



## South Carolina Supreme Court Sets Burden on Alternate Apportionment Formula

As an increasing number of states shift to single-factor apportionment, the issue of which party bears the burden of proof in establishing an alternative apportionment formula is becoming increasingly controversial. The South Carolina Supreme Court has weighed in on this issue by following the common-sense approach that whichever party invokes an alternative apportionment formula bears the burden of proving that the statutory formula does not fairly represent a taxpayer's in-state business activities.

In *CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*,<sup>1</sup> the South Carolina Supreme Court held that where the Department of Revenue asserts that a statutory apportionment formula does not fairly represent a taxpayer's business activity in the state for income tax purposes, the Department bears the burden of establishing that lack of fair representation by a preponderance of the evidence. The court further held that the Department also bears the burden of establishing by a preponderance of the evidence that its alternative accounting method is rea-

sonable. The court clarified that the Department was not required to prove that its alternative accounting method was *more reasonable* than any other method, but only that its alternative method was reasonable.

**Background.** CarMax, one of the nation's largest retailers of used automobiles, initially formed two wholly owned subsidiaries—CarMax Auto Superstores, Inc. (referred to by the court as CarMax East), which owned and operated used car stores throughout the East Coast and Midwest (including South Carolina), and CarMax West, which owned and operated all of the used car stores on the West Coast and owned all of CarMax's intellectual property. From 2002-04, CarMax East paid royalties to CarMax West for use of the CarMax intellectual property in accordance with a licensing agreement.

In 2004, CarMax reorganized its corporate structure by creating CarMax Business Services, LLC (CarMax Business) as a two-member LLC with CarMax East and CarMax West as its two members. CarMax Business managed all CarMax's intellectual property and provided all corporate overhead and financing services, and CarMax East and CarMax West each paid a management fee to CarMax

Business for these services. As a result, CarMax Business was taxed as a partnership, and CarMax East's management fee payments—as well as additional financing revenue generated by CarMax Business's financing arm in South Carolina—"flowed through" to CarMax East and CarMax West.

The sole issue in the case involved the apportionment of CarMax West's income under South Carolina law. Initially, for tax years 2002-07, CarMax West employed a weighted three-factor formula of property, payroll, and double-weighted sales. In 2008, the Department of Revenue audited CarMax West and issued a proposed assessment adjusting that apportionment formula. CarMax West filed a formal protest and, in early 2009, the Department issued a determination upholding the Department's assessment based on that three-factor apportionment formula.

Six months after the determination was issued, CarMax West filed amended tax returns based on a statutory "gross

The court's holding establishes that tax minimization strategies and a significant difference in tax between related companies alone are not enough to establish that the statutory apportionment formula is unfair.

receipts" formula. That statutory formula required CarMax West to determine its South Carolina income by multiplying CarMax West's total apportionable income by a fraction, the numerator of which is its gross receipts in South Carolina and the denominator of which is the gross receipts everywhere the company does business.

The Department rejected CarMax West's use of the gross receipts method on the ground that it did not fairly represent CarMax West's business activities in South Carolina. Specifically, the Department took the position that inclusion of all of CarMax West's retail sales inflated the denominator because Car-

DANIEL A. KITTLE is an attorney with the law firm of Lane Powell PC in Seattle, Washington.

Max West did not make *any* retail sales in South Carolina.

As a result, the Department applied an alternative apportionment formula that excluded retail sales from the denominator. In other words, the Department's alternative formula compared CarMax West's South Carolina income (from financing and intangibles) to only CarMax West's financing and intangible income everywhere else. The Department also sought to include income from the sale of securitized consumer lending contracts in CarMax West's South Carolina income.

The Department issued a final determination upholding the alternative formula, and CarMax West filed a contested case in the Administrative Law Court. The Administrative Law Court affirmed the Department's use of the alternative formula but dismissed any penalties against CarMax West. CarMax West appealed to the South Carolina Court of Appeals, and the Court of Appeals reversed and remanded to the Administrative Law Court for application of the correct burden of proof. The South Carolina Supreme Court accepted review.

**Burden of proof.** Where a taxpayer conducts business both inside and outside the state, South Carolina law imposes income tax only on "a base which reasonably represents the proportion of the trade or business carried on within" South Carolina using allocation and apportionment.<sup>2</sup>

CarMax West utilized a statutory gross receipts apportionment formula, which requires a taxpayer to multiply its total apportionable income by "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."<sup>3</sup> However, if the use of that formula does not "fairly represent the extent of the taxpayer's business activity in this State," then the taxpayer "may petition for" or the Department "may require" an alternative apportionment method—as long as the alternative method is "reasonable."<sup>4</sup>

The sole issues in this case related to the proper burden of proof and the application of that burden. The Administrative Law Court placed the burden of proof of establishing proper apportionment on CarMax West as the party re-

questing an administrative proceeding. The Court of Appeals reversed, holding that as the "proponent of the alternative apportionment method," the Department was required to establish that the statutory apportionment formula did not fairly represent CarMax West's South Carolina business activity. The Court of Appeals also went on to hold that the Department was required to establish that its alternative apportionment method was more appropriate than any other method.

The Supreme Court concluded that the Court of Appeals was partly correct. The Supreme Court agreed that as the proponent of the alternate method, the Department first bears the burden of proving by a "preponderance of the evidence" (i.e., greater than 50% likelihood) that the statutory formula does not fairly represent the taxpayer's business activity in South Carolina.

However, the Supreme Court further held that if the Department meets its burden of establishing that the statutory formula does not fairly represent the taxpayer's business activity in South Carolina, the Department only has to establish that its alternative accounting method is "reasonable." The Supreme Court rejected the Court of Appeals' holding that the Department had to prove its method was more reasonable than any other method.

**Department failed to meet its initial burden.** In applying the proper burden of proof, the Department and CarMax West both requested that the Supreme Court decide the merits of the case based on the record—without sending the case back to the Administrative Law Court for further determination. The Supreme Court held that although there was substantial evidence to support the reasonableness of the Department's alternative method, the Department failed to meet its initial burden of proving that the statutory apportionment formula did not fairly represent CarMax West's South Carolina business activities.

The Department offered only two pieces of evidence to show that the statutory apportionment formula did not fairly represent CarMax West's in-state business activity. First, a Department auditor testified that the CarMax business structure was often

"linked with tax minimization strategies." Second, the Department noted that the statutory formula yielded a significantly lower tax than CarMax East.

The Supreme Court held that even if those findings accurately described CarMax West's motives, the findings "do not provide a sound evidentiary basis" to support the Department's position that the statutory formula did not fairly represent CarMax West's South Carolina activities. According to the Supreme Court, the Department "described what it did rather than cite any evidence justifying what it did." As a result, the Supreme Court held that the Department failed to satisfy its burden of proof as a matter of law.

This holding is significant because it affirms that even if the Department is the party arguing in favor of an alternative apportionment formula, the Department still bears the burden of proving that the statutory formula does not fairly represent the taxpayer's in-state business activities. The court's holding further establishes that tax minimization strategies and a significant difference in tax between related companies alone are not enough to establish that the statutory apportionment formula is unfair. Finally, the opinion is important because it holds that the Department must also establish that its alternative method is "reasonable."

One justice concurred in part and dissented in part, acknowledging that the Supreme Court correctly described the Department's burden but arguing that the Supreme Court should not have decided the case based solely on the record. According to this concurring and dissenting opinion, the Supreme Court should have remanded to the Administrative Law Court to hold another evidentiary hearing, even though the parties agreed to have the Supreme Court decide the matter on the record.

<sup>1</sup> No. 27474, 2014 WL 7273958 (S.C. Dec. 23, 2014).

<sup>2</sup> S.C. Code Ann. § 12-6-2210(B).

<sup>3</sup> S.C. Code Ann. § 12-6-2290.

<sup>4</sup> S.C. Code Ann. § 12-6-2320(A).

<sup>5</sup> 155 So. 3d 511 (La. 2015).

<sup>6</sup> La. Const. art. VI, § 29(A).

<sup>7</sup> No. SC94260, 2015 WL 777715 (Mo. Feb. 24, 2015).

<sup>8</sup> Mo. Ann. Stat. § 144.020.1.

<sup>9</sup> Mo. Ann. Stat. § 144.020.1(2).



## Louisiana Supreme Court Considers True Object of Clean Toilets

Courts in many states apply the “true object” test to determine the taxability of transactions involving both taxable and nontaxable elements. In fairly unique circumstances, the Louisiana Supreme Court considered the applicability of the true object test to the lease of portable toilets in *Pot-O-Gold Rentals, LLC v. City of Baton Rouge*.<sup>5</sup> Specifically, the court grappled with whether payments received by Pot-O-Gold for cleaning portable toilets were part of the taxable “gross proceeds” (no pun intended) from Pot-O-Gold’s lease of those same toilets.

Ultimately, the Louisiana Supreme Court concluded that the “true object” of the portable toilet rental transactions was “debatable.” Accordingly, the court declined to determine the true object of the transaction and ruled in favor of the taxpayer on the ground that any uncertainty about the meaning of the ordinance must be interpreted liberally in the taxpayer’s favor.

The court’s decision takes a broad approach in determining whether a transaction should be considered a mixed or bundled transaction in the first instance. The decision provides little guidance, however, to allow taxpayers to make that determination. The court’s decision likewise provides little guidance regarding the factors to be considered in determining the true object of any given transaction.

As a result, taxpayers must remain aware that services related to the rental or sale of tangible personal property may still be considered part of the same rental or sales transaction—even if the services are optional and can be purchased separately. If those services are considered part of the same transaction, and the “true

object” of the transaction is the rental or sale of tangible personal property, then the services will be taxable as well. Conversely, if the true object is the provision of nontaxable services, then the rental or sale of tangible personal property is also nontaxable. Note that this latter conclusion could have the unintended consequence of limiting the ability to claim a resale exemption.

**Background.** Pot-O-Gold leases portable toilets and holding tanks to customers, as well as cleaning and sanitation services for those toilets and tanks. Pot-O-Gold offers its customers three options: the lease of portable toilets without cleaning services, the lease of portable toilets with cleaning services included, and cleaning services for another vendor’s portable toilet.

During a 2011 sales and use tax compliance audit, the City of Baton Rouge discovered that where Pot-O-Gold leased portable toilets with cleaning services included, the company collected sales tax from its customers only on the toilet rental payments and not on the related cleaning services. The City issued an assessment for \$69,821.65 for sales tax, interest, and penalties on fees collected for the cleaning services. Pot-O-Gold paid the assessment under protest and filed a lawsuit seeking a refund.

The trial court found that the “true object” of the lease was the rental of the toilets. Nonetheless, the trial court concluded that the charges for cleaning and sanitation services remained nontaxable because they were not within the scope of taxable services under the applicable City ordinance. The City appealed.

The Louisiana Court of Appeals reversed. It held that “[m]oney collected for ordinarily nontaxable cleaning and sanitation services became taxable gross proceeds of the lease by virtue of the inexorably intertwined relationship between the services and the leased property.”

**The “true object” of the lease was “debatable.”** The Louisiana Constitution permits local governments to impose tax on the “lease or rental” of tangible personal property and on “sales of services as defined by law.”<sup>6</sup> Pursuant to this authority, Baton Rouge adopted Ordinance 10127 § 2, which imposes a 2% sales tax on the “gross proceeds from the lease or rental of tangible per-

sonal property” and separately on the “sale of services.”

The scope of taxable “services” under the Baton Rouge ordinance did not include cleaning or sanitation of portable toilets. Accordingly, the issue was whether the amounts Pot-O-Gold received from cleaning services for the same toilets it rented were part of the taxable “gross proceeds” of the lease of those toilets.

On appeal, the Louisiana Supreme Court followed the Court of Appeals’ approach in treating the toilet rental and cleaning services as part of the same lease transaction. However, the Supreme Court did not provide any explanation for its bundled treatment of the transaction. The Supreme Court went on to hold that the “true object” of those transactions was “in the least, debatable.”

In its explanation for this conclusion, the Supreme Court noted that two related rulings of the Louisiana Department of Revenue inconsistently applied the true object test. In LDR RR 06-012, the Department held that in transactions involving both the rental of dumpsters combined with waste removal from those dumpsters, the true object of the transaction was the removal of the trash. As a result, the entire transaction was not taxable. In contrast, in LDR RR 06-013, the Department concluded that the true object of transactions involving the rental of portable toilets and cleaning of those toilets was for the rental of the toilets. Consequently, the entire toilet rental transaction was taxable.

The Supreme Court explained that it was “difficult to determine why one situation is treated differently than the other,” and concluded that it was “just as reasonable to find that the true object of the portable toilet transactions is the removal of human waste as it is to find that the object of the dumpster transactions is the removal of trash.” Accordingly, the Supreme Court held that it was required to adopt Pot-O-Gold’s interpretation as “the least onerous to the taxpayer.”

The Supreme Court also pointed out that a contrary outcome would lead to the “absurd” result that if the cleaning service were performed by a separate entity, that service would not have been taxable. In other words, if Pot-O-Gold had formed a separate entity to clean the portable toi-

lets, the cleaning services would not have been taxable under Baton Rouge's interpretation.

Although the impact of the Supreme Court's opinion is that it would render the entire toilet lease nontaxable, the Supreme Court nonetheless held that it would "re-instate the judgment of the trial court." The trial court treated the toilet rental and cleaning services separately, finding that the toilet rental was taxable but the cleaning service was not taxable. As a result, the effect of the Supreme Court's opinion appears to be that Pot-O-Gold's transactions at issue in this case should be treated as independent transactions for tax purposes, but that other similar transactions must be treated as mixed or bundled transactions going forward, and that the treatment of those transactions will be interpreted in favor of the taxpayer.

One justice dissented, arguing that the Supreme Court should consider what impact (if any) that Pot-O-Gold's reduced fee for customers renting toilets and using Pot-O-Gold's cleaning services would have on the taxability of the income from those services.



## Missouri Supreme Court Holds Fees Paid to Fitness Center Are Nontaxable

State courts continue to take a hard look at the substance of transactions to determine whether the business activity at issue is actually taxable, regardless of the transaction's form. Often, this close examination will benefit taxing authorities. In *Tatson, LLC d/b/a Powerhouse Gym of Joplin v. Director of Revenue*,<sup>7</sup> however, the taxpayer benefited from the Missouri Supreme Court's examination of the substance of transactions between

a fitness facility and a personal training company. In *Tatson*, the court held that fees paid by a personal training company (Custom Built) to a fitness center (Powerhouse Gym) for the lease of office space and the opportunity to sell training services were not subject to retail sales tax under Missouri law.

The Department of Revenue took the position that the fees were taxable as "fees paid" to a "place of recreation." While Powerhouse was undisputedly a place of recreation, the Missouri Supreme Court rejected that over-simplified argument, holding that in order for the fees to be taxable, Powerhouse must still provide a "taxable service" in exchange for the fee. In order to be considered a taxable service, the court stated, there must be some "affirmative act" by the taxpayer.

Here, the court held that Powerhouse did not provide any affirmative act to Custom Built that could be considered a "service." According to the court, Powerhouse was merely "passive" in providing the space for Custom Built to operate its personal training service. The court's opinion suggests that merely providing the space and opportunity to perform a business activity cannot be considered the equivalent of providing a "service" for state and local tax purposes. The true substance of the transaction was the use of space, not the provision of services.

**Background.** Powerhouse Gym is a fitness facility where members pay a fee to join. The membership fee entitles members to use weights and exercise machines and to join fitness classes. Powerhouse Gym did not offer personal training services.

Custom Built paid Powerhouse Gym a monthly flat fee for the ability to market and provide its personal training services to Powerhouse's members at Powerhouse. The monthly fee also allowed Custom Built to use office space at Powerhouse. The personal trainers were employed by Custom Built and were not allowed to use the Powerhouse facilities for personal use.

Powerhouse reported and paid income tax on the rental fees it received from Custom Built. The Department of Revenue audited Powerhouse and assessed an additional \$12,207 for unpaid sales tax on the same rental fees. Powerhouse challenged the assessment, and the Administrative Hearing Commission held in favor of Powerhouse. The Department peti-

tioned the Missouri Supreme Court to review the decision.

**Providing an opportunity and space to operate is not a taxable service.** Missouri law imposes sales tax on the sale of tangible personal property or "rendering a taxable service at retail" in Missouri.<sup>8</sup> The rate for "fees paid to, or in any place of . . . recreation" is four percent.<sup>9</sup>

The Department took the position that *all* fees paid to any place of recreation are subject to sales tax. The court noted that although the Department was "partially correct," the statute first requires a determination of the "threshold matter" of whether the rental fees were collected in exchange for rendering a "taxable service at retail."

The court began its analysis of that issue by examining the meaning of "rendering a taxable service." The court noted that because the phrase was not defined in the statute, the court would look to the plain meaning of the phrase based on dictionary definitions. Webster's Third New International Dictionary defines the verb "to render" as "to do (a service) for another." The court concluded that the verb "to do" in the definition meant that an "affirmative act" was required to be considered rendering a taxable service under Missouri law.

The Department argued that the "opportunity to market and sell personal training services to Powerhouse's members and access to its facilities to hold personal training sessions" were enough to be considered a taxable service beyond the "simple rental of office space." The court rejected that argument, holding that Powerhouse "did not 'do' anything for Custom Built." The court reasoned that Powerhouse "was passive regarding the interactions between Custom Built and [Powerhouse's] members." In other words, Custom Built was merely renting space from Powerhouse. Powerhouse was not providing any service to Custom Built.

The court did not provide further analysis regarding why the opportunity to use the fitness facility was not a sufficiently "affirmative act" to be considered a taxable service. The court likewise did not specify what factors should be considered in determining when an activity crosses the threshold from a nontaxable "passive" activity to a taxable "affirmative act." ■