

THE STATE OF SOUTH CAROLINA
In the Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2017-000265

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

v.

South Carolina Department of Revenue, Petitioner.

AMENDED APPENDIX

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**THE STATE OF SOUTH CAROLINA
In The Court of Appeals**

Rent-A-Center West Inc., Appellant,

v.

South Carolina Department of Revenue, Respondent.

Appellate Case No. 2012-208608

Appeal From The Administrative Law Court
Ralph King Anderson, III, Administrative Law Judge

Opinion No. 5447
Heard March 16, 2016 – Filed October 26, 2016

REVERSED

John C. Von Lehe, Jr. and Bryson Moore Geer, both of
Nelson Mullins Riley & Scarborough, LLP, of
Charleston, for Appellant.

William J. Condon, Jr. and Sean Gordon Ryan, both of
the South Carolina Department of Revenue, of Columbia,
for Respondent.

KONDUROS, J.: Rent-A-Center West Inc. (RAC West) appeals the administrative law court's (ALC) finding the standard statutory apportionment formula did not fairly represent its business activities in South Carolina and the Department of Revenue's (the DOR) alternative apportionment method for calculating its income tax was reasonable. It also maintains the ALC erred in

finding it was not a unitary business. It further asserts the ALC erred by concluding the DOR did not violate its constitutional rights. We reverse.

FACTS/PROCEDURAL HISTORY

This case involves the assessment of corporate income tax on RAC West, a subsidiary of the Rent-A-Center Inc. business. Rent-A-Center is a rent-to-own business, providing consumer goods to customers for rent. Rent-A-Center East Inc. (RAC East) owns and operates retail stores in eastern states including South Carolina and is a wholly-owned subsidiary of Rent-A-Center. RAC East has two wholly-owned subsidiaries: RAC West, which owns and operates retail stores in western states, and Rent-A-Center Texas LP, which owns and operates retail stores in Texas and provides management services. RAC West does not operate any retail stores in South Carolina, but it owns and licenses the Rent-A-Center intellectual property, including the trademarks and trade names to all other Rent-A-Center companies. These royalty payments for the use of the intellectual property by the South Carolina stores are RAC West's only activity in the state. This arrangement was formalized in a licensing agreement between RAC West and RAC East. The licensing agreement sets the amount of a royalty fee equal to 3% of the gross revenues of the RAC East stores, an amount based upon a transfer pricing study.¹

RAC West filed their corporate income tax returns for 2003, 2004, and 2005 using the three-factor apportionment formula, consisting of property, payroll, and sales.

The DOR audited RAC West's 2003-2005 initial tax returns and found RAC West owed an additional \$144,971 in corporate income tax; \$35,086 in interest; and \$36,243 in penalties for the period of 2003-2005. According to the DOR, RAC West's only income in South Carolina was the royalty income it obtained from RAC East. The DOR applied an alternative apportionment method pursuant to section 12-6-2320(A) of the South Carolina Code, which it stated "more fairly represent[ed] the taxpayer's activity in South Carolina." The DOR based this alternative apportionment method on RAC West's 3% royalty agreement with RAC East.

¹ In the relevant years, this 3% amounted to \$830,247 in 2003; \$861,437 in 2004; and \$844,348.13 in 2005.

RAC West filed an appeal and requested a hearing before the ALC. One month prior to the hearing, RAC West filed amended South Carolina income tax returns, changing the method from the three-factor apportionment formula for dealers of tangible personal property to the gross-receipts method under section 12-6-2290 of the South Carolina Code.² This single-factor apportionment formula required RAC West to pay an additional \$1,326 in taxes to what it had previously paid.

The ALC held a hearing on August 10 and 11, 2011. The DOR argued RAC West diluted the sales/gross receipts ratio by including the retail sales of RAC West in the denominator because no retail sales are in the numerator, as RAC West's only activity in South Carolina is the licensing of the intellectual property. According to testimony from Dr. Glenn Harrison, the DOR's expert witness on law and economics, the gross receipts ratio did not provide an accurate reflection of the economic connection of RAC West to South Carolina. Dr. Harrison indicated including royalty receipts in the numerator of the ratio while including both total royalty and total retail receipts in the denominator was like putting apples in the numerator and apples and oranges in the denominator. He further testified the DOR's alternative method was economically reasonable and excluding the retail operations from the calculations was essential in order to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina." Additionally, Dr. Harrison indicated even if RAC West was a unitary business, it should still be able to separate its accounts.

RAC West argued there is a unitary relationship between the business activities of the retail stores in the western states and the licensing of intellectual property in other states because the same management is over both businesses and the stores contribute to the profitability of the intellectual property and vice versa. Further, it argued it does not separately track the costs of the intellectual property alone and this South Carolina audit was the first time it had been asked to do so.

According to RAC West's expert economist, Dr. Ronald P. Wilder, and tax policy expert, Professor Richard Pomp, RAC West was a single unitary business based upon the mutual interdependence of the trademark and retail business. Dr. Wilder

² Under section 12-6-2290 of the South Carolina Code (2014), a taxpayer apportions its net income by using a ratio in which the numerator is its gross receipts from within South Carolina during the taxable year and the denominator is its total gross receipts from all states during the taxable year.

was asked his opinion of whether or not the standard apportionment formula fairly represented the extent of RAC West's activities in the state, and he responded that it did. Dr. Wilder based this "conclusion on the fact that RAC West uses its total corporation income as what is to be apportioned [and t]hat the use of corporation net income corresponds to the economic concept of profit on which taxable income should be based." When asked what would result if the retail sales from RAC West were not included in the denominator of the apportionment formula, Dr. Wilder explained that because RAC West is a unitary business, the "separate accounting cannot accurately measure the activities of RAC West." Professor Pomp explained the standard apportionment worked the way it was supposed to in this case. He stated, "That's not a defect. That's not anything unusual, out of the ordinary." Further, he found an "inextricable link" and "synergy" between the value of the intellectual property and the profitability of the retail store business.

Joseph P. Southard, a former employee of the DOR who worked specifically on the RAC West audit, testified the audit began as a routine audit of Rent-A-Center as a whole. When asked why the DOR did not make an assessment based on the standard apportionment formula, Southard responded the gross receipts formula "didn't fit into the definition," so the DOR "had to come up with kind of a hybrid."

The ALC found for the DOR on all issues except the penalty, which it dismissed. Specifically, the ALC found (1) the DOR demonstrated RAC West's apportionment formula failed to fairly represent its business in South Carolina; (2) the DOR's proposed alternative apportionment method was reasonable in light of RAC West's business activities in South Carolina; (3) the imposition of an alternative method in this case did not violate the Constitution; (4) RAC West did not substantiate any expenses, therefore it was not entitled to deduct any expenses; and (5) RAC West was not liable for substantial understatement penalties.

RAC West filed a motion for reconsideration, which the ALC denied. RAC West filed a Notice of Appeal and shortly thereafter requested, with the DOR's consent, a stay of the matter until a final decision was made in *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue (Carmax I)*, 397 S.C. 604, 725 S.E.2d 711 (Ct. App. 2012), *aff'd as modified*, 411 S.C. 79, 767 S.E.2d 195 (2014). The parties asserted some or all of the issues could be decided or

affected by the final decision in that case. This court granted the stay on April 16, 2012. Following a decision by the supreme court,³ this appeal proceeded.

STANDARD OF REVIEW

The review of the [ALC]'s order must be confined to the record. The court may not substitute its judgment for the judgment of the [ALC] as to the weight of the evidence on questions of fact. The court of appeals may affirm the decision or remand the case for further proceedings; or, it may reverse or modify the decision if the substantive rights of the petitioner have been prejudiced because the finding, conclusion, or decision is:

- (a) in violation of constitutional or statutory provisions;
- (b) in excess of the statutory authority of the agency;
- (c) made upon unlawful procedure;
- (d) affected by other error of law;
- (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or
- (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

S.C. Code Ann. § 1-23-610(B) (Supp. 2015).

"In reaching a decision in a contested violation matter, the ALC serves as the sole finder of fact in the *de novo* contested case proceeding." *S.C. Dep't of Revenue v. Sandalwood Soc. Club*, 399 S.C. 267, 279, 731 S.E.2d 330, 337 (Ct. App. 2012). "The Rules of Procedure for the Administrative Law Judge Division require that the AL[C] make independent findings of fact in contested case hearings, and the Administrative Procedures Act clearly contemplates that the AL[C] will make [its]

³ *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue (Carmax II)*, 411 S.C. 79, 767 S.E.2d 195 (2014).

own findings of fact in a contested case hearing." *Reliance Ins. Co. v. Smith*, 327 S.C. 528, 534, 489 S.E.2d 674, 677 (Ct. App. 1997) (citation omitted). When the evidence conflicts on an issue, the court's substantial evidence standard of review defers to the findings of the fact-finder. *Risher v. S.C. Dep't of Health & Env'tl. Control*, 393 S.C. 198, 210, 712 S.E.2d 428, 435 (2011).

"The decision of the [ALC] should not be overturned unless it is unsupported by substantial evidence or controlled by some error of law." *Original Blue Ribbon Taxi Corp. v. S.C. Dep't of Motor Vehicles*, 380 S.C. 600, 604, 670 S.E.2d 674, 676 (Ct. App. 2008). "A reviewing court may reverse or modify an administrative decision if the findings of fact are not supported by substantial evidence." *Risher*, 393 S.C. at 210, 712 S.E.2d at 434. "Substantial evidence is 'evidence which, considering the record as a whole, would allow reasonable minds to reach the conclusion that the administrative agency reached.'" *Se. Res. Recovery, Inc. v. S.C. Dep't of Health & Env'tl. Control*, 358 S.C. 402, 407, 595 S.E.2d 468, 470 (2004) (quoting *Lark v. Bi-Lo*, 276 S.C. 130, 135, 276 S.E.2d 304, 306 (1981)). Substantial evidence . . . is more than a mere scintilla of evidence." *Original Blue Ribbon Taxi Corp.*, 380 S.C. at 605, 670 S.E.2d at 676.

"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). "[T]he construction of a statute by the agency charged with its administration will be accorded the most respectful consideration and will not be overruled absent compelling reasons." *Brown v. S.C. Dep't of Health & Env'tl. Control*, 348 S.C. 507, 515, 560 S.E.2d 410, 414 (2002) (alteration by court) (quoting *Dunton v. S.C. Bd. of Exam'rs in Optometry*, 291 S.C. 221, 223, 353 S.E.2d 132, 133 (1987)).

LAW/ANALYSIS

RAC West argues the ALC erred by finding the standard statutory apportionment formula did not fairly represent RAC West's business activities in South Carolina. We agree.

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. A taxpayer subject to taxation under

this section is considered to have been transacting or conducting business partly within and partly without the State if the taxpayer is subject to a net income tax or a franchise tax measured by net income in another state, the District of Columbia, a territory or possession of the United States, or a foreign country, or would be subject to the net income tax in any other taxing jurisdiction if the other taxing jurisdiction adopted the net income tax laws of this State.

S.C. Code Ann. § 12-6-2210(B) (2014).

For profits or income of a taxpayer derived from sources like those here, "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." S.C. Code Ann. § 12-6-2290 (2014).

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

S.C. Code Ann. § 12-6-2320(A) (2014).

In South Carolina, corporate 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."

Carmax II, 411 S.C. at 85-86, 767 S.E.2d at 198 (alteration by court) (quoting S.C. Code Ann. § 12-6-530 (2014)). "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.'" *Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue*, 388 S.C. 138, 145, 694 S.E.2d 525, 528 (2010) (quoting S.C. Code Ann. § 12-6-580). "When '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.'" *Carmax II*, 411 S.C. at 86, 767 S.E.2d at 198 (quoting § 12-6-2210(B)).

"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." Any income "remaining after allocation is apportioned in accordance with the general apportionment statute, section 12-6-2250, or one of the special apportionment formulas" provided in [s]ections 12-6-2290 through 12-6[-]2310.

Id. (quoting *Media Gen. Commc'ns*, 388 S.C. at 145, 694 S.E.2d at 528).

"The purpose of the allocation statutes is to provide for imposition of South Carolina income tax 'upon a base which reasonably represents the proportion of the trade or business carried on within this State.'" *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) (quoting *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 95, 142 S.E.2d 445, 446 (1965)). Our supreme court has held that "the apportionment formula is a reasonable basis for establishing the income tax of corporations which . . . do business on a multistate level." *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 419, 418 S.E.2d 542, 544 (1992).

"[T]he statutory apportionment method found in section 12-6-2290 of the South Carolina Code . . . [is] commonly referred to as the 'gross receipts method'" *Carmax II*, 411 S.C. at 83, 767 S.E.2d at 197. "This method . . . calculates a

multistate taxpayer's taxes due by creating an apportionment ratio that divides the taxpayer's receipts from financing and intangibles in South Carolina by the taxpayer's receipts from financing, intangibles, and retail sales everywhere else the taxpayer does business." *Id.*

In *CarMax*, the corporate structure of CarMax was somewhat similar to Rent-A-Center's.

In 2002, CarMax became a separate, publicly-traded holding company of CarMax Auto Superstores, Inc., (CarMax East) and CarMax West, two wholly owned subsidiaries, which primarily performed retail automobile sales. CarMax East owned and operated the used car superstores on the East Coast and in the Midwest, including South Carolina, and managed all of the financial operations and corporate overhead of CarMax. CarMax West owned and operated the used car superstores on the West Coast and owned all of the intellectual property. From 2002-2004, CarMax East paid royalties to CarMax West for the use of this intellectual property in accordance with a licensing agreement.

Id. at 81-82, 767 S.E.2d at 196.

In 2004, CarMax reorganized its corporate structure, and created CarMax Business Services, LLC (CBS), a multi-member limited liability company with two members: CarMax East and CarMax West. CarMax East contributed the financing operations and corporate overhead management to the partnership, and CarMax West contributed the intellectual property. Ownership percentages of CBS were based on the value of the assets contributed, and the members' income derives from their respective percentages of ownership.

After the restructuring, CarMax East and CarMax West became vehicle retailers only, and CBS began to provide all of the corporate overhead services, house financing operations through its financing arm (CAF), and manage

the intellectual property for its members. Both CarMax East and CarMax West pay CBS a management fee for these services.

Id. at 82, 767 S.E.2d at 196 (footnote omitted).

CarMax West claim[ed] that it ha[d] no financial connection to South Carolina outside of royalty payments from CarMax East. From 2002-2004, CarMax East made direct payments to CarMax West for use of the intellectual property; and since 2004, CarMax East has made management fee payments to CBS on a per-vehicle-sold basis, and CAF has generated further financing revenue in South Carolina. Because of its status as an LLC, CBS is taxed as a partnership; therefore, both sources of revenue "flow through" CBS to its members, and thus indirectly, to CarMax West.

Id.

"CarMax West filed the amended tax returns in question, using the statutory apportionment method found in section 12-6-2290 of the South Carolina Code." *Id.* at 83, 767 S.E.2d at 197. That method "requires a 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.* at 86, 767 S.E.2d at 198 (alteration by court) (quoting S.C. Code Ann. § 12-6-2290). "CarMax West then multiplied its net income by the apportionment ratio, and multiplied that number by South Carolina's income tax rate to arrive at its South Carolina income tax." *Id.* at 83, 767 S.E.2d at 197.

The DOR "rejected CarMax West's use of the gross receipts method, claiming it did not fairly represent the extent of CarMax West's business dealings in South Carolina. Rather, the [DOR] proposed an alternate apportionment method pursuant to section 12-6-2320(A)(4) of the South Carolina Code." *Id.*

The [DOR]'s proposed alternative formula employed an apportionment ratio of CarMax West's South Carolina income from intangibles and financing divided by CarMax West's intangibles and financing income from

everywhere else that it does business. According to the [DOR], this alternative formula focused on CarMax West's actual business activity in South Carolina. The [DOR] sought to prevent CarMax West from diluting its income by inflating the denominator of its apportionment ratio with sales from its Western retail operations. Furthermore, the [DOR] sought to include the income from the sale of securitized consumer lending contracts in CarMax West's South Carolina income.

Id. at 84, 767 S.E.2d at 197.

"[T]he statutory language of section 12-6-2320(A) clearly evinces a two-part analysis" *Id.* at 88, 767 S.E.2d at 199.

[W]hen a party seeks to deviate from a statutory formula under section 12-6-2320(A), the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that: (1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternative accounting method is reasonable.

Id. at 89, 767 S.E.2d at 200.

[W]he[n] the [DOR] alone is arguing that the statutory formula does not fairly represent the taxpayer's business in South Carolina[,]the [DOR] bears the burden to prove (1) that the statutory formula does not fairly represent CarMax West's business activity in South Carolina and (2) that the proposed alternative formula is reasonable.

Id. at 89-90, 767 S.E.2d at 200 (citing *St. Johnsbury Trucking Co. v. State*, 385 A.2d 215, 217 (N.H. 1978) (holding "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"); *Donald M. Drake Co. v. Dep't of Revenue*, 500 P.2d 1041, 1044 (Or. 1972) (holding "the use of any method other than apportionment should be exceptional" and the party seeking to use an alternative method bears the burden of proof)). The threshold issue is whether the

statutory formula fairly represents a taxpayer's business activity within South Carolina. *Id.* at 90, 767 S.E.2d at 200.

In *Eastman Kodak Co.*, the court determined:

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

308 S.C. at 419, 418 S.E.2d at 544.

In arriving at its decision in *CarMax*,

the ALC relied on testimony from an auditor that the business structure of CarMax West and CBS is often "linked with tax minimization strategies." Furthermore, the ALC relied on evidence regarding the sourcing of income, and the fact that CarMax West's apportionment ratio yielded a significantly lower tax than that of CarMax East, to support its determination that CarMax West's income was diluted. This was the extent of the evidence offered by the [DOR] to prove the contention that the statutory formula did not fairly represent CarMax West's business activity in South Carolina, other than bald assertions by its witnesses that it satisfied this threshold question.

Even if these findings accurately characterize CarMax West's motives, they do not provide a sound evidentiary basis to support the conclusion that the statutory formula did not fairly represent CarMax West's business in South Carolina. *See St. Johnsberry Trucking Co.*, 385 A.2d at

217 ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula." (citations omitted)).

Carmax II, 411 S.C. at 90-91, 767 S.E.2d at 201.

In this case, the burden was on the DOR to show the statutory formula did not fairly represent RAC West's business activity in South Carolina. The DOR presented the same level of evidence in this case as in *CarMax*. Based on the supreme court's holding in *CarMax* the evidence was insufficient to meet the DOR's burden for the threshold issue, we likewise conclude the DOR failed to meet its burden here. Substantial evidence does not support finding the statutory apportionment method fairly reflected RAC West's business activities in South Carolina. The DOR auditor, Southard, testified the investigation started because Rent-A-Center was comprised of multiple entities and he believed a management services fee was too high. He did not point to any specific evidence the standard apportionment method did not fairly represent RAC West's business activities. Additionally, the DOR's expert, Dr. Harrison, indicated excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina." *See id.* at 91, 767 S.E.2d at 201 (holding bald assertions by the DOR's witnesses that it satisfied the threshold question was not enough to meet its burden). Dr. Harrison testified that using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator. However, this is how the apportionment method is intended to work, as Professor Pomp testified. A very small amount of RAC West's business comes from the royalties; therefore, this should only comprise a small amount of its taxes. *See Eastman Kodak Co.*, 308 S.C. at 419, 418 S.E.2d at 544 ("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, and sales in this state are computed. Therefore, the apportionment formula reflects a 'reasonable representation' of Kodak's business in this state."). Accordingly, substantial evidence does not support the ALC's finding the DOR met its burden.

Additionally, because the DOR did not meet its burden in proving the threshold issue of whether the statutory formula fairly represented RAC West's business activities in the state, we need not decide whether the ALC erred in finding the DOR's alternative method was reasonable. *See Carmax II*, 411 S.C. at 90, 767

S.E.2d at 200 (holding the threshold issue is whether the statutory formula fairly represents a taxpayer's business activity within South Carolina); *see also Futch v. McAllister Towing of Georgetown, Inc.*, 335 S.C. 598, 613, 518 S.E.2d 591, 598 (1999) (holding an appellate court need not review remaining issues when its determination of a prior issue is dispositive of the appeal). Accordingly, the ALC's decision is

REVERSED.⁴

HUFF and GEATHERS, JJ., concur.

⁴ RAC West also argues the ALC erred in (1) finding RAC West did not operate a unitary business when the uncontested evidence established it was unitary; (2) allowing the DOR to apply a separate accounting to a unitary business; and (3) concluding the DOR did not violate RAC West's constitutional rights by applying separate accounting to a unitary business. In *CarMax*, similar additional issues were raised. *See Carmax II*, 411 S.C. at 84-85, 767 S.E.2d at 197 ("On appeal, CarMax West argued the ALC erred in . . . failing to consider that CarMax West operates a unitary business and permitting the [DOR] to use separate accounting procedures when calculating tax liability of a unitary business . . . and . . . finding that the [DOR] did not violate CarMax West's constitutional rights by applying a separate accounting to a unitary business and by sourcing financing receipts to South Carolina."). The court in *Carmax II* determined it did not need to reach these issues based on its decision. Based on our decision above, like *Carmax II*, we need not address RAC West's remaining issues. *See id.* at 91 n.11, 767 S.E.2d at 201 n.11 ("We need not reach . . . CarMax West's remaining issues on appeal, as they were all raised as defenses to the [DOR]'s use of an alternative apportionment method, and the proper allocation of the burden of proof resolves this appeal." (citing *Futch*, 335 S.C. at 613, 518 S.E.2d at 598)).

The South Carolina Court of Appeals

Rent-A-Center West Inc., Appellant,

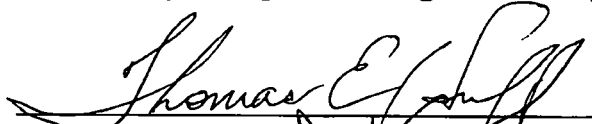
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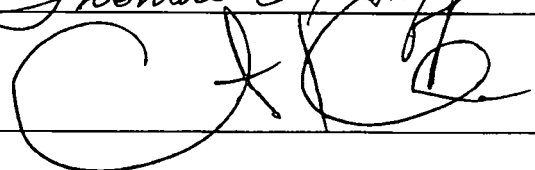
South Carolina Department of Revenue, Respondent.

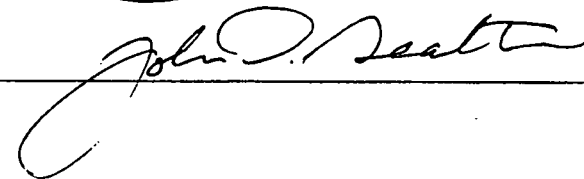
Appellate Case No. 2012-208608

ORDER

After careful consideration of the petition for rehearing, the Court is unable to discover that any material fact or principle of law has been either overlooked or disregarded, and hence, there is no basis for granting a rehearing. Accordingly, the petition for rehearing is denied.



J.


J.


J.

Columbia, South Carolina

cc:
Sean Gordon Ryan, Esquire
John C. Von Lehe, Jr., Esquire
Bryson Moore Geer, Esquire
William J. Condon, Jr., Esquire

FILED

January 20, 2017

**THE STATE OF SOUTH CAROLINA
In the Court of Appeals**

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

**Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608**

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

v.

South Carolina Department of Revenue,Respondent.

PETITION FOR REHEARING

RECEIVED
NOV 28 2016
SC Court of Appeals

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Pursuant to Rules 221(a), 219, and 240 of the South Carolina Appellate Court Rules, Respondent, South Carolina Department of Revenue (“Department” or “Respondent”), hereby files this Petition for Rehearing in the above-referenced matter, which resulted in Opinion number 5447 filed on October 26, 2016 (the “Opinion”). The Department respectfully submits that rehearing and/or issuance of a new opinion denying the relief sought by the Appellant and affirming the decision of the Administrative Law Court (“ALC”) is warranted. This Petition for Rehearing is based on the grounds that the Court overlooked and/or misapprehended the substantial evidence in the record that the Department satisfied its burden and that Appellant’s retail and trademark businesses are not unitary businesses.

INTRODUCTION

As this Court is aware, the primary issue in this matter has been whether the Department satisfied its burden of proof to demonstrate that the statutory apportionment method used by the Appellant, Rent-A-Center West, Inc., did not fairly reflect the extent of Appellant’s business activity in South Carolina. Another issue is whether Appellant’s retail and trademark activities are non-unitary activities such that Appellant’s inclusion of both of the non-unitary activities in one gross-receipts formula was improper.

On January 6, 2012, the ALC issued its Final Order and Decision (“ALC Order”) in this matter and concluded that the Department satisfied its burden with sufficient evidence. (*See R. pp. 3-23.*)¹ The ALC, who is in trier of fact in this matter, found that “the evidence in this case

¹The ALC in this case appropriately placed the burden on the Department to show 1) that the standard apportionment method used by the taxpayer did not fairly represent the taxpayer’s business activity within SC and 2) that the Department’s alternative method was reasonable. As will be discussed, this is what distinguishes the instant case from the outcome in *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014), where the trial judge placed the burden on the taxpayer to disprove the appropriateness of the Department’s alternative apportionment formula.

demonstrates that the standard formulas for apportionment (and, in particular, use of Section 12-6-2290) did not reasonably represent the proportion of trade of business that RAC West carried on in South Carolina. Furthermore, the facts established that the Department's [alternative] method of apportionment is reasonable." (R. p. 14.)

The ALC also found that the facts demonstrated that Appellant's retail operations were "unrelated" to its trademark business. (R. p. 13.) Accordingly, the ALC concluded that including Appellant's gross receipts from its out-of-state retail operations in the denominator of the combined gross-receipts formula diluted and distorted Appellant's actual economic activity in South Carolina. (R. p. 13.)

LAW

During the years at issue in this case, South Carolina law allowed two standard statutory formulary apportionment methods to apportion a taxpayer's apportionable income from within and without South Carolina. The first standard method used a three-factor apportionment formula set forth in S.C. Code Ann. § 12-6-2250 (Supp. 2000). This three-factor formula applied to manufacturers and dealers in tangible personal property, so it was not applicable to Appellant. The second standard method used a gross-receipts apportionment formula set forth in S.C. Code Ann. § 12-6-2290 (2014). The gross-receipts formula applied to all other multi-state taxpayers other than manufacturers or dealers in tangible personal property.²

²Despite not being a manufacturer or a dealer in tangible personal property, Appellant initially filed its corporate income tax returns for the years at issue using the three-factor formula. After litigation commenced, Appellant filed amended income tax returns that used the gross-receipts apportionment formula. (R. p. 4 n.1.) The ALC found that the three-factor formula was not applicable to the Appellant and its business. (R. pp. 11-12.) Therefore, the dispute in this case is whether the gross-receipts formula fairly represents the extent of the Appellant's business activity in South Carolina.

If the standard apportionment formula for a taxpayer does not fairly represent the extent of the taxpayer's business activity in South Carolina, the taxpayer may petition for or the Department may require the use of an alternative apportionment method, if that alternative apportionment method is reasonable. S.C. Code Ann. § 12-6-2320(A) (2014); see *CarMax Auto Superstores West Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 86-87, 767 S.E.2d 195, 198-99 (2014). “[T]he proponent of the alternative formula bears the burden of proving by a preponderance of the evidence that: (1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternative accounting method is reasonable.” *CarMax*, 411 S.C. at 89, 767 S.E.2d at 200.

Upon an appeal from the ALC, a South Carolina appellate court:

[M]ay not substitute its judgement for the judgement of the agency as to the weight of the evidence on questions of fact. The Court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if substantial rights of the appellant have been prejudiced because the administrative findings, inferences, conclusions, or decisions are:

- (a) in violation of constitutional or statutory provisions;
- (b) in excess of the statutory authority of the agency;
- (c) made upon unlawful procedure;
- (d) affected by other error of law;
- (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or
- (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

S.C. Code Ann. § 1-23-380(5) (Supp. 2015).

In a contested case hearing such as the one in this case, “the ALC serves as the sole finder of fact in the de novo contested case proceeding.” (Opinion, p. 5 (citation omitted).) “When the evidence conflicts on an issue, the court’s substantial evidence standard of review defers to the findings of the fact-finder. (Opinion, p. 6 (citation omitted).) “The decision of the

[ALC] should not be overturned unless it is unsupported by substantial evidence or controlled by some error of law.” (Opinion, p. 6 (citation omitted).) “Substantial evidence is ‘evidence which considering the record as a whole, would allow reasonable minds to reach the conclusion that the administrative agency reached.’” (Opinion, p. 6 (citation omitted).) “Substantial evidence . . . is more than a mere scintilla of evidence.” (Opinion, p. 6 (citation omitted).)

LEGAL ANALYSIS

The Court overlooked or misapprehended the substantial evidence that exists in the record to support the ALC’s finding that the Department satisfied its burden to prove that the statutory gross-receipts formula did not fairly reflect Appellant’s business activity in South Carolina. Further, this Court overlooked or misapprehended the substantial evidence that exists in the record demonstrating that Appellant’s out-of-state retail business and its trademark business are unrelated and not unitary. Given this substantial evidence, this Court should defer to the facts as found by the ALC and issue a new opinion affirming the ALC Order.

I. The Department Presented Substantial Evidence to Satisfy its Burden of Proof to Demonstrate that the Standard Gross-Receipts Apportionment Formula Did Not Fairly Reflect the Extent of Appellant’s Business Activity in South Carolina.

The record is replete with evidence that supports the ALC’s finding that the Department satisfied its burden to prove that the statutory gross-receipts apportionment formula used by Appellant did not fairly represent the extent of Appellant’s business activity in South Carolina. Accordingly, this Court should modify its Opinion to affirm the ALC Order or should rehear this matter.

The ALC, who was the trier of fact in this case, was in the best position to determine the facts in this case, (see Opinion, p. 6 (citing *Risher v. S.C. Dep’t of Health & Envtl. Control*, 393 S.C. 198, 201, 712 S.E.2d 428, 435 (2011)), and found that “the evidence in this case

demonstrates that the standard formulas for apportionment (and, in particular, use of Section 12-6-2290) did not reasonably represent the proportion of trade of business that RAC West carried on in South Carolina,” (R. p. 14). This evidence relied on by the ALC constituted sufficient evidence as it was specific and more than mere bald assertions; however, this Court relied upon only one statement by the Department’s auditor and two statements by the Department’s expert witness (Opinion, p. 13) and overlooked the additional and sufficient evidence in the record that supports the Department’s position. By failing to recognize the sufficient evidence that supports the Department’s position, the Court overlooked or misapprehended the evidence presented at the contested case hearing resulting in this Court erroneously finding that the Department presented the same insufficient evidence in this case that it presented in *CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep’t of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014).³

³The Department submits that the Court should rely on *CarMax* solely for the legal conclusion regarding the burden of proof under S.C. Code Ann. § 12-6-2320 and nothing more. The result in *CarMax* – finding that the Department had not met its burden of proof to show that the standard formula did not fairly represent the extent of CarMax’s business activity in South Carolina – should not be used to draw any conclusion on the sufficiency of the Department’s evidence here. Significantly, the trial court in *CarMax* imposed the burden of proof on the wrong party, requiring the taxpayer to show that the Department’s alternative formula was inappropriate instead of placing the affirmative burden on the Department. As observed by Chief Justice Pleicones in dissent, “The ALC placed the burden of proof on CarMax West, and accordingly its findings of fact and conclusions of law are premised on that error of law.” *CarMax*, 411 S.C. at 92, 767 S.E.2d at 201 (Pleicones, J., dissenting in part). The dissent further observed that “[i]t is therefore not surprising that as the majority states, ‘the Department relied on CarMax West to refute [the Department’s] use of an alternate formula,’ or that the Department, lacking any burden of proof, largely offered evidence of **what** it did rather than **why** it did it.” *Id.* While the Department acknowledges that the *CarMax* Court ultimately reviewed the record to determine that the Department’s evidence was insufficient, the *CarMax* Court did not have the same perspective on the evidence there as did the trial judge in the instant case. Here, the ALC imposed the proper burden of proof. (R. pp. 10, 12.) The trial judge here thus had the ability to weigh the testimony of witnesses and assess their credibility and evaluate all other evidence. Using the correct burden of proof, the ALC here arrived at the factual conclusion that the Department met its burden of proof. The Department respectfully submits that these conclusions – that the standard formula does not fairly represent the extent of the

This Court improperly found that substantial evidence does not support the ALC's finding that the Department met its burden. (Opinion, p. 13.) In its analysis, this Court stated that the Department's auditor "did not point to any specific evidence" to show that Appellant's use of the gross-receipts formula did not fairly represent the extent of its business activity in South Carolina. (Opinion, p. 13.) It further indicated that the Department's economic expert made mere "bald assertions" regarding Appellant's use of the gross-receipts formula. (Opinion, p. 13.)

The Department, however, satisfied its burden of proof by presenting sufficient evidence that the standard gross-receipts formula used by Appellant does not fairly represent the extent of Appellant's business activity in South Carolina. This evidence demonstrates that by including Appellant's out-of-state retail receipts in the denominator of the gross-receipts ratio, when Appellant conducted no retail activity in South Carolina, the gross-receipts ratio was diluted and distorted such that the resulting tax base did not fairly represent Appellant's business activity in South Carolina. The ALC found that "the facts clearly reflect the revenue from the operations of [Appellant's out-of-state] stores is unrelated to the trademark business [Appellant] operates in South Carolina" and that "the evidence does not show that [Appellant's] retail operations, which generates a very large portion of its gross receipts, contribute a comparable amount to {Appellant's} net income." (R. p. 13.)

A witness for the Appellant testified that Appellant did not operate any retail stores in South Carolina, but it operated retail stores only in the western part of the United States. (R. p. 125.) This witness also testified that Appellant had no management or employees in South Carolina. (R. p. 131.)

taxpayer's activity in the State and that the Department's alternative methodology is reasonable – were supported by substantial evidence.

The Department's auditor testified that Appellant had only two streams of income: (1) retail sales conducted entirely outside of South Carolina that made up 87% of Appellant's income and (2) royalty income from trademark licensing agreements earned partially from within South Carolina that made up 13% of Appellant's income. (R. p. 254.)

The Department's auditor also testified that Appellant's only income generated from within South Carolina was royalty income and that Appellant did not operate any retail stores in South Carolina. (R. pp. 253-54.) The auditor testified that Appellant's out-of-state retail operations had "nothing" to do with its trademark activities in South Carolina. (R. p. 253.) Through a trademark licensing agreement, Appellant licensed use of its trademarks to RAC East, Inc., a separate but affiliated company that operated retail stores in South Carolina. (R. 383-390.)

Further, the record indicates that Appellant engages in two business activities – retail and trademark – that have widely divergent profit margins and that the result of combining both activities into one gross-receipts formula is a dilution and distortion of Appellant's business activity in South Carolina. Appellant conducts a high profit margin trademark licensing business in South Carolina while it conducts a lower profit margin retail business in western states. (R. pp. 253-56.) The Department's auditor testified that Geoffrey-type companies (i.e., companies that own and license trademarks) do not incur many expenses and would therefore be a high profit margin business when compared to a retail business that has many expenses to offset its income. (R. p. 256.) Even though the Department asked for documentation of any trademark-related expenses incurred by Appellant (R. p. 254-55), the record is void of Appellant even naming any trademark-related expenses that it incurred, much less substantiating any such deductions. However, the record includes statements from an RAC Texas employee stating that

RAC Texas manages Appellant's trademark portfolio, indicating that Appellant incurs little or no expense related to its trademarks. (R. p. 154.) Therefore, Appellant operates only its high margin trademark business in South Carolina from which it generates more net income from every dollar of sales. Apportioning Appellant's total net income using a gross-receipts ratio that includes both the lower margin retail receipts that make up 87% of total receipts and the higher margin royalty receipts will result in less total net income being apportioned to South Carolina although Appellant operates only its high margin business in South Carolina. Separating these lines of businesses for apportionment purposes is supported by the decision in Microsoft Corporation v. Franchise Tax Board, 39 Cal.4th 750, 767-71, 139 P.3d 1169, 1180-83 (2006) (stating that a qualitative analysis is necessary because by applying the worldwide average margin to each state's gross receipts when the much lower margin treasury operations operate only in Washington State "would result in severely underestimating the amount of income attributable to every state except the state hosting the treasury department).

The ALC demonstrated the distortion and dilution of the gross-receipts ratio caused by including both retail and royalty receipts in the denominator while including only Appellant's South Carolina royalty receipts in the numerator. (R. pp. 6-7.) For example, the ALC noted that while Appellant's total net income for 2004 was \$19,840,800 the gross-receipts ratio used by Appellant apportioned only \$40,317 of that total net income to South Carolina. (R. p. 6.) This is despite the fact that Appellant generated \$861,437 from South Carolina in 2004 through its high margin trademark licensing business. (R. pp. 6, 254.) Due to the qualitative differences in Appellant's retail and trademark businesses, the gross-receipts formula dilutes and distorts the extent of Appellant's business in South Carolina because it results in a reduction of Appellant's South Carolina gross receipts from trademarks of \$861.437 by 95% to arrive at a South Carolina

taxable income amount of only \$40,317. (R. p. 6.) Such a significant reduction is absurd when the record is void of any expenses which Appellant incurred that should offset the South Carolina-based royalty income and the evidence in the record clearly indicates that another entity, RAC Texas, manages and maintains Appellant's portfolio or trademarks and tradenames (R. p. 154). The absurd result of using one gross-receipts formula that includes both the high margin and the lower margin activities is even starker in 2005 and 2006. (R. p. 7.)

Further, the Department's expert recognized and testified regarding the inherent problem of including the out-of-state retail sales in the denominator of the gross-receipts ratio while no retail sales are included in the numerator when Appellant conducts no retail operations in South Carolina. Dr. Harrison, an expert in law and economics, testified that using the standard gross-receipts ratio, which included retail sales in the denominator, "would not provide an accurate reflection of the economic connection of [Appellant] with South Carolina." (R. p. 274.) He called it mixing apples and oranges (R. p. 274), which is the same analogy used by the California Supreme Court in Microsoft Corp. when addressing the different profit margin activities within Microsoft's business, 39 Cal.4th at 768, 139 P.3d at 1180.

The above demonstrates that the Department, unlike in *CarMax*, presented much more than a scintilla of evidence to support its assertion that Appellant's use of the gross-receipts formula did not fairly represent the extent of Appellant's business activity in South Carolina. Therefore, the Department presented the necessary sufficient evidence for the ALC's decision to be affirmed. Additionally, the ALC as the trier of fact made the factual determinations based on such sufficient evidence and its factual determinations should not be overturned.

II. The Department Presented Substantial Evidence that Appellant's Out-of-State Retail Business and its Trademark Businesses Are Unrelated and Not Unitary.

Although the above is sufficient for this Court to issue a new opinion affirming the ALC Order, the ALC Order should also be affirmed because the ALC found that Appellant's retail and trademarks activities are "unrelated" and it is not proper, as Appellant did, to combine non-unitary activities into one standard apportionment method.⁴ (R. pp. 12-13, 15.)

"Under both the Due Process and the Commerce Clause of the [United States] Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983). In addition to not taxing income earned outside of a taxing authority's state, the standard formulary apportionment methods used in a particular state should be applied only to activities that are unitary, and unrelated activities should not be apportioned by using one combined formulary apportionment method. As the ALC found, the entire "unitary business" concept functions to determine whether certain activities of a taxpayer may be subject to income tax on a formulary apportionment basis. (R. p. 15 (citing 71 Am. Jur. 2d *State and Local Taxation* § 511 (updated Nov. 2011)).) The United States Supreme Court confirmed that formulary apportionment is applied only to unitary activities as follows:

The unitary business/formulary apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It . . . calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the

⁴It is proper however to use separate accounting even if a taxpayer's business activities are unitary because, for example, S.C. Code Ann. § 12-6-2320(A) allows separate accounting as an alternative apportionment method without any mention of unitary or non-unitary businesses. (See also R. p. 16.)

basis of a formula taking into account objective measurers of the corporation's activities within and without the jurisdiction.

Container Corp., 463 U.S. at 165. South Carolina law also has recognized that formulary apportionment applies to unitary activities but not to unrelated activities. See S.C. Code Ann. Regs. 117-710.1 (2012).

The ALC addressed the factors necessary in a unitary-business analysis and found that “the facts clearly reflect the revenue from the operation of those [out-of-state] stores is unrelated to the trademark business [Appellant] operates in South Carolina.” (R. p. 13.) The test to determine whether a business is unitary is to determine if the business has the characteristics of unity of ownership, unity of management, and unity of operations (i.e., the “unities” definition) and if the activities of the business in question contribute to or depend on the other activities of the business (i.e., the “contribution-dependence” definition). (R. p. 16 (citing *Eastman Kodak Co. v. South Carolina Tax Commission*, 308 S.C. 415, 418 S.E.2d 542 (1992)).)

As noted below, the record is again replete with substantial evidence supporting that Appellant's retail and trademark businesses are unrelated and non-unitary such that using a single gross-receipts formula combining these unrelated activities would not fairly represent the extent of Appellant's business activities in South Carolina. Appellant's trademark business, which is the only business that Appellant conducted in South Carolina, (R. pp. 152, 253, 342), is not unitary with Appellant's primary business, its retail business. For example, unity of management does not exist between Appellant's retail and trademark businesses. (R. p. 17.) Appellant manages its retail stores but not its trademarks and tradenames. Evidence demonstrates that Appellant has store managers who manage the day-to-day retail operations at each store, (R. pp. 127, 129, 152), but Appellant does not manage the day-to-day operations of its trademark business (R. pp. 152, 154). RAC Texas, a separate entity that does not pay income

taxes in South Carolina, provides the services for protecting, licensing, and monitoring use of Appellant's intellectual property in South Carolina and elsewhere. (R. pp. 152, 154.) Ms. Wolverton of RAC Texas is "responsible for maintaining the company's portfolio of trademarks and trades names" including determining whether a desired name would be available for federal registration, filing the registration and leading the registration process, filing continuing use statements, and monitoring use of the Intellectual Property by others. (R. p. 154.) Additionally, although RAC West owns the intellectual property, Appellant's own economic consultant in its transfer pricing study stated that RAC Texas is responsible for developing advertising and marketing strategies to create, maintain, and expand the RAC brand name. (R. p. 425.) Appellant asserts that a unity of management exists here because a related company, RAC Texas, manages Appellant's trademark business, (Appellant's Brief p. 32.); however, this fact actually proves the opposite. The fact that another entity manages and maintains Appellant's portfolio of trademarks and tradenames and the fact that Appellant's economic consultant could separate Appellant's trademark licensing activities in order to determine the royalty fee demonstrate that Appellant's retail and trademarks activities are not unitary because Appellant does not have centralized management over both activities and shows that Appellant's retail and trademark businesses can be separated.

In addition to not meeting the unity of management test, there are several reasons why Appellant does not meet the contribution-dependence test, meaning that its trademark business is not unitary with its retail business. First, Appellant's trademark business depends on retail sales made by its retail affiliates (i.e., RAC East and RAC Texas) and their customers, not from Appellant's own retail sales. (See, e.g., R. pp. 383-87.) Unlike the retail sales of RAC East (R. pp. 383-87), the retail sales of Appellant do not generate any royalty income for Appellant's

trademark business because Appellant does not charge itself a royalty fee. Second, as the ALC noted, Appellant did not prove that its retail and trademark operations have an inextricable link between the two businesses. (R. p. 8.) Appellant's own expert placed a value on the trademark activities by determining an appropriate royalty percentage. (R. p. 8.) Appellant made bald assertions that such an inextricable link existed but offered no documentary or other meaningful evidence to support this claim except for self-serving testimonial statements. Third, Appellant's assertion that as the customer service and performance of the retail stores increased the intellectual property become "more famous" (R. pp. 155), is irrelevant because notoriety does not necessarily cause an increase in value and Appellant certainly did not present any estimates of how much the value of the intellectual property increased or decreased in any year because of retail service or performance. Assuming, arguendo, that good retail service or performance increased the value of the intellectual property in any one of the tax years at issue, such an increase in the value of intellectual property is not a taxable event and has no relevance to Appellant's income tax returns for 2003, 2004, or 2005 as Appellant did not change the royalty fee charged to its affiliates due to a change in value, which would have affected Appellant's income, or did not sell its intellectual property in a taxable transaction. The taxable event for Appellant in South Carolina is the receipt of the royalty fees from RAC East. That taxable event is the centerpiece of the Department's alternative apportionment method. Appellant could affect the taxable event, if the value of the intellectual property increased or decreased, by increasing or decreasing the royalty percentage in the licensing agreements with RAC East. Fourth, Appellant did not strategically acquire the intellectual property to enhance the value of its retail business as it already owned the intellectual property when that company was acquired. (R. p. 132.) Fifth, whatever value Appellant's intellectual property has on its retail operations and vice versa is

applicable to all retail operations of RAC West, RAC Texas, and RAC East, not merely on the retail operations of RAC West. (R. p. 155.) Therefore, Appellant's intellectual property equally serves the retail operations of RAC West, RAC East, and RAC Texas and does not provide any unique value to RAC West's retail business. Finally, although the retail operations of RAC East and Appellant are the same (R. p. 152), only Appellant owns the intellectual property (R. pp. 152, 155). This indicates that operating the retail stores, whether by RAC East, RAC Texas, or Appellant, is not dependent on also owning the trademark business; otherwise RAC East's and RAC Texas' retail business would be failing because they do not own the trademarks.

Still another example of Appellant's trademark business not being unitary with its retail business is the fact that Appellant's royalty income is identifiable, quantifiable, and separable. Its royalty income comes from its retail affiliates, primarily RAC East and RAC Texas, and is established through licensing agreements. (See, e.g., R. pp. 383-90.) In the agreement with RAC East, Appellant receives a royalty fee of 3% of RAC East's net sales. (R. p. 389.) KPMG was able to look separately at Appellant's trademark business and determine an arm's length royalty fee. (R. pp. 409-77.) Since the royalty fee has been quantified and KPMG separately analyzed Appellant's trademark business, Appellant's trademark business can be separated from its retail business.

Appellant cites Exxon Corp. v. South Carolina Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1993) to assert that Appellant's trademark business is unitary with its retail business. (Appellant's Brief p. 28-33.) In Exxon, Humble Oil and Refining Company (Humble) operated a vertically integrated oil and gas company engaged in exploration and production of oil and gas, refining of crude oil, and the retail sales of petroleum products. Exxon, 273 S.C. at 596, 258 S.E.2d at 94. When filing income tax returns in South Carolina, Humble excluded from its tax

base the portion of its income related to the exploration and production operations. Id. The Supreme Court affirmed the lower court's decision that Humble operated a single unitary business that included the exploration and production operations and that South Carolina income tax should be calculated by applying the apportionment ratio to Humble's entire corporate net income. Id., 273 S.C. at 595, 596, 602, 258 S.E.2d at 94, 97. The Supreme Court used the unities and contribution-dependence definitions in its Exxon analysis, but, as discussed, above, the facts of the instant case, unlike Exxon, show that unity of management and the requisite contribution-dependency between Appellant's retail and trademark businesses did not exist. Additionally and critically, Exxon does not prohibit the use of separate accounting as an alternative apportionment method inasmuch as that opinion predated the 1995 enactment of Section 12-6-2320(A) which allows separate accounting. Prior to the enactment of Section 12-6-2320(A), South Carolina law did not have a statute that authorized the use of separate accounting as an alternative apportionment method.

Based on the above, the ALC found that Appellant's retail and trademark businesses are unrelated; hence, they are non-unitary. The record includes sufficient evidence to support the ALC's finding. Therefore, based on how formulary apportionment formulas are intended to be applied to only unitary activities, this Court should modify its opinion to affirm the ALC Order.

CONCLUSION

For the reasons specified herein, the Department respectfully requests that this Court grant its Petition for Rehearing and/or issue a new opinion denying the relief requested by Appellate and affirming the judgement of the ALC.

Respectfully submitted,



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November 28, 2016

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

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SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608

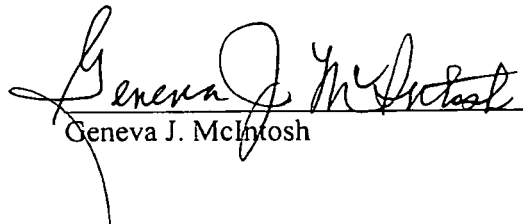
Rent-A-Center West, Inc.,Appellant,

v.

South Carolina Department of Revenue,Respondent.

PETITION FOR REHEARING

I, Geneva J. McIntosh, do hereby certify that I have caused to be mailed, via United States Postal Service, postage prepaid, a copy of the South Carolina Department of Revenue's Petition for Rehearing in re: Rent-A-Center West, Inc., v. South Carolina Department of Revenue, Trial Court Case No. 09-ALJ-17-0204-CC, Appellate Case No. 2012-208608 to John C. Von Lehe, Jr. and Bryson M. Geer, Esquires, Nelson, Mullins, Riley & Scarborough, LLP, P. O. Box 1806, Charleston, SC 29402-1806 on this 28th day of November, 2016.


Geneva J. McIntosh



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November 28, 2016

The Honorable Jenny Abbott Kitchings
Clerk of Court
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Columbia, SC 29211

RECEIVED

NOV 28 2016

SC Court of Appeals

Re: Rent-A-Center West, Inc. v. South Carolina Department of Revenue
Appellate Case No. 2012-208608
Trial Court Case No. 2009ALJ170204CC

Dear Ms. Kitchings:

Respondent South Carolina Department of Revenue files the original and six (6) copies of its Petition for Rehearing in the above-referenced matter. The Court filed its Opinion on October 26, 2016, and extended the deadline to serve and file this Petition until November 28, 2016.

By a copy of this letter, Respondent is serving the Petition on Appellant's counsel.

Sincerely,

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APP 034

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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APPEAL FROM ADMINISTRATIVE LAW COURT

SC Court of Appeals

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2012-208608

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

v.

South Carolina Department of Revenue Respondent.

FINAL BRIEF OF APPELLANT

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STATEMENT OF ISSUES

- I. DID THE ALC ERR IN FINDING THAT THE STANDARD STATUTORY APPORTIONMENT FORMULA DID NOT FAIRLY REPRESENT RAC WEST'S BUSINESS ACTIVITIES IN SOUTH CAROLINA AND THAT SCDOR'S ALTERNATIVE METHOD WAS REASONABLE?
- II. DID THE ALC ERR IN FINDING THAT RAC WEST DID NOT OPERATE A UNITARY BUSINESS WHERE THE UNCONTESTED EVIDENCE ESTABLISHED THAT IT WAS UNITARY?
- III. DID THE ALC ERR IN ALLOWING SCDOR TO APPLY SEPARATE ACCOUNTING TO A UNITARY BUSINESS WHEN DOING SO IS PROHIBITED BY EXXON CORP. V. S.C. TAX COMM'N, 273 S.C. 594, 258 S.E.2D 93 (1979) AND S.C. CODE ANN. § 12-6-2320(A)(4) (2014) BECAUSE IT PRODUCES AN UNREASONABLE RESULT, OR, ALTERNATIVELY, BECAUSE SEPARATE ACCOUNTING PRODUCES AN UNREASONABLE RESULT IN THIS CASE?
- IV. DID THE ALC ERR IN CONCLUDING THAT SCDOR DID NOT VIOLATE RAC WEST'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS?

STATEMENT OF THE CASE

This case involves a protest by Rent-A-Center West, Inc. ("RAC West") of an assessment of corporate income taxes by the South Carolina Department of Revenue ("SCDOR") for the income tax years ending in 2003, 2004 and 2005. SCDOR audited RAC West's initial returns filed for 2003-2005, which were filed using the three-factor apportionment formula, and issued an additional assessment claiming that RAC West owed the following in income tax, interest and penalties:

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

See Field Audit for RAC West, R. pp. 340-350. RAC West timely protested this assessment. See RAC West Notice of Protest, R. pp. 351-360. Following a conference, SCDOR issued a Department Determination upholding the assessment. See SCDOR Department Determination for RAC West. R. pp. 29-37. RAC West then timely requested a contested case hearing before the Administrative Law Court ("ALC") pursuant to S.C. Code Ann. § 12-60-460 (2014). Thereafter, and prior to this hearing, RAC West filed amended tax returns based on the single-factor apportionment formula and paid \$1,326.00 in additional taxes owed under that method.

The ALC held a hearing on August 10 and 11, 2011, and issued a Final Order (the "Order") finding for SCDOR on all issues except the penalty, which the ALC dismissed, on January 6, 2012. See Order, R. pp. 3-24. RAC West received written notice of the Order that same day and subsequently filed a motion for reconsideration on January 17, 2012. See RAC West's Motion for Reconsideration, R. pp. 38-103. The ALC denied this motion on February 1, 2012, and RAC West received that order that same day. RAC West timely filed a Notice of Appeal on February 27, 2012.¹

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

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

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

STATEMENT OF FACTS

A. **General Background on RAC West**

The Rent-A-Center ("RAC") business is a rent-to-own business that rents and sells appliances, furniture, electronics, computers, televisions, etc. R. p. 125 at 83:24-84-2. RAC stores are located in all 50 states. R. p. 125 at 84:10-12. The ownership of these stores is split between three entities: RAC East owns and operates retail stores in eastern states (including South Carolina), RAC West owns and operates retail stores in western states and RAC Texas owns and operates retail stores in Texas. R. p. 125 at 84:18-25.

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

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

RAC West licenses the IP to RAC East pursuant to a licensing agreement. Trademark License Agreement dated 12/31/2002, R. pp. 383-390. Per this agreement, RAC West charges a royalty fee for the license that is equal to 3% of the net sales of the RAC East stores. Id. RAC West and RAC East set the amount of this fee based upon the analysis and conclusions of a transfer pricing study. R. p. 130 at 104:13-18 and p. 162 at 230:23-231:25. SCDOR stipulated at trial that it did not dispute that the amount of this fee was reasonable. R. p. 259 at 134:5-6 and 9-10.

Beyond receiving these royalty payments for the use of the IP by the South Carolina stores, RAC West has no activities in this State. R. p. 131 at 106:3-6. It has no physical presence in South Carolina as it has no employees, facilities or tangible property in this State. R. p. 131 at 105:17-22. It also makes no sales in South Carolina and receives *de minimus*, if any, services or benefits from the State. R. p. 131 at 105:23-106:2.

Additionally, RAC West presented evidence regarding the unitary relationship between its two business activities of owning and licensing IP and owning and operating retail stores in western states. The same management is over both business activities. R. p. 131 at 107:14-21. The two activities also share services and systems that create efficiencies and cost savings across both business lines. R. p. 131 at 108:4-11. All income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole. R. p. 131 at 107:22-108:3. The retail stores contribute to the profitability of the IP and vice versa. R. p. 131 at 108:12-25. More

specifically, as the RAC brand name becomes more well-known, it builds brand loyalty, public recognition and goodwill, which increases traffic to the stores and leads to customers being willing to pay more to buy the RAC brand versus another brand. R. p. 130 at 102:9-25 and p. 131 at 108:20-25. This, in turn, leads to increased sales and thus higher profitability of RAC East (via increased sales revenue) and RAC West (via increased royalty payments). Id. Likewise, as the RAC West retail store sales increase, the RAC IP becomes more valuable as it is tied to a more profitable and successful business. R. p. 155 at 203:4-8. Stated another way, the retail sales activities and the intellectual property activities of RAC West contribute to and depend on one another and there is a flow of value between the two activities. R. p. 155 at 203:20-204:2. In addition to the foregoing factual testimony, RAC West also presented expert testimony regarding the unitary nature of its business. Its expert economist testified that RAC West was a single unitary business based on these facts and the mutual interdependence of the trademark and retail businesses (R. p. 170 at 264:3-23) as did RAC West's tax policy expert, who found an "inextricable link" and "synergy" between the IP and retail store businesses. R. p. 241 at 64:9- p. 242 at 65:1 and p. 242 at 65:17-66:6.

The evidence regarding these relationships was uncontested as SCDOR presented no evidence to challenge or refute any of the above. In fact, SCDOR's auditor testified that he thought the RAC IP owned by RAC West probably contributed to the profitability of the RAC West stores but that he did not consider this fact in his analysis.² R. p. 267 at 167:3-11.

² More specifically, when SCDOR's auditor was asked whether the IP owned by RAC West contributed to the profitability of the RAC West stores, he responded: "Well, they probably do. When we go and audit, we don't think about that; we're just looking at

Finally, RAC West's witness testified that RAC West kept records of the total costs for its unitary business activities (IP and retail stores), which it reported in its returns, but it did not separately track the costs of the IP alone because there was no reason to do so and it would be very difficult to do with any degree of accuracy or reliability. R. p. 132 at 111:11- p. 133 at 115:17 and p. 155 at 204:3- p. 156 at 205:8. In fact, this South Carolina audit was the first time RAC West had ever been asked for this information. R. p.157 at 112:1-4. Separately tracking the IP costs (versus tracking total costs) is difficult because of the interrelated and interdependent nature of the company's business activities. R. p. 132 at 111:11- p. 133 at 115:17 and p. 155 at 204:3- p. 156 at 205:8.

While SCDOR's economist claimed that managerial accountants routinely track costs for companies, tracking indirect costs like overhead or man hours spent on one task versus another of a unitary business such as RAC West would fail to capture all of the contributions and flows of value between the two activities. R. p. 155 at 204:3- p. 156 at 205:8 (RAC West witness discussing that because work performed related to the IP increases the value of the retail operations and vice versa, it is difficult to accurately account for the actual costs of one versus the other even if one could make an effort to track an employee's time on tasks for the two different operations); R p.163 at 235:15-24 (RAC West's economist and transfer pricing expert, Dr. John Wells, discussing the difficulty of separating costs and explaining that the employees of RAC West were performing "integrated functions which both supported the intangibles and were

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

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

B. Tax Returns, Audit, Protest and Determination

RAC West's Tax Director testified that the company followed the instructions and guidance provided in the tax returns in preparing the returns at issue. More specifically, RAC West started with its federal taxable income (which would include the total income less costs of RAC West), made South Carolina adjustments and applied the standard single factor gross receipts statutory apportionment formula set forth in S.C. Code Ann. §12-6-2290 to determine South Carolina apportionable net income all in accordance with what the statute, tax return and instructions dictate.³ See R. p. 134 at 117:17-118:7; S.C. Code Ann. §12-6-2290 (2014); Sample SCDOR Corporate Income Tax Instruction, R. pp. 479-499; RAC West Amended Tax Returns 2003-2005, R. pp. 361-382. The standard formula computes an income tax by apportioning corporate net

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

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

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

⁴ RAC West's Tax Director also testified that in preparing and submitting the returns at issue, he acted in good faith and with substantial authority, that he made adequate disclosures on the returns, and that nothing in the instructions or anything else he had seen suggested that RAC West should file its return using the separate accounting method SCDOR now asserts. R. p. 138 at 133:10-134:21.

⁵ This was a point of contention between the parties as SCDOR argued that it was the taxpayer's burden to provide it with the accurate costs associated with its royalty income, while RAC West argued that nothing under the law required it to track the costs of one business line versus another for a unitary business engaged in multiple business activities and asserted that it would be impossible to do so accurately or reliably. See *supra* pp. 6-7 (explaining that attempts to allocate costs for IP activities versus retail store activities would not likely be accurate or reliable due to the interrelated and interdependent nature of these activities and that separate accounting of the costs would fail to capture all of the contributions and flows of value between the two activities).

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

STANDARD OF REVIEW

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

STATUTORY CONSTRUCTION

When interpreting a statute, the sole function of the Court is to determine and give effect to the intent of the legislature. Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). The starting point in doing so should always be the text of the statute

itself. Id. (holding that "[w]hat a legislature says in the text of a statute is considered the best evidence of the legislative intent or will"); Wigfall v. Tideland Utilities, Inc., 354 S.C. 100, 580 S.E.2d 100 (2003). In interpreting the text, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "[w]here the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." Hodges, 341 S.C. at 85, 533 S.E.2d at 581.⁶

ARGUMENT

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

The central issue in this case is the proper method to use in determining RAC West's taxable income in this State during the audit period (tax years ending 2003 through 2005). RAC West's position is that the standard statutory method fairly represents its business activities and that SCDOR's alternative separate accounting method does not, while SCDOR claims the opposite is true. Because the ALC's findings in favor of SCDOR on these issues are contrary to all evidence presented and

⁶ See also State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002) (holding when the language of the statute is clear, "a court cannot rewrite the statute and inject matters into it which are not in the legislature's language. . . ."); Rosmer v. Pfizer, 263 F.3d 263 (4th Cir. 2001) (holding that when a statute is plain on its face, the court's inquiry is at an end).

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

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

Under South Carolina law, a multi-state taxpayer that does business both within and without this State is subject to a 5% corporate income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). The General Assembly's language in this statute focuses on the **proportion** of a taxpayer's business within South Carolina and makes no mention of the **type** of income stream that is being taxed. The starting point for determining the "base" referenced in § 12-6-2210(B) is the taxpayer's "federal taxable income" plus or minus certain adjustments (under Article 9 of Title 12) which results in the taxpayer's South Carolina "apportionable net income." See S.C. Code Ann. §12-6-580 (2014). This net income figure is then adjusted by the amount of income, deductions or credits that should be allocated (i.e. assigned) to another state. The parties agree that there are no allocable items at issue in this matter.

Next, the taxpayer's "apportionable net income" is apportioned under the appropriate statute, which, in this case, the parties agree is the single-factor "gross receipts" statute if the standard statutory method is to be applied. S.C. Code Ann. § 12-6-2290 (2014); R. p. 268 at 172:12-18 (testimony of auditor that single-factor formula would be the correct method). Under this statute, the taxpayer's "gross receipts from within this State" are divided by the taxpayer's "total gross receipts from everywhere." S.C. Code Ann. § 12-6-2290 (2014). This statutorily defined fraction is then multiplied

by the taxpayer's apportionable net income to arrive at the South Carolina taxable income, i.e. the "base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). Finally, the South Carolina taxable income is multiplied by the 5% corporate income tax rate resulting in the amount due in taxes. S.C. Code Ann. § 12-6-530 (2014).

In this case, RAC West followed the above standard statutory formula by starting with its federal taxable income and making any appropriate adjustments to arrive at its apportionable net income. See supra Facts at p. 7. It then applied the single-factor gross receipts formula to its apportionable net income to determine its South Carolina net income. Id. Thus, RAC West divided its South Carolina gross receipts by its total gross receipts. Id. It then multiplied this fraction by its apportionable net income to determine its South Carolina taxable income, which it then multiplied by the South Carolina corporate income tax rate of 5%. Id.

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

First, it is clear that the General Assembly was focused on obtaining a fair measure of the **proportion** of a multi-state taxpayer's business activity in South Carolina versus other states. S.C. Code Ann. § 12-6-2210(B) (2014) (stating that a

multi-state taxpayer that does business in this State as well as others is subject to a 5% tax "upon a base which reasonably represents the **proportion** of the trade or business carried on within this State") (emphasis added). Nothing in the statute even suggests that the "proportion" be limited to a comparison of the business done in this State versus **the same type of business** performed in other states as SCDOR has done.

Additionally, the General Assembly used federal taxable income as its starting point for determining a multi-state taxpayer's income, which by definition includes all income streams of a taxpayer. See S.C. Code Ann. §12-6-580 (2014). The gross receipts method, which SCDOR agrees would be the appropriate standard method if a standard method is to be used (see R p. 268 at 172:12-18), apportions net income by dividing "gross receipts from within this State" by "total gross receipts from everywhere." S.C. Code Ann. §12-6-2290 (2014).⁷ The General Assembly could easily have drafted the gross receipts statute to read that net income should be apportioned by dividing "gross receipts from within this State" by "total gross receipts everywhere **for the same type of business activity as is performed in this State**" if that was its intention. Thus, the plain meaning of the relevant statutes does not support SCDOR's position in this case that RAC West's gross receipts related to its retail business be excluded from consideration and that gross receipts from royalties be separately taxed.

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

⁷ See also R. p. 234 at 38:12-15 (testimony of RAC West's tax policy expert explaining that the standard apportionment formula under the Uniform Division of Income for Tax Purposes Act is "trying to get a relative measure of the sales occurring in the taxing state as a percentage of the corporation's total sales.").

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

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

Even if this Court determines that the relevant statutes do not reflect RAC West's activities in South Carolina and therefore permit SCDOR to propose an alternative method that revises the gross receipts formula as it suggests, SCDOR must still meet all statutory requirements. An alternative method of apportionment is only authorized in certain circumstances, which are set forth in S.C. Code Ann. §12-6-2320(A):

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Thus, an alternative method may only be used where (a) the standard method does not fairly represent the taxpayer's in-state business activities, and (b) the alternative method

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

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

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

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

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

⁸ Additionally, RAC West would note that an alternative method should be used "only in limited and specific cases. . . where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the [standard] apportionment and allocation provisions" See Uniform Division of Income for Tax Purposes Act ("UDITPA") and related regulations at 37, R. pp. 500-543. As the United States Supreme Court has explained, this approach to using alternative formulas sparingly is based on the belief that formulary apportionment is presumed to be fair and reasonable. See *Butler Bros. v. McCollgan*, 315 U.S. 501 (1942). On the other hand, separate accounting, is "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164-65 (1983). See also *CarMax* at p. 10 (citing *St. Johnsbury's Trucking Co. v. State*, 385 A.2d 215, 217 (N.H. 1978) and *Donald M. Drake Co. v. Dep't of Revenue*, 500 P.2d 1041, 1044 (Or. 1992)(both holding that an alternative formula is the exception and thus party seeking to use bears the burden of proof).

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

SCDOR's position as to why the standard method does not fairly reflect RAC West's in-state activities appears to be that considering all of its net income, which would include both the retail store income and the royalty income, results in a dilution or distortion of RAC West's income in South Carolina. SCDOR presented no evidence to support this argument other than to point to the percentage of royalty revenues to total revenues of RAC West (royalty receipts are 13% of total revenues) and to show that a greater taxable amount would result with a separate accounting method. See R p. 254 at 114:4-25.

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

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

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

Additionally, the fact that RAC West's royalty receipts are a relatively low percentage of its total revenue proves nothing and could be true of any taxpayer that has multiple income streams but with only one line of business in South Carolina. As the gross receipts statute indicates and as RAC West's tax policy expert testified, that is exactly how formulary apportionment works for multi-state taxpayers. Using a pizza pie analogy, RAC West's tax policy expert explained that formulary apportionment takes the total pizza (i.e. the total corporate income of a business in all states) and determines the slice of the pizza that the taxing state should get. R.p. 238 at 49:3-5; Pomp's RAC West Report, R. pp. 401-402 and 404-406. Separate accounting, on the other hand, "just want[s] to tax the pepperoni." R. p. 238 at 49:5-7. It seeks to tax only the "high profit item" and ignores the entire pizza, which Professor Pomp explained is not appropriate for a unitary business that has interdependencies with "component parts that are too closely connected to each other to merit any kind of division." R. p. 238 at 49:19-22. From a policy perspective, the proper way to tax a unitary business is with an apportionment formula. R. p. 238 at 50:4-7. Assuming a taxpayer's business is profitable and that it expands outside the taxing state, then the pizza pie will get larger (because it has more total profits), and the taxing state's slice

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

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

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

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

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

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

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

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

Finally, the record contained substantial evidence that the ALC either failed to consider or improperly discounted the evidence showing that the standard statutory method reasonably reflected RAC West's business activities in South Carolina. First, the record contained testimony and evidence showing that the receipts at issue were produced by RAC West's total unitary business activities and were not solely attributable to its limited activities in South Carolina. See R. p. 131-132 at 105:23-106:2 and 107:14-109:25; R.p. 155 at 202:9-204:2 (testimony of RAC West witness regarding unitary nature of business, fact that its retail store operations contributed to the profitability of its IP operations and vice versa and its minimal contact with South Carolina); R. p. 171 at 268:4-10 (testimony of RAC West's expert economist that standard apportionment method fairly reflected RAC West's in-state activities based on benefit principle of tax fairness). The ALC's findings to the contrary were not supported by any evidence in the record. See infra, Argument, § III, at pp. 33-39 for full discussion.

Additionally, the standard method is reasonable because it is based on corporate net income especially when compared to SCDOR's method, which is not (because it failed to take costs into account) and thus is not even a corporate income tax. See R. p. 171 at 268:11-16 (testimony of RAC West's expert economist that a gross receipts tax is not a corporate income tax as it ignores costs or profits).

Finally, the ALC does not appear to have considered RAC West's lack of physical presence in South Carolina, that its in-state activities are minimal and that it receives minimal benefits from the State. R. p. 131 at 105:17-106:2. When a taxpayer has a minimal presence in this State, it does not burden the government services funded

by South Carolina tax revenues. RAC West's tax burden must have some relation to the benefits received from South Carolina, and because it receives few benefits, its tax burden should be correspondingly low. See Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("The simple but controlling question is whether the state has given anything for which it can ask return"). SCDOR's method has produced a shocking result in light of the taxpayer's minimal activities in South Carolina. The taxation of gross receipts from royalties has produced a so-called income of \$861,437 in 2004 compared to the income assigned to South Carolina by the standard statutory apportion formula of \$40,317, some twenty times the standard formula amount. Similar results occur in other audit years, including taxing income in 2005 when there was a *loss* from corporate operations. Order, R. pp. 106-107.

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

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

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

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

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

Moreover, the evidence presented at trial established that excluding the gross receipts related to the income from the retail stores operating in other states produced a result that was not a fair representation of RAC West's activities in this State. RAC West presented substantial evidence of the relationship between its unitary business activities. See supra Statement of Facts, §A at pp. 4-5. It showed that its retail business activities in other states contributed to the profitability of its IP activities in South Carolina. Id. More specifically, as the retail stores sell more products, the value of the

IP increases and the amount of the royalties paid to RAC West increases. Id. SCDOR's auditor admitted that the retail store activities probably increased the profitability of the IP, but he simply chose not to consider this fact before breaking apart the business (R. p. 267 at 167:3-11), and SCDOR presented no evidence to dispute the interdependencies and flows of value between the two activities.

Also, SCDOR's method of taxing only royalty receipts fails to take into account the implicit royalty value of the RAC IP because it does not consider royalties computed on revenues generated in stores that RAC West owns and operates in 13 states. See R. p. 267 at 167:15-22 (testimony of auditor agreeing that RAC IP has intrinsic value to RAC West); Audit Report for RAC West, R. pp. 340-350 (no consideration given to implicit royalty value). In other words, if RAC West did not own the IP, it would have to license it and pay a fee just as the other RAC companies do. Failing to consider royalties that would result from the revenues generated in states where RAC West owns stores distorts the ratio of its true business activities within and without South Carolina thereby causing SCDOR's method to be unreliable in measuring RAC West's activities in South Carolina. In sum, RAC West established, though not its burden to do so, that the income received as a result of its activities in South Carolina was not solely a result of its royalty licensing activities in this State but was also produced by its retail store activities in other states.

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

West presented evidence that because of the interdependencies and contributions that each activity provides to the other, it could not *accurately* separate the royalty costs from the retail store costs. See supra Statement of Facts, §A, at p. 6. As RAC West's tax policy expert explained, such a taxpayer is being neither unreasonable nor recalcitrant; the beauty of the standard apportionment formula is that it does not ask a taxpayer to do something that is inappropriate or impossible to do with reasonable accuracy. See R. p. 250 at 98:5-13. He further explained in his report as follows:

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

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

Pomp Report on RAC West, R. pp. 406-407. The clear and uncontroverted evidence is that RAC West does not keep its books and records in this fashion and did not have this information to give to SCDOR. Furthermore, any allocation of expenses would require a system to capture certain nonfinancial information (e.g. hours spent on a specific task) which can only be captured at the time the expense is incurred. See also supra Statement of Facts, §A, at pp. 6-7.

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

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

It is also telling that RAC West, which does business in all 50 states, has never before been asked for this information by any taxing authority. R. p. 132 at 112:1-4. Because SCDOR's attempt at separate accounting ignores the costs incurred by RAC West to generate the royalty income, it results in an improper gross receipts tax versus a corporate income tax (which is based upon the profits of a corporation), which cannot, on its face, be reasonable. See R. pp. 171-172 at 268:17-269:1 (testimony of RAC West's expert economist on same); Pomp Report on RAC West, R. pp. 406-407 (testimony of RAC West's tax policy expert on same).

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

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

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

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

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

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

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

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

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

The term "unitary business" is a term of art that has been employed by the United States Supreme Court and South Carolina courts to characterize a business that is made up of integrated component parts and functions, the income from which is not capable of accurate separation and measurement. In determining whether a business is unitary, South Carolina courts apply two tests: (1) the three unities test; and (2) the

contribution-dependence test. Exxon, 273 S.C. at 598, 258 S.E.2d at 95. These tests are not mutually exclusive, and the courts often apply both. Id. Under the three unities test, the courts look at whether the business or businesses have unity of ownership, unity of management and unity of operation. Id. Under the contribution-dependence test, the court considers whether the "activities of the business in question contribute to or depend on the other activities of the business." Id., 273 S.C. at 600, 258 S.E.2d at 96. The courts do not require that it be "necessary" or "essential" that the business or businesses be operated together; cost savings or increased profits gained by operating together are acceptable reasons. Id., 273 S.C. at 599-601, 258 S.E.2d at 96-97.

For example, in Exxon, the taxpayer argued that only its marketing income should be taxed by South Carolina because it only marketed gasoline here and that it should not be taxed on its exploration and refining income, which took place in other states. However, the court found that the taxpayer operated a unitary business and could not separate its business in South Carolina from its unitary corporate income where, among other things, it held itself out to the public as one company; it employed central staffing on which all companies were dependent; it used centralized purchasing techniques that resulted in cost savings throughout the company; it had strong, centralized management over all segments of company; the structure provided profit stability, reduced risk and insured full capacity utilization of the company's facilities; it made no attempt to segregate earnings or funds of the various segments; and the various operating activities of the company of exploration, production, refining and marketing contributed to and depended upon each other. The Court held that the

taxpayer satisfied both the three unities test and the contribution-dependence test. Exxon, 273 S.C. at 602 and 258 S.E.2d at 97.¹²

In the case at hand, RAC West presented undisputed evidence that it operates a unitary business, including the following: RAC West has shared ownership (it is one company) and management (same management is over the retail stores operations and the IP operations); it has shared services and systems that create efficiencies and cost savings across the company; all income from the retail sales and the royalties is placed in a general account and is used for the benefit of the company as a whole; and the retail sales activities and the intellectual property activities contribute to and depend on one another (including, but not limited to, that each contributes to the profitability of the other) and there is a flow of value between the two activities. See supra, Statement of Facts, §A at pp. 4-5; R. p. 131 at 107:14-108:25. More specifically as to the contribution/dependency and flow of values elements, as the retail stores sell more products, the value of the IP increases as it is associated with a more profitable brand

¹² See also Eastman Kodak Co. v. S.C. Tax Comm'n, 308 S.C. 415, 418 S.E.2d 542 (1992) (finding that a multi-national camera and film corporation that was also doing safe harbor lease transactions involving tangible personal property was a unitary business where only a small portion of leased assets were in South Carolina, the funding for the leasing came from the general corporate treasury and the income benefited the company as a whole); Lowenstein Corp. v. S.C. Tax Comm'n, 298 S.C. 93, 378 S.E.2d 272 (Ct. App. 1989) (finding that affiliated New York textile manufacturing companies that also earned interest income from inter-company loans and from repurchasing their own bonds on the open market were unitary where the funding for the leasing came from the general corporate treasury, the interest income and loan payments were deposited in general company accounts and used for normal business operations, and the income benefited the companies as a whole); Texaco v. Wasson, 269 S.C. 255, 237 S.E.2d 75 (1977) (finding multi-state oil and gas company that also contracted on a royalty basis with third parties to mine salt and sulphur discovered on prospective oil lands was a unitary business where salt and sulphur was discovered during oil exploration process, which was an integral part of the business).

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

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

The ALC appears to have ignored all of the above evidence and cites to two factors that led it to conclude that RAC West was not a unitary business. First, it states that "RAC West's retail operations are not funded by the trademark operations, nor are the trademark operations funded by the retail operations. To the contrary, each line of business generates its own distinct income from different sources." Order, R. p. 17. It follows this statement with a cite to Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 22, 437 S.E.2d 13, 18 (1993) as standing for the proposition that "the 'real source' of a foreign corporation's income from licensing 'Toys R Us' trademarks to South Carolina stores was 'South Carolina Toys R Us customers.'" Id. The ALC is mistaken as to both its factual conclusions and the applicability of Geoffrey to this case.

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

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

The ALC also notes that "RAC West's trademark business and retail business have separate staffs handling the different lines of business. A separate subsidiary, Rent-A-Center Texas, L.P., manages RAC West's royalty operations." However, the question is whether there is *common management* over the business' different lines. See Exxon, 273 S.C. at 601, 258 S.E.2d at 96 (finding "strong centralized management was employed over all segments of the company"). The evidence here clearly showed that there was. R. p. 131 at 107:14-21 (same management is over the retail stores operations and the royalty operations).

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

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

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

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

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

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

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

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

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

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

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

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

See Order, R. p. 17.

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

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

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

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

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

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

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

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

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

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

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

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

More specifically, the method of taxation employed by SCDOR in this case violates the Due Process Clause of the South Carolina and United States Constitutions and the Interstate Commerce Clause of the United States Constitution. U.S. Const. amend. XIV, § 1; S.C. Const. art. I, § 3; U.S. Const. art. I, § 8, cl. 3. The Commerce Clause "prohibits economic protectionism- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." Fulton Corp. v. Faulkner, 516 U.S. 325, 330 (1996)(internal quotations omitted). As the Supreme Court has explained, the purpose of such a rule is "to preven[t] a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if

it were free to place burdens on the flow of commerce across its borders that commerce wholly within its borders would not bear." Id. at 330-31 (internal quotations omitted).

The four-part test for determining whether a state taxing statute violates the commerce clause is set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). To be sustained, a tax must: (1) be applied to an activity with a substantial nexus to the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the taxing state. Id. at 279. See also Travelscape, LLC v. S.C. Dept. of Rev., 391 S.C. 89, 705 S.E.2d 28 (2011). In evaluating the fairness prong, the courts apply both an internal and external consistency test. See Container Corp., 463 U.S. at 169; Travelscape, 391 S.C. 89, 705 S.E.2d 28. Internal consistency requires that if the formula was applied by every jurisdiction, "it would result in no more than all of the unitary business' income being taxed." See Container Corp., 463 U.S. at 169 (discussing fairness issue under both Commerce Clause and Due Process Clause). External consistency requires that the factors used by the state in the apportionment formula "must actually reflect a reasonable sense of how income is generated." Id. A formula will not satisfy this test if it attributes income to the state that is "out of all appropriate proportions to the business transacted . . . in that State" (id. at 170 (quoting Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell, 283 U.S. 123, 135 (1931)) or has "led to a grossly distorted result." Id. (quoting Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978)). See also Amerada Hess Corporation v. Director, Division of Taxation, 490 U.S. 66 (1989) (applying Complete Auto test and due process analysis and holding that expenses and income associated with the taxpayer's crude oil production activities were part of the taxpayer's unitary business and

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

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

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

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

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

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

CONCLUSION

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

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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2012-208608

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

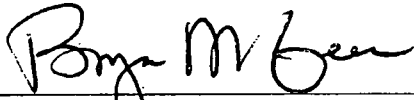
v.

South Carolina Department of Revenue Respondent.

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The undersigned certifies that this Final Brief complies with Rule 211(b),
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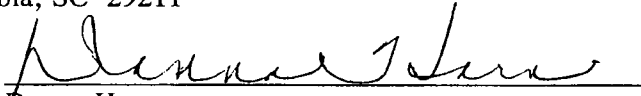
PROOF OF SERVICE

I the undersigned Administrative Assistant of the law firm of Nelson Mullins Riley & Scarborough, LLP, attorneys for Rent-A-Center West, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

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THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

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

v.

South Carolina Department of Revenue,Respondent.

FINAL BRIEF OF RESPONDENT

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**THE STATE OF SOUTH CAROLINA
In the Court of Appeals**

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

**Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608**

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

v.

South Carolina Department of Revenue,Respondent.

PROOF OF SERVICE

I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, via US Postal Service, postage pre-paid, a copy of the Department of Revenue's Brief to Bryson M. Geer, Esquire and John von Lehe, Jr., Esquire, Nelson Mullins Riley & Scarborough, LLP, PO Box 1806, Charleston, SC 29402 this 9th day of September 2015.

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SC Court of Appeals


Jean M. O'Connor

**THE STATE OF SOUTH CAROLINA
In the Court of Appeals**

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

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Appellant Case No. 2012-208608**

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v.

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STATEMENT OF ISSUES ON APPEAL

- I. DID THE ALC PROPERLY FIND THAT THE STANDARD STATUTORY APPORTIONMENT FORMULAS USED BY APPELLANT DID NOT FAIRLY REPRESENT ITS BUSINESS ACTIVITIES IN SOUTH CAROLINA AND THAT THE ALTERNATIVE METHOD OF APPORTIONMENT CHOSEN BY THE DEPARTMENT WAS REASONABLE?

- II. DID THE ALC FIND THAT APPELLANT DID NOT OPERATE A UNITARY BUSINESS BUT, EVEN IF IT DID, WOULD SUCH A FINDING REQUIRE THIS COURT TO REVERSE THE ALC'S DECISION?

- III. DID THE ALC PROPERLY ALLOW THE DEPARTMENT TO APPLY SEPARATE ACCOUNTING TO APPELLANT AND FIND THAT SUCH SEPARATE ACCOUNTING WAS REASONABLE?

- IV. DID THE ALC PROPERLY CONCLUDE THAT THE DEPARTMENT DID NOT VIOLATE APPELLANT'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS?

STATEMENT OF THE CASE

Rent-A-Center West, Inc. (Appellant or RAC West) has two primary sources of income: income from operating retail stores outside of South Carolina and royalty income from licensing its trademarks and trade names to affiliated companies that operate in many states including South Carolina. (See R. p. 354 (Attachment to RAC West's Protest Ex. 1, Tab 3 p. 2); R. pp. 273-74, 284 (KPMG's Analysis of RAC's Profit Distribution Ex. 1, Tab 13 pp. 5-6, 16).) The affiliated companies are Rent-A-Center Texas, L.P. (RAC Texas) and Rent-A-Center East, Inc. (RAC East), respectively. (R. pp. 269, 273, 284-85; KPMG's Analysis of RAC's Profit Distribution Ex. 1, Tab 13 pp. 1, 5, 16-17.) RAC West had no stores in South Carolina, but it licensed the use of its trademarks and trade names to RAC East, which operates retail stores in South Carolina. (R. p. 354; Attachment to RAC West's Protest Ex. 1, Tab 3 p. 2.)

RAC West filed corporate income tax returns in South Carolina apportioning its net income to South Carolina based on the standard apportionment formula for dealers in tangible personal property as expressed in S.C. Code Ann. § 12-6-2250. (R. p. 354; Attachment to RAC West's Protest Ex. 1, Tab 3 p.2.) The South Carolina Department of Revenue (Department) then audited RAC West for tax years 2003 through 2005. (R. pp. 340-41; Report of Field Audit Ex. 1, Tab 1 pp. 1-2.) The Department found that RAC West's only income in South Carolina was the royalty income that it generated through sales made in South Carolina by RAC East. (R. p. 342; Report of Field Audit Ex. 1, Tab 1 p. 3.) The Department applied an alternative apportionment method pursuant to S.C. Code Ann. § 12-6-2320(A) and on March 12, 2008 issued its Report of Field Audit assessing the taxes, interest, and penalties as follows:

<u>Period Ended</u>	<u>Income Tax</u>	<u>Interest</u>	<u>Penalties</u>	<u>Totals</u>
12/31/2003	\$ 44,887	\$ 14,018	\$ 11,222	\$ 70,125
12/31/2004	46,607	11,748	11,652	70,007
12/31/2005	<u>53,477</u>	<u>9,322</u>	<u>13,369</u>	<u>76,168</u>
Totals	<u>\$144,971</u>	<u>\$ 35,084</u>	<u>\$ 36,243</u>	<u>\$216,300</u>

(R. pp. 340-50; Report of Field Audit Ex. 1, Tab 1.)

On or about June 3, 2008, RAC West filed a protest of the Department's Report of Field Audit. (R. pp. 351-60.) On May 6, 2009, the Department then issued its Department Determination. (R. pp. 29-37.) When preparing its Determination, the Department adjusted the alternative apportionment method so that the apportionment formula would be in accordance with the trademark licensing agreements that RAC West had entered into with RAC East. (R. p. 31.) This change in method reduced the proposed assessment to \$204,183, consisting of \$130,194 in income tax, \$41,440 in interest, and \$32,459 in penalties. (R. pp. 29-30.)

On July 11, 2011, one month before the hearing in this case, Appellant filed amended South Carolina income tax returns in which it changed its method of apportionment from the method for dealers of tangible personal property under Section 12-6-2250 to the gross-receipts method under Section 12-6-2290. (See R. pp. 361-382; Amended Form SC 1120 for 2003, 2004, and 2005 Ex. 1, Tab 7.) An administrative hearing was held on August 10 and 11, 2011, and the Administrative Law Court (ALC) issued a Final Order and Decision (Order) on January 6, 2012. (R. pp. 3, 23.)

After Appellant's Motion for Reconsideration was denied, Appellant filed a Notice of Appeal. Subsequently this appeal was stayed pending a final ruling in CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue, 411 S.C.

79, 767 S.E.2d 195 (S.C. 2014). The South Carolina Supreme Court issued its decision in CarMax on December 23, 2014. CarMax, 411 S.C. 79, 767 S.E.2d 195 (S.C. 2014).

STATEMENT OF FACTS

A. Organization and Operations of RAC West and Affiliates

Rent-A-Center, Inc. is a holding company that owns and controls at least three affiliated entities: RAC West, RAC East, and RAC Texas. (R. p. 398; Organization Chart Ex. 1, Tab 9.) The rent-to-own business model is to offer tangible consumer goods to customers pursuant to a rental purchase agreement. (R. p. 125, Tr. p. 83, lines 15-21.)

RAC West is a Delaware corporation with its principal place of business in Plano, Texas. (R. p. 30.) RAC West owns and operates retail stores on the west coast and in the middle of the country. (R. p. 415; KPMG's Analysis of RAC's Profit Distribution Ex. 1, Tab 13 p. 5.) While RAC West does not operate any retail stores in South Carolina, (R. p. 354; Attachment to RAC West's Protest Ex. 1, Tab 3 p. 2), it owns intellectual property in South Carolina (R. p. 131, Tr. p. 106, lines 3-6; Transcript Day One p. 106:3-6). It licenses "Rent-A-Center" trademarks and trade names (Intellectual Property) to RAC East and RAC Texas. (R. p. 354 (Attachment to RAC West's Protest Ex. 1, Tab 3 p. 2.); see, e.g., R. pp. 383-390 (Trademark License Agreement Ex. 1, Tab 11).) Except for Intellectual Property, RAC West has no property or payroll in South Carolina. (R. pp. 354, 364-66, 372-74, 380-82.) RAC West uses its own Intellectual Property. (R. p. 155, Tr. p. 202, lines 14-18; Transcript Day One p. 202:14-18.)

At the hearing, two of RAC West's witnesses made broad assertions of a value exchange between the Intellectual Property and retail sales in an attempt to show that RAC West's trademark and retail businesses were unitary. For example, Dawn

Wolverton, RAC Texas' Vice-President, General Counsel, and Secretary, who had responsibility over RAC West's Intellectual Property, (R. p. 154, Tr. p. 197, line 25-Tr. p. 198, line 5, Tr. p. 199, lines 12-16; R. p. 154, Tr. p. 200, line 8-R. p. 155, Tr. p. 201, line 21), testified that, as RAC West provides quality services, the value of its Intellectual Property increases, (R. p. 155, Tr. p. 202, line 7-Tr. p. 203, line 1; R. p. 155, Tr. p. 203, lines 16-19). She continued by saying that, as the retail stores in general perform better, the Intellectual Property becomes "more famous." (R. p. 155, Tr. p. 203, lines 2-8.) She also said that, as the Intellectual Property becomes more famous, the Intellectual Property may draw people into the retail stores. (R. p. 155, Tr. p. 203, lines 9-16.)

However, the Intellectual Property was not strategically placed into RAC West to enhance the value of RAC West's retail business as the Intellectual Property was already owned by the same company that owns it now when that company was acquired. (R. p. 132, Tr. p. 110, lines 16-25.) Whatever effect on value RAC West's Intellectual Property has on all of the retail operations, and vice versa, it is applicable to all retail operations of RAC West, RAC Texas, and RAC East, not merely on the retail operations of RAC West. (R. p. 155, Tr. p. 203, lines 2-24; Transcript Day One p. 203:2-24.)

RAC East is also a Delaware corporation, (R. p. 354), which operates retail stores in the eastern part of the country, including South Carolina, (R. p. 125, Tr. p. 84, lines 18-19; R. p. 128, Tr. p. 93, lines 13-15; R. p. 136, Tr. p. 125, lines 1-12; R. p. 354). Through the retail stores operated by RAC East¹, as well as the retail stores operated by RAC West

¹RAC RR, Inc. and Rainbow Rentals also made retail sales in South Carolina during one or more of the tax years at issue and are subject to a trademark licensing agreement with Appellant. (R. pp. 346-49; Report of Field Audit Ex. 1, Tab 1 pp. 6-7.) The Department's audit report and its Department Determination include the South

and RAC Texas, these entities rent and sell tangible personal property to customers. (R. p. 125, Tr. p. 83, line 7-R. p. 126, Tr. p. 85, Line 1; R. p. 353.)

In addition to operating retail stores in Texas, RAC Texas performs various management services for RAC East and RAC West. (R., p. 125, Tr. p. 84, line 22-R. p. 126, Tr. p. 86, line 1; R. pp. 411, 427; see, e.g., R. pp. 391-97 (Mgt. Servs. Agreement Ex. 1, Tab 10).) These management services include providing the services for protecting the RAC West's Intellectual Property. (R. p. 152, Tr. p. 190, line 20-Tr. 191, line 3.) Ms. Wolverton testified that she is "responsible for maintaining the company's portfolio of trademarks and trades names" and that such work includes determining whether a desired name would be available for federal registration, filing the registration and leading the registration process, filing continuing use statements, and monitoring use of the Intellectual Property by others. (R. p. 154, Tr. p. 197, line 25-Tr. p. 198, line 5; R. p. 154, Tr. p. 199, lines 12-16; R. p. 154, Tr. p. 200, line 22-R. p. 155, Tr. p. 201, line 18.) RAC Texas operates the legal department of the RAC affiliated entities and handles all of the legal needs of the RAC affiliates. (R. p. 140, Tr. p. 143, line 16-Tr. p. 144, line 2; R. p. 142, Tr. p. 150, line 22-Tr. p. 151, line 3; R. p. 147, Tr. p. 170, line 25-Tr. p. 171, line 5; R. p. 150, Tr. p. 181, lines 1-18.) Additionally, although RAC West owns the Intellectual Property, RAC Texas is responsible for developing advertising and marketing strategies to create, maintain, and expand the RAC brand name. (R. p. 425.)

RAC West and RAC East entered into a Trademark License Agreement in 2002 under which RAC West, the owner of the Intellectual Property, granted a license to RAC

Carolina retail operations of these entities. (R. pp. 342-43; Report of Field Audit Ex. 1, Tab 1 pp. 6-7.) When the Department refers to RAC East herein, it is generally including these two entities along with RAC East.

East to use and exploit the Intellectual Property, including in South Carolina. (R. pp. 383-84; Trademark License Agreement Ex.1, Tab 11 pp.1-2.) In exchange, RAC East agreed to pay to RAC West a royalty of 3% of RAC East's net sales of licensed services. (R. p. 389; Amend. No. 1 to Trademark License Agreement Ex. 1, Tab 11 p. 1.) Licensed services are rental service(s) from home appliances, furniture, home furnishings, computer equipment, and home entertainment products. (R. p. 383.)

Rent-A-Center, Inc. engaged KPMG LLP (KPMG) to conduct a study to determine the arm's length pricing for transactions between affiliates, including the royalty payments from RAC East to RAC West for use of the Intellectual Property. (R. p. 411; KPMG's Analysis of RAC's Profit Distribution Ex. 1, Tab 13 p.1.) Specifically, in 2003 KPMG determined that an arm's length royalty payment from RAC East and RAC Texas to RAC West would be in the range of 2% to 4% of gross sales. (R. p. 442.)

The retail businesses of RAC West and RAC East receive essentially the same management services from RAC Texas. (R. p. 152, Tr. p. 190, lines 13-19.) RAC East has store managers who hire and fire employees. (R. p. 127, Tr. p. 90, lines 5-22; R. p. 129, Tr. p. 98, lines 18-25.) As a whole, the only difference between RAC West and RAC East is the fact that RAC West owns the Intellectual Property. (R. p. 152, Tr. p. 190, lines 20-23.) RAC West does not even protect its own Intellectual Property, as that task is performed by RAC Texas. (R. p. 152, Tr. p. 190, line 24-Tr. p. 191, line 3.)

Regarding whether RAC West was a unitary business, Dr. Glenn Harrison, the Department's expert on law and economics, testified that the issue of whether Appellant's retail and trademark businesses constitute a unitary business is a "red herring" because Appellant argues that if it is a unitary business then the financial

activities of the trademark business cannot be separately identified. (R. p. 275, Tr. p. 197, line 1-Tr. p. 198, line 15.) He added that it would be wrong from both an economic and an accounting perspective to assume that a business cannot separate its accounts if it is determined to be part of a unitary business. (R. p. 275, Tr. p. 197, line 10-Tr. p. 198, line 15.)

Regarding RAC West's ability to separately account for its retail and trademark businesses, Dr. Harrison also testified that he saw no evidence and heard no testimony during the administrative hearing that would lead him to believe that an economist could not separate RAC West's retail and trademark businesses and that such a division of revenues and expenses within a business is a standard activity of an economist in the field of industrial organization. (R. p. 276, Tr. p. 203, lines 4-16; R. p. 277, Tr. p. 206, lines 2-7.) He stated that companies use managerial or cost accounting when they want to determine how an operation like a retail store is performing. (R. p. 275, Tr. p. 199, line 18-R. p. 276, Tr. p. 201, line 2.) Mr. Hugh Tollack, a CPA and the Director of Tax Audits, Planning, and Research for RAC Texas, testified that one can determine whether any of their individual retail stores is profitable. (R. p. 152, Tr. p. 191, lines 23-25.) In fact, under a management agreement with RAC Texas, the retail stores are guaranteed a 4.5% profit of each store's operating expenses, and the difference between the "actual profit of the store" and the guaranteed 4.5% profit is paid to RAC Texas as a management fee. (R. p. 137, Tr. p. 130, lines 4-23; R. p. 162, Tr. p. 230, lines 5-22.) Although the Management Services Agreement entered as evidence is an agreement between RAC East and RAC Texas, (R. pp. 391, 394), RAC Texas also performs management services for RAC West, and RAC West has a similar management services

agreement with RAC Texas, (R. pp. 411-13, 415, 426-27; see also R. p. 130, Tr. pp. 103, line 25-Tr. p. 104, line 6). Additionally, KPMG separately determined an arm's length management fee based on RAC West's retail business and an arm's length royalty fee based on RAC West's trademark business. (R. pp. 409-77.)

B. Tax Returns, Audit, and Financial Information about RAC West

RAC West filed corporate income tax returns in South Carolina because it owned Intellectual Property located in South Carolina. (R. p. 131, Tr. p. 106, lines 3-16.) Mr. Tollack testified that RAC West filed income tax returns in South Carolina based on Geoffrey v. South Carolina Tax Commission, 313 S.C. 15, 437 S.E.2d 13. (S.C. 1993). (R. p. 124, Tr. p. 80, line 22-R. p. 125, Tr. p. 81, line 15; R. p. 131, Tr. 106, lines 3-13.)

RAC West initially filed its South Carolina income tax returns using a three-factor formula which included payroll, property, and sales factors. (R. p. 133, Tr. p. 116, lines 10-23; Transcript Day One p. 116:10-23.) Mr. Tollack testified that the Department's auditor informed Appellant that this method may not be correct and suggested use of the single factor gross-receipts formula. (R. p. 133, Tr. p. 116, line 24-R. p. 134, Tr. p. 117, line 10; Transcript Day One pp. 116:24-117:10.) The Department sent its audit report to RAC West on March 12, 2008 and asserted an alternative apportionment method. (R. pp. 340, 342-43; Report of Field Audit, Ex. 1, Tab 1 pp. 1, 3-4.) After making an adjustment to the alternative apportionment formula proposed by the auditor, the Department issued its determination on May 6, 2009. (R. pp. 29-30, 37; Dep't Determination, Ex.1, Tab 5 pp. 1-2, 9.) On January 7, 2009, RAC West responded by filing amended income tax

returns using the standard apportionment formula (i.e., the four-factor formula).² (R. pp. 364-66, 372-74, 380-82.) Then one month before the administrative hearing, RAC West filed additional amended returns for each tax year using the standard gross-receipts apportionment formula set forth in Section 12-6-2290. (R. pp. 361-63, 369-71, 377-79; R. p. 134, Tr. p. 117, lines 2-16.) The amended returns and RAC West's use of multiple standard statutory apportionment formulas did not change the issue in this case which is whether the Department's use of an alternative apportionment method for the tax years 2003 through 2005 was proper.

Regardless of the standard apportionment formula, Appellant diluted the sales/gross-receipts ratio by including the retail sales of RAC West in the denominator. (See R. p. 152, Tr. pp. 189, line 20-Tr. p. 190, line 3; see, e.g., R. p. 374 (Amended Form SC 1120 for 2004 signed on Jan. 7, 2009 Ex. 1, Tab 7, p. 3); R. p. 371 (Amended Form SC 1120 for 2004 signed on July 11, 2011 Ex. 1, Tab 7 p. 3); R. p. 478 (Apportionment Data by State Ex. 1, Tab 21); R. p. 6 (Order p. 4); R. p. 34 (Dep't Determination Ex. 1, Tab 5 p. 6)). RAC Texas' tax director, (R. p. 124, Tr. p. 80, lines 22-25; R. p. 125, Tr. p. 81, lines 14-19), testified that including retail sales in the apportionment formula only adds to the denominator, while there are no retail sales in the numerator, (R. p. 152, Tr. p. 189, line 20-Tr. p. 190, line 3). RAC West originally filed South Carolina corporate income tax returns apportioning net income to South Carolina based on a multi-factor apportionment method under Section 12-6-2250. (R. p. 133, Tr. p. 116, line 10-R. p. 134, Tr. p. 117, line 1; see, e.g., R. p. 374 (Amended Form SC 1120 for 2004 signed on Jan. 7,

²As distinguished from the three-factor formula, the four-factor formula uses the same three factors (i.e., payroll, property, and sales) but it double weights the sales factor. This double weighting of the sales factor creates the fourth factor.

2009 Ex. 1, Tab 7 p. 3)). Although RAC West sourced its royalty income generated from RAC East's sales and rentals in South Carolina to the numerator of the sales factor, the multi-factor apportionment ratio used by RAC West was diluted because RAC West had no property or payroll in South Carolina and included all of its retail income from western states in the denominator of the sales factor. (See R. pp. 33-34; see, e.g., R. p. 374 (Amended Form SC 1120 for 2004 signed on Jan. 7, 2009 Ex. 1, Tab 7 p. 3).)

Dr. Harrison testified that the gross-receipts ratio used by Appellant pursuant to Section 12-6-2290 (i.e., the ratio was the result of dividing royalty income from SC by the sum of total royalty income and total retail income from all states) did not provide an accurate reflection of the economic connection of Appellant to South Carolina. (R. p. 274, Tr. p. 193, line 14-Tr. p. 194, line 9.) He stated that including royalty receipts from South Carolina in the numerator of the gross-receipts ratio while including both total royalty and total retail receipts in the denominator was like putting apples in the numerator and apples and oranges in the denominator. (R. 274, Tr. p. 194, lines 10-22.) He concluded that such an apples and oranges approach diluted the gross-receipts ratio. (R. p. 274, Tr. p. 194, line 23-Tr. p. 195, line 1.)

The Department found that RAC West's sole source of income from South Carolina consisted of royalty fees received from RAC East. (R. p. 342 (Report of Field Audit Ex. 1, Tab 1 p. 3); R. p. 253, Tr. p. 111, lines 16-18; R. p. 152, Tr. p. 189, lines 10-13). The Department's auditor did not include Appellant's retail operations in the Department's alternative apportionment method because those out-of-state retail operations had "nothing" to do with Appellant's business activity in South Carolina. (R. p. 253, Tr. p. 112, lines 6-12; R. pp. 342, 345 (Report of Field Audit Ex. 1, Tab 1 pp. 3,

9.) Accordingly, the Department determined that RAC West should not be using either statutory apportionment formula because neither fairly reflected RAC West's business activity in South Carolina. (R. pp. 31-34; Dep't Determination Ex. 1, Tab 5 pp. 3-6.) The Department determined that RAC West should be apportioning its net income to South Carolina using a reasonable alternative apportionment method. (R. pp. 34-36.) The Department used an alternative method under Section 12-6-2320(A)(4) that was based on RAC West's own formula: the 3% royalty agreement that RAC West had with RAC East. (R. p. 35; see also R. p. 389.)

During the auditor's testimony, the Department focused on Appellant's financial activity in tax year 2004 to explain the Department's findings and reasoning. (R. p. 253, Tr. p. 112, line 16-R. p. 254, Tr. p. 115, line 19.) Appellant had \$424,004,077 of total revenue in 2004. (R. p. 478 (Apportionment Data by State Ex. 1, Tab 21); R. p. 253, Tr. p. 112, lines 16-25; R. p. 254, Tr. p. 113, line 20-Tr. p. 114, line 6.) Only \$55,221,912 of RAC West's 2004 revenues was from royalty income. (R. p. 478 (Apportionment Data by State Ex. 1, Tab 21); R. p. 254, Tr. p. 113, line 20-Tr. p. 114, line 16.) Accordingly, the auditor testified that only 13% of Appellant's total revenues were from royalties, while 87% of Appellant's total revenues were not from its trademark business and had nothing to do with Appellant's business activity in South Carolina. (R. p. 254, Tr. pp. 113, line 7-Tr. p. 115, line 9.) The auditor testified further that these 2004 percentages were roughly the same in 2003 and 2005. (R. p. 254, Tr. p. 115, lines 10-19.)

The auditor also testified that Appellant's final 2004 South Carolina amended income tax return showed gross receipts from South Carolina of \$861,437, which was 0.2032% of Appellant's total 2004 revenues of \$424,004,077. (R. pp. 253, Tr. p. 112,

line 13-R. p. 254, Tr. p. 113, line 6; see also R. p. 371 (Amended Form SC 1120 for 2004 signed on July 11, 2011 Ex. 1, Tab 7 p. 3).) Schedule H-2 of Appellant's 2004 amended South Carolina income tax return shows that the ratio of 0.2032% was the gross-receipts ratio that Appellant used on its final 2004 amended return to apportion net income to South Carolina. (R. p. 371.)

Appellant's final 2004 South Carolina amended income tax return also showed that Appellant had total adjusted net income of \$19,840,800 and South Carolina taxable income net income of only \$40,317. (R. p. 371; Amended Form SC 1120 for 2004 signed on July 11, 2011 Ex. 1, Tab 7 p. 1.) Accordingly, of the \$861,437 in gross receipts from South Carolina in 2004 only 4.68% was taxed on Appellant's final 2004 amended South Carolina income tax return. (R. p. 6; Order p. 4.)

Appellant's 2003 and 2005 South Carolina amended income tax returns reflect similar results. (R. p. 254, Tr. p. 115, lines 10-19; see, e.g., R. pp. 361, 363; R. pp. 377, 379.) In 2003, only 1.53% of Appellant's 2003 gross receipts from within South Carolina of \$830,247 were taxed in South Carolina. (R. p. 7; Order p. 5.) In 2005, none of Appellant's 2005 gross receipts from within South Carolina of \$844,348 were taxed in South Carolina. (R. p. 7.)

Dr. Harrison stated that the Department's alternative method was economically reasonable. (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 25.) He said that excluding the retail operations from the Department's alternative method was "absolutely essential" for the tax burden on the Appellant to fairly represent its economic nexus with South Carolina. (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 4; R. p. 274, Tr. p. 196, lines 18-25.)

Regarding deductible expenses for Appellant's trademark business, the Department's auditor testified that Appellant did not provide the Department with proof of expenses to offset the royalty income; however, the Department would have allowed such deductions had Appellate identified and substantiated such deductions: (R. p. 254, Tr. p. 116, line 21-R. p. 255, Tr. p. 117, line 4.)

ARGUMENT

This Court should affirm the Order of the ALC because, under the applicable standard of review, the factual findings of the ALC are supported by substantial evidence, the ALC made no errors of law, the Order did not violate any of Appellant's constitutional rights, and the Order was not arbitrary or capricious or characterized by abuse of discretion. In this case, the Department met its burden for proposing an alternative apportionment method by demonstrating that the statutory apportionment methods do not fairly represent Appellant's business activity in South Carolina and that the alternative apportionment method chosen by the Department was reasonable. The Department presented and the ALC found sufficient evidence to support these conclusions. Further, although the Department used an alternative method under Section 12-6-2320(A)(4), separate accounting, as an alternative apportionment method, is statutorily permitted and reasonable in this case.

The standard of review applicable in this case is based on S.C. Code Ann. § 1-23-610(B) and applicable case law. The Administrative Procedures Act states that an appellate court's review of an ALC order "must be confined to the record" and that an appellate court "may not substitute its judgment for the judgment of the ALJ as to the weight of the evidence on questions of fact." S.C. Code Ann. § 1-23-610 (Supp. 2014).

This Court may affirm the ALC's decision, or it may reverse or modify the decision if the substantive rights of the Appellant have been prejudiced because the decision is, among others, (1) in violation of constitutional provisions, (2) affected by other error of law, (3) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record, or (4) arbitrary or capricious or characterized by an abuse of discretion. Id. "The ALC's findings are supported by substantial evidence if, looking at the record as a whole, there is evidence from which reasonable minds could reach the same conclusion the administrative agency reached." Olson v. South Carolina Dep't of Health & Env'tl. Control, 379 S.C. 57, 663 S.E.2d 497 (S.C. Ct. App. 2008). "The mere possibility of drawing two inconsistent conclusions from the evidence does not prevent a finding from being supported by substantial evidence." Id.

I. THE ALC PROPERLY FOUND THAT THE STANDARD STATUTORY APPORTIONMENT FORMULA CHOSEN BY APPELLANT DID NOT FAIRLY REPRESENT THE EXTENT OF APPELLANT'S BUSINESS ACTIVITIES IN SOUTH CAROLINA AND THAT THE ALTERNATIVE METHOD OF APPORTIONMENT CHOSEN BY THE DEPARTMENT WAS REASONABLE.

The ALC properly found that the Department, as the proponent of an alternative apportionment method, satisfied its burden to prove that the statutory apportionment formulas used by Appellant did not fairly represent the extent of Appellant's business activity in South Carolina and that the Department's chosen alternative apportionment formula was reasonable. The ALC also properly found that the Department's alternative apportionment method provided a more appropriate base on which Appellant was taxed in South Carolina than the base provided by either the four-factor formula or the gross-receipts formula now used by Appellant. Accordingly, this Court should affirm the

ALC's decision because evidence in the record clearly supports the conclusion that reasonable minds could reach the same conclusions that the ALC made and because the ALC did not make an error of law.

A. The Department's Method Imposes An Income Tax On Appellant's Corporate Net Income On A Base Which Reasonably Represents The Proportion Of The Trade Or Business Carried On Within South Carolina.

Appellant's method of apportionment violated S.C. Code Ann. § 12-6-2210(B) because it did not create a tax base which reasonably represents the proportion of Appellant's trade or business carried on within South Carolina. Appellant conducted only its trademark business in South Carolina, yet it utilized an apportionment formula wherein the unrelated retail activities conducted in western and mid-western states were included in the denominator while adding nothing to the numerator. Under Section 12-6-2320, the Department attempted to satisfy the fundamental focus of South Carolina's corporate income tax scheme, which is to tax an entity's business activities that occurred within this State. Although Appellant's method violated Section 12-6-2210(B), the Department's alternative apportionment method creates a tax base which reasonably represents the proportion of Appellant's trade or business carried on within South Carolina.

South Carolina law imposes an income tax on a taxpayer who is transacting or conducting business partly within and partly without South Carolina "upon a base which reasonably represents the proportion of the trade of business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). This "base" is South Carolina taxable income, and for multistate corporations this base is primarily determined by applying a statutory apportionment formula to federal taxable income (plus or minus certain state

adjustments). During the tax years at issue here, a taxpayer generally would determine this base by applying one of two statutory apportionment formulas: the multi-factor formula under Section 12-6-2250 or the gross-receipts formula under Section 12-6-2290; however, when the base determined by one of the statutory apportionment formulas does not fairly represent the extent of a taxpayer's business activity in South Carolina, a reasonable alternative apportionment formula under Section 12-6-2320(A) may be used.

Appellant receives royalties from its trademark business, (see R. pp. 383-90), while generating more traditional income from sales when offering tangible consumer goods to consumers, (see R. p. 125, Tr. p. 83, line 7-R. p. 126, Tr. p. 85, line 1). Since Appellant's sole source of income in South Carolina consisted of royalty fees from RAC East, (R. p. 342; Report of Field Audit Ex. 1, Tab 1 p. 3), Appellant's base comes from its trademark business, not its out-of-state retail business. While RAC West does not operate any retail stores in South Carolina, (R. pp. 354; Attachment to RAC West's Protest Ex. 1, Tab 3 p. 2), it owns intellectual property in South Carolina, (R. p. 131, Tr. p. 106, lines 3-6), and has licensed the use of the Intellectual Property to RAC East, (R. pp. 383-390), which operates retail stores in the eastern United States, including South Carolina, (R. p. 125, Tr. p. 84, lines 18-19; R. p. 128, Tr. p. 93, lines 13-15; R. p. 136, Tr. p. 125, lines 1-12). Except for Intellectual Property located in South Carolina, RAC West has no property or payroll in South Carolina. (R. p. 354.)

Here Appellant used both the multi-factor and the gross-receipts formulas during each of the tax years at issue, but Appellant's use of the statutory apportionment formulas was improper. First, Appellant recognized that its use of the multi-factor formula under Section 12-6-2250 was not appropriate as evidenced by Appellant amending its South

Carolina income tax returns on the eve of the hearing in this case.³ Appellant filed these additional amended income tax returns to switch from the multi-factor formula under Section 12-6-2250 to the single gross-receipts ratio under Section 12-6-2290. (R. p. 133, Tr. p. 116, line 14-Tr. p. 117, line 16; see R. pp. 361-63, 369-71, 377-79 (Form SC 1120 for 2003 through 2005 signed on July 11, 2011 Ex. 1, Tab 7).) Second, Mr. Tollack testified that RAC West filed income tax returns in South Carolina based on Geoffrey v. South Carolina Tax Commission, 313 S.C. 14, 437 S.E.2d 13 (S.C. 1993), (R. p. 124, Tr. p. 80, line 22-R. p. 125, Tr. p. 81, line 15; R., p. 131, Tr. p. 106, lines 3-13), where the Circuit Court upheld the South Carolina Tax Commission's determination that Geoffrey owed South Carolina tax on its royalty income generated from sales in South Carolina by the licensee, Toys-R-Us, Geoffrey at 17-18, 437 S.E.2d at 15. While Appellant's use of the standard gross-receipts formula under Section 12-6-2290 would generally be appropriate for its trademark business, the mixing of gross receipts from Appellant's in-state trademark business with gross receipts from its out-of-state retail business distorts the tax base that is required under Section 12-6-2210(B). Such mixing of gross receipts

³Appellant first used the multi-factor formula under Section 12-6-2250, which uses payroll, property, and sales factors, for the tax years at issue.³ (R. p. 133, Tr. p. 116, lines 14-23; see R. pp. 364-366, 372-74, 380-82 (Amended Form SC 1120 for 2003 through 2005 signed on Jan. 7, 2009 Ex. 1, Tab 7).) The multi-factor formula is applicable only for taxpayers whose principal business *in this State* is manufacturing or dealing in tangible personal property. S.C. Code Ann. § 12-6-2250 (Supp. 2007) (emphasis added). However, Appellant conducts only its trademark business in South Carolina. (R. p. 342 (Report of Field Audit Ex. 1, Tab 1 p.3); R. p. 253, Tr. p. 112, lines 6-12; see R. p. 124, Tr. p. 80, line 22-R. p. 125, Tr. p. 81, line 15; R. p. 131, Tr. p. 106, lines 3-13.) Since Appellant conducts only its trademark business in South Carolina and its trademark business is engaged in neither manufacturing nor dealing in tangible personal property, the multi-factor formula is not applicable to Appellant regarding apportionment of its net income in South Carolina.

did not apply to Geoffrey because, unlike Appellant, Geoffrey did not have its own retail operations. See Geoffrey at 17-19, 437 S.E.2d at 15-16.

The gross-receipts ratio is the fraction in which the numerator is total gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. S.C. Code Ann. § 12-6-2290 (Supp. 2007). Using this gross-receipts ratio, Appellant included in the numerator only the gross receipts from royalties in its trademark business related to transactions in RAC East's South Carolina stores while including in its denominator its gross receipts from its trademark business and its retail business from all states. (R. p. 152, Tr. p. 189, line 20-Tr. p. 190, line 3.) Because Appellant conducted only its trademark business in South Carolina, Appellant's inclusion of all of its retail sales in the denominator – none of which is conducted in South Carolina – substantially dilutes the statutory gross-receipts ratio. As stated earlier, 87% of Appellant's gross receipts came from its retail business conducted in western and mid-western states, so 87% of its gross receipts came from a type of business that Appellant did not conduct in South Carolina. (R. p. 254, Tr. p. 113, line 7-Tr. p. 115, line 19.) Despite the fact that 87% of its gross receipts had nothing to do with its trademark business in South Carolina, Appellant included this 87% of gross receipts in the denominator of the gross-receipts ratio but added nothing to the numerator.

Dr. Harrison, the Department's expert, confirmed this dilution of the gross-receipts ratio. He stated that Appellant is mixing apples and oranges. (R. p. 274, Tr. p. 194, lines 10-22.) As a result, Appellant significantly lessened the gross-receipts ratio because the denominator included a significant amount of gross receipts from retail sales when Appellant did not engage in any retail business in South Carolina. (R. p. 274, Tr. p.

194, line 23-Tr. p. 195, line 1.) The lowering of the gross-receipts ratio correspondingly caused a lowering of the amount of the South Carolina taxable income (or the “base”). This lower base, in violation of Section 12-6-2210(B), did not reasonably represent the proportion of Appellant’s trade or business carried on within South Carolina. Appellant conducted only its trademark business in South Carolina, but its apples and oranges approach to the gross-receipts ratio created a tax base out of proportion to its trademark business carried on in South Carolina.⁴

Appellant argues that the South Carolina General Assembly could have drafted Section 12-6-2290 differently so that the denominator of the gross-receipts ratio must include gross receipts “for the same type of business activity” as the gross receipts included in the numerator. (Appellant’s Brief p. 13.) Such a targeted definition of the gross-receipts ratio was not needed. The General Assembly enacted a broad alternative apportionment statute that allows an alternative method to be used to correct any situation, not solely a targeted situation as Appellant suggests, in which the statutory formula is flawed. See S.C. Code Ann. § 12-6-2320(A) (2014).

⁴This analysis and conclusion also applies to Appellant’s use of the multi-factor formula under Section 12-6-2250. Although Section 12-6-2250’s multi-factor formula is not applicable to Appellant in this State because its principal and only business in South Carolina is its trademark business, the multi-factor formula does not create a base which reasonably represents the proportion of Appellant’s trademark business carried on in South Carolina. Even when using the multi-factor formula, Appellant used the apples and oranges approach by including all of Appellant’s retail sales in the denominator of the sales factor. In addition, Appellant reported that it had no payroll or property in South Carolina, so the payroll and property factors of the four-factor formula are zero. (R. pp. 366, 374, 382; Amended Form SC 1120 for 2003, 2004, and 2005 signed on Jan. 7, 2009 Ex. 1, Tab 7.) Having two of the four factors being zero also substantially dilutes and distorts the multi-factor formula and the tax base.

The Department's alternative apportionment method satisfies the goal of Section 12-6-2210(B) to tax the proportion of a taxpayer's business that was conducted in South Carolina. Although Appellant asserts that there is no provision in South Carolina law for the Department to consider the "type" of income, (Appellant's Brief pp 11-13), the alternative apportionment statute unambiguously states that the Department may require an alternative method, including separate accounting, "to all or any part of the taxpayer's business activity," S.C. Code Ann. § 12-6-2320(A) (2014) (emphasis added). Here, the Department is merely taxing the only part of Appellant's business conducted in South Carolina: its trademark business. The Department, in its alternative apportionment method, considered only royalty income, not income from retail sales. In this manner and complying with Section 12-6-2210(B), the Department taxes only Appellant's trademark business because it is the only activity that Appellant conducted in this State.

Appellant also mistakenly asserts that the Department is imposing a gross-receipts tax on Appellant's royalty income from South Carolina. If the Department's alternative method looks like a gross-receipts tax, it is only because Appellant did not identify or substantiate any deductions related to its trademark business.⁵ (See R., p. 254, Tr. p. 116, line 21-R. p. 255, Tr. p. 117, line 1; Transcript Day Two pp. 116:21-117:1.) The Department's auditor testified that, had the Appellant provided and supported any such

⁵When Appellant filed its South Carolina income tax returns using the standard four-factor or gross-receipts formulas, there was no need for Appellant to specifically identify deductions applicable to its South Carolina business activities. Under a standard formula, the resulting ratio is applied to adjusted federal taxable income from which deductions have already been taken. From 2003 to 2005, the four-factor formula ranged from 0.0991% to 0.1016%, while the gross-receipts ratio ranged from 0.1981% to 0.2032%. Under the Department's alternative apportionment method, South Carolina gross-receipts from royalties were specifically identified, so related deductions also needed to be specifically identified.

deductions, the Department would have allowed the deductions as part of the alternative apportionment method. (R. p. 255, Tr. p. 117, lines 2-4; Transcript Day Two p. 117:2-4.)

Based on the above, the apportionment formula used by Appellant dilutes the Appellant's net income within South Carolina by including retail sales from other states in the denominator when Appellant does not engage in retail sales in South Carolina such that the result significantly understates the base on which Appellant is taxed in South Carolina. Accordingly, that significantly reduced base does not reasonably represent the proportion of Appellant's trademark business conducted in South Carolina. In response to the dilution caused by the statutory formulas, the Department's alternative apportionment method reasonably represents the proportion of Appellant's business conducted in South Carolina because, in calculating the tax base under Section 12-6-2210(B), the Department included only the proportion, or part, of Appellant's business that its conducts within South Carolina (i.e., the trademark business).

B. The Department Satisfied Both Requirements Necessary To Impose An Alternative Apportionment Method On Appellant.

This Court should affirm the ALC's decision because the Department met, and the ALC properly applied, the two-pronged burden on the proponent of an alternative apportionment method that was enacted through Section 12-6-2320(A) and discussed in CarMax, so there was not an error of law. CarMax, 411 S.C. at 89, 767 S.E.2d at 200. As the proponent of the alternative apportionment method in this matter, the Department satisfied both of the requirements necessary to impose an alternative apportionment method on Appellant. First, the Department proved that the statutory apportionment formulas used by Appellant did not fairly reflect Appellant's business activity in South

Carolina. Second, the Department proved that its chosen alternative method was reasonable. Additionally, this Court should affirm because sufficient evidence exists in the record for reasonable minds to make the same conclusions as the ALC (i.e., that the Department met its two-pronged burden).

Both a taxpayer and the Department may propose the use of an alternative apportionment method to replace the applicable statutory apportionment formula. South Carolina law states:

(A) If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

S.C. Code Ann. § 12-6-2320(A) (2014). Regarding this provision, the South Carolina Supreme Court recently held:

Accordingly, when a party seeks to deviate from a statutory formula under section 12-6-2320(A), the proponent of the alternate formula bears the burden of proving by a preponderance of the evidence that: (1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternate accounting method is reasonable.

CarMax, 411 S.C. at 89, 767 S.E.2d at 200.

1. The Department Demonstrated that the Statutory Apportionment Formulas Used by the Appellant Did Not Fairly Represent Appellant's Business Activity in South Carolina.

The ALC properly found that the statutory apportionment formulas used by Appellant did not fairly represent the extent of Appellant's business activity in South Carolina. (R. p. 11; Order p. 9.)

As explained above, Appellant initially used a three-factor formula under Section 12-6-2290's to apportion its net income in South Carolina. (R. p. 133, Tr. p. 116, lines 10-23.) Appellant later filed amended returns using the four-factor formula under Section 12-5-2290. (R. pp. 364-66, 372-74, 380-82; Amended Form SC 1120 for 2003, 2004, and 2005 signed on Jan. 7, 2009 Ex. 1, Tab7.) Either multi-factor-formula method of apportionment however was not allowed for Appellant in South Carolina because Appellant conducted only its trademark business in South Carolina and its trademark business was neither manufacturing nor dealing in tangible personal property. See S.C. Code Ann. § 12-6-2250 (Supp. 2007). The ALC properly concluded that "Section 12-6-2250 is simply not applicable" to Appellant. (R. p. 12; Order p. 10.)

One month before the administrative hearing in this case, Appellant filed additional amended returns for each tax year using the gross-receipts ratio set forth in Section 12-6-2290. (R. pp. 361-63, 369-71, 377-79 (Amended Form SC 1120 signed on July 11, 2011 for 2003, 2004, and 2005 Ex.1, Tab 7); R. p. 134, Tr. p. 117; lines 2-16.) The ALC noted that Section 12-6-2290 appears on its face to be applicable to apportion the net income related to Appellant's business activity in South Carolina. (R. p. 12; Order p. 10.) However, in its gross-receipts ratio Appellant included only the South Carolina royalty receipts in the numerator but included company-wide royalty and retail sales in the denominator. (See R. p. 152, Tr. p. 189, line 20-Tr. p. 190, line 3.)

The Department's auditor and its expert in law and economics found that Appellant's gross-receipts ratio distorts Appellant's business activity in South Carolina. The Department's auditor testified that Appellant's retail sales had "nothing" to do with Appellant's trademark business in South Carolina. (R. p. 253, Tr. p. 112, lines 6-12; R. pp. 342, 345 (Report of Field Audit Ex. 1, Tab 1 pp. 3, 9). Further, the Department's expert in law and economics characterized Appellant's gross-receipts ratio as not accurately reflecting the economic connection that Appellant had with South Carolina, (R. p. 274, Tr. pp. 193, line 14-Tr. p. 194, line 9), and as mixing apples and oranges, (R. p. 274, Tr. p. 194, lines 10-22). The result of this mixture is that Appellant significantly lessens the gross-receipts ratio because the denominator includes a significant amount of gross receipts from retail sales made in other states when Appellant does not engage in retail business in South Carolina. (R. p. 274, Tr. p. 194, line 23-Tr. p. 195, line 1.)

Evidence presented demonstrated that the vast majority of Appellant's total revenues came from its non-South Carolina retail sales which have nothing to do with Appellant's South Carolina trademark business. Nationally only 13% of its revenues was generated from its trademark business. (R. p. 254, Tr. p. 114, line 4-Tr. p. 115, line 19; R. p. 478 (Apportionment Data by State Ex. 1, Tab 21).) Appellant's retail operations that generated the other 87% of its total revenues have nothing to do with its trademark business in South Carolina, which is why the Department's auditor did not include the retail sales in the Department's apportionment calculations. (R. p. 253, Tr. p. 112, lines 6-12; R. p. 254, Tr. p. 115, lines 7-9; Transcript Day Two pp. 112:6-12, 115:7-9.)

Because of this disparity, including the retail sales in the denominator diluted the gross-receipts ratio and significantly lowered the amount of net income from Appellant's

trademark business which would be taxable in South Carolina. In fact, because South Carolina taxable income was significantly reduced by the dilution of the gross-receipts ratio, only 1.53% in 2003, 4.68% in 2004, and 0% in 2005 of Appellant's South Carolina royalty income was taxed in South Carolina.⁶ (R. pp. 6-7; Order pp. 4-5.)

The ALC found this evidence convincing. After stating that Appellant's retail sales, which occurred totally outside of South Carolina, are unrelated to its South Carolina trademark business, the ALC properly concluded that the "inclusion of RAC West's gross receipts from its retail operations in the denominator of the apportionment ratio would so dilute the gross receipts received from South Carolina as to distort the taxpayer's actual economic activity in this State." (R. pp. 7, 13; Order pp. 5, 11.) Therefore, the ALC properly concluded that apportioning Appellant's income using a gross-receipts ratio as stated in Section 12-6-2290 "would not accurately reflect RAC West's business in South Carolina." (R. p. 12; Order p. 10.)

Based on the above, the evidence clearly supports the conclusion that including Appellant's out-of-state retail sales in the denominator of the gross-receipts ratio (or in the denominator of the sales factor in the multi-factor formula) dilutes that ratio to the extent that the result does not fairly represent Appellant's trademark business activity in South Carolina. Additionally, the multi-factor formula as a whole does not fairly represent Appellant's business activity in South Carolina. After seeing and hearing the

⁶The above analysis focused on the dilution of Section 12-6-2290's gross-receipts factor. Although the multi-factor formula in Section 12-6-2250 is not applicable to Appellant, if it was applicable, the sales factor within the multi-factor formula would likewise be diluted. This multi-factor formula would be further diluted because Appellant's payroll and property factors would be zero in South Carolina since Appellant has no payroll or property in South Carolina, (R. p. 354; R. pp. 366, 374, 382.)

evidence presented, reasonable minds undoubtedly could conclude, as did the ALC, that the statutory formulas used by Appellant do not fairly represent the extent of Appellant's business activity in South Carolina. Therefore, this Court should affirm that the ALC's decision that the Department met the first prong of Section 12-6-2320(A).

2. The Department Demonstrated that the Alternative Apportionment Method Was Reasonable.

The ALC's decision that the Department met the second prong of Section 12-6-2320(A) – that the Department's alternative apportionment method was reasonable – was also proper. Sufficient evidence supports its decision, including the four reasons it gave for the reasonableness of the Department's alternative method of apportionment.

First, the ALC found that the Department's alternative method was reasonable because it was based on a formula created by the taxpayer itself in its trademark licensing agreements. (R. p. 14; Order p. 12.) Sufficient facts supported the ALC's finding. The alternative method used by the Department was based on RAC West's own formula: the 3% royalty agreement that RAC West had with RAC East (R. p. 35; Dep't Determination Ex. 1, Tab 5 p. 7). Unlike other apportionment cases, this case does not involve using some mathematical theory to determine the amount of gross receipts generated from within this State. Here, the amount that Appellant generated from within South Carolina is known and identifiable as the gross receipts, were earned and payable to Appellant based on a royalty agreement between Appellant and RAC East. Just before the three tax years at issue in this case began, Appellant entered into this royalty agreement in which RAC East could use Appellant's Intellectual Property in exchange for a royalty of 3% of RAC East's net sales of licensed services. (R. p. 389.) Because the formula existed in

the royalty agreement, all parties know exactly how much Appellant received from South Carolina. In other words, the parties know exactly the amount of gross receipts Appellant generated from its South Carolina activities and that is the amount (less substantiated deductions) that the Department taxed in its alternative method. This 3% license fee received by Appellant was given credibility when KPMG shortly thereafter concluded a transfer pricing study in which KPMG said that an arm's length license fee of this nature would be in the range of 2% to 4%. (R. p. 442.) Therefore, it was entirely reasonable for the Department to determine that Appellant's gross receipts from South Carolina were 3% of RAC East's net sales in South Carolina during each tax year at issue.

Second, the ALC found that the Department's alternative method was reasonable because it treats each state equally and consistently. (R. p. 14; Order p. 12.) If the Department's alternative method was applied to each of the fifty states, for apportionment purposes Appellant's retail business would not be mixed with its trademark business in any state in which Appellant does not have a retail store. Therefore, in each state in which Appellant generates royalty income (but not income from retail sales), Appellant would be taxed only on its trademark business that occurred in that state. Additionally, since Appellant does not license its Intellectual Property to itself, in states in which Appellant has retail stores, only retail sales (not royalty income) would be part of the apportionment.

Third, the ALC found that the Department's alternative method was reasonable because applying this alternative method to all states operates to apportion 100% of the royalty revenue, without any revenue being taxed twice. (R. p. 14; Order p. 12.) If, according to the Department's alternative method, each state in which Appellant conducts

its trademark business taxed only net income from the trademark business, then the sum of royalty income claimed as income in those states would be exactly 100%. Therefore, no more and no less than 100% of Appellant's royalty income would be taxed if all states applied the Department's alternative apportionment method.

Fourth, the ALC found that the Departments' alternative method was reasonable because it "does not tax more than 100% of the income generated in South Carolina, whereas RAC West's method includes income from its retail operations which is not connected to South Carolina in any way." (R. p. 14; Order p. 12.) In other words, the Department's alternative method is reasonable because it does not include retail income earned from Appellant's out-of-state retail operations when its retail operations have nothing to do with its trademark business in South Carolina. Appellant's only source of income in South Carolina is royalty income from its trademark business. (R. p. 342 (Report of Field Audit Ex. 1, Tab 1 p. 3); R. p. 253, Tr. p. 111, lines 16-18; R. p. 152, Tr. p. 189, lines 10-13.) Specifically, it was reasonable that the Department and its auditor did not include Appellant's retail operations in the Department's apportionment formula because those out-of-state retail operations had "nothing" to do with Appellant's business activity in South Carolina. (R. p. 253, Tr. p. 112, lines 6-12; R. pp. 342, 345.)

In addition to the four reasons given by the ALC, the Department's expert in law and economics also stated that the Department's alternative method was economically reasonable. (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 25.) He said that excluding the retail operations from the Department's alternative method was "absolutely essential" for the tax burden on the Appellant to fairly represent its economic nexus with South Carolina. (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 4; R. p. 274, Tr. p. 196, lines 18-

25.) By including the retail sales, the apportionment formula would adopt an apples and oranges approach. (R. p. 274, Tr. p. 194, line 10-Tr. p. 195, line 1.) On the other hand, the Department's method only looks at apples. In this matter, "apples" are the trademark royalties from within South Carolina, while the "oranges" represent the income from Appellant's out-of-state retail business.

Based on the above, the evidence clearly supports the conclusion that the Department's alternative apportionment method was reasonable. The ALC properly found that "the facts established that the Department's method of apportionment is reasonable." (R. p. 14; Order p. 12.) After seeing and hearing the evidence presented, reasonable minds undoubtedly could conclude that the Department's alternative apportionment method of considering only the royalty income from Appellant's sole business activity in South Carolina was reasonable. Therefore, this Court should affirm the ALC's decision that the Department met the second prong of Section 12-6-2320(A).

In conclusion on the first issue, the statutory apportionment formulas do not establish the correct "base" under Section 12-6-2210(B); however, by focusing on only the trademark business that Appellant conducts in South Carolina, the Department's alternative method established a proper tax "base." Additionally, the Department met its burden by proving that the statutory apportionment formulas did not fairly represent the extent of Appellant's business activity in South Carolina and that the Department's alternative method was reasonable. Because sufficient evidence supports these conclusions, reasonable minds could also come to these same conclusions. When combined with the facts that the ALC used the proper statutes and applied the law properly, this Court should affirm.

II. ALTHOUGH THE ALC DID NOT FIND THAT THE APPELLANT WAS NOT A UNITARY BUSINESS, SUCH A FINDING WOULD NOT REQUIRE THIS COURT TO REVERSE THE ALC'S DECISION.

The Department finds Appellant's second and third issues to be so closely linked that it is difficult to determine why Appellant separated them into two issues. The ultimate question raised by the two issues is whether separate accounting may be used in this case. The General Assembly specifically allows the use of separate accounting as an alternative apportionment method, while not precluding a unitary business' use of separate accounting. S.C. Code Ann. § 12-6-2320(A) (2014). Although the ALC did not rule whether Appellant's retail and trademark businesses were operated as a unitary business, the ALC found "that the separate accounting method employed by the Department here is appropriate." (R. p. 17.) As discussed in the first issue above, the ALC found that the Department met its two-pronged burden to impose an alternative apportionment method, including separate accounting. Accordingly, this Court should dismiss Appellant's second and third issues and affirm the ALC's decision on the basis of the first issue above and the fact that Section 12-6-2320(A) allows separate accounting.

Nonetheless, the Department will answer Appellant's second and third issues in kind. In the conclusion to its second issue, Appellant wrongly asserts that "this Court should reverse the ALC because its finding that RAC West was not operating a unitary business is contrary to South Carolina law" and erroneous in light of the evidence in this case. (Appellant's Brief p. 33.) Although the ALC discussed some of the characteristics of a unitary business, (R. pp. 7-8, 15-17.), the ALC never concluded that Appellant was not a unitary business that consisted of both its retail and trademark businesses. However, contrary to Appellant's assertion, any such finding would not require that this

Court reverse the ALC's decision. The trademark business is separable. Assuming, arguendo, that Appellant's retail and trademarks businesses were operated as a unitary business, the issue would still be whether South Carolina law allows separate accounting as an alternative apportionment method, which is Appellant's third issue.

Although the ALC did not conclude whether Appellant operated a unitary business, the ALC did address factors that would be addressed in a unitary-business analysis. The ALC stated the correct test for whether a business is unitary when it observed that a unitary business has the characteristics of unity of ownership, unity of management, and unity of operations (i.e., the "unities" definition) and the activities of the business in question contribute to or depend on the other activities of the business (i.e., the "contribution-dependence" definition). (R. p. 16; Order p. 14 (citing Eastman Kodak Co. v. South Carolina Tax Commission, 308 S.C. 415, 418 S.E.2d 542 (1992)).)

Appellant's trademark business, which is the only business that Appellant conducted in South Carolina, (R. p. 342; R. p. 253, Tr. p. 111, lines 16-18; R. p. 152, Tr. p. 189, lines 10-13), is not unitary with Appellant's primary business, its retail business. For example, unity of management does not exist within Appellant's retail business because Appellant's store managers operate the stores, (R. p. 127, Tr. p. 90, lines 5-22; R. p. 129, Tr. p. 98, lines 18-22), but employees of RAC Texas perform various management services for Appellant, (R. p. 125, Tr. p. 84, line 22-R. p. 126, Tr. p. 86, line 1; R. p. 130, Tr. p. 103, line 25-Tr. p. 104, line 6; R. p. 140, Tr. p. 143, line 16-Tr. p. 144, line 2; R. p. 142, Tr. p. 150, line 22-Tr. p. 151, line 3; R. p. 147, Tr. p. 170, line 25-Tr. p. 171, line 5; R. p. 150, Tr. p. 181, lines 1-18; R. pp. 411, 417; see, e.g., R. pp. 391-397.) Moreover unity of management does not exist between Appellant's retail and trademark

businesses. Appellant has store managers who manage the day-to-day retail operations at each store, (R. p. 127, Tr. p. 90, lines 5-22; R. p. 129, Tr. p. 98, lines 18-25), but Appellant does not manage the day-to-day operations of its trademark business, (R. p. 152, Tr. p. 190, line 24-Tr. p. 191, line 3; R. p. 154, Tr. p. 199, lines 12-16; R. p. 154, Tr. p. 200. Line 8-R. p. 155, Tr. p. 201, line 4.) RAC Texas actually provides the services for protecting, licensing, and monitoring use of Appellant's Intellectual Property. (R. p. 152, Tr. p. 190, line 20-Tr. p. 191, line 3; R. p. 154, Tr. p. 199, lines 12-16; R. p. 154, Tr. p. 200. Line 8-R. p. 155, Tr. p. 201, line 4.) Ms. Wolverton of TAC Texas is "responsible for maintaining the company's portfolio of trademarks and trades names" including determining whether a desired name would be available for federal registration, filing the registration and leading the registration process, filing continuing use statements, and monitoring use of the Intellectual Property by others. (R. p. 154, Tr. p. 197, line 25-Tr. p. 198, line 5, R. p. 154, Tr. p. 199, lines 12-16; R. pp. 154, Tr. p. 200, line 22-R. p. 155, Tr. p. 201, line 18.) Additionally, although RAC West owns the Intellectual Property, RAC Texas is responsible for developing advertising and marketing strategies to create, maintain, and expand the RAC brand name. (R. p. 425.) Appellant asserts that a unity of management exists here because a related company, RAC Texas, manages Appellant's trademark business, (Appellant's Brief p. 32.); however, this fact proves the opposite. The fact that another entity performs these aspects of Appellant's business demonstrates that Appellant is not unitary and shows that Appellant's businesses can be separated, even if they were unitary.

There are several reasons why Appellant does not meet the contribution-dependence test meaning that its trademark business is not unitary with its retail business.

First, Appellant's trademark business depends on retail sales made by its retail affiliates, not from its own retail sales. (See, e.g., R. pp. 383-390.) Unlike the retail sales of RAC East, (R. pp. 383-390), the retail sales of Appellant do not generate any royalty income for Appellant's trademark business. Second, as the ALC noted, Appellant did not prove that its retail and trademark operations have an inextricable link or that there is some type of opaque flow of value and interdependency between the two businesses. (R. p. 8.) Appellant asserted that such values existed but offered no documentary evidence to support this claim. Third, Appellant's assertions that as the service and performance of the retail stores increased the Intellectual Property become "more famous," (R. p. 155, Tr. p. 202, line 7-Tr. p. 203, line 8; R. p. 155, Tr. p. 203, lines 16-19), is irrelevant because notoriety does not necessarily cause an increase in value and Appellant certainly did not present any estimates of how much the value of the Intellectual Property increased or decreased in any year because of retail service or performance. Assuming *arguendo* that good retail service or performance increased the value of the Intellectual Property in any one of the tax years at issue, such an increase in the value of Intellectual Property is not a taxable event and has no relevance to Appellant's income tax returns for 2003, 2004, or 2005. The taxable event for Appellant in South Carolina is the receipt of the royalty fees from RAC East. That taxable event is the centerpiece of the Department's alternative apportionment method. Appellant could affect the taxable event, if the value of the Intellectual Property increased or decreased, by increasing or decreasing the royalty percentage in the licensing agreements with RAC East. Fourth, Appellant did not strategically acquire the Intellectual Property to enhance the value of its retail business as it already owned the Intellectual Property when that company was acquired. (R. p. 132,

Tr. p. 110, lines 16-25.) Fifth, whatever value Appellant's Intellectual Property has on its retail operations and vice versa is applicable to all retail operations of RAC West, RAC Texas, and RAC East, not merely on the retail operations of RAC West. (R. p. 155; Tr. p. 203, lines 2-24.) Therefore, Appellant's Intellectual Property equally serves the retail operations of RAC West, RAC East, and RAC Texas and does not provide any unique value to RAC West's retail business. Finally, although the retail operations of RAC East and Appellant are the same, (R. p. 152, Tr. p. 190, lines 13-23), only Appellant owns the Intellectual Property, (R. p. 152, Tr. p. 190, lines 20-23; R. p. 155, Tr. p. 202, lines 14-15). This indicates that operating the retail stores, whether by RAC East, RAC Texas, or Appellant, is not dependent on also owning the trademark business; otherwise RAC East's and RAC Texas' retail business would be failing because they do not have trademark businesses.

Still another example of Appellant's trademark business not being unitary with its retail business is the fact that Appellant's royalty income is identifiable, quantifiable, and separable. Its royalty income comes from its retail affiliates, primarily RAC East and RAC Texas, and is established through licensing agreements. (See, e.g., R. pp. 383-390.) In the agreement with RAC East, Appellant receives a royalty fee of 3% of RAC East's net sales. (R. pp. 385, 389). KMPG was able to look separately at Appellant's trademark business and determine an arm's length royalty fee. (R. p. 442.) Since the royalty fee has been quantified and KPMG separately analyzed Appellant's trademark business, Appellant's trademark business can be separated from its retail business.

Appellant cites Exxon Corp. v. South Carolina Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1993) to assert that Appellant's trademark business is unitary with its

retail business. (Appellant's Brief p. 28-33.) In Exxon, Humble Oil and Refining Company (Humble) operated a vertically integrated oil and gas company engaged in exploration and production of oil and gas, refining of crude oil, and the retail sales of petroleum products: Exxon, 273 S.C. at 596, 258 S.E.2d at 94. When filing income tax returns in South Carolina, Humble excluded from its tax base the portion of its income related to the exploration and production operations. Id. The Supreme Court affirmed the lower court's decision that Humble operated a single unitary business that included the exploration and production operations and that South Carolina income tax should be calculated by applying the apportionment ratio to Humble's entire corporate net income. Id., 273 S.C. at 595, 596, 602, 258 S.E.2d at 94, 97. The Supreme Court used the unities and contribution-dependence definitions in its Exxon analysis, but, as discussed, above, the facts of the instant case, unlike Exxon, show that unity of management and the requisite contribution-dependency between Appellant's retail and trademark businesses did not exist. Additionally and critically, Exxon does not prohibit the use of separate accounting as an alternative apportionment method inasmuch as that opinion predated the 1995 enactment of Section 12-6-2320(A) which allows separate accounting. Prior to the enactment of Section 12-6-2320(A), South Carolina law did not have a statute that authorized the use of separate accounting as an alternative apportionment method.

Based on the above, this Court should dismiss Appellant's second issue because the evidence supports the fact that Appellant is not operating a single unitary business and because, even if it was unitary, the evidence shows that Appellant 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.

III. THE ALC PROPERLY ALLOWED THE DEPARTMENT TO APPLY A SEPARATE ACCOUNTING TO APPELLANT AND FOUND THAT SUCH SEPARATE ACCOUNTING WAS REASONABLE.

This Court should affirm the ALC's decision because the General Assembly has allowed the use of separate accounting as an alternative apportionment method, the ALC did not make an error of law, and, as discussed in the first issue above, sufficient evidence confirms that the ALC properly found that the Department met its two-pronged burden of imposing such an alternative method. The ALC properly found that the Department's separate accounting method was appropriate. (R. p. 17; Order p. 15.)

Although Appellant mixes whether Appellant's trademark and retail businesses are unitary with the Department's ability to impose separate accounting on Appellant's trademark business, the South Carolina General Assembly did not mix the two together. The General Assembly allows the use of separate accounting as an alternative apportionment method, while it says nothing about a unitary business not being able to use separate accounting. S.C. Code Ann. § 12-6-2320(A) (2014). This statute was enacted in 1995 and postdates cases such as Exxon and Eastman Kodak, which are often incorrectly used to assert that a unitary business cannot use separate accounting. Had the General Assembly sought to exclude a unitary business from using separate accounting, it simply and easily could have included such language in Section 12-6-2320(A). Excluding such language demonstrates the inaccuracy of Appellant's assertions.

Although the evidence indicates that Appellant's trademark and retail businesses are not unitary, such a determination isn't the primary issue that Appellant makes it. What is relevant is whether the financial activities of Appellant's trademark business can be separately identified. Dr. Harrison agreed. He testified that the issue of whether

Appellant's retail and trademark businesses constitute a unitary business is a "red herring" because Appellant argues that, if its businesses are unitary, then it cannot separately identify the financial activities its trademark business. (R. p. 275, Tr. p. 197, line 1-Tr. p. 198, line 15.) Dr. Harrison added that it would be wrong from both an economic and an accounting perspective to assume that a business cannot separate its accounts if it is determined to be part of a unitary business. (R. p. 275, Tr. p. 197, line 10-Tr. p. 198, line 15.)

Citing a state and local tax treatise, the ALC stated that "'separate accounting' is a technique of carving out of an 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." (R. p. 15; Order p. 13 (citing 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes ¶ 8.03(3rd ed. 2000)).) This definition, like the opinion of Dr. Harrison, does not focus on unitary status, but it raises the issue of whether the financial activities related to business in a single state can be separated from the taxpayer's other financial transactions.

Although South Carolina law allows the use of separate accounting as an alternative apportionment method, it is reasonable that a prerequisite to the use of separate accounting be that the financial activities of Appellant's trademark business in South Carolina be identifiable. Here the evidence indicates that the financial activities of Appellant's trademark business can be separately identified. As discussed in the Department's second issue above, RAC East paid a fixed 3% of its South Carolina net sales to Appellant. (R. p. 389.) Since Appellant quantified its South Carolina net sales

each year on its federal income tax returns, (R. p. 31), the royalty income paid to Appellant for South Carolina sales was easily identifiable and quantified.

Just like the royalty income of the trademark business is separately identified, expenses of the trademark business must be separately identified and substantiated. The ALC found that Appellant “failed to adequately establish that it incurred expenses in conducting its trademark business.” (R. p. 7; Order p. 5.) It is well established under both state and federal law that deductions from income are a matter of legislative grace rather than entitlement. See Adams v. Burts, 245 S.C. 339, 140 S.E.2d 586 (1965); Fennell v. S.C. Tax Comm'n, 233 S.C. 43, 103 S.E.2d 424 (1958). Accordingly, to deduct an expense, the taxpayer must bring himself squarely within the terms of the statute expressly authorizing the deduction. AVCO Corp. v. Wasson, 267 S.C. 581, 230 S.E.2d 614 (1976). Moreover, deduction statutes are not to be liberally construed. M. Lowenstein & Sons v. S.C. Tax Comm'n, 277 S.C. 561, 290 S.E.2d 812 (1982). The taxpayer bears the burden of substantiating every business expense that he claims. Hradesky v. Comm'r, 65 T.C. 87, 89-90 (1975), aff'd per curiam, 540 F.2d 821 (5th Cir. 1976). Furthermore, “[w]here a tax officer has disallowed a deduction, the ruling of such officer is presumed to be correct and the taxpayer has the burden of proving it to be wrong.” Anonymous Taxpayers v. S.C. Dep't of Revenue, 03-ALJ-17-0366-CC (Dec. 15, 2003). Per the Department’s auditor, Appellant did not provide evidence of any expenses. (R. p. 254, Tr. p. 116, line 21-R. p. 255, Tr. p. 117, line 4.) Accordingly, no allowable expenses could be deducted.

Evidence also showed that Appellant was capable of identifying and substantiating such expenses. First, Dr. Harrison testified that companies use managerial

or cost accounting when they want to determine how a component of a business is performing. (R. p. 275, Tr. p. 199, line 18-R. p. 276, Tr. 201, line 2; R. p. 276, Tr. p. 203, lines 4-16; R. p. 277, Tr. p. 206, lines 2-7.) Second, Mr. Tollack, a CPA, testified that one can determine whether any of his individual retail stores is profitable. (R. p. 152, Tr. p. 191, lines 23-25.) Third, under a management agreement with RAC Texas, the retail stores are guaranteed a 4.5% profit of each store's operating expenses, and the difference between the "actual profit of the store" and the guaranteed 4.5% profit is paid to RAC Texas as a management fee. (R. p. 137, Tr. p. 130, lines 4-23; R. p. 162, Tr. p. 230, lines 5-22.) If Appellant can determine the profitability of its retail stores and hence its entire retail business, it is common sense that it can determine the profitability, which includes expenses, of its trademark business. The difference between Appellant's total expenses and its retail expenses would be its trademark expenses. Then, as the Department's expert said, Appellant could use managerial or cost accounting techniques to determine the share of trademark expenses applicable to South Carolina.

In addition to separate accounting being lawful and available in this case, its use is also reasonable. Appellant asserts that "separate accounting is prohibited for a unitary business because it cannot produce reasonable results." (Appellant's Brief p. 38.) Although separate accounting in a unitary business *may* pose difficulties, see, e.g., Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438 (1980), evidence shows that Appellant's trademark and retail businesses are not unitary and, even if they were unitary, that separate accounting could produce reasonable results in this case. The ALC stated that "many of the drawbacks that usually accompany separate accounting are not present here." (R. p. 17.) In fact, Appellant's South Carolina royalty income was easily

identified and quantified for each tax year at issue, (R: p. 31 (Dep't Determination Ex. 1, Tab 5 p. 3); see R. pp. 389 (Amend. No. 1 to Trademark License Agreement Ex. 1, Tab 11, p. 1)), as demonstrated by the transfer pricing study, (R. pp. 409-477), and the licensing agreement, (R. pp. 383-390; R. p. 17 (Order p. 15)).

As further support of its reasonableness in this case, separate accounting provides a more accurate tax "base" from which to calculate Appellant's South Carolina taxable income compared to the statutory formulas that distorted Appellant's business activity in South Carolina. This distortion was discussed above. Dr. Harrison stated that the Department's alternative method was economically reasonable, (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 25), stating that excluding the retail operations from the Department's alternative method was "absolutely essential" for the tax burden on the Appellant to fairly represent its economic nexus with South Carolina. (R. p. 274, Tr. p. 195, line 24-Tr. p. 196, line 4; R. p. 274, Tr. p. 196, lines 18-25.)

Lastly, the Department described above several reasons above why its alternative method is reasonable, and the ALC noted at least four of these reasons, (R. p. 14).

Based on the above, South Carolina law clearly permits the Department to use separate accounting as an alternative apportionment method. Separate accounting not only is a reasonable method for taxing Appellant's South Carolina activities but also it provides reasonable results. For these reasons, this Court should affirm the ALC's decision that separate accounting is appropriate in this case.

IV. THE ALC PROPERLY CONCLUDED THAT THE DEPARTMENT DID NOT VIOLATE APPELLANT'S CONSTITUTIONAL RIGHTS BY APPLYING SEPARATE ACCOUNTING TO A UNITARY BUSINESS.

This Court should affirm the ALC's findings that the Department's method of taxing Appellant's South Carolina income is not barred by the Commerce Clause and that the tax does not violate the Due Process Clause because it fairly relates to the services provided by South Carolina. (See R. p. 20; Order p. 18.)

As an initial matter, Appellant asserts that the Department violated its constitutional rights "by applying separate accounting to a unitary business." (Appellant's Brief p. 39.) Since evidence demonstrates that Appellant's trademark business was not unitary with its retail business and that separate accounting is lawful and reasonable, the Department did not violate Appellant's constitutional rights.

Turning to the broader constitutional issues, Appellant does not dispute the ALC's recitation of the law concerning whether a tax will survive a challenge under the Commerce Clause. Both cite the four-part test in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). (R., p. 18; Appellant's Brief p. 40.) Under this four-part test, a tax will survive a Commerce Clause challenge if the tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State. Complete Auto at 279. Appellant wrongly claims that the tax, as applied, fails to meet the last three prongs of the above four-part test. (Appellant's Brief p. 41.)

Regarding the first prong at issue, the tax imposed by the Department is fairly apportioned. To be fairly apportioned, a tax must be both internally and externally consistent. Travelscape, LLC v. South Carolina Dep't of Revenue, 391 S.C. 89, 107, 705 S.E.2d 28, 37038 (S.C. 2011). An income tax is internally consistent where it is structured such that if it were applied by every state, it would result in no more than all of

the business's income being taxed. Container Corp. of Am. V. Franchise Tax Bd., 463 U.S. 159, 169 (1983). To meet the external consistency test, the state's tax must not reach beyond that portion of value that is fairly attributable to economic activity within the taxing State." Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995): This means that a state can tax "only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed." Goldberg v. Street, 488 U.S. 252, 262 (1989).

The Department's tax on Appellant meets the internal consistency test. Appellant wrongly claims otherwise asserting that (1) not allowing a deduction for Appellant's expenses associated with the royalty income in all states will result in more than 100% of Appellant's net income being taxed and (2) the tax on net royalty income applied to all states would have no relationship to the income of the unitary business and may cause multiple taxation. (Appellant's Brief p. 42.) Appellant is incorrect on the first item because the Department did not disallow a deduction for expenses. Appellant merely failed to provide the Department with proof of expenses to offset the royalty income; however, the Department would have allowed such deductions had Appellate identified and substantiated such expenses. (R. p. 254, Tr. p. 116, line 21-Tr. p. 117, line 4; R. p. 21 (Order p. 19).) Appellant is also incorrect on the second item because by applying the Department's method only income generated in each taxing state would be taxed in that taxing state. By using Appellant's own trademark licensing formula, (R. p. 35), the Department is only taxing in South Carolina the royalty income generated from within South Carolina. Therefore, the Department's method when applied in all applicable states has a direct relationship with the income generated in each state. Under the

Department's method, in each state that RAC East or RAC Texas operates a retail store that generates royalties for RAC West, only the net royalty income based on separate accounting would be taxed in that state. In each case, the only business that Appellant conducted in that state would be its royalty business. Appellant wants to combine Appellant's out-of-state retail operations in the tax calculations for the royalty states, so it is Appellant's method that results in the tax applied to all states from which Appellant received royalties having a distorted relationship with the taxing state.

The Department's tax on Appellant also meets the external consistency test. Appellant wrongly claims otherwise asserting that the Department's "separate accounting method on gross receipts fails to account for the unitary nature of the RAC West business." (Appellant's Brief p. 42.) Appellant continues to assert that the Department's method is a tax on gross receipts and not an income tax. If the Department's alternative method looks like a gross-receipts tax, it is only because Appellant did not provide or support any deductions related to its trademark business. (See R. p. 254, Tr. p. 116, line 21-R. p. 255, Tr. p. 117, line 1.) Had Appellant identified and substantiated any such deductions, the Department would have allowed the deductions. (R. p. 255, Tr. p. 117, lines 2-4.)

Regarding the second prong at issue, the tax imposed by the Department does not discriminate against interstate commerce. Appellant makes the same argument here that it did to argue that the Department failed the external consistency test. For the same reasons discussed immediately above, Appellant's argument has no merit. Also the Department's separate-accounting method does not discriminate between states because it taxes net royalty income in the state in which it was earned.

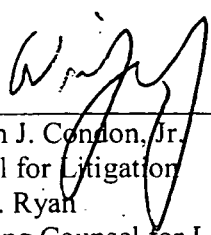
Regarding the third prong at issue, the tax imposed by the Department is fairly related to the services provided by the State. There is a fair relationship between the tax imposed on Appellant and the services it received in South Carolina. By taxing the net royalty income generated in South Carolina, the Department is taxing only net income related to South Carolina activities. The State of South Carolina and its local governments have provided many services that allow Appellant to earn an income in this State. The ALC properly relied on Geoffrey. In Geoffrey, and in the instant case, an out-of-state owner of trademarks and trade names licensed the use of that intangible property to a retailer operating in South Carolina. Geoffrey, 313 S.C. at 16-17, 437 S.E.2d at 15. The S.C. Supreme Court said that the foreign owner of property licensed for retail use in South Carolina benefited from the State-provided services and that the South Carolina tax on royalty income was “rationally related” to those benefits. Geoffrey, 313 S.C. at 21-22, 437 S.E.2d at 17. The Supreme Court stated that South Carolina provided Geoffrey with an “orderly society” in which to conduct business so that it could earn income from its royalty agreement with the South Carolina retail operation. Id., at 22, 437 S.E.2d at 18. A few examples of the benefits that Appellant received from South Carolina are police protection and the courts which allow people to move freely and confidently engage in commerce, roads on which inventory – which is later sold to customers generating the royalty fee – is delivered to the retail stores in South Carolina, and the regulation and provision of utilities to the retail stores that can make royalty-generating sales and to customers who can plug in and watch a television obtained at a retail store.

Turning to the Due Process Clause, Appellant asserts that the Department’s method of taxing Appellant violates the Due Process Clause, but Appellant neither

explains nor makes another mention of the alleged due process violation. The Due Process Clause requires some minimum connection between a state and the person, property, or transaction it seeks to tax and income attributed to the tax must be rationally related to the taxing state. Geoffrey, 313 S.C. at 18, 437 S.E.2d at 16. Here, Appellant has the minimum contacts with South Carolina because it purposefully directed its activities toward this State through the licensing agreement, (R. p. 383-390), and owned Intellectual Property located in South Carolina, (R. p. 131, Tr. p. 106, lines 3-6; Transcript Day One p. 106:3-6). Also, the income attributed to the tax is rationally related to this State because of the benefits that this State has provided to Appellant, as explained above. Additionally, like in Geoffrey, the real source of Appellant trademark income is RAC East's South Carolina customers. Geoffrey, 313 S.C. at 22, 437 S.E.2d at 18.

CONCLUSION

For the foregoing reasons and for any other reason appearing in the Record on Appeal, the South Carolina Department of Revenue respectfully requests that the decision of the ALC in this matter be affirmed.



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**THE STATE OF SOUTH CAROLINA
In the Court of Appeals**

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellate Case No. 2012-208608

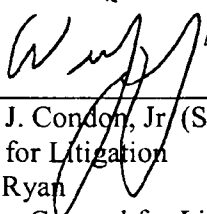
Rent-A-Center West, Inc., Appellant,

v.

South Carolina Department of Revenue, Respondent.

RESPONDENT'S CERTIFICATE OF COMPLIANCE

The undersigned certifies that this Final Brief complies with Rule 211(b) of the South Carolina Appellate Court Rules.



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THE STATE OF SOUTH CAROLINA
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SC Court of Appeals

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ARGUMENT

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

The parties agree that the South Carolina apportionment statute imposes a tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). See SCDOR Brief at p. 16. They disagree on what the phrase "proportion of the trade or business carried on within this State" means. RAC West contends that the phrase means the proportion of the taxpayer's business in South Carolina as compared to the entirety of the taxpayer's business in all states. SCDOR, on the other hand, appears to argue that it means a taxpayer's business line performed in South Carolina compared to its income from that business line in other states. See SCDOR Brief at pp. 16-20.

The starting point in interpreting a statute is the text of the statute itself. Hodges v. Rainey, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000). Additionally, the plain meaning rule requires that "words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand that statute's operation." State v. Leopard, 349 S.C. 467, 471, 563 S.E.2d 342, 344 (Ct. App. 2002). Finally, "statutes dealing with the same subject matter are in *pari materia* and must be construed together, if possible, to produce a single, harmonious result." Brown v. James, 389 S.C. 41, 53, 697 S.E.2d 604, 611 n.13 (Ct. App. 2010).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The only evidence pointed to by SCDOR, and adopted by the ALC, in support of its contention that its formula was reasonable is that RAC West entered into a royalty agreement that attempted to value the use of the RAC trademarks. SCDOR Brief at p. 29. However, licensing agreements that set a price for the use of a trademark, or any product for that matter, have nothing to do with and are not a substitute for a tax formula. See RAC West Brief at pp. 26 and 37-38.² The other support offered by SCDOR regarding its method consists of arguments and conclusory statements made by SCDOR and its expert; not one shred of evidence via a document or a fact witness is cited. In sum, this Court should reverse the ALC's decision because SCDOR failed to carry its burden of proof to show that its method was reasonable. CarMax, 411 S.C. at 89, 767 S.E.2d at 200.

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

² See also Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164-65 (1983)(holding that inter-company transfer of value pricing is not controlling for a unitary business); Exxon, 273 S.C. at 603-604, 258 S.E.2d at 98 (quoting Butler Bros., 315 U.S. at 507) (finding arguments of the Tax Commission that "transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income" and stating that "[a]ccounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.'").

explain that one could determine the direct expenses at the store level but not the "real expenses." R. p. 152 at 192:1-8. See also R. pp. 155-156 at 204:3-205:8 (Mr. Tollack's testimony discussing that because work performed related to the IP increases the value of the retail operations and vice versa, it is difficult to accurately account for the actual costs of one versus the other even if one could make an effort to track an employee's time on tasks for the two different operations).

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

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

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

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

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

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

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

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

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

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

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

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


(2014). Mobil Oil, 445 U.S. at 439; Butler Bros., 315 U.S. at 508-509; Container Corp., 463 U.S. 164-65 (1983); Exxon, 273 S.C. at 599, 258 S.E.2d at 96; Eastman Kodak, 308 S.C. at 419-20, 418 S.E.2d at 544; Lowenstein, 298 S.C. at 101-107, 378 S.E.2d at 276-279; S.C. Code Ann. §12-6-2320 (A) (2014). See also, RAC West Brief, Argument, § II at pp. 28-33.

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

CONCLUSION

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

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Charleston, South Carolina
September 8, 2015

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

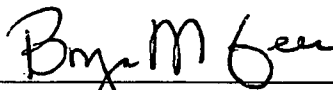
Appellate Case No. 2012-208608

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

CERTIFICATE OF COUNSEL

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

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September 8, 2015

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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APPEAL FROM ADMINISTRATIVE LAW COURT **SEP 11 2015**

SC Court of Appeals

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2012-208608

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

v.

South Carolina Department of Revenue Respondent.

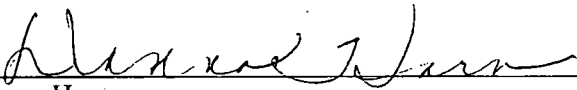
PROOF OF SERVICE

I the undersigned Administrative Assistant of the law firm of Nelson Mullins Riley & Scarborough, LLP, attorneys for Rent-A-Center West, Inc., do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

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Sept 9, 2015

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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SC Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

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

v.

South Carolina Department of Revenue Respondent.

APPELLANT'S RETURN TO RESPONDENT'S PETITION FOR REHEARING

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Pursuant to Rule 240(e) of the South Carolina Appellate Court Rules ("SCACR"), Appellant Rent-A-Center West, Inc. ("RAC West") files this Return to Respondent South Carolina Department of Revenue's ("SCDOR") Petition for Rehearing (the "Petition") in this matter involving Op. No. 5447, which was filed on October 26, 2016 (the "Opinion"). As explained more fully below, the Petition should be denied. SCDOR's Petition fails to identify any substantive points of fact or law in the Opinion that the Court overlooked or misapprehended as required by SCACR Rule 221(a) and South Carolina case law and instead rehashes arguments previously presented to this Court, which were properly rejected in the Opinion, or makes new arguments that should not be considered. This Court correctly reversed the ALC's decision, and, thus, SCDOR's Petition should be denied.

PROCEDURAL AND FACTUAL BACKGROUND

As this Court will recall, the primary issue in this case is whether SCDOR met its burden of proof to show that the standard statutory apportionment formula did not fairly reflect RAC West's business activities in South Carolina. The ALC concluded that it did meet that burden; however, this Court correctly determined that this was in error because SCDOR failed to present sufficient evidence to meet the burden of proof and thus reversed the ALC. Opinion at p. 13.

A. Brief Summary of Relevant Facts

RAC West has retail stores in western states. R. p. 125 at 84:18-25. It also owns certain intellectual property (trade names and trademarks) ("IP") that it licenses to two related entities, Rent-A-Center Texas, LP ("RAC Texas") and Rent-A-Center East ("RAC East"), which, in return, pay RAC West a royalty fee. R. p. 125 at 84:20-21 and p. 126 at 85:6-8. Beyond receiving these royalty fees for the use of the IP by the South Carolina stores, RAC

West has no activities in this State. R. p. 131 at 106:3-6. It has no physical presence in South Carolina as it has no employees, facilities or tangible property in this State. R. p. 131 at 105:17-22. It also makes no sales in South Carolina and receives *de minimus*, if any, services or benefits from the State. R. p. 131 at 105:23-106:2.

RAC West reported its taxable net to this State using the standard statutory apportionment method. See R. p. 134 at 117:17-118:7; S.C. Code Ann. §12-6-2290 (2014); Sample SCDOR Corporate Income Tax Instruction, R. pp. 479-499; RAC West Amended Tax Returns 2003-2005, R. pp. 361-382. The standard method begins with a corporation's total net income and then apportions it to determine the portion due here based on its business in this State. S.C. Code Ann. §12-6-2290 (2014); Sample SCDOR Corporate Income Tax Instruction, R. pp. 479-499. The reported portion in this case was based on the gross receipts apportionment statute, which uses an apportionment fraction in which the numerator is comprised of gross receipts from South Carolina and the denominator is total gross receipts of the corporation. *Id.* RAC West's gross receipts from South Carolina consisted of royalties paid by RAC East (on its rentals of household goods to South Carolina customers), and the total gross receipts were all of RAC West's receipts, i.e. the total of its royalties, retail rentals and other income. R. p. 134 at 117:17-118:7; RAC West Amended Tax Returns 2003-2005, R. pp. 361-382. In other words, RAC West followed the literal wording of the gross receipts apportionment statute.

SCDOR objected to the standard method and computed a tax based solely on the gross royalties paid by RAC East to RAC West. This method completely ignores corporate net income as is graphically illustrated by SCDOR assessing a tax liability against RAC West in

2005 when the corporate net income was a loss. See Order, R. p. 7; RAC West Audit Report, R. p. 342.

B. Brief Summary of Procedural History

The ALC's Final Order (the "Order") found in favor of SCDOR on all issues except the penalty, which the ALC dismissed, on January 6, 2012. See Order, R. pp. 3-24. The ALC erroneously concluded that SCDOR met its burden to show that the standard apportionment method did not represent RAC West's business activity in South Carolina and that SCDOR's alternative method did. Id. RAC West then timely filed a Notice of Appeal. Thereafter, because the parties believed that some or all of the issues in this case might be decided by the Court of Appeals' decision in CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue (Appeal from ALC Case No. 09-ALJ-17-0160-CC) (the "CarMax Appeal"), they requested a stay of this matter until the opinion in the CarMax Appeal was issued. The Supreme Court issued a decision in the CarMax Appeal on December 23, 2014, and the stay was lifted. CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev., 411 S.C. 79, 767 S.E.2d 195 (2014).

After full briefing by the parties and oral arguments in this matter, this Court issued its Opinion reversing the ALC on or about October 26, 2016. This Court correctly held that based on the evidence in the record, SCDOR had failed to meet its burden to show that the standard apportionment method did not fairly reflect RAC West's business activities in South Carolina. Opinion at p. 13. More specifically, this Court found that SCDOR presented the same level of evidence as it did in the CarMax case, including unsupported allegations by SCDOR witnesses that the management services fee was too high and bald assertions by its expert witness that using the standard method was like "having apples in the numerator, while

having apples and oranges in the denominator" and that "excluding the retail operations from the calculations was essential to 'come up with a tax burden that fairly represented the economic nexus' of the entity with South Carolina." Id. Because SCDOR failed to meet its burden to prove this threshold issue, this Court declined to decide whether the ALC erred in (a) finding that SCDOR's alternative method was reasonable, (b) failing to find that RAC West operated a unitary business, (c) allowing SCDOR to apply separate accounting to a unitary business, and (d) concluding that SCDOR did not violate RAC West's constitutional rights. Id. at pp. 13-14 and n. 4. SCDOR now petitions this Court for a rehearing on the basis that this Court overlooked or misapprehended certain evidence or arguments.

ARGUMENT

As will be discussed below, SCDOR's Petition for Rehearing should be denied. Rule 221(a) of the South Carolina Rules of Appellate Procedure requires that a party submitting a Petition for Rehearing "state with particularity the points supposed to have been overlooked or misapprehended by the court." See also Kennedy v. South Carolina Retirement Sys., 349 S.C. 531, 532, 564 S.E.2d 322, 322 (2001) (stating that appellants "must demonstrate the Court overlooked or misapprehended their argument."). Additionally, the purpose of a petition for rehearing is not "to have the case tried in the appellate court a second time" or to "present points which lawyers for the losing parties have overlooked or misapprehended." Id. at 349 S.C. at 532, 564 S.E.2d at 322 (citations omitted).

In its Petition, SCDOR claims that this Court "overlooked and/or misapprehended the substantial evidence in the record that . . . " (1) SCDOR satisfied its burden to show that the

¹ Not only is this statement a bald assertion by the Department's expert witness, "economic nexus" has nothing to do with "business activity."

standard statutory apportionment formula did not fairly reflect RAC West's business activities in South Carolina; and (2) Appellant's retail and trademark business are not unitary businesses. Petition at p. 4. The first argument was squarely addressed and rejected by this Court in its Opinion. While SCDOR points to various facts, purported facts or other assertions that it claims this Court did not consider in relation to this argument, these alleged facts either are not supported by the evidence, do not support SCDOR's position, are not relevant, or were not previously raised by SCDOR, and most, if not all, relate to an argument that was clearly and thoroughly examined by the Court. The second argument, i.e. that RAC West's retail and trademark businesses were not unitary, did not need to be reached by the Court as SCDOR failed to meet its threshold burden to show that the standard formula did not apply. Opinion at pp. 13-14. Thus, because SCDOR failed to identify any substantive issues that have been "overlooked or misapprehended by the court" and, in any event, its arguments have no merit, this Court should deny the Petition.

I. SOUTH CAROLINA LAW ON CORPORATE INCOME TAX FOR MULTI-STATE TAXPAYERS

As this Court is aware, under South Carolina law, a multi-state taxpayer that does business both within and without this State is subject to a 5% corporate income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014). The allocation statutes provide apportionment formulas that determine the proportion that represents a multi-state taxpayer's business that is carried on in South Carolina. See Lockwood Greene Eng. v. S.C. Tax Comm'n, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987). For the type of income that is at issue here, the parties agree that the single-factor "gross receipts" statute is the standard statutory method

to be applied. S.C. Code Ann. § 12-6-2290 (2014); R. p. 268. at 172:12-18 (testimony of auditor that single-factor formula would be the correct method). Under this statute, the taxpayer's "gross receipts from within this State" are divided by the taxpayer's "total gross receipts from everywhere." S.C. Code Ann. § 12-6-2290 (2014).

As both parties agree, an alternative method of apportionment is only authorized in certain circumstances, which are set forth in S.C. Code Ann. §12-6-2320(A):

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Thus, an alternative method may only be used where (a) the standard method does not fairly represent the taxpayer's in-state business activities, and (b) the alternative method (in this case a flat tax on gross receipts) is reasonable. See S.C. Code Ann. §12-6-2320(A) (2014). Additionally, the party seeking to deviate from the standard statutory formula bears the burden of proving both of these elements by a preponderance of the evidence. CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev., 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014). Thus, SCDOR, as the proponent of an alternative method, had the burden of proof on those two elements, which must be proven in sequence.

The South Carolina Supreme Court recently examined the first prong of this test in the CarMax case, wherein it held that SCDOR had not met its burden to show that the standard formula did not fairly represent CarMax West's business activities in this State. Id., 411 S.C. at 90, 767 S.E.2d at 200. The ALC in that case had relied on testimony from an auditor that the business structure of the taxpayer is often "linked with tax minimization strategies" and the fact that the taxpayer's method yielded a significantly lower tax than that of a related company to support its determination that the taxpayer's income was diluted by the standard statutory apportionment method. Id., 411 S.C. at 90, 767 S.E.2d at 201. The ALC had also considered the same "apples and oranges" allegation made in this case by the same expert witness. CarMax v. S.C. Dept. of Rev., Docket no. 09-ALJ-17-0160-CC, at p. 9, n. 7 (Admin. Law Ct. April 22, 2010). In affirming as modified the Court of Appeals decision reversing the ALC, the Supreme Court noted that "the Department merely 'describe[d] what it did rather than cite any evidence justifying what it did.'" CarMax, 411 S.C. at 90, 767 S.E.2d at 200. It also found that "[t]his was the extent of the evidence offered by the Department to prove the contention that the statutory formula did not fairly represent CarMax West's business activity in South Carolina; other than bald assertions by its witnesses that it satisfied this threshold question." Id., 411 S.C. at 90-91, 767 S.E.2d at 201. The Court then held that such findings, even if true, "do not provide a sound evidentiary basis to support the conclusion that the statutory formula did not fairly represent CarMax West's business activity in South Carolina." Id., 411 S.C. at 91, 767 S.E.2d at 201 (citing *St. Johnsbury Trucking Co.*, 385 A.2d at 217 ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula")). In other words, simply because SCDOR's chosen

method produces a higher income figure than the standard method is not a reason to reject the standard method.

As this Court noted, the South Carolina Supreme Court examined a similar issue in Eastman Kodak wherein SCDOR did not want Eastman Kodak to include the income from its safe harbor lease transactions in the denominator of the apportionment formula because only a very small percentage of the leased assets were located in South Carolina. 308 S.C. at 419, 418 S.E.2d at 544. However, as recognized by this Court in its Opinion, the Supreme Court disagreed and found that the apportionment formula properly reflected the taxpayer's business activities in South Carolina when it only had the minor South Carolina leasing operations in the numerator of the formula. Id.; see also Opinion at p. 13. As RAC West's tax policy expert testified, this is exactly how apportionment is supposed to work. Using a pizza pie analogy, he explained that formulary apportionment takes the total pizza (i.e. the total corporate income of a business in all states) and determines the slice of the pizza that the taxing state should get. R.p. 238 at 49:3-7 and 52:8-18; RAC West Final Brief at pp. 18-19.

II. THIS COURT PROPERLY RULED THAT SCDOR FAILED TO PRESENT SUBSTANTIAL EVIDENCE THAT THE STANDARD APPORTIONMENT METHOD DID NOT FAIRLY REPRESENT RAC WEST'S BUSINESS ACTIVITIES IN THIS STATE.

As this Court will recall, the basic issue in this appeal is whether SCDOR met its two-prong burden to establish, first, that the standard apportionment method (which seeks to determine the portion of RAC West's total net income that should be apportioned to South Carolina) did not fairly represent RAC West's business activities in this State; and, second, if the first prong is met, then to establish that its alternative method (i.e. a flat tax on only RAC West's gross royalty revenue in South Carolina) did. In its Opinion, this Court concluded that

SCDOR failed to meet its burden to show under the first prong that the standard formula does not fairly represent RAC West's in-state business activities because it produced the same level of evidence as was submitted in CarMax. Opinion at p. 13.² It specifically noted the auditor's testimony regarding multiple business entities and a management services fee that he stated was "too high" as well as SCDOR's experts "apples and oranges" testimony and his assertion that exclusion of the retail sales was necessary to fairly reflect RAC West's business activities in this State and concluded that these were bald assertions and constituted insufficient evidence to satisfy SCDOR's burden. Id.

SCDOR's Petition for Rehearing claims that this Court overlooked the following purported evidence and assertions in the record, which it claims support its contention that it presented substantial evidence to show that the standard apportionment method did not fairly represent RAC West's business activities in this State:

- Dr. Harrison's testimony that using the standard apportionment method would not provide an accurate reflection of RAC West's business activities in South Carolina because it was mixing apples and oranges (Petition at p. 9)
- testimony that RAC West did not operate any retail stores or have any management or employees in South Carolina (Id. at p. 6)
- testimony of the auditor that RAC West's "out-of-state retail operations had 'nothing' to do with its trademark activities in South Carolina" (Id. at p. 7)

² SCDOR asserts that CarMax should only be relied upon by this Court for its holding that the burden of proof is on the party asserting an alternative method. Petition at p. 5, n. 3. It claims that this Court should ignore the Supreme Court's analysis of the sufficiency of the evidence in CarMax based on a lone dissent stating that the ALC had placed the burden of proof on the taxpayer and thus it was not surprising that SCDOR did not attempt to offer evidence in support of its position but rather relied on CarMax to refute it. Id. SCDOR cites no authority that would support this Court ignoring binding precedent based on a lone dissent. Moreover, SCDOR did not actually present that case at trial as if the burden was on the taxpayer. Following CarMax counsel's closing arguments in which he argued that the burden of proof should be on SCDOR, counsel for SCDOR stated as follows: "Your Honor, we do not disagree with Mr. von Lehe's discussion of our burden in this case. We welcome that burden. If we cannot show that they have not fairly represented their business in South Carolina, we should not be allowed to apply this statute." CarMax Trial Transcript at p. 443:3-9. Accordingly, this Court properly recognized CarMax as binding precedent and applied the analysis therein to the facts in this case, which are similar if not identical to those in CarMax.

- evidence that another entity (RAC Texas) manages and maintains RAC West's trademarks and trade names (Id. at pp. 7-8)
- the fact that while RAC West's total net income for 2004 was \$19,840,800, the standard method only apportioned \$40,317 of that net income to South Carolina despite the fact that RAC West generated \$861,437 in gross receipts (Id. at p. 8)
- the fact that retail sales in other states comprised 87% of RAC West's income while royalty income in South Carolina totaled 13% of RAC West's income (Id. at p. 7)
- purported evidence that the retail sales and trademark activities have "widely divergent profit margins" and that "the result of combining both activities into one gross receipts formula is a dilution and distortion of Appellant's business activity in South Carolina" (Id.)

As will be discussed below, the above are either unsupported assertions, do not support SCDOR's position or have not been previously argued.

A. SCDOR's Apples and Oranges Argument Was Fully Considered and Properly Rejected by This Court.

Almost all of the evidence and arguments that SCDOR claims this Court overlooked relate to its apples and oranges argument, which was fully considered and properly rejected by this Court. This Court thoroughly examined the apples and oranges argument (which was made by the very same expert in the CarMax case) and expressly mentioned the submissions from the auditor that Rent-A-Center was comprised of multiple entities and that the auditor believed the management fee was too high and found them not to be "substantial evidence" based on CarMax. Opinion at p. 13. SCDOR's allegations in this case and the CarMax case are identical: that the out-of-state sales should not have been included in the denominator of the apportionment fraction. Or as the Supreme Court put it in the CarMax case: "The Department sought to prevent CarMax West from diluting its income by inflating the denominator of its apportionment ratio with sales from its Western retail operations." CarMax, 411 S.C. at 84,

767 S.E.2d at 197. CarMax argued (as Rent-A-Center does here) that including the out-of-state sales does not cause the apportionment formula to be diluted and therefore to unfairly represent the extent of its business in South Carolina. To the contrary, the formula correctly responds to the fact that there are no retail sales in South Carolina, and that fact is correctly recognized by including the sales in the denominator with none in the numerator. As this Court recognized, this result is also directly supported by the Eastman Kodak case. Eastman Kodak, 308 S.C. at 419, 418 S.E.2d at 544 (stating that "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 . . . [and t]herefore the apportionment formula reflects a 'reasonable representation' of Kodak's business in this State"). See also Opinion at p. 12.

This Court also noted that SCDOR presented no specific evidence that the standard formula did not represent RAC West's business activities (id. at p. 14), and the record shows that no documentary evidence (such as management fee studies) was offered in support of the auditor's assertion regarding such fees. In fact, SCDOR stipulated at trial that it did not dispute that the amount of this fee was reasonable (see R. p. 259 at 134:5-6 and 9-10) and chose not to challenge the deduction for those expenses taken by RAC East, which the auditor acknowledged would have addressed SCDOR's concerns. See R. p. 256.

As to the factual finding in the ALC's Order that RAC West's total net income for 2004 was \$19,840,800 and that the standard method only apportioned \$40,317 of that net income to South Carolina, this is similarly unresponsive of SCDOR's argument. These facts are very similar, if not identical, to those relied upon by the ALC in CarMax. The ALC here simply compared RAC West's computation using the standard formula to SCDOR's alternative computation and observed that the latter's method produces a higher tax. If this were a reliable

method, then every formula that SCDOR comes up with that shows more tax should be accepted. SCDOR merely showing what it did is not evidence of anything, much less distortion, and showing that its method will produce a higher tax, as this Court recognized, is insufficient as a matter of law under CarMax to establish that the standard statutory method does not reasonably reflect a taxpayer's business activities in this State. CarMax, 411 S.C. at 91, 767 S.E.2d at 201, citing St. Johnsbury Trucking Co., 385 A.2d at 217 ("Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.").

SCDOR relies on the ALC's observation that RAC West had \$861,437 of gross receipts from South Carolina in 2004 but only paid \$40,317 of tax. The obvious error here is that the formula is not taxing a percentage of gross receipts but instead is designed to tax a portion of the taxpayer's net income. As the gross receipts statute indicates and as RAC West's tax policy expert testified, that is exactly how formulary apportionment works for multi-state taxpayers.³

SCDOR also pointed to testimony that retail sales accounted for 87% of RAC West's total corporate income while royalties accounted for only 13%. How this relates to the issue at hand is a mystery, and SCDOR has given no explanation as to why this is relevant to the issue of measuring the taxpayer's business activity in South Carolina. The fact that RAC West's royalty receipts are a relatively low percentage of its income proves nothing and could

³ RAC West's tax policy expert used a pizza pie analogy to illustrate this point. He explained that formulary apportionment takes the total pizza (i.e. the total corporate income of a business in all states) and determines the slice of the pizza that the taxing state should get. R. p. 238 at 49:3-5. Separate accounting, on the other hand, "just want[s] to tax the pepperoni." R. p. 238 at 49:5-7. It seeks to tax only the "high profit item" and ignores the entire pizza. R. p. 238 at 49:19-22.

be true of any taxpayer with multiple lines of business. SCDOR never provided any evidence as to why RAC West's retail sales are not a true reflection of its business activity.

SCDOR also claims that this Court overlooked the fact that RAC West did not operate any retail stores nor did it have any management or employees in South Carolina. However, these facts support RAC West's and not SCDOR's position. All RAC West does in this State is receive royalties from a related company doing business in South Carolina, and even these royalties are primarily the result of activities that take place out-of-state. See supra pp. 2-3. RAC West has no physical presence here. Id. Despite this minimal presence, the royalties from South Carolina have not been ignored but have been placed in the numerator of the apportionment formula. The higher the royalties from South Carolina are, the higher the apportionment ratio will be resulting in increased South Carolina income and tax. The fact that RAC West's activities in this State are minimal cannot be ignored. The standard method has allocated a fair share of RAC West's total income to South Carolina when compared to its minimal activities here.

Finally, SCDOR makes the unsupported and inaccurate assertion that RAC West's "out-of-state retail operations had 'nothing' to do with its trademark activities in South Carolina." Whether this (with all due respect, clearly erroneous conclusion) is true or not, it relates primarily to the unitary question not reached by this Court as directed by the CarMax decision. See infra §III. It simply does not address the threshold question of what substantial proof was offered by SCDOR upon which the ALC could have reached its conclusion that RAC West's minimal activities in this State are not fairly represented by the standard apportionment method.

B. SCDOR Failed to Present Evidence to Support its Assertions that the Retail Sales and Trademark Activities have Widely Divergent Profit Margins and that Combining Both Activities in the Standard Method is a Dilution and Distortion of RAC West's business activity in South Carolina.

SCDOR claims for the first time in this case in its Petition that RAC West's retail sales and trademark activities have widely divergent profit margins and thus that combining these activities is a dilution and distortion of RAC West's business activities in South Carolina.⁴ Although not argued by SCDOR below, the ALC's Order stated that "the evidence does not show that RAC West's retail operations, which generate a very large portion of its gross receipts, contribute a comparable amount to RAC West's net income" and then erroneously concluded that including RAC West's income from its retail sales would dilute its gross receipts and distort its economic activity in this State. Order at p. 11. The implication, which is now being explicitly asserted by SCDOR, is that RAC West's retail business is less profitable than its royalty business. However, the ALC reached this conclusion not based on any evidence in the record (there was none) but on the basis that the evidence did not show that this conclusion was *not* accurate. *Id.* The ALC then cited a California case (which is not even cited in SCDOR's Final Brief before this Court) holding that a taxpayer's investment income from short-term securities distorted the results of the standard apportionment formula because the investments produced less than 2% of the company's business income but 73% of its gross receipts. *Id.* (citing Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178-79 (Cal. 2006)). Thus, the ALC appears to have concluded that because RAC West did not prove that

⁴ Kennedy, 349 S.C. at 532, 564 S.E.2d at 322 (citations omitted) (stating that the purpose of a petition for rehearing is not to "present points which lawyers for the losing parties have overlooked or misapprehended.").

its retail business is as profitable as its royalty business, that amounts to proof of distortion in this case.

However, as this Court properly held, it was not RAC West's burden to prove anything; SCDOR bore the burden of showing that the standard formula did not reasonably represent RAC West's business activities in South Carolina. If SCDOR wanted to try to establish this by showing that the royalty business was more profitable than the retail business, then it could have chosen to do so; however, it presented no such evidence.⁵ The supposed evidence SCDOR points to in its Petition is a general statement by the auditor that a "pure Geoffrey company has very large income, very little expense . . . , " a statement by RAC West's witness that RAC Texas manages RAC West's trademark portfolio, and testimony that SCDOR had requested RAC West's trademark expenses but none had been provided. Petition at pp. 7-8; R. p. 256 and 154. First, a general statement that "a pure Geoffrey company" has a large income and little expense can in no way be considered as evidence as to RAC West's royalty business, nor can a statement that certain functions of the company are outsourced be considered as evidence as to what those functions cost. RAC West could not provide SCDOR with information regarding its royalty expenses because none of the 50 states in which Rent-A-Center operates had ever asked for this information and so it was not tracked. R. p. 132 at 112:1-4. RAC West is under no obligation to create documents that do not exist for SCDOR. SCDOR could have examined RAC West's detailed financial records, which RAC West did provide, and attempted to prepare its own analysis of royalty expenses, but it failed to do so.

⁵ And if evidence that one line was more profitable than another was sufficient to show distortion, then all taxpayers would have to determine the profit margin for each line of business in South Carolina and separately report every line of business with differing profit margins, which would be an administrative nightmare for taxpayers.

Moreover, SCDOR never introduced any evidence in the record regarding the expenses or profitability of RAC West's retail business. Thus, even if the testimony regarding royalty companies in general or the absence of evidence of expenses by the party not bearing the burden of proof was somehow sufficient to establish the profitability of RAC West's royalty business, no comparison (such as was made in Microsoft) could be made vis à vis RAC West's retail business.

Thus, the record is devoid of any facts that would support applying the Microsoft decision here. Additionally, the court in Microsoft based its holding, in large part, on the fact that Microsoft's treasury function was unrelated to its primary business. That is not the case here where RAC West's retail sales business is highly related to and interconnected with its IP business. See Microsoft, 139 P.3d at 1179; RAC West Brief at pp. 4-5 and 28-33. Moreover, Microsoft had complete control over its treasury receipts and could arbitrarily increase them to reduce its California apportionment. That is not the case here because RAC West cannot control its retail sales; only RAC West's customers can do that.

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

III. THE COURT OF APPEALS DID NOT NEED TO REACH THE ISSUE OF WHETHER RAC WEST WAS A UNITARY BUSINESS.

SCDOR claims that this Court failed to consider evidence in the record that RAC West's "out-of-state retail business and its trademark businesses are not unitary" (Petition at p. 4) and claims that the alleged fact that it is not unitary provides additional support for SCDOR's position that the standard method should not be applied. Id. at pp. 10-15.

In its Opinion, this Court determined, as the Supreme Court did in CarMax, that it need not reach the issue of whether RAC West operated a unitary business because SCDOR failed to establish the threshold issue of whether the standard method fairly reflected RAC West's business activities in South Carolina. While RAC West has argued in this case that the fact that it operates a unitary business provides additional support that the standard method does fairly reflect its activities in this State, SCDOR has made no arguments in its briefing in this case that whether RAC West was unitary was relevant, and, in fact, pointed in its Final Brief to the testimony of its expert that whether RAC was unitary was a "red herring." See SCDOR Final Brief at pp. 32-38 (also stating that whether the business is unitary "is not the primary issue that Appellant makes it" and arguing that even if the business is unitary, it can still be separated). Thus, because this argument regarding whether RAC West is operating a unitary business is being asserted for the first time by SCDOR in its Petition for Rehearing, it is not appropriate for this Court to consider it. Kennedy, 349 S.C. at 532, 564 S.E.2d at 322 (citations omitted) (stating that the purpose of a petition for rehearing is not to "present points which lawyers for the losing parties have overlooked or misapprehended.").

However, if this Court does decide to review the issue of whether RAC West operated a unitary business, the overwhelming evidence in the record supports that it was, and RAC

West would submit that this evidence provides additional support for the conclusion that the standard apportionment method fairly reflected RAC West's business activities in South Carolina. See RAC West Brief at pp. 4-5 and 28-39.

CONCLUSION

Based on the foregoing, RAC West respectfully requests that this Court deny SCDOR's Petition for Rehearing.

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Charleston, South Carolina
December 19, 2016

CERTIFICATE OF SERVICE

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

Pleadings:

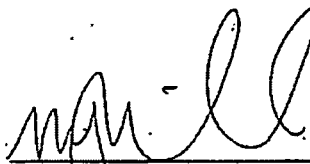
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SC Court of Appeals



Grace Hamill
Administrative Assistant

December 19, 2016

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

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

v.

South Carolina Department of Revenue Respondent.

**APPELLANT'S NOTICE OF SUPPLEMENTAL SUPPORT FOR ITS RETURN TO
PETITION FOR REHEARING**

Pursuant to Rule 240 of the South Carolina Appellate Court Rules, Rent-A-Center West, Inc. ("RAC West") hereby files this Notice of Supplemental Support for its Return to the South Carolina Department of Revenue's ("SCDOR") Petition for Rehearing ("the Return"). Included herewith is Exhibit A, which is an excerpt from the Record on Appeal in *CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014). This portion of the Court's records was referenced in RAC West's Return on p. 10, n. 2.

RAC West files this notice to make this information readily accessible to this Court in the context of these filings. Of course, the attachment is part of this Court's own records and is a matter of public record of which this Court may take judicial notice. As explained below, based on the position that SCDOR has taken in seeking rehearing, it has placed at issue the accuracy of information from this Court's prior proceeding in the *CarMax* matter.

BACKGROUND

In its Petition for Rehearing (the "Petition"), SCDOR asserts that the *CarMax* decision should only be relied upon for its holding that the burden of proof is on the party asserting an alternative method. Petition at p. 5, n. 3. It claims that this Court should ignore the Supreme Court's analysis of the sufficiency of the evidence in *CarMax* based on an isolated statement made by a single dissenting justice stating that the ALC had placed the burden of proof on the taxpayer in *CarMax* and thus it was not surprising that SCDOR did not attempt to offer evidence in support of its position but rather relied on *CarMax* to refute it. Id.

SCDOR did not make this argument relying on the single justice dissent in its Final Brief to this Court, and thus, it cannot raise it now in a Petition for Rehearing. Moreover, RAC West did not have a previous opportunity to address this issue. Further, SCDOR cites no authority in its Petition that would support this Court ignoring binding precedent based on a dissent.

However, in the event this Court considers this argument, it should have the material before it demonstrating, contrary to SCDOR's position, that SCDOR tried the *CarMax* case as if the burden were on it. Return at p. 10, n. 2. More specifically, following *CarMax* counsel's closing arguments in which he argued that the burden of proof should be on SCDOR as the party asserting the alternative method, counsel for SCDOR stated as follows: "Your Honor, we do not disagree with Mr. von Lehe's discussion of our burden in this case. We welcome that burden. If we cannot show that they have not fairly represented their business in South Carolina, we should not be allowed to apply this statute." (R. p. 461; *CarMax* Trial Transcript at p. 443:3-9 (attached hereto as Exhibit A)). Accordingly, RAC West asserted in its Return that this Court properly recognized *CarMax* as binding precedent and properly applied the analysis therein to the facts in this case, which are similar if not identical to those in *CarMax*. Return at p. 10, n. 2. Because

that transcript excerpt is filed in this Court's records in another appeal, this Court necessarily must consider the relevant information in light of SCDOR's position in seeking rehearing.

LEGAL ANALYSIS

RAC West cited to the above-described excerpt from the trial transcript in *CarMax*, which is in the Record on Appeal in that case and is a publicly filed court document. This matter is properly cited in the Return given its existence in this Court's records, and this Court is empowered to take judicial notice of these records on appeal.

"A court can take judicial notice of its own records, files and proceedings for all proper purposes including facts established in its records." *Wise v. Wise*, 394 S.C. 591, 601, 716 S.E.2d 117, 122 (Ct. App. 2011) (citing *Freeman v. McBee*, 280 S.C. 490, 494, 313 S.E.2d 325, 327 (Ct. App. 1984) (taking judicial notice of court records reflecting the disposition of another action involving the same plaintiff). This rule applies even at the appellate level where it would "violate the general principle that appellate review should be limited to the record..." where it is "... limited to matters which are indisputable." *Wise*, 394 S.C. 591, 600-01, 716 S.E.2d at 122 (quoting *Masters v. Rodgers Dev.*, 283 S.C. 251, 256, 321 S.E.2d 194, 197 (Ct. App. 1984).

In this case, the excerpt from the Record on Appeal in *CarMax* should be considered by this Court because of the argument that SCDOR has made in its Petition concerning *CarMax* (which as previously stated was not made in its prior briefing, and, thus, was not preserved for review and could not have been previously addressed by RAC West). More specifically, SCDOR has stated that the Supreme Court's analysis regarding the sufficiency of the evidence should not be considered based on a dissent by a single justice, which speculated that it would not be surprising that SCDOR did not present evidence at trial and instead relied on *CarMax* to prove its case since the ALC found that the burden of proof was on *CarMax*. However, the

dissenting opinion failed to recognize that at trial in *CarMax*, SCDOR tried the case as if the burden were on it.¹ (R. p. 461, attached as Exhibit A, CarMax Trial Transcript at p. 443:3-9.) SCDOR should not be able to now proceed as if the dissenting opinion's statement is valid in light of its own in-court statements to the contrary, and RAC West is entitled to present to this Court the public documents that disprove the mistake of record fact by a dissenting justice.

CONCLUSION

For these reasons and those stated in RAC West's return opposing rehearing, this Court should deny the petition for rehearing.

NELSON MULLINS RILEY & SCARBOROUGH LLP

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December 28, 2016

¹ A lawyer that makes statements on behalf of the client binds the client. *Shelton v. Bressant*, 312 S.C. 183, 184, 312 S.C. 208, 439 S.E.2d 833, 834 (1993) ("Acts of an attorney are directly attributable to and binding upon a client."). This rule encompasses statements made in open court. *Smith v. Pearson*, 210 S.C. 524, 530, 43 S.E.2d 479, 481 (1947) (finding appellants bound by statement made by counsel at the outset of hearing). A party is estopped from taking contrary positions. "Judicial estoppel is an equitable concept that prevents a litigant from asserting a position inconsistent with, or in conflict with, one the litigant has previously asserted in the same or related proceeding." *Cothran v. Brown*, 357 S.C. 210, 215, 592 S.E.2d 629, 631 (2004). "The purpose of the doctrine is to ensure the integrity of the judicial process . . ." *Id.* This same reasoning applies here and should bar SCDOR from asserting a position contrary to that taken in *CarMax*.

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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


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

PROOF OF SERVICE

I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for Rent-A-Center West, Inc., do hereby certify that I have served all counsel in this action with a copy of Appellant's Motion to Supplement Return by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

Counsel Served:

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Columbia, SC 29211


Administrative Assistant

Charleston, South Carolina
December 28, 2016

EXHIBIT A

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT COUNTY

Carolyn C. Matthews, Administrative Law Judge

Case No. 09-ALJ-17-0160-CC

CarMax Auto Superstores West Coast, Inc.....Appellant

v.

South Carolina Department of Revenue.....Respondent

RECORD ON APPEAL - VOLUME I

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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT DIVISION
Docket No. 09-ALJ-17-0160-CC

CarMax Auto Superstores
West Coast, Inc.,

Petitioner,

v.

South Carolina Department of
Revenue,

Respondent.

COPY

ADMINISTRATIVE HEARING

Thursday, February 18, 2010
9:06 a.m. - 5:40 p.m.

AND

Friday, February 19, 2010
9:04 a.m. - 12:26 p.m.

The hearing before the Honorable Carolyn C. Matthews, was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 18th and 19th day of February, 2010 before Cassandra E. Vance, Court Reporter and Notary Public in and for the State of South Carolina.

1 As one final matter, Your Honor, I'd like to
2 discuss the Constitutional issues that were
3 raised in the taxpayer's brief. Your Honor, we
4 do not disagree with Mr. von Lehe's discussion
5 of our burden in this case. We welcome that
6 burden. If we can't show that they have not
7 fairly represented their business in South
8 Carolina, we should not be allowed to apply
9 this statute.

10 But it is fundamental that when a taxpayer
11 raises a possible Constitutional violation,
12 it's their burden to show the Constitution has
13 been violated. No evidence has been presented
14 on that issue, Your Honor. . . . Only legal
15 arguments and bald assertions in the pretrial
16 brief. No testimony or any other evidence has
17 been presented that would establish that any
18 Constitutional rights have been violated in
19 this case and we would ask, Your Honor, that
20 that issue not be considered at all.

21 Your Honor, I have nothing further. We would
22 welcome the opportunity to offer any memos or
23 post-trial briefs the Court feels are necessary
24 at its request.

25 THE COURT: Thank you very much.

RECEIVED

JAN 03 2017

SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608

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

v.

South Carolina Department of Revenue,Respondent.

**REPLY TO APPELLANT'S RETURN TO RESPONDENT'S PETITION FOR
REHEARING AND MOTION TO STRIKE APPELLANT'S RETURN**

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Pursuant to Rules 221(a), 219, and 240 of the South Carolina Appellate Court Rules, Respondent, South Carolina Department of Revenue ("Department" or "Respondent"), hereby files this Reply to Appellant's Return to Respondent's Petition for Rehearing ("Reply") in the above-referenced matter. This Court filed its Opinion number 5447 on October 26, 2016 (the "Opinion"). The Department subsequently served and filed its Petition for Rehearing ("Petition"), which was based on the grounds that the Court overlooked and/or misapprehended the substantial evidence in the record (1) that the Department satisfied its burden of proof and (2) that Appellant's retail and trademark businesses are not unitary businesses. The Appellant served and filed its Return to Respondent's Petition for Rehearing ("Return"). The Department respectfully submits this Reply in response to Appellant's Return. This Reply will assist the Court in this matter.

Further, in its Return Appellant improperly included arguments concerning and a quotation from a Department attorney in closing arguments in a case about another taxpayer. Because such information was not presented to the Administrative Law Court in this matter, it is not available pursuant to appellate court rules to be in the record on appeal in this case; therefore, the Department respectfully requests that the entire Return be stricken or alternatively that the last four sentences of Footnote 2 beginning with "Moreover" be stricken from the Return.

INTRODUCTION

In its recitation of "relevant facts" and despite the fact that nexus with South Carolina is not an issue in this case, Appellant downplays its relationship to South Carolina and tries to divert this Court's focus away from Appellant's substantial intangible assets in South Carolina. Appellant stated, "It has no physical presence in South Carolina as it has no employees, facilities or tangible property in this State. It also makes no sales in South Carolina and receives *de minimus*, if any, services or benefits from the State." (Appellant's Return, p. 3.) Downplaying Appellant's

relationship with South Carolina essentially supports the Department's position that Appellant's trademark licensing activities in South Carolina are not unitary with the substantial out-of-state retail business that Appellant conducts.

However, Appellant's ties to South Carolina are substantial even though these ties are related only to Appellant's trademark licensing business. It licenses its trademarks and trade names to Rent-A-Center East, Inc., an affiliate that operates retail stores in South Carolina. (See e.g., R. pp. 354, 383-390.) Therefore, Appellant owns intangible property that exists and is used in South Carolina. (See e.g., R. p. 131, Tr. 106:3-6.) Additionally, when the affiliate makes retail sales in South Carolina, Appellant earns a royalty of 3% of each sale and accordingly has an accounts receivable, another intangible asset, that was created in and is owed from South Carolina. (R. p. 389.)

The South Carolina Supreme Court has found that owning and licensing intangible assets for use in South Carolina are important ties to South Carolina and are not to be taken lightly. In *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13 (1993), the Supreme Court held "that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey has the 'minimum connection' with this State that is required by due process." 313 S.C. at 19, 437 S.E. 2d at 16. The Supreme Court also found that the presence of an accounts receivable due from a South Carolina affiliate to the out-of-state licensor of the trademarks and tradenames was a separate intangible asset owned by the licensor that sustains a South Carolina tax on that out-of-state licensor. *Id.* at 19-20, 437 S.E.2d at 16. Further, the Supreme Court stated, "It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus." *Id.* at 23, 437 S.E.2d at 18.

Although nexus is not an issue in this case, Appellant's lack of a physical presence, lack of any personnel/payroll, and lack of any retail sales in South Carolina (R. pp. 131, Tr. Day 1 105:14-24) and the existence of substantial intangibles assets in South Carolina (R. pp. 131, Tr. Day 1 106:3-9) are evidence of the disconnectedness between Appellant's brick-and-mortar out-of-state retail operations and its intangible-based in-state trademark licensing business.

Appellant's recitation of "relevant facts" also continues to mischaracterize the Department's alternative apportionment method as a flat tax on gross receipts that ignores Appellant's net income. (*See e.g.*, Appellant's Return, pp. 3, 7.) However, the Department sought to determine and tax only the net income generated by Appellant's trademark business activity in South Carolina by calculating its South Carolina royalty income and subtracting all trademark-related expenses.¹ The Department's expert testified that the Department's alternative method of taxing the difference between the South Carolina royalty income and the proven trademark-related expenses was "in proportion to what goes on in the state." (R. p. 274, Tr. Day 2 196:5-8.) The Department's alternative method to tax only the net income of Appellant's trademark business in South Carolina was appropriate as it satisfied the overarching requirement of any apportionment method to impose a tax based on the proportion of taxpayer's business activity within South Carolina, *see* S.C. Code Ann. § 12-6-2210(B) (2014), so Appellant's characterization of the Department's alternative method as a flat tax and not in compliance with South Carolina law is misguided.

¹ In the Field Audit Report dated March 12, 2008, the Department's Audit Division stated that the Department would deduct trademark-related expenses from the South Carolina royalty income if Appellant could prove that expense was related to the production of the royalty income. (R. p. 342 n. a.)

Appellant's mischaracterization of the Department's alternative method is also misguided because Appellant failed to identify and substantiate any trademark-related expenses that could be deducted from its South Carolina royalty income. Testimony showed that the Department sought Appellant's expenses related to its trademark business so that such expenses could be deducted from its royalty income. (R. pp. 254-55, Tr. Day 2 116:21-107:4.) Testimony also showed that these trademark expenses are often minimal (R. p. 256, Tr. Day 2 122:6-13) and that another entity, Rent-A-Center Texas, L.P., incurs such trademark licensing expenses anyway (see R. pp. 154-55, Tr. Day 1 197:25-198:5, 199:12-16, 200:8-202:2). Although an employee of Appellant testified that Appellant had previously never been asked for its trademark expenses, at least three important pieces of evidence support Appellant's ability to identify its trademark-related expenses. First, Appellant's witness, the Director of Tax Audits, Planning, and Research for Rent-A-Center Texas, L.P., who has been a CPA for more than thirty years (R. pp. 124-25, Tr. Day 1 80:22-81:19), testified that Appellant operates two lines of business – retail stores in the western United States and ownership of certain intellectual property (R. p. 125, Tr. Day 1 84:20-22). He also testified that Appellant can determine the net income of its retail stores by store and by state (R. p. 151, Tr. Day 1 185:19-186:5), which means that it can also determine the net income (and related expenses) of its other business, the trademark business. Second, the Department's expert on law and economics testified that he heard no evidence to lead him to believe that Appellant's retail business cannot be separated from its trademark business. (R. pp. 273, 277, Tr. Day 2 189:2-16, 206:2-7.) He also testified that it is common through managerial and costs accounting to separate the income and expenses of different lines of business to determine profitability of each line of business and that Appellant should also be able to use accounting methods to financially separate its two lines of business. (R. pp. 291-92, Tr. Day 2 264:12-266:4.) Third, Appellant's consultant in his "Profit

Distribution" report was able to calculate a royalty fee to be paid to Appellant by affiliates who used Appellant's trademarks and trade names (R. pp. 409-77), implying that trademark expenses are identifiable. Based on all of the evidence presented at the hearing, the ALC found that Appellant "failed to adequately establish that it incurred expenses in conducting its trademark business." (R. p. 7.) The Department's alternative method was proper; it was Appellant's failure to identify and substantiate any trademark-related expenses that allowed Appellant to mischaracterize the Department's alternative method. The power to prove such expenses was always with the Appellant.

LAW

The South Carolina Appellate Court Rules state, "The Record shall not, however, include matter which was not presented to the lower court or tribunal." Rule 210(c), SCACR.

For matter presented to the lower court, "after argument commences, a party desiring to supplement the Record on Appeal must move the appellate court for leave to do so. In response to that motion, the other party(s) shall designate any supplemental materials which that party desires to add if the Court grants the motion." Rule 212(b), SCACR.

LEGAL ANALYSIS

In its Petition, the Department stated that the Court overlooked or misapprehended the substantial evidence that exists in the Record on Appeal that supports the ALC's finding that the Department satisfied its burden to prove that the statutory gross-receipts formula did not fairly reflect Appellant's business activity in South Carolina and the substantial evidence that exists in the Record on Appeal that demonstrates that Appellant's out-of-state retail business and its trademark business are unrelated and not unitary; hence these two activities cannot be combined into one formulary apportionment method. The Return merely tells this Court to ignore the

evidence presented by the Department and relied upon by the ALC and not to defer to the ALC, the finder-of-fact, despite the existence of such evidence in the record and the clear use of such evidence in some cases by the ALC.² Accordingly, this Court should modify its Opinion to deny the relief sought by Appellant and affirm the ALC's order on all issues, or alternatively it should rehear this matter.

Further, Appellant has included material in its Return that is not in the Record on Appeal and is not available to be included in the record because it was not presented to the lower court. Accordingly, the Department has been prejudiced by that inclusion, and this Court should strike the Return.

I. THIS COURT SHOULD MODIFY ITS OPINION TO AFFIRM THE ORDER OF THE ADMINISTRATIVE LAW COURT OR SHOULD REHEAR THIS MATTER.

Appellant's Return is not sufficient to refute the fact that the Department presented sufficient evidence at the ALC hearing to satisfy its burden of proof. This case is not a replay of *CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014). In the instant case, the Department presented sufficient evidence to satisfy its burden of proof and this Court should give deference to the ALC, the finder-of-fact in this case, who heard the facts and judged the credibility of the witnesses and ruled in favor of the

² For example, although this Court stated that the DOR auditor "did not point to any specific evidence" that the gross-receipts method did not fairly represent RAC West's business activity in South Carolina, the ALC's order proves otherwise. In finding that the gross-receipts method does not meet this requirement for Appellant, the ALC relied upon the following facts presented by the DOR auditor by testimony or in his audit report: (1) Appellant does not operate any retail stores in South Carolina (R. p. 4), (2) Appellant's only business in South Carolina was its trademark licensing business (R. p. 5), (3) Appellant's gross-receipts consisted of 87% retail sales and only 13% trademark licensing fees (R. p. 6), (4) based on various financial numbers presented, the ALC found that Appellant's use of the gross-receipts method resulted on only 4.68%, 1.53%, and 0% of Appellant's South Carolina gross-receipts for 2004, 2005, and 2006, respectively, were determined to be taxable in South Carolina (R. pp. 6-7).

Department. Therefore, this Court should modify its opinion to deny the relief sought by Appellant and affirm the ALC's order on all issues, or alternatively it should rehear this matter.

A. The Department Presented Substantial Evidence to Satisfy its Burden of Proof Demonstrating that the Standard Gross-Receipts Apportionment Formula Did Not Fairly Reflect the Extent of Appellant's Business Activity in South Carolina.

This Court wrongly found that the Record on Appeal does not contain substantial evidence to support that the Department satisfied its burden (Opinion, p. 13), and Appellant wrongly argues in its Return that the evidence identified by the Department in its Petition consisted of unsupported assertions, evidence that does not support the Department's position, or evidence that has not been previously argued (Appellant's Return, p. 11). This case is NOT a replay of *Carmax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014) as this Court implies. (Opinion, p. 13.) Instead, the Record on Appeal in this case is replete with evidence that supports the ALC's finding that the Department satisfied its burden to prove that the statutory gross-receipts apportionment formula used by Appellant did not fairly represent the extent of Appellant's business activity in South Carolina. Accordingly, this Court should modify its Opinion to affirm the ALC Order or should rehear this matter.

In its Return, Appellant recites some of the evidence in the Record on Appeal that the Department asserts to support the Department's position. (Appellant's Return, pp. 10-11.) However, the Record on Appeal includes other evidence. In fact, the ALC identified many other facts and evidence that it used to find that the standard gross-receipts apportionment method did not fairly represent Appellant's business activity in this State. The ALC's findings of fact plus the evidence that Appellant notes include the following:

1. Rent-A-Center East, Inc. (RAC East) operates retail stores in South Carolina (R. p. 4);

2. Appellant operates retail stores in the western United States and licenses "Rent-A-Center" intellectual property to RAC East (R. p. 4);
3. Appellant's "only activity in South Carolina is its receipts of those royalties for use of the Rent-A-Center related trademarks, so its "only business in South Carolina is its trademark business" (R. pp. 4-5);
4. The revenues from Appellant's retail stores in other states are unrelated to Appellant's trademark business in South Carolina (R. p. 6);
5. In all applicable tax years, 13% of Appellant's gross receipts were from its trademark business while 87% of its gross-receipts was from its out-of-state retail business (R. p. 6);
6. In 2004 (and similarly for other years at issue), Appellant had gross receipts from retail of \$368,782,164.65 and from royalties of only \$55,221,912.35 (R. p. 6);
7. In 2004 Appellant generated royalties of \$861,437 in South Carolina (R. p. 6);
8. Appellant failed to establish any trademark-related expenses (R. p. 7);
9. Appellant's combined retail and royalty net income for 2004 was \$19,840,800 but only \$40,317 of that net income was apportioned to and taxed in South Carolina (R. p. 6);
10. Only 4.68%, 1.53%, and 0% of Appellant's royalty receipts from South Carolina for 2004, 2005, and 2006, respectively, were taxed in South Carolina based on Appellant's use of the standard gross-receipts method (R. pp. 6-7);
11. Appellant's retail business dilutes the impact of Appellant's royalty income (R. p. 6);
12. Appellant's consultant was able to place a value on Appellant's trademark business when it determined as documented in the transfer pricing study that is in the Record that a 3% royalty fee is an arms-length fee (R. p. 8);

13. Being able to separately value the trademark business "negates [Appellant's] contention from a taxing perspective of an 'inextricable' relationship" between the retail and trademark businesses (R. p. 8); and
14. Appellant presented "no evidence [that] RAC West actually manages the trademarks that it owns" as "RAC Texas manages RAC West's trademark's and RAC West's employees manage its retail operations" (R. p. 8).

As is evident, the ALC heard, considered, and used many facts and calculations in its analysis. The ALC did not conduct an insufficient *Carmax*-like analysis, and it properly placed the burden of proof on the Department. Based on its thorough analysis of the evidence, the ALC determined that the standard gross-receipts apportionment method "significantly diluted its South Carolina taxable income" and that its much larger retail gross receipts "caused a distorting result." (R. pp. 8-9.) As the trier-of-fact, the ALC was in the best position to determine the facts of this case. See *Risher v. S.C. Dep't of Health & Envtl. Control*, 393 S.C. 198, 201, 712 S.E.2d 428, 435 (2011).

Additionally, Appellant denied in its Return that this Court overlooked important evidence. For example, this Court overlooked evidence presented by the Department's auditor. In its Opinion, this Court stated that the auditor "did not point to specific evidence the standard apportionment method did not fairly represent RAC West's business activities" but instead merely testified that the investigation started because Rent-A-Center was comprised of multiple entities and that the management fee was too high. (Opinion, p. 13.) However, the Department's auditor testified to much more. For example, the auditor testified that the only business that Appellant engages in in South Carolina is its royalty business, that a retail business and a trademark-licensing business have "nothing" to do with each other, that Geoffrey type businesses (i.e., companies that

license trademarks generally incur minimal expenses), and that Appellant's total net income from its trademark business in South Carolina "was strictly [its] royalty income." (R. pp. 253-54, Tr. Day 2 111:10-115:19; R. p. 256, Tr. Day 2 122:6-13, 124:18-25). However, the auditor went further. In his audit report, which was issued to the Appellant and which the Appellant was allowed to discuss with the Department's Audit Division long before this litigation commenced, the auditor stated:

Taxpayer has no income in the state of South Carolina other than royalty income that is generated by the operations of Rent-A-Center East All expenses shown on US1120 of taxpayer did not occur within the state of South Carolina nor did they bear any relationship to royalty income and should not be considered in the calculation of apportionable income to South Carolina. . . . The apportionable income above [i.e., the South Carolina royalty income] was generated exclusively within the state of South Carolina.

(R. p. 342 n. a, b.) The auditor continued:

CONCLUSION: Since the taxpayer's only business activity in South Carolina is the receipt of royalty income, pursuant to SC Code Section 12-6-2320, separate accounting is required on the royalty receipts. This method more fairly represents this taxpayer's activity in South Carolina.

(R. p. 343.)

This Court and Appellant also overlook the substance of the testimony of the Department's expert in law and economics. This seemed to imply that one of Dr. Harrison's statements was a "bald assertion[]" (Opinion, p. 13), but Dr. Harrison's testimony and opinions were substantive and on point. Dr. Harrison used the apples and oranges analogy to characterize the fact that Appellant has two different lines of business. Here, the issue is whether combining the retail and trademark businesses into the same standard gross-receipts apportionment method fairly reflects Appellant's business activity in South Carolina. Dr. Harrison testified that it did not but that the Department's alternative method of taxing the difference between the South Carolina royalty income and the proven trademark-related expenses was "in proportion to what goes on in the state."

(R. p. 274, Tr. Day 2 196:5-8.) As an economist, Dr. Harrison used the phrase "economic nexus with the state of South Carolina" as synonymous with the use of the phrase "the taxpayer's business activity with this State" in section 12-6-2320(A) and testified "it would be absolutely essential" to exclude the retail operations of Appellant "to come up with a tax burden that fairly represented the economic nexus of [Appellant] with South Carolina. (R. p. 274, Tr. Day 2 195:24-196:8, 196:18-25.)

Further, despite Appellant's bald assertions, sufficient evidence exists in the Record on Appeal to support the divergent profit margins (and the analogy of apples and oranges) between Appellant's retail and trademark businesses and the applicability of *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750, 139 P.3d 1169 (Cal. 2006). See Petition, pp. 7-9.

Based on the evidence in the Record on Appeal, the ALC therefore concluded that the Department properly determined that the standard gross-receipts method did not fairly reflect the extent of Appellant's business activity in South Carolina. (R. p. 9.) Looking at the Record on Appeal as a whole, reasonable minds can make the same decision as the ALC made, see *Olson v. South Carolina Dep't of Health & Envtl. Control*, 379 S.C. 57, 663 S.E.2d 497 (S.C. Ct. App. 2008), and this Court "may not substitute its judgment for the judgment of the ALC as to the weight of the evidence on questions of fact," S.C. Code Ann. § 1-23-610 (Supp. 2014). Accordingly, pursuant to South Carolina law that defines the applicable standard of review in this case, this Court should modify its Opinion to deny the relief sought by Appellant and affirm the ALC's order in full.

B. The Department Presented Substantial Evidence that Appellant's Out-of-State Retail Business and its Trademark Businesses Are Unrelated and Not Unitary.

It is a question of fact whether Appellant's retail and trademark businesses are unitary. Once that question of fact is resolved, the application of law will determine which apportionment

method(s) to use. In its Opinion, this Court did not address whether these businesses were unitary. (Opinion, p. 14 n. 4.) However, these different lines of business must be unitary for the Appellant to combine its retail and trademark receipts into the same gross-receipts apportionment formula. S.C. Reg. 117-710.2 (stating that multi-state unrelated businesses determine their South Carolina net income separately and that unitary businesses are subject to the apportionment formulas with respect to the unitary business but not the unrelated business); *see also Exxon Corp. v. South Carolina Tax Comm'n*, 273 S.C. 594, 596-602, 258 S.E.2d 93, 94-97 (1979) (finding that Humble Oil's exploration and production activities were unitary with its refining and sales activities, so all of the unitary activities were to be combined into the tax base upon which Exxon's South Carolina taxable income would be calculated); *Eastman Kodak Co., v. South Carolina Tax Comm'n*, 308 S.C. 415, 420, 418 S.E.2d 542, 544-45 (1992) (allowing deductions for the safe harbor leasing business in South Carolina only because that activity was unitary with Kodak's other taxable activities in South Carolina). If they are not unitary, then the Appellant's use of a single gross-receipts formula is improper and this Court must affirm the ALC's ruling on this ground.³

The Department has made its arguments on this issue in its Petition. (Petition, pp. 10-15). The Department also clarified some facts in the Introduction to this Reply above. In these clarifications, the Department shows that when Appellant downplays its nexus with South Carolina, it is actually demonstrating that its retail business is so much different than its in-state

³ S.C. Code Ann. § 12-6-2302(A) does not use the term "unitary" and does not therefore impose that analysis on a proponent of an alternative method of apportionment. Therefore, if this Court finds that there was sufficient evidence in the Record on Appeal that the standard gross-receipts method did not fairly reflect Appellant's business activity in South Carolina, then there is no need to address whether the lines of business are unitary. However, if the Court finds that there is not sufficient evidence in the Record to make that showing, this Court must still determine whether there is sufficient evidence in the Record on Appeal to show that the lines of business are unitary because lines of business that are not unitary cannot be combined into a single gross-receipts apportionment method as Appellant did here.

However, Appellant is wrong to conflate the apportionment in the instant case with the apportionment in *Eastman Kodak* and in Professor Pomp's unitary pizza pie analogy. Unlike in *Eastman Kodak*, in the instant case it is wrong to determine which piece of the entire pie should be apportioned to and taxed in South Carolina by using a standard formulary apportionment method because the entire pie (i.e., here Appellant's gross receipts from both its trademark and retail activities) does not consist of only unitary activities. Appellant's pie consists of "unrelated" in-state trademark activities and out-of-state retail activities, so the gross receipts of the two unrelated activities cannot be combined into one standard gross-receipts formula.

Accordingly, the instant case and the application of Professor Pomp's pizza pie example to Kodak's unitary businesses are inapposite because Kodak's lease transactions were unitary with its other activities while the ALC found Appellant's trademark and retail activities to be "unrelated" and this Court made no finding whatsoever concerning the unitary nature of Appellant's in-state and out-of-state activities. Therefore, it is wrong to combine Appellant's two activities into one pizza pie (i.e., into one formulary apportionment method) for purposes of South Carolina apportionment.

Appellant's use of *Eastman Kodak* to support its argument is flawed, and this Court should use *Eastman Kodak* to support the Department's position that only unitary business activities should be combined into one formulary apportionment formula.

II. THIS COURT SHOULD STRIKE APPELLANT'S RETURN WHICH INCLUDES MATTER NOT IN THE RECORD ON APPEAL AND NOT AVAILABLE TO BE IN THE RECORD ON APPEAL

In its Return, Appellant improperly includes a quotation from the Department's counsel purportedly made during closing arguments in an ALC hearing in a case against another taxpayer and improperly makes arguments based on this quotation. This quotation and related arguments

are included in Footnote 2 to the Return. (Appellant's Return, p. 10 n.2.) Appellant included a quotation from "counsel for SCDOR" purportedly made during "closing arguments" and cited multiple lines from the "CarMax Trial Transcript." (Appellant's Return, p. 10 n.2.) Appellant also included arguments based on the quotation in the sentence before and the sentence after the two-sentence quotation. (Appellant's Return, p. 10 n.2.). Neither the trial transcript from the ALC hearing in the *CarMax* case (i.e., ALC Docket No. 09-ALJ-17-0160-CC) nor the quotation itself are in the record of this case (*see* R. Vol. I pp. 1-224, Vol. II pp. 225-499, Vol. III pp. 500-543) and neither is available for being included in the record of this case because neither was presented to the ALC (Rule 210(c), SCACR; R. Vol. I pp. 104-180, Vol. II pp. 225-298).

The quotation and the related arguments will not be repeated in this motion as their mere presence in this document would prejudice the Department. Such prejudice is reason to strike the entire Return as any person who has read the Return has already been influenced by the inclusion of information that is not in the record and is not available to be included in the record.

Additionally, Appellant has not filed a motion to supplement the record pursuant to Rule 212(b), SCACR. Further, although the rule states that Appellant can move to supplement the record "after argument commences," Rule 212(b), SCACR, supplementing the record after the Court has issued its decision cannot be consistent with the intent of the rule.

Accordingly, the Department respectfully requests that this Court strike the entire Return because it includes information not in the record and not available to be in the record and that the Return as filed has already prejudiced the Department. Although the Department believes that striking the entire Return is appropriate, if this Court decides not to do so, it should strike the last four sentences of Footnote 2 of the Return. If the Court does not strike anything from the Return and although the Appellant has not asked to supplement the record by adding the quotation in

trademark business that nexus with South Carolina is minimal. Additionally, Appellant's lack of a physical presence, lack of any personnel/payroll, and lack of any retail sales in South Carolina (R. pp. 131, Tr. Day 1 105:14-24) and the existence of substantial intangibles assets in South Carolina (R. pp. 131, Tr. Day 1 106:3-9) are evidence of the disconnectedness between Appellant's brick-and-mortar out-of-state retail operations and its intangible-based in-state trademark licensing business.

This is not a new issue. The facts about whether the businesses are unitary are in the Record on Appeal. It is a determination of fact that can be made that will affect the application of law.

C. Appellant Confuses the Issues by Conflating the Instant Case with *Eastman Kodak* and Professor Pomp's Unitary Pizza Pie Analogy.

Appellant unsuccessfully tried to instruct this Court on the law in the section of its Return titled, "South Carolina Law on Corporate Income Tax for Multi-State Taxpayers," but Appellant failed to mention that the safe-harbor lease transactions that were included in the standard apportionment formula in *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 418 S.E.2d 542 (1992), were part of Kodak's unitary business. See 308 S.C. at 420, 518 S.E.2d at 544. (Appellant's Return, pp. 6-7.)

The instant case however is different. First, the ALC found that Appellant's out-of-state retail business was "unrelated" to its trademark business. (R. pp. 5, 7-8.) Such a statement by the ALC implies that the ALC found that Appellant's two lines of business were not unitary. Second, this Court did not address whether Appellant's two lines of business were unitary. (Opinion, p. 14 n. 4.) Third, in *Eastman Kodak*, some of the property related to the activity in question, the safe harbor lease transactions, was located in South Carolina, *Eastman Kodak*, 308 S.C. at 417, 518 S.E.2d at 543, while here Appellant did not operate the activity in question, its retail operations, in

South Carolina and therefore had no tangible property or payroll in South Carolina, (R. p. 125, Tr. Day 1 84:20-22; R. p. 105, Tr. Day 1 105:14-22).

Just looking at *Eastman Kodak*, Appellant is correct to conflate the unitary activities of Kodak that included the safe harbor lease transactions with Professor Pomp's pizza pie analogy because formulary apportionment is intended to estimate the piece of the entire pie that should be taxed in a state. Appellant states that Professor Pomp testified that using a standard formulary apportionment method is supposed to determine how much of total corporate net income from all states South Carolina should tax. (Appellant's Return, p. 9.) However, as discussed above, for formulary apportionment purposes the entire pie (or the amount of corporate net income to be apportioned) must consist of only unitary business activities of the taxpayer. Here, Appellant's tax-policy expert admitted that only net income of unitary activities is to be apportioned using formulary apportionment. (R. p. 402.) Professor Pomp defined the issue in this case as whether "RAC West [should] be taxable on a slice of its total unitary income, which consists of its royalties and income from stores" and continued by stating that "the size of the pizza [to be apportioned by formulary apportionment] is determined by the unitary taxable income of the corporation." (R. p. 402.) In the case of *Eastman Kodak*, Professor Pomp's pizza pie analogy in which the activities of all unitary business activities of a taxpayer are combined into one formulary apportionment method was appropriate because the South Carolina Supreme Court found "the safe harbor lease transactions to be part of Kodak's unitary business." Therefore, the lease transactions "were properly included in the denominator of the apportionment formula" (i.e., the safe harbor lease transactions were included in the entire pie to be apportioned). *Eastman Kodak*, 308 S.C. at 419-420, 518 S.E.2d at 544.

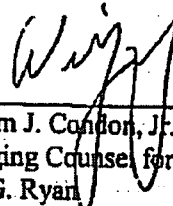
Footnote 2, the Court should grant the Department ten days to provide additional materials to Appellant to include in the record consistent with the principles of Rule 212(b), SCACR.

CONCLUSION

For the reasons specified herein, the Department respectfully requests that this Court grant its Petition for Rehearing and/or issue a new opinion denying the relief requested by Appellate and affirming the judgement of the ALC.

Further, the Department respectfully requests that this Court strike the entire Return or alternatively strike the last four sentences of Footnote 2 of the Return or alternatively grant the Department ten days to provide additional materials to Appellant to include in the record consistent with the principles of Rule 212(b), SCACR.

Respectfully submitted,



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Columbia, South Carolina
January 3, 2017

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

RECEIVED

JAN 03 2017

SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608


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

v.

South Carolina Department of Revenue,Respondent.

PROOF OF SERVICE

I, Tonie M. Miranda, do hereby certify that I have caused to be mailed, via United States Postal Service, postage prepaid, a copy of the South Carolina Department of Revenue's Reply to Appellant's Return to Respondent's Petition for Rehearing and Motion to Strike Appellant's Return in the above-referenced matter to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, Nelson, Mullins, Riley & Scarborough, LLP, P.O. Box 1806, Charleston, SC 29402-1806 on this 3rd day of January, 2017.


Tonie M. Miranda

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

RECEIVED
JAN 09 2017
SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608

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

v.

South Carolina Department of Revenue,Respondent.

RETURN TO APPELLANT'S NOTICE OF SUPPLEMENTAL SUPPORT FOR ITS
RETURN TO PETITION FOR REHEARING

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Appellant filed Appellant's Notice of Supplemental Support for its Return to Petition for Rehearing ("Notice") in the above-referenced matter as a motion or petition pursuant to Rule 240, SCACR. Respondent, South Carolina Department of Revenue ("Department" or "Respondent"), hereby files this Return to Appellant's Notice pursuant to Rule 240(c), SCACR.

After this Court filed its Opinion number 5447 in this case on October 26, 2016 (the "Opinion"), the Department timely served and filed its Petition for Rehearing ("Petition"). The Appellant then served and filed its Return to Respondent's Petition for Rehearing ("Return"). The Department responded by serving and filing its Reply to Appellant's Return to Respondent's Petition for Rehearing and Motion to Strike Appellant's Return ("Reply and Motion").

In its Return, Appellant's argument included a quotation from a Department attorney's closing arguments during an Administrative Law Court ("ALC") hearing in a different case against a different taxpayer. This quotation was not presented to the ALC in the instant case and is not in the Record on Appeal in the instant case. Appellant did not seek to supplement the Record on Appeal but instead now argues that this Court should take judicial notice of the quotation. This Court should not take judicial notice of this quotation.¹

INTRODUCTION

The appeal in this matter was held in abeyance pending the outcome of an appeal of an income tax dispute between the Department and another taxpayer, Carmax Auto Superstores West Coast, Inc. On December 23, 2014, the South Carolina Supreme Court issued its opinion in that case setting forth that the proponent of an alternative apportionment method bears the burden of

¹ Additionally, this Court should grant the Department's previously filed Motion to Strike Appellant's Return because the inclusion of the quotation prejudices the Department by including and arguing based on a quotation that is not in the Record on Appeal and is not available to be put into the Record under Rule 210(c), SCACR. Further, Appellant did not move to supplement the record under Rule 212(b), SCACR. See the Department's Reply and Motion.

proving by a preponderance of the evidence that (1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternative accounting method is reasonable. *Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, 411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014).

Subsequently this appeal commenced, and recently the Appellant filed its Return including the quotation made during closing arguments when the ALC heard the case between the Department and Carmax. (Appellant's Return, p. 10 n.2.) The Appellant cited the three-sentence quotation with "CarMax Trial Transcript at p. 443:3-9." (Appellant's Return, p. 10 n.2.) Further, the Appellant included an argumentative sentence before and after the quotation that were based on the quotation. (Appellant's Return, p. 10 n.2.)

Regarding the burden of proof, the ALC placed the burden of proof on Carmax, the taxpayer. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep't of Revenue*, Final Order and Decision, No. 09-ALJ-17-0160-CC, p. 6 (ALC Apr. 22, 2010). The Court of Appeals in its decision recognized and found that the ALC wrongly placed the burden of proof on Carmax. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep't of Revenue*, 397 S.C. 604, 611, 725 S.E.2d 711, 714 (Ct. App. 2012). The Supreme Court similarly recognized that the ALC found that Carmax bore the burden of proof. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep't of Revenue*, 411 S.C. 79, 87, 767 S.E.2d 195, 199 (2014). The Supreme Court settled the burden issue by holding that the proponent of the alternative method bears the burden of proof that "(1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternative accounting method is reasonable." *Id.* at 89, 767 S.E.2d at 200.

Regarding the application of the burden to the evidence by the Supreme Court, the Supreme Court's majority decision indicates that the parties agreed for the sake of judicial economy to

resolve the case in the Supreme Court instead of remanding the matter to the ALC for a proper application of the burden to the evidence. *See id.* at 90, 767 S.E.2d at 200 n. 10. The majority decision also noted that to show that the statutory formula did not fairly represent Carmax's business activity in South Carolina that the Department "merely 'described what it did rather than cite any evidence justifying what it did'" and that "the Department relied on CarMax West to refute its use of an alternative formula." *Id.* After considering the above, the dissenting Justice wrote the following:

Since we are holding that the burden of proof is on the Department, I agree with the Court of Appeals that we should remand this matter to the ALC for reconsideration. Whether the Department can meet its burdens are questions of fact which, in my opinion, should not be decided on certiorari despite the parties' agreement that we do so. The ALC placed the burden of proof on CarMax West, and accordingly its findings of fact and conclusions of law are premised on that error of law. It is therefore not surprising that as the majority states, "the Department relied on CarMax West to refute [the Department's] use of an alternative formula," or that the Department, lacking any burden of proof, largely offered evidence of what it did rather than why it did it.

Id. at 92, 767 S.E.2d at 201 (Pleicones, J., dissenting).

LAW

This Court's review is limited to the Record on Appeal. "Except as provided by Rule 212 and Rule 208(b)91(C) and (2), the appellate court will not consider any fact which does not appear in the Record on Appeal." Rule 210(h), SCACR.

The South Carolina Appellate Court Rules state, "The Record shall not, however, include matter which was not presented to the lower court or tribunal." Rule 210(c), SCACR.

For matter presented to the lower court, "after argument commences, a party desiring to supplement the Record on Appeal must move the appellate court for leave to do so. In response

to that motion, the other party(s) shall designate any supplemental materials which that party desires to add if the Court grants the motion." Rule 212(b), SCACR.

LEGAL ANALYSIS

In its Return, Appellant improperly included a three-sentence quotation from the closing arguments of a different case against a different taxpayer and used that quotation to argue its position in this case. Both were inappropriate, and this Court should not take judicial notice of the quotation, as requested by Appellant in its Notice, and should not consider its related argumentative sentences.

Additionally, although Appellant styled this Notice to be solely about taking judicial notice of the quotation from a different case against a different taxpayer, Appellant took the opportunity to argue that this Court should not consider the Department's argument that this Court should use *Carmax* to only impose the proper burden of proof on the proper party. It is absurd to ignore (1) that the ALC in *Carmax* wrongly placed the burden of proof placed on *Carmax*, not on the Department; (2) that this error is very likely to have an important effect on how each party presented its case, the ALC's evaluation of the same and the ALC's final written order, (3) that the Supreme Court in *Carmax* did not hear the evidence and judge the credibility of witnesses in real time like the ALC did in the instant case, and (4) that the parties in *Carmax*, solely for the sake of judicial economy, agreed to resolve the case in the Supreme Court instead of remanding it to the ALC. Therefore, this Court should limit its use of *Carmax* solely for the legal conclusion regarding the burden of proof and no more, as the Department stated in its Petition.

- I. **THIS COURT SHOULD NOT TAKE JUDICIAL NOTICE OF THE QUOTATION FROM CLOSING ARGUMENTS IN A DIFFERENT CASE AGAINST A DIFFERENT TAXPAYER.**

This Court should not take judicial notice of the quotation that Appellant provided and from which it argued in its Return. The cases cited by Appellant are distinguishable and do not support the taking of judicial notice of files in the Court's records from a different case against a different taxpayer.

A. The Case Law Cited by Appellant Does Not Support Taking Judicial Notice Here.

Appellant cites three South Carolina Court of Appeals cases to argue that “[b]ecause [the Carmax trial] transcript excerpt is filed in this Court’s records in another appeal, this Court necessarily must consider the relevant information” (Appellant’s Notice, 2-3), and wants the Court take judicial notice that the quotation allegedly proves the fact that the Department tried the *Carmax* case in the ALC as if ALC had placed the burden of proof on the Department (Appellant’s Return, p. 10. n. 2; Appellant’s Notice, p. 3-4). However, the cases cited by Appellant do not support taking judicial notice here because of procedural and party differences and because the quotation at issue is not an adjudicative fact.

Appellant cites *Freeman v. McBee*, 280 S.C. 490, 313 S.E.2d 325 (Ct. App. 1984), in which the court stated, “A court can take judicial notice of its own records, files and proceedings for all proper purposes including facts established in its records.” (Appellant’s Return, p. 3.) Although this sentence in isolation seems rather broad, the *Freeman* Court in the next two sentences significantly narrowed a court’s ability to take judicial notice of its own records, files, or proceedings. Following the above sentence cited by Appellant, the *Freeman* Court wrote:

It is not error for a judge to take judicial notice of what was *stated in a former opinion in a prior action of the same case*. Thus, it was proper for the court to take judicial notice of the consent to dismiss with prejudice in its own order

Freeman, 280 S.C. at 494, 313 S.E.2d at 327 (citations omitted) (emphasis added).

In *Freeman*, the parties had been granted a divorce in an earlier proceeding. A little more than two and a half years after the Family Court issued the divorce order, the husband initiated a contempt proceeding to enforce that divorce order. The husband sought an order to have the ex-wife sign the necessary papers to remove her name from a real estate document consistent with the divorce order. The Court of Appeals indicated that the divorce proceeding and the contempt proceeding were the "same case." Certainly, both proceedings consisted of the same parties, and the contempt proceeding was to enforce an earlier court order issued to those same parties.

Here, the earlier proceeding was a case between Carmax and the Department, while the later proceeding is between Appellant and the Department. Unlike in *Freeman*, the two proceedings are not between the same parties, and the *Freeman* Court limited judicial notice to "what was stated in a former opinion in a prior action of the same case." This is not the case here. Appellant is not seeking this Court to take judicial notice of a "former opinion," but a statement by an attorney in closing arguments, which is not even admissible evidence. Certain *Carmax* and the instance case are not the "same case." The order in *Carmax* did not impose a duty on Appellant that needs to be enforced. The only thing that *Carmax* imposes on this case is the proper burden of proof, which is not the issue in this case.

Appellant also cites *Masters v. Rodgers Development Group, S.C., Inc.*, 283 S.C. 251, 321 S.E. 2d 194 (Ct. App. 1984), in which the court wrote:

Appellate courts are generally reluctant to notice adjudicative facts even when those facts may be absolutely reliable. Notice of "facts" for the first time on appeal may deny the adverse party the opportunity to contest the matters noticed; it may also violate the general principle that appellate review should be limited to the record. Finally, appellate courts, limited to the "cold" record, cannot be as sensitive to the appropriateness of judicial notice as the trial judge. For the foregoing reasons we hold that *original judicial notice of adjudicative facts* at the appellant level should be limited to matters which are indisputable.

283 S.C. at 256, 321 S.E.2d at 197 (citations omitted) (emphasis added).

In *Masters*, Masters was a plumbing contractor who sought to foreclose a mechanic's lien on a subsequent owner of real property. *Id.* at 252-53, 321 S.E.2d at 195. Masters agreed to perform services for the prior owner of the property, who transferred the property by deed to a new owner before Masters completed the work. *Id.* at 253, 321 S.E.2d at 195. After the work was completed, the prior owner refused to pay Masters, and Masters filed a notice of mechanic's lien and initiated the action to foreclose the lien after the new owner had purchased the property. *Id.* Masters named both the prior owner and the new owner of the property in the foreclosure action. *Id.* at 251, 321 S.E.2d at 194. Although the new owner did not have actual notice of the lien when he purchased the property, the issue was whether the new owner purchased the property for valuable consideration. *Id.* at 254-55, 321 S.E.2d at 196. During oral arguments in the Court of Appeals, not at trial, the new owner asked the Court to take judicial notice of the recitals in the deed transferring the property from the prior owner to the new owner. *Id.* at 255, 321 S.E.2d at 196. The Court refused to take judicial notice of the recitals in the deed because they did "not constitute 'indisputable matter.'" *Id.* at 256, 321 S.E.2d at 197. The Court found that, although the deed and its recitals are found in the public records, "[w]hether [the new owner] paid valuable consideration is not 'common or general knowledge'" and "mere recitals in a deed do not establish, as against strangers, facts recited there." *Id.* at 256-57, 321 S.E.2d at 197.

Masters is also distinguishable from the instant case. First, in *Masters*, there was only one proceeding and all applicable parties were part of the foreclosure action from the start. Here, Carmax and the instant case are different actions brought by different taxpayers. In *Masters*, both the prior owner and the new owner of the property were parties to the deed and its recitals. Second, the *Masters* Court says that an appellate court may take judicial notice of only indisputable

adjudicative facts. *Id.* at 256, 321 S.E.2d at 197. A statement by the Department's attorney in closing arguments is not an adjudicative fact. In fact, it is not even admissible evidence.

Even if the Court does not agree that *Masters* is distinguishable, the reason that the *Masters* Court chose not to take judicial notice of the recitals is similar to the facts here. Just as the *Masters* Court found the recitals not to be indisputable matter, how the Department tried its case in *Carmax* also is not indisputable. As stated above, the ALC imposed the burden of proof on *Carmax*, which the Court of Appeals and the Supreme Court – both the justices in the majority and the dissenting justice – acknowledged. Similar to *Masters*, just because the *Carmax* transcript is a public record does not mean that how the Department tried its case with *Carmax* is common or general knowledge, and a statement by an attorney in closing arguments does not indisputably prove how the Department tried its case.

Finally, Appellant cites *Wise v. Wise*, 394 S.C. 591, 716 S.E.2d 117 (Ct. App. 2011), in which the *Wise* Court cites both *Freeman* and *Masters*. (Appellant's Notice, p. 3.) By citing *Wise*, Appellant has finally cited a decision in which there were, in fact, two different cases; however, these two cases – one a workers' compensation case and the other a civil tort case – arose from the same set of facts. *See* 394 S.C. at 594, 716 S.E.2d at 118 (stating that *Wise* "appeal[ed] the circuit court's dismissal of his workers' compensation claim that arose from the same facts as the civil action he settled against a third party and a default judgment he obtained against his employer").

Wise is a workers' compensation action in which the related civil action became relevant. The relevant issue in *Wise* was whether the circuit court could take judicial notice that *Wise* filed a civil action and recovered damages against his employer. *Id.* at 600-01, 716 S.E.2d at 122. The *Wise* Court took judicial notice of the summons and complaint and default judgment in the civil suit because these court documents were indisputable. *Id.* at 601, 716 S.E.2d at 122.

Wise is also distinguishable because the *Wise* Court took judicial notice of a summons, a complaint, and a default judgment. Each of these documents is a document either filed with or issued by a court. They were used by the *Wise* Court to prove that Wise filed a separate civil suit and that he recovered damages against his employer. *Id.* The mere existence of these three court documents provides the proof. They were indisputable. Here, Appellant wants this Court to take judicial notice not of filings or court-issued orders but of a statement in a closing argument by an attorney in an entirely different matter. Although the fact that the attorney made the statement may be indisputable, such a statement in closing arguments is by its own nature an argument – not a fact - and, unlike the three court documents in *Wise*, does not by itself prove how the Department conducted its trial in *Carmax*. The statement is therefore disputable and not ripe for judicial notice.

The *Masters* Court stated, “appellate courts, limited to the ‘cold’ record, cannot be as sensitive to the appropriateness of judicial notice as the trial judge,” *Masters*, 283 S.C. at 256, 321 S.E.2d at 197, and this matter deserves such sensitivity. This Court should find that the cases cited by Appellant do not support the taking of judicial notice in this case.

B. Appellant’s Broad Reading of the Case Law Cited by Appellant Is Not Consistent with the Law.

Appellant broadly interprets the three cases cited in its Notice to mean that this Court may take judicial notice and any record, file, or proceeding in this Court’s own records. (Appellant’s Notice, p. 1, 3 (saying the *Carmax* transcript in the ALC “is part of this Court’s own records”).) Such a broad interpretation is not appropriate as explained above; however, Appellant’s broad reading of the cases is also not appropriate here because the matter of which Appellant seeks this Court to take judicial notice is not an adjudicative fact.

Rule 201, SCRE “governs only judicial notice of adjudicative facts.” Rule 201(a), SCRE; *see also Masters v. Rodgers Development Group, S.C., Inc.*, 283 S.C. 251, 256, 321 S.E. 2d 194,

197 (Ct. App. 1984) (saying that an appellate court may take judicial notice of only indisputable adjudicative facts).

Blacks defines "adjudicate" as "to rule upon judicially." *Black's Law Dictionary* 42 (7th ed. 1999). Therefore, an adjudicative fact is a finding of fact by the applicable court. Here Appellant seeks this Court to take judicial notice of a three-sentence quotation by a Department attorney in his closing arguments to the ALC in the *Carmax* case and then argues that this statement means that the Department tried the *Carmax* case in the ALC as if it had the burden of proof. (Appellant's Notice, p. 1; Appellant's Return, p. 10 n. 2.) These are not adjudicative facts. Pursuant to Rule 201, SCRE and *Masters*, this Court may not take judicial notice of the quotation at issue and Appellant's accompanying arguments.

C. Appellant Incorrectly Asserts that the Department Has Placed at Issue the Accuracy of Information from this Court's Prior Proceeding in the *Carmax* Matter.

Appellant wrongly asserts that the Department "has placed at issue the accuracy of information from this Court's prior proceeding in the *CarMax* matter." (Appellant's Notice, p. 1.) The Department has not done so. As described above, the ALC, the Court of Appeals, and the Supreme Court – both the justices in the majority and the dissenting justice – recognized that the ALC in the *Carmax* case placed the burden of proof on Carmax.

The ALC placed the burden of proof on Carmax, the taxpayer. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep't of Revenue*, Final Order and Decision, No. 09-ALJ-17-0160-CC, p. 6 (ALC Apr. 22, 2010). The Court of Appeals in its decision recognized and found that the ALC wrongly placed the burden of proof on Carmax. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep't of Revenue*, 397 S.C. 604, 611, 725 S.E.2d 711, 714 (Ct. App. 2012). These are indisputable facts as evidenced in at least three decisions, as cited above. The Department in no

way is questioning the accuracy of information from this Court's *Carmax* proceeding. The Department merely stated in its Petition that this Court should rely on the Supreme Court's decision in *Carmax* only for the holding that the proponent of the alternative apportionment method bears the burden of proof. (Department's Petition, p. 5 n.3.)

Because the cases cited by Appellant do not support judicial notice in this case, Appellant does not seek judicial notice of an adjudicative fact, and the Department has not questioned information in this Court's *Carmax* proceeding, this Court should not take judicial notice of the quotation in the trial transcript in a different case against a different taxpayer and Appellant's accompanying arguments from that quotation.

II. THIS COURT SHOULD RELY ON *CARMAX* SOLELY FOR THE LEGAL CONCLUSION REGARDING THE BURDEN OF PROOF AND NOT MORE, AS THE DEPARTMENT ARGUED IN ITS PETITION.

Although Appellant styled this Notice to be solely about taking judicial notice of the quotation from a different case against a different taxpayer, Appellant took the opportunity to argue that this Court should not consider the Department's argument that this Court should use *Carmax* to only impose the proper burden of proof on the proper party. It is absurd to ignore (1) that the ALC in *Carmax* wrongly placed the burden of proof placed on Carmax, not on the Department, (2) that this error is very likely to have an important effect on how each party presents its case, (3) that the Supreme Court in *Carmax* did not hear the evidence and judge the credibility of witnesses in real time like the ALC did in the instant case, and (4) that the parties solely for the sake of judicial economy agreed to resolve the case in the Supreme Court instead of remanding it to the ALC. Therefore, this Court should limit its use of *Carmax* solely for the legal conclusion regarding the burden of proof and no more, as the Department stated in its Petition.

A. The Department Is Not Relying on an Isolated Statement by a Single Dissenting Judge But Is Relying on the Opinions of Three Courts.

Appellant argues that the Department:

“[C]laims that this Court should ignore the Supreme Court’s analysis of the sufficiency of the evidence in CarMax based on an isolated statement made by a single dissenting judge stating that the ALC had [placed the burden of proof on the taxpayer in CarMax and thus it was not surprising that [the Department] did not attempt to offer evidence in support of its position but rather on CarMax to refute it.”

(Appellant’s Notice, p. 2.)

It is without doubt, however, that the Department did not rely on “an isolated statement made by a single dissenting judge.” As shown above, the ALC placed the burden of proof on Carmax, the taxpayer. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep’t of Revenue*, Final Order and Decision, No. 09-ALJ-17-0160-CC, p. 6 (ALC Apr. 22, 2010). The Court of Appeals clearly understood that the ALC wrongly placed the burden of proof on Carmax. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep’t of Revenue*, 397 S.C. 604, 611, 725 S.E.2d 711, 714 (Ct. App. 2012). Finally, the Supreme Court similarly recognized that the ALC found that Carmax bore the burden of proof. *Carmax Auto Superstores West Coast, Inc., v. S.C. Dep’t of Revenue*, 411 S.C. 79, 87, 767 S.E.2d 195, 199 (2014).

B. Any Evaluation of Evidence by the Supreme Court in *Carmax* Is Not Binding Precedent.

Appellant appears to want this Court to accept *Carmax* as “binding precedent” regarding the sufficiency of the evidence. (Appellant’s Notice, p. 2.) The Department recognizes the binding nature of the Supreme Court decision on who has the burden of proof and what that burden is and believes that this is the sole legal conclusion that this Court should use from *Carmax*. (Department’s Petition, p. 5 n.3.)

Because of the imposition of the burden on the wrong party and the difference in taxpayers and the evidence presented in each case, the Supreme Court's evaluation regarding the sufficiency of evidence in *Carmax* is not binding on this Court. Regarding application of the burden to the evidence by the Supreme Court in *Carmax*, the majority decision indicates that the parties agreed for the sake of judicial economy to resolve the case in the Supreme Court instead of remanding the matter to the ALC for a proper application of the burden to the evidence. *See Carmax*, 411 S.C. 90, 767 S.E.2d at 200 n.10. It is reasonable to believe that since the ALC imposed the burden on the wrong party, that its analysis of the facts to the law may have been affected and that the record, as seen and used by the Supreme Court, may similarly have been affected. That may be why the *Carmax* majority noted that to show that the statutory formula did not fairly represent Carmax's business activity in South Carolina, the Department "merely 'described what it did rather than cite any evidence justifying what it did'" and that "the Department relied on CarMax West to refute its use of an alternative formula." *Id.* After considering the above, the dissenting Justice wrote that whether the Department can meet its burdens are questions of fact which the Supreme Court should not decide. *Id.* at 92, 767 S.E.2d at 201 (Pleicones, J., dissenting).

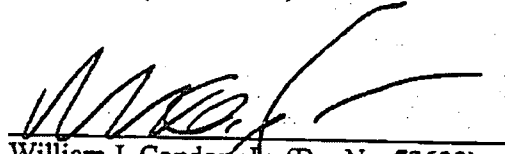
Based on the above, this Court should rely on *Carmax* solely for the legal conclusion regarding the burden of proof and no more.

CONCLUSION

For the reasons specified herein, the Department respectfully requests that this Court deny Appellant's request that this Court take judicial notice of a quotation by a Department attorney from closing arguments in a different case and against a different taxpayer when the quotation was not in the Record on Appeal in the instant case.

Further, the Department respectfully requests that this Court use *Carmax* solely for the legal conclusion regarding the burden of proof and no more.

Respectfully submitted,



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January 9, 2017

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

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SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

The Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 09-ALJ-17-0204-CC
Appellant Case No. 2012-208608

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

v.

South Carolina Department of Revenue,Respondent.

PROOF OF SERVICE

I, Jean M. O'Connor, do hereby certify that I have caused to be mailed, via United States Postal Service, postage prepaid, a copy of the South Carolina Department of Revenue's Return to Appellant's Notice of Supplemental Support for Its Return to Petition for Rehearing in re: Rent-A-Center West, Inc., v. South Carolina Department of Revenue, to John C. Von Lehe, Jr. and Bryson M. Geer, Esquires, Nelson, Mullins, Riley & Scarborough, LLP, P. O. Box 1806, Charleston, SC 29402-1806 on this 9th day of January 2017.



Jean M. O'Connor

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

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

v.

South Carolina Department of Revenue Respondent.

**APPELLANT'S RESPONSE TO RESPONDENT'S MOTION TO STRIKE AND REPLY
TO RESPONDENT'S RETURN TO APPELLANT'S NOTICE OF SUPPLEMENTAL
SUPPORT**

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Attorneys for Rent-A-Center West, Inc.

Charleston, South Carolina
January 12, 2017

Pursuant to Rule 240 of the South Carolina Appellate Court Rules, Rent-A-Center West, Inc. ("RAC West") hereby files this Response to the South Carolina Department of Revenue's ("SCDOR") Motion to Strike¹ (the "Motion") and its Reply to Respondent's Return to Appellant's Notice of Supplemental Support for its Return to Petition for Rehearing (the "Reply").

INTRODUCTION

SCDOR's Motion to Strike seeks to strike RAC West's entire Return to SCDOR's Petition for Rehearing based on RAC West's reference in a footnote to a quote by SCDOR's counsel in *CarMax Auto Superstores West Coast, Inc. v. S.C. Dept. of Rev.*, 411 S.C. 79, 767 S.E.2d 195 (2014), which is in the Record on Appeal in that case and a matter of public record. Both this Motion as well as SCDOR's Reply (which contains similar assertions and reasoning) are without merit.

RAC West referenced this cite only in response to a new argument made by SCDOR for the first time in its Petition for Rehearing ("SCDOR's Petition"), which asserted that this Court should not rely on *CarMax* giving a basis that was contradicted by SCDOR's own counsel's statement at trial. RAC West did not cite to a case involving some random other taxpayer but rather cited from the case that SCDOR claims should not be relied upon by this Court, and calling the Court's attention to SCDOR's own statement that contradicts its assertions is clearly proper under the law regarding judicial notice. Moreover, SCDOR's claim of some unnamed prejudice has no merit, and, to the contrary, it is RAC West that would be prejudiced should SCDOR be allowed to assert an argument that is based on inaccurate facts. For the reasons set forth below, SCDOR's Motion to Strike should be denied.

¹ SCDOR filed its Motion to Strike as part of its Reply to Appellant's Return to SCDOR's Petition for Rehearing, which was filed with this Court on January 3, 2017.

BACKGROUND

In its Petition, SCDOR asserts that the *CarMax* decision should only be relied upon for its holding that the burden of proof is on the party asserting an alternative method. Petition at p. 5, n. 3. It claims that this Court should ignore the Supreme Court's analysis of the sufficiency of the evidence in *CarMax* based on an isolated statement made by a single dissenting justice stating that the ALC erroneously placed the burden of proof on the taxpayer in *CarMax* and thus it was not surprising that SCDOR did not attempt to offer evidence in support of its position but rather relied on the taxpayer to refute it. Id. In other words, SCDOR is arguing that the Supreme Court's analysis of the facts in *CarMax* should not be given any weight by this Court with the primary basis appearing to be an inference that SCDOR did not present its full case at that trial but rather relied upon *CarMax* to refute it.

In its Return, RAC West pointed out to this Court that the statement made by the dissenting justice was actually inaccurate as SCDOR's counsel stated in open court at the close of the *CarMax* trial that it welcomed the burden of proof being placed upon it;² thus, SCDOR would not have tried its case as if the burden was on *CarMax*. See Return at p. 10, n. 2. RAC West then filed a Notice of Supplemental Support for Its Return to Petition for Rehearing ("Notice of Supplemental Support") to provide this Court with a copy of the relevant page from the hearing transcript in that matter, which is in the appellate court records and is a matter of public record, so that this Court could have all relevant information before it on this issue.

SCDOR has now filed a Motion to Strike, which seeks to strike Appellant's Return in its entirety, on the basis that this information was not presented to the Administrative Law Court

² The exact statement by counsel for SCDOR was as follows: "Your Honor, we do not disagree with Mr. von Lebe's discussion of our burden in this case. We welcome that burden. If we cannot show that they have not fairly represented their business in South Carolina, we should not be allowed to apply this statute." (R. p. 461; *CarMax* Trial Transcript at p. 443:3-9 (attached to RAC West's Notice of Supplemental Support at Exhibit A)).

("ALC") in this matter and therefore may not be cited pursuant to Rule 210(c) and/or 212(b) of the South Carolina Appellate Court Rules and because considering this information will prejudice SCDOR. Motion at pp. 1, 5 and 16. In the alternative, it asks this Court to strike the last four sentences of footnote 2 or to allow it to provide supplemental materials in response pursuant to Rule 212(b) SCACR. *Id.* at 16-17. SCDOR also filed a Return to RAC West's Notice of Supplemental Support that made similar arguments. As will be discussed below, SCDOR's position is without merit, and its Motion to Strike should be denied.

LEGAL ANALYSIS

RAC West's citation to the quote from the *CarMax* transcript was proper because SCDOR raised the issue of the *CarMax* dissent in its Petition, the Court's own records contain information showing the dissent's factual assumptions (and thus its conclusion) to be inaccurate, and these records may be cited under the case law regarding judicial notice.

First, RAC West did not offer this quote in any underlying briefs in this appeal or at the ALC because SCDOR had never made this argument regarding the single justice dissent in *CarMax*. SCDOR improperly made this argument for the first time in its Petition for Rehearing. Although this argument was not timely raised and should not be considered by this Court, in an abundance of caution and in the event that the Court does consider SCDOR's new argument, RAC West submitted the material to the Court that it would need to evaluate it, namely the statement by SCDOR's counsel at trial showing that SCDOR accepted the burden of proof at trial and thus would have tried its case accordingly.

A. This Court May Take Judicial Notice of the CarMax Transcript as it is in the Court's Own Records.

RAC West's reference to this quote is proper because it is in the Record on Appeal in that case and is a publicly filed court document. "A court can take judicial notice of its own records,

files and proceedings for all proper purposes including facts established in its records." *Wise v. Wise*, 394 S.C. 591, 601, 716 S.E.2d 117, 122 (Ct. App. 2011) (citing *Freeman v. McBee*, 280 S.C. 490, 494, 313 S.E.2d 325, 327 (Ct. App. 1984) (taking judicial notice of court records reflecting the disposition of another action involving the same plaintiff). This rule applies even at the appellate level where it would "violate the general principle that appellate review should be limited to the record. . ." where it is ". . . limited to matters which are indisputable." *Wise*, 394 S.C. 591, 600-01, 716 S.E.2d at 122 (quoting *Masters v. Rodgers Dev.*, 283 S.C. 251, 256, 321 S.E.2d 194, 197 (Ct. App. 1984).

Here, this Court may take judicial notice of the quote from the Court's records in *CarMax* as it is a matter that is indisputable, i.e. that SCDOR took the position at trial that it bore the burden of proof and that if it could not establish that the taxpayer did "not fairly represent[] [its] business in South Carolina, [SCDOR] should not be allowed to apply this statute." *See* R. p. 461; *CarMax* Trial Transcript at p. 443:3-9 (attached to RAC West's Notice of Supplemental Support at Exhibit A). The law is clear that a statement made by a party's counsel in open court is binding on that party. *See Shelton v. Bressant*, 312 S.C. 183, 184, 312 S.C. 208, 439 S.E.2d 833, 834 (1993) ("Acts of an attorney are directly attributable to and binding upon a client."); *Smith v. Pearson*, 210 S.C. 524, 530, 43 S.E.2d 479, 481 (1947) (finding appellants bound by statement made by counsel at the outset of hearing).³ Furthermore, SCDOR's counsel was obviously correct in his candid and straightforward position that SCDOR had the burden of proof.

³ Additionally, generally a party is estopped from taking contrary positions. "Judicial estoppel is an equitable concept that prevents a litigant from asserting a position inconsistent with, or in conflict with, one the litigant has previously asserted in the same or related proceeding." *Cothran v. Brown*, 357 S.C. 210, 215, 592 S.E.2d 629, 631 (2004). "The purpose of the doctrine is to ensure the integrity of the judicial process" *Id.* This same reasoning applies here even more so as SCDOR is not simply asserting a different position in this case as

This excerpt must, in fairness, be considered by this Court because SCDOR has argued in its Petition that the Supreme Court's analysis regarding the sufficiency of the evidence should not be considered based on the dissent by a single justice speculating that it would not be surprising that SCDOR did not present evidence at trial and instead relied on CarMax to prove its case as the ALC found that the burden of proof was on CarMax.⁴ However, the dissenting opinion failed to recognize that at trial in *CarMax*, SCDOR accepted (and, in fact, welcomed) that it bore the burden of proof. (R. p. 461; CarMax Trial Transcript at p. 443:3-9 (attached to RAC West's Notice of Supplemental Support at Exhibit A)). Thus, SCDOR would have tried the case (quite accurately) as if it bore the burden of proof,⁵ and if it did not, it was certainly not due to the ALC's subsequent erroneous ruling several months later that CarMax bore the burden of proof. SCDOR should not be allowed to now proceed as if the dissenting opinion's statement is valid in light of the clear facts in the *CarMax* transcript to the contrary.

it did in *CarMax*, but rather is relying on the inaccurate statement by the dissenting opinion to convey that SCDOR did not take the position that it actually took in *CarMax*.

⁴ SCDOR makes an argument in its Reply that it "did not rely on 'an isolated statement made by a single dissenting justice'" but rather relied on "the [o]pinions of [t]hree Courts." Reply at p. 11 (heading) and 12. It then goes on to discuss the ALC decision, which erroneously placed the burden of proof on CarMax, and the opinions of the Court of Appeals and the Supreme Court recognizing that this was improper. The point being made by this argument is a mystery to RAC West. Which party bears the burden of proof is not at issue in this appeal. The statement made by the dissenting justice regarding how SCDOR tried its case is the issue raised by SCDOR in its Petition and is the reason for RAC West's cite to *CarMax*. If SCDOR is not relying on this dissent's statement and is willing to strike that from its Petition, then RAC West would agree to strike its reference to the *CarMax* transcript.

⁵ It would have been non-sensical for SCDOR to have tried the case as if CarMax bore the burden of proof when both parties took the position that SCDOR bore that burden, and the ALC had not yet ruled or otherwise indicated. SCDOR could not have been impacted in any way at trial (and more specifically, in its decisions as to how to try its case and what evidence to submit) by the ALC's subsequent ruling several months later that CarMax bore the burden of proof.

SCDOR claims that the Court should not take judicial notice of the statement by its counsel because "how the Department tried its case in *CarMax* also is not indisputable." Reply at p. 8. However, how the Department tried its case is not the statement on which RAC West is asking this Court to take judicial notice. The statement referenced in the transcript is SCDOR's counsel's acceptance of the burden of proof at trial, and it is indisputable that the statement was made. Each party is free to make its arguments regarding whether or how this statement impacts this appeal, but there is no dispute whatsoever that SCDOR accepted the burden of proof at trial, and this Court is entitled to know this in light of SCDOR's arguments.

SCDOR argues that it has not "placed at issue the accuracy of information from this Court's prior proceeding in the *CarMax* matter" Reply at p. 10. However, by quoting and relying on the dissent's erroneous statement, SCDOR has done just that. Thus, again, RAC West is entitled to show that SCDOR actually accepted the burden of proof at trial.

B. South Carolina Appellate Court Rules 210(c) and 212(b) and South Carolina Rule of Evidence 201 are Not Applicable.

SCDOR cites Rule 210(c) SCACR, which prevents inclusion of materials not considered by the ALC in the Record on Appeal, Rule 212(b) SCACR, which requires parties desiring to supplement the Record on Appeal to seek leave of Court to do so, and SCRE 201, which governs admissibility of certain matters at trial. However, those rules are inapplicable here as RAC West has not sought to supplement the Record on Appeal or to introduce evidence at trial. Instead, RAC West has asked this Court to take judicial notice of material in its own records, which as previously discussed is proper under the law.

C. SCDOR Has Suffered No Prejudice.

SCDOR also claims that it has suffered prejudice by RAC West's inclusion of this statement from its counsel. SCDOR does not articulate how it has been prejudiced, and given

that it does not assert that its counsel's statement has been misquoted, it is difficult to understand how it could be prejudiced. To the contrary, it is RAC West that will be prejudiced if SCDOR is allowed to make its argument that *CarMax*'s analysis of the facts should be disregarded because of the dissent's statement that the ALC's decision improperly placed the burden of proof on the taxpayer and thus it was not surprising that SCDOR did not present its case and relied on the taxpayer to refute it when, in fact, its own counsel accurately stated at trial that the burden should be on SCDOR and thus would have presented its case accordingly.

D. CarMax is Binding Precedent as to All Issues Considered Therein.

SCDOR argues in its Petition and its Reply that CarMax should be considered only for the legal proposition of which party bears the burden of proof. *See* Petition at p. 5, n. 3; Return at p. 11. SCDOR cites no law for this proposition and bases its argument solely on the statement at issue here by the dissent in *CarMax*.

In *CarMax*, the parties agreed to have the Supreme Court review the record and determine if SCDOR had met its burden of proof. Whether this was done for "judicial economy" as the Department now alleges or whether it was done because the parties each believed that it had met its burden of proof is unknown; however, the only important point is that each party agreed to have the Supreme Court review the evidence and decide if SCDOR had met its burden of proof. The Supreme Court reviewed the record and stated what was necessary for SCDOR to meet its burden and found that it had not done so. It is patently erroneous to say that the Supreme Court's ruling as to what facts are insufficient to meet this burden is not binding precedent for a later decision (i.e. this decision) involving precisely the same issue. *See* S.C. Const. Art. V, § 9 ("[I]t is incumbent upon the court of appeals to apply this Court's precedent"); *State v. Phillips*, 416 S.C. 184, 194, 785 S.E.2d 448, 453 (2016)

(holding that "[t]he decisions of the Supreme Court shall bind the Court of Appeals as precedents.").

E. The Relief Requested by SCDOR is Not Appropriate.

SCDOR requests that this Court strike the entire Return due to the inclusion of the excerpt from *CarMax* from the Court's records. It cites no law that would support striking an entire brief based on a reference therein to a matter of public record, and RAC West is not aware of any. SCDOR asks, alternatively, that this Court strike the last four sentences in footnote 2. RAC West opposes this as well based on the law previously discussed that would allow this Court to take judicial notice of this citation in its records. As a final alternative, SCDOR asks this Court to allow it to submit additional materials. RAC West opposes this as well. SCDOR raised this issue in its Petition and should have included a discussion of all facts that were relevant; it chose not to do so. In the alternative, in the event the Court determines that SCDOR should be allowed to supplement on this issue, SCDOR should be limited to referencing any other portions of the *CarMax* transcript that should be considered on this issue.

CONCLUSION

Based on the foregoing, RAC West respectfully requests that this Court deny SCDOR's Motion to Strike and allow RAC West's supplemental support.

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Charleston, South Carolina
January 12, 2017

THE STATE OF SOUTH CAROLINA
In The Supreme Court

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

Case No. 09-ALJ-17-0204-CC
Appellate Case No. 2017-000265

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S.C. SUPREME COURT

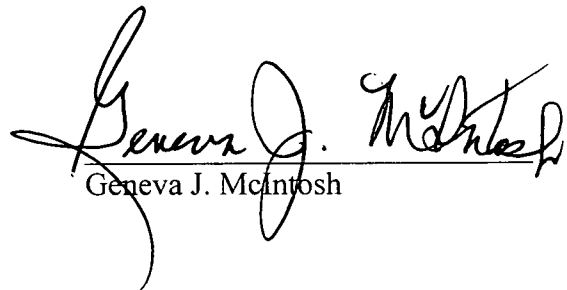
Rent-A-Center West, Inc.,.....Respondent,

v.

South Carolina Department of Revenue,.....Petitioner.

PROOF OF SERVICE

I, Geneva J. McIntosh, do hereby certify that I have hand delivered VIA Personal Delivery, the Department's Revised Copies of the Appendix in re: Rent-A-Center West, Inc., Respondent, v. South Carolina Department of Revenue, Petitioner, Appellate Case No. 2017-000265, Trial Court Case No. 09-ALJ-17-0204-CC, to John C. von Lehe, Jr. and Bryson M. Geer, Esquires, Nelson Mullins Riley & Scarborough, LLP, P.O. Box 1806, Charleston, SC 29402-1806 on this 4th day of May, 2017.


Geneva J. McIntosh