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LEGAL ALERT

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South Carolina Court Places Dual Burden on Department of Revenue in Alternative Apportionment Cases

On March 14, 2012, the South Carolina Court of Appeals issued its decision in *CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, No. 4953 (S.C. App. Ct. 2012), holding that the South Carolina Department of Revenue (Department) must satisfy two burdens in asserting an alternative apportionment formula: (1) that the statutory apportionment method did not fairly represent the taxpayer's business activities in the state; and (2) that the Department's proposed alternative apportionment method was more reasonable than any competing method.

Background

CarMax Auto Superstores West Coast, Inc. (CarMax West) operated a network of car dealerships, which sold used vehicles in the western United States. It also licensed intangibles to an affiliated entity, which sold used vehicles in the eastern United States and performed some financial functions for itself and its affiliate.

On audit, the Department determined that the South Carolina standard statutory apportionment formula did not fairly represent the extent of CarMax West's business activity in the state. The Department invoked its authority to apply an alternative apportionment method by apportioning CarMax West's income from royalties and financing separately from its income from retail operations. The bifurcation approach used by the Department produced a significantly higher South Carolina apportionment ratio than the statutory apportionment formula used by CarMax West.

The Administrative Law Court (ALC) initially held that the Department met its burden that the statutory method did not fairly represent the taxpayer's South Carolina business activities and that the *taxpayer* had the burden of proving that the alternative apportionment formula used by the Department was not reasonable.

Court of Appeals Decision

On appeal, the South Carolina Court of Appeals reversed the ALC and held that the Department, as the party seeking to deviate from the standard statutory formula, had to satisfy two burdens. First, the Department had the burden of proving that the statutorily prescribed formula did not fairly represent CarMax West's business activity in South Carolina. Second, the Department had the burden of proving that its alternative method is not only appropriate, but more appropriate that any other competing method. The Court of Appeals stated in its opinion, "[i]t is only logical that a party seeking to override the legislatively determined apportionment formula bears the burden of proving that method is not appropriate and an alternative method more accurately reflects the taxpayer's business activity within the state."

The Court of Appeals did not address the substantive issues in the case and remanded the case to the ALC for a reconsideration of all issues. However, the Court of Appeals rejected CarMax West's assertion that the clear and convincing standard of proof should apply and held that, although the statutes did not provide the standard of proof, the correct standard to apply is the preponderance of the evidence burden of proof.

Sutherland Observations: The Court of Appeals holding that an alternative apportionment method must not only be appropriate but also be more appropriate than any other method creates a much higher burden on the party seeking to deviate from the statutorily provided apportionment method. On remand, the Department will not only be required to prove by a preponderance of the evidence that the standard statutory formula is not appropriate and its proposed alternative apportionment formula is appropriate, but also that its alternative apportionment formula is more appropriate than any other proposed formula.

In *Media General Communications v. South Carolina Department of Revenue*, 338 S.C. 138 (2010), the South Carolina Supreme Court approved the use of combined reporting as an authorized alternative apportionment method. The decision created potential risks for taxpayers because it opened the door for the Department to use a "forced combination" tactic to require taxpayers to apportion their income on a combined reporting basis. The *CarMax* decision should alleviate some taxpayer fears as it places a limitation on the Department's ability to force taxpayers to file a combined report because the Department must first prove by a preponderance of the evidence that combined entity apportionment is the most appropriate alternative method.

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