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South Carolina Bar

Real World Examples of How to Correct Faulty Beneficiary

J. Aaron Nelson, Jr.
Greenville, SC

Eugene "Gene" Parrs
Beaufort, SC

Real World Examples of How to Correct Faulty Beneficiary Designations

January 21, 2017

Eugene Parrs
Harvey & Battey, P.A.
1001 Craven Street (29902-5577)
P.O. Drawer 1107
Beaufort, SC 29901-1107
(843) 524-3109
eparrs@gmail.com

J. Aaron Nelson, Jr.
Merline & Meacham, P.A.
812 East North Street
Greenville, SC 29601
(864) 242-4080
anelson@merlineandmeacham.com

I. General Advice

a. Examine the beneficiary designations as soon as possible.

b. Do not accept benefits.

c. Do not give-up if at first glance the beneficiary designation appears incorrect.

d. Be prepared to request Private Letter Rulings ("PLRs"). Many custodians will not allow advantageous treatment (such as the establishment of a spousal rollover IRA) without such a ruling.

II. Goals:

a. Spousal Rollover
   i. Electing to treat the participant's IRA as the Spouse's own.
   ii. Allows deferral of minimum required distributions ("MRDs") until the spouse reaches age 70 ½.
   iii. Allows the spouse to redesignate beneficiaries.
   iv. Spousal rollover is not always beneficial, but usually is.

b. Separate Shares.
   i. When there is more than one beneficiary of an IRA, plan or trust that is a beneficiary of the IRA or plan, the general rule is that MRDs are calculated based on the life expectancy of the oldest beneficiary.
   ii. It is possible, however, to divide the assets in order for each beneficiary to calculate the MRDs using his or her own life expectancy.

III. De facto Spousal Beneficiary (spousal rollover through an estate or trust)

a. Often times the goal of post-mortem planning for deferred compensation assets is to allow the surviving spouse to rollover the assets into their own account. While from a tax perspective, this is almost universally beneficial, before proposing the plans below, planners should consider whether it is truly what is desired. A couple things to consider:

i. Is this a second marriage such that allowing the surviving spouse to redesignate beneficiaries creates family strife?
ii. Is the spouse so much younger than the participant that a rollover would cause the spouse to be subject to the 10% penalty on early withdrawals.

b. In PLR 9416045 the IRS stated that if a decedent's plan or IRA pass through a third party (such as an estate or trust) to the decedent's spouse, then the spouse is treating as acquiring the assets from the third party and not from the decedent.
    i. Notwithstanding this ruling, the IRS has ruled in several circumstances (since 1993) that the surviving spouse is eligible to rollover the plan or IRA.
    ii. Natalie Choate calls it the "IRS's most longstanding, consistent, and logical position in the entire field of employee benefit distirbutions."

c. The rulings have focused on the following factors:

    i. Whether the distribution to the spouse could have consisted or other assets.
    ii. Whether the spouse had the power to select which assets he or she received.
    iii. Whether the spouse has the power to withdraw the assets (of a marital trust), or whether the distribution is dependent on the discretion of a trustee (as well as whether or not the spouse was the trustee).

d. PLRs 9623056, 9416045 and 9623056 all support the position that the spouse should be treated as having acquired the benefits from the decedent (and not from the trust), so that the spouse can roll over the assets into her own IRA if:
    i. The trustee has no discretion with respect to the allocation of the retirement benefits, but instead must allocate the benefits to the surviving spouse's share.
    ii. The trustee has no discretion with respect to the distribution of the benefits from the trust to the spouse, but instead must distribute such assets to the surviving spouse.

e. Note that some older rulings are inconsistent with these later rulings. In theory, none of the rulings can be relied upon (as they are only PLRs), but

the later rulings should be a more accurate indication of the IRS's current position.

IV. Qualified Disclaimers

a. What to comply with:
    i. Section 2518.
    ii. State law of the decedent-participant's domicile.
    iii. Requirements of the plan or IRA.

b. Section 2518 Requirements:
    i. Irrevocable, unqualified, and in writing.
    ii. Must not have accepted benefits.
        1. Non-acceptance of benefits is a big part of a qualified disclaimer with deferred compensation assets. This is particularly true when the plan administrator may not be aware of the many moving parts of the estate and simply wants to distribute the assets in accordance with the beneficiary designation.
        2. Mere retitling of an account by the custodian without direction from the beneficiary is not determinative, as there has to be some affirmative act taken by the beneficiary.
        3. A beneficiary can receive and keep the MRD from the decedent's IRA for the year of the participant's death and still disclaim the rest. Rev. Rul. 2005-36. However, keep in mind that the beneficiary is deemed to have also accepted the income attributable to the MRD.
        4. It should be possible to receive other distributions from the plan as there are specific regulations (Treasury Regulation 25.2518-3) dealing with disclaimers of less than an entire interest, but care should be taken to ensure such regulations are complied with.
    iii. Delivered to the correct parties within 9 months.
    iv. Must pass without direction to someone other than the disclaimant (except for spouses).

c. Note that the nine month requirement for a qualified disclaimer under Section 2518 is not extended by the September 30 beneficiary finalization date.

d. Prototypical example of the effective use of a disclaimer:
    i. Suppose the sole beneficiary of an estate is the surviving spouse; however, the decedent-participant neglected to update his or her beneficiary designation after remarrying. The beneficiary designation still designates the decedent's children as primary beneficiaries.
    ii. If they desire, the children (and their descendants if the beneficiary designates "per stirpes") should be able to disclaim the IRA or plan resulting in the asset passing to the decedent's surviving spouse through the estate. PLR 9615043.

e. Another example of the effective use of a disclaimer: The decedent-participant died without having named a beneficiary and the plan passed to the decedent's estate and on to a testamentary trust of which the decedent's spouse was a beneficiary. The other beneficiaries each executed qualified disclaimers and under the applicable local law, the corpus of the trust, including the plan, passed outright to the decedent's spouse (and was therefore eligible for rollover). PLR 2005-05030.

f. One example of where a disclaimer will not work:
    i. The default beneficiary under the IRA or plan is the decedent's surviving spouse and the decedent named his estate as the primary beneficiary (and designated no contingent beneficiary).
    ii. In PLR 9437042, the IRS ruled that the executors of the estate could not disclaim the interest (and thereby trigger the default beneficiary under the plan) because the decedent (even though not his estate) exercised control over his plan benefits.
    iii. Notably, the spouse was not the sole beneficiary of the estate. It should have been possible if all of the non-spouse beneficiaries of the estate had executed disclaimers that the spouse should have been able to rollover the IRA or plan.

g. Because the concept of a "qualified disclaimer" is an income tax concept, it *may* be possible to execute a non-qualified disclaimer (presumably, one that complies with S.C. Code Section 62-2-801, but not Section 2518) prior to the beneficiary finalization date and still qualify for advantageous treatment. PLR 9350041. However, it is important not to have the disclaimer be classified as an assignment of the IRA or plan.

V. Miscellaneous ways to correct a faulty beneficiary designation:

a. Check the default beneficiary.
    i. If the decedent-participant did not select a beneficiary or selected the wrong beneficiary, it is possible that the plan documents provide for a default beneficiary other than the decedent's estate.
    ii. If the default beneficiary is the decedent's spouse, then a spousal rollover may possible.
    iii. As described in the example above, it may be possible through the effective use of disclaimers to trigger the default beneficiary to allow the estate to be the beneficiary, which may result in the spouse being able to rollover the asset.

b. Invalidate or contest the beneficiary designation.
    i. Often times, beneficiary designation forms have an almost impossible-to-satisfy archaic set of requirements in order for the beneficiary designation form to be valid.
    ii. Invalidating a beneficiary designation form may leave the IRA or plan without a named beneficiary, triggering the default beneficiary (which may be the decedent's spouse) or allowing the asset to pass to the spouse, via the estate.
    iii. Incompetence is also a possible way a beneficiary designation can be invalidated.
    iv. An interesting example is in *Liberty Life Assurance Co. of Boston v. Kennedy* in which the plan documents (an ERISA life insurance plan) allowed any writing to be a beneficiary designation and allowed posthumously delivered beneficiary designations to be effective. The decedent's will specifically referred to the plan and the court held it was a valid beneficiary designation.
    v. In a situation where a spouse challenges a beneficiary designation and settles with the designated beneficiary, the IRS has ruled (in PLR 2001-27027) that such settlements are acceptable, and spousal rollover is permitted, if:
        1. The dispute was bona fide; and
        2. The settlement was within the range of reasonable settlements.

c. Elective Share
    i. If the spouse has the ability to select the assets to satisfy the elective share, the IRS has ruled (in PLR 9524020) that an IRA used to satisfy such elective share is eligible for the spousal rollover.
    ii. The conclusion should be the same if the personal representative selects the IRA or plan that satisfy the elective share, so long as the spouse is the sole personal representative (or if the personal representative has no other choice but to use the IRA or plan).
    iii. In South Carolina, a spouse does not have the right to select the assets which fund the elective share. S.C. Code Section 62-2-207(d).

d. Reformation
    i. Reformation is often used to correct trusts that are not properly drafted as designated beneficiaries.
    ii. Scriveners' errors vs. poor planning.
        1. A scriveners' error is one in which the drafting attorney did not draft the will or trust as the client instructed. Often times, however, the error is that the income tax consequences of the estate plan are simply ignored.
        2. The IRS is not going to allow a taxpayer to reform a trust if the error is poor planning and not a scrivener's error. PLR 200944059.
    iii. See *Estate of Bosch*. Only rulings from the highest court of a state must be respected by the IRS.
    iv. There are several favorable rulings allowing the taxpayer to reform a trust to allow it to be a "see-through" trust. However, the IRS position has recently changed and such a reformation was not respected in PLR 200742026 (a trust was reformed to remove a testamentary power of appointment exercisable in favor of charitable beneficiaries).

THE U.S. SUPREME COURT RULES ON BENEFICIARY DESIGNATION DISPUTES

EUGENE PARRS
HARVEY & BATTEY, P.A.
1001 CRAVEN STREET
BEAUFORT, SC 29902

TEL: 843-524-3109
E-MAIL: EPARRS@GMAIL.COM

The U.S. Supreme Court decided a case in 2009 that adds certainty to the law of beneficiary designations in qualified retirement plans. The case is *Kennedy v. The DuPont SIP*, 129 S.Ct. 865 (2009).

Clients are surprised by how much of their wealth is controlled at their death by beneficiary designations, not a will. Life insurance, annuities, IRAs, 401(k)'s and almost all other retirement plans, both qualified and nonqualified, pass at death according to beneficiary designations. For many clients those assets are a large portion of their wealth. Incorrect, outdated, and unmade beneficiary designations are the most likely source of a mistake in a client's estate plan.

ERISA, the federal pension law, has been on the books since 1974. Since then, plan administrators have faced problems when disappointed relatives of a deceased participant challenge a payout because they believe the beneficiary designation was "wrong." Plan administrators are liable if the "wrong" person is paid. Must a plan administrator evaluate challenges to the beneficiary designation to determine if it was "right"?

The Supreme Court answered that question with a resounding "No." Administrators are obligated to pay the person designated on the beneficiary form and look no further.

BACKGROUND This takes us to the story of William and Liv Kennedy. William was employed by DuPont and married Liv in 1971. William was a participant in two DuPont plans: the DuPont Savings and Investment Plan (SIP) and the DuPont Pension and Retirement Plan. In 1974 he signed a beneficiary designation form naming Liv as primary beneficiary of both plans. The SIP was a 401(k) plan and the pension plan was a defined benefit plan. Mr. Kennedy and Liv were divorced in 1994. In the divorce decree, Liv received a portion of Mr. Kennedy's pension benefits, but she waived her rights to the SIP. In 1997 a qualified domestic relations order, or "QDRO," was entered transferring the pension benefits to Liv. (A "QDRO" is a special court order that transfers retirement benefits to an ex-spouse as part of a divorce.) There was no QDRO for the SIP.

Mr. Kennedy died in 2001. It was then discovered that he had never changed his SIP beneficiary designation naming Liv, although he had been free to do so after the 1994 divorce. Over the objections of Mr. Kennedy's estate, the SIP plan administrator honored the beneficiary designation and paid Liv the SIP balance of $402,000. Mr. Kennedy's estate sued, claiming the

SIP beneficiary designation naming Liv was void because she had waived her rights to the SIP benefits in the divorce decree. The administrators of the SIP said they were obligated by ERISA to follow the plan documents, which included the beneficiary designation naming Liv, and disregard the divorce decree. If Mr. Kennedy had not wanted Liv to receive the SIP death benefits, the SIP plan administrator reasoned, he should have filed a new SIP beneficiary designation form after the divorce.

The US Supreme Court held that Liv's waiver in the divorce proceeding was ineffective and that the SIP had to pay Liv under the beneficiary designation. The Court said "there is no exception to the plan administrator's duty to act in accordance with the plan documents."

ERISA sets out four principal responsibilities for plan fiduciaries: Fiduciaries must (i) operate the plan for the exclusive benefit of participants, (ii) invest assets prudently, (iii) diversify investments, and (iv) administer the plan according to it documents. It is the last one that came into play here.

Before we conclude that William was inattentive or foolish in not filing a new SIP beneficiary designation, there's an interesting fact noted in his estate's brief filed with the Supreme Court.

> Four days after the divorce, on June 7, 1994, William Kennedy designated his only child, Kari Kennedy, as his only beneficiary on a DuPont beneficiary designation form. Its title was "COMPANY PAID SURVIVOR BENEFITS (PRE-RETIREMENT) SECTION XVI OF THE PENSION AND RETIREMENT PLAN."

That's odd. The ink was not even dry on the divorce decree before Mr. Kennedy updated his beneficiary designation for the *pension* plan but not the SIP. Yet, in the seven years from his divorce until his death, he ignored a $400,000 SIP benefit he certainly wanted to pass to his only child. Perhaps he thought the form he signed four days after his divorce covered the SIP. The title to that beneficiary designation form might mislead anyone. Or, as was pointed out in the oral argument, Mr. Kennedy may have thought the divorce decree nullified the SIP beneficiary designation naming Liv. The Supreme Court opinion said a QDRO could have been entered terminating Liv's rights under the SIP. However, under the divorce decree no SIP benefits were to be paid to her. What divorce lawyer obtains a QDRO for a retirement plan when the ex-spouse is getting nothing from it? (Note: QDROs are complicated. It took three years in this case for the pension QDRO to be entered).

Nonetheless, the Supreme Court spoke, and it did so unanimously. At the death of a plan participant, the plan administrator of a qualified plan must pay the person named on the beneficiary designation form filed by the participant (or the person named in a QDRO). There are no exceptions.

South Carolina Bar

Update from the South Carolina Department of Revenue

Milton G. Kimpson
Columbia, SC

State and Local Tax CLE

Case Law Update

January 21, 2017

SOUTH CAROLINA DEPARTMENT OF REVENUE

MILTON G. KIMPSON

GENERAL COUNSEL FOR LITIGATION

Milton.Kimpson@dor.sc.gov

NOTE:

The opinions expressed in this presentation are the authors' opinions and should not be attributed to the South Carolina Department of Revenue.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

SCDOR's New Director

Hartley Powell

- Served in South Carolina state government for 10 years before taking a position in the private sector
- Served at the SC Department of Commerce as:
  - International project manager
  - Director of the agency's European Office
  - Chief of Staff
- Joined KPMG, professional service company, in 2001
- Working with former director, Rick Reames, on a seamless transition

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

INDIVIDUAL INCOME TAX

SOUTH CAROLINA
DOR
DEPARTMENT OF REVENUE

RESIDENCY

Gamble v. SCDOR

(14-ALJ-17-0273-CC)

- Issue: Were the TPs residents of SC for the tax year 2012?
  - Resident individual – an individual domiciled in SC (see 12-6-30(2))
  - Domiciled – true, fixed, and permanent home and principal establishment; intent to return when absent
- Facts:
  - TPs allege they lived on a boat in Florida in 2012 and had employment w/ a FL-based company.
  - However, in 2012 both were registered to vote in SC; both had SC drivers licenses; both were members of a church in Bluffton, SC; they leased a home in Bluffton, SC in 2012 and used the SC address as the billing address for several accounts.
  - TPs claimed an SC refund of $14K for 2012 b/c of their non-resident status.
  - TPs testified that they had no intent to change their SC residence during 2012.
- ALC found that evidence established TPs' domicile was SC in 2012.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Residency

Frances H. Floyd v. SCDOR

(15-ALJ-0458-CC)

- Issue: Was the Taxpayer a resident of SC for tax year 2008?
  - Resident individual – an individual domiciled in SC (see 12-6-30(2))
  - Domiciled – true, fixed, and permanent home and principal establishment; intent to return when absent
- Facts:
  - TP was native of Spartanburg but lived in Oxford Mississippi while attending Ole Miss. After graduation, TP moved to Jackson Hole, Wyoming in the hopes of obtaining a job in the event-planning industry.
  - In spring of 2009, TP moved to Charleston, South Carolina upon finding a job in the event-planning industry. Currently, TP lives exclusively in Charleston, South Carolina.
  - TP used her parents' SC mailing address on the 2008 return, never obtained a Wyoming driver's license, her vehicle remained registered in her father's name (with SC address), did not register to vote in Wyoming, and did not own any property in Wyoming.
  - Nevertheless, TP testified that she considered herself a permanent resident of Wyoming in 2008.
- ALC found that evidence established TPs' domicile was Wyoming in 2008.
- The Department filed an appeal with the Court of Appeals. Case is pending.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Business Mileage

Tucker v. SCDOR

(15-ALJ-17-0143-CC)

- Facts: Minister, who has a full-time job elsewhere, deducted an expense for business mileage from his home to various locations where he performed ministerial duties. He kept a mileage log (did not include time of day or location of departure or arrival). He performed various ministerial duties in his home and did not have a designated office at the church.
- Issue: Is TP entitled to deduct unreimbursed employee mileage?
- Rule: TP's commuting expenses b/t home and work are personal and not deductible. However, a TP's cost of transportation b/t his residence and local job sites may be deductible if (a) TP has a home office that is his principal place of business and (b) the travel from his home office was related to work.
- Finding:
  - TP had a home office (used for more than researching and preparing sermons.
  - Mileage was related to work (descriptions included "worship" and "bible study")
  - Mileage log was sufficiently detailed
- Holding: TP can deduct the business mileage, (but must reduce the deduction by the amount the church annually reimbursed him for mileage).

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Hobby Loss

David M. McInnis v. SCDOR

(13-ALC-17-0443-CC)

- Taxpayer owns and operates an orthodontics practice. The Taxpayer also began operating an aviation leasing business.
- During the audit period, the Taxpayer presented only four invoices for the leasing of the airplane. The Taxpayer sustained a loss in each of the years.
- The Taxpayer subsequently claimed depreciation and deductions on his individual income tax returns related to the aviation activities. The Department disallowed the deductions as hobby losses under IRC § 183.
- The ALC ultimately found that the Taxpayer engaged in aviation activities for profit and thus was eligible for the depreciation and deductions for the period under audit.
- The Department's Motion for Reconsideration was denied.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Unsubstantiated Deductions

St. William White and Tiffany White v. SCDOR

(14-ALJ-17-0379-CC)

- The taxpayers claimed several deductions on their IIT returns related to real estate taxes, home office expenses, charitable contributions, and unreimbursed employee expenses. The Taxpayers also failed to report income received during the audit period. The Department denied the claims for deductions based upon the taxpayers' failure to substantiate the claimed deductions.
- The ALC agreed with the Department on all accounts, with the exception of one deduction for unreimbursed employee expenses.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

RAR

Harrell Durant and Jeannie Durant v. SCDOR

(15-ALJ-17-0528-CC)

- The IRS conducted an audit of the Taxpayers' 2009 federal return and ultimately denied certain deductions claimed by the TPs on such return. As a result, the Taxpayers' adjusted gross income increased.
- The IRS notified DOR of the adjusted FTI, and the Department made a corresponding adjustment to the Taxpayers' South Carolina return and assessed additional tax, penalties, and interest.
- The ALC found that the evidence at the hearing supported the Department's position that it properly adjusted the Taxpayers' state individual income tax for tax year 2009. Further, the ALC found that the Department properly imposed penalties against the Taxpayers.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

SALES TAX

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Gross Proceeds

Boggero d/b/a Boggero's Portable Toilets v. SCDOR

414 S.C.(Ct. App. Sept. 30, 2015)

- Boggero's operated a portable toilet business. TP never paid sales tax. SCDOR assessed sales tax on gross proceeds of portable toilet business. TP claimed she provided a service (i.e., the removal and disposal of human waste).
- Issue : are the fees received by Boggero proceeding or accruing from the lease or rental of TPP? (See § 12-36-90)
- Ct App noted that the analysis under the true object test (SC Reg § 117-308) focuses on whether the customer's purpose for entering the transaction was to procure a good or service.
- Ct App noted there is evidence the customer is paying for the use of Boggero's personal property for a limited amount of time – an arrangement essential to a lease or rental.
  - E.g., pick up and delivery charges for special events.
  - E.g., special fees charged for extra amenities (hand wash unit)
- Ct App affirmed ALC's decision – substantial evidence existed - that the fees were subject to sales tax. Ct. App. Believed the true object to be a question of fact.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Prosthetic Devices

CareAlliance Health Services d/b/a Roper St. Francis Healthcare v. SCDOR
787 S.E.2d 475, 416 S.C. 484 (2016)

- Before the Supreme Court: Heard February 9, 2016
  Decided April 20, 2016
  Petition for Rehearing denied July 14, 2016

- Petitioner filed refund claim for: (1) prescription reconstructive musculoskeletal and trauma musculoskeletal prosthetic devices; (2) prescription cardiac prosthetic devices and (3) blood derivatives (e.g., Gamunex, Plasbumin, Albutein and others.) Section 12-36-2120(28)(a) exempts "medicine and prosthetic devices sold by prescription."

- Under Home Medical Systems, Inc. v. SC DOR, 382 S.C. 556, 677 S.E. 2d 582 (2009) the Supreme Court adopted DOR's 3 part test for the prosthetic device exemption: (1) the sale must require a prescription; (2) the device must actually be sold by prescription; and (3) the device must replace a missing part of the body. The parties agreed that the devices were prescription type devices but disagreed whether their sale to the taxpayer (hospital) required prescriptions.

- Relying on Home Medical, the SC Supreme Court found that Federal regulation did not provide that orthopaedic prosthetic devices could only be sold by prescription, and thus such devices were not exempt from sales tax. TP has 90 days from the denial of the Petition for Rehearing to appeal to the US Supreme Ct.

- This case resolved the first two issues of the TP's refund claim; the issue related to the blood derivatives is still pending at the Administrative Law Court.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Gross Proceeds

Southeast Cinema Entertainment, Inc. v. SCDOR

2015 WL 9393942 (Ct App. Dec. 23, 2015)

- Facts: Petitioner, who owned and operated a movie theater business in Charleston, purchased an IMAX theatre system from IMAX for $1.15 million. He paid IMAX sales taxes. He subsequently determined that the technical equipment if purchased from a vendor other than IMAX, would have cost $170,694. He filed a sales tax refund claim for the difference arguing that it constituted an intangible IMAX trademark license. On cross motions for summary judgment the ALC disagreed with the taxpayer. The ALC disagreed, stating "Although the purchase of a trademark license is generally considered an intangible and un-taxable, Petitioner has not presented this Court with an itemized accounting sheet showing the purchase price of $1.15 million is the sum of the cost of the system and the cost of the trademark." Further, the ALC recognized that the sale of the trademark was "inextricably connected to the purchase of system" and thus, incidental to the sale of tangible personal property.
- The TP's contract also required the TP to make "additional payments to IMAX equal to $40,000 per year or a percentage of theatre admissions proceeds, whichever was greater. The Department assessed sales taxes on these payments as being part of the gross proceeds of sales. The ALC ruled that the "additional payments" were "box office fees" tantamount to film rental fees that are exempt from sales tax under SC Code Ann. 12-36-2120(35). The Department appealed this ruling to the Court of Appeals.
- Court of Appeals reversed the ALC's grant of partial summary judgment to Southeast on the issue of whether the Additional Monthly Payments were untaxable box office fees and remanded the issue to the ALC for additional proceedings to resolve ambiguities in the taxpayer's purchase contract.
- TP never responded to ALC on remand, and the case was dismissed against the TP.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Purchase Mark-up Method

Richard M. Ruth, d/b/a Richard's Bar and Grill v. SC DOR

(14-ALJ-17-0147-CC & 14-ALJ-17-0284-CC)

- TP challenged the Department's calculations of his gross sales. The Court found that the Taxpayer underreported his gross sales for the audit period and therefore underpaid his sales and excise taxes.
- Court upheld the Department's use of the purchase markup method for estimating gross sales (and liquor sales) in order to calculate the resulting sales and excise taxes.
- Court found that the Department generously accounted for any spillage, breakage, theft, or loss that the Petitioner claimed should reduce the estimate of gross sales.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Gross Proceeds

Rent a Center East/Rent Way v. SCDOR (13-ALJ-17-0601-CC)

- Issue: Whether the Taxpayers' Liability Damage Waivers sold in South Carolina stores should be included in the taxpayers' gross proceeds of sales and therefore subject to sales tax?
- Facts:
  - The Taxpayers, Rent A Center East, Inc., and Rent Way, Inc., were in the business of renting tangible personal property to customers in South Carolina. Additionally, the taxpayers offered their customers the opportunity to add a Liability Damage Waiver to their rental for an additional monthly fee, which the taxpayers calculated based on a percentage of the rental payment.
  - The taxpayers asserted that the sale of a Liability Damage Waiver constituted a separate transaction apart from the rental transaction, and because the Liability Damage Waivers were not tangible personal property such were not subject to sales tax.
  - The Department asserted that there was only one transaction, and the Liability Damage Waivers were required to be included in the taxpayers' gross proceeds of sales because the proceeds from the Liability Damage Waiver fees proceeded or accrued from the rental of tangible personal property. Ultimately, the ALC agreed with the Department's position.
  - TPs filed an appeal with the Court of Appeals on May 5, 2016.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Withdrawal From Inventory

Lowe's Home Centers, LLC v. SCDOR (14-ALJ-17-0552-CC)

- TP engages in 2 types of retail transactions at its stores: (1) traditional retail sales transaction and (2) installed sales transaction.
- Installed sales transaction
  - Customer selects and purchases materials from Lowe's. Lowe's subsequently contracts with a third-party to install such materials.
    - Materials include tile, hardwood floors, carpet, select kitchen appliances, windows, etc.
- For the installed sales transactions, Lowe's asserts that it is a contractor; thus, it pays use tax to the Department when the materials are withdrawn from inventory to use in the installed sales contract
  - Use tax paid is based upon the price of the materials Lowe's purchased at wholesale
- The Department asserts that Lowe's withdrawal, use, or consumption of the materials is subject to sales tax
  - Gross proceeds of sales must be valued at the FMV of the materials as measured by the price which these materials are offered for sale by Lowe's as part of the installed sales transaction. See §§ 12-36-110(1)(c), 12-36-90, and Regulation 117-309.17
- Hearing held on April 20, 2016 and reconvened June 7, 2016
- Proposed orders submitted by the parties in September; decision pending at the ALC.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Withdrawal From Inventory

Home Depot, Inc. d/b/a The Home Depot v. SCDOR

(15-ALJ-17-0253-CC)

- Similar to Lowe's case
- Pending before C.J. Anderson
- Hearing currently scheduled for February 2017

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Gross Proceeds

Alltel Communications, Inc. v. SCDOR

11-ALJ-17-0603-CC

- Issue: Whether the insurance coverage purchased by Alltel customers is "tangible personal property" such that the amounts collected by Alltel for the insurance coverage constitute "gross proceeds of sales", therefore making them subject to sales taxation.
- Facts:
  - Alltel challenged the Department Determination imposing sales tax on the proceeds from Alltel's sale of various protection plans for the handheld communication devices purchased by Alltel's customers.
  - Alltel offered a contract for indemnification coverage in the form of repair or replacement in the event that the device was "lost, stolen or damaged"

Holding: ALC determined that the coverage against the loss of, theft of, or damage to a device provided to Alltel's customers constituted insurance under SC Law.

Furthermore, the coverage against loss of, theft of, or damage to the devices made available to Alltel's customer did not constitute a service contract under SC law which would be subject to sales tax.

Department appealed ALC decision to Court of Appeals. The case was resolved on appeal.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Exemption

Greenville Hospital System (GHS) v. SCDOR

(13-ALJ-1-0523-CC)

- GHS is a political subdivision that includes profit and not-for-profit entities as well as educational programs (USC School of Medicine).
  - Approximately 122 Physician practices (Internal, Family, OB/GYN, Oncology, Orthopaedics, Pediatrics, Psychiatry, Radiology, Surgery, ENT, etc.)
  - 8 Residency Program Facilities
  - Employee Care Facilities
  - 9 Locations throughout the Upstate
- Department denied GHS's application for sales tax exemption under S.C. Code Ann. § 12-36-2120(41). GHS seeks to sell food items free of sales tax
  - This subsection provides for an exemption from sales taxes for sales by organizations which are exempt from property taxes under certain subsections of § 12-37-220 "if the net proceeds are used exclusively for exempt purposes and no benefit inures to any individual."
  - Department denied sales tax exemption request on the basis that GHS is not eligible for property tax exemption under §§ 12-37-220(A)(4) or (B)(16)(a). GHS is exempt from property taxes under §12-37-220(A)(1).
  - Further, GHS has not shown that it meets the requirements of § 12-36-2120(41) regarding the use of net sales proceeds.
- Case pending at the ALC.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Miscellaneous

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Statutory Interpretation

Hock RH, LLC v SCDOR

(15-ALJ-17-0105-CC)

- Issue: Is York Preparatory Academy, a public charter school, entitled to a property tax exemption for 2013?
- Gen'l Assembly passed Act 208 in 2014 saying that charter schools are exempt from property tax. Act states, "Time effective. SECTION 2. This act takes effect upon approval by the Governor."
- Governor approved act on June 2, 2014.
- Finding: No exemption available in 2013.
  - Language of act is plain and unambiguous.
  - No need to search for clues to Gen'l Assembly's intent.
- TP filed appeal. The matter is ready for consideration by the Court of Appeals.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Revenue Procedures Act

Brad Lightner v. Hampton Hall

(App. Case No. 2015-001952)

- Brad Lightner filed an action in circuit court for certain relief, to include a refund of admissions taxes, naming his golf club, Beaufort County, the Department and State of SC as defendants in a putative class action.
- The Department and State filed a Rule 12(b)(6) Motion to Dismiss because the Plaintiff failed to exhaust administrative remedies under the Revenue Procedures Act (RPA) and because S.C Code Ann. § 12-60-80(C) prohibits class actions being brought against the Department.
- The Circuit Court ultimately denied the Department's Motion to Dismiss, ruling that the case could not proceed as a class action but that the Plaintiff could pursue the suit individually without exhausting administrative remedies based on SC Code Ann. §12-60-20 which limits RPA to disputes with the Department concerning property taxes.
- The Department petitioned the Supreme Court for a writ of certiorari to hear the RPA issue in its original jurisdiction. The Court granted certiorari over the issue.
- At the Supreme Court, the Department argued that the RPA provides a procedure to resolve disputes with the Department regarding not only property taxes, but other types of taxes to include state taxes and regulatory matters. Lightner argued that the RPA applies only to disputes with the Department concerning property taxes. The decision is pending.
- The Plaintiff's appeal of ruling on the class action was dismissed by Ct. of Appeals; Plaintiff has petitioned for certiorari. Matter is stayed pending decision by Supreme Court.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Setoff Debt Collection Act

George Cleveland, III v. Greenville County (15-ALJ-30-0588-CC)

- Cleveland pled guilty to 3 charges and as part of the sentence, he was required to pay $130 in fees.
- Cleveland did not pay, and the Clerk of Court notified him that it intended to request that DOR deduct the debt from Cleveland's income tax refunds pursuant to the setoff debt collection procedures
  - The letter also informed Cleveland of the procedures to request an informal hearing regarding the setoff debt
- ALC found that Clerk of Court mailed the notice to the wrong address and remanded the matter so that Cleveland could be properly notified of the informal hearing process.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Tax Injunction Act

Roberts v. Jones

2016 WL 3912069 (D.S.C., Charleston Div)

- Roberts filed an action and asserted several claims related to the sale of property due to delinquent property taxes
- Facts:
  - Roberts was incarcerated in Maryland during the time of the suit
  - Alleged that he was not provided with any information regarding property taxes he owed in Dorchester County.
  - Also alleged that he was not given a reasonable amount of time to pay the delinquent taxes given his location at the time
- Roberts requested injunctive relief including return of the property and notice of future taxes at least 2-3 months in advance
- Court dismissed the case for lack of jurisdiction
- In most cases, the Tax Injunction Act prevents a federal district court from issuing an injunction enjoining the collection of state taxes
  - "District courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."

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4-R Act

CSX Transportation, Inc. v. SCDOR

Civil Action No. 3:14-cv-03821-MBS; Appellate No. 16-1726

- Railroad Revitalization and Regulatory Reform Act of 1976
  - Authorizes federal district courts to grant equitable and declaratory relief in cases alleging discriminatory taxation of railroads
- CSX sued and alleged that the taxation of its railroad real property without the benefit of limitations on value afforded to other commercial and industrial taxpayers under the South Carolina Real Property Valuation Reform Act (SC Valuation Act) is discriminatory under the 4-R Act
- SC Valuation Act caps any increase in the value of real property for *ad valorem* tax purposes at 15% within a five year reassessment cycle.

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CSX (con't)

- Cap applies to most commercial and industrial property
- However, property valued using the unit valuation concept, such as railroads, is not capped at 15% (full value is taxed as it increases in value)
- District court granted CSX's preliminary injunction
- After bench trial, district court ruled for the Department and concluded that the SC Valuation Act does not "impose a tax" within the meaning of § 11501(b)(4)
- CSX appealed to the 4th Circuit Court of Appeals; oral argument set for January 26, 2017.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Multi-State Corporate Income Tax

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Multi-State Corporate Income Tax

- Apportionment refresher
  - Use single sales ratio (used to be 4-factor ratio) when TP is manufacturer or dealer in TPP
  - Use single gross-receipts ratio when TP is not a manufacturer or dealer in TPP
- What business is the TP in?
- Sourcing of gross receipts to the numerator of the applicable ratio
- Alternative apportionment

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

What Business Is the Taxpayer In?

- Is a producer of electricity a manufacturer or a service provider?
- Duke Energy Corp. v. SC Dept of Revenue, 410 SC 415, 423, 764 SE 2d 712, 716 (SC Ct. App. 2014) cert. denied on this issue.
- Generating electricity is manufacturing

> [I]t is undisputed that Duke [] generates electricity . . . that did not previously exist. As the ALC stated, "No matter what moniker [is] used to describe the product produced by Duke [], the electric current . . . is produced through a mechanical process run by Duke []" We therefore hold that what Duke [] does to generate electricity is "manufacturing" as that term is used in section 12-6-2252.

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Sourcing of SC Sales or Gross Receipts to Applicable Numerator

- 12-6-2252 – single sales ratio (supplemented by 12-6-2280)
- 12-6-2290 – single gross-receipts ratio
- 12-6-2295 – non-exclusive list of how to source sales/gross receipts to numerator
  - 12-6-2295(a)(5) – sourcing for service providers (adopted effective 1/1/07)

Sales and gross receipts include "receipts from services if the entire [IPA] is within this State. If the [IPA] is performed partly within and partly without this State, sales are attributable to this State to the extent the [IPA] is performed within this State."

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SOURCING

DIRECTV, Inc. & Subsidiaries v. SCDOR

14-ALJ-17-0158-CC

- Operates in all 50 states.
- DIRECTV first sourced 100% of SC subscription receipts to SC in 2006-08. It then amended - not sourcing subscription receipts to SC, causing a significant reduction in the numerator of the gross receipts ratio, resulting in claims for refunds. DIRECTV subsequently sourced little or no subscription receipts from SC customers to SC in 2009-11.
- Issues:
  - what is the IPA of DIRECTV?
  - where does the IPA occur?
  - how should gross receipts be sourced to the numerator of the gross-receipts ratio?

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

SOURCING

DIRECTV, Inc. & Subsidiaries v. SCDOR

14-ALJ-17-0158-CC

- Amended Final Order and Decision – ALJ – June 12, 2015

  DIRECTV's [IPA] is the delivery of the signal into the homes and onto the [TV] sets of DIRECTV's customers. All of those [IPAs] related to [SC] customers occurred entirely within [SC]; therefore, 100% of DIRECTV's subscription receipts from [SC] customers must be sourced to the numerator of the gross receipts ratio. This Court rejects DIRECTV's attempt to source the subscription receipts from [SC] customers outside of [SC] based on costs of performance.

- Case has been appealed and is currently on the Court of Appeals' preliminary list

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

SOURCING

Dish DBS Corp. & Affiliates v. SCDOR

14-ALJ-17-0285-CC

- The Department issued a proposed assessment asserting that TP should be using the gross-receipts apportionment method and sourcing its receipts from SC subscribers to SC.
- ALC Final Decision issued May 20, 2016.
- ALC Amended decision issued July 11, 2016.
  - Similar to the decision in DIRECTV, the ALC found that Dish's income-producing activity is the delivery of the signal into the homes and onto the television sets of Dish's customers.
  - All of the income-producing activity related to SC customers occurred entirely within SC; thus, 100% of Dish's subscription receipts from SC customers must be sourced to the numerator of the gross receipts ratio. This Court also rejected Dish's attempt to source the subscription receipts from SC customers outside of SC based on costs of performance
- TP appealed to the Court of Appeals on August 8, 2016

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SOURCING

Duke Energy Corp. v. SCDOR

415 S.C. 351, 782 S.E.2d 590 (2016)

- Issue: whether Duke could include in the denominator of the applicable apportionment ratio its gross receipts from sales of short-term investments. (Using the sales factor definition in 12-6-2280(A).)
- Facts: Duke Cash Management Group invests its excess cash in short-term marketable securities almost every day. Investment terms can be very short (e.g., 8 days).
- Court of Appeals:
  - Narrowed the issue to be whether the "receipt" was the total amount (principal and interest) or merely just the interest.
  - Found that the return of principal is NOT a receipt.
  - Affirmed ALC's determination that Duke may not include its gross receipts from sales of short-term investments.
  - Found the ALC correctly concluded the principal recovered from the sale of short-term securities is not includable in the sale factor of the multi-factor appointment formula
- Supreme Court:
  - Decided Feb. 17, 2016
  - Supreme Court agreed with Court of Appeals that ALC correctly concluded that the principal recovered from the sale of short-term securities is not includable in the sales factor of the multi-factor apportionment formula.
  - Disagreed with the Court of Appeals' use of the term "receipt" rather than "total sales."

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Alternative Apportionment

Carmax Auto Superstores West Coast, Inc. v. SCDOR

411 S.C. 79, 89, 767 S.E.2d 195, 200 (2014)

- Supreme Court decision – December 23, 2014
- The Supreme Court found that the proper burden of proof under 12-6-2320(A) requires the proponent of an alternative apportionment method to show by a preponderance of evidence that:
  - 1) the statutory apportionment formula does not fairly represent the taxpayer's business activity in SC, and
  - 2) the proponent's alternative apportionment method is "reasonable."

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Alternative Appointment

Rent a Center West, Inc. v. SCDOR

(09-ALJ-17-0204-CC), pending at the SC Court of Appeals

- Facts:
  - The taxpayer operates retail stores in the western portion of the United States, as well as licenses intangibles to companies throughout the United States, including South Carolina. The South Carolina Rent A Center stores pay the taxpayer a licensing fee for the use of the intangibles in South Carolina.
  - In apportioning its South Carolina income, the taxpayer used a gross receipts method in which it apportioned the licensing fees from South Carolina over its total gross receipts from all sources. The taxpayer included its receipts from its retail stores in its denominator, despite the fact that those stores were unrelated to the activities the taxpayer conducted in South Carolina.
  - The Department disputed that method because it diluted the apportionment ratio and failed to accurately reflect the taxpayer's activities in South Carolina.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Rent A Center West (con't)

- Instead, the Department utilized its alternative apportionment power pursuant to S.C. Code Ann. § 12-6-2320(A) and determined the taxpayer's income using a method in which the taxpayers gross receipts from licensing in South Carolina were placed in the numerator, receipts from licensing in South Carolina were placed in the numerator, and the taxpayer's total gross receipts from licensing everywhere were placed in the denominator.
- The taxpayer disagreed with the Department's method and appealed to the South Carolina Administrative Law Court.
- The ALC agreed with the Department's determination that the taxpayer's chosen method was not accurate, and furthermore it found the alternative method utilized by the Department to be fair and accurate. In so finding, the ALC recognized that 87% of the taxpayer's total gross receipts came from its retail operations, retail operations that were unrelated to the taxpayer's activities in South Carolina.

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Rent A Center West (con't)

- The ALC agreed with the Department that including the revenue from the unrelated retail operations diluted the apportionment formula and thereby failed to accurately reflect the taxpayer's activities in South Carolina.
- The Court of Appeals reversed the ALC, opining that the Department presented the same body of evidence found to be insufficient by the Supreme Court in CarMax.
- The Department has filed a Petition for Rehearing.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

ALTERNATIVE APPORTIONMENT
Policy and Procedure

- SC Revenue Procedure # 15-2
- Issued June 1, 2015
- Addresses how to request an alternative allocation or apportionment method under 12-6-2320(A).
  - File request ASAP as process can be lengthy.
  - Deadline to file is the extended due date of the TP's income tax return
  - Includes specific list of items to include in application
  - Written agreement to be made if DOR approves TP's request

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

ALTERNATIVE APPORTIONMENT
Policy and Procedure

- SC Revenue Ruling # 15-5
- Issued June 12, 2015
- Addresses use of alternative apportionment methods, including combined unitary reporting under 12-6-2320(A).
  - No single alternative apportionment method fits every scenario.
  - Any alternative apportionment method should be determined in relation to the reasons the standard statutory method does not fairly represent the business activity in SC.
  - Combined unitary reporting ("CUR") as an alternative apportionment method (see Media General v SCDOR):
    - Under CUR, TPs apportion income to a state based on a unitary business with multiple entities rather than on a separate entity basis.
  - Addresses some administrative issues

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

Recap of Active Cases on Appeal

- Supreme Court
  - Roper
  - Lightner
- Court of Appeals
  - Rent a Center West
  - Rent a Center East/Rent Way
  - DIRECTV
  - Dish DBS
  - Hock RH, LLC
  - Frances Floyd

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

QUESTIONS?

SOUTH CAROLINA
DOR
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MISSION

The mission of the SCDOR is to administer the revenue and regulatory laws of this state in a manner deserving the highest degree of public confidence in our integrity, effectiveness and fairness. The Department will administer these duties with a focus on information security and the protection of taxpayer information.

We work to advance South Carolina.

The South Carolina Department of Revenue is focused on **security**, **service** and **accountability**.

- We are committed to security that is functional and non-negotiable and service that is responsive, efficient and fair.
- We recognize our responsibility to our customers, and we continually work to identify and make needed improvements.

The South Carolina Department of Revenue actively partners with government leaders and policymakers, state agencies and the business community to promote fiscal responsibility and stability.

SOUTH CAROLINA DOR DEPARTMENT OF REVENUE

South Carolina Bar

Tax Considerations in Business Exit Planning

Douglas O'Neal
Greenville, SC