THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 14-ALJ-17-0158-CC

Appellate Case No. 2015-001509

DIRECTV, Inc. and its Subsidiaries,..... Appellant,

v.

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

FINAL REPLY BRIEF OF APPELLANT

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Pursuant to Rule 242(g) of the South Carolina Appellate Court Rules, Appellant, DIRECTV, Inc. & its Subsidiaries, ("DIRECTV") files this Final Reply Brief in response to Respondent South Carolina Department of Revenue's Final Brief ("Department Brief") in this matter. For the reasons stated in the Final Brief of DIRECTV ("DIRECTV Brief") and herein, this Court should grant the relief requested in DIRECTV's Brief and as set forth more specifically in the Conclusion hereinbelow.

STATEMENT OF THE CASE AND STATEMENT OF FACTS

Please see DIRECTV's Brief at pp. 3-15 for a statement of the case and statement of facts in this matter.

ARGUMENT

I. THE ALC ERRED BY APPLYING AN INCORRECT BURDEN OF PROOF AND BY FINDING THAT DIRECTV FAILED TO MEET ITS BURDEN OF PROOF.

In its Brief, DIRECTV argued that the ALC erred in not applying the proper burden of proof as set forth in *Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988). In response, the Department claims that DIRECTV's reliance on *Cloyd* is "misguided" and "not applicable." Department Brief, p. 16.

Cloyd stands for the proposition that although a tax assessment is initially presumed correct, once a taxpayer establishes that it is incorrect, the presumption of correctness is removed, and the taxpayer is entitled to appropriate relief. *Cloyd*, 295 S.C. at 88-89, 367 S.E.2d at 173. The Department first argues that *Cloyd* is not applicable because it is a property tax case. However, as set forth in DIRECTV's Brief, multiple South Carolina cases have cited the presumption in *Cloyd* with approval, including personal income tax cases and a sales and accommodation tax case. See DIRECTV

Brief, p. 17, citing *Anonymous Taxpayer v. S.C. Dep't of Revenue*, No. 07-ALJ-17-0189-CC (S.C. Admin. Law Ct. Aug. 23, 2007), *Lawton v. S.C. Dep't of Revenue*, No. 08-ALJ-17-0118-CC (S.C. Admin. Law Ct. Sept. 5, 2008) and *Travelscape, LLC v. S.C. Dep't of Revenue*, No. 08-ALJ-17-0076-CC (S.C. Admin. Law Ct. Feb. 12, 2009) (involving personal income tax (*Anonymous* and *Lawton*) and sales and accommodation tax (*Travelscape*) assessments and each citing to the burden of proof set forth in *Cloyd*).

Next, the Department contends that even if the assessment is determined to be incorrect, the appropriate relief is not dismissal of the assessment. Department Brief, p. 17. However, the Department fails to address what the appropriate relief is, when, as in this case, the lower court determines that the assessment is incorrect. *See* Am. Final Order, R. p. 40 (stating that the ALC "does not adopt the view of the Department that income-producing activity of businesses within the direct broadcast services industry is completely limited to the delivery of the signal into the customer's home and onto the customer's television"); and Tr., R. p. 264, 561:11-14 (wherein ALC acknowledges that the Department's position is incorrect and too "simplistic"). Surely, the appropriate relief cannot be to deny the refund in full, enforce the entire proposed assessment and assess penalties against the taxpayer as the Department requests and as the ALC has done here.

Moreover, DIRECTV met the standard burden of proof to show by a preponderance of the evidence that the income producing activity in this case occurs partly within and partly without South Carolina. Therefore, DIRECTV's income tax refund claim for tax years 2006-2008, appeal for a reduced income tax assessment for tax years 2009-2011, and appeal for a reduced license fee assessment for tax years 2010-2012 should be granted in full. DIRECTV established through detailed factual testimony

as well as expert testimony, the extent to which its income producing activity took place within South Carolina using evidence and a sourcing formula that closely tracks the controlling case law (*Lockwood Greene*). *See* DIRECTV Brief, p. 21. Such evidence is considered relevant in virtually every other state in the country.

Finally, if the ALC had determined that DIRECTV was entitled to relief but that dismissal was not appropriate, then it should have granted the appropriate remedy based on the evidence in the record, which presented a calculation of tax liability as shown on Exhibit A to DIRECTV's Brief that would support reducing the total income tax assessment due for tax years 2006-2011 to $894,214.00 and reducing the total license fee assessment due to $13,991.00 for tax years 2010-2012 for a total sum due by DIRECTV of $908,205 plus appropriate interest. *See supra* p. 15-16 (for a more detailed discussion of the income tax and license fee liability calculations). Alternatively, the ALC should have ordered a supplemental hearing requesting that the parties present additional evidence so that the ALC could determine the actual revenue properly attributable to South Carolina under the ALC's construction of the statute, which DIRECTV would note is not set forth in existing case law or in any Department policy documents such that taxpayers have notice of and can apply such a method.[1] *See Cloyd*, 295 S.C. 86, 367 S.E.2d 171; DIRECTV Brief, pp. 20-21.

[1] The closest "guidance" that can be found is this Court's decision in *Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1986), which used payroll as a proxy. The method presented by DIRECTV at trial also used a payroll proxy but added an assets proxy, which actually increased the amount of income attributable to South Carolina.

II. THE ALC ERRED IN FINDING THAT THE ONLY INCOME PRODUCING ACTIVITY WAS THE DELIVERY OF THE SIGNAL WHEN SUCH A FINDING WAS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE AND IS CONTRARY TO THE LAW.

The Department's assertion that income is earned only by the final act of delivery of the signal is unsupported by substantial evidence in the record and is contrary to South Carolina law. Consequently, the ALC erred in so finding for all the reasons set forth in DIRECTV's Brief. *See* DIRECTV Brief, pp. 22-32. In response to DIRECTV's Brief, the Department makes three main arguments: (1) that the ALC properly determined that the only income producing activity in this case is the "final act" of delivery of the signal into the homes and onto the television screens of its customers (*id.* at pp. 20-25); (2) that *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964) supports the first argument above and establishes a narrow construction of income producing activities (*id.* at pp. 25-28); and (3) that the ALC properly interpreted S.C. Code Ann. §12-6-2295(A)(5) to require market based sourcing for DIRECTV (*id.* at p. 28-31). All of these arguments were anticipated and addressed in DIRECTV's Brief and will not be repeated in full herein; however, a few additional points are warranted on these and related arguments and on the cases from other jurisdictions cited by the Department.

A. The ALC's Conclusion that the Final Act of Delivery is the Only Income Producing Activity is Contrary to the ALC's Own Findings and Analysis.

First, the conclusion by the ALC that the only income producing activity in this case is the final act of delivery of the signal into the home is inconsistent with its own findings and analysis. As previously mentioned, the ALC agreed that the Department's position was incorrect specifically stating that it "does not adopt the view of the

Department that income-producing activity of businesses within the direct broadcast services industry is completely limited to the delivery of the signal into the customer's home and onto the customer's television." Am. Final Order, R. p. 40. The ALC further agreed with Professor Pomp that "opinions can differ on how to measure the extent to which income-producing activities take place in South Carolina, *but answering that question by simply ignoring the outside activities is unacceptable.*" *Id.* (emphasis added). The above findings and conclusions are supported by the record and are completely inconsistent with the ALC's ultimate ruling that DIRECTV is not entitled to any relief from the erroneous assessment.

B. The ALC's Conclusion that the Final Act of Delivery is the Only Income Producing Activity is Contrary to South Carolina Law.

By accepting the Department's method, which looks only to the location of the customer (or, as it more recently characterizes it, the "final act" of delivering the signal into the homes of the customers), the Order has adopted the "market approach" or the "origin of payment" approach, which is contrary to S.C. Code Ann. § 12-6-2295(A)(5), *Lockwood Greene* and *Mercury Motor*. Although referencing the statute, which requires that the focus be on the "extent the income producing activity is performed within this state," the ALC ignores the plain language of the statute and abandons the "place of activity" test set forth therein and applied by this Court in *Lockwood Greene* as well as the analysis and logic set forth in *Mercury Motor*.

The Department's interpretation of *Mercury Motor* and *Lockwood Greene* is flawed and misled the ALC to incorrectly apply these cases when it concluded that the final act of delivery is the only income producing activity. As discussed in DIRECTV's Brief, the issue in *Mercury Motor* was whether the mileage-based apportionment formula

for motor carriers resulted in a discriminatory or unconstitutional assessment when applied to Mercury Motor where that formula apportioned 17% of its income to this state, while revenue from customers paying for freight picked up in or delivered to South Carolina only accounted for 1% of its revenue. DIRECTV Brief, p. 28; *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964). The taxpayer argued that the mileage-based formula taxed activities that did not contribute to its income in South Carolina. *Id.* The court, however, disagreed. It upheld the mileage-based formula because the Court found that the "hauling of freight" was the transaction that primarily earned the income at issue. *Id.*, 244 S.C. at 141, 135 S.E.2d at 759.

The case does *not* say "that only the hauling of freight was the IPA [income producing activity] while excluding the other incidental activities" as the Department's Brief states. Department Brief, p. 26. Instead, the Court states as follows:

> The appellant operates a unitary business and its gross income and, therefore, *its net income, is derived from a series of transactions*. Here the series of transactions consists of the solicitation of freight, the picking up of freight, the hauling of freight, the delivery of the same and the collections of charges therefor. *Each transaction in the series contributes to the earnings and net income of the appellant. . . .*

Mercury Motor, 244 S.C. at 141, 135 S.E.2d at 759-60 (emphasis added). Thus, the Court is acknowledging that all of the transactions in the series contribute to the production of income. *Id.* The Court then goes on to say that "while each transaction is necessarily incidental to the production of its income, the transaction which primarily earns the income is the hauling of the freight." *Id.* This makes perfect sense where the only issue before the Court was whether it was unconstitutional to take into account the income related to the hauling of freight. The Court did not consider or address, of course, whether it would be appropriate to ignore some income producing activities when

applying a statutory apportionment method based strictly on the "income producing activities" of a taxpayer. In fact, to the extent the opinion can be read to discount "incidental" activities, that would appear to include delivery of the freight, which would be akin to the "final act" of delivering the signal into the customers' home, which is the only act that the ALC considered in this case. Thus, considering delivery of the signal to be the only income producing activity is completely contrary to *Mercury Motor.* Moreover, even if this Court determined on some basis that delivery of the signal was the primary or only income producing activity, the evidence establishes that this would include a multitude of activities, including collecting of programming and transmission of programming to broadcast centers, uplink facilities, satellites and customers. *See* Tr., R. pp. 135, 47:14- 144, 84:25.

The Department also focuses on dictum in *Lockwood Greene*, which states that the "place of activity" test might not apply to "media broadcasters." Department Brief, p. 34. It also makes the unsupported and erroneous assertion that DIRECTV is a "media broadcaster." *Id.* at p. 18. First, no evidence in the record supports this statement. DIRECTV is not a media broadcaster, but rather is a producer of original content and a multichannel video programming distributor, whose revenue is derived from fees paid by its customers for rentals of set-top boxes and subscriptions to its programming services. In contrast, media broadcasters such as CBS, NBC, ABC earn their revenue almost exclusively from advertising receipts. Advertising receipts earned by media broadcasters is the only income addressed by the policies referred to in *Lockwood Greene*, and such income is not at issue here. *See* R. pp. 520-529. Moreover, the Department admits that these policies pre-dated the existence of businesses like DIRECTV (Tr., R. p. 210,

348:19- 211, 349:10) and admits that they do not address subscription revenue, the satellite industry or even cable companies. *Id. See also infra* §III (for additional discussion regarding the policies).

Additionally, the *Lockwood Greene* dictum relates to the taxpayer's argument in that case that the court should adopt an "origin of payment" approach because that would be consistent with the policy of the Department at that time to apply such an approach to media broadcasters and finance companies. *Lockwood Greene*, 293 S.C. at 450, 362 S.E.2d at 348. The Court of Appeals declined to adopt the "origin of payment" approach and was likely simply conveying that it need not consider policies related to businesses that were not before it (and to the extent it could be read to be commenting on these businesses, such a statement would be dictum). *Id.* In no way, shape or form does *Lockwood Greene* dictate that an "origin of payment" test be applied to certain taxpayers. *Id.*

C. The Cases from Other Jurisdictions Cited by the Department Do Not Support its Position and are Contrary to Established South Carolina Law.

The Department cites to cases from other jurisdictions in support of its argument that it is appropriate to interpret an activities based sourcing statute to reach a market based result. *See Walter E. Heller Western, Inc. v. Wis. Dept. of Rev.*, 775 P.2d 1113 (Wis. 1989); *Ameritech Publishing, Inc. v. Wis. Dept. of Rev.*, 788 N.W.2d 383 (Wis. Ct. App. 2010); *Anonymous Taxpayer v. Texas Cptr of Pub. Accts.*, 2013 WL 3490605 (Tex. Cptr. Pub. Accts. May 17, 2013). While these cases are obviously not binding on this Court, a review of them reveals that they do not support the Department's position and are contrary to established South Carolina law.

In *Walter E. Heller Western, Inc. v. Wis. Dept. of Rev.*, 775 P.2d 1113 (Wis. 1989), the Arizona Supreme Court analyzed how interest income earned on loans made to Arizona customers should be sourced. Tr., R. pp. 235, 446:1-14; 261, 551:18-552:9. In reaching its decision, the court did not consider the activities conducted by the taxpayer outside of Arizona, such as the raising of funds that were loaned to customers, to be the income producing activities. *Heller Western*, 775 P.2d at 1117. Instead, the court determined that the income producing activities consisted of "the solicitation of new customers, the investigation of potential customers' credit records, and the servicing of these contracts," all of which occurred in Arizona. *Id.* However, and in sharp contrast to the situation here, the court in *Heller Western* was interpreting detailed regulations adopted by the Department of Revenue, which, the court held, defined income producing activity by reference to solicitation, negotiation and sales activities conducted by the taxpayer. *Id.* at 1116-17. As discussed in its Brief and §III herein, no such regulations or any other published guidance exist in South Carolina to guide this Court's interpretation of S.C. Code Ann. §§12-6-2290 and 12-6-2295(A)(5). Moreover, and quite unlike the Department's theory in this case, the Arizona Supreme Court, in reaching its decision, actually identified income producing activities conducted by the taxpayer such as the solicitation of new customers, investigation of credit reports of potential customers and servicing of contracts and did not simply look to the location of the customer as the Department does here.

Likewise, *Ameritech Publishing, Inc. v. Wis. Dept. of Rev.*, 788 N.W.2d 383, 2010 WL 2519583 (Wis. Ct. App. 2010) does not support the Department's theory. In *Ameritech*, the Wisconsin Court of Appeals analyzed how local advertising revenue

generated by the taxpayer from the placement of advertisements in telephone directories should be sourced and held that because the income producing activity was "the provision of access to a Wisconsin audience," the local advertising revenue should be sourced to Wisconsin. *Ameritech*, 2010 WL 2519583, slip op. at 10-12. In reaching its decision, however, the court did not ignore the activities conducted by Ameritech outside of Wisconsin, as the Department does here, but instead, after analyzing the nature of Ameritech's business, determined that providing "access" to the Wisconsin market was the income producing activity with respect to the advertising services provided. *Id.* Although the court looked to the Wisconsin "market," the court's conclusion was simply that, under the facts of the case, the location of the market coincided with the location of the income producing activity of a taxpayer providing advertising services. Thus, as in *Heller Western*, not only does *Ameritech* involve an entirely different type of service than is involved here, the court actually identified income producing activities and did not simply look to the location of the customer.

Although *Heller Western* and *Ameritech* both reach market-oriented *results*, neither case supports the legal theory advanced by the Department.[2] Instead, these cases stand for nothing more than the proposition that the determination of income producing activities is a fact intensive inquiry that must be made on a case-by-case basis, which is precisely the position advanced by DIRECTV here. Defining income producing activity as providing "access" to a market may be entirely appropriate for an advertising business, but it does not support the Department's legal theory that DIRECTV's subscription

[2] The analysis applied in both cases directly contradicts the opinion of the Department's expert economist, Dr. Harrison, as the income producing activities identified by the courts certainly generate "costs" and therefore would not be considered to be income producing activities under Dr. Harrison's opinion.

revenue should be sourced based on the location of the customer. As the decisions demonstrate, income producing activities will be different for different industries, and the ALC should have determined the income producing activities here based on an analysis of DIRECTV's business.

Finally, the Department also cites a case from the Texas Comptroller of Public Accounts in support of its position. *See Anonymous Taxpayer v. Texas Cptr of Pub. Accts.*, 2013 WL 3490605 (Tex. Cptr. Pub. Accts. May 17, 2013). However, because both the facts and the law in the Texas case are distinguishable from this case, it is not instructive here. First, unlike DIRECTV, the taxpayer in the Texas case only purchased the right to broadcast programming from other networks; it produced no original content. *Id.* at 7. Additionally, Texas law regarding sourcing of services is quite different than South Carolina law. The relevant Texas statute defines "gross receipts" from business done in Texas to include receipts from "each service performed in this state." *Id.* at 10, citing Tex. Tax Code §171.103(a). Service receipts are apportioned to the location where the service is performed, and if a taxpayer performs services both within and outside of Texas, then receipts are sourced to Texas "on the basis of the fair value of the services that are rendered in Texas." *Id. citing* Tex. Admin. Code § 3.549(e)(38) and 3.557(e)(33). The Texas Comptroller also states that "the focus should be on the specific, end-product acts for which the customer contracts and pays to receive, not on non-receipt producing, albeit essential, support activities." *Id. citing* Tex. Comptroller Decision no. 10,028 (1980). The Texas statute and related department guidance, which require the focus to be on the "fair value of the services" and the "final act" for which the customer contracts and pays to receive, is completely contrary to South Carolina law (*i.e.* S.C.

Code Ann. §12-6-2295, *Lockwood Greene* and *Mercury Motor*), which as discussed above, requires the focus to be on the income producing activities of the taxpayer, and thus, this case does not provide support for the Department's position. *See supra* § II(B).

III. THE DEPARTMENT'S PURPORTED LONGSTANDING POLICIES ARE NOT ENTITLED TO ANY DEFERENCE.

The Department asserts that it has longstanding policies in this case that should be given deference by this Court. Department Brief, p. 39-42. According to the Department, it has a longstanding policy of sourcing gross receipts of personal service firms (like an engineering firm) to the state in which the personal services are performed, while gross receipts of firms such as finance companies and media broadcasters are sourced differently. *Id.* at 40. Interestingly, when asked for these longstanding policies in discovery in this case, the Department could find nothing, and its audit supervisor testified at trial that these policies were not in writing. Tr., R. p. 202, 315:24-316:7. Moreover, the Department's auditor in this matter testified in his deposition that he was not even aware of any such policies. Tr., R. p. 202, 315:6-21.

The *only* evidence regarding these purported policies was contained in the form of a stipulation of facts sometime prior to 1986 between two private parties in the *Lockwood Greene* case. *See* R. pp. 520-529. The Department admits that these policies were never updated after 1983 (Tr., R. p. 210, 347:20-348:5), admits that they pre-dated the existence of businesses like DIRECTV (R. p. 210, 348:19- 211, 349:10) and admits that they do not address subscription revenue, the satellite industry or even cable companies. *Id.* Under these circumstances, the ALC correctly declined to give deference to such policies (see Am. Final Order, R. p. 46 at n. 19), and this Court should likewise give them no weight.

IV. THE ALC ERRED IN FINDING THAT DIRECTV FAILED TO ESTABLISH THE PORTION OF ITS BUSINESS ACTIVITIES THAT ARE CONDUCTED IN SOUTH CAROLINA.

The Department argues in its Brief that the ALC was correct in finding that the taxpayer failed to meet its burden to show that any of its income producing activities occurred outside of South Carolina. Department Brief, pp. 23-25. The Department repeats statements from the Amended Final Order that describe the method used by DIRECTV's expert, Dr. Cody, for determining the amount of income that was produced by DIRECTV's activities in South Carolina as "too nebulous," and asserts that DIRECTV did not sufficiently establish the effect of the "value drivers" discussed by Dr. Cody on income production in this state. *Id.* at 25. The ALC acknowledged that "the evidence. . . suggested that there may be other activities, such as advertising, that influence the customer's decision to make the purchase." Am. Final Order, R. p. 41. However, the ALC found DIRECTV's proof on this insufficient because "[t]hough its evidence did reflect that its advertising probably produced some income, the evidence did not reflect what portion of DIRECTV's cost was either attributable to South Carolina customers or may have influenced South Carolina customers to subscribe to DIRECTV. Instead, the court was left to speculate as to the extent to which DIRECTV's content and programming, acquisition and distribution thereof, advertising, and customer service in installing and maintaining its equipment within this State influenced customers' decision[s] to subscribe to DIRECTV." *Id.* at pp. 41-42.

The ALC's standard would require DIRECTV to establish with mathematical precision why each South Carolina customer chose to purchase a subscription to DIRECTV. Did he choose DIRECTV because of an advertisement he saw or because of

programming and quality of service? This standard would be impossible for any taxpayer to meet and, fortunately, is not required by the law. The law only requires that taxpayers use a reasonable apportionment method not one that is perfect or mathematically precise. *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 684-85 (1986) (rejecting taxpayer's challenge that formula did not accurately reflect income earned in the state because its track in North Carolina was not as profitable as its track elsewhere and explaining that "division of revenues and costs in accordance with state lines can never be made for a unitary business with more than approximate correctness," and the "[t]axpayer and state would be swamped with administrative difficulties if left to struggle through every case without the aid of a formula of ready application."); *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66-67, 212 S.E.2d 574, 577-78 (1975), citing *Illinois Central Railway Co. v. State of Minnesota*, 309 U.S. 157,161 (1940) (explaining that "this Court has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of Appellant, and has declared that 'rough approximation rather than precision' is sufficient.").

Lockwood Greene endorsed this approach when it held that "gross receipts from within this State" should be determined based on the "place of activity" and that the "place of activity" should be determined by use of a formula that compared Lockwood Greene's payroll expense for South Carolina employees to the firm's total payroll expense for all employees. *Lockwood Greene*, 293 S.C. at 449, 361 S.E.2d at 347. In reaching its decision, the court explained that "an engineering firm's business carried on

in a state is *reasonably measured* by the services rendered by its personnel in the state." *Id.* (emphasis added).

As explained more thoroughly in its Brief, DIRECTV, through its expert Dr. Cody, presented a method for determining the portion of DIRECTV's activities that took place in South Carolina using two commonly employed proxies: (1) payroll expenses, and (2) the net book value of assets (collectively, the "Payroll and Assets Method"). *See* DIRECTV Brief, p. 8-13; and Tr., R. p. 181, 229:7-231:18. This Payroll and Assets Method is both fair and reasonable as it reflects the fundamental economics of DIRECTV's business, and more specifically, the "value drivers" of the business (i.e. the factors that lead customers to subscribe to DIRECTV's programming services), which include content development, marketing, broadcast operations and customer service. *Id.* at 9. DIRECTV is not required to show why each individual South Carolina customer chose to subscribe to DIRECTV, but rather need only provide a reasonable formula that measures its activity in South Carolina. The Payroll and Assets Method is consistent with *Lockwood Greene* and provides a reasonable measure of the business activity carried on by DIRECTV in South Carolina.

Exhibit A to DIRECTV's Brief shows the results of applying the "value drivers" submitted by Dr. Cody. This method approximates the portion of the taxpayer's subscription receipts and license fees that are generated by its income activities as dictated by S.C. Code Ann. §12-6-2295(a)(5), which attributes receipts to this state "to the extent the income activity is performed within this state." Under Dr. Cody's calculations, which use the ratio of South Carolina payroll and net assets to total payroll and net assets as a proxy, DIRECTV overpaid its income taxes for tax years 2006-2008

and is entitled to a refund of $2,076,540.00[3] and underpaid its income taxes due for tax years 2009-2011 and thus owes $2,970,754.00 of that assessment.[4] The netting of the over and underpayments produces a net income tax due for the years under consideration of $894,214.00. Dr. Cody's method also results in a reduction of the license fees owed for tax years 2010-2012 to $13,991.[5] *See* DIRECTV Brief at Exh. A (second chart). Thus, the total sum due by DIRECTV for both its income tax and license fee assessments under Dr. Cody's method is $908,205.00.

V. THE ALC ERRED IN FINDING THAT IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS PROPER.

Nothing in the record supports substantial understatement penalties being imposed in this case. In its Brief, the Department argues that such penalties are justified for tax years 2009-2011 because "DIRECTV did not have substantial authority for how it sourced its South Carolina-based subscription receipts" and "erroneously relied upon *Lockwood Greene* and *Mercury* to support its treatment of subscription revenue . . . ." Department Brief, p. 47.

Under South Carolina law, substantial understatement penalties may not be imposed for tax treatment of items where there "is or was substantial authority for that treatment" or where the relevant facts affecting the tax treatment "are adequately disclosed in the return" and there is a "reasonable basis for the tax treatment of the item. . . ." S.C. Code Ann. §12-54-

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[3] This total is calculated by adding the overpayment amounts contained in the first chart on Exhibit A to DIRECTV's Brief for 2006 ($30,265), 2007 ($1,085,270) and 2008 ($961,005).

[4] This total is calculated by adding the underpayment amounts in the first chart on Exhibit A to DIRECTV's Brief for 2009 ($927,557), 2010 ($1,037,493) and 2011 ($1,005,704).

[5] This total is calculated by adding the underpayment amounts contained in the second chart on Exhibit A to DIRECTV's Brief for tax years 2010 ($5,053), 2011 ($4,449) and 2012 ($4,489).

155(B)(2)(b). Additionally, no penalty may be imposed where there was "reasonable cause" for an understatement and the taxpayer acted in good faith. S.C. Code Ann. §12-54-155(D)(1).

Here, the ALC did determine that the substantial understatement penalty should be reduced by 25%. Am. Final Order, R. p. 51. The ALC explained that this reduction was appropriate because it found that DIRECTV acted in good faith regarding the understated amounts. *Id.* Although apparently not the basis for the reduction, the ALC also found that DIRECTV "appropriately disclosed relevant facts affecting subscription receipts." *Id.* However, it did not abate the penalties entirely because, for reasons that are not entirely clear, the ALC determined that DIRECTV had no substantial authority for its position and that DIRECTV's basis for its tax treatment of the subscription receipts was not reasonable. *Id.*

As discussed in its Brief and above, existing South Carolina law supports DIRECTV's position in every respect, and thus, DIRECTV had substantial authority for its position and there was a reasonable basis for its tax treatment of the subscription receipts. S.C. Code Ann. §12-6-2290(A)(5) speaks to "income producing activity" and *Lockwood Greene* outlines a "place of activity" test and endorses a method based on a payroll proxy. *Mercury Motor* states that each transaction in the series of activities engaged in by the taxpayer to conduct its business contributed to its earnings and net income, and the Court did not consider the "final act" of delivering the package to the customer's residence to be the primary income producing activity. Neither case focuses on the location of the customer (*i.e.* market based sourcing), which some states have adopted by statute. Moreover, the Department has no published guidance to alert taxpayers to any policy that is interpreting the existing law, and even its own auditor was not aware of such a policy. *See supra* §III. If South Carolina had adopted market based sourcing or the Department had published guidelines that set forth its

position, then it would be clear to taxpayers how its income should be apportioned and failure to follow such guidance could potentially justify a penalty against the taxpayer (although no penalty would be justified if the policy was contrary to South Carolina law). But where a statute and the existing case law, by their plain words, state one view, and the court construes those words to mean the opposite view, it is simply incredible that a penalty could be imposed.

Moreover, the ALC expressly found that the Department's method was *incorrect* and that DIRECTV did, in fact, have income producing activities outside of South Carolina. *See supra* §I. If a taxpayer protesting an assessment deemed erroneous by the court and proposing an alternative method that closely tracks the existing law does not qualify as having substantial authority for its position and a reasonable basis for its tax treatment, then it is difficult to see how any taxpayer could ever meet that standard.

Even the Texas case framed by the Department as reaching the result it seeks here (though the law and facts in that case were distinguishable) did not uphold the imposition of a penalty on the taxpayer. *Anonymous Taxpayer v. Texas Cptr of Pub. Accts*, 2013 WL 3490605 (Tex. Cptr. Pub. Acct., May 17, 2013) (declining to uphold penalty imposed by Texas DOR based, in part, on fact that case involved a complex and novel issue). *See also Ameritech*, 2010 WL 2519583, slip op. at 12 (although ultimately finding in favor of the Wisconsin Department of Revenue due to the due deference standard it applied, it concluded that the taxpayer's view that its income producing activities to produce its directories were performed outside the state was reasonable). Because the existing law supported its position in this case and there was no guidance published by the Department to the contrary, DIRECTV had substantial authority for its position, a reasonable basis for

its tax treatment and, acted in good faith. Thus, the substantial understatement penalties for 2009-2011 should be dismissed.

CONCLUSION

For the reasons set forth above and in DIRECTV's Brief, DIRECTV respectfully requests that this Court (i) reverse the Amended Final Order of the ALC because DIRECTV's rights have been prejudiced by the ALC's findings, conclusions and decisions, which are in violation of statutory provisions, affected by errors of law and/or clearly erroneous in light of the reliable, probative and substantial evidence in the record, (ii) declare that, per the computations on Exhibit A to DIRECTV's Brief, the refunds owed to DIRECTV on its income taxes paid for tax years 2006-2008 total $2,076,540.00 plus appropriate interest, while the income tax assessments for tax years 2009-2011 should be reduced to $2,970,754.00 plus appropriate interest such that the total amount owed on its income tax assessments is $894,214.00 plus appropriate interest; (iii) declare that also per Exhibit A to DIRECTV's Brief, its license fee assessment for tax years 2010-2012 should be reduced to $13,991.00 plus appropriate interest, and (iv) dismiss the substantial understatement penalties imposed by the Department.

Alternatively, if this Court determines that the evidence presented by DIRECTV is insufficient to rule as DIRECTV requested, it should not allow the Department's assessment, which the ALC properly characterized as erroneous, to stand. Instead, it should either articulate the proper standard and remand this case for additional findings consistent with that standard or fashion an appropriate remedy based on the evidence in the record.

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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

Case No. 14-ALJ-17-0158-CC

Appellate Case No. 2015-001509

DIRECTV, Inc. and its Subsidiaries,..... Appellant,

v.

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

CERTIFICATE OF COUNSEL

The undersigned certifies that this Final Reply Brief complies with Rule 211(b), SCACR.

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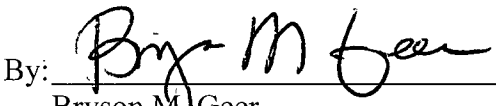
By: 

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PROOF OF SERVICE

I the undersigned Administrative Assistant of the law firm of Nelson Mullins Riley & Scarborough, LLP, attorneys for DIRECTV, Inc. & Subsidiaries, do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified by mailing a copy of the same by United States Mail, postage prepaid, to the following address(es):

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