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Tax Law

Delores A. Timko

TAX LAW

I. New Method Approved for Apportionment of Corporate Taxable Income

In an effort to achieve a fair result, the South Carolina Court of Appeals stretched statutory language to the breaking point in *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission.*[1] In *Lockwood* the court sought to prevent a multistate taxpayer from distorting the amount of its income taxed by South Carolina. Affirming the Tax Commission's interpretation of section 12-7-1190 of the 1976 code,[2] the court approved a method of income apportionment that compared payroll paid for services performed in South Carolina to total payroll. The decision broadens the scope of the statute and gives the Tax Commission flexibility in apportioning corporate taxable income for a variety of businesses.

As a corporation with offices in South Carolina and four other states and with clients and projects in South Carolina and numerous other states, apportionment is the proper tax method for Lockwood to use when reporting its income to South Carolina. This method divides the income of a multistate business among the various states in which it does business. Section 12-7-1190 provides the South Carolina apportionment formula for businesses that do not deal in tangible personal property. A dispute arose as to the meaning of the phrase "gross receipts from within this state." Lockwood apportioned a share of its income to South Carolina based on the "origin of payment" view. Lockwood argued that the disputed phrase referred to the location

1. 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

2. S.C. Code Ann. § 12-7-1190 (Law. Co-op. 1976) provides as follows:

> If the principal profits or income of a taxpayer, other than those described in former 1962 Code § 65-256 or § 12-90-100, are derived from sources other than manufacturing, producing, collecting, buying, assembling, processing or selling, distributing or dealing in tangible personal property such taxpayer shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

from which it received its fees, where its customers were located. Lockwood compared gross receipts from clients located in South Carolina to its total receipts. On the other hand, the Commission apportioned Lockwood's South Carolina income based on the "place of activity" view. According to the Commission, the phrase referred to the place where the services were performed, where its income was earned. In order to determine gross receipts from services performed in this state, the Tax Commission compared the payroll Lockwood paid to its employees for services performed in South Carolina to its total payroll. The circuit court held that the place of activity view was correct, and Lockwood appealed.

The court of appeals affirmed the circuit court's interpretation of section 12-7-1190 as the approach that recognized the proportion of the engineering firm's business actually carried on in South Carolina. A statutory provision should be given a "reasonable and practical construction consistent with the purpose and policy expressed in the statute."[3] The purpose of the allocation statutes is to provide for imposition of South Carolina income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this state."[4] The court of appeals found the place of activity view to give a reasonable result and recognized the proportion of Lockwood's business carried on in the state. Since the client pays for services of the firm's employees, the services rendered by its personnel determined by its payroll is a reasonable measure of an engineering firm's business carried on in the state. An unreasonable result would occur under the origin of payment view.[5] The court viewed Lockwood's business as similar to law firms, accounting firms, entertainment and sports companies, and hospital management companies, which are controlled by Tax Commission guidelines focusing on where services are performed.

Lockwood is a fair decision although the court faced the difficulty of applying a narrow statute to a broad, diverse category:

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3. Hay v. South Carolina Tax Comm'n, 273 S.C. 269, 273, 255 S.E.2d 837, 840 (1979).

4. Hertz Corp. v. South Carolina Tax Comm'n, 246 S.C. 92, 95, 142 S.E.2d 445, 446 (1965) (quoting 1958 S.C. Acts 731).

5. If engineering services are performed in South Carolina for an out-of-state client, income from the gross receipts are attributed to the client's state, rather than to South Carolina, even though all the work is performed in South Carolina.

all businesses that do not deal in tangible property. The statute is clear and exact on its face, but the method prescribed probably does not always yield a result consistent with the statute's purpose. The statute refers to receipts, not services, payroll, or even the vague concept of where income is "earned." Legislative intent, however, must prevail.[6] "A client pays an engineering firm for the expertise and time of its employees. Therefore, an engineering firm's business carried on in a state is reasonably measured by the services rendered by its personnel in the state."[7]

One-third of Lockwood's payroll is in South Carolina, which indicates that one-third of Lockwood's business was carried on in this state. Therefore, legislative intent would dictate that Lockwood apportion one-third of its income to South Carolina. Under the place of activity view, Lockwood would apportion its income to South Carolina based on the ratio of direct job payroll for services rendered in South Carolina to total direct job payroll for services rendered everywhere. Thus, if Lockwood's total payroll is $60,000 and its payroll attributable to services performed by its engineers in South Carolina is $20,000, Lockwood must report one-third of its total income to South Carolina under the place of activity view. This figure follows the apparent legislative intent.

Only ten percent of Lockwood's receipts, however, are "from within" South Carolina. Using the origin of payment method, Lockwood would apportion its income to South Carolina based on the ratio of its gross receipts from clients located in South Carolina to its total receipts. Thus, if Lockwood's gross receipts from clients in South Carolina are $100,000 and its total receipts are $1,000,000, Lockwood must apportion one tenth of its income to South Carolina. This result is not the intent of the legislature, although it is consistent with the language of the statute.

When faced with another relevant statute that gave an unfair result, the Supreme Court of South Carolina chose to base its decision on legislative intent. In *Hercules, Inc. v. South Carolina Tax Commission*,[8] the court chose not to apply section 12-

6. Peoples Nat'l Bank v. South Carolina Tax Comm'n, 250 S.C. 187, 191, 156 S.E.2d 769, 771-72 (1967).

7. 293 S.C. at 449, 361 S.E.2d at 347.

8. Hercules, Inc. v. South Carolina Tax Comm'n, 279 S.C. 177, 304 S.E.2d 815 (1983).

7-1120.[9] Under apportionment, 1.5 percent of Hercules' income was allocated to South Carolina. The Tax Commission used section 12-7-1120 to argue that the total gain was South Carolina income and was not subject to apportionment. The court was concerned that application of the statute in question would result in double taxation. *Hercules* affirmed the taxpayer's position and resulted in less tax for South Carolina.

Previous decisions by South Carolina courts indicate that the court should have interpreted the disputed phrase narrowly. A clear and unambiguous statute requires that the plain language of the statute control.[10] Further, tax statutes are to be construed strictly against the state and in favor of the taxpayer.[11] Finally, the Tax Commission has no authority to enact new laws in the nature of regulations.[12] Conversely, the court in *Emerson Electric Co. v. Wasson* held that "[t]he construction of a statute by an agency charged with its administration is entitled to the most respectful consideration and should not be overruled absent compelling reasons."[13] The court needs to have adequate reason to overrule a Tax Commission construction that is in conflict with the plain language of a statute. The *Lockwood* court, however, did not address the plain language of the statute but, instead, based its decision on the *purpose* of the statute. Possibly the court did not overrule the construction because the Tax Commission's interpretation was consistent with the purpose of the statute.

The court expanded the statute in order to arrive at a result consistent with the legislative purpose, rather than the language of the statute. This result is compatible with the law in other states. While South Carolina considers only gross receipts, most states solve the problem of fair apportionment for corporations not dealing in tangible property with statutes that apportion income on a three-factor formula based on property, payroll, and sales. These states deem a "sale" to have been made in the state when the services producing income are rendered in the state.

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9. S.C. CODE ANN. § 12-7-1120 (Law. Co-op. 1976).

10. State v. Goolsby, 278 S.C. 52, 53, 292 S.E.2d 180, 181 (1982).

11. Colonial Life & Accident Ins. Co. v. South Carolina Tax Comm'n, 233 S.C. 129, 149, 103 S.E.2d 908, 918 (1958).

12. Heyward v. South Carolina Tax Comm'n, 240 S.C. 347, 126 S.E.2d 15 (1962).

13. 287 S.C. 394, 397, 339 S.E.2d 118, 120 (1986).

Iowa, like South Carolina, uses gross receipts as the sole factor in apportioning the income of service businesses. Whether gross receipts are taxable to Iowa depends on where the services are performed. The Iowa statute, however, does not contain an apportionment method but delegates the authority to establish one.

A question arises as to the possibility of double taxation for a business that apportions income to South Carolina and to another state which uses the three-factor formula. Given the proper fact pattern, the corporation could experience a distortion in its tax liability. That problem, however, arises because of the single-factor formula used in South Carolina versus the three-factor formula used in other states and not the interpretation of South Carolina's statute.[14]

The court's decision results in a flexible rule but gives few guidelines to businesses trying to comply with section 12-7-1190. The Tax Commission has applied guidelines to eight different categories of businesses.[15] New corporations will have to predict whether or not they fit into one of these categories. In doubtful situations, businesses will have to depend on a case-by-case determination of whether the court will apply gross receipts, payroll, or some other standard. Businesses have warning, however, that the court will expand the statute in order to achieve an equitable result.

The courts should not be placed in a position of stretching the construction of a statute in order to achieve justice. Efforts should be made to amend the statute to allow the Tax Commission to establish the rules needed to comply with the purpose of the allocation statutes or to replace the designated method with broader language.

Delores A. Timko

14. If a business had 100% of its property, 100% of its payroll, and 50% of its receipts from another state, and none of its property, none of its payroll and 50% of its receipts from South Carolina, it would apportion its income at 83% to the other state and 50% to South Carolina. This could be normal for a finance company on the border of two states. It does not matter whether the single factor is payroll or receipts. The result is the same.

15. Record at 26-29.