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SC Court of Appeals

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Mastercard International Incorporated,
Petitioner,

Docket Number: 20-ALJ-17-0008-CC

v.

FINAL ORDER AND DECISION

South Carolina Department of Revenue,

Respondent.

APPEARANCES: Leah Robinson, Esquire
Michael J. Kerman, Esquire
Bryson M. Geer, Esquire
For Petitioner Mastercard International Incorporated

Adam J. Neil, Esquire
Nicole M. Wooten, Esquire
Jason P. Luther, Esquire
Sean G. Ryan, Esquire
For Respondent South Carolina Department of Revenue

STATEMENT OF THE CASE

This matter is before the South Carolina Administrative Law Court (“ALC” or “Court”) following Mastercard International Incorporated’s (“Mastercard”) request for a contested case hearing pursuant to subsection 12-60-460 of the South Carolina Code (2014). Mastercard challenges the South Carolina Department of Revenue’s (“Department”) assessment of corporate income taxes, license fees, interest, and penalties for the tax years 2007 through 2016 (“Audit Period”).

The dispute concerns the income tax implications of Mastercard’s activities in South Carolina. The Department’s Determination concluded that Mastercard should have sourced to South Carolina all of the gross receipts arising from revenue generated from Merchant/Cardholder transactions initiated in South Carolina. The Department determined that Mastercard’s income producing activity - the provision of a credit card network (also referred to herein as the “Mastercard Network” or “Network”) - occurs in South Carolina, which subjects Mastercard to income taxes according to subsection 12-6-2290 (2014 & Supp. 2023).



Mastercard operates a worldwide credit card Network, including accepting cards at Merchant locations in South Carolina. While Mastercard contends that it does not have contractual relationships with Cardholders, the Mastercard Network enables Cardholders to purchase goods and services from Merchants using Mastercard branded credit and debit cards. Mastercard does not dispute that credit and debit card transactions occur in South Carolina, but contends its Network is not present in the State and that its income is generated elsewhere. Thus, Mastercard asserts it has no obligation to pay income taxes to South Carolina.

The Department argues that Mastercard's Network is present in South Carolina and that the provision of the Mastercard Network is Mastercard's income producing activity. According to the Department, Mastercard contracts with banks in South Carolina, advertises in South Carolina, and maintains, operates, and regulates its Network within South Carolina. Mastercard charges fees each time one of its cards is used to pay for goods or services at Merchant locations or used at an automatic teller machine (ATM). Therefore, the Department contends that Mastercard derives revenue from transactions initiated here. Because Mastercard operates its Network in South Carolina and that Network produces income, the Department assessed income taxes to Mastercard.

This dispute requires the Court to decide three issues. First, what is Mastercard's income producing activity? Second, did the income-producing activity occur within South Carolina such that Mastercard should have paid income taxes to the State? Lastly, if Mastercard is liable for South Carolina taxes, is it also required to pay penalties and interest because of its failure to file income tax returns and pay income taxes during the Audit Period?

EXHIBITS AND TESTIMONY

This contested case hearing began March 8, 2022, and concluded on March 11, 2022. At the start of the hearing, the Court admitted into the record 37 exhibits offered jointly by Mastercard and the Department (Joint Exhibit Nos. 1–37). During the hearing, the Court admitted two additional exhibits offered by Mastercard (Petitioner's Exhibits 1 and 2) and one exhibit offered by the Department (Respondent's Exhibit 1). Four fact witnesses and two expert witnesses gave testimony, as described below. In addition, pursuant to Rule 32(a)(2), SCRCF, Mastercard designated several statements from the deposition of Robert King, the Department's representative for purposes of Rule 30(b)(6), SCRCF, and the Department counter-designated statements of its own. The parties filed the designations during trial on March 9, 2022.

Mastercard presented three fact witnesses: (a) Ruby Naskiewicz, Mastercard's Vice President of Federal Tax; (b) Ken Cavallo, a Senior Operations Engineer for Mastercard; and (c) Joe Buehler, Mastercard's Senior Vice President of Technology Risk Management. Mastercard did not believe expert testimony was needed in this matter and, accordingly, did not call any expert witnesses.

The Department presented one fact witness and two expert witnesses: (a) Orville Sharpe, the Department's lead auditor in the Mastercard audit; (b) Jim Hawkins, a professor at the University of Houston Law Center, who was admitted as an expert in "consumer credit markets"; and (c) John Swain, a professor emeritus from the University of Arizona's College of Law, who was admitted as an expert in state and local tax policy.

DISCUSSION and FINDINGS OF FACT

Having observed the witnesses and evidence at the hearing and considering the burden of proof and the witnesses' credibility, the Court makes the following findings of fact by a preponderance of the evidence:

I. Mastercard's Business Operations.

Mastercard is a wholly owned subsidiary of Mastercard Incorporated, a technology company in the payments industry, headquartered in Purchase, New York. Mastercard's primary business is transaction processing, which includes services commonly referred to as "authorization", "clearing", and "settlement". Mastercard does not itself loan money or issue credit cards to consumers and contends that it does not facilitate Merchants' acceptance of credit cards for the purchases of goods and services.

Mastercard operates a payment systems Network using what is commonly called the "four party" model. Mastercard's Network and the parties thereto are governed by a complex system of rules and regulations initially outlined in the "Mastercard Rules" (also referred to herein as "Rules"), a copy of which was introduced into evidence.¹ In addition, the Record contains the

¹ Ruby Naskiewicz testified that the Mastercard Rules "are the backbone, if you will, of – of Mastercard's guidance to our customers. They provide standards so that it ensures that the parties involved in the transaction processing is going to do what they need to do." The Rules create a comprehensive framework of rules, regulations and policies governing the relationships between, and operations of, Mastercard, its Issuer and Acquirer banks, Merchants who accept Mastercard-branded credit and debit cards, and Cardholders.

Mastercard License Agreement, Mastercard Authorization Manual, Mastercard Settlement Manual, and various other documents and information.

Despite its name, the “four party model” actually includes five parties: (1) the Cardholder (an individual or business using a Mastercard-branded credit or debit card to pay for goods or services); (2) the Merchant (a seller of goods and services who is authorized to accept Mastercard branded cards as payment pursuant to what is referred to in the Rules as a “Merchant Agreement”²; (3) the Merchant’s bank or “Acquirer Bank” (the bank used by a Merchant to process credit/debit card transactions); (4) the Cardholder’s bank or “Issuer Bank” (the bank that issues credit/debit cards to Cardholders, authorizes payments to Merchants on the Cardholder’s behalf, and allows the Cardholder to carry a credit balance)³; and (5) Mastercard itself via the Mastercard Network. If a Cardholder’s transaction is authorized, there are two other steps: clearing and settlement. Clearing is the process through which Issuer and Acquirer banks reach a net position with respect to batches of transactions. Settlement occurs when Acquirer Banks and Issuer Banks actually exchange funds. Mastercard controls and facilitates all steps in these processes. During the Audit

The Mastercard Rules define “Cardholder” as “[t]he Authorized User of a Card or Access Device issued by a Member.” The Rules further define “Card” as a “card issued by a Member pursuant to License and in accordance with the Standards that provides access to a credit or debit Mastercard account.” “Member” is defined in the Mastercard Rules as “[a] financial institution or other entity that has been granted membership in and has become a member of the Corporation in accordance with the Standards.” Each Member signs a “Membership Agreement” with Mastercard defined as “[t]he written, executed agreement between the Corporation [Mastercard] and a Member setting forth the terms of Membership in the Corporation.”

² The “Merchant Agreement” is defined under the Rules as “[a]n agreement between a Merchant and Member that sets forth the terms pursuant to which the Merchant is authorized to accept cards and Access Devices.” An “Access Device” is “a means other than a card with which the Cardholder may access a Mastercard account in accordance with the Standards.” Standards” are defined in the Rules as “The Amended and Restated Certificate of incorporation, Bylaws, Rules [defined as the Standards set forth in the Mastercard Rules manual], and policies and the operating regulations and procedures of the Corporation, including, but not limited to any manuals, guides or bulletins as may be amended from time to time.”

According to Mastercard, the Merchant Agreement is signed between the Merchant and the Merchant’s Acquirer Bank and imposes various standards regarding the Merchant’s acceptance of Mastercard-branded cards and its display of the Mastercard logo. Mastercard contends that the terms of this agreement, while created by Mastercard, are enforced by the Merchant’s Acquiring Bank. In other words, Mastercard contends it has no interaction with or control over the Merchant’s compliance with the Merchant Agreement. If terms of the Agreement are violated, the Merchant’s Acquiring Bank remains responsible for any penalties which Mastercard might impose.

³ Acquirer and Issuer Banks are “Members” under the Mastercard Rules.

Period, some of Mastercard's Issuer Banks, Acquirer Banks, Merchants and Cardholders were located in South Carolina..

II. Mastercard's Generation of Income and the Steps in Transaction Processing.

Mastercard receives the vast majority of its income from (a) authorization, (b) clearing, (c) settlement, and (d) assessment.⁴

(a) Authorization Approval Process for Credit Card Transactions.

Authorization, from an industry-wide perspective, refers to the overall process of seeking a payment approval or declined message for a particular card transaction. Under this meaning, authorization starts with a Cardholder's purchase attempt using a credit or debit card at the point of sale, such as a cash register or the checkout page on a website. Once the Cardholder attempts a purchase, the transaction information is routed from the Merchant's point of sale to the Merchant's Acquirer Bank. The Merchant's Acquirer Bank will then relay this information to Mastercard via a Mastercard Interface Processor ("MIP"), which is hardware located at the Acquirer Bank's data processing center used to connect to the Mastercard Network.⁵ Once Mastercard receives this information from the Acquiring Bank's MIP, Mastercard will "authenticate" (or validate) the transaction information and transmit this information to the MIP located at the Issuer (Cardholder's) Bank's processing facilities.⁶ The Issuer Bank then decides whether to approve or decline the transaction and notifies Mastercard of its decision. Mastercard transmits the Issuer Bank's response to the Merchant's Acquiring Bank and this information is thereafter relayed to

⁴ Mastercard also receives some revenue from other activities, including various value-added services provided during the authorization process. It also receives revenue from consulting, which is entirely separate from the transaction processes described above. Furthermore, there is a stream of income identified by the Department as "contra-revenue" meaning that it results in deductions from gross revenue. While calculated into the Department's proposed assessment, this item will not be analyzed by the Court.

⁵ Mr. Cavallo testified that a MIP is "a server that runs Mastercard proprietary software and its primary job is to send and receive transaction request and response messages.. And then it also performs some other functions like file the transfer that facilitate[s] other services for customers." Mastercard performs its authorization services at the locations of these MIPs, which are located throughout the country, and at Mastercard's two data processing facilities located in Missouri. There are no MIPs in South Carolina, as none of Mastercard's customer banks have data processing facilities in this State.

⁶ Mastercard might additionally perform value-added services for a customer bank at this stage, such as relaying fraud prevention messages, if the bank has opted for these services.

the Merchant. Mastercard contends that its authorization service is complete once it delivers the Issuer Bank's decision to the Acquirer bank.

Mastercard divides the authorization process into twelve distinct steps. Attachment A to this Order is a diagram from a joint exhibit depicting the various steps in the process. In most instances, authorization takes less than seven seconds and as little as 130 milliseconds. Mastercard's authorization process begins when a Cardholder presents a Mastercard as payment for a transaction; at the end of the authorization process, a Merchant is advised whether the payment is approved or declined. Mastercard charges a variety of fees during the authorization process.

Ken Cavallo, Mastercard's Senior Operations Engineer, testified, that "Authorization from an industry-wide perspective is the process of taking a transaction request all the way from the point of sale to the issuing bank, which has issued the card to the cardholder, and then generating an authorization request or an authorization response and delivering that response back to the point of sale, so that the – so that the transaction can either proceed or not proceed." Cavallo further testified that Mastercard is only involved in authorization between the Acquirer and Issuer Banks' respective MIPs.⁷ The MIPs are owned by Mastercard and are leased to Issuers and Acquirers or to third-party processors. A MIP is typically located at the bank's facility, but Mastercard does not control the location of the MIP. There are no MIPs in South Carolina.

According to Cavallo, Mastercard plays no role in either the Cardholder's or Merchant's interaction with their respective banks, and further, that the Mastercard Network stops at the MIPs. He specifically testified that there was no access to the Mastercard Network at the "points of interaction", which is a term defined in the Mastercard Rules as "the location at which a transaction occurs." He also explained that the authorization platform is the part of the Network that "facilitates our authorization and clearing services to our acquiring and issuing customers."

The Department disputes Mastercard's characterization of the Network as isolated from Cardholders and Merchants. The Mastercard Network facilitates the messages received by Merchants from their Acquiring Banks. For instance, Mastercard's Authorization Manual - a

⁷ According to Mastercard, its role in the transaction process begins at Step 3 and ends at Step 9, as shown in Attachment A. As will be discussed, the Court believes this characterization of Mastercard's role in Merchant/Cardholder transactions to be too limited. Attachment A illustrates the interconnectedness of the parties in the credit card transaction.

Mastercard handbook detailing the steps in the authorization process- without more, contradicts Cavallo's testimony. The Authorization Manual states, "The authorization platform transmits authorization validation data among issuers, acquirers, and *points of interaction*." (emphasis added.) The Mastercard Rules define "Point of Interaction" as "the location at which a Transaction occurs, as determined by the Corporation." The Rules further define "transaction" as "the sale of goods or services by a Merchant to a Cardholder pursuant to acceptance of a Card or Access Device by a Merchant." Thus, pursuant to the Authorization Manual, the Mastercard Network extends to the point of interaction where the Merchant/Cardholder are located and the sale occurs.

Mastercard contends that all of its activities related to authorization occur in either O'Fallon, Missouri or Kansas City, Missouri, at its "central site" data centers. Because, according to Mastercard, its activities take place in Missouri, there are no "income producing activities" occurring in South Carolina. For most of the audit period – until 2014 – it was not necessarily true that data was transmitted to the Missouri data centers. Since 2014, however, all authorizations are routed to the Missouri data centers because Mastercard performs fraud prevention measures called "safety net." Further, for the entire Audit Period, if a transaction involved "value added services," which are services Mastercard provides for a fee if requested by an Issuer or Acquirer, then the transaction is likewise routed through the Missouri data centers.

Mr. Cavallo also testified that Cardholders do not have access to the authorization platform. While nominally true, Mastercard's Authorization Manual states that the "[t]he Mastercard Authorization Platform operates on a continuous basis, ensuring that Cardholders can use a Mastercard card program anytime and that acquirers and issuers always have access to Mastercard authorization processing facilities." At minimum, this statement in the Authorization Manual supports the Department's position that Mastercard provides a network that extends to the Merchant and Cardholder and relies on the Cardholder's swipe of his or her card at the Merchant's location.

(b) Clearing.

Clearing is the process of netting and reconciling thousands of previously authorized transactions to determine the final amounts owed to and from each bank at the end of each clearing cycle. In this process, Mastercard's Acquirer and Issuer Banks, some of which are located in South Carolina, provide large batches of transactional data to Mastercard so that Mastercard can compute and net those amounts on a large scale. Mastercard computes these batches of transactional data at

its data centers in Missouri, and then sends summary reports to the Acquirer and Issuer Banks showing how much money each will either owe or receive as a result of the activity period being reconciled. The clearing process ends once Mastercard provides these reports to its banks and internally forwards the same to Mastercard's settlement systems.

Clearing is a separate process from authorization. Transactions are not "relayed for clearing" unless they were "previously authorized." This is obvious because there is no way to arrive at a "net settlement position" without looking to the authorized transactions. Mastercard charges fees to its Issuer and Acquirer banks based on the number and size of clearing messages sent to, or received from, each bank. Neither Cardholders nor Merchants are directly involved in the clearing process.

According to Mastercard's Senior Vice President of Technology Risk, Joseph Beuhler, Mastercard has two systems in place – the Global Clearing Management System and the Mastercard Debit Switch – which process credit and debit transactions. During the clearing process, Mastercard provides "multiple reports" to the banks that "they would utilize...together to understand their holistic position." The "end of clearing would be the reports to the customers [Acquirer and Issuer Banks] to give them their overall position. And then it [Mastercard] would hand off as a...finalization stage to our settlement process, so that [Mastercard] can actually then move forward with the exchange of funds between our customers." Mastercard charges more fees for providing clearing services.

(c) Settlement.

Settlement occurs after clearing and is the process by which Mastercard facilitates the exchange of funds among its Acquirer and Issuer Banks based on the amounts determined to be owed to, or due from, each bank during the preceding clearing process. The goal of the settlement process is for each Issuer and Acquirer Bank to have one transfer of money per cycle (e.g., per day), even though there may have been thousands or hundreds of thousands of separate transactions. Cardholders and Merchants are not involved in this process.

During this process, Mastercard provides each of its Issuer and Acquirer Banks with an elective advisement report, which alerts the bank of the amount it owes or is owed so that the bank can ensure that it is ready to receive funds or has sufficient funds for withdrawal. Mastercard itself does not move money between the banks; instead, it provides the customer banks with "transfer

fund orders”, which are used by the banks to initiate the actual movement of funds. These advisement reports and transfer fund orders are the two “end results” of the settlement process.

As with authorization and clearing, Mastercard collects fees for settlement services. The fee is based on the number of reports Mastercard delivers to Issuer and Acquirer Banks.⁸

(d) Assessment.

While not part of its transaction processing, Mastercard imposes assessment fees on each of its Issuer and Acquirer Banks to recoup funds invested in the infrastructure necessary for the Mastercard Network, to include hardware and software. Ms. Naskiewicz explained that the infrastructure expenses to be recovered through assessment fees are totaled and each member bank is then charged a share of that total based on its proportionate use of Mastercard services, using the dollar volume of activity by that bank’s customers [Cardholders] as a proxy or metric for its proportionate share. Significantly, Ms. Naskiewicz further testified that this practice started when Mastercard was still a non-profit association and a continues now that Mastercard is a for-profit corporation:

So, it [Mastercard] would charge those banks transaction processing services, similar to what we, you know, talked about. But there are other costs that Mastercard incurred first that benefitted and provided services to those banks. And Mastercard continues to provide those services and those benefits to our acquirer and issuer banks. And, so, now that Mastercard is actually a for-profit, there's a margin that Mastercard recognizes. And that's why you'll see it as a revenue stream. Before, when it was a not-for-profit, what it would do – and the services relate to a few things that I could describe, but what it would do would -- it would total up the cost it -- it incurred and then, based on the activity or the volume of -- the dollar volume, based on the activity that the issuer and banks received, if you will, that cost would be divvied up by the members of the association. So now, because Mastercard is a for-profit, as I mentioned before, there's a margin that they recognize.

III. The Department’s Audit Examination.

The Department initiated the Mastercard audit in 2017. Before the audit, Mastercard never filed a corporate income tax return with the Department or paid South Carolina corporate income taxes. Based on information Mastercard provided during the audit, as well as publicly available information about the company, the Department determined that Mastercard generates income by

⁸ The Record includes Mastercard’s “Summary of Costs for U.S. Region Members”, which outlines the applicable rates.

charging fees to Issuer and Acquirer Banks for Merchant/Cardholder transaction processing and ancillary value-added services provided in its Mastercard Network. These fees are based primarily on the number of transactions in which Mastercard cards are used for payment and the gross dollar volume (also referred to herein as “GDV”) of the transactions. The Department calculated the gross receipts that should have been sourced to South Carolina based on its view that Mastercard’s income producing activity happens in South Carolina when the transaction is initiated here.⁹

The Department’s auditor, Orville Sharpe, testified that he used the data provided by Mastercard to calculate a proxy for the gross receipts attributable to South Carolina.¹⁰ Mastercard generally agreed that the Department calculated a reasonable number for gross receipts under its theory of sourcing.¹¹ It must be reiterated, however, that Mastercard has adamantly contended that the Department’s sourcing methodology is incorrect.

In the March 26, 2018 proposed assessment, the Department assessed Mastercard income taxes, license fees, interest, and penalties for 2007 through 2016¹² as follows:

⁹ The “gross receipts ratio” is defined in S.C. Code Ann. 12-6-2290 as “a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.” The Department introduced a summary of its calculation of Mastercard’s South Carolina receipts, the gross receipts ratio, and the ultimate income tax due from Mastercard during the Audit Period. The Department’s step-by-step calculations were included in the detailed schedule of the auditor’s workpapers.

¹⁰ Mastercard provided reports to the Department for each year of the Audit Period that detailed the total Mastercard branded transactions in South Carolina and the United States. Mastercard also provided a breakdown of Mastercard’s U.S. revenue generated for the five revenue streams. The Department used the information in these reports and the revenue breakdown to determine the amount of gross receipts that should have been sourced to South Carolina based upon the Department’s view of Mastercard’s income-producing activity in South Carolina.

¹¹ Mr. Sharpe testified that a Mastercard’s representative commented that the Department “did a great job on computing the gross receipts” using its theory.

¹² Because Mastercard had not filed returns or remitted any income tax, the Department was authorized to extend the audit period beyond the typical 36 months. *See* S.C. Code Ann. § 12-54-85 (2014).

FY	SC Receipts	Everywhere Receipts	Ratio	SC Income subject to Tax	Income Tax Due
2007	14,253,564	2,490,494,550	0.5723%	5,339,119	\$266,956
2008	17,028,490	2,887,751,528	0.5897%	(1,179,335)	\$0
2009	15,662,402	3,165,301,566	0.4948%	(299,632)	\$0
2010	19,701,808	3,756,514,868	0.5245%	4,620,276	\$231,014
2011	24,720,371	4,429,902,032	0.5580%	11,594,161	\$579,708
2012	27,559,986	4,783,744,330	0.5761%	10,592,454	\$529,623
2013	31,984,149	5,440,068,254	0.5879%	18,477,435	\$923,872
2014	35,793,391	6,249,714,209	0.5727%	21,885,872	\$1,094,294
2015	39,803,347	6,392,533,839	0.6227%	22,520,667	\$1,126,033
2016	42,532,159	7,049,862,856	0.6033%	25,803,328	\$1,290,166
TOTAL					\$6,041,666

The Department’s proposed assessment concluded that: (1) during the audit period, Mastercard was doing business in South Carolina pursuant to section 12-6-530 of the South Carolina Code (2014)¹³; (2) Mastercard’s business in South Carolina is the provision of a credit card Network that allows Cardholders and Merchants to consummate credit card purchases and debit card purchases in South Carolina; (3) Mastercard’s five major revenue streams are directly and wholly generated from Mastercard’s credit card Network¹⁴; and (4) based on Mastercard’s

¹³ This codes section states, in pertinent part:

An income tax is imposed annually at the rate of five percent on the South Carolina taxable income of every corporation ... transacting, conducting or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate or foreign commerce.” The terms "transacting", "conducting", and "doing business" include transacting or engaging in any activity for the purpose of financial profit or gain.

Mastercard conducted business in South Carolina during the audit period by the following means: (1) Mastercard licensed intangibles for use in the state; (2) it contracted with businesses that operate in South Carolina; and (3) it generated substantial income in South Carolina from fees based on the dollar value and on the number of credit card transactions initiated in South Carolina.

¹⁴ Mastercard’s five revenue streams are (1) domestic assessment fees based on the gross dollar volume of Mastercard branded transactions; (2) cross border volume fees based on the gross dollar volume of Mastercard branded transactions; (3) transaction processing fees based on the number of Mastercard transactions; (4) other income based on the dollar amount of Mastercard’s assessment fees, cross border dollar volume fees, and transaction processing fees, all of which are based on the volume of activity generated by Cardholder/Merchant transactions; and (5) rebates and incentives that are contra-revenue.

information about its five revenue streams, a portion of its income producing activity was conducted in South Carolina for taxation purposes. In sum, through the use of the Mastercard Network, which includes the activities of Cardholders, Merchants, Issuer Banks, Acquirer Banks and Mastercard, transactions occur in South Carolina when a Cardholder initiates cashless purchases of goods and services from a Merchant located in the State.

After evaluating Mastercard's protest, the Department issued a Determination finding that Mastercard's income producing activity was providing access to its Network that facilitates cashless transactions between Cardholders and Merchants, generating the various fees discussed earlier. Accordingly, the Department concluded Mastercard should have included all income derived from the use of its credit card Network for card transactions initiated in South Carolina in the numerator of the gross receipts ratio.

Evaluation of Expert Witness Testimony

The Department presented testimony from two expert witnesses. Professor Jim Hawkins offered opinions generally about how Mastercard generates revenue. Professor John Swain testified that the Department's taxation of Mastercard reflected good tax policy. Both witnesses were accepted by the Court as experts in the areas as proffered by the Department and it stands by those decisions. Nevertheless, for the stated reasons, the Court will qualify its reliance on the testimony provided by Professor Hawkins.

(a) Professor Jim Hawkins' Testimony and Mastercard's Objections Thereto.

Jim Hawkins¹⁵ is a tenured professor at the University of Houston Law Center. He has been a law professor for fourteen years and has studied credit markets, to include credit cards, much of that time.¹⁶ He has taught secured financing, bankruptcy, contracts, and Texas consumer law. Professor Hawkins has also taught seminars and classes on consumer credit and credit cards.

¹⁵ Professor Hawkins attended Baylor University where he obtained an undergraduate degree in Philosophy. He then worked as an internal auditor and a personal banker before attending law school. Hawkins attended the University of Texas School of Law, where he served as the Chief Articles Editor of the Texas Law Review. During law school, Professor Hawkins was a Fellow at the Center for Law and Business Economics. Immediately after law school, Hawkins clerked for Judge Jerry Smith of the U.S. Court of Appeals for the Fifth Circuit. Before joining the University of Houston Law Center faculty, Professor Hawkins worked as a commercial litigator for an international law firm. As will be discussed below, Professor Hawkins has other private law practice employment which was not revealed at trial.

¹⁶ Professor Hawkins acknowledged, however, that other than in preparation for this case, "he had not studied and researched Mastercard, specifically."

His seminars on credit cards included topics such as consumer issues with credit cards and credit card networks, together with their history and effects on society. Professor Hawkins also taught classes on credit card interchange fees, surcharge rules established by credit card networks, and the Mastercard initial public offering. It was unclear as to how many classes Professor Hawkins taught pertaining specifically to the sourcing of income of credit card processors. The Court notes that Professor Hawkins was not teaching any courses generally dedicated to credit cards at the time he was designated as an expert witness in this case.¹⁷ He has written articles or book chapters focusing on credit cards, although he has not written a specific article about Mastercard.¹⁸ In addition to teaching, Professor Hawkins peer reviews articles for the American Law and Economic Review, which is an organization dedicated to the study of the interaction between law and economics. Professor Hawkins has given presentations at symposiums related to credit cards. Professor Hawkins has previously served as an expert witness in legal proceedings, although his testimony was unclear as to how many times he has actually testified in, and thus been recognized by, a court as an expert. Professor Hawkins was not asked during his testimony to identify his areas of expertise in any of the other legal proceedings in which he has offered expert opinions.

The Department asked Professor Hawkins to explain how Mastercard transactions work and to give an opinion about Mastercard's revenue generating activities. Professor Hawkins

¹⁷ At the time of his testimony, Professor Hawkins had taught the credit card classes for “two semesters.”

¹⁸ Some of the published articles Professor Hawkins is credited with authorship include: (1) *Advertising Injustices: Marketing Race and Credit in America*, 70 Emory L.J. 1619 (2021) which addresses the exacerbation of racial inequalities in consumer credit markets through targeted advertising to certain populations; (2) *Doctors as Bankers: Evidence from Fertility Markets*, 84 Tul. L. Rev. 841 (2020), which presents a study of medical doctors acting as “bankers, lending directly to patients or arranging for patients to obtain loans from third-party lenders in connection with fertility treatments;” (3) *Protecting Consumers As Sellers*, 94 Ind. L.R. 1407 (2019) which argues that current consumer protection laws protecting sellers of goods to buyers should be updated to provide protections to buyers as they have begun to act as sellers in the modern economy; (4) *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 Ind. L.J. 1361 (2011), which explores “the relationship between fringe banking and financial distress by analyzing the structure of fringe credit markets and the characteristics of specific fringe credit transactions” and regulations designed to address fringe banking markets.”; (5) *The Card Act on Campus*, 69 Washington & Lee L. Rev. 1471 (2012) which studies the effectiveness of federal legislation passed to regulate student credit card markets so as to prevent student over-indebtedness, end aggressive marketing to college students and to change avaricious agreements between credit card issuers and colleges; (6) *Renting the Good Life*, 49 Wm. & Mary L. Rev. 2041 (2008) which addresses the fringe consumer credit market occupied by the rent to own industry. During *voire dire*, Prof, Hawkins admitted that none of these articles contained any discussion of Mastercard and that the word “Mastercard” was used twice in the footnotes of a thousand pages of written work.

testified that he is an expert in consumer credit markets, which encompasses the operation of credit card networks. He defined “consumer credit markets” as “a broad term . . . that includes other things like where lending is facilitated and other things like it. . . . I construe it as a broad term [to include] lending businesses plus related activities including the operation of networks.” Consumer credit markets include credit card business because there is a borrower, a lender, and an entity that facilitates the transaction. Hawkins testified that when formulating his opinions he relied upon documentation provided by Mastercard during discovery, peer reviewed research, information from the Mastercard website and “some other websites”.¹⁹ Over the objections of Mastercard, the Court qualified Hawkins as an expert in consumer credit markets.

Moreover, both before and during the hearing, Mastercard challenged Hawkins’ testimony on the grounds that the opinions he offered addressing Mastercard went beyond his stated area of expertise in consumer credit markets.. According to Mastercard, “consumer credit markets” is a field that only involves lending money, which Mastercard does not do. Mastercard provided no authority, however, defining “consumer credit markets” in a way that excludes its credit card business. Mastercard further suggested that Hawkins should not have been allowed to testify about Mastercard at all given that his previous work did not concentrate on Mastercard’s operations. Alternatively, Mastercard argued that Hawkins should not have been allowed to testify about Mastercard’s generation of revenue because he is not an economist. Ultimately, the Court overruled Mastercard’s objections and elected to allow Professor Hawkins to testify.

The Court believes the term “consumer credit markets” is more expansive than Mastercard suggested and that it includes more than merely lending money. The term includes businesses lending to borrowers and related activities such as the operation of payment networks like that operated by Mastercard which facilitate lending. As an expert witness, Professor Hawkins may define his expertise in a manner that he believes is consistent with his education, training and experience. The question for the Court is whether the boundaries of his expertise are broad enough to capture Mastercard’s business.

Professor Hawkins’ previous work in consumer credit markets – the classes taught, his scholarly writing and experience– does not evidence a longstanding, in-depth knowledge of the operations of credit card companies as they relate to the issues under consideration here.

¹⁹ Professor Hawkins did not identify the peer reviewed research, or the “other websites” used in preparation for his testimony.

Nevertheless, the Court believes he possesses more knowledge of credit card company operations than would the normal lay person such that his testimony was helpful to the Court in understanding the issues and arriving at its decisions in this case. *See* Rule 702, SCRE (“If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.”). In *Risher v. South Carolina Dep’t of Health and Env’tl. Control*, 393 S.C. 198, 205, 712 S.E. 2d 428 432 (2011), the South Carolina Supreme Court upheld the ALC’s qualification of an expert in forestry, land surveying, and the identification of wetland boundaries, including critical area boundaries, with the observation that “[t]o be competent to testify as an expert, a witness must have acquired by reason of study or experience or both such knowledge and skill in a profession or science that he is better qualified than the jury to form an opinion on the particular subject of his testimony.” (citing *Gooding v. St. Francis Xavier Hosp.*, 326 S.C. 248, 252–53, 487 S.E.2d 596, 598 (1997)).

Although Professor Hawkins candidly acknowledged that his academic writings were not specifically focused on Mastercard, his previous work, such as law review articles, professional presentations, and teaching, demonstrated a knowledge of consumer credit markets, to include the credit card industry, was sufficient to allow the Court to exercise its discretion to qualify him as an expert in the field of consumer credits markets for the instant case. *See Risher*, 393 S.C. 198, 206, 712 S.E.2d 428, 432 (2011) (noting that absent an abuse of discretion, “[t]he qualification of a witness as an expert and the admissibility of his testimony are matters largely within the discretion of the trial judge”) (citing *Payton v. Kearse*, 329 S.C. 51, 60–61, 495 S.E.2d 205, 211 (1998)).²⁰ Furthermore, as an expert witness in the area of consumer credit markets, Professor

²⁰ In *Watson v. Ford Motor Co.*, 389 S.C. 434, 446, 699 S.E.2d 169, 175 (2010), the South Carolina Supreme Court concluded that a court must make three findings before the fact-finder can consider expert testimony: (1) that “the subject matter is beyond the ordinary knowledge of the [fact-finder]”; (2) “that the proffered expert has indeed acquired the requisite knowledge and skill to qualify as an expert in the particular subject matter”; and (3) “evaluate the substance of the testimony and determine whether it is reliable.”

The Court finds that Professor Hawkins meets each of these thresholds: (1) the subject matter of Professor Hawkins’ expertise is beyond the Court’s normal knowledge and is helpful to the Court’s understanding of the case; (2) based on Professor Hawkins’ academic work and study in consumer credit markets, he has the requisite knowledge and skill to qualify as an expert in the particular subject matter for which he was proffered; and (3) based on the Court’s evaluation of his testimony, as supported by the Record, Professor Hawkins’ testimony was reliable. *Id.*, at 450, 389 S.C.2d at 177, footnote 3 (“The test for reliability for expert testimony does not lend itself to a one-size fits all approach”).

Hawkins reviewed information furnished by Mastercard during discovery, as well as publicly available information about the company such as its Annual Reports, in preparation for his testimony. In addition, Professor Hawkins was present for most, if not all, of Mastercard's testimony during its case-in-chief. Accordingly, subject to some concerns going to the weight of his testimony, the Court finds that Hawkins' expertise is sufficient to include Mastercard's operations as a credit/debit card payment Network.

After the hearing, Mastercard asserted that it learned for the first time that Hawkins also worked as an attorney in private practice and offered that his failure to disclose this work as a practicing attorney discredited his testimony. At the time Hawkins appeared before the Court, as well as at the time he sat for a pretrial deposition, he had an "of counsel" relationship with Daniels & Tredennick, PPLC, a Houston law firm which bills itself as a personal injury and commercial litigation firm, with whom Hawkins is described as a "commercial litigator." Hawkins had such a relationship even at the time the Department retained him in this matter. Professor Hawkins did not reveal this relationship despite having been given ample opportunity to do so at trial and during the deposition, which the Court observed in its May 3, 2022, posttrial order denying Mastercard's Motion to Supplement Record. The Court believes that Professor Hawkins should have disclosed his "of counsel" relationship with the Houston law firm. And, while the Court also finds that Professor Hawkins was generally forthcoming and tried to answer all of the extensive cross examination by Mastercard, this omission is of concern to the Court.²¹

The Court stands by its decision to qualify Professor Hawkins as an expert in consumer credit markets, as well as the decision to allow his testimony over the various objections interposed by Mastercard; however, given Professor Hawkins' limited knowledge of Mastercard's operations prior to this case and the omission of his "of counsel" employment during trial and discovery, the Court will pay particular attention to evidence in the Record which supports his testimony and opinions, or at least, allows his testimony and opinions to logically flow therefrom.

²¹ The disclosure of this relationship would not have served to disqualify Professor Hawkins from testifying as an expert witness in this case. As the Court noted in its posttrial order, it is difficult to understand why Hawkins would not have disclosed this relationship. Nevertheless, this omission does have some adverse impact on the Court's evaluation of Hawkins' candor toward the Court, and, potentially more importantly, deprived Mastercard of an opportunity to explore potential bias during its examination of the witness.

(b) Professor Hawkins’ Opinions Regarding Mastercard’s Income Producing Activity.

Although Mastercard points out that it does not actually lend money, the Record is replete with evidence that a Mastercard branded card is known as a “credit card” or a “charge card.”²² In several Mastercard documents entered into evidence by consent of the parties, Mastercard refers to its “consumer credit and charge” programs:

- Concerning Mastercard’s Transaction and Network Interface Fees known as BIN (Bank Identification Number) and ICA fees, Mastercard’s 2009 Cost Summary states “All members may obtain, as necessary, one consumer credit ICA and BIN, one corporate credit ICA and BIN, and one debit ICA and BIN at no charge.” (emphasis added.)
- Concerning the calculation of Acquirer Brand Volume Fees, Mastercard’s 2016 Cost Summary states, “Mastercard increased the acquirer brand volume from 0.13% to 0.14% for consumer credit and commercial credit volume generated from transactions US \$1,000 and higher.” (emphasis added.)
- Concerning the calculation of Merchant Investment Fees, Mastercard’s 2016 Cost Summary states, “The Merchant Investment Fee (MIF) will be assessed at 5 basis points on consumer credit card volume....” (emphasis added.)
- In its 2012 Form 10K Annual Report Mastercard provides a full description of its “Consumer Credit and Charge” program. The program is “customized ... to address specific customer segments” and includes “standard,” “premium,” and “affluent” tiers. During 2012 the program generated \$1.8 trillion in gross dollar volume, which was a full 50% of the total gross dollar volume for that year.²³ (emphasis added.)
- The 2013 Mastercard Annual Report provides a similar description of the “Consumer Credit and Charge” program but omits the data about the gross dollar volume of those transactions. (emphasis added.)
- Mastercard’s 2014 and 2015 Annual Reports include an even further truncated description of the Consumer Credit and Charge program, but notes that Mastercard “offer[s] a number of programs that enable issuers to provide consumers with cards that allow them to defer payment.” (emphasis added.) Unlike Mastercard’s position at the hearing, this indicates that Mastercard is directly involved in the creation of deferred payment programs.

²² The definition of “charge” includes “to defer payment for (a purchase) until a bill is rendered by the creditor.” <https://www.dictionary.com/browse/charge> (last visited June 20, 2022).

²³ This section of the 2012 Annual Report continues to state that “[a]s of December 31, 2012, the Mastercard logo appeared on 686 million consumer credit and charge cards worldwide, representing a 5% increase from December 31, 2011. ”

- In its 2015 Annual Report Mastercard notes that the company is subject to regulation by the Consumer Financial Protection Bureau (CFPB), which it offers “has significant authority to regulate consumer financial products in the United States, including consumer credit, deposit, payment and similar products.” (emphasis added.)

- Mastercard’s 2016 Annual Report makes several references to the company’s involvement in consumer credit, including its “focus on growing our core business globally, including growing our consumer credit, debit, prepaid, and commercial products and solutions.” Similarly, the Consumer Credit and Charge program is noted in this report to be one of Mastercard’s “core products.” Finally, when discussing regulation by the CFPB, Mastercard acknowledges that it is subject to CFPB oversight as a result of “our consumer credit...products.” Thus, Mastercard’s 2016 Annual Report particularly undercuts its efforts to discredit Professor Hawkins’ testimony regarding credit card markets as being unrelated to Mastercard’s business operations and provides further support for his views.

Mastercard’s documents show that it is operating within the consumer credit markets business. Thus, there is congruence between Mastercard’s operations and Professor Hawkins’ area of expertise. Having determined that Professor Hawkins’ expertise includes Mastercard’s business, the Court turns to the opinions he offered during the hearing:

- 1) “Mastercard generates revenue by providing a network for Cardholders and Merchants to transact business and they provide that network by licensing logos, advertising to Merchants and Cardholders, by creating and enforcing rules that everyone – that people in the system have to obey and by transmitting information and funds to -- between parties.”
- 2) “Mastercard has solved the problem of multiple parties being in this market by creating that network. And so, they solved the problem what’s called a two sided market by creating a network.”
- 3) “Mastercard generates revenue because a Cardholder uses a card at a Merchant location.”

Professor Hawkins’ opinions are supported by the Record. Each of the opinions points to Mastercard’s business in South Carolina evidenced by the operation of its Network in this State which facilitates credit card transactions. Hawkins noted that it is apparent that the Mastercard Network is in South Carolina because of the display of the Mastercard logos by Merchants throughout the State. In addition, and perhaps more importantly, the fact that Mastercard is present and doing business in the State is underscored by the Department’s computation of the number and dollar amount of Cardholder transactions occurring here during the Audit Period. Mastercard did not dispute either point.

(c) Professor Hawkins’ Opinion that the Mastercard Network Consists of More Than MIPs and Data Centers.

It is Hawkins’ opinion that Mastercard has a relationship with each of the participants in the four-party model and that Mastercard’s relationship extends beyond authorization for any single transaction. Long before a Cardholder presents a Mastercard credit or debit card to a Merchant, it has worked to attract both Merchants and Cardholders to use its products and established and maintained a network that supports cashless payments.²⁴ According to Hawkins, Mastercard’s account of its involvement – or lack thereof – at each step in a transaction is distorted because its perspective is too narrow. Mastercard is directly involved in establishing the Mastercard Rules that govern how transactions are to be treated,²⁵ inducing Cardholders and Merchants to use Mastercard, and creating and managing the hardware and software that allow the Cardholders and Merchants to transact business without using cash. For instance, Merchants that

²⁴ The Record includes contracts between Mastercard and South Carolina banks which contain various incentives for promoting and issuing Mastercard branded credit cards to Cardholders. For instance, a June 20, 2020 document entitled “Brand Agreement” between Mastercard and Heritage Trust Federal Credit Union (Heritage) in Summerville, SC, provides for “Marketing Support” wherein Mastercard agreed to “reimburse [Heritage] for actual out-of-pocket, third party expenses incurred ... in directly promoting Mastercard Card issuance, activation and usage, including, without limitation, the production, mailing or other execution of marketing material prominently featuring Mastercard Cards.” The agreement further provides for monetary incentives payable to Heritage “in U.S. dollars at the end of such Year” calculated on “base Qualified Volume” and “Incremental Qualified Volume” generated by Heritage. The agreement defines “Qualified Volume” as “offline, signature-based Volume generated by Mastercard Cards to the extent that such Volume undergoes the process of authorization, clearing and settlement by Mastercard [subject to certain exclusions].” Further, the agreement incentivizes Heritage to reach a minimum card volume over a four year period called a “Cumulative Qualified Volume Requirement” by obligating Heritage to repay money Mastercard previously paid the bank if the volume goal is not met:

Customer [bank] shall cause the aggregate amount of Qualified Volume generated during the period that begins on the first day of Year One and ends on the last day of Year Four to be equal to or greater than [content redacted] (the “Cumulative Qualified Volume Amount”). If the aggregate amount of Qualified Volume generated by Customer in such period is not equal to or greater than the Cumulative Qualified Volume Amount, then Customer shall pay to Mastercard a portion on the Sign-on bonus reflecting the shortfall in the Cumulative Qualified Volume Amount...

The Record also contains copies of Mastercard’s contracts with South Carolina Federal Credit Union, Charleston, SC and Conway National Bank, Conway, SC.

²⁵ The Mastercard Brand Agreement with Heritage obligates Heritage to “abide by all present and future [Mastercard] Rules.”

accept Mastercard for payment must abide by restrictions contained in the Rules governing the use of Mastercard marks:

A Merchant is prohibited from using the Card face design to indicate acceptance in Merchant advertising or other signage, other than signage for a Co-brand Program in which the Merchant is a Co-brand Partner. A Merchant may display an Issuer-specific Card face design in Merchant advertising and any other signage that is not used to signify acceptance.

The Rules, as well as other documents in the Record, such as a 2010 Licensing Agreement, make it clear that the Mastercard marks are owned by Mastercard and are used by banks and other entities pursuant to a license, which, of course, makes such use subject to Mastercard's control.²⁶ Significantly, Mastercard is a worldwide brand and its Rules create goodwill and trust, which contributes to the reasons why a Cardholder uses, and a Merchant accepts, the Mastercard-branded credit/debit card. Hawkins therefore opined that Mastercard is involved in credit card transactions even before a card is presented as payment. Based on the Record, the Court agrees with this opinion.

Mastercard's argument that it generates revenue only at the MIP or data center stages²⁷ ignores what is perhaps the most valuable service that Mastercard offers - its Network of software, hardware and Rules that allow a Cardholder and a Merchant to connect and complete a transaction without immediate payment.²⁸ It is misleading to declare that Mastercard is only a limited

²⁶ In section 4.2.5, Signage System, the Rules provide:

The Corporation's interlocking circles signage system is employed when one or more brand using the Mastercard interlocking circles device is accepted at a point of interaction [defined earlier as Merchant location]. The system requires the consecutive vertical or horizontal display of the brand Marks in the following sequence – Mastercard, Mastercard Electronic, Maestor, Cirrus. Of the four brands, only those brands that are accepted at a particular point of interaction may be display there. The Mastercard Electronic band mark must not be displayed on an ATM.

²⁷ Mastercard offered two possibilities for the location of its income producing activity at the hearing: the Missouri data centers or the MIPs locations.

²⁸ Mastercard's position that its income-producing activity occurs only at the MIP or data center stages is not supported by the Record. While the Court accepts Mastercard's description of its activities at the MIP stage, it rejects the notion that the Mastercard Network ends at the MIP. The Mastercard Network extends to the Merchant and it can be accessed by the Cardholder to consummate transactions. It is of no consequence to this analysis that the card swipe machines at the Merchant locations are not owned by Mastercard. These devices are the means by which the Mastercard Network, owned, maintained and

participant in the transaction process. Breaking the transaction process into several small steps to create the perception that each step is made in isolation from the others does not reflect reality. In sum, as offered by Professor Hawkins, the Mastercard Network consists of a “technological network that is providing and taking information and funds, and there’s human relationship and rules network that Mastercard controls the whole transaction by putting rules on everybody in the transaction.” Based on the Record, to include the Rules and various contracts between Mastercard and its Member Banks, the Court agrees that Mastercard exerts its control and/or influence over all parties to the transaction, to include the Merchant, Issuer and Acquirer Banks and the Cardholder.

(d) Professor Hawkins’ Opinion that the Mastercard Network is Mastercard’s Revenue Generator.

There are three drivers of Mastercard’s fees generated by South Carolina transactions: the number of transactions, the dollar volume of transactions, and number of Merchants. The Acquirer Banks pay fees for Mastercard’s transmission of the Issuer Banks’ authorization decisions and communication of clearing and settlement information. The 2016 Mastercard Cost Letter lists an Annual Merchant Location Fee that Acquiring Banks pay to Mastercard based upon the total number of Merchants accepting Mastercard branded credit cards, including Merchants located in South Carolina. Inasmuch as there are Merchants in South Carolina that use the Mastercard Network, these Merchants are generating revenue for Mastercard. In short, the more Merchants in South Carolina that accept Mastercard credit and debit cards, the more fees are paid to Mastercard.

Likewise, Issuer Banks pay fees to Mastercard based on the number and dollar volume of Cardholder transactions. Professor Hawkins referenced Mastercard’s 2009 Cost Letter, which shows Issuer Bank assessments that occur based on the gross dollar volume of transactions, including, of course, transactions initiated in South Carolina. There are fees paid to Mastercard related to the number of card transactions and there are fees related to the dollar amount of those transactions. Again, as the volume of transactions in South Carolina increases, so do the fees paid to Mastercard. The 2009 Cost Letter also shows fees related to the use of ATMs and debit cards.²⁹

operated by Mastercard, enables Cardholders to use their Mastercard-branded cards to buy goods and services at Merchant locations.

²⁹ The Cost Letters in the Record demonstrate that the fees charged by Mastercard to its Members are largely based on the number of Merchant/ Cardholder transactions and the dollar amounts of those transactions.

Professor Hawkins observed that Mastercard advertises to Cardholders. Advertising to Cardholders benefits Mastercard because the more Cardholders that use Mastercard branded cards, the more revenue is generated for Mastercard as more Cardholder transactions create more fees. Mastercard generates fee income by having all four parties operating in the Mastercard Network. If the Merchant and the Cardholder fall out of the transaction, Mastercard generates no revenue. While Issuer and Acquirer Banks pay fees to Mastercard as a result of transactions which occur in South Carolina, Cardholders and Merchants generate fees to Mastercard upon sales of goods and services. Merchants pay fees to Acquirer Banks and Cardholders pay fees to Issuing Banks; some or all of these per-transaction fees are paid by these banks to Mastercard.

The U.S. District Court in *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation* (hereinafter “*Payment Card I*”), 986 F. Supp. 2d 207 (E.D.N.Y. 2013), *rev'd and vacated*, 827 F.3d 223 (2d Cir. 2016) (“*Payment Card II*”), provided an overview of the Visa/Mastercard credit card transaction as follows:

A Visa or Mastercard credit card transaction involves five parties: (1) the customer [Cardholder]; (2) the merchant; (3) the “acquiring bank”; (4) the “issuing bank”; and (5) the network itself, that is, Visa or Mastercard. The acquiring bank is the link between the network and the merchant that accepts the card for payment. The issuing bank is the bank that issued the credit card to the customer. When the cardholding customer presents a credit card to pay for goods or services, the accepting merchant relays the transaction information to the acquiring bank. The acquiring bank processes the information and transmits it to the network. The network relays the information to the issuing bank, which approves the transaction if doing so is consistent with the cardholder's account status and credit limit. The approval is conveyed to the acquiring bank, which in turn relays it to the merchant.

The issuing bank then transmits to the acquiring bank the amount of the purchase price minus the “interchange fee.” The acquiring bank withholds an additional fee—called the “merchant discount fee”—for its processing services. Thus, the total amount the merchant receives for the transaction is the purchase price minus the sum of the interchange fee and the merchant discount fee.

Interchange fees vary based on factors that include the type of card used and the type of merchant. Many Visa and Mastercard credit cards provide rewards to the cardholders. Those rewards cost money, and thus these cards, referred to in the industry and here as “premium cards,” are associated with higher interchange fees.³⁰

³⁰ It is of no consequence to the analysis for the instant case that the *Payment Card I* court's description of the card transaction seems to separate the transaction into discrete steps such that the Issuing and Acquiring

986 F.Supp.2d at 214.

As such, the Court finds that Mastercard's fees are generated by the transactions between Cardholders and Merchants. While these are paid by Issuer and Acquirer Banks, the source of the fees is the transaction between Cardholders and Merchants facilitated by the Mastercard Network.

(e) Professor John Swain's Opinion that the Department's Position is Good Tax Policy.

The Department's second expert was Professor John Swain.³¹ Professor Swain was previously recognized as an expert by the ALC in *Dish DBS Corp. v. S.C. Dep't of Revenue*, No. 14-ALJ-17-0285-CC (S.C. Admin. Law Ct. Feb 10, 2015), *aff'd*, 2018 WL 5733487 (S.C. Ct. App. filed 2018); and *DIRECTV, Inc. v. S.C. Dep't of Revenue*, No.14-ALJ-17-0158-CC (S.C. Admin Law Ct. June 12, 2015), *aff'd*, 421 S.C. 59, 804 S.E.2d 633 (Ct. App. 2017). In both *Dish* and *DIRECTV*, Swain was qualified as an expert in the field of state and local tax policy. For the purposes of this litigation, Mastercard conceded that Professor Swain is an expert in state and local tax policy and this Court recognized him as such.

Professor Swain opined that the Department's assessment of income taxes to Mastercard was good tax policy and he offered four bases for the opinion: (1) the Department's determination reflects South Carolina's contribution to Mastercard's income, which, according to Professor Swain, is the purpose of the gross receipt factor; (2) the Department's determination is consistent with South Carolina's manner of attributing receipts from the sales of intangible personal property

Banks seem to be the only parties in the system that have contact with the Mastercard Network. Instead, the court's reference to the Acquiring Bank as "the link between the network and the Merchant that accepts the card for payment" must be emphasized. It is through this "link" that the Mastercard Network has a presence here in South Carolina that extends to the Merchant and facilitates the exchange of information, and ultimately funds, in order to consummate sales transactions in this State.

Finally, it must be noted that although the decision in *Payment Card I* was reversed and vacated by *Payment Card II*, the U.S. Court of Appeals in *Payment Card II* referred approvingly to "detailed information about how the credit card industry operates" as set out in *Payment Card I*. 827 F.3d 223, 287-288.

³¹ Swain is a law professor emeritus at the University of Arizona and an adjunct professor in the University of Alabama's L.L.M. program. Beginning in 2001 he taught state and local tax, federal tax, corporate income tax, advanced corporate income tax, international tax, estate and gift tax, property, estates and trusts, and professional responsibility. Professor Swain has published roughly 50 articles on tax related issues, including an article in *Tulane Law Review* on the attribution of receipts for state corporate income tax purposes, which is directly related to the issues addressed in his testimony to the Court. Swain also co-authored the learned treatise on state and local taxation with Walter Hellerstein.

and intangibles on a destination basis, and that there is no principled reason why the rule should be different for services; (3) the Department's determination is consistent with the legislature's intent of taxing the market rather than attributing receipts based on payroll or property, which Professor Swain believes would discourage people from locating property and payroll in the state; and (4) the Department's determination discourages tax planning and other tax avoidance behaviors by not sourcing Mastercard's income based on the location of its MIP machines. Swain testified that the Department's position "attributes Mastercard's receipts to the state that provides the demand for Mastercard services.... And that's good tax policy because it's the purpose of the gross receipts factor to reflect the market state's contribution to a taxpayer's income."

Secondly, Swain believed the Department's determination is good tax policy because it is "consistent with the manner in which South Carolina attributes the receipts from sales of tangible personal property and intangibles, which is ... where the product is used. There is no principle[d] reason why the rule should be different for services than it is for tangible or intangible property. South Carolina provides the market for credit card transactions that occur here and, as a result, income from those transactions should be sourced to South Carolina."

Third, Professor Swain opined that the Department's position is consistent with the intent of the legislature, which has mandated use of only the sales factor for the attribution of receipts to the South Carolina numerator.³² South Carolina has chosen to solely tax sales and not to tax payroll and property. To attribute receipts based on where property and/or payroll is located would discourage economic development because that attribution rule creates a disincentive to locating property and payroll in the state. Furthermore, according to Swain, the sales factor reflects demand, which is important because income is produced by supply and demand. Mastercard is creating demand for its service in South Carolina so that attributing the resulting income for the purposes of taxation to the market that provides the demand is good tax policy.

³² Allocation and apportionment are governed by S.C. Code Ann. § 12-6-2252, which was enacted in 2007. Previously, allocation and apportionment were addressed in § 12-7-1140 (from the 1976 Code), which applied to tax years 1978-1995 and § 12-6-2250 (from the 2000 Code), which applied to tax years 1996-2001. Sections 12-7-1140 and 12-6-2250 were both repealed by the time § 12-6-2252 was enacted. The enactment of § 12-6-2252 marked a significant change in South Carolina's income tax law because it moved South Carolina from income apportionment based on sales, property, and payroll to income apportionment based solely on sales. In tax parlance, South Carolina is now a "single factor" state rather than a "three factor" state. The Sales factor is defined within S.C. Code Ann. § 12-6-2280 and sets forth that the sales factor is a fraction in which the numerator is the total sales of the taxpayer in this State during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year.

Fourth, Swain testified that the Department's position is good tax policy because it discourages tax planning and other tax avoidance behaviors. Attributing sales to the state of Mastercard's market makes it much harder for a taxpayer to manipulate the rule. A taxpayer cannot reduce its tax liability by moving the market to a low income tax jurisdiction. For example, sourcing income to South Carolina based on the location of the transaction discourages Mastercard from dictating that MIPs must be located in a low tax jurisdiction. Swain suggested that government should avoid any tax policy that leads to distorting economic behavior.

Finally, Professor Swain offered that if all of Mastercard's income was sourced to Missouri it would not be subject to tax because Missouri is a market sourcing state.

CONCLUSIONS OF LAW

The Administrative Law Court has subject matter jurisdiction over this matter. S.C. Code Ann. § 1-23-600(A) (2005 & Supp. 2023); § 12-60-460 (2014). A contested case hearing before the ALC is heard *de novo*. *Marlboro Park Hosp. v. S.C. Dep't of Health and Envtl. Control*, 358 S.C. 573, 579, 595 S.E.2d 851, 854 (2004). This Court must make its factual findings based on the preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (2005 & Supp. 2023). Because Mastercard is challenging the Department's Determination, it has the burden of proof. *See* SCALC Rule 29(B); *see also DIRECTV, Inc. v. S.C. Dep't of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017) (finding the burden of proof in a corporate income tax case rested on the taxpayer: "the party asserting the affirmative issue in an adjudicatory administrative proceeding has the burden of proof") (*citing Leventis v. Dep't of Health and Envtl. Control*, 340 S.C. 118, 132033, 530 S.E.2d 643, 651 (Ct. App. 2000)). Thus, to prevail in this contested case, Mastercard must prove by a preponderance of the evidence that the Department's Determination is incorrect. *Id.*

Corporate income tax in South Carolina "is imposed annually at the rate of five percent on the South Carolina taxable income of every corporation ... transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C. Code Ann. § 12-6-530. In South Carolina, a corporation's taxable income "is computed using the Internal Revenue Code with modifications as provided by South Carolina law, and this amount is 'subject to allocation and apportionment as provided in Article 17 of this chapter.'" *Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue*, 388 S.C. 138, 694 S.E.2d 525 (2010) (quoting S.C. Code Ann. § 12-6-580). "If a

taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.” S.C. Code Ann. § 12-6-2210(B); *see also Lockwood Greene Eng'rs, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987) (“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.’”) (quoting *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 95, 142 S.E.2d 445, 446 (1965)).

Our Supreme Court has previously held that “the apportionment formula is a reasonable basis for establishing the income tax of corporations [that] ... do business on a multistate level.” *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 419, 418 S.E.2d 542, 544 (1992). In South Carolina, the nature of the taxpayer's business in the State determines the method of apportionment a taxpayer must use. *DIRECTV, Inc.*, 421 S.C. 59, 70–71, 804 S.E.2d 633, 639 (Ct. App. 2017). The relevant statute to this case is § 12-6-2295(A)(5), which provides:

(A) The terms “sales” as used in Section 12-6-2280 and “gross receipts” as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:

* * *

(5) receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State.

S.C. Code Ann. § 12-6-2295(A)(5).

Based upon the entirety of the evidence, Mastercard has not met its burden. The Record demonstrates that Mastercard generates revenue by charging fees based on the number of credit and debit transactions that use Mastercard branded cards and the gross dollar volume of those transactions. The transactions are initiated when Cardholders present Mastercard branded credit or debit cards to accepting Merchants as payment for goods and services. These transactions are possible only because Mastercard has created a payment system that connects Cardholders, Merchants, and their respective Issuing and Acquiring Banks, so that the exchange of goods and services is acceptable to all parties without simultaneous payment by cash or check. That payment system, which is known as the Mastercard Network, is present and operating in South Carolina.

Therefore, Mastercard's income producing activity is providing Network access to Cardholders, Merchants, and banks; that activity occurs, in part, in South Carolina. Accordingly, Mastercard owes income taxes to the state according to subsections 12-6-2290 and 12-6-2295(A)(5) of the South Carolina Code.

I. Apportioning and Sourcing Income to South Carolina.

The Court's analysis begins with an examination of the statutory method established by the South Carolina General Assembly for apportioning and sourcing the income of multistate businesses to South Carolina. "The obvious purpose of the apportionment formula is the determination of income from business activities within this State and is a proper subject for legislative action. *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 65, 212 S.E.2d 574, 577 (1975) (citing *State Ex Rel. Maxwell v. Kent Coffey Manufacturing Co.*, 204 N.C. 365, 168 S.E. 397, 90 A.L.R. 476, *affd. per curiam*, 291 U.S. 642, 54 S.Ct. 437, 78 L.Ed. 1040 (1934)). See also *Eastman Kodak*, 308 S.C. 415, 419, 418 S.E.2d at 544 ("[T]he apportionment formula is a reasonable basis for establishing the income tax of corporations which ... do business on a multistate level."). The method of apportionment applicable to any particular taxpayer depends upon the nature of the taxpayer's business in this state:

Although exactness in apportionment is desirable, all that is required is a reasonable approximation. "Furthermore, this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of appellant, and has declared that 'rough approximation rather than precision' is sufficient. *Illinois Central Ry. Co. v. State of Minnesota*, 309 U.S. 157, 161 (1940). Unless a palpably disproportionate result comes from an apportionment, a result which makes it patent that the tax is levied upon interstate commerce rather than upon an interstate privilege, this Court has not been willing to nullify honest state efforts to make apportionments." *International Harvester Co. v. Evatt*, 329 U.S. 416, reh. den., 329 U.S. 834 (1947).

Covington Fabrics v. S.C. Tax Comm'n, 264 S.C. 59, 66-67, 212 S.E.2d 574, 577 (1975).

Mastercard is a service provider that is not regularly engaged in the sale of tangible personal property. Mastercard's income is derived from providing access to a Network that facilitates credit card transactions between Merchants and Cardholders throughout the country, including South Carolina. Section 12-6-2290 of the South Carolina Code instructs taxpayers on how their net income should be apportioned to South Carolina pursuant to a "gross receipts" apportionment method: "[T]he taxpayer shall apportion its... net income using a fraction in which

the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year.”

Next, subsection 12-6-2295(A)(5) requires a taxpayer to calculate the gross receipts from South Carolina (the numerator) by sourcing all sales to South Carolina to the extent that the income producing activity was performed here.³³

II. Defining the Source and Location of Mastercard’s Income Producing Activity.

The Department’s longstanding policy with respect to the application of section 12-6-2290 and subsection 12-6-2295(A)(5) is to examine a taxpayer’s industry to determine what revenue should be sourced to South Carolina. For example, when sourcing the income of a multistate engineering firm, the income-producing activity is providing engineering services, so the income is sourced to the location of the engineer. *Lockwood Greene Engineers, Inc. v. S.C. Tax Comm’n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

The most recent published appellate decision on sourcing of income is from the South Carolina Court of Appeals in *DIRECTV, Inc. v. S.C. Dep’t of Revenue*, 421 S.C. 59, 78, 804 S.E.2d 633, 643 (Ct. App. 2017).³⁴ The Court of Appeals noted that “the service DIRECTV provides...is the delivery of high quality television entertainment.” *Id.* at 77. Thus, the court determined that DIRECTV’s income producing activity was “the delivery of its programming signal to its customers across the country and in South Carolina.” *Id.* While *DIRECTV*, *Lockwood Greene*, and other sourcing decisions are informative, none are dispositive as to the sourcing issues presented in the instant case. Nevertheless, this Court believes the principles underlying these decisions to be helpful here.

³³ This code section states:

(A) the terms “sales” as used in Section 12-6-2280 and “gross receipts” as used in Section 12-6-2290 include, but are not limited to , the following items if they have not been separated allocated....(5) receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State.”

³⁴ The Court of Appeals also decided, and Mastercard has referenced, *Dish DBS Corp. v. S.C. Dep’t of Revenue*, No. 14-ALJ-17-0285-CC (S.C. Admin. Law Ct. Feb 10, 2015), *aff’d*, 2018 WL 5733487 (Ct. App. 2018), which dealt with similar issues to *DIRECTV* with similar results. *However*, the appellate court’s *Dish* order was issued as an unpublished decision, which has no substantive precedential value. *See* Rule 268(d)(2), SCACR.

First, Mastercard was doing business in South Carolina during the audit period inasmuch as its Network was providing services to South Carolina Cardholders and Merchants and generating revenue from fees paid to it for various transaction related purposes. S.C. Code Ann. § 12-6-530. During the Department’s Audit Period, Mastercard processed over 1.2 billion credit card transactions in South Carolina with a total value in excess of \$73.5 billion. During that same time, the gross dollar volume of Mastercard debit card transactions in this State was about \$9.7 billion spread across almost 190 million transactions. Mastercard entered into contracts with its Member Banks in South Carolina, requiring them to, among other things, issue a minimum amount of credit cards to Cardholders,³⁵ follow all of the Mastercard Rules (and ensure that Merchants do the same), and pay Mastercard fees based on the usage of those cards by Cardholders. Mastercard also licensed its marks for use in South Carolina and advertised in this State.

Second, the Record is replete with evidence that Mastercard’s income producing activity is the provision of a payment systems Network that facilitates cashless transactions. The Network produces income for Mastercard through the fees that Mastercard charges for use of the Network. Ruby Naskiewicz, a Mastercard employee and witness, conceded that “the higher the dollar volume, there would be more fees...” and “the more transactions there are, the more the total fees the bank would owe to Mastercard...” Mastercard acknowledges this relationship in its Annual Reports:

³⁵ Mastercard Rules section 2.6, Obligation to Issue Cards, also requires certain Members to issue a requisite number of cards:

Each Class A Member, together with its Sponsored Affiliate Members, must have issued and outstanding a reasonable number of Cards based on such criteria as the Corporation may deem appropriate from time to time. In addition to any other action the Corporation deems appropriate, a Class A Member that does not issue and have outstanding the requisite number of Cards will be assessed an additional 20% of the assessment paid on its acquiring volume for each year in which the Card issuing shortfall exists. (emphasis added.)

The Rules define a “Class A Member” as an “Association Member” and/or a “Principal Member.” Each of these categories of Member “participates directly in Activity.” “Activity” is further defined as “[t]he undertaking of any act that can be lawfully undertaken only pursuant to License by the Corporation.” The Rules further provide for an “Affiliate Member” that only “participates indirectly in Activity” and must be sponsored by a Principal Member.

Mastercard generates revenue by charging fees to our customers for providing transaction processing and other payment-related services and by assessing our customers based primarily on the dollar volume of activity, or gross dollar volume (“GDV”), on the cards that carry our brands.... [T]he payment network we operate supports what is often referred to as a “four party” payment system. Using our transaction processing services, issuers and acquirers who are our customers facilitate payment transactions between Cardholders and Merchants throughout the world, providing Merchants with an efficient and secure means of receiving payment, and consumers and businesses with a convenient, quick and secure payment method that is accepted worldwide.

Mastercard notes in its financial reporting the positive correlation between the number of credit and debit card transactions and an increase in its revenue.³⁶ In every year of the audit period, Mastercard reported an increase in revenue which followed an increase in the number of Cardholder transactions. In all but one year of the audit period, Mastercard reported an increase in the gross dollar volume (GDV) of transactions.

In its 2013 Annual Report, Mastercard declared that its increased revenue was “primarily driven by increased growth in dollar volume of activity on cards carrying our brands and the number of transactions processed by the company....”.³⁷ Similar representations are made in each of the last four Annual Reports during the audit period. Notably, Mastercard’s Annual Report for 2008 makes evident that its revenue is proportional to cardholder transactions:

We generate revenues from the fees we charge our customers for providing transaction processing and other payment-related services. We also earn revenues by charging our customers assessments based on the GDV of activity on the cards that carry our brands. Accordingly, our revenues are impacted by the number of transactions that we process and by the use of cards carrying our brands. (emphasis added.)

To be clear, the transaction-based fees are charged only when there is a transaction initiated by a Cardholder using a Mastercard branded card at an accepting Merchant’s location. These transactions, which are possible because of the licensing of Mastercard’s marks, accessing the

³⁶ Cardholders and Merchants make no direct payments to Mastercard. Mastercard’s fees are nominally paid by the Acquirer and Issuer banks. Nonetheless, Cardholders and Merchants actually pay Mastercard fees as there would be no fees paid at all without Cardholder/Merchants transactions and the fees associated with those transactions.

³⁷ This language supports the Court’s finding that Mastercard’s revenue is directly proportional to Cardmember use of Mastercard-branded credit and debit cards both in terms of the number of transactions and the transaction amount. The Rules define “Volume” as the “aggregate value of a group of Transactions” and continues to state that “Volume does not mean the number of transactions.”

Mastercard authorization platform, complying with Mastercard's Rules, and participating in the Mastercard clearing and settlement process, occur, in part, in South Carolina. Granting the right to use the Mastercard Network to South Carolina Cardholders and Merchants also allows Mastercard to produce income in the form of transaction fees and GDV fees. In other words, without Mastercard's permission to use the marks, access to Mastercard's Network, compliance with the Mastercard Rules, and consent to Mastercard's clearing and settlement processes, there could be no Mastercard-branded transactions in South Carolina for which Mastercard would earn associated fees.

Relying on *DIRECTV*, Mastercard disagreed with the Department's identification of its Network as the income-producing activity, and also took issue with the Department's use of receipts from Cardholder transactions as a proxy for Mastercard's income-producing activity. According to Mastercard, its income producing activity is the delivery of transactional messages to the MIPs of its respective Issuer and Acquirer Banks. Mastercard contends that this income producing activity ends at its MIPs. Therefore, according to Mastercard, its income should be sourced to the locations where Mastercard delivers these messages - which occur at its MIP locations outside of South Carolina.

Moreover, Mastercard argues that the Issuer Banks and the Acquirer Banks are its customers insomuch that it receives revenue from these customers based on their receipt of approval or denial messages related to Cardholder transactions. Mastercard contends that its true income producing activity is the delivery of messages to and from these customer banks, and that this conclusion is supported by the Court of Appeals' decision in *DIRECTV*. There, the appellate court found that "DIRECTV's primary income-producing activity is the delivery of the signal to the customer because this activity actually generates income for DIRECTV." *DIRECTV*, 421 S.C. 59, 77, 804 S.E.2d 633, 643 (2017). The *DIRECTV* court continued to state that "While the other activities occurring prior to the delivery of signal are important for DIRECTV in that it can help lead to income, section 12-6-2295(A)(5) requires activities that actually produce income." *Id.* Mastercard asserts that similar logic applies here insomuch as the fees paid by its customer banks in South Carolina for messages exchanged through Mastercard's out-of-state MIPs are actually what produces Mastercard's income.

Mastercard further insists that even if the income producing activity is the provision of its Network beyond its MIPs, the larger operations of its Network are not present in South Carolina

(but rather in Missouri and New York) and thus, Mastercard owes no income tax here. That claim is based on testimony from Mastercard's three witnesses but is unsupported by the totality of the Record. Ms. Naskiewicz testified that the term "Mastercard Network" refers to either or both of two networks: (1) the association of Mastercard's Issuer and Acquirer Banks and (2) the Mastercard "physical network," which consists of Mastercard's hardware and software, including its MIPs and data centers.

III. Mastercard is Subject to South Carolina Corporate Income Tax.

Mastercard's business is actually the provision of a payment systems Network that enables card transactions between Cardholders and Merchants. Mastercard's Network is broader than the association of customer banks or the data processing facilities that these banks, and Mastercard, use to transmit transactional information. The Mastercard Network connection extends to the Merchant and the Merchant's customers (Cardholders). *See Payment Card I*, 986 F.Supp.2d 207 at 214 (highlighting the extent by which Merchants could be subject to Mastercard's Rules). It is through this Network that Merchants and Cardholders are informed whether purchases for goods and services are approved or declined. Even if, as Mastercard claims, its direct participation in transaction processing does not begin until the MIP stage, the Network that Mastercard hosts, controls and maintains, extends to the Merchant and Cardholder and transmits messages to those parties.

Mastercard additionally levies a robust fee structure that incentivizes and disincentivizes behavior of its Acquirer and Issuer Banks, which in effect further influences the behavior of Merchants and Cardholders. Inasmuch as Cardholders buy goods and services in South Carolina using Mastercard-branded cards and Merchants receive transaction approval/denial messages here, the preponderance of the evidence before the Court does not support Mastercard's claim that its Network is not in South Carolina. Instead, the Court finds that Mastercard is doing business in South Carolina and generates revenue in the State through the presence of its Network and the transactional activity that its presence facilitates.³⁸ As such, the Court further finds that Mastercard is subject to South Carolina income tax.

³⁸ Ms. Naskiewicz testified that the term "Mastercard Network" refers to either or both of two networks: (1) the association of Mastercard's Issuer and Acquirer Banks and (2) the Mastercard "physical network," which consists of Mastercard's hardware and software, including its MIPs and data centers. Significantly, she emphasized that the Network was "more of a relationship, a relationship in terms of the business

The Court cannot accept Mastercard's assertion that its income is generated or produced solely by the services it performs for Issuer and Acquirer Banks. As alluded to earlier, the Court recognizes that these banks nominally pay fees to Mastercard. However, the overwhelming evidence in the Record leads to the conclusion that actual source of Mastercard's fees and thus, its income, are the transactions between Merchants and Cardholders. Without the Cardholders purchasing goods and services from Merchants and the parties employing the Mastercard Network to consummate these transactions, none of Mastercard's five streams of income would exist.³⁹

a. Mastercard's Customers are Not Solely Issuer and Acquirer Banks.

Mastercard's witnesses testified unequivocally that its only customers were the Issuer and Acquirer Banks, not Cardholders and Merchants. Mastercard contends that its income producing activity cannot be in South Carolina because its customers – the Issuers and Acquirers – are located elsewhere. Mastercard argues that there is no South Carolina authority even suggesting that the acts of a taxpayer's customers' customers – here Merchants and Cardholders - can be the income producing activity. As indicated earlier, the Court rejects Mastercard's assertion.

transactions between parties, the acquirer and the issuer bank.” Ms. Naskiewicz also testified that the Mastercard logo appears on the front of its branded cards so that the Merchant and Cardholder can “determine whether or not that store or business actually accepts that – that network, so Mastercard in our case.” As already noted, according to Mastercard's documents, the “authorization platform” is a part of the Mastercard network and it extends to the “points of interaction,” which is Mastercard's term for the point of sale at Merchant's locations.

³⁹ In its proposed order, Mastercard characterizes this point – that Mastercard would not generate income at all without the Merchants' and Cardholders' transactions – as a “but for” test, and asserts that the court in *DIRECTV* rejected a similar argument offered by the taxpayer in that case. According to Mastercard, the taxpayer in *DIRECTV* maintained that certain of the taxpayer's activities such as marketing, customer services, and producing television shows were necessary to the generation of income and that without them, *DIRECTV* could generate no income. The Court of Appeals characterized these activities as “income anticipatory” (or preparatory) and ruled that the true income producing activity was *DIRECTV*'s delivery of the satellite signal to the customer's set top box.

Here, Mastercard says that the Cardholders' “swipe” “helps to lead” to the generation of income for Mastercard but “in and of itself, it [card swipe] produces no income” and further, the customers' swipe “does not cause Mastercard to perform any activities.” Mastercard seeks to ignore the pervasive role played by the Mastercard Network in these credit/debit card transactions. It cannot be overlooked that the true sources of Mastercard's income are the transactions between Merchant and Cardholders because of the fees generated by these interactions. The Mastercard Network is just not infrastructure as the *DIRECTV* court called some of that taxpayer's preparatory activities. Instead, the Mastercard Network, governed by the Rules which regulate every step in the transaction process, connects all participants in the Mastercard four party model and controls every aspect of card transaction processing.

First, even if the Court were to accept Mastercard's position that the Issuers and Acquirers are deemed located at the place of their MIPs, that is irrelevant because the location of the taxpayer's customer is not dispositive. *See Lockwood*, 293 S.C. at 449. Second, even if Mastercard's position is correct, it does not excuse Mastercard from the obligation to pay some South Carolina income taxes because, during the Audit Period, there were Mastercard Issuer and Acquirer Banks located in South Carolina.

Moreover, and more importantly, based on all of the evidence, the Court does not accept Mastercard's contention that Cardholders and Merchants are also not Mastercard's customers. Mastercard promotes its cards and services to both Cardholders and Merchants, has designed specific benefits for each, and generates income based on their activities. The Merchants and Cardholders, who, because of the Mastercard Network, are able to consummate cashless transactions, are beneficiaries of Mastercard's services. The determination that Merchants and Cardholders - like Mastercard's Issuer and Acquirer Banks- are also customers of Mastercard, adds additional support for the conclusion that Mastercard's income producing activity is partially within South Carolina.⁴⁰

Mastercard strenuously asserts that (1) Cardholders and Merchants are customers of the Issuer and Acquirer Banks (in other words, that Cardholders and Merchants are "customers of Mastercard's customers"); and (2) no South Carolina precedent stands for the proposition that a taxpayer's income-producing activity can be based on the activity of its "customers' customers". The Department's Rule 30(b)(6) witness could not identify any such precedent during his deposition and the Department's auditor, Orville Sharpe, who testified during the hearing, could not identify any situation where income taxes had been imposed on a taxpayer in such a situation.

To support its position that courts have refused to "look through" to a taxpayer's downstream customer, Mastercard cites cases from other jurisdictions as persuasive authority. In *Wisconsin Dep't of Revenue v. Microsoft Corp.*, 2019 WI App 62, 389 Wis. 2d 350, 936 N.W.2d 160, the Wisconsin Court of Appeals refused to uphold a franchise tax assessment imposed on royalties Microsoft received from the licensing of its software to computer manufacturers, all of which were located outside the state of Wisconsin, who then sold computers to customers located

⁴⁰ The Court recognizes that there are no formal contracts between Mastercard and the Merchants and Cardholders. Nevertheless, primarily through the Mastercard Rules, Mastercard exercises its control and orchestrates every aspect of the Mastercard Network, to include the activities at the point of sale between Merchants and Cardholders.

in Wisconsin. The Wisconsin Department of Revenue (DOR) issued its proposed assessment claiming that Microsoft owed franchise taxes because Wisconsin consumers bought computers with Microsoft software installed.

The applicable Wisconsin tax statute, WIS. STAT. § 71.25(9)(d), similar to that in South Carolina, imposed franchise tax on sales of intangibles if the income producing activity occurs in Wisconsin. The lower tribunal (Commission) determined that the royalties paid to Microsoft by manufacturers “should not be included ... because those royalties were not [the result of] income-producing activities in Wisconsin.” 389 Wis. 2d at 361, 936 N.W.2d at 166. Significantly, the Wisconsin DOR did not contest this issue at the appellate court but instead sought to rely upon an exception to the sourcing statute applicable to taxpayers which provided that “[g]ross receipts from the use of computer software are in this state if the ... licensee uses the software in Wisconsin.” *Id.* The appellate court held that Wisconsin consumers using Microsoft software installed on computers purchased from out of state manufacturers were not “licensees” as that term was used in the statute such that Microsoft was not liable for franchise taxes under the exception. *Id.* at 389 Wis.2d 366-367, 936 N.W. 2d at 168-169.⁴¹

As an initial matter, the Wisconsin *Microsoft* case is not applicable here because Mastercard’s income producing activity is the operation of its Mastercard Network allowing Merchants and Cardholders to consummate cashless sales of goods and services. Further, that Network is present in South Carolina. Nevertheless, there are issues raised in the Wisconsin *Microsoft* case that bear some mention here.

In an argument similar to that made by the Department here, the Wisconsin Department of Revenue offered that the transactions between Microsoft, the computer manufacturers and end user consumers must be “viewed as a whole” and that the determination that consumers were not licensees of Microsoft was “myopic” and “disregarded the economic reality of the transactions.” *Microsoft Corp.*, 2019 WI App 62 at 29, 389 Wis. 2d 350 at 364, 936 N.W.2d at 160. The *Microsoft* court reiterated that the end users still did not fit into the term “licensees”, in part, by observing the soundness of the lower tribunal’s findings that “the end users did not purchase software and software licenses from, and [were] not customers of, Microsoft” and that “there was no direct

⁴¹ Although the Wisconsin court observed that the computer software users were “sublicensees” for the use of the software, it held that the statutory exception applied only to “licensees” and not to “sublicensees”. *Id.* at 363, 936 N.W. 2d at 166-167.

relationship between Microsoft and its end-users.” *Id.* The appellate court further examined the end user agreements and found that they were contracts only between the end user and computer manufacturers.

This Court believes there is a relationship between MasterCard, the Merchants, and Cardholders. Without Merchant and Cardholder transactions using MasterCard branded cards, MasterCard would earn no fees. The Record is replete with documents wherein Mastercard acknowledges that the more cardholder transactions that occur in terms of absolute numbers, and in terms of greater dollar amounts, the more revenue Mastercard earns. Every completed Merchant and Cardholder transaction results in fee income to Mastercard. And, while the Issuer and Acquirer banks nominally pay these fees to Mastercard, the actual payors are the Merchants and Cardholders.

The Wisconsin *Microsoft* court considered the Wisconsin DOR’s position that consumer end users actually paid for the Microsoft software because they paid a “premium for the licenses to use Microsoft’s software, over the cost of the hardware alone” and rejected this theory by noting “the DOR’s argument is nothing more than a re-wording of the unremarkable proposition that OEMs [original equipment manufacturers] paid Microsoft for the software licenses, and the end-users paid OEMs for the sublicenses as part of the cost of the purchased computers.” The Wisconsin court continued:

Second, the DOR asserts that each end-user had a license with Microsoft because each paid Microsoft “indirectly” for the right to use Microsoft software. That is based on the DOR’s further assertion that “Microsoft receives these gross receipts [using the phrase in WIS. STAT. § 71.25(9)(df)] for end users’ licenses to use Microsoft’s computer software.”

The Commission rejected this argument and found that “Microsoft’s gross receipts were not a function of use by actual end-users.” We affirm the Commission’s finding because substantial evidence in the record demonstrates that the amounts paid to Microsoft by OEMs for the software licenses were not paid as a result of end-user payments to OEMs for the sublicenses as the DOR asserts. The Commission found, and the DOR does not dispute, that the obligations of OEMs to pay royalties to Microsoft for licenses did not depend on OEMs’ sales of the computers because OEMs were required to pay royalties to Microsoft even when OEMs did not sell the computers on which the Microsoft software was installed. Microsoft, in briefing in this court, relies on evidence in the record that Microsoft was paid by OEMs for the licenses months (if not years) before OEMs sold the

computers, with licensed Microsoft software included, to the end-users... The Commission further found, and the DOR does not dispute, that the royalties that OEMs paid to Microsoft were not tied in any way to the prices for which OEMs sold the computers, and that OEMs, not Microsoft, were entitled to the sale proceeds and profits from the sales of all of the OEMs' computers, including any amounts attributable to the software. Thus, the licensing royalties that OEMs paid Microsoft were not paid indirectly by the end-users.

389 Wis.2d at 367-368, 936 N.W. 2d at 169.

The Wisconsin *Microsoft* court's affirmance of the lower tribunal's decision is based primarily on its determination that the "licensee" exception to the income producing statute did not apply because the end users were not licensees as contemplated by the statute. This is not at issue in the present case as the operation of the Mastercard Network in South Carolina is Mastercard's income producing activity. Moreover, the Wisconsin court's decision was influenced by the lower tribunal's conclusion that "Microsoft's gross receipts were not a function of use by actual end-users" in that the record did not substantiate that "the amounts paid to Microsoft by OEMs for the software licenses were paid as a result of end-user payments to OEMs for the sublicenses as the DOR asserts." Here, the evidence establishes Mastercard's gross receipts resulted from Cardholder/Merchant transactions. The Court is not persuaded that the Wisconsin *Microsoft* case has any bearing on the decision in the instant case.

Mastercard next cites *LendingTree, LLC v. Washington Department of Revenue*, 12 Wash. App. 2d 887, 460 P.3d 640 (2020). There, the relevant Washington sourcing statute imposed B&O (business and occupation) tax on a taxpayer based on the location "[w]here the customer received the benefit of the taxpayer's service". *Id.*, 12 Wash. App. 2d 887, at 891, 460 P.3d 640, at 642. The taxpayer in that case was an online loan marketplace that matches prospective borrowers with potential lenders, and the taxpayer's customers were the various lenders that paid referral fees to the taxpayer in order to be connected with potential borrowers. At issue was whether the taxpayer should have sourced its income based on the location of the potential borrowers, rather than the taxpayer's customer-lenders. The analysis required the court to determine where the taxpayer's lender-customers received the benefit of LendingTree's services for the purpose of apportioning B&O tax. The parties did not dispute that the taxpayer's services were the various referrals provided to its customer-lenders, who received no value from the taxpayer unless the referrals connected them with potential borrowers. However, the parties disputed where the benefit of these services should be deemed received. The taxpayer contended that its customer-lenders received

the benefit of its services at the lenders' business locations, which was where the lenders received and evaluated the loan referrals. In contrast, the Washington DOR argued that the benefit to the lender-customers was received at the location where "the consumer [borrower] seeking the information is located." *Id.*, 12 Wash. App. 2d 887 at 892, 460 P.3d 640 at 642 (2020).

The appellate court rejected the Washington DOR's argument that the benefit of the taxpayer's services should have been sourced to the location of the borrowers who utilized the taxpayer's website in order to be connected with potential lenders. The appellate court found that LendingTree's customers (institutional lenders) received the benefit of LendingTree's services at the lenders' locations, and as such, these locations constituted the location where the taxpayer's receipts should have been sourced.

Here, Mastercard offers *LendingTree* as an example of courts rejecting an end-user theory that sources a corporate taxpayer's income to the location of the "taxpayer's customer's customer". In *LendingTree*, the taxpayer's customers were the institutional lenders that paid fees to the taxpayer in order to be connected with potential borrowers. As such, the location of the borrowers was not the location where the "customer benefits from the service". *Id.* 12 Wash. App. 2d 887 at 894, 460 P.3d 640 at 643 (2020). Mastercard asserts that similar logic applies here, in that Issuer and Acquirer Banks are its customers, and Cardholders and Merchants are "customers of Mastercard's customers".

In *LendingTree*, applicable Washington statute looks to the taxpayer's customer and the location where that customer receives the benefit of the taxpayer's services, while the South Carolina statute looks to the taxpayer and location of the taxpayer's income producing activity. The customer in the Washington case was the lender – the only entity that the Wisconsin appellate court referenced as having paid any fee to LendingTree. Here the Department has shown that the Merchant and Cardholder are customers of Mastercard inasmuch as it is their transaction that generates the fees to Mastercard. To use the *Lending Tree* court's analysis, the Merchant and Cardholder certainly receive the benefit of Mastercard's services because their transaction could not be consummated without operation of the Mastercard Network.⁴²

⁴² Mastercard cites two other cases as persuasive authority, *Defender Security Co. v. McClain*, 162 Ohio St. 3d 473, 165 N.E.3d 1236 (2020), and *Walter Dorwin Teague Associates, Inc. v. Dep't of Revenue*, 20 Wash. App. 2d 519, 500 P.3d 190 (2021). Mastercard offers these cases as examples where courts rejected taxation based on the "customer's customer rationale.

In *DIRECTV*, the court looked to the source of DIRECTV'S income to determine the company's income producing activity for the purpose of South Carolina taxation:

We note DIRECTV states its principal aim is to “package and deliver high quality video entertainment” to subscribers, and that it is not a media broadcaster, but “is a producer of original content and a multichannel video programming distributor, whose revenue is derived from fees paid by its customers for rentals of set-top boxes and subscriptions to its programming services.” Stated differently, the service DIRECTV provides to its approximately twenty million nationwide customers is the delivery of high quality television entertainment. Its clients pay DIRECTV for the delivery of its television programming packages and for the equipment to process the signal DIRECTV sends to its customers. Thus, as a service provider, DIRECTV's IPA [income producing activity] is the delivery of its programming signal to its customers across the country and in South Carolina.

In *Defender*, the Ohio tax authority denied a refund claim filed by Defender Security Company, an Indiana based corporation, on the grounds that the state's Commercial Activity Tax (CAT) applied to Defender's receipts generated by the assignment or sale of Ohio residents' alarm contracts to ADT, which was located in Colorado. The Ohio court granted the refund upon its review of a statute which allowed Ohio to tax gross receipts where “gross receipts[are] situated to this state [Ohio] under section 5751.033 of the Revised Code.” *Defender*, 162 Ohio St. 3d 473, 477, 165 N.E.3d 1241. In part, section 5751.033 provided that to determine the situs of gross receipts, “[t]he physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere.” *Id.*, at 477-478, 165 N.E.3d at 1241. The Court ultimately ruled that the purchaser of the assigned contracts—ADT—received the benefit of the contract assignments/sales transactions in a place other than Ohio such that the CAT tax did not apply to this source of Defender's receipts. *Id.*, at 478, 165 N.E.3d at 1242. Aside from the differences between the Ohio and South Carolina statutes, it is the Court's conclusion that Merchants and Cardholders are customers of Mastercard and received the benefit of the Network—Mastercard's income producing activity—in South Carolina.

Walter Dorwin Teague Associates is another case under the state of Washington's B&O tax regime. Teague, a Washington firm which created interior designs for airplanes, sold its designs to the Boeing Corporation, which was also located in Washington. Boeing would use the designs to assemble/construct airplanes which Boeing then sold to airlines located outside of Washington state and used in other areas of the country. Boeing paid Teague for the airplane interior designs and had ownership of the designs. *Teague*, 20 Wash. App. 2d 519, 520-522, 500 P.3d 190, 192 (2021).

Teague sought a B&O tax refund from the Washington DOR claiming that the revenue from its sales of airplane designs to Boeing should have been sourced to the location of the airline—the purchaser of the plane from Boeing—because that location was where the “customer” received the benefit of Teague's services. *Teague*, 20 Wash. App. 2d 519, 522-523, 500 P.3d 190, 193 (2021). The Washington Court rejected this claim and ruled that Boeing was Teague's customer inasmuch as Boeing paid Teague for the interior designs and received the benefit of the same as Boeing was able to incorporate the design into its construction of the airplane. *Id.*, at 528-531, 500 P.3d at 195-197. Here, the Court, believes the *Teague* case, like *LendingTree*, does not serve to alter the Court's conclusions, here, inasmuch as Cardholders and Merchants are also Mastercard's customers.

Last, we find DIRECTV's *Mercury Motor* argument unpersuasive. The "preparatory" activities that DIRECTV engages in for the production of its programming and marketing are not an IPA for the purposes of section 12-6-2295(A)(5). We note Dr. Cody testified these activities were conducted "in anticipation" of customers signing up for DIRECTV's services and DIRECTV engages in these activities "in anticipation of future profits." Accordingly, these activities cannot be IPAs because they do not produce income, but rather, are "income-anticipatory" activities. DIRECTV's primary income-producing activity is the delivery of the signal to the customer because this activity actually generates income for DIRECTV. While the other activities occurring prior to the delivery of signal are important for DIRECTV in that it can help lead to income, section 12-6-2295(A)(5) requires activities that actually produce income. Thus, we agree with the ALC and find that these activities are "too attenuated" to be considered income-producing for the purposes of section 12-6-2295(A)(5).

DIRECTV, 421 S.C. 59, 77, 804 S.E.2d at 642.(emphasis added)

Mastercard asserts that its fees are paid solely by its Issuer and Acquirer Banks; that these entities are Mastercard's only customers; and further, that these customer banks are the entities that pay for the approval/denial messages regarding Cardholder transactions. As indicated earlier, the Court believes the evidence demonstrates that Merchants and Cardholders are also Mastercard's customers as they are the true fee generators from Mastercard's income producing activity -- the Mastercard Network.

The *DIRECTV* court characterized DIRECTV's pre-signal delivery activities - which the company claimed were income producing activities - as "income anticipatory" (or "preparatory") activities that occurred prior to the delivery of the satellite signal to homeowners' television sets. *DIRECTV*, 421 S.C. 59 at 78, 804 S.E.2d 633, 643 (Ct. App. 2017). Identifying Mastercard's income producing activity as the operation of its Mastercard Network does not fit neatly within this "income anticipatory" framework from the standpoint of timing as the trigger for the income payments is at the beginning of the transaction not at the end as was the case in *DIRECTV*. Nevertheless, it is the Court's conclusion that the relay of messages to Mastercard's MIPs regarding Cardholder approval or denial, while certainly necessary to the transaction, is not what

generates income for Mastercard; instead, Mastercard's income is generated by the transaction between the Merchant and Cardholder when they utilize the Mastercard Network.⁴³

Mastercard advertises extensively through a variety of media. Its "Priceless" campaign is well-known. Mastercard also sponsors many sporting events. According to Mastercard's 2008 Annual Report, the targets of its advertising are both Cardholders and Merchants.

Our advertising plays an important role in building brand visibility, usage and loyalty among Cardholders globally. Our award-winning 'Priceless' advertising campaign has run in 51 languages in 110 countries. The 'Priceless' campaign promotes Mastercard acceptance and usage benefits that permit Cardholders to pay for what they need, when they need it. It also provides Mastercard with a consistent, recognizable message that supports our brand positioning. In order to promote usage of our cards, we conduct frequent promotions on a regional and national basis, often in conjunction with Merchants or our customers.

In short, Mastercard targets Cardholders and Merchants to increase the use of Mastercard's credit and debit cards, but also claims that they are not its customers. This is not a credible claim. Professor Hawkins testified that people obtain Mastercard branded cards because they are persuaded by Mastercard advertisements. Merchants decide to accept Mastercard credit cards because they know about the brand through Mastercard's advertising and understand the potential for generating business from more customers (Cardholders) by accepting Mastercard-branded credit and debit cards. As demonstrated by the excerpts from the Annual Reports and Member Agreements cited earlier, Mastercard also spends on member incentives and advertising to convince Merchants to accept Mastercard. Similarly, a Cardholder trusts that the Merchant will protect the Cardholder's information because of Mastercard's involvement. Mastercard's Rules, which are applicable to every participant in the four-party model, are critical to the development of trust in the Mastercard Network.

Professor Hawkins relied on several Mastercard documents to refute Mastercard's contention that it has no relationship with Merchants. In fact, Mastercard is involved at all stages of the transaction throughout the Network. For example, Mastercard allocates the risks among the

⁴³ In *Dish DBS Corporation v. S.C. Dep't of Revenue*, Op. No. 2018-UP-404, 2018 WL 5733487 (S.C. Ct. App. filed Oct. 31, 2018), the Court of Appeals referenced the Department of Revenue's expert witness' characterization of the taxpayer's necessary, but not primary, income producing activities as "intermediate inputs." This is an apt characterization for Mastercard's approval/denial message delivery to its MIPs. These communications are necessary to the function of the Mastercard Network but the primary income producing activity is the operation of the Network to consummate transactions between the Merchant and Cardholder.

parties by determining which party bears the loss if there is a fraudulent transaction or a payment default. Also, on its public website, Mastercard provides Terms of Use that show Mastercard does not grant a license to use its trademark to everyone in the world; only Merchants who accept a Mastercard payment brand are authorized to display the Mastercard marks. It is important for Mastercard to control the use of its marks because its marks have value in facilitating transactions between Cardholders and Merchants. Displaying the Mastercard logo demonstrates that the Merchant and the transaction are governed by the Mastercard Rules, which means the Cardholder can trust the security of the transaction.

In addition to the licensing agreements, Mastercard controls Merchants through its contracts with Acquirer Banks. The Mastercard Authorization Manual governs not only the conduct of the Acquirers, but also directs the conduct of Merchants by mandating the terms of contracts between Acquirers and Merchants. While Mastercard firmly characterizes the Manual as a “customer-facing” manual applicable only to Acquirer and Issuer Banks, Ken Cavallo, Mastercard’s senior operations engineer for Mastercard, acknowledged the Manual as “instructions, directives, requirements...that is helping the acquirer and issuer set their policies to be compliant with Mastercard.” For instance, the Manual limits Merchants’ actions in response to an authorization message and requires Merchants to inform a Cardholder of certain information based on a pre-authorization. A Merchant must follow the Rules in order to remain part of the Network. Although the Manual does not contractually bind Merchants, it does indicate that Acquirers face compliance penalties if the Acquirer’s Merchants do not follow the Rules, and further, explains how a Merchant could face penalties imposed by an Acquirer Bank if such rules are not followed.

Mastercard further mandates terms that Acquirers must include in their agreements with Merchants. For instance, the Mastercard Rules compel an Acquirer to “ensure that all of its Merchants, ATM Terminals, and PIN-based In-branch Terminals prominently display the appropriate Acceptance Marks at the Point-of-Interaction (POI), wherever payment options are presented.” Similarly, the Mastercard Rules prohibit a Merchant from using the Mastercard card face design to indicate acceptance in Merchant advertising or other signage. The Rules additionally require Merchants “to honor all valid [Mastercards] without discrimination when properly presented for payment.” Merchants have gone so far as to challenge Mastercard’s mandates in court proceedings. *See e.g. In re Visa Check/Mastermoney Antitrust Litigation*, 297 F.Supp.2d

503 (E.D.N.Y. 2003) (awarding attorneys' fees to the Merchant class attorneys as a result of litigation over antitrust implications of Mastercard rule requiring Merchants who accept Mastercard credit cards to also accept Mastercard debit cards).

Mastercard also has many programs that are designed specifically for Merchants and the Merchants pay fees to Mastercard by way of the Acquirer Banks. Merchants may use the Purchase Account Status Inquiry service to determine if “a Cardholder account is open and not listed on the Electronic Warning Bulletin.”⁴⁴ Merchants may access Mastercard’s Expert Monitoring Real-time Fraud Scoring Service for Merchants through the Acquirers. Finally, Mastercard acknowledged in its 2011 Annual Report that it entered “into arrangements with selected Merchants under which these Merchants receive performance incentives for the increased use of Mastercard programs or indicating a preference for Mastercard-branded programs when accepting payments from consumers.”

Mastercard also has programs that directly benefit Cardholders. Mastercard allows Cardholders to set controls on how, where, and when cards may be used and to establish spending rules by way of the “In Control Purchase Controls service platform.” Mastercard provides new credit or debit cards to Cardholders in the event of an emergency, has protocols that allow Cardholders to receive cash advances, and provides an ATM locator that allows Cardholders to find ATMs that accept Mastercard-branded cards. Mastercard also benefits Cardholders by way of its data cleansing suite of services, which gives Issuer Banks more detailed information regarding a Cardholder’s transaction, such as location and merchant information, for inclusion on a Cardholder’s billing statements. In turn, Cardholders benefit Mastercard by using their Mastercard branded cards, which generates fees that the Issuer and Acquirer Banks nominally pay to Mastercard but are actually paid by Merchants and Cardholders.

The Court finds that the witness testimony presented by Mastercard is less persuasive than the documentary evidence that was admitted by consent during the hearing. The Mastercard Rules and Manuals plus its Annual Reports are documents that Mastercard prepared for the purpose of governing its worldwide business operations or for complying with its federal reporting obligations. While Mastercard presented witness testimony regarding its business operations, this

⁴⁴ The Authorization Manual states that “[t]he Account Status Inquiry service for purchase transactions is an optional service that allows merchants to validate that a cardholder account is open and the account is not listed in the Electronic Warning Bulletin...” The description does not indicate whether the Merchant must first contact the Acquirer Bank to access this service.

testimony often contradicted the documentary evidence prepared by Mastercard for purposes wholly unrelated to this litigation. The Court considers the documents to be a more accurate representation of Mastercard's actual business operations.

Accordingly, the Court concludes that Mastercard's income producing activity is the provision of the Mastercard Network that facilitates cashless payments for goods and services. Each time a Cardholder uses a Mastercard credit or debit card, Mastercard is entitled to fees as shown in the Cost Letters admitted into evidence. Those fees are Mastercard's revenue, which is generated, in part, through Cardholder/Merchant credit and debit transactions in South Carolina.

To be clear, the Court finds that each of Mastercard's five revenue streams - (1) domestic assessment fees based on the gross dollar volume of Mastercard branded transactions; (2) cross border volume fees based on the gross dollar volume of Mastercard branded transactions; (3) transaction processing fees based on the number of Mastercard transactions; (4) other income based on the dollar amount of Mastercard's assessment fees, cross border dollar volume fees, and transaction processing fees, all of which are based on the gross dollar volume of activity generated by Cardholder/Merchant transactions; and (5) rebates and incentives that are contra-revenue – are subject to tax for transactions that occur in South Carolina. All of these streams of income are based on, and/or generated by, Merchant/Cardholder transactions.

b. The Department's Method for Allocating and Sourcing Mastercard's Income to South Carolina was Proper.

During the audit, Mastercard did not produce any data concerning the actual income generated by credit and debit card transactions initiated in South Carolina. Mastercard did, however, provide the exact number of credit card transactions initiated in South Carolina for every year of the audit period and the annual GDV of those transactions. Mastercard also provided the total number of transactions in the United States and total United States GDV for each year of the audit period. The Department used that information and Mastercard's federal taxable income to arrive at a proxy for the revenue generated as a result of credit and debit transactions initiated in South Carolina.

Mastercard is a service provider which must apportion income to South Carolina based on a fraction in which the numerator is Mastercard's gross receipts from within the state and the denominator is its gross receipts from everywhere. S.C. Code Ann. § 12-6-2290. This is South Carolina's standard apportionment method and it is the method that was used in this audit.

For each year of the audit, the Department ascertained the ratio of South Carolina GDV to GDV from the entire United States and of South Carolina transactions to all U.S. transactions. The Department then applied the appropriate ratio to the U.S. revenue for each of the five income streams to reach the South Carolina apportioned revenue from each income stream. The sum of the South Carolina portion of the five income streams for each year of the Audit Period was the Department's proxy for the South Carolina receipts, which is used in the numerator of the apportionment ratio. *DIRECTV, Inc.*, 421 S.C. 59, 80, 804 S.E.2d 633, 644 (Ct. App. 2017) (recognizing the use of a proxy as a reasonable approximation of income producing activity in South Carolina). The denominator of the apportionment ratio fraction was Mastercard's gross receipts taken from the Mastercard, Inc. and Subsidiaries' federal consolidated income tax return for each year of the Audit Period. The apportionment ratio was applied to the South Carolina adjusted federal taxable income to arrive at the South Carolina net income. Then the Department applied the corporate income tax rate (5%) to Mastercard's South Carolina net income to determine the income tax due. Mastercard owed a total income tax due \$6,041,666.

To determine the license fee, the Department applied the apportionment ratio to Mastercard's Total Capital and Paid in Surplus as reported on its annual financial statements. Then, as required by S.C. Code Ann. § 12-20-40, the Department applied a 0.1% tax to the South Carolina share of the Total Capital and Paid in Surplus and added \$15.00 to determine the annual license fee. In two of the ten years of the audit period, Mastercard was assessed the statutory minimum license fee of \$25.00. The total assessed license fee was \$84,476.

Mastercard did not offer any alternative proxy for calculating the South Carolina revenue generated as a result of its income producing activity here. Despite its comment regarding the Department's calculations at the time of the audit, at the hearing Mastercard criticized the Department's audit method. First, Mastercard pointed out that the auditor did not look to its customer billing information to determine gross receipts and, second, it noted that most of Mastercard's costs were incurred outside of South Carolina. Neither of these points undermines the Department's audit.

The Department did not request or consider the amounts billed by Mastercard to banks domiciled in South Carolina during the audit. There are Mastercard Cardholders in South Carolina whose issuing banks are not domiciled in South Carolina. Mastercard's own witnesses acknowledged that a Cardholder from out of state may use his or her Mastercard to make purchases

in this State. Thus, billing information only from South Carolina domiciled banks will represent only a fraction of the income generated by Mastercard from South Carolina out of the nearly 1.4 billion total credit and debit transactions during the audit period.

Secondly, the audit recognized that most of Mastercard's costs were incurred outside of South Carolina, but the Department considered such to be irrelevant to sourcing to South Carolina. *See* S.C. Code Ann. § 12-6-2295(A)(5). South Carolina is a "single sales factor" state and does not use cost-of-performance for the purpose of apportioning the income of service providers. As Professor Swain recognized:

[T]he sales factor ... is to reflect the contribution of the market state to the taxpayer's income.... I think the Department's position is consistent with the role of the sales factor – with the gross receipts factor. It's attributing the receipts to the market for Mastercard services, which is where ... the purchase or transaction occurs, and where the banks are lending money and agreeing to buy the receivable of the Merchant."

The Department's calculation of Mastercard's taxable income in South Carolina by way of a proxy was a reasonable approximation of its income from the income producing activity in South Carolina. This is particularly true in light of the fact that Mastercard did not produce its actual fee income from South Carolina initiated credit and debit card transactions or offer any alternative method for calculating its taxable income in South Carolina.

IV. Penalties and Interest

Civil penalties are applied to every South Carolina tax law which requires a return unless otherwise provided. S.C. Code Ann. § 12-54-43. Such penalties are considered a tax owed to this State. *Id.* The Department imposed "failure to file" and "failure to pay" penalties on Mastercard. Further, "[i]f any tax is not paid when due, interest is due on the unpaid portion from the time the tax was due until paid in its entirety." S.C. Code Ann. § 12-54-25(A).

a. Failure to File Penalties.

In South Carolina, a corporate taxpayer must file its income tax return with the Department on or before the fifteenth day of the third month following the taxable year. S.C. Code Ann. § 12-6-4970. When a taxpayer fails to timely file a tax return, five percent of the amount of the tax due

is levied as a failure to file penalty for each month during which the failure continues, up to twenty-five percent. S.C. Code Ann. § 12-54-43(C)(1).⁴⁵

In its Request for a Contested Case Hearing, Mastercard contended that it had no obligation to file income tax returns because it had no nexus with South Carolina. Mastercard eventually dropped that argument, conceding that it had income tax nexus with the State. It was undisputed at trial that Mastercard did not file corporate income tax or license fee returns during the Audit Period. By abandoning its nexus argument, Mastercard has acknowledged that it should have filed returns, even if it disputed that it earned income in South Carolina. *See* S.C. Code Ann. § 12-6-2210(B); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13 (1993) (holding that licensing intangibles for use in this state subjects one to income tax). Mastercard's concession that it had sufficient nexus with the State to subject it to a filing requirement is further supported by the fact that Mastercard began filing tax returns with South Carolina in 2017, the year following the Audit Period. The parties produced no evidence that Mastercard's business practices changed in any appreciable way during the period between the beginning of the Audit Period and 2017. Accordingly, the Department properly assessed penalties against Mastercard for failure to file corporate income tax returns for the Audit Period.

b. Failure to Pay Penalties.

South Carolina also penalizes taxpayers who fail to timely pay their taxes. The penalty is one-half of one percent of the amount due per month, up to twenty-five percent. *See* S.C. Code Ann. § 12-54-43(E). Taxpayers have a duty to pay the outstanding tax by the due date of the return and if taxes are not paid by the date due, the taxpayer is subject to penalties. *Id.*, S.C. Code Ann. § 12-54-43(E) is couched in mandatory terms:

In case of failure to pay any amount of any tax required to be shown on a return which is not shown, including an assessment within ten days of the date of the notice and demand for payment, there must be added to the amount of tax stated in the notice and demand one-half of one percent of the amount of the tax if the failure is for not more than one month, with an additional one-half of one percent for each additional month or fraction of a month during which the failure continues, not exceeding twenty-five percent in the aggregate.

⁴⁵ This subsection states: “[i]n the case of failure to file a return on or before the date prescribed by law, determined with regard to any extension of time for filing, there must be added to the amount required to be shown as tax on the return, a penalty of five percent of the amount of the tax if the failure is for not more than one month, with an additional five percent for each additional month or fraction of the month during which the failure continues, not exceeding twenty-five percent in the aggregate.

Nevertheless, the S.C. General Assembly has allowed the Department the discretion to waive penalties when circumstances warrant: “Unless otherwise specifically prohibited, the department may waive, dismiss, or reduce penalties provided for in this chapter.” S.C. Code Ann. § 12-54-160. The Department’s policy document, Rev. Procedure #08-6, Penalty Waiver, provides the following general rule:

A complete penalty waiver is appropriate when lack of performance required by a taxpayer is due to reasonable cause. The general standard for determining whether reasonable cause exists is whether the taxpayer exercised ordinary business care and prudence and was nevertheless unable to perform the act required. This question is one of fact and the burden of proof that the failure to perform is due to reasonable cause is on the taxpayer.

The Revenue Procedure continues to provide examples of situations where complete waiver of penalties should be considered. Section IV. F., suggests such a waiver when:

The delay or failure was caused by ignorance of the law in conjunction with other facts and circumstances such as limited education of the taxpayer or the lack of previous tax and penalty experience. For example, the taxpayer may have reasonable cause for noncompliance where difficult and complex issues are involved when reasonable persons differ as to the appropriate tax treatment of the issue and there is no Department guidance with respect to the issue. Also, the taxpayer may have reasonable cause if the failure was a result of a recent change in law or form revision and the taxpayer could not reasonably be expected to be aware of the recent change. However, this reason does not include ignorance of the law in situations where the taxpayer in the exercise of ordinary business care should have been aware of his tax obligations or consulted a tax advisor. (emphasis added.)

Subsection I of this section of the Revenue Procedure further states that complete penalty waiver may be appropriate when “[t]he taxpayer demonstrates good faith reliance on substantial, official written authority, such as case law, Department advisory opinions and instructions to South Carolina tax forms.”

While Mastercard is not an unsophisticated taxpayer with “limited education ...or the lack of previous tax and penalty experience”, the instant case is one where “difficult and complex issues are involved when reasonable persons differ as to the appropriate tax treatment of the issue.” *See Travelscape, LLC v. S.C. Dep’t of Revenue*, Docket No. 08-ALJ-17-0076-CC (Anderson, CJ, Feb. 12, 2009), *aff’d*, 391 S.C. 89, 705 S.E.2d 28 (2011) (ALC granted penalty waiver because of the complexity of the issues). Furthermore, as testified to by the SCRCF Rule 30(b)(6) witness in the instant case, “there is no Department guidance with respect to the issue.”

As such, the Court accepts Mastercard's assertion that it, in good faith, believed that its income tax position was consistent with the holding in *DIRECTV*. Despite the Court's conclusion to impose income taxes on Mastercard under the circumstances here - where the Merchants' and Cardholders' transactions actually generate Mastercard's income such that these entities are also its customers - Mastercard's position is not entirely unreasonable given that both the Department's Rule 30(b)(6) and testifying witnesses declined knowledge of situations where income taxes were imposed on a taxpayer as a result of what could be perceived to be of the actions of its customer's customer. Accordingly, because of the complexity of the issues presented, the Court finds that Mastercard exercised ordinary business care and prudence such that the majority, but not all, of the failure to pay penalties the Department has levied against Mastercard should be waived.

Despite its position that it owed no tax, Mastercard had an obligation to file income tax returns during the Audit Period in South Carolina because it was doing business in the State. As a result, license fees are owed to the State for each of the years during this period. Accordingly, for each of Audit Years, given that the Court has determined that the failure to pay penalties for tax generated by Mastercard's income producing activity should be waived, the failure to pay penalties must be levied based on Mastercard's outstanding license fees owed for each of the years at issue.

c. Interest.

Interest on unpaid tax obligations is mandatory. *See* S.C. Code Ann. § 12-54-25(A) ("If any tax is not paid when due, interest is due on the unpaid portion from the time the tax was due until paid in its entirety."). "Interest is not a penalty." *Anonymous Taxpayers, Petitioners*, No. 01-ALJ-17-0187-CC, 2001 WL 1744519 (Dec. 13, 2001). Interest is compensation allowed by law for the use or forbearance of money. *Rosen v. U.S.*, 288 F.2d 658, 660 (3rd Cir. 1961). Because Mastercard failed to timely pay the taxes and fees due to the State, interest is due and continues to accrue until the income tax and license fees are paid.

CONCLUSION AND ORDER

Mastercard's contention that its purpose in a credit/debit card transaction is to connect Issuer and Acquirer Banks ignores the reality of a credit/debit card transaction. At the hearing, Mr. Cavallo testified that the Mastercard Network extended only as far as the MIPs. The Court has instead determined that the Mastercard Network extends to the Cardholder and Merchant at the Merchant's location. The overarching purpose of the Mastercard Network is to allow a Merchant

and a Cardholder to complete a cashless sales transaction and not to simply convey approval or denial messages back and forth between banks.

In its Annual Reports during the Audit Period and in the Mastercard Rules, Mastercard repeatedly emphasizes that the value of Mastercard – and its ability to generate revenue – is based primarily on the ability of Cardholders to purchase goods and services from Merchants using the Mastercard Network. Because Mastercard’s fees are calculated from the number of transactions and the dollars spent on them, the more Cardholders and Merchants that are using the Mastercard Network, the more revenue Mastercard generates. Mastercard has acknowledged for years that its income is produced by providing a Network that connects Cardholders and Merchants for the purpose of engaging in cashless transactions. The control that Mastercard exercises over the parties and the mechanism of a transaction demonstrate clearly that Mastercard generates revenue because a Cardholder uses a Mastercard-branded card to make a purchase at an accepting Merchant’s location.

Thus, Mastercard’s income producing activity is providing a payment Network in South Carolina allowing South Carolina Merchants and consumers to sell and buy goods and services. While it was undisputed that Mastercard engages in certain transaction processing functions at locations outside of this state, those functions are secondary to the activity that truly generates revenue. Recognizing Mastercard’s income producing activity occurs in South Carolina reflects the evolution of the State’s income tax code from a three-factor model to the single sales factor. South Carolina provides a market for Mastercard’s business. There are millions of transactions that take place here every year; the resulting income should be sourced to South Carolina and taxed accordingly.

Finally, the Department properly calculated Mastercard’s taxable income. The Department is fully authorized to use a proxy for determining taxable income, particularly when the taxpayer does not produce evidence of its South Carolina income during the audit.

IT IS THEREFORE ORDERED that Mastercard pay, in full, the assessed tax of \$6,041,666, plus \$84,476 in license fees and \$1,560,722 in interest plus all additional interest accrued through the date of this Order. Mastercard also owes failure to file penalties. The failure to pay penalties are partially waived as provided herein and Mastercard is liable for failure to pay

penalties calculated only upon its license fee obligations for each tax year during the Audit Period.⁴⁶

IT IS SO ORDERED.



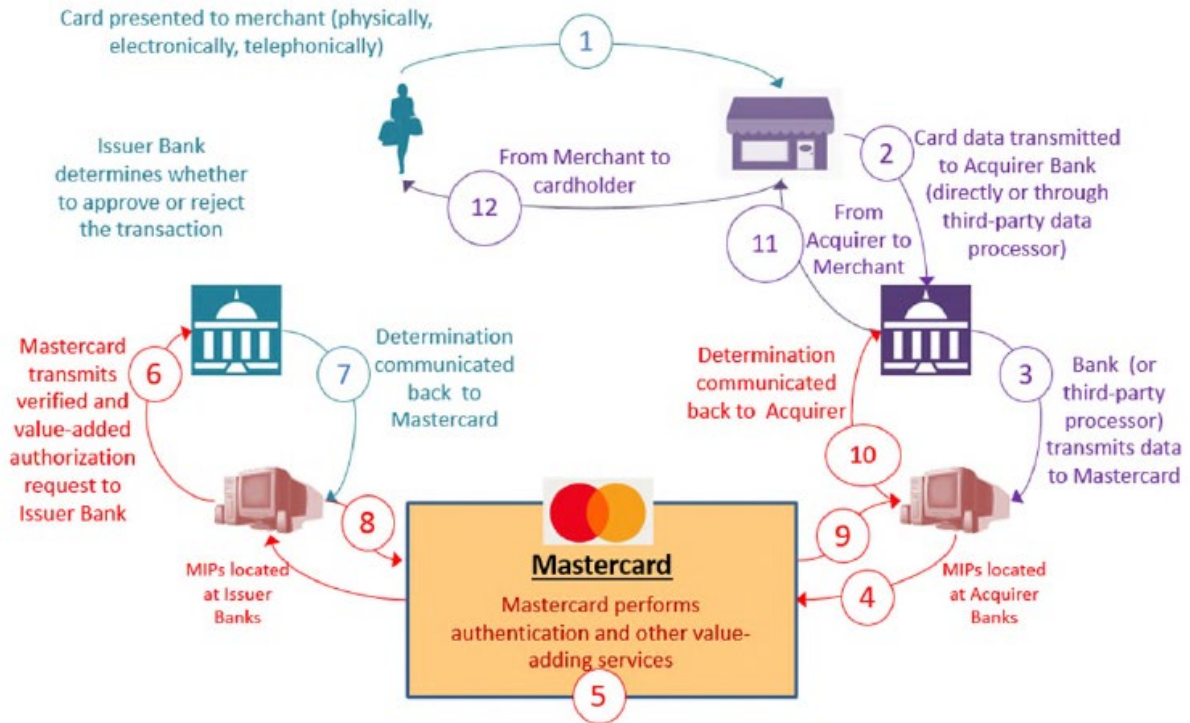
Milton G. Kimpson
South Carolina Administrative Law Court

Columbia, South Carolina
June 3, 2024

⁴⁶ The Department has the responsibility of determining the amount of the failure to file penalty and communicating the same to the Court and to Mastercard.

ATTACHMENT A

AUTHORIZATION



CERTIFICATE OF SERVICE

I, Robert Reid hereby certify that I have on this date served this order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).



Judicial Law Clerk

June 3, 2024
Columbia, South Carolina