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South Carolina Supreme Court Rejects Duke Energy's $126 Million Tax Refund Bid

The South Carolina Supreme Court has determined that the principal recovered from the sale of short-term securities was distortive, could not be included in the sales factor and thus could not be used to reduce the percentage of income attributable to South Carolina.[1]

Background

Duke Energy generates and sells electricity in South Carolina and other states. As a result, it must apportion its income to determine the income attributable to, and taxable in, South Carolina.[2] In addition to selling electricity, Duke Energy also has a department dedicated to purchasing and selling securities. From 1978-1999, Duke Energy only included the interest or gain from the sale of securities in its sales factor. In 2002, Duke Energy filed amended corporate income tax returns with the South Carolina Department of Revenue seeking to include the principal recovered from these sales of securities in its sales factor and seeking a refund of $126,240,645 plus interest.

The Department denied the refund request and, after Duke Energy appealed, the Department's Office of Appeals also denied the refund request. The Office of Appeals held that including recovered principal in the apportionment formula would lead to an absurd result and would misrepresent the amount of business Duke Energy does in South Carolina.

Duke Energy filed an appeal with the Administrative Law Court (ALC) to determine whether it could properly include the recovered principal in its sales factor. Duke Energy argued that South Carolina's apportionment statute required it to include "total sales," which would include the principal recovered from the sale of short-term securities. The ALC granted summary judgment in favor of the Department on the grounds that including recovered principal in the sales factor would lead to "absurd results" and would distort the apportionment calculation, no longer fairly representing the amount of business done in the state.

Duke Energy then filed an appeal with the South Carolina Court of Appeals. The Court upheld the ALC's decision in part on the grounds that the return of principal is not a

[1] *Duke Energy Corp. v. South Carolina Dep't of Revenue*, South Carolina Supreme Court, No. 27606, Feb. 17, 2016.
[2] *See* S.C. CODE ANN. § 12-6-2210(B).

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"receipt" within the meaning of the South Carolina apportionment statute.[3] Thus, the Court reasoned that only the gain on these sales, and not the return of principal, is considered part of the gross receipts of the company and included in the computation of the sales factor.

Duke Energy then appealed the Court of Appeals' decision to the South Carolina Supreme Court. However, Duke Energy only appealed the issue of whether the return of principal is includable in total sales, and did not appeal the lower courts' findings that Duke Energy was a manufacturer and thus required to utilize an apportionment formula specified for manufacturers.

Return of Principal Not Includable in Total Sales

The South Carolina Supreme Court agreed with the Court of Appeals' decision in favor of the Department. However, the Supreme Court did not agree with the analysis the Court of Appeals used in coming to its conclusion. Specifically, the Supreme Court held that the Court of Appeals' reliance on the term "receipt" caused confusion because the term is only relevant to the single sales factor apportionment formula, which was not at issue in the case.

Duke Energy used the three-factor apportionment formula and that apportionment formula uses the term "total sales."[4] Therefore, according to the Supreme Court, the proper analysis should have focused on whether the principal recovered from the sale of short-term securities could be included as "total sales" in the sales factor of the three-factor formula. Since that analysis had never been undertaken by a South Carolina court, the Supreme Court relied on cases from New Jersey and Arizona for guidance.[5]

Following the guidance of decisions by those states, the Supreme Court held that including principal recovered from the sale of short-term securities in the sales factor would lead to an absurd result not intended by the legislature and would distort the sales factor. The Court reasoned that a taxpayer could easily manipulate its sales factor by entering into a series of transactions in rapid succession using the same capital. In such a case, by repetitively selling and reselling securities, the taxpayer would be recovering the same principal but adding that amount to its sales factor with each transaction, thus resulting in significant distortion.

In addition, the Court noted that, in 2007, the state legislature enacted a new statute which defined the term "sales" for apportionment purposes and specifically excluded from the sales factor "repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or other certificate of deposit or similar marketable instrument."[6] The Court found this legislative enactment to clarify an existing statute, rather than constitute a change in position. Therefore, the Court held that it was clear the legislature did not intend

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[3] 764 S.E.2d 712 (S.C. Ct. App. 2014). For a discussion of this case, see GT SALT Alert: South Carolina Holds Electric Utility Company Is Manufacturer, Gross Proceeds Not Includable in Sales Denominator.

[4] S.C. CODE ANN. § 12-6-2252.

[5] *American Tel. & Tel. Co. v. Director, Div. of Taxation*, 476 A.2d 800, 802 (N.J. Super. Ct. App. Div. 1984); *Walgreen Ariz. Drug Co. v. Arizona Dep't of Revenue*, 97 P.3d 896 (Ariz. Ct. App. 2004).

[6] S.C. CODE ANN. § 12-6-2295(B).

to include the return of principal from the sale of short-term securities in the sales factor under the prior statute.

Commentary

The South Carolina Supreme Court was clearly not persuaded by Duke Energy's fourth bite at the apple in its attempt to reduce its South Carolina apportionment percentage. The three-factor formula and related sales factor statute which were at issue in this case were phased out for all taxpayers between 2007 and 2010, so statutes of limitation are nearly closed for most impacted taxpayers.

From the perspective of statutory construction and legislative intent, the case is also notable because it supports the idea that subsequent changes in statutes may support the legislature's original intent of a predecessor statute. The Supreme Court could have found that the South Carolina legislature's detailed definition of "sales" which specifically excluded principal from such definition in taxable years after 2007, was a substantive departure in policy from prior taxable years. Instead, the Supreme Court determined that the statutory change merely clarified the legislature's intent that principal from securities should not be included in the sales factor calculation. This development may create ambiguity for taxpayers and practitioners in determining when changes to statutes reflect a mere clarification of original intent or a true change in position.
