STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Dish DBS Corporation, f/k/a/ EchoStar, DBS Corp., and Affiliates, Petitioner, v. South Carolina Department of Revenue, Respondent.	)	Docket No.: 14-ALJ-17-0285-CC **AMENDED FINAL ORDER**[1]

APPEARANCES: Petitioner: Burnet R. Maybank, III, Esquire
Jim Rourke, Esquire
Respondent: Nicole M. Wooten, Esquire
William J. Condon, Esquire

STATEMENT OF THE CASE

This matter is before the South Carolina Administrative Law Court ("the ALC" or "the Court") pursuant to a Request for a Contested Case Hearing filed by Dish DBS Corporation, f/k/a EchoStar DBS Corp., and Affiliates ("Petitioner") challenging the South Carolina Department of Revenue's ("Respondent's" or "the Department's") final determination, in which the Department assessed Petitioner taxes, interest, and understatement penalties following an audit for tax years 2004-2010.[2] In its determination, the Department assessed Petitioner $544,286.00 in income taxes, $399,496.00 in related interest, and $276,307.00 in related penalties for tax years 2004-2010. It also assessed Petitioner $90,551.00 in license fee taxes, $32,196.00 in related interest, and $21,846.00 in related penalties for tax years 2006-2011. The Department assessed Petitioner a total of $1,364,682.00 in taxes, interest, and related penalties. In this case, Petitioner contests: (1) the apportionment method the Department used to determine the amount of income tax owed by Petitioner for tax years 2004-2010; (2) the Department's assessment of additional taxes,

[1] This order is amended for clarification of issues raised in Petitioner's Motion for Reconsideration, filed May 31, 2016. Specifically, the Court seeks to dispel any impression that the "audience," or "market share," method was applied in this case.

[2] The Department auditor testified tax year 2004 was included "exclusively for the purpose of auditing [Petitioner's South Carolina net operating loss] that was carried forward" to the following year, 2005. The Department determined Petitioner had a "substantial understatement" for tax year 2004, but did not include the 2004 assessment because the statute of limitations had expired. Additionally, the tax years noted relate to income tax years. Income taxes are generally due in arrears, while license fees are due in advance. For example, when tax year 2008 is referred to, reference is being made to income taxes for 2008 and license fees due for 2009.

EXHIBIT A

interest, and civil penalties for tax years 2004-2010; and (3) the Department's assessment of license fees, interest, and related penalties for tax years 2006-2011.

The Department issued its final determination on May 13, 2014. Petitioner timely appealed to this Court on June 12, 2014. Subsequently, the parties filed cross motions for summary judgment, which this Court denied in an order dated February 10, 2015. Thereafter, on September 23-25, 2015, this Court held a hearing on the merits of the case.

ISSUE

Did the Department Correctly Assess and Calculate Petitioner's Income Tax Liability Following its Audit of Petitioner for Tax Years 2004-2010?

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of persuasion and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence:

Petitioner's Business Operations

Petitioner is a multistate taxpayer organized under the laws of the State of Nevada with principal executive offices located in Englewood, Colorado. Petitioner provides direct broadcast satellite video services across the United States, including in South Carolina. These services are provided through the transmission of digital signals (programming) from several satellites to receiver boxes ("set-top boxes") located in subscribers' homes. Subscribers pay Petitioner a monthly subscription fee for access to this programming, which Petitioner purchases from vendors. Subscribers also pay Petitioner to lease a small satellite dish, a set-top box, and remote control(s).

Englewood, Colorado is the primary location for Petitioner's business functions. It is the location of Petitioner's corporate headquarters, legal department, accounting department, product development department, and advertising department. In addition, all programming contracts and licensing agreements are executed in Englewood.

Petitioner has approximately 14.057 million subscribers nationwide, and employs approximately 22,000 domestic employees. Approximately 227,000 of Petitioner's subscribers are located in South Carolina, which represents about 1.6% of Petitioner's total subscribers. Petitioner also maintains an infrastructure to support its services. This infrastructure includes uplink centers, broadcast centers, customer call centers, service and remanufacturing centers, and warehouses. One of Petitioner's two service and remanufacturing centers is located in

Spartanburg, South Carolina. Petitioner has no other principal properties located in South Carolina.

The distribution of Petitioner's satellite programming is comprised of five main elements: (1) the programming source; (2) the uplink center; (3) the satellite; (4) the receiving dish; and (5) the in-home receiver/set-top box. Petitioner does not create original programming, rather, Petitioner licenses the vast majority of its programming from vendors, like ESPN, who distribute their programming to purchasers through satellite, fiber-optic cable, or over-the-air broadcast. In addition, Petitioner purchases and collects programming from local broadcast television stations using local receiver facilities. Programming content is collected at the uplink centers.

Petitioner's witness, Rex Povenmire, a former Project Manager for Petitioner, spoke extensively about the costs of obtaining programming. According to Povenmire's estimation, Petitioner's contract to televise ESPN costs around $725 million annually. Povenmire also testified that local programming in South Carolina is collected and sent to an uplink center in Texas, for example, where it is then processed before it is distributed. Incoming programming is processed at uplink centers to assure quality (e.g., amplifying the signal), to protect copyrights (e.g., by encrypting the data),[3] to insert content (e.g., public service announcements), and to put the signal into a form that can be transmitted from the uplink centers to satellites orbiting the Earth. After the programming is transmitted to the satellites, the satellites transmit the signal to small satellite dishes mounted on or near subscribers' homes. The small satellite dishes then relay the signal to subscribers' set-top boxes, which un-encrypt the signal and deliver the programming to the subscriber's television for viewing. Petitioner uses two types of satellites: Continental United States "CONUS" satellites and spot beam satellites. Povenmire testified to the hundreds of millions of dollars Petitioner spends to purchase/lease, launch, or otherwise operate and use the satellites. Petitioner owned or leased thirteen satellites during the tax years in question.

Attracting Subscribers and Contracting for Service

To attract subscribers and retain existing subscribers, Petitioner engages in advertising. For example, Petitioner expended $17 million in 2010 on retention marketing and $309 million on subscriber acquisition marketing. Petitioner utilizes direct mail, radio, media, and contracts with national firms to conduct its advertising activities.

[3] Povenmire indicated Petitioner spends a lot of time, effort, and money on anti-fraud devices to protect its signal.

Once a person decides to become a subscriber, he or she must execute a contract for service, which provides that Petitioner will install or provide a small satellite dish, a set-top box, and remote control(s) at the subscriber's home to allow Petitioner to deliver its signal into the subscriber's home. During the years at issue, a subscriber could not contract for services online. Rather, a subscriber had to call a vendor (who calls one of Petitioner's eleven call centers) or call one of Petitioner's call centers directly.

When a call center is contacted for service, a call center representative determines what service packages are available based on the subscriber's location. After the subscriber selects a service package, the subscriber pays for the service package with a credit card. The representative then sets up a time for installation, during which the installer activates the set-top box and trains the subscriber on how to use the system. Call centers are responsible for billing, customer complaints, inquiries, and promotion of optional plans and services.

Petitioner's Revenue

Subscribers pay a monthly subscription fee for Petitioner's service. This monthly subscription fee from its approximately fourteen million subscribers is Petitioner's primary source of revenue. However, Petitioner's total revenue from customers includes revenue from the following: (1) monthly fees for subscribing to one or more programming packages (including pay-per-view programming); (2) the sale or lease of the set-top boxes; (3) the sale of an optional warranty on the leased boxes; and (4) fees associated with high definition set-top boxes, set-top boxes with DVR, multi-room viewing charges, and in-home services (installation of TVs, surround sound, etc.). The parties do not dispute that all income associated with the set-top boxes (installation, rental, repair and/or warranty) that Petitioner receives from South Carolina subscribers should be sourced to South Carolina for apportionment purposes. However, the parties dispute whether all monthly subscription fees from South Carolina purchasers should be sourced to South Carolina.

Petitioner's Tax Returns

For the tax years at issue, Petitioner filed original and amended tax returns in South Carolina using inconsistent methods to calculate its corporate income tax liability in South Carolina: sometimes Petitioner used versions of the gross receipts ratio and sometimes Petitioner

used the four factor method.[4] The Department used the gross receipts ratio during the tax years in question. When Petitioner filed using the gross receipts ratio, it only sourced a portion of its income from South Carolina subscription receipts to the numerator of the ratio instead of 100% of its South Carolina subscription receipts.[5] Using the four factor method and the gross receipts ratio, Petitioner calculated ratios of 0.2384%,[6] 0.2086%, 0.1258%, 0.2400%, 0.3086%, and 0.2717% for years 2005 through 2010, respectively.

In contrast, during its audit, the Department assessed Petitioner for income taxes and license fees for 2005 through 2010 using a gross receipts ratio that sourced 100% of Petitioner's South Carolina subscription receipts to the numerator of the ratio. The Department's method resulted in gross receipts ratios of 1.3467%, 1.3563%, 1.4537%, 1.4075%, 1.4982%, and 1.6144% for years 2005 through 2010, respectively. In its Report of Field Audit dated June 29, 2012, the Department noted:

> The auditor feels the taxpayer's predominant business is selling access to cable programing (intangible property) via subscriber fees which are required before the cable programing can be accessed and 100% of SC subscriber receipts should be sourced to SC.

Later, in its Department Determination issued May 13, 2014, the Department sourced 100% of Petitioner's South Carolina subscription receipts to the numerator, asserting the Petitioner's South Carolina subscription receipts represent its income-producing activity in South Carolina pursuant to the applicable statutes defining the gross receipts ratio. Discussing Petitioner's income-producing activity, the Department found:

---

[4] Methods of apportioning income to a state for tax purposes are based in part on the type of business operated by the taxpayer. The "gross receipts," or "single factor," method is used in South Carolina for service companies or other businesses not dealing in tangible property, or as otherwise provided for by law. See S.C. Code Ann. § 12-6-2290 (2014) The "gross receipts ratio" represents a single fraction used for multistate taxpayers "in which the numerator is [the taxpayer's] gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year." Id. The four factor method consists of similar fractions based on a property factor, a payroll factor, and a doubled sales factor. The four factor method is a variation on the three factor method previously used in South Carolina for businesses dealing in tangible property. See S.C. Revenue Ruling #09-15. Petitioner used the four factor method in filing its 2005 return. Petitioner also filed using the four factor method in 2008, but amended its return to use the gross receipts method.

[5] The president of Petitioner's Tax Division, Matthew Shears, testified 100% of South Carolina set-top rentals and set-top repairs were sourced to South Carolina in the numerator. The parties agree as to the allocation of this income. The issue raised by this case is how to correctly apportion income to the numerator, i.e., whether 100% of the subscription receipts from South Carolina should be sourced to South Carolina in the numerator of the gross receipts ratio.

[6] This ratio was derived from the four factor method. See Petitioner's Exhibit #1.

> It is ***the final act***, the culmination of those enumerated activities[7]—the delivery of the signal into the homes and onto the television screens of its customers—that produces income for [Petitioner]. [Petitioner] does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. [Petitioner] is in the business of selling television broadcast subscriptions to customers, and without the actual delivery of that broadcast signal into South Carolina homes it would not have generated the income at issue here. It is that act alone for which South Carolina customers sign contracts and pay their monthly fees.

The Department's determination appears, at least in part, to rely on the audience method[8] to determine how to source Petitioner's income. For example, the Department maintains it sources gross receipts related to cable companies and telephone companies to the location of the sale, as it similarly did with Petitioner.

According to the Department's Corporate Income Tax policy manual published in 2005,

> South Carolina is not a "cost of performance state;" *i.e.*, a state where receipts are always sourced to the state where the costs to produce the receipts are incurred. It is also 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.

Rick Handel, Deana West & William West, South Carolina Department of Revenue Policy: South Carolina Corporate Income Taxes 17 (2005) (hereinafter "2005 Policy"). In support of its theory, the Department introduced the testimony of John Swain, a law professor specializing in state and local taxation, whom the Court qualified as an expert in Tax Policy and Multi-state Apportionment. Professor Swain testified he is one of the authors of the "Hellerstein & Hellerstein" treatise on state taxation,[9] and opined the treatise does not state South Carolina is a strict costs of performance state, nor does the treatise definitively state South Carolina is a pro rata costs of performance state.[10]

Professor Swain discussed the Department's method of income sourcing/apportionment in this case and described the Department's method as good tax policy for three specific reasons.

---

[7] The "enumerated activities" refer to the activities Petitioner alleged were its income-producing activities, including: selecting, negotiating, and acquiring programming; managing and servicing its subscriber network; managing its broadcast infrastructure; and receiving programming content.

[8] The audience, or market share, method is based upon the origin of payment (the location of the customer).

[9] Walter Hellerstein & John A. Swain, State Taxation (3d ed. 2016) (hereinafter "Hellerstein Treatise").

[10] Professor Swain testified he did not author the particular section of the treatise on multi-state apportionment, but he is familiar with it and the author, Hellerstein.

First, he stated section 12-6-2290 of the South Carolina Code mandates the use of a gross receipts ratio, and commonly the purpose of a gross receipts ratio is to "reflect the contribution of the market state" (in this case, South Carolina) to Petitioner's income production, even though Petitioner is not principally located in South Carolina. Second, he noted the General Assembly's adoption of statutes mandating the use of a sales/gross receipts apportionment ratio reflects the nationwide movement to a "single-sales factor apportionment," which allows states to compete with other states in an age when "capital and labor are mobile." Third, he explained the Department's approach promotes equity by attempting to treat like taxpayers in a like manner, unlike Petitioner's approach, which would result in similar businesses in comparable industries being treated differently.[11] Professor Swain contrasted the Department's policy, which he described as easily applied, with UDIPTA's costs of performance method, which he described as leading to uncertainty for both taxpayers and the Department because the costs of performance method is "[c]onfusing and indefinite and plagued by vagueness, ambiguity, substantial debate, lack of clear guidance, whipsawing,[12] tremendous flexibility, and hence tax planning opportunities, [and] frequent litigation." See Hellerstein Treatise at ¶ 9.18, 51 (quoting J. Swain, Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Receipts, 83 Tel. L. Rev. 285, 306 (2008)). Finally, Professor Swain stated the Department's method of sourcing, in addition to being good tax policy, is consistent with authority in other jurisdictions, including jurisdictions that have cost of performance statutes.

The Department's Historic Tax Policy

Historically, however, the Department has relied on Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (1987), in apportioning income based upon the location of the activity that generated the income without utilizing an audience approach. See, e.g. S.C. Private Letter Ruling #13-3. In fact, the Department has a long-standing policy of examining the specific activities of each applicable industry to determine what activities are income-producing prior to determining how gross receipts are sourced. See Lockwood Greene,

[11] For example, at the hearing, the Department explained that for cable broadcast companies, like Time Warner Cable, and telephone companies it sources gross receipts from South Carolina subscription revenue. However, Petitioner requests its income be sourced differently although it competes with Time Warner Cable in the same industry and has a similar, but not exactly the same business model.

[12] Professor Swain described "whipsawing" as when "[y]ou can have very similar businesses, but when you have a difference in the rule, the treatment of those [businesses] can turn on slight differences in the[ir business] model[s] when they're substantially in the same business and competitors."

293 S.C. at 450, 361 S.E.2d at 348 (noting the Tax Commission's guidelines for different type of businesses focusing on "whether the services are performed in South Carolina"). For example, when the Department sources the taxable income of an engineering firm, it looks to the actual engineering services performed as constituting the income-producing activity generating the gross receipts. See S.C. Private Letter Ruling #13-3. In addition, the 2005 Policy manual provides the following comment discussing the two leading tax cases in South Carolina addressing gross receipts and apportionment:

> Considering Lockwood Greene and Geoffrey,[13] together, it appears that gross receipts are sourced to the state which is most significantly associated with the production of the income; *e.g.*, personal services, where those services are performed; intangibles, where those intangibles are used in a business for the production of income. This conclusion is consistent with the longstanding administrative policy of the department, which was referenced in the Lockwood Greene case, that the gross receipts of loans from finance companies are sourced to the location of the companies' customers.

2005 Policy at 20.

The Department also introduced evidence of minutes from a Department meeting held on August 24, 1977, in which the Department reviewed a proposed regulation describing the gross receipts ratio. This proposed regulation provided that a taxpayer rendering "personal services . . . shall include in the numerator and denominator of the gross receipts ratio the amount charged for services performed within this State" and the denominator shall include the total charged for services without the state. According to handwritten notes on the minutes, instead of approving the regulation, the Department adopted it as a "rule of construction." Id. John Swearingen, a Department employee at the time this rule of construction was adopted, testified the rule has been followed ever since for businesses engaged in personal services, such as engineering firms.

CONCLUSIONS OF LAW

Standard of Review

This Court has jurisdiction to hear this contested case pursuant to section 1-23-600(A) of the South Carolina Code (Supp. 2015) and section 12-60-460 of the South Carolina Code (2014). The Court hears contested cases *de novo*. Hill v. S.C. Dep't of Health & Envtl. Control, 389 S.C. 1, 9, 698 S.E.2d 612, 616 (2010) ("The proceeding before the ALJ was a de novo hearing, which

[13] Geoffrey, Inc. v. S.C. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993).

included the presentation of evidence and testimony."). The Court makes its factual findings based upon a preponderance of the evidence. See S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2015). Generally, the party asserting the affirmative issue in an adjudicatory administrative proceeding has the burden of proof. See Leventis v. S.C. Dep't of Health & Envtl. Control, 340 S.C. 118, 133, 530 S.E.2d 643, 651 (Ct. App. 2000) (citing 2 Am.Jur.2d *Administrative Law* § 360 (1994)). Here, Petitioner requested a contested case hearing and, therefore, has the burden of proof to show by a preponderance of the evidence that the Department's tax assessment is incorrect. See id.; Anonymous (M-156-90) v. State Bd. of Med. Examiners, 329 S.C. 371, 375, 496 S.E.2d 17, 19 (1998) (holding the standard of proof in "administrative hearings is generally a preponderance of the evidence"). Although a tax assessment is initially presumed correct, if a taxpayer establishes an assessment is incorrect, either by proving the actual valuation or through other evidence establishing that the assessment is incorrect, the presumption of correctness is removed and the taxpayer is entitled to appropriate relief. Cloyd v. Mabry, 295 S.C. 86, 88-89, 367 S.E.2d 171, 173 (Ct. App. 1988).

South Carolina Corporate Income Tax Generally

In South Carolina, corporate income tax "is imposed annually at the rate of five percent on the South Carolina taxable income of every corporation . . . transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C. Code Ann. § 12-6-530 (2014). "A corporation's taxable income in South Carolina is computed using the Internal Revenue Code with modifications as provided by South Carolina law, and this amount is 'subject to allocation and apportionment as provided in Article 17 of this chapter.'" Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue, 388 S.C. 138, 145, 694 S.E.2d 525, 528 (2010) (citing S.C. Code Ann. § 12-6-580 (2000)). Further, when "a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014); see Lockwood Greene, 293 S.C. at 449, 361 S.E.2d at 347 ("The purpose of the allocation statutes is to provide for imposition of South Carolina income tax 'upon a base which reasonably represents the proportion of the trade or business carried on within this State.'" (citation omitted)). This method of imposition is consistent with constitutional requirements for the taxation of corporations engaged in interstate commerce. See Geoffrey, 313

S.C. at 23, 437 S.E.2d at 18 ("A tax will survive challenge under the Commerce Clause so long as it 1) is applied to an activity with a substantial nexus with the taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State.").

Petitioner is a Service Provider

Petitioner is a media broadcasting company, and its primary income is derived from providing direct broadcast satellite video services to subscribers throughout the country. Recently, in a nearly identical matter, this Court concluded that DIRECTV, also a media broadcasting company, was a service provider for corporate income tax purposes. See DIRECTV, Inc. & Subsidiaries, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC, 9 (filed Jun. 12, 2015), *appeal docketed*, No. 2015-001509 (Ct. App. Jul. 14, 2015); see also Anonymous Taxpayer v. Texas Comptroller of Public Accounts, 2013 WL 3490605 (Tex. Cptr. Pub. Acct.) (May 17, 2013) (finding that a direct broadcast satellite company was a service provider for purposes of its apportionment laws). Additionally, the parties agree Petitioner is a service provider; therefore, I begin by concluding Petitioner is a service provider.

Apportionment Methods Generally

Generally, there are two predominate methods for apportioning income from services to the numerator of the gross receipts ratio used for service providers: the "costs of performance" method and the "market share," or "audience," method. The costs of performance method

> requires the taxpayer first to determine which of its activities are the income-producing activities for its service income and then to determine where the costs of performing those income-producing activities were incurred. The taxpayer then compares the amount of costs of performance incurred in the taxing state to the amount of such costs in the other individual states. The sales are attributed to the state with the greatest amount of costs of performance.

Hellerstein Treatise, at ¶ 9.18, 47 (footnote omitted). Costs of performance is the method utilized in the Uniform Division of Income for Tax Purposes Act ("UDIPTA"). Section 17 of UDIPTA utilizes standard costs of performance language:

> Sales, other than sales of tangible personal property, are in this state if:
>
> > (a) the income-producing activity is performed in this state; or
> > (b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, *based on costs of performance*.

Unif. Div. of Income for Tax Purposes Act § 17 (emphasis added). Under the costs of performance method, income is sourced based on where the costs are incurred for the income-producing activity. This method creates an "all-or-nothing" situation because, out of all states where costs are incurred, only the one with the greatest costs is apportioned the income.

There is a modified version of costs of performance known as "pro rata costs of performance," which Petitioner asserts is South Carolina's method for sourcing income. This approach eliminates the all-or-nothing factor associated with strict costs of performance and allocates the costs of performance between states:

> Under the pro rata cost-of-performance approach, in contrast to the "all-or-nothing" methodology, gross receipts derived from the performance of a service are prorated among multiple states based on the costs of performing the service in each state.

See Sutton et al., The Increasingly Complex Apportionment Rules for Service-Based Businesses: Basic Issues, 17-OCT JMTAX 24, 30-31 (2007 WL 3201540).

In contrast, the market share/audience method or, as it has been referred to in this State, the "origin of payment" method, sources receipts "to where a taxpayer's customers are located and payments made," Lockwood Greene, 293 S.C. at 448, 361 S.E.2d at 347. Under this method, even if all the costs of performance take place in a foreign state, the taxing state can source income from the receipts of in-state purchasers. The Hellerstein Treatise provides several examples of market share language, including the following phrases: sales are in this state "if the taxpayer's market for the sale is in this state;" sales are attributable to the state in which the purchaser "received the benefit of the service;" or sales from services are assigned to the state "to the extent the purchaser of the service received the benefit of the service in this state." Hellerstein Treatise, at ¶ 9.18, 54-55.

South Carolina's Apportionment Statute

In South Carolina, the applicable apportionment statute for service providers directs that:

> [T]he taxpayer shall apportion its remaining net income using a fraction [ratio] in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.

S.C. Code Ann. § 12-6-2290 (2014).[14] Thus, a service-providing taxpayer is required to use a gross receipts apportionment ratio. Section 12-6-2295 defines "gross receipts" depending upon the type of business in which the corporation is engaged. S.C. Code Ann. § 12-6-2295 (2014). For corporations that provide services, subsection (A)(5) applies, and provides the following:

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

S.C. Code Ann. § 12-6-2295(A)(5) (2014).

Here, the parties disagree about what receipts are to be included in the numerator of the gross receipts ratio pursuant to section 12-6-2290 and 12-6-2295(A)(5). Specifically, the parties disagree about whether the Department properly sourced 100% of Petitioner's South Carolina subscription receipts to the numerator of the gross receipts ratio. However, I note the parties agree that receipts from the sale/lease, installation, repair, and warranty sales of set-top boxes in South Carolina should be included in the numerator of the gross receipts ratio because these are income-producing activities that take place in South Carolina. See S.C. Code Ann. § 12-6-2295(A)(5).

---

[14] In 2007, the General Assembly amended section 12-6-2290 by adding the last sentence: "For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295." 2007 S.C. Act Nos. 110 & 116. Therefore, only section 12-6-2290 is applicable for tax years 2005-2006, and sections 12-6-2290 and 12-6-2295(A)(5) are applicable for tax years 2007-2010. This does not significantly affect the Court's analysis in this case, since the additional statutory language was intended to provide consistency in interpretation. See 2007 S.C. Act Nos. 110 & 116 (stating intent to achieve consistency); see also State v. Ramsey, 311 S.C. 555, 562, 430 S.E.2d 511, 516 (1993) (citation omitted) (presumption that legislature intended to achieve a consistent body of law); State v. McKnight, 352 S.C. 635, 648, 576 S.E.2d 168, 175 (2003) (citations omitted) (presumption that legislature has knowledge of prior judicial decisions on the related subject when enacting legislation); Hoogenboom v. City of Beaufort, 315 S.C. 306, 318 n.5, 433 S.E.2d 875, 884 n.5 (Ct. App. 1992) (citation omitted) (presumption that new legislation is enacted with reference to existing law and that the legislature does not intent by statute to change common law rules). Although the Department adopted an approach in this case that could be characterized as audience-based, the longstanding practices and policies of the Department, in addition to the existing case law, prior to the enactment of the statute appear consistent with the approach adopted by the legislature. See Etiwan Fertilizer Co. v. S.C. Tax Comm'n, 217 S.C. 354, 359, 60 S.E.2d 682, 684 (1950) (citations omitted) ("We have held in many cases that where the construction of the statute has been uniform for many years in administrative practice, and has been acquiesced in by the General Assembly for a long period of time, such construction is entitled to weight, and should not be overruled without cogent reasons.").

Petitioner claims the Department should not source 100% of South Carolina subscription receipts to the numerator of the gross receipts ratio. It claims South Carolina subscription receipts do not accurately reflect its income-producing activities in South Carolina. Additionally, Petitioner claims it has several income-producing activities that take place within and without South Carolina and this activity is best measured by costs of performance principles. Petitioner's method of income sourcing is based on its assertion that South Carolina is a pro rata costs of performance state. As support for its sourcing theory, Petitioner offered the testimony of Ray Stevens, a tax attorney, and former Director of the Department and former Administrative Law Judge. The Court qualified Mr. Stevens as an expert in Policy Issues in Multi-State Taxation. Mr. Stevens testified that to his knowledge, South Carolina is not a strict costs of performance state or a market share state; rather, he believes it is a pro rata costs of performance state. He cited to the Hellerstein Treatise to support his theory, contending that Hellerstein & Hellerstein found South Carolina to be a pro rata costs of performance state.[15] Mr. Stevens also cited Mercury Motors[16] and Lockwood Greene, cases in which South Carolina courts rejected the argument that South Carolina is a market share state, to further suggest South Carolina sources income based on cost-based principles in contrast to market based principles. He then recounted his time litigating Lockwood Greene and opined Lockwood Greene stands for the principle that income tax is apportioned based on where the costs of performance are located. Although Mr. Stevens acknowledged that the court in Lockwood Greene mentioned different types apportionment methods for different types of industry, he asserted this was merely dicta and has no legal bearing on the current case. Mr. Stevens further acknowledged that the services provided by the taxpayers in Lockwood Greene, Mercury Motors, and Rent-A-Center[17] are different from the media broadcasting services at issue here, but opined that in each of these cases the underlying apportionment principles were based on pro rata costs of performance.

---

[15] See Hellerstein Treatise, ¶ 9.18, 46 n.1187 (quoting P. Mata & M. Smith, The Implementation of "Market" Sourcing Rules: Practical Concerns, State Tax Notes, Sept. 6, 210, p. 649)): "According to two knowledgeable observers, as of late 2010 "[f]our states use a proportionate costs-of-performance method: Arkansas, Mississippi, North Carolina (services only) and South Carolina (services only)."

[16] Mercury Motor Express, Inc. v. S.C. Tax Comm'n, 244 S.C.134, 135 S.E.2d 756 (1964).

[17] Rent-A-Center v. S.C. Dep't of Revenue, Docket No 09-ALJ-17-0206-CC (filed January 6, 2012).

Analysis

Having reviewed the applicable statutes, case law, and testimony at the hearing, I reject the Petitioner's contention that South Carolina is a pro rata costs of performance state.

Initially, I find South Carolina is not a strict costs of performance state. Comparing section 12-6-2295(A)(5) to Hellerstein's description of strict costs of performance and section 17 of UDIPTA, it is clear South Carolina has not adopted strict costs of performance. Specifically, while section 12-6-2295(A)(5) is similar to section 17 of UDIPTA, the differences between the two are determinative. The General Assembly, while aware of section 17 of UDITPA, *specifically chose not* to include the phrase "based on costs-of-performance" in section 12-6-2295(A)(5).[18] Moreover, unlike section 17 of UDIPTA or the Hellerstein example of costs of performance, section 12-6-2295(A)(5) does not result in an all-or-nothing outcome where only the state with the most income-producing activity, *as measured by costs of performance*, can source receipts for tax purposes. Rather, section 12-6-2295(A)(5) focuses solely on the "income-producing activity" and where that activity takes place. The only real similarity between the South Carolina statute and UDIPTA is that both rely on "income-producing activity" as a measure of sales; however, as noted above, unlike section 12-6-2295(A)(5), section 17 of UDIPTA requires the use of cost of performance as a proxy for income-producing activity. Additionally, the Department's policy manual from 2005 claims South Carolina is not a cost of performance state. See 2005 Policy at 17. Therefore, based on the clear language of section 12-6-2295(A)(5) and its marked differences from section 17 of UDIPTA, I find South Carolina is not a strict cost of performance state.

[18] The phrase "cost of performance" has only been mentioned in South Carolina law once, in a statue related to manufacturers and dealers in tangible personal property, and the General Assembly deleted the reference to "cost of performance" in 2006. From 1958 until 2006, the sales factor in the three-factor apportionment formula for manufacturers and dealers in tangible personal property included cost of performance language. See S.C. Code Ann. § 12-6-2280(C)(2) (1995); S.C. Code Ann. § 12-6-2250 (1995). However, the cost of performance language, which was deleted by the General Assembly in 2006, has never been included in the statute governing apportionment for service providers, like Petitioner. See also Whitner v. State, 328 S.C. 1, 6, 492 S.E.2d 777, 779 (1997) ("[T]here is a basic presumption that the legislature has knowledge of previous legislation as well as of judicial decision construing that legislation when later statutes are enacted concerning related subjects.").

Next, it is equally clear South Carolina is not a market share or audience state, although, as the Department points out, many states have adopted this method for media broadcasting companies.[19] Indeed, Hellerstein comments:

> Most states have modified their general apportionment rules for apportioning the income of radio and television broadcasters. Many states have done so by adopting regulations identical or similar to the Multistate Tax Commission's (MTC's) special rule for radio and television broadcasting and, in particular, the "audience factor" for assigning receipts from programming and advertising.

Hellerstein Treatise, at ¶ 10.05, 1 (footnotes omitted). However, section 12-6-2295(A)(5) does not include language typical of a market share statute because it does not include language referencing the taxpayer's "market for the sale" or "the place in which the purchaser received the benefit of the service." See Hellerstein Treatise, at ¶ 9.18, 54-55. Rather, section 12-6-2295(A)(5) focuses solely on the "income-producing activity" and where this activity is performed. Further, the Department's 2005 policy manual states South Carolina is not a market share state. See Rick Handel, Deana West & William West, South Carolina Department of Revenue Policy: South Carolina Corporate Income Taxes 17 (2005). Therefore, based on the foregoing, I find South Carolina is not a market share state.

Now we turn to Petitioner's contention that South Carolina is a pro rata costs of performance state. While pro rata costs of performance eliminates the all-or-nothing aspect of strict cost of performance, it still uses costs of performance as a proxy for income-producing activity. Section 12-6-2295(A)(5) focuses exclusively on income-producing *activity* and where it takes place without requiring or referencing a proxy to measure income-producing activity. Therefore, I conclude South Carolina is not a pro rata costs of performance state. Rather, as this Court suggested in its decision in DIRECTV, I find South Carolina's apportionment statute provides a flexible standard based upon the income-producing activity for a given industry. See DIRECTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC, 18 (finding "S.C. Code Section 12-6-2295(A)(5) provides 'flexibility' in determining the relative amount of income-producing activities in the State. This approach necessitates flexibility in application of law and policy to different and often

[19] The Department Determination noted: "South Carolina is not alone in this method of sourcing receipts for taxpayers like [Petitioner]. Twenty-three states have adopted the 'audience approach' for assigning receipts from programming and broadcasting companies." This Court overrules the Department's Determination to the extent that it relies on the audience method. While the results of the Department's Determination and the Court's analyses are the same, the reasoning is different.

diverse service industries."). In essence, South Carolina's statute was constructed to avoid a one-size fits all apportionment method because one size does not fit every industry. This position is supported by the Court of Appeals decision in Lockwood Greene.

In Lockwood Greene, the issue was how to define "gross receipts from within this State" under what is now codified as section 12-6-2290. Lockwood Greene, 293 S.C. at 448, 361 S.E.2d at 347. Notably, at the time Lockwood Greene was decided, South Carolina had not yet adopted section 12-6-2295(A)(5) defining "gross receipts," but Lockwood Greene is relevant because, in defining "gross receipts within this State," the court was essentially providing the definition later codified in section 12-6-2295(A)(5). Id. The taxpayer in Lockwood Greene asserted "receipts" should be sourced to where the taxpayer's customers were located and payments made. Id. This was a version of the market share method or, as the court phrased it, the "origin of payment" method. Id. In contrast, the Tax Commission asserted "receipts" should be sourced to the place where the services were performed, or what the court phrased the "place of activity" method. Id. 293 S.C. at 448-49, 361 S.E.2d at 347. The court agreed with the Tax Commission. Specifically, the court determined:

> A client pays an engineering firm for the expertise and time of its employees. Therefore, an engineering firm's business carried on in a state is reasonably measured by the services rendered by its personnel in the state. This approach to "gross receipts from within this State" is epitomized by the "place of activity" test advanced by the Tax Commission.

Id. 293 S.C. at 449, 361 S.E.2d at 347.

Essentially, the court chose to use the phrase "place of activity," and never used the phrase "cost of performance" in its opinion even though it used payroll (a cost) as a proxy for income-producing activity. Id. Further, while the "place of activity" method resembles the cost of performance method to some extent, an all-or-nothing component was not applied based upon the location of the "greater proportion" of the activities. Thus, the court's "place of activity" method resembles pro rata costs of performance. However, the court's comments in Lockwood Greene suggest the type of industry being taxed may affect the application of the statute:

> Lockwood also argues the statute has not been consistently interpreted by the Tax Commission. *Lockwood refers to Tax Commission guidelines concerning computation of the gross receipts of finance companies and media broadcasters. We are not persuaded these businesses are comparable to Lockwood.* By contrast, the Tax Commission guidelines concerning law firms, accounting firms, entertainment and sports companies, and hospital management companies all focus

> on whether the services are performed in South Carolina. These situations are analogous and consistent with the situation of Lockwood.

Id., 293 S.C. at 450, 361 S.E.2d at 348 (emphasis added). It is important to note that, in the context of the engineering firm in Lockwood Greene, the costs of performance and income-producing activity took place in the same location.[20] In Lockwood Greene, the court affirmed the use of the engineering firm's payroll to determine the location of the income-producing activity. In the case of an engineering firm, the location of the employee personally providing the service is perhaps the best representation of the income-producing activity available to the court. See S.C. Private Letter Ruling #13-3 (determining that another engineering firm's South Carolina payroll demonstrates the location of its income-producing activity because the firm "only uses employees to perform its services"). However, the use of payroll to determine location of the engineering service activity does not mean that the court was using the *cost* of the payroll as a proxy, nor would such a proxy always be the appropriate way to determine where an industry's services are performed.

Thus, the decision in Lockwood Greene does not, as Petitioner contends, clearly demonstrate South Carolina is a pro rata costs of performance state. Rather, Lockwood Greene could be interpreted to apply a flexible standard based on where the income-producing activity takes place, which varies upon industry type.

This Court's 2012 decision in Rent-A-Center v. South Carolina Department of Revenue, Docket No. 09-ALJ-17-0206-CC (filed January 6, 2012), is consistent with my determination that South Carolina's apportionment method does not require income-producing activity to be measured using costs of performance. In Rent-A-Center, this Court determined that management services performed in Texas for a South Carolina affiliate could not be sourced to South Carolina because the income-producing activity—the professional management services—took place in Texas, not South Carolina. Id. at 7, 9, 10. This Court in Rent-A-Center referred to Lockwood Greene's "place of activity" test, but at no time described the method of apportionment as costs of performance. See id. at 1-13. The focus was solely on where the income-producing activity took place.

[20] Indeed, this overlap may explain Hellerstein's description of South Carolina as a pro rata cost of performance state since the decision in Lockwood Greene, read only in the context of an engineering firm without regard for its discussion of other industries, would appear to suggest South Carolina is a pro rata cost of performance state. See Hellerstein Treatise, at ¶ 9.18, 46 n.1187.

Further, my determination is in accordance with this Court's decision in DIRECTV, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC. In DIRECTV, a similarly-situated taxpayer to Petitioner, DIRECTV, asserted that South Carolina is a cost of performance state and, therefore, the Department should not source 100% of gross receipts from South Carolina subscribers to South Carolina. Id. at 1-2. Ultimately, this Court rejected DIRECTV's attempt to source the income from South Carolina subscription receipts to other states based upon cost of performance elements or factors. Id. at 21. Specifically, the Court noted DIRECTV's approach "unduly emphasizes what amounts to 'costs of performance.'" Id. at 17. This Court also noted "South Carolina courts have never imposed a costs-of-performance approach to sourcing receipts of service providers to South Carolina." Id. at 18. Finally, just as the Department concluded in its Determination here, and this Court noted in its Order Denying Cross Motions for Summary Judgment, the DIRECTV decision concluded section 12-6-2295(A)(5) focuses solely on income-producing activity and where the income-producing activity is performed without requiring a particular method of sourcing. Id. at 18 ("South Carolina has not adopted any such 'blanket approach, be it market-based, costs of performance, or otherwise.'").

Simply put, South Carolina is neither a strict nor pro rata costs of performance state because South Carolina law does not require sourcing of a service provider's gross receipts based upon costs of performance principles. See S.C. Code Ann. § 12-6-2290; S.C. Code Ann. § 12-6-2295(A)(5); Lockwood Greene, 293 S.C. at 447, 361 S.E.2d at 346; DIRECTV, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC; Rent-A-Center, Docket No. 09-ALJ-17-0206-CC. Neither is it a market share state. See id. South Carolina's applicable statutes merely require the apportionment of a service provider's net income using a gross-receipts ratio, and the gross receipts are attributable to South Carolina if the income-producing activity occurs within South Carolina or, if it occurs within and without South Carolina, it is attributable to the extent it occurs within South Carolina. See S.C. Code Ann. § 12-6-2290; S.C. Code Ann. § 12-6-2295(A)(5). Where the income-producing activity takes place may vary upon industry, and South Carolina statutes do not require the income-producing activity to be measured using any particular method or proxy. Rather, the focus is on using a method that fairly represents the taxpayer's business activities in South Carolina. See S.C. Code Ann. § 12-6-2210(B) ("[T]he South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.").

What Constitutes Petitioner's "Income-Producing Activity"?

Having determined that South Carolina applies a flexible income tax apportionment standard based on where the income-producing activity takes place for a particular industry, I now address what constitutes Petitioner's income-producing activity in the context Petitioner's industry of media broadcasting and the facts of this case. Initially, I note Petitioner and the Department agree that the lease/sale of set-top boxes, their installation and repair, and the sale of related warranties are income-producing activities that take place within South Carolina. The parties disagree as to whether South Carolina subscription receipts adequately reflect Petitioner's income-producing activity in South Carolina for the purposes of section 12-6-2295(A)(5).

Unfortunately, South Carolina's statutory law does not define "income-producing activity." Petitioner argues this Court should apply the Multi-state Tax Commission's[21] definition of income-producing activity developed for section 17 of UDIPTA to determine Petitioner's income-producing activities. This definition provides:

> The term "income producing activity" applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.

Multi-state Tax Commission, Regulation IV.17(2). This definition was developed in the context of UDIPTA's costs of performance approach for sourcing receipts for tax purposes. Because I have already established South Carolina is not a UDIPTA/costs of performance state and South Carolina is not a member of the Multi-state Tax Commission, I find the definition proposed by Petitioner to be unpersuasive.

Petitioner argues South Carolina subscription receipts do not accurately represent its income-producing activities in the state. Petitioner claims it has eight income producing activities, including: (1) the acquisition of programming/content; (2) the operation of satellites and uplink centers; (3) advertising; (4) providing subscriber equipment; (5) installation of equipment; (6) in-home repair; (7) the operation of call centers; and (8) general and administrative activities. Petitioner provided the testimony of Mr. Povenmire to describe the costs associated with these eight activities. And additionally, Mr. Stevens expressed his belief that these eight activities

---

[21] The Multi-State Tax Commission (MTC) is a commission composed of State Revenue Departments, which issues various policy documents. The South Carolina Department of Revenue is not a member.

represent Petitioner's income-producing activities. When asked about the DIRECTV decision, which determined many of these activities are not income-producing, Mr. Stevens stated the decision in DIRECTV was a result of DIRECTV's failure in that case to provide sufficient evidence of its income-producing activities for the court to perform the correct apportionment analysis based on costs of performance factors.

In contrast, the Department argues the income-producing activity of businesses within the direct broadcast services industry is limited to the delivery of a signal into the customer's home and onto the customer's television. The Department contends subscribers' monthly payments are directly tied to the delivery of the signal onto the television and fairly represent Petitioner's income-producing activity in South Carolina. Accordingly, the Department contends 100% of the subscription receipts from Petitioner's South Carolina subscribers should be sourced to the numerator of the gross-receipts ratio.

To support its position, the Department introduced the testimony of Glenn Harrison, who this Court qualified as an expert in Applied Economics. Dr. Harrison testified that in his opinion, subscriber revenue is the simplest way to determine Petitioner's income-producing activity. He noted that Petitioner acknowledges in its own corporate filing to the United States Securities and Exchange Commission that it recognizes its subscription receipts as revenue when the service has been delivered.[22] Dr. Harrison opined Petitioner's expenditures on satellites, engineering skills, the purchasing of programming and networking licenses, etc., are intermediate inputs that generate costs rather than income, and stated he would not include these intermediate activities in a calculation of revenue. He further explained that while call centers, for example, are necessary to the ultimate income-producing activity of delivering the broadcasting service into customer homes, the call center itself does not actually produce income.

Dr. Harrison also opined it is appropriate to source Petitioner's income differently than a professional service firm like an engineering firm. Making the distinction, he explained an engineering firm does not "have to provide the services in the place that [the services are] actually produced; whereas in the case of [Petitioner], and media services generally, [the services are] produced at the place in which they're consumed, whether it was my house in Irmo or counsel's

[22] Dr. Harrison read the following quotation from Petitioner's Form 10-K during his testimony: "[Petitioner] recognize[s] revenue when . . . the goods and services have been delivered. Revenue from our subscription television services is recognized when programming is broadcast to subscribers."

house in Edisto Island." Dr. Harrison testified he believes the most accurate way to measure Petitioner's income-producing activity in South Carolina is to use Petitioner's subscription receipts from its South Carolina customers.

I agree with Dr. Harrison and the Department's description of Petitioner's income-producing activity. Accordingly, I find the activities Petitioner puts forth as income-producing are preparatory activities that are all necessary for it to ultimately broadcast its signal. However, none of these activities—the acquisition of programming, the operation of uplink centers, etc.—is sufficient to be categorized as producing income. Petitioner's income-producing activity is the delivery of Petitioner's signal into the subscriber's home and onto the subscriber's television. While Petitioner's preparatory activities are lurking behind delivery of its signal subscribers would not pay for Petitioner's preparatory activities/infrastructure alone without access to its programming on their television sets.

Both parties cite to the South Carolina Supreme Court's decision in Mercury Motor Express, Inc. v. South Carolina Tax Commission, 244 SC 134, 135 S.E.2d 756 (1964) to support its theory of income-producing activity. As Petitioner notes, because Mercury Motor focused on a constitutional issue, its holding is not directly applicable, but is instructive, and I find it is consistent with my determination that the income-producing activity in this case is the delivery of Petitioner's signal into subscribers' homes and onto their television sets. In Mercury Motor, a trucking company, Mercury Motor, contracted with various businesses to haul freight. The supreme court described Mercury Motor's business operations as follows:

> 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, and, 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. 244 S.C. at 141, 135 S.E.2d at 759. Thus, the income-producing activity in Mercury Motor was the "hauling of freight." Petitioner seeks to analogize its preparatory activities, such as the acquisition of programming and processing at its uplink centers, to Mercury Motor's "picking up of freight, the hauling of freight, the delivery of the same and collections of charges therefor." Id. I disagree with this analogy and find the analogy drawn by this Court in the DIRECTV decision to be more apt:

> Analogizing the facts in this case to the holding in Mercury [Motor], the beaming of the satellite signals through the air of South Carolina to the customer's dish, set-top box, and television screen, and the collection of charges for such service, are also analogous to the loading, hauling, and delivery of freight following the customer's solicitation of that freight, and the collection of charges therefor. However, the other prior activities that prepare the way for DIRECTV's provision of services, i.e., the infrastructure for producing and collecting the programming content and transmitting the signals would, in comparison to the facts in the Mercury [Motor] case, be akin to the manufacturing and transfer of the freight through its infrastructure to a storage location, from which it is later – **only after an order is placed** (or "solicited," as the Supreme Court put it) – loaded, hauled, and delivered, and for which charges are collected.

DIRECTV, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC, at 13.

Although this Court in DIRECTV found delivery of the signal into subscribers' homes and onto their television sets is the income-producing activity, the Court also suggested "other activities," particularly advertising, may be an income-producing activity. Id. at 14 n.15, 19-20. However, this Court ultimately found DIRECTV "did not provide any evidence that reflected approximately how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated in South Carolina" and therefore did not include advertising as an income-producing activity.

In this case, Petitioner has presented evidence of its 2010 advertising costs within and without South Carolina in a chart, but it has presented no evidence as to how this advertising affected its revenue generated in South Carolina. See Petitioner's Exhibit #36. Accurately measuring the effect advertising had on Petitioner's South Carolina revenue as opposed to its national revenue would be a difficult task and highlights one of the problems associated with using cost-based factors to estimate income-producing activity. Based on the lack of evidence of the effect advertising had on Petitioner's South Carolina revenue, I decline to include advertising in this Court's analysis.

Also, I find it is appropriate, as Dr. Harrison opined, to distinguish the income-producing activity of media broadcasting company services from other services, like professional engineering services. Specifically, I agree with DIRECTV's differentiation between the income-producing activity of media broadcasting companies and the income-producing activity of personal professional service providers like the engineering firm in Lockwood Greene. Analogizing Petitioner to DIRECTV, I agree with this Court's comment in DIRECTV that

> [u]nlike the taxpayer in Lockwood Greene, a DIRECTV customer did not hire specific professionals and is not paying for those professionals' expertise and time, or that of any other DIRECTV employee or contractor. Instead, the customer is paying for video programming to be viewed on the customer's television at the time and place the customer demands. DIRECTV does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. Rather, DIRECTV is in the business of selling television broadcast subscriptions to customers; and without the actual delivery of that broadcast signal into South Carolina homes, it would not have generated the income at issue here.

DIRECTV, Amended Final Order and Decision, Docket No. 14-ALJ-17-0158-CC, at 17.

In sum, I conclude that pursuant to section 12-6-2295(A)(5), Petitioner's income-producing activity is the delivery of its signal into a subscribers' homes and onto their television screens. Because South Carolina subscription receipts are directly tied to the income producing activity, I find Petitioner's South Carolina subscription receipts most accurately represent Petitioner's income attributable to this State. I also find subscription receipts, rather than Petitioner's costs of performance, most accurately reflect the proportion of business Petitioner carries on within this State in accordance with section 12-6-2210(B) of the South Carolina Code. S.C. Code Ann. § 12-6-2210(B) ("[T]he South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State."); see also Geoffrey, Inc., 313 S.C. at 23, 437 S.E.2d at 18 ("A tax will survive challenge under the Commerce Clause so long as it 1) is applied to an activity with a substantial nexus with the taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State."); Exxon Corp. v. S.C. Tax Comm'n, 273 S.C. 594, 606, 258 S.E.2d 93, 99 (1979) ("A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State."). Petitioner's costs of performance in South Carolina are not a fair representation of Petitioner's business in South Carolina because its costs of performance are relatively small in South Carolina compared to the revenue Petitioner's reaps from South Carolina subscribers.[23]

[23] For example, although Petitioner's South Carolina subscribers make up approximately 1.6% of Petitioner's total subscribers (and one would assume approximately 1.6% of its revenue as a result), Petitioner's gross receipts ratios that it calculated using pro rata costs of performance for the tax years at issue are much lower than 1.6%, illustrating its costs in South Carolina are a poor representation for the income Petitioner receives from its activity in South Carolina. See Petitioner's Exhibit #36

Where Does Petitioner's Income Producing Activity Take Place?

Pursuant to Section 12-6-2295(A)(5), a service provider's gross receipts are sourced to South Carolina based on the location of the income-producing activity using a two-prong test. In the first prong, all of the gross receipts are sourced to South Carolina "if the entire income-producing activity is within this State." S.C. Code Ann. § 12-6-2295(A)(5). In the second prong, "[i]f the income-producing activity is performed partly within and partly without this State, [gross receipts are sourced to South Carolina] to the extent the income-producing activity is performed in this State." Id. I conclude all of the income producing activity—the delivery of Petitioner's signal into South Carolina subscribers' homes and onto their television sets—occurs within South Carolina.

Substantial Understatement Penalties

Civil penalties are applied to every South Carolina tax law that requires a return unless otherwise provided. S.C. Code Ann. § 12-54-43 (2014). Such penalties are considered a tax owed to this State. Id. Further, "[i]f any tax is not paid when due, interest is due on the unpaid portion from the time the tax was due until paid in its entirety." S.C. Code Ann. § 12-54-25(A) (2014). Section 12-54-155(A)(1) states that "[i]f there is an underpayment attributable to . . . a substantial understatement of tax for a taxable period . . . there must be added to the tax an amount equal to twenty-five percent of the amount of the underpayment." For purposes of this subsection, "understatement" means the excess of the amount of the tax required to be shown on the return for the taxable period over the amount of the tax imposed which is shown on the return. S.C. Code Ann. § 12-54-155(B)(2)(a) (2014). "[T]here is a substantial understatement of tax for a taxable period if the amount of the understatement for the taxable period exceeds the greater of ten percent of the tax required to be shown on the return for the taxable period or five thousand dollars." S.C. Code Ann. § 12-54-155(B)(1)(a) (2014).

However, section 12-54-155(B)(2)(b) adds the following:

> The amount of the understatement . . . must be reduced by that portion of the understatement which is attributable to the tax treatment of an item: (i) by the taxpayer if there is or was substantial authority for that treatment, or (ii) with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of the item by the taxpayer. . . .

Subsection (D)(1) further adds that "[a] penalty must not be imposed pursuant to this section with respect to a portion of an underpayment if it is shown that there was a reasonable cause for the

portion and that the taxpayer acted in good faith with respect to the portion." S.C. Code Ann. § 12-54-155(D)(1) (2014). Finally, "[u]nless specifically prohibited, the department may waive, dismiss, or reduce penalties provided for in this chapter." S.C. Code Ann. § 12-54-160 (2014).

Based on its audit, the Department determined Petitioner is responsible for a substantial understatement for the tax years at issue. As a result, the Department assessed Petitioner civil penalties. The Department's Determination shows it calculated Petitioner owes $544,286.00 in income taxes, $399,496.00 in related interest, and $276,307.00 in related penalties. The Department also calculated Petitioner owes $90,551.00 in license fee taxes, $32,196.00 in related interest, and $21,846.00 in related penalties. Based on my finding that the Department calculated the correct gross receipts ratio during its audit to determine Petitioner's tax liability for tax years 2004-2010, I find the Department correctly assessed the taxes, interest, and penalties owed by Petitioner for this time period.

Regarding the penalties, I find there was no substantial authority for Petitioner's treatment of subscription receipts. Upon review, it is quite clear that South Carolina authority has consistently applied an activity test to service providers like Petitioner and never used costs of performance. Also, although Petitioner disclosed the relevant facts regarding the subscription receipts, I find there was no reasonable basis for Petitioner's tax treatment of the subscription receipts. Furthermore, Petitioner's wildly different treatments of its income in its multiple original and amended returns suggests no good faith belief in any particular method of apportionment. Therefore, I uphold the Department's assessment of penalties in this case.

CONCLUSION

Based on the foregoing, I find South Carolina statutes provide a flexible apportionment standard based on where the income-producing activity takes place for the particular industry being assessed. Further, in this case, I find the income-producing activity was the delivery of Petitioner's signal to South Carolina subscribers' set-top boxes and onto the subscribers' television sets. Moreover, I find the income-producing activity takes place entirely within South Carolina. Because South Carolina subscription receipts accurately represent the income-producing activity taking place in South Carolina, I find the Department appropriately sourced 100% of Petitioner's South Carolina subscription receipts to South Carolina in the numerator of the gross receipts ratio pursuant to sections 12-6-2290 and 12-6-2295(A)(5) of the South Carolina Code. Accordingly, I uphold the Department's Determination in its result.

ORDER[24]

THEREFORE, IT IS HEREBY ORDRED that Petitioner be assessed $544,286.00 in income taxes, $399,496.00 in related interest,[25] and $276,307.00 in related penalties for tax years 2004-2010.

IT IS FURTHER ORDERED that Petitioner be assessed $90,551.00 in license fees, $32,196.00 in interest,[26] and $21,846.00 in related penalties for tax years 2006-2011.

AND IT IS SO ORDERED.

SHIRLEY C. ROBINSON
Administrative Law Judge

July 11, 2016
Columbia, South Carolina

CERTIFICATE OF SERVICE

This is to certify that the undersigned has this date served the Order in the above entitled action upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by the Interagency Mail Service addressed to the party(ies) or their attorney(s)

This 11th day of July 2016

By _____
Judicial Law Clerk

[24] To the extent the Court has modified this order to reflect concerns raised by Petitioner inn its Motion for Reconsideration, that motion is **GRANTED**. The remainder of the motion is **DENIED**.

[25] Interest was calculated through May 31, 2014, and will continue to accrue until this matter is resolved.

[26] Interest was calculated through May 31, 2014, and will continue to accrue until this matter is resolved.

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

DIRECTV, Inc. & Subsidiaries, Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 14-ALJ-17-0158-CC **AMENDED FINAL ORDER AND DECISION**

Appearances:

For the Petitioner: R. Gregory Roberts, Esq.; Andres Vallejo, Esq.; Bryson M. Geer, Esq.; and John von Lehe, Esq.

For the Respondent: Nicole M. Wooten, Esq.; William J. Condon, Jr., Esq.; Timothy C. Thompson, Esq.; and Mary Elizabeth Campbell, Esq.

STATEMENT OF THE CASE

This matter comes before the South Carolina Administrative Law Court (ALC or Court) following DIRECTV, Inc. & Subsidiaries' (DIRECTV or Petitioner) request for a contested case hearing under S.C. Code Ann. § 12-60-460 (2014). DIRECTV is contesting the South Carolina Department of Revenue's (Department or Respondent) Determination denying DIRECTV's claim for a refund of South Carolina corporate income and license fee taxes for the tax years 2006 through 2008 and the assessment of South Carolina corporate income and license fee taxes, interest, and penalties for the tax years 2009 through 2011 (Tax Periods at Issue).[1]

The Department's Determination (Determination) concluded that applicable South Carolina law and long-standing Department policy require DIRECTV to source all of the gross receipts of its South Carolina subscription revenue to South Carolina because all of the income-producing activity related to DIRECTV's South Carolina customers occurs in South Carolina. DIRECTV asserts that little or no subscription revenue from South Carolina customers should be

[1] The tax years noted relate to income tax years. Income taxes are generally due in arrears, while license fees are due in advance. For clarity, when the Court refers to tax years, reference is being made to income taxes for that year and license fees due for the following year.

included in the numerator of the gross receipts ratio because the majority of the income-producing activity occurs outside of South Carolina.

A hearing was held before this Court on January 13 and 14, 2015.

ISSUES

The following issues are raised in this proceeding:

1. To what extent under S.C. Code Sections 12-6-2290 and 12-6-2295(A)(5) did Petitioner's applicable income-producing activity occur within South Carolina?[2]
2. Whether the Department properly assessed substantial understatement penalties against DIRECTV for taxes owed for 2009 through 2011.

STIPULATIONS OF FACT

At the hearing into this matter and pursuant to Rule 25(C) of the Rules of Procedure for the Administrative Law Court (ALC Rules), the parties entered the following written stipulations of fact into the Record:

1. One of the issues presented by Petitioner for determination in this appeal is whether Respondent is seeking an alternative method of apportionment to source Petitioner's subscription revenue from the provision of its direct broadcast satellite services (Subscription Revenue).

2. In Petitioner's Request for Contested Case Hearing and Prehearing Statement filed with this Court, one of the issues presented for determination was whether Respondent satisfied its burden of proof for the use of an alternative apportionment methodology under S.C. Code Ann. § 12-6-2320.

3. The parties wish to clarify that Respondent does not assert that an alternative apportionment methodology under Section 12-6-2320 was used or should be used to source Petitioner's Subscription Revenue for tax years 2006 through 2011 (Period at Issue).

4. The sole remaining issue presented for determination with respect to the sourcing of Petitioner's Subscription Revenue is how that revenue should be sourced under Sections 12-6-2290 and 12-6-2295(A)(5).

5. As a result, Petitioner's Prehearing Statement is deemed to be amended to remove the assertions set forth in Paragraph No. 3(b) and Paragraph No. 4(b).

6. The parties submitted Exhibit A, a schedule setting forth the amount of (i) Petitioner's total Subscription Revenue for each year during the Period at Issue, (ii) Petitioner's

---

[2] The parties agree that at least some income-producing activity occurred within South Carolina.

total Subscription Revenue from South Carolina Customers for each year during the Period at Issue, (iii) the total revenue from leases of set-top boxes and sales of tangible personal property to South Carolina customers for each year during the Period at Issue, (iv) Petitioner's total revenue from leases of set-top boxes and sales of tangible personal property for each year during the Period at Issue, and (v) Petitioner's total gross receipts for each year during the Period at Issue.

7. The parties agreed to work together in good faith to verify and to confirm the amounts set forth in Exhibit A to provide this Court with a final version of Exhibit A within two weeks of the conclusion of the trial.

8. For each year during the Period at Issue, Petitioner included revenue from the leases of set-top boxes and sales of tangible personal property (e.g., remote controls) to South Carolina customers in the numerator of the gross receipts factor and the parties do not dispute the treatment of this revenue.

After the hearing, the parties determined Exhibit A that was attached to the Stipulations did not need to be amended. Based upon the Stipulations of the parties, the Court adopts the schedule setting forth the amounts listed in Exhibit A, and these figures shall be used in calculating the gross receipts ratio:

	S.C. Subscription Revenue	**Total Subscription Revenue**	**S.C. Lease/Sale Revenue from Set-top Boxes**	**Total Lease/Sale Revenue from Set-top Boxes**	**Total Revenues**
2006	265,155,289	13,583,081,711	3,376,851	160,263,938	13,743,345,649
2007	297,356,680	14,900,247,218	12,547,540	582,796,802	15,483,044,020
2008	334,652,301	16,321,615,758	19,605,211	923,326,252	17,244,942,010
2009	361,394,437	17,348,388,812	26,702,174	1,238,157,983	18,586,546,795
2010	392,627,654	18,654,864,389	31,565,700	1,444,720,825	20,099,585,214
2011	409,564,133	19,689,434,914	42,129,631	1,925,855,682	21,615,290,596

FINDINGS OF FACT

Having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of persuasion and the credibility of the witnesses, I make the following findings of fact by a preponderance of the evidence:

DIRECTV's Business Operations

DIRECTV is a multistate taxpayer headquartered in Los Angeles, California that offers direct broadcast satellite video services to customers throughout the United States. DIRECTV

accomplishes this through four general types of activities: marketing and sales; content development (both original and acquired programming); broadcast operations; and customer service.[3] Through DIRECTV's marketing and sales activities, it advertises its programming services to subscribers. DIRECTV engages in distinctive marketing activities on a national scale which includes South Carolina. The goal of DIRECTV's print and television advertising is to encourage customers to call a toll-free number to place an order for television services.

Customers pay DIRECTV a subscription fee for access to hundreds of television programming channels and other audio/visual options that are transmitted nationwide to customer's homes or businesses via satellites. DIRECTV receives its programming from third parties through satellite, fiber-optic cables, and over-the-air broadcast. DIRECTV also collects programming from local broadcast television stations through the use of local collection facilities throughout seven designated market areas (DMA). During the Tax Periods at Issue, DIRECTV had four to six local collection facilities in South Carolina.

The signals for the programming content are collected at broadcast and uplink centers. These broadcast centers and uplink facilities transmit the programming content signals to the satellites. The satellites then transmit the signals received from the broadcast centers and uplink facilities directly to DIRECTV satellite dishes mounted on or near customer homes. DIRECTV transmits its broadcast utilizing two types of beams from its satellites. One beam, the "CONUS" beam, covers the entire United States. It transmits the national programming sold to DIRECTV. The other beam is a narrow beam that transmits the local programming to the DMAs. Those signals are then relayed from the dish to a set-top box located in the customer's home or business, which delivers the signals to the customer's television set.

Customers pay a monthly subscription fee for access to basic channels and can also purchase premium channels and pay-per-view programs for an additional fee. In order to receive the receive programming, customers must contract with DIRECTV for the service, and then use a satellite dish, remote controls, and set-top box provided by DIRECTV in order to access DIRECTV's programming. During the Period at Issue, DIRECTV provided customer service support to customers in South Carolina through both owned-and-operated internal call centers and third-party call centers, none of which were located in South Carolina. DIRECTV also employed

---

[3] Although several affiliated entities are involved in the provision of DIRECTV's programming services, this case involves only DIRECTV Inc., and thus, the Court's focus is upon the activities of that entity.

two employees in South Carolina and contracted with third-party home service providers who installed and serviced equipment in homes of new customers in South Carolina. Also during the Tax Periods at Issue, DIRECTV began leasing the set-top boxes to customers in exchange for a lease fee. However, the importance of these services as to income production has not been sufficiently explained.

DIRECTV's source of revenue is the subscription revenue it receives from its approximately twenty million subscribers. DIRECTV's revenue includes monthly fees for subscribing to one or more packages of video programming; revenue from pay-per-view programming; revenue from the sale or lease of the set-top boxes; revenue from optional warranty on the leased boxes (protection plans); and revenues from fees associated with high-definition set-top boxes, set-top boxes with DVR, and multi-room viewing. I find that the rental and sales receipts received from South Carolina customers are properly included in the numerator of the gross receipts ratio.[4]

DIRECTV's Income Tax Returns

For the 2006 through 2008 tax years, DIRECTV filed corporate income tax returns in South Carolina in which it sourced 100% of subscription receipts from South Carolina customers to the numerator of the gross receipts ratio. By doing so, DIRECTV used gross receipts ratios of 1.9539%, 2.0016%, and 2.0543% for years 2006 through 2008, respectively. In 2008, the Department began an audit of DIRECTV. As a result of the audit, the Department accepted DIRECTV's original 2006 through 2008 corporate income tax returns as filed (i.e., the Department did not make any adjustments to the tax returns). DIRECTV subsequently filed amended corporate income tax returns for the 2006 through 2008 tax years, and the single change was the removal from the gross receipts ratio of 100% of the subscription receipts from South Carolina customers that DIRECTV originally included in the numerator. The amended gross receipts ratios for years 2006 through 2008 were 0.0246%, 0.081%, and 0.1137%, respectively. DIRECTV explained the change in a statement attached to each of the three amended returns:

> This return is being amended to apportion sales receipts to the state under S.C. Code Ann. § 12-6-2295 which sources sales of services under a pro-rata cost of

[4] The parties do not dispute the treatment of the rental income of the set-top boxes and agree that all such rental income from the set-top boxes received by DIRECTV from South Carolina customers should be included in the numerator of the gross receipts ratio for apportionment purposes. *See* Stipulation of Facts, filed January 13, 2015.

performance method.[5] The originally filed return incorrectly apportioned satellite television subscription receipts to South Carolina using market-based sourcing, rather than the cost of performance sourcing that is prescribed by statute.

Because of the amended returns for 2006 through 2008, DIRECTV decreased its tax and license fee liability by $5,976,816.00 and sought a refund in this amount. In a field audit report dated November 29, 2011, the Department denied the amended returns and related refunds and accepted the original returns as filed.

DIRECTV then filed its original 2009 through 2011 corporate income tax returns using the same costs-of-performance method that it used on its 2006 through 2008 amended returns; the Department audited these returns as well.[6] In a field audit report dated January 28, 2014, the Department assessed DIRECTV for income taxes and license fees for 2009 through 2011 using a gross receipts ratio that included all of the subscription receipts from South Carolina customers in the numerator.

The Department subsequently issued its Determination and found that the income-producing activity of DIRECTV was the delivery of the signal into the South Carolina customer's home or business and onto the customers' television sets and that, accordingly, DIRECTV should include 100% of the subscription receipts received from South Carolina customers in the numerator of the gross receipts ratio. DIRECTV subsequently requested a contested case hearing regarding this Determination.

CONCLUSIONS OF LAW

General Conclusions

This Court has subject matter jurisdiction in this case pursuant to S.C. Code Ann. §§ 1-

---

[5] Both Petitioner and the Department originally erred in how they referenced South Carolina's apportionment method for receipts from services; Petitioner in its amended returns for 2006-2008 referred to it as a "cost of performance method," and the Department referred to it as "market base sourcing" in its Report of Field Audit of Petitioner's 2009-2011 receipts. However, both parties agree, and have subsequently clarified their positions to reflect, that South Carolina uses a method of apportionment based on the proportion of income-producing activity conducted within the State.

[6] DIRECTV did not include any of the subscription receipts from South Carolina customers in the numerator of the gross receipts ratio on its amended 2006 through 2008 returns and on its original 2009 and 2010 returns. On its 2011 South Carolina return, DIRECTV changed its method again by including approximately $22 million of its $410 million subscription receipts from South Carolina customers in the numerator. DIRECTV did this by sourcing 0.11% of its total subscription receipts to South Carolina based on a ratio of its alleged payroll in South Carolina to its total payroll. From 2006 through 2010, DIRECTV did not source any subscription receipts to South Carolina because it claims that the vast majority of its payroll and property were located outside of South Carolina.

23-600(A) (Supp. 2014) and 12-60-460 (2014). The hearing before the ALC is a contested case hearing and is heard de novo. *Marlboro Park Hosp. v. S.C. Dep't of Health and Envtl. Control*, 358 S.C. 573, 579, 595 S.E.2d 851, 854 (2004). This Court must make its factual findings based on the preponderance of the evidence. *See* S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2014); *see also Anonymous (M-156-90) v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998); *Nat'l Health Corp. v. Dep't of Health and Envtl. Control*, 298 S.C. 373, 379, 380 S.E.2d 841, 844 (Ct. App. 1989). Because DIRECTV is challenging a determination by the Department that it must source its South Carolina subscription receipts from South Carolina customers to the numerator of the gross receipts ratio, DIRECTV has the burden of proof. *See Ford v. Atl. Coast Line R. Co.*, 169 S.C. 41, 168 S.E. 143, 167 (1932) ("The general rule is, in the absence of valid statutory enactment to the contrary, that the burden of proof rests upon him who has the affirmative of the issue. . . ."); *see also Leventis v. Dep't of Health and Envtl. Control*, 340 S.C. 118, 132-33, 530 S.E.2d 643, 651 (Ct. App. 2000). This burden requires DIRECTV to prove that the Department's determination is errant by a preponderance of the evidence. *See, e.g., Janasik v. Fairway Oaks Villas Horizontal Prop. Regime*, 307 S.C. 339, 346, 415 S.E.2d 384, 388 (1992) ("Findings of fact based upon a 'preponderance' of the evidence are those supported by the greatest 'weight, amount, credibility or truth' as reflected by the whole of the evidence before the court, or 'evidence which convinces as to its truth.'").

Applicable Law

It is well-settled law that the purpose of the South Carolina allocation and apportionment provisions is to provide for imposition of income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 142 S.E.2d 445 (1965).[7] Furthermore, a statutory provision must be given a reasonable and practical construction consistent with the purpose and policy expressed in the statute. *Hay v. S.C. Tax Comm'n*, 273 S.C. 269, 255 S.E.2d 837 (1979). The method of apportionment that a taxpayer must use depends upon the nature of the taxpayer's business in this

---

[7] Generally, allocation refers to the assignment of nonbusiness income to a specific state. *See* S.C. Code Ann. § 12-6-2220; *Emerson Elec. Co. v. S.C. Dep't of Rev.*, 395 S.C. 481, 486, 719 S.E.2d 650, 652-653 (2011) (noting that a multistate corporation's "non-business income is not apportioned among various states. Rather, non-business income is allocated to or deemed to be earned in a particular state . . . ."). Apportionment generally refers to the assignment of business income of a corporation that is taxable in more than one state. *See* S.C. Code Ann. § 12-6-2210(B); *Emerson*, 395 S.C. at 485, 719 S.E.2d at 652 (stating that "[a] corporation's business income is apportioned among the states in which it conducts business.").

State. During the Tax Periods at Issue, net income of a manufacturer or a dealer in tangible personal property was apportioned based on a three-factor formula and later on a single sales factor (*see* S.C. Code Ann. §§ 12-6-2250, -2252 (Supp. 2007)),[8] while net income of substantially all other taxpayers was apportioned based on a single gross receipts formula (*see* S.C. Code Ann. § 12-6-2290 (Supp. 2007)). Accordingly, for service providers, South Carolina law mandates the following method of apportionment:

> If the principal profits or income of a taxpayer are derived from sources other than those described in Section 12-6-2252 or Section 12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.

S.C. Code Ann. § 12-6-2290.[9] Thus, service providers are required to use the single gross receipts apportionment formula. For tax years after 2006, the final sentence of Section 12-6-2290 directs taxpayers to S.C. Code Ann. § 12-6-2295 for a non-exclusive list of the items to be sourced, or included, in the gross receipts apportionment ratio.[10] The relevant subsection in this matter is Section 12-6-2295(A)(5), which states:

> (A) The terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:
>
> * * *
>
> (5) receipts from services if the entire income producing activity is within this State. If the income producing activity is performed partly within and

---

8. In 2006, the South Carolina Legislature enacted a change in the apportionment method provided in Section 12-6-2250 for taxpayers whose principal business in South Carolina is manufacturing or any form of collecting, buying, assembling, or processing goods and materials within South Carolina, or selling, distributing, or dealing in tangible personal property within South Carolina. The three-factor apportionment method for a multistate taxpayer (based on property, payroll, and double weighted sales) changed to a single-sales-factor apportionment method. This change was phased-in for income tax years beginning in 2007 through 2010. For income tax years beginning in 2011, the single-sales-factor apportionment method in Section 12-6-2252 replaced the three-factor apportionment method in Section 12-6-2250. *See* S.C. Rev. Ruling #09-15.

9 In 1995, the General Assembly repealed Chapter 7 and added Chapter 6 of Title 12. Accordingly, Section 12-6-2290 replaced Section 12-7-1190 as the statute that directed taxpayers how to apportion net income related to services. In 2007, the General Assembly amended Section 12-6-2290 by adding an additional sentence to the end of the existing statute. That sentence reads as follows: "For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295." 2007 South Carolina Laws Act 110 (S.B 91).

10 2007 South Carolina Laws Act 110 (S.B. 91) also added Section 12-6-2295, the companion statute to Section 12-6-2290. *See* 2007 South Carolina Laws Act 110, § 51.A; eff. June 21, 2007. These additions were effective for DIRECTV's 2007 tax year.

partly without this State, sales are attributable to this State to the extent the income producing activity is performed within this State[.]

Taxpayer Is a Service Provider

DIRECTV provides direct broadcast satellite services to customers throughout the United States. Its income is subscription revenue from providing these services and is not from engaging in manufacturing or dealing in tangible personal property. In a similar case, a Texas administrative law court found that a direct broadcast satellite company was a service provider for purposes of its apportionment laws. *Anonymous Taxpayer v. Texas Comptroller of Pub. Accounts*, 2013 WL 3490605 (Tex. Cptr. Pub. Acct.) (May 17, 2013). As a service provider, Section 12-6-2290 is the applicable statute to apportion DIRECTV's adjusted net income to South Carolina. Further, after 2006, Section 12-6-2295(A)(5) is the supplemental sourcing statute when determining the numerator of the gross receipts ratio, and requires DIRECTV to source receipts from South Carolina customers to South Carolina if the income-producing activity occurs in this State. Therefore, for all Tax Periods at Issue, DIRECTV must apportion its net income to South Carolina using a gross receipts factor in Section 12-6-2290.

As noted above, since 1958, the applicable South Carolina apportionment statutes have always mandated that gross receipts be used when apportioning net income to South Carolina for a corporation whose income is generated from the provision of services.[11]

Income-Producing Activity of DIRECTV

The Court must first determine whether any income-producing activity occurred in this State and then decide whether that activity occurred within or without South Carolina. Only after identifying the income-producing activity is there a need to quantify how much of the income-producing activity occurred in South Carolina.

Identification of the Income-Producing Activity

Effective for the 2007 tax year, Section 12-6-2295(A)(5) was applicable and supplemented Section 12-6-2290.[12] Section 12-6-2295(A)(5) added the "income producing activity" language

---

[11] Section 12-6-2295(A)(5) is the applicable sourcing statute for the 2007-2011 tax years at issue. Only Section 12-6-2290 is applicable for tax year 2006.

[12] Notably, when adding Section 12-6-2295(A) for the 2007 tax year, the General Assembly stated the following in 2007 South Carolina Laws Act 110, § 51.A, eff. June 21, 2007: "To Amend . . . by adding Sections 12-6-2252 and 12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes

to the apportionment statutes for service providers. The Department argues that the identity of DIRECTV's income-producing activity is the delivery of the signal into the homes and onto the television screens of its customers. Therefore, the Department contends that 100% of the subscription receipts from South Carolina should be sourced to the numerator of the gross-receipts ratio because there is no other income-producing activity related to DIRECTV's business in South Carolina. To the contrary, DIRECTV presented evidence that its income-producing activities in South Carolina could be identified using four "value drivers." Those "value drivers" are: 1) DIRECTV's content and programming; 2) DIRECTV's acquisition and distribution of the content to customers; 3) DIRECTV's marketing and sale of its service; and 4) DIRECTV's customer services.

The Court concludes that pursuant to Section 12-6-2295(A)(5), DIRECTV's income-producing activity includes the customers' subscriptions and delivery of the signal into the location and onto the television screens of its customers. In identifying this income-producing activity, the Court considered the activities of businesses in the direct broadcast services industry and the sources of income within the industry. DIRECTV derives income from monthly subscription receipts that customers pay to DIRECTV in order to view its video programs in their homes and businesses. These subscription receipts are received as a result of the delivery of the signal into the customer's home and onto the customer's television, and are therefore directly related to the income-producing activity of DIRECTV.

The Court, however, 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 a signal into the customer's home and onto the customer's television. Rather, the Court agrees with Professor Richard D. 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."

In *Walter E. Heller W., Inc. v. Dep't of Revenue*, 161 Ariz. 49, 775 P.2d 1113 (1989), the Arizona Supreme Court analyzed how interest income earned on loans made to Arizona customers should be sourced under provisions that mirrored the Uniform Division of Income for Tax

---

by basing the determination only on a sales factor and to define the terms 'sales' and 'gross receipts' consistently and specifically for that purpose[.]"

Purposes Act (UDITPA).[13] In reaching its decision, the Arizona Supreme Court did not simply look to the location of the customer as the Department does here. Rather, the court determined that the income-producing activities consisted of the solicitation of new customers, the investigation of credit records of potential customers, and the servicing of such contracts, all of which occurred in Arizona. *Id.* at 53-54, 775 P.2d at 1116-17. Therefore, the court's reasoning implies that the location of customers does not necessarily identify the income-producing activities of the taxpayer and therefore is not a reasonable method of identification.

In this case, the evidence also suggested that there may be other activities, such as advertising, that influence the customer's decision to make the purchase. In explaining those activities from DIRECTV's perspective, Dr. Brian J. Cody testified that he employed DIRECTV's payroll and net value of assets as proxies in identifying DIRECTV's income-producing activities. Dr. Cody explained the "[t]wo measures which are proxies . . . [a]re not perfect, but they're proxies . . . ." However, that evidence is simply insufficient to satisfy DIRECTV's burden of proof.

Our Supreme 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." *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66-67, 212 S.E.2d 574, 577-78 (1975). The Court also noted that "[a]lthough exactness in apportionment is desirable, all that is required is a reasonable approximation." Though this Court recognizes that an exact determination of the identity of the income-producing activities is not possible, I find that Dr. Cody's proxies in identifying DIRECTV's income-producing activities are so far from perfect as to be of no practical value. DIRECTV did not sufficiently explain the effect of its value drivers on income production in this State. In other words, DIRECTV's evidence is just too nebulous to properly identify whether DIRECTV's value drivers are income producing and the extent to which such production occurs. Therefore, though Section 12-6-2295(A)(5) provides "flexibility" in determining the relative amount of income-producing activities in the State, Dr. Cody's payroll-and-assets method does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina or the value attributable to such activities. Though its evidence did

---

[13] UDITPA was created in 1957 by the Uniform Law Commission as a model statute for the division of income for income tax purposes. The goal of the Uniform Law Commission in drafting UDITPA was to develop a model act that would be widely adopted..

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 to subscribe to DIRECTV.

Moreover, it does not appear that some of the activities that DIRECTV attributes to income production are actually income-producing activities. DIRECTV argues that its cost to produce the content and broadcast of signals into South Carolina should be considered as an income-producing cost. The Department, on the other hand, argues that only the delivery of the signal into the customer's home and onto the customer's television is income-producing activity. Thus, the pertinent issue here is at what point DIRECTV's activities become income-producing. Both parties assert that the holding in *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964) is applicable to this case. In *Mercury*, the South Carolina Supreme Court addressed the income-producing activity of an interstate freight hauler. The taxpayer argued that the apportionment formula produced an unconstitutional result because it apportioned 17% of its income to the State (reflecting that 17% of its mileage was in the State), while revenue from freight either originating or delivered to South Carolina accounted for only 1% of its gross revenue. The taxpayer asserted that when its trucks were merely traveling through South Carolina, they were not engaged in any activity that contributed to the taxpayer's net income. Rather, the taxpayer argued that the taxable event should only occur if it was delivering freight in the State of South Carolina; otherwise the State's mileage formula produced "an arbitrary, discriminatory and unconstitutional results, in violation of the commerce clause. . . ." In other words, the taxpayer in *Mercury* contended that the incidental act of transporting freight through the State should not be considered as a taxable event.

The Supreme Court listed a series of transactions that occurred in the freight hauling business: solicitation of the freight, picking up the freight, hauling the freight, dropping off the freight, and collecting the hauling charges. The Supreme Court held that while each of these transactions was "necessarily incidental to the production of [the business's] income," the activity that "primarily earn[ed] the income" was the hauling of freight "through and over the highways of the State of South Carolina." *Id.* Thus, the Court focused upon the company's primary activity in

determining whether South Carolina's tax was arbitrary. However, that focus did not specifically equate to the issue to be determined in this case.

In *Mercury*, the Supreme Court found that both the "incidental" and "primary" activities of the appellant's business "contribute[d] to the earnings and net income of the appellant" and were "necessarily incidental to the production of its income." Presumably, the Court distinguished those activities for a reason.[14] However, the Court gave no explanation of the distinction between the "incidental" versus "primary" activities or why such a distinction was made. Nevertheless, *Mercury* did not address activities occurring prior to the "solicitation of freight." Therefore, *Mercury* provides no guidance for activities occurring before the solicitation of DIRECTV's services.

Here, Petitioner engages in other "preparatory" activities that eventually lead to satellite signals being beamed into this State. But those activities have no bearing on a customer's decision to subscribe to, i.e. solicit, Petitioner's services, nor do they occur as a result of that decision to subscribe. For instance, the national programming through the CONUS beams would exist regardless of whether there were any subscribers in South Carolina. Thus, such "preparatory" activities are too attenuated to the production of income to be considered "income-producing activity" for purposes of Section 12-6-2295(A)(5).

Analogizing the facts in this case to the holding in *Mercury*, the beaming of the satellite signals through the air of South Carolina to the customer's dish, set-top box, and television screen, and the collection of charges for such service, are also analogous to the loading, hauling, and delivery of freight following the customer's solicitation of that freight, and the collection of charges therefor. However, the other prior activities that prepare the way for DIRECTV's provision of services, i.e., the infrastructure for producing and collecting the programming content and transmitting the signals would, in comparison to the facts in the *Mercury* case, be akin to the manufacturing and transfer of the freight through its infrastructure to a storage location, from which it is later – **only after an order is placed** (or "solicited," as the Supreme Court put it) – loaded, hauled, and delivered, and for which charges are collected. Though *Mercury* did not

---

[14] It is notable that the Supreme Court was not considering the same issue that is before the ALC. The Supreme Court was seeking to determine whether the taxing method utilized by this State was constitutional. The Court's purpose in considering whether South Carolina was taxing the primary activity could simply have been a method to determine whether the statute had a rational basis. Therefore, the emphasis placed upon the Court's analysis of "incidental" versus "primary" activities appears to be undue.

address such pre-order activities, I find that the ones at issue in this case are too attenuated to be considered income-producing.

More importantly, the evidence failed to establish that these services directly related to the production of income. In sum, DIRECTV failed to sufficiently identify its outside income-producing activities.[15] Even as to local programming, though it is almost completely geared towards South Carolina residents, DIRECTV failed to prove what impact the availability of local programming has on South Carolina customers' decision to subscribe to DIRECTV. Consequently, the remaining evidence is that the transmission of the beams to the customers, as well as the subsequent activities performed that allow South Carolina customers to experience DIRECTV's services – such as the sale/lease, installation, or repair of set-top boxes that are sold or leased to customers –are income-producing activities under Section 12-6-2295(A)(5); and all occur entirely within the State.

Sourcing of the Income-Producing Activity

DIRECTV argues that nearly all of the income-producing activities it identified in this matter occurring outside of South Carolina should be sourced to the location of the activities performed by DIRECTV. At the outset, the Court disagrees that DIRECTV has sufficiently identified its activities to be sourced.[16] Furthermore, even if it had identified those activities, DIRECTV failed to sufficiently establish that those activities should be sourced elsewhere.

Pursuant to Section 12-6-2295(A)(5), a service provider's gross receipts are sourced to South Carolina based on the location of the income-producing activity according to one of two prongs. In the first prong, all of the gross receipts are sourced to South Carolina "if the entire income-producing activity is within this State." S.C. Code Ann. § 12-6-2295(A)(5) (Supp. 2007). In the second prong, "[i]f the income-producing activity is performed partly within and partly

---

[15] For example, as will be discussed *infra*, advertising performed within or without the South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected approximately how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated in South Carolina.

[16] As noted above, DIRECTV argues its "value drivers," reflect its income-producing activity. While DIRECTV may rely heavily upon "value drivers" in determining the value of certain components within its company, DIRECTV has, as aforementioned, failed to sufficiently demonstrate whether and to what extent those value drivers are income-producing activities as required by the applicable and mandatory language of Section 12-6-2295(A)(5) when calculating the numerator of the gross receipts factor.

without this State, [gross receipts are sourced to South Carolina] to the extent the income-producing activity is performed in this State." *Id.*

DIRECTV argues that its income should be sourced based upon payroll and assets/property factors, similar to the taxpayer in *Lockwood Greene Eng'rs, Inc. v. S. C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). The applicable statute for apportioning net income from a taxpayer whose principal profits were derived from services at the time of *Lockwood Greene* was Section 12-7-1190 (1976) which stated:

> If the principal profits or income of a taxpayer . . . are derived from sources other than manufacturing, producing, collecting, buying, assembling, processing, or selling, distributing or dealing in tangible personal property such taxpayer shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

S.C. Code Ann. § 12-7-1190 (1976).

The taxpayer in *Lockwood Greene* unsuccessfully argued that the then-applicable apportionment statute for net income related to services – Section 12-7-1190 – prescribed one rule (i.e., the origin-of-payment rule) for all businesses that do not deal in tangible personal property. The South Carolina Court of Appeals did not accept the taxpayer's argument that Section 12-7-1190 was a one-rule statute and that all net income to be apportioned under Section 12-7-1190 must be apportioned under the same method. Several facts support the Court of Appeals' determination: (1) the Court of Appeals did not believe that the use of different methods for different industries when applying Section 12-7-1190 created a constitutional problem;[17] (2) the Court of Appeals clearly suggested a distinction between finance companies and media broadcasters on one hand and personal *professional* service firms, such as Lockwood, on the other when determining where to source service receipts;[18] and (3) the Court of Appeals noted that the

---

[17] After hearing the taxpayer's argument (that the Department had not consistently applied Section 12-7-1190) and considering the guidelines (which illustrated the Department's policy of allowing the use of different methods for different industries), the Court of Appeals stated, "[w]e discern no constitutional basis for Lockwood's argument." *Lockwood Greene*, 293 S.C. at 450 n.1, 361 S.E.2d at 348 n.1.

[18] *Id.* at 450, 361 S.E.2d at 348 ("We are not persuaded [finance companies and media broadcasters] are comparable to Lockwood. By contrast, the Tax Commission guidelines concerning law firms, accounting firms, entertainment and sports companies, and hospital management companies all focus on whether the services are performed in South Carolina."). *Implicit in this finding* is the fact that the only reason for the Court of Appeals to distinguish a taxpayer like Lockwood from companies in other industries was the Court of Appeals' belief that Section 12-7-1190 was not a "one-rule statute," and that different methods could be used for different industries when applying Section 12-7-1190.

Lockwood firm "provides services to its clients through highly trained engineers and personnel in various offices" and that a "client pays an engineering firm for the **expertise and time** of its employees." *Lockwood Greene*, 293 S.C. at 449, 361 S.E.2d at 347 (emphasis added). Based on the specifics of Lockwood's business, the Court of Appeals then concluded, "Therefore, an engineering firm's business carried on in a state is reasonably measured by the services rendered by its personnel in the state," which "is epitomized by the 'place of activity' test advanced by" the Department. *Id.* Again, it would not have been necessary for the Court of Appeals to address the specifics of Lockwood Greene's business if Section 12-7-1190 was a "one-rule statute."

On one hand, the Court's decision in *Lockwood Greene* did **not** mandate that the net income of **all** service providers be apportioned based on a "place of activity" test that is quantified by a payroll factor or some other cost-based factor. The Court of Appeals specifically recognized that the Department's audit guidelines at the time sourced revenues of personal *professional* service providers (e.g., engineering, law, and accounting firms) to the "place of activity."[19] *Lockwood Greene*, 293 S.C. at 450, 293 S.E.2d at 348. At the same time, the court was **not persuaded** that service industries, such as finance companies and media broadcasters, were comparable, thus implying that revenues of service industries were sourced to the "origin of payment" (i.e., location of the borrower or customer) *Id.* The Court of Appeals also held that no constitutional problem existed with the Department's policy of sourcing revenues of services providers in a different manner for different industries. *Id.* at 450 n.1, 361 S.E.2d at 348 n.1.

Accordingly, the result of *Lockwood Greene* was the Court of Appeals' holding that (1) a personal professional service firm should source its gross receipts to South Carolina based on the "place of activity" test; and (2) affirmation that the Department's then-existing policy of using different methods for different industries to source service-related net income to South Carolina, was in compliance with Section 12-7-1190. Further, despite DIRECTV's contention, the Court of

---

[19] The Department argues that it has had a longstanding policy in place regarding the sourcing of service-related net income and that it is therefore entitled to deference. However, this policy, though once apparently written down and acknowledged by the Court of Appeals in *Lockwood Greene*, is no longer written anywhere and apparently has not been for some time. As the finding of fact in *Lockwood Greene* is the only evidence of this policy, I find that this finding of fact is insufficient as a basis for deference. Moreover, "[p]olicy or guidance issued by an agency other than in a regulation does not have the force or effect of law." *See* S.C. Code Ann. § 1-23-10(4) (2005). *See also Kirven v. Cent. States Health & Life Co., of Omaha*, 409 S.C. 30, 45, 727 S.E.2d 794 802 (2014) ("[A]n agency guideline does not have the force of law, and in any event, can never trump a regulation.... *Policy or guidance issued by an agency other than in a regulation does not have the force or effect of law.*") (quoting *Doe v. S.C. Dep't of Health & Human Servs.*, 398 S.C. 62, 68 n.7, 727 S.E.2d 605, 608 n.7 (2011)).

Appeals in *Lockwood Greene* did not impose a one-rule "place of activity" test for apportioning service-related income in South Carolina on *all* multistate corporate taxpayers. The Court of Appeals clearly supported the Department's use of different methods for different industries and did not reject Lockwood's "one-rule" argument only to replace it with a different one-rule requirement.[20]

Unlike the taxpayer in *Lockwood Greene*, a DIRECTV customer did not hire specific professionals and is not paying for those professionals' expertise and time, or that of any other DIRECTV employee or contractor. Instead, the customer is paying for video programming to be viewed on the customer's television at the time and place the customer demands. DIRECTV does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. Rather, DIRECTV is in the business of selling television broadcast subscriptions to customers; and without the actual delivery of that broadcast signal into South Carolina homes, it would not have generated the income at issue here. Indeed, as noted above, the national programming through the CONUS beams would exist regardless of whether there were any subscribers in South Carolina; therefore, such broadcasting is preparatory activity. As to local broadcasting in South Carolina, though it is almost completely geared towards South Carolina residents, DIRECTV provided no evidence of what impact the availability of local programming has on South Carolina customers' decision to subscribe to DIRECTV.

Furthermore, as noted above, Dr. Cody testified that he employed DIRECTV's payroll and net value of assets as proxies in determining and sourcing DIRECTV's income-producing activities. However, as with the determination/identification of income-producing activities, the Court also rejects as too nebulous this approach to sourcing gross receipts to South Carolina. In sum, the payroll-and-assets method of Dr. Cody does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina, and the value attributable to such activities.

Moreover, the approach proposed by Dr. Cody unduly emphasizes what amounts to "costs of performance." It is clear that South Carolina is not a UDITPA State, and it does not require

---

[20] When Section 12-6-2295(A)(5) was enacted, the distinction between "place of activity" and "origin of payment" became irrelevant and the question then became whether the income-producing activity occurred completely within the State of South Carolina, and if only partly within the State, in what proportion it was conducted within the State. Lockwood Greene, in light of Section 12-6-2295(A)(5), still suggests that income-producing activity is the acts of a business that directly result in the purchase of a product or service. Finally, as discussed supra, the location of income-producing activity will vary depending on the industry.

apportionment of the net income of service providers based upon costs-of-performance elements. Although South Carolina's Section 12-6-2295(A)(5) is similar to UDITPA's Section 17, the General Assembly specifically chose not to include the phrase "based on costs of performance." South Carolina's applicable statutes merely require the apportionment of a service provider's net income using a gross-receipts ratio, and the gross receipts are attributable to South Carolina if the income-producing activity occurs within South Carolina or, if the income-producing activity occurs both within and outside of South Carolina, to the extent that the income-producing activity is performed within South Carolina.

Likewise, the South Carolina courts have never imposed a costs-of-performance approach to sourcing receipts of service providers to South Carolina. In addition to not being a costs-of-performance state, South Carolina has never been a state that always sourced receipts to the state in which the market exists (i.e., to the location of the customer or where the benefit is received). While some states, such as California, have statutorily adopted a market-based approach to source gross receipts of a service provider,[21] South Carolina has not adopted any such "blanket" approach, be it market-based, costs of performance, or otherwise. Rather, its policy has been one of apportioning net income "upon a base which reasonably represents the proportion of the trade or business carried on within this State." *Lockwood Greene*, 292 S.C. at 449, 361 S.E.2d at 347 (citing *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 142 S.E.2d 445 (1979)); *see also* S.C. Code Ann. § 12-6-2320(A) (Supp. 2000). Thus, the Court agrees with Professor Pomp that instead of mandating one method (*e.g.*, "costs of performance" or "market-based") for determining the amount and location of income-producing activities, S.C. Code Section 12-6-2295(A)(5) provides "flexibility" in determining the relative amount of income-producing activities in the State. This approach necessitates flexibility in application of law and policy to different and often diverse service industries. *See Dish DBS Corp.*, at *9-10 ("Lockwood Greene could be interpreted to apply a flexible standard based on where the income producing activity takes place, which varies upon industry type.").

Even in many states that **have** adopted the costs-of-performance language within their applicable statutes or regulations, such states have found that the income-producing activity was **not** located in the state(s) in which significant costs were incurred. For instance, in *Heller W.*,

---

[21] *See* Cal. Rev. & Taxation Code (R&TC) § 25136; Cal. Code Regs. § 25136-2.

Inc., the Arizona Supreme Court determined that the taxpayer's income-producing activity occurred solely in Arizona despite the fact that the California-based commercial financing company that received income from loans it made to Arizona borrowers incurred most of its costs in California. 116 Ariz. at 51, 53, 775 P.2d at 1115, 1117. Importantly, the applicable Arizona statute was the same as S.C. Code Ann. § 12-6-2295(A)(5) except that the Arizona sourcing statute **actually used** the phrase "costs-of-performance." Even though this language in the Arizona statute gave that taxpayer's costs-of-performance argument more merit, it was not enough to convince the court to find that the income-producing activity occurred outside of Arizona. The taxpayer argued that its income-producing activity was the borrowing of money by Heller Western through its Los Angeles headquarters to make loans to customers in Arizona. *Id.* at 50, 775 P2d at 1114. The Arizona Supreme Court held that "[t]hough borrowing of funds [in California] may be an important step in Heller Western's financing process, the direct generation of the loans occurred in Arizona. We conclude that Heller Western's sales activity in Arizona constituted the income producing activity contemplated by our tax regulations." *Id.* at 53, 775 P2d at 1117. That court went on to provide the following reasoning:

> Heller Western's costs in procuring the [product that it has sold to Arizona customers] are analogous to the costs of a merchandise retailer in procuring his inventory. Heller Western can no more argue that its receipts from Arizona loan consumers should not be taxed due to its out-of-state involvement in procuring its 'inventory' than a retailer who is engaged in extensive dealings out of state to buy his merchandise could argue that he should not be taxed on the goods he sells to consumers here."

Id. This reasoning is applicable in the instant case.

This is not to suggest that the Court should not consider out-of-state activity when determining whether activity is income-producing, nor does this suggest that no such out-of-state income-producing activity occurred in this case. For instance, it is possible that advertising performed within or without the South Carolina could be considered income-producing activity.[22]

---

[22] For example, in *Ameritech Publ'g, Inc. v. Wis. Department of Revenue*, 327 Wis.2d 798, 788 N.W.2d 383 (Ct. App. 2010) (unpublished), 2010 WL 2519583, the Wisconsin Court of Appeals affirmed the taxing authority's determination that the income-producing activity of a company that received advertising revenue by placing the advertisements in telephone directories distributed in Wisconsin "was performed in Wisconsin when the advertisement reached its intended, Wisconsin audience." *Id.* at 2010 WL 2519583, *5. Indeed, the court found that the income-producing activity occurred *solely* in Wisconsin, even though the vast majority of the taxpayer's costs to gather the advertising and to publish the telephone directory were incurred outside of Wisconsin and despite the fact that the applicable Wisconsin statute *included* the phrase "costs of performance" (unlike the South Carolina statute). The Court of Appeals concluded that the advertising company's customers were paying for the broad access that the

However, DIRECTV did not provide any evidence that reflected approximately how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated in South Carolina. Therefore, the Court cannot consider advertising in this case.

Finally, even if this Court ruled that South Carolina was a costs-of-performance state, and that costs of performance therefore applied in this case, DIRECTV did not present sufficient evidence to determine its income-producing activities or to quantify how much income-producing activity occurred in any applicable state. Furthermore, DIRECTV put no value on its subscriptions or the value perceived by its customers. DIRECTV simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur.

Substantial Understatement Penalties

Civil penalties are applied to every South Carolina tax law that requires a return unless otherwise provided. S.C. Code Ann. § 12-54-43. Such penalties are considered a tax owed to this State. *Id.* Further, "[i]f any tax is not paid when due, interest is due on the unpaid portion from the time the tax was due until paid in its entirety." S.C. Code Ann. § 12-54-25(A). Section 12-54-155(A)(1) states that "[i]f there is an underpayment attributable to . . . a substantial understatement of tax for a taxable period . . . there **must** be added to the tax an amount equal to twenty-five percent of the amount of the underpayment." (emphasis added). For purposes of this subsection, "understatement" means the excess of the amount of the tax required to be shown on the return for the taxable period over the amount of the tax imposed which is shown on the return. "[T]here is a substantial understatement of tax for a taxable period if the amount of the understatement for the taxable period exceeds the greater of ten percent of the tax required to be shown on the return for the taxable period or five thousand dollars." *Id.* § 12-54-155(B)(1)(a). However, Section 12-54-155(B)(2)(b) adds the following:

> The amount of the understatement . . . must be reduced by that portion of the understatement which is attributable to the tax treatment of an item: (i) by the taxpayer if there is or was substantial authority for that treatment, or (ii) with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of the item by the taxpayer. . . .

---

company could provide to a Wisconsin audience, and that the taxpayer's income-producing activity was thus "the provision of access to a Wisconsin audience." *Id.* at *9-10

Moreover, subsection (D)(1) further adds that "[a] penalty must not be imposed pursuant to this section with respect to a portion of an underpayment if it is shown that there was a reasonable cause for the portion and that the taxpayer acted in good faith with respect to the portion." Finally, "[u]nless specifically prohibited, the department may waive, dismiss, or reduce penalties provided for in this chapter." S.C. Code Ann. § 12-54-160.

In the instant matter, the Department was correct in its calculation of the understatement of taxes owed for 2009-2011 (and interest thereon), and that amount was properly not reduced. I find that there was no substantial authority for DIRECTV's treatment of subscription receipts. Also, though DIRECTV appropriately disclosed relevant facts affecting subscription receipts, I find that DIRECTV's basis for its tax treatment of the subscription receipts to be unreasonable.

I also find that the Department was correct to apply a substantial understatement penalty for underpayment of taxes owed for 2009 through 2011. Though DIRECTV acted in good faith with respect to bringing its claim regarding the portions of the understated tax amounts, I find that DIRECTV did not have "**reasonable** cause" (emphasis added) for the underpaid taxes, i.e., DIRECTV's method of calculating subscription receipts was unreasonable. Nevertheless, because the Court finds that DIRECTV acted with sufficient belief in bringing its claim regarding the portion of the understated tax amounts, the Court, pursuant to Section 12-54-160, concludes that a reduction in the penalty imposed upon DIRECTV should be reduced. Therefore, the Court shall reduce the penalty originally sought by the Department to 25% of that amount.

Conclusion

After considering the evidence in the record and the pertinent legal authorities, I conclude that based upon the reliable evidence, DIRECTV's income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV's customers. All of those income-producing activities related to South Carolina customers occurred entirely within South Carolina; therefore, 100% of DIRECTV's subscription receipts from South Carolina customers must be sourced to the numerator of the gross receipts ratio. This Court rejects DIRECTV's attempt to source the subscription receipts from South Carolina customers outside of South Carolina based upon costs of performance. Finally, DIRECTV is liable for substantial underpayment penalties.

ORDER

IT IS THEREFORE ORDERED that DIRECTV's refund requests for its amended 2006, 2007, and 2008 income tax returns are denied.

IT IS FURTHER ORDERED that DIRECTV be assessed $6,646,168.00 in tax and license fees, $653,425.00 in interest, and $1,246,155.75 in penalties with regard to its 2009, 2010, and 2011 income tax returns.

AND IT IS SO ORDERED.

Ralph King Anderson, III
Chief Administrative Law Judge

June 12, 2015
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, E. Harvin Belser Fair, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, in the Interagency Mail Service, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).

E. Harvin Belser Fair
Judicial Law Clerk

June 12, 2015
Columbia, South Carolina