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SC Court of Appeals

THE STATE OF SOUTH CAROLINA

In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

Milton G. Kimpson, Administrative Law Judge
Robert L. Reibold, Administrative Law Judge (on Reconsideration)

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Appellate Case No. 2024-001577

Trial Court Case No. 20-ALJ-17-0168-CC

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U.S. Bank National Association, ..... Appellant,

v.

South Carolina Department of Revenue, ..... Respondent.

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# FINAL REPLY BRIEF OF APPELLANT U.S. BANK NATIONAL ASSOCIATION

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Bryson M. Geer (S.C. Bar No. 13606)
(843) 534-4306
Nelson Mullins Riley & Scarborough LLP
151 Meeting Street / Sixth Floor
Post Office Box 1806
Charleston, SC 29401-2239

Craig B. Fields (admitted *pro hac vice*)
(212) 885-5170
Nicole L. Johnson (admitted *pro hac vice*)
(212) 885-5286
Blank Rome LLP
1271 Avenue of the Americas
New York, NY 10020

*Attorneys for U.S. Bank National Association*

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## INTRODUCTION

South Carolina's tax apportionment law provides distinct sourcing provisions for specific categories of gross receipts. Receipts from services are sourced to South Carolina to the extent that the income-producing activity is performed within the State. Receipts from intangibles are sourced to South Carolina if the intangible is used in the State.

The core issue in this case is the sourcing of U.S. Bank National Association's ("U.S. Bank's") receipts related to mortgages, credit cards and credit card processing. U.S. Bank sourced each of these service receipts to South Carolina to the extent that its income-producing activities were performed in the State.

The Administrative Law Court ("ALC") disregards the distinct sourcing provisions, choosing instead to lump together all of U.S. Bank's receipts and source them to the location of U.S. Bank's customers or the customers' customers. In support of the ALC's sourcing methodology, the Department of Revenue (the "Department") claims that no matter which provision of South Carolina's apportionment law is applied, the sourcing is the same. The Department further claims that this sourcing is consistent with its "longstanding administrative practice." Nevertheless, the ALC's sourcing is unsupported and the Department's claims are meritless. In addition, the ALC's sourcing methodology renders South Carolina's apportionment law superfluous, which violates the rules of statutory construction.

The Department also improperly seeks to limit this Court's scope of review to only whether the ALC's findings are supported by substantial evidence. However, this Court's scope of review is not so limited.

Contrary to the Department's assertions, the record in this case establishes that U.S. Bank properly apportioned its receipts under South Carolina law. Therefore, the ALC's erroneous orders should be reversed.

## CORRECTIONS TO THE DEPARTMENT'S STATEMENT OF FACTS

U.S. Bank submits that the "facts" upon which the Department relies contain numerous errors, including the following:

First, the Department makes many incorrect and/or misleading assertions regarding U.S. Bank's mortgage and credit card activities in South Carolina, including the following:

| **Department's Assertion** | **Analysis** |
|---|---|
| U.S. Bank's mortgage-related activities in South Carolina include the "payment of principal, interest and fees[.]" Resp. Br. 4, 17.[1] | *Incorrect*. This is an activity of the borrower, not U.S. Bank. The activities performed by U.S. Bank to process mortgage payments all occur outside of South Carolina. R. p. 332, lines 2-14. |
| U.S. Bank's mortgage-related activities in South Carolina include the borrower providing application documents. Resp. Br. 4. | *Incorrect*. Again, this is an activity of the borrower, not U.S. Bank. The activities performed by U.S. Bank to process, close and fund mortgages all occur outside of South Carolina. R. p. 330, line 15-p. 331, line 9. |
| U.S. Bank appraises property in South Carolina. Resp. Br. 4. | *Incorrect*. Appraisals of property in South Carolina are performed by third parties, not by U.S. Bank. R. p. 357, lines 9-21. |
| U.S. Bank pays homeowner's insurance in South Carolina. Resp. Br. 4, 17. | *Incorrect*. The homeowner's insurance payments that U.S. Bank facilitates are made from outside of South Carolina. R. p. 344, line 4-p. 345, line 13. |
| U.S. Bank provides customer service in South Carolina. Resp. Br. 4, 17. | *Incorrect*. The customer service hotlines that U.S. Bank operates for its mortgage and credit card customers are all located outside of South Carolina. R. p. 337, lines 2-20; p. 374, line 23-p. 375, line 12. |

[1] All references to "Resp. Br." are to the Respondent's Initial Brief, filed with this Court on May 12, 2025, and all references to "App. Br." are to U.S. Bank's Initial Brief, filed with this Court on February 6, 2025.

| **Department's Assertion** | **Analysis** |
|---|---|
| U.S. Bank performs collections and foreclosure activities in South Carolina. Resp. Br. 4, 17. | *Misleading*. U.S. Bank's collections activities occur outside of South Carolina. R. p. 337, lines 9-20; p. 344, line 6-p. 345, line 13; p. 375, lines 13-25; p. 404, line 23-p. 405, line 14. Foreclosures in South Carolina are rare. R. p. 337, lines 9-17; p. 344, lines 21-22. |
| U.S. Bank's credit card activities include the offering of co-branded credit cards with partners "who are physically present in South Carolina." Resp. Br. 5. | *Misleading*. The physical presence of co-branding partners (such as Harley-Davidson) in South Carolina is an activity of the third-party partners, not an activity of U.S. Bank in the State. R. p. 366, lines 4-18; p. 382, line 25-p. 383, line 3. |

Second, the Department states that U.S. Bank sourced no interest income, mortgage service fee income, sale of mortgage income, interchange fee income or credit card fee income to South Carolina. Resp. Br. 3-4. This statement is incorrect. In July 2023, U.S. Bank amended its South Carolina Bank Tax returns to correct its sourcing for the tax years ended December 31, 2011 through December 31, 2016 (the "Years at Issue"). R. p. 418, lines 11-16; p. 419, lines 16-21.

Third, the Department states that U.S. Bank failed to produce evidence related to "loans other than residential mortgages" and chose to abandon any argument regarding the Department's sourcing of non-mortgage loans. Resp. Br. 8-9, 18. At issue in this case is the sourcing of U.S. Bank's receipts related to mortgages, credit cards and credit card processing services. Evidence related to other receipts and any decision by U.S. Bank to not challenge the Department's sourcing of those other receipts has no relevancy here. The Department's assertions to the contrary are baseless.

Finally, though the Department concedes that merchants pay U.S. Bank fees in exchange for services including authorizing transactions and ensuring the merchant is ultimately paid for the transaction, the Department mischaracterizes the services that U.S. Bank performs to earn interchange and merchant fees.[2] Resp. Br. 19. The Department states that merchants pay U.S. Bank for obtaining "data from the merchant at the point of sale… and then delivering data back to the merchant" at the point of sale. *Id*. Contrary to the Department's claims, U.S. Bank does not obtain any data from merchants or deliver data back to merchants. Rather, U.S. Bank obtains data from and sends data to merchant processors – none of which are located in South Carolina. R. p. 376, line 25-p. 377, line 21; p. 513, line 6-p. 515, line 8. Moreover, U.S. Bank does not send approval/disapproval decisions to the merchant's location. Instead, those decisions are sent to the merchant processors. R. p. 376, line 19-p. 377, line 9; p. 406, lines 12-16; p. 513, lines 6-24. Thus, the Department's claims are contrary to the record in this case.

## ARGUMENT

### I. The Department Improperly Attempts to Limit This Court's Scope of Review

The scope of review in this case is clear – the Court has *de novo* review over all questions of law, including those of statutory interpretation, and the Court must find that the ALC's findings of fact are supported by substantial evidence. *See Jack's Custom Cycles, Inc. v. S.C. Dep't of Revenue*, 439 S.C. 35, 48, 885 S.E.2d 433, 440 (Ct. App. 2023); *see also Original Blue Ribbon Taxi Corp. v. S.C. DMV*, 380 S.C. 600, 606, 670 S.E.2d 674, 676 (Ct. App. 2008). It is a "settled principle that any substantial doubt in the application of a tax statute must be resolved in favor of the taxpayer." *Alltel Commc'ns, Inc. v. S.C. Dep't of Revenue*, 399 S.C. 313, 318, 731 S.E.2d 869, 872 (2012) (internal citations omitted).

[2] Merchant fees are an immaterial amount of income for U.S. Bank during the Years at Issue. R. p. 421, line 21-p. 422, line 4.

The Department attempts to limit this Court's scope of review by framing the issues on appeal as only requiring a review of the ALC's findings of fact. Resp. Br. 2. However, questions of law, specifically interpretation of South Carolina's tax law, permeate this case. Moreover, the Department seeks to have this Court disregard the "settled principle" in *Alltel* by asserting that there is no substantial doubt in this case surrounding the application of South Carolina's law. Resp. Br. 11.

While the parties do not dispute that South Carolina's tax law applies in this case, ambiguities in the law, and how it should apply to U.S. Bank's various income streams are at the heart of this matter. Where a tax statute is ambiguous, it must be construed in favor of the taxpayer. *See Alltel*, 399 S.C. at 321, 731 S.E.2d at 873. Thus, the Department's attempts to limit this Court's scope of review are meritless.

## II. U.S. Bank's Receipts Are Properly Sourced Under the Service Sourcing Statute

The apportionment provisions of South Carolina law enumerate separate categories of gross receipts and provide specific sourcing mechanisms for each category. *See* S.C. Code Ann. § 12-6-2295(A). The "Service Sourcing Statute" requires that receipts from services be sourced to South Carolina "if the entire income-producing activity is within [South Carolina,]" or, if "performed partly within and partly without [the State]… to the extent the income-producing activity is performed within [the State]." *Id*. at (A)(5). The "Intangible Sourcing Statute" provides that receipts from certain intangible property are in South Carolina if the intangible is used in the State. *See id*. at (A)(3). However, the terms "service" and "intangible" are undefined in the apportionment provisions. *See* S.C. Code Ann. § 12-6-2295.

Where a word is undefined in a statute, the Court should look to "the usual dictionary meaning to supply its meaning." *See Jack's Custom Cycles*, 439 S.C. at 43, 885 S.E.2d at 437 (internal citation omitted). As undisputed by the Department, the usual meaning of the term

"service" is "useful labor that does not produce a tangible commodity" while an intangible is "an asset (such as goodwill) that is not corporeal." App. Br. 13; Resp. Br. 9-23. U.S. Bank does not perform labor to produce tangible commodities. Moreover, U.S. Bank's activities do not result in income from assets akin to goodwill. Rather, U.S. Bank performs mortgage, credit card and credit card processing activities that are properly classified as services. Thus, U.S. Bank's gross receipts are properly sourced under the Service Sourcing Statute, and the ALC's findings to the contrary are meritless.

### A. The ALC Ignored South Carolina Law to Improperly Lump Together U.S. Bank's Receipts from Mortgages and Credit Cards as from Intangibles

The ALC disregards South Carolina apportionment law, which requires that each category of receipt earned by U.S. Bank be analyzed to determine its correct sourcing. *See* S.C. Code Ann. § 12-6-2295(A); R. pp. 52-54, 62-64, 79-81, 85-86. The Department's response cannot and does not support the ALC's lumped treatment of U.S. Bank's receipts as from intangibles.

#### i. U.S. Bank's Receipts from Mortgages Are Not from Intangibles

To support the ALC's treatment of mortgages as intangibles, the Department misrelies upon several inapplicable provisions of South Carolina law. First, the Department relies upon the definition of mortgage provided under Chapter 49, Article 9, of South Carolina's Code of Laws, titled "Rights of Real Property Mortgagees." Resp. Br. 12. The Department argues that because this definition excludes "any mention of service," then mortgages must be intangibles. *Id*. However, the Department ignores that the definition also excludes any mention of the term intangible. *See* S.C. Code Ann. § 12-49-1110(8). Thus, the Department's reliance on this definition to classify mortgages as intangibles falls flat. Moreover, the Department ignores that this definition only applies under Chapter 49, Article 9 ("Rights of Real Property Mortgagees"),

not Chapter 6, Article 17 ("Allocation and Apportionment"), which is at issue here. *See* S.C. Code Ann. § 12-49-1110.

The Department also incorrectly relies on provisions of South Carolina law that define intangible property but fail to define "service." Resp. Br. 12-13; S.C. Code Ann. §§ 12-6-30, 12-16-20. Neither provision relied upon by the Department can provide the proper context in this case, which requires determining what is a service and what is an intangible. Moreover, the Department ignores that the definition of intangible that it relies on is limited to the Estate Tax unless "the context clearly shows otherwise." S.C. Code Ann. § 12-16-20. The Department makes no clear showing that the definition applies here.

As discussed, the activities that U.S. Bank performs to earn its mortgage related receipts fit the definition of a service because they are a financial service and do not involve the production of tangible commodities. To earn mortgage service fees from government sponsored entities ("GSEs"), U.S. Bank performs services including processing monthly payments, facilitating the payment of taxes and insurance, and managing any necessary collections activities for the GSEs. R. p. 343, line 1-p. 344, line 24. To earn income from the sale of mortgages to the GSEs, U.S. Bank performs multiple services, including working with the GSEs to price and pool the loans in either the form of mortgage-backed securities or bonds to be sold to the GSEs. R. p. 342, lines 5-23. Finally, to earn mortgage interest income, U.S. Bank not only lends money but performs ongoing financial services for the borrowers. R. p. 344, lines 4-24; p. 345, line 25-p. 347, line 17; p. 496, line 3-p. 497, line 7. Significantly, Judge Reibold determined that mortgage service fees are "a product of a service provided by U.S. Bank…." R. p. 81.

Categorizing U.S. Bank's mortgage related receipts as from services rather than intangibles is also consistent with the Intangible Sourcing Statute, which provides examples of the types of intangible property the statute is intended to address. *See* S.C. Code Ann. § 12-6-2295(A)(3). Even Judge Kimpson acknowledged that the intangible examples in the Intangible Sourcing Statute seem to contrast with the nature of mortgages. R. p. 56.

Despite the Department's arguments to the contrary, U.S. Bank's receipts from its mortgage activities are not from intangibles and are properly sourced under the Service Sourcing Statute.

ii. U.S. Bank's Receipts from Credit Cards Are Not from Intangibles

Like its incorrect stance on mortgages, the Department claims that the ALC is correct to treat "credit card receivables [as] intangibles" because the Estate Tax defines intangible personal property to include "debts" and "receivables." Resp. Br. 17. As discussed above, that definition is inapplicable. *See supra* p. 7. Not only does the definition only apply in the Estate Tax context, but it fails to make any mention of the term "service." *Id.*; S.C. Code Ann. § 12-16-20.

The activities that U.S. Bank performs to earn credit card fees and interest are akin to services because they are financial services and do not involve the production of tangible commodities. To earn credit card interest income, U.S. Bank performs a number of financial services, including allowing borrowers to make a purchase at a point of sale without using funds from their checking account. R. p. 380, lines 4-14. To earn credit card fees, U.S. Bank performs specific services to earn each fee type – including operating rewards programs to earn annual fees and engaging in collections actions to earn late fees. R. p. 381, lines 9-21; p. 382, lines 1-23.

The ALC failed to address how the activities that U.S. Bank performs to earn credit card fees and interest are from intangibles – nor can the Department rectify that failure here.

Significantly, both the ALC and the Department conceded that certain credit card receipts, including interchange and merchant fees, are sourced under the Service Sourcing Statute. R. pp. 64, 87-90, 1160-11686; Resp. Br. 19. Like U.S. Bank's receipts from its mortgage, interchange, and merchant processing activities, U.S. Bank's credit card interest and fees are not from intangibles and are properly sourced under the Service Sourcing Statute.

### B. The Department Fails to Support the ALC's Error in Misapplying the Intangible Sourcing Statute

Even if some of U.S. Bank's receipts from mortgages and credit cards are from intangibles, such receipts are only sourced to South Carolina if the intangible is *used* in the State. *See* S.C. Code Ann. § 12-6-2295(A)(3). Disregarding the requirements to review each category of income and to determine where the alleged intangibles are used, the ALC misrelied on the Department's so-called "longstanding administrative practice" and made numerous unsupported assertions regarding the use of the mortgages and credit cards. R. pp. 53-54, 63, 84, 87-88. The Department's efforts to support such inaccurate assertions are unsuccessful.

#### i. The ALC Failed to Analyze the Use of Intangibles in the State

The ALC failed to analyze whether the mortgage and credit card receipts at issue are "from the use" of intangible property in the State. R. pp. 52-54, 62-64, 83-84; *see also* S.C. Code Ann. § 12-6-2295(A)(3). In an attempt to remedy the ALC's failure, the Department incorrectly claims that U.S. Bank's "interest income from loans to debtors in South Carolina" is intangible income that must be sourced "[l]ike the royalty income from trademarks in *Geoffrey*[.]" Resp. Br. 13. However, the Department's reliance on *Geoffrey, Inc. v. South Carolina Tax Commissioner* is misplaced. At issue in *Geoffrey* was whether royalties paid to a passive holding company constituted gross receipts from within the State. *Geoffrey*, 313 S.C. 15, 17, 437 S.E. 2d 13, 15 (1993). Neither the apportionment provisions at issue here, nor whether

the royalty income was from the use of intangibles or from the provision of services, were at issue in *Geoffrey*. *Id*. Thus, the Department's reliance on *Geoffrey* to source U.S. Bank's interest income to the State is misplaced.

Next, the Department baldly asserts that "[a] mortgage is used at the location of the real property[.]" Resp. Br. 13. This conclusory statement lacks any analysis. In fact, the only support for the Department's assertion is the Multistate Tax Commission's model statute, which has not been adopted by South Carolina, and a series of leading questions posed to the Department's auditor and the Department's expert witness. *Id*. (citing R. p. 443, lines 12-14 (Question to Department's auditor: "And the mortgage is used at the location of the real property?" Answer: "Yes.").

As shown, the Department failed to conduct any analysis or provide any evidence to support the ALC's conclusory finding that some of U.S. Bank's mortgage and credit card receipts are from the use of intangibles in the State.

ii. The Department's "Longstanding Administrative Practice" Does Not Justify the Department's Disregard of South Carolina Law

The Department claims that its "longstanding administrative practice" is to source "income from loans to the location of the borrower." Resp. Br. 13. Regardless of how arguably longstanding the Department's statutory construction is, such construction is owed no deference if it contradicts the plain language of the law. *See Jack's Custom Cycles*, 439 S.C. at 48, 885 S.E.2d at 440; *see also Colonial Pipeline Co. v. S.C. Dep't of Revenue*, 443 S.C. 448, 458, 905 S.E.2d 129, 134 (Ct. App. 2024). Thus, the ALC improperly gave deference to the Department's "longstanding administrative practices." R. pp. 49-50, 54-55.

Under the Intangible Sourcing Statute, receipts from intangibles are only sourced to the State if the intangible is used in the State. *See* S.C. Code Ann. § 12-6-2295(A)(3). The

Department's "longstanding administrative practice" cannot contravene the statute and source U.S. Bank's receipts in a manner that contradicts the law. Here, the statute requires sourcing based on where an intangible is used. *Id*. Without any analysis, the Department's practice does not establish where the alleged intangibles are used. Therefore, support cannot be found in the Department's "longstanding administrative practice."

## III. U.S. Bank Properly Analyzed Its Income-Producing Activities

The Service Sourcing Statute provides that receipts from services are sourced to South Carolina to the extent the taxpayer's income-producing activities are performed within the State. *See* S.C. Code Ann. § 12-6-2295(A)(5). The term "income-producing activity" is undefined. *Id*. However, the parties agree that the term means "what is [the] business doing that it [is getting] paid for." R. p. 493, line 9-p. 494, line 5; Resp. Br. 14.

U.S. Bank determined what it is doing that its customers are paying for and the extent to which those activities occur in South Carolina. *See* S.C. Code Ann. § 12-6-2295(A)(5). Based on its analysis, U.S. Bank properly determined that each category of its income should be assigned as follows:

| **Category of Income** | **Income-Producing Activities** |
|---|---|
| Mortgage Servicing Fees | Income-Producing Activities – Processing monthly payments, facilitating payments of taxes and insurance, collections activities.<br>Location – Entirely outside of South Carolina.<br>R. p. 344, lines 6-24. |
| Gain on Sale of Mortgages | Income-Producing Activities – Pooling and sale of loans.<br>Location – Entirely outside of South Carolina.<br>R. p. 338, lines 1-10; p. 342, lines 7-20; p. 489, lines 14-20. |

| Category of Income | Income-Producing Activities |
|---|---|
| Mortgage Interest | Income-Producing Activities – Lending of money, servicing of loans.<br>Location – 1/3 to borrower location, 2/3 to the location where U.S. Bank makes funding decisions and services the loans.<br>R. p. 345, line 25-p. 347, line 17; p. 496, line 3-p. 497 line 7; p. 500, lines 7-25; p. 505, line 6-p. 513, line 2. |
| Credit Card Fees and Interest | Income-Producing Activities – Extending credit, servicing credit card loans, collections, reward program and balance transfer activities.[3]<br>Location – 1/3 to borrower location, 2/3 to the location where U.S. Bank makes funding decisions, servicing credit card accounts and providing fee-related services.<br>R. p. 380, lines 4-14; p. 381, lines 7-24; p. 505, line 6-p. 513, line 2; p. 500, lines 7-24; p. 505, line 6-p. 513, line 2. |
| Interchange Fees | Income-Producing Activities – Approving and funding transactions.<br>Location – Entirely outside of South Carolina.<br>R. p. 380, line 19-p. 381, line 3; p. 382, line 25-p. 383, line 7; p. 406, line 2-p. 408, line 20; p. 410, lines 5-13; p. 513, line 3-p. 515, line 8. |
| Merchant Fees | Income-Producing Activities – Processing transactions.<br>Location – Entirely outside of South Carolina.<br>R. p. 382, line 25-p. 383, line 6; p. 410, lines 5-13; p. 451, lines 4-8. |

### A. The Department Misconstrues U.S. Bank's Sourcing Methodology

The Department repeatedly misstates U.S. Bank's sourcing methodology. Resp. Br. 16-17, 20. First, the Department claims that U.S. Bank determined that its income from mortgage services "should not be sourced to South Carolina because the cost to perform these services is incurred out of state." *Id*. 16. Unsurprisingly, the Department provides no support for this claim – nor can it because U.S. Bank did not conduct a cost of performance analysis in order to source

[3] Contrary to the Department's assertion, U.S. Bank did not "admit" that "allowing a person to make a purchase at point of sale without delivering funds from their checking account" is how it earns interest income. Resp. Br. 6. U.S. Bank performs a number of financial services in order to earn interest income, including allowing a person to make a purchase on credit. R. p. 380, lines 4-14.

its receipts. *Id.* As established in U.S. Bank's initial brief, U.S. Bank conducted a detailed analysis of its income-producing activities in order to source its receipts in accordance with South Carolina law. App. Br. 10-36.

Likewise, the Department incorrectly claims that "U.S. Bank urges this Court to approve a cost of performance or payroll and assets method of sourcing…." Resp. Br. 20. Yet again, the Department is unable to support this inaccurate claim. *Id.*

Next, the Department inaccurately asserts that U.S. Bank argued for sourcing of its mortgage receipts to the location of the GSEs based on an approximate "origin-of-payment" method. Resp. Br. 17. Contrary to the Department's assertion, U.S. Bank *never* argued for an "origin-of-payment" sourcing method. U.S. Bank earns two types of receipts from providing services to the GSEs – receipts from the sale of mortgages and receipts from mortgage servicing. R. p. 342, lines 2-4; p. 343, lines 16-22. The GSEs pay U.S. Bank for the loans, processing of monthly payments, facilitating payments of taxes and insurance, and collections activities. R. p. 338, lines 1-10; p. 342, lines 7-20; p. 344, lines 6-24; p. 489, lines 14-20. Notably, the ALC agreed with U.S. Bank's identification of its income-producing activities for mortgage service fees. R. p. 82. Moreover, all of the sales to the GSEs and U.S. Bank's mortgage servicing activities occur outside of South Carolina. R. p. 347, lines 21-23; p. 522, lines 8-13. Based on its income-producing activities, and the fact that they are performed entirely outside of South Carolina, U.S. Bank properly sourced its receipts from the GSEs to outside of the State.

Further, the Department asserts that U.S. Bank disregarded this Court's holding in *DIRECTV, Inc. v. South Carolina Department of Revenue* to argue that its income-producing activities are the activities that U.S. Bank performs "in anticipation" of earning money. Resp. Br. 16, 18. Specifically, the Department claims that U.S. Bank argues that its income-producing

activities include "income-anticipatory activities" such as soliciting borrowers, checking the borrower's creditworthiness and ancillary administrative activities. *Id*. U.S. Bank never made such an argument and, thus, the Department is unable to provide any support for its assertions. *Id*.

### B. The Department Fails to Support the ALC's Misstated Conclusion Regarding the Sourcing of U.S. Bank's Interchange and Merchant Fees Services and the Related Income-Producing Activities

The ALC incorrectly determined that U.S. Bank's interchange and merchant fees are the result of U.S. Bank delivering an approval/disapproval decision to the merchant location. R. p. 64. However, the Department concedes that merchants pay U.S. Bank fees in exchange for the services of routing, processing, authorizing and funding of transactions. Resp. Br. 19.

Despite this concession, the Department claims that merchants pay interchange and merchant fees "each time a credit/debit card is 'swiped.'" *Id*. This is inaccurate. As conceded, merchants pay U.S. Bank interchange fees in exchange for approving and funding transactions. R. p. 380, lines 21-24; p. 408, lines 2-7. Merchants pay U.S. Bank merchant fees in exchange for processing credit card transactions. R. p. 451, lines 4-8. Despite the Department's claims, U.S. Bank is not paid an interchange or merchant fee merely because a credit card is "swiped."

Without support or analysis, the Department re-frames U.S. Bank's argument as asserting that "the preparatory and ancillary administrative support activities" produce its interchange and merchant fee income. Resp. Br. 20. U.S. Bank made no such argument. Instead, as required under the Service Sourcing Statute, U.S. Bank identified what it is doing that the merchants are paying it for, and the extent to which those activities occurred in the State. *See* S.C. Code Ann. § 12-6-2295(A)(5); *see supra* p. 12.

Based on its mischaracterization of U.S. Bank's services, the Department concludes that the interchange and merchant fees should be sourced to the State if the merchant is located in the

State, or if an online merchant, to the merchant's customer's location. Resp. Br. 20. Directly contradicting the Service Sourcing Statute, the Department conflates who is paying U.S. Bank the fee with where U.S. Bank's income-producing activities actually take place, which the ALC erred in adopting. *See* S.C. Code Ann. § 12-6-2295(A)(5); R. pp. 64, 89-90. Moreover, by focusing on the location of the merchant/customer, the ALC's sourcing results in an origin-of-payment sourcing methodology. As the Department acknowledges, this Court rejected origin-of-payment sourcing. *See Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987); Resp. Br. 17.

The ALC's misapplication of South Carolina law cannot be justified by the Department's mischaracterizations. The ALC also ignored the substantial evidence presented by U.S. Bank concerning its interchange and merchant fee income-producing activities in order to adopt a new "test" whereby the ALC chose "to draw the line between non-income-producing activities and income-producing activities based upon whether or not an activity can be performed without generating income." App. Br. 18-19; R. p. 89. There is no basis for this "test" under South Carolina law and the Department makes no attempt to defend it. Resp. Br. 19-20.

Despite mischaracterizations by the ALC and the Department, U.S. Bank's methodology for sourcing its interchange and merchant fees to the State is consistent with the Service Sourcing Statute. *See* S.C. Code Ann. § 12-6-2295(A)(5).

### C. The Department Fails to Support the ALC's Conflation of the Location of U.S. Bank's Customers with the Location of U.S. Bank's Income-Producing Activities

As discussed above, the ALC incorrectly lumps together U.S. Bank's receipts related to mortgages and credit cards as intangible loan income. *See supra* p. 6-9; R. pp. 52-54, 62-63. Based on this lumped treatment, the Department claims that its longstanding practice for "the loan income of banks" is to source the income to the location of the borrower "because a bank's

income-producing activity with respect to a loan is loaning money to a borrower." Resp. Br. 13-14. In addition to improperly disregarding the sourcing provisions of South Carolina's apportionment law, the ALC improperly relies on the Department's "longstanding administrative practice" to conflate the location of U.S. Bank's customers with the location of U.S. Bank's income-producing activities. *See* S.C. Code Ann. § 12-6-2295(A); R. pp. 54-55, 63.

For example, if U.S. Bank's mortgage and credit card receipts are from services, the ALC sourced the income to where the borrower/cardholder is located because, according to the Department, that is where the income-producing activity occurs. Resp. Br. 14, 21; R. pp. 55-60, 63. However, the ALC failed to give any consideration to the activities performed by U.S. Bank that actually produce this service income. Even where the Department concedes that "U.S. Bank's income producing activity is loaning money and enabling merchants and cardholders to consummate cashless transactions" and that activity is performed "*both* in South Carolina *and elsewhere*," the Department treats such income as entirely sourced to the State if the cardholder is in the State. Resp. Br. 21 (emphasis added).

Under the Service Sourcing Statute, receipts from services are sourced to the State "*to the extent* that the income-producing activity is performed within the State." S.C. Code Ann. § 12-6-2295(A)(5) (emphasis added). Even if the income-producing activity is loaning money to the borrower/cardholder, the ALC failed to address why the income should be sourced fully to the State if none of U.S. Bank's activities occur in the State.

South Carolina's apportionment law provides specific sourcing provisions for specific categories of income. *See* S.C. Code Ann. § 12-6-2295(A). The Department's alleged "practice" of sourcing the income to the location of the borrower no matter the categorization of the income or the location of the income-producing activities improperly renders these

provisions superfluous. *See Mead v. Beaufort Cnty. Assessor*, 419 S.C. 125, 135, 796 S.E.2d 165, 170-171 (Ct. App. 2016).

Further, the ALC's sourcing based on the location of the borrower results in the adoption of market-based sourcing of U.S. Bank's receipts. As acknowledged by the Department, South Carolina is "not a 'market state;' i.e., a state where receipts are always sourced to the state where the item or service is consumed or the location of the payer." Resp. Br. 16. Yet, the Department justifies the ALC's market-based sourcing as good tax policy. R. p. 610, lines 5-23; p. 618, lines 7-11; p. 620, line 18-p. 621, line 8. Here, whether or not market-based sourcing is good tax policy is irrelevant because South Carolina law requires sourcing based on a taxpayer's income-producing activities. *See* S.C. Code Ann. § 12-6-2295(A)(5). The Department cannot disregard the law in favor of a tax policy that it prefers.

Therefore, the Department's "longstanding administrative practice" cannot justify the ALC's conflation of the location of the borrower/cardholder with the location of the taxpayer's income-producing activities, which contradicts South Carolina law and is without merit.

## IV. The Imposition of Substantial Understatement Penalties is Not Justified

The ALC incorrectly upheld the Department's imposition of substantial understatement penalties. R. pp. 67-73, 95. In support of the ALC's holding, the Department incorrectly claims that substantial understatement penalties are justified because U.S. Bank "produced no evidence" to support that such penalties should be reduced and because U.S. Bank chose a sourcing method that "contravenes established case law." Resp. Br. 22. Notably, the ALC determined that U.S. Bank acted in good faith in sourcing its income. R. p. 72. Moreover, U.S. Bank sourced its receipts based on a well-reasoned construction of South Carolina's apportionment provisions. This well-reasoned construction is based on the plain language of South Carolina law and is consistent with the testimony and substantial evidence presented by U.S. Bank, which

established that its receipts should be sourced under the Service Sourcing Statute. U.S. Bank's determination of its actual income-producing activities for each of its income streams is also consistent with this Court's decision in *DIRECTV*, which provides that income-producing activities do not include anticipatory activities. *DIRECTV*, 421 S.C. 59, 77-78, 804 S.E.2d 633, 643 (Ct. App. 2017); App. Br. 16, 20-21, 25, 40.

In a further attempt to justify imposition of substantial understatement penalties, the Department argues that "[i]f U.S. Bank wanted guidance [on how to source its income], it could have followed the established process for making such a request." Resp. Br. 22. In so stating, the Department effectively admits that it failed to publish relevant guidance on its so-called "longstanding administrative practice" of sourcing receipts to the borrower's location. R. pp. 1160-1168. Moreover, the Department's position – which places the burden on the taxpayer to seek guidance to discern the Department's internal policies and practices – directly contradicts the testimony of the Department's expert witness who testified that it is "good tax policy" for the Department to issue as much written guidance as possible on the Department's interpretation of a statute. R. p. 627, lines 4-7. U.S. Bank should not be penalized for the Department's lack of guidance.

Thus, the ALC's upholding of substantial understatement penalties in this case is without justification.

## CONCLUSION

For all of the foregoing reasons and the reasons stated in its initial brief, U.S. Bank respectfully requests that this Court reverse the Order and Reconsideration Order and rule in U.S. Bank's favor. The ALC's orders are unsupported by substantial evidence and conflict with South Carolina law. Thus, both decisions warrant reversal by this Court.

Respectfully submitted,

By: s/ Bryson M. Geer

Bryson M. Geer
SC Bar No. 13606
(843) 534-4306
Nelson Mullins Riles & Scarborough LLP
151 Meeting Street/Sixth Floor
Post Office Box 1806
Charleston, SC 29401-2230

Craig B. Fields
Admitted *pro hac vice*
(212) 885-5170
Nicole L. Johnson
Admitted *pro hac vice*
(212) 885-5286
Blank Rome LLP
1271 Avenue of the Americas
New York, NY 10020

Attorneys for Appellant

Charleston, South Carolina
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