrect. First, the same witness for the Taxpayer also testified, and the Taxpayer's filed income tax returns support, that the Taxpayer owned intellectual property located in South Carolina, (ROA 0131, Tr. p. 106, lines 3-6), and that it received significant revenues from royalties (e.g., \$861,437 in 2004) that were generated from within South Carolina, (ROA 0130, Tr. p. 104, lines 2-10; ROA 0371). Second, the State of South Carolina and its local governments have conferred many benefits upon the Taxpayer, an entity that has consciously elected to conduct its trademark business in South Carolina's economic forum. See Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 21-22, 437 S.E.2d 13, 17-18 (1993) (stating, for example, that South Carolina makes it possible, by providing an orderly society for commerce, for a business that licenses its intellectual property into South Carolina to earn income in South Carolina pursuant to a royalty agreement).

In its summary of relevant facts, the Taxpayer also mistakenly stated that the Department's first mention of the relevance of whether the Taxpayer operated a unitary business was in the Department's Petition for Rehearing before the Court of Appeals. In its Final Brief of Respondent, the Department clearly stated that this issue was relevant. The Department discussed unitary businesses for six pages, (App. 31-36), and, more specifically, for five of those pages argued why the Taxpayer does not operate a unitary business concluding that the Court of Appeals "should dismiss [the Taxpayer's] second issue because the evidence supports the fact that [the Taxpayer] is not operating a unitary business" (App. 32-36). The Taxpayer appears to confuse the totality of the Department's arguments in which the Department also asserts that "even if [the Taxpayer's businesses were] unitary, the evidence shows that [the Taxpayer] can use separate accounting under Section 12-6-2320(A) because it can separately identify and quantify the financial transactions of its trademark business, its sole business in South Carolina." (App. 129.)

In its summary of relevant facts, the Taxpayer also stated that the Department “objected to the standard [gross-receipts] method on the basis that the inclusion of the retail sales in the denominator diluted or distorted RAC West’s *income* in South Carolina.” Respondent’s Return, p. 6 (emphasis added). This is not the basis of the Department’s challenge to the use of the standard apportionment formula. There is an important distinction between a company’s income and its “business activit[ies] in this State,” the relevant term in section 12-6-2320(A). In its Department Determination, the Department focused on the Taxpayer’s business activities in South Carolina when addressing whether the standard gross-receipts formula fairly represented the Taxpayer’s business activities in South Carolina:

Because the taxpayer engages in significantly different types of businesses in states other than South Carolina, which bring in far greater revenues than the intangible fees received from South Carolina, the gross receipts denominator would so dilute the gross receipts received from South Carolina as to distort the taxpayer’s actual economic activity in the state.

(ROA 0034.) As described below, the Department followed section 12-6-2302(A) by addressing the Taxpayer’s actual business activities conducted within South Carolina (i.e., its South Carolina royalty business). It did so by separating the income and expenses of the Taxpayer’s royalty business in South Carolina. This is preferred over using a standard gross-receipts formula which, when applied to the Taxpayer’s overall federal taxable income that includes all of its retail and trademark activities inside and outside of South Carolina, merely estimated the Taxpayer’s business activities in South Carolina and was distorted by the inclusion of the Taxpayer’s out-of-state retail business.

REPLY TO ARGUMENTS

This Court should grant the Department’s Petition because this matter involves important and novel questions of law and because, other than the rule expressed regarding the two-part

burden of proof on the proponent of an alternative apportionment method, the Court of Appeals should not have used the Supreme Court's decision in Carmax, 411 S.C. 79, 767 S.E.2d 195, to reverse factual findings of the trial court in this case. Important differences exist between this case and Carmax, so this Court should issue a writ of certiorari.

I. A NOVEL ISSUE OF LAW EXISTS.

Despite the Taxpayer's assertion in its Return, this Court should not use its decision in Carmax as a reason to deny the Department's petition for a writ of certiorari. In the case against Carmax, both the ALC and the Court of Appeals used improper burdens of proof. Carmax, 411 S.C. at 199-200, 767 S.E.2d at 87-89. As Justice Pleicones stated in dissent, the misapplication of the burdens of proof created a problem which the parties aggravated because they agreed that this Court should decide questions of fact on certiorari concerning Carmax instead of remanding the matter to the ALC for reconsideration. Id. at 92, 767 S.E.2d at 201. In the Carmax cases, the evidence may have been distorted because of the misapplied burdens of proof, so this Court should not use the Carmax decision for anything more than determining who has the burden of proof under section 12-6-2302(A). Here, unlike in Carmax, substantial evidence exists in the record to support the ALC's decision that the Department satisfied its two-part burden. Petition, pp. 14-18 (discussing the facts in the record and citing those facts included in the ALC's Order, the transcript from the ALC hearing, and other evidence in the record); see App. 006 (citing Risher v. S.C. Dep't of Health & Env'tl. Control, 393 S.C. 198, 210, 712 S.E.2d 428, 435 (2011) (giving deference to the fact-finder)). The Court of Appeals in this case made a critical error in deciding that this case was Carmax redux, so this Court should issue a writ for certiorari, analyze the evidence in the record, and ultimately reverse the Court of Appeals and affirm the ALC's decision. In summary, this case is unlike Carmax and does present a novel issue of law.

II. THE COURT OF APPEALS FAILED TO PROPERLY RULE ON THE TWO ISSUES RAISED BY THE PETITIONER.

This Court should issue a writ of certiorari because the Court of Appeals made errors in law by not properly ruling on the two issues raised by the Department.

A. South Carolina Law Focuses on Business Activities, Not Income.

When analyzing a standard apportionment formula for purposes of section 12-6-2320(A), the Taxpayer wrongly focuses on income instead of the actual business activities that the Taxpayer conducts in South Carolina. The statute requires an analysis of “business activity in this State” to determine whether the standard apportionment formula may be replaced by an alternative apportionment method. S.C. Code Ann. § 12-6-2320(A) (2014).

As the Taxpayer acknowledges, the taxable base of a multi-state business for South Carolina income tax purposes is “a base which reasonably represents the proportion of the trade or business carried on within this State.” Return, p. 10 (citing S.C. Code Ann. §12-6-2110(B) (2014)). The Taxpayer focuses on the word “proportion” asserting that the South Carolina income tax base of a multi-state business must be a certain percentage of that business’s federal taxable net income. Return, pp. 10-15. The Taxpayer’s assertion is correct when applied to the standard formulary apportionment ratios set forth in sections 12-6-2252 and 12-6-2290. However, the Taxpayer’s application of section 12-6-2210(B) is limiting and not consistent with alternative apportionment methods, which can vary greatly.

South Carolina law allows alternative methods including separate accounting and “any other method” that results in equitable apportionment of a taxpayer’s income. S.C. Code Ann. § 12-6-2320(A)(1), (4) (2014). These allowable and appropriate alternative apportionment methods do not conform to one mere apportionment sales or gross-receipts formula that can be easily multiplied by the taxpayer’s federal taxable income to calculate the taxpayer’s South Carolina

taxable income. For example, separate accounting, which the Department used in this case, is not formula based. It is “a technique of carving out of the overall business of the taxpayer the income derived from sources within a single State and ascertaining the profits attributable to that portion of the business.” ROA 0015 (citing I Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶8.03 (2d. ed. 1993)).

Here, one can separate and carve out the Taxpayer’s financial transactions of its royalty business in South Carolina from the Taxpayer’s entirely out-of-state retail business. The Department’s expert testified about the accounting methods to do so. (ROA 0275—0277, Tr. p. 199, line 18-p. 202, line 5, Tr. p. 203, line 4-p. 206, line 7). The Taxpayer’s ability to establish a royalty fee to charge its South Carolina affiliate for use of the intellectual property in South Carolina, (ROA 0383-0390), means that the Taxpayer must know its income and expenses from its royalty business.

The Department’s alternative formula of separating the income and expenses of the Taxpayer’s royalty business in South Carolina determines a proportion of the Taxpayer’s federal taxable income to be taxed in South Carolina just as a an amount calculated as a percentage of the Taxpayer’s federal taxable income determines a proportion of the Taxpayer’s federal taxable income. The difference is that the Department’s separate accounting method actually measures the actual business activities that the Taxpayer conducted in South Carolina (i.e., its South Carolina royalty business only), while the Taxpayer’s use of the standard gross-receipts ratio merely estimates the Taxpayer’s activity in South Carolina while being distortive by including in-state and out-of-state activities and retail and trademark activities.

This Court should not adopt or be sidetracked by the Taxpayer’s misrepresentation of the Department’s separate accounting method as “a flat tax on gross income.” See Return, p. 13. The

Department's separate accounting method calculated the royalty revenues based on the Trademark Licensing Agreement between the Taxpayer and its South Carolina affiliate and then deducted from that royalty income all applicable expenses. (See ROA 0031 (stating that the Department calculated the royalty income primarily from the Trademark Licensing Agreement); (ROA 0254-0255, Tr. p. 116, line 21-p. 117, line 4 (testifying that the Department would have deducted from the royalty income any related expenses for which the Taxpayer provide proof)).) However, although the Department asked for such expenses, the Taxpayer never provided any evidence of deductible expenses. (ROA 0254-0255, Tr. p. 116, line 24-p. 117, line 1.) In addition, the Department's auditor testified that companies that license intangibles incur very few related expenses. ROA 0256, Tr. p. 122, lines 6-10.) Finally, a witness for the Taxpayer, its Vice President, Assistant General Counsel, and Secretary, testified that she works for another affiliate, not the Taxpayer or the Taxpayer's South Carolina affiliate, and maintained and protected the Taxpayer's intellectual property assets through a long list of tasks. (ROA 0154, Tr. p. 197, line 25-p. 202, line 2.) The record is void of any evidence that the Taxpayer incurred any expenses to offset its South Carolina royalty income resulting the ALC's finding that the Taxpayer did not prove any expenses to offset its royalty income. (ROA 0023.)

B. The Court of Appeals Erred by Finding that the Department Did Not Satisfy its Burden of Proof When Sufficient Evidence Existed in the Record.

As stated above, this case is not a replay of Carmax. Here, the record contains substantial evidence to support the ALC's finding that the Department satisfied both of its burdens of proof. Petition, pp. 14-18. The ALC made numerous findings of fact to which the Court of Appeals gave no weight. (ROA 0003-0009, 0023.) These facts, which are in the record, are more than bald assertions and unsupported statements by Department witnesses as characterized by the Court of Appeals. (App. 013.) For example, through the testimony of the Department's auditor and expert,

the Department's Field Audit Report, the Trademark Licensing Agreement, and other evidence in the record, the Taxpayer's South Carolina royalty business could be and was separated from its out-of-state activities, and such separation of the Taxpayer's South Carolina royalty business, which more accurately represented the Taxpayer's business activities in South Carolina, clearly demonstrated that the Taxpayer's use of the standard gross-receipts formula did not fairly reflect the extent of its royalty business in South Carolina. (ROA 0006-0007 (demonstrating that in 2003-2005 the Taxpayer's use of the standard gross-receipts formula significantly understated the Taxpayer's royalty business in South Carolina).)

Additionally, some of the Taxpayer's arguments need some clarity.

The Taxpayer wrongly dismisses the "apples and oranges" metaphor used by the Department's expert. Return pp. 17-19. First, although the expert used that metaphor against Carmax too, its significance may not have been given proper weight in that case because the ALC imposed the burden of proof on Carmax, not the Department. Second, the "apples and oranges" metaphor was used in an important case in California in which the taxpayer, Microsoft, operated two widely different business activities – software activities and internal treasury management activities. Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750, 767-71, 139 P.3d 1169, 1180-83 (2q006). The "apples and oranges" metaphor is therefore useful in this case and not a "bald assertion" as the Taxpayer asserted in its Return.

The Court of Appeals also improperly compared the "apples and oranges" metaphor by the Department's expert with the "pizza pie" metaphor used by the Taxpayer's expert. (See App. 013.) The pizza pie metaphor by the Taxpayer's expert applies to formulary apportionment, not to alternative apportionment. The Taxpayer's expert considers the Taxpayer to operate a unitary business, so he applies a standard formulary apportionment ratio to determine how much of the

pizza pie to apportion to and tax in South Carolina. (ROA 0401-0402.) In formulary apportionment, one multiplies a single apportionment ratio by the taxpayer's entire federal taxable income (i.e., by the entire pizza pie.) to determine how much of the federal taxable income shall be taxed in a specific state. Separate accounting, the apportionment method favored here by the Department's expert, is different from the pizza pie metaphor that uses standard formulary apportionment. The expert for the Department is saying that when the pizza pie consists of apples and oranges (here retail and trademark activities), it is not proper to use a standard apportionment formula as the Taxpayer did in this case.¹ In fact, the ALC stated in its Order that separate accounting is suited for a single taxable entity carrying on a separate activity in each jurisdiction (ROA 0015), and the Taxpayer here carries on only one business in South Carolina.

Finally, in oral arguments at the Court of Appeals the Department addressed the Microsoft case and the use of an alternative apportionment method when a taxpayer operates two different lines of business that have widely divergent profit margins. This Department has preserved this issue.

- C. The Court of Appeals Erred by Not Ruling on Whether the Taxpayer Operated Unitary Business Activities Making the Standard Formula for Apportionment Inapplicable.

As stated above, in its Final Brief for Respondent, the Department explained for at least five pages why the Taxpayer in this case does not operate unitary businesses. The Department therefore absolutely deemed this issue relevant and absolutely preserved the issue for appeal to this Court.

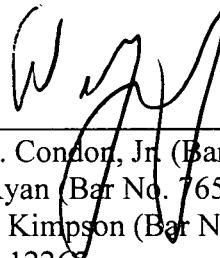
¹Regardless of whether the Taxpayer here operates a unitary business, section 12-6-2320(A) does not prohibit the use of separate accounting when a Taxpayer's relevant activities are unitary.

This Court should not adopt the Taxpayer's assertion that comment by the Department's expert that whether the Taxpayer was operating a unitary business was a 'red herring' means that neither the Department nor the expert believed that the unitary issue was relevant in this case. As stated above, the Department's expert was explaining that that whether the Taxpayer operated a unitary business does not mean that the Taxpayer could not separate its trademark business from its retail business. The expert clearly did not state that the unitary issue was not relevant.

CONCLUSION

For the reasons specified herein, the South Carolina Department of Revenue respectfully requests that this Court grant its Petition for Writ of Certiorari to review the Court of Appeals' decision in this matter.

Respectfully submitted,



William J. Condon, Jr. (Bar No. 72632)
Sean G. Ryan (Bar No. 76585)
Milton G. Kimpson (Bar No. 7917)
P. O. Box 12265
Columbia, SC 29211-9979
(803) 898-5278
Attorneys for Petitioner
South Carolina Department of Revenue

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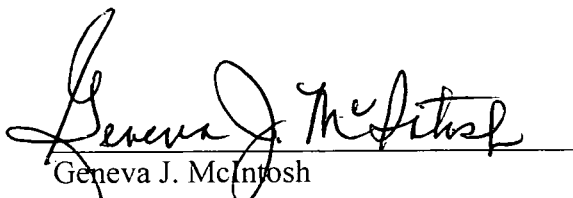
Rent-A-Center West, Inc.,.....Respondent,

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PROOF OF SERVICE

I, Geneva J. McIntosh, do hereby certify that I have hand delivered a copy of the Petitioner's Reply To Respondent's Return To The Petition For A Writ of Certiorari in re: Rent-A-Center West, Inc., Respondent, v. South Carolina Department of Revenue, Petitioner, Appellate Case No. 2017-00265, Opinion No. 5447 filed October 26, 2016, Trial Court Case No. 09-ALJ-17-0204-CC, to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, Nelson Mullins Riley & Scarborough, LLP, 151 Meeting Street, 6th Floor, Charleston, SC 29401-1806 on this 4th day of May, 2017.


Geneva J. McIntosh