

EXHIBIT B

August 20, 2012

Briani Bennett Mellen
Associate
Admitted in SC, NC

VIA HAND DELIVERY

The Honorable Ralph K. Anderson III
South Carolina Administrative Law Court
Edgar A. Brown Building
1205 Pendleton Street, Suite 224
Columbia, SC 29201

RECEIVED
JAN 03 2013
SC Court of Appeals

Re: Duke Energy Corporation v. South Carolina Department of Revenue
Case No. 10-ALJ-17-0270-CC

Dear Judge Anderson:

Enclosed please find one original and one copy of the following documents to be filed in the above matter.

1. Motion for Reconsideration of the Court's Order Granting the South Carolina Department of Revenue's Motion for Summary Judgment as to the Waiver and Gross Receipts Issues; and

2. Duke Energy's Memorandum of Authorities in Support of the above Motion.

Please return the file stamped copy to us via our courier. Copies of this filing are being served on counsel of record.

If there are any questions, or if the Court requires anything further, please let me know.

Very truly yours,



Briani Bennett Mellen

Enclosures

cc: Tracey C. Green, Esquire
John M. S. Hoefer, Esquire
John Roberts, Esquire
Harry Hancock, Esquire
Milton Kimpson, Esquire
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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

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JAN 03 2013

SC Court of Appeals

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

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

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

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

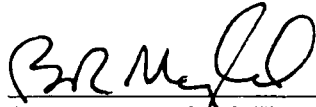
As more fully set out in the attached Memorandum of Authorities filed contemporaneously herewith, Duke Energy respectfully submits that the Court should reconsider its ruling with respect to (1) the Waiver Issue because an evidentiary hearing is necessary to resolve the material facts in dispute with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

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

Respectfully submitted this 20 day of August 2012.



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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

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

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

INTRODUCTION

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

FACTUAL AND PROCEDURAL BACKGROUND

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

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

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

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

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

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

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

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

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

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

STANDARD OF REVIEW

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

ARGUMENT AND CITATION OF AUTHORITY

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

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

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

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

II. The Court Erred in Concluding that Duke Energy Is Not Permitted to Include the Principal from Sales of Securities in Its Apportionment Formula.

1. The Court Erred in Concluding that the Inclusion of the Principal from Sales of Securities in the Standard Apportionment Formula Would Encourage Distortion or Inevitably Result in Distortion.

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

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

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

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

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

...

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

...

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Id. at 265, at 485.

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

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

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

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

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

Id. at 419.

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

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

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

application of the alternative apportionment formula and thus an absurdity.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

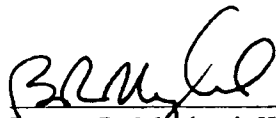
income and thus includable in the apportionment formula denominator, or non-business income and thus allocable. The court held that the receipts at issue constituted business income and were properly includable in the apportionment formula. The Court correctly noted the use of the phrase “net sales,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

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

CONCLUSION

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

Respectfully submitted this 20 day of August 2012.



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STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DUKE ENERGY CORPORATION,

Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF
REVENUE,

Respondent.

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

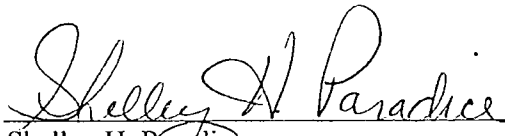
CERTIFICATE OF SERVICE

The undersigned, being an employee of Nexsen Pruet, LLC, hereby certify that on the 20th day of August, 2012 the following document were served upon the following by hand delivery:

1. Duke Energy's Motion for Reconsideration of the Court's Order Granting the South Carolina Department of Revenue's Motion for Summary Judgment as to the Waiver and Gross Receipts Issues; and
2. Duke Energy's Memorandum of Authorities in Support of Motion for Reconsideration of the Court's Order Granting the South Carolina Department of Revenue's Motion for Summary Judgment as to the Waiver and Gross Receipts Issues.

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AUG 20 2012

SC ADMIN. LAW COURT

Exhibit A

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT DIVISION
Docket No. 10-ALJ-17-0270-CC

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

(C O Y)

MOTIONS HEARING

Tuesday, June 26, 2012
9:56 a.m. - 2:22 p.m.

The hearing before the Honorable Ralph King Anderson, III, was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 26th day of June, 2012 before Cassandra E. Vance, Court Reporter and Notary Public in and for the State of South Carolina.

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1 MR. GREEN: Thank you, Your Honor.

2 THE COURT: All right.

3 REPLY ARGUMENT BY MR. GREEN:

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

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

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

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

1 transactions that we're dealing with here.
2 The taxpayer's argument is to include the
3 principal from the return of that loan here,
4 which is the same as the type of transaction
5 the intangibles address in the prior agency
6 rulings.
7 So we'd submit, Your Honor -- and we'd submit
8 that even aside from the agency precedent,
9 frankly, by applying the material -- or the
10 authorities and sources we've referenced in our
11 brief, it would lead you to the same
12 conclusion, which is that including principal
13 in transactions such as these is inappropriate
14 and does not provide a reasonable basis on
15 which to determine income properly reported in
16 South Carolina.

17 **THE COURT:** Well, when you say it doesn't provide a
18 reasonable basis, is that analysis more one
19 that should be made in the second stage of --
20 by this case or is that one that is one that is
21 more -- I know you're going to say "yes," so
22 it's more proper in determining what the
23 statute says.

24 **MR. GREEN:** Admittedly, Your Honor, they're probably
25 a pretty similar analyses, frankly. I think

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

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

7 MR. GREEN: Yes, sir.

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

10 MR. GREEN: If you --

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

12 MR. GREEN: Gross receipts.

13 THE COURT: Receipts, yeah.

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

25 THE COURT: Yeah.

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

8 THE COURT: Okay.

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

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

19 MR. GREEN: There --

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

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

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

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

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

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

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

20 THE COURT: And who falls in it?

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

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

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

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

9 THE COURT: And not?

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

12 THE COURT: And why would 22...

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

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

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

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

Exhibit B

15x page
of Brief
Can't even
read it on
microfilm

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STATEMENT OF ISSUES ON APPEAL¹

I.

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

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

II.

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

III.

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

STATEMENT OF THE CASE

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

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

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

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

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

ARGUMENT I

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. The Development Of The Legal Standard.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[REDACTED]

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

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

ARGUMENT II

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * * *

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

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

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

From the Instant Case.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ARGUMENT III

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

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

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

First the statute which started the safe harbor treatment was § 12-7-700(8). That Section granted ". . . the same depreciation as allowed by Federal Internal Revenue Code Section 168(f)(8) and applicable regulations . . ." The "applicable federal regulations" are found at 5c.168(f)(8)-7 of the federal regulations. There the regulations are specific that the lessor must include the rental income and the lessee must include any interest income. Further, the lessor claims the interest deduction and the lessee deducts the rental payment. Thus it is clear the General Assembly was not enacting a provision that limited safe harbor transactions to depreciation only.

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

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

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

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

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

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

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

CONCLUSION

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

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RAY N. STEVENS
Deputy Attorney General
Attorneys for Respondent
South Carolina Tax Commission

Columbia, South Carolina
July 3, 1991.

THE STATE OF SOUTH CAROLINA

IN THE SUPREME COURT

DOCKET NO.

APPEAL FROM RICHLAND COUNTY

HONORABLE JAMES E. LOCKEMY, CIRCUIT COURT JUDGE

CASE NO. 89-CP-40-3213

Eastman Kodak Company,

Appellant,

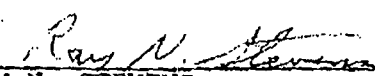
vs.

South Carolina Tax Commission,

Respondent.

CERTIFICATE OF COUNSEL

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


RAY N. STEVENS
Deputy Attorney General

July 3, 1991.

THE STATE OF SOUTH CAROLINA

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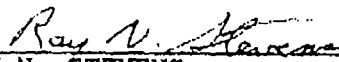
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CERTIFICATE OF MAILING

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


RAY N. STEVENS
Deputy Attorney General

THE STATE OF SOUTH CAROLINA
IN THE SUPREME COURT
DOCKET NO.

APPEAL FROM RICHLAND COUNTY
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RAY N. STEVENS
Deputy Attorney General

SD

JUL 25 1991

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JUL 3 1991
S. C. SUPREME COURT

THE STATE OF SOUTH CAROLINA

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RAY N. STEVENS
Deputy Attorney General

July 3, 1991.

JUL 3 1991
S. C. SUPREME COURT

Exhibit C

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND)

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

Eastman Kodak Company,

Plaintiff,

vs.

South Carolina Tax Commission,

Defendant.

O R D E R

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

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FACTUAL BACKGROUND

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

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

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

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

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

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

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

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

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

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

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

ISSUES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Statutory Interpretations

1. The Requirements of Section 12-7-250

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. Rental Income Is Involved.

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

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

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

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

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

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

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

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

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

Judicially the same result has been reached:

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

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

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

c. Allocation Is Required

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Constitutional Interpretations

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

1. Interstate Commerce

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

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

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

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

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

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

2. Equal Protection

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

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

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

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

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

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

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

3. Due Process

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

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

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

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

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

CONCLUSION

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

AND IT IS SO ORDERED.

James E. Lockemy
JAMES E. LOCKEMY, JUDGE
Fourth Judicial Circuit

December 12, 1990