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SC TECHNICAL ADVICE MEMORANDUM #88-8

TO: Mr. Marvin Davant, Director  
Field Services Division

FROM: John Swearingen, Manager  
Tax Policy and Procedures Department

DATE: March 2, 1988

SUBJECT: Computation of South Carolina Net Income on Consolidated Returns

REFERENCE: S.C. Code Ann. Section 12-7-1570 (1976)  
S.C. Regulation 117-77

AUTHORITY: S.C. Code Ann. Section 12-3-170 (1976)  
SC Revenue Procedure #87-3

SCOPE: A Technical Advice Memorandum is a temporary document issued to an individual within the Commission, upon request, and it applies only to the specific facts or circumstances related in the request. Technical Advice Memoranda have no precedential value and are not intended for general distribution.

Question:

Can corporations that file consolidated returns be required to compute South Carolina net income separately and combine to determine South Carolina consolidated net income? Can this method be applied retroactively to all years in the statute?

FACTS:

The taxpayer filed consolidated corporate income tax returns with this State pursuant to South Carolina Code Section 12-7-1570 and Regulation 117-77. The corporations includable in the consolidated return were all subject to the same method of apportionment (three factor formula). The taxpayer was audited for the years December 31, 1983; November 1, 1984 (short period); and December 31, 1984. Audit adjustments were made to require the taxpayer to determine its South Carolina consolidated income by computing the South Carolina net income for each corporation separately. Under this method each corporation's South Carolina apportionment ratio

is computed separately and applied to each corporation's apportionable income to arrive at South Carolina net income. Additional income tax for the three years was assessed in the amount of \$113,610.00 plus interest of \$31,734.00 totaling \$145,344.00. Some other minor adjustments were made to income, and certain corporations were eliminated from the return because no nexus existed. Substantially all of the tax deficiency is a result of the change in method of consolidation.

Discussion:

Section 12-7-1570 of the South Carolina Code provides:

Any taxpayer capable of exercising, directly or indirectly, substantially the entire control of the business of another taxpayer, either by ownership or control of substantially the entire capital stock (if a corporation) of such taxpayer or other-wise, may, under regulations prescribed by the Commission, be permitted to make a consolidated return, showing the consolidated net income and such other information as the Commission may require in order to compute the net income properly attributable to the state and to impose the tax upon the taxpayers concerned.

Regulation 117-77 allows corporations two methods of filing a South Carolina consolidated return. When all the corporations included in the consolidated return are subject to the same method of apportionment, the net income of each corporation is added and a single ratio including all payroll, property, and sales is computed. Then this total net income is multiplied by the single ratio to determine South Carolina consolidated net income. If the corporations included in the consolidated return are subject to different methods of apportionment, the net income of each corporation is multiplied by the ratio of that corporation, then the South Carolina net incomes separately computed are added together to arrive at South Carolina consolidated net income.

The Supreme Court in the case of Emerson Electric Co. v. Wasson 287 S.C. 394, 339 S.E.2d 118 (1986), while not ruling on the validity of Regulation 117-77, reversed a decision of the Court of Appeals, 283 S.C. 257, 322 S.E.2d 671 (S.C. App. 1984). The Court of Appeals had ruled that South Carolina could tax Emerson only on a pro rata share of its "homogenized" net income utilizing a single ratio and that sales attributable to South Carolina under the "throwback rule" are sales in those states where neither of the consolidated entities is taxable. The Supreme Court's reversal of the Court of Appeals was based on an analysis of several code sections relating to multistate taxpayers and consolidation.

The Supreme Court stated that:

Section 12-7-250 also provides that if a taxpayer is transacting or conducting business partly within and partly without South Carolina, the income tax "...shall be imposed upon a base which reasonably represents the proportion of the trade or business carried in within this state." This section clearly indicates the intent of the legislature that each taxpayer shall pay taxes based on the proportion of business they conduct in this state.

Regarding Section 12-7-1570, the statute allowing consolidated returns, the Supreme Court stated:

The language of the statute clearly allows two corporations to make a consolidated return showing net income, but it also requires that the return contain such other information necessary to compute the net income of each taxpayer properly attributable to the state so that South Carolina can impose a tax on the taxpayers concerned. The legislature's use of the plural "taxpayers" instead of taxpayer" indicates that corporations filing consolidated returns are not to be considered a single entity.

Based on the rationale of Emerson, some provisions of Regulation 117-77 appear to be at odds with the requirements of Section 12-7-1570. In a finding issued September 2, 1987, the Commission ruled that a consolidated return should be filed in a manner consistent with a separate determination of each corporation's South Carolina net income or loss. Accordingly, the Commission is currently in the process of amending the regulation to eliminate the method which allows the apportionment of one net income using one ratio. In furtherance of this objective, the Commission will apply the rationale of the Emerson case on a prospective basis to all tax periods beginning on or after January 1, 1988.

CONCLUSION:

Corporations that file consolidated returns are required to compute South Carolina net income separately and add the results to determine South Carolina consolidated net income. The rationale of the Emerson case shall be applied prospectively for tax periods beginning on or after January 1, 1988.

Comparison of the Consolidated Methods

1) Separately Computed

A) Ratio Computation	<u>Corp. A</u>			<u>Corp. B</u>		
	<u>Within S.C.</u>	<u>Everywhere</u>	<u>Total Ratio</u>	<u>Within S.C.</u>	<u>Everywhere</u>	<u>Total Ratio</u>
Property	6,000	10,000	60%	1,000	10,000	10%
Payroll	2,000	6,000	33 1/2%	1,000	4,000	25%
Sales	20,000	30,000	<u>66 2/3%</u>	7,500	20,000	<u>37.5%</u>
		Total	160%	Total		72.5%
		Average Ratio	<u>53.3%</u>	Average Ratio		<u>21.17%</u>

B) Taxable Income Computation

	<u>Net Income</u>		<u>Ratio</u>	=	<u>S.C. Income</u>
Corp. A	\$750	x	53.3%	=	\$400.00
Corp. B	\$250	x	21.17%	=	<u>53.40</u>
	S.C. Taxable Income				<u>\$453.00</u>

2) One Net Income/Single Ratio

A) Ratio Computation  
Within South Carolina

	<u>Corp. A</u>	<u>Corp. B</u>	<u>Total Within S.C.</u>	<u>Total Everywhere</u>	<u>Ratio</u>
Property	6,000	1,000	7,000	20,000	35%
Payroll	2,000	1,000	3,000	10,000	30%
Sales	20,000	7,500	27,500	50,000	<u>55%</u>
				Total	120%
	Single Average Ratio		<u>40%</u>		

B) Taxable Income Computation

	<u>Net Income</u>
Corp. A	\$ 750
Corp. B	<u>250</u>
Total Net Income	1000
Single Ratio	x <u>40%</u>
S.C. Taxable Income	<u>\$ 400</u>