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State and Local Government

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STATE AND LOCAL GOVERNMENT

I. HOME RULE

In *Richardson v. McCutchen*,[1] the South Carolina Supreme Court held that two acts of the General Assembly, which increased membership on the Williamsburg County Recreation Commission, did not come within the exception of transitional legislation[2] and were, therefore, in violation of Article VIII, section 7 of the South Carolina Constitution. This decision clarifies the court's position that attempts by the General Assembly to control functions reserved for local county governments by article VIII are unconstitutional.

The constitutional attack on Act No. 246 of 1975[3] and Act No. 381 of 1977[4] was brought by the discharged director of the Williamsburg County Recreation Department. The plaintiff brought his action to recover the unpaid portion of his employment contract. His complaint alleged that the two acts, which increased the number of recreation commissioners from five to seven and then from seven to nine, were unconstitutional and that his discharge by the nine-member commission was therefore invalid. The Court of Common Pleas of Williamsburg County granted summary judgment in favor of the county, but the supreme court reversed and remanded for trial.

The court determined that article VIII, section 7 of the South Carolina Constitution[5] applied to both Acts No. 246 and

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1. ___ S.C. ___, 292 S.E.2d 787 (1982).

2. Duncan v. York County, 267 S.C. 327, 345, 228 S.E.2d 92, 100 (1976)(interpreting S.C. CONST. art. VIII, § 1). *See infra* notes 9-11 and accompanying text.

3. Act No. 246, 1975 S.C. ACTS 579. This was an act to amend Act No. 191, 1971 S.C. ACTS 191, by increasing the membership of the Williamsburg County Recreation Commission from five to seven.

4. Act No. 381, 1977 S.C. ACTS 1019. This act again amended Act No. 191, 1971 S.C. ACTS 191, as amended, by changing the Williamsburg County Recreation Commission from a seven to a nine-member body.

5. S.C. CONST. art. VIII, § 7, provides:

> The General Assembly shall provide by general law for the structure, organization, powers, duties, functions, and the responsibilities of counties, including the power to tax different areas at different rates of taxation related to the nature and level of governmental services provided. Alternate forms of govern-

No. 381 as a constitutional ban on specific county legislation.[6] The court has interpreted article VIII, section 7 to mean that the General Assembly may pass no law concerning a specific county which relates to those powers, duties, functions, and responsibilities that are set aside for counties.[7] The court found that Acts No. 246 and No. 381 evidenced an attempt by the General Assembly to regulate the recreational district within a county—a power that is now a reserved function of local government.[8] The supreme court concluded that the acts were, therefore, unconstitutional.

The court also refused to permit the acts to stand under the transitional legislation exception of article VIII, section 1.[9] The court noted that although this section permits the General Assembly to pass legislation necessary for a smooth transition to local home rule government, transitional legislation is limited to

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ment, not to exceed five, shall be established. *No Laws for a specific county shall be enacted and no county shall be exempted from the general laws or laws applicable to the selected alternative form of government.*

(emphasis added).

This article has been interpreted to reflect a serious effort on the part of the General Assembly to restore local government to the county level. Knight v. Salisbury, 262 S.C. 565, 206 S.E.2d 875 (1974).

6. Article VIII, § 7 applies to special legislation dealing with districts created prior to ratification of article VIII or to the amendment of prior special legislation. ___ S.C. at ___, 292 S.E.2d at 788 (1982). *See, e.g.*, Cooper River Park and Playground Comm. v. City of N. Charleston, 273 S.C. 639, 642, 259 S.E.2d 107, 109 (1979); Torgerson v. Craver, 267 S.C. 558, 230 S.E.2d 228 (1976). *See generally* Survey, *Constitutional Law, Annual Survey of South Carolina Law, 29* S.C.L. REV. 51 (1977)(survey of the effect of the *Torgerson* decision on South Carolina law).

Since the two acts amended the prior special legislation that created the Williamsburg County Recreation Commission, article III, § 7 applies. ___ S.C. at ___, 292 S.E.2d at 788.

7. Kleckley v. Pulliam, 265 S.C. 177, 183, 217 S.E.2d 217, 220 (1975). *See generally* Survey, *Constitutional Law, Annual Survey of South Carolina Law, 28* S.C.L. REV. 259 (1976).

8. ___ S.C. at ___, 292 S.E.2d at 788. *See, e.g.*, Knight v. Salisbury, 262 S.C. 565, 206 S.E.2d 875 (1974).

9. S.C. CONST. art. VIII, § 1 provides: "The powers possessed by all counties, cities, towns, and other political subdivisions at the effective date of this Constitution shall continue until changed in a manner provided by law." The South Carolina Supreme Court has recognized an exception to the outright prohibition against laws for a specific county by reading art. VIII, § 1 and § 7 together. Specific legislation necessary to effect an orderly transition to home rule is constitutionally permissible because the legislation's authority is temporary and extends only as far as necessary to place article VIII into full operation. Horry County v. Cooke, 275 S.C. 19, 267 S.E.2d 82 (1980).

a "one shot" proposition.[10] Once a legally constituted local government becomes functional, the transitional legislation exception is no longer available.[11] The supreme court concluded that the acts in question were not encompassed by the transitional legislation exception because they were not necessary for the change to home rule and were enacted after the local recreation commission was fully operational.[12]

Richardson is a well-reasoned decision illustrating the court's intent to support the home rule mandate of article VIII. The purpose of returning local government to the counties was to free the General Assembly for state-wide problems and to remove the inconvenience of having Columbia as the seat of county government.[13] Upholding legislation such as Acts No. 246 and No. 381 would permit the General Assembly to curtail the powers of the county governments by passing special acts when the subject matter of those acts is of purely local concern.

Richardson v. McCutchen should provide notice to county governments that legislation dealing with local matters passed after the ratification of article VIII is susceptible to constitutional attack under article VIII, section 7, with the exception of acts clearly aimed at the establishment of home rule. Further, the General Assembly should recognize the disruptive effect on local administrative authorities and avoid a potential challenge to constitutionality when considering laws that may affect local matters.

Diane B. McColl

II. COUNTY GOVERNMENT TAX PROCEDURES

In *County of Lee v. Stevens*,[14] the South Carolina Supreme

10. ___ S.C. at ___, 292 S.E.2d at 788. *See, e.g.*, Van Fore v. Cooke, 273 S.C. 136, 138, 255 S.E.2d 339, 340 (1979); Duncan v. County of York, 267 S.C. 327, 345, 228 S.E.2d 92, 100 (1976). *See generally* Survey, *Constitutional Law, Annual Survey of South Carolina Law, 29* S.C.L. REV. 47 (1977)(survey of the effect of the *Duncan* decision on South Carolina law).

11. ___ S.C. at ___, 292 S.E.2d at 788 (1982)(citing Horry County v. Cooke, 275 S.C. 19, 267 S.E.2d 82 (1980)).

12. ___ S.C. at ___, 292 S.E.2d at 788.

13. Knight v. Salisbury, 262 S.C. 565, 571, 206 S.E.2d 875, 877 (1974). *See generally* Glauberman, *County Home Rule: An Urban Necessity*, 1 URB. LAW. 170 (1969).

14. 277 S.C. 421, 289 S.E.2d 155 (1982).

Court held that a county auditor could not alter the property tax rate set by a county's governing body. In addition, the court concluded that tax rates should be based on current property valuations rather than the previous year's valuations.

On June 26, 1979, the respondent, Lee County Council, adopted its budget for the fiscal year ending June 30, 1980,[15] and enacted by ordinance a tax rate of 118 mills. The appellant Stevens, who was county auditor, reduced the tax rate to 115 mills, claiming that the reduction was necessary to prevent a surplus. After a hearing, the circuit court issued an order requiring that the original tax rate be followed.[16] On appeal, the South Carolina Supreme Court affirmed.

The court first addressed the issue of who has the authority to set tax rates. The supreme court held that the authority belonged to the county governing body based on a comparative reading of two South Carolina Code provisions. Section 4-9-30(5) of the Code empowers the county government to assess property and levy ad valorem property taxes;[17] section 12-39-180 provides that the auditor is to calculate individual property taxes "*after receiving the rates and sums to be levied for the coming year.*" (court's emphasis).[18] The court characterized these two provisions as defining respectively the authority of the county government and the duty of the county auditor and summarily held that the county governing body had the authority to set tax rates.[19]

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15. For budgetary purposes, the county government operates on a fiscal year of July 1 through June 30. S.C. CODE ANN. § 4-9-140 (1976).

16. 277 S.C. at 422, 289 S.E.2d at 155. The facts were not disputed.

17. S.C. CODE ANN. § 4-9-30(5)(Supp. 1980). This section provides in part that the county government shall have the power "[t]o assess property and levy ad valorem property taxes and uniform service charges, *including the power to tax different areas at different rates related to the nature and level of governmental services provided and make appropriations for functions and operations. . ..*" ___ S.C. at ___, 289 S.E.2d at 156 (court's emphasis).

18. 277 S.C. at 424, 289 S.E.2d at 156. S.C. CODE ANN. § 12-39-180 (1976) states: "Each county auditor, after receiving from the Comptroller General and from such other officers and authorities as shall be legally empowered to determine the rate or amount of taxes to be levied for the various purposes . . . shall proceed to determine the sums to be levied."

19. In limiting the power of the county auditor to that specifically granted by statute, this decision is in line with several other jurisdictions in the United States. *See, e.g.*, Bloomfield Democrat, Inc. v. Board of Comm'rs of Greene County, 93 Ind. App. 226, 177 N.E. 361 (1931); Brink v. Curless, 209 N.W.2d 758 (N.D. 1973); Patton v. Cass County,

The court next determined the appropriate time to set tax rates. It first acknowledged that under South Carolina law assessed valuations are not known until September 30th,[20] even though these valuations are essential in accurately determining tax rates.[21] The court stated that Lee County was proceeding erroneously in using the previous year's valuations to compute its tax rates, despite the statutory deadline of June 30—the county's fiscal year end. It then asserted that current valuations were required to be used in setting tax rates.[22] Nevertheless, the court concluded that under *Simkins v. City of Spartanburg*,[23] the estimated property values of Lee County would not be invalidated.[24]

At least two other jurisdictions have adopted a flexible approach to allow discretion in the exactness required for setting tax rates.[25] Under the present statutory scheme, this is the best alternative since assessments are not completed until sometime after local budgetary needs are determined.[26] As noted by the *Lee* court, unexpected circumstances frequently arise, and in the event of a deficit or surplus, adjustments may be made the following year.[27] It appears, however, that a discrepancy between budgetary needs and tax rates could be avoided by legislatively altering either the auditor's or the county government's time frame so that exact assessments could be obtained *prior* to the time tax rates are set. Moreover, the court itself recognized that

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13 N.D. 351, 102 N.W. 174 (1904); Mott Bldg., Inc. v. Park, 24 Ohio Misc. 110, 263 N.E.2d 688 (1970).

20. *See* S.C. CODE ANN. § 12-39-150 (1976).

21. 277 S.C. at 424, 289 S.E.2d at 156. Individual property taxes are determined by multiplying the millage rate and the assessed value of an individual parcel of property. The millage rate used in this calculation is obtained by dividing the assessed property values into that part of the budget to be generated by property taxes. *Id.* at 426, 289 S.E.2d at 155-56.

22. *Id.*, 289 S.E.2d at 156.

23. 269 S.C. 243, 237 S.E.2d 69 (1977). In *Simkins*, the court held that the use of estimated property values did not violate art. X, § 29 of the South Carolina Constitution which provides that "[a]ll taxes . . . shall be laid upon actual value of the property taxed." For a general discussion of the state constitution and the property tax system, see Quirk & Watkins, *A Constitutional History of the Property Tax in South Carolina*, 26 S.C.L. REV. 397 (1974).

24. 277 S.C. at 426, 289 S.E.2d at 157.

25. *See, e.g.*, Feigl v. Raacke, 32 Conn. Supp. 237, 349 A.2d 150 (1975); Burnet v. City of Grand Rapids, 264 Mich. 593, 250 N.W. 320 (1933).

26. *See supra* notes 15 and 18 and accompanying text.

27. 277 S.C. at 427, 289 S.E.2d at 158.

the best method of resolving the problem would be to simply delay calculating tax rates until final assessments are known.[28]

In conclusion, the *Lee* decision gives local governments in South Carolina more definite guidelines regarding the appropriate procedures for calculating tax rates. The court has also clarified the roles of the county governing body and the auditor in the scheme of property taxation. Finally, by making the decision prospective in its application,[29] the court allowed adjustments to be made, where appropriate, without burdening local governments and the state's courts with litigation regarding past practices.

Thomas M. Neal, III

III. State Tax—Deduction of Payments to Subsidiaries

In *M. Lowenstein & Sons, Inc. v. South Carolina Tax Commission*,[30] the South Carolina Supreme Court considered for the first time the deductibility of payments made by a parent company to a wholly owned domestic international sales corporation (DISC).[31] The court's per curiam opinion[32] held that payments made to the DISC, which were in excess of commissions paid by the DISC to its foreign sales agents, were not deductible by the parent corporation as necessary business expenses for state income tax purposes. In addition, the court denied the deductibility of unrepaid advances made by the parent company to two of its conventional subsidiaries.

The appellant taxpayer, M. Lowenstein & Sons, Inc. (hereinafter Lowenstein), established Lowenstein International Corporation (hereinafter International) in compliance with federal tax provisions allowing for the creation of DISCs.[33] International

28. *Id.*, 289 S.C. at 157.

29. The court stated: "Because various methods have been employed throughout the state, up to this date, we rule as a matter of practicability and reasonableness that the holding reached in this case shall apply prospectively only." ___ S.C. at ___, 289 S.E.2d at 158.

30. 277 S.C. 561, 290 S.E.2d 812 (1982).

31. *Id.* at 562, 290 S.E.2d at 813. The court adopted "with modifications" the order of Judge Moss as the opinion of the court.

32. The court also decided the issue of whether funds advanced to Lowenstein's subsidiaries were bad debts deductible under S.C. Code Ann. § 12-7-700(7)(1976).

33. 26 U.S.C. §§ 991-997 (1976). A DISC is a corporation that derives its income from the export of domestic goods. *See generally* Gordon, *Domestic International Sales*

acted as Lowenstein's agent by contracting with independent foreign sales agents for the sale of Lowenstein's goods. International paid commissions to the agents. Lowenstein then transferred funds to International in excess of the commissions paid and deducted the total amounts transferred as necessary business expenses on its 1972 and 1973 income tax returns.[34] The South Carolina Tax Commission disallowed that portion of the deductions which were in excess of the commissions actually paid to the foreign sales agents. Both the circuit court and the supreme court affirmed the Commission's decision.[35]

The supreme court first noted that the purpose of the DISC provisions of the Internal Revenue Code is to equalize the tax treatment of domestic corporations that manufacture goods abroad with those that sell domestically manufactured goods in international markets.[36] No comparable provision exists under South Carolina law.

Deductions generally allowed as necessary business expenses under state law include wages, salaries, and management fees for services actually rendered.[37] The court noted, however, that International had no employees of its own. Its services were actually performed by Lowenstein's employees, with the DISC paying no salaries or wages.[38] The court perceived that the only "service" rendered by International to Lowenstein was that of "theoretically" paying the sales commissions to the foreign salesmen.[39] But this "service" was apparently accomplished through mere accounting procedures. Thus, while the plaintiff could deduct that portion of its payments which the DISC expended as commissions to the sales agents, payments in excess of that amount could not be considered legitimate business expenses since no service was being rendered to the parent company in return. While recognizing that the DISC's existence as a paper corporation may not be offensive to the federal tax scheme,[40] the

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Corporations (DISC), 264-3rd TAX MANAGEMENT PORTFOLIO (BNA) A-1 (hereinafter cited as Gordon).

34. 277 S.C. at 563, 290 S.E.2d at 814.

35. *Id.* at 562, 290 S.E.2d at 813.

36. *Id.* at 563, 290 S.E.2d at 814. *See generally* Gordon, *supra* note 33.

37. *See* S.C. CODE ANN. § 12-7-700(1)(c)&(d) (1976).

38. 277 S.C. at 564, 290 S.E.2d at 814.

39. *Id.* at 565, 290 S.E.2d at 814.

40. *Id.*, 290 S.E.2d at 815 (citing 34 AM. JUR. 2d *Federal Taxation* § 8181 (1980)).

court asserted that the federal statute did not affect taxation under state law.[41] The court expressed its disfavor of income shifting to a DISC as a means of escaping state taxes and concluded that the deductions were properly disallowed.[42]

The deductibility of commissions paid to a DISC is a new issue facing state courts.[43] In *Lowenstein*, the court focused on the paper corporation aspect of the DISC, whose only function was to act as Lowenstein's selling agent. As the court noted, however, under a federal law a DISC may be utilized instead to purchase goods from a domestic manufacturer and then resell them.[44] This alternative relationship between a parent and its subsidiary DISC, along with internal indicia of the DISC's independence, may further a recognition of two distinct entities for purposes of state tax law.

Lowenstein also claimed deductions for unrepaid advances made to two of its operating subsidiaries. The court found well-established precedent on which to uphold the tax commissioner's disallowance of the deductions. The taxpayer failed to meet the statutory requirement of establishing the amount of the debt with certainty;[45] the interest income from the putative debts was not taxable by South Carolina;[46] and the advances were in the nature of investments, conditioned upon the subsidiaries' success, rather than loans.[47]

In conclusion, *Lowenstein* should serve as a reminder to South Carolina practitioners to consider state tax laws when examining the advantages of a business incentive under federal tax

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See generally Gordon, *supra* note 33, at A-1.

41. 277 S.C. at 565, 290 S.E.2d at 815. *See also* Fakar Co. v. R.A. Hanson DISC, Ltd., 441 F. Supp. 841 (S.D.N.Y. 1977)(noting that the distinction between the parent and its paper DISC corporation was not valid for other than federal tax purposes and holding that the parent was required to appear at arbitration proceedings concerning an agreement signed by the DISC).

42. 277 S.C. at 565, 290 S.E.2d at 815.

43. *See, e.g.*, Bunge Corp. v. Commissioner of Revenue, 305 N.W.2d 779 (Minn. 1981); FMC Corp. v. Woods, 618 S.W.2d 307 (Tenn. 1981).

44. 277 S.C. at 565, 290 S.E.2d at 814.

45. *Id.* at 567, 290 S.E.2d at 816 (citing Southern Soya Corp. v. Wasson, 252 S.C. 484, 167 S.E.2d 311 (1969); Chronicle Publishers v. S.C. Tax Comm'n, 244 S.C. 192, 136 S.E.2d 261 (1964); Southern Weaving Co. v. Query, 206 S.C. 307, 34 S.E.2d 51 (1944)).

46. 277 S.C. at 567, 290 S.E.2d at 816 (citing S.C. CODE ANN. § 12-7-1120(1) (1976), formerly § 65-279.1 of the 1962 S.C. Code).

47. 277 S.C. at 568, 290 S.E.2d at 816 (citing Gilbert v. C.I.R., 248 F.2d 399 (2d Cir. 1957)).

laws. The beneficial effects of the federal law may be negated by incompatible state provisions, especially in light of the expense of litigating a questionable application of state law as demonstrated by *Lowenstein.*

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