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South Carolina Supreme Court upholds denial of deduction for expenses related to excluded dividends

Authored by: Ferdinand Hogroian

An out-of-state corporation filing a South Carolina consolidated return properly excluded dividends received from its wholly owned subsidiaries from South Carolina income, but was not entitled to a deduction for expenses related to such excluded dividend income, the South Carolina Supreme Court held. [*Emerson Electric Co. v. South Carolina Dep't of Rev.*, S.C., No. 27073, 12/12/2011]

The taxpayer, Emerson Electric Co., has its principal place of business in Missouri and conducts business worldwide, including in South Carolina. Emerson and its wholly owned subsidiaries filed consolidated income tax returns in South Carolina for tax years 1999-2001. On its original returns for these years, Emerson did not claim deductions for expenses related to its receipt of dividends from the subsidiaries. Emerson later filed amended returns, claiming the expense deductions and seeking a refund. The South Carolina Administrative Law Court upheld the Department of Revenue's disallowance of the expense deductions, and the South Carolina Supreme Court affirmed on a direct appeal.

The Supreme Court noted that Emerson properly excluded from taxable income dividends received from its wholly-owned subsidiaries under the state's conformity to the I.R.C. and reference to federal taxable income in defining South Carolina taxable income. Further, Emerson and the Department stipulated that Emerson's claimed

expenses were related to dividend income qualifying for the dividends received deduction. The court cited South Carolina's adherence to the "matching principle," whereby expenses incurred in generating income taxable in South Carolina may be matched against such income as a deduction. "Conversely, where income is not taxable in South Carolina, as is the case here, the expenses incurred in generating that income may not be matched against it as a deduction in South Carolina," the court concluded.

The court rejected Emerson's challenge to S.C. Code Ann. Sec. 12-6-2220, as in effect for the tax periods at issue, which provided: "The following items of income must be directly *allocated* and *excluded* from the apportioned income and the apportionment factors: ... (2) Dividends received from corporate stocks owned, *less all related expenses,* are allocated to the state of the corporation's principal place of business..." (emphasis added). The court noted that although it granted Emerson's motion to argue against precedent, it chose to adhere to its decision in *Avco Corp. v. Wasson,* 267 S.C. 581 (1976), wherein it construed the predecessor to Sec. 12-6-2220 to require that if dividend income was allocated out-of-state, the expenses related to that allocable dividend income must also be allocated out-of-state. "For purposes of applying this statute, we reject Emerson's contention that allocation of related expenses is triggered only in the presence of taxable income from the receipt of a dividend," the court explained. As the *Avco* court opined, "the actual receipt of a dividend from each stock purchased is not required before the interest expenses... are to be allocated."

The court further rejected Emerson's Commerce Clause challenge to the constitutionality of the statute. The court found that "Emerson objects only to the application of section 12-6-2220 to deny interest deductions related to dividends that are not taxable in South Carolina because such an application results in disparate treatment of taxpayers based solely on residence." Specifically, the court found that the constitutional challenge "is made only because Emerson was not allowed the interest expense deduction in its home state of Missouri -- a feature of Missouri law over which we have no control. We reject the implication that the constitutionality of one state's allocation statute turns on the allowance of certain deductions in another state." [In a footnote, the court noted that Emerson claimed the same expense deductions in other states. "Some states, like South Carolina, denied the deductions altogether, some allowed Emerson to deduct only a portion of the expenses, and other states permitted 100% of the expense deductions."] The court concluded that "by nature allocation rules necessarily result in income and expenses being assigned to different geographic locations for similarly situated taxpayers," and that the Commerce Clause "does not require any particular method of allocation or apportionment, nor does it prohibit variety in methods among states" (citing *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978)).

PwC Observes

"The key to understanding this ruling is that South Carolina adopts the federal definition of gross income as well as I.R.C. Section 243 (and also expands Section 243 to include foreign dividends)," observes Stu Lockerbie, State and Local Tax Director with PwC in Charlotte. "In spite of the way the tax form appears, the allocation provisions (in the years at issue) actually apply to ALL dividends included in gross

income before the deduction under Section 243 would apply. Thus, according the court, the statutory requirement to allocate all dividends *less all related expenses* took precedent. The allocation provisions were revised in 2005 to provide that only "dividends... not connected with the taxpayer's business, less all related expenses" are allocated. Thus, most taxpayers for open years will not have to deal with the issue of this case. However, taxpayers should be aware that the South Carolina statute of limitations extends to 72 months if there is a 20% understatement in tax."

For more information, please do not hesitate to contact:

Stu Lockerbie	*(704) 344-4133*	*stu.lockerbie@us.pwc.com*
Scott King	*(704) 344-7648*	*scott.king@us.pwc.com*
Ferdinand Hogroian	*(202) 414-1798*	*ferdinand.hogroian@us.pwc.com*