Alert 10-145

South Carolina Courts Tackle UDITPA Section 18 Issues in ***Media General*** and ***Carmax***

The South Carolina courts have recently issued two important decisions interpreting the South Carolina Department of Revenue's ("Department") alternative apportionment authority under South Carolina's version of UDITPA section 18 – S.C. Code § 12-6-2320. S.C. Code § 12-6-2320 allows a taxpayer to petition for, or the Department to require, the use of an alternate allocation and apportionment method if the standard allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state.[1]

Yesterday, the South Carolina Supreme Court unanimously affirmed a lower court decision in *Media General*, concluding that S.C. Code § 12-6-2320 permits the use of combined reporting as an alternate apportionment method. *Media General Communications, Inc., et al. v. South Carolina Department of Revenue*, Opinion No. 26828 (June 14, 2010). This decision comes on the heels of an April 2010 decision by the South Carolina Administrative Law Court that authorizes the Department's use of a "bifurcation" apportionment method as an alternative to the standard apportionment provisions. *Carmax Auto v. South Carolina Department of Revenue*, Docket No. 09-ALJ-17-0160-CC (April 22, 2010). Both decisions have important implications for taxpayers. Specifically, taxpayers with corporate structures that include an intangible holding company may find that the Department will use its powers under S.C. Code § 12-6-2320 to require combined reporting or bifurcation on audit. In fact, it is possible that the Department may use both methods of attack against the same taxpayer for different tax years, with the method chosen dependent on which method produces the most tax.

Media General: Combined Reporting Permitted to Prevent Distortion

Background

Media General, Inc. ("Media General") and its affiliates comprised a "unitary group" and operated converged media operations where television, newspaper, and online products and information were merged and leveraged off of each other. Under the facts, certain Media General affiliates licensed their intangible assets to Media General and charged Media General a flat royalty fee. Media General then sublicensed the intangibles to other members of the unitary group and charged a royalty fee. These assets were used in multistate operations, including those operations conducted in South Carolina.

Pursuant to a "Geoffrey" nexus theory, the Department asserted nexus over Media General, and its affiliates, MG Communications, and MG Broadcasting (collectively, the "MG Group") and issued corporate income tax assessments. In determining these assessments, the Department utilized the separate entity apportionment method, which is the standard apportionment method used in South Carolina for apportioning income among multistate, related business entities. The MG Group responded by protesting the assessments and asking the Department to use an alternative combined entity apportionment methodology to fairly represent their business activities in South Carolina pursuant to S.C. Code § 12-6-2320.

Although the Department agreed that the standard statutory method it used did not fairly represent the MG Group's income, and that the combined entity apportionment method did fairly measure the MG Group's business activity in South Carolina, the Department declined the group's petition to use the combined apportionment method on the ground that the Department was not authorized under South Carolina statutory and case law to apply the combined entity apportionment method.

The South Carolina Supreme Court disagreed. It held that S.C. Code § 12-6-2320 was a "relief mechanism," and that

subsection (A)(4) "clearly authorizes the Department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income, including the combined entity apportionment method."

Taxpayer Implications

Although the *Media General* case is a taxpayer victory, it is not necessarily a loss from the Department's perspective. Taxpayers should note that the Department will likely view the court's approval of the combined entity apportionment method as an invitation to begin using its discretionary power to proactively combine taxpayers on audit. The court's decision does not appear to limit the use of the combined entity apportionment method to instances in which the method is petitioned for by a taxpayer. In fact, the court indicated in its opinion that "the Department need not automatically use the method requested by a taxpayer, as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina." Thus, *Media General* is likely to have implications for any unitary business operating in South Carolina through separate corporations, including captive Real Estate Investment Trusts, cash management companies and intangible holding companies.

Carmax: SC Administrative Law Court Approves Bifurcated Apportionment Method

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. In 2004, Carmax Business Services, LLC ("CBS") was created. CBS is a flow-through entity that is owned by Taxpayer and East.

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 from that income for royalty and other payments.

Beginning in 2004, the ownership of the groups' intangibles changed. The IP previously held by Taxpayer was placed in CBS in exchange for an interest in CBS's income distributions. East also contributed certain assets to CBS in exchange for an ownership interest in CBS. After the restructuring, CBS managed the intangibles formerly held by Taxpayer and provided financial services to all Carmax retailers.

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, the Department utilized an alternative apportion method under which the Taxpayer's income from its retail operations and its income from royalties and financing were "bifurcated" and apportioned separately. 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.

The Taxpayer argued that the alternative apportionment statute was not triggered in this case because the Taxpayer income was derived from a unitary business and that, consequently, no portion of its income can be separately considered for apportionment purposes. The court rejected this argument stating that the question of whether a taxpayer's business is "unitary" or "non-unitary" is not outcome determinative. Rather, "[t]he significance of considering the taxpayer's South Carolina source income apart from its retail operations is inherent in the language of § 12-6-2320 regarding 'the extent of the taxpayer's business activity in this State.'"

> Where a taxpayer engages in a trade or business in another state but receives income from a separate line of business in this State, it is only reasonable that careful consideration be given to how that taxpayer's business is represented in this State for tax purposes. In this case, the lines of business and the South Carolina ratios of the various entities involved showed that a standard statutory formula could not fairly represent the taxpayer's business activity in this State. Thus an alternative formula was warranted.

The Taxpayer also argued that the Department's method was unreasonable. The court determined that excluding the retail income earned by the Taxpayer in other states from the ratio used to apportion its income was reasonable because "the Department's method considers only the business conducted in this State, and because separate accounting is a method expressly permitted by § 12-6-2320(A)(1)."

The Taxpayer also challenged to no avail whether the Department had properly sourced the Taxpayer's financing income to South Carolina, and whether the Department's application of S.C. Code § 12-6-2320 to the Taxpayer violated the Taxpayer's rights under the Commerce Clause. The court rejected these grounds. However, the court did dismiss the negligence and substantial understatement penalties assessed by the Department because the Taxpayer lacked notice of the Department's "alternative self-designed" bifurcation method.

Taxpayer Implications

The Department has applied the bifurcation approach in a number of recent taxpayer audits and the Administrative Law Court's ruling in *Carmax* will surely embolden the Department to apply the bifurcation approach to other taxpayers. Taxpayers with corporate structures that include an entity that conducts retail / operational activities outside of South Carolina, while also managing intangible assets used in South Carolina, should take heed. However, all is not lost. Although the Department has won round one at the Administrative Law Court level, the battle over the Department's bifurcation approach is not over. We believe that the Administrative Law Court's decision misunderstands the unitary business concept, which is a constitutional principle that cannot be trumped by a state discretionary adjustment statute.

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For more information on the *Media General* or *Carmax* cases, or the tax issues discussed in this *Alert*, please contact one of the authors, or the Reed Smith attorney with whom you regularly work. For additional information on Reed Smith's State Tax Practice, visit www.reedsmith.com/statetax.

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1. Specifically, S.C. Code § 12-6-2320(A)(4) provides that if the allocation and apportionment provisions do not fairly represent the taxpayer's business activities in South Carolina, the taxpayer may petition for, or the Department may require, if reasonable, the employment of any other method to effectuate the equitable allocation and apportionment of the taxpayer's income.

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