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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT
Milton G. Kimpson, Administrative Law Judge

Case No. 20-ALJ-17-0008-CC
Appellate Case No. 2024-001252

Mastercard International Incorporated, Appellant,

v.

South Carolina Department of Revenue, Respondent.

FINAL BRIEF OF APPELLANT

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II. Did the ALC abuse its discretion by allowing the Department of Revenue's proffered expert, Jim Hawkins, to testify and by relying on his testimony to support key aspects of its decision notwithstanding its findings that the witness lacked relevant knowledge, experience, and candor toward the court?

III. Did the ALC err in upholding the Department's imposition of penalties for failure to file under S.C. Code Ann. § 12-54-43(C)?

INTRODUCTION

The Legislature enacted industry-specific sourcing provisions for six specialized industries and one rule of general application for all other services. S.C. Code Ann. §§ 12-6-2295, 12-6-2310. Under that generally applicable rule, a service provider must compute its South Carolina corporate income tax based on where it performs its "income-producing activity." S.C. Code Ann. § 12-6-2295(A)(5). In DirecTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, 421 S.C. 59, 804 S.E.2d 633 (Ct. App. 2017), the Court determined that a service provider's income-producing activity is its final act of delivering the service to its paying customer, even though it may perform other critical activities before delivery, such as maintaining an overall network and advertising to potential customers. The ALC here misapplied § 12-6-2295 and DirecTV by creating a different sourcing rule that disregards Mastercard's final act of delivering its processing services

to its paying customers and instead identifying Mastercard's income-producing activity as the provision of an overall network, including advertising to potential customers.

The ALC's decision rests on unreliable testimony given by an unqualified expert. Rule of Evidence 702 requires the ALC to act as a gatekeeper to prevent unqualified expert testimony by ensuring that a proffered expert has requisite skill and knowledge to testify on the particular subject matter at issue. For one of the Department's proffered experts, Jim Hawkins, the ALC found that his "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," that he had only "limited knowledge of Mastercard's operations prior to this case," and that his repeated "omission" of responsive information about his employment had an "adverse impact" on the Court's evaluation of his "candor toward the Court." (R. 18, 20.) Yet the ALC allowed him to testify and relied on his testimony to support key aspects of its decision notwithstanding these findings regarding his knowledge, experience, and candor. The ALC's decision is erroneous and should be reversed.

STATEMENT OF THE CASE

Mastercard International Incorporated ("Mastercard") requested a contested case hearing at the ALC pursuant to S.C. Code Ann. § 12-60-460 to review a December 19, 2019 Determination of the Department of Revenue ("Department"), which upheld an assessment of corporate income tax for 2007 through 2016. The ALC held a hearing in March 2022, where it admitted Joint Exhibits 1 through 37, Petitioner's Exhibits 1 and 2, Respondent's Exhibit 1, and the parties' designated deposition statements of the Department's Rule 30(b)(6) representative, Robert King.

Three fact witnesses testified for Mastercard. Ruby Naskiewicz, Mastercard's Vice President of Federal Tax, who has worked for Mastercard for more than twelve years, testified

regarding Mastercard's general business operations, the activities that generate assessment fees, Mastercard's customers and revenue, and the Department's audit. (R. 259–433.) Kenneth Cavallo, a Senior Operations Engineer who has worked for Mastercard for four years, testified regarding Mastercard's authorization service, including Mastercard's role in authorization, how it performs those activities, who they are performed for, and where the services are delivered. (R. 438–513.) Joe Buehler, Mastercard's Senior Vice President of Technology Risk Management, who has worked for Mastercard for more than twelve years, testified regarding Mastercard's clearing and settlement services, including its role in each service, the activities it performs for each service, who those services are performed for, and where they are delivered. (R. 515–62.) Mastercard did not call an expert witness as it contended that the facts speak for themselves. (R. 7.)

One fact witness (Orville Sharpe, the lead auditor) and two expert witnesses testified for the Department. Expert witness John Swain testified for the Department regarding "market-based sourcing" concepts and the notion that services should be assigned like sales of tangible property (i.e., to where delivered) (R. 1007–1020), and proffered expert Jim Hawkins testified, over Mastercard's objection (see infra at 16, n.5; R. 18) regarding Mastercard's business, sources of income, and revenue-generating activities. (R. 725:6–9; R. 6520.)

On June 3, 2024, the ALC issued a Final Order and Decision upholding the Department's assessment of tax but partially abating penalties. (R. 53.) Mastercard moved for reconsideration on June 13, 2024, and the ALC denied the motion on July 2, 2024. (R. 1, 1125.) On July 30, 2024, Mastercard filed a Notice of Appeal to this Court. (R. 6614.)

STATEMENT OF FACTS

A. Mastercard's Operations and "Network"

Mastercard is a subsidiary of Mastercard Incorporated, a technology company in the

payments industry headquartered in Purchase, New York. (R. 261:15–17; R. 263:21.) Its primary business is transaction processing, which includes services known as authorization, clearing, and settlement. (R. 262:11–15; R. 263:1; R. 270:24–25; R. 271:2.) Mastercard participates in what the payments industry calls the "four-party" system. Despite this name, it includes five parties—Mastercard plus four other parties: (1) issuer banks, (2) acquirer banks, (3) cardholders, and (4) merchants. (R. 271:7–13; R. 272:15–18; R. 5342.)[1] Each party has a defined role in the system.

"Issuer banks" extend credit by issuing cards to cardholders who apply for credit or debit card accounts. (R. 273:25–274:3; R. 278:11–16; R. 2466.) "Cardholders" are the people or businesses that use credit or debit cards to make purchases from "merchants," who are sellers of goods or services. (R. 273:13–16, 20–24; R. 2457, 2470–71.) The issuer bank checks the applicant's creditworthiness and decides whether to extend credit. (R. 278:12–16.) If the bank chooses to, it will issue a card to the consumer under the bank's name, send billing statements to the cardholder, and receive the cardholder's monthly payments. (R. 279:11–15.) Mastercard is not involved in this process—it does not review cardholders' credit, issue cards, bill cardholders, or receive payments from cardholders. (R. 274:14–275:4; R. 278:8–279:15; R. 1065:25–1066:19.)[2] Mastercard does not enter into a contractual relationship with cardholders; it contracts with the issuer bank. (R. 275:5–276:20; R. 2824–30.)

"Acquirer banks" facilitate merchants' acceptance of credit cards from cardholders seeking to purchase goods or services. (R. 273:13–16; R. 274:8–10; R. 2456.) A merchant seeking to accept

[1] In a "three-party" system, the processor also acts as the issuer bank. This model describes the historic arrangements engaged in by Discover Bank and American Express. (R. 277:22–278:3.)

[2] The ALC found that Mastercard's fees are "nominally" paid by banks but "actually" paid by cardholders and merchants. (R. 34, 37, 40, 47.) This is factually wrong and contrary to the Department's own concessions that only banks pay fees to Mastercard (R. 1066, 1068, 1070) as well as other testimonial and documentary evidence. This is addressed further infra § I.E.

credit or debit payments must apply to an acquirer to establish a relationship. (R. 279:18–25.) If the acquirer accepts the merchant, it will facilitate the merchant's acceptance of credit cards, which can include providing the point-of-sale device the merchant may have at a cash register to allow a cardholder to swipe, insert, or tap a card. (R. 274:8–21; R. 279:16–25; R. 348:12–25.) Mastercard is not involved in this process—it does not review merchants' applications or receive transaction-related payments from merchants.[3] (R. 276:21–277:1; R. 348:12–25; R. 1066:3–19; R. 1068:1–12; R. 1069:22–1070:2; R. 1071:5–10.) Nor does it own or use point-of-sale devices or connect to or deliver messages to them. (R. 348:12–349:10; R. 443:23–444:23; R. 469:2–23; R. 473:5–474:5.) Mastercard does not contract with merchants for transaction processing services; it contracts only with the acquirer bank. (R. 276:5–7, 21–23; R. 422:18–19; R. 432:4–7; R. 2824–30.)

Only the issuer and acquirer banks are Mastercard's customers.[4] (R. 274:14–16; R. 290:15–19; R. 1065:25–1066:19; R. 1067:24–1068:12; R. 1069:20–1070:2; R. 1071:5–10.) Each issuer and acquirer bank enters into a contract with Mastercard, called a Mastercard License Agreement, and agrees to be bound by rules promulgated and enforced by Mastercard. (R. 275:14–17; R. 2824–30.) The rules provide guidelines that issuer and acquirer banks must follow to ensure the integrity of the payments ecosystem, including that issuer banks will remit funds for transactions they authorize and that acquirer banks will enforce fraud-prevention measures. (R. 372:15–373:25; R. 1375.)

[3] Mastercard derived a small amount of revenue from consulting services, which are not at issue and are available to all types of customers. (R. 263:1–7.) Thus, Mastercard may derive consulting revenue from companies that happen to be merchants, but it does not receive the types of revenue at issue here from them. (R. 277:2–18.)

[4] The ALC found that cardholders and merchants are Mastercard's customers. (R. 37, 42, 44.) This is factually incorrect and contrary to the unequivocal testimony of the Department's own auditor that cardholders and merchants are not customers (R. 674:9–675:8; R. 681:7–25), as well as other testimonial and documentary evidence. This is addressed further infra § I.E.

The issuer and acquirer banks that contract with Mastercard are often referred to as Mastercard's "network," as in the network of banks that are part of Mastercard's payments ecosystem. (R. 285:12–286:22.) The term "network" is also separately used to describe Mastercard's physical network consisting of the hardware and software that composes its technology infrastructure. (R. 286:4–287:3.) The physical network consists of Mastercard Interface Processors, or "MIPs," and two large data centers in Missouri. (R. 286:4–287:3.) MIPs are computer hardware containing proprietary software that send and receive transaction request and response messages, and that are the points through which banks physically connect their equipment to Mastercard's physical network. (R. 301:13–19; R. 442:2–444:15; R. 469:4–8; R. 473:5–474:8.) Issuer and acquirer banks are the only parties that access Mastercard's physical network, and they do so predominantly via the MIPs. (R. 451:3–24.) MIPs are the endpoints of Mastercard's physical network, meaning it extends only as far as the MIPs. (R. 444:8–23; R. 450:6–21.)

One or more MIPs reside at the locations where each bank processes its payments transactions, which can be a facility maintained by the bank or a third-party processor the bank engages. (R. 301:20–302:20.) Mastercard does not determine the locations where banks set up their processing facilities, which dictates where MIPs will reside. (R. 280:23–281:11; R. 301:13–302:20; R. 313:7–18; R. 451:17–453:7.) Mastercard had up to 400 MIPs in the U.S. during the years at issue, and none were in South Carolina. (R. 5532; R. 329:15–330:1.) Several issuer and acquirer bank customers had billing addresses in South Carolina during the years at issue, and details regarding these South Carolina banks were admitted into the record. (R. 6600.)

Mastercard's two data centers, collectively referred to as the "central site," are located in Missouri. (R. 336:2–9; R. 445:2–23.) The 550,000 square foot data centers contain a vast

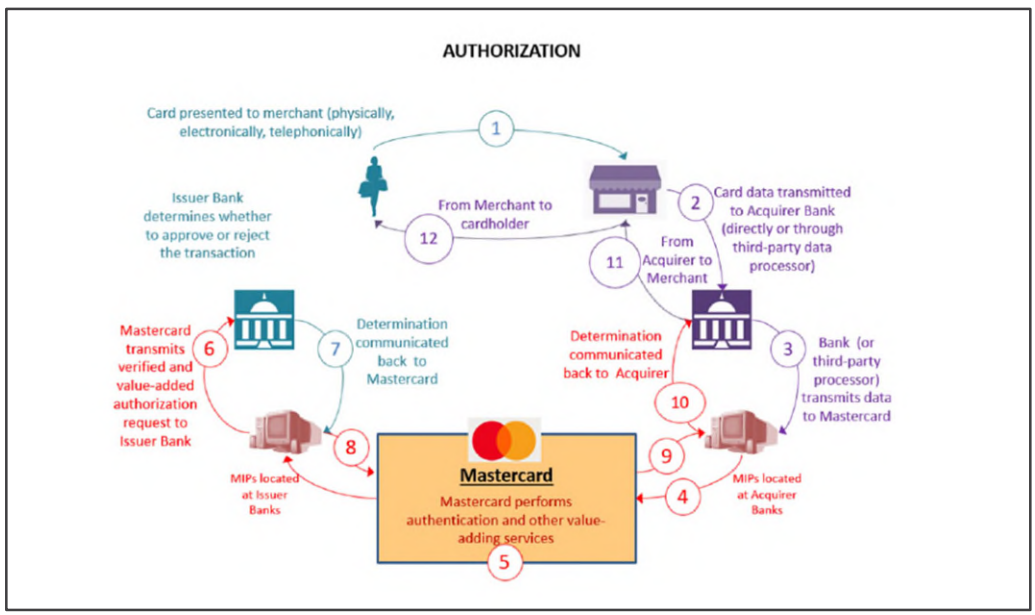
infrastructure of mainframe computers to process transactions. (R. 336:19–337:24; R. 443:4–18.) Mastercard did not maintain any processing equipment or property in South Carolina. (R. 5441–5532.) Details regarding Mastercard's property and payroll were admitted into the record. (R. 5441–5532.) The vast majority of Mastercard's employees were located in New York and Missouri. (R. 5530.) Mastercard had two or three remote employees in South Carolina, and negligible South Carolina payroll. (R. 612:1–3; R. 5530 (0.02% of total payroll in 2016)).

B. Mastercard's Services and Sources of Revenue

Mastercard receives the vast majority of its income from: (1) authorization; (2) clearing; (3) settlement; and (4) assessment. (R. 5545.) Each is discussed below.

1. Authorization

"Authorization" has two meanings in the payments industry, both relevant here. (R. 441:7–442:12.) First, it refers to the overall industry-wide process of seeking a payment approval or decline. (R. 441:7–21.) In this context, authorization starts with a cardholder's purchase attempt using a credit or debit card at a merchant's store or website. (R. 287:17–24; R. 441:7–17.) A diagram of the industry-wide process, with twelve discrete steps, is below and in the ALC's Order:



(R. 56, 2883.) The Department conceded that this diagram accurately shows the authorization process. (R. 1094:13–16.) The second use of the term "authorization" refers to the specific activities Mastercard performs for banks within this industry-wide process, as in Mastercard's authorization service—steps 4 through 6 and steps 8 through 10. This is the process for which Mastercard earns authorization fees. (R. 441:25–442:13.) This distinction in terminology exists because Mastercard is not involved in every step in the diagram above, as acknowledged by the Department. (R. 1094:1–1095:13; R. 304:2–305:13; R. 454:22–455:6; R. 468:6–22.)

The overall authorization process begins when a cardholder presents a credit or debit card to a merchant when purchasing goods or services (step 1 in the diagram). (R. 2883.) The merchant routes the transaction to its acquirer bank (step 2), and the acquirer bank then submits an authorization request to Mastercard via the MIP located at the acquirer bank's processing facilities (step 3). (R. 2883; R. 300:9–301:9; R. 442:9–12.) This is the point when Mastercard first becomes aware of the transaction and allows Mastercard's authorization service to begin. (R. 300:9–301:9; 441:25–442:12; R. 454:22–R. 455:3; R. 468:6–22; R. 1094:1–1095:13 (conceding that Mastercard does not become aware of the transaction until step 3).)

Once Mastercard's authorization service has begun, it validates the data provided by the acquirer bank (step 4). (R. 456:7–457:9.) Mastercard then performs additional functions, including optional value-added services like fraud protection, and adds additional information to the authorization request (step 5). (R. 2883; R. 456:13–459:17.) Mastercard then relays the authorization request to the bank that issued the card for it to decide whether to approve the transaction (step 6). (R. 2883; R. 459:21–461:4.) Mastercard delivers the request to the issuer bank via the MIP at the bank's processing facilities. (R. 442:2–8; R. 459:21–23.) The issuer communicates its decision to Mastercard by sending a transaction response message to the MIP at

the issuer's processing facilities (step 7). (R. 459:21–460:20; R. 465:4–15.) Mastercard then relays the issuer's decision to the acquirer bank, delivering that message to the MIP at the acquirer's processing facility (steps 8 and 9). (R. 2883; R. 464:23–465:15.) When the issuer's response is delivered to the acquirer bank—step 10—Mastercard's authorization service is complete. (R. 465:16–468:17.)

The acquirer bank then transmits the issuer's response to its merchant customer (step 11) and the merchant can complete its transaction with the cardholder (step 12). (R. 2883.) Mastercard is not involved in these two final steps and does not communicate or deliver anything to the merchant or cardholder. (R. 304:7–306:15.)

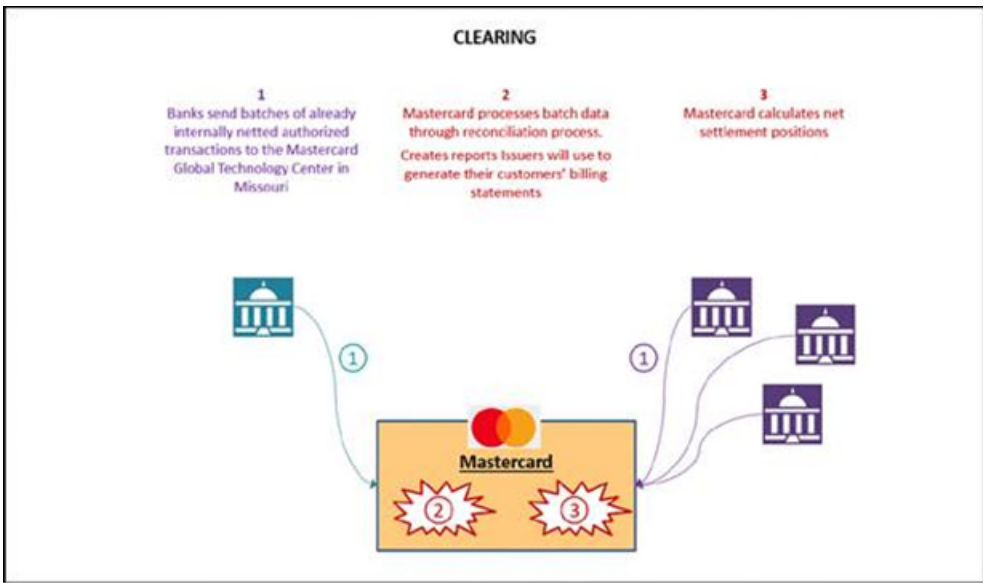
Mastercard charges an authorization fee to issuer and acquirer banks for each authorization request it processes. (R. 2787; R. 308:5–22; R. 395:17–19; R. 1066:9–19.) The Department conceded that Mastercard receives no authorization fees from cardholders. (R. 1066:12–19 ("Q. What is your understanding of the authorization fee? A. They charge a fee to the acquirer and the issuing banks in order for that credit card to be authorized. Q. Do cardholders pay Mastercard for authorization? A. No. They do not.").) Mastercard performs its authorization services at the MIPs and at its Missouri data centers. (R. 469:4–23.) None of Mastercard's authorization activities occur at merchant locations. (R. 472:16–474:5.)

2. Clearing

Clearing is a separate service from authorization, and 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 a clearing cycle. (R. 319:4–19; R. 474:6–8; R. 519:1–14; R. 527:15–23; R. 541:5–14; see generally R. 3402 (J. Ex. 13).) The clearing process simplifies operations for banks by preventing them from having to compute amounts owed to and from every other bank for each individual transaction in which they were an issuer or acquirer. (R. 524:7–20.)

Instead, banks can provide large batches of transactional data for Mastercard to compute and net those amounts on a large scale, among many issuers and acquirers and across hundreds of thousands or even millions of transactions. (R. 524:8–525:14.)

The following diagram (R. 2887) summarizes Mastercard's clearing process:

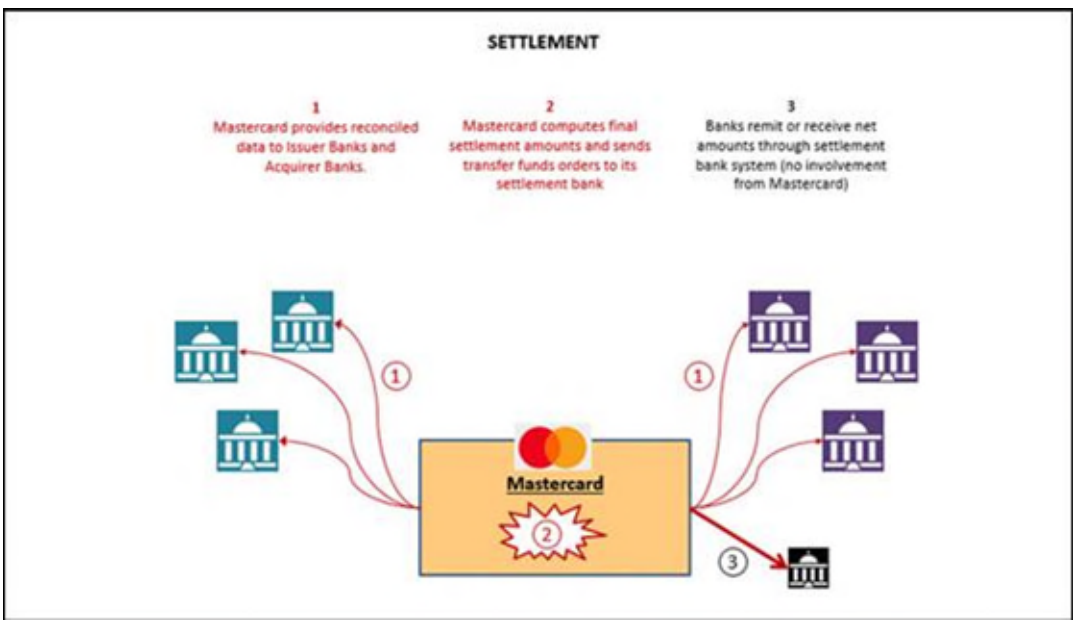


The clearing process starts when Mastercard receives a batch of transactional data from a bank for processing, typically a day or two after the authorization process has finished. (R. 322:16–25; R. 474:6–8; R. 519:1–527:23; R. 538:10–25.) Mastercard processes the data at its Missouri data centers to arrive at a "net settlement position" for each issuer and acquirer bank for all of their activity for the daily period. (R. 519:1–14; R. 531:2–23; R. 540:2–23.) Mastercard then sends issuer and acquirer banks summary reports showing how much money each bank will either owe or receive based on the reconciliation of each bank's activity for the time period being processed. (R. 535:1–13; R. 537:1–15.) The clearing process ends when Mastercard has provided these reports to the banks and when that information is passed along internally from Mastercard's clearing systems to its settlement systems. (R. 539:4–16.)

Clearing involves only Mastercard, the issuer banks, and the acquirer banks. (R. 520:7–22.) Cardholders and merchants are not involved in clearing. (R. 520:7–22; R. 1067:24–1068:7.) Clearing fees are charged to issuer and acquirer banks based on the number and size of clearing messages each sends to or receives from Mastercard. (R. 319:4–320:8; R. 540:19–23.) Mastercard receives no clearing fees from cardholders or merchants, a point the Department conceded. (R. 1068:8–12 ("Q. Who pays Mastercard for clearing? A. The acquirer and issuer. Q. Do cardholders or merchants pay Mastercard for clearing? A. No.").) Mastercard performs all of its clearing activities at its processing centers in Missouri. (R. 540:2–13.)

3. Settlement

Settlement occurs after clearing, and is the process in which Mastercard facilitates the exchange of funds among issuer and acquirer banks based on the amounts determined to be owed to or from each bank during clearing. (R. 543:2–4; R. 545:1–25.) The goal of settlement 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. (R. 546:1–550:17.) The following diagram (R. 2888) summarizes Mastercard's settlement process:



Settlement starts after Mastercard's clearing service generates various reports that form the basis for settlement, and consists of additional data processing. (R. 519:1–14; R. 535:1–21; R. 539:1–23; R. 555:14–24.) At the end of settlement, Mastercard provides each issuer and acquirer bank with an advisement report, which tells the bank how much it owes or is owed so the bank can ensure it is ready to receive funds or has sufficient funds for withdrawal. (R. 551:2–R. 552:15.) Mastercard does not move money between the banks; instead, it provides a third-party settlement bank with "transfer fund orders," which are financial messages used to initiate the movement of funds between issuers and acquirers. (R. 552:15–553:4.) Advisement reports and transfer fund orders are the "end results" of settlement. (R. 552:15–553:14.)

Settlement involves only Mastercard, the issuer banks, acquirer banks, and a third-party settlement bank. Cardholders and merchants are not involved. (R. 545:1–546:9; R. 554:3–22; R. 1069:20–25.) Mastercard charges each issuer and acquirer bank settlement fees based on the number of reports it delivers. (R. 321:8–14; R. 2785.) Settlement fees are paid by issuer and acquirer banks. (R. 546:5–9; R. 555:25–556:8; R. 1070:1–2.) Mastercard receives no settlement fees from cardholders or merchants. (R. 556:5–8.) Mastercard performs all of its settlement activities at its processing centers in Missouri. (R. 556:9–21.)

4. Assessment

Mastercard also charges assessment fees to recover various costs it incurs to maintain, expand, and enhance the services it offers to issuer and acquirer banks. (R. 298:21–299:4; R. 325:10–331:20.) Mastercard originally operated as a not-for-profit association of member banks. (R. 285:19–25.) Historically, it was required to invest heavily in its hardware and software infrastructure to create and maintain a reliable and secure transaction processing network. (R. 327:3–25.) It also had to establish and enforce a formal set of rules that dictate how the issuer and acquirer banks would act within the payments network to ensure that security protocols would

be followed, that inter-bank disputes would be resolved fairly, and that payment commitments would be honored. (R. 327:10–328:25.) These activities and others entailed significant costs. (R. 326:3–328:25.)

The per-transaction service fees discussed above for authorization, clearing, and settlement cover the costs of performing those services, but were not designed to cover these broader expenditures. (R. 325:10–329:23.) Instead, Mastercard imposed assessment fees to allow it to make these investments and recoup costs. (Id.) The total amount of expenses to be recovered through assessment fees was determined and each member bank was charged a share of the total based on its proportionate use of Mastercard's services, using the dollar volume of activity as a proxy. (R. 326:6–15.) Mastercard has been a for-profit company since 2001 but continues this practice of charging banks for various infrastructure and ecosystem costs through assessment fees. (R. 325:10–326:17; R. 4406.)

Issuer and acquirer banks thus pay assessment fees for: Mastercard's maintenance of its physical network, including the security and integrity of the network; development of products to enhance the network; development and enforcement of the Mastercard Rules, which ensure that the banks uphold their respective obligations; marketing and advertising of the Mastercard brand globally, which in turn benefits issuers and acquirers; and the prevention of fraud and cyber-attacks against the network. (R. 327:3–328:19.) Assessment fees consist of both domestic assessment fees (when both the issuer bank and acquirer bank are in the same country) and cross-border assessment fees (when the issuer bank and acquirer bank are in different countries). (R. 298:24–299:4; R. 326:20–327:8.) The fee is called a "retail assessment fee" or "cash assessment fee" when imposed on an issuer bank, and a "brand volume fee" when imposed on an acquirer, but the purpose is the same. (R. 2784–85; R. 327:3–25.) Cardholders and merchants do not pay assessment

fees, a point the Department conceded. (R. 331:16–332:8; R. 1071:5–10.) The employees performing the activities that generate these fees work at Mastercard's data centers in Missouri and its headquarters in New York. (R. 329:2–331:15; R. 336:2–24.)

C. The Department's Audit

The Department began its audit of Mastercard in July 2017. (R. 5630.) Although the Department had yet to review any Mastercard documents, its letter initiating the audit already concluded that Mastercard's income-producing activity occurs "when the transaction is initiated by the MasterCard cardholder." (R. 5630, 5632.) Based on this preordained position, the Department requested reports showing the amounts of receipts attributable to South Carolina based on the location of the cardholder's "swipe" of a card to initiate a transaction. (R. 353:3–25; R. 645:4–16.) Mastercard disagreed with the Department's methodology, asserting it was not supported by South Carolina law, but provided the requested data, which the Department used as a proxy to compute an assessment. (R. 5554; R. 352:22–354:25; R. 589:1–12; R. 593:1–18; R. 596:1–24; R. 609:5–21; R. 645:4–16.)

At the end of its audit, the Department issued a proposed assessment asserting additional tax, interest, and failure to file and failure to pay penalties for tax years 2007 through 2016. (R. 5533–37.) Like the July 2017 letter, the proposed assessment concluded that the income-producing activity occurs "when the transaction is initiated by the MasterCard cardholder" or "when the MasterCard Cardholder uses his card to make a purchase." (R. 5549–50.) The Department added that all of Mastercard's fees "from the card issuing entities and acquirers occurs at the time the transaction is initiated by the SC cardholder." (R. 5551.)

Mastercard protested the Department's assessment, and the Department issued a Determination upholding it. (R. 5595–5618, 6494.) The Determination states:

> Taxpayer's income is produced by a cardholder accessing a continuously provided network in South Carolina. It is that accessing of the network by a cardholder—the income producing activity—which produces the revenue generated when merchants accept Cards to complete transactions.

(R. 6512.) Mastercard then filed a request for a contested case hearing at the ALC.

D. The ALC Hearing and Decision

The ALC upheld the Department's Determination and concluded that Mastercard's income producing activity is "providing Network access to Cardholders, Merchants and banks." (R. 31.) The ALC indicated that the "Network" includes not only Mastercard's activities but also "the activities of Cardholders, Merchants, Issuer Banks, [and] Acquirer Banks," and that the Network "was providing services to South Carolina Cardholders and Merchants." (R. 16, 33.)

The ALC confirmed that cardholders and merchants do not contract with Mastercard and "make no direct payments to Mastercard." (R. 34, n.36.) The ALC nevertheless concluded that fees are only "nominally" paid by issuer and acquirer banks but "actually" paid by cardholders and merchants because if cardholders and merchants did not make purchases or sales, Mastercard would have nothing to process. (R. 34, 37, 40.) The ALC relatedly found that Mastercard is entitled to all of its fees at the time a cardholder uses a credit or debit card (step 1 in the authorization diagram). (R. 48.)

Although it upheld the Department's position, the ALC abated failure to pay penalties for corporate income tax "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 the actions of its customer's customer," referring to a sourcing method based on the activities of cardholders and merchants, i.e., the banks' customers. (R. 53.)

At the hearing, the ALC admitted the testimony of two experts proffered by the Department—John Swain, an expert in state tax policy, and Jim Hawkins, a purported expert in

"consumer credit markets." (R. 7.) Swain was admitted as an expert without objection, and the ALC relied upon his testimony without noting any concerns about his competency or candor. (R. 16, 27.) Regarding Hawkins, however, the ALC stated that his testimony was entitled only to "qualif[ied] reliance" due to: (1) "some concerns going to the weight of his testimony"; (2) that he had not studied or researched Mastercard specifically apart from preparing for his testimony here; (3) that his previous work, scholarly writing, and teaching did not show a longstanding, in-depth knowledge of credit card company operations as they relate to the issues under consideration; and (4) that his failure to disclose responsive information at his deposition and trial (despite "ample opportunity to do so") was "of concern to the Court" and deprived Mastercard of the opportunity to "explore potential bias" during his deposition and at trial. (R. 16–20.) The ALC nevertheless admitted Hawkins's testimony over Mastercard's repeated objections on the basis that he knows more about credit card operations "than would the normal lay person," (R. 19), and that there is "congruence" between his area of expertise and Mastercard's business, (R. 22).[5]

Despite the ALC's cautionary language regarding qualified reliance, it relied heavily, and sometimes exclusively, on Hawkins's opinions, giving his testimony more weight than that of Mastercard's employees (none of who raised concerns for the ALC regarding lack of experience or candor) and accepting his testimony even where it contradicted the Department's own concessions, such as that merchants and cardholders do not pay Mastercard's fees. (R. 45–48; R. 1066:17–19; R. 1068:8–12; R. 1070:1–2; R. 1071:5–10.) The ALC's conclusion that

[5] Mastercard filed a motion in limine prior to the ALC hearing seeking to limit the scope of Hawkins's testimony. (R. 101.) The ALC denied the motion at the start of the hearing. (R. 239.) Mastercard renewed its objection based on Hawkins's lack of qualifications when his testimony was offered, and the Court again overruled the objection. (R. 768, 784–88.) Mastercard also objected several times throughout his testimony on the basis that he was testifying on specific topics in which he had no demonstrated expertise, including advertising, intellectual property, and economics. (R. 799–800, 815–17, 841–44.) Each objection was overruled. (Id.)

cardholders and merchants are "customers" who "actually" pay Mastercard, and its conclusion regarding Mastercard's income-producing activity, are based on Hawkins's opinions. See infra § II.C.

STANDARD OF REVIEW

Appeals from the ALC are governed by the Administrative Procedures Act, S.C. Code Ann. § 1-23-310, et seq. This Court may reverse, vacate, or modify the ALC's decision if Mastercard's substantial rights were prejudiced because the decision: (a) violated constitutional or statutory provisions; (b) exceeded its statutory authority; (c) was made upon unlawful procedure; (d) was affected by other error of law; (e) was clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or (f) was arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion. S.C. Code Ann. § 1-23-380(5); CarMax Auto Superstores W. Coast, Inc. v. S.C. Dep't of Revenue, 397 S.C. 604, 608-09, 725 S.E.2d 711, 713 (Ct. App. 2012), aff'd as modified, 411 S.C. 79, 767 S.E.2d 195 (2014).

For any questions of law, including the interpretation of the "income-producing activity" in § 12-6-2295, the Court has de novo review and owes no deference to the ALC's or Department's construction of the statute, even if longstanding. Colonial Pipeline Co. v. S.C. Dep't of Revenue, 443 S.C. 448, 905 S.E.2d 129 (Ct. App. 2024), quoting Loper Bright Enters. v. Raimondo, 603 U.S. 369, 144 S. Ct. 2244 (2024); Univ. of S. Cal. v. Moran, 365 S.C. 270, 274-75, 617 S.E.2d 135, 137 (Ct. App. 2005). Section 12-6-2295 is a tax imposition statute; if the Court finds any ambiguity when interpreting the provision, it must resolve that doubt in Mastercard's favor. Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue, 399 S.C. 313, 321, 731 S.E.2d 869, 873 (S.C. 2012).

For any questions of fact, the Court's review is limited to determining whether the ALC's order is supported by substantial evidence. MRI at Belfair, LLC v. S.C. Dep't of Health & Envtl.

Control, 379 S.C. 1, 6, 664 S.E.2d 471, 474 (2008). Substantial evidence is that which would allow reasonable minds to reach the conclusion the ALC reached. Leventis v. S.C. Dep't of Health & Envtl. Control, 340 S.C. 118, 130, 530 S.E.2d 643, 650 (Ct. App. 2000) (quoting Welch Moving Storage & Co. v. Pub. Serv. Comm'n of S.C., 301 S.C. 259, 261, 391 S.E.2d 556, 557 (1990)).

The ALC's qualification of a witness as an expert is subject to review for whether the trial court has acted in accordance with the discretion granted to trial courts. State v. Wallace, 440 S.C. 537, 541–42, 892 S.E.2d 310, 312 (2023); Gooding v. St. Francis Xavier Hosp., 326 S.C. 248, 487 S.E.2d 596 (1997). An abuse of discretion exists when there is an error of law or a factual conclusion that lacks evidentiary support. Id., 326 S.C. at 251, 487 S.E.2d at 598.

ARGUMENT

I. The ALC Failed to Apply This Court's Decision in DirecTV, Which Requires Sourcing to the Locations of Mastercard's Actual Customers

The Legislature established provisions for how taxpayers must compute the portion of their income that will be subject to South Carolina corporate income tax. It established industry-specific rules for railroads, motor carriers, telephone services, pipeline companies, airlines and shipping lines—each an industry with unique considerations. S.C. Code Ann. § 12-6-2310. For every other service provider, the Legislature set forth one rule: receipts are to be assigned based on where the income-producing activity occurs. S.C. Code Ann. § 12-6-2295(A)(5).

This Court established a clear and administrable rule for determining a taxpayer's income-producing activity in DirecTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, 421 S.C. 59, 804 S.E.2d 633, 636, 641–42 (Ct. App. 2017), concluding that the service provider's income-producing activity was the last step it performed in its process entitling it to revenue: delivering its service to paying customers. For DirecTV, that was transmitting a satellite signal to set-top boxes in subscribers' homes. Id. The Court then used customer billing addresses to measure

the portion of this activity attributable to payments made by South Carolina subscribers. Id., 421 S.C. at 71, 74, 804 S.E.2d at 641, 643; DirecTV, Am. Final Br. Resp't, 2017 WL 5514322, at * 9.

The Legislature intended for one rule to be applied for all service providers, and DirecTV can be readily applied to Mastercard's services. Just like DirecTV, Mastercard delivers its services to its paying customers at specific locations. For example, Mastercard delivers its authorization service to its own version of set-top boxes, the MIPs located at each bank's processing facility. (R. 304:2–305:13; R. 329:15–23; R. 441:7–442:12.) The answer here is simple: following this Court's precedent, Mastercard's income-producing activity occurs where it delivers its services to its paying customers, issuer and acquirer banks, at the banks' processing locations. All of Mastercard's income-producing activities occurred at banks' facilities, which can be measured by MIP location (leading to zero receipts assigned to South Carolina) or, like in DirecTV, to billing addresses of South Carolina customers (leading to some of Mastercard's receipts being assigned to South Carolina, see R. 6600–01). The ALC instead applied the specific approach this Court rejected in DirecTV, creating an unworkable and unjust sourcing rule with no predictability.

DirecTV can be readily applied here, but if the Court determines that a separate sourcing rule should be applied to each industry notwithstanding the Legislature's enactment of other industry-specific rules, the Court should rely on Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). There, the Court sourced the service provider's receipts based on the activities of the taxpayer and where those activities occur, using payroll as a metric. Id., 293 S.C. at 449, 361 S.E.2d at 347. All of Mastercard's activities occurred outside of South Carolina, and Mastercard's payroll would result in a very small but representative percentage of receipts being sourced to South Carolina (see R. 5441–5532 (J. Ex. 26).) In either event, the ALC's decision should be reversed.

A. Legal Background – The Income-Producing Activity Standard and This Court's Prior Construction of That Standard

South Carolina imposes an annual corporate income tax on the taxable income of every corporation doing business in the state. S.C. Code Ann. § 12-6-530. When a taxpayer does business in multiple states, South Carolina taxes the portion of the taxpayer's income that "reasonably represents the proportion of the trade or business carried on within" South Carolina. S.C. Code Ann. § 12-6-2210(B). This is commonly referred to as "apportionment," or as an "apportioned" share of the taxpayer's total net income. S.C. Code Ann. §§ 12-6-2240, 2252.

The formula used to apportion a taxpayer's income depends on the taxpayer's business and the type of receipts at issue, and sometimes the taxpayer's industry. South Carolina has a handful of industry-specific apportionment provisions, for example for railroads, telephone service companies, and airlines. S.C. Code Ann. § 12-6-2310. But for all other service providers, like DirecTV and Mastercard, there is one approach: 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." S.C. Code Ann. § 12-6-2290. For all these service providers, "gross receipts from within this State" include:

> [R]eceipts 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). This is the "income-producing activity" standard at issue in DirecTV and here.

The Court has addressed the apportionment of receipts from services on only a few occasions, most recently in DirecTV, where the Court was tasked with determining a satellite television provider's income-producing activity under § 12-6-2295(A)(5). The taxpayer provided

direct-to-home satellite services to residential and commercial customers nationwide and delivered the programming to subscribers who signed customer agreements and had signal-receiving equipment installed. 421 S.C. at 64–65, 804 S.E.2d at 635. DirecTV delivered the satellite signal to a set-top box at the customer's location, which allowed the customer to view its programming. Id., 421 S.C. at 64, 804 S.E.2d at 636. Although the taxpayer had South Carolina customers, nearly all of its assets, employees, and property were located outside of the state. Id.

DirecTV argued that it had several income-producing activities, consisting of its entire programming network—its development, advertising, and broadcast of its content, and its customer service operations. Id., 421 S.C. at 72–73, 804 S.E.2d at 640. It contended that its South Carolina gross receipts should be measured by comparing its South Carolina payroll and assets to its total payroll and assets. Id. The Department argued instead that "income-producing activity" in § 12-6-2295(A)(5) must be interpreted much more narrowly. It identified DirecTV's income-producing activity solely as the "final act" of delivering a satellite signal into subscribers' homes, and measured this using subscription fees paid by subscribers with South Carolina billing addresses. Id., 421 S.C. at 67, 77, 804 S.E.2d at 637, 643; DirecTV, Am. Final Br. Resp't, 2017 WL 5514322, at * 20 (Feb. 8, 2017).

The Court agreed with the Department and held that the delivery of the signal to customers' set-top boxes was "the activity that 'actually generate[d] income'" for DirecTV. Id., 421 S.C. at 75, 804 S.E.2d at 641. The Court focused on what DirecTV's customers were paying for: "the end result of the personnel's work—the delivery of the signal that allows customers to enjoy the digital entertainment for which they pay." Id., 421 S.C. at 75, 804 S.E.2d at 641–42. The Court considered the broader network activities put forth by DirecTV—developing, advertising, and broadcasting content—to be "preparatory" activities that "do not produce income," and referred to them as

"income-anticipatory" activities. Id., 421 S.C. at 77–78, 804 S.E.2d at 643. The Court reasoned that while these activities are important in that they "can help lead to income," the income-producing activity standard "requires activities that actually produce income." Id., 421 S.C. at 78, 804 S.E.2d at 643. The Court deemed the activities identified by DirecTV to be "too attenuated" from the production of income for purposes of § 12-6-2295(A)(5). Id.

DirecTV thus established a straightforward rule: a service provider's income-producing activity is the specific activity for which it gets paid, often the delivery of its service to the paying customer. That, the Court reasoned, is what "actually generates" the taxpayer's income. Id. While other preparatory or anticipatory activities may be important and even necessary, they are not what produces income. Id. Rather, it is only the final act of delivery that actually generates income. Id.; Am. Final Br. Resp't, 2017 WL 5514322 at *20.

B. Under *DirecTV*, Mastercard's Income-Producing Activity Is Its Delivery of Services to Issuer and Acquirer Banks

Just like DirecTV, Mastercard generates income when it delivers its services to its paying customers. Issuer and acquirer banks pay Mastercard to process transactions and data, and they pay Mastercard only if it completes those tasks. Mastercard's delivery of authorization messages and clearing and settlement reports are all analogous to DirecTV's final act of delivering its satellite signal to the subscriber's set-top box. Just like DirecTV's delivery of the satellite signal, these activities of Mastercard are the ones that issuer and acquirer banks pay for, and are thus Mastercard's income-producing activities.

Mastercard's final act entitling it to authorization fees is delivering the authorization message containing the issuer bank's approval or denial of the cardholder's purchase transaction request to the acquirer bank (step 10 in the diagram supra at 7). (R. 468:13–17; R. 2883.) Mastercard's final act entitling it to clearing fees is its delivery of reports to the issuer and acquirer

bank advising them of their respective "positions," i.e., whether they will owe or receive funds. (R. 538:11–539:23.) And Mastercard's final act entitling it to settlement fees is its delivery of reports to the issuer and acquirer bank alerting them of impending deposits or withdrawals and transfer fund orders to a settlement bank to facilitate the movement of funds among issuer and acquirer banks. (R. 552:3–553:14.)

Mastercard's fees for authorization, clearing, and settlement are each calculated based on precisely these activities. (R. 2786 (describing authorization fees as being charged "for each authorization request received from an acquirer in the U.S. region that is processed"), 2785 (describing clearing and settlement fees as being charged based on the "number of messages received")); see also R. 2810–11. This per-delivery fee structure is also evident from invoices in the record, which show the number of messages or reports delivered, multiplied by a per-delivery fee. See, e.g., R. 6370–71 (showing a fee of $0.011 for authorization and 697 individual triggers of that fee).

After determining that the income-producing activity in DirecTV was the delivery of the signal to customers' set-top boxes, the Court used customer billing addresses in the taxpayer's accounting records to measure the extent to which the income-producing activity occurred in South Carolina. 421 S.C. at 67, 77, 804 S.E.2d at 637, 643; 2017 WL 5514322, at *9. Just like DirecTV, the locations of Mastercard's "set-top boxes" (i.e., the MIPs) are in the record. (R. 5532.) Using actual delivery locations, none of Mastercard's receipts are attributable to South Carolina because none of Mastercard's customers have established their data processing facilities (where MIPs are located) in the state. (R. 5532.) Alternatively, if the Court applies a more literal application of DirecTV's sourcing method (based on payments made by South Carolina customers), that information is in the record here as well. (R. 6600 (amounts paid by issuer and acquirer banks

based in South Carolina); R. 6601 (tax based on the amounts in Petitioner's Exhibit 1); R. 680:5–7 (Department auditor confirming that the tax shown in Petitioner's Exhibit 2 is a mathematically correct application of that method).)[6]

C. Instead of Applying *DirecTV*, the ALC Adopted the Exact Reasoning This Court *Rejected* in That Case

Despite being bound by DirecTV, the ALC adopted the sourcing method this Court rejected there, concluding that Mastercard's income-producing activity is its overall network of operations and its advertising. DirecTV asked this Court to look to its overall network—its acquisition and creation of content, its marketing and advertising, and more—but the Court expressly declined to do so, instead adopting a narrow transaction-based view, looking to the last act of delivery.

While Mastercard's position is consistent with the Court's holding in DirecTV, the ALC's decision is analogous to the taxpayer's unsuccessful position in that case. First, the ALC considered Mastercard's view of its income-producing activity to be too narrow. (R. 23.) But DirecTV adopted a narrow view of income-producing activity, accepting the Department's argument that income-producing activities must be viewed on a transaction-by-transaction basis. Am. Final Br. Resp't, 2017 WL 5514322, at * 21, 24, 25 (Feb. 8, 2017). This Court agreed, identifying DirecTV's income-producing activity narrowly, focusing on the final act of delivery.

The ALC did not apply the required narrow approach, instead using an impermissibly broad one. It concluded that "Mastercard's income producing activity is the provision of the Mastercard Network that facilitates cashless payments for goods and services," essentially saying that

[6] If the Court determines that DirecTV does not control here, it should rely on Lockwood Greene's "place of activity" test and use payroll as a metric. 293 S.C. 447, 449, 361 S.E.2d 346, 347. The activities Mastercard performed to carry out its services occurred entirely outside of South Carolina, and its South Carolina payroll was negligible. See, e.g., R. 5530 (showing South Carolina payroll of 0.02% of total payroll for tax year 2016).

Mastercard's income-producing activity is its entire business. (R. 48.) Customers do not pay fees simply because Mastercard exists or because it operates a network; the fees are for specific activities Mastercard performs. DirecTV requires a much narrower lens and the identification of a specific activity that produces income. Moreover, the ALC's view was not even contained to Mastercard's business—it looked to the entire industry:

> 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.

(R. 16.) There is no basis under § 12-6-2295(A)(5) to impute the activities of every other business to Mastercard. Nothing in the plain meaning of the statute, the broader statutory context, the legislative history, or case law supports this. In fact, in DirecTV the Department told the Court that the "income-producing activity" standard under § 12-6-2295 must identify an activity of the taxpayer. Am. Final Br. Resp't, 2017 WL 5514322, at *26 (Feb. 8, 2017). By defining the income-producing activity as the "Network," and in turn including the activities of every bank, cardholder, and merchant, the ALC adopted an impermissibly broad view of income-producing activity.

Second, the ALC focused on the supposed importance of advertising even though DirecTV says advertising is an income-anticipatory activity. (R. 26, 45); 421 S.C. 59, 75, 804 S.E.2d 633, 643. Again, this Court adopted that reasoning in DirecTV at the Department's urging—the Department said that advertising is "too nebulous" to be tied to specific items of income. 2017 WL 5514322, at *23, 30. Yet the ALC adopted the Department's contradictory position here even though Mastercard's advertising is directed at the entire U.S. and, just like in DirecTV, there is no evidence tying advertising to any item of income. (R. 925:1–25.) The ALC went even further here,

basing its reasoning on far more nebulous concepts like "trust" and "goodwill." (R. 24, 45.) None of these amorphous concepts are income-producing activities.

Third, the ALC looked to the cardholder's initiation of a purchase transaction here even though it looked to the taxpayer's completion of the service in DirecTV where the Department expressly advocated for a "final act" standard. (R. 30, 34); 421 S.C. at 77, 804 S.E.2d at 642; 2017 WL 5514322, at *20; R. 1002:13–21 (Department's tax policy expert, Professor Swain, testifying that DirecTV "look[s] at sort of the last step"). The Department abandoned that position here, instead adopting a first-act standard by looking at the cardholder's "initiation" of the transaction. The ALC adopted this new, contradictory position despite recognizing the inherent discrepancy with DirecTV:

> 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.

(R. 44.) Instead of trying to neatly fit its reasoning within DirecTV, the ALC simply moved on without resolving the tension between its analysis and binding precedent.

The ALC's attempt to distinguish this case by suggesting that Mastercard's income is triggered at the beginning of the cardholder transaction is also factually wrong. The ALC insinuates that once a cardholder swipes a card, Mastercard is entitled to all of its fees right away. (R. 47.) That is not how Mastercard's fees work, and the Cost Letters the ALC purportedly relies on show as much. (See R. 2779–2823.) They have a clear fee structure, showing that fees are generated at specific times, for specific activities. No fee described in those letters is generated because a cardholder swipes a card. And if Mastercard were entitled to all of its fees as soon as a cardholder swiped a card, why would it even bother to perform any of its processing activities after that?

The ALC's analysis is also nothing more than "but-for" reasoning, i.e., but for a cardholder swiping a card Mastercard would not be able to earn fees later on. That is not the analysis that § 12-6-2295 or DirecTV requires. "But for" DirecTV's acquisition and creation of content there would be no programming to receive, and "but for" DirecTV's investment in its transmission network it would have no infrastructure to deliver the signal. Those activities were still deemed to be income-anticipatory, not income-producing. DirecTV recognizes that an activity is not income-producing simply because it is a necessary precursor to subsequent activities that are. A cardholder's initiation of a transaction is, at most, an income-anticipatory activity. The ALC went even further afield here, considering activities occurring "long before" a cardholder initiates a purchase transaction, such as Mastercard's creation of rules, licensing of marks, and development of "goodwill and trust," deeming these to be factors showing that "Mastercard is involved in credit card transactions even before a card is presented as payment." (R. 23–24.) Under no fair reading of DirecTV could one conclude that activities that occur "long before" the generation of income are income-producing, rather than income-anticipatory.

Lastly, the ALC adopted the Department's use of a "proxy" to compute the portion of Mastercard's gross receipts attributable to South Carolina even though DirecTV expressly rejected the taxpayer's use of a "proxy" to determine the portion of receipts attributable to South Carolina. (R. 14, 48–50.) The Court there said that "proxies" were unnecessary because the subscription fees received from customers "directly placed a value" on its services. 421 S.C. 59, 76, 804 S.E.2d 633, 642; 2017 WL 5514322 at *9. Here, the ALC rejected Mastercard's alternative proposal to use revenue paid by South Carolina customers, and instead adopted a method that both the Department and the ALC call a "proxy." (R. 14, 48–50.) Petitioner's Exhibits 1 and 2 (R. 6600–01), looking to

payments of Mastercard's bank customers are a "direct measure" of its services that obviate the need for any proxy.[7]

D. The ALC Improperly Upheld the Department's Results-Oriented Application of the Sourcing Statute Under the Guise of Industry-Specific "Flexibility"

The ALC said the Department's "longstanding policy" is "to examine a taxpayer's industry to determine what revenue should be sourced to South Carolina." (R. 32.) First, the Court need not uncritically accept any such policy, as it has the "solemn duty" of applying its independent judicial judgment. Colonial Pipeline Co. v. S.C. Dep't of Revenue, 443 S.C. 448, 905 S.E.2d 129 (Ct. App. 2024), quoting Loper Bright Enters. v. Raimondo, 603 U.S. 369, 385, 144 S. Ct. 2244, 2257 (2024). Second, the Legislature did not intend for the Department to craft a unique apportionment rule for every single industry. The Legislature knows how to adopt industry-specific rules—it did so for railroads, motor carriers, telephone services, pipeline companies, airlines, and shipping lines. S.C. Code Ann. § 12-6-2310. For every other service provider, it adopted one rule, based on the taxpayer's "income-producing activity." S.C. Code Ann. § 12-6-2295(A)(5).

In DirecTV, the Court set out a framework for applying the income-producing activity standard, looking to the activity for which the customer pays and the location of that customer, since that directly places a value on the taxpayer's services. 421 S.C. 59, 76, 804 S.E.2d 633, 642. Nothing in DirecTV suggests that this interpretation of § 12-6-2295(A)(5) applies only to the

[7] The ALC says that Mastercard did not offer any alternative method to calculate South Carolina revenue based on its income producing activity. (R. 49–50.) This is simply not true. Mastercard provided two methods consistent with DirecTV: (1) based on delivery to issuer and acquirer banks, using the locations of MIPs; and (2) based on delivery to issuer and acquirer banks, using banks' billing addresses. It was undisputed that no Mastercard MIPs were in South Carolina and, as a result, that method would place no receipts in the numerator. As an alternative, Mastercard offered Petitioner's Exhibits 1 and 2, showing fees from banks with South Carolina billing addresses and the resulting tax owed. (R. 6: R. 6600–01.) Mastercard expressly offered these as an alternative method for sourcing its receipts. (R. 1266, 1282, 1298.)

satellite television industry. Rather, the Court described the meaning of income-producing activities generally. There is no reason, industry-based or otherwise, to not apply that same reasoning here. If income-anticipatory activities are disregarded for the satellite television industry, they must be disregarded for the credit card industry. If income-producing activities are viewed narrowly for the satellite television industry, they must be viewed narrowly for the credit card industry. If the income-producing activity standard looks to the "final act" for the satellite television industry, it cannot look to the first act for the credit card industry. The income-producing activity standard is not so flexible that it allows the Department or ALC to apply a position the Court expressly rejected under the guise of industry-specificity.

Nor is there any factual basis for the analysis here to depart from DirecTV. Mastercard's activities are just like the satellite companies' activities—both get paid to deliver electronic messages to customers. Indeed, the Department's 30(b)(6) witness testified that there is "nothing unique" about credit card processing that would merit applying a different legal standard to Mastercard than any other service provider. (R. 1081:2–1082:13.) The supposed industry-specific flexibility conceals what is really results-oriented applications of § 12-6-2295. Statements of the Department's witnesses make this clear. The Department's proffered expert, Professor Hawkins, testified that a cardholder's relationship with a merchant is "what happens in South Carolina and so, that's the thing that triggers the generation of revenue." (R. 900:8–12.) Its 30(b)(6) witness, Rob King, conversely testified that DirecTV's acquisition of programming was not an income-producing activity because "[t]hat was not what was produced in South Carolina." (R. 1090:14–18.) Section § 12-6-2295(A)(5) requires a two-step process—first identify the income-producing activity and only then determine the extent to which that activity occurred in South Carolina. The

Department lets the tail wag the dog, looking at the industry and the taxpayer to see what activity occurs in the state and then declaring that to be the income-producing activity.

The Legislature adopted one rule for all service providers and absent any legislative intent otherwise that rule must be applied consistently across industries, not retrofitted for each based on what produces the highest apportionment. The Department's tax-policy expert testified that a hallmark of good tax policy is that a tax regime be "administrable." (R. 992:7–22.) The analysis set out in DirecTV is administrable; a service provider can readily identify where it delivers its services. The ALC's "flexible" standard that requires taxpayers to be clairvoyants to figure out which of their activities the Department will deem relevant on any given day is not.

E. Appellate Courts Around the Country Have Consistently Rejected Sourcing Based on the Locations of a Taxpayer's Customer's Own Customers

In DirecTV, the Court required the taxpayer to source its receipts to where it delivered its services, i.e. the locations of paying customers. Here, the Department and ALC depart from that framework, attributing Mastercard's receipts based on the locations of merchants, which are Mastercard's customers' customers. Department witnesses acknowledged that no South Carolina authority, including the Department's own guidance, provides for a customer's customer approach. The auditor testified that he was not aware of any Department guidance calling for sourcing based on the customer's customer, and the Department's tax policy expert testified he was not aware of any cases in South Carolina or elsewhere interpreting the term "income producing activity" to require sourcing based on the location of a customer's customer. (R. 690:9–691:23; R. 1046:3–14.)

In fact, the customer's customer approach has been consistently rejected by state supreme courts and courts of appeal around the country. See Wisconsin Dep't of Rev. v. Microsoft Corp., 936 N.W.2d 160, 166–68 (Wis. Ct. App. 2019) (rejecting a customer's customer approach and

revenue department's theory that the taxpayer was paid "indirectly" by its customers' customers); Lending Tree, LLC v. Washington Dep't of Rev., 460 P.3d 640, 643 (Wash. Ct. App. 2020) (rejecting customer's customer approach and reasoning that "[t]he focus must remain on the customer" and the "contractual payment structure"); Walter Dorwin Teague Assocs., Inc. v. Washington Dep't of Rev., 500 P.3d 190 (Wash. Ct. App. 2021) (rejecting customer's customer approach and looking to whom the taxpayer contracted with and received income from); Defender Security Co. v. McClain, 165 N.E.3d 1236, 1241–42 (Ohio 2020) (rejecting customer's customer approach and describing the "paramount" consideration as the physical location of the purchaser). Of course, none of these decisions are binding in South Carolina, but they show how other appellate courts have approached this very issue, consistently focusing on the paying, contracting customer and not on the customer's own customer. And while no appellate court in South Carolina has previously considered the propriety of a customer's customer sourcing approach before this case, the rejection of such a method by these courts is consistent with this Court's instruction in DirecTV to look to the location of delivery to the paying customer.

Instead of addressing the disconnect between the Department's customer's customer sourcing position in this case and the lack of any support for that position, in South Carolina or elsewhere, the ALC circumvented the issue by finding cardholders and merchants to be Mastercard's "customers."[8] The record simply does not support the ALC's conclusion. Mastercard does not contract with cardholders or merchants, a point the Department's auditor and Rule 30(b)(6) witness both confirmed. (R. 2824–30 (sample contract with banks); R. 2831–2879

[8] In abating penalties, the ALC said the method "could be perceived" to be a customer's customer approach. (R. 53.) The Department's auditor referred to it as "looking to where Mastercard's customers' customers' activity occurs." (R. 681:17–21.) Counsel for the Department referred to it as sourcing based on the "end user." (R. 257:20–21.)

(executed contracts with specific banks); R. 612:19–613:8; R. 813:7–22; R. 827:17–20; R. 851:18–23; R. 1065:25–1066:5.)[9] Three Mastercard witnesses with decades of collective experience testified "unequivocally" that cardholders and merchants are not Mastercard's customers. (R. 37.) Several documents describe who Mastercard's customers are, and none identify cardholders or merchants as such:

- Mastercard's Authorization Manual calls both issuer and acquirer banks "customers." (R. 2928–29.) It does not use that term for a cardholder or merchant, referring to "a person to whom a card has been issued" and a retailer that "agrees to accept credit cards." (R. 2928.)
- Mastercard's Clearing Manual describes Mastercard's customers as the banks, stating that "[a] customer can be an issuer, an acquirer, or both." (R. 3414.) It describes the issuer as having its own contractual relationship with the cardholder, and the merchant as having its own contractual relationship with the merchant. (R. 3415.)
- Mastercard's annual reports filed with the SEC describe the company's customers only as issuers and acquirers. See, e.g., R. 4874.
- Mastercard's Rules, which are incorporated into its contracts with banks, define "customer" as a "financial institution" and define "acquirer" and "issuer" as customers. (R. 2456, 2462, 2466.) They define "cardholder" not as a customer, but

[9] The Multistate Tax Commission's model apportionment regulations state that when sourcing credit card processing receipts, "a taxpayer's customer is the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer's services." Multistate Tax Commission, Model General Allocation & Apportionment Regulations as of July 25, 2018, § IV.17.(d)(4)(A), (C), available at https://www.mtc.gov/uniformity/model-receipts-sourcing-regulation-review-project/.

as an authorized user of a card "issued by a Customer." (R. 2457.) And they define "merchant" as a retailer that agrees to accept cards under a separate agreement with an acquirer bank. (R. 2470–71.)

- The representative Mastercard contract is clearly intended to be signed by a bank, not a cardholder or merchant; it covers credit and debit card programs offered by signatories that are engaged in "Issuing and Acquiring card activities." (R. 2824–25, 2830.)
- In the two Cost Letters, every charge described is imposed on "principal members" or "affiliate members," "financial institutions," "issuers," or "acquirers." See, e.g., R. 2782–89, 2805. No charge is described as being imposed on a cardholder or merchant.

These documents are not self-serving. They were all prepared for non-tax purposes and are confirmed by the Federal Deposit Insurance Corporation ("FDIC"), a federal regulatory agency that describes issuer banks as the entities that "hold and maintain the cardholder relationships" and acquirer banks as the entities that "contract[] with merchants to accept, process, and settle credit card transactions." (R. 5712–25.) The FDIC describes credit card processors like Mastercard as organizations that provide services to "their member financial institutions." (R. 5713.)[10]

In reaching its contrary conclusion, the ALC contorted the facts, declaring cardholders and merchants to be the "actual payors" of Mastercard's fees (R. 34, 37, 40) even though they do not "actually" pay any fees to Mastercard. The Department's own auditor testified unequivocally that Mastercard's fees are paid by issuer and acquirer banks only:

[10] The ALC acknowledged that the Eastern District of New York described Mastercard's network as being accessed only by issuer and acquirer banks, but dismissed this as being "of no consequence." (R. 26–27, n.30.)

Q. Is the merchant paying Mastercard?

A. Is the merchant paying Mastercard? No.

Q. So, who would the deliv- -- who would the paying customer be?

A. The paying customers are the issuers and the acquirers.

(R. 674:23–675:4.) The Department's Rule 30(b)(6) witness also testified unequivocally that fees are paid only by issuer and acquirer banks, not cardholders or merchants. (R. 1066:17–19; R. 1068:8–12; R. 1070:1–2; R. 1071:5–10.).[11]

The ALC's conclusion that cardholders and merchants are "customers" and the "actual payors" appears to be a legal rather than factual conclusion. Yet the ALC provides no support for its contention that cardholders and merchants are Mastercard's customers—not even a dictionary definition. "Customer" means "a purchaser of goods or services"; "purchaser," in turn, means "a person who purchases something with money (or an equivalent); a buyer"; and "purchase" means "to acquire in exchange for payment." Oxford English Dictionary Online (accessed Oct. 8, 2024). Cardholders and merchants are not customers under ordinary use of the term.

Defining Mastercard's "customers" as the cardholders and merchants, and its "network" as something provided to cardholders and merchants, ignores the realities of business-to-business transactions. Mastercard provides its services to banks, who use those services in providing services to their own customers. In nearly all business-to-business transactions, there is a direct customer base, and those customers then have their own customer bases. The ALC collapses this

[11] Under Federal Rule 30(b)(6), this testimony would bind the Department. See Covol Fuels No. 4, LLC v. Pinnacle Min. Co., LLC, 785 F.3d 104, 113, n.13 (4th Cir. 2015) ("The organization is permitted to designate a person to testify on its behalf, and the organization is bound by that testimony."). While it appears that the South Carolina courts have not expressly addressed the binding effect of Rule 30(b)(6) testimony, the Department's Rule 30(b)(6) testimony should be given significant consideration here even if not technically binding.

common structure and portrays Mastercard as having direct relationships with cardholders and merchants. But there is no reason to disregard the clear structure and ignore the separate role each party plays in the payments ecosystem, let alone to attribute every participant's actions to Mastercard. Just weeks after issuing its decision here, the ALC issued a decision on how a bank acting as both an issuer and an acquirer must apportion its receipts. U.S. Bank Nat'l Ass'n v. S.C. Dep't of Revenue, No. 20-ALJ-17-0168-CC, 2024 WL 3259821, at *15–16 (S.C. Admin. L. Ct. June 25, 2024). There, the ALC described the cardholder and the merchant as the bank's customers, and concluded that the bank's income producing activity for fees paid by merchants for credit card processing is its delivery of the credit card approval or denial decision to its customer, the merchant. Id. at *4, 23, 25. The ALC's contrary conclusion here is irreconcilable.

F. The ALC Attributed All of Mastercard's Revenue Streams to the Same Income-Producing Activity Even Though Each Is Generated by Different Activities at Different Times

The ALC incorrectly attributed all of Mastercard's receipts from five different revenue streams to a single activity—"the provision of the Mastercard Network that facilitates cashless payments for goods and services." (R. 48.) There is no factual or legal basis to attribute every revenue stream to a single activity, particularly one so amorphous. Rather, each revenue stream must be sourced based on its respective "income-producing activity."

While the statute does not define that term, the Multistate Tax Commission—an intergovernmental state tax agency—and many other states have concluded that it "applies to each separate item of income." See DirecTV, Am. Final Br. Resp't 21 (citing Hellerstein et al., State Taxation ¶ 9.18(3)(b) (3d ed. 2000). Thus, in DirecTV, the Department argued, and this Court agreed, that the taxpayer's income-producing activity should be considered on a subscription-by-subscription basis. Id. Here, the Department flipped the script and argued that one activity should be determinative for every cent Mastercard earned from disparate revenue streams, and the ALC

adopted this faulty reasoning. The ALC concluded that each time a cardholder swipes a card, "Mastercard is entitled to fees as shown in the Cost Letters admitted into evidence," adding that all of Mastercard's revenue streams are "based on, and/or generated by, Merchant/Cardholder transactions." (R. 48.)

The ALC's conclusion is again incompatible with its findings. The ALC found that clearing and settlement are "separate process[es] from authorization" and that cardholders and merchants are not even involved in these processes. (R. 12.) It found that clearing does not start until issuer and acquirer banks submit data for processing. (R. 11.) It found that the process itself—Mastercard's netting of transactional data—occurs at Mastercard's data centers in Missouri. (R. 11–12.) And it found that clearing ends when Mastercard sends various reports showing the reconciliations and amounts owed to issuer and acquirer banks. (R. 12.) The ALC described settlement as the process by which Mastercard facilitates the exchange of funds among issuer and acquirer banks to ensure that each has only one transfer of money per cycle. (R. 12.) It described the end products of settlement as reports Mastercard provides to banks, which the latter use to initiate the actual movement of funds. (R. 12–13.) And the ALC stated that the fees Mastercard charges are based on the number of reports Mastercard delivers to the banks. (R. 13.)

The ALC's conclusion references Mastercard's Cost Letters (R. 2779–2883), but nothing in those documents supports the conclusion that Mastercard is entitled to fees simply because a cardholder "swipes" a card. In fact, the Cost Letters show the opposite, that different activities generate different fees. The Cost Letters and representative invoices in the record also show that no fees are triggered by a cardholder's swipe of a card, nor by something as overly broad and vague as Mastercard's so-called provision of a network. (R. 2779–2883, 6369–6383.) When looking at the activities that trigger clearing and settlement fees, as DirecTV requires, none occur

at the cardholder-merchant location. As the ALC itself found, the clearing and settlement processes end when Mastercard delivers clearing and settlement reports to issuer and acquirer banks, and those are the activities that trigger fees. Under DirecTV, that delivery to the paying customer is the income-producing activity for each service. The ALC was required to identify the income-producing activity for each service, not simply apply one conclusion to every income stream.

The same is true for Mastercard's assessment fees, which are incurred by issuer banks on a quarterly basis and by acquirer banks on a weekly basis, triggered by quarterly or weekly reports submitted by the banks. (R. 2808–09.) As the ALC found, assessment fees are imposed on issuer and acquirer banks based on each bank's proportionate use of Mastercard's services. (R. 13.) These fees compensate Mastercard for establishing and maintaining rules, enhancing and maintaining its physical infrastructure, and similar operating expenses, and Mastercard performed the activities generating these fees at its New York headquarters and its Missouri data centers. (R. 327:13–331:9; R. 336:2–24.) It was undisputed that Mastercard had no property in South Carolina, billions of dollars of infrastructure outside the state, and a nearly non-existent amount of payroll in the state. (R. 5441–5532.) Thus, the expenses for which assessment reimburses Mastercard are not incurred in South Carolina. Like with clearing and settlement, the ALC failed to identify the income-producing activity for the assessment revenue stream. The ALC attributed Mastercard's assessment fees to the locations where cardholders swipe their cards despite finding that assessment is not even part of transaction processing. (R. 13.)

The ALC erred by treating each of Mastercard's separate services as having a single income-producing activity and looking to Mastercard's customers' customers for the location of that activity. This Court should view each service separately and should identify the income-producing activity specific to that revenue stream.

II. The ALC Failed to Serve as a Gatekeeper When It Admitted Unqualified and Unreliable Expert Testimony

The ALC abused its discretion by admitting and relying on the testimony of the Department's proffered expert Jim Hawkins. The ALC's admission of Hawkins's testimony cannot be reconciled with its own finding that Hawkins had only limited knowledge relevant to the issues under consideration and its own concerns regarding Hawkins's lack of candor toward the court. (R. 18–20.) Its reliance on Hawkins's testimony to support key parts of its decision—including as to material facts where his testimony was contradicted by the unequivocal testimony of Mastercard witnesses and other Department witnesses—compels a presumption of prejudice for which the Department bears the burden to prove otherwise. See infra § II.C.

In exercising its gatekeeping duties, the ALC must give heightened scrutiny to expert testimony by making preliminary findings under Rule of Evidence 702. Relevant here, the ALC must determine that the proffered expert has the requisite knowledge and skill to qualify as an expert in the particular subject matter upon which he is testifying and that the testimony is reliable. Watson v. Ford Motor Company, Inc., 389 S.C. 434, 699 S.E.2d 169, 175 (2010). While the ALC briefly acknowledged these requirements and asserted that Hawkins satisfied them (R. 19, n.20), it did not properly apply them. His testimony should not have been admitted and the admission was prejudicial.

A. The ALC Erred by Admitting Professor Hawkins's Testimony Despite Finding That He Had No "In-Depth Knowledge" of the Issues Under Consideration

The ALC's own findings show that Hawkins does not have the requisite knowledge or skill to qualify as an expert in the particular subject matter on which he testified. Watson, 389 S.C. at 446, 699 S.E.2d at 175. The ALC found that:

> 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.

(R. 18 (emphasis added).) The ALC added that Hawkins had "limited knowledge of Mastercard's operations prior to this case." (R. 20 (emphasis added).) These findings compel the conclusion that Hawkins does not satisfy the requirements to be qualified as an expert under Rule 702 and that the ALC improperly admitted his testimony.

Despite its own finding that Hawkins lacked the requisite qualifications, the ALC admitted his testimony over Mastercard's objections on the basis that he knows more about credit card companies "than would the normal lay person such that his testimony was helpful to the Court." (R. 19.) But Rule 702 imposes a more rigorous standard than that.

The ALC incorrectly framed the threshold qualification question as "whether the boundaries of [Hawkins's] expertise are broad enough to capture Mastercard's business." (R. 18.) The ALC thus looked at whether the subject of "consumer credit markets," in which the ALC found Hawkins to have expertise, was broad enough to encompass the specific topics of credit card processing and revenue generation. That is not the correct standard. It is not enough for Hawkins to show expertise in some broader or adjacent field (consumer credit markets); he must show expertise in the specific subject he testified on—revenue from credit card processing activities. 389 S.C. at 446, 699 S.E.2d at 175. That both happen to include the word "credit" is not sufficient. (R. 740:12–24.)

In Watson, the Supreme Court made clear that an expert need not be a specialist, but must still have demonstrated expertise in the "particular subject matter" on which he is testifying, regardless of whether his expertise in a broader topic has been established. Id., 389 S.C. at 446, 699 S.E.2d at 175. There, the court held that the witness was not an expert in cruise control systems just because he had decades of experience with automobiles. Id., 389 S.C. at 447–48, 699 S.E.2d

at 176. The court instead looked at whether he had expertise specific to cruise control systems, the topic he offered testimony on. The court concluded he did not, because he had no "knowledge, skill, experience, training or education specifically related to cruise control systems" apart from what he studied "just before trial." Id. Thus, while the witness "may have been qualified in other aspects of automobile components, such as the brake system, the trial court failed to properly evaluate [his] qualifications specific to cruise control systems." Id.

Just like in Watson, the ALC was required to consider whether Hawkins had expertise in the specific subject matter of his testimony—how credit card processors like Mastercard generate revenue and where they do so—regardless of whether he might have expertise in a broader field. While Professor Hawkins was nominally called as an expert in the general field of "consumer credit markets," his testimony was far more specific to the issues in this case. The Department's expert disclosure stated that Hawkins would testify "regarding the nature of Petitioner's business, Petitioner's sources of income, and the connections between Petitioner's income streams and the state of South Carolina." (R. 6520.) When he took the stand, Hawkins said he was asked to serve as an expert by explaining how Mastercard transactions work and by forming an opinion about "Mastercard's revenue generating activities." (R. 725:8–9.) And the ALC's decision states that he testified "about how Mastercard generates revenue." (R. 16.)

Hawkins was permitted to testify on those topics notwithstanding:

- His admission that he had never studied or researched Mastercard specifically "other than in preparation for this case." (R. 16, n.16; R. 729:10–731:8 ("Q. All right. Have you studied and researched Mastercard specifically? A. I have not.").[12]

[12] Despite this admission, Hawkins proclaimed to know more about credit cards than each of Mastercard's witnesses. (R. 762:25–763:9.)

- That, just like the unqualified expert in Watson, he learned the subject of his testimony in the lead-up to trial by reviewing information furnished by Mastercard during discovery. (R. 19–20; R. 767:17–23 (stating that he "learned more" about Mastercard's business between his deposition and trial because he had "studied the documents more").
- His acknowledgment that before discovery in this case, he had never seen or read any contracts between credit card processors and their bank customers—the very contracts that resulted in the revenue at issue in this matter and upon which he opined. (R. 749:22–750:18.)
- That in all of his academic writing on consumer credit markets, totaling more than 1,000 pages, Mastercard is mentioned only twice, both times in a footnote in an article about fertility treatment financing, and that Visa and Discover are similarly mentioned only a few times. (R. 17, n.18; R. 758:22–759:10; R. 105–06.)
- That the course he taught that he identified as being the most relevant to his purported expertise was a law school course called "Writing Seminars." (R. 107; R. 170:1–7.)
- His admission that the issue here—where revenue gets generated—is "not something outside of this litigation that it -- that I'm going to spend a lot of time thinking about." (R. 967:12–23.)

Under Rule 702, Hawkins was not qualified to testify regarding how or where Mastercard generates revenue (the subject matter he testified on), and the ALC erred in allowing him to do so over Mastercard's motion in limine and frequent objections that his testimony was beyond his

supposed expertise. This was an error of law that constitutes an abuse of discretion under Gooding v. St. Francis Xavier Hosp., 326 S.C. 248, 487 S.E.2d 596, 598 (1997).

B. The ALC Erred by Not Evaluating the Reliability of Hawkins's Opinions

Hawkins also fails Rule 702's reliability requirement. His testimony is not reliable for many of the same reasons he is not qualified—namely, because he has no demonstrated experience in these topics and had never testified on them before—but also because of his lack of candor toward the court in withholding responsive information during both his deposition and at trial.

Professor Hawkins has no experience in identifying a taxpayer's "income-producing activities" for apportionment purposes or in identifying the geographic source of income. Nothing in his resume indicates any experience, let alone expertise, in the sourcing of income of credit card processors or the sourcing of income of any business. (R. 6550–58.) In fact, he admitted that "where revenue gets generated generally isn't important in commercial law . . . [a]nd so, it's not something outside of this litigation that it -- that I'm going to spend a lot of time thinking about." (R. 967:12–20.) He has never testified as an expert before, let alone on this type of issue. (R. 738:16–740:5.)

Hawkins developed his entire framework for analyzing the issue he was purportedly already an expert in specifically for this case. That framework has no indicia of reliability. He could not demonstrate how his opinions might be applied to any other taxpayer, let alone others in the credit card industry—when asked where issuer banks and acquirer banks generate their credit card processing revenue, he could not answer or give even basic impressions because he had not "thought a ton" about it. (R. 962:20–965:16.) The issue in this case is how to source credit-card related income, and by his own admission he has no experience with that. His admitted inability to identify a bank's income-producing activity calls into question his ability to identify Mastercard's income-producing activity.

When asked about the business activities of Mastercard or its competitors, Hawkins was often unable to answer the question. (R. 882:14–885:25; R. 927:3–928:17; R. 942:3–943:20; R. 946:13–952:20; R. 957:2–958:20; R. 960:4–961:9.) He frequently testified to what are essentially economics issues, but he has no economics qualifications—he has a philosophy degree and a law degree and teaches law. (R. 6550.) He justified his economics-based opinions by asserting that all his articles have "some sort of economics bend" simply because credit card markets "involve money." (R. 747:4–15.) He testified that he is a member of an economics organization, but could not remember the name of it. (R. 734:7–13.)

He also testified that credit card advertising falls within his "consumer credit markets" expertise and provided opinions regarding the supposed impact of Mastercard's advertising on cardholder behavior. (R. 793:4–13; R. 814:12–815:24; R. 828:14–22; R. 852:5–14; R. 872:2–873:8.) Yet when asked to name any issuer bank's advertising slogan, he failed to name a single one. (R. 957:2–15.) When prompted with the slogan, "What's In Your Wallet?," one of the most ubiquitous card advertising campaigns, he could not state with certainty which bank used it. (R. 957:2–15.) His inability to answer such basic questions about advertising in the credit card industry is incompatible with his claimed expertise and calls into question the reliability of his testimony on the supposed importance of Mastercard's advertising, particularly when the source of his opinions is unidentified "peer reviewed research" and "some other websites." (R. 18, n.19.)

The reliability concerns go beyond substance too. During both his deposition and trial testimony, Hawkins represented himself as a full-time professor at a law school, failing to disclose that he was also employed as a practicing attorney in a Houston law firm.[13] The ALC expressed

[13] Hawkins testified at his deposition that he worked in private practice for less than a year before he transitioned to academia in 2008. (R. 1303–04.) However, he failed to disclose that he was currently employed as a commercial litigator at a private law firm. He omitted this from two

"concern" regarding Professor Hawkins's omission of relevant information "despite having been given ample opportunity to do so at trial and during [his] deposition." (R. 20.) The ALC added that Hawkins's omission would 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." (R. 20, n.21.) The ALC's ultimate determination that Hawkins satisfied the reliability requirements is inconsistent with its own concerns and supposed "qualified" reliance on his testimony. (R. 16.)

There is no clear formula for determining whether non-scientific expert testimony is reliable. State v. White, 382 S.C. 265, 676 S.E.2d 684, 688 (S.C. 2009). But Hawkins's testimony was not reliable under any formula. He lacked experience and expertise in the substantive area on which he testified. He lacked candor toward the ALC. And he deprived Mastercard of an opportunity to explore potential bias by withholding relevant information on multiple occasions. The ALC abused its discretion in admitting his testimony.

C. The ALC's Improper Admission of Hawkins's Testimony Is Presumptively Prejudicial and Without It, the ALC's Decision Is Unsupported

The ALC's improper admission of Hawkins's testimony prejudiced Mastercard because the ALC relied on Hawkins's testimony to discredit competing testimony from other witnesses with far more knowledge, to interpret Mastercard documents, and to support key aspects of its decision.

When incompetent evidence is admitted, it is presumed to be prejudicial if it has "some probative value upon a material issue of fact." Mali v. Odom, 295 S.C. 78, 367 S.E.2d 166 (S.C. Ct. App. 1988), citing South Carolina State Highway Dep't v. Graydon, 246 S.C. 509, 144 S.E.2d

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resumes provided to Mastercard and when asked several questions during both his deposition and trial testimony that should have elicited this information. (R. 20, 1371–72, 6539, 6557–58.) As the ALC noted, because this omission was not identified until after the hearing, there was no opportunity to evaluate why he omitted it or whether the employment related in any way to Mastercard, its competitors, or anyone else in the credit card industry.

484 (1965). For example, when there is witness testimony on both sides of a disputed issue such that incompetent evidence on one side may have influenced the factfinder, prejudice must be presumed. Graydon, 246 S.C. at 511, 144 S.E.2d at 485. Prejudice also exists when improperly admitted expert testimony "goes to the heart of the case." State v. Crumpton, 444 S.C. 16, 28, 905 S.E.2d 448, 455 (S.C. Ct. App. July 31, 2024); see also State v. Ellis, 345 S.C. 175, 547 S.E.2d 490, 491 (S.C. 2001). In these circumstances, the burden shifts to the propounding party to prove the absence of prejudice. Odom, 295 S.C. at 84, 367 S.E.2d at 170.

Prejudice is presumed to exist here because Hawkins's testimony had probative value upon material issues. This case implicates the scenario discussed in Graydon, where competing evidence is presented on an issue, some of which is deemed incompetent. The ALC here noted that three Mastercard witnesses testified "unequivocally" that cardholders and merchants are not Mastercard's customers. (R. 37.) The Department's auditor also testified that cardholders and merchants are not Mastercard's customers. (R. 681:17–21 (describing the Department's sourcing method as "looking to where Mastercard's customers' customers' activity occurs").) Several exhibits describe Mastercard's customers as issuer and acquirer banks, and none describe cardholders or merchants as such. See supra at 32–33. Despite all the evidence being to the contrary, the ALC concluded that cardholders and merchants are, in fact, Mastercard's customers. Hawkins's testimony is the only support for that conclusion. His testimony necessarily influenced the factfinder here, and under Graydon and Odom, prejudice is presumed.

Prejudice is also clear under Crumpton and Ellis because Hawkins's testimony goes to the heart of the case. The core issue here is identifying Mastercard's income-producing activity under § 12-6-2295(A)(5). Hawkins offered three opinions about "Mastercard's income producing activity" (R. 21–22), and the ALC adopted Hawkins's opinion on the overarching question of what

Mastercard's income-producing activity is. Compare R. 31 (ALC concluding that "Mastercard's income producing activity is providing Network access to Cardholders, Merchants, and banks") with R. 22 (Hawkins opining that Mastercard generates revenue by providing a network for cardholders and merchants to transact business).

The ALC relied heavily on Hawkins's testimony, using it time and again to support essential components of its analysis. See R. 45–49. Whole paragraphs of the decision are obvious paraphrases, or sometimes nearly verbatim, of Hawkins's testimony, as shown below:

ALC's Decision	**Hawkins's Testimony**
"Mastercard targets Cardholders and Merchants to increase the use of Mastercard's debit and credit cards, but also claims that they are not its customers." (R. 45.)	"Mastercard is saying that cardholders aren't its customers and yet it directs its advertising at cardholders." (R. 873:1–3.)
"In fact, Mastercard is involved at all stages of the transaction through the Network. For example, Mastercard allocates the risks among the parties by determining which party bears the loss if there is a fraudulent transaction or a payment default." (R. 45–46.)	"Here it just shows Mastercard's involvement in the entire system because this is one example of where Mastercard allocates the risks. Right? Who's going to be owed if there's a fraudulent transaction or something doesn't get paid." (R. 835:2–7.)
"It is important for Mastercard to control the use of its marks because its marks have value in facilitating transactions between Cardholders and Merchants." (R. 46.)	"Q. And why is it important for Mastercard to -- to control the use of its branding and marks? A. Because its important to facilitate transactions between cardholders and merchants." (R. 839:20–23.)
"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." (R. 46.)	"Q. What does the logo demonstrate . . .? A. It demonstrates that the merchant or this transaction will be governed by the Mastercard rules and so, the cardholder can trust that they're not going to be charged a bunch of fraudulent charges from the merchant." (R. 839:25–840:7.)
"In addition to the licensing agreements, Mastercard controls Merchants through its contracts with Acquirer Banks." (R. 46.)	"Mastercard controls some of the terms in the merchant's relationship with the acquirer." (R. 813:1–3.)

"Mastercard also has many programs that are designed specifically for Merchants and the Merchants pay fees to Mastercard by way of the Acquirer Banks." (R. 47.)	"Mastercard has programs that are designed specifically for the merchant. And the merchant pays fees to Mastercard indirectly through the acquirer." (R. 813:3–6.)
"Mastercard also has programs that directly benefit Cardholders . . . 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." (R. 47.)	"So, Mastercard has programs that directly benefit cardholders. And cardholders benefit Mastercard by using their Mastercard branded cards and generating fees through -- that the issuer and acquirer pay Mastercard. And the cardholder actually does pay extra for goods and services. So, indirectly they pay some of those fees." (R. 813:9–16.)

The ALC's analysis parrots Professor Hawkins's unqualified and unreliable opinions.

Even when the ALC relies on exhibits for support, its interpretation is guided by its view of Hawkins's testimony. See, e.g., R. 45 ("Professor Hawkins relied on several Mastercard documents to refute Mastercard's contention that it has no relationship with Merchants."). And when the ALC expressed concerns about Hawkins's credibility given his "limited knowledge of Mastercard's operations prior to this case," the ALC said it would "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." (R. 20.) This is a textbook example of confirmation bias.[14] The ALC should not have looked to the exhibits with the stated goal of finding support for Hawkins's opinions. It should have looked at the documents impartially and independent of Hawkins's testimony.

Worse still, the ALC relied on Hawkins's opinions even when they contradicted DirecTV. For example, the ALC relied on Hawkins's opinion that Mastercard's view of its income-producing

[14] See Oxford English Dictionary Online (accessed Oct. 8. 2024) ("The tendency to seek or favour new information which supports one's existing theories or beliefs, while avoiding or rejecting that which disrupts them."); Cambridge Dictionary Online (accessed Sept. 24, 2024) ("The fact that people are more likely to accept or notice information if it appears to support what they already believe or expect").

activity was too narrow. (R. 23.) But in DirecTV this Court adopted a narrow view, agreeing with the Department's then-construction of the statute. DirecTV, Am. Final Br. Resp't, 2017 WL 5514322 at *24 (Feb. 8, 2017) ("[T]he term 'income-producing activities' should have a narrow meaning under § 12-6-2295(A)(5)."). The ALC also relied on Hawkins's opinion that Mastercard is involved "long before" a cardholder swipes a card because cardholders see Mastercard's nationwide advertising (R. 23–24, 26), but in DirecTV advertising was deemed irrelevant because it is "too attenuated" from the production of income. 421 S.C. at 78, 804 S.E.2d at 643.

Even if Professor Hawkins were qualified, the ALC should not have adopted opinions that were foreclosed by DirecTV. The ALC noted that its adoption of Hawkins's opinion did not "fit neatly" with the framework required by DirecTV. (R. 44.) But instead of rejecting Hawkins's opinions, it rejected DirecTV.

The ALC effectively carved out exceptions to binding case law through Hawkins's testimony, which is the furthest thing from "qualified" reliance. Mastercard was prejudiced by the ALC's admission of Hawkins's testimony, and the Department must prove otherwise.

III. The ALC Erred in Upholding the Department's Imposition of Penalties for Failure to File

The Department imposed penalties on Mastercard for failure to file a return pursuant to S.C. Code Ann. § 12-54-43(C) and failure to pay pursuant to § 12-54-43(D). (R. 50.) The ALC abated the vast majority of failure to pay penalties, finding that Mastercard had a good-faith belief that its sourcing position was consistent with DirecTV, particularly given that the Department's Rule 30(b)(6) witness, auditor, and state tax policy expert all testified that they were unaware of any situations where income taxes were imposed on a taxpayer based on "what could be perceived to be the actions of its customer's customer." (R. 53.)

The ALC thus acknowledged the reasonableness of Mastercard's substantive position, a position that would have resulted in zero tax. The ALC nevertheless upheld the imposition of penalties for failure to file returns. It is unreasonable to impose penalties of more than $1.5 million for failure to file returns that would have showed no tax. The ALC's conclusion regarding Mastercard's good-faith belief should have resulted in the abatement of failure to file penalties in addition to failure to pay.[15]

CONCLUSION

Mastercard respectfully requests that the Court reverse the Final Order of the ALC and rule in Mastercard's favor. The ALC's decision is irreconcilable with DirecTV, and the ALC relief on unqualified and unreliable expert testimony to support key aspects of its decision. The decision below merits reversal.

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[15] In any event, if the Court determines that Mastercard owes no tax, or less tax than the Department assessed, failure to file penalties must be eliminated or reduced accordingly, because they are imposed as a percentage of the tax required to be paid. S.C. Code Ann. § 12-54-43(C), see also S.C. Revenue Procedure #08-6 at 8 (Oct. 28, 2018), available at https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RP08-6.pdf (explaining that a penalty that is based on a percentage of tax due must be reduced when the amount of tax assessed is later reduced).

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