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.05 Allocation and Apportionment

A. Overview

South Carolina and other states generally use allocation and apportionment to assure that they are taxing multistate and multinational corporations on an appropriate amount of income. National policy expressed through the Due Process and Commerce Clauses of the Constitution prevent states from over taxing multistate and out-of-state businesses. They do this by prohibiting states from taxing businesses which do not have Due Process and Commerce Clause nexus with the state; by prohibiting taxes which discriminate against multistate and out-of-state businesses; and by limiting states to taxing property, activities, or income earned within their geographical limits. State political considerations generally assure that states do not over tax in-state businesses compared with multistate and out-of-state businesses.

A taxpayer whose entire business is transacted or conducted in South Carolina is subject to income tax based on the entire taxable income of the business for the taxable year. The entire business of the taxpayer is transacted or conducted within South Carolina if the taxpayer is not subject to a net income tax or a franchise tax measured by net income in another state, the District of Columbia, a territory or possession of the United States, or a foreign country; and would not be subject to a net income tax in another jurisdiction if the other taxing jurisdiction adopted the income tax laws of South Carolina.¹

A taxpayer transacting or conducting business partly within and partly outside of South Carolina is subject to income tax based on the portion of its business carried on in South Carolina.² A taxpayer is considered to be transacting or conducting business partly within and partly without the State if the taxpayer is subject to a net income tax or a franchise tax measured by net income in another state, the District of Columbia, a territory or possession of the United States, a foreign country, or would be subject to the net income tax in any other taxing jurisdiction if the other taxing jurisdiction adopted the net income tax laws of South Carolina.³

South Carolina taxable income for a taxpayer transacting or conducting business partly within and partly without South Carolina is determined by adding income allocated to South Carolina to income apportioned to South Carolina.⁴

¹SC Code §12-6-2210(A).

²SC Code §12-6-2210.

³SC Code §12-6-2210(B).

⁴After allocation, South Carolina apportions remaining business income regardless of the form of the business. Even single member limited liability companies owned by individuals and disregarded for federal income tax purposes and sole proprietorships can apportion their income.

Certain classes of income, less related expenses, are allocated. Items directly allocated include dividends, nonbusiness interest, nonbusiness rents and royalties from the lease or rental of real estate or tangible personal property, certain gains and losses from the sale of real property, and nonbusiness gains and losses from sales of intangible property.⁵

The income remaining after allocation is apportioned⁶ using one of the following apportionment methods:

1. A “three factor” apportionment (based on property, payroll, and double-weighted 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, or rent tangible personal property.⁷
2. A “gross receipts” apportionment for taxpayers not dealing in tangible personal property. This method is typically used by financial businesses and service businesses, including businesses that install or repair tangible personal property and contractors.⁸
3. A “special” apportionment method provided in SC Code §12-6-2310 for certain companies, such as railroad companies, telephone companies, pipeline companies, airline companies, and shipping lines.⁹
4. An individualized apportionment method tailored to a particular business because the normally required method would not fairly represent the extent of the taxpayer’s business in South Carolina, or as an economic incentive.¹⁰

B. Allocation

Allocation assigns certain classes of income, less related expenses, to specific locations. Allocation is an attempt to attribute revenue to the geographical source of particular items of net income. In South Carolina, the statutory provisions authorizing specific allocation generally, but not always, apply to nonbusiness items of net income.¹¹

⁵SC Code §§12-6-2220 and 12-6-2230. See Section .05 B. of this portfolio.

⁶SC Code §12-6-2240.

⁷See Section .05 E. 2. of this portfolio.

⁸See Section .05 E. 3. of this portfolio.

⁹See Sections .05 E. 4. and 5. of this portfolio.

¹⁰SC Code §12-6-232. See Section .05. E. 6. of this portfolio.

¹¹See Section .05 C. of this portfolio.

In South Carolina the following items of income and their related expenses must be directly allocated and excluded from apportioned income and the apportionment factors.¹² For the purposes of this list, the term “related expenses” mean any cost incurred, directly or indirectly, in connection with investments for the production of income or future income which is or will be specifically and directly allocable;¹³ and a corporation’s principal place of business is the domicile of the corporation unless none of the business is conducted in the state of domicile in which case the Department will determine the principal place of business based upon the available evidence.¹⁴ Items allocated are:

1. Interest received from intangible property not connected with the taxpayer’s business, less all related expenses, is allocated to the state of the corporation’s principal place of business.
2. Dividends received from corporate stocks owned, less all related expenses, are allocated to the state of the corporation’s principal place of business whether or not they are related to the taxpayer’s trade or business.

Comment: During settlement negotiations some taxpayers have claimed that this section violates the discrimination prong of the Commerce Clause, but the issue has never been raised formally in an appeal or case.¹⁵

3. Rents and royalties received from the lease or rental of real estate or tangible personal property, less all related expenses, are allocated to the state where the property is located at the time the income is derived, providing the property was not used in or connected with the taxpayer’s trade or business during the taxable year.

¹²SC Code §12-6-2220.

¹³SC Reg. §117-700.1.

¹⁴SC Code §12-6-30(9).

¹⁵In accordance with *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), a tax will survive challenge under the Commerce Clause if it does not violate any of the four prongs of the Commerce Clause. The four prongs are:

1. The tax is applied to an activity with a substantial nexus with the taxing state;
2. The tax is fairly apportioned;
3. The tax does not discriminate against interstate commerce; and
4. The tax is fairly related to the services provided by the state.

4. Gains and losses from the sale of real property less all related expenses are allocated to the state in which the real property is located except to the extent that gain represents the return of amounts deducted as depreciation. The amount of gain which represents the return of amounts deducted as depreciation is allocated to South Carolina to the extent of depreciation previously deducted in computing South Carolina taxable income. Gain in excess of recaptured depreciation is allocated to the state where the real property is located whether or not the real property was used in or connected with the taxpayer's trade or business.

Comment: The South Carolina depreciation deduction for each year for the real property sold may not be available or may be excessively time consuming to obtain. Many taxpayers seem to apportion the recapture based on the current or previous year's apportionment percentage. This approach is subject to challenge, but may be economically expedient.

5. Gains and losses from sales of intangible personal property not connected with the business of the taxpayer and not held for sale to customers in the regular course of business, less all related expenses, are allocated to the state of the corporation's principal place of business.¹⁶

Note: In Commission Decision 91-5, the Department held that gain on the sale of a partnership interest was allocated. Given the cases discussed in "Matching Deductions to Income" of this portfolio,¹⁷ this decision is open to question.¹⁸

Another allocation provision for all income not allocated by the above provisions and not connected with a business that is at least partially transacted or conducted in South Carolina provides:

"Any income, less all related expenses, which is not allocated under Section 12-6-2220 and not properly includable in the net apportionable income of taxpayers engaged in interstate commerce under the Constitution of the United States because it is unrelated to the business activity of the taxpayer conducted partly within and partly without this State, is allocated to the state in which the business situs of the investment is located. If the business situs of the investment is partly within and partly without South Carolina, the investment is apportioned using the same formula used for apportioning the net income of the corporation."¹⁹

¹⁶In addition, all income from personal services received by a South Carolina resident individual is allocated to South Carolina, and all income from personal services received by a nonresident individual for services rendered in South Carolina is allocated to South Carolina.

¹⁷See Section .05 D. of this portfolio.

¹⁸See the last Comment in Section .05 D of this portfolio.

¹⁹SC Code §12-6-2230.

Comment: Although the purpose of this provision has been the subject of some question, it is rarely used. The authors believe that it refers, at least in part, to any income no part of which is apportionable to South Carolina²⁰ and which is not contained in any of the specific allocation provisions of SC Code §12-6-2220.

C. Business vs. Nonbusiness Income

In order to determine whether interest, rents, royalties, and gains and losses from the sale of intangible personal property are allocable, it must be determined if the income is used in, or connected with, the taxpayer's trade or business.

In *Geoffrey v. South Carolina Tax Commission*,²¹ the South Carolina Supreme Court concluded that in order for a corporation to be taxed in South Carolina the corporation must be “transacting, conducting, doing business, or having an income within this State.”²² The Court construed this language as extending to the limits of the Constitution South Carolina’s authority to tax foreign corporations. Thus, the controversy surrounding the definition of business income in the Uniform Division of Income for Tax Purposes Act (UDITPA)²³ is irrelevant for South

²⁰See Section .05 F. for a discussion of the unitary business doctrine and what income is apportionable.

²¹437 S.E.2d 13 (SC 1993), cert. denied 114 S. Ct. 550 (1993).

²²SC Code §12-7-230 (recodified as SC Code §12-6-530).

²³UDITPA provides that “business income” is:

[I]ncome arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.

There is a dispute over whether this definition creates one or two tests; a transactional test, or a transactional and a functional test. Some courts have held that there is only a transactional test and income which is not earned in the regular course of business is not business income. See BNA Multistate Tax Portfolio #1140, *Income Taxes: The Distinction Between Business and Nonbusiness Income*.

Although South Carolina does not have to deal with this issue, the Department’s auditors are instructed that if the answer to either of the following two tests is yes, the income is business income:

a) Transactional test — Does the income arise from transactions or activities conducted in the regular course of the taxpayer’s trade or business operations?

b) Functional test — Does the income come from property where the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business. Under the functional test, all gain from property is business income if the property was used by the taxpayer in its regular trade or business. BNA

Carolina income tax purposes. South Carolina treats as business income any income that is part of the taxpayer's unitary business. See the discussion on the unitary business doctrine, especially the discussion on *Eastman Kodak Company v. SC Tax Comm.*,²⁴ for some insight into the business/nonbusiness issue in South Carolina.

D. Matching Deductions to Income

Expenses incurred in earning allocable income are matched and offset against the income they generate.²⁵ These expenses may not be used to offset apportionable income. Also taxpayers that have business deductions for businesses which are not transacted or conducted in South Carolina, must use those deductions against those businesses' income. The deductions are not available to use against South Carolina income. The importance of matching income and deductions in South Carolina is demonstrated by the following South Carolina Supreme Court decisions:

1. In *Avco Corporation v. Robert C. Wasson*,²⁶ the Supreme Court held that interest expenses incurred by a corporation in connection with debentures issued to finance acquisitions of stock in other corporations could not be allowed as a deduction against the corporation's apportioned income.

Avco owned and operated a manufacturing plant in Charleston County, South Carolina. Avco is incorporated in Delaware and its principal office is in Connecticut. Avco issued and sold debentures to finance the purchase of stock in two finance companies. In preparing its South Carolina income tax returns, Avco deducted the interest expense incurred in connection with the issuance of these debentures in arriving at apportionable income.

The issue was whether or not the expenses incurred in connection with the issuance of debentures used to finance the acquisition of stock in the finance companies should be allowed as a deduction against Avco's income. It was stipulated that Avco's income must be apportioned.

Multistate Tax Portfolio #1140:0046, Income Taxes: The Distinction Between Business and Nonbusiness Income.

Negative answers to both questions do not necessarily mean that the income is nonbusiness income.

²⁴418 S.E.2d 542 (SC 1992). See Section .05 F. 4. c. of this portfolio.

²⁵See SC Reg. §117-700.1 defining "related expenses" to mean any cost incurred, directly or indirectly, in connection with investments for the production of income or future income which is or will be specifically and directly allocable.

²⁶267 S.C. 581 (1976).

The SC Code provides that the dividends which a corporation receives are to be allocated to the state of a corporation's principal place of business and are taxable by that state. It further provides that all related expenses must be allocated to that state.²⁷

The parties stipulated that the interest expense involved was incurred for the sole purpose of purchasing stock. They also agreed that any dividend income received by Avco from the stock ownership in the corporations is not taxable in South Carolina. Therefore, the Court held that the interest expense incurred solely for the purpose of purchasing stock was related to the stock and allocable to Connecticut where the dividend income is taxable.

Avco argued that the allocation sections do not require the allocation of a net loss, which would be the result here as the related interest expenses exceeded the dividends received from the stock. The allocation of a net loss results in a higher figure for the income apportionable to South Carolina than Avco reported in its returns. The Court held that the net loss must be allocated. The actual receipt of dividends is not required before a related expense adjustment can be made.

Note: SC Rev. Rul. #98-14 recognizes an argument that may be useful in appropriate cases for distinguishing *Avco*. This advisory opinion upholds the deduction of commissions paid to a subsidiary, a properly formed and operated foreign sales corporation (FSC). This advisory opinion distinguished *Lowenstein v. South Carolina Tax Commission*,²⁸ which denied the deduction of commissions paid to a domestic international sales corporation (DISC) because the DISC lacked economic substance. To allow the deduction of the commission paid to the FSC the advisory opinion reasoned that the payments were legitimate business expenses, and therefore, not expenses related to the generation of a dividend.

2. In *Seward v. South Carolina Tax Commission*²⁹ the South Carolina Supreme Court held that the taxpayers could not claim deductions arising from operating losses incurred by the taxpayers in an out-of-state cattle operation. They bought cattle for breeding purposes and hired a management company to run the business. The Court ruled that the deductions could not be taken against South Carolina income because the deductions were expenditures incurred in connection with cattle having a situs outside of South Carolina, the sales of which would not be taxed in South Carolina. Secondly, under South Carolina apportionment statutes, income from an out-of-state business is not taxed by South Carolina and, conversely losses from such a business are not deductible.

²⁷SC Code §12-6-2220(2).

²⁸277 S.C. 561, 290 S.E.2d 812 (1982).

²⁹236 S.E.2d 198 (SC 1977).

3. *Ellis v. South Carolina Tax Commission*³⁰ involved South Carolina residents who incurred losses as limited partners in an out-of-state oil and gas limited partnership. The Court held that since the losses in question were incurred by taxpayers from out-of-state limited partnership interests, those losses retained the character of out-of-state losses when distributed to taxpayers by reason of a statutory “pass through” provision. Thus, the taxpayers could not deduct the losses on their South Carolina income tax returns. The Court held that gains from a partnership which conducts no business in South Carolina would be passed through the partnership to the partner in South Carolina. Pursuant to South Carolina statutes, none of these gains are included in the base to which South Carolina income tax is applied. Therefore, if no gains are included in the base by reason of the statutes involved, then no losses would be included in the base.

The Court reasoned that partnerships and limited partnerships are not taxed on their income or losses. Although partnerships file information returns, the income or losses are passed through and distributed to the partners and reported in their income tax returns.³¹

The Court made it clear that the “pass through” rule is equally applicable to limited partnerships. South Carolina does not distinguish between general and limited partnerships or partners.

“By reason of the ‘pass through’ rule, the character of any item of income, gain, loss, deduction or credit included in a partner’s distributive share of gains and losses shall be the same as if such item was realized directly from the source from which realized or incurred by the partnership. In other words, each item of income, gain, loss, deduction or credit is treated as if it were realized or incurred by the partner directly from the source without ever having passed through the partnership....

“Since the losses in question were incurred by the taxpayer from out-of-state partnership interests, these losses retained the character of out-of-state losses when distributed to the taxpayer by reason of the ‘pass through’ provision....”³²

Comment: Some publications have reported that South Carolina taxes resident individuals on their world-wide income. This statement appears to be based upon a negative inference from SC Code §12-6-1720 (1)(b) which provides that a nonresident individual is only taxed on his apportioned share of business conducted in South Carolina. The authors suggest that it is incorrect to infer from

³⁰280 S.C. 65, 309 S.E.2d 761(1983).

³¹Cited by the Court as SC Code §12-7-300, but since recodified as SC Code §12-6-600.

³²280 S.C. at 68; 309 S.E.2d at 762–3. See the discussion of the Hercules case in Section .05 D. 4. and the comment regarding sales of partnership interests at the end of this Section .05 D. of this portfolio.

this section that South Carolina residents are taxed on their worldwide income. South Carolinians are taxed on their worldwide personal service income,³³ but nothing has overruled the *Seward* and *Ellis* cases. The Department has never attempted to tax South Carolina residents on their world-wide (non-personal service) business income.

4. In *Hercules v. South Carolina Tax Commission*,³⁴ the Court held that the matching principle can take precedence over the literal reading of a statute. When *Hercules* was decided, South Carolina's allocation statutes provided that gains and losses from the sale of real property located in South Carolina are allocable to South Carolina, and gains and losses from the sale of real property located outside South Carolina are allocated to the state in which the real property is located.³⁵ It did not matter whether or not the real property was connected with the taxpayer's trade or business.

The South Carolina Tax Commission argued that the Code provides that the gain or loss from sales of real estate located in South Carolina is allocated to South Carolina and that such income is not income that can be apportioned.

The Court responded that this argument overlooked the fact that the Tax Commission allowed Hercules to apportion depreciation of the real property for income tax purposes throughout the many states in which it did business. This caused South Carolina to receive greater income tax revenues from Hercules during this period of time than would have been received had all the depreciation been allocated to South Carolina. Further, the Court reasoned, other states that allowed Hercules a tax deduction for this apportioned depreciation are entitled to recapture this depreciation upon the sale of the plant.

“If we were to hold that §12-7-1120(4) [since amended and then recodified as SC Code §12-6-2220(4)] allows South Carolina the sole benefit of recapturing all of the depreciation taken, one of two gross inequities would result. Either all other states which allowed depreciation would be denied the right to recapture or Hercules would be subjected to double taxation. It cannot be seriously argued that the legislature intended such a result.”³⁶

³³SC Code §12-6-2220(6).

³⁴279 S.C. 177, 304 S.E.2d 815 (1983).

³⁵SC Code §12-7-1120(4). SC Code §12-7-1120(4) has since been recodified as SC Code §12-6-2220(4) and amended consistent with the holding in *Hercules* to read:

Gains and losses from the sale of real property less all related expenses are allocated to the state in which the real property is located except to the extent that gain represents the return of amounts deducted as depreciation. The amount of gain which represents the return of amounts deducted as depreciation is allocated to this State to the extent of depreciation previously deducted in computing South Carolina taxable income.

³⁶279 S.C. at 181–182 , 304 S.E.2d at 818.

Therefore, if a taxpayer claims that some of its income is not apportionable to South Carolina because it is not connected with a business that is conducted or transacted in South Carolina, auditors will generally look to see whether any of the expenses incurred in that business were deducted against South Carolina apportionable income.

There is no statute, regulation, or formal Department policy on how general expenses (interest expenses, salaries, etc.), should be allocated and/or apportioned between business and non-business income. The Department will trace funds where possible and apportion expenses which cannot be traced. Generally, the Department's auditors use the "DC Formula."³⁷ The DC Formula segregates expenses used to carry investment (nonbusiness) assets, the income from which is allocated, using the following formula:

$$\text{Related Expenses} = \text{Attributable Expenses} \times \text{Investment assets} \div \text{Total Assets}$$

Related Expenses: the interest and general and administrative expenses which will be associated with the investment assets and allocated to the state to which the income from the investment assets is allocated.

Attributable Expenses: all interest and general and administrative expenses that cannot be directly traced to a business or nonbusiness activity.

Investment Assets: the book value of investment assets, the income from which would be allocable or nontaxable.

Total Assets: the book value of all assets of the corporation.

Although the DC Formula is generally used by South Carolina auditors, taxpayers may suggest using other reasonable methods, including apportioning the attributable expenses using a ratio of allocable and tax exempt income to total income, or the method the Internal Revenue Service uses in IRS Rev. Proc. 72-18 to divide interest expenses between taxable and excludable income.

Comment: These cases call into question Commission Decision #91-5 which held that gain on the sale of a partnership interest was allocated. The business of the partnership was not unitary with a business otherwise being conducted by the partners, and it was a limited partnership interest. The authors cannot predict what the Department's position may be in a future case where the partnership interest is owned by a corporation and the business of the partnership is not unitary with the business of the corporation (except to the extent the corporation may be deemed to be conducting the partnership's business). It is sometimes argued that the gain or loss should be allocated as the sale of an intangible not connected with the taxpayer's trade or business. On the other hand, it is argued that the gain or loss should be apportioned because the pass through nature of partnership makes it the equivalent of the sale of business assets by the person in business, or it should be at least partially apportioned because the gain or loss on the sale of the

³⁷Commission Decision I.D. 309 (June 30, 1982).

partnership interest should be matched with the apportioned pass through income and losses of the partnership which affected the partner's basis in his partnership interest. The authors do, however, believe that the Department will take the position that gain or loss from the sale of a partnership interest should be apportioned where the business of the partnership is unitary with the business of the corporation.

E. Apportionment

1. Introduction

All income remaining after allocation³⁸ is apportioned.³⁹ The purpose of using an apportionment formula is to attribute to each state its fair share of the total business net income of the taxpayer. The formula does not "source" net income. Its use is based upon the presumption that the net income of a unitary business is properly determined by its activities in a state which are reflected by the factors in the formula.

Businesses which deal in tangible personal property apportion income using a three factor (property, payroll, and double weighted sales) formula.⁴⁰ There are special apportionment formulas for certain companies.⁴¹ Other businesses apportion income using a single factor formula based upon gross receipts.⁴²

Note: Taxpayers who install or repair, but do not sell or manufacture tangible personal property use the single factor formula based upon gross receipts.⁴³ Rental companies use the three factor formula.⁴⁴

If a business conducts activities which would be apportioned in different ways, *e.g.*, it is a dealer in tangible personal property and a service provider, generally the ratio would be based on the business activity from which the principal profits or income of the taxpayer are derived. See SC Code §12-6-2320 which allows the taxpayer to petition the Department for a "hybrid" method of apportionment, and allows the Department to require another method if these rules does not fairly represent the extent of the taxpayer's business activity in South Carolina.⁴⁵

³⁸SC Code §§ 12-6-2220 and 12-6-2230.

³⁹SC Code §12-6-2240.

⁴⁰SC Code §12-6-2250.

⁴¹SC Code §§12-6-2300 and 12-6-2310.

⁴²SC Code §12-6-2290.

⁴³Commission Decision 380 (1985).

⁴⁴Commission Decision 380 (1985); *Hertz Corp v. SCTC*, 246 S.C. 92, 142 S.E.2d 445 (1965).

⁴⁵See Section .05 E. 6. a. of this portfolio.

2. Businesses Dealing in Tangible Personal Property — Three Factor (Double Weighted Sales) Formula

The income of a taxpayer whose principal business in this State is (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; apportions its income by multiplying its income remaining after allocation by a fraction, the numerator is the property ratio, plus the payroll ratio, plus twice the sales ratio, and the denominator is four.⁴⁶

If the sales ratio does not exist, the denominator of the fraction is the number of existing ratios. If the sales ratio exists but the payroll ratio or the property ratio does not exist, the denominator of the fraction is the number of existing ratios plus one.⁴⁷ For example, if the sales factor (double-weighted) and the property factor exist, but the payroll factor does not, the denominator of the apportionment formula is three.

The property, payroll, and sales ratios must be determined in accordance with SC Code §§12-6-2260, 12-6-2270, and 12-6-2280, respectively.

Comment: There is not much written authority, other than the SC Code, concerning the items included in the individual apportionment factors. There are many questions which have never been answered. The information in the sections of this portfolio concerning the apportionment factors which is not in the SC Code or cited to a particular source is the longstanding administrative policy of the Department. The authors met with the manager of the foreign audit section of the Department, the analyst in charge of corporate income tax research for the processing section of the Department, the analyst responsible for most of the income tax appeals for the Department, and the attorney who has litigated most of the Department's corporate income tax cases. The included information is based on their consensus of the Department's longstanding administrative policy.

a. The Property Factor

The property factor⁴⁸ is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in South Carolina during the taxable year, and the denominator is the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the taxable year. It does not include property which produces income that is allocated.⁴⁹

⁴⁶SC Code §12-6-2250.

⁴⁷SC Code §12-6-2250.

⁴⁸SC Code §12-6-2260.

⁴⁹SC Code §12-6-2260(A).

For purposes of the property factor, tangible personal property does not include cash, shares of stock, bonds, notes, accounts receivables, credits, franchises, goodwill, or evidences of debt.⁵⁰

Comment: It is the longstanding administrative policy of the Department to treat property that is “available for use” or “capable of being used” as “used.” Types of property included in the property factor that are available for use, but are not actually used, include timber tracts for lumber companies, oil leases for oil companies, and mineral leases for mining companies. A plant that is temporarily idle is available for use, as is a plant that is for sale.

Property under construction during the income year is excluded from the factor until it is actually used in the regular course of the trade or business. If it is partially used in the regular course of the trade or business while under construction, the value of the property to the extent used is included in the property factor. If a company constructs new, or additions to, manufacturing facilities and capitalizes the costs, including wages, then the wages go into the property factor, not the payroll factor.⁵¹

The average value of property is determined by averaging the values at the beginning and end of the taxable year. If this average does not fairly represent the yearly average because of material changes during the year, the average must be determined on a monthly or daily basis.⁵²

The value of property is determined as follows:

1. No deduction is made for encumbrances on the property.⁵³
2. Inventory is included in a manufacturer’s property factor and valued using the taxpayer’s book accounting practices unless, in the Department’s opinion, a different method more accurately reflects net income. If the taxpayer does not take or keep records of periodic inventories or if the method and time of taking the inventories does not accurately reflect the true average inventory, the Department may determine the average inventory from the information available.⁵⁴

⁵⁰SC Code §12-6-2260(B).

⁵¹Commission Decision 144 (1970). See also SC Tech. Adv. Memo. #88-12 which provided that intangible drilling costs, which for the years in question, had to be capitalized in South Carolina, are included in the property factor. South Carolina now follows the federal income tax treatment of intangible drilling costs.

⁵²SC Code §12-6-2260(C).

⁵³SC Code §12-6-2260(D)(4).

⁵⁴SC Code §12-6-2260(D)(1).

Inventories of unmanufactured tobacco stored in a warehouse in South Carolina for subsequent shipment to a manufacturer in another state, are not considered property used in South Carolina.⁵⁵

3. Property owned, other than inventory, is valued at original cost plus any additions or improvements without regard to deductions for depreciation, amortization, write-downs, or similar charges. If this method results in the taxation of more than 100% of the income of the taxpayer in all the states in which the taxpayer files a return, the Department may, in its discretion, adjust the value of property within South Carolina to bring the percentage to 100%, but in no case can the property in South Carolina be valued at less than 80% of the value determined by this rule.⁵⁶

If the taxpayer owns an interest in a partnership that is in a unitary business with another business conducted directly, or indirectly, by the taxpayer, then the partnership's property, both owned or rented and used during the year, is included in the taxpayer's other business' property factor to the extent of the taxpayer's interest in the partnership. Generally, mobile or movable assets are included in the numerator based upon time spent in the State.

4. For rented and leased real and personal property, value is the net annual rental rate multiplied by eight. For rented or leased personal property the Department may require a factor other than a multiplier of eight to be used if it better reflects the value.⁵⁷

Net annual rental rate means the gross annual rate paid by the taxpayer, less the gross annual rental rate received by the taxpayer for any subrentals of real estate.⁵⁸ If property is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, reasonable market rental rate for such property is used. Rental of property at below market rates may occur when a local government is renting the property to new industry.

If the taxpayer using the property is the lessee of a financial lease and is properly depreciating the property for federal income tax purposes as a fixed asset, it should be included in the property factor at original cost. If it is properly treated as rent for federal income tax purposes, the rent is multiplied by eight.

⁵⁵SC Code §12-6-2260(D)(5).

⁵⁶SC Code §12-6-2260(D)(2).

⁵⁷SC Code §12-6-2260(D)(3).

⁵⁸SC Code §12-6-2260(D)(3).

Any additional amounts paid as rent for the income year such as a percentage of sales, taxes, or interest on rented property, insurance, repairs, or the like are considered to be paid as rent and are, therefore, capitalized and included in the property factor.

Daily rents for such things as hotel rooms, daily rental of automobiles, etc., are not included. However, if such items are rented for long term periods, such as the lease of an automobile, the rent is capitalized and included in the property factor.

Note: SC Reg. §117-740.1 provides that “any taxpayer electing the non-recognition of gains or losses realized upon the normal retirement of assets from productive use in the taxpayer’s trade or business pursuant to IRS Reg. 1.167(a)-8, in effect on December 31, 1975, shall remove all such dispositions from the denominator of the property factor and, if the property disposed of had a situs in this State, from the numerator of the property factor in computing the property ratio for the purposes of the three factor apportionment formula (with a double weighted sales factor) prescribed by Section 12-6-2250.” Therefore, if the property is normally retired and no gain or loss is recognized pursuant to IRS Regulation 1.167(a)-8, in effect on December 31, 1975,⁵⁹ the property will not be included in the numerator or denominator of the property factor.

b. The Payroll Factor

The payroll factor⁶⁰ is a fraction, the numerator of which is the total amount paid by the taxpayer for compensation in this State during the taxable year and the denominator is the total compensation paid everywhere during the taxable year.

Compensation includes salaries, wages, commissions, and other personal service compensation paid or incurred in connection with the taxpayer’s trade or business. All compensation paid to employees chiefly working at, sent out from, or chiefly connected with an office, agency, or place of business of the taxpayer in South Carolina is deemed to be in connection with the trade or business of the taxpayer in South Carolina.⁶¹

Comment: Practitioners often use the taxpayer’s South Carolina annual wage withholding summary and the federal Form W-3 (“Transmittal of Wage and Tax Statements”) to obtain this information. These sources are easily auditable, but exclude payments for leased employees, and amounts paid to independent contractors, such as commissions paid to outside sales personnel. Although auditors have not generally adjusted a taxpayer’s payroll ratio if it only includes amounts paid directly to employees, SC Code §12-6-2270(B) states that compensation

⁵⁹The regulation has not been amended since June 11, 1956.

⁶⁰SC Code §12-6-2270.

⁶¹SC Code §12-6-2270(B).

“includes salaries, wages, commissions, and other personal service compensation paid or incurred in connection with the taxpayer’s trade or business.” Given the extensive use of independent contractors and leased employees by some businesses, auditors are likely to reconsider what should be included in this factor, at least for businesses where it appears that independent contractors or leased employees, or both, are used more extensively in South Carolina than in other states.

If the taxpayer owns an interest in a partnership that is in a unitary business with another business conducted directly, or indirectly, by the taxpayer, then the partnership’s payroll is included in the taxpayer’s other business’ payroll factor to the extent of the taxpayer’s interest in the partnership.

The payroll factor does not include:

1. Compensation paid to general executive officers having company-wide authority.⁶²
2. Compensation paid to employees who construct capital assets when their wages are capitalized; their wages go into the property factor, not the payroll factor.⁶³
3. Compensation paid in connection with income separately allocated.⁶⁴

c. The Sales Factor

The sales factor⁶⁵ is a fraction, the numerator of which is the total sales of the taxpayer in South Carolina during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year.

Note: Since South Carolina does not have a throwback rule,⁶⁶ sales in states which do not tax the corporation are not added to the South Carolina numerator, but are included in the denominator.

⁶²SC Code §12-6-2270(C).

⁶³Commission Decision 144 (1970). See also SC Tech. Adv. Memo. #88-12 which provides that costs, to the extent capitalized in an asset (intangible drilling costs which were at one time capitalized), are in the property factor.

⁶⁴SC Code §12-6-2270(D).

⁶⁵SC Code §12-6-2280.

⁶⁶South Carolina’s throwback rule was phased out beginning in 1984 and finally eliminated for taxable years beginning after December 31, 1987. See Act No. 512, Part II, §61A (1984).

Comment: South Carolina is not a “cost of performance state;” *i.e.*, a state where receipts are always sourced to the state where the costs to produce the receipts are incurred. It is also not a “market state;” *i.e.*, a state where receipts are always sourced to the state where the item or service is consumed or the location of the payer.⁶⁷

Apportionable sales are receipts which are not allocated.

The sales factor includes:

1. The selling price from the sale of inventory. The selling price is the gross sales price less returns and allowances. “Returns” are defined as goods returned for credit. “Allowances” are credits from breakage, spoilage, inferior quality, shortages in shipping, and the like.

Sales in South Carolina include sales of goods, merchandise, or property received by a purchaser in South Carolina other than the United States Government. The place where goods are received by the purchaser after all transportation is completed is considered to be the location of the sale. Direct delivery into South Carolina by the taxpayer to a person designated by a purchaser is considered delivery to the purchaser in South Carolina.⁶⁸

Note: It has been the longstanding administrative policy of the Department to allow sales to the United States Government to be included in the denominator. Only payments made directly by the United States Government to a seller pursuant to a contract for the sale of property are treated as sales to the United States Government. Sales made by a subcontractor to a United States Government prime contractor are included in the numerator and denominator even though the United States Government is the ultimate recipient and the work is subject to United States Government approval.

2. Interest receipts, service charges, and carrying charges resulting from sales of tangible personal property are assigned in the same manner as the sales of the tangible personal property to which they relate.
3. The net gain (not the selling price) from sales of assets, including intangibles, other than inventory.⁶⁹

Note: This factor does not include gain which is allocated pursuant to SC Code §12-6-2220.

⁶⁷See the discussion in Section .05. E. 3. of this portfolio regarding sourcing gross receipts.

⁶⁸SC Code §12-6-2280(B).

⁶⁹Commission Decision I.D. 309 (1982).

Comment: The sales factor of the target corporation includes the net gain from the sale of assets, other than inventory, and the gross sales price for inventory from the deemed sale if an Internal Revenue Code §338(h)(10) election is made.

4. Rents from real or stationary personal property are assigned to the sales factor numerator of the state in which the property is located. Rental income from mobile property is assigned among states on the basis of the amount of time during which the property was used in each state. Gross rents, with no deduction for items such as taxes and interest, are used for sales factor purposes.⁷⁰
5. Receipts from intangible personal property are assigned to the state where the income-producing activity is. If the income-producing activity is performed partly within and partly without South Carolina, sales are attributable to South Carolina to the extent the income-producing activity is performed within South Carolina. For income tax purposes, interest income received from directly owned U.S. Government securities is not included in either the numerator or denominator.⁷¹
6. Royalty income.
7. Personal service receipts, including management fees are assigned to the state in which the services are performed. If the services are performed in more than one state, sales are attributable to South Carolina to the extent the income-producing activity is performed in South Carolina. Time actually spent performing the services is usually the measure to those activities.
8. Receipts from the sale of a unitary partnership interest.
9. Miscellaneous receipts like:
 - a. Receipts from vending machine sales to employees;
 - b. Receipts from sales of by-products and scrap; and
 - c. Receipts from cafeteria operations for employees.
10. If the taxpayer owns an interest in a partnership that is in a unitary business with another business conducted directly, or indirectly, by the taxpayer, then the partnership's sales are included in the taxpayer's other business' sales factor to the extent of the taxpayer's interest in the partnership.

⁷⁰SC Code §12-6-2280(C)(1).

⁷¹SC Code §12-6-2280(C)(2).

3. Businesses Not Dealing in Tangible Personal Property — Single Factor (Gross Receipts) Formula

The “gross receipts” formula is used by businesses not dealing in tangible personal property⁷² and not using a special formula for particular industries.⁷³ This formula is typically used by financial and service businesses, including businesses that install and repair tangible personal property and contractors. The gross receipts formula provides that the taxpayer apportions its remaining net income 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.⁷⁴

The “gross receipts” ratio is most commonly used by service businesses and businesses dealing with intangibles. The proper sourcing of gross receipts was reviewed in *Lockwood Greene Engineers v. South Carolina Tax Commission*.⁷⁵ The Court held that the purpose of the apportionment statutes is to provide for the imposition of South Carolina income tax “upon a base which reasonably represents the proportion of the trade or business carried on within this State.” The Court held that in allocating income of a multistate engineering firm, “gross receipts from within this State” were to be determined according to where the services were performed rather than according to where the customers were located. The Court was not persuaded by Lockwood Greene’s argument that its holding was inconsistent with the Department guidelines concerning computation of the gross receipts of finance companies whose income is sourced to the location of the companies’ customers.

In *Geoffrey, Inc. v. South Carolina Tax Commission*,⁷⁶ the taxpayer earned its income by licensing trademarks and tradenames for a percentage of the sales made by its retail licensees. The South Carolina Supreme Court determined that it was proper for South Carolina to tax its apportioned share of the royalty income. The Court held that intangibles and their income could be taxed at their business situs,⁷⁷ and that the real source of Geoffrey’s income was not the

⁷²SC Code §12-6-2250 providing a three factor (double weighted sales) formula for taxpayers dealing in tangible personal property. See the discussion in Section .05 E. 2. of this portfolio.

⁷³See SC Code §12-6-2310 and the discussion in Section .05 E. 4. of this portfolio.

⁷⁴SC Code §12-6-2290.

⁷⁵361 S.E.2d 346 (1987).

⁷⁶437 S.E.2d 13 (S.C. 1993) cert. denied 114 S. Ct. 550 (1993).

⁷⁷See also *Curry v. McCanless*, 307 U.S. 357, 59 S.Ct. 900 (1939), which states:

“[T]here are many circumstances in which more than one state may have jurisdiction to impose a tax and measure it by some or all of the taxpayer’s intangibles. Shares of corporate stock may be taxed at the domicile of the shareholder and also at that of the corporation which the taxing state has created and controls; and income may be taxed both by the state where it is earned and by the state of the recipient’s domicile.” *Curry v. McCanless*, 307 U.S. at 368, 59 S.Ct at 906.

licensing agreement but South Carolina's customers. Geoffrey's South Carolina apportioned income was determined under the single factor, gross receipts, apportionment formula; *i.e.*, gross receipts from royalty payments from South Carolina sales divided by gross receipts from everywhere.

Comment: Considering *Lockwood Greene* and *Geoffrey*, together, it appears that gross receipts are sourced to the state which is most significantly associated with the production of the income; *e.g.*, personal services, where those services are performed; intangibles, where those intangibles are used in a business for the production of income.⁷⁸ This conclusion is consistent with the longstanding administrative policy of the Department, which was referenced in the *Lockwood Greene* case, that the gross receipts of loans from finance companies are sourced to the location of the companies' customers.

4. Special Apportionment Formulas for Particular Industries

Special apportionment formulas are provided for railroad companies, motor carriers, telephone service companies, pipeline companies, airline companies, and shipping lines.⁷⁹

After allocation, the remaining income of these companies must be apportioned as follows:

1. Railroad companies

Railroad companies use a fraction, the numerator of which is railway operating revenue from business done within South Carolina during the taxable year, and the denominator is total railway operating revenue from all business done by the taxpayer as shown by its records kept in accordance with the Uniform System of Accounts prescribed by the Interstate Commerce Commission.

Railway operating revenue from business done within South Carolina means railway operating revenue from business wholly within South Carolina, plus the equal mileage proportion within South Carolina of each item of railway operating revenue received from the interstate business of the taxpayer. Equal mileage proportion means the proportion which the distance of movement of property and passengers over lines in South Carolina bears to the total distance of movement of property and passengers over lines of the taxpayer receiving the revenues. Interstate business means railway operating revenue from the interstate transportation of persons or property into, out of, or through South Carolina.

⁷⁸See also SC Tech. Adv. Memo. #94-2.

⁷⁹SC Code §12-6-2310.

2. Motor carriers

Motor carriers of property and passengers use a fraction, the numerator of which is vehicle miles within South Carolina during the taxable year, and the denominator is total vehicle miles everywhere during the taxable year. The Department determined that a company which did not own any trucks, but which leased trucks and hired independent contractors to haul property was a motor carrier which must apportion its income under this method.⁸⁰

3. Telephone service companies

Telephone service companies use a fraction, the numerator of which is gross receipts in South Carolina during the taxable year, and the denominator is total gross receipts everywhere. Gross receipts in South Carolina includes gross revenues derived from services rendered wholly within South Carolina, plus that portion of the company's interstate revenues attributable to South Carolina in accordance with the Federal Communications Standard Classification of Accounts.

4. Pipeline companies

Pipeline companies use a fraction, the numerator of which is revenue ton miles (one ton of solid property transported one mile), revenue barrel miles (one barrel of liquid property transported one mile), or revenue cubic foot miles (one cubic foot of gaseous property transported one mile) within South Carolina during the taxable year, and the denominator is total revenue ton miles, revenue barrel miles, or revenue cubic foot miles, of the taxpayer everywhere during the taxable year.

5. Airline companies

Airline companies use a fraction, the numerator of which is revenue tons loaded and unloaded in South Carolina during the taxable year, and the denominator is revenue tons loaded and unloaded everywhere during the taxable year. A revenue ton is a short ton (2,000 pounds) and is computed by using a standard weight of 190 pounds a passenger (including free baggage) multiplied by the number of passengers loaded and unloaded plus the tons of airmail, express, and freight loaded and unloaded within and without South Carolina.

6. Shipping lines

Where the income is derived principally from the operation of a shipping line, the corporation apportions its income to South Carolina on the basis of the ratio of revenue tons loaded and unloaded within and without the State for the year. A revenue ton is a short ton (2,000 pounds) and must be computed using a standard weight of 190 pounds per passenger (including free baggage) multiplied by the number of passengers loaded and unloaded.

⁸⁰SC PLR #93-3.

5. Special Election for Foreign Corporations

A business incorporated in a foreign country may elect to only apportion its United States source income as determined for federal income tax purposes on Internal Revenue Service Form 1120F. No change in the election may be made without permission of the Department.⁸¹

6. Apportionment Formulas Tailored for a Corporation

There are four provisions which may result in an apportionment formula tailored to a particular corporation. The first is used if the regular allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina.⁸² The others are economic development incentives.⁸³

a. Fairness Based Apportionment

If the statutorily mandated allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina, the taxpayer may request, or the Department may require, in respect to all or any part of the taxpayer's business activity:

1. Separate accounting;
2. The exclusion of one or more factors;
3. The inclusion of one or more additional factors; or
4. The use of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.⁸⁴

Any taxpayer who believes that the statutory allocation and apportionment provisions do not represent the extent of the taxpayer's business within this State may apply to the Department for approval of an alternative method. The procedure to apply for the use of an alternative allocation and apportionment method based on fairness is explained in detail in SC Rev. Proc. #95-4.⁸⁵ Written approval of the new method must be received prior to using it to determine income allocated or apportioned to South Carolina. The new method will also be used to determine the taxpayer's corporate license fee.⁸⁶

⁸¹SC Code §12-6-2300.

⁸²SC Code §12-6-2320(A).

⁸³SC Code §§12-6-2320(B) and (C) and 12-15-40.

⁸⁴SC Code §12-6-2320(A).

⁸⁵SC Rev. Proc. #95-4 is reproduced as Worksheet 14.

⁸⁶See Section .08 of this portfolio for a discussion of corporate license fees.

b. Economic Development Incentive Based Apportionment⁸⁷

(i) New Facility or Expansion — 5 Year Formula

The Department may enter into a special allocation and apportionment agreement with the taxpayer⁸⁸ for a period not to exceed 5 years. The agreed method need not use any part of South Carolina's regular apportionment methods. In order to use the agreed method for 5 years, the following requirements must be met:

1. The business must be planning a new facility or an expansion of an existing facility in South Carolina.
2. The business must ask the Department to enter into a contract reciting a new allocation and apportionment method.
3. The Coordinating Council for Economic Development at the Department of Commerce must certify that the new facility or expansion will have a significant beneficial economic effect on the region for which it is planned and that its benefits to the public exceed its costs.

(ii) New Facility or Expansion — 10 Year Formula

The Department may enter into a special allocation and apportionment agreement with the taxpayer for a period not to exceed 10 years. The agreed method need not use any part of South Carolina's regular apportionment methods. In order to use the agreed method for 10 years, the following requirements must be met:

1. The business must be planning a new facility or an expansion of an existing facility in South Carolina that results in: (1) a total investment of \$10 million or more, and (2) the creation of 200 new full time jobs with an average cash compensation level of more than three times the per capita income of South Carolina at the time the jobs are filled which must be within 5 years of the Coordinating Council for Economic Development's certification.
2. The business must ask the Department to enter into a contract reciting a new allocation and apportionment method.

⁸⁷SC Code §12-6-2320(B).

⁸⁸For the purposes of this provision the word "taxpayer" includes any one or more of the members of a controlled group of corporations authorized to file a "consolidated return" under SC Code §12-6-5020. See Section .07 B. 1. of this portfolio for a discussion of South Carolina "consolidated" returns.

3. The Coordinating Council for Economic Development at the Department of Commerce must certify that the new facility or expansion will have a significant beneficial economic effect on the region for which it is planned and that its benefits to the public exceed its costs to the public.

Comment: The most common agreed upon formula to date has been the single factor sales formula.

The procedure to request approval of an alternative allocation or apportionment method based on economic development is provided in SC Rev. Proc. Bull. #02-4.⁸⁹

The new method will also be used to determine the taxpayer's corporate license fee, if any.⁹⁰

(c) Special Economic Development Incentive Based Apportionment for Certain Recycling Facilities⁹¹

A taxpayer who is constructing or operating a qualified recycling facility may petition the Department for the use of separate accounting with respect to all or any part of the taxpayer's or taxpayer's subsidiaries' business activities or for the use of any other method to determine taxable income. The Department may approve the petition if the Coordinating Council for Economic Development at the Department of Commerce certifies that the benefits to the public exceed the costs to the public.

A qualified recycling facility is a facility that will be used by the taxpayer to manufacture products for sale composed of at least 50% postconsumer waste material by weight or by volume. In addition, the taxpayer must invest at least \$300 million in the facility by the end of the fifth calendar year after the year in which the taxpayer begins construction or operation of the facility. Postconsumer waste material is any product generated by a business or consumer which has served its intended end use and which has been separated from the solid waste stream for the purpose of recycling and includes, but is not limited to, scrap metal and iron, and used plastics, paper, glass, and rubber.⁹²

The procedure to request approval of an alternative allocation or apportionment method for recycling facilities is provided in SC Rev. Proc. Bull. #02-4.⁹³

⁸⁹SC Rev. Proc. Bull. #02-4 is reproduced as Worksheet 15.

⁹⁰See Section .08 of this portfolio for a discussion of corporate license fees.

⁹¹SC Code §12-6-2320(C).

⁹²See SC Code §12-6-3460 for additional details regarding the definition of qualified recycling facility.

⁹³SC Rev. Proc. Bull. #02-4 is reproduced as Worksheet 15.

(d) Special Economic Development Incentive Based Apportionment for Certain Life Sciences Facilities⁹⁴

A taxpayer establishing a life sciences facility may request the Department enter into an agreement for up to 15 years to establish an alternative allocation or apportionment method pursuant to SC Code §12-6-2320.

A “life sciences facility” is a business engaged in pharmaceutical, medicine, and related laboratory instrument manufacturing, processing, or research and development, including a business under North American Industry Classification System Manual Code 3254 (Pharmaceutical and Medical Manufacturing) or 334516 (Analytical Laboratory Instrument Manufacturing.)⁹⁵

In order to use another method for up to 15 years, the following requirements must be met:

1. The life sciences facility must invest at least \$100 million in the project and create at least 200 new, full time jobs at the project with an average annual cash compensation of at least 150% of annual per capita income (in South Carolina or the county the facility is located, whichever is less) based on the most recent per capita income data available as of the end of the taxable year in which the jobs are filled.
2. The Coordinating Council for Economic Development at the Department of Commerce must certify that the new facility or expansion will have a significant beneficial economic effect on the region for which it is planned and that its benefits to the public exceed its costs.
3. The Department, in its discretion, may enter into an agreement with the taxpayer to use an alternative method.

The procedure to request approval of an alternative allocation or apportionment method for life sciences facilities is provided in SC Rev. Proc. Bull. 02-4.⁹⁶

The new method will also be used to determine the taxpayer’s corporate license fee, if any.⁹⁷

⁹⁴SC Code §12-15-40.

⁹⁵SC Code §12-15-20.

⁹⁶C Rev. Proc. Bull. #02-4 is reproduced as Worksheet 15.

⁹⁷See Section .08 of this portfolio for a discussion of corporate license fees.

F. Unitary Business Doctrine

1. General Overview

Apportionment is tied to the unitary business concept. Before an apportionment formula can be applied by a state to ascertain the taxable income of a multistate corporation, or an affiliated group of corporations, a determination must be made that the divisions of the corporation, or the members of the controlled corporate group, constitute one unitary business. “The linchpin of apportionability in the field of state income taxation is the unitary business principle.”⁹⁸

A state cannot tax value earned outside of the state,⁹⁹ but a state may look beyond its borders to get the true value of taxed property or privileges within its borders, when in-state activities are an integral part of an organic interstate system that gives an enhanced value to the property or privileges which are taxed.

“In a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state.”¹⁰⁰ Thus, the privilege of doing business within a state may be made more valuable owing to its being an integral part of a multistate operation.

Therefore, to determine the amount a state can tax, first the unitary business is determined. A corporation can have income which is not connected with a trade or business, and a corporation can conduct more than one unitary business. The income and apportionment must be computed separately for each unitary business. On the other hand, one unitary business can encompass a group of related corporations¹⁰¹ and the income from the unitary business, which is not otherwise allocated, is apportioned between the taxing state and everywhere else.

There is no objective and easy definition of unitary business. Rick Pomp and Oliver Oldman explain:¹⁰²

⁹⁸Exxon Corp v. Dept of Revenue, 447 U.S. 207, 223 (1980).

⁹⁹Conn. General Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).

¹⁰⁰Ford Motor Co. v. Beauchamp, 308 U.S. 331 at 336 (1939) (franchise tax case).

¹⁰¹See Mobil Oil v. Vermont, 445 U.S. 425 (1980).

¹⁰²State & Local Taxation, Richard D. Pomp and Oliver Oldman (3d ed. 2000) at 10-20 to 10-21. See also the draft of the Public Participation Working Group - Uniformity Committee Liaison Group on Definitions of Unitary Businesses on the Multistate Tax Commission website; www.mtc.gov.

The unitary business concept is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.¹⁰³ Instead it [US Supreme Court] has identified some of the indicia of a unitary business: unity of use and management;¹⁰⁴ a concrete relationship between the out-of-state and the in-state activities;¹⁰⁵ functional integration, centralization of management, economies of scale;¹⁰⁶ substantial mutual interdependence;¹⁰⁷ and some sharing or exchange of value not capable of precise identification of measurement — beyond the mere flow of funds arising out of a passive investment or a distinct business operation.¹⁰⁸ The Court has recognized that in a unitary business, it is exceedingly difficult to determine the profits earned by the processes conducted within a state's borders.¹⁰⁹

In a unitary multistate business, no method of assigning net income can precisely determine the exact amount of income attributable to any geographic area or to any given part of a series of multistate business operations. States have devised statutory apportionment formulas for multistate income designed to arrive at a portion of income reasonably attributable to the state. The formula method provides a rough approximation of a company's income that is reasonably related to the activities conducted within the taxing state; it does not identify the precise geographical source of a company's income.

2. South Carolina Overview

South Carolina is a separate entity state, and generally treats related corporations as if they were unrelated. South Carolina does not normally apportion the income of related corporations together, even when they are part of one unitary business.¹¹⁰ Single member limited liability companies and QSubs that are disregarded for all South Carolina tax purposes are

¹⁰³Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

¹⁰⁴Butler Bros. v. McCollgan, 315 U.S. 501 (1942).

¹⁰⁵Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

¹⁰⁶Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980).

¹⁰⁷F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).

¹⁰⁸Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

¹⁰⁹Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

¹¹⁰The South Carolina Supreme Court held in Emerson Elec. Co. v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986), that parent and subsidiary corporations are not to be considered a single entity for apportionment purposes.

exceptions to this rule.¹¹¹ Another possible exception is provided by SC Code §12-6-2320(A) which provides that if South Carolina’s statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer’s business activity in South Carolina, the taxpayer may petition for, or the Department may require, in respect to all or any part of the taxpayer’s business activity a different method.¹¹² It is possible that in certain circumstances the taxpayer may request, or the Department may require, combined reporting; *i.e.*, the apportionment of multiple related corporations together. Although this type of alternative combined apportionment has been discussed, the Department has, to date, never attempted to impose it over a taxpayer’s objection.

South Carolina does allow what it refers to as consolidated returns.¹¹³ They are nothing like what federal tax practitioners consider consolidated returns.¹¹⁴

South Carolina recognizes that it is possible that one corporation can carry on two or more separate unitary businesses. When that is the case, each unitary business is apportioned separately.¹¹⁵

3. Unitary Business Issues

There are really two separate unitary business issues.

¹¹¹See the discussions of single member LLCs in Section .03 C. 3. and Worksheet 5 of this portfolio, and the discussion of QSubs in Section .03 C. 2. of this portfolio.

¹¹²See discussion of SC Code §12-6-2320(A) in Section .05 E. 6. a. of this portfolio.

¹¹³SC Code §12-6-5020 and *Emerson Elec. Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986).

¹¹⁴See Section .07 B. 1. of this portfolio for a discussion of South Carolina’s “consolidated” returns.

¹¹⁵*Exxon Corporation v. South Carolina Tax Commission*, 273 S.C. 594, 258 S.E.2d 93 (1979). See also SC Reg. §117-710.1 Proper Allocation and Apportionment of Income:

The phrase “transacting or conducting his business partly within and partly without this State” ... is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. A taxpayer operating two or more unrelated businesses, each of which is entirely within and without the State, is not subject to the provisions of this section, but each business determines its South Carolina net income separately. A taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without is subject to the [apportionment] formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business is allocated and apportioned separately as appropriate to the State where such business is conducted.

A review of South Carolina cases below will attest, this possibility is not a common occurrence in South Carolina.

1. Are two (or more) entities or segments unitary so that their apportionment factors and incomes should be combined and used in determining income subject to income tax in a state? A segment for this purpose is a subdivision of an entity consisting of any grouping of business activities, functions, or transactions.
2. If the answer to the first issue is no, then is the income in question part of apportionable income? A yes answer to the second issue means that the income is apportionable, but that the apportionment factors of the payer are not included in the apportionment formula.

The first issue is the traditional unitary business issue for corporate income tax. Are the entities or segments not separate businesses, but an integral part of a multi-state unitary operation, such that the income from the operations within each state cannot accurately be attributed to a given state by the separate accounting method?¹¹⁶ The underlying rationale is that there is but one business and the apportionment factors and income are really the apportionment factors and income of one business which should be allocated and apportioned together.¹¹⁷

The second issue is a determination of whether income is apportionable. In South Carolina that is the same as determining whether it is business income or non-business income,¹¹⁸ and in some cases where a corporation is carrying on more than one unitary business, determining to which unitary business the income relates.¹¹⁹

¹¹⁶The Supreme Court has declared the “principal virtue of the unitary business principle of taxation is that it does a better job of accounting for ‘the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise’ than, for example, geographical or transactional accounting.” *Allied Signal, Inc. v. New Jersey*, 504 U.S. 768, 783 (1992) quoting from *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164-165 (1983).

¹¹⁷See e.g., *Exxon Corp. v. Wisconsin*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *F.W. Woolworth, Co. v. New Mexico*, 458 U.S. 354 (1962); *ASSARCO, Inc. v. Idaho Sate Tax Comm.*, 458 U.S. 307 (1982); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); and see BNA Multistate Tax Portfolio #1110, *Income Taxes: Definition of a Unitary Business*.

¹¹⁸In South Carolina, all apportionable income is business income. See the discussion above and the Geoffrey case in Section .02 D. of this portfolio.

¹¹⁹The payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment. What is required instead is that the transaction serve an operational rather than an investment function. For example, interest earned on short-term deposits in a bank located in another state where that income forms part of the working capital of the corporation's unitary business, is part of that corporation's apportionable income, notwithstanding the absence of a unitary relationship (issue 1) between the corporation and the bank.

In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state. See *Allied Signal, Inc. v. New Jersey*, 504 U.S. 768 (1992); and *Eastman Kodak Company v. SC Tax Comm.*, 418 S.E.2d 542 (SC 1992); and see BNA Multistate Tax Portfolio #1110, *Income Taxes: Definition of a Unitary Business*.

4. Significant South Carolina Cases

a. *Exxon*

Exxon Corporation v. South Carolina Tax Commission,¹²⁰ was South Carolina's first unitary business doctrine case.¹²¹ Exxon (Humble Oil and Refining Company during the tax years in question) marketed and sold its products in South Carolina. It argued that it should be able to exclude its exploration and production activities from its apportionment factors and net income used to determine the amount of its income taxable in South Carolina. The Court rejected Exxon's claim. Relying primarily on *Butler Bothers v. McColgan*¹²² it held that:

“the proper answer to the questions of whether or not a business is unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management, and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business.”¹²³

The Court recognized that the unitary business issue requires a factual analysis and does not lend itself to an objective rule. It quotes the following from *Ex rel. Maxwell v. Kent Coffey Manufacturing Co.*:¹²⁴

“That term (unitary) is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business -- a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units.”

Citing SC Reg. §117-87.17 (since recodified as SC Reg. §117-710.1) the Court also recognized that a taxpayer may operate more than one unrelated business which should be apportioned separately, and that if only one of those businesses operated in South Carolina, then South Carolina could only tax that one business.

¹²⁰273 S.C. 594, 258 S.E.2d 93 (1979).

¹²¹There was a 1974 Commission Decision I.D. 179 (July 9, 1974) (1974 WL 22327 (S.C.Tax.Com.)), where a vertically integrated oil company argued that only the income from its marketing operations should be included in South Carolina's apportionable income to which the apportionment percentage is applied. The taxpayer argued for a departmentalization of its business activities into production, transportation, refining, and marketing. The Commission, however, found that the taxpayer was engaged in a unitary business because the portion of the taxpayer's business within South Carolina was dependent upon, as well as contributory to, the operation of its business outside South Carolina.

¹²²315 U.S. 501 (1942).

¹²³258 S.E.2d 93, 96 (1979).

¹²⁴168 S.E.2d 397, affirmed, 291 U.S. 642 (North Carolina 1933).

Recapitulating the facts the Court found that:

(1) Humble held itself out to the public as one company. It made no attempt to externally identify its exploration and production activities as a separate business. (2) The company employed central staff services upon which all departments were dependent. (3) Humble used centralized purchasing techniques which produced savings throughout the company. (4) Strong centralized management was employed over all segments of the company. (5) The combination of the various activities within a single corporation was beneficial to Humble in that it provided profit stability, reduced risk and insured full capacity utilization of the company's facilities. (6) Humble's crude production and crude sales made crude purchases available for its refineries. (7) High-level personnel within the various departments were selected by upper management, not by departmental vice presidents, and the movement of personnel throughout the company was a beneficial practice employed by Humble. The combination of the various functions created a pool or source of talent which otherwise would not have been available. (8) A central source of earnings and funds was employed and no attempt was made to segregate accumulated earnings or funds based on the company's internal assignment of earnings to these functions. (9) Based on the company's internal assignment of earnings and assets to the various functions, refining and marketing were dependent upon the company as a whole during the years in question. Had the functions not been combined, an additional cost of capital would have existed because of the necessity for borrowed funds. This cost was averted because of the vertical integration of the company. (10) The various operating activities of exploration and production, refining and marketing both contributed to, and depended on, each other.

Based upon these facts, the Court found that Humble (Exxon) possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of exploration and production, refining and marketing all contributed to, and depended upon, each other. Therefore, the Court held that Humble was a single unitary business comprised of the exploration and production of crude oil and natural gas, the refining of crude oil and the marketing of natural gas and refined petroleum products.

Having found that Humble conducted one unitary business, it rejected Exxon's argument that extraterritorial values are being reached and that because of severance taxes levied by numerous oil producing states it is being subjected to multiple taxation. Relying in part on *Butler Brothers* and the lack of evidence that separate accounting would be more accurate, the Court determined that the tax in question did not violate the Due Process Clause since it clearly bears fiscal relation to the protection, opportunities, and benefits given Humble by the State.

Rejecting Exxon's claim with regard to the Commerce Clause and preventing double taxation, the Court reasoned that only a very small portion of the business, about 1%, was being taxed in South Carolina, and Exxon made no attempt to prove multiple taxation. It also found severance taxes to be privilege taxes, and distinguished them from income taxes. The Court stated that it "has been settled law for many years that it is not multiple taxation to levy taxes on different incidents, for example, a single taxpayer may pay property taxes, privilege taxes and income taxes and not be subject to multiple taxation."¹²⁵

¹²⁵Exxon Corp. v. SC Tax Comm., 258 S.E.2d at 100.

b. *Lowenstein*

The next significant unitary business case in South Carolina is *M. Lowenstein Corporation v. SC Tax Comm.*¹²⁶ Lowenstein is in the business of manufacturing textiles. Clark-Schwebel is a subsidiary of Lowenstein and is in the business of manufacturing fiberglass fabrics. They both have their principal places of business in New York, and they both do business in South Carolina.

The case involved two issues:

1. Whether South Carolina can tax the gain Lowenstein made from the repurchase of bonds it issued; and
2. Whether South Carolina can tax Clark-Schwebel on the interest income it earned from loans it made to Lowenstein.

Although these corporations are related, South Carolina is a separate entity state, so there was no claim that the apportionment factors of Lowenstein and Clark-Schwebel should be combined. The issue was the second unitary issue, whether the income was nonbusiness income which should be allocated to the state of the corporation's principal place of business,¹²⁷ or whether it was business income which should be included in the income that South Carolina apportions.

The Court characterized the question as whether or not the property producing the income in dispute is “connected with the business of the taxpayer.” If the property is connected with the business of the taxpayer it is properly apportioned to South Carolina and all other states in which the corporation conducts business, but if the property is not connected with the business of the taxpayer, it must be allocated to New York.

Gain from Repurchase of Bonds

The only reason given for the bonds issuance was that the company needed the funds to put into their operations. Therefore, the Court concluded that the bonds which Lowenstein repurchased were connected to its business, and thus the gain from their repurchase should be apportioned.

Interest income

Clark-Schwebel consistently generated excess cash which it loaned to Lowenstein. The loans were made daily and evidenced by demand notes providing for interest at prime plus one percent. Clark-Schwebel used both the repaid funds and interest income in its normal business operations.

¹²⁶298 S.C. 93, 378 S.E.2d 272 (SC Ct. App. 1989).

¹²⁷See Section .05 B. of this portfolio concerning allocation and SC Code §12-6-2220.

The Court held that the demand notes were connected to the business of Clark-Schwebel, and thus the income from the notes was properly apportioned. It reasoned:

1. The funds loaned to Lowenstein all originated from, and were generated by, the business of Clark-Schwebel.
2. Each month, the interest income produced by the notes and any principal repayments were deposited in Clark-Schwebel's general bank accounts and used for normal business operations.
3. The notes were created on virtually a daily basis. The comptroller for Clark-Schwebel monitored its cash daily and wired excess funds to Lowenstein thus creating a continuous stream of notes between Clark-Schwebel and Lowenstein.
4. Clark-Schwebel demanded payment on the notes when it required cash to meet the needs of its business.
5. The notes were demand notes indicating Clark-Schwebel sought to have the funds available, and in fact had the funds available, to meet the needs of its business.

Clark-Schwebel argued that the notes should be treated as long-term assets, and that a distinction should be made between operating funds and investment funds and that only that portion of the interest income actually used for operations was connected with its business. The Court rejected these arguments because the notes were demand notes and they were never segregated from Clark-Schwebel's general business accounts used for normal business purposes.

Unitary Business Doctrine

The Court went on to consider Clark-Schwebel's argument that the taxation of its interest income violated its due process rights. The issue was whether South Carolina taxed value earned outside its borders. This issue turned on whether the interest was part of Clark-Schwebel's unitary business, since only unitary business income is apportionable.¹²⁸ Lowenstein and Clark-Schwebel argued that there was a denial of the right to due process unless Clark-Schwebel and Lowenstein were operating a single "unitary business." The Department, argued that there is no denial of the right to due process because Clark-Schwebel's business of manufacturing fiberglass fabrics and the interest income it received were both part of a "unitary business."

The Court agreed with the Department. If this issue arose today, the Court would most likely rely on *Allied Signal*.¹²⁹ At the time of the decision, it relied on decisions in several other states to the effect that when the surplus funds are produced by that business, the investments are

¹²⁸The Court determined that the only constitutional issue raised was Clark-Schwebel's due process rights relating to the taxation of its interest income.

¹²⁹*Allied Signal, Inc. v. New Jersey*, 504 U.S. 768 (1992).

short-term, liquid, and made with the intent that both the principal and interest are to be used in the regular course of the taxpayer's trade or business, the relationship between the payer and the taxpayer is not dispositive on the issue of whether a corporate unity exists.

The Court then determined the tests it discussed in the South Carolina *Exxon* case¹³⁰ for a unitary business were met by Clark-Schwebel's activities in South Carolina. Thus, the interest income was part of Clark-Schwebel's "unitary business."

The characteristics of the unity of ownership test was met since the fiberglass fabrics activities and the interest earning activities are both carried on by the same corporation. Unity of management is present since the comptroller for Clark-Schwebel handled both the interest income and the funds used in the day-to-day manufacture of fiberglass fabrics, and no separate management existed for either activity, but rather the same management carried out all activities of the business as a unit. Unity of operation was evidenced by the fact that the interest income activity was operated from the same facilities as the fiberglass production, and by the fact that the fiberglass fabrics activity provided the funds from which the interest income was produced.

The second part of the South Carolina *Exxon* test is whether the interest earning activities contribute to or depend on the other activities of the business. This part of the test was satisfied by the fact that the interest income and principal repayments were deposited in Clark-Schwebel's general business bank accounts and used by Clark-Schwebel in its fiberglass fabrics business.

Finally, relying on *Container Corp. of America v. Franchise Tax Bd.*,¹³¹ the Court held that even under the theory put forth by Lowenstein and Clark-Schwebel, the right to due process has not been denied because they were, in fact, operating a single "unitary business." The Court found the following factors demonstrated the unitary nature of the income:

1. The Court found that the system of loans and repayments created a central pool of money which each corporation drew upon as its business needs dictated. Lowenstein and Clark-Schwebel each depended upon the pool to carry on business and this created a unitary business arrangement;
2. The corporations' held themselves out to the public as being integrated;
3. The extent of management services provided by Lowenstein to Clark-Schwebel; and
4. The fact that Lowenstein exercised virtually total control over Clark-Schwebel.

Note: Although the Court held that Lowenstein and Clark-Schwebel were unitary with each other, South Carolina is a separate entity state, therefore, there was no argument and no consideration by the Court of combining their apportionment factors.

¹³⁰ *Exxon Corporation v. South Carolina Tax Comm.*, 273 S.C. 594, 258 S.E.2d 93 (1979).

¹³¹ 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983), in which, based on evidence of significant mutual interdependence and flow of value between a corporation and its foreign subsidiaries, the Court held that the corporation and its subsidiaries constituted a single unitary business.

Note: Similar Commission Decisions

Commission Decision 94-44 (June 10, 1994) also dealt with cash from a foreign subsidiary doing business in South Carolina that was transferred daily to its out-of-state parent corporation and returned by the parent to meet the subsidiary's day-to-day needs for its ordinary business expenses. The parent corporation did not have nexus with South Carolina. The Commission determined that the transfers were loans and repayments and imputed interest on the loans.¹³² With regard to the issue of whether the interest is allocable to the taxpayer's principal place of business, or includable in the taxpayer's income subject to apportionment, the Commission relied on *Lowenstein* and held that the interest was connected with the taxpayer's business and therefore apportionable.

The Commission reasoned that like *Lowenstein* the funds loaned to the parent all originated from, and were generated by, the business of the taxpayer (subsidiary). Second, the loans between the taxpayer and the parent occurred on almost a daily basis. Third, the parent's use of the money for funding the taxpayer's (subsidiary's) everyday needs supported finding that the interest generated by the loans was connected with the business of the taxpayer.

Similarly, Commission Decisions 88-195 and 90-33 held that whether losses on worthless debt and stock are allocated or apportioned depends on whether they are unitary; *i.e.*, apportionable. These decisions relied, in part, on *Texaco v. Wasson*,¹³³ which held that property that produced salt and sulfur royalties was connected with an oil company's business since the salt and sulfur properties were found while searching for oil.

c. Kodak

*Eastman Kodak Company v. SC Tax Comm.*¹³⁴ concerned safe harbor leases.¹³⁵ Kodak entered into 34 safe harbor leases at an acquisition cost of over \$650 million. These leases produced approximately \$840 million of cash flow from tax benefits. Only a very small percentage of the leased assets were located in South Carolina.

¹³²See Section .05 D. 1. of this portfolio for a discussion of this issue.

¹³³269 SC 255, 237 S.E.2d 75 (1977).

¹³⁴418 S.E.2d 542 (SC 1992).

¹³⁵Safe harbor leases were authorized by the Internal Revenue Code. They allowed one corporation to transfer tax benefits to another corporation. One corporation (the lessee) needed special assets, generally equipment, but could not utilize the related investment tax credits and depreciation deductions. The lessor (Kodak) made an initial payment on the asset, then leased it back to the lessee. The lessee made all other payments on the asset; however, the lessor utilized the tax benefits associated with the asset.

The issues were whether the safe harbor leases were connected with Kodak's trade or business and whether the safe harbor lease transactions were part of Kodak's unitary business, and therefore deductible from Kodak's apportionable income.

The Department argued that any deductions attributable to the safe harbor leases should have been allocated to those states where the leased assets were located. The Court disagreed. It relied on a North Carolina case which said that "the lease arrangement was a means of gaining working capital and increasing cash flow for all of [the taxpayer's] ... business operations."¹³⁶

The Department argued in the alternative that the income from the safe harbor lease activity should be computed separately because it was not part of Kodak's unitary business. The Court again disagreed. The Court cited its *Exxon* opinion¹³⁷ and stated that whether or not a business is unitary depends upon whether or not the business possesses the characteristics of unity of ownership, unity of management, and unity of operation, and whether or not the activities of the business in question contribute to, or depend on, the other activities of the business.

The Court found that the safe harbor leases were part of Kodak's unitary business because the safe harbor leases could not be segregated from Kodak's general business operations for the following reasons:

1. The funding for the safe harbor leases came from the general corporate treasury;
2. No separate staff supervised the transactions; and
3. The magnitude of the transactions and resulting tax benefits suggest a significant contribution to Kodak's general business.

Note: Kodak's win was a disappointment for most other South Carolina taxpayers who had purchased safe harbor leases. The Department had consistently taken the position that safe harbor leases were not part of the unitary business of the "investor."¹³⁸ By the time the case was decided the deductions from safe harbor leases had ended and most taxpayers could no longer amend their South Carolina income tax returns to include the deductions on their prior returns because the time to file claims for refunds had run. This left those taxpayers in the unenviable position of having allocated their deductions to their principal place of business (outside of South Carolina) and now that these shelters had turned around, they had to include income from them in their South Carolina apportionable income.

¹³⁶Eastman Kodak Company v. SC Tax Comm., 418 S.E.2d at 544, quoting from National Service Industries v. Powers, 391 S.E.2d 509, 512 (N.C. App. 1990), cert. denied, 395 S.E.2d 685 (1990).

¹³⁷258 S.E.2d 93 (1979).

¹³⁸See Commission Decisions 91-25 and 91-63. These decisions were effectively overruled by the Kodak case.

In Commission Decision 94-44¹³⁹ the Commission, finding the taxpayer failed to provide sufficient facts to distinguish its case from that presented in *Kodak*, relied on the *Kodak* case and held that the net income generated by safe harbor lease transactions is subject to apportionment even though losses in earlier years from the safe harbor leases were not included in the taxpayer's net income subject to apportionment.

d. Factor Representation — The NCR Case

Taxpayers may attempt to prove a state's apportionment formula is unconstitutional because it does not properly reflect the way their income was earned. They argue that the factors used in the formula do not "actually reflect a reasonable sense of how income is generated."¹⁴⁰ This issue has been litigated in a number of state "factor representation" cases. These cases generally involve a multinational corporation that is receiving dividends and other income, such as royalties and interest, from foreign subsidiaries.

In South Carolina's factor representation case, NCR claimed that South Carolina should include its foreign subsidiaries factors in NCR's apportionment formula because they generated the income that was used to pay royalties and interest to NCR.

(i) NCR I

NCR is a multinational corporation with several foreign subsidiaries engaged in the business of developing, manufacturing, marketing, installing, and servicing business information processing systems. It develops, acquires, owns, and uses patents and patent rights, both in the United States and in foreign countries. NCR enters into patent licensing agreements which generate royalty income from its foreign subsidiaries. In addition, NCR receives interest income from the various loans it makes to its foreign subsidiaries. This royalty and interest income is itemized in NCR's federal income tax return as royalty and interest income earned in foreign countries. The foreign countries in which NCR and its subsidiaries do business tax the net income of the subsidiaries. In addition, many of the countries impose an unapportioned tax on NCR on the full value of all royalty and interest amounts earned by NCR and paid to it by its foreign subsidiaries. A federal tax credit is granted to NCR for the royalty and interest income taxes paid to foreign governments.¹⁴¹

The Department determined NCR's income included royalties and interest income it received from its foreign subsidiaries. The Department did not include in its apportionment formula any of the foreign subsidiaries' sales, property or payroll. NCR objected to the inclusion of this income because the Department did not include in the apportionment formula the

¹³⁹June 10, 1994.

¹⁴⁰*Container Corp. v. Franchise Tax Bd*, 463 U.S. 159, 169 (1983).

¹⁴¹South Carolina does not have a comparable credit.

contribution of the foreign subsidiaries in generating that income. NCR argued that South Carolina may not tax it in this manner, since such a tax: (1) is contrary to statutory mandates; (2) violates the Foreign Commerce Clause of the United States Constitution; and (3) violates the Due Process clause of the United States Constitution.

Statutory Construction

NCR argued that South Carolina's statutory apportionment taxing scheme requires that NCR's foreign subsidiaries' payroll, property, and sales be included in the denominator of South Carolina's apportionment formula. The Court stated that each of the statutory sections defining the ratios of property, payroll, and sales use the singular word "taxpayer." It cited its holding in *Emerson Elec. Co. v. Wasson*¹⁴² for the proposition that parent and subsidiary corporations are not to be considered a single entity for purposes of income apportionment. South Carolina is not taxing the income of NCR's subsidiaries, but instead only the income of NCR itself as a separate corporate entity. Consequently, a subsidiary's payroll, sales, and property should not generally be considered under South Carolina's statutory scheme. The Court therefore rejected NCR's statutory argument.

Foreign Commerce Clause

NCR argued that since foreign countries have taxed the royalty and interest amounts in full, South Carolina may not do so since that would amount to a violation of the Foreign Commerce Clause.

The Foreign Commerce Clause provides: "Congress shall have power ... to regulate commerce with foreign nations, and among the several states, and with the Indian tribes."¹⁴³

NCR argued that the United States Supreme Court decision in *Japan Line, Ltd. v. County of Los Angeles*¹⁴⁴ required a decision in its favor.

Japan Line dealt with an attempt by California to impose an ad valorem property tax on cargo containers, owned by Japanese companies, which were instrumentalities of foreign commerce and which were temporarily located in various California ports while in route to other destinations. The same containers were also subject to an unapportioned property tax in Japan. The *Japan Line* Court first set forth the *Complete Auto*¹⁴⁵ test used in determining whether an impermissible burden on interstate commerce had resulted from the state tax, and established that test as a threshold challenge to be met by the state in foreign commerce clause tax cases. The

¹⁴²287 S.C. 394, 339 S.E.2d 118 (1986).

¹⁴³U.S. Const. Art. I, 8, cl. 3.

¹⁴⁴*Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 99 S.Ct. 1813, 60 L.Ed.2d 336 (1979).

¹⁴⁵*Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977).

Court stated: “[i]f the State tax ‘is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State,’ no impermissible burden on interstate commerce will be found.”¹⁴⁶

The *Japan Line* Court next established that:

An inquiry more elaborate than that mandated by *Complete Auto* is necessary when a state seeks to tax the instrumentalities of foreign, rather than of interstate, commerce. In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and second, whether the tax prevents the Federal Government from “speaking with one voice when regulating commercial relations with foreign governments.” If a State tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.¹⁴⁷

The Court proceeded to employ those two additional tests, and found that the California tax contravened both “precepts.” Specifically, the Court found that California’s tax in fact caused a “double tax;” and that a treaty entitled the “Customs Convention on Containers” existed between the United States and Japan, which stated that containers used exclusively in foreign commerce and “temporarily imported are admitted free of ‘all duties and taxes whatsoever chargeable by reason of importation.’”¹⁴⁸ Hence, the Court reasoned, the actual double tax violated the first prong of the additional foreign commerce clause test, and the state tax in the face of the treaty contravened the second prong – that the Federal Government must be able to speak with one voice.

The South Carolina Supreme Court stated that in isolation, *Japan Line* appears to support NCR’s position here, but *Container Corp. v. Franchise Tax Bd.*¹⁴⁹ is the controlling case.

The South Carolina Supreme Court concluded that *Container Corp.* restricted *Japan Line* substantially. *Container Corp.* involved an apportioned corporate income tax on Container Corporation, a company headquartered in Illinois but doing business in California as well as other states and countries. California imposed the same three factor apportionment formula upon Container as the Department imposed on NCR.¹⁵⁰

¹⁴⁶Japan Line, 441 U.S. at 444-45, 99 S.Ct. at 1819 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977)).

¹⁴⁷441 U.S. at 451, 99 S.Ct. at 1823.

¹⁴⁸441 U.S. at 453, 99 S.Ct. at 1824.

¹⁴⁹463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983).

¹⁵⁰This was prior to South Carolina double weighting the sales factor.

The *Container Corp.* Court stated:

Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, “tax value earned outside its borders.” In the case of a more-or-less integrated business enterprise operating in more than one State, however, arriving at precise territorial allocations of “value” is often an elusive goal, both in theory and in practice. For this reason and others, we have long held that the Constitution imposes no single formula on the states, and that the taxpayer has the “distinct burden of showing by ‘clear and cogent evidence’ that [the state tax] results in extraterritorial values being taxed....”

This Court long ago upheld the constitutionality of the unitary business/formula apportionment method....¹⁵¹

The *Container Corp.* Court went on to state that the three factor formula used by California (and South Carolina here) not only met its approval but was “something of a benchmark against which other apportionment formulas are judged.”¹⁵²

In *Container Corp.*, California required Container Corporation to include all foreign subsidiary income as part of its “unitary” business, and at the same time included in its calculations the foreign subsidiaries’ property, payroll, and sales. Container Corporation complained that the inclusion of the foreign subsidiary income in California’s apportionment tax scheme violated the *Japan Line* case, since the foreign countries had already taxed the same income on an unapportioned basis.

The taxing scheme employed by the Department differs from California’s. California ignored corporate identities and included all foreign subsidiary income and all foreign subsidiary property, payroll, and sales in its apportionment formula. South Carolina uses the “separate entity” method, in which corporate entities are recognized. The South Carolina Supreme Court found that either method is permissible as a general matter.¹⁵³ *Container Corp.* rejected the foreign commerce clause complaint of multiple taxation where the California method of ignoring corporate identities was involved; the South Carolina Supreme Court rejected the same argument here, where the separate entity method is used.

The Court went on to find that double taxation is not “inevitable” under the South Carolina taxing scheme.

As to the second prong of *Japan Line* – that a state taxing scheme should not prevent the federal government from speaking with one voice – the Court found that the test is “whether a state tax implicates foreign policy issues or violates a clear federal directive.” It then rejected

¹⁵¹ 463 U.S. at 164-65, 103 S.Ct. at 2939-40. (Citations omitted.)

¹⁵² 463 U.S. at 170, 103 S.Ct. at 2943.

¹⁵³ See *Container Corp.*, supra, 463 U.S. at 167-168, 103 S.Ct. at 2933.

NCR's contention that this prong of *Japan Line* was violated, as the Court found no clear federal directive precluding the South Carolina Tax Commission's (since renamed the Department of Revenue) actions.

Therefore, the Court rejected NCR's foreign commerce clause argument, and held that the method of taxation employed by the Department passed all constitutional tests in that regard.

Due Process

The South Carolina Supreme Court stated that an apportionment formula must be fair under both the Due Process and Commerce Clauses. Relying on *Container Corp.* it stated that the first component of fairness in an apportionment formula is "internal consistency;" *i.e.*, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second requirement is "external consistency;" *i.e.*, the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

The Court held that in order to prove a violation of Due Process, a taxpayer must clearly and cogently prove the apportionment formula, as applied, has led to a grossly distorted result, or that the income attributed to the state is in fact out of all proportion to the business transacted in that state.

NCR argued that unfairness resulted from South Carolina's taxing scheme because no foreign subsidiary property, payroll, or sales are considered in the denominator of South Carolina's apportionment formula for determining NCR's percentage of business conducted in South Carolina. While at the same time income generated at least in part by those foreign subsidiaries is included in NCR's income subject to taxation.

The South Carolina Supreme Court relied on the NCR case in Maryland.¹⁵⁴ The Maryland Court noted that "NCR is correct in asserting that the formula, as applied to it, does not produce ideally fair results.... The question becomes whether NCR has demonstrated that the existing distortion is so grossly disproportionate that it is unconstitutional."¹⁵⁵ The Maryland Court also held that not all of the subsidiaries' payroll, property, and sales should be included, "[i]nstead, the denominators should be modified by including only those percentages of the foreign subsidiaries' property, payroll, and sales that generated the foreign subsidiary dividend income taxed by Maryland."¹⁵⁶

The South Carolina Supreme Court also held that South Carolina's taxing scheme is not ideally fair. To a degree, the income received by NCR from its foreign subsidiaries was earned in the United States (and to an extent in South Carolina) as it was partly here where loan monies

¹⁵⁴NCR Corp. v. Comptroller of the Treasury, 313 Md. 118, 544 A.2d 764 (1988).

¹⁵⁵544 A.2d at 780.

¹⁵⁶544 A.2d at 781.

were created and patents developed and researched. Hence, domestic payroll, property, and sales which related to producing this royalty and interest income (like domestic research and development companies) have already been included in the formula denominator. However, the Court reasoned, if the wholly owned foreign subsidiary did not exist, no royalty or interest income could be generated for NCR.

The South Carolina Supreme Court remanded the case to the trial court with specific instructions to: (1) recompute NCR's taxable income by factoring into the apportionment formula the proportionate contribution by foreign subsidiaries in generating NCR's income; (2) determine NCR's tax liability accordingly; and (3) compare this new calculation to the tax liability actually imposed. If there was a "gross disparity" between these two amounts, NCR would be entitled to a refund. The basis of this holding was that NCR's Due Process rights would be violated if the apportionment formula as applied resulted in a tax liability that was grossly disproportionate to the income generated in South Carolina.

(ii) *NCR II*

On remand, the trial court recomputed NCR's tax liability, determined there was no gross disparity, and concluded NCR was not entitled to a refund. NCR appealed.

There were two issues on appeal:

1. Whether the trial court properly recomputed NCR's taxable income?
2. Whether the tax imposed was grossly disproportionate to the income attributable to South Carolina?

Issue 1:

The trial judge used a pro rata method to calculate the proportion of sales, property, and payroll of foreign subsidiaries to be included in the denominator of the apportionment formula. He took the amount of royalty and interest income paid by a foreign subsidiary to NCR, divided it by that subsidiary's total income, and multiplied the resulting fraction by the total sales, property, and payroll of the subsidiary. This proportion of each subsidiary's sales, property, and payroll was then added to the denominator of the apportionment formula and NCR's taxable income was determined accordingly.

NCR challenged two steps in the computation. First, it contended that a subsidiary's total income should exclude foreign taxes paid. Second, it contended the calculation should not be done separately for each subsidiary but rather the proportion of sales, property, and payroll should be calculated by adding the totals from all the subsidiaries together.

The South Carolina Supreme Court held:

1. South Carolina law does not allow a deduction to net income for income taxes paid when computing taxable income. Since a foreign subsidiary's net income is determined with the ultimate goal of inserting it into the apportionment formula in order to compute NCR's taxable income, no deduction should be allowed for foreign income taxes paid by a subsidiary.
2. Subsidiaries are treated as separate entities for tax purposes. Combining NCR's subsidiaries would in effect be treating them as if they exist only in relation to NCR. The trial judge correctly made the calculation for each subsidiary separately.

The Court concluded that the trial judge properly calculated the proportion of sales, property, and payroll of foreign subsidiaries to be added to the denominator of the apportionment formula.

Issue 2:

The second issue was whether there is a gross disparity of constitutional proportion between the resulting tax liability calculated under the new formula and the tax liability actually imposed.

The Court reiterated that NCR had the burden to show that application of the apportionment formula has led to "a grossly distorted result."¹⁵⁷

The Court reasoned that the fact that the application of an apportionment formula results in an imperfect measure of apportioned unitary income does not prove a violation of Due Process. In *Container Corp.*, the United States Supreme Court found the application of California's three factor formula withstood a due process challenge because the margin of error was "within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."¹⁵⁸ The *Container* Court noted application of the three factor formula resulted in only a 14% increase in taxable income when compared to the accounting method espoused by the taxpayer and concluded the taxpayer had failed to meet its burden of showing a due process violation.

The *NCR II* trial judge found an average difference of 27.9% for the three tax years in question. He concluded this margin of error indicated no gross disparity in NCR's apportioned income calculated under the apportionment formula and held there was no due process violation.

The South Carolina Supreme Court agreed that 27.9% is not a gross disparity and held that the apportionment formula as applied by the Department did not result in a due process violation.

¹⁵⁷NCR I, 304 S.C. at 11, 402 S.E.2d at 672.

¹⁵⁸463 U.S. at 184, 103 S.Ct. at 2950.

(iii) Comment: Other Arguments which the Department Might Use in Future Cases

It is important to note that the Maryland case concerned dividends from the foreign subsidiaries and not royalty and interest income like the South Carolina case. This difference was not explored by the Court. There is a likelihood that if another company brought a factor representation case in South Carolina, that the Department would ask the Court to reexamine its holding as it applies to income, other than dividends.¹⁵⁹

The Maryland Court held:

[i]t may not be unreasonable to suggest that inclusion of subsidiaries' dividends in the apportionable income [of NCR] should be balanced by some changes in the formula denominator.¹⁶⁰

This holding may make sense for dividends which are paid from earnings of subsidiaries. But royalty and interest payments are not part of the subsidiaries' income stream. They are expenses which are hopefully used to generate income, but must be paid whether they generate income or not. No one would suggest that if NCR licensed patents and lent money to a foreign subsidiary of IBM that IBM's subsidiary's factors should be included in NCR's factors.

The South Carolina Supreme Court reasoned that to a degree, the income received by NCR from its foreign subsidiaries was earned in the United States (and to an extent in South Carolina) as it was partly here where loan monies were created and patents developed and researched. Hence, domestic payroll, property, and sales which are related to producing this royalty and interest income (like domestic research and development companies) have already been included in the formula denominator. However, if the wholly owned foreign subsidiary did not exist, no royalty or interest income could be generated for NCR.

There is an issue in the last sentence the Court did not address. While it is true of dividends and true in a literal sense with royalties and interest, if the royalty and interest rates were at arm's length rates, all of the income would be earned by NCR whether NCR licensed the patents or lent the money to NCR foreign subsidiaries or to IBM foreign subsidiaries, or IBM's domestic subsidiaries for that matter. If the rates were not at arm's length, the Department could

¹⁵⁹South Carolina does not tax dividend income from wholly owned subsidiaries regardless of whether the subsidiaries are domestic or foreign. It allows a dividends received deduction for dividends from domestic corporations because it has adopted Internal Revenue Code §243. Before *Kraft v. Iowa Dept. of Revenue and Finance*, 505 U.S. 71 (1992), the Department had a long standing administrative policy of allowing a dividends received deduction for dividends from foreign corporations equal to the deduction provided for domestic corporation, because the Department believed that to do otherwise would violate the Foreign Commerce Clause of the U.S. Constitution. This position has since been codified in SC Code §12-6-1130(11).

¹⁶⁰544 A.2d at 781.

require an adjustment since South Carolina has adopted Internal Revenue Code §482,¹⁶¹ or NCR could adjust the rates to an arm's length rate.

When *NCR I* and *NCR II* were decided, SC Code §12-6-2320 had not been enacted. SC Code §12-6-2320 allows the Department to require alternate allocation and apportionment provisions if the normal provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina.¹⁶² If a new case were presented, the Department may argue, in the alternative, that if South Carolina statutes do not meet the external consistency test required by the Constitution, that the taxpayer should be required to use the benchmark of apportionment formulas – worldwide combined reporting¹⁶³ (subject to the right of a company incorporated in a foreign country to use SC Code §12-6-2290 and elect to apportion only United States source income as determined for federal purposes on Form 1120F).¹⁶⁴

5. Comment: Conclusions

From these cases, most practitioners in South Carolina conclude that South Carolina is a separate entity state, and the courts are not likely to require combined reporting. On the other hand, within the same entity, in all but the clearest cases, income will generally be considered to be income from a unitary business.

The Department's auditors are generally instructed that:

1. If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business outside the state, the operations are unitary (the Dependency/Contribution test); and
2. A business is unitary if the three unities exist:
 - a. Unity of ownership; *i.e.*, more than 50% of the component parts of the unitary business must be commonly owned, either directly or indirectly. Satisfaction of this requirement is a prerequisite to a finding that a component is unitary with other components of a business.

¹⁶¹SC Code §§12-6-40 and 12-6-50; see also Section .04 A. of this portfolio. Internal Revenue Code §482 permits the Internal Revenue Service to allocate gross income, deductions, or credits between two or more organizations which are owned or controlled by the same interests, if it determines the reallocation is necessary to clearly reflect income or to prevent the evasion of taxes.

¹⁶²See Section .05 E. 6. a. of this portfolio.

¹⁶³See *Container Corp. v. Franchise Tax Bd*, 463 U.S. 159 (1983); and *Barclays Bank, PLC v. Franchise Tax Bd*, 114 S.Ct. 2268 (1994).

¹⁶⁴See Section .05 E. 5. of this portfolio.

- b. Unity of operation as evidenced by central purchasing, advertising, accounting, management, etc.; and
- c. Unity of use (or management) as evidenced by a centralized executive force and by a centralized general operations system.

Note: On January 15, 2004, the Multistate Tax Commission (MTC) adopted a regulation on principles for determining the existence of a “unitary business.” These regulations are available on the MTC website at www.mtc.gov. These regulations characterize unitary businesses as having significant flows of value evidenced by such factors as functional integration, centralization of management, and economies of scale. It is possible that these regulations will be used in the future training of Department auditors.