THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph K. Anderson III, Administrative Law Judge

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

Duke Energy Corporation..... Appellant,

v.

South Carolina Department of Revenue..... Respondent.

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STATEMENT OF ISSUES ON APPEAL

I. Did the ALC err in holding that Duke Energy's South Carolina amended income tax returns for the tax periods 1978-1993 were untimely when the Department and Duke Energy entered into written agreements to extend the time for Duke Energy to file its amended returns?

II. Did the ALC err in holding that only Duke Energy's net receipts from sales of securities are included in the computation of its income apportionment formula when the plain language of the statutes requires that Duke Energy's gross receipts must be included in the computation of its apportionment formula?

III. Did the ALC err in holding that Duke Energy is engaged in manufacturing and electricity is tangible personal property when as a matter of law and fact the record establishes that electricity is not tangible and Duke Energy provides a service?

STATEMENT OF THE CASE

This case arises from the South Carolina Department of Revenue's (the "Department") denial of Duke Energy Corporation's amended returns seeking a refund of South Carolina corporate income taxes (collectively "refund claims") for the tax years 1978 through 2001 ("Tax Periods at Issue") in the amount of $126,240,645 plus interest. (Duke Energy's Amended Returns 1978-2001; Amended MSJ Order at 1; Trial Tr. 58:14-:21.) Duke Energy's refund claims were based primarily on two grounds. First, during the Tax Periods at Issue, Duke Energy sold securities in the regular course of its business and amended its corporate income tax returns to include the gross receipts from those sales in its sales factor denominator. (Duke Energy's Preh'g Stmt. § 5.A at 4; Amended MSJ Order at 3.) Second, Duke Energy originally used a three-factor apportionment formula to apportion its income to South Carolina instead of the single factor apportionment formula which is required for service providers.

The Department denied Duke Energy's refund claims and Duke Energy timely appealed. (Department's Denial; Application for Appeal; Amended Final Order at 4;

Trial Tr. 59:17-:23, 62:14-63:11.) The Department denied Duke Energy's appeal, (Department's Determination; Amended Final Order at 4; Trial Tr. 69:13-:18), and Duke Energy requested a contested case hearing before the Administrative Law Court ("ALC"). (Contested Case Hearing Request; Amended Final Order at 4; Trial Tr. 73:10-:11.)

On April 20, 2012, the Department filed a Motion for Summary Judgment asking the ALC to rule that: (1) Duke Energy's refund claims (amended returns) for the tax years 1978-1993 were untimely (the "Waiver Issue"); (2) Duke Energy was not permitted to include the gross proceeds from sales of securities in the calculation of the denominator of its South Carolina corporate income tax apportionment formula (the "Gross Receipts Issue"); and (3) Duke Energy is a manufacturer of electricity and thus not entitled to use the single-factor gross-receipts apportionment formula to apportion its income to South Carolina (the "Electricity Issue"). (Department's MSJ; Amended MSJ Order at 1-2.)

Duke Energy opposed the Department's Motion for Summary Judgment ("Department's MSJ") on the grounds that: (1) genuine issues of material fact existed regarding the Waiver and Electricity Issues; and (2) as a matter of law, Duke Energy was required to include the entire proceeds from sales of securities in its apportionment formula. (Duke Energy's Cross-Motion; Amended MSJ Order at 2.)

A hearing on the Department's MSJ and Duke Energy's Cross-Motion was held before the ALC on June 26, 2012. (Amended MSJ Order at 2.) On June 29, 2012, the ALC held a teleconference and informed the parties of its decision (1) to grant the Department's MSJ on the Waiver Issue; (2) to grant Duke Energy's Cross-Motion on the

Gross Receipts Issue; and (3) to order an evidentiary hearing with regard to the Electricity Issue.[1]

On August 9, 2012, without any further briefing by the parties, the ALJ changed his mind and issued an Order finding for the Department on the Waiver Issue ***and*** the Gross Receipts Issue, and ordering an evidentiary hearing on the Electricity Issue. (MSJ Order.) Duke Energy filed a Motion for Reconsideration on August 20, 2012, (Motion for Reconsideration), which the ALC denied on October 11, 2012.[2] (Reconsideration Order; Amended MSJ Order.)

The ALC held a hearing regarding the Electricity Issue on September 5 and 6, 2012 and on November 2, 2012, issued a Final Order and Decision finding for the Department. (Final Order.) Duke Energy filed a Motion for Reconsideration which the ALC denied on December 4, 2012. (Motion for Reconsideration; Reconsideration Order; Amended Final Order.) On January 3, 2013, Duke Energy timely filed a Notice of Appeal from all orders issued in this matter.

Duke Energy filed a Motion to Consolidate asking this Court to consolidate all of the Notices of Appeal in this case and asking this Court to hold in abeyance the thirty-day timeline for filing its Initial Appellant's Brief and Designation of Matter while the Motion to Consolidate was pending. (Motion to Consolidate.) This Court granted Duke

[1] As a result, the ALC asked the Department to draft a proposed order regarding the Waiver Issue and Duke Energy to draft a proposed order regarding the Gross Receipts and Electricity Issues.

[2] On August 29, 2012, the ALC suspended its MSJ Order, pending a decision on Duke Energy's Motion for Reconsideration. (Suspension Notice.) On October 9, 2012, Duke Energy filed a Notice of Appeal appealing the MSJ Order. (Notice of Appeal.) On October 11, 2012, the ALC issued an Order denying Duke Energy's Motion for Reconsideration in part and granting reconsideration in part, and an Amended MSJ Order. (Reconsideration Order; Amended MSJ Order.) On October 23, 2012, an Amended Notice of Appeal was filed to include the orders from October 11, 2012. (Amended Notice of Appeal.) On November 6, 2012, this Court requested that Duke Energy submit a memorandum addressing the appealability of the pending orders. (Request.) Duke Energy's appealability memorandum was filed and served on November 16, 2012. (Appealability Memorandum.) The appellate case number for that appeal was 2012-213180.

Energy's Motion on January 23, 2012. (Order Granting Motion to Consolidate.) The appellate case number for the consolidated appeal is 2012-213180.

STATEMENT OF FACTS

I. DUKE ENERGY'S BUSINESS OPERATIONS.

Duke Energy's primary business in South Carolina is the provision of electric service to its customers. (Trial Tr. 44:22-46:1, 116:18-117:5, 134:8-:18, 140:25-141:10; PSC Proposed Order at 10; PSC Direct Testimony of Mr. Jamil at 26; Duke Energy's 10-K for the Fiscal Year Ended 2000 at 3; Duke Energy's 10-K for the Fiscal Year Ended 1997 at 1.) During the Tax Periods at Issue, Duke Energy was required to list a Principal Business Activity Code on its Federal and South Carolina Income Tax returns. The Principal Business Activity Code is derived from the North American Industry Classification System ("NAICS"), formerly known as the U.S. Standard Industrial Classification system ("SIC"), and is determined based on the activity from which the company derives the highest percentage of its total receipts. (Trial Tr. 51:17-53:20.)

The NAICS lists industry classifications with different codes for "utilities" and "manufacturing." (Trial Tr. 53:7-55:25.) "Utilities" provide electric power, natural gas, steam supply, water supply, and sewage removal through a permanent infrastructure of lines, mines and pipes. *Id.* Electric power generation, transmission and distribution are included under "utilities." *Id.*

"Manufacturing" is a separate category. *Id.* During the Tax Periods at Issue, Duke Energy's federal and South Carolina income tax returns included the code for the electric power generation, transmission and distribution utilities category. (Trial Tr. 51:9-:13, 53:3-:6, 56:4-:8.) The Department never contested Duke Energy's use of the utility NAICS classification.

II. THE DEPARTMENT'S AUDIT OF DUKE ENERGY.

This case began with the Department's examination (also referred to as an "audit") of Duke Energy's corporate income taxes for the year 1978. (Amended MSJ Order at 2; McCarver Aff. ¶ 5.) What began as a routine audit evolved into a protracted review of Duke Energy's South Carolina tax returns that spanned decades. (Amended MSJ Order at 2-3; Trial Tr. 63:21-67:25; McCarver Aff. ¶ 5.) Duke Energy, cooperatively and patiently, accommodated the Department's serial requests to extend the audit due to health issues experienced by the Department's auditor, changes in the Department's personnel, and the pending results of an audit of Duke Energy by the Internal Revenue Service ("IRS"). (Amended MSJ Order at 2-3; Department's Requests.)

III. THE AGREEMENT BETWEEN THE DEPARTMENT AND DUKE ENERGY TO EXTEND THE STATUTE OF LIMITATIONS.

The Department did not complete the audit in a timely manner and continued to audit Duke Energy for subsequent years. (McCarver Aff. ¶¶ 5, 6.) To extend their time to audit, the Department's auditors systematically asked Duke Energy to sign agreements extending the audit. (Amended MSJ Order at 2-3; Department's Requests.) These agreements, generally referred to as "Waivers" also extended the time period for Duke Energy to file corporate income tax refund claims. (Amended MSJ Order at 2-3; McCarver Aff. ¶ 8; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10; Waivers.)

Years went by and each time a Waiver agreement was about to expire, the Department asked Duke Energy to sign a new agreement further extending the statute of limitations. (Amended MSJ Order at 2-3; McCarver Aff. ¶ 6; Department's Requests.) Duke Energy agreed to the Waivers because the Department represented verbally and in

writing that the statute of limitations was extended for both tax assessments and tax refund claims. (McCarver Aff. ¶ 3; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶¶ 10, 12, 13; J. Urban Dep. at 68-70.)

IV. DUKE ENERGY'S TAX OVERPAYMENTS.

Within the time frame agreed to by the Department in writing in the Waivers, Duke Energy filed amended South Carolina corporate income tax returns for the 1978 through 2001 tax periods. (Amended Final Order at 3; Amended MSJ Order at 3; Trial Tr. 57:4-:18; Duke Energy's Preh'g Stmt. § 5.A at 3-4.) The amended returns related to two issues in the computation of Duke Energy's apportionment formula – which is the mechanism for determining how much income is associated with Duke Energy's South Carolina's business activities. (Amended MSJ Order at 3; Trial Tr. 57:4-:18.)

The first issue was that South Carolina law requires a corporation to include all of its "gross receipts" in the denominator of its gross-receipts apportionment factor. Duke Energy's original returns for the tax years 1978-1999[3] excluded receipts from certain sales of securities from the denominator of the gross-receipts factor. (Duke Energy's Preh'g Stmt. § 5.A at 4.) The amendments included these receipts in the gross receipts factor. (Amended MSJ Order at 3.)

The second issue was that because Duke Energy was primarily engaged in the business of selling electric service to its customers, it was required to apportion its income using the single-factor gross-receipts apportionment method rather than the three-factor method required for companies that manufacture tangible personal property. (Duke Energy's Preh'g Stmt. § 5.A at 4.) The amendments applied the single-factor

[3] For 2000 and 2001, Duke Energy's original tax returns included receipts from sales of securities in the sales factor denominator.

formula (based on gross receipts) applicable to enterprises engaged in the provision of services. (Amended Final Order at 3; Amended MSJ Order at 3; Trial Tr. 57:12-:18.)

V. THE DEPARTMENT'S DENIAL OF THE AMENDED RETURNS

The Department could not have been surprised by the receipt of the amended returns. For years Duke Energy discussed with the Department in emails and in writing that Duke Energy intended to file the amended returns. (Correspondence between Duke Energy and the Department; J. Urban Dep. 68-70.) The Department denied Duke Energy's refund claims without conducting any examination. (Amended Final Order at 3; Trial Tr. 61:4-62:13.) Duke Energy timely protested the denial soon thereafter. (Amended Final Order at 4.) The Department took no action on Duke Energy's protest for approximately seven years before finally denying Duke Energy's Protest. (Trial Tr. 68:5-70:6; Amended Final Order 4; Trial Tr. 68:5-70:6; Departmental Determination.) At no time during this seven-year period did the Department assert that the refund claims were not timely or that the Waivers did not allow Duke Energy to file refund claims.

In 2002, the Department issued assessments of corporate income, license, and sales taxes for the tax years 1978 through 1994 (some of the periods that are at issue in this case) and determined that for these same years, Duke Energy should receive corporate income tax refunds. (Monroe Aff. ¶¶ 8, 9.) On August 13, 2002, the Department and Duke Energy agreed to offset Duke Energy's corporate income tax refund against the unrelated tax assessments for the tax years 1978-1994. *Id.* Duke Energy received a net refund of $3,067,703. *Id.*

VI. DUKE ENERGY'S PROVISION OF ELECTRICITY.

During the Tax Periods at Issue, the majority of Duke Energy's income was derived from the provision of electric service to its customers. (Trial Tr. 45:10-46:1;

Amended Final Order at 4.) The evidence presented at trial shows that Duke Energy provides a service. Further, both parties' expert witnesses agreed that Duke Energy provides a service.[4] (Trial Tr. 260:14-:18, 384:5-385:13.) Duke Energy's electric service business includes the generation, transmission and distribution of electricity. (Amended Final Order at 4.)

Duke Energy generates electricity by various means including hydro, nuclear, coal, natural gas, wind, and solar power. (Amended Final Order at 5; Trial Tr. 100:23-102:19.) Electric service is provided using a generator which creates a force field. (Trial Tr. 101:13-:22, 298:22-:25, 298:22-300:19.) The force field causes oscillation of electrons in the generator which causes a flow of an electromagnetic field, or electricity, which is then transmitted and delivered to Duke Energy's customers. (Amended Final Order at 20, Trial Tr. 113:10-116:1, 266:8-:22, 288:13-289:3). No electrons, charges or other particles are created by the generation process. (Trial Tr. 112:18-114:3, 291:2-:13, 302:14-303:5.)

Mr. Dhiaa Jamil, Duke Energy's Chief Generation Officer, and Professor Ioannis "John" Papapolymerou[5], Duke Energy's expert witness, testified that Duke Energy does not create the electrons residing in the power lines, and the provision of electricity is not the transfer of electrons to the customer: the electrons simply facilitate the propagation of electricity. (Trial Tr. 112:18-114:3, 187:4-:8, 270:12-:14, 298:13-:21, 302:14-303:5.) The Department's expert witness agreed. (Trial Tr. 363:25-364.4, 374:13-25.) Professor

[4] The Department's expert Mr. Robinson testified that "if [electric energy] were provided on a flat-fee basis, you could consider it a service." (Trial Tr. 385:2-:3.)

[5] Dr. Papapolymerou is an esteemed professor at the School of Electrical and Computer Engineering at the Georgia Institute of Technology. He is highly published, has won several awards, and is a fellow of the Institute of Electrical and Electronics Engineers, a highly selective worldwide professional organization. He also regularly consults for the United States government. (Trial Tr. 249:25-254:1.)

Papapolymerou also testified that "Duke Energy provides a service, and that the electrical energy it sells is not something that one can possess or does not have physical dimensions." (Trial Tr. 260:14-:18.) The Department's expert agreed with Duke Energy's expert that electricity is a force and not a material and that Duke Energy provides electric service. (Trial Tr. 329:15-:18; 363:14-:23; 367:13-:17; 384:10-385:13; Robinson Dep. 72:19-73:20.)[6]

The evidence presented at trial showed that electricity is not an object that is manufactured; rather, it is a flow of electrical energy that is generated by the manipulation of magnetic fields. (Trial Tr. 113:16-:23, 153:4-:7, 163:8-:25, 261:20-262:14, 270:12-:14.) Electricity has no shape, form or geographic location. (Trial Tr. 121:5-:23, 270:15-271:3, 303:11-:17.) It cannot be created or destroyed. (Trial Tr. 186:23-187:8, 278:20-279:3.) It is not a matter or a material, and it has no form or substance which can be touched. (Trial Tr. 120:1-121:4, 148:20-149:4, 187:9-188:15, 261:14-262:14, 270:15-:19, 273:1-274:6.) It has no height, weight, volume or other dimension that is typically associated with tangible property. (Trial Tr. 119:17-:19, 270:15-272:10, 303:11-:17.) It is of a nature similar to heat, light, wind, and gravity, all of which can be sensed and measured, but are not considered tangible. (Trial Tr. 185:5-:22, 258:20-259:15, 263:13-:24, 276:1-277:10, 364:16-367:7, 290:8-291:1.) Professor Papapolymerou testified that electricity is not an electric charge; rather, an electron is the most fundamental carrier of charge and an electric charge is the source of the

[6] The Department itself agrees that Duke Energy provides a service. In its Determination denying Duke Energy's refund claims, the Department stated that "while the taxpayer [Duke Energy] is correct that it provides a service, its service is statutorily defined [for sales and use tax] as tangible personal property." (Departmental Determination.) As discussed below, the Department's reliance on the sales tax statute is misplaced. Also, in its prehearing statement, the Department asserted that "Petitioner [Duke Energy] is a manufacturer of electricity and a power service provider . . . ." (Department's Prehearing Statement.)

electromagnetic field. (Trial Tr. 259-260, 264.) Disregarding the evidence presented at trial, the ALC incorrectly found that electricity is a physical product and that Duke Energy produces an electric charge. (Amended Final Order at 7-8.)

Duke Energy provides electric service on both a metered and flat-fee basis. (Trial Tr. 106:18-108:4, 111:20-112:12; Amended Final Order at 4.) The electricity provided to customers under either plan is the same. (Trial Tr. 107:15-:20, 385:4-:13.) Under the flat-fee service plan, Duke Energy provides electric service to its customers for a fixed price, regardless of how much electricity a customer consumes. *Id.* The metered service plan is based on usage, i.e., the electricity provided by Duke Energy is read by a meter and billed to the customer on the basis of time and usage. *Id.*

Regardless of the service plan, a portion of each Duke Energy customer's service charge is known as a capacity charge. (Trial Tr. 108:5-111:19; Amended Final Order at 4.) The capacity charge is billed to the customer each month even if Duke Energy does not generate any electricity or if the customer does not use electricity in a given month. *Id.* The capacity charge is a significant portion of the customer's monthly bill. (Trial Tr. 111:4-:8.) As a result, Duke Energy receives electric service revenue, every month, notwithstanding whether the customer uses any electricity or whether Duke Energy generates any electricity. (Trial Tr. 108:5-111:19; Amended Final Order at 4.)

STANDARD OF REVIEW

The appellate court will reverse a decision of the ALC when the administrative decision is: (a) in violation of constitutional or statutory provisions; (b) in excess of the statutory authority of the agency; (c) made upon unlawful procedure; (d) affected by an error of law; (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or (f) arbitrary or capricious or characterized by abuse of

discretion or clearly unwarranted exercise of discretion. S.C. Code Ann. § 1-23-610(B); *Brownlee v. S.C. Dep't of Health & Envtl. Control*, 382 S.C. 129, 136, 676 S.E.2d 116, 119-120 (2009). Each of these factors exists in this case.

Summary judgment is appropriate only if "it is clear there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." *Summer v. Carpenter*, 328 S.C. 36, 42, 492 S.E.2d 55, 58 (1997). Even if the evidentiary facts are not disputed, but the conclusions or inferences to be drawn from them are, summary judgment should be denied. *Id.*; *see also Ellis v. Davidson*, 358 S.C. 509, 518, 595 S.E.2d 817, 821 (Ct. App. 2004). To determine if triable issues of fact exist, the evidence and all inferences must be viewed in the light most favorable to the nonmoving party. *Hancock v. Mid-S Mgmt. Co*, 381 S.C. 326, 329-30, 673 S.E.2d 801, 802 (2009).

ARGUMENT

I. THE ALC ERRED IN CONCLUDING THAT DUKE ENERGY'S AMENDED INCOME TAX RETURNS FOR THE TAX PERIODS 1978-1993 WERE UNTIMELY.

A. During the periods 1978 through 1993, South Carolina Law authorized the Department to extend the applicable limitations period for assessments of tax underpayments and refund claims for tax overpayments.

For the periods 1978 through 1993, the Department signed Waivers to extend the time period for Duke Energy to file refund claims (amended returns) and for the Department to assess additional tax. (Amended MSJ Order at 2-3; McCarver Aff. ¶¶ 8, 9; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10; Waivers). In many cases, the Department requested the Waivers so it could have more time to conduct its audit. (Amended MSJ Order at 2-3; Department's Requests; McCarver Aff. ¶¶ 6, 8.)

In spite of the Department's oral and written Waiver agreements, the ALC granted the Department's MSJ on the Waiver Issue. The ALC reasoned that whether the Department misled Duke Energy or not, an evidentiary hearing was not necessary because the Department did not have the authority to extend the limitations period for filing tax refund claims.

The ALC's ruling is the first of its kind. In South Carolina, like virtually every other state in the country, taxpayers and state revenue officials routinely agree, in writing, to extend the time period for assessments and refund claims. (McCarver Aff. ¶ 8; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10, 12, 13.) And taxpayers and tax administrators routinely rely on waivers to allow additional time while preserving a taxpayer's rights to file refund claims as part of the audit process. *Id.* The ALC disregarded all of these facts and decades of past practice by the Department and other taxpayers.

Aside from the inequity in allowing the Department to renege on its written agreements, the ALC's decision is incorrect for a number of reasons. First, for tax years prior to 1995, former S.C. Code Ann. § 12-54-80 provided that: (1) "the amount of taxes due on a return which has been filed . . . must be ***determined*** or assessed within thirty-six months from the date the return was filed ***or due to be filed***, whichever occurs later;" (2) in the case of an adjustment made by the IRS to the taxpayer's federal income tax return, "the commission ***may determine*** and assess ***income taxes*** after the thirty-six months limitation if it makes the determination and assessment within one hundred eighty days of receiving notice from the Internal Revenue Service of a final determination of an income adjustment . . . ." ("Final IRS Adjustment");[7] and (3) "[i]f before the expiration of the

[7] South Carolina Code section 12-54-80 was repealed and recodified effective for tax years after 1994. *See* S.C. Code Ann. § 12-54-85. Effective for years after 1994, a refund claim resulting from an IRS

time prescribed in this section for the mailing of a notice of any assessment, ***the taxpayer has consented in writing to the mailing of the notice after the time,*** notice of assessment may be mailed at any time prior to the expiration of the period agreed upon." *See* S.C. Code Ann. § 12-54-80 (Supp. 1990) (repealed 1995).

A "determination" is not limited to an assessment of additional tax. A determination of the amount of taxes due may produce an amount that is higher or lower than the amount reported on a taxpayer's return filing. This determination reflects information obtained from the receipt of supplemental information, including amended tax returns, provided by a taxpayer. A "determination" also contemplates assessment of a tax overpayment – a point the ALC failed to acknowledge in granting summary judgment for the Department. Indeed, taxpayers regularly seek refunds of tax overpayments, yet the Department did not, and could not, identify one instance where a taxpayer's refund claim was rejected because of the claimed inapplicability of S.C. Code Ann. § 12-54-80. (McCarver Aff. ¶ 8; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10; Department's Resp. to Duke Energy's First Req. for Prod. ¶ 23.) In fact, the Department paid income tax refunds to Duke Energy for the years at issue in this case, many years after the expiration of the limitations period the Department argues controls in this case. (Monroe Aff. ¶¶ 8, 9.)

Former S.C. Code Ann. §12-54-80 explicitly authorized the Department and a taxpayer to enter into an agreement to extend the limitations period applicable to assessments for underpayments or overpayments, prior to the expiration of the limitations

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adjustment must be limited to the overpayment of taxes resulting from the IRS adjustment. S.C. Code Ann. § 12-54-85(D)(3). Such a limitation was not in place prior to 1995.

period. And that was exactly what Duke Energy and the Department did for more than twenty years. (McCarver Aff. ¶ 8; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10.)

Duke Energy's interpretation of the statutes at issue in this case is also supported by the plain language of the Waiver agreements, which were drafted by the Department. For periods prior to 1995, the Waiver agreements provided: "This agreement extends the time for mailing the notice of assessment **or refund** of the above tax pursuant to the provisions of **Section 12-54-80** of the 1976 South Carolina Code of Laws, as amended." (Waivers.)

The ALC's holding that S.C. Code Ann. §§ 12-47-210 and 12-47-220 "were the exclusive remedy for obtaining a refund of income taxes" is simply incorrect. (Amended MSJ Order 8.) Those sections offered a different procedural mechanism for obtaining a refund. If S.C. Code Ann. §§ 12-47-210 and 12-47-220 were the sole remedial procedures available to taxpayers seeking refund claims, then every taxpayer would have been required to pay the tax under protest and file suit in circuit court within thirty days of filing its original tax returns. This interpretation of South Carolina law is not only inconsistent with the plain reading of the relevant statutes, but it also produces an unfair result that implicates Due Process Clause concerns.[8] In contrast, the refund claim procedure provided by S.C. Code Ann. § 12-54-80 offered taxpayers the opportunity to correct an error - a tax overpayment – within a reasonable period of time – a period of time that the Department universally accepted prior to articulating its litigation position in this case.

[8] *See McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 36 (1990) (the U.S. Supreme Court has held Due Process requires a state to provide a procedural safeguards sufficient to ensure that a state collects only the amount of tax to which it is legally entitled.)

1. Waiver Agreements for the Tax Years 1978-1989

The Waiver agreements for tax years 1978-1989 were executed prior to the expiration of the statute of limitations and Duke Energy's amended returns were filed within the time frames provided for in the Waivers. (Return File Date Chart.)

Additionally, the IRS made adjustments to Duke Energy's tax returns for the tax years 1984 and 1986 through 1989. The IRS made a final determination with respect to those adjustments on September 23, 1992. (Monroe Aff. ¶ 5; September 23, 1992 Determination.) The Waiver agreements for those years were executed long before the expiration of one hundred eighty days from the date the IRS notified the Department of those IRS final adjustments. (IRS Notice; Waiver Schedule; Waivers). Thus, the ALC erred in holding that Duke Energy's refund claims for tax years 1978 through 1989 were untimely.

2. Waiver Agreements for the Tax Years 1990-1993

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

B. The ALC erroneously concluded that a tax limitations period cannot be tolled or waived.

The Department waived the limitations period contained in former S.C. Code Ann. § 12-54-80. The ALC's decision attempts to distinguish between a general statute of limitation and a statutory timeframe for filing a request for refund, holding that the former can be waived or tolled whereas the latter cannot. (Amended MSJ at Order 14-15.) To support its view, the ALC relies exclusively on a single case, decided by a different court, in a different jurisdiction. *Dep't of Conservation v. Co-De Coal Co.*, 388 S.W.2d 614 (Ky. Ct. App. 1964). (Amended MSJ Order at 14-15.) However, the ALC failed to recognize that it did not need to go beyond South Carolina's own legal precedents on this issue.

South Carolina law is clear that a statutory timeframe for issuing assessments for additional taxes or filing claims for tax refunds is a "Statute of repose as are all ordinary Statutes of Limitations" and **can be tolled or extended**. *See Webb v. Greenwood Cnty.*, 229 S.C. 267, 92 S.E.2d 688 (1956); *Hercules Inc. v. S.C. Tax Comm'n*, 274 S.C. 137, 143, 262 S.E.2d 45, 48 (1980) ("[T]he statute in question is remedial since it has the effect of tolling the general three-year statute of limitations on tax assessments.")

A statute of limitations, even in the tax context, is simply procedural in nature and operates as a defense to limit the remedy available from an existing cause of action. *Hercules Inc.*, 274 S.C. at 143, 262 S.E.2d at 48 ("[A] statute of limitations affects the remedy and not the right . . . ."); *Jenkins v. Meares,* 302 S.C. 142, 146, 394 S.E.2d 317, 319 (1990) (holding that the statute of limitations "is remedial or procedural in nature"); *Langley v. Pierce*, 313 S.C. 401, 403-04, 438 S.E.2d 242, 243 (1993) (same); *Case v. Hermitage Cotton Mills*, 236 S.C. 285, 287, 113 S.E.2d 794, 795 (1960) (same). As a

procedural limitation, the statute of limitations can be waived as evidenced by the opinions of the South Carolina Supreme Court and Court of Appeals:

> **A party can waive a statute of limitations defense**, but the waiver must be shown by words or conduct, including an express agreement, failure to claim the defense, or any action or inaction inconsistent with an intention to use the statute of limitations defense.

See, e.g., Anon. Taxpayer v. S.C. Dep't of Rev., 377 S.C. 425, 440, 661 S.E.2d 73, 80 (2008) (emphasis added); *see also Mende v. Conway Hosp., Inc.*, 304 S.C. 313, 315, 404 S.E.2d 33, 34 (1991) (same); *City of N. Myrtle Beach v. Lewis-Davis*, 360 S.C. 225, 235, 599 S.E.2d 462, 466-67 (Ct. App. 2004) (same).

More importantly, the South Carolina Court of Appeals has specifically held that a "[w]aiver is a **question of fact for the finder of fact**." *City of N. Myrtle Beach*, 360 S.C. at 234-35, 599 S.E.2d at 466 (emphasis added). "To constitute a waiver there need not be a new agreement for a valuable consideration." *S.C. Tax Comm'n v. Metro. Life Ins. Co.*, 266 S.C. 34, 40, 221 S.E.2d 522, 524 (1975). The U.S. Court of Appeals for the Fourth Circuit has also held that "though ... a waiver of the applicable [statute of] limitations period [is] not a contract, many courts have recognized that principles of contractual interpretation must be utilized in construing them." *Ripley v. Commissioner*, 103 F.3d 332, 337 (4th Cir. 1996) (citing *United States v. Hodgekins*, 28 F.3d 610, 614-15 (7th Cir. 1994) (holding that the IRS could not induce a taxpayer to relinquish the protection afforded by the statute of limitations based on representation contained in the extension agreement drafted by the IRS and then disregard the condition) (internal citation omitted).

The ALC's holding that the Department could not extend the limitations period in this case is in direct conflict with prior holdings of this Court, the Department's written agreements, policies, and actions, and the principles set forth by the U.S. Court of Appeals for the Fourth Circuit and should be reversed.

C. Form FS-43 Extended the Statute of Limitations for Tax Refund Claims.

Form FS-43 is a formal agreement drafted by the Department to seek a taxpayer's agreement to extend the time in which the Department may assess a tax or the taxpayer may file a refund claim. Prior to 1995, Form FS-43 provided:

> This agreement extends the time for mailing the notice of assessment **or refund** of the above tax pursuant to the provisions of Section 12-54-80 of the 1976 South Carolina Code of Laws, as amended.

(Pre-1995 Waivers.) After 1995, Form FS-43 provided:

> This agreement extends the time for mailing the notice of assessment **or refund** of the above tax pursuant to the provisions of Section 12-54-85(C)(5) of the 1976 South Carolina Code of Laws, as amended.

(Post-1994 Waivers.)

Form FS-43 remained substantially the same throughout all Tax Periods at Issue. Minor changes were made to Form FS-43 in 1995 to reflect the redesignation of S.C. Code Ann. § 12-54-80 into S.C. Code Ann. § 12-54-85. However, these changes still provided that upon agreeing to a Waiver, the Department had an extended period of time to assess taxes, and the taxpayer had an extended period of time to file a refund claim. Both versions of Form FS-43 use the term "refund" and contemplate a taxpayer's ability to file refund claims. Neither version limits the Department's ability to issue tax assessments nor a taxpayer's ability to file tax refund claims within the time frame

mutually agreed upon by the taxpayer and the Department. However, the ALC erroneously concluded that Form FS-43 applied only to actions by the Department. (Amended MSJ Order at 7.) In so doing, the ALC arbitrarily overwrote the plain language of the Waiver Form, disregarded the Department's interpretation of applicable limitations periods, and ignored the representations made by the Department by agreeing to execute the Waivers.

D. The ALC erred in holding that the Department is not estopped from arguing that the Waivers have no effect.

The Department should be held to its written agreement and should be estopped from claiming that the Waivers did not extend the statute of limitations to allow Duke Energy to file its refund claims prior to 1992. Only recently, this Court stated:

> Estoppel may apply against a government agency, but "the party asserting estoppel against the government must prove: (1) lack of knowledge and of the means of knowledge of the truth as to the facts in question; (2) justifiable reliance upon the government's conduct; and (3) a prejudicial change in position.

Logan v. Cherokee Landscaping & Grading Co., 389 S.C. 611, 618–19, 698 S.E.2d 879, 883 (Ct. App. 2010) (citation omitted); *see also Bishop v. City of Columbia*, 2013 S.C. App. LEXIS 14, 15-18 (2013). "A governmental body is not immune from the application of the doctrine of estoppel where its officers or agents act within the proper scope of their authority." *Quail Hill, LLC v. County of Richland*, 387 S.C. 223, 236, 692 S.E.2d 499, 506 (2010) (citation omitted).

The Waivers were executed on a form drafted by the Department, on the Department's letterhead. In many instances, the Department even asked Duke Energy to execute the Waivers so it could continue its audit in exchange for the Department's agreement to extend the statute of limitations period. (Amended MSJ Order 2-3; Trial Tr.

64-67; McCarver Aff. ¶ 8.) Duke Energy justifiably relied on the Department's representations, its published opinions, and the plain language of the Waivers that the time for filing refund claims for the Tax Periods at Issue had been extended. (Waivers; McCarver Aff. ¶¶ 8, 9; Davant Aff. ¶¶ 6, 14, 19; Anderson Aff. ¶ 10.) Therefore, the Department should be estopped from asserting that such a defense presented questions of fact for the ALC's consideration.

E. The ALC erred in holding that equitable tolling does not apply in this case.

The ALC held that the Department is not subject to equitable tolling. The ALC's holding is premised on its distinction between a general statute of limitations and "a condition precedent to seeking [a refund.]" As discussed earlier, Duke Energy contends that the ALC's distinction has no meaningful significance. In fact, tax statutes of limitations are viewed as general statutes of limitations by South Carolina courts.

Courts have invoked the equitable tolling doctrine to suspend or extend a statutory period to "ensure fundamental practicality and fairness." *Hooper v. Ebenezer Senior Servs. & Rehab. Ctr.*, 377 S.C. 217, 233-34, 659 S.E. 2d 213, 221-22 (Ct. App. 2008). Equitable tolling is a judicially created mechanism that "stems from the judiciary's inherent power to formulate rules of procedure where justice demands it." *Hooper v. Ebenezer Senior Servs. & Rehab. Ctr.*, 386 S.C. 108, 115, 687 S.E. 2d 29, 32 (2009). *See also Nevada Dep't of Taxation v. Masco Builder Cabinet Group*, 265 P.3d 666 (Nev. 2011) (the doctrine of equitable tolling applied to extend the limitations period to allow taxpayer's refund claims.)

In this case, fundamental fairness requires that the Department be precluded from disregarding the agreements it entered into with Duke Energy. The Department

repeatedly requested Duke Energy's consent to extend the time for assessment and the time to file a refund claim. (Department's Requests.) Equity requires the Department to live up to its agreement.

II. THE ALC ERRED IN CONCLUDING THAT DUKE ENERGY SHOULD NOT INCLUDE THE GROSS RECEIPTS FROM SALES OF SECURITIES IN ITS INCOME APPORTIONMENT FORMULA.

The only question before the ALC with respect to the Gross Receipts Issue was whether, as a matter of law, gross receipts from the sales of securities should be included in the gross-receipts apportionment formula.[9] The ALC concluded that only net receipts should be included. As explained below, the ALC's conclusion conflicts with South Carolina law and this Court should reverse the ALC's holding.

A. The Plain Language of the South Carolina apportionment statute requires taxpayers to include all gross proceeds in the denominator of the gross receipts/sales apportionment factor.

During the Tax Periods at Issue, South Carolina law provided that a taxpayer required to apply the single-factor gross-receipts apportionment formula must do so "using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is **total gross receipts** from everywhere during the taxable year." *See, e.g.,* S.C. Code Ann. § 12-6-2290 (applicable for tax years beginning after 1995) (emphasis added); former S.C. Code Ann. § 12-7-1190 (applicable for tax years prior to 1996) (emphasis added). For a taxpayer required to apportion its income based on the three-factor apportionment formula, the sales factor consists of "[t]he ratio of sales made by such taxpayer during the income year which are attributable to this State to the **total sales** made by such taxpayer everywhere during the income year . . . ." S.C.

[9] To the extent that the judge based his decision on distortion, summary judgment was inappropriate because there are factual issues in dispute. These factual issues were not before the ALC.

Code Ann. § 12-6-2280 (for tax years after 1995); former S.C. Code Ann. § 12-7-1170 (for tax years prior to 1996).

Neither "gross receipts" nor "total sales" were defined under South Carolina law during the Tax Periods at Issue. Accordingly the ALC should have looked to the plain meaning of the statute:

> The language of a tax statute must be given its plain ordinary meaning in the absence of an ambiguity therein. . . . . [I]f a legislative intent is clearly apparent from the language of the statute there is no occasion for resort to the rule of statutory construction.

Beach v. Livingston, 248 S.C. 135, 139, 149 S.E.2d 328, 330 (1996) (citation omitted); *see also Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue*, 399 S.C. 313, 320, 731 S.E.2d 869, 873 (2012); *Duke Power Co. v. S.C. Tax Comm'n*, 292 S.C. 64, 66, 354 S.E.2d 902, 903 (1987) ("The ... language [of the statute] clearly states that the license fee on power companies, such as Duke, is based on entire gross receipts and not just receipts from customer charges.")

Applying this standard to the apportionment statutes at issue in this case, "gross receipts" or "total sales" does not mean "net receipts". These terms mean exactly what they say: gross means gross and total means all. Neither of these terms can be interpreted as including only "net receipts" as set forth in the ALC's Amended MSJ Order.

The plain meaning of S.C. Code Ann. § 12-6-2290 and § 12-6-2280 is further demonstrated by actions of the South Carolina Legislature. In 2006, the South Carolina Legislature specifically addressed the very issue in dispute in this case. It changed the meaning of "gross receipts" and total "sales" to eliminate receipts from the sales of securities from the South Carolina income tax apportionment formula. S.C. Code Ann. §

12-6-2295(B)(1) ("repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument").

This change in law was material and drastic. The 2006 law change added a new section to the statute which excluded ten new categories of receipts, including the sales of securities, from the definition of "gross receipts." When the Legislature amends a statute to include a **material** change, there is a **presumption** that the Legislature intended to change the existing law rather than to clarify its original intent. *Key Corporate Capital, Inc. v. Cnty. of Beaufort*, 373 S.C. 55, 60-61, 644 S.E.2d 675, 678 (2007). Excluding ten new categories of receipts from the definition of "gross receipts" is material by any measure.

Indeed, the Department previously argued that more limited statutory amendments were changes in the law. For example, in *Duke Power Co. v. South Carolina Tax Commission*, 292 S.C. at 66, 354 S.E.2d at 903, the Department argued that an amendment to the South Carolina license tax statute, which imposed the tax on "the entire gross receipts from business" and was later changed to "the gross receipts from services rendered from regulated business," limited the scope of the tax and was thus a change in the law. Br. App't at 8-9; *Duke Power* (1987). The South Carolina Supreme Court agreed with the Department and held that the language of the pre-amendment statute "clearly states that the license fee on power companies, such as Duke, is based on entire gross receipts and not just receipts from customer charges." *Duke Power Co. v. S.C. Tax Comm'n*, 292 S.C. at 66, 354 S.E.2d at 903.[10]

Ignoring the material nature of the 2007 legislative amendment, the ALC stated that it "has set forth in its Amended Order reasons not to apply the presumption [that the

[10] Duke Power Company changed its name to Duke Energy Corporation, the Appellant in this case.

Legislature intended to change the existing law]" and held that the amendment was not a change in law but a mere clarification of original legislative intent. (MSJ Reconsideration Order at 4.) The ALC offered no evidence in support of its holding and cited no cases on point in this regard. Indeed, nothing in the ALC's Amended MSJ Order supports the ALC's holding.[11]

The 2006 law change was material. It excluded ten new categories of receipts from the definition of gross receipts. Accordingly, the ALC should have applied the presumption that the 2006 amendment was indeed a change in the law and found that, for the Tax Periods at Issue in this case, gross means gross and that Duke Energy was required to include all of its gross receipts in the denominator of its South Carolina corporate income tax apportionment formula.

B. The ALC did not apply the long-standing principle that in case of doubt, tax statutes must be construed in favor of the taxpayer and against the State.

In interpreting the meaning of "gross receipts," the ALC made a critical error by failing to apply the long-standing principle that "[i]n the enforcement of tax statutes, the taxpayer should receive the benefit in cases of doubt." *Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue*, 399 S.C. 313, 321, 731 S.E.2d 869, 873 (2012), (*citing S.C. Nat'l Bank v. S.C. Tax Comm'n*, 297 S.C. 279, 281, 376 S.E.2d 512, 513 (1989)). "[W]here the language relied upon to bring a particular person within a tax law is ambiguous or is reasonably susceptible of an interpretation that will exclude such person, then the person will be excluded, any substantial doubt being resolved in his favor." *Id.*

[11] The only judicial authority relied upon by the ALC, *Duvall v. South Carolina Budget & Control Board*, 377 S.C. 36, 659 S.E.2d 125 (2008), provides no support for its holding. (MSJ Reconsideration Order at 2, 4.) The title of the legislative amendment at issue in *Duvall* specifically stated that the amendment was a clarification rather than a change. *See, e.g., Duvall*, 377 S.C. at 46, 659 S.E.2d at 130. In contrast, nothing in the title or language of the 2007 amendment or its legislative history suggests the same legislative intent as the intent of the Legislature in *Duvall*.

In its Amended MSJ Order, the ALC devotes more than eleven pages to an analysis of the meanings of "gross receipts" and "sales" in terms of purported logic, holdings from other jurisdictions, and various tax principles. Because the ALC's analysis is predicated on a conclusion that the statutes were ambiguous, and not plain, any ambiguity should have been construed in favor of Duke Energy.

The ALC also failed to consider South Carolina's definitions of "gross receipts" and "sales" in other contexts. Most recently, the South Carolina Supreme Court affirmed the broad meaning of the term "gross proceeds" in *Travelscape, LLC v. South Carolina Department of Revenue*, 391 S.C. 89, 705 S.E.2d 28 (S.C. 2011), *upholding Travelscape, LLC v. South Carolina Department of Revenue*, 08-ALJ-17-0076-CC (S.C. Admin. L.J. Div. Feb. 12, 2009). In *Duke Power Co. v. South Carolina Tax Commission*, 292 S.C. 64, 66, 354 S.E.2d 902, 903 (1987), the court held that the language of the license fee imposition statute "clearly states that the license fee . . . is based on **entire gross receipts** . . . ." (emphasis added). *See also* No. I-D-352, 1984 S.C. Tax LEXIS 14, at *2 (S.C. Tax Comm'n Mar. 26, 1984) ("**[g]ross receipts** is a **broad term** which includes **all** proceeds received by the entity so long as such receipts resulted from any part of its business"); No. I-D-384, 1985 S.C. Tax LEXIS 6, at *5 (S.C. Tax Comm'n May 17, 1985) ("gross receipts" are not "net receipts" because "[t]he two are something separate and apart. 'Gross receipts' has been defined to mean the whole receipts as opposed to net receipts."); Op. Att'y Gen., 2012 WL 1615813, at *2 (Apr. 2, 2012) ("all 'gross receipts' not specifically excluded by ordinance and not exempted by other law should be reported . . as the basis for its tax"). Indeed, a Westlaw search reveals that some eighty-five code sections in Title 12 of the South Carolina Code use the term "gross receipts." (Duke

Energy's Cross-Motion 32-33; Gross Receipts Statutes.) These statutes **uniformly** have been interpreted by the Department to mean "gross" and not "net.

C. This Court should reverse the decision of the ALC because the ALC's holding is premised on factual questions not before it.

1. The ALC erred in considering distortion principles in interpreting the meaning of "gross receipts."

In determining the meaning of the term "gross receipts" and total "sales," the ALC reasoned that including the principal from the sales of securities in the denominator of the corporate income tax apportionment formula is improper, because to do so would "encourage excessive distortion" and "distortion of business activity representation would be fostered on the front end (through the principal-inclusive standard apportionment formula)." (Amended MSJ Order at 32, 33.)

The ALC's analysis is fundamentally flawed. The only issue before the ALC was whether, as a matter of law, the gross receipts from the sales of securities should be included in the standard apportionment formula. Whether the inclusion of the principal in the apportionment formula 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 Media Gen. Commc'ns., Inc. v. S.C. 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. S.C. Dep't of Revenue, 397 S.C. 604, 611, 725 S.E.2d 711, 714 (Ct. App. 2012).

Notably, the ALC itself correctly recognized this two-part analysis during the summary judgment hearing.[12] Contrary to its own reasoning, the ALC ignored the two-step analysis and subsumed fundamentally factual distortion arguments (part two of the inquiry) into its analysis of the standard apportionment formula (part one of the inquiry) and held that "distortion of business activity representation would be fostered on the front end (through the principal-inclusive standard apportionment formula)." (Amended MSJ Order at 33.)

Not only is the ALC'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, S.E.2d 525 at 531. The ALC's reasoning presumes that the inclusion of principal in Duke Energy's apportionment formula is distortive and the ALC's remedy of that distortion was its limited construction of the standard

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[12] 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**. (MSJ Tr. 141:17-:23, 143:23-144:11 (emphasis added).)

apportionment formula. The ALC, 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 so that "no word, clause, sentence, provision or part shall be rendered surplusage, or superfluous . . . ." *CFRE, LLC v. Greenville Cnty. Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) (internal citations and 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 ALC's suggestion, the application of alternative apportionment cannot be said to constitute mere "futility of going through this extra-step process needlessly." (Amended MSJ Order at 33.) 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 that does not render it meaningless. *CFRE*, 395 S.C. 67, 716 S.E.2d 877.

2. The ALC erred in determining that the inclusion of the principal in the standard apportionment formula produces an absurd result because it is inherently distortive.

The ALC determined that the inclusion of the principal from the sales of securities in the denominator would produce an absurd application of the standard apportionment formula because it would lead to inevitable distortion of business activity representation. (Amended MSJ Order at 33.) The ALC appears to conflate the "absurd

result" theory under the standard apportionment method and the distortion analysis under the alternative apportionment method.

As discussed above, a determination of distortion is an inherently factual issue to be addressed only **after** the standard apportionment formula results are determined. [13] *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 gross receipts or sales factor. Distortion, an issue not before the ALC, is determined only after the apportionment results are calculated. *See CarMax Auto Superstores*, 397 S.C. at 611, 725 S.E.2d at 714.

The ALC'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.

The 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 the sales of securities in the sales factor or gross-receipts factor denominator produces an absurd result in most, if not all, cases. The ALC did not provide any analysis as to why the inclusion of all receipts

[13] If the ALC's decision and the Department's argument are premised on distortion, there are facts at issue and summary judgment is not appropriate.

from the sales of securities in the gross-receipts/sales factor denominator is distortive or at a minimum would 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. (Love Aff. ¶¶ 6, 7.) Including all of its receipts in its sales factor denominator using the standard apportionment formula reasonably represents the proportion of Duke Energy's business carried on in South Carolina. The Department presented no evidence whatsoever to show that including all of the receipts from the sales of securities in the gross-receipts/sales factor denominator produces an absurd result for Duke Energy.

3. The ALC erred in *sua sponte* considering the application of the alternative apportionment formula.

Not only is the ALC's analysis misapplied, but also it is impermissibly based on grounds not raised by the parties. *See, e.g., State v. Dicapua*, 383 S.C. 394 (2009); *Southern Ry. Co. v. Coltex, Inc.*, 285 S.C. 213 (1985) (a trial court lacks authority to grant relief *sua sponte* on a ground not raised by a party).

In its Order, the ALC devoted more than three pages to a discussion focusing on the notion that including the principal from the 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. Amended MSJ Order at 31-34. This argument, a factual inquiry, was not raised by either party during the extensive briefing or at the summary judgment hearing.

4. The Court erred in interpreting the meaning of "Gross Receipts" based on the definition of "Gross Income."

The ALC erroneously determined that "gross receipts" excluded the principal from the sales of securities because "gross income necessarily excludes principal." (Amended MSJ Order 28.) The fallacy of the ALC's reasoning is known as the "fallacy of denying the antecedent," which the ALC describes in detail in its Amended MSJ Order. (Amended MSJ Order 13.)

"Gross receipts" and "gross income" relate to two entirely different tax concepts. A taxpayer's "**gross 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; I.R.C. § 61(a). In contrast, "**gross receipts**" as used in the income apportionment provisions determines the income subject to South Carolina income tax. *Id.* To describe the concepts colloquially, if gross income/taxable income is a cake, the gross-receipts apportionment provision is used to determine the portion of the cake South Carolina is entitled to. The Court's reliance on the definition of "gross income" in construing "gross receipts" conflates two different terms and results in a construction not intended by the Legislature. Accordingly, the ALC's reliance on "gross income" to limit the definition of "gross receipts" as used in the apportionment statute - an argument not advanced by either party - was an error.

5. The ALC erred in interpreting the meaning of "sales" based on the principle of "income-producing activity."

The ALC also concluded that the principal from the sales of securities was excluded from the term "sales" because the definition of "sales" 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." (Amended MSJ Order at 29.) 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. (Amended MSJ Order at 29-30.) Once again, this argument was not advanced by either party in its briefs or during the summary judgment hearing.

More importantly, the ALC once again confused two sections of the income tax statute intended to apply to different state income tax concepts. "Income-producing," as used in the sales factor apportionment statute, is a cost-based **sourcing principle** applied to determine **where** a receipt should be sourced for purposes of determining the numerator of the apportionment factor. The concept of income-producing activity has no bearing on whether particular receipts should be included or excluded from the sales factor **denominator**.

The ALC also relied on *Eastman Kodak Co. v. South Carolina Tax Commission*, 308 S.C. 415, 418 S.E.2d 542 (1992), in support of its holding. However, this case is 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 issue of whether the receipts from the transactions were included at "gross" or "net" was simply not before the *Kodak* court.

III. THE ALC ERRED IN CONCLUDING THAT DUKE ENERGY IS ENGAGED IN MANUFACTURING AND ELECTRICITY IS TANGIBLE PERSONAL PROPERTY.

The ALC ignored much of the evidence in the record and the testimony of both Duke Energy's expert witness and the Department's expert witness who gave sworn

testimony that electricity was not tangible personal property. (Amended Final Order 7, 22-26.) Instead, the ALC concluded on its own that electricity was tangible personal property. *Id.* The ALC then concluded that Duke Energy "manufactures" tangible personal property. (Amended Final Order 12-19.) As a matter of law the ALC's holding is incorrect. Further, the ALC's holding is erroneous in view of the reliable, probative, and substantial evidence on the whole record, the ALC decision constitutes an abuse of discretion and, thus, this Court should reverse. S.C. Code Ann. § 1-23-610(B).

During the Tax Periods at Issue, taxpayers whose "principal business" in South Carolina was the "(a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State; or (b) selling, distributing, or dealing in tangible personal property within this State" were required to apportion their income based on a multi-factor apportionment formula, consisting of property, sales, and payroll factors. S.C. Code Ann. § 12-6-2250 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1140 (applicable to tax years prior to 1996). **All other taxpayers** (except certain specific industries not relevant here) whose "principal profits or income ... are derived from sources other than those described in Section 12-6-2250" had to apportion their income using a single-factor gross-receipts apportionment formula. S.C. Code Ann. § 12-6-2290 (applicable to tax years after 1995); S.C. Code Ann. § 12-7-1190 (applicable to tax years prior to 1996).

The ALC stated the Electricity Issue before it as follows:

> [W]hether Duke Energy, based on its activities within the State, falls under Section 12-6-2250 as a "manufactur[er]," **or** whether Duke Energy is a seller of service, or otherwise falls under none of the above categories, and is therefore required to apportion its income to South Carolina based on

> the single-factor gross-receipts apportionment formula pursuant to Section 12-6-2290 . . . ."

(Amended MSJ Order 23 (emphasis added).)

A. The ALC's holding fails to recognize that taxpayers engaged in the business of manufacturing are only those dealing in tangible personal property.

South Carolina courts and the Department have always viewed manufacturers as persons dealing in tangible personal property. *Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev.*, 2009 S.C. Tax LEXIS 56, *48, *58 (S.C. Admin. L. Ct. May 4, 2009) (the multi-factor apportionment method set forth in S.C. Code Ann. § 12-6-2250 "is used for taxpayers whose principal business in South Carolina is dealing in **tangible personal property** (typically used by businesses that manufacture, sell, or rent tangible personal property)," whereas the gross-receipts apportionment method set forth in S.C. Code Ann. § 12-6-2290 is "normally used by taxpayers **who do not deal with tangible personal property**, such as financial businesses and **service businesses** . . . .)) (emphasis added), *upheld on appeal*, 388 S.C. 138, 694 S.E.2d 525 (2010); S.C. Rev. Proc. No. 09-1, 2009 S.C. Tax LEXIS 84, *2-3 (S.C. Dep't of Rev. 2009) ("South Carolina generally requires the use of one of the following apportionment methods: 1. (a) A 'three factor' apportionment method (based on property, payroll, and double-weighted sales) or (b) [after 2006,] a 'single factor' apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in **tangible personal property**. This method is typically used by businesses that **manufacture**, sell, distribute, or rent **tangible personal property**. 2, A 'gross receipts' apportionment method for taxpayers **not**

dealing in tangible personal property. This method is typically used in the financial businesses and **service businesses** . . . .") (Emphasis added).[14]

Taxpayers whose principal business in South Carolina is dealing in tangible personal property, and service providers are two distinct categories of taxpayers, subject to entirely different apportionment regimes. The ALC failed to recognize this distinction and held that Duke Energy is engaged in manufacturing – even though Duke Energy provides a service.

1. Electricity is not "tangible personal property."

"Tangible property," as set forth in Article 1 of the Income Tax Act, is defined to include "real property and corporeal personal property but does not include money, bank deposits, shares of stock, bonds, credits, evidence of debt, choses in action, or evidence of an interest in property." S.C. Code Ann. § 12-6-30(11).

The Department agreed that Duke Energy was providing a service, but it, nevertheless, contended that Duke Energy was engaged in the sale of tangible personal property for **income tax purposes** because the service of providing electricity was included in the definition of tangible personal property **for South Carolina sales and use tax** purposes. See S.C. Code Ann. § 12-36-60. (Department's Pre-Trial Brief at 8-9; Departmental Determination at 3.) However, that very same statute clearly stated that electricity is a service. And nothing in the income tax code provides that the service of providing electricity is included in the definition of tangible personal property for income

[14] *See also* Private Letter Ruling No. PLR-03-1, 2003 S.C. Tax LEXIS 263 (S.C. Dep't of Rev. March 10, 2003); Private Letter Ruling No. PLR-95-9, 1995 S.C. Tax LEXIS 325 (S.C. Dep't of Rev. Aug. 14, 1995) (same); Technical Advice Memorandum No. TAM-94-2, 1994 S.C. LEXIS 162, *4 (S.C. Dep't of Rev. Sept. 20, 1994) (same); *In Re: A Finding Concerning The Income Tax Liability Of XXX, Inc.*, 1993 S.C. Tax LEXIS 113 (1993); Information Letter No. IL-11-13, 2011 S.C. Tax LEXIS 20 (S.C. Dep't of Rev. Aug. 19, 2011); Information Letter No. IL-10-9, 2010 S.C. Tax LEXIS 42 (S.C. Dep't of Rev. Sept. 14, 2010).

taxes. In fact, the income tax definition of tangible personal property makes no mention of electricity or electric service.

The sales and use tax definition of "tangible personal property" provides:

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

S.C. Code Ann. § 12-36-60 (emphasis added). Unlike the definition of "tangible personal property" under the Sales and Use Tax Act, the definition of "tangible property" as set forth in the Income Tax Act does not include sales of any services or intangibles such as sales of electricity.

The ALC also failed to recognize the significance of the differences between the sales tax definitions of "tangible personal property" and the income tax definition of "tangible property." (Amended Final Order at 23-24.) The ALC reasoned that because the first sentence of the sales and use tax definition of "tangible personal property" "coincides with the general understanding of the term 'corporeal' included in the [income tax] definition of 'tangible property,'" "according to the plain and ordinary meaning [of the income tax definition] which is supported by the general [sales and use tax] definition of tangible personal property given in the first sentence of Section 12-36-60, I conclude that electricity is tangible personal property." *Id.*

The ALC's reasoning makes little sense. While the First Clause of the sales tax definition of "tangible personal property" might be instructive in interpreting the term "corporeal" used in the income tax definition of "tangible property," it does not follow

that electricity is tangible personal property for **income tax** purposes. Indeed, the South Carolina Legislature recognized that "tangible personal property" is not ordinarily understood to include services and intangibles such as sales of electricity when it included services like electricity in the sales tax definition of tangible personal property. The specific inclusion of electricity would be superfluous if, as the ALC reasoned, the Legislature understood the general meaning of tangible personal property to include electricity. *See, e.g., CFRE, LLC v. Greenville Cnty. Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) ("a statute must be construed in a manner so 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.") (internal citations and quotations omitted).

This common understanding of the nature of electricity in South Carolina law is also confirmed by *Consolidated Hydro Southeast, Inc.v. South Carolina Department of Revenue & Taxation*, No. 95-ALJ-17-0634, 1996 WL 909155 (S.C. Admin. L.J. Div. May 13, 1996). In that case, the court concluded that sale of power by the company was a sale of services for South Carolina license tax purposes. The Court specifically noted:

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

Id. at *4 (emphasis added).

Even if the definition of "tangible property" is deemed to be ambiguous, such ambiguities must be resolved in favor of Duke Energy. "Generally, a court must apply the rules of statutory construction to resolve the ambiguity and discover the intent of the

legislature. However, in the enforcement of tax statutes, the taxpayer should receive the benefit in cases of doubt." *See, e.g., Alltel Commc'ns. Inc.*, 399 S.C. at 321, 731 S.E.2d at 873 (internal citations and quotations omitted).

2. Electricity is not "tangible" and thus, it cannot be "tangible personal property."

The ALC abused its discretion in finding that electricity was tangible personal property. The ALC denied the Department's Motion for Summary Judgment on the Electricity Issue finding that material facts were necessary to determine the nature of electricity.

The ALC heard extensive testimony from a number of witnesses, all of whom concluded that the sale of electricity was the sale of a service.[15] According to Professor Papapolymerou[16], Duke Energy's expert witness, the provision of electricity involves the provision of a field – an electromagnetic field that lacks physical characteristics, cannot be created or destroyed, and is neither a matter nor a material. (Trial Tr. 254:16-:25, 261:3-262:24, 270:15-271:5, 278:25-279:3.) Electricity is not an object; it is a flow of power that is generated by the manipulation of magnetic fields. *Id.* Electricity has no physical shape or form, height, weight, volume or other dimension typically attributable to tangible property. (Trial Tr. 119:13-121:4, 270:15-271:24, 302:6-304:24.) Professor Papapolymerou testified that one could see the effects of electricity, as in a lightning strike, or feel the effects, as in a shock, but electricity itself cannot be seen or touched. Like wind, sunlight, sound, and heat, electricity has no physical form or body. (Trial Tr.

[15] The Department's expert witness Glen Robinson's testimony at trial was conflicting, at best. Mr. Robinson testified that Duke Energy's provision of electricity on a flat-fee basis is a service, and its provision of electricity on a metered-basis is tangible property. (Trial Tr. 384:5-385:13.) Yet, Mr. Robinson acknowledged that in either scenario, the electricity provided is exactly the same. (Trial Tr. 385:4-:13.)

[16] Professor Papapolymerou

258:20-259:2, 263:1-:3, 270:15-:24, 273:1-274:25, 290:8-291:1.) *See Omaha Pub. Power Dist. v. Neb. Dept't of Revenue*, 248 Neb. 518, 531, 537 N.W.2d 312, 320 (1995) (Caporale, J. concurring) (electricity "has no physical substance in the sense those two words are commonly understood . . . it has no readily discernible physical form in the sense that do items such as axes, books, cloth, desks, elevators, fiddles, gavels, and the like.").

Professor Papapolymerou's testimony also established, and Respondent's expert agreed, that Duke Energy does not create the electrons residing in the power lines, and the provision of electricity is not the transfer of electrons to the customer: the electrons simply facilitate the propagation of electricity. (Trial Tr. 291:2, 298:13-:21, 363:25-364:4.)

Disregarding both experts' testimony, and the testimony of Duke Energy's Chief Generation Officer, Mr. Jamil, the ALC erroneously held that electricity is tangible personal property because: it "is a physical product" with "physical characteristics;" "the electric charge associated with electricity is a physical property of matter;" "the electric charge ... can be stored;" "it certainly is possible to feel electricity's impact in the body;" "electricity can be moved, manipulated, and stored;" "electricity is a fungible product;" electricity "can be created, measured, felt, stored, and consumed, and an electric utility may exercise ownership rights over it." (Amended Final Order at 24.)

Many things that can be measured, manipulated, felt, or stored are not "tangible." For example, uncontroverted testimony shows that time can be measured and hardly anyone can argue that time is tangible. (Trial Tr. 276:7-:12, 364:23-:24.) Gravity can be measured, manipulated and stored, but is not tangible. (Trial Tr. 148:4-:19, 263:13-:18,

275:1-:25.) Sunlight, heat and cold can be felt, measured and stored, but are not tangible. (Trial Tr. 274:7-:19, 290:14-291:1, 302:6-:13.) As succinctly summarized in *EUA Ocean State Corp. v. Commissioner of Revenue*, 2006 Mass. Tax. LEXIS 35, *29 (Mass. Tax 2006), which examined this precise issue in the context of computing the sales apportionment factor, electricity "is of a nature similar to heat, light and sound, all of which can be sensed and even measured but, given their lack of form or substance, would not be considered 'tangible.'"

The ALC also refers multiple times to electricity as a "product" in interpreting its meaning. (Amended Final Order at 17, 18, 20, 24, 26.) The reference is not proper and is not relevant. First, the term "product" is not found in the income tax definition of "tangible property" or the apportionment statutes at issue here. Second, there is nothing in the record that indicates electricity is a "product."

3. Other authority holding that electricity is not tangible personal property.

In reviewing the characterization of electricity for state income tax purposes, the North Carolina Department of Revenue has opined as follows:

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

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

Most recently, the Oregon Tax Court addressed the precise issue in this case – the characterization of electricity for purposes of the income apportionment formula – and gave a concise analysis of the nature of electricity. *Powerex Corp. v. Dep't of Revenue,* TC 4800, 2012 Ore. Tax LEXIS 299, 2012 WL 4068501 (Or. Tax Ct. 2012). The court held that sales of electricity are sales of other than tangible personal property for Oregon corporate income tax apportionment purposes. Specifically, the court found that:

> The testimony of taxpayer's expert witness supports a finding that electricity does not involve the transfer of something that is tangible or a "thing" that is delivered to a purchaser. Rather, according to that testimony, the transmission of electricity involves transmission of a force occurring by reason of the operation of "virtual photons," which have no mass. Importantly, the testimony of taxpayer's expert established, and the department's witness agreed, that the sale of electricity is not the transfer of electrons from the seller to the buyer. There are as many electrons in the relevant system after the point of transmission of energy to the purchaser as before.
>
> . . .
>
> The conclusion that taxpayer's expert established is that electricity is a phenomenon in which virtual photons transmit force—not matter. Transmitters of force with no mass do not, in the opinion of the court, come within the legislative understanding of tangible personal property.

Id., 2012 Ore. Tax LEXIS 299 at *6-8, 2012 WL 4068501 at *2-3. The court also noted that the Multistate Tax Commission ("MTC")[17] treats electricity as intangible property. *Id.*, 2012 Ore. Tax LEXIS 299 at *8-9, 2012 WL 4068501 at *3-4.[18]

California and Massachusetts have also concluded that electricity is other than tangible personal property for corporate income tax purposes.[19] *In re Appeal of*

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[17] The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. *See* About the Multistate Tax Commission, *available at* http://www.mtc.gov/About.aspx?id=40. South Carolina is a sovereignty member of the Commission.

[18] The Department has looked to the Multistate Tax Commission for guidance in interpreting South Carolina's corporate income tax law. *See* Rev. Rul. No. 97-15 (Oct. 22, 1997).

PacifiCorp, 2002-SBE-005-A, 2002 Cal. Tax LEXIS 469 (Cal. SBE Sept. 12, 2002), the California State Board of Equalization ("SBE") concluded that electricity is intangible rather than tangible and that the sale of electricity is the sale of a service rather than a product. The SBE also noted that both the MTC and the Federation of Tax Administrators[20] treat the sale of electricity as a service, rather than the sale of tangible personal property for corporate income tax purposes. *Id.* at *11.

The Massachusetts Appellate Tax Board also ruled that electricity was not tangible personal property for income tax apportionment purposes. *EUA Ocean State Corp. v. Commissioner of Revenue,* No. C258405-406, 2006 Mass Tax LEXIS 35 (Apr. 24, 2006).[21]

4. The ALC improperly mischaracterized Duke Energy as a manufacturer.

The ALC's mischaracterization of Duke Energy as a manufacturer is premised on two decisions, issued in other contexts more than eighty years ago and disregards more current interpretations of Duke Energy's business: *Columbia Railway, Gas & Electric Co. v. South Carolina Tax Commission*, 134 S.C. 319, 132 S.E. 611 (1926), and *Duke Power Co. v. Bell*, 156 S.C. 299, 152 S.E. 865 (1930). Those decisions were, of course, issued under a different set of tax statutes - the Manufacturer's Tax Act, former 33 S.C. Stat. 12, § 11-A (1923). Unlike the tax regime at issue in those cases, the term "manufacturing" used in the income tax statutes presupposes a taxpayer dealing in tangible personal property. And more importantly, the courts in those cases did not

[19] California and Massachusetts are Associate & Project members of the Multistate Tax Commission. Oregon is a Compact Member.
[20] The Federation of Tax Administrators ("FTA") is an organization of state tax officials. *See* http://www.taxadmin.org/. The Department is a member tax agency of the FTA.
[21] Duke Energy notes that while other states have ruled that the sale of electricity is a sale of tangible personal property in other tax contexts, none of those cases are in the context of income tax apportionment.

examine the taxpayer's activities – the courts simply relied on a single statement in the company's charter. These cases are of little help in interpreting, eighty years later, whether Duke Energy is principally engaged in manufacturing or in providing services.

B. The ALC erred in holding that the Department has a "Long-standing Policy" of Treating Electric Service Providers as Manufacturers.

Agencies adopt (or announce) policies through the promulgation of regulations or policy documents, which in the Department's case would include Revenue Rulings, Revenue Procedures, Public Letter Rulings and Agency Publications. The Department's only evidence of its purported longstanding policy to treat power companies as manufacturers is a corporation audit manual which was never published or otherwise distributed outside of the Department.[22] (Trial Tr. 211:8-217:15; 237:10-:14.)

At best, the audit manual offers conflicting evidence of Respondent's policy. On the one hand, the audit manual states that service providers (those whose principal business was providing a service) must apportion their income to South Carolina based on the single-factor gross-receipts apportionment method. If the provision of electricity constitutes the provision of a service, then under the audit manual, a company like Duke Energy, engaged in the provision of electric service, is required to apportion using the single-factor apportionment formula. On the other hand, the audit manual states, without any further explanation, that power companies must use the multi-factor apportionment formula. (Trial Tr. 223:22-:25.) The Department's witness was unable to explain this inconsistency.

Indeed, the South Carolina Supreme Court only recently opined that because an agency guideline "has not been formally adopted as a regulation, it does not have the

[22] The audit manual relied upon by the Department is not dated and the Department has not otherwise introduced testimony to indicate when the manual was prepared by the Department.

force and effect of law and is entitled to no deference." *Doe v. S.C. Dep't of Health & Human Srvc.*, 398 S.C. 62, 68, 727 S.E.2d 605, 608 (2011). Because the policy stated in Respondent's audit manual contains unexplained inconsistencies and is an invalid "bootleg" regulation, the ALC erred in affording it any deference. *Comm'rs of Pub. Works v. S.C. Dep't of Health & Envtl. Control*, 372 S.C. 351, 359, 641 S.E.2d 763, 767 (Ct. App. 2007).

C. Other Evidence Indicating that Duke Energy's provision of electricity is a service.

The Department agreed that Duke Energy's provision of electricity was a service. (Departmental Determination at 3.) However, as described above, it mistakenly relied on the sales tax definition of "tangible personal property" in concluding that Duke Energy's sales of electricity were sales of tangible personal property for income tax purposes. *Id.*

The General Assembly also repeatedly refers to the furnishing of electricity as a "service" in the South Carolina Public Service Commission ("SCPSC") statutes, *e.g.*, S.C. Code Ann. § 58-27-620. Mr. Jamil testified that Duke Energy was a service provider. (Trial Tr. 116:18-117:5, 134:8-:18, 140:25-141:10.) Duke Energy holds itself as a service provider in its annual reports filed with the U.S. Securities and Exchange Commission ("SEC"). (Duke Energy's 10-K for the Fiscal Year Ended 2000 3; Duke Energy's 10-K for the Fiscal Year Ended 1997 1.) Duke Energy is subject to the jurisdictions of the SCPSC, which regulates electricity service providers, not manufacturers. (Trial Tr. 111:13-:19, 118:23-:24, 124:6-127:2, 134:1-:7).

Further, in preparing its federal income tax returns which are part of Duke Energy's South Carolina income tax returns, Duke Energy was required to list a Principal Business Activity Code, which is derived from the NAICS (formerly the U.S. Standard

Industrial Classification system ("SIC")).[23] These codes are determined based on the activity from which the company derives the highest percentage of its total receipts. During all of the Tax Periods at Issue, on its original and amended returns, Duke Energy included the code for the electric power generation, transmission and distribution utilities category, and not the manufacturing category, on its federal corporate income tax returns, which it filed as part of its South Carolina corporate income tax returns. (Trial Tr. 56:1-:3.) The Department never contested Duke Energy's use of the utility NAICS classification despite multiple audits that lasted for years at a time.

1. Duke Energy is a service provider because more than 50 percent of its receipts are from the sale of electric service.

The Department has previously ruled that:

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

Rev. Rul. No. RR-87-5, 1987 S.C. Tax LEXIS 15, at *3 (S.C. Tax Comm'n Sept. 16, 1987) (emphasis added).

Mr. Jamil and Duke Energy's State and Local Tax Director, Mr. Cooper Monroe, testified that the provision of electric service is Duke Energy's primary and principal business because Duke Energy derives its principal receipts or income from sales of

[23] The NAICS codes are available on the U.S. Department of Commerce's website, http://www.census.gov/eos/www/naics/. The ALC took issue in its Amended Final Order that the NAICS and federal income tax return instructions referenced by the witness pertained to years after the Tax Periods at Issue. However, Appellant's witness Cooper Monroe, who has prepared or reviewed Duke Energy's federal tax returns for twenty four years, testified that the NACIS (formerly SIC) codes that exist today are substantially the same as the ones in effect during the Tax Periods at Issue. (Trial Tr. 94:15-95:25.)

electrical service. (Trial Tr. 45:10-46:1; Amended Final Order 4.) Mr. Jamil's and Mr. Monroe's testimony is supported by Duke Energy's Form 10-Ks filed with the SEC and its federal income tax returns filed with the IRS and the Department. (1978-2001 Form 10-Ks; Duke Energy's 1978-2001 Tax Returns.) Although Duke Energy was engaged in other lines of businesses, such as sales of appliances, telecommunications, etc., at all times during the Tax Periods at Issue, more than 50 percent of Duke Energy's gross receipts were derived from the provision of electric services. *Id.*; (Trial Tr. 45:10-46:1.)

2. The ALC erred in holding that Duke Energy is engaged in processing goods or materials.

The ALC held that because Duke Energy uses coal, water or nuclear fuel to power its generators, it is engaged in the processing of goods and materials for income tax purposes and thus, required to use the three-factor formula. The ALC's reasoning makes little sense. Duke Energy's generators do not process any goods or materials. Instead, the generators cause a changing magnetic field that induces a flow of current, or electricity. Nothing tangible is created by this process. As the *Powerex* court stated succinctly, "[t]here are as many electrons in the relevant system after the point of transmission of energy to the purchaser as before." *Powerex Corp.*, 2012 WL 4068501 at *3.

CONCLUSION

Based on the foregoing, Duke Energy respectfully requests that this Court:

I. Reverse the ALC and enter a finding that the ALC erred in holding that, as a matter of law, Duke Energy's refund claims for the tax years 1978 through 1993 were untimely.

II. Reverse the ALC and enter a finding that Duke Energy is required to include its gross receipts from the sales of securities in the computation of its apportionment formula.

III. Reverse the ALC and enter a finding based on the uncontested evidence that Duke Energy is not a manufacturer, is not engaged in processing goods and materials, that electricity is not tangible personal property, and therefore, Duke Energy is required to apportion its income pursuant to the single-factor gross-receipts apportionment method.

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