SALT WATCH

The South Carolina Department of Revenue Issued a Final Revenue Procedure and Ruling for the Use of Alternative Apportionment

Summary

On June 12, 2015, the South Carolina Department of Revenue (the "Department") issued Revenue Procedure #15-2 and Revenue Ruling #15-5, which together provide detailed information regarding determining when to use an alternative apportionment method, selecting an alternative apportionment method, combined reporting as an alternative apportionment method, and the procedural/administrative aspects related to alternative apportionment methods. The provisions of Revenue Procedure #15-2 are effective June 1, 2015, whereas, Revenue Ruling #15-5 is effective for all taxable periods open under the statute of limitations.

Details

Background

Under its standard apportionment formula, South Carolina requires most businesses to apportion unallocated income using a single sales factor. However, South Carolina allows for the use of an alternative apportionment method, which may include separate accounting, the exclusion or inclusion of one or more factors, or the use of any other method to effectuate allocation and apportionment of a taxpayer's income, including combined reporting, where the standard apportionment formula does not fairly represent the extent of the taxpayer's business in the state.[1]

Determining When to Use an Alternative Apportionment Method

Under Revenue Ruling #15-5, use of an alternative apportionment method is based on the facts and circumstances of the taxpayer and the use of an alternative apportionment method is not limited to those cases where application of the standard apportionment formula would be unconstitutional. Whatever the facts or circumstances, Revenue Ruling #15-5 provides that the party seeking the use of an alternative apportionment method, whether the Department or the taxpayer, must factually identify why, by a preponderance of the evidence, the use of the standard apportionment method does not fairly represent the taxpayer's in-state business activity, and propose a reasonable alternative method that will result in equitable allocation and apportionment of the taxpayer's income.[2] Thus, the party seeking the application of an alternative apportionment method has the burden to justify its use.

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Details (cont.)

Selecting an Alternative Method

No particular alternative apportionment method is provided for in Revenue Ruling #15-5. In fact, the Department states in Revenue Ruling #15-5 that there is no single alternative apportionment method that fits every scenario, but that whatever the selected method, it should be determined in relation to the reasons the standard apportionment formula does not fairly represent the taxpayer's in-state business, be reasonable, and fairly reflect the taxpayer's in-state business activity. By way of quoting the Oregon Supreme Court's decision in Twentieth Century-Fox Film Corp. v. Department of Revenue, 299 Or. 220, 700 P.2d 1035 (1985), the Department indicates in Revenue Ruling # 15-5 that an alternative apportionment method will be considered reasonable where: (1) the division of income fairly represents business activity and if applied uniformly would result in no more or no less than 100% of the taxpayer's income; (2) the division of income does not create or foster a lack of uniformity among states; and (3) the division of income reflects the economic reality of the taxpayer's in-state business activity.

Combined Reporting as an Alternative Method

When to Use Combined Reporting. Under Revenue Ruling #15-5, the Department may use combined reporting as an alternative apportionment method when the taxpayer is a member of a unitary group. Some of the facts the Department will examine when assessing whether the standard apportionment formula fairly reflects the taxpayer's in-state activity for purposes of using combined reporting include: (1) amounts paid to related parties for goods and services or goods and services are provided without payment; (2) profit margins associated with business activities; (3) capital investments associated with business activities; (4) whether goods or services are provided to both related and unrelated parties on similar terms; (5) whether taxpayers in similar industries provide similar goods and services to unrelated parties under similar terms; and (6) whether the taxpayer would be willing to enter into a similar arrangement with an unrelated party considering, among other things, the relinquishment of control over the business activity. The Department states in Revenue Ruling #15-5 its position that a transfer pricing study to support pricing between related entities is not determinative of whether South Carolina's statutory apportionment formula fairly represents the taxpayer's in-state business activities, and notes that it has required or approved unitary combined reporting in situations involving the use of purchasing companies, management fee companies and "east/west" companies.

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Details (cont.)

Combined Reporting as an Alternative Method (cont.)

Combined Reporting Group. In instances when combined reporting is the chosen alternative apportionment method, Revenue Ruling #15-5 provides that the combined reporting group comprises those members of the business group that are unitary under the U.S. Constitution. The composition of the combined group is further limited to a "water's edge" group – i.e., U.S. corporations, DISCs, controlled foreign corporations, and any member that earns, directly or indirectly, more than 20% of its income from intangible property or service related activities that are deductible against the income of other members of the group.

Calculation of Combined Income. Revenue Ruling #15-5 contemplates calculation of the combined reporting group's income (or loss) using the Finnigan approach – the same method used by California.[3] Under Finnigan, first, the pre-apportioned income of the entire combined reporting group is apportioned to South Carolina based on a single sales factor, the numerator of which is South Carolina sales of every member of the combined reporting group and the denominator of which is everywhere sales of every member of the combined reporting group. Then, the apportioned income is divided among the members of the combined reporting group that have a taxable nexus with the state. Intercompany income and sales are eliminated in this process. While each member of the combined reporting group are able to use the net operating losses and credits of the other members of the combined reporting group, net operating losses and credits are tracked at the member level and follow each member when it ceases to be a member of the group.

Alternative Apportionment Procedure

Under Revenue Procedure #15-2, the Department must approve an application for the use of an alternative apportionment method before a taxpayer may use it. A taxpayer must submit the application for approval, which is filed separate from the return, prior to the extended due date of the return for which the alternative method will be used. A taxpayer would be required to file an amended return if it receives approval from the Department after its original return is filed. The taxpayer must use an approved alternative apportionment method until it receives permission from the Department to use the statutory method or another alternative method. A taxpayer may appeal the denial of an application. Revenue Procedure #15-2 provides many more details regarding the application process.

If an assessment results in a substantial understatement of tax because the Department requires the use of an alternative apportionment method, the Department will limit the statute of limitations to 36 months rather than use the 72 months statute of limitations that ordinarily applies in the case of a substantial understatement of tax. In addition, the Department will not apply the 25% substantial understatement of tax penalty. However, if a taxpayer fails to use an alternative apportionment method it was required to use and an assessment results in a substantial understatement of tax, the Department will apply the 72 months statute of limitations as well as the 25% substantial understatement of tax penalty.

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Insights

- For the past several years, the procedural details related to requesting an alternative apportionment method were found in Revenue Procedure #09-1. Effective June 1, 2015, taxpayers should instead refer to Revenue Procedure #15-2 with respect to a request to use an alternative apportionment method.
- While Revenue Procedure #15-2 may be effective as of a date certain, Revenue Ruling #15-5 applies to all taxable years open under the statute of limitations. Thus, unlike Revenue Procedure #15-2, it appears the Department will apply the principles under Revenue Ruling #15-5 prospectively as well as retroactively, which means that the Department should apply Revenue Ruling #15-5 to an application for an alternative apportionment method currently under review as well as to a prior taxable year of a taxpayer currently under audit.
- Revenue Procedure #15-2 and Revenue Ruling #15-5 relate to the alternative apportionment provisions under South Carolina Code § 12-6-2320(A) only. Revenue Procedure #15-2 and Revenue Ruling #15-5 do not at all relate to the economic development based alternative apportionment provisions under South Carolina Code § 12-6-2320(B), wherein the Department has the authority to enter into an agreement with a multistate taxpayer that is planning a new facility or expansion in South Carolina. Thus, with respect to economic development based alternative apportionment, taxpayers should continue to follow Department guidance that relates to those provisions.
- The Department may have appropriately incorporated the holdings in Carmax Auto Superstores and Media General in Revenue Ruling #15-5.[4] However, it does not seem appropriate for the Department to, on the one hand, state that there is no single alternative apportionment method that fits every scenario, but, on the other hand, administratively "legislate" a particular method of combined reporting. But, on the bright-side, taxpayers will have set rules regarding combined reporting which they may plan for.

1. S.C. Code § 12-6-2320(A); Media General Communications, Inc. v. South Carolina Dep't of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010).

2. See also Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue, 411 S.C. 79, 767 S.E.2d 195 (2014).

3. See Appeal of Finnigan, No. 88-SBE-022, California Board of Equalization (opinion filed Aug 28, 1988).

4. Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue, 411 S.C. 79, 767 S.E.2d 195 (2014) (the party that seeks to deviate from the statutory apportionment formula bears the burden of showing that it does not fairly represent the taxpayer's in-state business activity, and its alternative apportionment method is reasonable); Media General Communications, Inc. v. South Carolina Dep't of Revenue, 388 S.C. 138, 694 S.E.2d 525 (2010) (the alternative apportionment provisions authorize the Department to use combined reporting).