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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 REPLY BRIEF OF APPELLANT

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INTRODUCTION

The core issue here is the proper identification of Mastercard's "income-producing activity" under S.C. Code Ann. § 12-6-2295(A)(5). The Department asks this Court to grant it the "flexibility" to apply the statute any way it sees fit—even though the Department's application here ignores how the Court applied the statute in DirecTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, 421 S.C. 59, 804 S.E.2d 633 (Ct. App. 2017). There, the Department advanced an interpretation diametrically opposed to what it now proposes here, and the Court adopted that prior interpretation. In fact, the Court rejected the rationale offered by the taxpayer in that case, which mirrors the interpretation now offered by the Department here. While the Department asks for the "flexibility" to create a new apportionment method here, in DirecTV the Department told this Court that flexibility in applying § 12-6-2295 is bad because it really means "uncertainty."

No new apportionment method is needed. The Court can simply apply the same method it applied in DirecTV, by determining what the taxpayer's customers pay it to do and where those activities occur. In DirecTV, the taxpayer's customers (television subscribers) paid the company to deliver a television signal into their homes and businesses; none of the taxpayer's other activities were relevant. This approach is simple and straightforward, and does not require every taxpayer to hire an expert to figure it out. Applied here, Mastercard's customers (issuer and acquirer banks) paid the company for four specific credit card-related activities—authorization, clearing, settlement, and assessment. Where those activities occurred is clear from the Record. There is no basis to focus instead on Mastercard's "income-anticipatory" activities—the same types of activities that were rejected as irrelevant in DirecTV—or to look through Mastercard's actual bank customers to find "indirect" customers.

The Court has a critical choice here. It can look to invoices, price lists, and the consistent testimony of all five fact witnesses (three proffered by Mastercard and two by the Department), or it can adopt the Department's convoluted theory that treats cardholders and merchants as Mastercard's "indirect" customers simply because they allegedly pay more for goods and services because banks pay fees to Mastercard. The best answer is usually the simple one: apply DirecTV, which provides a straightforward, consistent, and administrable interpretation of § 12-6-2295(A)(5). The Administrative Law Court's decision should be reversed, and Mastercard's revenues should be sourced to the locations where its bank customers receive its services, which locations are out-of-state. See App. Br. 23–24.

Further undermining the Department's theory of the case here is that it is built upon opinions given by purported expert Jim Hawkins. The ALC failed to fulfill its gatekeeping role by allowing Hawkins to testify to matters he had only "limited knowledge" of. Having "limited knowledge" is utterly incompatible with being admitted as an expert. Moreover, the ALC questioned Hawkins's credibility and noted his lack of candor in answers provided both at his deposition and at trial, adding that this prevented Mastercard from fully exploring any potential bias. The ALC compounded this error by accepting all of Hawkins's opinions, including as to the ultimate issue of identifying Mastercard's income-producing activity, and by relying heavily on Hawkins's opinions throughout its decision. The ALC's improper admission and reliance on Hawkins's testimony is prejudicial and merits reversal.

ARGUMENT

I. This Case Presents a Question of Law, Not a Question of Fact as the Department Asserts

The Department incorrectly claims that the identification of Mastercard's income-producing activity is "a question of fact." Resp't Br. 12 (citing DirecTV, 421 S.C. 59, 72, 804

S.E.2d 633, 640). But DirecTV says the opposite: "Because this argument concerns statutory interpretation, it is a question of law, which we may decide without any deference to the ALC." 421 S.C. 59, 72, 804 S.E.2d 633, 640. The question here, just like in DirecTV, is whether the ALC misinterpreted § 12-6-2295(A)(5) when identifying Mastercard's income-producing activity. That was a question of law in DirecTV, and it is a question of law here.

II. The Department's Request for "Flexibility" to Develop Ad-Hoc Interpretations of the Income-Producing Activity Method Should Be Rejected

A. As the Department's Own Tax-Policy Expert Stated, "Flexibility Is a Nice Sounding Word, But I Think It Ends Up Being Uncertainty"

The Department says DirecTV reaffirmed that the "income-producing activity" method in § 12-6-2295(A)(5) is "flexible," Resp't Br. 32, so flexible that the Department can interpret it to have one meaning in DirecTV and the opposite meaning here. The Department seems to have forgotten everything it told this Court in DirecTV about how to interpret § 12-6-2295(A)(5). There, the Department said that advertising is irrelevant. DirecTV, Am. Final Br. Resp't, No. 2015-001509, 2017 WL 5514322, at *11–12, 23 (Ct. App. Feb. 8, 2017). Yet here, the Department's brief opens by discussing the supposed importance of Mastercard's advertising. Resp't Br. 1. In DirecTV, the Department said that income-producing activity must be viewed narrowly. 2017 WL 5514322, at *25. Yet here, it criticizes Mastercard for doing just that. Resp't Br. 2. At no point does the Department try to reconcile its current position with its insistence on a narrow interpretation of income-producing activity in DirecTV. Its position here, that "income-producing activity" is the service that all participants in a transaction, or even a combination of transactions, want in exchange for payment, Resp't Br. 15–16, is not the narrow view required, but an astoundingly broad one.

Every principle the Department asserted in DirecTV is the opposite of what it says now:

Principle	Department's Position in DirecTV	Department's Position Here
How should the income-producing activity test be interpreted?	Narrowly[1]	Broadly[2]
Which act is the income-producing activity?	The Final Act[3]	The First Act[4]
Is the taxpayer's entire network of physical infrastructure relevant?	Not Relevant[5]	Crucial[6]
Is the taxpayer's advertising relevant?	Not Relevant[7]	Crucial[8]
Whose activities are considered income-producing?	The Taxpayer's[9]	Everyone's[10]
Are activities considered if they do not directly produce income but help lead to future income?	No, those are Income Anticipatory[11]	Yes, even if conducted "Long Before"[12]

[1] Am. Final Br. Resp't, 2017 WL 5514322, at *25 ("[T]he term 'income-producing activities' should have a narrow meaning under § 12-6-2295(A)(5).").

[2] Resp't Br. 2 (criticizing Mastercard for "narrowly defin[ing] its income producing activity").

[3] 2017 WL 5514322, at *20 ("It is this 'final act,' which excludes all of the pre-order and other preparatory acts which are too attenuated to the production of income, that generates DIRECTV's monthly subscription receipts.") (internal citations omitted).

[4] Resp't Br. 28 (looking to where the merchant and cardholder "initiate" a transaction); R. 44 (looking to "the beginning of the transaction not at the end as was the case in *DIRECTV*").

[5] DirecTV, 421 S.C. 59, 78 (reasoning that DirecTV's creation of content and a distribution infrastructure "help[ed] lead to income" but alone did not "actually generate" any).

[6] R. 33 (reasoning that the provision of Mastercard's "Network," which includes the technological infrastructure and the rules, is what produces Mastercard's income).

[7] 2017 WL 5514322, at *11–12, 23 (deeming advertising irrelevant because "the evidence did not reflect what portion of the advertising was attributable to South Carolina sales").

[8] R. 45 (accepting the relevance of advertising even though no evidence in the record connects any advertising to a specific portion of Mastercard's sales).

[9] 2017 WL 5514322, at *26 ("Although the subjective intent of the customer may be relevant," the inquiry must be "focused on [the taxpayer's] activities, not the activities of the customers.").

[10] R. 16, 31, 39 (identifying the income-producing activity to "include[] the activities of Cardholders, Merchants, Issuer Banks, Acquirer Banks and Mastercard.").

[11] 421, S.C. 59, 77–78 (finding the production and marketing of programming to be "preparatory," "income-anticipatory" activities that "cannot be IPAs because they do not produce income'").

[12] R. 23–24 (accepting the Department's position that Mastercard worked to attract cardholders and merchants "long before" any actual payment is made).

The Department's only attempt to align its diametrically opposed positions is to advance a severely constricted reading of DirecTV, telling the Court that the only binding legal principle it should glean from its prior decision is that the Court in DirecTV "reaffirm[ed] that section 12-6-2295(A)(5) is a flexible standard." Resp't Br. 32. Under no fair reading of DirecTV can "flexibility" be the takeaway—the decision says nothing of the sort, nor does it suggest that the Department can apply the standard willy nilly based on the taxpayer's industry, such that the Department can take drastically opposing positions from one taxpayer to the next.

Ironically, in DirecTV the Department urged the Court to keep flexibility out of § 12-6-2295(A)(5), with its brief there emphasizing why flexibility in apportionment is problematic. 2017 WL 5514322, at *10. The Department's expert, John Swain (who testified for the Department both in DirecTV and here), testified in that case that the use of cost data to measure income-producing activities was bad tax policy because "it certainly hurts the value of certainty" by opening the door for both taxpayers and the Department to take advantage of "vagueness, ambiguity . . . lack of clear guidance, whipsawing, [and] tremendous flexibility." DirecTV, Tr. at 463:8–15, No. 14-ALJ-17-0158-CC (Admin. L. Ct. Jan. 13, 2015). Professor Swain concluded: "'flexibility' is a nice sounding word, but I think it ends up being uncertainty." Id. at 464:8–10. The Department quoted this testimony in its brief to this Court in DirecTV. 2017 WL 5514322, at *10. Its current attempt to interpret DirecTV as reaffirming the importance of flexibility is revisionist history.

The Department draws this supposed flexibility from the Court's statement that "[i]n South Carolina, the nature of the taxpayer's business in the state determines the method of apportionment a taxpayer must use." Resp't Br. 16 (quoting DirecTV, 421 S.C. 59, 71, 804 S.E.2d 633, 639). But this innocuous sentence does not mean what the Department understands it to mean. It simply indicates that the "nature of the business," meaning whether the taxpayer sells services or tangible

goods or licenses intangibles, determines what general apportionment provision applies at the threshold. This is apparent from the next sentence, where the Court says that service providers like DirecTV use a fraction based on gross receipts, measured by income-producing activity under § 12-6-2295(A)(5). 421 S.C. 59, 71–72, 804 S.E.2d 633, 639–40. Thus, the sentence upon which the Department hangs its "flexibility" hat merely positions that case within the income-producing activity standard of § 12-6-2295(A)(5) and does not explain how the income-producing activity standard applies to any given taxpayer. And nothing in that language suggests that the Legislature intended to give the Department the authority to apply such extreme flexibility.

A fair reading of DirecTV reflects what the Court actually said about the income-producing activity standard and what the Department told the Court about how the standard should apply. The Department's brief there explained that "'income producing activities' should have a narrow meaning under § 12-6-2295(A)(5)." 2017 WL 5514322, at *24 (emphasis added). The Department found support in the statute's plain language, which uses the term "income-producing" to modify "activities," such that the statute is not focused on "all activities of a taxpayer," but only the narrow subset of the taxpayer's activities that actually and directly produce income. Id. (emphasis added). The Department's reading of the statute there was based on simple statutory interpretation, which could be applied to all service providers independent of industry-specific considerations. In other words, a narrow reading of "income-producing activity" was compelled directly by the statute, not by industry considerations specific to satellite television providers. The narrow interpretation is clear: identify the specific activity that actually produced income.

There is no basis to treat "income-producing activity" narrowly in DirecTV, but then "flexibly" switch to a broad application for another industry, as the Department argues here. Nothing in the Legislature's use of the phrase "income-producing activity" indicates any intent for

that result. The Department's own 30(b)(6) witness was asked, "Is there anything unique about credit card processing that would cause the Department to apply a different legal standard to Mastercard than it would apply to another service provider?" to which he testified: "No. There's nothing unique." (R. 1082:9–13.) And while the Department bases its theory in part on Mastercard's business being a "two-sided" or "multi-sided" platform (Resp't Br. 19–20), its own expert testified that television providers (like DirecTV) are also multi-sided platforms, bringing together advertisers and viewers. (R. 973:6–974:7.) See also William F. Baxter, Bank Interchange of Transactional Paper: Legal and Economic Perspectives, 26 J. L. & Econ. 541, 558, 575–76 (1983) (describing the four-party credit card system as a means of solving problems of "interbank indebtedness" and the transfer of payments between banks by alleviating the need for each bank to enter into a bilateral agreement with every other bank).

In short, there is no reason Mastercard should be subjected to an apportionment method that is the opposite of the one used for DirecTV. Mastercard's activities align with DirecTV's in that each earns revenue by performing specific and identifiable tasks for its customers. In DirecTV, that was the delivery of its programming signals into its customers' homes and businesses. 421 S.C. 59, 75, 804 S.E.2d 633, 641–42. For Mastercard, the specific and identifiable tasks it performs for its customer banks are delivering authentication messages to the banks as part of authorization, delivering reconciliation reports to the banks as part of clearing, and delivering advisement reports and transfer fund orders to the banks as part of settlement. App. Br. 9–13. Even though the actions for which banks pay Mastercard are clear—they are set out expressly in the Cost Letters at Joint Exhibits 2 and 3—the ALC and the Department instead looked to the activities this Court expressly rejected in DirecTV for being too nebulous, things like advertising and developing a network of infrastructure in anticipation of providing specific services to specific customers.

The Department describes its approach here as "flexibility," but what it seeks is carte blanche authority to discern a new method of apportionment on a taxpayer-by-taxpayer basis. The Department's tax policy expert explained in DirecTV why flexibility is a problem. And here, he testified that good tax policy manifests in taxpayers having clear guidance and administrable rules. (R. 1010:9–1011:6; R. 1060:4–10.) The Court should endorse those principles and apply the administrable rule from DirecTV, which service providers can apply without ad hoc applications by the Department. Otherwise, no service provider can know what rule the Department will choose to apply to it, and this standardless rule can be applied in an unfair and discriminatory manner.

B. Undisputed Documents in the Record Show Exactly What Mastercard's Customers Pay It to Do

The Department defines "income-producing activity" as the service that participants in a transaction want in exchange for payment. Resp't Br. 15–18. Yet the Department ignores the clear evidence of the exchange of payments in the Record along with the testimony of its own auditor and 30(b)(6) witness—both as to who is paying and what they are paying for—and instead relies on a convoluted theory of "indirect" payment buried in a footnote in its brief.

First, the "who." The Record shows exactly who is paying Mastercard. It includes actual invoices Mastercard sent to its bank customers and two Cost Letters that describe the fees Mastercard charged in its invoices. (R. 2779–2823; R. 6369–83.) Every charge described in those Cost Letters is imposed on an issuer or acquirer bank. (R. 2782–89.) The documents make clear that Mastercard provides its services to issuer and acquirer banks in exchange for payment from those banks. The Record does not include any invoices Mastercard sent to cardholders or merchants because no such invoices exist; Mastercard does not provide services to cardholders or merchants, and cardholders and merchants do not pay Mastercard. The Department's own fact

witnesses—its auditor and its 30(b)(6) designee—clearly understood that cardholders and merchants do not pay Mastercard, and each testified to this understanding. App. Br. 33–34.

The Department ignores all of this and instead looks to a theory of "indirect" payment by cardholders and merchants. After acknowledging that the banks are the "technical payors" of Mastercard's fees, the Department argues that "the banks often pass on their fees to the Merchants, who in turn increase the cost of their goods and services," such that "the cardholder ends up paying for part of Mastercard's fees indirectly." Resp't Br. 26, n.9. This is the Department's evidence of the supposed "exchange of payment" between cardholders or merchants and Mastercard. It posits that a cardholder "indirectly" exchanges payment to Mastercard when she purchases a pair of shoes because the shoe store includes some indeterminate amount of mark-up into the cost of the shoes, and because the acquirer bank also includes some indeterminate amount of mark-up into the store's cost of doing business to reflect that it has to pay fees to Mastercard.

But a cardholder's bearing of some indeterminate amount of Mastercard's fees indirectly through two layers of the general cost of doing business is hardly the "narrow" interpretation of income-producing activity the Department set forth in DirecTV. Merchants undoubtedly mark up their prices to reflect all sorts of costs of doing business, like rent, employee salaries, utility bills, advertising, and insurance costs. A consumer does not become an indirect tenant of the landlord, an indirect employer of the workers, or an indirect customer of the electric company, the advertising agency, or the insurance company simply because it buys something from a merchant. Moreover, the Department focuses on the wrong transaction. It is irrelevant to Mastercard if a merchant charges more for a pair of shoes. Mastercard does not make more or less money based on this supposed mark-up. Mastercard earns its authorization, clearing, and settlement receipts for processing transactions regardless of the cost of the items being purchased.

Second, the "what." Again, the Record shows exactly what the banks are paying Mastercard for. While the Department paints an overly broad picture, asserting that Mastercard earns fees because it provides an overall payment system "to Cardholders, Merchants, and Issuing and Acquiring Banks so that these parties can exchange goods and services" (Resp't Br. 19), the actual documents in the Record show what Mastercard gets paid for much more specifically. The Cost Letters do not describe any fee for the overall provision of the network; rather, they describe specific fees banks pay for specific activities, for example, an authorization fee incurred by an issuer bank for each authorization request processed by Mastercard (R. 2786), and a settlement fee incurred by a bank for "receiv[ing] settlement and clearing records" from Mastercard's clearing system, with the fee being "determined by the weekly number of messages [the bank] received" through that system (R. 2785).

Nor do the sample invoices show any fees for generic network provision as the Department's argument would require. Consistent with the Cost Letters, the invoice shows specific fees paid by banks for specific activities performed by Mastercard. For example, Exhibit 30 includes an invoice Mastercard issued to Conway National Bank, which shows that for this specific billing cycle, this bank had 697 authorization messages processed by Mastercard, and for each one paid a fee of $0.011. (R. 6370.)

As the Court acknowledged in DirecTV, the statute requires the identification of the activity of a taxpayer that "actually" and "directly" produces income. 421 S.C. 59, 67, 79, 804 S.E.2d 633, 637, 643. The invoices and Cost Letters in the Record show exactly what payments were made, by whom, and for what. Under DirecTV, the inquiry should end there.

C. If an Industry Rule Is Needed, One Can Only Be Adopted Through the Legislative or Regulatory Processes

The Department believes it has the flexibility to reinterpret the income-producing activity standard in § 12-6-2295(A)(5) for each industry that comes before it. But the Legislature already enacted industry-specific provisions for several other industries. S.C. Code Ann. § 12-6-2310. If the Legislature thinks another one is needed for the credit card industry, it knows how to enact one.

Several other states have adopted, by statute or regulation, rules for groups of industries that include credit card services. None has adopted the Department's method here; in fact, many expressly reject it. The Multistate Tax Commission—an intergovernmental state tax agency, of which South Carolina is an associate member—has adopted a model apportionment rule for all "professional services," which includes "credit card services (including credit card processing services)." Multistate Tax Commission, Model General Allocation & Apportionment Regs., § IV.17.(d)(4)(A), (C); App. Br. 32, n.9. Under the MTC model, receipts from such professional services are assigned to the state where the business "customer" manages the contract of sale, places an order for the services, or has its billing address. Id. at § IV.17.(d)(4)(C)(1)(b). The rule makes clear that the "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." Id. at § IV.17.(d)(4)(C). Thus, for a credit card processor like Mastercard, the rule looks to the banks' locations; any indirect benefits for cardholders and merchants are irrelevant.

The MTC's rule is not a hypothetical one. At least nine states have adopted it or one that is substantially similar: Colorado, Idaho, Massachusetts, Montana, North Carolina, Oregon, Tennessee, Vermont, and West Virginia.[13] Other states have adopted their own industry rules for

[13] Colo. Code Regs. § 201-2:39-22-303.6-10(4); Idaho Admin. Code r. 35.01.01.548(04); 830 Mass. Code Regs. § 63.38.1(9)(d)(4)(d); Mont. Admin. R. 42.26.248(4); 17 N.C. Admin. Code

credit card processors apart from the MTC model, and again do not consider the cardholders or merchants to be relevant. New York, for example, uses a rule that assigns the receipts to the locations where issuer and acquirer banks physically access Mastercard's network—the exact result Mastercard seeks here. N.Y. Tax Law § 210-A(5)(c)(4); N.Y.C.R.R. tit. 20, § 4-2.15(b)(1).

This case of course involves South Carolina law, and the South Carolina courts are not beholden to industry rules adopted by sister states. But the other states that have adopted credit card industry rules have uniformly adopted rules that reject the relevance of cardholders and merchants when apportioning the income of a credit card processor. And those states reached those rules through the formal legislative or regulatory processes, not by ad hoc decision-making through the audit of a single taxpayer. If an industry-specific rule is needed for credit cards in this State, the Legislature should adopt one like it has for several other industries. Or, at a minimum, the Department should propose a rule for the industry like other states have, with fair notice to the public and prospective application.

D. At a Minimum, the ALC's Order Should Be Reversed for Mastercard's Clearing, Settlement, and Assessment Revenues

Mastercard argued in its opening brief that the ALC's decision with respect to Mastercard's clearing, settlement, and assessment revenues was incompatible with its own findings of fact regarding these services. App. Br. 35–37. For example, the ALC found that cardholders and merchants were not involved in clearing or settlement and that these processes end when Mastercard provides reports to issuer and acquirer banks. (R. 12–13.) Moreover, the ALC found that assessment is not even a part of transaction processing, and that the charges for this are paid by banks based on the banks' proportionate use of Mastercard's services. (R. 13.)

5G.1001, 1003; Or. Admin. R. 150-314-0435(4)(d); Tenn. Comp. R. & Regs. 1320-06-01.42(4)(d); 1-3-103 Vt. Code R. 1.5833(D)(3)(3); W. Va. Code R. § 110-24-6.5.7.d.1.

The Department did not address this argument in its response brief, but several statements in the brief further bolster Mastercard's position. The Department itself describes clearing as the facilitation of financial transaction information between issuer and acquirer banks, and settlement as the facilitation of the exchange of funds between the banks. Resp't Br. 6. The Department defines "income-producing activity" to mean what the participants in a transaction want in exchange for payment. Id. at 15–18. As the ALC found, however, cardholders and merchants are not involved in these services, so how do they want anything in exchange for their non-participation?

To the extent the Department implicitly addresses this point, it is simply in its incorrect argument that every fee Mastercard charges is based on the number or dollar volume of transactions between cardholders and merchants. Id. at. 2, 9, 10, 19, 27, 29. The Department cites Mastercard's 10-Ks (id. at 9), but the documents do not say that—they merely say revenue is "impacted by" those metrics and that transaction processing fees are "primarily" based on the number of transactions. See, e.g., R. 4574. That characterization of Mastercard's fees is not true for clearing and settlement as the ALC's own findings make clear. The ALC found that "Mastercard charges fees to its Issuer and Acquirer banks based on the number and size of clearing messages sent to, or received from, each bank," and that Mastercard's settlement fees are "based on the number of reports Mastercard delivers to Issuer and Acquirer Banks. (R. 12–13.) While assessment fees are charged based on dollar volume, the Department itself acknowledges that these fees are charged "based on a bank's proportionate use" of Mastercard's services. Resp't Br. 27.

Even if the Court affirms the ALC's decision with respect to authorization, its conclusions for clearing, settlement, and assessment are incompatible with its own findings and merit reversal based on a separate determination of the income-producing activity for each category of revenue.

III. The Department's So-Called "Expert" and His "Limited Knowledge"

A. The Department's Argument That the Bar for Admitting Expert Testimony Is Lower Than What Rule 702 Calls for Is Inconsistent With South Carolina Law, and Hawkins's "Limited Knowledge" Shows That He Is No Expert

The Department suggests that the bar for admitting expert testimony is lower than what Rule of Evidence 702 calls for, arguing that it need only show that the witness has acquired enough knowledge to make him better qualified than the fact finder to form an opinion. Resp't Br. 40 (citing Fields v. J. Haynes Waters Builders, Inc., 376 S.C. 545, 556, 658 S.E.2d 80, 86 (2008)). But Fields says no such thing. The Supreme Court said that "Rule 702 recognizes that there are a variety of ways in which a person can become so skilled or knowledgeable in a field that their opinion in a scientific, technical, or specialized area can assist the trier of fact in determining a fact or in understanding the evidence." 376 S.C. 545, 556, 658 S.E.2d 80, 86 (emphasis added). The Supreme Court did not endorse the watered-down standard suggested by the Department, where any witness may testify as long as they know more about the topic than the trial judge. Similarly, in Watson v. Ford Motor Co., 389 S.C. 434, 448, 699 S.E.2d 169, 176 (S.C. 2010), the Supreme Court looked at whether the proffered expert had sufficient knowledge about cruise control systems to testify as an expert on that topic, not at whether the witness knew more about cruise control systems than the judge or jury. Such a low bar would undermine the value of expert testimony.

The ALC evaluated Hawkins's credentials, and expressly concluded that he had only "limited knowledge of Mastercard's operations prior to this case." (R. 20 (emphasis added).)[14] The ALC concluded that Hawkins's body of work "does not evidence a longstanding, in-depth knowledge of the operations of credit card companies as they relate to the issues under

[14] For a detailed explanation of the shortcomings of Hawkins's experience, including that he had never published regarding credit card networks' activities, that he had not studied Mastercard's business specifically, and his admission that income-producing activities and the geographic sourcing of income "generally isn't important" in his field, see R. 1268–74 and R. 1195–1201.

consideration here." (R. 18 (emphasis added).) Having only limited knowledge, a lack of in-depth knowledge, and a lack of longstanding knowledge does not satisfy the plain language of Rule 702, which says that if "specialized knowledge" will assist the trier of fact to understand the evidence or determine a fact in issue, "a witness qualified as an expert by knowledge, skill, experience, training, or education" may testify. Rule 702, SCRE. His "limited knowledge" also does not make him "so skilled or knowledgeable" in the issues under consideration, as contemplated by Fields, nor does it mesh with a common-sense understanding of the word "expert"—someone with the special skill or knowledge representing mastery of a particular subject.[15]

The ALC's findings compel the conclusion that Hawkins is not qualified, and the ALC's decision to admit his testimony despite those findings is clear, reversible error.

B. Contrary to the Department's Assertion, Rule 703 Does Not Allow a Witness to Develop New Expertise by Studying Documents Produced in Discovery

The Department admits that Hawkins learned about Mastercard's operations and the issues in the case in the run-up to trial, but nevertheless argues that his testimony was proper because Rule of Evidence 703 allows him to base opinions on information he learned after the case began. Resp't Br. 42.[16] The Department misreads Rule 703. That rule does not go to an expert's qualification, which is the province of Rule 702. See JoAnne A. Epps, Clarifying the Meaning of Federal Rule of Evidence 703, 36 B.C. L. Rev. 53, 53 n.4 ("Experts are defined, and their testimony authorized, by Rule 702."). Rule 703 presumes an expert is qualified under Rule 702 and simply clarifies that the qualified expert may base an opinion on facts learned before trial. Id. at 70.

[15] Expert, Merriam-Webster Dictionary Online (accessed Feb. 11, 2025).

[16] Rule 703 says that "[t]he facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing." Rule 703, SCRE.

This interplay between Rule 702 and Rule 703 makes perfect sense. Imagine a case in which there is a question as to whether a slip-and-fall on an icy sidewalk could have resulted in a specific bone break. Rule 702 would require that an expert have substantial medical training and experience with respect to evaluating X-rays, and in-depth knowledge regarding bone breaks. Rule 703 then makes clear that the already-qualified expert can review a specific patient's X-ray for the first time at trial, or shortly before, and opine on the nature and extent of that party's injuries. See Id. at 62–63; State v. Jenkins, 436 S.C. 362, 872 S.E.2d 620 (S.C. 2022). Rule 703 would not allow the witness to learn about bone breaks or how to analyze an X-ray in the lead-up to trial.

But that is precisely what Hawkins did. The ALC found that Hawkins did not have "longstanding" knowledge of the issues under consideration. His knowledge was not longstanding because he only recently learned about the Mastercard-specific processes at issue by studying the documents produced in discovery, a point he admitted in his testimony. App. Br. 41. He testified that the issue in this case—the identification of income-producing activities—"generally isn't important" in his field such that it was not something he would "spend a lot of time thinking about." (R. 967:12–20.) In his thousands of pages of writing about bank lending, credit card networks (including Mastercard and its major competitors) were mentioned a mere handful of times, nearly always in footnotes. (R. 105–06; R. 760:2–7 ("Q: How – how many of your articles have a meaningful discussion of credit card networks meaning the companies Mastercard, Visa, American Express, Discovery or their competitors? A: None directly talk about those four companies.").)[17] Hawkins did not review Mastercard data to derive an opinion based on preexisting experience; he reviewed Mastercard data to develop that expertise in the first place.

[17] In 1,026 pages composed of 25 of Hawkins's publications, MasterCard was mentioned twice, in a footnote about fertility treatment financing; Visa was mentioned seven times; American Express three times; and Discover once. (R. 106.)

Perhaps recognizing this flaw, the Department now claims that Hawkins "was not offered as an expert on the specific topic of 'Mastercard.'" Resp't Br. 43. But this is not a credible statement. The Department's Disclosure of Expert Witnesses stated that Hawkins was "expected to provide testimony 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 Hawkins took the stand, he testified, "I was asked to help explain how the transactions work and then also to form an opinion about how – about Mastercard's revenue generating activities." (R. 725:1–9.) The Department's post-trial brief said "Professor Jim Hawkins opined generally about how Mastercard generates revenue." (R. 1215.) The Department told the ALC "[o]f course, Hawkins offered testimony about Mastercard's business operations and its income producing activities, but Hawkins was not offered as an expert in Mastercard. Rather, he was offered as an expert in 'consumer credit markets.'" (R. 1111.) Under the Department's reasoning, Hawkins can testify all he wants about Mastercard's business as long as they formally offer him as an expert in consumer credit markets. The subject matter of his testimony, not the self-serving label, is what matters.

The Department similarly contends that there is nothing wrong with Hawkins testifying on the topic of income-producing activities—after all, neither of the experts who testified in DirecTV were experts in apportionment or income-producing activities, or so the Department claims. Resp't Br. 42, n.19. In DirecTV, both the taxpayer and the Department called experts in economics, who testified to economic considerations for which they were qualified. The Department's expert in DirecTV, Dr. Harrison, oversaw the School of Accounting and the Department of Economics at Georgia State University. DirecTV, Tr. at 382:11-16. He testified, "I'm an economist . . . my general training [is] in economics," and explained that he had worked in several sub-areas, including

environmental economics, tax policy, regional economics, and public finance. Id. at 383:18–384:3. He had an undergraduate degree, two Masters degrees, and a Ph.D. in economics, and had previously testified as an expert approximately fifteen times. Id. at 387:21–388:11.

DirecTV's expert, Dr. Cody, had an undergraduate degree in economics, a PhD in economics, taught finance at the Wharton School, worked in economics at the Federal Reserve Bank, worked at Coopers & Lybrand in an economic group analyzing intercompany transactions, and had worked on multi-state issues related to apportionment since the early 1990s. Id. at 195:17–197:20. He had previously published an article describing his approach to identifying a company's income-producing activities, and had given speeches at tax conferences and economics conferences specifically on "these kinds of issues in terms of value creation, identification of income-producing activities." Id. at 198:7–18, 199:5–15. He testified as an expert on that issue approximately fifteen times before DirecTV, and testified that multi-state apportionment was an issue he focused on in his day-to-day employment. Id. at 199:16–200:16. He added that "the identification of value, where it is, and the compensation of it is really a core issue" in his field of study. Id. at 200:9–16.[18]

The experts in DirecTV were eminently qualified on the topics they testified on. Contrast their testimony with Hawkins's testimony. Hawkins had not testified about income-producing

[18] Even with his abundant expertise, the ALC and this Court still scrutinized and declined to adopt Dr. Cody's opinions. 421 S.C. 59, 76, 804 S.E.2d 633, 642. The ALC said Dr. Cody's focus on DirecTV's advertising and programming network was incorrect because those activities were "too nebulous" to be connected to specific items of income attributable to South Carolina. DirecTV, Inc. v. Department of Revenue, No. 14-ALJ-17-0158-CC, 2015 WL 2265424, at *8, 12 (S.C. Admin. L. Ct. May 12, 2015). This Court similarly said there was no reason to rely on those activities when fees paid by customers "directly placed a value" on the taxpayer's activities. DirecTV, 421 S.C. 59, 76, 804 S.E.2d 633, 642. Hawkins's opinions here were based on the same nebulous concepts, and far more nebulous ones, like "goodwill" and "trust." See App. Br. 25–26. Those opinions were rejected in DirecTV when offered by an eminently qualified witness; they should not be accepted here when offered by one found to have limited knowledge.

activities a dozen times before; he had never done so. (R. 1133.) Hawkins did not focus on the identification of a taxpayer's income-producing activity in his daily life as an academic; he admitted that the identification of a taxpayer's income-producing activity is something he would not spend a lot of time thinking about because it is not important in his field. (R. 967:12–20.) Hawkins was not qualified to testify as an expert here under Rule 702. His studying of the documents Mastercard produced in discovery in the lead-up to trial does not change that.

C. The Admission of Hawkins's Testimony Was Not Harmless Error as the Department Suggests, Because the ALC Relied Heavily on His Opinions

The Department argues that even if Hawkins's testimony was improperly admitted, the admission was harmless error for three reasons: (1) the ALC could have reached the same conclusions independent of Hawkins's testimony; (2) Hawkins did not offer an opinion on the ultimate issue; and (3) this case was not decided by a jury. Resp't Br. 45–47. Each of the Department's reasons fails.

First, the ALC's conclusion that cardholders and merchants "actually" pay Mastercard was critical to the ALC's determination, and this conclusion was based on Hawkins's testimony. No document in the Record evinces any payments from cardholders or merchants to Mastercard. App. Br. 31–35; R. 2779–2823 (Cost Letters); R. 6369–83 (sample invoice); R. 6600 (schedule of fees paid by banks). Five witnesses with direct knowledge of Mastercard's facts—all three of Mastercard's witnesses, along with the Department's auditor and the Department's 30(b)(6) witness—testified that cardholders and merchants do not pay Mastercard. (R. 274:11–277:1 (Naskiewicz); R. 464:17–20 (Cavallo); R. 540:19–541:3, 555:25–556:8 (Buehler); 674:23–675:4 (Sharpe (Department's auditor)); R. 1066:17–19, 1068:8–12, 1070:1–2, 1071:5–10 (Department's 30(b)(6) witness).)

Hawkins's testimony claiming that there are "indirect" payments is the only evidence purportedly connecting payments from cardholders to Mastercard. (R. 857:4–19 ("So, obviously, this is indirect, but the cardholder ends up paying for part of Mastercard's services" because "merchants increase the cost of their services because they accept credit cards and pass those fees onto cardholders," referring in turn to "the fees that the merchant has to pay the acquirer, who has to pay Mastercard.").) This alone constitutes prejudice, because his testimony was the only support in the Record for this pivotal aspect of the ALC's holding. See Watson v. Ford Motor Co., 389 S.C. 434, 452, 699 S.E.2d 169, 178–79 (S.C. 2010) (finding the improper admission of expert testimony to be prejudicial when it was "[t]he only evidence Respondents presented to support their theory").

The Department downplays the importance of Hawkins's testimony to the ALC's decision by arguing that most of the ALC's discussion of Hawkins comes in its findings of fact and that the ALC "references Professor Hawkins's testimony only twice in its Conclusion of Law." Resp't Br. 46 (emphasis added). If one performs a "control-find" search for "Hawkins" in the ALC's decision, it is true that they will see only two hits within the Conclusion of Law section. But as Mastercard pointed out in its opening brief, entire paragraphs of the ALC's analysis are copied directly from Hawkins's testimony, regardless of whether the ALC expressly cited Hawkins each time. App. Br. 46–47 (listing examples where the ALC's analysis mirrored Hawkins's testimony).

But more importantly, there is no reason to limit the evaluation of Hawkins's influence to the Conclusions of Law section of the decision. The ALC discusses, cites to, and relies upon Hawkins's testimony and opinions over at least twelve pages of the decision. (R. 16–27.) The ALC described three opinions offered by Hawkins, and accepted them all, which undoubtedly carried over into the ALC's subsequent analysis. (R. 21–27.) The Department itself cites Hawkins's

testimony (transcript pages 495 through 753 (R. 724–982)) more than twenty times in its brief.[19]

Second, the Department claims that Hawkins "never offered an opinion on the 'ultimate issue' in this case; namely, what is Mastercard's income-producing activity under section 12-6-2295(A)(5)." Resp't Br. 47. But the ALC recognized that Hawkins gave such an opinion. Its heading atop page 17 of its decision says: **"Professor Hawkins' Opinions Regarding Mastercard's Income Producing Activity."** (R. 21.) And the Department acknowledged in its filings to the ALC that "Of course, Hawkins offered testimony about Mastercard's business operations and its income producing activities." (R. 1111.) Hawkins testified on the ultimate issue, the determination of Mastercard's income-producing activity, which this Court said in DirecTV is a question of law, and which Hawkins admitted is a topic he does not spend a lot of time thinking about. DirecTV, 421 S.C. 59, 72, 804 S.E.2d 633, 640; R. 967:12–20.

Third, the fact that this case was decided by the ALC rather than a jury does not preclude a finding of prejudice. The Department cites two cases for this proposition, but neither is on point. Resp't Br. 47. In State v. Inman, 395 S.C. 539, 720 S.E.2d 31 (2011), the court considered whether a defendant in a capital murder case was prejudiced by the prosecutor's improper intimidation of a defense expert. The prejudice evaluated there was prejudice of the prosecutorial misconduct in trying to keep qualified expert testimony out of the case, not prejudice resulting from the admission of incompetent evidence by an unqualified expert, as is the issue here. 395 S.C. 539, 565, 720 S.E.2d 31, 45. Even where the Inman court stated the exact quote the Department relies on—that

[19] This does not include references to Hawkins's testimony related to the issue of whether he is qualified, nor the wholesale paragraphs of the Department's brief that contain no citations to anything in the Record in the present case but could only be supported, if at all, by Hawkins's testimony. For example, the Department repeatedly relies on supposed facts it gleaned, not from the Record in this case, but from a court decision in a case involving American Express, and the Department did so even though evidence in the Record here makes clear that American Express operates a different business model than Mastercard. See Resp't Br. 19–25; R. 277:19–278:3.

it is a near insurmountable burden to prove prejudice in a bench trial—the court itself cited to a Virginia case for that proposition, Cole v. Commonwealth, 428 S.E.2d 303, 305 (Va. Ct. App. 1993).[20] Cole does not describe this as a nearly insurmountable burden. Quite the opposite. It makes clear that admitting improper evidence is reversible error in a bench trial if the record shows that the judge "considered such inadmissible evidence in adjudicating the merits of the case." Id.

The other case the Department cites also misses the mark. In Brown v. Allstate Insurance Co., 344 S.C. 21, 542 S.E.2d 723 (2001), the court determined that there was no prejudice because the party claiming prejudice had failed to prove an essential element of its case unrelated to the incompetent evidence. Thus, the party could not have been entitled to the relief it sought regardless of the disputed evidence. Moreover, the Department cites Brown for the proposition that trial court judges must admit all evidence and then evaluate it later. Resp't Br. 47. But the incompetent evidence in Brown was not expert testimony. So while the court there described the trial court's role as admitting all evidence, and then later deciding what weight to give that evidence, that does not comport with the Supreme Court's clear instruction to gatekeep incompetent expert testimony.

The Supreme Court made clear that gatekeeping comes first, and it is improper to simply admit evidence to decide what weight to give it later. In State v. White, 382 S.C. 265, 273–74, 676 S.E.2d 684, 688–89 (2009), the court said "the trial courts of this state have a gatekeeping role with respect to all evidence sought to be admitted under Rule 702," and "[t]he familiar tenet of evidence law that a continuing challenge to evidence goes to 'weight, not admissibility' has never been intended to supplant the gatekeeping role of the trial court in the first instance in assessing the admissibility of expert testimony, including the threshold determination of reliability."

[20] Inman also considered the context that a mistrial in a criminal case is "an extreme measure" with "a severe remedy," implicating double-jeopardy. 395 S.C. 539, 553, 565, 720 S.E.2d 31, 39, 45.

Nor is this gatekeeping function limited to jury trials. The Supreme Court subsequently applied State v. White and the emphasis on the trial court's threshold gatekeeping function in an appeal from the Administrative Law Court following a bench trial, reaffirming that "trial courts have a gatekeeping role with respect to all evidence sought to be admitted." Risher v. South Carolina Dep't of Health and Environmental Control, 393 S.C. 198, 206, 712 S.E.2d 428, 432 (2011). If the Department were right that the ALC should just "admit all evidence," it could never perform the gatekeeping function the Supreme Court has consistently emphasized.

The ALC failed to fulfill its gatekeeping function here. Its decision makes plain that the incompetent testimony was heavily considered in adjudicating the merits of the case. The ALC accepted all of Hawkins's opinions, even when contradicted by every other witness, including the Department's auditor and 30(b)(6) designee, and relied on his testimony throughout the decision. The ALC did so despite its own finding that Hawkins had "limited knowledge of Mastercard's operations prior to this case," that Hawkins showed no evidence of any "longstanding, in-depth knowledge of the operations of credit card companies as they relate to the issues under consideration here," that Hawkins's testimony merited only "qualified reliance," that Hawkins failed to disclose responsive information "despite having been given ample opportunity to do so at trial and during the deposition," and that this omission was "of concern to the Court," adversely impacted the Court's evaluation of his "candor toward the Court," and deprived Mastercard of an opportunity to explore whether Hawkins had any bias or conflict.[21] (R. 16, 18, 20.)

[21] The Department tries to whitewash the omission by saying "Mastercard's counsel simply failed to ask him about it at all." Resp't Br. 45, n.22. This is not true. As the ALC stated, "the various questions asked of the witness gave him ample opportunity to disclose" the information, and he "was asked a number of questions during his direct examination that should reasonably have elicited" it, including when "specifically asked whether his CV needed to be updated." (R. 59–61.) The ALC said the information "should have been revealed" based on these questions and it was "difficult to understand why" it was not. (R. 61–62; R. 20.)

The ALC's acceptance of all of Hawkins's opinions, and his repeated reliance on them throughout the decision, was not harmless. These issues go to the heart of both the witness's qualifications and credibility. The admission of his testimony was prejudicial and merits reversal.

IV. The Department Fails to Acknowledge That Mastercard's Returns Would Have Showed No Tax, a Position the ALC Found to Be Reasonable

The Department insists it was appropriate to impose penalties for failure to file tax returns (Resp't Br. 49), but fails to acknowledge that those returns would have showed $0 of tax based on Mastercard's substantive position that none of its receipts were attributable to South Carolina. App. Br. 49. That substantive position was consistent with the Court's holding in DirecTV, and the ALC found that position to be a sufficient basis to abate penalties for failure to pay the tax ultimately assessed by the Department. (R. 53.) There is no reason why Mastercard's good-faith substantive position should only justify the abatement of penalties for failure to pay tax and not the penalties for failure to file,[22] and it is unreasonable for Mastercard to be subjected to more than $1 million in penalties for failure to file returns that would have showed no tax due.

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 relied on unqualified and unreliable expert testimony to support key aspects of its decision.

[22] The Department says failure to file penalties are "mandated by law" (Resp't Br. 48), but S.C. Code Ann. § 12-54-160 authorizes the waiver or reduction of such penalties.

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