

## Taxpayer Victory in South Carolina 'Bifurcated' Apportionment Case

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The South Carolina Court of Appeals, in an opinion released today, ruled in favor of the taxpayer in *CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, Opinion No. 4953 (March 14, 2012). The Court of Appeals ruled that where the SC Department of Revenue ("Department") seeks to deviate from the standard method of apportionment, the Department – and not the taxpayer – bears the burden of proving that (1) the standard method should not be used and (2) the alternative method is reasonable and is more appropriate than any competing method.

A copy of the court's opinion can be [accessed here](#).

Reed Smith participated in the case, on behalf of the Council on State Taxation, as amicus curiae.

### Background

CarMax Auto Superstores West Coast, Inc. ("Taxpayer") is a retailer of used light trucks and automobiles, and operates CarMax retail locations in several Western states, including California, Utah, and Nevada. CarMax Auto Superstores, Inc. ("East") is a related entity that operates CarMax retailers in several Eastern states, including South Carolina. Also, prior to 2004, East handled financing and corporate overhead/management.

The transactions at issue in the case involved an "East-West" structure. Prior to 2004, and in addition to its retail activities, Taxpayer held and managed certain intangible property ("IP"). Taxpayer licensed the use of the IP to East, in exchange for a royalty fee payment. East regularly filed South Carolina corporate income tax returns and received a deduction against its income for royalty and other payments to Taxpayer. In 2004, the Taxpayer's corporate structure was reorganized. As a result, the financing operations and ownership of the intellectual property

were moved to CBS. Taxpayer and East paid a management services fee, which included a royalty component, to CBS.

On audit, the Department contended that the Taxpayer's returns failed to reflect fairly the extent of the Taxpayer's business in South Carolina. To correct this perceived distortion, the Department essentially bifurcated Taxpayer into two separate entities – an intangibles licensing company and a company that conducted the rest of Taxpayer's retail sales business. To accomplish this, the Department utilized an alternative apportionment method. The Taxpayer's income from royalties and financing was apportioned to South Carolina using a ratio of the Taxpayer's receipts from royalties and financing from within South Carolina by the Taxpayer's royalty and financing receipts from all locations in which it does business. None of the Taxpayer's retail income was apportioned or allocated to South Carolina.

Taxpayer filed a contested case hearing before the SC Administrative Law Court. The Administrative Law Court ("ALC") ruled in favor of the Department and determined that the alternate method was reasonable and did not violate the Commerce Clause.<sup>1</sup>

## **The Court of Appeals Decision**

The Court of Appeals decided the case in favor of the Taxpayer solely on the issue of burden of proof, finding that the Department – not the Taxpayer – had the burden of proving that (1) the standard apportionment method did not fairly represent the Taxpayer's business activity in South Carolina, and (2) the alternative method proposed is reasonable and more fairly represents the business activity in the state. With respect to the second burden of proof, the Court of Appeals relied on the South Carolina Supreme Court's decision in *Media General Communications, Inc. v. South Carolina Department of Revenue*<sup>2</sup>, and determined that the Department, as the proponent of an alternative apportionment method, must establish that the bifurcated apportionment method is not only appropriate, but is also more appropriate than any competing methods. The court did not address the substantive issues – that is, whether bifurcation is an appropriate method – in the case.<sup>3</sup> Instead, the court ruled that the ALC erred in finding Taxpayer had the burden of proving that the Department's bifurcated apportionment method was not reasonable. The case has been remanded back to the SC Administrative Law Court for a reconsideration of all issues.

## Reed Smith's Observations

The court's decision in this case is not surprising, given that the bench's line of questioning during the January 26 oral argument in the case was almost exclusively focused on the burden-of-proof issue. It will be interesting to see whether the Administrative Law Court's review of this case on remand, under the burden of proof as outlined by the Court of Appeals, will alter the Administrative Law Court's prior analysis of the issues.

## About This Reed Smith State Tax Alert

For more information on the *CarMax* case, or to discuss the potential implications of this decision on South Carolina audit disputes, please contact the authors of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's state tax practice, visit [www.reedsmith.com/statetax](http://www.reedsmith.com/statetax).

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1. For additional background regarding the Administrative Law Court's decision, please see our June 15, 2010 Alert entitled, "South Carolina Courts Tackle UDITPA Section 18 Issues in *Media General and CarMax*," [accessible here](#).
  2. 388 S.C. 138 (SC 2010).
  3. In addition to the burden-of-proof issue, CarMax raised the following substantive issues not addressed by the Court of Appeals: the Administrative Law Court erred in (1) failing to consider and find that CarMax West operates a unitary business; (2) concluding that the activities of CarMax West in South Carolina are not fairly represented by the standard statutory apportionment method; (3) allowing the Department to apply separate



accounting to a unitary business; (4) failing to apply the “place of activity” test set forth in *Lockwood Greene Engineers v. South Carolina Tax Commission*, 293 S.C. 447 (SC Ct. App. 1987) and concluding that CarMax West’s financing receipts should be sourced to South Carolina; and (6) concluding that the Department did not violate CarMax West’s constitutional rights by applying separate accounting to a unitary business and by sourcing financing receipts to South Carolina.

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