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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

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

Appellate Case No. 2015-001509

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

v.

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

AMENDED RECORD ON APPEAL

VOLUME I of III

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**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

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

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.

FILED

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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 primary 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. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2009); *see also Anonymous (M-156-90) v. State Bd. of Med. Examiners*, 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* ALC Rule 29(B); *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 and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption."); *see also Leventis v. Dep't of Health and Envtl. Control*, 340 S.C. 118, 132033, 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

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.").

apportionment that a taxpayer must use depends upon the nature of the taxpayer's business in this 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:

* * *

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.

(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[.]

Taxpayer Is a Service Provider

DIRECTV provides direct broadcast satellite services to customers throughout the United States. Its primary 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

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 primary 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

12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes 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 thus 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's inclusion of "incidental" in its definition of income-producing activities distinguishes that activity from the primary income-producing activity. However, the Court did not determine that those "incidental" activities were not income-producing. Nevertheless, the consideration of primary versus incidental activities does offer a point for analysis. Here, Petitioner engages in other out-of-state activities that cause satellite signals to be beamed into this State. But, it is not until a customer subscribes to Petitioner's services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals that Petitioner's actions have any income producing value. Indeed, the national programming through the CONUS beams would exist regardless of whether there were **any** subscribers in South Carolina. Therefore, such broadcasting is an incidental activity to producing income until a customer subscribes to DIRECTV.

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 in *Mercury*. 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, though necessary, are merely incidental to the income-generating activities themselves, i.e., the services that directly produce income for DIRECTV. In this case, the production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites 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.

In sum, DIRECTV failed to sufficiently identify its outside income-producing activities. 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.¹⁴ 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 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).

¹⁴ As noted above, DIRECTV argues its "value drivers" reflect its income-producing activity.¹⁴ 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.

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;¹⁵ (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;¹⁶ and (3) the Court of Appeals noted that the 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

¹⁵ 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.

¹⁶ *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.

providers (e.g., engineering, law, and accounting firms) to the “place of activity.”¹⁷ *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.¹⁸ *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 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.¹⁹

¹⁷ 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, though the fact that DIRECTV previously filed its returns sourcing 100% of the South Carolina subscription revenue to South Carolina before filing the amended returns suggests that the Department had such a policy in place. 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)).

¹⁸ It is noteworthy that the payroll factor that was used by the Department to source Lockwood’s gross receipts to South Carolina was used merely as a proxy for calculating Lockwood’s actual gross receipts from within South Carolina. If the Department had had all of Lockwood’s records, the Department would not have had to use the payroll proxy but could have examined all of Lockwood’s invoices and added the fees billed for the work of South Carolina engineers. Here, DIRECTV has added up all of its actual subscription receipts from South Carolina customers for the applicable tax years; therefore, no cost-based proxy is needed.

¹⁹ 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

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 incidental 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 apportion 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

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.

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 also 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 also 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,²⁰ 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., 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

²⁰ See Cal. Rev. & Taxation Code (R&TC) § 25136; Cal. Code Regs. § 25136-2.

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.²¹ However, DIRECTV did not provide any evidence that reflected 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

²¹ 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 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

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).

In the instant matter, the Department was correct to apply a substantial understatement penalty for underpayment of taxes owed for 2009 through 2011, and this Court concludes DIRECTV must be assessed the substantial understatement penalty.

Conclusion

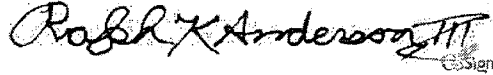
After considering the evidence in the record and the pertinent legal authorities, I conclude that based upon the reliable evidence, DIRECTV’s income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV’s customers. All of those income-producing activities 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 \$1,661,541.00 in penalties with regard to its 2009, 2010, and 2011 income tax returns.

AND IT IS SO ORDERED.

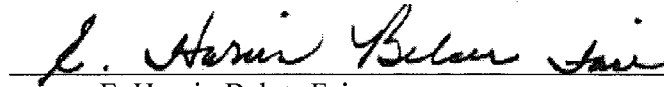
A handwritten signature in black ink, reading "Ralph King Anderson, III". The signature is written in a cursive, flowing style. To the right of the signature, there is a small, faint circular stamp that appears to contain the word "Sign".

Ralph King Anderson, III
Chief Administrative Law Judge

May 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

May 12, 2015
Columbia, South Carolina

DIRECTV, Inc. & Subsidiaries,
Petitioner,
vs.
South Carolina Department of Revenue,
Respondent.

RECONSIDERATION ORDER

SC ADMIN. LAW COURT

DISCUSSION

ROA 00023

producing activities and their locations such that it established by a preponderance of the evidence that the Department's assessment was incorrect, thus meeting its "only burden." DIRECTV also argues that the Court misinterpreted DIRECTV's burden of proof and improperly placed an additional burden on it by "requiring DIRECTV to establish the actual revenue attributable to South Carolina" in addition to requiring DIRECTV to establish that the Department's apportionment was incorrect. DIRECTV relies on *Cloyd v. Mabry*, 295 S.C. 86, 88-89, 367 S.E.2d 171, 173 (Ct. App. 1988) for the proposition that if a taxpayer demonstrates "that the assessing authority's valuation is incorrect[,] . . . the presumption of correctness is then removed and the taxpayer is entitled to appropriate relief." DIRECTV appears to interpret these phrases to mean that once it established the incorrectness of the Department's apportionment approach, it had no further burden of proof beyond that point. I disagree.

As set forth in the Court's Order, the burden of proof in this case is a 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. Examiners*, 329 S.C. 371, 375-78, 496 S.E.2d 17, 19-20 (1998); *Nat'l Health Corp. v. Dep't of Health and Env'tl. Control*, 298 S.C. 373, 379, 380 S.E.2d 841, 844 (Ct. App. 1989). Also, "[t]he general rule . . . is that the burden of proof rests upon him who has the affirmative of the issue and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption." *Ford v. Atl. Coast Line R. Co.*, 169 S.C. 41, 168 S.E. 143, 167 (1932); see also *Leventis v. Dep't of Health and Env'tl. Control*, 340 S.C. 118, 132-33, 530 S.E.2d 643, 651 (Ct. App. 2000) (noting that the complaining party in an adjudicatory administrative proceeding bears the burden of proof). Accordingly, DIRECTV had the burden of proof because it was 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.

Moreover, the standard of review in this case is de novo, i.e., the ALC stands in the shoes of the Department and makes its own findings of fact. *Marlboro Park Hosp. v. S.C. Dep't of Health and Env'tl. Control*, 358 S.C. 573, 579, 595 S.E.2d 851, 854 (2004). As the finder of fact, the ALC is entitled to weigh the evidence and make credibility determinations. See *MRI at Belfair, LLC v. S.C. Dep't of Health and Env'tl. Control*, 392 S.C. 314, 324, 709 S.E.2d 626, 631 ("[A]s

argument to the application and imposition of the burden of proof, the Court, for the sake of expediency and convenience, has combined these two sections into one section of discussion.

the fact-finder, the ALC was free to make factual findings based on its view of the credibility and weight of the evidence.”) (2011). The ALC is free to accept or reject the testimony of any witness, including an expert witness. *Maull v. S. Carolina Dep't of Health & Envtl. Control*, 411 S.C. 349, 359, 768 S.E.2d 402, 408 (Ct. App. 2015); *Estate of Hicks*, 284 S.C. 462, 466, 327 S.E.2d 345, 348 (1985) (“It is the duty of the trier of facts to evaluate witness testimony and assign to it such weight as he determines proper.”); *Small v. Pioneer Mach., Inc.*, 329 S.C. 448, 465, 494 S.E.2d 835, 843 (Ct. App. 1997) (“The fact finder is imbued with broad discretion in determining credibility or believability of witnesses.”).

It is questionable whether *Cloyd* applies in this case as that case involved a property tax assessment instead of a corporate income tax apportionment. But assuming that *Cloyd* does apply, the Court’s disagreement with the Department’s apportionment approach did not remove the Court’s ability to make its own findings as to the proper apportionment approach to be taken; it simply removed the presumption that the Department’s apportionment approach was correct.² Therefore, the fact that the Court did not accept the Department’s apportionment approach did not absolve DIRECTV of its responsibility to prove its case by a preponderance of the evidence. The burden remained upon DIRECTV to show that its version of the case was correct.³ And the Court did not require DIRECTV to prove the “actual revenue attributable to South Carolina,” but rather a **reasonable approximation** thereof. DIRECTV may have provided evidence to support its claim, but the Court, as the finder of fact, found that evidence to be unpersuasive and that it failed to satisfy DIRECTV’s burden of proof. As DIRECTV points out in its Motion for Reconsideration, the Court made the following findings:

- The “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.”

² For example, citing another property tax assessment case, *Smith v. Newberry Cnty. Assessor*, 350 S.C. 572, 578-79, 567 S.E.2d 501, 504-05 (Ct. App. 2002), the Court of Appeals found that the administrative law judge properly determined a fair market value of a property even though it was not the value presented by any of the experts in the case because the ALC has the ability to determine the proper assessed value based on the evidence presented even when the county assessor’s value is deemed incorrect.

³ If DIRECTV’s assertion was a correct interpretation of the law, a taxpayer would only be required to challenge the validity of the Department’s determination and once exposing an error in that determination it would prevail no matter how erroneous its claim.

- “Though [DIRECTV’s] evidence did reflect that its advertising probably produced some income, the evidence did not reflect what portion of DIRECTV’s cost was either attributable to South Carolina customers or may have influenced South Carolina customers to subscribe to DIRECTV.”
- “[I]t is possible that advertising performed within or without [] South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected 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.”⁴
- “DIRECTV simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur.”

Thus, the reason the Court agreed with the apportionment outcome originally reached by the Department, though disagreeing with the approach it took, is because DIRECTV’s evidence was either insufficient or not credible.

Consideration of Evidence Pertaining to DIRECTV’s Income-Producing Activities and the Portion of DIRECTV’s Receipts Attributable to South Carolina⁵

DIRECTV next argues that “the Court failed to consider and/or overlooked the substantial evidence presented by DIRECTV regarding its income-producing activities and the location from which those activities were conducted.” To support this argument, DIRECTV cites Mr. Goswitz’s testimony regarding the activities necessary to produce DIRECTV’s programming services; Dr. Cody’s testimony that he viewed the income-producing activities of DIRECTV as “the activities that DIRECTV engages in in order to convert potential customers into subscribers and to retain and drive additional income from existing subscribers;” and testimony from DIRECTV that it considers its income-producing activities to be the “assets and the employees that perform the service which puts the video into the television of its customers.” DIRECTV also cites to excerpts of Dr. Cody’s testimony to support its assertion that “the Court failed to consider and/or overlooked

⁴ The Court did acknowledge the potential that advertising cost directed to customers in this State could be an income-producing activity. However, whether that would be sourced outside of this State greatly depended upon the evidence presented, but it was simply lacking in this case.

⁵ Though DIRECTV devotes two sections of its argument to the Court’s alleged failure to consider and/or overlooking of evidence, the Court, for the sake of expediency and convenience, has combined these two sections into one section of discussion.

the evidence presented by DIRECTV establishing the portion of its subscription revenue that should be attributed to South Carolina.”

However, the Court considered all the testimony cited by DIRECTV (and indeed all of the evidence presented by the parties) and gave it the weight the Court deemed warranted.⁶ As mentioned above, the Court is entitled to make credibility determinations and to weigh the evidence as it deems proper. *See MRI at Belfair, supra; Estate of Hicks, supra; and Small, supra.* Moreover, the question of whether there is “substantial evidence” arises in an appeal, not a contested case; and that determination is whether the evidence in the record that this Court relied on – not what it rejected – in arriving at its decision is substantial, i.e., is such that “would allow reasonable minds to reach the same conclusion as the agency.” *See Friends of Earth v. Pub. Serv. Comm’n of S.C.*, 387 S.C. 360, 366, 692 S.E.2d 910, 913 (2010). Simply because the Court rejected or refused to accord much weight to evidence presented by DIRECTV does not mean that the Court did not consider that evidence.

Primary Income-Producing Activity

DIRECTV next argues that the Court erred in considering only “primary” income-producing activity, when the statute only requires an analysis of a taxpayer’s income-producing activity. The Court has clarified its language regarding this issue in the Amended Order to more precisely reflect the distinction between activity that produces income and activity that is merely preparatory to the production of income. Nevertheless, the Court maintains its original position that DIRECTV failed to sufficiently prove its contentions regarding income-producing activity occurring outside of South Carolina. The only activities that the evidence established as attributable to income production in South Carolina were when a customer subscribes to DIRECTV’s services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals. And even if the other activities were income-producing, DIRECTV’s evidence failed to establish that those activities should be apportioned to South Carolina.

⁶ In its Reply, DIRECTV stated, “[I]t is beyond dispute that the Department provided no credible evidence on the identity or location of DIRECTV’s income-producing activities, beyond the simplistic assertion that only the final step in the delivery process produces income because only then does the customer pay for the service.” However whether the evidence was presented by the Department or DIRECTV, the evidence, as set forth in the findings, established the income-producing activities that occurred in this State.

Construction of DIRECTV's Methodology as Being Cost-of-Performance

DIRECTV next argues that the Court misconstrued the payroll-and-assets method applied by Dr. Cody as a costs-of-performance methodology. DIRECTV contends that relying on the payroll-and-assets method "as a proxy for measuring gross receipts attributable to South Carolina does not imply that DIRECTV is asserting that South Carolina is a cost of performance state." DIRECTV also relies on *Lockwood Greene Eng'rs, Inc. v. S. C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987) to assert that the payroll-and-assets method is consistent with current South Carolina law.

First, the Court, in its Order, has already distinguished the present case from *Lockwood Greene* and declines to do so again. Second, as explained in its decision, the Court agrees with Professor Pomp that S.C. Code Section 12-6-2295(A)(5) provides "flexibility" in determining the relative amount of income-producing activities in the State. Following that reasoning, the Court was charged with discerning the appropriate methodology of assessing the income-producing activity in this State. In making that assessment, the Court found that Dr. Cody's method "unduly emphasized" what amounted to the costs-of-performance method. In other words, the Court attributed Dr. Cody's proxies of payroll expense and net book value of assets to the cost-of-performance method and found that the way in which he did so unduly emphasized DIRECTV's costs outside of the State while giving little consideration to the significant factors that occur within the State.⁷ Again, the Court, as the factfinder, did not find Dr. Cody's method persuasive.⁸

Substantial Understatement Penalty

DIRECTV argues that the Court erred in failing to consider DIRECTV's argument that substantial understatement penalties should be abated where there is substantial authority for a taxpayer's position and/or where a taxpayer acts in good faith. I agree, in part. Accordingly, this correction will be reflected in the Court's forthcoming Amended Final Order.

⁷ This is not to suggest that elements of the costs-of-performance method cannot be utilized, though they are certainly not required. However, regardless of whether the proxies used by Dr. Cody are subsumed under the costs-of-performance method, DIRECTV's evidence gave too little consideration to important factors occurring within the State.

⁸ Dr. Cody testified that payroll and assets are proxies that "provide a practical and actually a very well-trod path for allocating and determining the location of income-producing activities." However, this Court found that he should have trodden down another path.

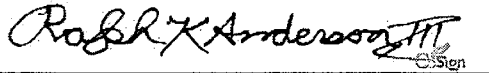
ORDER

IT IS THEREFORE ORDERED that DIRECTV's Motion for Reconsideration is **GRANTED IN PART AND DENIED IN PART**, in keeping with this Order.

IT IS FURTHER ORDERED that all additional factual findings in this Order are incorporated into the Amended Final Order as findings of fact.

IT IS FURTHER ORDERED that all additional legal conclusions in this Order are incorporated into the Amended Final Order as conclusions of law.

AND IT IS SO ORDERED.

A handwritten signature in black ink, reading "Ralph King Anderson, III". The signature is written in a cursive style. To the right of the signature, there is a small, faint circular stamp that appears to say "eSign".

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).

A handwritten signature in black ink, reading "E. Harvin Belser Fair". The signature is written in a cursive style with a large initial "E".

E. Harvin Belser Fair
Judicial Law Clerk

June 12, 2015
Columbia, South Carolina

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

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

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.

FILED

June 12, 2015

SC ADMIN. LAW COURT

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, 361 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 P.2d at 1114. The Arizona Supreme Court held that "[t]hrough 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 P.2d 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

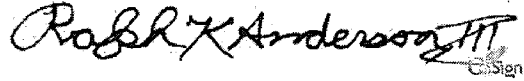
After considering the evidence in the record and the pertinent legal authorities, I conclude that based upon the reliable evidence, DIRECTV’s income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV’s customers. All of those income-producing activities 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.

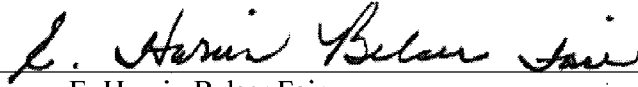
A handwritten signature in black ink, reading "Ralph King Anderson, III". The signature is written in a cursive style. To the right of the signature, there is a small, faint logo that appears to say "eSign".

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).

A handwritten signature in cursive script, reading "E. Harvin Belser Fair", is written over a horizontal line.

E. Harvin Belser Fair
Judicial Law Clerk

June 12, 2015
Columbia, South Carolina

The South Carolina Court of Appeals

DIRECTV, Inc. & Subsidiaries, Appellant,

v.

South Carolina Department of Revenue, Respondent.

Appellate Case No. 2015-001509

The Honorable Ralph King Anderson, III
Trial Court Case No. 2014ALJ170158CC

ORDER

The time for serving and filing the appellant's initial brief and designation of matter is hereby extended until September 09, 2015.

FOR THE COURT

BY V. Claire Allen, Deputy
CLERK

Columbia, South Carolina

cc:

Bryson Moore Geer, Esquire
John C. Von Lehe, Jr., Esquire
R. Gregory Roberts, Esq, Esquire
Andres Vallejo, Esq, Esquire

FILED

08-11-2015

The South Carolina Court of Appeals

DIRECTV, Inc. & Subsidiaries, Appellant,

v.

South Carolina Department of Revenue, Respondent.

Appellate Case No. 2015-001509

The Honorable Ralph King Anderson, III
Trial Court Case No. 2014ALJ170158CC

ORDER

The time for serving and filing the appellant's initial brief and designation of matter is hereby extended until October 09, 2015. No further extensions will be granted absent extraordinary circumstances.

FOR THE COURT

BY

Jenya A. Kite
CLERK

Columbia, South Carolina

cc:

Bryson Moore Geer, Esquire
John C. Von Lehe, Jr., Esquire
R. Gregory Roberts, Esq, Esquire

FILED

15-09-11-2015

Andres Vallejo, Esq, Esquire
William J. Condon, Jr., Esquire
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State of South Carolina
Department of Revenue
Office of General Counsel, Tax, and Regulatory Services
300A Outlet Pointe Blvd., (29210) P.O. Box 12265, Columbia, South Carolina 29211
Telephone (803) 898-5130 FAX (803) 896-0171

February 18, 2014

John Galloway
Deloitte Tax LLP
Suite 550 South Tryon St.
Charlotte, NC 28202

Re: Department Determination
DIRECTV, Inc. & Subsidiaries
Income Tax Periods, 2006-2011; License Fee Periods, 2010-2012.

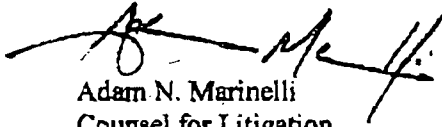
Dear Mr. Galloway:

Enclosed is the South Carolina Department of Revenue's Determination in the above-referenced matter. If you disagree with the Determination, you may request a contested case hearing before an Administrative Law Judge. If you choose to pursue such remedy, you must do so within thirty (30) days of the date of this letter. If you fail to respond within this time limitation, you will lose your right to appeal the Department Determination and your protest will be ended. Should you desire a contested case hearing, you must complete the enclosed request form and mail it, along with a \$500.00 filing fee, to the Administrative Law Court at the address stated on the form's instruction sheet.

The Administrative Law Court rules require that you also send me a copy of your request. My address is as follows: PO Box 12265, Columbia, SC 29211.

If you would like to pay your liability, please mail your payment to my attention at the Office of General Counsel, PO Box 12265, Columbia, SC 29211

OFFICE OF GENERAL COUNSEL, TAX, AND REGULATORY SERVICES


Adam N. Marinelli
Counsel for Litigation

ANM:acc

Enclosures

DEPARTMENT DETERMINATION

Taxpayer:

DIRECTV, Inc. & Subsidiaries
2250 E. Imperial Highway
El Segundo, CA 90245

By and Through: John Galloway
Deloitte Tax LLP
Suite 550 South Tryon St.
Charlotte, NC 28202

Periods Involved:

Income Tax Periods Ending 2006 through 2011,
License Fee Periods Ending 2010 through 2012.

Matter In Dispute:

Is the Taxpayer entitled to source its income related to the sale of television broadcast subscriptions in South Carolina to another state?

2006 through 2008 Requested Refund Amount: \$5,976,816.00

2009 through 2011 Tax Years:

	TAX	INTEREST	PENALTY	TOTALS
Income Tax	\$6,613,067.00	\$651,397.00	\$1,653,233.00	\$8,917,730.00
License Fee	33,101.00	2,028.00	8,725.00	43,404.00
TOTALS	\$6,646,168.00	\$653,425.00	\$1,661,541.00	\$8,961,134.00

Determination:

The Taxpayer is not entitled to source its income related to the sale of television broadcast subscriptions in South Carolina to another state.

Facts:

1. DIRECTV, Inc. & subsidiaries (DIRECTV) is headquartered in El Segundo, California, and provides access to digital television entertainment to South Carolina customers. It operates throughout the United States and Latin America.

2. DIRECTV grants its subscribers access to hundreds of television programming channels and other audio/visual options that are transmitted nationwide to subscriber's homes or businesses via high-powered satellites. Subscribers pay a monthly fee for access to basic channels and can also purchase premium channels and pay-per-view programs for an additional fee.

3. Each South Carolina subscriber rents a satellite, remote controls, and receiver box in order to access DIRECTV's programming from their home.

4. Originally, DIRECTV filed its 2006, 2007, and 2008 returns to reflect a market based sourcing method for its subscription revenue, which sourced its subscription receipts to the origin of its customers.

5. DIRECTV subsequently amended those returns to reflect a cost of performance approach, sourcing its income generated from customer subscriptions to its headquarters in California. Based upon the amended approach, the taxpayer's South Carolina tax liability was substantially decreased and it claimed a sizable refund for those years. The taxpayer also filed its original 2009 through 2011 returns to reflect the same cost of performance sourcing scheme.

6. The Department of Revenue (Department) audited the taxpayer's amended returns and in a letter dated November 29, 2011, denied the refunds claimed, asserting the taxpayer's receipts from South Carolina subscribers should be sourced to this State. Subsequent to that audit, and prior to the issuance of this Determination, the Department audited the taxpayer's returns for 2009 through 2011 and issued an assessment on the same legal basis as the refund denial.

7. The taxpayer timely protested the Department's denial of the refund claim and adjustments on the returns in a letter dated February 27, 2012. The taxpayer has also protested the additional assessment for its subsequent returns.

Discussion:

DIRECTV does not contest its duty to file for engaging in business in South Carolina. Rather, it raises a new objection to the inclusion of its South Carolina subscription receipts as part of its apportioned net income for its state tax liability and contends that only the receipts from equipment rentals should be sourced here. As discussed below, the taxpayer's assertions are without merit and inconsistent with South Carolina law and jurisprudence.

Because DIRECTV is a media broadcasting company and is not regularly engaged in the sale of tangible personal property, its apportioned net income is determined pursuant to S.C. Code Ann. § 12-6-2290 (Supp. 2006). For tax years prior to 2010:¹

[i]f the principal profits or income of a taxpayer are derived from sources other than [manufacturing or dealing in tangible personal property] or [certain industries], 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.

Section 12-6-2290 (citations omitted) (emphasis added). 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). Furthermore, a statutory provision must be given a reasonable and practical construction consistent with the purpose and policy expressed in the statute. Hav v. S.C. Tax Comm'n. 273 S.C. 269, 255 S.E.2d 837 (1979).

The operative question that remains upon application of Section 12-6-2290's plain language to the facts of this case is quite simple: are DIRECTV's subscription receipts from South Carolina customers generated "from within this State?" The Department's auditor contends the question should be answered in the affirmative. DIRECTV believes that these subscription receipts should be deemed produced in California, based upon its interpretation of Lockwood Greene Engineers, Inc. v. South Carolina Tax Comm'n. 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). The analysis required to reach the appropriate answer to this argument rests squarely upon a determination of what is the "income producing activity" in relation to the generation of the subscription receipts at issue.

1. The Income Producing Activity for DIRECTV Occurs Within This State.

In Lockwood, the Court of Appeals determined that the gross receipts of an engineering firm must be apportioned according to the location where the services were performed rather than to where its customers were located. The court referred to this as the "place of activity" test. Lockwood's income producing activity was the provision of personal engineering services. The court held that because the engineer rendered his services where he physically worked, then the income derived from those services was part of the

¹In 2007, Section 12-6-2290 was amended by replacing "12-6-2252" for "12-6-" and adding the language "For purpose of this section, items included in gross are as provided in Section 12-6-2295". These amendments, however, are for tax years after 2010.

receipts of the state in which the engineer was located – meaning, work performed in South Carolina was held to be South Carolina receipts.

DIRECTV erroneously contends that Lockwood “solidified the ‘place of activity’ test as the operative test to determine the portion of a taxpayer’s income producing activities occurring within South Carolina for the purpose of assigning receipts to the South Carolina apportionment factor.”² Such belief, however, completely disregards the clear limitations of the Lockwood Court’s holding:

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

Lockwood, 293 S.C. at 450, 361 S.E.2d at 348 (emphasis added). The Lockwood Court’s decision was based on the Department’s long standing administrative practice of apportioning income for certain taxpayers. For example, finance companies are taxed in South Carolina based on whether the borrower resides in this State. Engineers and architects are taxed here if they perform any services in the state. Law firms and accounting firms are subject to tax based on where they perform the personal services for which they are paid. Restaurant franchise companies that have no activity in this State except the presence of their franchise name from which they derive their income are subject to tax in South Carolina. Based on this language, it is abundantly clear that the Court of Appeals intended to limit its holding to certain types of service providers. Lockwood logically stands for the proposition that personal service providers should apportion their South Carolina income based on a cost of performance approach, as that type of service has a direct causal link to the production of income. Here, however, DIRECTV is not a personal service provider and, therefore, Lockwood is wholly inapplicable.

DIRECTV further argues that it should apportion its income pursuant to S.C. Code Ann. § 12-6-2280 (Supp. 2006), which is the sales factor for businesses whose principal business is manufacturing or dealing in tangible personal property who are apportioning their income pursuant to the three-factor formula under S.C. Code Ann. § 12-6-2250 (Supp. 2006). However, as demonstrated above, DIRECTV’s principal business is the provision of television programming via satellite and, therefore, must apportion its

²Taxpayer’s Letter dated October 5, 2012 at 2.

income pursuant to Section 12-6-2290. Nonetheless, DIRECTV further relies on S.C. Code Ann. § 12-6-2295(A)(5) (Supp. 2006) which reads "sales are attributable to this State to the extent the income-producing activity is performed within this State." It is this very language that provides the basis for DIRECTV's suggestion that its income should be sourced based on a cost of performance approach. While some jurisdictions, including the Multistate Tax Commission (MTC), have enacted statutes or regulations with identical language, those jurisdictions have also included the language "based on cost of performance" in the sourcing provisions. The South Carolina General Assembly, however, chose not to include such language, meaning Section 12-6-2295(A)(5) does not require that income be sourced for South Carolina apportionment purposes based on a cost of performance.

Furthermore, DIRECTV argues that its activities, a majority of which occur outside the State, including (1) selecting, negotiating, acquiring, and managing broadcast programming; (2) managing and servicing the subscriber network; (3) managing the broadcast infrastructure; and (4) receiving programming content (which is then uplinked to the satellites) are its income producing undertakings. However, as noted above, DIRECTV's business is one centered upon broadcasting television programming via satellites into the homes of its customers. Meaning, all of the specific activities identified by DIRECTV lack any and all intrinsic value without the actual provision of television programming to South Carolina customers. It is vital to note here that each and every one of the activities the taxpayer attempts to characterize as "income producing" has no direct causal effect upon the generation of income. All of them are inherently indirect activities, or rather, precursors to the only directly engaged activity that creates DIRECTV profit. It is this final act, the culmination of those enumerated activities – the delivery of the signal into the homes and onto the television screens of its customers – that produces income for DIRECTV. It does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. 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. It is that act alone for which South Carolina customers sign contracts and pay their monthly fees.

South Carolina is most certainly not alone in this method of sourcing receipts for taxpayers like DIRECTV. Twenty-three states have adopted the "audience approach" for assigning receipts from programming and broadcasting companies.³ Florida, for example, adopted the following language:

³See e.g., Alabama - Ala. Admin. Code R. 810-27-1-4.18(h) (2013); Arkansas - Ark. Admin. Code § 006.05.308-26-51-718(d)(2.26-51-718(d)) (2013); Colorado - 1 Colo. Code Regs. § 201-3, Spec. Reg. 5A (2013); Connecticut - Conn. Gen. Stat. § 12-218(l) (2013); Florida - Fla. Admin. Code Ann. R. 12C-1.0155(2)(i) (2013); Georgia - Ga. Comp. R. & Regs. 560-7-7.03(5)(c) 6(vii) (2013); Hawaii - Haw. Code R. § 18-235-38-06.04 (2013); Idaho Admin. Code R. 35.01.01.580(01)(e) (2013); Iowa Admin. Code R. 701-54.7(5)(422) (2013); Maryland - Md. Code Regs. 03.04.03.09 (2013); Michigan -

Television and Radio Broadcasting. Gross receipts, including advertising revenues, from broadcasting within and without the state will be attributed to the numerator of the sales factor on the basis of the ratio of the audience within the state to the audience everywhere.

Fla. Admin. Code Ann. R. 12C-1.0155(2)(i) (2013). This approach has been tested in adjudicative proceedings as well, and courts in other jurisdictions have held that audience based sourcing for taxpayers like DIRECTV is the proper method. In Texas, an Administrative Law Judge illuminated the income producing activity when he held:

The act Petitioner's customer contracts and pays to receive, and the act that produces the receipts at issue, is the act performed by the receiver (i.e., the set top box) that Petitioner sells or leases to its subscribers. Petitioner's customers contract for the receipt of television programming. Petitioner contracts to provide the programming, and it is the microchips within the receiver that unscramble and decode the satellite's encrypted signal that completes the transaction and produces the programming receipt. It is undisputed that each of the programming receipts scheduled within the audit are receipts Petitioner received from Texas subscribers. The ALJ finds the auditor correctly apportioned the receipts at issue.

Anonymous Taxpayer v. Texas Comptroller of Public Accounts, 2013 WL 3490605 (Tex. Cptr. Pub. Acct.) (May 17, 2013) (emphasis added.). The approach the auditor has taken denying the refund claimed by DIRECTV's amended returns and in auditing its originally filed returns is identical to the Texas ALJ's rationale. DIRECTV produces income in South Carolina by providing receiver boxes that interpret a signal and provide television services to South Carolina customers. To that extent, and in complete

Mich. Comp. Laws Ann. § 208.1305(20) (2013); Montana - Mont. Admin. R. 42.26.1103 (2013); New Hampshire - NH Code R. Rev. 304.09 (2013); New Mexico - NM Code R. § 3.5.19(18) (2013); North Dakota - ND Admin. Code R. 81-03-09-38 (2013); Oregon - Or. Rev. Stat. § 314.684 (2013); Or. Admin. R. 150-314.684(4) (2013); California - 18 CA ADC § 25137-8.1 (2013); Illinois - 35 ILCS 5/305(B7) (2013); Louisiana - La. Rev. Stat. Ann. § 47:287.95(K)(2)(c)(i) (2013); New Jersey - Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 478 A.2d 742 (1984) (citing N.J. Stat. Ann. § 54:10A-8.(2013)); Ohio - Ohio Admin. Code 5703-29-17(9)(a) (2013); Rhode Island - R.I. Admin. Code § 60-1-194:1 (2013); Washington - Wash. Admin. Code 458-20-241(2013).

consistency with Section 12-6-2290, those gross receipts should be sourced to South Carolina.

Conclusion

The gross receipts that DIRECTV generates from the sale of subscriptions are directly produced from activity that occurs within this state. The taxpayer's attempts to argue its out-of-state activities create the income at issue, pursuant to its strained interpretation of Lockwood, lack all merit. The refund claimed by the taxpayer in this matter was properly denied, and its revenue from subscription receipts should be sourced to South Carolina.

February 18, 2014

MAY 22 2015

SC ADMIN. LAW COURT

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

VS.

MOTION FOR RECONSIDERATION
UNDER ALC RULE 29(D) AND/OR TO
ALTER OR AMEND UNDER SCRPC
RULE 59(E)

Respondent.

A. The Court Applied an Improper Standard of Review and Failed to Find that Once DIRECTV Met Its Burden to Establish that the Assessment was Incorrect, the Assessment Should be Dismissed.

ROA 00065

proof in administrative hearings is generally a preponderance of the evidence”) and *Leventis v. S.C. Dep’t of Health & Envtl. Control*, 340 S.C. 118, 132, 530 S.E.2d 643, 651 (Ct. App. 2000) (explaining that “the complaining party bears the burden of proof”)); *see also DISH DBS Corp. v. S.C. Dep’t of Revenue*, No. 14-ALJ-17-0285-CC (ALC Feb. 10, 2015) (“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 was incorrect.”).

Although a tax assessment is initially presumed correct, once a taxpayer establishes that 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. *See Cloyd v. Mabry*, 295 S.C. 86, 88-89, 367 S.E.2d 171, 173 (Ct. App. 1988) (explaining that “[a] taxpayer contesting an assessment has the burden of showing that the valuation of the taxing authority is incorrect” and that, although “[o]rdinarily, this will be done by proving the actual value . . . [t]he taxpayer may, however, show by other evidence that the assessing authority’s valuation is incorrect” and “[i]f he does so, the presumption of correctness is then removed and the taxpayer is entitled to appropriate relief”); *see also Anonymous Taxpayer v. S.C. Dep’t of Revenue*, No. 07-ALJ-17-0189-CC (ALC Aug. 23, 2007), *Lawton v. S.C. Dep’t of Revenue*, No. 08-ALJ-17-0118-CC (ALC Sept. 5, 2008), and *Travelscape, LLC v. S.C. Dep’t of Revenue*, No. 08-ALJ-17-0076-CC (ALC Feb. 12, 2009) (each citing to the burden of proof and standard of review set forth in *Cloyd*).

Similarly, this Court explained that “DIRECTV has the burden of proof” and that “[t]his burden requires DIRECTV to prove that the Department’s determination is errant by a preponderance of the evidence.” Order, p. 7.

As explained by the Court, the assessment was based on the Department's contention that "100% of [DIRECTV's] 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." Order, p. 10. Similarly, uncontroverted evidence presented during the hearing through the testimony of Robert N. King, Timothy Donovan and John Swearingen established that the Department's assessment was based solely on customer location.¹ Tr. 302:4-6; Tr. 314:20-23; Tr. 349:13-17.

DIRECTV, however, presented substantial evidence regarding its income-producing activities and where those activities were conducted, including, but not limited to the following:

- Testimony by Philip J. Goswitz, Senior Vice President of Space, Communications and Video at DIRECTV regarding the activities necessary to produce DIRECTV's programming services and where those activities were conducted. Tr. 47:14-85:5.
- Dr. Cody's testimony that he viewed the income-producing activities of DIRECTV as "the activities that DIRECTV engages in in order to convert potential customers into subscribers and to retain and drive additional income from existing subscribers." Tr. 221:6-11.
- Testimony from DIRECTV that the company considered its income-producing activities to be the "assets and the employees that perform the service which puts the video into the television of its customers." Tr. 379:15-18.

Based on the evidence presented and arguments made, the Court acknowledged that the assessment was incorrect. For example, the Court expressly states that it "does not adopt the view of the Department that income-producing activity of businesses within the direct broadcast services industry is completely limited to the delivery of a signal into the customer's home and onto the customer's television." Order, p. 10. Similarly, the Court agreed with Professor Pomp that "opinions can differ on how to measure the extent to which income-producing activities take

¹ Robert N. King is an auditor for the Department and conducted the audit of DIRECTV. Timothy Donovan is an employee of the Department and was involved in the audit of DIRECTV. John Swearingen is an employee of the Department.

place in South Carolina, *but answering that question by simply ignoring the outside activities is unacceptable.*" Order, p. 10 (emphasis added). Moreover, the Court found that, "[i]n 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." Order, p. 11. Finally, the Court explained 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." Order, p. 11.

Thus, not only does the evidence presented during the hearing establish that the Department's assessment is incorrect, but the Court's own analysis confirms this. Accordingly, as DIRECTV's only burden is to establish by a preponderance of the evidence that the Department's assessment is incorrect, the Department's assessment should be dismissed.

Based on the above, DIRECTV respectfully requests that the Court (i) reconsider the above facts and arguments, (ii) alter or amend its Order to find that DIRECTV satisfied its burden of proof by establishing by a preponderance of the evidence that the assessment is incorrect, and (iii) alter or amend its Order to dismiss the assessment.

B. The Court Misinterpreted the Burden of Proof Imposed on DIRECTV and Improperly Imposed an Additional Burden on DIRECTV.

As discussed above, DIRECTV's burden of proof in this matter is to establish by a preponderance of the evidence that the assessment is incorrect. Despite the evidence presented during the hearing and the Court's own analysis establishing that the assessment is incorrect (discussed above in Section A), the Court nevertheless upheld the assessment based on its findings that:

- The "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." Order, p. 11.

- “Though [DIRECTV’s] evidence did reflect that its advertising probably produced some income, the evidence did not reflect what portion of DIRECTV’s cost was either attributable to South Carolina customers or may have influenced South Carolina customers to subscribe to DIRECTV.” Order, pp. 11-12.
- “[I]t is possible that advertising performed within or without [] South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected 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.” Order, p. 19.
- “DIRECTV simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur.” Order, p. 20.

However, by not only requiring DIRECTV to establish that the assessment is incorrect, but also requiring DIRECTV to establish the actual revenue attributable to South Carolina, the Court misinterpreted the burden of proof on DIRECTV and improperly placed an additional burden on DIRECTV. *See Cloyd v. Mabry*, 295 S.C. at 88-89, 367 S.E.2d at 173 (explaining that a taxpayer can contest an assessment by proving the actual value *or* “by other evidence that the assessing authority’s valuation is incorrect” and “[i]f he does so, the presumption of correctness is then removed and the taxpayer is entitled to appropriate relief”).

Based on the above, DIRECTV respectfully requests that the Court (i) reconsider the above facts and arguments, (ii) alter or amend its Order to find that DIRECTV satisfied its burden of proof by establishing by a preponderance of the evidence that the assessment is incorrect, and (iii) alter or amend its Order to dismiss the assessment.

C. The Court Failed to Consider and/or Overlooked Substantial Evidence in the Record Establishing DIRECTV's Income Producing Activities.

In reaching its decision, the Court found that "DIRECTV failed to sufficiently identify its outside income-producing activities" (Order, p. 13) and that "DIRECTV did not present sufficient evidence to determine its income-producing activities" (Order, pp. 19-20).

In so finding, the Court failed to consider and/or overlooked the substantial evidence presented by DIRECTV regarding its income-producing activities and the location from which those activities were conducted, which included the following:

- Mr. Goswitz's detailed testimony regarding the activities necessary to produce DIRECTV's programming services, which includes (i) procuring and developing premium quality video entertainment, including the development of original programming and acquisition of programming from third-parties, (ii) operation of local collection facilities, uplink centers, broadcast centers, and satellites that are used to collect and deliver the programming services to customers, and (iii) customer service and marketing activities that allow DIRECTV to maintain and enhance its brand and brand awareness. Tr. 47:14-85:5.
- Dr. Cody's testimony that he viewed the income-producing activities of DIRECTV as "the activities that DIRECTV engages in in order to convert potential customers into subscribers and to retain and drive additional income from existing subscribers." Tr. 221:6-11.
- Testimony from DIRECTV that the company considered its income-producing activities to be the "assets and the employees that perform the service which puts the video into the television of its customers." Tr. 379:15-18.

Thus, DIRECTV provided sufficient evidence to identify its income-producing activities.

Accordingly, DIRECTV respectfully requests that the Court (i) reconsider the above facts, and (ii) alter or amend its Order to find that DIRECTV sufficiently identified its income-producing activities.

D. The Court Failed to Consider and/or Overlooked Substantial Evidence in the Record Establishing the Portion of DIRECTV's Receipts that Should be Attributed to South Carolina.

In reaching its decision, the Court found that "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" (Order, p. 17) and that "DIRECTV simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur" (Order, p. 20).

In so finding, the Court failed to consider and/or overlooked the evidence presented by DIRECTV establishing the portion of its subscription revenue that should be attributed to South Carolina, which included the following:

- Dr. Cody's testimony that the income-producing activities of DIRECTV are best reflected by a formula that considers both payroll and assets because services rendered by DIRECTV personnel and tangible assets, such as (i) the local collection facilities, (ii) set-top boxes, and (iii) regional uplink facilities, play important roles in the generation of DIRECTV's subscription revenue. Tr. 229:7-231:18.
- Dr. Cody's testimony that payroll and assets are two measures that "provide a practical and actually a very well-trod path for allocating and determining the location of income-producing activities." Tr. 496:16-21.
- Dr. Cody's further testimony that "[a] couple of very common factors or proxies [for income-producing activities] are payroll and assets. Professor Pomp referred to labor and capital. It's the same thing, fundamental economics. There are some other measures that could potentially be used, but payroll and assets are two very common measures that are used. So I developed methodologies using those measures." Tr. 229:11-21.

In its Order, the Court acknowledged that the South Carolina 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" and that "[a]lthough exactness in apportionment is desirable, all that is required is a reasonable approximation." Order, p. 11

(citing and quoting *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66-67, 212 S.E.2d 574, 577-78 (1975)). As discussed in DIRECTV's Proposed Final Order, the Court of Appeals endorsed this approach in *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987).² In finding that the "place of activity" was properly determined using only a payroll factor, the Court of Appeals explained that "an engineering firm's business carried on in a state is *reasonably measured* by the services rendered by its personnel in the state." *Id.*³ (emphasis added).

Thus, contrary to the Court's conclusions, DIRECTV presented substantial evidence supporting Dr. Cody's use of the Payroll and Assets Method as a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina, and the value attributable to those activities, which, as the case law authorities cited here and in DIRECTV's Proposed Final Order indicate, is all that is required in the context of a unitary business such as DIRECTV.

Based on the above, DIRECTV respectfully requests that the Court (i) reconsider the above facts and arguments, (ii) alter or amend its Order to find that Dr. Cody's Payroll and

² Although the Court rejects the Department's reliance on its so-called longstanding guidelines relating to the sourcing of service-related income, the Court nevertheless states that the "fact that DIRECTV previously filed its returns sourcing 100% of the South Carolina subscription revenue to South Carolina before filing the amended returns suggests that the Department had such a policy in place." Order, p. 16, n.17. There is no support in the record for the inference drawn by the Court. In fact, the uncontroverted testimony presented at the hearing establishes that (i) the Department's so-called longstanding guidelines did not apply to taxpayers like DIRECTV and (ii) the guidelines did not apply to subscription revenue. Tr. 348-349; 348:24-349:4.

³ In footnote 18 of the Order, the Court observes that "[i]t is noteworthy that the payroll factor that was used by the Department to source Lockwood's gross receipts to South Carolina was used merely as a proxy for calculating Lockwood's actual gross receipts from within South Carolina" and that "[i]f the Department had had all of Lockwood's records, the Department would not have had to use the payroll proxy but could have examined all of Lockwood's invoices and added the fees billed for the work of South Carolina engineers." As noted in footnote 18 of DIRECTV's Proposed Final Order, there is no basis for these claims. These statements were not supported by anything in the Court of Appeals' decision, there was nothing in the court's decision indicating that a different result would be warranted if additional information were available, and there is no evidence in the record to support these claims.

Assets Method provides a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina, and (iii) alter or amend its Order to find that DIRECTV sufficiently established the portion of its receipts that should be attributed to South Carolina.

E. The Court Misinterpreted the Language of South Carolina Code Section 12-6-2295(A)(5) As Requiring an Examination of "Primary" Income-Producing Activities.

In reaching its decision, the Court misinterpreted South Carolina law by looking only to what it considered to be DIRECTV's "primary" income-producing activities.

The Court explained that "DIRECTV derives income from monthly subscription receipts that customers pay to DIRECTV in order to view its video programs in their homes and businesses" and that "[t]hese 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 *primary* income-producing activity of DIRECTV." Order, p. 10 (emphasis added).

Despite acknowledging that DIRECTV "engages in other out-of-state activities that cause satellite signals to be beamed into this State," the Court found that "it is not until a customer subscribes to [DIRECTV's] services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals that [DIRECTV's] actions have any income producing value." Order, p. 13. The Court explained that, "the national programming through the CONUS beams would exist regardless of whether there were **any** subscribers in South Carolina" and "[t]herefore, such broadcasting is an incidental activity to producing income until a customer subscribes to DIRECTV." Order, p. 13 (emphasis in original). The Court further explained that "[t]he 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,

though necessary, are merely incidental to the income-generating activities themselves, i.e., the services that directly produce income for DIRECTV.” Order, p. 13.

The Court’s conclusion is inconsistent with the plain language of the statute, which simply requires an analysis of a taxpayer’s income-producing activities, not just so-called “primary” income-producing activities. See S.C. Code Ann. § 12-6-2295(A)(5).

The Court’s conclusion is also inconsistent with the South Carolina Supreme Court’s decision in *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964), in which the Supreme Court rejected a narrow construction of income-producing activities that would have considered only the activities for which the company was actually paid. Although the Court acknowledges that the Supreme Court considered “incidental” activities to be income-producing activities, the Court nevertheless concludes that only DIRECTV’s “primary” activities should be considered for purposes of applying Section 12-6-2295(A)(5).⁴

Although DIRECTV does not agree with the Court’s characterization of its “primary” income-producing activities, the Court’s consideration of only so-called “primary” activities to determine DIRECTV’s income-producing activities (i) ignores the substantial evidence in the record regarding DIRECTV’s income-producing activities, (ii) misinterprets the plain language of the statute, and (iii) is inconsistent with established case law. Moreover, by focusing on the activities of South Carolina subscribers, the Court misconstrues Section 12-6-2295(A)(5) by looking to activities conducted by third parties instead of the activities conducted by DIRECTV (i.e., the taxpayer).

⁴ Further, by only focusing on the delivery of the signal in South Carolina, the Court completely ignores the other activities involved in delivering the signal, almost all of which take place outside of South Carolina.

Based on the above, DIRECTV respectfully requests that the Court (i) reconsider the above facts and arguments and (ii) alter or amend its Order to consider all of the income-producing activities performed by DIRECTV.

F. The Court Misconstrued the Methodology Applied by DIRECTV As Being A Cost of Performance Methodology.

In reaching its decision, the Court misconstrues the Payroll and Assets Method applied by Dr. Cody as a cost of performance methodology, stating that, "the approach proposed by Dr. Cody unduly emphasizes what amounts to 'costs of performance'" and explaining that "[i]t is clear that South Carolina is not a UDITPA State, and it does not apportion the net income of service providers based upon costs-of-performance elements." Order, p. 17.

DIRECTV has not asserted that South Carolina is a cost of performance state, and the Payroll and Assets Method is not a cost of performance methodology. Instead, evidence presented by DIRECTV included the following:

- Testimony by Professor Pomp that was adopted by the Court, which stated that it "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." Order, p. 18.
- Testimony by Dr. Cody that he employed two common proxies using data from DIRECTV's financial records to identify and locate its income-producing activities: (i) payroll expense inside and outside of South Carolina; and (ii) the net book value of assets inside and outside of South Carolina. Tr. 229:7-21.
- Testimony by Dr. Cody that payroll and assets are proxies that "provide a practical and actually a very well-trod path for allocating and determining the location of income-producing activities," and that payroll and asset proxies also reflect the fundamental economics of DIRECTV's operations. Tr. 496:16-21.

Thus, as the record establishes, simply relying on the Payroll and Assets Method as a proxy for measuring the gross receipts attributable to South Carolina does not imply that DIRECTV is asserting that South Carolina is a cost of performance state. Moreover, the Payroll

and Assets Method is consistent with existing South Carolina case law. *See Lockwood*, 293 S.C. 447.

Based on the above, DIRECTV respectfully requests that the Court (i) reconsider the above facts and arguments, and (ii) alter or amend its Order to adopt the Payroll and Assets Method applied by Dr. Cody.

G. The Court Failed to Consider DIRECTV's Argument that Penalties Must be Abated When There is Substantial Authority and/or the Taxpayer Acted in Good Faith.

In its Proposed Final Order, DIRECTV argued that the asserted substantial understatement penalties should be abated because there was substantial authority for its position and it acted in good faith. Proposed Final Order, pp. 36-37.

In upholding the substantial understatement penalty, the Court considered only the portion of the statutory provision providing 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." Order, p. 20 (quoting S.C. Code Ann. § 12-54-155(A)(1)) (emphasis in Order). The Court, however, failed to consider and/or overlooked the portion of the statute providing that:

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.

S.C. Code Ann. § 12-54-155(B)(2)(b).

The Court also failed to consider and/or overlooked the portion of the statute providing 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).

DIRECTV presented testimony and substantial evidence that its treatment of subscription revenue was correct. Moreover, as the only adjustment made by the Department relates to the apportionment of DIRECTV’s subscription revenue, even if the assessment is upheld, pursuant to South Carolina’s apportionment provisions and case law, DIRECTV had substantial authority for its treatment of subscription revenue. DIRECTV’s treatment of its subscription revenue was consistent with the theory applied by the Court of Appeals in *Lockwood*, the only published decision on point, and also with *Mercury Motor Express*, which rejected a narrow view of income-producing activities—similar to the view advanced by the Department in this case—that would have considered only activities for which the company was actually paid. Further, the position taken by DIRECTV on its return for the 2011 tax year, in which it sourced a portion of its subscription revenue to South Carolina, demonstrates that DIRECTV was acting in good faith and trying to comply with Sections 12-6-2290 and 12-6-2295(A)(5).

Based on the above, DIRECTV respectfully requests that this Court (i) reconsider these facts and arguments; and (ii) alter or amend its Order to find that the substantial understatement penalties should be abated.

CONCLUSION

Based on the foregoing, DIRECTV respectfully requests that this Court reconsider its rulings and alter or amend its Order to find in favor of DIRECTV on all issues, dismiss the Department’s proposed assessment in its entirety, and grant the refund claims requested by DIRECTV.

Dated: May 22, 2015

By:

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CERTIFICATE OF SERVICE

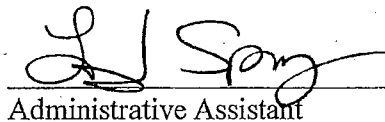
I, the undersigned Administrative Assistant of the law offices of Nelson Mullins Riley & Scarborough LLP, attorneys for DIRECTV Inc. & Subsidiaries, do hereby certify that I have served all counsel in this action with a copy of the pleading(s) hereinbelow specified via E-Mail and U.S. Mail to the following address(es):

Pleadings:

MOTION FOR RECONSIDERATION UNDER ALC RULE 29(D) AND/OR TO ALTER OR AMEND UNDER SCRCR RULE 59(E)

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May 22, 2015

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FILED

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SC ADMIN. LAW COURT

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

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

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.

May 12, 2015

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 primary 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. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2009); *see also Anonymous (M-156-90) v. State Bd. of Med. Examiners*, 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* ALC Rule 29(B); *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 and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption."); *see also Leventis v. Dep't of Health and Envtl. Control*, 340 S.C. 118, 132033, 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

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.").

apportionment that a taxpayer must use depends upon the nature of the taxpayer's business in this 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:

* * *

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.

(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[.]

Taxpayer Is a Service Provider

DIRECTV provides direct broadcast satellite services to customers throughout the United States. Its primary 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

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 primary 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

12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes 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 thus 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's inclusion of "incidental" in its definition of income-producing activities distinguishes that activity from the primary income-producing activity. However, the Court did not determine that those "incidental" activities were not income-producing. Nevertheless, the consideration of primary versus incidental activities does offer a point for analysis. Here, Petitioner engages in other out-of-state activities that cause satellite signals to be beamed into this State. But, it is not until a customer subscribes to Petitioner's services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals that Petitioner's actions have any income producing value. Indeed, the national programming through the CONUS beams would exist regardless of whether there were **any** subscribers in South Carolina. Therefore, such broadcasting is an incidental activity to producing income until a customer subscribes to DIRECTV.

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 in *Mercury*. 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, though necessary, are merely incidental to the income-generating activities themselves, i.e., the services that directly produce income for DIRECTV. In this case, the production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites 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.

In sum, DIRECTV failed to sufficiently identify its outside income-producing activities. 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.¹⁴ 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 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).

¹⁴ As noted above, DIRECTV argues its "value drivers," reflect its income-producing activity.¹⁴ 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.

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;¹⁵ (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;¹⁶ and (3) the Court of Appeals noted that the 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

¹⁵ 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.

¹⁶ *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.

providers (e.g., engineering, law, and accounting firms) to the “place of activity.”¹⁷ *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.¹⁸ *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 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.¹⁹

¹⁷ 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, though the fact that DIRECTV previously filed its returns sourcing 100% of the South Carolina subscription revenue to South Carolina before filing the amended returns suggests that the Department had such a policy in place. 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)).

¹⁸ It is noteworthy that the payroll factor that was used by the Department to source Lockwood’s gross receipts to South Carolina was used merely as a proxy for calculating Lockwood’s actual gross receipts from within South Carolina. If the Department had had all of Lockwood’s records, the Department would not have had to use the payroll proxy but could have examined all of Lockwood’s invoices and added the fees billed for the work of South Carolina engineers. Here, DIRECTV has added up all of its actual subscription receipts from South Carolina customers for the applicable tax years; therefore, no cost-based proxy is needed.

¹⁹ 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

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 incidental 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 apportion 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

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.

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 also 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 also 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,²⁰ 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., 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

²⁰ See Cal. Rev. & Taxation Code (R&TC) § 25136; Cal. Code Regs. § 25136-2.

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]hrough 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.²¹ However, DIRECTV did not provide any evidence that reflected 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

²¹ 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 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

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).

In the instant matter, the Department was correct to apply a substantial understatement penalty for underpayment of taxes owed for 2009 through 2011, and this Court concludes DIRECTV must be assessed the substantial understatement penalty.

Conclusion

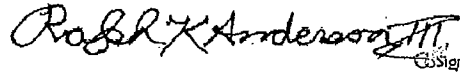
After considering the evidence in the record and the pertinent legal authorities, I conclude that based upon the reliable evidence, DIRECTV’s income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV’s customers. All of those income-producing activities 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 \$1,661,541.00 in penalties with regard to its 2009, 2010, and 2011 income tax returns.

AND IT IS SO ORDERED.

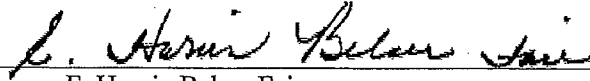
A handwritten signature in cursive script, reading "Ralph King Anderson, III". To the right of the signature is a small, stylized logo that appears to say "eSign".

Ralph King Anderson, III
Chief Administrative Law Judge

May 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

May 12, 2015
Columbia, South Carolina

**STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT**

DIRECTV, Inc. & Subsidiaries,	)	Docket No. 14-ALJ-17-0158-CC
	)	
Petitioner,	)	
	)	
vs.	)	RESPONDENT'S RESPONSE TO
	)	PETITIONER'S MOTION FOR
South Carolina Department of Revenue,	)	RECONSIDERATION UNDER ALC
	)	RULE 29(D) AND/OR TO ALTER OR
Respondent.	)	AMEND UNDER SCRCP RULE 59(E)

COMES NOW, Respondent South Carolina Department of Revenue (Department) by and through its counsel and provides the Administrative Law Court (ALC or Court) with the following response to Petitioner DIRECTV, Inc. & Subsidiaries' (Petitioner or DIRECTV) Motion for Reconsideration Under ALC Rule 29(D) and/or To Alter or Amend Under SCRCP Rule 59(e) (Motion): As set forth more fully herein, the Court's Final Order and Decision dated May 12, 2015 (Order) fully and correctly addresses the issues in this case and therefore the Petitioner's Motion must be denied.

ARGUMENT

Petitioner's Motion presents numerous arguments which it asserts the Court did not properly address and/or evaluate in its Order. Contrary to Petitioner's assertions, the Court properly addressed the issues consistent with South Carolina law and properly considered the evidence in this case, and as such, Petitioner's Motion must be denied.

A. The Court Applied The Proper Burden of Proof And Correctly Found That Petitioner Failed To Meet Its Burden Of Proof

In its first argument, Petitioner asserts that the Court failed to apply the proper standard of review, but the Department believes that Petitioner's true argument is whether the Court applied the proper burden of proof. Based on South Carolina law and this Court's decision, this Court properly applied the burden of proof and appropriately found that Petitioner failed to meet its burden of proof in this matter. Petitioner was required to prove that the Department's determination was incorrect by a preponderance of the evidence, and it simply failed to do so.

The standard of proof in a contested case is by a preponderance of the evidence. S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2014). It is well established that generally, “the burden of proof rests upon him who has the affirmative of the issue and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption.” Ford v. Atl. Coast Line R. Co., 169 S.C. 41, 168 S.E. 143, 167 (1932). As the Petitioner stated in its Motion, “the complaining party bears the burden of proof.” Leventis v. S.C. Dep’t of Health & Env’tl. Control, 340 S.C. 118, 132, 530 S.E.2d 643, 651 (Ct. App. 2000). The Court properly recognized that “[b]ecause 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.” (Order at 7) (citations omitted). Frankly, the Court made it very clear that Petitioner did not satisfy its burden of proof because its evidence was insufficient to prove that there were other income-producing activities in South Carolina. (Order at 11-13).

It is important to note the posture of the instant case before the ALC. As properly stated by this Court, “[t]he hearing before the ALC is a contested case hearing and is heard de novo.” (Order at 7) (citing Marlboro Park Hosp. v. S.C. Dep’t of Health and Env’tl. Control, 358 S.C. 573, 579, 595 S.E.2d 851, 854 (2004)). The ALC hears this case as the de novo fact finder. Young v. S.C. Dep’t of Health and Env’tl. Control, 383 S.C. 452, 680 S.E.2d 784 (Ct. App. 2009); Risher v. S.C. Dep’t of Health and Env’tl. Control, 393 S.C. 198, 207, 712 S.E.2d 428, 433, reh’g denied (July 21, 2011) (“The ALC, as the ultimate finder of fact in this action, was free to . . . draw its own conclusions therefrom.”). As the finder of fact, the ALC can choose to accept in part or in whole the testimony of witnesses. MRI at Belfair, LLC v. S.C. Dep’t of Health and Env’tl. Control, 392 S.C. 314, 324, 709 S.E.2d 626, 631 (“[A]s the fact-finder, the ALC was free to make factual findings based on its view of the credibility and weight of the evidence.”). The Court therefore makes its determination based upon its reasonable view of the facts. Petitioner carries the burden of proof, and as the finder of fact, the Court is entitled to assign as much or as little weight to evidence as it wishes. Id. Furthermore, the Court is free to reach its own conclusions of law. As such, after its review of the evidence, this Court properly concluded 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.” The Court further determined that Petitioner’s “evidence is simply insufficient to satisfy DIRECTV’s burden of proof.” (Order at 10).

Additionally, Petitioner is required to establish by a preponderance of the evidence that the Department’s determination is incorrect. Petitioner failed to satisfy its burden of proof as the preponderance of the evidence supported the Department’s determination. Specifically, this Court stated the evidence presented in this matter “suggested that there *may* be other activities, such as advertising, that influence the customer’s decision to make the purchase. . . .”, it ultimately concluded “that evidence is simply insufficient to satisfy DIRECTV’s burden of proof.” (Order at 10) (emphasis added).¹ The following excerpt from the Order summarizes the Court’s view of Petitioner’s evidence:

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 reflect that its advertising *probably* produced some income, the evidence did not reflect that portion of DIRECTV’s cost was 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 attributed to income production are actually income-producing activities.

(Order at 10-11) (emphasis added).

Here, the Court properly applied the burden of proof. The Court noted that Petitioner’s evidence suggested that there *may* be income-producing activities in South Carolina beyond the delivery of the signal into subscribers’ homes and onto their televisions, but the Court made clear statements that Petitioner did not satisfy its burden of proof regarding any such additional income-producing activities.

Although the above discussion demonstrates that the Court properly applied the standard of review and the burden of proof in this case, Petitioner erroneously used a property tax case –

¹ Even if Petitioner established that its advertising was an income-producing activity, it failed to prove that any such advertising occurred outside of South Carolina. See Ameritech Publishing, Inc. v. Wisconsin Dep’t of Rev., 327 Wis.2d 798, 788 N.W.2d 383 (Ct. App. 2010) (unpublished), 2010 WL 2519583, ¶19 (ultimately concluding that advertising occurred in Wisconsin although many services provided by Ameritech such as “arranging, creating, developing, designing, assembling and producing the advertisement” occurred outside Wisconsin).

in which the Department was not a party – to assert that the Court should have dismissed this case because Petitioner allegedly met its burden of proof by showing that the Department’s determination was incorrect. Unfortunately, the Petitioner solely relied on the Court’s statement that Petitioner’s evidence *may* suggest additional income-producing activities in South Carolina. As support for its argument, Petitioner cites Cloyd v. Mabry, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988) to incorrectly assert that if Petitioner established that the Department’s assessment was incorrect, then it met its burden of proof, and therefore, the Department’s assessment should be dismissed. Specifically, the Petitioner cited the following:

‘[A] taxpayer contesting an assessment has the burden of showing that the valuation of the taxing authority is incorrect’ and that, although ‘[o]rdinarily, this will be done by proving the actual value. . . . [t]he taxpayer may, however, show by other evidence that the assessing authority’s valuation is incorrect’ and ‘[i]f he does so, the presumption of correctness is then removed and the taxpayer is entitled to appropriate relief.’

(Motion at 2) (citations omitted). The Petitioner then asserted that such “appropriate relief” was dismissal of this case. Nevertheless, even if Petitioner could somehow establish that it met its burden of proof by proving the Department’s Determination is incorrect, Petitioner’s suggestion that the appropriate remedy is dismissal of the determination is disingenuous at best.

First, Petitioner’s use of Cloyd is misguided and not applicable in this case. At the outset, it should be noted that Cloyd was decided in the context of a property tax matter and not with regard to corporate income tax. Cloyd, 295 S.C. at 87, 367 S.E.2d at 172. Nevertheless, in that case, Cloyd was the Richland County Assessor, and Mabry was a landowner. Id. The South Carolina Tax Board of Review had made a final agency decision to reduce the property tax assessments by twenty percent (20%). Id. The circuit court affirmed the administrative agency’s reduction of the property assessment, and the matter was subsequently heard by the Court of Appeals. Id., 295 S.C. at 88, 367 S.E.2d at 172.

Although the Court of Appeals stated that the landowner would be entitled to “appropriate relief” if the landowner proved that county assessor’s valuation of the property was incorrect and thereby removed the presumption of correctness of the assessor’s valuation, the Court of Appeals did not conclude that “appropriate relief” included absolving the taxpayer of any property tax liability through dismissal of the assessment. Id., 295 S.C. at 88-89, 367 S.E.2d at 173. To the contrary, to the extent a taxpayer were to prove the “actual tax assessment”

instead of the proposed assessment of the taxing authority, the taxpayer would be obligated to pay the actual assessment. Similarly, to the extent other evidence proved a proposed tax assessment to be wrong, the Court would then be required to decide the “appropriate relief” to be afforded to the taxpayer – not dismissal of any tax liability but instead some reduction of the tax owed based on evidence produced by the taxpayer. Because of Petitioner’s failure of proof on these issues, it certainly did not show any “actual assessment” and further, produced insufficient credible evidence allowing the Court to determine a presumably lesser tax obligation.

Moreover, in another property tax assessment case, the Court of Appeals found that the administrative law judge properly determined a fair market value of a property even though it was not the value presented by any of the experts in the case. Smith v. Newberry County Assessor, 350 S.C. 572, 578-79, 567 S.E.2d 501, 504-05 (Ct. App. 2002). Accordingly, the ALC has the ability to determine the proper assessed value based on the evidence presented even when the county assessor’s value is deemed incorrect. The ALC is not required to dismiss the case as the so-called “appropriate relief.”

Put simply, Petitioner failed to meet its burden of proof to prove by a preponderance of the evidence that the Department’s determination was incorrect. Because Petitioner failed to make such a showing and evidence supported the Court finding that the Department’s determination was correct, the Court’s decision was proper.² Additionally, Petitioner is not entitled to dismissal of this case by the ALC merely because Petitioner’s insufficient evidence suggested that there may be income-producing activities in South Carolina in addition to the delivery of the signal into subscribers’ homes and onto their televisions.

B. The Court Properly Interpreted The Burden Of Proof Imposed on Petitioner And Did Not Impose An Additional Burden On Petitioner

Petitioner also improperly asserts that the Court misinterpreted the burden of proof imposed on Petitioner and improperly imposed an additional burden on Petitioner. As discussed above, this Court applied the proper standard of proof and burden of proof and correctly found that Petitioner failed to meet its burden of proof.

² See e.g., Order at 10 (“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 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.””).

Nevertheless, Petitioner argues the Court further erred by imposing an additional burden on Petitioner by “requiring DIRECTV to establish the actual revenue attributable to South Carolina. (Motion at 5). As discussed above, Petitioner’s burden of proof is to demonstrate by a preponderance of the evidence that the Department’s determination is incorrect. In its Department determination, the Department identified the income-producing activity as the “delivery of the signal into the homes and onto the television screens of its customers.” (Department Determination at 5). The Department then determined the location of the income-producing activity: “[t]he gross receipts that DIRECTV generates from the sale of subscriptions are directly produced from activity that occurs within this state.” (Department Determination at 7). Accordingly, since all of the income-producing activity related to the subscription receipts from South Carolina customers occurred in South Carolina, pursuant to the first prong of section 12-6-2295(A)(5), the Department sourced all of those subscription receipts to South Carolina.

During the hearing, Petitioner alleged that the second prong of section 12-6-2295(A)(5) is applicable because income-producing activity related to the South Carolina subscription receipts occurs in multiple states. Under Petitioner’s view, to prove that the Department’s Determination is incorrect, Petitioner had the burden to prove by a preponderance of the evidence that it had income-producing activities outside of South Carolina and that some other subscription receipts should be sourced to another state. The Court made it clear that Petitioner failed to meet its burden of proof in this regard: Petitioner failed to prove that it had another income-producing activity – inside or outside of South Carolina – in addition to the income-producing activity concluded by the Court. Moreover, even if Petitioner identified an additional income-producing activity, it failed to sufficiently quantify that income-producing activity occurring outside of South Carolina to prove that the Department’s Determination was incorrect.

In its Motion, Petitioner cites four passages from the Court’s decision as apparent support for its assertion. (Motion at 4-5). However, in each cited passage and in opposition to Petitioner’s assertion, the Court stated that Petitioner did not prove that income-producing activities occurred outside of South Carolina and/or that Petitioner failed to sufficiently quantify out-of-state income-producing activities. In the first passage, the Court stated that Dr. Cody’s “payroll-and-assets method does not provide a reasonable approximation of income-producing activity by DIRECTV in South Carolina.” (Motion at 4). The Court statements means that Dr. Cody’s calculations did not properly quantify how much of Petitioner’s payroll or property

contributed to income-producing activities occurring in South Carolina. By not being able to quantify income-producing activities in South Carolina, Dr. Cody's work failed to prove that additional income-producing activities occurred in South Carolina. In the second passage, the Court stated that Petitioner's "evidence did not reflect what portion of DIRECTV's costs was either attributable to South Carolina customers or may have influenced South Carolina customers to subscribe to DIRECTV." (Motion at 5). By failing to present such evidence, the Court is stating that Petitioner was unable to articulate what activities produced the subscription receipts from South Carolina; hence again, Petitioner failed to prove any out-of-state income-producing activities. In the third passage, the Court stated that Petitioner "did not present any evidence that reflected how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated at South Carolina." (Motion at 5). Here the Court is stating that, although Petitioner probably engaged in advertising, Petitioner did not present any evidence establishing how any advertising impacted its receipts from South Carolina customers; hence, Petitioner did not show that advertising was an income-producing activity or in what state it occurred. In the final passage, the Court stated that Petitioner "simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur." (Motion at 5). Again, to quantify how much income-producing activity occurs in multiple states, a taxpayer must be able to clearly identify each income-producing activity. Petitioner was unable to do either. In the two sentences before this final passage, the Courts stated that Petitioner "did not present sufficient evidence to determine its income-producing activities" and that Petitioner "put no value on its subscriptions or the value perceived by its customers." (Order at 19-20).

In conclusion, the Court applied the proper burden of proof on Petitioner and did not impose an additional burden on Petitioner. First, Petitioner did not prove that it engaged in income-producing activities related to the South Carolina subscription receipts outside of South Carolina. Second, it failed to prove that less than 100% of the South Carolina subscription receipts should be sourced to South Carolina.

C. The Court Appropriately Considered And Addressed The Evidence In The Record Offered by Petitioner To Establish Its Position on Income Producing Activities

Petitioner next asks the Court to reconsider its ruling, alleging that the Court failed to consider or overlooked substantial evidence in the record that established DIRECTV's income-producing activity. The Department adamantly disagrees with this contention. This Court's in-depth analysis within its Order demonstrates the Court thoroughly considered all of the evidence presented by both parties.

S.C. Code Ann. § 1-23-600 grants authority to the administrative law judges to preside over and decide cases arising as a contested case before the ALC. This requires the administrative law judge to hear the case, analyze the evidence, and to render a decision in the matter. The administrative law judge is the fact finder in the matter and has discretion. MRI at Belfair, 392 S.C. 314, 709 S.E.2d 626. Pursuant to ALC Rule 26, the administrative law judge is to follow the established rules of evidence as provided in S.C. Code Ann § 1-23-330, and as dictated by ALC Rule 26, "shall apply the tests under established rules of evidence otherwise relating to admissibility and credibility and determine the weight to be given such evidence." ALC Rule 26 (emphasis added). The qualification of witnesses as experts and the admissibility of testimony are matters largely within the discretion of the trial judge. MRI at Belfair, 392 S.C. 314, 709 S.E.2d 626. Likewise, the general credibility of witnesses and the weight the Court gives to the evidence presented is in the discretion of the judge when making his final decision. Id.

Petitioner argues the Court failed to properly consider the testimony of Mr. Goswitz, Dr. Cody, and Petitioner's SCRCF 30(b)(6) witness that the income-producing activity was considered by Petitioner to be the assets and employees that perform the services which puts the video programming onto the television. Similarly, the Petitioner argues that the Court failed to properly consider the testimony of Dr. Cody opining that income-producing activities are best reflected by payroll and assets, and his testimony that those measures are practical and commonly used. While the Court may have made a decision that was not in line with the Petitioner's argument, the Court did not fail to properly consider the testimony presented by the Petitioner before making its ruling.

S.C. Code Ann. § 1-23-350 requires a final decision from the ALC to be in writing and further states that findings of fact, if set forth in statutory language, “shall be accompanied by a concise and explicit statement of the underlying facts supporting the findings.” This in no way creates a duty upon the administrative law judge to methodically list all the things it considered in its analysis and rendering of its decision. The Court is not required to list all witnesses and evidence and then confirm each was considered by the judge to show that it properly considered the evidence presented. Nevertheless, the extensive analysis contained in the Order here would convince the most skeptical reader that the Court properly considered all of the evidence before it. In this case, the Court explicitly stated it has made the finding of facts, “having observed the witnesses and exhibits presented at the hearing and taking into consideration the burden of persuasion and the credibility of the witnesses.” (Order at 3).

The Court considered the evidence regarding the Petitioner’s operations from Mr. Goswitz, its vice president of space and communications and video. (Hr’g Tr. 47:14-48:7, 49:16-81-11). The Court undoubtedly considered that testimony and the operational activities of Petitioner in its decision, as demonstrated by references to “content and broadcast of signals,” “infrastructure” related to content and transmission, “production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites.” (Order at 12-13).

The Court fully analyzed Dr. Cody’s testimony and report but did not find it sufficient or persuasive. Indeed, the Court analyzed and/or referenced the testimony of Dr. Cody approximately four times within its Order. Specifically, the Court recognized in its decision that Petitioner presented evidence through Dr. Cody of the so-called four “value drivers” that could identify Petitioner’s income-producing activities, and that Dr. Cody testified about his calculations using Petitioner’s payroll and assets as proxies in identifying Petitioner’s income-producing activities. (Order at 10-11). The Court discusses, in detail, Dr. Cody’s testimony about value drivers, and the Court openly considers Dr. Cody’s testimony to include reciting his analysis in the pages of the Order. Id.

Only after considering the testimony of Dr. Cody, could the Court find that Dr. Cody’s payroll and asset proxies for identifying Petitioner’s income-producing activities were “of no practical value,” and that Petitioner “did not sufficiently explain the effect of [Dr. Cody’s] value drivers on income production in this State,” and further, that the Petitioner’s evidence was “just

too nebulous” to make the connection between Dr. Cody’s value drivers and income-producing activities. (Order at 11). The basic statement made by the Court that the testimony was unpersuasive clearly indicates the Court considered the testimony given by Dr. Cody and is enough to establish the Court properly considered the evidence in the record.

D. The Court Appropriately Considered And Addressed The Evidence In The Record Establishing The Portion Of Petitioner’s Receipts That Should Be Attributed to South Carolina

Petitioner next asserts that the Court failed to appropriately consider and address the evidence in the record regarding a portion of Petitioner’s receipts it alleges should be attributed to South Carolina. To the contrary, the Court did not ignore evidence in the record regarding Petitioner’s argument of the portion of DIRECTV’s receipts it alleges should be attributed to South Carolina. The Court considered the testimony of Mr. Goswitz, Dr. Cody, and the other witnesses in order to make its determination, as evidenced by the discussion of that testimony and evidence within the Order. See supra, § C. The Petitioner states it provided sufficient evidence for the Court to identify DIRECTV’s income-producing activity, but the Court simply did not agree. The Court did not fail to consider or overlook the evidence provided by Petitioner’s witnesses. Rather, it properly considered and weighed that evidence and disagreed with the witness’ opinion. See Order at 16-18. Specifically, the Court concluded that following:

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. However, DIRECTV did not provide any evidence that reflected 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.

(Order at 18) (emphasis added).

Petitioner cannot ignore the discussion within the Order and claim the Court failed to consider testimony when it clearly studied that testimony and evaluated the same within its Order. This Court simply found that the evidence presented proved a conclusion other than the one asserted by Petitioner.

E. This Court Properly Interpreted Income-Producing Activity Language of S.C. Code Ann. § 12-6-2295(A)(5)

Next, Petitioner wrongly asserts that this Court misinterpreted the language of section 12-6-2295(A)(5) to require an examination of “primary” income-producing activities. Specifically, Petitioner wrongly asserts that this Court’s consideration of Petitioner’s “primary” activities to determine its income-producing activities ignores substantial evidence in the record of Petitioner’s income-producing activities, misinterprets the plain language of section 12-6-2295(A)(5), and is inconsistent with Mercury Motor Express, Incorporated v. South Carolina Tax Commission, 244 S.C. 134, 135 S.E.2d 756 (1964).

First, this Court did not ignore substantial evidence in the record of Petitioner’s income-producing activity. The decision establishes that the Court properly considered the testimony of Petitioner’s witnesses on what they contended constitute Petitioner’s income-producing activities and sufficiently understood the operations of Petitioner as was described by a corporate officer. See Order at 3-5, 9-14. Upon evaluation, the Court found that Petitioner failed to prove its contentions regarding non-South Carolina income-producing activities. (Order at 13).

In its decision, the Court recognized that it heard extensive testimony from and admitted a report by Dr. Cody, Petitioner’s expert on economics, concerning Petitioner’s income-producing activities, but the Court was not persuaded by Dr. Cody’s testimony. See, e.g., Order at 11. Dr. Cody testified that he was engaged by Petitioner “to identify from an economic perspective the income-producing activities of” Petitioner. (Hr’g Tr. p. 204, lines 11-16). The Court recognized in its decision that Petitioner presented evidence through Dr. Cody that the so-called four “value drivers” could identify Petitioner’s income-producing activities. (Order at 10). These value drivers included major components of Petitioner’s operations, including (1) content and programming, (2) acquisition and distribution of programming content, (3) marketing and sales of its service, and (4) customer service. Id. Dr. Cody described these activities of Petitioner in great detail in his testimony. (Hr’g Tr. 206:2-221:1). Dr. Cody also testified about his calculations, using Petitioner’s payroll and assets as proxies in identifying Petitioner’s income-producing activities. (Order at 11).

The Court fully analyzed Dr. Cody’s testimony and report but did not find it sufficient or persuasive. The Court found that Dr. Cody’s payroll and asset proxies for identifying

Petitioner's income-producing activities was "of no practical value," that Petitioner "did not sufficiently explain the effect of [Dr. Cody's] value drivers on income production in this State," and that Petitioner's evidence was "just too nebulous" to make the connection between Dr. Cody's value drivers and income-producing activities. (Order at 11).

Despite Dr. Cody's testimony and report and after "consider[ing] the activities of businesses in the direct broadcast services industry, the Court properly concluded that Petitioner's income-producing activity includes the customers' subscriptions and delivery of the signal into the location and onto the television screens of its customers." (Order at 10). The Court also stated that Petitioner argued that its costs to produce the content and broadcasting of signals into South Carolina should be considered an income-producing activity, but the Court concluded that these and other incidental activities of Petitioner have no income-producing value "until a customer subscribes to Petitioner's services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals" in his or her home. (Order at 12-13).

This Court also heard evidence of Petitioner's operations from Mr. Goswitz, its vice president of space and communications and video. (Hr'g Tr. 47:14-48:7, 49:16-81:11). The Court considered the operational activities of Petitioner in its decision as demonstrated by, for example, references to "content and broadcast of signals," "infrastructure" related to content and transmission, "production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites." (Order at 12-13).

Because the Court heard and considered extensive evidence from Dr. Cody, Petitioner's expert, who was engaged to identify Petitioner's income-producing activities, and from Mr. Goswitz, and because the Court found that Petitioner failed to sufficiently identify its non-South Carolina income-producing activities, this Court did not ignore substantial evidence in the record of Petitioner's income-producing activities. This Court merely found that the evidence presented proved a conclusion other than the one asserted by Petitioner.

Second, this Court properly interpreted the income-producing activity language of section 12-6-2295(A)(5). This provision 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 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). The Court's reference to the primary income-producing activity of Petitioner was not a misinterpretation of this provision.

In its motion for reconsideration, Petitioner referenced a sentence in which the Court used the phrase "primary income-producing activity" of Petitioner when stating that Petitioner's subscription receipts are received solely as a result of the delivery of the signal into a subscriber's home and onto the subscriber's television. Further, Petitioner referenced the Court's statements of other activities of Petitioner being incidental to the production of income. Based on these statements, Petitioner asserts that the Court misinterpreted the language of section 12-6-2295(A)(5) presumably because the statute does not include the word "primary."

Petitioner's argument is without merit. If one looks beyond the Court's use of the words "primary" and "incidental," it is obvious that the Court's application of section 12-6-2295(A)(5) was on target. As clearly seen in the same excerpts of this Court's decision that Petitioner cited in its motion for reconsideration, the Court merely put activities performed by Petitioner into two buckets: one that produced income and one that did not produce income. In the first bucket, the Court put the delivery of the signal into the subscribers' homes and onto their television because the subscription receipts were received as result of this activity. (Order at 10). In the second bucket, the Court put other activities such as broadcasting, producing and collecting the programming content, and transmitting the signals because the Court found that these "incidental" activities have no income-producing value unless a subscriber subscribers and receives the unscrambled signal in his home and on his television set. (Order at 13).

It is clear that the Court considered whether Petitioner's other activities were income-producing activities but was not persuaded by Petitioner's evidence. The Court noted that Petitioner failed to sufficiently identify its outside income-producing activities and failed to prove the impact on gross receipts of its local programming activities. (Order at 13).

The Court made it clear that all activities of Petitioner were not income-producing activities and that its analysis was a means to make this distinction among Petitioner's activities. The Court stated, "[t]hus, the pertinent issue here is at what point DIRECTV's activities become

income-producing.” (Order at 12). When the Court concluded that the delivery of the signal into the homes and onto the televisions of subscribers was the income-producing activity, the Court properly interpreted section 12-6-2295(A)(5) by identifying the income-producing activity, as shown by the evidence. Based on the above, the Court properly interpreted section 12-6-2295(A)(5). The mere use of the word “primary” in its analysis was not a flaw by this Court but a means to distinguish income-producing activities from non-income-producing activities. Additionally, the Court found that the Petitioner failed to prove that its other activities were income-producing activities.

Third, this Court’s analysis of income-producing activities was consistent with applicable case law. Here, Petitioner asserted that the Court’s decision was inconsistent with the South Carolina Supreme Court’s decision in Mercury Motor. Despite Petitioner’s assertion, the Court’s analysis was wholly consistent with Mercury Motor. Mercury Motor was “a common carrier of freight for compensation.” Mercury Motor, 244 S.C. 134, 136, 135 S.E.2d 756, 757 (1964). The Supreme Court stated that Mercury Motor was a unitary business and that its “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. . . . [W]hile 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. The Supreme Court continued by stating that, while Mercury Motor’s trucks were traveling along South Carolina’s highways, Mercury Motor “was engaged in income producing activity.” Id. The result of Mercury Motor was to uphold the Department’s use of the mileage formula, which used the hauling of freight as the income-producing activity and not the other incidental activities of Mercury Motor, to apportion its net income to South Carolina. See id., 244 S.C. at 141-42, 135 S.E.2d at 759-60.

In Mercury Motor, the Supreme Court clearly distinguished between a taxpayer’s activities that primarily produce income and those activities that are incidental to the production of income. This distinction is proper. First, the General Assembly’s use in section 12-6-2295(A)(5) of the limiting adjective, “income-producing,” to describe the noun, “activities,” means that all activities of a taxpayer, even if important to the overall service, are not income-producing activities and are not used to source gross receipts to South Carolina. Second, contrary to Petitioner’s argument, the General Assembly did not say in section 12-6-2295(A)(5)

that – if the taxpayer operates a unitary business – all of its activities are to be used to source gross receipts to South Carolina. See S.C. Code Ann. § 12-6-2295(A)(5). Third, the Supreme Court in Mercury Motor referred to each of the transactions in the identified series of transactions as being “incidental to the production of income,” but it referred only to the hauling of freight as an “income producing activity.” Mercury Motor, 244 S.C. at 141, 135 S.E.2d at 759. Fourth, the Supreme Court’s use in Mercury Motor of the phrase “incidental to the production of income” to describe the taxpayer’s activities does not mean that each of those activities are also income-producing activities that should be used to source gross receipts to South Carolina. Consistent with the statute, activities that are incidental to the production of income are not necessarily income-producing activities. “Incidental” is defined as (1) “[s]ubordinate to something of greater importance” and (2) “having a minor role.” BLACK’S LAW DICTIONARY 765 (7th ed. 1999). Therefore, incidental activities are merely subordinate to or have a minor role with the main, primary, and principal activities. In Mercury Motor, the hauling of freight, as the main purpose of the taxpayer, was the primary and principal activity. The other incidental activities, although important, were not income-producing activities but were subordinate to or played a minor role to the only income-producing activity of the taxpayer, which was the hauling of freight. Finally, Petitioner’s expert, Dr. Cody, confirmed the different nature of income-producing activities and the other incidental activities. Dr. Cody stated that Petitioner performed the other incidental activities “in anticipation of – and in order to deliver that signal in anticipation of customers signing up and paying” and that these other incidental activities have “a risk” because Petitioner has only “an anticipation of future profits.” (Hr’g Tr. 219:15-19, 220:1-5). These other incidental activities of Petitioner are distinguished from the delivery of the signal into subscribers’ homes and onto their televisions because that later activity is the activity that actually creates the subscriber revenue.

Petitioner asserted in its motion for reconsideration that the Supreme Court in Mercury Motor rejected a narrow construction of income-producing activities and that this Court “acknowledge[d] that the Supreme Court considered ‘incidental’ activities to be income-producing activities.” (Motion at 13). Both of these assertions by Petitioner are wrong. By stating that only the hauling of freight was the income-producing activity while excluding the other incidental activities, the Supreme Court did not reject a narrow construction of income-producing activities. Also, the Supreme Court did not refer to the other incidental activities as

income-producing activities. It referred to only the hauling of freight as an income-producing activity.

Based on the above, this Court's analysis of income-producing activities was consistent with Mercury Motor. Although Petitioner performs many important activities dependent upon or connected with the income-producing activity of delivering the signal into subscribers' homes and onto their television, activities such as content acquisition and development, satellite launches, and broadcasting and transmitting are not income-producing activities.

In conclusion, this Court did not misinterpret the language of section 12-6-2295(A)(5) by using the term, "primary," when determining Petitioner's income-producing activities. The Court heard and properly considered the evidence of income-producing activities presented by Petitioner. Additionally, the Court's analysis of income-producing activities was consistent with section 12-6-2295(A)(5) and a proper interpretation of Mercury Motor.

F. The Court Properly Construed Petitioner's Sourcing Methodology As Being A Costs-of-Performance Methodology

Petitioner wrongly asserts that the Court misconstrued Petitioner's methodology as being a costs-of-performance methodology. Petitioner states that its use of the "Payroll and Assets Method as a proxy for measuring the gross receipts attributable to South Carolina does not imply that DIRECTV is asserting that South Carolina is a cost of performance state. Moreover, the payroll and assets method is consistent with existing South Carolina law." Petitioner cites Lockwood Greene, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), as support for the later statement. Petitioner is stating that although it is using costs-of-performance elements – payroll and assets – it is not using a costs-of-performance method. This is a distinction without a difference.

Petitioner's statement that it is not using a costs-of-performance method to source its gross receipts to South Carolina is hard to believe. The crux of Petitioner's case was that Lockwood Greene imposed a costs-of-performance method on service providers when sourcing gross receipts to South Carolina. See Pet'r Pre-Hearing Br. at 6 (stating that the issue is whether its subscription revenues should be sourced to South Carolina based on the location of its activities, which is the "place of activity" test used in Lockwood Greene where a payroll factor was used to source gross receipts to South Carolina). It also asserted that the General Assembly codified Lockwood Greene's so-called costs-of-performance requirement when it enacted

section 12-6-2295(A)(5). See Pet'r Pre-Hearing Br. at 11. Further, the Department presented evidence and the Court noted in its decision that, when Petitioner amended its South Carolina corporate income tax returns, it amended the returns to source gross receipts under a "cost of performance method" and that the costs of performance sourcing was "prescribed by statute." (Order at 5-6). Petitioner's tax policy expert, Professor Richard Pomp, stated that section 12-6-2295(A)(5) did not require costs-of-performance but that it is one option that may be considered by the Court. See Hr'g Tr. 522:20-523:5.

As previously stated, Petitioner is making a distinction without a difference. Regardless of whether the statute says to use costs-of-performance to source gross receipts or whether the statute is silent, Petitioner nonetheless uses costs-of-performance elements when sourcing gross receipts. The corresponding UDITPA statute, section 17, sources gross receipts "based on costs-of-performance." UDITPA Section 17. Section 17 is widely known as a costs-of-performance statute; however, costs-of-performance does not identify the income-producing activity or even its location but it merely is used to quantify how much income-producing activity occurs in various states when the income-producing activity occurs in more than one state. This is identical to what Petitioner is doing in the instant case. It is using payroll and/or assets, which are costs-of-performance elements, to quantify how much income-producing activity occurred in South Carolina. Therefore, Petitioner is certainly using a costs-of-performance method.

However, this allegation in Petitioner's motion for reconsideration is a red herring because the Court applied section 12-6-2295(A)(5) as written. Under the first prong of section 12-6-2295(A)(5), the Court determined the income-producing activity and that all of the income producing activity occurred in South Carolina. (Order at 13-14). Accordingly, there was no need to use the second prong of Section 12-6-2295(A)(5) which is used when income-producing activity occurs in more than one state. It is only in this second prong that costs-of-performance would be used at all. See UDITPA, section 17. Additionally, section 12-6-2295(A)(5) is similar to UDITPA, section 17; however, one of the two major difference is that the South Carolina statute omitted the phrase "based on costs-of-performance." Therefore, costs-of-performance is not required by South Carolina law.

In conclusion, this Court properly construed Petitioner's sourcing methodology as a costs-of-performance methodology. Although Petitioner was seemingly trying to determine how much income-producing activity occurred in South Carolina under section 12-6-2295(A)(5), it is

clear that Petitioner did so using costs-of-performance elements even though all of the income-producing activity occurred in South Carolina and the statute did not impose a costs-of-performance method.

G. The Court Considered and Addressed Petitioner's Argument That Penalties Must Be Abated When There Is Substantial Authority and/or The Taxpayer Acted In Good Faith

Petitioner wrongly asserts that the substantial understatement penalties should be abated because there was substantial authority for its position and it acted in good faith. Specifically, Petitioner argues that it presented testimony and evidence that its treatment of subscription revenue was correct, and that its position is supported by Lockwood Greene, Mercury Motor, and the position taken by Petitioner on its corporate tax return for the 2011 tax year. However, this Court properly concluded that the Department was correct to apply a substantial understatement penalty for the underpayment of taxes owed for tax years 2009 through 2011.

First, the Lockwood Greene decision does not explicitly or implicitly direct taxpayers such as Petitioner to file its corporate tax returns based on a costs-of-performance method or elements. As this Court recognized, the Court of Appeals 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.” (Order at 14). The Lockwood Greene Court recognized that the Department sourced revenues of service providers such as engineering, law, and accounting firms to the place of activity, while sourcing income from other service industries, such as finance companies and media broadcasters, to the location of the borrower and the advertisers, respectively. Petitioner is not like the taxpayer in Lockwood Greene: Petitioner’s customers do not hire specific professionals and are not paying for those professionals’ expertise and time. Rather, “the customer is paying for video programming to be viewed on the customer’s television at the time and place the customer demands.” (Order at 16). Petitioner and its operations are not comparable to the taxpayer in Lockwood Greene, and there is no basis in Lockwood Greene upon which Petitioner may rely when filing its corporate income tax returns.

Next, Petitioner asserts that the decision in Mercury Motor supports the position taken with respect to its tax returns at issue. Specifically, Petitioner argues that Mercury Motor “rejected a narrow view of income-producing activities . . . that would have considered only

activities for which the company was actually paid.” (Motion at 13). While it was completely proper for Petitioner to appropriately rely upon Mercury Motor in filing its corporate income tax returns, Petitioner absolutely misinterprets the facts and application of the case to the instant matter. The court in Mercury Motor recognized that a taxpayer may engage in many transactions in its business, and 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.’” (Order at 11) (citation omitted). As this Court properly recognized, the facts in this case “are akin” to the transactions discussed in Mercury Motor, and that “DIRECTV failed to sufficiently identify its outside income-producing activities.” (Order at 12). Specifically, Petitioner engages in incidental activities such as “the infrastructure for producing and collecting the programming content and transmitting the signals.” (Order at 12). However, as the Court succinctly noted, “it is not until a customer subscribed to Petitioner’s services by purchasing a satellite dish to receive those signals and a set-top box to decode those signals that Petitioner’s action have any income producing value.” Id. Accordingly, from the plain reading of Mercury Motor, it is clear that Petitioner’s reliance upon a taxpayer’s total business activities to justify its position in this matter is unpersuasive.

Finally, Petitioner asserts that the position taken on its corporate tax return for the 2011 tax years demonstrates that it was acting in good faith to comply with sections 12-6-2290 and 12-6-2295(A)(5). It is important to note the filing history of DIRECTV with regard to the tax years in question. Initially, Petitioner sourced 100% of the subscription revenue received from South Carolina customers to the numerator of the gross receipts ratio. Petitioner subsequently changed its position, and on its amended 2006-2008 returns as well as its original 2009 and 2010 returns, Petitioner did not include any of the subscription receipts from South Carolina customers in the numerator of the gross receipts ratio. Finally, on its original 2011 return, Petitioner changed its method again by including approximately \$22 million of its \$410 million subscription receipts from South Carolina customers in the numerator. Petitioner did so 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. Notably, this Court concluded that “the approach proposed by Dr. Cody unduly emphasizes what amounts to ‘costs of performance.’” Finally, Petitioner’s expert at trial presented another method by asserting that Petitioner may use a mixed payroll and property

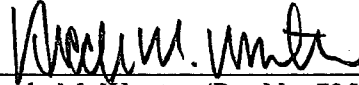
factor. Petitioner's various approaches to filing in South Carolina is still changing despite the statute being static since 2007. As noted above, Petitioner is making a distinction without a difference – it advances a position in this case that is grounded upon costs-of-performance elements.

South Carolina is absolutely not a costs-of-performance state, and this is clearly established, in addition to the case law recited above, by the actions of our General Assembly. As noted by this Court in its Order, while 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 cost of performance." (Order at 16). Moreover, 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 by basing the determination only on a sales factor and to define the terms 'sales' and 'gross receipts' consistently and specifically for that purpose[.]" The statutory amendment does not include the language "based on costs of performance" and there are no references to costs-of-performance elements, such as property and payroll. As such, Petitioner's reliance upon property and payroll factors to justify its position with regard to its 2011 tax return is unpersuasive.

Accordingly, Petitioner must be assessed the substantial understatement penalties as there is no substantial authority for its position and it did not act in good faith. During the course of this single audit period, Petitioner utilized three difference sourcing methodologies and presented a fourth method at trial. Moreover, Petitioner utilized a costs-of-performance method and/or elements, and the cases relied upon by Petitioner do not apply a costs-of-performance method – implicitly or explicitly – to services providers such as Petitioner. Finally, the General Assembly's statutory amendments and additions in 2006 and 2007 to the relevant statutory scheme clearly do not envision the use of a costs-of-performance method in light of the distinct deletion of "based on costs of performance" from section 17 of UDITPA's model act.

CONCLUSION

Petitioner has not put forth any grounds for which the Court needs to reconsider or amend its Order in this case. To the contrary, the Court's Order properly considered and addressed the facts and evidence in this matter and should not be reconsidered or amended.



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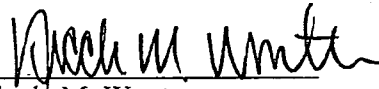
Attorneys for S.C. Department of Revenue

June 1, 2015

Columbia, South Carolina

PROOF OF SERVICE

I, Nicole M. Wooten, do hereby certify that I have caused to be mailed, via United States Postal Service, postage prepaid, a copy of the Department's Response to Petitioner's Motion For Reconsideration re: DIRECTV Inc. & Subsidiaries vs. South Carolina Department of Revenue, Docket No. 14-ALJ-17-0158-CC to R. Gregory Roberts, Esquire, 250 West 55th Street, New York, NY 10019-9601, and to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, Nelson Mullins Riley & Scarborough LLP, 151 Meeting Street, Sixth Floor, Charleston, SC, 29401-2239 on this 1st day of June, 2015.


Nicole M. Wooten

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT DIVISION
Docket No. 14-ALJ-17-0158-CC

DIRECTV, Inc. & Subsidiaries,)
)
Petitioner,)
)
v.)
)
South Carolina Department of)
Revenue,)
)
Respondent.)
-----)

COPY

ADMINISTRATIVE HEARING

Tuesday, January 13, 2015
10:00 a.m. - 5:15 p.m.

Wednesday, January 14, 2015
9:00 a.m. - 5:03 p.m.

The hearing before the Honorable Ralph King Anderson, III, was taken at the Edgar A. Brown Building, 1205 Pendleton Street, Suite 224, Columbia, South Carolina, on the 13th and 14th days of January, 2015 before Cassandra E. Vance, Court Reporter and Notary Public in and for the State of South Carolina.



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STIPULATIONS

It is stipulated and agreed that this hearing is being taken pursuant to the rules of the Administrative Law Judge Division and the South Carolina Rules of Civil Procedure.



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1 **THE COURT:** All right. This is a hearing in the
2 matter of DIRECTV, Inc., and Subsidiary --
3 Subsidiaries, Petitioners, vs. South Carolina
4 Department of Revenue, Respondent. The docket
5 number is 14-ALJ-17-0158-CC.

6 Are there any -- I'll tell you what, before we
7 even go forward, I want to state for the
8 record, at least from an ethical standpoint, I
9 am a DIRECTV customer; however, I do not
10 believe that that will impact my -- or affect
11 my decision in deciding this case. As a matter
12 of fact, if DIRECTV wants to release me from my
13 binding contract, I'll gladly get out of it and
14 go look somewhere else, so. But with that
15 said, I'm just going to let y'all know that.
16 So are there any motions or stipulations the
17 parties wish to make before we proceed?

18 **MS. GEER:** Good morning, Your Honor, Bryson Geer for
19 DIRECTV. We did have a few stipulations as to
20 procedural matters. First of all, we filed the
21 other day an actual stipulation as to certain
22 facts and I'll be happy to hand the Court up a
23 copy, if you would like one.

24 **THE COURT:** You filed it with us?

25 **MS. GEER:** Yes, Your Honor.



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1 **THE COURT:** Any objection?

2 **MR. CONDON:** No, Your Honor, no objection.

3 **THE COURT:** All right.

4 **MS. GEER:** Thank you, Your Honor. Second, we have
5 also -- this is not in those stipulations, but
6 the parties have stipulated as to the
7 authenticity of all the documents that each
8 side has identified as exhibits in this
9 matter --

10 **THE COURT:** All right.

11 **MS. GEER:** -- so that is not an issue in the case.
12 We have also stipulated as to the admissibility
13 of the following documents: DIRECTV's original
14 and amended tax returns, the Department of
15 Revenue's audit reports, and the Department's
16 Determination in this matter. So those we have
17 stipulated that they are admissible.
18 And, lastly, we have some deposition -- joint
19 deposition designations for a Mr. William
20 Spina. And we had some issues where some
21 things were included that shouldn't have been,
22 and vice versa. So we are going to actually
23 together today sign an amended deposition
24 designation that has everything correct and
25 we'll get that to Your Honor later today,



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1 perhaps after lunch.

2 And then we intend to have Mr. Condon -- we'll
3 have someone on the witness stand and he will
4 read his questions and we will likely do that
5 at the end of our case, because it contains
6 things that we would want in during our case.
7 And I don't know if we need to stipulate that
8 the things that y'all designated came in during
9 your case to me. It doesn't matter and they
10 can all come in during our case, but whatever
11 the Department prefers on that.

12 **MR. CONDON:** I don't think it matters. We can treat
13 them as if they came in on your case, the whole
14 thing.

15 **MS. GEER:** Okay. That's fine with us, if that suits
16 the Court.

17 **THE COURT:** Well, that doesn't matter. I do want to
18 address one issue.

19 **MS. GEER:** Yes.

20 **THE COURT:** So y'all can address that whenever you
21 want, at least -- are you offering it now
22 or ...

23 **MS. GEER:** No, Your Honor.

24 **THE COURT:** It's not complete?

25 **MS. GEER:** That's correct, so we will submit that



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1 later today.

2 **THE COURT:** Is this something I'm going to need to
3 read?

4 **MS. GEER:** You will not. We will --

5 **THE COURT:** I'm going to need -- am I going to need
6 to read it to understand your arguments or ...

7 **MS. GEER:** No, Your Honor.

8 **THE COURT:** Okay.

9 **MS. GEER:** We'll just -- we'll have it all read in --

10 **THE COURT:** Okay.

11 **MS. GEER:** -- if that suits you.

12 **THE COURT:** That's fine.

13 **MS. GEER:** Okay. And then, lastly, we have some
14 demonstrative exhibits that the Department has
15 not objected to and we were hoping that Your
16 Honor would be okay with us using an easel
17 during openings and during examinations of
18 witnesses.

19 **THE COURT:** Oh, definitely.

20 **MS. GEER:** If Your Honor has any preferences on
21 where they go, we were just thinking somewhere
22 here where they don't block anyone's view.

23 **THE COURT:** My preference is that I be able to see
24 them.

25 **MS. GEER:** Okay. Perfect. We will definitely make



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1 sure that happens.

2 **THE COURT:** After that, y'all can deal with that.

3 **MS. GEER:** Okay. And that's all I have, unless the
4 Department has any other initial issues.

5 **MR. CONDON:** No, Your Honor. We agree with the
6 stipulations she referenced and we're ready to
7 go.

8 **THE COURT:** All right. I will tell you, y'all
9 submitted a pretrial brief?

10 **MR. CONDON:** We did, Your Honor, yesterday
11 afternoon.

12 **THE COURT:** Yeah, it was kind of late yesterday
13 afternoon, so I didn't get a chance to read it.

14 **MR. CONDON:** Okay.

15 **THE COURT:** So, I've read theirs, but if you -- in
16 presenting your case at this point in time,
17 don't assume that I am knowledgeable as to your
18 brief yet. Probably after lunchtime I will
19 be --

20 **MR. CONDON:** Okay.

21 **THE COURT:** -- but not at this point in time.

22 **MR. CONDON:** Thank you for letting us know, Your
23 Honor.

24 **THE COURT:** Okay. All right.

25 **MS. GEER:** Thank you, Your Honor.



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1 **THE COURT:** I'm ready for openings.

2 **MS. GEER:** Okay. Your Honor, we'll set up these
3 easels --

4 **THE COURT:** Okay.

5 **MS. GEER:** -- real quick and then we'll get started.

6 **THE COURT:** All right.

7 **(Off the Record)**

8 **THE COURT:** Mr. Condon, if you want to come around
9 to see these, you're welcome to do that
10 whenever you want to.

11 **MR. CONDON:** Thank you, Your Honor. I've read them,
12 so I may --

13 **THE COURT:** Okay.

14 **MR. CONDON:** -- stay here. But if I get up, you'll
15 know why.

16 **MR. ROBERTS:** Your Honor, I think we should move
17 these so people can see. Would you prefer them
18 over there in the corner or over here in the
19 corner? Trying not to block anybody, but --

20 **THE COURT:** Probably over there.

21 **MR. ROBERTS:** Thank you, Your Honor.

22 **THE COURT:** And if you have that on a sheet of
23 paper, you can always put it up on the ELMO.

24 **(Off the Record)**

25 **THE COURT:** Tell you what, before we proceed, let's



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1 go through your names so my court reporter can
2 identify each one of you.

3 **MR. ROBERTS:** Your Honor, my name is Greg Roberts
4 from Morrison & Foerster on behalf of DIRECTV.

5 **MR. VALLEJO:** Andres Vallejo on behalf of DIRECTV.

6 **MS. GEER:** Bryson Geer with Nelson Mullins on behalf
7 of DIRECTV.

8 **MR. VON LEHE:** John von Lehe with Nelson Mullins on
9 behalf of DIRECTV.

10 **THE COURT:** All right. Mr. Condon?

11 **MR. CONDON:** And I'm Bill Condon with the Department
12 of Revenue.

13 **MS. WOOTEN:** Nikki Wooten with the Department of
14 Revenue.

15 **MR. THOMPSON:** Tim Thompson with the Department of
16 Revenue.

17 **THE COURT:** Oh.

18 **MS. CAMPBELL:** Mary Beth Campbell with the
19 Department of Revenue.

20 **THE COURT:** I didn't see you hiding back there,
21 Mary.

22 All right. Got them?

23 **THE COURT REPORTER:** (Nods head affirmatively.)

24 **THE COURT:** Okay. Proceed.

25 **OPENING STATEMENT BY MR. ROBERTS:**



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1 **MR. ROBERTS:** Thank you, Your Honor. As I said, my
2 name is Greg Roberts from Morrison & Foerster
3 on behalf of DIRECTV.

4 The issue in this case is whether South
5 Carolina has adopted an apportionment statute
6 that looks to where the services are performed
7 or whether the State has adopted an
8 apportionment statute that looks to the
9 location of the customer.

10 Now, you're going to hear lots of testimony
11 today from the Department and the Department's
12 witnesses about how that simple explanation
13 isn't sufficient and that all of DIRECTV's
14 income-producing activities take place solely
15 in South Carolina.

16 When you peel back the layers of the
17 Department's argument, however, the Department
18 is doing nothing other than looking to the
19 location of DIRECTV subscribers for purposes of
20 determining the gross receipts from within
21 South Carolina.

22 Now, there's no dispute as to the relevant
23 statutory sections at issue here, South
24 Carolina Code Sections 12-6-2290 and 12-6-2295.
25 As you can see from the demonstrative here,



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1 Section 12-6-2290 provides that service
2 providers like DIRECTV whose income is
3 apportioned using a fraction, the numerator of
4 which is gross receipts from within the state
5 during the taxable year, and the denominator is
6 total gross receipts from everywhere during the
7 taxable year.

8 **THE COURT:** You're using 2290 for what year?
9 Because I know they did 2013, I think, and then
10 y'all had 2007 or 2006.

11 **MR. ROBERTS:** The relevant parts of 2290, which I
12 just read, are applicable for 2006 through 2011
13 period, Your Honor.

14 **THE COURT:** Okay. That makes everything easier.

15 **MR. ROBERTS:** Yes.

16 **THE COURT:** Okay.

17 **MR. ROBERTS:** There is no dispute that receipts from
18 services are gross receipts. The issue in this
19 case is whether they're gross receipts from
20 within South Carolina. And for tax years
21 beginning 2007, 2290 instructs us to look to
22 Section 12-6-2295. And as you can see, the
23 receipts at issue in this case fall within
24 Sections 22 -- 12-6-2295(A)(5).

25 **THE COURT:** The same thing, all applicable years?



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1 **MR. ROBERTS:** This applies for tax years beginning
2 in 2007; so for 2007 through 2011.

3 **THE COURT:** Okay.

4 **MR. ROBERTS:** So for those tax years, receipts from
5 services is the entire income-producing
6 activity is within this state. If the
7 income-producing activity is performed partly
8 within and partly without the state, sales are
9 attributable to the state to the extent that
10 the income-producing activity is performed
11 within the state.

12 The language of the statute is clear. For
13 example, if 50 percent of the taxpayer's
14 income-producing activities are performed in
15 South Carolina, then 50 percent of the
16 taxpayer's total gross receipts go in the
17 numerator of the receipts fraction. Similarly,
18 if only ten percent of the taxpayer's
19 income-producing activities take place in the
20 state, then ten percent of its gross receipts
21 go in the numerator of the receipts factor.

22 There's no dispute that DIRECTV is a service
23 provider. Therefore, the plain language of the
24 statute instructs us to first identify
25 DIRECTV's income-producing activities and then



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1 to determine the extent to which those
2 income-producing activities are performed
3 within this state.

4 Now, DIRECTV is engaged in the packaging and
5 distribution of premium quality video
6 entertainment. You're going to hear testimony
7 today from a senior operations person at
8 DIRECTV who will testify in great detail to the
9 operations of DIRECTV.

10 The testimony will establish the importance of
11 DIRECTV's content, particularly its original
12 programming and programming such as the NFL
13 Sunday Ticket, which are exclusive to DIRECTV
14 subscribers.

15 You'll also hear about the importance of the
16 broadcast centers and the up-link facilities
17 and the sales and marketing activities and the
18 customer service activities; all of those
19 activities take place outside of South
20 Carolina.

21 Now, DIRECTV readily acknowledges that it does
22 have income-producing activities within the
23 state. We have set-top boxes at customer
24 locations. We have four local collection
25 facilities within the state. We readily



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1 acknowledge that those are income-producing
2 activities that are related to the provision of
3 our programming services.

4 Now, you will also hear testimony from the
5 Department and its witnesses that all of these
6 activities that occur throughout the United
7 States are completely irrelevant.

8 For instance, you will hear testimony from the
9 Department's economist that you can't consider
10 all these activities outside of South Carolina
11 because those are costs. They don't generate
12 income and that the only income-producing
13 activity is the customer turning on its
14 television and paying its bill.

15 You'll also hear testimony from the
16 Department's tax policy witness who will say
17 that the approach that the State is taking in
18 this case is good for the State and that
19 receipts factor should always be interpreted to
20 apply a market-based approach. In fact, the --

21 **THE COURT:** I think we would all have to agree that
22 if they get the maximum tax revenue out of you,
23 it is probably good for the State. We have to
24 decide if it's lawful, though.

25 **MR. ROBERTS:** We would probably concede that.



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1 In fact, if you take the Department's -- with
2 the opinions of the Department's experts,
3 DIRECTV itself conducts no income-producing
4 activities at all.

5 The Department's attempt to squeeze its theory
6 into the language of Section 12-6-2295 has to
7 be rejected. At the end of the day, the
8 Department is doing nothing other than looking
9 to the location of the customer for purposes of
10 determining DIRECTV's gross receipts from
11 within the state.

12 And this approach is not only inconsistent with
13 the plain language of the statute, Your Honor,
14 it's also inconsistent with settled case law.
15 For instance, in *Lockwood Greene* the court
16 adopted the place of activity approach, which
17 looks to where services are performed and when
18 it expressly rejected -- it expressly rejected
19 the origin of payment view, which looked to
20 where the customer was located.

21 You know, it's somewhat ironic that the same
22 Department who in *Lockwood Greene* was
23 advocating for place of activities is now
24 advocating for an origin of payment view in our
25 case.



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1 That being said, in reaching its determination,
2 the court in *Lockwood Greene* explained that the
3 business carried on by the engineering firm in
4 the state was reasonably measured by the
5 activities -- by the services performed by the
6 engineers in the state.

7 The court didn't say you look to where the
8 service was received. The court didn't say you
9 look to where the customer was. You look to
10 where the service was performed.

11 And, in fact, the court explicitly held that
12 the origin of payment view would not recognize
13 the proportion of the engineering firm's
14 business actually carried on in South Carolina.
15 To determine the extent of *Lockwood Greene's*
16 activities and the services performed in the
17 state during this period, the court looked to
18 the location of its payroll and it sourced its
19 receipts -- sourced its gross receipts based on
20 the ratio of its South Carolina payroll to its
21 total payroll.

22 In 2007, this Court in *Rent-A-Center* explained
23 that, "Furthermore, in 2007, *Lockwood Greene's*
24 interpretation of gross receipts from within
25 this state was codified at 12-6-2295(A)."



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1 Now --

2 **THE COURT:** And I've looked at that. I'm not so
3 sure that it was fully codified. I know that's
4 my own language. I'm going to have to
5 rethink -- that doesn't mean I'm going to
6 change my view in that case at all. It just
7 means my view that *Lockwood* was codified in
8 2295 -- I started looking at the language again
9 and I'm not so sure it completely codified it.
10 I'll have -- I assume y'all will educate me on
11 that today.

12 **MR. ROBERTS:** We will certainly educate you on that,
13 Your Honor.

14 **THE COURT:** Okay.

15 **MR. ROBERTS:** What you're going to hear from the
16 Department is that *Lockwood Greene* only applies
17 to so-called personal service providers and
18 that it doesn't apply to service providers like
19 DIRECTV because of so-called Department --
20 long-standing Department guidelines that were
21 referenced in *Lockwood Greene*.

22 Now, no one at the Department has been able to
23 explain to us what a "personal service
24 provider" is and the language in *Lockwood*
25 *Greene* certainly doesn't say anything about



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1 personal service providers.

2 Moreover, we've asked the Department in
3 discovery and in deposition of four witnesses
4 for copies of these so-called long-standing
5 guidelines and we haven't gotten a copy of
6 them. In fact, not one of the four people that
7 we deposed has ever even seen the guidelines.

8 Now, the Department's emphasis on the
9 guidelines is somewhat of a distraction. The
10 law in this case is clear. The statute and the
11 case law say that services are sourced to the
12 extent the services are performed in the state;
13 that is the place of activity.

14 Now, as I said before, DIRECTV readily
15 acknowledges that we have income-producing
16 activities in the state and you will also hear
17 testimony from DIRECTV's expert economist who
18 will testify that an economically appropriate
19 way of determining the extent that DIRECTV's
20 income-producing activities take place in South
21 Carolina is to look at the location of its
22 payroll and assets.

23 Now, the Department will argue that DIRECTV is
24 doing nothing other than adopting a
25 cost-to-performance approach and that South



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1 Carolina is not a cost-to-performance state.
2 The Department entirely misconstrues DIRECTV's
3 argument. DIRECTV is doing nothing other than
4 looking to the place of activity and looking to
5 where the services are actually performed as
6 the statute and case law requires. In fact --

7 **THE COURT:** Can I stop you here?

8 **MR. ROBERTS:** Yes, sir.

9 **THE COURT:** I don't want you to lose track, so --
10 but you said a couple of things and I want to
11 ask about. You said the economist will tell me
12 that I can make my determination based on the
13 location of the payroll and the assets.
14 Well, under that theory, you could have -- you
15 could set up your payroll outside of the state,
16 you could have assets outside of the state, but
17 actually perform the services significantly
18 within the state that argue that the percentage
19 should be all outside of the state because
20 that's where your payroll and assets are.
21 Isn't there a flaw in that argument?

22 **MR. ROBERTS:** Presumably one could do that, but
23 that's -- that's not our facts and what the
24 statute --

25 **THE COURT:** I know, but if that's your premise --



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1 I'm going with the premise.

2 **MR. ROBERTS:** Well, what the -- what this --

3 **THE COURT:** If that is the premise of the
4 economist -- and I'm just trying to verify the
5 authenticity -- the validity of the premise.

6 **MR. ROBERTS:** Let me try to explain what we're doing
7 and hopefully this will answer your question.
8 The statute says you look to income-producing
9 activity and the receipts are sourced to the
10 extent that the income-producing activity is
11 performed in the state.

12 So what our fact witness will do is we'll
13 establish where the income-producing activities
14 occur and all of the activities that DIRECTV
15 does.

16 **THE COURT:** That will be helpful.

17 **MR. ROBERTS:** But the statute then requires us to
18 locate where those income-producing activities
19 occur. And so -- and so what the economist
20 will do is, is using sound economic theory,
21 he's reviewed this and he's determined that a
22 reasonable way of locating where the
23 income-producing activities take place is to
24 look at where the payroll occurs, where DIRECTV
25 employees actually perform all of these



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1 services --

2 **THE COURT:** Okay.

3 **MR. ROBERTS:** -- that we're going to talk about, as
4 well as the location of its assets, which would
5 include the assets that we have in South
6 Carolina.

7 **THE COURT:** Is there a distinction between
8 activities and income-producing activities?

9 **MR. ROBERTS:** I think there could be. I think -- I
10 think in this case, the testimony that you will
11 hear today about DIRECTV's operations will
12 establish that, you know, the content
13 acquisition, all of these broadcast facilities,
14 the up-link facilities, you know, the people
15 who negotiate these contracts, those are all
16 income-producing activities that DIRECT --
17 which are related to DIRECTV's provision of
18 programming.

19 **THE COURT:** All right. I cut you off. Do you know
20 where you were so you can get back on track?

21 **MR. ROBERTS:** I do, Your Honor. I just had one
22 additional thought.

23 You know, DIRECTV's theory in this case is
24 consistent with the plain language of the
25 statute, with the theory of *Lockwood Greene*, as



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1 well as with sound tax policy. Thank you.

2 **THE COURT:** Well, how about *Mercury Motor Express*?
3 You cited that in your pretrial brief. How
4 does that fit into this case from your
5 perspective? I mean, I've read it, but tell me
6 about that.

7 **MR. ROBERTS:** Well, *Mercury Motor* involved a case in
8 which a taxpayer was a transportation company
9 hauling freight and the taxpayer conducted
10 activities both inside and outside South
11 Carolina. And the special apportionment
12 formula that applied to this type of company
13 basically said you compute your tax based on
14 miles in South Carolina over total miles.

15 **THE COURT:** Yeah.

16 **MR. ROBERTS:** And using that fraction, it was a
17 17 percent apportionment fraction. Now, the
18 taxpayer says that that was distorted; that
19 didn't fairly reflect its activities in the
20 state because the activities -- the only
21 activities that directly resulted in payment
22 were the activities in which the taxpayer
23 hauled freight into the state or picked up
24 freight in the state and hauled it outside the
25 state.



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1 **THE COURT:** All right.

2 **MR. ROBERTS:** And that accounted for only
3 one percent of its activity -- sorry, that
4 accounted for one percent of its income.
5 And what the Supreme Court said in *Mercury*
6 *Motor* is that, no, it was the solicitation,
7 it's the hauling, it's the picking up, it's all
8 of those activities that create the 17 percent.
9 All of those activities are part of its unitary
10 business and those were the activities that
11 helped it produce the income that was at issue.
12 And that's exactly -- that's on all fours with
13 DIRECTV.

14 **THE COURT:** That's what I'm trying to figure out
15 with -- if I could take the language out of
16 *Mercury Motor*, it said, "While each transaction
17 is necessarily incidental to the production of
18 its income," comma, "the transaction which
19 primarily earns the income is the hauling of
20 the freight." It went with -- or the court
21 said "primarily."
22 So would I follow the tenets of *Mercury Motors*
23 in analyzing this case regarding the -- looking
24 for what primarily produces the -- I'm not --
25 I don't see the phrase right now -- the



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1 income-producing activity?

2 **MR. ROBERTS:** Well, the hauling of freight for
3 DIRECTV, for instance, is akin to how its
4 programming is produced and how it gets to the
5 customers.

6 **THE COURT:** Yeah.

7 **MR. ROBERTS:** That's the up-link facilities, that's
8 the broadcast centers, and that's the
9 satellites. And what the court in *Mercury*
10 *Motor* said is that there are all these
11 activities, it's a unitary business, and all of
12 these activities have to be considered. And
13 it's the hauling of freight. We didn't say it
14 was the picking up and delivering of freight
15 only in South Carolina --

16 **THE COURT:** Well, I guess --

17 **MR. ROBERTS:** -- or else they would have sided with
18 the taxpayer in that case.

19 **THE COURT:** I guess what I'm asking is, *Mercury*
20 *Motor* seemed to be more of an "all or nothing"
21 kind of approach; whereas, here, when you say
22 "the extent," there's a percentage possibility,
23 correct?

24 **MR. ROBERTS:** That is absolutely correct, Your
25 Honor.



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1 **THE COURT:** All right. Thank you.

2 **MR. ROBERTS:** Thank you.

3 **THE COURT:** Mr. Condon?

4 **OPENING STATEMENT BY MR. CONDON:**

5 **MR. CONDON:** May it please the Court. This case is
6 about a commoditized service that produces
7 income only when it delivers its service
8 onto -- into the homes and onto the television
9 screens of South Carolina customers.

10 **THE COURT:** Wouldn't that be true with any service?
11 Let's say I'm selling -- I'll go back to
12 Lockwood. I mean, the engineers, they -- they
13 did their schematic drawings and et cetera in
14 South Carolina, but the -- under your -- how
15 you just started out, they -- when they -- the
16 client did not receive anything until -- or
17 anything of value until they sent them the
18 drawings and schematics. So, under that
19 theory, then would the drawings and schematics
20 be the service?

21 **MR. CONDON:** Well, Your Honor, what I just said was
22 related to DIRECTV and we make a distinction -

23 **THE COURT:** Okay.

24 **MR. CONDON:** -- for personal services in Lockwood.
25 Because we are, as Mr. Roberts pointed out,



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1 looking at in both cases, *Lockwood* and in this
2 case, what the income-producing activity is and
3 really where it is.

4 And when you get to personal services, the
5 *Lockwood* decision clearly stated that the
6 customer's buying, quote, the expertise and
7 time of an engineering professional. And
8 that's what in *Lockwood* the customer was buying
9 and primarily that's done when a *Lockwood* --
10 when an engineer sits at his -- or an architect
11 or whatever sits at his desk in his home
12 office, probably.

13 Here, similarly, we're just looking at the
14 income-producing activity and what is the
15 customer buying? The customer in this type of
16 service is buying the receipt of the signal
17 into his home and onto his TV screen. He's not
18 buying the services of an engineer in
19 California or a lawyer somewhere else
20 negotiating contracts.

21 **THE COURT:** Those services don't make up that which
22 he receives?

23 **MR. CONDON:** Could you repeat that?

24 **THE COURT:** Yeah. Those services, the engineer, the
25 negotiating of the broadcast rights, et cetera,



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1 that doesn't make up that which the customer
2 receives?

3 **MR. CONDON:** They are -- our position is they are
4 important steps, but intermediate steps and
5 similar to *Mercury Motors* that used the term
6 "incidental" transactions or incidental steps
7 to the income-producing activity.
8 So we certainly agree that they are important
9 steps, but it's not what the customer is
10 buying. It's not -- it's not what's generating
11 the income from the service point of view.

12 **THE COURT:** All right.

13 **MR. CONDON:** Your Honor, you'll hear that DIRECTV
14 does a lot of fancy things, you know, hiring --
15 you know, launching satellites, possibly, and
16 hiring a lot of well-qualified engineers,
17 rocket scientists, I'm sure. But these are, as
18 I just stated, intermediate steps in a process
19 whose ultimate goal is to deliver satellite TV
20 onto the -- into the TVs and onto the screens
21 of customers.
22 You'll likely be told -- and I think you were
23 already told -- that the Department is ignoring
24 all of these other activities, but we're not
25 ignoring those activities. We're just



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1 determining where the income-producing activity
2 is.

3 And, of course, as Your Honor knows, you know,
4 DIRECTV will get a full -- or an appropriate
5 income tax deduction for all of its costs
6 related to all of its activities.

7 But, in fact, it is the -- it is DIRECTV that's
8 ignoring the role of the customer subscriptions
9 in producing income. And we take the
10 position -- and you'll hear that in 2011,
11 DIRECTV started to apportion a small part of
12 subscription revenues to South Carolina based
13 on a payroll factor. But that's a very small
14 portion of South Carolina's subscription
15 revenues and we don't think that's -- that
16 rises to the level of recognizing the important
17 role of customer subscriptions.

18 What the Department is doing is following
19 Section 12-6-2290, which is now hidden up
20 there, but that's the one that says you use a
21 gross receipts ratio for service providers to
22 apportion that income for service providers;
23 that's what we're doing.

24 And we are -- have defined in our audit report
25 and in our determination what the numerator is,



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1 and that's the gross receipts in South Carolina
2 within South Carolina, and we believe those to
3 be a hundred percent of the subscription
4 revenues received from South Carolina
5 customers.

6 **THE COURT:** Well, that's what I was going tell you.
7 I don't think anybody is arguing about the
8 gross receipts aspect. They're just arguing
9 about the extent of the income-producing.

10 **MR. CONDON:** Right. And so that was my next point.
11 So the next point, we're also following
12 12-6-2295(A)(5) which is the one, of course,
13 that talks about income-producing activity and
14 has that "to extent" language.

15 We are following that. We have identified the
16 income-producing language -- or identified the
17 income-producing activity, the delivery of the
18 signal into the homes and onto the television
19 screens of its customers for South Carolina
20 customers. We know where that's happening.
21 That's happening right in South Carolina living
22 rooms all over the state, so.

23 So -- and then we are also following the "to
24 the extent" language, because we're only
25 apportioning to South Carolina the South



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1 Carolina subscription receipts.

2 We're not apportioning North Carolina or
3 Michigan or any other subscription receipts in
4 South Carolina. So we're following that part,
5 as well. We are only apportioning the receipts
6 to the extent that they -- the income-producing
7 activity is in South Carolina.

8 The Department concluded, as you know in the
9 determination, that it's --

10 **THE COURT:** Well, can I stop you here?

11 **MR. CONDON:** Yes -- yes, Your Honor.

12 **THE COURT:** When you say -- when you just said that,
13 then do you interpret 2295 to be "the extent"
14 language applies not based on an analysis of
15 what may occur within and without of this
16 state -- I don't know how -- I have trouble
17 wording that.

18 It seems to me that the way you did that is
19 you -- you said, okay, the "extent" language
20 only affects the analysis of how this state is
21 affected, as opposed to other states are
22 affected, and that is the purpose of that
23 language; as opposed to getting a specific
24 analysis pertinent to the state of South
25 Carolina as to whether or not to what extent



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1 occurs within this state and what extent the
2 business model has activity outside of the
3 state.

4 **MR. CONDON:** Yes, Your Honor, I think --

5 **THE COURT:** Did you follow that? Because I --

6 **MR. CONDON:** Yeah, I did. I think I did, Your
7 Honor.

8 **THE COURT:** All right.

9 **MR. CONDON:** And I think the result would be the
10 same regardless of how you interpreted what I
11 just said. But what I really -- what the view
12 is is -- and I don't know how many customers
13 DIRECTV has nationwide, but let's say they have
14 a hundred customers nationwide and we've got
15 ten percent in South Carolina.

16 **THE COURT:** Okay.

17 **MR. CONDON:** There are a hundred income-producing
18 activities all over the country and -- you
19 know, because they're happening in living rooms
20 all over the country. Ten percent of those
21 income-producing activities are happening in
22 South Carolina because South Carolina customers
23 are receiving those -- ten South Carolina
24 customers are receiving those here.
25 So we are looking at the income-producing



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1 activity on a global basis, on a nationwide
2 basis. It's just when we get to the extent of,
3 we only have to look at the South Carolina
4 customers, because only those are in South
5 Carolina, because those living rooms are here
6 in South Carolina.

7 **THE COURT:** All right.

8 **MR. CONDON:** Okay? So DIRECT -- so DIRECTV's
9 income-producing activity is -- for every one
10 of those South Carolina customers is right here
11 in South Carolina. Based on this, of course,
12 we believe that a hundred percent of the
13 subscription revenues from South Carolina
14 customers should be in the numerator, the gross
15 receipts ratio.

16 And you will hear that that's how -- that's how
17 DIRECTV originally filed their income tax
18 returns for 2006 through 2008, by putting all
19 the South Carolina -- all the subscriptions
20 from South Carolina customers in its numerator.
21 Of course, it then filed amended tax returns to
22 move to a cost-to-performance approach to
23 justify taking a hundred percent of those
24 subscription receipts out; which, of course,
25 gave rise to this review of their tax returns



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1 by the Department.

2 You'll hear from the Department's economic and
3 tax policy witness that the Department's
4 position on including the gross receipts or the
5 subscription receipts from South Carolina
6 customers in the numerator is justified and
7 there is sufficient evidence -- *Mercury Motors*
8 being one -- but there's sufficient evidence
9 and sufficient justification from other cases
10 and from an economic analysis to do that.

11 You will hear from the Department's employees
12 that this position that the Department has
13 taken in this case is consistent with how we
14 handle apportionment for cable television
15 companies and it's consistent with the
16 Department's long-standing guidelines.

17 **THE COURT:** Where are those guidelines?

18 **MR. CONDON:** Those guidelines were developed in the
19 '70s and, to our knowledge, they no longer
20 exist in written form, except that they were
21 written and entered into the record in
22 *Lockwood*. And so we hope to have Your Honor
23 take a look at those later, but -- so we do
24 have them in a written form. They were
25 stipulated to in *Lockwood*. But it appears as



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1 though they've been so ingrained into our
2 culture that a document no longer exists.

3 **THE COURT:** Well, that's interesting.

4 **MR. CONDON:** But the Tax Commission --

5 **THE COURT:** It becomes so ingrained that it
6 nothing -- it no longer needs to be in writing.

7 **MR. CONDON:** But you will hear -- well, one of the
8 reasons for that is, is years ago -- and I'm
9 not an expert at this, but maybe '70s -- '60s
10 '70s, maybe even into the '80s, nexus -- you
11 know, South Carolina or any state getting nexus
12 against an out-of-state company was a big
13 issue.

14 **THE COURT:** Yeah.

15 **MR. CONDON:** And so until that got resolved --
16 because now taxing authority states can get
17 nexus over companies that don't have a physical
18 presence in the state.

19 So until that got resolved, it was very -- it
20 was -- it was a new thing for taxing agencies
21 to kind of try to figure out how to source
22 revenues from various types of service
23 companies that may have a lot of activities in
24 other states, or maybe all their property or
25 payroll in other states, so. So it was



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1 developing at that time and I think that has
2 now changed because the nexus issues were
3 resolved quite a while ago.

4 **THE COURT:** All right.

5 **MR. CONDON:** Sorry for that long-winded answer or
6 explanation.

7 But you'll also hear that South Carolina is not
8 a cost-to-performance state for at least two
9 reasons. It's not in the statute, the
10 2295(A)(5) that was listed over here. The --
11 it is not there and I'll talk about that in a
12 minute.

13 And then, of course, our position is that
14 Lockwood Greene -- and not just our position,
15 but the Department's position since Lockwood
16 Greene is that Lockwood Greene did not impose
17 a cost-to-performance approach or a place of
18 activity test on all service providers.
19 Personal service providers, yes, but not all
20 service providers.

21 Regarding the Statute 12-6-2295(A)(5) --

22 **THE COURT:** Can you give me the theory for that
23 distinction, the theory for having a
24 distinction for personal service providers
25 versus other providers?



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1 **MR. CONDON:** Well, the -- there's really two issues
2 related to those.

3 **THE COURT:** And if I'm throwing you off and you want
4 to respond later, I --

5 **MR. CONDON:** No, no, I'm happy to do it now, Your
6 Honor.

7 But, as I stated earlier, in *Lockwood*, the
8 court used the phrase "experience and time."
9 It really focused on the customer of a
10 professional service firm was buying the
11 experience and time of a professional engineer,
12 in this case.

13 So -- and then it said looking at -- it didn't
14 use the word "payroll." Payroll had been
15 addressed in a previous paragraph, but, in
16 essence, I think it was referring to payroll.
17 "Looking at the time spent," I think it said,
18 of the engineer is a reasonable way to measure
19 what he's doing.

20 So looking at the experience and time -- even
21 though *Lockwood* did not use the term
22 "income-producing activity," it's clear, I
23 think, in the opinion that looking -- it found
24 that the location, the place of activity of the
25 engineer, his office, was where he was using



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1 that experience and time for the benefit of the
2 customer.

3 Alternatively in DIRECTV, we're still looking
4 at the income-producing activity, but the
5 customer is not buying the experience and time
6 of anybody; i.e., that's the distinction with
7 personal services. He's buying a service; in
8 this case, it's a viewable program.

9 **THE COURT:** All right.

10 **MR. CONDON:** So -- and then the other thing, the
11 other part of that is whether
12 cost-to-performance plays a part in any of
13 that.

14 In *Lockwood*, the Department actually used -- I
15 guess during its audit, used a payroll formula
16 to, in fact, estimate the gross receipts of
17 *Lockwood* from within South Carolina to put in
18 the numerator.

19 The Department didn't have all of -- I mean, I
20 think it could be taken for granted, the
21 Department wouldn't have had all of the
22 taxpayer's records. The taxpayer likely could
23 have used invoices that it billed its customers
24 to actually come up with an actual number. So
25 payroll was really just used as a proxy to



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1 calculate actual gross receipts from within
2 South Carolina.

3 So that's the position of why Lockwood -- the
4 distinction Lockwood makes in personal
5 services, time and experience, and that it
6 really didn't require a payroll or any other
7 cost factor. It used it as a proxy when the
8 Department didn't have another -- didn't have
9 records of the taxpayer to make a more accurate
10 determination.

11 **THE COURT:** All right.

12 **MR. CONDON:** So I talked about the statute.
13 2295(A)(5) does not have cost-to-performance.
14 There's a model act about apportionment you
15 probably know about, the Uniform Division of
16 Income and Tax Purposes Act, or UDITPA.

17 **THE COURT:** Don't know about that.

18 **MR. CONDON:** You don't know about that? You'll hear
19 about it, but --

20 **THE COURT:** I'm going to dip into UDITPA, huh?

21 **MR. CONDON:** Yeah. So UDITPA -- but it's the
22 Uniform Division of Income for Tax Purposes
23 Act. It's a model act for apportionment. It
24 was created in the late '50s and it hasn't
25 changed since.



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1 It's Section 17 is the section that's
2 applicable to apportioning net income for
3 service providers. So its Section 17 is
4 synonymous to our 2290, basically, and
5 2295(A)(5) -- or the purposes are synonymous.
6 What you'll see is twenty -- is when our
7 General Assembly in 2006, effective for 2007
8 tax years, adopted Section 12-6-2295(A)(5) to
9 help explain gross receipts that were in
10 12-6-2290, when our General Assembly adopted
11 that, it basically adopted Section 17 of
12 UDITPA. But our General Assembly omitted the
13 last five words of UDITPA Section 17 and those
14 last five words were, quote, "based on
15 cost-to-performance."

16 So it's absolutely clear that our General
17 Assembly if it wanted to make South Carolina a
18 cost-to-performance state, that it absolutely
19 could have by adding those five words. It took
20 the rest of Section 17. It could have added
21 those five words, but it chose not to.

22 **THE COURT:** And that is significant to me for what
23 reason?

24 **MR. CONDON:** That's significant because I think it
25 shows legislative intent, that the Legislature



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1 did not mean South Carolina to be a
2 cost-to-performance state. So using all of the
3 payroll and property from out of state as the
4 general rule, as a mandated general rule to
5 apportion income for all service providers.

6 **THE COURT:** And I would like to know down the road
7 under what theory of statute -- or can I
8 pursuant to the laws of statutory construction
9 come to a conclusion that the failure to adopt
10 a new -- a portion of the Uniform Act carries
11 significance as to the meaning of our current
12 act? That goes for both sides.

13 **MR. CONDON:** Okay. Thank you, Your Honor.

14 **THE COURT:** All right.

15 **MR. CONDON:** So, just briefly, and then I'll
16 close -- and also -- so that was talking about
17 the statute not including cost-to-performance.
18 Also, in *Lockwood Greene*, you'll hear that for
19 decades -- that was a 1987 case. Since that
20 time, the Department has never treated *Lockwood*
21 *Greene* as imposing the place of activity test
22 on all service providers.

23 **THE COURT:** All right.

24 **MR. CONDON:** Only on personal service providers.
25 And, of course, since *Lockwood Greene*, we've --



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1 the Department has never interpreted *Lockwood*
2 to mandate a cost-to-performance approach on
3 all service providers.

4 Thank you, Your Honor, and we're ready to
5 begin.

6 **THE COURT:** Well, not quite.

7 **MR. CONDON:** Not ready? Okay.

8 **THE COURT:** How about the audience approach?
9 Because I haven't read your response. Are
10 you -- or your pretrial brief. Are you arguing
11 that approach in the pretrial brief?

12 **MR. CONDON:** No, Your Honor. The audience
13 approach -

14 **THE COURT:** Okay. If you're not arguing that, I
15 don't need to ask you about it.

16 **MR. CONDON:** I mean, it's a similar approach to what
17 we're arguing --

18 **THE COURT:** Okay.

19 **MR. CONDON:** -- because in the audience approach --
20 that was a Florida statute that -- I believe it
21 was Florida.

22 **THE COURT:** Well, I think they said y'all argued the
23 audience approach that 23 states had adopted?

24 **MR. CONDON:** That was in a footnote in our
25 Determination, in our Department Determination,



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1 but --

2 **THE COURT:** So I don't need to consider that now?

3 **MR. CONDON:** I don't think so, Your Honor.

4 **THE COURT:** Okay.

5 **MR. CONDON:** I mean, that was an analogy of what
6 other states are doing that are similar to what
7 we're doing.

8 **THE COURT:** Okay. All right. That's one more thing
9 I can delete off my outline.

10 **MR. CONDON:** Okay. Thank you.

11 **THE COURT:** All right.

12 **MR. ROBERTS:** And, Your Honor, I have four quick
13 points, if I may.

14 **THE COURT:** Are we having counterpoint on opening
15 statements? Never done that before, but -- all
16 right. Do you believe that they've made a
17 statement that is inaccurate that you need to
18 correct?

19 **MR. ROBERTS:** I believe there are -- there's at
20 least one statement that I would like to
21 correct which is inaccurate.

22 **THE COURT:** Okay.

23 **OPENING STATEMENT BY MR. ROBERTS (Continued):**

24 **MR. ROBERTS:** Your Honor, they will talk about the
25 tax returns and the position that DIRECTV took



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1 in its tax returns. I would just like to
2 clarify for the Court that we're in court now
3 and the position that we are taking in this
4 case is that a percentage of its total
5 subscription revenue should be included in the
6 numerator of the receipts factor.

7 In fact, you will hear the testimony from our
8 economist who will testify that on average for
9 this period, .85 percent of DIRECTV's
10 income-producing activities took place in South
11 Carolina. And so, mechanically, the way that
12 this would work would be that we -- similar
13 to -- almost exactly what happened in *Lockwood*.
14 We are using payroll and assets as a proxy.
15 *Lockwood* used payroll as a proxy, exactly as
16 Mr. Condon just discussed.

17 And what we would do, then, is take that .85
18 percent times DIRECTV's total subscription
19 revenue and then that would go in the numerator
20 of the receipts factor and then you would
21 calculate your receipts factor numerator
22 divided by the -- with denominator. So I just
23 wanted to clarify that for the Court.

24 **THE COURT:** All right.

25 **MR. ROBERTS:** Thank you, Your Honor.



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1 **THE COURT:** Mr. von Lehe, did you ...

2 **MR. VON LEHE:** No, Your Honor. I put him up to
3 that, so I was going to kind of --

4 **THE COURT:** Oh.

5 **MR. VON LEHE:** -- support him in it. So I just --
6 he said it, so.

7 **THE COURT:** All right.

8 **MR. VON LEHE:** Thank you.

9 **THE COURT:** Okay. Call your first witness.

10 **MR. ROBERTS:** DIRECTV would like to call Phil
11 Goswitz to the stand, please.

12 **PHILIP GOSWITZ,** having been duly sworn, testifies and
13 examines as follows:

14 **MR. GOSWITZ - DIRECT EXAMINATION BY MR. ROBERTS:**

15 Q: Can you please state your full name for the
16 record?

17 A: Philip Joseph Goswitz.

18 Q: And who is your current employer?

19 A: DIRECTV.

20 Q: And how long have you been employed by DIRECTV?

21 A: I started with the parent to DIRECTV in 1979 as
22 a satellite technician and then worked through
23 school at Hughes Electronics, Hughes Space and
24 Communications Group. I worked on all of the
25 different aspects of building satellites and



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1 then in 1996, after building the first
2 satellite for DIRECTV Latin America, I moved
3 over to DIRECTV and I've been with DIRECTV ever
4 since.

5 Q: And what's your current position at DIRECTV?

6 A: I'm the senior vice president of space and
7 communications and video.

8 Q: And what are your responsibilities in your
9 current position?

10 A: I've got three principal areas of
11 responsibility. I am responsible for all of
12 our video processing, so everything that has to
13 do with processing the video signal and
14 creating a very high quality video service. We
15 bring in very high data rate video and my group
16 is responsible for all of the video
17 compression.

18 And we also do the space part of it -- that's
19 the video part. The space part is the
20 satellites and the rockets. I guess I'm the
21 rocket scientist. And that's what most of my
22 career was; that's my expertise.

23 And then we also do all of the communications,
24 so the communications from the broadcast
25 centers up to the satellites, the satellites



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1 themselves, and then the equipment in the
2 subscriber's home, the rooftop dish, and all of
3 the communications through the home.

4 Q: And what position did you hold at DIRECTV
5 during the 2006 through 2011 period that we
6 have at issue here?

7 A: I was -- in 2006, I was the vice president of
8 space and communications and then in 2010 was
9 promoted to senior vice president, and included
10 the video and the broadcast engineering, in
11 addition to space and communications.

12 Q: Okay. And what were your responsibilities in
13 that position?

14 A: I was just the rocket and satellite part of
15 that.

16 Q: And as the result of your position at DIRECTV
17 during 2006 through the 2011 period at issue
18 here, can you just please describe your
19 familiarity with the various aspects of
20 DIRECTV's business operations?

21 A: Sure. DIRECTV -- DIRECTV started as a company
22 that did direct to home satellite distribution
23 of video. So our principal aim is to package
24 and deliver high quality video entertainment
25 and we use satellites as the principal delivery



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1 mechanism.

2 We use -- we spend a lot of our time trying to
3 procure the highest quality content, to set up
4 exclusive arrangements with content that we
5 believe will set us apart.

6 We like to think we have a premier brand at
7 DIRECTV, so we provide things like the NFL
8 Sunday Ticket so that our subscribers can see
9 every game; that's an exclusive arrangement
10 that we have with the NFL. Very expensive, but
11 we think worth it.

12 We do special coverage of events like the
13 Masters, close by here at Augusta, that puts up
14 a mosaic mix on a particular channel so that
15 you can see the leaders, Amen Corner, a lot of
16 different views around the course that you can
17 appreciate the event. And then our customers
18 can go to that and select whichever --
19 whichever particular view they would like and
20 that gives our customers an exclusive,
21 differentiated kind of sporting experience.

22 So it's the creation of a unique video
23 experience, along with the delivery of classic
24 video content, like ESPN and HBO, that kind of
25 builds our brand and that we use to try to set



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1 us apart.

2 So the biggest part, I think, is the -- is
3 the -- is the procurement and the curation of
4 high quality content and all of the broadcast
5 operation associated with collecting,
6 processing that signal, and distributing it to
7 our customers through our broadcast
8 infrastructure, which includes the satellites.
9 You know, we take a lot of pride in our
10 marketing and sales. You know, we try to have
11 very distinctive advertising. Like it or not,
12 most people probably know about the Rob Lowe
13 commercials and things like that. And then we,
14 of course, have our customer service, which we
15 spend a lot of time and a lot of -- a lot of
16 effort into making that as good as possible.

17 Q: Thank you. And what do you consider to be kind
18 of the principal value drivers of DIRECTV's
19 business?

20 A: Pretty much what I just said. It's kind of
21 content, the broadcast operations and
22 distribution, the marketing and sales, and
23 the -- and the customer care.

24 Q: All right. Now, what activities do you
25 consider to be necessary for DIRECTV to provide



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1 its programming activities or what activities
2 are related to its programming services?

3 A: We -- we do a -- we do a lot of negotiation
4 with content providers, to try to set up deals
5 that allow us to provide the highest quality
6 programming without having to carry a lot of
7 sub-tier programming.

8 Programming providers like to monetize all of
9 their content and most of it -- a lot of it is
10 not as popular with our customers, so we use
11 our -- the size of our company and our brand in
12 order to negotiate only the highest quality
13 programming that we carry.

14 We do put a lot of effort into creating a
15 unique sporting experience for sports fans.
16 So, for example, we're at the Super Bowl now
17 and we're creating an entire week of events
18 called SuperFan around the Super Bowl. We'll
19 do the same thing with the Augusta National
20 Golf Tournament and other tournaments that take
21 place.

22 So we put a lot of effort into our own content
23 creation and positioning our content uniquely.
24 So I think a lot of it has to do with the
25 creating a -- just a premier quality video



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1 entertainment that we then package and
2 distribute.

3 Q: Where is DIRECTV's corporate headquarters
4 located?

5 A: The company started in Los Angeles and -- and
6 that's principally where all of our -- all of
7 the business units within our company reside.
8 We started to have a -- also a corporate office
9 in -- as you can see there (indicating) in New
10 York. So we have a corporate office in
11 Rockefeller Center and -- and that's where
12 we're principally located.

13 Q: And what functions are housed at the
14 headquarters in California that you mentioned?

15 A: We've got the bulk of our operations, so we
16 have all of our executive offices. We have
17 finance, legal, human resources, IT. We have
18 our core engineering functions that are there.
19 We also have the -- the areas of sales and
20 marketing and customer care.

21 Q: All right. You mentioned a few minutes ago
22 that content acquisition was one of the
23 principal value drivers. Why is the type of
24 content important to DIRECTV?

25 A: Well, that's what -- as much as I like to think



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1 that they love the satellites, it's the --
2 actually the football and the HBO and the
3 movies and the entertainment experience. So
4 our customers -- we like to say "content is
5 king" and so the procurement and the -- the
6 positioning of that content is -- is -- is
7 really the key.

8 Q: Okay. And during the 2006 through 2011 period
9 at issue, what types of general types of
10 programming were offered?

11 A: We have -- you know, we -- the first type of
12 programming that we have are movies, so we get
13 movies through negotiated arrangements with the
14 studios. Then we have network television, so
15 we have the major classic premier networks like
16 HBO and ESPN and Starz and things like that.
17 And then -- so that's the second type.
18 The third type are kind of our premier sporting
19 events, NFL being the -- the marquee that we
20 have that exclusive arrangement for Sunday
21 Ticket with. But all the other leagues and --
22 and we try to have unique experiences for our
23 customers; things like, for tennis fans you --
24 you have this unique DIRECTV mosaic where you
25 can go in and watch several matches at once at



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1 Wimbledon, for example.

2 And then the fourth would be local channels, so
3 that people get their -- within a given market
4 area, they get their ABC, CBS, NBC, FOX, as
5 well as all the -- all the local channels in a
6 given market.

7 Q: What type of original programming is offered by
8 DIRECTV?

9 A: We do -- we do several types. We do our own
10 series, so we have a series like "Rogue" or
11 "Sunday Night Lights" -- "Friday Night Lights",
12 which is kind of a football show, high school
13 football show.

14 We've got our own originated series. We have
15 our own originated sports. We do specials
16 around Super Bowl or around major events. We
17 do morning -- morning sportscast shows that are
18 on our audience network. We do special
19 pay-per-view events for boxing. We have our
20 own branded kind of ultimate fighting, called
21 "Bare Knuckle Boxing," BKB, and we have our own
22 sporting events like that. And then we also
23 have Guitar Sessions. We have musical specials
24 that we film.

25 Q: And where are the employees who are responsible



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1 for developing that programming located?

2 A: In Los Angeles.

3 Q: And you mentioned a few minutes ago about the
4 Masters experience. Can you provide a little
5 more detail as to exactly what that is?

6 A: Sure. We have an arrangement, exclusive
7 arrangement with CBS and the Masters in order
8 to put multiple cameras out on the course so
9 that we can see -- you see the -- the network
10 coverage of the tournament that's provided by
11 CBS, but we also have a fixed camera on Amen
12 Corner.

13 We have a fixed camera on some of the marquee
14 groups, the leader group, and -- and then the
15 16th hole, some of the classic holes, 11, 12,
16 13. And customers can -- if they love a
17 particular hole, they can select and watch only
18 that hole, or they can watch -- go back to the
19 network coverage or they can just follow the
20 leaders.

21 Q: And how does DIRECTV develop that programming?

22 A: Well, we -- our content group and engineering
23 work together to create a new technology that
24 provided this multi-pane experience, our
25 so-called mix channel. And by working



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1 together, we were able to brainstorm and create
2 this kind of unique technology that -- that
3 we've trademarked and patented and it allows us
4 to create just an immersive differentiated
5 experience for, you know, kind of high-end
6 sports fans.

7 Q: And, again, I think you briefly touched on
8 this, but what exactly is the NFL Sunday
9 Ticket?

10 A: The NFL Sunday Ticket is an exclusive
11 arrangement with the NFL whereby we can show,
12 and we do show, all -- every single NFL game.
13 So there's two sets of games on any given
14 Sunday, the morning and the afternoon games,
15 and we show all of them at once.
16 So in order to view that, a customer goes to --
17 in the 700s. You watch -- there's a mix
18 channel, for example, that shows all of the
19 games at once and then you're allowed to, by
20 selecting on that pane, watch whichever game
21 you want or you can watch the mosaic that has
22 all of them.

23 Then we have two kind of special feature
24 additional channels that we actually create and
25 produce in our Los Angeles broadcast center.



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1 One is called the -- the Red Zone and the Red
2 Zone refers to the scoring -- you know, you're
3 in the red zone when you're within ten yards of
4 the goal line.

5 It refers to the highlights, so it shows
6 highlights around the league, special plays.
7 That allows our customers to instead of trying
8 to frenetically go between games, if they don't
9 have a favorite team, they can just watch the
10 highlight channel.

11 And then the other thing we've created is
12 called Fantasy Zone, that has a special focus
13 for people who are fantasy football fans. It
14 allows you to track individual player
15 performance and scores so that you can keep up
16 with your fantasy football, which has become --
17 we just started that this year and it's very
18 popular.

19 Q: And you mentioned several types of original
20 programming. Was that type of programming
21 offered during the 2006 through '11 period, as
22 well?

23 A: Yes. From what I just talked about, the only
24 thing that was -- that just recently innovated
25 was that Fantasy Zone, the Red Zone, and the



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1 NFL Sunday Ticket all at this ...

2 Q: What's the importance of these types of
3 exclusive arrangements that DIRECTV has with
4 third parties like the NFL?

5 A: You know, our goal is to create a
6 differentiated experience, something that our
7 customers can turn to or that -- from a
8 competitive perspective, when a customer is
9 looking at different entertainment options,
10 Comcast or AT&T U-verse or Verizon FiOS or
11 whatever other services are available in your
12 area, DIRECTV wants to have a distinct brand.
13 We like to -- we believe our brand we've
14 created over the last 20 years is around a
15 premiere video experience and especially for a
16 premier sporting experience.

17 Q: Okay. You also mentioned that DIRECTV acquired
18 programming from third parties and you
19 mentioned, I think, ABC and ESPN and several
20 others. How are DIRECTV's arrangements with
21 those content providers memorialized?

22 A: Well, we -- we have a large group of
23 hard-working lawyers that negotiate with the
24 studios and with all the leagues to kind of
25 around the -- around the -- year-around



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1 negotiations with all the different content
2 providers.

3 The cost of content has become one of the
4 biggest costs of our business. We -- we just
5 negotiated an NFL deal which is about, I think,
6 one and a half billion dollars a year for that,
7 for those rights, so they're one of the largest
8 costs of our business.

9 Q: And where are the employees located who
10 negotiate those agreements?

11 A: Los Angeles.

12 Q: And which legal entity are those employees
13 employed by?

14 A: DIRECTV, Inc.

15 Q: Which legal entity holds the contracts with the
16 content providers?

17 A: DIRECTV, Inc.

18 Q: Okay. How does -- would DIRECTV collect the
19 programming content from the national broadcast
20 networks like CBS and ABC?

21 **THE WITNESS:** Is it okay if I talk to the chart?

22 Your Honor, may I --

23 **THE COURT:** Talk to the chart?

24 **THE WITNESS:** May I approach the chart?

25 **THE COURT:** Okay.



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1 **THE WITNESS:** I can kind of show you from up here.

2 **THE COURT:** I'll let you use the chart --

3 **THE WITNESS:** Okay.

4 **THE COURT:** -- and talk to the rest of us.

5 **THE WITNESS:** So the content comes from -- for
6 example, I'll take HBO, for instance. HBO is
7 in New York and our up-link -- all of our
8 national up-links are in California, here in
9 Los Angeles.

10 So what we typically do is fiber the content
11 across the country. Our satellites are
12 actually sitting up here. You can see we have
13 11 satellites that are kind of sitting over the
14 center of country. They're actually 22,000
15 miles above the earth and they're actually
16 going about mach ten, so they're going very
17 fast, 7,000 miles per second, and -- but they
18 appear stationary because they're rotating once
19 every 24 hours, their orbital period, so they
20 look stationary to the Earth that's rotating at
21 the same rate.

22 And so what we do is we either -- we collect
23 most of that via fiber. So our national -- we
24 put down two types of beams of energy. One is
25 a beam of energy from the satellite that covers



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1 the entire United States, as well as Alaska,
2 Hawaii, and Puerto Rico. Or we put down tight
3 little beams of energy that just provides local
4 channels to a given market.

5 So our -- for the various types of content that
6 we have, from the studios, we fiber the
7 content, the movies from the studios to our
8 broadcast centers.

9 For our sporting events, we pick up the content
10 that's provided either by the service provider
11 satellites. For example, if ESPN is doing the
12 College National Championship, like last night,
13 we picked that up from a satellite that was
14 broadcasting it that was used by ESPN to go
15 from the game in Texas back to our broadcast
16 center, or we use fiber.

17 Q: All right. I think you mentioned that -- about
18 the broadcast centers. Where are the broadcast
19 centers located during the 2006 through 2011
20 period?

21 A: We have two central broadcast centers, the
22 first is Castle Rock, Colorado; that was the
23 original broadcast center when the company
24 started in 1994. And then in 1998, we created
25 the second broadcast center, which is in Los



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1 Angeles. So those are the two central
2 broadcast centers.

3 Q: How does -- would DIRECTV collect the
4 programming from the local broadcast stations?

5 A: Local broadcasts are -- you know, we have a lot
6 of channels. We have several hundred -- over
7 200, for example, high definition national
8 channels, but we have over 1500 local channels.
9 So what we have to do is, every single
10 market -- there's 210 markets in the United
11 States, designated market areas which are
12 Nielsen assigned areas for -- that have --
13 going way back to the original off-air
14 broadcast of satellites of -- excuse me, the
15 original off-air from antenna towers
16 distribution of television back in the '50s and
17 '60s.

18 Those designated market areas each have their
19 own ABC, CBS, NBC, FOX, et cetera, public
20 stations, free-to-air stations. And so they
21 pose a particular challenge to get the
22 programming to the satellites.

23 So what we do in those instances is in each
24 market, each of the 200 -- in the 50 states,
25 there's 210 designated market areas. We have



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1 to collect the off-air signals and fiber them
2 to an up-link facility.

3 So what we do is, each market has a local
4 collection facility, which is just an antenna
5 and a video encoder; usually an antenna and a
6 small rack of equipment. That signal then
7 collects from all 210 markets and takes them to
8 six different up-links throughout the United
9 States.

10 We've got one in LA. You can see one in
11 Arizona, one in Washington, one in Minnesota,
12 one in Virginia, and then one in New Hampshire.
13 We also have an antenna that we use for
14 up-linking in Atlanta, but -- so the basic
15 architecture for local channels is that within
16 each of these 210 markets, an LCF is used to
17 distribute back to the six up-links which go to
18 the satellite and then down to our customers.

19 Q: And how many local collection facilities were
20 in South Carolina during the 2006 through '11
21 period?

22 A: We had four.

23 Q: And where were those facilities located?

24 A: We have Charlotte, Columbia, Greenville, and
25 Myrtle Beach.



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1 Q: And which legal entity owned of the local
2 collection facilities?

3 A: DIRECTV, Inc.

4 Q: What geographic area are local collection
5 facilities typically located in?

6 A: Well, the -- they're close to the central tower
7 that used to -- back before satellite and
8 before cable, when there -- every city has kind
9 of a central high-point location that it
10 broadcasts its radio signals, its television,
11 using UHF frequencies and VHF frequencies,
12 so -- and people used to put up aerial antennas
13 on their roofs. So everything is kind of
14 developed around that. So our local collection
15 facility is typically near that radio frequency
16 tower.

17 Q: A few minutes ago you discussed designated
18 market areas. What exactly is a designated
19 market area?

20 A: A designated market area is a designation from
21 the Nielsen company that for a long time has
22 been measuring consumer behavior, and with the
23 advent of television and -- well, radio before
24 and then television after, they broke the
25 United States up into 210 markets.



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1 Q: And how many designated market areas cover
2 South Carolina?

3 A: Seven.

4 Q: And what counties in South Carolina are covered
5 by those DMAs?

6 A: Well, you've got the four that I just listed.
7 You've got Charlotte, Columbia, Greenville, and
8 Myrtle Beach. But then you've also got one
9 from Charlotte, North Carolina, that comes down
10 into -- it covers part of South Carolina.
11 You've got Savannah, Georgia, and you've got
12 Augusta, Georgia.

13 Q: And what's the relevance of what we've
14 designated market area to the local programming
15 that a customer can watch?

16 A: By law, you can only view local channels in
17 your -- from your designated market area. So
18 the challenge for DIRECTV is we have to -- for
19 example, in Columbia, South Carolina, we have
20 to take channel four and get it to the
21 satellite, send it up to the satellite, send it
22 back down, and it has to be viewable only to
23 consumers in Columbia, South Carolina.

24 Q: And you mentioned, for example, that the
25 Charlotte, North Carolina, designated market



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1 area covered areas in South Carolina, as well.
2 What local programming would South Carolina
3 customers in that designated market area watch?

4 A: They watch the -- they watch the local
5 programming that's in that designated market
6 area. So if you're in a part of South Carolina
7 that's near Charlotte and you're in the
8 Charlotte designated market area, then you
9 watch Charlotte local programming. If you're
10 in Savannah, you watch Savannah local
11 programming. If you're in Augusta, you watch
12 Augusta local programming, if you're near the
13 edges of those -- if you're in those designated
14 market areas which actually cover both states.

15 Q: And let's just take Charlotte, North Carolina,
16 for example. Would the programming in that
17 designated market area be collected from local
18 collection facilities in South Carolina or in
19 North Carolina?

20 A: The -- the local collection facility for
21 Charlotte is in Charlotte; it's in North
22 Carolina.

23 Q: You mentioned before that the national
24 programming from the HBOs, things like that,
25 were sent to the broadcast centers. Can you



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1 describe the functions of the broadcast
2 centers?

3 A: Sure. The broadcast center has a lot of
4 functions, but for each of the different
5 content types, for movies, they -- we receive
6 all of the movies in a very secure format from
7 the studio, so piracy is one of the biggest
8 problems in our -- in our industry. So having
9 a highly secure protected environment,
10 encrypted and highly secure environment for
11 movies is critical.

12 And then we have play-out of the movies. So
13 the movies are sent through all of our video
14 processing equipment to compress the signals.
15 Quality assurance is done to make sure that the
16 copy is perfect and then it's sent to the
17 satellite and down to our customers.

18 For network programming, we receive all of the
19 fiber feeds and everything comes in with
20 different video formats, so we have to convert
21 those to a standard format, we then compress
22 it, and then send it to the satellite, which
23 goes down to our customers. We have sporting
24 events, sporting -- sports, we do a lot more of
25 our production around.



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1 So, for example, the NFL feeds all come in, we
2 create a mix channel for the NFL Sunday Ticket
3 experience. We then have a production studio
4 that takes all the games, views them in real
5 time with a producer, actually creates a show
6 called The Red Zone that then shows the
7 highlights with a live commentator and host
8 taking you from game to game.

9 So sporting events has a lot of production in
10 addition to the video distribution and then we
11 have our local channels. Local channels are
12 done not -- are done at the broadcast centers,
13 but they're also done at these other up-link
14 facilities, so we have the six up-links that I
15 described earlier.

16 Q: And what types of employees are involved in the
17 operations of the broadcast centers?

18 A: We have all sorts of broadcast technicians and
19 broadcast engineers of various types, from
20 electrical to software to -- to encryption
21 specialists.

22 We have all of the entertainment types. We've
23 got cameramen. We've got production experts.
24 We've got video operators. We've got all kinds
25 of entertainment technical direction. So



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1 you've got a diversity of personnel from
2 broadcast technicians to real sports
3 production.

4 Q: Okay. And where do those employees primarily
5 work?

6 A: In Los Angeles.

7 Q: You mentioned that --

8 A: We have --

9 Q: Sorry.

10 A: -- in Los Angeles for the Los Angeles broadcast
11 center and then in Castle Rock, Colorado, south
12 of Denver for the Colorado broadcast center.

13 Q: You also mentioned that local programming was
14 sent to the regional up-link facilities.
15 Please describe the functions of the up-link
16 facilities.

17 A: The up-links facilities are pretty much, they
18 collect the local channels for, on average, 210
19 divided by six different markets, so each one
20 is responsible for collecting all of the local
21 channels from the local collection facilities
22 in their area.

23 So a local collection facility receives the
24 off-air signal, interactive equipment
25 compresses the signal, puts it on fiber, that



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1 goes to the up-link facility, and the up-link
2 facility uses a large antenna to broadcast the
3 signal to the satellite. The satellite
4 receives it and sends it to the -- our
5 customers.

6 Q: Which legal entity owns the broadcast centers?

7 A: DIRECTV Operation.

8 Q: And which legal entity owns the up-link
9 facilities?

10 A: DIRECTV, Inc.

11 Q: Where's the local programming sent after it
12 reaches the up-link facilities?

13 A: The local programming after it reaches the
14 up-link facility is sent up to the satellite.

15 Q: And where is the national programming sent
16 after it reaches the broadcast centers?

17 A: Let me just answer the last one a little more
18 precisely. The -- the local channels are sent
19 up to the satellites but they're down-linked in
20 little spot beams.

21 So we create two types of beams from our
22 satellites, one covers the entire United States
23 with the same programming, and one puts down a
24 little spot of energy that contains only the
25 local channels for one or a small set of



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1 designated market areas.

2 So for local channels, the LCF sends signals to
3 the up-link that goes to the satellite and it
4 comes down in spot beam, a tight little spot
5 beam on that market.

6 Q: You mentioned that national programming
7 would -- I think you described as conus beam.
8 So would people all throughout the country
9 receive the same signal?

10 A: Right.

11 Q: Okay. And with local programming and the spot
12 beams that you mentioned, is it possible that
13 people in separate DMAs could receive the same
14 programming?

15 A: Yes. So we put down this -- as tight a beam of
16 energy as we can, but we typically cover
17 multiple designated market areas. So each beam
18 of energy carries multiple DMA's worth of
19 content, of channels, of local channels. And
20 then we use conditional access to only allow
21 the customers in a given designated market area
22 to see their programming. They're blocked from
23 seeing, for example, NBC in the adjacent DMA.

24 Q: How many satellites did DIRECTV own during 2006
25 to '11 period?



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1 A: Eleven.

2 Q: And which legal entity owned the satellites?

3 A: DIRECTV, Inc. I'm sorry, DIRECTV Enterprises.

4 Q: What's the importance of the orbital slots that
5 the satellites occupy?

6 A: They're just a vital crown jewel of the
7 company. They -- we have orbital slots that
8 see the entire United States, so they're very
9 centrally located. So customers from the tip
10 of Florida to Texas up to Washington or to
11 Maine, wherever you are in the United States,
12 you have a clear view of the satellites. So we
13 have a single dish that can see all of our
14 satellites.

15 And that's the -- they represent the spectrum,
16 the pipe; that is often referred to as our
17 broadcast pipe. We have a very -- a very, very
18 high band width, high through-put fast pipe
19 into people's homes that represents the
20 spectrum from our satellites into our
21 subscribers dish.

22 Q: Okay. So we've got the programming up at the
23 satellites. Please describe how a customer
24 receives the programming.

25 A: The customer puts a dish on their roof and, as



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1 I said, the satellites are orbiting but they
2 appear motionless. So an installer puts a
3 satellite on our customer's home and the
4 satellite is pointed -- the dish is pointed at
5 the satellites to receive the signal.

6 **THE COURT:** Did you say -- I think you might have
7 misspoke. Did you say puts the satellite or
8 satellite dish on the customer's home?

9 **THE WITNESS:** Yeah.

10 **THE COURT:** I didn't hear "dish."

11 **THE WITNESS:** The dish.

12 **THE COURT:** Okay.

13 **THE WITNESS:** Sorry. The -- sorry, Your Honor.

14 A: The dish is positioned on a customer's home to
15 view the southern sky where the satellites are
16 and then the signal is received by the dish.
17 The installer then routes a coaxial cable to
18 our set-top box, which is then connected to the
19 customer's television and they can view the
20 programming.

21 Q: Which legal entity owns the set-top boxes?

22 A: DIRECTV, Inc.

23 Q: And does DIRECTV have set-top boxes in South
24 Carolina?

25 A: Yes.



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1 Q: Does DIRECTV have set-top boxes in all 50
2 states?

3 A: Yes.

4 Q: Are customers charged a fee for the set-top
5 boxes?

6 A: Yes. In -- I think it was 2008? I can't
7 remember what year, but we started -- we
8 transitioned during this time frame to a lease
9 model where the customer -- the company owns
10 the set-top box and the customer pays a lease
11 fee.

12 Q: Shifting gears a little, you described
13 previously that customer service in your mind
14 was one of the value drivers of DIRECTV's
15 business. Where are -- would DIRECTV's
16 customer service functions handled?

17 A: DIRECTV customer care is headquartered -- it
18 has a large executive presence in Los Angeles
19 and kind of a core organizational center in
20 Denver, but it's -- our call centers are where
21 customer care occurs.

22 When customers have questions, technical
23 questions about their equipment or their bills
24 or about the programming, programming packages,
25 they call one of our six customer care



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1 facilities, which are shown on the map there
2 (indicating) with the little phone, the
3 headset.

4 Q: How does a customer go about scheduling
5 installation?

6 A: They call 1-800-DIRECTV. So the goal of all of
7 our advertising and all of our print media and
8 all of our Rob Lowe ads or any ads that we're
9 running is to get people to call 1-800-DIRECTV
10 and to place their order with the company.

11 Q: Who owns and operates the call centers?

12 A: DIRECTV Customer Service.

13 Q: Were all the call centers owned by DIRECTV?

14 A: No, they're both -- some of them are -- some of
15 them are third party and some of them are owned
16 by the company.

17 Q: Where were the owned call centers located
18 during the 2006 through 2011 period?

19 A: We had six of them and they're kind of shown on
20 the map there (indicating) in Missoula,
21 Montana; Boise, Idaho; Colorado; Tulsa,
22 Oklahoma; then we've got one in Alabama there
23 and one in Virginia.

24 Q: All right. Were there any owned call centers
25 in South Carolina during the 2006 through '11



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1 period?

2 A: No.

3 Q: Were there any third party call centers in
4 South Carolina during that period?

5 A: No.

6 Q: You mentioned that one of the functions handled
7 by the call center was to schedule the
8 installation of the equipment. Please describe
9 the installation process.

10 A: A call center representative takes the order
11 from a customer, which involves understanding
12 how many television sets they have, where they
13 would like to view the programming, and what
14 kind of programming.

15 They then convert that into an order, which is
16 a certain set of equipment, that an installer
17 drives around in a van. The installer goes to
18 a home services center in his area, picks up
19 the equipment in the morning, calls the
20 customer, and there's an appointment made.

21 The -- at that appointment time, hopefully, our
22 installer shows up and goes on the roof,
23 installs the dish, points the dish, and routes
24 the coaxial cable into the customer's home to
25 the various set-top box locations and connects



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1 it, checks the signal, and enables service.

2 Q: Are those installation services provided by
3 DIRECTV employees or by third-party employees?

4 A: Both. There's -- there's an effort being made
5 to bring most of that within the company, but
6 there's still both third party, as well as
7 DIRECTV.

8 Q: And which legal entity would employ the
9 in-house installers?

10 A: DIRECTV, Inc.

11 Q: You also mentioned before and you touched on it
12 just now that one of DIRECTV's value drivers
13 was its sales and marketing activities. What's
14 the purpose of DIRECTV's sales and marketing
15 activities?

16 A: The purpose of the sales and marketing
17 activities is to communicate the services that
18 we provide and to show that distinctly with the
19 distinct brand flair. So we try to appeal to
20 a premium subscriber that wants the highest end
21 video experience, as well as kind of a sports
22 centric experience.

23 Q: What types of advertising campaigns does
24 DIRECTV engage in?

25 A: We do -- we do national advertising



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1 that's -- we try to have a very distinctive
2 advertising. You've probably seen -- currently
3 we've got a set of hopefully humorous Rob Lowe
4 advertisements, various forms of Rob Lowe
5 selling -- distinguishing himself from his
6 cable alter ego.

7 So we try to have creative -- our marketing
8 group likes to say they create advertising as
9 a feature film, as a feature event. They try
10 to use the same production value and writing
11 that is put into -- an investment that usually
12 goes into feature length films.

13 Q: How does a subscriber sign up for DIRECTV?

14 A: They go to -- there's two ways. They --
15 principally we drive customers to call
16 1-800-DIRECTV or they can go to the -- to our
17 website DIRECTV.com and order.

18 Q: Okay. I'd like to introduce Petitioner's
19 Exhibit One. Can you just take a look at this,
20 Mr. Goswitz and -- are you familiar with those
21 documents?

22 A: Yes.

23 Q: And what are those documents?

24 A: This is our customer agreement, contract with
25 our customers.



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1 Q: And all customers would then turn to those?

2 A: Yes.

3 MR. ROBERTS: I'd like to -- well, I move to have
4 this entered into evidence as Petitioner's
5 Exhibit One.

6 THE COURT: Any objection?

7 MR. CONDON: No, Your Honor.

8 THE COURT: It's admitted.

9 (Petitioner's Exhibit Number One was admitted into
10 evidence.)

11 THE COURT: You seem hesitant. Y'all stipulated on
12 the authenticity, but not on the admission,
13 correct?

14 MR. ROBERTS: Correct, Your Honor.

15 THE COURT: All right.

16 Q: Mr. Goswitz, you just spent a lot of time
17 discussing content acquisition, broadcast
18 operation, and the up-link facilities. Those
19 are expensive. Why does DIRECTV incur all
20 these costs?

21 A: Well, it's the -- the cost of procuring the
22 highest quality content is very high,
23 especially with sports, and it's climbing
24 higher and higher, but that's the cost -- cost
25 of our business.



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1 You know, you spend money to make money, so our
2 cost is in a -- in procuring -- is dominated by
3 the cost of the content and then our costs
4 associated with -- with distributing that
5 signal. Satellites cost \$200 million, a
6 hundred million dollars to launch, 300 million
7 each, so it is costly. But we -- we -- with
8 our 20 million subscribers across the United
9 States, we have a very efficient delivery
10 platform. So even though it's costly, we still
11 are considered a cash cow business.

12 **MR. ROBERTS:** Thank you, Your Honor. I have no
13 further questions right now, Your Honor.

14 **THE COURT:** Ms. Wooten?

15 **MS. WOOTEN:** Thank you, Your Honor.

16 **MR. GOSWITZ - CROSS-EXAMINATION BY MS. WOOTEN:**

17 Q: Just a few questions for you -- Mr. Goswitz?
18 Am I pronouncing that correctly?

19 A: You are, yes.

20 Q: Okay. Thank you. You stated earlier that you
21 are employed by DIRECTV. Are you employed by
22 the taxpayer in this matter or an affiliate
23 company?

24 A: DIRECTV, Inc.

25 Q: DIRECTV, Inc., okay. And just jumping to the



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1 set-top boxes. Are new customers required to
2 own or lease the set-top box from DIRECTV in
3 order to obtain the programming?

4 A: Correct.

5 Q: Okay. And can an individual or company
6 purchase or rent the set-top box without
7 obtaining the programming --

8 A: No.

9 Q: -- or purchasing the programming?

10 A: No.

11 Q: Okay. And you talked briefly about the
12 installers. Does DIRECTV employ any installers
13 in South Carolina?

14 A: Not that I'm aware of.

15 Q: Okay. And Mr. Roberts asked you -- or you --
16 y'all talked about value drivers. Is "value
17 driver" an income-producing activity? The
18 value drivers you talked about, the content
19 acquisition, the broadcasting, the marketing,
20 is that an income-producing activity?

21 A: I don't know. I'm a satellite engineer.

22 Q: Okay.

23 A: I don't know -- I wouldn't weigh in on
24 definitions.

25 Q: Okay. And you talk about content development



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1 process that -- you know, the negotiation with
2 content providers. Do customers have any input
3 in that or is that between the attorneys with
4 DIRECTV and the content providers? Is there
5 any kind of customer input into that process?

6 A: I'm not sure I understand the question.

7 Q: Do customers have a role in content
8 acquisition? The contracts that are negotiated
9 between content providers and DIRECTV, do
10 customers have a clear role in that?

11 A: No, we have the -- if I understand your
12 question, the content acquisition is a direct
13 exchange between DIRECTV's programming
14 acquisition department and the programming
15 provider, hopefully satisfying our customers.

16 Q: All right. And you also said that "As much as
17 I'd like to think customers like the
18 satellites, they're really interested in the
19 content, that the goal is to provide the
20 premium video experience to customers." Is
21 that correct?

22 A: Correct.

23 Q: So the goal of really all of this is to
24 provide -- to get customers to call and
25 subscribe to DIRECTV. Is that a fair



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1 statement?

2 A: I'm not sure I understand the question.

3 Q: The customers are not interested in satellites.
4 The customers are calling and subscribing to
5 the service in order to get the programming and
6 the content; is that correct?

7 A: Correct.

8 **MS. WOOTEN:** May I have a few moments, Your Honor,
9 please? Thank you.

10 (Off the Record)

11 **MS. WOOTEN:** Okay. Just a couple more follow-ups.

12 Q: The installers you said not -- DIRECTV does not
13 employ any in South Carolina. Are those done
14 by third-party installers?

15 A: Correct.

16 Q: Would those be independent contractors?

17 A: Right.

18 Q: Okay. And then, lastly, just a clarification
19 point. You were talking about the local
20 collection facilities and you stated that there
21 are four in South Carolina. You mentioned
22 Columbia, Greenville, Myrtle Beach, and
23 Charlotte.

24 A: Oh, I'm sorry, I meant Charleston.

25 Q: Charleston is the fourth one, okay.



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1 MS. WOOTEN: All right. That's all from the
2 Department, Your Honor.

3 THE COURT: Redirect?

4 MR. ROBERTS: No further questions, Your Honor.

5 THE COURT: You may step down.

6 THE WITNESS: Thank you, Your Honor.

7 THE COURT: All right. We're going to take a
8 five-minute break here.

9 (Off the record from 11:31 a.m. to 11:42 a.m.)

10 THE COURT: Y'all going to call your witness?

11 MR. VALLEJO: Yes, we'd like to call Professor
12 Richard Pomp to the stand, please, Your Honor.

13 RICHARD D. POMP, Ph.D., having been duly sworn,
14 testifies and examines as follows:

15 DR. POMP - DIRECT EXAMINATION BY MR. VALLEJO:

16 Q: Good morning, Professor.

17 A: Good morning.

18 Q: Could you please state your full name for the
19 record?

20 A: Richard D. Pomp.

21 Q: And, Professor, where are you currently
22 employed?

23 A: I hold two appointments. I am the Alva,
24 A-L-V-A, P. Loiselle, L-O-I-S-E-L-L-E,
25 Professor of Law at the University of



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1 Connecticut, and then Adjunct Professor of Law
2 at NYU in the LLM program in taxation.

3 Q: How long have you worked for your current
4 employer?

5 A: I've been at the University of Connecticut
6 since 1976 and at NYU since 1989.

7 Q: I'd like to introduce exhibit, Plaintiff
8 Exhibit Number Two to the Professor. This is
9 a copy of your CV is it, Professor?

10 A: Yes.

11 **MR. VALLEJO:** Your Honor, would you like a copy?

12 Q: And is this an accurate reflection of your
13 professional experience?

14 A: Yes.

15 Q: And is it up to date?

16 A: Yes.

17 Q: Could you please describe your educational
18 background for us, please?

19 A: I have a Bachelor of science degree from the
20 University of Michigan, suma cum laude. I have
21 a JD degree from Harvard Law School, magna cum
22 laude.

23 Q: And can you describe for us your teaching
24 experience?

25 A: I have taught in the area of taxation,



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1 primarily state and local taxation, but other
2 courses, federal income tax, American Indian
3 taxation, but certainly every year at NYU, I do
4 a two course state tax sequence.

5 Q: And could you please describe for us your
6 professional experience as it relates to policy
7 issues regarding state and local taxation?

8 A: I have lectured, taught, published, consulted,
9 testified on issues of state taxation for
10 nearly 40 years.

11 Q: What about any publications that you have
12 authored? Can you describe those for us?

13 A: Yes, on -- on, let's see, page five of the CV,
14 books and monographs are set forth and then
15 articles.

16 Q: And have you ever testified before on issues of
17 policy in connection with state and local
18 taxation in the United States?

19 A: I have.

20 Q: How many times?

21 A: I would say nearly a hundred times.

22 Q: And have you testified on behalf of
23 governmental taxing authorities before?

24 A: I have.

25 Q: And how many times on behalf of governmental



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1 taxing authorities?

2 A: I would say about 40 percent of my appearances
3 have been for state tax departments or state
4 subject.

5 Q: What about the Department of Revenue in South
6 Carolina, have you ever consulted for them?

7 A: I have consulted with the Department and
8 testified on its behalf two or three times.

9 Q: And have you ever served as an expert witness
10 on policy involving state and local taxation in
11 a South Carolina court?

12 A: I have.

13 Q: So you're familiar with policy considerations
14 of various types of state and local taxes in
15 the United States?

16 A: I am.

17 Q: And have you ever spoken publicly or do you
18 speak publicly on the issues related to state
19 and local taxation and the policy underlying
20 those issues?

21 A: I probably speak at maybe 15 major tax
22 conferences a year.

23 Q: What about more specifically state and local
24 apportionment issues; that is, the manner in
25 which income is apportioned to a particular



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1 state?

2 A: That's a major part of what most people teach
3 in the state tax area, major part of what we
4 write about, what we talk about.

5 Q: And more specifically, what about the
6 assignment of receipts from services for the
7 purposes of the sales factor apportionment; are
8 you familiar with that?

9 A: Yes, that has become a very hot issue.

10 Q: Are you familiar with the term
11 "income-producing activity" and how that
12 applies in the context of assigning receipts
13 from services?

14 A: I am.

15 Q: Are you familiar with the term "market-based
16 approach" and how that applies to assigning
17 receipts from services?

18 A: I am.

19 Q: What about any awards in the field of state and
20 local taxation, Professor?

21 A: Those are set forth on page two. The end of
22 last year, I received the Council on State
23 Taxation's Excellence in State Taxation award.
24 In 2013, Tax Analysts selected me as the State
25 Tax Person of the Year. In 2011, I received a



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1 Bureau of National Affairs Distinguished
2 Service in State and Local Tax Law. 2010, I
3 was a part of State Tax Note's All Decades
4 State Tax Team. In 2008, I won the NYU
5 Institute on State and Local Taxation,
6 Outstanding Achievement in State and Local
7 Taxation award.

8 **MR. VALLEJO:** At this time I'd like to move to have
9 Professor Pomp admitted as an expert in policy
10 matters regarding multi-state taxation,
11 including policy concerns surrounding
12 apportionment of income.

13 **MR. CONDON:** No objection.

14 **THE COURT:** He's so qualified.

15 **MR. VALLEJO:** Thank you very much.

16 **Q:** Professor, did you prepare a written expert
17 report in this case?

18 **A:** I did.

19 **MR. VALLEJO:** And if I may approach the witness,
20 Your Honor.

21 **Q:** Is this report labeled Petitioner Exhibit
22 Number Three the report that you prepared?

23 **A:** It is.

24 **Q:** And could you please review the exhibit quickly
25 and let me know if this is an accurate



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1 reflection of your expert opinion in this case?

2 A: It appears to be.

3 Q: Thank you, Professor.

4 MR. VALLEJO: I'd like to move to admit the report
5 into evidence as Exhibit Three?

6 MR. CONDON: Your Honor, the Department objects
7 based on Rule 702. We believe the Professor's
8 testified -- or at his deposition that his
9 opinions are on the last page and at two of
10 three -- at least two of the three opinions we
11 believe give legal conclusions.

12 THE COURT: Any response?

13 MR. VALLEJO: Yes, Your Honor, Section 702 very
14 clearly states that --

15 THE COURT: I'll tell you what. Hold on just a
16 second. Let me get there. All right.

17 MR. VALLEJO: Section -- first, I'd like to -- like
18 to say in South Carolina, as in most
19 jurisdictions, whenever you have a nonjury
20 trial, the Rules of Evidence are generally
21 relaxed because, of course, Your Honor is
22 perfectly competent to make a determination
23 about admissibility and, therefore, also
24 perfectly competent to make a determination as
25 to what weight to give evidence.



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1 Now, of course, legal conclusions I
2 understand --

3 **THE COURT:** Is there a case that says that out
4 there?

5 **MR. VALLEJO:** Yes, sir, I could --

6 **THE COURT:** In South Carolina?

7 **MR. VALLEJO:** Yes, there's a South Carolina case
8 that cites some federal authority and, in fact,
9 I think very specifically states that in a
10 nonjury trial, the role of the court is to
11 admit all evidence and then look at the
12 relevance and give proper weight to that
13 evidence. I can cite that case for you --

14 **THE COURT:** I'd like to get it.

15 **MR. VALLEJO:** -- in a couple minutes --

16 **THE COURT:** Okay.

17 **MR. VALLEJO:** -- if that's okay with you. But
18 that's just a general matter. 702 very clearly
19 states that an expert witness can testify to
20 the extent that it will help the trier-of-fact
21 in understanding the evidence, in other words
22 the facts in the case.
23 We believe that both Professor Pomp's report
24 and his testimony will do just that. He will
25 be providing, as he does in the report, context



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1 for the historical and policy development of
2 the term "income-producing activity" and
3 "market-based approach."

4 He'll be explaining, for example, UDITPA, which
5 you've heard about earlier, and I understand
6 that the Court may not be intimately familiar
7 with it. And that's really the context of his
8 testimony. We will not be asking him to apply
9 the law in South Carolina to the facts and give
10 you an ultimate conclusion of law in this case.

11 **THE COURT:** Any response to that?

12 **MR. CONDON:** Yes, Your Honor. In the -- Professor
13 Pomp's report itself on page five under number
14 three, he says he wasn't asked to opine on
15 legal issues. But if you flip back to page
16 nine -- or to nine, the conclusion, the next to
17 the last -- or the third paragraph from the
18 bottom in the last paragraph both give a legal
19 conclusion as to whether the Department
20 interpreted "income-producing activities"
21 correctly. And Professor Pomp says, you know,
22 the taxpayer -- the tax department disregards
23 the -- these activities are lacking intrinsic
24 value, is what he will say and we're not -- we
25 didn't include them as income-producing



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1 activities.

2 **MR. VALLEJO:** Your Honor, that part of the report is
3 quoting the Department Determination. The part
4 of the report that Mr. Condon just read is
5 quoting the Department Determination which
6 states that those activities have no intrinsic
7 value.

8 **THE COURT:** Can you hand that report to me?

9 **MR. VALLEJO:** Of course.

10 **THE COURT:** What page are we talking about?

11 **MR. CONDON:** Page nine. Second full paragraph on
12 page nine.

13 **THE COURT:** Hang on a second. Let me look at
14 the ...

15 All right. Following the holding of *Vortex*
16 *Sports versus Ware* -- the cite is 378 South
17 Carolina 197 in 2008 -- the Court in addressing
18 another opinion set forth that the Supreme
19 Court noted an opinion is not objectionable
20 simply because it embraces the ultimate issue
21 to be decided by the trier-of-fact. Supreme
22 Court also found the affidavit contained,
23 quote, "some helpful information," end quote,
24 such as Professor's previous opinions as to
25 value of stock and selling it for significantly



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1 less in the value than that value was proper.
2 Following that line of thinking, I'm going to
3 allow that -- or at least that paragraph, if
4 that's what you're objecting to, I think I can
5 sufficiently distinguish it if it does touch on
6 the conclusion of laws; although I think
7 Professor Pomp is a very erudite individual.
8 I think my past history shows that I can go my
9 separate way if I believe I should, so.

10 **MR. CONDON:** Okay. Your Honor, I also refer to the
11 very last paragraph in the report.

12 **THE COURT:** All right.

13 **MR. CONDON:** Because I think essentially that says
14 the same thing that -- that, you know, that the
15 Department ignored outside activities and,
16 hence, we got the income-producing activities
17 incorrect.

18 **MR. VALLEJO:** Your Honor, I would have the same
19 response to that. By the way, I mentioned a
20 case that I would cite for you. It's *Brown v.*
21 *Allstate*, 344 South Carolina 21, 2001, where
22 the South Carolina Supreme Court stated, "A
23 trial judge's role in a bench trial is to admit
24 all evidence and then evaluate it in a nonjury
25 setting." I think that's exactly what you were



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1 talking about doing earlier and I fully agree,
2 of course, but the --

3 **THE COURT:** What trial -- what court was the
4 appellate court reviewing?

5 **MR. VALLEJO:** This was a South Carolina Supreme
6 Court decision.

7 **THE COURT:** What court was the Supreme Court
8 reviewing?

9 **MR. VALLEJO:** It was reversing the Court of Appeal
10 and determining that the Court agreed with the
11 Court of Appeal's dissent. So it was a Court
12 of Appeal decision that was being reviewed by
13 the South Carolina Supreme Court.

14 **THE COURT:** And what court was the Court of Appeals
15 reviewing, is what I'm getting at?

16 **MR. VALLEJO:** I don't know. I would have to look
17 that up for you.

18 **THE COURT:** Okay. I don't think the Supreme Court
19 is -- at least on the case law I've read
20 reviews us based on the -- whether something is
21 admissible under the Rules of Evidence.
22 And it almost sounds like you're taking an end
23 run on the APA where it sets forth that we're
24 here to -- we hear cases based on the Rules of
25 Evidence. So I'm not going to follow that



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1 theory. I'm going to stick with reviewing the
2 case on the -- as I said Vortex.

3 I just overrule your objection. The first
4 sentence certainly doesn't come to a legal
5 conclusion and the final sentence sets forth
6 that "but from a policy perspective" -- I mean,
7 he's setting forth a policy perspective and not
8 specifically how I should interpret it. I
9 mean, I know that the -- they're pretty closely
10 connected.

11 **MR. CONDON:** Right.

12 **THE COURT:** But you've allowed him to be qualified
13 from the policy perspective, so I'm going to
14 allow him to pursue that line of testimony.

15 **MR. CONDON:** Thank you for your consideration, Your
16 Honor.

17 **MR. VALLEJO:** Thank you, Your Honor. I also would
18 like to move to introduce into evidence
19 Professor's CV, which was Exhibit Number Two.

20 **THE COURT:** Any objection?

21 **MR. CONDON:** No, Your Honor.

22 **THE COURT:** All right. So we're admitting
23 Petitioner's Two and Petitioner's Three?

24 **(Petitioner's Exhibit Numbers Two and Three were**
25 **admitted into evidence.)**



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1 **MR. VALLEJO:** Thank you very much. And I think,
2 Your Honor, as we discussed earlier, this might
3 be a good time to break for lunch. The next
4 set of questions are my substantive questions
5 for the Professor.

6 **THE COURT:** All right.

7 (Lunch break from 12:01 p.m. to 1:05 p.m.)

8 **THE COURT:** Y'all ready?

9 **MR. CONDON:** Yes, Your Honor. We just have one
10 administrative item.

11 First, earlier this morning, the parties
12 stipulated to 13 -- the admissibility of 13
13 exhibits, but we never identified them. So we
14 figured we'd better identify them and get them
15 properly numbered.

16 And so the 13 exhibits are actually in the
17 Respondent's or DOR's exhibit notebook and they
18 are labeled as Respondent's One through
19 Thirteen.

20 These are tax returns, 13 tax returns, two
21 field audit reports, and then the Department
22 Determination. And so if it pleases the Court,
23 we were thinking maybe those could just be
24 labeled as Joint Exhibit One through Thirteen.

25 **THE COURT:** Well, has the court reporter already



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1 marked them?

2 **THE COURT REPORTER:** (Nods head affirmatively.)

3 **MR. CONDON:** Oh, has she? Okay. So we'll keep them
4 as Plaintiff's One through Thirteen?

5 **THE COURT:** No.

6 **MR. CONDON:** I mean, not -- I mean Respondent's.

7 **THE COURT:** There you go.

8 **MR. CONDON:** Respondent's, yes.

9 **THE COURT:** And it's Petitioner's, too, so.

10 **MR. CONDON:** Okay.

11 **THE COURT:** It's not -- we don't have a plaintiff in
12 the courtroom.

13 **MR. CONDON:** I understand. I'm thinking ...

14 **THE COURT:** I know. I'm just messing with you.

15 **MR. CONDON:** Yeah. So is that okay, they're marked
16 as ...

17 **MS. GEER:** Your Honor, I just wanted to say, we
18 don't care how they're marked as long as
19 there's a stipulation in the record that those
20 exhibits are jointly offered, that we are
21 offering them in as evidence, as well.

22 **MR. CONDON:** We agree.

23 **MS. GEER:** Okay. Thank you.

24 **THE COURT:** When I was a trial lawyer, my goal was
25 to get it in. I didn't care how.



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1 MS. GEER: Right.

2 MR. ROBERTS: Exactly, Your Honor.

3 THE COURT: So it's in.

4 MR. CONDON: All right. Thank you.

5 THE COURT: Respondent's One through Thirteen is
6 admitted, so now it's in.

7 (Respondent's Exhibit Numbers One through Thirteen
8 were admitted into evidence.)

9 THE COURT: I'm ready.

10 MR. VALLEJO: Shall I continue?

11 THE COURT: Yes, you may.

12 Q: Professor Pomp, right before we broke for
13 lunch, I had handed you your report as I
14 believe Exhibit Three. And I would like, if
15 you would, to keep it handy. You might want to
16 refer to it throughout your testimony. But,
17 first, let me ask you a couple of foundational
18 questions here. Have you reviewed the relevant
19 income tax statutes that govern this case?

20 A: I have.

21 Q: And are you comfortable that you generally
22 understand how they operate?

23 A: Yes.

24 Q: And are you familiar with how the South
25 Carolina corporate income tax works in general?



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1 A: Yes.

2 Q: I wonder if you could give us a brief
3 description of the process that you would go
4 through in order to calculate South Carolina
5 corporate income tax.

6 A: Sure. And I -

7 **THE WITNESS:** Your Honor, may I stand and not talk
8 to the chart but approach it?

9 **THE COURT:** Yeah.

10 **THE WITNESS:** All right.

11 **THE COURT:** You could even mess with it.

12 **THE WITNESS:** I may flip it. And I know you are
13 well-versed in what I'm about to do. I think
14 some others here may not be and just for the
15 record.

16 So, you know, we have before us a multi-state
17 taxpayer and here is South Carolina and here's
18 the rest of the country (indicating). And the
19 issue that any state, of course, has to deal
20 with is, all right, we know what the income is
21 of a multi-state taxpayer and we could kind of
22 use a pizza pie to reflect the income. What is
23 South Carolina's slice of that income? What
24 slice of that pizza pie can South Carolina tax?
25 And so, in general terms, we start with the



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1 size of the pizza, which would be South
2 Carolina taxable income, and then South
3 Carolina, like almost every other state, will
4 apply an apportionment formula to determine its
5 slice.

6 And in the case of a service provider, South
7 Carolina says, okay, let's use South Carolina
8 gross receipts in the numerator of this
9 fraction and let's use gross receipts
10 everywhere in the denominator.

11 Q: Professor, if I could stop you for one second.
12 How would you normally compute the taxable
13 income in general terms?

14 A: Generally this -- this tees off of federal
15 taxable income and then South Carolina will
16 make certain unique South Carolina adjustments,
17 so. None of that is at issue in this case. I
18 think everyone agrees on what the starting
19 point is in taxable income.

20 So now we have this fraction: South Carolina
21 gross receipts divided by gross receipts
22 everywhere. And that is essentially what --
23 I'm having trouble reading these, but that is
24 essentially what 2290 says.

25 And this whole case is about the numerator.



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1 Everyone agrees, as Your Honor indicated in
2 your opening comments, that the gross receipts
3 here are going to be included in the South
4 Carolina fraction, that there's no question but
5 gross receipts for the performance of services
6 will be gross receipts from everywhere.

7 The question is: Okay, those are the total
8 gross receipts. How do we bore down and get
9 the South Carolina gross receipts numerator?
10 That's the question. That's what this whole
11 case is about.

12 And there, 2295 cap (A)(5) gives us the South
13 Carolina rule. It says, "If the
14 income-producing activity is performed partly
15 within and partly without the state" -- I think
16 the whole purpose of our fact witness and that
17 chart is to certainly support the proposition
18 there's income-producing activity performed
19 within and without the state -- "then sales are
20 attributable to South Carolina to the extent
21 the income-producing activity is performed
22 within this state."

23 So we're looking to try to figure out the
24 extent to which income-producing activity is
25 performed within South Carolina. And you're



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1 going hear testimony from Dr. Cody as to how
2 from an economic perspective one would answer
3 that question.

4 But that's what we're talking about, is how to
5 come up with the numerator of this fraction:
6 South Carolina gross receipts. And we are told
7 here's what we do. We've got to figure out the
8 extent to which the income-producing activity
9 is performed within South Carolina.

10 Q: And, Professor, you've mentioned the term
11 reading from the statute "income-producing
12 activity." I wonder if you could give us some
13 historical and policy perspective on how that
14 term "income-producing activity" developed.

15 A: And for that, Your Honor, we have to dip into
16 UDITPA. There's no avoiding it because that,
17 as you heard from State's counsel, is based on
18 UDITPA, Uniform Division of Income for Tax
19 Purposes Act.

20 And we turn the clock back, 1957. There's a
21 lot of debate in this country about how the
22 state should tax interstate corporations. The
23 corporations are complaining the rules aren't
24 uniform; they're being overtaxed. And the
25 states are saying the rules aren't uniform and



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1 the corporations are escaping tax. And so
2 there was a push to come up with a uniform
3 statute.

4 And so the same group of people that brought us
5 the UCC, the Uniform Commercial Code, got
6 together and they formulated UDITPA.

7 And UDITPA takes two fundamentally different
8 approaches to how you're going to source
9 receipts to a state depending on whether you're
10 talking about tangible personal property or
11 whether you're talking about services.

12 And so I think Mr. Condon referred to Section
13 17 of UDITPA. There's Section 16 and Section
14 17. Section 16 deals with tangible personal
15 property. And there, the Act sets forth this
16 three-factor formula; payroll in -- I'll use
17 South Carolina for convenience -- payroll --
18 I'll just make it U.S. for convenience.

19 It's interesting, long before *Lockwood Greene*
20 in 1957, there's a payroll factor for tangible
21 personal property. After that, we can look at
22 property in South Carolina, property
23 everywhere, and then, of course, the sales
24 factor. Sales in South Carolina divided by
25 sales everywhere. Call it U.S. And it's an



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1 evenly weighted three-factor formula. So A
2 plus B plus C divided by three gives us some
3 fraction.

4 This is Section 16. What's the definition of
5 "sales" in South Carolina? Well, it's -- if
6 the property is shipped or destined for South
7 Carolina. So we actually do have some kind of
8 destination principle. "Delivered or shipped"
9 is the statutory language, delivered or shipped
10 into South Carolina.

11 There were other approaches that the states
12 use. This was a nice one and I'll tell you why
13 it was nice. The Uniform Law Commission wants
14 to be successful. And success for them is
15 getting their statutes to be widely adopted.
16 Uniform Commercial Code has been widely
17 adopted. The states, of course, tinker with
18 it, but it's been widely adopted, one of their
19 great successes.

20 So if you're coming up with a uniform statute
21 and you want it to be attractive to all the
22 state so that they will get behind it and vote
23 it in, you've got to have something in it for
24 all the states.

25 The payroll factor, the property factor, that's



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1 great if you're a manufacturing state. The
2 sales factor is great if you're a state that
3 doesn't have much manufacturing but you got a
4 lot of people in your state buying products
5 that are made somewhere else. So you get to
6 eat some of the pizza. The -- this is what we
7 call the "origin states." Not to be confused
8 with *Lockwood Greene* which talks about the
9 origin of the payment. Very different concept.
10 This is where the income-producing activities
11 take place, the origin of the income: Labor
12 and capital.

13 This takes into account the market. So a very
14 nice political compromise. There is no grand
15 economic theory. There is no rigorous science
16 that underlies this formula.

17 As a matter of fact, there's a Nobel Prize
18 winning economist who sort of made fun of the
19 formula. He said, "Ah, concocted by a group of
20 lawyers who if they ever knew anything about
21 economics forgot what they knew."

22 But it's practical and it takes something that
23 you really don't know where its earned income
24 and you're going to answer that question with
25 something that's knowable. We know where



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1 payroll is, property. The beauty of
2 destination or shipped with tangible is you can
3 see it.

4 So it's -- it was an attractive formula. And
5 that's 1957, where a manufacturing economy, a
6 mercantile economy, a lot of effort went into
7 getting this right.

8 Then the commissioners said, "Well, what do we
9 do about services?" And they have a separate
10 section of UDITPA, Section 17. It says, "Okay,
11 everything that's not the sale of tangible
12 personal property." So our case services, that
13 would be one of the things that's not tangible
14 personal property.

15 So what do we do about services? And that's
16 where they came up with, let's look at where
17 the income-producing activities take place.
18 And the commissioners did something that you
19 did not do here in South Carolina, to your
20 credit, I think. I think the Legislature is
21 one step ahead of the Uniform Law Commission.
22 The UDITPA formula -- I don't know. Do we have
23 a copy for His Honor of Section 17?

24 But it says that we will do a ratio of
25 income-producing activity that takes place in



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1 your state versus everywhere and we'll do this
2 state by state. And then the State that has
3 the plurality of the cost-of-performance will
4 be the state that gets a hundred percent of the
5 receipts.

6 So I'll demonstrate. It's kind of odd. I
7 mean, you folks haven't done that, which is
8 really good.

9 So let's suppose there are 32 states and when
10 I look at the cost-of-performance that occurs
11 in each of these 32 states, I determine it is
12 three percent in each of these 32 states. In
13 the 33rd state, however, my cost-of-performance
14 turns out to be four percent. That 33rd state,
15 because that's the state that has the plurality
16 of the cost, gets a hundred percent of the
17 gross receipts from this service provider.

18 **THE COURT:** I'm missing the cost-of-performance, how
19 you move from that or to that from the
20 income-producing activity.

21 **THE WITNESS:** Yes, that's why -- could you give His
22 Honor the actual language of Section 17?

23 **MR. VALLEJO:** Yes, this is Exhibit Sixteen, which
24 has been labeled.

25 **THE COURT:** Labeled but not admitted?



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1 MR. VALLEJO: Not admitted yet.

2 THE COURT: Okay.

3 THE WITNESS: Is there a copy for me?

4 MR. VALLEJO: We can move to have it admitted at
5 this time, if you'd like.

6 THE COURT: Any objection? Any objection?

7 MR. CONDON: Can I make sure --

8 MR. VALLEJO: Sure.

9 MR. CONDON: -- this is what you gave me?

10 MR. VALLEJO: This is it right here, yeah, Exhibit
11 Thirteen (sic), which the clerk (sic) has
12 labeled.

13 MR. CONDON: Okay. No objection.

14 THE COURT: It's admitted.

15 THE COURT REPORTER: You said Thirteen?

16 MR. VALLEJO: Thirteen.

17 THE COURT: Well, this says Sixteen.

18 MR. VALLEJO: Oh, my apologies, that's Sixteen. I
19 was looking at the three when I handed it over
20 to you. It should be Sixteen.

21 THE COURT: All right. Sixteen is admitted.

22 (Petitioner's Exhibit Number Sixteen was admitted
23 into evidence.)

24 THE WITNESS: All right. So let us take a look at
25 Section 17 on page ten of eleven in my version.



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1 And it says, "Sales other than sales of
2 tangible personal property" -- so that would
3 include services -- "are in this state" -- and
4 if you look at cap B -- small (B) -- "the
5 income-producing activity is performed both in
6 and outside this state and a greater proportion
7 of the income-producing activity is performed
8 in this state than in any other state based on
9 cost-to-performance."

10 **THE COURT:** Okay. There you go.

11 **THE WITNESS:** So that's -- that's where they're
12 setting forth how to measure an
13 income-producing activity, how to compare it
14 from state to state. And they are saying,
15 well, use cost-of-performance.

16 The Legislature here did two very positive
17 things, in my opinion. One, as Mr. Condon
18 already indicated, they dropped the "based on
19 cost-of-performance." So they haven't
20 prohibited it. They haven't mandated it.
21 They're just giving the taxpayers and the
22 Department some flexibility in how to go about
23 determining the proportion of income-producing
24 activity that takes place.

25 The second major improvement by the



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1 Legislature -- this is what we call "all or
2 nothing" -- that sales from services will be in
3 the state if this state has a greater
4 proportion of the income-producing activity
5 than any other state does.

6 So this 33rd state that has four percent of the
7 income-producing activity would have a greater
8 proportion than these other 32 states that have
9 three percent and that 33rd state would get a
10 hundred percent of the gross receipts.

11 And that's been a well-criticized rule because
12 it is "all or nothing." Look at the virtue of
13 the South Carolina rule: "Sales are
14 attributable to this state to the extent the
15 income-producing activity is performed within
16 this state."

17 So what that means, in a state that has the
18 South Carolina rule, each of these 32 states
19 would pick up three percent of the gross
20 receipts, the 33rd state would pick up
21 four percent of the gross receipts. It
22 mitigates the harshness of the "all or nothing"
23 rule.

24 So two very notable changes, both very positive
25 at least in my opinion from a policy



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1 perspective.

2 Q: And, Professor, I believe Mr. Condon said in
3 his opening statement that South Carolina had
4 adopted Section 17 but omitted the
5 cost-to-performance language, which is what you
6 were just telling us about.

7 You've also added that the proportionality
8 portion of this statute is different and you've
9 explained why you think that's better. But
10 could you explain to us why you think dropping
11 "cost-to-performance" from the statute is
12 better from your perspective as you just
13 testified?

14 A: That UDITPA Section 17 ties the hands of both
15 the tax department and taxpayers by mandating
16 the rule for determining income-producing
17 activity.

18 It says in Section 17, "based on costs of
19 performance." So they are telling taxpayers,
20 they are telling the tax department, this is
21 how you measure income-producing activity.

22 The South Carolina Legislature is not telling
23 anyone how to go about it. Just do presumably
24 what makes sense, what's reasonable, even if
25 you deviate from a cost-of-performance



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1 standard.

2 Q: Professor, how did you come to be so familiar
3 with UDITPA and its history?

4 A: A lot of time on my hands, huh? In 2007, Your
5 Honor, the Uniform Law Commission decided it
6 was time to revise UDITPA. They've held it
7 forth as a model unchanged from 1957.

8 Absurd to think of anything from 1957 is going
9 to be a model, but it had never been changed,
10 and they took on the project. They said, okay,
11 it's been long enough. We're going to revise
12 it.

13 They hired myself and a well-known person in
14 the state tax field to serve as co-reporters.
15 And we met with them and we said, "You know,
16 this is a pretty contentious project," and they
17 said, "Don't you worry. We have a backbone
18 here at the Uniform Law Commission." And we
19 said, "It's not the Anatomical Gifts Act. You
20 know, this is series stuff." "Don't you
21 worry."

22 Well, they should have worried because they
23 experienced a well-orchestrated pushback by the
24 business community. And with real egg on their
25 face, in 2009, they abandoned the project.



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1 Their budgets are dependent on state
2 legislatures and the lobbyists were clever
3 enough to try to cut their budgets if they were
4 to push forward on this project. No more nice
5 meetings in San Diego. And so they saw the
6 handwriting and they said, "No, no, maybe we'll
7 do this sometime in the future but not for
8 now."

9 The Multistate Tax Commission, which is an
10 organization that represents the states,
11 voluntary basis, took on the challenge. The
12 Multistate Tax Commission is the administrative
13 arm for something called the Multistate Tax
14 Compact and that compact adopts UDITPA.

15 So they said, "Okay, you know, we administer
16 UDITPA. We issue regulations. We're going to
17 step into the vacuum because we have a
18 backbone, because we take on big business all
19 the time and we're not coward by big business."

20 So in about 2009, they formed some working
21 groups to come up with proposals to amend
22 UDITPA. They had a hearing in 2013. I was the
23 Hearing Officer. So we had awful lot of input.
24 I issued a report in 2014. They studied the
25 report, my recommendations, and they have



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1 pushed forward on a number of fronts, one of
2 which is to revise Section 17 by moving to a
3 market-based approach.

4 And this is what we would call "origin based."

5 This is where the corporation generates its
6 income, where its income-producing activities
7 take place. Market is destination; that says,
8 okay, well, where were your customers? I mean,
9 the problem with market, Your Honor, is it can
10 mean different things because it's not so
11 self-defining what the market is.

12 Well, the proposal by the MTC when it comes to
13 services is, look to place of delivery. Where
14 is the service delivered? Other states say,
15 "Oh, look to where the benefit of the service
16 is received." Some states have shorthanded
17 those problems by saying, "Well, let's look at
18 the billing address. Let's look at the office
19 from which the order was placed."

20 There's a variety of approaches around the
21 country right now. So it's not -- you know,
22 people say, "Oh, market-based sourcing." You
23 have to ask the next question: What do you
24 mean by that? Well, we know what the MTC means
25 by that. It means, where is the service



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1 delivered?

2 And that can be quite tricky. It's not so
3 obvious. And if you want to just take a simple
4 example of a law firm that is hired to deliver
5 an opinion and they send the client an e-mail
6 with the opinion as an attachment, which
7 general counsel reads on a flight over the
8 U.S., you know, where was the place of
9 delivery?

10 They FedEx it to the hotel where the general
11 counsel is staying. The general counsel comes
12 and picks it up at the location of the law
13 firm. The law firm posts the opinion letter,
14 password protected on their website, as some
15 law firms do, and they say to the client,
16 "Look, just access our website, here's the
17 password, and you'll download your opinion --
18 our opinion letter."

19 So it sounds good, market-based sourcing, but
20 lots of wrinkles in how you're going to
21 implement it. The MTC is struggling with that
22 right now. They're trying to come up with
23 regulations to answer some of these questions;
24 many of them I've raised in my report and
25 they're now dealing with it.



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1 Q: So, Professor, if I heard you correctly, you
2 were saying that originally Section 17 was an
3 income-producing activity test and that based
4 on your recent experience with the MTC, they
5 are proposing a market-based sourcing approach.

6 Q: Could you tell us the difference between the
7 two as you grappled with this --

8 A: Uh-huh (affirmatively responds).

9 Q: -- through the MTC process?

10 A: Yes. Let me -- let me go back to law firm
11 since it's one we're familiar with. Under
12 Section 17, as it now exists -- hasn't been
13 changed yet, but the MTC is just in the process
14 of suggesting regulations -- if I do all of my
15 legal work here in South Carolina and deliver
16 it in North Carolina, however we define
17 "deliver," then under the income-producing
18 activity approach, the gross receipts will be
19 viewed as occurring here in South Carolina.

20 Under a market approach, if that is viewed as
21 being delivered in North Carolina, then the
22 gross receipts will be sourced to North
23 Carolina.

24 Now, what makes this all much more complicated
25 than it would have been 25 years ago if we



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1 embarked on this project, 25 years ago -- let's
2 see if I have the math right -- early 1980's;
3 I guess that's a little bit more than 30 years
4 ago -- most states still had the evenly
5 weighted three-factor formula.

6 Today, there has been a movement for economic
7 development reasons to go to just the sales
8 factor, which, again, it's kind of interesting.
9 South Carolina was ahead of that movement when
10 it came to services. And South Carolina went
11 to a single factor quite early on, but only for
12 services. Now it's transitioning, as you
13 noted, and it will eventually do that for
14 manufacturing, too.

15 When you're dealing with just a single factor
16 sales formula, the world looks a little
17 different. Because if you go back to my law
18 firm situation, I am going to apportion income
19 to South Carolina using only one fraction,
20 South Carolina gross receipts divided by gross
21 receipts everywhere. And if I deliver that
22 report to a customer in North Carolina, client
23 in North Carolina, and if that is viewed as a
24 delivery of my service in North Carolina, then
25 South Carolina will receive no income on that



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1 transaction.

2 Because the formula says the numerator is South
3 Carolina gross receipts as determined by place
4 of delivery. You know, if you were to change
5 your law and go to a market-based sourcing and
6 use place of delivery or perhaps where even
7 benefit occurs, then you're going to have a
8 zero in that numerator and you'll, of course,
9 have gross receipts in the denominator, but
10 you'll get zero.

11 Under current South Carolina law, if I do all
12 my income-producing activities here in South
13 Carolina, we don't care where I send my report,
14 South Carolina will tax me on a hundred percent
15 of my income.

16 So which result is a better measure of where my
17 income was really generated? Zero when I do
18 all my work here in South Carolina or a hundred
19 percent?

20 And in a sense, this is what Lockwood Greene
21 was struggling with, because in Lockwood
22 Greene, you didn't have a law firm, you had an
23 engineering firm doing a lot of work in South
24 Carolina and they were actually arguing for,
25 without using the word, a market-based



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1 approach. They were saying, "Well, where is
2 the payment made from? What's the origin of
3 payment? Oh, that's not South Carolina. And,
4 therefore, we should not have any gross
5 receipts in the numerator."

6 So *Lockwood Greene* is actually one of the
7 earlier cases that represents a clash between
8 an origin approach, look to the place of
9 activity, which is what the court ultimately
10 said in *Lockwood Greene*, and now let's look to
11 where you get your payment, where the customer
12 is, the client. And the court in *Lockwood*
13 *Greene* said, "No, that's not the South Carolina
14 rule; place of performance, place of activity."

15 Q: And, Professor, in your view, is that case that
16 you just mentioned consistent with the policy
17 and the historical development of the
18 income-producing activity approach to assigning
19 receipts?

20 A: Yes. *Lockwood Greene* is certainly consistent
21 with the policy underlying the use of
22 income-producing activity. And if the South
23 Carolina Legislature wants to have a different
24 policy, they wouldn't be a renegade, of course.
25 A lot of states are moving to a market-based



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1 approach. But we've had that kind of statute
2 a long time here and, of course, we've had
3 Lockwood Greene a long time and the Legislature
4 has shown no interest to date, anyway, but they
5 certainly could change the law if they wanted
6 to.

7 Q: Professor, if I could switch subjects for just
8 a second, could you give us your understanding
9 of the Department's position in this case?

10 A: Well, it's changed a little bit, but I think
11 the Department is applying a market-based
12 approach, where the customer is. And I say
13 that really based on communication from the
14 auditor to the taxpayer. I think that's
15 exactly what the Department says. If you look
16 at --

17 Q: If I may introduce Exhibit Four, which I think
18 you have, Professor.

19 MR. VALLEJO: And this is a courtesy copy for the
20 Court.

21 Q: Have you seen Exhibit Four before, Professor?

22 A: What is Exhibit Four?

23 Q: I think you should have it in front of you.

24 A: It's not marked, so I don't ...

25 Q: It's right here.



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1 A: Okay.

2 Q: This is it.

3 A: Okay. What I have is Exhibit Four.

4 MR. VALLEJO: Exhibit Four is the audit
5 determination dated January 28.

6 MR. CONDON: Okay.

7 MR. VALLEJO: That's Exhibit Four.

8 Q: And have you seen Exhibit Four before,
9 Professor?

10 A: I have.

11 Q: And could you tell us what it is?

12 A: Yes. This is a report of the field audit which
13 explains the proposed notice of adjustment from
14 the Department of Revenue to DIRECTV.

15 MR. VALLEJO: I'd like to move to introduce Exhibit
16 Four into evidence.

17 THE COURT: Any objection?

18 MR. CONDON: Yeah, administrative issue. It was
19 Four on yours, but the way they were entered
20 into the record was based on our exhibit
21 numbers.

22 MR. ROBERTS: So you want to --

23 MR. CONDON: So the -- this report would -- it looks
24 like it would be Respondent's Number Eleven.
25 Well, let me make sure this is the right years,



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1 the first report and the second report. This
2 is the second report.

3 **MR. VALLEJO:** Respondent's Thirteen?

4 **MR. CONDON:** I think it would be Twelve. Thirteen
5 is the Department directive.

6 **MR. ROBERTS:** Department Determination is Thirteen.

7 **MR. VALLEJO:** No, this is the audit determination.

8 (Off the Record)

9 **MR. VALLEJO:** Okay. So, apparently this has already
10 been admitted into evidence as Respondent's
11 Exhibit Twelve.

12 **THE COURT:** I gathered that.

13 **MR. VALLEJO:** I apologize for the confusion.

14 **THE COURT:** That's fine.

15 **Q:** Professor, could you take a look at the
16 Department's audit determination, which you
17 were just looking at, and could you please turn
18 to the last page of that determination and read
19 the highlighted language under "sourcing of
20 receipts" where it says page one on the bottom
21 right-hand corner?

22 **A:** Okay. Just for His Honor's reference, it is
23 next to the last page in what I have, so -- but
24 it is marked. I have two page ones. I don't
25 know if there -- if it's just misstapled. But,



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1 in any event, the -- the correct page says
2 "sourcing of receipts" at the bottom.

3 And under that heading, the second sentence
4 says, "The apportionment ratio is determined on
5 a market-based sourcing of South Carolina
6 customer receipts over all receipts as provided
7 by the taxpayer."

8 Q: And would you agree with that statement in the
9 Department's audit determination?

10 A: I think that is what they are doing. Now, they
11 are getting there today looking at -- or
12 listening to Mr. Condon by claiming there's
13 only one income-producing activity and that's
14 performed in South Carolina.

15 So I think that's the way they are attempting
16 to get themselves out of the box of adopting
17 market-based sourcing. Because if you have
18 only one income-producing activity and it takes
19 place in South Carolina, then you're going to
20 reach the same result, but you're not going to
21 call it "market-based sourcing."

22 Q: If I could introduce Exhibit Five, labeled
23 Exhibit Five, Petitioner's Exhibit Five, which
24 is --

25 MR. VALLEJO: This is a courtesy copy for the Court.



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1 Q: Professor, have you seen Exhibit Five before?

2 A: Exhibit Five is the deposition of my good
3 friend, John Swain.

4 Q: And could you tell us whether this seems like
5 an accurate copy of pages 29 and 30 of that
6 deposition?

7 A: It certainly looks to be.

8 **MR. CONDON:** Objection; no basis for that.

9 Q: Professor, have you reviewed the deposition of
10 Professor Swain in the past?

11 A: I have.

12 Q: Do you have any reason to believe that this is
13 not an accurate copy of page 29 and 30 of the
14 deposition?

15 A: Well, the statements I am looking at certainly
16 appeared in the copy I previously reviewed, so.

17 **MR. VALLEJO:** Thank you. I'd like to move to admit
18 this into evidence.

19 **THE COURT:** Any objection?

20 **MR. CONDON:** No objection.

21 **THE COURT:** It's admitted.

22 (Petitioner's Exhibit Number Five was admitted into
23 evidence.)

24 **MR. VALLEJO:** Thank you. Professor, could you --

25 **THE COURT:** Just so we can be clear.



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1 **MR. VALLEJO:** Sorry, Your Honor.

2 **THE COURT:** When you made your previous objection, I
3 thought we were -- everyone stipulated on the
4 authenticity of the exhibits and if that's
5 true, then I don't really need to hear that
6 objection that you made, so I was missing it.
7 But I was just letting you know that that's
8 something that I will consider in the future.

9 **MR. CONDON:** You're right, Your Honor.

10 **THE COURT:** Okay.

11 **MR. CONDON:** I apologize.

12 **THE COURT:** Don't apologize.

13 **MR. VALLEJO:** Thank you, Your Honor.

14 Q: Professor Pomp, could you please to turn to
15 page 29 of Professor Swain's deposition?

16 A: I have it.

17 Q: Could you please read the highlighted language
18 that starts on line eight and goes through line
19 ten of page 29?

20 A: Question: "Has South Carolina adopted a
21 market-based approach to interpreting
22 statutes?" Answer: "In this case it has."

23 Q: Thank you. Could you turn to page 30 and could
24 you please read the highlighted language that
25 goes from line three to line four of Professor



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1 Swain's deposition?

2 A: "Certainly the result in this case reaches a
3 market-based result."

4 Q: And, Professor Pomp, is it your understanding
5 that Professor Swain is one of the experts for
6 the State in this case?

7 A: Yes.

8 Q: And would you agree with Professor Swain's
9 statements that you've just read?

10 A: I would and it's consistent with what the
11 Department said in their audit report.

12 Q: And, Professor, you've gone into this to some
13 extent, but I'd like to ask you from a policy
14 perspective, what's the difference between an
15 income-producing activity approach to assigning
16 receipts versus a market-based approach, which
17 we've just been talking about in these two
18 exhibits?

19 A: Market-based, depending on how it's defined,
20 will look to where the service is delivered or
21 where the customer is or where the benefit of
22 the service takes place; where under an
23 income-producing activity, we're focusing on
24 where the income was generated.

25 Q: Do you think that one or the other,



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1 income-producing activity on the one hand,
2 market-based approach on the other hand, is
3 better or worse from a policy perspective?

4 A: I think that depends on the kind of activities
5 you are dealing with, so -- and certainly the
6 Legislature could decide they like market for
7 some things, not for others; that would be
8 within the realm of the legislative
9 decision-making.

10 Q: Could the result, the ultimate result, be the
11 same under a market-based approach and an
12 income-producing activity approach depending on
13 circumstances?

14 A: Yes, I think if you're providing an activity
15 and it takes place entirely in South
16 Carolina -- like I'm getting a haircut. Well,
17 the service is provided in South Carolina.
18 Under an income-generating -- income-producing
19 approach, it will be performed entirely in
20 South Carolina, we would conclude that the
21 gross receipt is within South Carolina.
22 It so happens that the customer is also
23 receiving the delivery, the benefit, however
24 you want to define it, of that service here in
25 South Carolina. So it's co-terminus. The



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1 service happens to be co-terminus with the
2 customer.

3 But the reason we are concluding it's a South
4 Carolina gross receipt is not because the
5 customer is here. It's because the
6 income-generating activity takes place entirely
7 in South Carolina. It so happens the customer
8 is here, but we don't look to the customer. We
9 look to see where the income-generating
10 activity is.

11 Q: Professor, if I could direct you to the bottom
12 of page seven and the top of page eight in your
13 report. There is an example there that I'd
14 like you to explain to the Court in the context
15 of your testimony so far.

16 A: Bottom of seven, I have a taxpayer performing
17 all of its services in state A and mails a
18 document embodying those services to a customer
19 in South Carolina.

20 "Assume that South Carolina Department of
21 Revenue attributes the receipt for the service
22 as being attributable to the state because that
23 is where the customer is located. Assume
24 further the net income from the service is a
25 hundred dollars. The Department's position



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1 would mean that a hundred dollars of the net
2 income would be taxed by South Carolina" --
3 that's because there's only a single factor
4 formula here -- "thus disregarding all of the
5 income-generating activities that took place
6 outside the state."

7 "This position would be problematic under the
8 external consistency test, which is a test the
9 Supreme Court developed under the Commerce
10 Clause."

11 You have to have some relationship between
12 what's going on in the state and what you're
13 claiming the income is. You know, it's very
14 loosey goosey, but here you would be saying as
15 the State of South Carolina a hundred percent
16 of this income was earned here, regardless of
17 the fact, disregarding the fact, were
18 indifferent to the fact that all of the
19 income-producing activities occurred outside of
20 South Carolina.

21 **THE COURT:** So even though the test is loosey
22 goosey, this goes beyond --

23 **THE WITNESS:** I think it does --

24 **THE COURT:** -- the parameters of loosey and goosey?

25 **THE WITNESS:** I think it does, Your Honor. If you



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1 have good books and records that would show how
2 much actually occurred outside the state.
3 There is a case called *Moorman* --

4 **THE COURT:** *Moorman*?

5 **THE WITNESS:** *Moorman*, M-O-O-R-M-A-N -- in the late
6 '70s. Iowa had a single factor formula from
7 the time it adopted corporate income tax, 1934,
8 and the taxpayers based in Illinois selling
9 into Iowa and if you just make believe it did
10 all its manufacturing in Iowa and made all its
11 sales -- I mean, sorry, all its manufacturing
12 in Illinois and made all its sales in Iowa,
13 Iowa said, "Okay, a hundred percent of that
14 income is ours."

15 And the taxpayer did not put anything into the
16 record. It could read as a failure of proof
17 case. The taxpayer thought this was so obvious
18 that we don't need anything further. It's just
19 logic. All income can't be attributable to
20 Iowa. What about all the manufacturing in
21 Illinois?

22 And the court said, "Oh, for all we know, maybe
23 you manufactured at a loss and all the income
24 was earned through distribution and marketing.
25 You haven't given us anything in the record



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1 that shows the opposite." So there is this
2 case, a failure of proof case, they did not do
3 what you're going to hear Dr. Cody did in this
4 case, so.

5 Q: Professor, you told us earlier that there are
6 different ways of implementing a market-based
7 approach to assigning receipts. What's your
8 understanding of the way the Department is
9 approaching the market-based approach that you
10 testified you believe they're using in this
11 case?

12 A: Well, I first go to the audit report and they
13 say that the apportionment ratio is determined
14 on a market-based sourcing of South Carolina
15 customer receipts. So I think they are looking
16 to customers of DIRECTV that are here in South
17 Carolina and they're saying, "Okay, that's a
18 South Carolina receipt."

19 Q: And, Professor, a hypothetical for you. If you
20 had an engineering services firm and they
21 provided all -- they did all of their work here
22 in South Carolina, but at the last minute, the
23 client said, "I'd like you to deliver the plans
24 that you put together after the work that you
25 performed to North Carolina and I'd like you to



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1 drop them off in my office in North Carolina."
2 Under the Department's approach, where would
3 the receipts be assigned?

4 A: Well, under market-based sourcing, those
5 receipts would be assigned to North Carolina
6 because that would be the market. You know, if
7 they're consistent, that would be the market.
8 And I know Your Honor, in one of your early
9 questions, raised the possibility of kind of
10 manipulating the rules, which, of course,
11 always is a possibility; that's where we all
12 make our living, right, in playing with the
13 rules. But in the case of place of delivery,
14 it seems to me that raises so many more
15 possibilities rather than income-generating.
16 DIRECTV -- you're not going tell the operations
17 people, "Oh, you know what? You should really
18 put some more people in this state because it
19 will help us with South Carolina taxes."
20 Now, you could imagine what they're going to
21 say to you. And there's, of course, a lot of
22 economic literature that says businesses don't
23 do anything dramatic because of the corporate
24 income tax. The decision where to expand,
25 where to locate, it's driven by so many



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1 factors -- cost of labor, cost of land,
2 transportation, is it a place where your CEO
3 wants to live, is it convenient to suppliers,
4 convenient to this -- that the corporate income
5 tax is such a tiny part of the cost of doing
6 business.

7 Sure, if we can change the form, merge easily,
8 break up easily, tax lawyers might do that, but
9 you're not talking about changing the -- where
10 your people are; at least that's what the
11 literature seems to say.

12 Nonetheless, politicians act as if the Holy
13 Grail is, "Oh, let's just change our
14 apportionment formula and we'll jump-start this
15 economy." I wish it were that easy, but ...

16 Q: Professor, you've told us a lot about your
17 opinion about the differences between an
18 income-producing activity approach and a
19 market-based approach. Do you think that those
20 two approaches, income-producing activity on
21 the one hand, market-based approach on the
22 other hand, are conceptually mutually exclusive
23 approaches to assigning receipts?

24 A: Yes. I mean, it's possible, as my haircut
25 example shows, you could read the same result



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1 if you do all of the income-generating
2 activities in one state and that's where your
3 customer is. But as a conceptual matter, they
4 are the antithesis of each other.

5 Q: You told us earlier, Professor, that you
6 thought the South Carolina statute provided
7 flexibility to do what the Department and
8 taxpayers might think is more reasonable. So,
9 from a policy perspective, what's the problem
10 with applying a market-based approach under an
11 income-producing activity statute like the one
12 we have in South Carolina?

13 A: The flexibility is with respect to determining
14 the extent to which income-producing activities
15 are performed within South Carolina; that's
16 your flexibility. You're not handcuffed by
17 cost-to-performance. It may be a useful way to
18 proceed, but you're not told you must do that;
19 that's your flexibility.

20 There's nothing in the statute that says, "Hey,
21 tax department, you could do market if you
22 don't like income-producing activity," so. I
23 mean, look at A(5). So the flexibility is with
24 respect to determining the extent to which the
25 income-producing activity is performed in South



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1 Carolina. There you have some flexibility,
2 more than in other states.

3 Q: Professor, I'd like to prefer to Respondent's
4 Exhibit Thirteen, which has already been
5 introduced into the record.

6 **MR. VALLEJO:** Courtesy copy for the Court.

7 Q: Have you seen this document before, Professor?

8 A: I have.

9 Q: And could you tell us what it is?

10 A: This is the determination letter, the
11 Department's Determination letter.

12 Q: And could you turn to the second to last page
13 where you will see some highlighted language in
14 the middle of the page?

15 A: (Witness complies.) Yeah, just in my version
16 it is the third from the end.

17 Q: Fair enough. The document for the record does
18 not have page numbers, but do you see the
19 highlighted?

20 A: I do.

21 Q: Okay. Could you please read the highlighted
22 language for the Court?

23 A: Yes. "Meaning all of the specific activities
24 identified by DIRECTV lack any and all
25 intrinsic value without the actual provision of



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1 television programming to South Carolina
2 customers. It is vital to note here that each
3 and every one of the activities the taxpayer
4 attempts to characterize as income-producing
5 has no direct causal effect upon the generation
6 of income."

7 Q: Professor, from a tax policy perspective, what
8 is your view of the language that you just read
9 from the Department's Determination in this
10 case?

11 A: I think this would come as a complete shock to
12 our opening fact witness that everything he is
13 involved in, everything that takes place up
14 until the point the homeowner turns on the TV
15 is somehow has no direct causal effect upon the
16 generation of income and lacks all intrinsic
17 value.

18 I think, Your Honor, this was really the
19 question you asked Mr. Condon. Your argument
20 called always say that, that it's the only last
21 act that has the income-producing activity.

22 Well, it's the last act which makes sure you
23 get paid, but if you didn't have all these
24 other rather critical activities, like the
25 positioning of the satellite and the



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1 negotiating for content and negotiating with
2 the NFL, you wouldn't have anything to sell.
3 So I am -- I'm just puzzled by how anyone could
4 think this.

5 But it gets the Department out of the box by
6 saying there's only one income-producing
7 activity and it takes place here in South
8 Carolina, then they avoid having to make the
9 determination to the extent the
10 income-producing activity is performed within
11 South Carolina, because that applies only if
12 the income-producing activity is performed
13 partly within and partly without.

14 And so, Your Honor, this, of course, one of the
15 issues where the income-producing activities
16 take place and we heard quite a bit of evidence
17 on that.

18 **MR. VALLEJO:** Thank you, Professor. I have no
19 further questions at this time.

20 **THE COURT:** Who's going to be asking questions?
21 Mr. Condon?

22 **MR. CONDON:** (Indicating.)

23 **THE COURT:** Okay.

24 **DR. POMP - CROSS-EXAMINATION BY MR. CONDON:**

25 **Q:** Professor Pomp, let's take a look at your



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1 report. I believe it's Plaintiff's Number
2 Three. I did it again. Petitioner's Number
3 Three. And specifically page six.

4 A: (Witness complies.)

5 Q: Now, we've had another exhibit that introduced
6 Section 17 of UDITPA, but right here in the
7 middle of the page, your report includes it
8 also, doesn't it?

9 A: It does.

10 Q: Okay. And UDITPA -- this Section 17 deals with
11 service providers only; is that right?

12 A: No, it deals with sales other than the sale of
13 tangible personal property.

14 Q: Okay. Right, that's the distinction from
15 before --

16 A: Right, it includes --

17 Q: -- so I apologize.

18 A: It includes services.

19 Q: And so this statute, Section 17 of UDITPA, or
20 this model law, should I better say it, Section
21 17, for everything other than tangible personal
22 property, it would source revenues or source
23 receipts based on cost-of-performance, right?

24 A: Well, it sources it based on the state that has
25 the greatest proportion of income-producing



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1 activity and how we measure that will be the
2 use of cost-of-performance.

3 Q: And in Petitioner's Number Sixteen -- that is
4 the copy of UDITPA -- it, of course, has
5 Section 16 in there.

6 A: Yes.

7 Q: I believe on page nine of 11 it starts Section
8 16 of UDITPA. So this is the section that
9 deals with tangible personal property, right?

10 A: That is correct.

11 Q: Okay. Is income-producing activity, is that
12 term used in Section 16 of UDITPA?

13 A: It is not.

14 Q: Okay. So even though you were using -- talking
15 about Section 16, it's not relevant to the
16 income-producing activity issue in this case;
17 is that right?

18 A: I was drawing the contrast between the rules
19 for tangible and the rules for services. We,
20 of course, are a service, so we're Section 17.

21 Q: Okay. Did South Carolina adopt UDITPA?

22 A: Not as a formal matter, no.

23 Q: Are you aware of the -- that South Carolina is
24 now a single sales factor only -- has a single
25 sales factor only test for tangible personal



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1 property and manufacturing?

2 A: When you say now, you mean in 2015?

3 Q: Yes.

4 A: I know you were transitioning to it and since
5 this case doesn't involve tangible, I didn't
6 focus on the transitional period. But I
7 know -- if you're not there in 2015, it's the
8 direction you are moving in. I'm aware of
9 that.

10 Q: And our combination of Section 12-6-2290
11 amplified by 12-6-2295, that also is -- has a
12 single factor, but it's a gross receipts test;
13 is that right?

14 A: Well, here's what is going on. When it's
15 tangible, we use the word "sale" because by
16 custom and tradition, you sell tangible
17 personal property.
18 By custom and tradition, I guess professionals
19 don't like to view us as selling our services
20 to customers. And so we are service providers
21 to clients. You know, this is all part, I
22 think, of just our mind set. And so the word
23 "sale" would suggest a concept that we really
24 don't use in normal discourse. So when we move
25 to services, many states do change to the use



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1 of gross receipts.

2 Now, gross receipts would cover the sale of
3 tangible property, too, and the MTC in its
4 proposal is getting rid of this dichotomy for
5 tangible and for services.

6 But what I think you're seeing is the
7 reflection of a historical mind set, that we
8 don't sell a service, and so we really don't
9 have sales receipts. We provide a service and
10 we have gross receipts. That's all that's
11 going on. Nothing conceptual, nothing
12 substantive.

13 Q: Okay. So just to clarify, in 2295, it's
14 defining both sales, the single sales factor
15 for tangible personal property, and gross
16 receipts for basically everything else. So
17 there are -- is just one factor for both types
18 of property; is that right?

19 A: Well, I know during the audit period, you had
20 one factor for services; that's the only thing
21 I focused on, so.

22 Q: Now, I think I heard you say that -- and I hope
23 I get his name right -- that the first -- the
24 first witness for the Petitioner, Mr. Goswitz,
25 that his testimony showed that DIRECTV had



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1 income-producing activities outside the state;
2 is that what you said?

3 A: Absolutely.

4 Q: Now, did you hear -- were you here during his
5 testimony?

6 A: I was.

7 Q: Didn't -- when Ms. Wooten asked him about
8 income-producing activities, didn't he say he
9 wasn't going to make that legal opinion?

10 A: I don't know that he said legal. I think he
11 used the word definitional; entirely
12 appropriate response from someone who's a
13 rocket scientist and not imbued in taxation the
14 way we are. He's -- it's a term of art. He
15 has no great facility with a tax term of art.

16 Q: Right, understood. But he -- but from his
17 testimony, one -- especially after that answer,
18 one can't -- can't make that leap that he said
19 they're income-producing activities; is that
20 right?

21 A: From listening to his testimony and looking at
22 that chart, and listening to his whole
23 narrative about how much it takes to produce a
24 signal, starting with negotiation for content
25 and getting the satellites right and all the



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1 steps in between, I don't know how anyone could
2 conclude the opposite, that these are not
3 substantial, significant income-generating
4 activities.

5 Q: Right. But that's your conclusion, not his,
6 correct?

7 A: Yes. He doesn't know what Section 2295 is all
8 about and he's clueless as to what UDITPA is
9 all about, so why would he have an opinion.

10 Q: Can you point to any law that uses the word or
11 the phrase "intrinsic value" as part of a
12 definition of income-producing activities?

13 A: I have not done a Lexus search.

14 Q: Okay. California adopted the market -- is one
15 of those states that adopted this market-based
16 approach to sourcing of revenues; is that
17 right?

18 A: That is correct. And they use where the
19 benefit is received.

20 Q: Right. So California would not source any of
21 the subscription receipts from South Carolina
22 customers to California, would it?

23 A: You know, I have no idea. They have extensive
24 regulations. I've not looked at them. I've
25 been focused really on South Carolina. I have



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1 no idea what California would do.

2 Q: Okay. So let's flip back to your report,
3 please, again, Petitioner's Number Three, and
4 this time page seven.

5 A: (Witness complies.)

6 Q: In the first full paragraph, there at the end
7 of the first full paragraph, you have stated
8 that "Since South Carolina does not include
9 'cost-to-performance' in Section 12-6-2295,
10 that there are alternatives available." Is
11 that right? Do you see that?

12 A: Yes.

13 Q: Okay. And then I want to focus on the next
14 sentence in which you wrote, "These
15 alternatives would properly include payroll,
16 time spent in a state, or the location of
17 income-generating assets." Is that right? Did
18 I read that right?

19 A: You did.

20 Q: Okay. Aren't all of those alternatives you
21 listed cost-related alternatives?

22 A: Everything a corporation does to help generate
23 income is more than likely going to be a cost.
24 Think of the law firm that pays an associate a
25 hundred dollars an hour and bills their time



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1 out at \$200 an hour. That associate is an
2 income-producing activity and, of course,
3 there's a cost associated with the associate,
4 the salary. It takes money to make money. I
5 think I heard Phil say that. So the whole idea
6 of business is you spend "X" in order to make
7 "X" plus "Y."

8 "Cost-of-performance" is a term of art. The
9 MTC regulations go on to talk about direct
10 cost-of-performance versus indirect
11 cost-of-performance.

12 The South Carolina Legislature presumably did
13 not want to be saddled by some of the baggage
14 that comes along with the term
15 "cost-of-performance." It doesn't mean they're
16 prohibiting the use of costs at all. Indeed,
17 it doesn't mean they're prohibiting the use of
18 what another state might call
19 "cost-of-performance." All they're saying is,
20 "You have flexibility here, Tax Department.
21 You have flexibility, Taxpayers."

22 Q: So why wouldn't one of those alternatives be --
23 or one of those alternatives could be market
24 sourcing, market -- the location of the
25 customer, couldn't it?



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1 A: That is not an income-generating activity,
2 income-producing activity of the taxpayer.
3 Could be there are activities that happen to
4 take place, like the haircut situation, but the
5 fact that a customer sends you a check is not
6 the taxpayer's income-producing activity.

7 Q: But at this phase, aren't we after that
8 question? You're talking about
9 income-producing activity. Is not this talking
10 about how to allocate it amongst the states to
11 the extent of the income-producing activity?

12 A: When you say at this point, you mean the first
13 full paragraph on page seven?

14 Q: Yes, yes.

15 A: Well, once the income-generating activities are
16 identified, the next step is to determine the
17 extent to which the activities are performed in
18 South Carolina. So how are you going to
19 measure the extent to which income-producing
20 activities are performed in South Carolina for
21 purposes of the numerator of that sales factor,
22 gross receipts factor?

23 The paragraph goes on to say that South
24 Carolina does not explicitly reference
25 cost-of-performance; that's a term of art.



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1 There's cases talking about it. The MTC has
2 regulations about it. The Legislature is
3 freeing the State, freeing taxpayers, from that
4 baggage saying, "Look, you're not tied into
5 cost-of-performance as defined -- as used by
6 other states. You could use it. We're not
7 prohibiting it. There's not a statute that
8 says, 'And by the way, you cannot use
9 cost-to-performance.' It's simply saying
10 you're not mandated to use cost-to-performance.
11 There's other possibilities." That's all that
12 paragraph is saying.

13 Q: So if we're trying to figure out or
14 determine -- put a number in the numerator by
15 determining the extent to which the
16 income-producing activity is in South Carolina,
17 why don't we just add up the gross receipts in
18 South Carolina?

19 A: Well, you --

20 Q: That's an alternative, right?

21 A: You have the gross receipts of the taxpayer.
22 You now have to determine out of those gross
23 receipts. They represent gross receipts from
24 all sources across the country. You now have
25 to determine the extent to which those gross



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1 receipts are going to be attributable to South
2 Carolina; that's the goal.

3 You have all of these gross receipts. Which of
4 those will be attributable to South Carolina?
5 And we are told to determine the extent to
6 which the income-producing activity is
7 performed within South Carolina. So we're
8 told, that's the way you go about doing it.

9 Q: Right. So -- and it's kind of the same
10 question, but -- but if DIRECTV -- there's been
11 testimony earlier that DIRECTV had 20 million,
12 I think, customers in the United States. So if
13 we have a hundred thousand of those in South
14 Carolina, are we not determining the extent to
15 which the income-producing activity is in South
16 Carolina if we just add up the gross receipts
17 for those 100,000 customers in South Carolina?

18 A: You are not. That is market-based sourcing.
19 You are not looking at where the
20 income-producing activity is being performed.
21 You're simply looking to where the customer is;
22 that's market based, the antithesis of
23 income-producing activity.

24 Q: But, again, you understand that the
25 Department's Determination has determined that



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1 the income-producing activity is in the living
2 rooms of the customers, right?

3 A: Well, in one place I understand that you are --
4 according to the heading "sourcing of receipts"
5 in the report of the field audit, you are
6 determining the apportionment ratio on
7 market-based sourcing; that's what you say
8 under a heading "sourcing of receipts." And in
9 another place, you are saying that none of the
10 activities that take place out of state have
11 any intrinsic value and there's no direct
12 causal effect upon the generation of income.
13 So I think that's an attempt to justify
14 market-based sourcing.

15 Q: Okay. You've got Respondent's Number Thirteen
16 there, the Department Determination?

17 A: Let me just make sure.

18 (Off the Record)

19 Q: Okay. And, now, I do believe that the
20 Department's Determination has been labeled as
21 Respondent's Thirteen.

22 A: Okay.

23 Q: Okay. So we both said "okay," we're ready.

24 A: We're ready.

25 Q: Do you know that the Department's Determination



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1 is -- in this administrative law area, it's the
2 decision of the Department. Do you understand
3 that?

4 A: It's the decision of the Department. Is that
5 what you said?

6 Q: Yes, sir.

7 A: As opposed to what?

8 **THE COURT:** Well, I think you need to answer his
9 question.

10 **THE WITNESS:** I guess --

11 **THE COURT:** Is the Department's Decision a decision
12 of the Department?

13 **THE WITNESS:** Okay, yes.

14 Q: And generally in this case, it has affirmed
15 the -- at least the results of the numbers of
16 the audits from 2006 to 2011. Is that your
17 understanding of what its purpose was or is?

18 A: So it has upheld the audit.

19 Q: Yes.

20 A: Yes.

21 Q: Okay. So let's flip to -- and, again, it's not
22 numbered, but I think it's the third page from
23 the end and it has a -- just to identify it, it
24 has a bolded three words in the middle that
25 says "this final act."



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1 A: I am with you.

2 Q: Okay. And so exactly that sentence I want to
3 ask you about. Regardless of what was in the
4 audit reports, based on the nature of the
5 Department's Determination, do you see that the
6 Department's Determination was that the
7 income-producing activity was, quote, "The
8 delivery of the signal into the homes and onto
9 the television screens of its customers"?

10 A: I see that sentence, yes.

11 Q: Okay. Let's stay on page seven of your report,
12 Professor Pomp.

13 A: Right.

14 Q: So back to Plaintiff's Number Three -- or, I
15 apologize again, Petitioner's Number Three,
16 page seven.

17 A: Yes.

18 Q: And that's where you were talking about
19 external consistency.

20 A: Correct.

21 Q: Was that also the issue in that *Moorman* case
22 that you referred to?

23 A: The term had not yet been developed by the
24 Supreme Court at the time of *Moorman*. *Moorman*
25 predates a case called *Container*, maybe six,



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1 seven years later, and it is Container that
2 develops the external consistency test.

3 Q: So in *Moorman*, the issue was whether Iowa's
4 single factor sales test was okay, was
5 constitutional; is that right?

6 A: They were attacking it on the grounds that it
7 violated both the due process clause and the
8 Commerce Clause. They did not have the
9 external consistency test to rely on because
10 that test had not yet been developed.

11 Q: Has the *Moorman* case in Iowa been overruled?

12 A: No.

13 Q: Okay. On page seven, when you were talking
14 about external consistency, you stated that
15 "The South Carolina Supreme Court has held that
16 a factor or factors used in an apportionment
17 formula must reflect a reasonable sense of how
18 the income is generated." Is that right?

19 A: I'm sorry, what page?

20 Q: I believe it's page seven.

21 A: Page seven? And which paragraph?

22 Q: The second full paragraph and the second line
23 of the second full paragraph.

24 A: "The United States Supreme Court." I see why
25 I got -- I thought you said "South Carolina,"



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1 but I may have misheard you. "The United
2 States Supreme Court has held that the factor
3 or factors used in the apportionment formula
4 must reflect a reasonable sense of how income
5 is generated." That is correct.

6 Q: And courts have held that a single sales factor
7 satisfies that Supreme Court statement, right?

8 A: Well, there's no case after *Moorman* in which
9 the U.S. Supreme Court has revisited this
10 issue, so.

11 Q: A lot of jurisdictions use a single sales
12 factor test, don't they?

13 A: It's getting increasingly popular and there are
14 situations where we have not talked about
15 Section 18 of UDITPA because it is not at issue
16 in this Court -- in this case, but just for
17 background, for His Honor, Section 18 of UDITPA
18 is what we call "equitable apportionment" or
19 "alternative apportionment." It's a
20 recognition that Section 16, Section 17 really
21 can't possibly anticipate every possible fact
22 pattern and one size can't fit all.

23 And so Section 18 is a safety valve. It's an
24 exculpatory provision. It allows the tax
25 department on its own, it allows a taxpayer to



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1 request from a tax department a different
2 approach, one not in the statute, in order to
3 get a better reflection of income. And so
4 there are lots of Section 18 situations where
5 a taxpayer is coming in and attempting to
6 burnish their rough edges of single factor.

7 Q: Okay. So when a taxpayer is doing some
8 business in South Carolina that is going to
9 file a corporate tax -- you know, a multi-state
10 taxpayer is going to file a corporate income
11 tax in South Carolina and then when the
12 Department looks at it, we're going to use this
13 gross receipts ratio, right? A service
14 provider. And when we're talking about the
15 numerator, we're trying to figure out how much
16 of the denominator the total gross receipts
17 should go up in the numerator; is that right?

18 A: That's right. The denominator gross receipts
19 everywhere, numerator South Carolina gross
20 receipts.

21 Q: Right, okay. So let's turn to page six of your
22 report, please.

23 A: (Witness complies.)

24 Q: Okay. In the very last paragraph that looks
25 like it tabs over to the next page, in the



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1 first sentence of that very last paragraph it
2 says, "South Carolina can be characterized as
3 sourcing gross receipts from the provision of
4 services on a proportional basis." Do you see
5 that?

6 A: I do.

7 Q: Okay. And that gets back to the whole thing
8 that our General Assembly chose not to be a
9 greater proportion state but a "to the extent
10 of" or proportional state; is that right?

11 A: Correct.

12 Q: Okay. So isn't the Department -- isn't it true
13 that the Department is proportioning that total
14 receipts everywhere when it only puts South
15 Carolina receipts in the numerator?

16 A: No, you are not determining the extent to which
17 DIRECTV's income-producing activity is
18 performed in the state. You are simply
19 adopting a market-based approach. The customer
20 is in South Carolina, they pay "X," that goes
21 into the numerator. That's not what 2295 cap
22 (A)(5) says. So you are not following that
23 statute.

24 You could describe it any way you want, but
25 you're not following that statute. You are not



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1 making any determination of the
2 income-producing activity that is being
3 performed in South Carolina other than by
4 saying, "There is no other income-producing
5 activity. There is only one income-producing
6 activity and that takes place in South
7 Carolina." That's the way you justify
8 market-based sourcing, as I understand all
9 these documents.

10 And it couldn't be any clearer. You have the
11 Department saying, "Oh, there's no value at all
12 to these activities that take place outside of
13 South Carolina. They have no intrinsic value."
14 Well, I am a little taken aback by thinking:
15 There's no intrinsic value to programming, to
16 getting a satellite in a synchronous orbit, to
17 be able to transmit the programming?

18 Q: But your conclusion -- when I asked you whether
19 putting the South Carolina receipts in the
20 numerator was, in fact, proportional, your
21 conclusion was "no," and the reason was --
22 well, isn't it true that the reason was you've
23 just got a different definition of
24 "income-producing activity" than the
25 Department?



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1 A: Well, it is true that I am looking at if the
2 income-producing activity is performed partly
3 within and partly without. The Department
4 takes the position there is no income-producing
5 activity performed partly within and partly
6 without. There is only one income-producing
7 activity and that is when the consumer turns on
8 the TV, sees the signal, pays the bill, that
9 that is your understanding of what the
10 income-generating activity is.
11 And, A, that -- the paying the bill is not
12 income-generating activity by DIRECTV and
13 that's what the statute is looking to. What's
14 the income-generating -- income-producing
15 activity by DIRECTV? That's activity by the
16 consumer.
17 But, second, I do disagree in terms of there
18 being only one income-producing activity and it
19 takes place in South Carolina. I mean, I
20 listened to the testimony as you did and I have
21 come away with a completely opposite
22 conclusion.
23 I don't think the auditor ever talked to anyone
24 in the company other than the tax people to
25 really learn the operations at the time they



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1 wrote that determination letter, so.

2 Q: So the denominator of the gross receipts factor
3 that I think both parties are using -- I don't
4 think we disagree on that -- but the
5 denominator is the gross receipts from all of
6 the 50 states in the United States; is that
7 your understanding?

8 A: That's my understanding.

9 Q: Okay.

10 A: I think both sides agree on that.

11 Q: Okay. And, of course, DIRECTV has 20 million
12 customers -- we've already heard 20 million
13 customers all over the United States, right?

14 A: Whatever the number is, yeah.

15 Q: Yeah, yeah, whatever. So based on the
16 Department's view, wouldn't there be
17 income-producing activities in living rooms all
18 over the United States, not just in South
19 Carolina?

20 A: Well, I think that's your view. You would then
21 go to North Carolina and say, "Oh, there's one
22 income-producing activity that takes place in
23 North Carolina and that -- for the same reason,
24 that's when the North Carolina person turns on
25 their TV and they pay the bill." And that's



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1 what you and I and the Department and the
2 taxpayer fundamentally disagree, whether
3 they're income-producing activity that is
4 performed partly within and partly without
5 South Carolina.

6 Q: But under the Department's Determination and
7 view, we wouldn't tax DIRECTV on its revenues
8 in other states, would we?

9 A: No, under your market-based approach, you're
10 looking only to the South Carolina market.
11 It's not what the statute says.

12 Q: Okay. Let's flip to page nine of your report,
13 please.

14 A: (Witness complies.)

15 Q: And the second full paragraph beginning with
16 "The Tax Department." Again, you've mentioned
17 it several times, this is the -- at least one
18 of the paragraphs where you said -- referred to
19 the Department saying that the taxpayer -- the
20 non-South Carolina activities are lacking
21 intrinsic value, right?

22 A: Yes, this is really just a quote from the
23 Department's own document.

24 Q: No -- and you are correct, yes. When I brought
25 that up earlier, yeah, I realize -- even though



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1 there's no quotes in your text here, I do
2 realize that's in the -- in our Department
3 Determination.

4 So let's go to the Department Determination,
5 which, again, is Respondent's Number Thirteen.
6 And I didn't write down my page number
7 reference here, so let me find it.

8 **MR. CONDON:** One moment please, Your Honor.

9 Q: Unless you can find it ...

10 A: Well, there are no page numbers, in fact.

11 Q: Yes, but I'm looking for the reference to
12 "intrinsic value."

13 A: I think that's the issue. You might encourage
14 the Department to start using page numbers in
15 the future. It's just so much easier.

16 **THE COURT:** That should be a policy consideration?

17 **THE WITNESS:** Yes, I think it ought to go to the
18 highest levels or we wouldn't be sitting here
19 trying to figure out where anything else.

20 Q: Okay. I'll find that if I need to. But do you
21 remember that right after the Department's
22 comments about "lacking intrinsic value" that
23 it stated -- it included the words "lacked
24 intrinsic value," quote, "without the actual
25 provision of television programming to South



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1 Carolina customers"?

2 A: I really have to see the entire context.

3 Q: Okay. I'll try to see if I can find that and
4 let you look at it before we --

5 **MS. WOOTEN:** (Indicating.)

6 **MR. CONDON:** Oh, we've got it?

7 Q: Okay. It looks like -- it's the third page
8 from the back that has that quote or that
9 phrase highlighted, "The final act -- this
10 final act"?

11 A: Yes.

12 Q: Okay, yeah. So -- and about in that same
13 paragraph, just about six lines up from that
14 highlight, there's a sentence that starts with
15 "meaning." Do you see that?

16 A: One, two, three, four, five, six, in that
17 paragraph, six lines up. And what is the first
18 sentence of that?

19 Q: It says, "Meaning all of the specific
20 activities identified." That's the beginning
21 of that sentence?

22 A: Boy. Oh, the sentence or the line?

23 Q: The sentence, please.

24 A: The sentence?

25 Q: Yes.



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1 A: One, two, three, four, five, six. I have "That
2 produces income for DIRECTV" is my six one up.
3 What is the beginning of the line?

4 Q: "Satellite." "Satellites into the homes."

5 A: Huh, this is interesting.

6 **THE COURT:** Are you in the paragraph that starts
7 with "Furthermore DIRECTV argues"?

8 **THE WITNESS:** That's the paragraph I'm in. Is that
9 the one you're in, Mr. Condon, "Furthermore" --

10 **MR. CONDON:** Yes, sir.

11 **THE WITNESS:** -- "DIRECTV argues."

12 And you're saying that on the left side -- oh,
13 "Satellites" -- oh, it's not up from the
14 bottom. It's down from the top. One, two,
15 three, four -- I'm sorry, I thought you said up
16 from the bottom. Okay. I see it. I'm with
17 you.

18 Q: No, I probably didn't make that clear, I
19 apologize.

20 A: Okay.

21 Q: Okay. So the sentence that starts with
22 "meaning," comma, "all the specific
23 activities."

24 A: Yes.

25 Q: Do you see that?



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1 A: I do.

2 Q: Okay. Would you take a minute and read that,
3 please, to yourself?

4 A: Uh-huh (affirmative response). (Reading.)
5 Okay.

6 Q: Okay. So isn't it true that the Department
7 qualified its statement that these
8 activities -- out-of-state activities have no
9 intrinsic value when it said "without the" --
10 quote, "without the actual provision of
11 television programming in -- to South Carolina
12 customers"?

13 A: I am trying to find the "without" now. So just
14 help me. The "without" is found in which
15 sentence?

16 Q: Same sentence.

17 A: "It is this final act"?

18 Q: No.

19 A: Which -- oh, the one that begins -- yeah.

20 Q: There's "meaning" (indicating).

21 A: "Meaning" -- okay, "meaning all of the specific
22 activities identified by DIRECTV lack any and
23 all intrinsic value without the actual
24 provision of television programming to South
25 Carolina customers." Is that ...



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1 Q: Yes, that's the sentence I'm referring to.

2 A: Okay.

3 Q: So isn't it -- isn't that a statement that
4 the -- that the Department's qualifying its
5 statement that these non out-of-state
6 activities have no intrinsic value without the
7 actual provision of television programming to
8 South Carolina customers?

9 A: Well, you know, this is what we call the "but
10 for" fallacy. You're saying that but for the
11 ultimate sale to South Carolina customers,
12 there is no value at all in anything that you
13 have done previously.

14 And we call that the "but for" fallacy because
15 one could go on each step of the production and
16 say, "Well, but for the satellite, there would
17 be no signal that could be delivered to the
18 customer; therefore, the customer is no
19 intrinsic value. All the value is in the
20 satellite." And that is known as the "but for"
21 fallacy. First year law students learn this in
22 torts when they study causality.

23 Well, but for the alarm being defective, you
24 wouldn't have been late, and if you wouldn't
25 have been late, you wouldn't have been at that



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1 intersection, and if you wouldn't have been at
2 that intersection, you wouldn't have been in
3 that accident, so it's but for the alarm clock.
4 And this is the same thing. It's just a tax
5 application of the "but for" fallacy.
6 The point is, you need each step to have occur
7 for there to be something at the end to sell to
8 the customer. It's all critical steps. Take
9 away the satellites, you don't have anything to
10 sell. Take away the content, you have nothing
11 to sell. Take away the NFL franchise, you have
12 nothing to sell. So I don't know what this
13 actually shows, so.

14 Q: Okay. Let's move to the very next sentence in
15 that same paragraph that begins with "it is
16 vital."

17 A: Let me catch up to you. Yes.

18 Q: Okay. So this is the sentence -- you referred
19 to it earlier, because I think it was referred
20 to in your report, but it was referred in your
21 report about -- about the -- "has no direct
22 causal effect upon the generation of income."
23 Do you remember including that --

24 A: Yes.

25 Q: -- language in your report?



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1 A: Well, I'm happy to talk about it, whether it's
2 in the report or not, so.

3 Q: Well, isn't it true that without customers in
4 South Carolina subscribing to and then watching
5 DIRECTV's -- the video screen, the television
6 screen coming from DIRECTV, isn't that a direct
7 link, causal link to the revenues?

8 A: It is no more direct causal link than are the
9 satellite a direct causal link. So, again,
10 you're just restating the "but for" fallacy,
11 I'm afraid.

12 You know, two things are critical. We need --
13 well, there's more, but I'll just simplify to
14 two things. We need content and we need a way
15 of getting that content to the consumer.
16 It's -- as a matter of a priori logic, you
17 can't tell me one is the cause and the other's
18 not. Both are necessary.

19 Q: Okay. Let's flip to the very last paragraph of
20 your report, page nine, bottom of page nine.

21 A: Okay. I -- okay. I am with you.

22 Q: Okay. So this -- based on what I see on the
23 first line, this paragraph seems to be talking
24 about how we measure the extent to which
25 income-producing activity is performed in a



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1 state; is that right?

2 A: I will read it.

3 Q: Okay.

4 A: "Opinions can also differ on how to measure the
5 extent to which income-producing activities
6 should be viewed as taking place in South
7 Carolina."

8 Q: Okay. And so in your second sentence, you seem
9 to imply, strongly, that the Department is
10 simply ignoring those outside activities; is
11 that right?

12 A: Yes, but from a policy perspective answering
13 that question, by simply ignoring the outside
14 activities is unacceptable and that, I thought,
15 is what we just read. I thought you just had
16 me read why these outside activities should be
17 ignored, because they have no direct causal
18 effect according to the Department. They are
19 inherently indirect activities. No intrinsic
20 value. "All these specific activities taking
21 place outside South Carolina lack any and all
22 intrinsic value without the actual provision of
23 television programming to South Carolina
24 customers."

25 And what I am saying is, and I think



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1 accurately, that the statute says determine the
2 extent to which income-producing activities
3 should be viewed as taking place in South
4 Carolina. You claim there are no
5 income-producing activities that take place
6 outside of South Carolina. There's only one
7 income-producing activity and that takes place
8 in South Carolina.

9 And what I say is, look, opinions can differ on
10 how to measure the extent to which
11 income-producing activities take place in South
12 Carolina, but answering that question by simply
13 ignoring the outside activities is
14 unacceptable.

15 In other words, you might want to quibble about
16 how we're going to take into account those
17 income-producing activities of getting content
18 and programming. But to say they have no value
19 at all, to say they're not income-producing
20 activity is where you and I disagree.

21 Q: Yes, we disagree. But assuming that the
22 Department's view is correct, there would be no
23 need to use -- to do anything other to
24 calculate the numerator of the gross receipts
25 factor than to add up the subscription receipts



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1 from South Carolina customers, just as DIRECTV
2 did in its original returns from 2006 to '08;
3 is that right?

4 A: Well, I don't know what -- I didn't look to see
5 what they did in their original returns, but we
6 have amended returns exactly in case people
7 change their position.

8 But you're saying to me, "Assume the
9 Department's right; don't you agree?" I'm
10 assuming away the issue. So if you want me to
11 assume the Department has gone to market-based
12 sourcing, "Don't you agree we've done it
13 right?" Well, I guess, under some definition
14 of market-based sourcing you have done a good
15 job of market-based sourcing. It's just not
16 the South Carolina statute, that's all. If you
17 were in another state, yeah, maybe you would've
18 done a perfect market-based sourcing. It's
19 just not South Carolina law.

20 Q: All right. Let's change a little bit. We're
21 going to ask a few questions about your Direct
22 testimony, specifically follow-ups from some
23 that.

24 A: Uh-huh (affirmatively responds).

25 Q: When you were giving the -- talking about the



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1 three-factor formula that's related to tangible
2 personal property on your chart there, you
3 stated that the property and the payroll
4 factor -- not the sales factor, but the
5 property and payroll factor -- identified the
6 income-producing activities; is that right?

7 A: That they're origin based, that they take into
8 account the capital and the labor.

9 Q: But, again -- but the -- the Section 16 that
10 deals -- that has a three-factor test that
11 deals with tangible personal property doesn't
12 even mention income-producing activities.
13 We've already agreed to that, right?

14 A: That is correct.

15 Q: You said that *Lockwood Greene* gave the South
16 Carolina rule. Do you remember saying that?

17 A: I don't. We can read it back. I'm not sure
18 that's what I said, but I ...

19 Q: I'll ask a question and we can discuss it --

20 A: Sure.

21 Q: -- if we need to.

22 A: Sure.

23 Q: But isn't it true that *Lockwood Greene*, which
24 I assume you're familiar with since you've
25 answered questions about it, dealt only with an



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1 engineering firm?

2 A: That was the fact pattern before it.

3 Q: And isn't it true that the court in *Lockwood*
4 *Greene*, as written in the opinion,
5 differentiated an engineering firm from a
6 finance company and a media broadcasting
7 company?

8 A: Well, here's what it says at the end of the
9 opinion: That *Lockwood* also argues the statute
10 has not been consistently interpreted by the
11 Tax Commission. *Lockwood* refers to the Tax
12 Commission guidelines concerning computation of
13 the gross receipts of finance companies and
14 media broadcasters. We are not persuaded these
15 businesses are comparable to *Lockwood*. By
16 contrast, the Tax Commission guidelines
17 concerning law firms, accounting firms,
18 entertainment and sports companies, hospital
19 management companies, all focus on whether the
20 services are performed in South Carolina.
21 These situations are analogous and consistent
22 with the situation of *Lockwood*."

23 I have not seen the guidelines. I have asked.
24 Now I heard it conceded today that these
25 long-standing guidelines are in the minds of



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1 the Department, that you can't read them
2 anywhere.

3 It could well be that if I were to look at
4 these guidelines, I would say, "You know what?
5 They really are attempting to reach a place of
6 performance or a place of activity approach."
7 It's just maybe not obvious given where our
8 learning was back in these earlier years.

9 So I don't know what the guidelines are. I
10 don't know how to evaluate it. It became very
11 easy for the court to say, "Don't bother us
12 with guidelines because those are different
13 companies." For all I know, those guidelines
14 are perfectly consistent with the holding in
15 *Lockwood Greene*. I can't evaluate it because
16 I've now learned that these long-standing
17 guidelines really don't exist, or at least they
18 exist in the minds of the Department, but -- so
19 I don't know what that means.

20 Q: Okay. So you read that the court found that
21 *Lockwood Greene* was not comparable to finance
22 companies and media broadcasters.

23 A: That's what it says. "We are not persuaded
24 these businesses are comparable to *Lockwood*."
25 It could well be the guidelines are



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1 inconsistent with the statute for all I know,
2 that the guidelines are an improper application
3 of the statute. It's just impossible to know
4 how to evaluate this comment without having the
5 guidelines in front of us.

6 Q: So there would be no reason for the *Lockwood*
7 court to differentiate businesses in --
8 different service providers but in different
9 service providing industries if its rule -- if
10 its goal was to establish one rule for all
11 service providers, would it?

12 A: I'm sorry. Could you repeat that?

13 Q: Yes, I apologize. Since the court
14 differentiated between *Lockwood*, an engineering
15 company, and media broadcasters and finance
16 companies, it seems very logical that it was
17 not trying to establish a single sourcing rule
18 for all service providers; is that right?

19 A: It wasn't being asked to. For -- all the court
20 was saying is, "Look, don't bother us with
21 these guidelines for other companies. We don't
22 want to look at these guidelines. Those
23 companies aren't comparable." Maybe if it did
24 look, it would find the guidelines were
25 inconsistent with the statute. Maybe it would



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1 find that the guidelines were consistent with
2 the approach it took in *Lockwood*, but it didn't
3 have to go down that path.

4 **THE COURT:** So under that theory, *Lockwood* would not
5 necessarily be binding upon this Court in this
6 case because they made no pronouncement one way
7 or the other.

8 **THE WITNESS:** Well, they -- what they did was, they
9 rejected market-based sourcing, Your Honor. I
10 think we can say that.

11 **THE COURT:** I understand that.

12 **THE WITNESS:** And if that's what the Department is
13 interpreting --

14 **THE COURT:** I was really more asking beyond that
15 rejection and what analysis do we take --

16 **THE WITNESS:** Yeah.

17 **THE COURT:** -- following that.

18 **THE WITNESS:** That rejection's an important part of
19 *Lockwood*, of course, to reject market-based
20 sourcing.

21 Now, they endorse what I think is consistent
22 with the statute, that we're looking for
23 income-producing activity. And in terms of
24 what might the Department do with other
25 taxpayers? Who knows. I don't know. I know



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1 there's some stipulation, but that's not
2 binding on DIRECTV that didn't even exist then,
3 so.

4 Q: Professor, I'd now like to direct you to --
5 back to the binder of exhibits and it's
6 Respondent's Number Eighteen. It's your
7 Hearing Officer report, MTC Hearing Officer
8 report.

9 A: Yes. Now there's at least two of us that have
10 read it.

11 Q: Can you take a look at this, what's been
12 marked -- what did I say -- as Respondent's
13 Number Eighteen and determine that it's a
14 complete and accurate report -- or a copy of
15 your report?

16 A: Yeah. I mean, to do it right would take quite
17 a while. I'm willing to assume it is, unless
18 I see something that seems odd.

19 MR. CONDON: Okay. I would like to move this into
20 evidence.

21 THE COURT: Any objection?

22 MR. VALLEJO: No objection, Your Honor.

23 THE COURT: It's admitted.

24 (Respondent's Exhibit Number Eighteen was admitted
25 into evidence.)



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1 Q: Just to put this back in context -- I mean, you
2 got a lot in the report that's not really at
3 issue here today, so.

4 A: That is correct.

5 Q: To kind of put it into context of what is at
6 issue, you already said, but let's put it back
7 into context, if you don't mind. What's really
8 applicable -- or part of what might be
9 applicable here is the discussion related to
10 the decision or the intent to move to a
11 market-based sourcing method for service
12 providers, correct?

13 A: No, I don't know that that's relevant.

14 Q: No?

15 A: I mean, I don't know that the Legislature is
16 debating this. So I don't know that that's
17 relevant, but I'm happy to talk about the
18 report.

19 Q: Okay. But that was -- but that was part of the
20 issue of your -- in your report, correct, that
21 was a major issue?

22 A: Well, a major issue was the MTC recommending
23 that the states replace Section 17, you know,
24 the counterpart of what we see here in 2295,
25 with market-based sourcing.



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1 Q: Right.

2 A: That's a legislative decision.

3 Q: Right.

4 A: It's not for --

5 Q: Yeah, I didn't mean to --

6 A: Right, okay.

7 Q: -- imply that South Carolina was simultaneously
8 trying to do the same thing or anything.

9 A: Yeah. Well, I think the tax department said it
10 was doing the same thing, which is quite
11 astounding that an executive branch agency
12 could be doing market-based sourcing when the
13 legislative branch says, "No, we're not
14 market-based sourcing." I mean, that's a
15 separation of powers issue. But be that as it
16 may, let's go into whatever it is you'd like to
17 talk about.

18 Q: Okay. And I'll find the pages if we need it,
19 but a lot of this I think you might remember.

20 A: Luckily they're numbered.

21 Q: Yeah.

22 A: It's a great innovation.

23 Q: We're going to learn from you on that one.

24 A: Yeah, a great contribution.

25 Q: You say in here a couple -- a few references,



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1 I think, about that uniformity in apportionment
2 laws has been pretty difficult to achieve over
3 the years; is that right?

4 A: Uniformity in state taxation has been pretty
5 difficult to achieve for all sorts of reasons..

6 Q: And that includes in the apportionment area of
7 state taxation, correct?

8 A: We know we have UDITPA, evenly weighted
9 three-factor; we have states double weighting
10 the sales factor; we have states using only a
11 sales factor. Whatever uniformity there might
12 have been has broken down quite a bit.

13 Q: But in here, you actually said that even as --
14 even back as the late '50s when UDITPA was
15 proposed, uniformity never quite existed,
16 right?

17 A: Not exactly. Let's look at the page --

18 Q: Yeah.

19 A: -- and the statement..

20 Q: We can go to page 16.

21 A: Okay.

22 Q: And it's the second paragraph under Roman
23 numeral four there --

24 A: Right.

25 Q: -- little four.



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- 1 A: And the emphasis here is that we always had
2 specialized formulas for specialized industries
3 and these were distinct from the three-factor
4 formula.
5 So people argue that if you don't have the same
6 apportionment formula, my goodness, you're
7 sacrificing uniformity. All the states should
8 either double weight or whatever; it all ought
9 to be the same. And I guess what I'm saying
10 is, well, that probably overstates the issue,
11 because we've always had these specialized
12 formulas that coexisted with the three-factor
13 formula. That was the point of this paragraph.
- 14 Q: Okay. And you kind of refer to it, but later
15 on you talked about MTC, it said, "labored
16 mightily to develop industry specific
17 formulas," so.
- 18 A: Correct.
- 19 Q: So I guess many people in the industry have
20 thought, "Well, maybe we can't achieve complete
21 uniformity and possibly doing some
22 industry-specific rules that address those
23 industries specifically might actually be a
24 good thing." Is that what many people believe?
- 25 A: Yeah, I think that's correct.



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1 Q: So referring back to your report, when you say
2 the lack of cost-to-performance -- based on
3 cost-to-performance right here at the end of
4 12-6-2295, if the Department has different
5 sourcing methods all while applying a gross
6 receipts factor and looking at income-producing
7 activities but have them different for
8 different industries, isn't that one of the
9 alternatives that could be used?

10 A: As long as it's consistent with the statute.

11 Q: Okay. It's probably easier if I just tell you
12 the pages instead of asking you a question with
13 the page. Let's flip to page 58, I believe,
14 and the very top of page 58.

15 A: (Witness complies.)

16 Q: And let's look at the -- I'll give you a minute
17 to look -- a second to look at it or a minute
18 to look at it, whatever it takes. The first
19 sentence on the top of 58 -- and I'd also like
20 to refer you to a sentence on page 64. I think
21 it's -- wait a minute. 85, I'm sorry, is the
22 second reference.

23 A: (Reading).

24 Q: Okay. So let's look at the first sentence on
25 58.



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1 A: Yes.

2 Q: "The goal of harmonizing Act Article 416 and
3 draft Article 417 with respect to the
4 destination principle is laudable." There,
5 what we're really referring to is what we've
6 already kind of referred to as the UDITPA
7 Section 16 and 17?

8 A: Yes.

9 Q: Okay. So one's the apportionment factor for
10 tangible personal property and one's the
11 apportionment formula for everything else; is
12 that right?

13 A: Correct.

14 Q: Okay. And so here, you seem to be recognizing
15 that it's a reasonable goal to have -- for the
16 apportionment of those two different types of
17 businesses to be, if not the same, at least
18 very similar; is that fair?

19 A: It's a laudable goal.

20 Q: Okay.

21 A: Later, I point out the difficulties in trying
22 to conform the two sections, but it's
23 certainly --

24 MR. VALLEJO: Your Honor --

25 A: -- a laudable goal.



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1 **MR. VALLEJO:** Objection. I object to relevance.
2 This has been going on for a long time and I'm
3 very much struggling to find out why this is
4 relevant.

5 **THE COURT:** You want to respond?

6 **MR. CONDON:** Yes, Your Honor. I mean, my next
7 question might help clarify it, but in this
8 case in specific --

9 **THE COURT:** Well, I'll tell you what. We'll go to
10 the next question --

11 **MR. CONDON:** Okay.

12 **THE COURT:** -- but then I'll hear the objection
13 again.

14 **MR. CONDON:** Okay.

15 **MR. VALLEJO:** Thank you.

16 Q: And so if harmonizing the apportionment for
17 tangible personal property and everything else
18 which includes services is a laudable goal,
19 wouldn't South Carolina's current statute that
20 has a single gross receipts factor for
21 services -- well, really everything other than
22 tangible personal property and
23 manufacturing -- and the single sales factor
24 for tangible personal property, wouldn't that
25 be a laudable goal, as well?



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1 **MR. VALLEJO:** Objection, irrelevant.

2 **THE COURT:** You want to respond to that?

3 **MR. CONDON:** Your Honor, the General Assembly
4 passed -- when it added this (indicating),
5 2295, and this references 2295 down here, at
6 the same time it was also moving to a single
7 sales factor for -- from a three-factor test to
8 a single-factor test for tangible personal
9 property. I think this goes to legislative
10 intent, that it was trying to harmonize these
11 two calculations.

12 **THE COURT:** I'm not so sure what the MTC report has
13 to do with any of this. I mean, it's a report
14 that hasn't even been adopted yet, has it?

15 **MR. CONDON:** Well, it shows that a tax -- that that
16 view of the legislative intent is on target
17 because we have an esteemed law professor here
18 who's testifying on tax policy saying that it's
19 a laudable goal.

20 **THE COURT:** Well, he's on Cross; there's wide
21 latitude. I mean, I do think we're getting
22 close to irrelevant, but I'll let you proceed.

23 **MR. VALLEJO:** I have a further objection, Your
24 Honor, which this is clearly beyond the scope
25 of Direct at this point and I've let this go on



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1 for a long time.

2 **THE COURT:** But in South Carolina, the
3 Cross-Examination is not limited to Direct.

4 **MR. VALLEJO:** It's obviously your call.

5 **THE COURT:** Well, I think the Rules of Evidence kind
6 of made that call when they said that it's
7 beyond the scope of Direct, but go ahead.

8 **MR. VALLEJO:** Fair enough.

9 **THE COURT:** But I would like to move this along.

10 **MR. CONDON:** Yes. Almost finished, Your Honor.

11 Q: Professor Pomp, are you being compensated for
12 your work here today?

13 A: Yes, but not on a contingency basis.

14 Q: Okay, yes. And I believe at the deposition you
15 told me you were getting paid in the range of
16 about \$600 an hour; is that right?

17 A: Actually, I never even went back and looked
18 after the deposition, but I was in a
19 transitional period of my rates, so somewhere
20 in there.

21 Q: And, of course, you get paid for the deposition
22 and various preparation time, as well, right?

23 A: Of course.

24 Q: Earlier on Direct, didn't you make a comment
25 that, quote, "We all make a living playing with



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1 the tax rules"?

2 A: Something of that effect; of course, that's
3 what tax lawyers do.

4 MR. CONDON: No more questions, Your Honor.

5 THE COURT: Redirect?

6 MR. VALLEJO: It's up to the Court, if you'd like to
7 take a break, or else we can call our next
8 witness right now if you want to move along.

9 THE COURT: Well, I've got a couple of -- I said do
10 you have any --

11 MR. VALLEJO: Oh, I don't have any Redirect for
12 Professor Pomp.

13 THE COURT: I've got a few questions. When we're
14 looking at determining income-producing
15 activity, you testified that we look to the
16 intrinsic value of the activity; am I correct
17 on that?

18 THE WITNESS: No, I -- their correspondence said
19 there was no intrinsic value to these
20 out-of-state activities.

21 THE COURT: Well, then what do you believe we look
22 to?

23 THE WITNESS: Well, I think you look to see -- I
24 mean, I guess one position is, everything a
25 corporation does is to make a profit or else



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1 the corporation is not going to be doing it.
2 They're not charitable organizations. So all
3 of its activities are income-producing.
4 The MTC regulations say, well, that's too
5 broad. Look at direct versus indirect. And
6 there's some logic to this, because I think we
7 don't want to bias the calculation in favor of
8 states where your overhead is located. So they
9 want you to look -- at least the regs and
10 states that draw this direct/indirect, they
11 want you to look at the activities that are not
12 heating the factory, those kind of indirect
13 costs, but really things that are more directly
14 related to the generation of the ultimate
15 profit.
16 And so that would be negotiation of content,
17 the getting the signal to the centers where you
18 up-link it, the design and launching and
19 maintaining the satellite, the call centers,
20 the installation; in my mind, those would be
21 income-generating activities.

22 **THE COURT:** So it's a factual analysis.

23 **THE WITNESS:** Yes, it is, Your Honor.

24 **THE COURT:** And whose point --

25 **THE WITNESS:** And that why cases come out



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1 differently.

2 **THE COURT:** And whose point of view do you use?

3 **THE WITNESS:** I think you use the taxpayer's point
4 of view and I'll tell you why. The consumer --
5 I think you alluded to this in your -- in one
6 of your opening comments, that if you take the
7 position all the consumer wants is the service
8 or product here in South Carolina, now you've
9 reduced the whole thing to one income-producing
10 activity that takes place in South Carolina.

11 **THE COURT:** Well, would it not be important, though,
12 to consider the consumer's analysis of the
13 intrinsic value of that which is offered and
14 their making their determination of purchasing
15 the service?

16 **THE WITNESS:** I think they will buy something
17 because it is valuable to them. Do they care
18 how DIRECTV deals with the NFL? No. All they
19 want to know is that they'll be able to watch
20 that football game on Sunday. Do I care when
21 I buy a car how the sensor is programmed? No,
22 I just want to make sure I can pass the
23 pollution control emission standard.

24 **THE COURT:** But along those lines, though, you would
25 still -- following up on the car, in deciding



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1 whether to purchase the car, you're still going
2 to look at the components of the car to
3 determine its value into whether or not you
4 make the purchase.

5 **THE WITNESS:** Yes, I may well take into account the
6 sound system and everything else.

7 **THE COURT:** So you would also, in this instance, the
8 customer would take in the intrinsic value of
9 whether or not the DIRECTV offers local
10 programming, whether or not they offer movies,
11 whether or not the service is available in
12 their area. I mean, all those would be
13 aspects --

14 **THE WITNESS:** That's right. How reliable is the
15 signal? Do they have blackouts? Is it a
16 strong picture? All that kind of stuff. And
17 do they have what I want to see?
18 But the fact that I'm not paying directly as
19 was said in one of the documents for them to
20 negotiate content, well, I'm not even thinking
21 of that as a consumer and that's not the way
22 consumers think.

23 **THE COURT:** Okay.

24 **THE WITNESS:** Do they have the movies that I want?
25 And I'm not thinking: How do they get those



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1 movies? That's way above most consumer's pay
2 grade, so.

3 **THE COURT:** And then following along that, then, in
4 South Carolina, we don't necessarily consider
5 the cost -- what was it, the cost of -- let me
6 find it.

7 **THE WITNESS:** Cost of performance?

8 **THE COURT:** Cost of performance. In other words, we
9 don't -- we would not necessarily consider the
10 cost of the infrastructure of the product. We
11 just consider analysis of what aspect of the
12 company is income-producing.

13 **THE WITNESS:** Well, that would be for Your Honor to
14 decide, whether the infrastructure is part of
15 the income-generating activity.

16 **THE COURT:** It's a component that could be
17 considered, but other components can be
18 considered.

19 **THE WITNESS:** I would think it's all facts and
20 circumstances, correct.

21 **THE COURT:** Well, that's what I wanted to go -- I
22 want to understand is -- I wanted to ask you,
23 if we can use methods other than
24 cost-to-performance, what methods can we use?

25 **THE WITNESS:** Well, it's funny, you're going to hear



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1 Dr. Cody next.

2 **THE COURT:** Oh, okay. So I'm going to hear about
3 all that?

4 **THE WITNESS:** You're going to hear about some of
5 that. I don't know "all that," but he's
6 certainly capable to talk about all that. But
7 he has a methodology.

8 **THE COURT:** If he has one, I want to know from you
9 what other methods can we use.

10 **THE WITNESS:** I like what Professor Cody did. I
11 think he has -- he takes into account payroll.
12 I don't want to speak for him. He's going to
13 speak for himself in a minute. But he takes
14 into account payroll. He takes into account
15 the assets. And that's capital, that's labor.
16 Those are your two major components of income
17 generation.
18 So I like what he did. There may be other
19 approaches, but he looked at this and he made
20 a decision as to what is appropriate given the
21 nature of what DIRECTV does. And that's really
22 what you have to do is, is take a look,
23 understand the business model, and then figure
24 out: Okay, what are the real drivers in this
25 business model and how do I figure out what the



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1 costs are associated with them? And it might
2 be different if you were in a different
3 industry, so.

4 **THE COURT:** All right. Any follow-up questions on
5 what I have asked?

6 **MR. VALLEJO:** I don't have any further questions,
7 Your Honor.

8 **MR. CONDON:** No, Your Honor.

9 **THE COURT:** You may step down.

10 **THE WITNESS:** Thank you.

11 (Witness excused.)

12 **MR. VALLEJO:** I would like, with Your Honor's
13 permission, to reserve Professor Pomp for
14 potential rebuttal.

15 **THE COURT:** That's definitely --

16 **MR. VALLEJO:** Thank you.

17 **THE COURT:** -- an option you have, so you don't have
18 to reserve it.

19 We're going to take a short break. I'm going
20 to try to make it short.

21 (Off the record 3:20 p.m. to 3:33 p.m.)

22 **THE COURT:** All right. Next witness.

23 **MR. VALLEJO:** Thank you, Your Honor. We'd like to
24 call to the stand Dr. Brian Cody.

25 **BRIAN CODY, Ph.D.,** having been duly sworn, testifies



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1 and examines as follows:

2 **DR. CODY - DIRECT EXAMINATION BY MR. VALLEJO:**

3 Q: I'll let you get settled in and get your water.

4 A: Thank you. That will get me started.

5 Q: Good. Good afternoon, Dr. Cody. How are you
6 today?

7 A: I'm very well, thank you.

8 Q: Could you please state your full name for the
9 record?

10 A: Yes, it's Brian Joseph Cody.

11 Q: And where are you currently employed?

12 A: I am a principal, a non-CPA partner at KPMG,
13 LLP.

14 Q: And what is your current position in that
15 employment?

16 A: I am a principal in the economic and valuation
17 services practice within KPMG.

18 Q: And what is your business address?

19 A: My business address is 10 South Broadway,
20 St. Louis, Missouri.

21 Q: How long have you worked for your current
22 employer?

23 A: I joined KPMG in the fall of 2006.

24 Q: Dr. Cody, you should have in front of you here
25 Petitioner's Exhibit marked Number Seven.



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1 A: Okay.

2 Q: If you can take a look at that for me.

3 **MR. VALLEJO:** A courtesy copy for the Court.

4 Q: Could you tell us, is this your CV?

5 A: Yes, it is.

6 Q: And did you prepare this document?

7 A: I did.

8 Q: It's an accurate reflection of your
9 professional experience?

10 A: Yes, it is.

11 **MR. VALLEJO:** I'd like to introduce this exhibit
12 into evidence.

13 **MS. WOOTEN:** No objection, Your Honor.

14 **THE COURT:** It's admitted.

15 **(Petitioner's Exhibit Number Seven was admitted into**
16 **evidence.)**

17 Q: Dr. Cody, could you please describe your
18 educational background for us?

19 A: Yes, I have two undergraduate degrees. I have
20 a Bachelor's of arts in economics from the
21 University of Missouri-Columbia, suma cum
22 laude. I also have a Bachelor of arts in
23 French from the University of
24 Missouri-Columbia. After undergraduate, I went
25 to graduate school, the study of economics in



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1 the Ph.D. program at the University of North
2 Carolina. I received my Ph.D. in economics
3 from the University of North Carolina in 1987.

4 Q: Could you describe for us your teaching
5 experience, if any?

6 A: Yes, aside from the teaching experience I had
7 while I was a graduate student, during my first
8 employment after graduate school, while we were
9 living in Philadelphia and I was an employee at
10 the Federal Reserve Bank, I was also an
11 instructor in finance at The Wharton School of
12 the University of Pennsylvania where I taught
13 international finance to both under -- upper
14 class undergraduates and in the MBA program at
15 The Wharton School.

16 Q: And could you describe your professional
17 experience as it relates to the economic issues
18 that you've been asked to opine on today?

19 A: Yes. I worked in economics at the Federal
20 Reserve Bank in Philadelphia from 1987 through
21 early 1991 in the monetary and macroeconomic
22 department of -- within the research group.
23 There, we gave a lot of briefings and did a lot
24 of current analysis on economic conditions,
25 what were some of the major drivers of economic



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1 development, both nationally and within the
2 region. So there was a lot of that kind of
3 very much applied economics there.

4 Beginning in 1991, I left the Federal Reserve
5 Bank, the research group, and I joined Coopers
6 & Lybrand in their economic group where I was
7 predominantly engaged in the analysis of
8 intercompany transactions.

9 It was during that time that I started working
10 with companies on their -- essentially their
11 multi-state issues; how their businesses were
12 organized both domestically, much like what we
13 described earlier today in terms of DIRECTV,
14 where their value-creating activities, where
15 they're located, how are they organized, how
16 are they compensated. I worked with them both
17 in a domestic context and as their business
18 crossed international borders. So that began
19 in 1991 when I was a manager with Coopers &
20 Lybrand.

21 Q: Thank you. Could you describe for us any
22 publications that you have authored that you
23 believe are relevant to the economic analysis
24 that you've been asked to opine on.

25 A: Yes, there are several -- I list all my



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1 publications in my CV. Aside from the -- more
2 the academic publications which primarily came
3 out of my research, I've written extensively on
4 really the value of various business
5 operations, how you locate and evaluate that
6 value.

7 One article, in particular, I would point to
8 really is -- I think I mentioned in my
9 deposition testimony is really fundamental to
10 the approach that I took here and I think it
11 was a proper approach.

12 There's an article on functional analysis,
13 which basically describes the process that you
14 go through when you're trying to identify those
15 reasonable valuable, really value-creating,
16 income-producing activities of a company and
17 how that then gets analyzed in these kinds of
18 forums.

19 Q: And, Dr. Cody, have you ever testified before
20 on economic issues similar to the ones that
21 we're discussing today?

22 A: Yes, I have.

23 Q: About how many times?

24 A: I've testified about 15 times; similar kinds of
25 economic issues that we have here, about a



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1 dozen times.

2 Q: And have you testified on behalf of
3 governmental taxing agencies before?

4 A: Yes, I have.

5 Q: What about public speaking? Do you do any
6 public speaking with respect to economic issues
7 that are similar to the ones that we're
8 discussing here today?

9 A: Yes, I've regular -- I regularly give public
10 speeches on -- as part of panels or individual
11 speakers at tax conferences, banking
12 associations, National Association for Business
13 Economics, discussing these kinds of issues in
14 terms of value creation, identification of
15 income-producing activities, and so forth.

16 Q: And are you generally familiar with
17 apportionment issues at the state tax level?

18 A: Yes, I am.

19 Q: And why is that?

20 A: It's really part and parcel of the daily
21 activities as we're talking with our clients,
22 currently KPMG clients, about their state --
23 state issues, how their businesses are
24 organized across the country. I interact quite
25 a bit with our state and local tax practice and



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1 with the state and local tax practitioners that
2 my clients -- and so it's just part of the
3 basic understanding and how our work fits in
4 with their overall considerations.

5 Q: And how many cases would you say you've worked
6 on or testified in that involved apportionment
7 issues in which you were testifying about
8 economic issues in that context?

9 A: There, I would say, the economic issues --
10 roughly a dozen, as I've said -- in one way or
11 another have affected these. There were a
12 couple in particular where that was the key
13 issue. But, really, in each of the state cases
14 in which I've testified, really the
15 identification of value, where it is, and the
16 compensation of it is really a core issue.

17 Q: What about any awards or honors in your field?

18 A: Yes, I wish there were more out there, but
19 there aren't too many that we -- that we get,
20 but one that I'm quite proud of is, I've been
21 named multiple times as a world expert in
22 transfer pricing by the National Bureau.

23 **THE COURT:** In what pricing?

24 **THE WITNESS:** Intercompany pricing.

25 **THE COURT:** Intercompany, okay.



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1 **THE WITNESS:** I mean, transfer pricing, yes.

2 **MR. VALLEJO:** I'd like to move to admit Dr. Cody as
3 an expert on economics and economic issues as
4 applied in the context of state tax
5 apportionment and transfer pricing.

6 **THE COURT:** Are you cogitating?

7 **MS. WOOTEN:** I am. No objection to that, Your
8 Honor.

9 **THE COURT:** All right. He's qualified.

10 **MR. VALLEJO:** Thank you, Your Honor.

11 Q: Dr. Cody, did you prepare a written expert
12 report in this case?

13 A: Yes, I did.

14 Q: I'd like to introduce what is labeled
15 Petitioner's Exhibit Eight.

16 **MR. VALLEJO:** Courtesy copy for the Court.

17 Q: Would you please review what I've put in front
18 of you labeled Exhibit Eight, please, and tell
19 us whether this is the report you prepared in
20 this case?

21 A: Yes, this is the report I prepared.

22 Q: Is it an accurate reflection of your expert
23 opinion in this case?

24 A: It is, yes.

25 **MR. VALLEJO:** I'd like to move to admit this report



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1 into evidence.

2 **THE COURT:** Any objection?

3 **MS. WOOTEN:** No objection. I'm sorry, what number
4 was that again, please?

5 **MR. VALLEJO:** Number Eight.

6 **MS. WOOTEN:** Eight, thank you.

7 **THE COURT:** Number Eight?

8 **MR. VALLEJO:** Yes, Petitioner's Exhibit Eight.

9 **THE COURT:** Petitioner's Eight is admitted.
10 (Petitioner's Exhibit Number Eight was admitted
11 into evidence.)

12 **MR. VALLEJO:** Thank you, Your Honor.

13 **THE WITNESS:** If I may, just in reviewing my report
14 yesterday one final time, I did notice one
15 minor typo that I'd like to just call to the
16 Court's attention.

17 **MR. VALLEJO:** Of course.

18 **THE WITNESS:** It's on page 18 of the -- of my report
19 in table 1-B. The second row from the bottom
20 where it says "payroll" and then we have in
21 parentheses the percent sign and then it says
22 "see table 2-A," that should be table 1-A. So
23 it refers to the table on the previous page,
24 sorry.

25 **MR. VALLEJO:** Thank you for the clarification.



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1 Q: Dr. Cody, what do you understand is the issue
2 in this case?

3 A: My understanding of the issue in this case is
4 the location of DIRECTV, Inc.'s
5 income-producing activities and, in particular,
6 that the Department has determined that those
7 income-producing activities are solely located
8 in the customer location; in their living room,
9 in their place of business, where they turn on
10 their TV set, where they turn on the set-top
11 box.

12 And that raises the issue because, as I look at
13 it as an economist, the simple fact that they
14 turn on the set -- and as we've heard,
15 they're -- in so doing, they're interested in
16 the service that's coming through, the content
17 and so forth.

18 When they turn on that set, they've taken those
19 things into account. But the simple fact that
20 they've turned that set on in their living room
21 tells me absolutely nothing about the location
22 of all of that infrastructure, all of the
23 activities of DIRECTV that have gone into
24 bringing that signal to the house.

25 That, to me, is the key issue that we have



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1 here, is the location of those services and the
2 disconnect between the position that I can
3 identify those as where I turn the set on
4 versus where the actual location of all of that
5 activity is actually being performed.

6 Q: And we'll talk in a few minutes about your
7 definition of "income-producing activities,"
8 but for now, Dr. Cody, could you please tell us
9 who retained you in this case?

10 A: Yes, I was retained by Morrison & Foerster.

11 Q: And what did you understand your assignment to
12 be?

13 A: My assignment is a couple of parts. First part
14 of my assignment is to identify from an
15 economic perspective the income-producing
16 activities of DIRECT (sic), Inc. Second, then,
17 is to determine the location of those
18 income-producing activities; again, the
19 activities of DIRECT, Inc. TV (sic), and that
20 that is really for the purpose, then, of
21 sourcing gross subscribers receipts for the
22 gross subscriber receipts that are attributable
23 to South Carolina versus elsewhere.

24 Q: And what work did you undertake in fulfilling
25 your assignment in this case and preparing your



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1 expert report?

2 A: Undertook a wide range of activities. I
3 started by reviewing public documents on
4 DIRECTV, their 10-K analyst reports and so
5 forth. I requested and received various
6 documents pertinent to the case around the
7 termination and facts of the case, requested
8 financial data to understand some of the basic
9 financial results of DIRECTV, where their
10 assets are, how they're accounted for and so
11 forth.

12 I also spoke with a number of folks at DIRECTV
13 itself to understand their operations and
14 really to get behind what we're seeing in terms
15 of their financials and their operations, to
16 really get a deep understanding how -- when I
17 look at DIRECTV, what the components are and
18 how all those components come together to bring
19 that signal to the home.

20 Q: And based on that diligent preparatory work,
21 could you give us your summary from an economic
22 perspective of what you believe to be the key
23 profit drivers of the DIRECTV enterprise?
24 They're identified in your report and if you
25 could, please, list them for us first, we can



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1 go through each one in turn after that.

2 A: Certainly. Based upon my analysis, it's my
3 conclusion that there are four key value
4 drivers to DIRECTV's business: Content,
5 content acquisition, and development; that's
6 one.

7 **THE COURT:** Wait a second. I want to set myself up
8 to get this. All right. You said content?

9 **THE WITNESS:** Yes. Yes, Your Honor.

10 **THE COURT:** Go ahead.

11 **THE WITNESS:** So content. Second are the broadcast
12 services, those activities actually entailed in
13 bringing the content to the subscriber. Third,
14 are the marketing and sales activities that are
15 conducted by DIRECTV. And then finally
16 customer service. Those are the four.

17 Q: Thank you. Now let's focus on content
18 acquisition and development, I think you
19 referred to. Could you please explain what it
20 is and why you believe it's a key profit driver
21 for the company?

22 A: Yes, content -- I think this was reinforced
23 this morning by Mr. Goswitz. Content is what
24 the subscriber ultimately receives from
25 DIRECTV. They want to watch that football



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1 game. They want to be able to watch that
2 movie. They want to be able to watch their
3 local news when they want. So content is
4 really the basis of the service offering that
5 we have from DIRECTV.

6 Now, why is it so valuable? As we look at the
7 range of content that DIRECTV brings to the
8 customer, it really -- their offering really
9 sets themselves apart. As we -- as I was doing
10 my analysis, came across a number of specific
11 proprietary, self-developed programming options
12 that DIRECTV has created.

13 Certainly they have the traditional HBO, ESPN,
14 other contracts like that that are very
15 important and the negotiation of those
16 contracts are critical. But one of the things
17 that really sets DIRECTV's content apart are
18 all the created, the -- not the acquired, but
19 self-created content that DIRECTV brings.

20 And as I was doing my research and I looked at
21 DIRECTV's ability to charge premium prices, it
22 really kept bringing me back to that premium
23 content that was there.

24 And I think in terms of importance, you don't
25 have to take kind of my word for it, because



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1 one of the things that came out was, earlier
2 this year, AT&T announced plans to acquire
3 DIRECTV for tens of billions of dollars. Well,
4 that's a large acquisition. There's got to be
5 some real value here.

6 One of the really I just thought astonishing
7 things and it pointed out the importance of
8 content was that AT&T in its announcement and
9 in its deal structure said, if we don't -- if
10 we're not able to retain the NFL Ticket
11 contract, that exclusive relationship that
12 DIRECTV has with the NFL, the deal is off and
13 they could just simply walk away.

14 So that, to me, said more -- just said volumes
15 about the importance of content, a market value
16 of the content is to DIRECTV.

17 Q: And can you talk about a little bit in terms of
18 competition in the market in which DIRECTV
19 competes, how is that related to content?

20 A: It's a very, very highly competitive industry.
21 Their -- DIRECTV's competitors are legion, all
22 right? Most directly on a satellite basis, we
23 have DISH. But we also, as mentioned, there's
24 U-verse, Verizon, Comcast. You have all your
25 local cable providers. You have over-the-air



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1 signals. We have the Internet being able to
2 stream, all right. So competition is
3 incredibly important and it's fierce.

4 And so what we're dealing with here and for
5 DIRECTV to succeed and to continue to generate
6 the kind of profits that would induce a company
7 like AT&T to buy them, they've had to set
8 themselves apart. So how you stand out from
9 what could otherwise be a very commodity type
10 business; a signal in the house. Well, one of
11 the ways you do that is through the content.
12 So the content helps to distinguish AT&T (sic)
13 in this highly competitive industry and allows
14 them in many respects to charge premium prices.

15 Q: I think you said AT&T.

16 A: I'm sorry.

17 Q: You meant DIRECTV?

18 A: DIRECTV, thank you.

19 Q: That's content acquisition and development.
20 The second one you mentioned was broadcast
21 operations. Turning to that, could you please
22 explain to us what they are and why you believe
23 that they constitute a key profit driver?

24 A: Sure. If DIRECTV has great content, but they
25 can't get it to -- from the location of the



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1 creation of the content, be that HBO, the local
2 station, their own studios, if they can't get
3 that reliably, high quality to the consumer,
4 the whole deal kind of falls apart, all right?
5 Customers will go away, all right?

6 So the ability to have and to be able to
7 provide that continuous signal so that any time
8 the consumer wants, they can go to their TV and
9 turn it on and their television is ready for
10 them and they have that full selection of
11 content, that's what broadcast services enables
12 them to do.

13 So my research and also we heard testimony that
14 the system, the whole network of operations
15 that DIRECTV has organized from the local
16 collection facilities, the feeding the signals
17 to the regional up-link facilities, broadcast
18 centers, the up-link centers, and very, very
19 importantly, what they've been able to get in
20 terms of the satellite orbital slots enables
21 them to deliver that high quality signal.

22 And when I mean -- when I say deliver, I really
23 mean the signal across the entire span of the
24 operations; aggregation from all different
25 sources and the entire span.



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1 One of the other things that came up in the
2 AT&T acquisition, the analysis I was doing
3 around that, and what it says about -- even
4 about broadcast operations is that AT&T -- Ma
5 Bell got all kinds of copper out there, all
6 right? Heavy infrastructure to maintain. Been
7 able to get DIRECTV's operations. And now
8 being able through satellites to beam a signal
9 anywhere without laying cable is incredibly
10 valuable activity for them to be able to
11 perform.

12 That's a -- that, again, to me, really points
13 out the extremely important value that we
14 should put upon the ability to conduct
15 broadcast operations and why it really is a
16 significant income-producing activity for
17 DIRECTV.

18 Q: Moving on to marketing and selling activities,
19 I think you referred to them, could you please
20 explain what they are and why you believe they
21 constitute a key profit driver, as well?

22 A: We often think about marketing, I think, as
23 just kind of advertising and certainly DIRECTV
24 has fun and engaging advertising. You've heard
25 about the production that goes into it, the Rob



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1 Lowe commercials, and why that's -- gets
2 people's attention and gets them interested in
3 DIRECTV.

4 But I think as we think about marketing, it
5 really is broader than that. And marketing is
6 a strategy, if you will. It's how do with
7 develop products that our customers will be
8 interested in buying that will find valuable?

9 All right. So it really goes back to product
10 development and I think this goes back to the
11 NFL Sunday Ticket. It goes back to saying,
12 "Oh, well, we've got an idea and everyone wants
13 to see the exciting points in the football
14 game, so we're going to develop Red Zone and we
15 can charge a premium price for that."

16 That's marketing. Figuring out how do we --
17 how do we put ourselves above this competitive
18 fray of all the other producers, of all the
19 other providers of broadcast services? How do
20 we distinguish ourselves?

21 Marketing is at key part of that. And then how
22 do we communicate that to our customers?
23 That's where the advertising comes in. And so
24 it's an incredibly important part of the
25 income-producing activities of DIRECTV.



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1 Q: And how does that impact the amount of money
2 that customers are willing to pay for DIRECTV
3 services?

4 A: All right. I think it has a -- it has a direct
5 impact on the amount of money that consumers
6 are willing to pay. Consumers are offered an
7 array of packages that they can -- that they
8 can purchase, all right?

9 If I'm interested in movies, I have movie
10 packages, and I'll pay for that. I can pay a
11 premium price for that; I get greater access.
12 If I'm a football fan, I've got an array of
13 activities there that I can then pay for, I pay
14 a premium for it, all right, but it's a product
15 that meets my needs.

16 If I just want basic service, fine, they offer
17 that, as well. That's fine. But they
18 recognize that some customers just want that.
19 So, that's fine, we'll price it that way. So
20 the marketing has a direct impact.

21 Another point that came out as we were doing
22 the -- as I was doing my analysis is that, we
23 really think about two kinds of subscribers.
24 There are potential subscribers and there are
25 existing subscribers.



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1 And so potential subscribers are those that are
2 not currently DIRECTV customers but that
3 DIRECTV would like to get to join, all right?
4 Call that "subscriber acquisition."

5 Well, subscriber acquisition is quite
6 expensive. Something like on the order of 750
7 to \$900, some numbers I've read in terms of
8 what it would cost DIRECTV to acquire a new
9 subscriber. All right. That's quite an
10 investment, all right?

11 But if you can -- if you have a subscriber and
12 you can keep them, all right, keep them
13 happy -- I'll talk about customer service
14 later -- but if I can keep them and induce them
15 to come onto one of my premium packages, now
16 I've really got something. Because I don't --
17 I didn't lose one. I didn't have to gain a new
18 subscriber, but I can get additional revenue
19 from my current subscribers. That's where
20 these marketing activities really become
21 important because they -- they do attract new
22 customers, certainly, but they enhance the
23 value. They get -- produce additional income
24 from existing customers, as well.

25 Q: And I think the final one you mentioned was



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1 customer service. Could you explain how it
2 works and why you think that is also a key
3 profit driver for the company?

4 A: Well, I think -- I certainly have had the
5 experience where I'm -- something goes wrong,
6 all right? One of the kids messes with the
7 remote, something happens to my set-top box, I
8 can't get my service to work, and I call up the
9 tech service and I want them to help me, help
10 fix it, right?

11 And so if there's someone on the other end of
12 that line that can solve my problem quickly,
13 that makes me happy. If they can't fix it but
14 they can get service out quickly to me to
15 resolve my problem, that makes me happy.

16 So it's a very, very important part of customer
17 retention. I can't talk to any of my friends
18 about one of them having explained some type of
19 situation they've had either with their cable
20 provider or their phone company or something
21 like that where if something has gone wrong and
22 the service is terrible and they've cut the
23 line, right, and they've moved on.

24 So customer service is an incredibly important
25 part of retaining and enhancing the



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1 satisfaction the customers have with DIRECTV.
2 As we've said, one, keeping the customer is
3 much more efficient income-producing than
4 having to lose them and having to gain them
5 back; that's one. The second thing is, happy
6 customers will -- and I've certainly done
7 this -- say, "Well, if I'm happy, gosh, you
8 know, they've done a good job for me, I hadn't
9 really thought about it before, but, yeah, I'd
10 like to have more access to those new games,
11 right, tennis, golf, all right? I hadn't
12 really thought about it, but U.S. Open is
13 coming up, maybe I'll sign up for it, right?"
14 And so I call up customer service and now I
15 talk to a knowledgeable person who can tell me
16 about pricing and about my options. And so
17 that is another important part of the customer
18 service function activity that's performed by
19 DIRECTV, Inc. And so it helps to retain
20 existing customers and then also helps to
21 generate additional income from existing
22 customers. So it's an important part.

23 Q: Thank you. We've been discussing the entire
24 operations of the DIRECTV business. I'd like
25 to focus now on just the specific taxpayer in



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1 this case, namely DIRECTV, Inc. Could you give
2 us a relatively brief summary of its functions
3 in the context of the larger business?

4 A: Certainly. DIRECTV, Inc. -- and some of this
5 we heard this morning from Mr. Goswitz -- on
6 the content side, DIRECTV, Inc. is entirely
7 responsible for content acquisition and
8 development, both from third parties, the HBOs,
9 ESPNs and so forth, as well as for producing
10 their own content at the various broadcast
11 centers. So content, that's there.

12 They engage in the contracts with the content
13 providers. And, as I've said, responsible for
14 development of the content.

15 With respect to broadcast services, as we've
16 said, DIRECTV, Inc. owns the regional up-link
17 centers. They also own the local collection
18 facilities, predominantly. There are a few
19 local collection facilities which I believe are
20 owned by Operations. And they own all the
21 set-top boxes.

22 So a number of the key assets in the delivery
23 of the signal to the households -- South
24 Carolina, as well as elsewhere -- those assets
25 are -- and the maintenance of them and



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1 development of them are responsibility of
2 DIRECTV, Inc.

3 Marketing -- described what it is -- all of
4 those marketing activities take place within
5 DIRECTV, Inc. They have responsibility for
6 that.

7 Coming out of that, then, on the customer
8 service side, DIRECTV, Inc. owns the customer
9 service centers that are operated across the
10 country, the six centers that we spoke about
11 before. DIRECTV, Inc. is also responsible for
12 the installation services. So getting the
13 local customers up and running on DIRECTV.

14 I believe before 2008, all of those installers
15 were independent contractors and since 2008,
16 they've been bringing those home service
17 technicians more into the DIRECTV, Inc. family
18 as opposed to using third parties, but I think
19 they still use third parties for some of that,
20 but they pay them. They're responsible for
21 that function.

22 Q: What about the assets of DIRECTV, Inc.?

23 A: I've mentioned a few of the physical assets,
24 the up-link centers, the local collection
25 facilities, the call centers. Importantly, if



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1 I go back through each of their -- the four
2 value drivers, four income-producing
3 activities, on the content, certainly we have
4 all of the contracts that DIRECTV, Inc. has
5 with the content providers. Those are very
6 important intangible assets that DIRECTV has.
7 Likewise, DIRECTV has and owns all of the
8 trademarks, the trade names, service marks and
9 so forth associated with the business. For
10 instance, NFL Sunday Ticket is a trademark
11 name, highly valuable. They've taken the steps
12 to protect that name, legally protect it;
13 that's a DIRECTV asset there, as well.

14 Q: What about the risks that DIRECTV takes?

15 A: They're substantial. DIRECTV performs all of
16 these functions that I've described, as I said,
17 in anticipation of -- and in order to deliver
18 that signal in anticipation of customers
19 signing up and paying.
20 So all the way from content development,
21 they're expending funds on developing new
22 content, making commitments on contracts to the
23 NFL, right, and so forth in anticipation that
24 they'll be able to then recoup that through
25 gross subscriber receipts.



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1 So those income-generating activities are --
2 certainly have a cost associated with them and
3 that's a risk that they bear, but that's like
4 any business. They have a cost and then they
5 do an anticipation of future profit.

6 On the -- if we look at it from the subscriber
7 side, all of the subscriber contracts are with
8 DIRECTV. So they have the responsibility,
9 then, to deliver that signal to them, provide
10 the level of service, and if they don't, as
11 I've said, and they lose the customer, they
12 lose that contract, and now they have to incur
13 the cost and bear the risk, loss of revenue
14 associated with that loss of that subscriber;
15 that's on them.

16 As well as, then, any kind of degradation of
17 trademark value, infringement, and things like
18 that that we might find.

19 And, in fact, I think if you look on the bottom
20 of the DIRECTV website, it says, "We are
21 DIRECTV" one "T", all right, no space. So it's
22 clear that people are trying to infringe and
23 trying to nip away at the value there that
24 some -- so that's a risk to them. They're
25 taking steps to mitigate it, so substantial



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1 risk that they bear.

2 Q: Dr. Cody, you mentioned the term
3 "income-producing activities" earlier. From an
4 economic perspective, how would you define that
5 term?

6 A: In the context of this case, I would define
7 that term as the activities that DIRECTV
8 engages in in order to convert potential
9 customers into subscribers and to retain and
10 drive additional income from existing
11 subscribers.

12 Q: And what's your understanding of the
13 Department's position in this case?

14 A: It's my understanding that the Department's
15 position is that the income-producing activity
16 is the turning on of the set by the customer
17 and the paying of the bill, full stop. There's
18 one income-producing activity, it's at that --
19 it's what the activity of the customer is.

20 Q: You heard Professor Pomp earlier talk about the
21 Department using a market-based approach; is
22 that what you mean?

23 A: I'm not conversant and I'm not an expert in
24 this -- in the full application of market-based
25 approach. Listening to the testimony and from



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1 just readings that I've done, if we're saying
2 that the focus is on the customer and where
3 they are and looking to that as the only
4 activity to determine where the income is
5 produced, that sounds like a market-based
6 result to me.

7 Q: And what's your view of the Department's
8 position from an economic perspective?

9 A: As I look at the Department's view, to me, it's
10 wholly unsupportable from an economic position
11 and it's unreasonable in its conclusion.

12 Q: Why is that?

13 A: There are several factors. First, the location
14 of the subscribers is not an income-generating
15 activity. The subscribers are where they are,
16 but they tell me nothing about the
17 infrastructure of DIRECTV.

18 They're not even a good proxy for the location
19 of DIRECTV's income-producing activities.

20 Another factor: The gross subscriber receipts,
21 which what we're looking at here as
22 identifying -- identified what the result of
23 that activity -- they're quite simply the
24 result of DIRECTV's income-producing
25 activities. They're not the income-producing



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1 activity itself. They're the result of it, the
2 result of the customer paying.

3 And, here, I think there's a fundamental
4 misunderstanding, quite frankly, of how
5 businesses work.

6 We heard Mr. Goswitz this morning describe all
7 of the activities that DIRECTV performs in
8 order to get that signal to the customer's
9 home. All right? All the way from, as we
10 said, content acquisition, broadcast services,
11 product development, customer service, to get
12 it to its home.

13 If I just look at customer receipts, it tells
14 me nothing about, one, the location of those,
15 but importantly, it also ignores the fact that
16 I have to expend money to perform those
17 activities. And I do that in anticipation of
18 revenue later. That's what a business does.
19 It incurs costs in anticipation of generating
20 income, all right?

21 Now, we do it in anticipation of generating
22 profits. Great, I might have a profit and that
23 would mean that I've run a good business and
24 I've been lucky and been fortunate and a good
25 industry and performed well in that industry.



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1 But I may not. I may generate a loss, all
2 right? But the outcome tells me nothing about
3 how I should characterize my activities.

4 In all cases, I am performing an activity:
5 Content development, broadcast services, and so
6 forth. I've created this network; speaking as
7 DIRECTV here -- in anticipation -- incurred
8 those costs in anticipation of income later.
9 And so saying that the income-generating
10 activity is gross receipts simply misses the
11 point entirely.

12 And, in fact, what it does -- and I think this
13 goes back to a point that Professor Pomp made,
14 where we've got kind of an antithesis between
15 income-producing activities from a -- and I'm
16 using it from an economic perspective -- and
17 looking at it from the customer's point of
18 view.

19 If I'm the customer -- and I like the example
20 of -- I go into -- I realize it's a product,
21 not a service, but I think the economics
22 follow. I walk into a butcher shop and I want
23 to buy some sausage, all right? And I know
24 this butcher shop. They've got a reputation
25 for good sausage. I walk in, looks good, looks



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1 fresh, I buy it, all right?
2 Now, I'm confident that that butcher has taken
3 measures to source the pork appropriately,
4 process it appropriately. I think they've done
5 a great job with all of that, all right, and I
6 bought it and that's value to me. Okay?
7 But then as an economist, if I look at that
8 transaction and say, "Well, my purchasing now
9 is the value generating activity," I'm looking
10 at it solely from the customer's point of view,
11 all right, which is not what we're intended to
12 do here. The customer is not the issue.
13 DIRECTV, the supplier, the vendor is the
14 issue -- the entity at issue here.
15 The fact that the customer, that I go in and
16 buy the sausage, tells me nothing about the
17 value of each of those steps, nor does it -- it
18 tells me absolutely nothing about where the
19 butcher performed any of those activities. It
20 simply says that I bought it here, all right?
21 And, in fact, I don't want to know how he made
22 his sausage, all right? It's of no concern to
23 me. In fact, I -- probably kind of gruesome in
24 some cases. I don't want to know.
25 Mr. Goswitz said he wishes that customers cared



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1 more about where the satellites were and
2 everything, but they don't. They care about
3 their -- about their service and paying for it
4 there.

5 But the fact that they do that, and if we focus
6 just on them, we miss the fundamental point
7 which I think is really at the heart of the --
8 the Department's misunderstanding and miss --
9 error in this case; their error in this case in
10 terms of their position. And that is, we need
11 to look at it from the company's point of view,
12 from the taxpayer's point of view, what are the
13 income-producing activities that it performs.

14 One last thing here, if we look at it from --
15 purely from a cost standpoint, which -- and
16 going through the testimony and reading
17 depositions and reading the Department's
18 position, they say, well, if it incurs a cost,
19 it can't be an income-producing activity.

20 Quite frankly, I don't understand what that
21 means, all right? And the reason I don't
22 understand what it means is that it leads me to
23 a ridiculous conclusion, because in the end,
24 everything is a cost-producing activity.

25 Even when the customer pays me their -- hands



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1 me their check as a DIRECTV subscriber, I know
2 I incur a cost, because I have to process that
3 check or I have to process their electronic
4 funds transfer. I've had to send them a bill.
5 Now I have to credit their account and I'm
6 maintaining their account. So even after I've
7 delivered the signal, I receive their bill and
8 now I have another cost.

9 So if I take that logic, that cost -- if an
10 activity involves a cost, that it's not an
11 income-generating activity, then from the
12 company's point of view, there are no
13 income-generating activities, because
14 everything incurs a cost onto me. So that
15 can't be the right -- that can't be the right
16 logic.

17 And, again, I think the way to square it is
18 that the Department has erred by essentially
19 taking the position -- taking the point of view
20 from the customer side and then saying, "That's
21 how we should view DIRECTV," as opposed to
22 saying, "No, I need to look at it from the
23 taxpayer's point of view. I have their
24 income-generating activities. I need to locate
25 where their value is," and then allocate that



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1 profit, the income, across -- according to the
2 rules, across all of those activities.

3 Q: And what in your view, Dr. Cody, would be an
4 economically reasonable approach to determining
5 DIRECTV's income-producing activities then?

6 A: I think quite simply, you need to look at each
7 of those activities I described and get behind
8 what is really creating the value that
9 consumers ultimately pay for.

10 So it goes back to that basic economic
11 functional analysis where I look at the
12 important functions, risks and assets that are
13 employed in the business.

14 And, in fact, a lot has been made -- a lot of
15 discussion has been made around *Lockwood Greene*
16 case. And I did read that case from an
17 economic point of view and I think what the
18 court did in that was exactly this: When they
19 looked at what the customers of the engineering
20 firm were actually paying for, they said,
21 "Well, it's the -- and the revenue generating,
22 the income-generating activity really is the
23 activities of the engineers here," all right?
24 They look to those underlying functions, the
25 activities there, and said those are the



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1 income-producing activities -- my term; I think
2 they used "place of activity" -- and said
3 that's the right way to approach it.

4 So from a methodology standpoint, it's how I
5 would do it, and I think it's consistent with
6 what the court did in *Lockwood Greene*.

7 Q: And how did you go about, more specifically,
8 determining the income-producing activities and
9 then the proportion inside the state and
10 outside the state in this case?

11 A: All right. There are a number of measures that
12 can be used to identify and then locate the
13 income-producing activities. A couple of very
14 common factors or proxies are payroll and
15 assets.

16 Professor Pomp referred to labor and capital.
17 It's the same thing, fundamental economics.
18 There are some other measures that could
19 potentially be used, but payroll and assets are
20 two very common measures that are used. So I
21 developed methodologies using those measures.

22 Q: And from an economic perspective, how did you
23 then determine the location of the
24 income-producing activities?

25 A: Okay. I did two -- two analyses. One analysis



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1 looked just at the location of payroll. So the
2 payroll that's in South Carolina as a proxy for
3 the income-generating activities that takes
4 place in South Carolina versus payroll
5 everywhere.

6 As I looked at it, I thought that was a
7 reasonable approach as we know that through
8 each of those value-generating or
9 income-producing activities I described,
10 there's a very large labor content, negotiating
11 contracts, building and maintaining broadcast
12 network, marketing, and providing customer
13 service. So I think labor is -- as proxied by
14 payroll is a good measure there.

15 I took some comfort in that -- going back to
16 Lockwood Greene, this was also the approach
17 that Lockwood -- that was used in Lockwood
18 Greene where they looked at payroll as a
19 reasonable proxy.

20 In the end, I also then used this method, the
21 payroll, as really a sanity check on the -- on
22 what I ultimately determined was a more
23 appropriate, more reasonable way to determine
24 this.

25 Q: And of the two approaches, just to clarify,



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1 which one did you think is the more
2 economically reasonable one?

3 A: Right. The more economically reasonable one is
4 one that also, then, takes into account assets.
5 Payroll alone for a company like DIRECTV, I
6 think, misses the asset intensity. All right.
7 We've got broadcast centers. We've got fiber
8 optic networks. We've got large call centers.
9 And so -- we've got set-top boxes, local
10 collection facilities. So assets are clearly
11 an important part, as I've said, of the whole
12 operation.

13 So I felt it was appropriate to take assets
14 into account when I was determining the
15 location of those income-producing activities.
16 So I developed an analysis that builds on both
17 assets and payroll, so I take those into
18 account.

19 Q: Thank you. You may have heard a question
20 earlier regarding the potential for a taxpayer
21 to set up payroll and assets outside of the
22 state to reduce the number of gross receipts
23 that may be sourced to the state. Could you
24 please explain that in the context of your
25 economic approach in this case?



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1 A: Right. It really is a fundamental question as
2 part of the analysis that when I did my
3 economic analysis, the functional analysis, in
4 looking where from the description and how the
5 operations were put together, so that, you
6 know, there really is no distortion or shifting
7 of the assets and the payroll across the
8 jurisdictions.

9 Listening to Mr. Goswitz, their operations were
10 set up by the business folks, not for tax
11 purposes, but by the business folks. You have
12 an office in New York that's set up to
13 negotiate with content providers there. New
14 York is a major publishing house; great. We've
15 got production facilities in L.A. We've got
16 regional up-link centers that are spread across
17 the country, and so forth.

18 So, I think, in this case there's no question
19 that the payroll and the assets, as I look at
20 them, that they're very reasonable proxies and
21 very fair proxies for the location of the
22 activities.

23 And, I think, in my experience, you're just not
24 going to have a business that is moving
25 payroll -- moving the location of their



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1 operations around for purposes other than try
2 to maximize the result from all of those
3 income-producing activities.

4 Q: And, Dr. Cody, you've mentioned a couple of
5 times that payroll and assets you used as a
6 proxy for the location of income-producing
7 activities. Could you please explain to us why
8 you use payroll on the one hand as a proxy and
9 then assets on the other hand as a proxy?

10 A: Right. So payroll for a proxy for the
11 contribution of all the DIRECTV employees to
12 these value-creating activities and where
13 they're located. As I've said, for each of the
14 main value drivers, personnel activities are a
15 major component of that contract negotiations,
16 providing customer service, maintaining the
17 network, all those kinds of things. So I
18 needed to know where those employees were and
19 the -- and the value that they're bringing.
20 So rather than -- one of the -- one of the
21 things I did consider was, well, I could just
22 look at head count; that'd be another way to
23 go, right? That's -- those are employees.
24 But if I just did head count, then an office
25 clerk would count equally to the content



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1 development leader for NFL Ticket. Well, that,
2 to me, didn't seem quite right in terms of
3 value, all right?

4 And so by taking payroll into account, I take
5 into account the company's view of the value of
6 the different employees. Obviously, I would
7 expect the content development folks to get
8 paid more than a -- say, a billing clerk would.
9 So that's -- I think that's why I chose
10 payroll, for instance, rather than, say, head
11 count.

12 For assets, looked at the net book value of the
13 assets. Assets are important here because
14 we've got a whole range of physical assets that
15 go into DIRECTV's operations, as I've said,
16 from the broadcast side, as well.

17 Also, and I think very importantly here, just
18 like payroll, where we have payroll in the
19 state of South Carolina, looking at the assets,
20 I also get a measure of the activity from that
21 side in the state of South Carolina, as well,
22 because location -- excuse me, local collection
23 facilities are an important part of that whole
24 broadcast system. They collect the signals
25 locally.



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1 Likewise, for the final delivery of the signal,
2 which the Department has focused all of its
3 attention on, there is the set-top box and
4 that's an assets of DIRECTV, Inc. So I do
5 capture that important activity, as well. So
6 that's why I've looked at both of those.
7 If I may just add one thing. I think in
8 contrast to *Lockwood Greene* which, you know,
9 just looked at payroll, I think, perhaps, we
10 need to take it a little bit into context.
11 Because you could say, well, why -- why did you
12 bring in assets? They didn't do assets, right?
13 And if I think back, certainly as I was working
14 in the mid '80s, we didn't have a lot of
15 computers, all right? The economics -- we do
16 a lot of computer work now, but we didn't have
17 a lot of computers then. I think engineers
18 were much the same, a lot of manual processes,
19 drawings, all right; whereas now we have a lot
20 of computer-aided design software, systems to
21 test materials and so forth.
22 So, while I think payroll was entirely
23 appropriate at the time that *Lockwood* was
24 considering their operations, today they might
25 very well -- and I would think probably

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1 appropriately so -- include assets because of
2 those software and computer systems and so
3 forth that I think are very important to
4 engineering services.

5 So I think, again, my approach matches very
6 well with some of the other authorities that
7 are out there.

8 Q: Thank you, Dr. Cody. And now that we've
9 described your reasons for choosing payroll and
10 assets, could you please tell us how you
11 determined the scope of payroll and assets in
12 your analysis?

13 A: Sure. I'm looking at solely DIRECTV, Inc., the
14 taxpayer in this case; that might seem obvious,
15 but it wasn't obvious to me when I first
16 started because when I -- when I looked at it
17 and I thought, well, you know, we've got --
18 we've got all these other things. We've got
19 satellites. We've got broadcast centers.
20 Well, the satellites are owned by DIRECTV
21 Enterprises. The broadcast centers and some
22 other assets are owned by DIRECTV Operations.
23 Shouldn't I include them in the calculation, as
24 well, because clearly they're part of that
25 whole scope of delivery of services?



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1 But then as I got into it, I looked at it and
2 said, well, no, DIRECTV, Inc. is paying an
3 arm's length fee to Enterprises and to
4 Operations for use of those assets and their
5 contributions. So if I included them, I would
6 essentially be giving some, if you will,
7 contribution to DIRECTV, Inc. for something
8 that's already paid for on an arm's length
9 basis. So it's appropriate not to include it.

10 Q: Now, what -- sorry to interrupt, but what would
11 have happened to your analysis if you had
12 included the aggregate activities?

13 A: Yes. Note that the assets that are owned by
14 DIRECTV Operations, like I said, predominantly
15 the broadcast centers and some of the other
16 major assets, none of those are in South
17 Carolina. Certainly none of the assets,
18 satellites, of DIRECTV Enterprises are in South
19 Carolina.

20 So if I had used or included their assets in my
21 calculation, I would have greatly diluted the
22 measure of the income-producing activities
23 attributable to assets in South Carolina. I
24 would have added significantly to my
25 denominator and I would have added nothing to



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1 my numerator.

2 So by leaving them out I think both is
3 economically sound and also from an income
4 location and sourcing of gross receipts'
5 perspective, it's conservative from a South
6 Carolina perspective.

7 Q: Dr. Cody, what did you do with intangible
8 assets which you've described are very
9 significant for DIRECTV?

10 A: Yes, intangibles -- intangible assets are very
11 significant, as we talked about trademarks and
12 trade names, the content contracts, customer
13 lists, and so forth.

14 Normally I would want to include those because
15 they are an important asset and they are owned
16 by DIRECTV, Inc. However, exact values, highly
17 reliable values for those were simply not
18 available.

19 And so rather than make an estimate that I
20 wasn't completely confident in, I simply
21 excluded the intangible assets from my
22 analysis.

23 Now, what's the import of that or what's the
24 implication of that? Well, remember that
25 the -- those intangible assets are primarily --



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1 or they're really all generated by activities
2 that are conducted outside of the state of
3 South Carolina.

4 For instance, we know that, as Mr. Goswitz
5 testified, all the content negotiation and
6 development takes place in the broadcast
7 centers in California, some in New York; it's
8 not in South Carolina.

9 So if I'd included those intangible assets, I
10 wouldn't -- I would add nothing to my numerator
11 in my fraction as I'm trying to locate the
12 percentage of income -- or percentage of gross
13 receipts in South Carolina, and I would have
14 increased the denominator.

15 So, again, I would have diluted the amount of
16 income-producing activity associated with
17 assets that goes to South Carolina. By leaving
18 them out, again -- while I think it's
19 reasonable, it certainly is conservative from a
20 South Carolina perspective.

21 Q: If you could, please turn to page 17 and 18 of
22 your report.

23 A: (Witness complies.)

24 Q: And using the charts on those two pages as a
25 reference, could you please explain to us in



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1 detail how you determined the amount of payroll
2 and, as you've now told us, tangible assets
3 within and outside South Carolina?

4 A: Certainly. It really is a straight-forward
5 calculation and let me walk you through each of
6 the pieces.

7 So I have requested from DIRECTV the financial
8 statements for DIRECTV, Inc. so that I could
9 identify the payroll for South Carolina versus
10 total DIRECTV, Inc. payroll and I did the same
11 for assets, which I'll talk about in a minute.
12 So what I have in table one -- and you'll see
13 on the columns it's 2006 through 2011, so a
14 separate calculation for each of the years that
15 are at issue, as well as I do a weighted
16 average of those.

17 So the first row in the table is South Carolina
18 payroll. So that's the payroll actually
19 reported by DIRECTV, Inc.'s employees that are
20 resident in South Carolina, very straight
21 forward. It's total comp and -- total comp.
22 All right?

23 **THE COURT:** Does that include third party pays?

24 **THE WITNESS:** No, sir. No, Your Honor.

25 Q: Can you explain why not to Your Honor's



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1 question?

2 A: Yes. Your Honor, I excluded the third party
3 payments -- so, for instance, payments to
4 installers in South Carolina -- for exactly the
5 same reason that I excluded the assets of
6 Operations and Enterprises.

7 DIRECTV, Inc. has paid an arm's length price to
8 those -- to those third parties, to the
9 contract installer, and so they already have
10 reflected that return to that activity in that
11 price that they've paid.

12 So in terms of identifying what DIRECTV, Inc.'s
13 own income-producing activity is, I don't think
14 it's appropriate to include those third-party
15 contractors. They're reporting their own
16 income-producing activity there.

17 Q: Thank you, Dr. Cody.

18 A: Certainly.

19 Q: You were going through your charts.

20 A: Yeah. So the second row, then, in the chart is
21 total payroll for DIRECTV, Inc. on the exact
22 same basis here.

23 So if we just look at those two, take 2006 as
24 an example, all of the figures in these tables
25 are in thousands of dollars. So in 2006,



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1 DIRECTV, Inc. had roughly 70,000, 69.6 thousand
2 dollars of payroll in South Carolina.

3 Across DIRECTV, Inc.'s entire operations, they
4 had payroll of approximately \$80.6 million.
5 Just doing the calculation, then, that meant
6 that approximately .09 percent of DIRECTV,
7 Inc.'s payroll was in South Carolina in 2006.

8 I repeated that same calculation for each of
9 the years. Naturally, with changes in
10 businesses, you can see that the percent of
11 payroll in South Carolina varies somewhat from
12 a low of about .03 percent to .1 percent in
13 2011.

14 But on average, weighted average, just adding
15 up all of the payroll across the years, find
16 that South Carolina payroll accounted for
17 .07 percent of total DIRECTV, Inc. payroll on
18 average across the years at issue in this
19 matter.

20 So let's just put payroll off on the side for
21 a second. And as I said, I could have just
22 stopped here and said I think that's a fair --
23 that .07 percent, then, of DIRECTV's gross
24 receipts should be sourced to South Carolina
25 because .07 percent of payroll, .07 percent of



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1 its income-producing activities would be
2 sourced there. But I also then went on and
3 calculated the percent for assets and then
4 would bring the two together.

5 So if we can turn to page 18, then, on table
6 1-B, do a similar calculation that I just
7 described for payroll but this time for assets.
8 And here, assets are all of -- as we said, all
9 of the tangible assets. So this building,
10 equipment, so it's the broadcast centers. It's
11 equipment, so it's the local collection
12 facilities. It's the set-top boxes, so I am
13 accounting for local contributions there.

14 It's inventory. I think we heard Mr. Goswitz
15 say that when someone calls up customer service
16 and they need to dispatch an installer, they go
17 and pick up the set-top box; well, that's
18 inventory that's held in this state, all right?
19 So there's -- all those assets are included in
20 here at net book value.

21 So when I look at South Carolina assets, then,
22 the first row in table 1-B in 2006, and roughly
23 \$20.4 million of assets in South Carolina in
24 2006.

25 Your Honor, for your benefit, the vast majority



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1 of those assets are the set-top boxes in South
2 Carolina, just so you can put things in
3 perspective here. And that holds for South
4 Carolina.

5 And then for total U.S. assets or total assets
6 of DIRECTV, Inc., as we look in 2006, had
7 roughly 1.26, \$1.3 billion of assets across the
8 entire DIRECTV, Inc. company.

9 So then that means for 2006, 1.61 percent of
10 DIRECTV, Inc.'s assets were in South Carolina.
11 I would then say on a pure asset basis that
12 1.16 percent of gross receipts associated with
13 the production income-producing activities
14 associated with the assets.

15 But we don't want to stop there. We want to
16 put the two together. So as is typical in
17 these kinds of formulations, I take a simple
18 average of the two percentages and that's what
19 I do in the bottom panel of the table 1-B.

20 So carrying forward the figures from the
21 previous page, the payroll percent for 2006 was
22 .09 percent. If I average the asset percent,
23 1.61, and the payroll percent, .09, I get a
24 combined or average payroll of .85 percent
25 there in 2006.



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1 That varies -- did that on each individual year
2 basis across and that at that average percent
3 certainly varies on a year by year basis,
4 although within a fairly tight range from about
5 .81 percent to .87 percent. But when I look at
6 the period overall as an average, my combined
7 sourcing or locating -- location percentages is
8 0.85 percent.

9 If we go back to the -- what my assignment was
10 and say I'm going to identify the
11 income-producing activities of DIRECTV,
12 identify those as those four categories, said
13 now I need to measure the contribution and the
14 location of those assets -- of those -- of
15 those income-producing activities, that's where
16 this .85 percent comes in.

17 And it says that .85 percent of DIRECTV, Inc.'s
18 gross receipts are attributable to
19 income-producing activities in South Carolina
20 as I use payroll and assets as my proxies, my
21 justifiable economic proxies for locating those
22 activities.

23 **MR. VALLEJO:** Thank you, Dr. Cody. I have no
24 further questions at this time, Your Honor.

25 **THE COURT:** Ms. Wooten?



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1 MS. WOOTEN: Thank you.

2 THE COURT: Wait a second.

3 MR. VALLEJO: Your Honor, one quick housekeeping
4 matter. My co-counsel tells me that he's not
5 sure I asked for the expert report to be
6 introduced into evidence. I think I did, but
7 I just want to make sure that we've done that.

8 THE COURT: Well, any objection to it being in
9 evidence?

10 MS. WOOTEN: No, Your Honor.

11 THE COURT: It's admitted.

12 MS. WOOTEN: I think it was previously admitted as
13 Number Eight.

14 THE COURT: If it wasn't admitted, it is now.

15 THE COURT REPORTER: It was admitted.

16 MR. VALLEJO: It was?

17 THE COURT REPORTER: Uh-huh (affirmatively responds).

18 THE COURT: There you go.

19 MR. VALLEJO: Okay. Thank you very much.

20 DR. CODY - CROSS-EXAMINATION BY MS. WOOTEN:

21 Q: Good afternoon. Just have a few questions for
22 you, Mr. -- or Dr. Cody, I apologize. You
23 testified earlier and I believe it's included
24 in your report that you defined DIRECTV's
25 income-producing activities as, quote, "Those



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1 activities which convert potential customers
2 into subscribers and retain existing
3 subscribers." Is that correct?

4 A: Yes.

5 Q: Okay. Is this definition included in any of
6 the relevant South Carolina statutes?

7 A: No, it's an economic interpretation as I look
8 at the specifics of DIRECTV, Inc.'s business
9 and answer what I believe is the economic
10 question, which is the determination of what
11 those activities actually are. So it's an
12 economic interpretation based upon my analysis.

13 Q: Okay. And you state "potential customers" in
14 your definition. You would agree that DIRECTV
15 has incurred costs up to this point but it has
16 not generated any income from potential
17 customers; is that correct?

18 A: Yes, just like any business, that they will
19 engage in activities in anticipation of a
20 particular sale; that's just normal business
21 operations, yes.

22 Q: Okay. And in your report, you further describe
23 income-producing activities as "content
24 development and contract negotiations." You
25 list some others, technology, research and



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1 development, marketing customer service. Can a
2 DIRECTV customer purchase any of those
3 activities independently of programming?

4 A: I don't believe that -- you'd have to -- well,
5 you'd have to ask Mr. Goswitz whether or not
6 they're able to purchase any of those
7 separately. I'm not aware of any contracts.

8 Q: You also state in your report that "From an
9 economic standpoint, functional analysis is the
10 appropriate standard for identifying where a
11 business's income is generated." Is that a
12 standard economics term? Where do you get the
13 term or the phrase "functional analysis"?

14 A: "Functional analysis" is really a term of art
15 and it's meant to describe the process that we
16 go through. All of the economic analysis, the
17 background industry research that we do to put
18 the company's operations in context, the
19 financial analysis. And so it's really meant
20 to encompass the entire process that one would
21 go through to determine then what the
22 value-creating, the income-producing activities
23 are.

24 Q: But this "functional analysis" is not included
25 in any of the relevant South Carolina statutes



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1 regarding income-producing activities; is that
2 correct?

3 A: Well, I don't want to speak from a legal
4 standpoint. I can't comment from that. I
5 haven't -- I don't know the statutes. But as
6 I read the -- what we had up before as
7 "sourcing gross receipts to the extent that
8 income-producing activities are performed
9 within the state," as I read that, as an
10 economist it says go out and determine where
11 those income-producing activities are located,
12 how they're performed, where they're performed,
13 what's taken into account in their performance.
14 And, to me, that's an economic -- as an
15 economist, that is an economic exercise that's
16 presented in those words.

17 **(Off the Record)**

18 Q: In your report, you also state that this
19 method, the functional analysis approach, makes
20 sense from a tax policy standpoint. Are you an
21 expert on tax policy?

22 A: No, I'm not an expert on tax policy, but the
23 reason I said that was that, broadly speaking,
24 you want to -- just like any activity, you want
25 to match cost and benefit, all right?



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1 And so if we're going tax income, it makes
2 sense to tax income where the profit or the
3 income that's being generated has been
4 generated. So there's a matching. And so it's
5 really a more matching of tax and income that,
6 to me, is the -- is the issue, the question
7 here, and that's -- that's what is the economic
8 principle.

9 Q: In your testimony, you talk -- and in your
10 report, you talk about the four value drivers
11 of DIRECTV's business: Content, marketing and
12 subscriber acquisition, broadcast operations,
13 and customer service. You refer to them in
14 your report as "value drivers" not "profit
15 drivers;" is that correct?

16 A: Yes, because the idea is that they are
17 performed in anticipation of generating income
18 and profit. Whether or not they do is the
19 outcome of the activities, but it has nothing
20 to do with recharacterization of them as
21 something else.

22 I always -- and we heard Mr. Goswitz talk about
23 it and it takes money to make money. So I'm
24 going to engage in activities in the
25 expectation, the hope that I will generate a



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1 profit.

2 It doesn't guarantee it. That's why there are
3 markets. So I might lose money, might make a
4 loss. I might make profit and my shareholders
5 are happy. So it would be inappropriate to
6 call them "profit drivers" because they're not
7 guaranteeing profit, but they're
8 income-producing in the sense that they enable
9 me to conduct my business in anticipation of
10 that.

11 Q: But if it's in anticipation of generating
12 income, you haven't generated that income yet,
13 correct?

14 A: Well, certainly at that point that I hire a new
15 technician or that I am working on developing
16 a satellite that takes years to produce,
17 certainly I'm incurring costs along the way.
18 And I'm doing that because I'm going to launch
19 the satellite and at that point, I would be
20 able to hopefully generate a receipt and
21 receive some actual gross receipt from my
22 customer.

23 But I'm paying that technician for their
24 expertise, for their value, for the
25 income-producing that they're going to enable



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1 me to be in the position to do at the time.

2 So I think you're mixing the idea that if I
3 have a cost today, that defines my activity,
4 all right? If I have a cost today but no
5 yet -- no income yet, it can't be an
6 income-producing activity.

7 I think that's just -- I think that's just a
8 complete misunderstanding of -- quite frankly,
9 of business, because I always incur costs today
10 in anticipation of future income. That doesn't
11 change the characterization of my activity
12 today from income-producing. It could produce
13 a profit. It might produce a loss. I'll find
14 that out once I go to market.

15 Also, I think is important here is that whether
16 or not that customer turns on their TV, all the
17 activities that we've talked about here are
18 continually being provided, continually being
19 performed by DIRECTV, all right?

20 I've got to constantly have that signal there.
21 It's always being done, all right, whether or
22 not they turn it on, whether they watch it 24
23 hours a day. So this timing difference that
24 you're talking about and saying that it drives
25 the characterization I think is really



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1 misplaced.

2 Q: You're saying they're continuing to provide
3 these services, but aren't the customers
4 continuing to pay every month for their monthly
5 subscription?

6 A: Perhaps. Perhaps they might cancel it. But
7 the activity is -- they're providing the
8 service and they're paying the subscription.
9 I guess I don't quite understand the
10 distinction you're trying to make there.
11 Whether or not I have enough subscribers to
12 cover my costs is a separate question, all
13 right? I may -- I may be providing a service
14 and now I don't have enough subscribers, so I
15 actually make a loss.

16 Q: But, again, you're describing costs, not
17 income.

18 A: No, I'm talking about both. I'm talking about
19 both. Because I have -- if you're talking
20 about net income, profit, all right, that's a
21 result of the revenues that I receive and all
22 the costs that I incur.

23 But what puts me in the position to get that --
24 to get that top line revenue? It's all
25 these -- and that's my income, all right?



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1 That's my revenue. That's my receipts. That's
2 what we're talking about here. It's all these
3 activities that I'm performing, all right?

4 Whether or not that produces sufficient
5 revenue, income, receipts, that I make a profit
6 is really a separate question. It's separate
7 from that I'm performing these activities in
8 anticipation of that.

9 Q: Going back to your value drivers analysis, is
10 "value drivers" included in any of the South
11 Carolina statutes?

12 A: I think inherently -- again, from an economic
13 perspective, when I read "income-producing
14 activities," I interpret that as creating
15 value, creating income, producing income. So,
16 again, I haven't studied the statutes to know
17 whether those exact words are, but the -- to
18 me, as an economist, the economic concepts are
19 quite clear in there.

20 Q: As an economist, do you define "value" the same
21 as "income"?

22 A: Well, value can have a number of different
23 meanings and depending on the context in which
24 the term is used..

25 Q: And in your report, you state that cable



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1 companies are a competitor to DIRECTV; is that
2 correct?

3 A: Cable companies certainly are one of the
4 competitors to DIRECTV, yes.

5 Q: And you also state telephone companies are a
6 competitor to DIRECTV?

7 A: Well, certain telephone companies, like AT&T
8 has U-verse. Their U-verse service is a
9 competitor to DIRECTV.

10 Q: Okay. And, you know, to -- and you state,
11 quote, "Competitors offer substantially similar
12 services to those that DIRECTV offers;" is that
13 correct?

14 A: They're substantially similar in that they are
15 broadcast services, but I think it's -- we
16 don't stop there. And I think that was an
17 important part of my description of how DIRECTV
18 then sets itself apart as a premium service and
19 all the activities that it performs in order to
20 set itself apart.

21 If you just stop at the signal coming through
22 on your television set and say, "Well, that's
23 the commodity," again, I think you miss the
24 business that DIRECTV is in in saying that,
25 "Well, we want to and we actually do



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1 distinguish ourselves from those other -- the
2 other competitors."

3 Q: And in your report, you talk briefly about the
4 two sourcing methodologies, table 1-A and 1-B
5 and used for your economically appropriate
6 standard -- excuse me, primary sourcing
7 methodology, you used a property and payroll
8 factor, correct?

9 A: Yes, that's correct.

10 Q: I think you might have used the term "assets,"
11 but is "property" a fair statement for
12 "assets"?

13 A: Economically to me --

14 Q: Okay.

15 A: -- they're the -- I'd say they're the same.

16 Q: Isn't that really getting into a
17 cost-to-performance analysis if you're looking
18 solely at property and payroll factors?

19 A: Much like what I said before on the market
20 approach, quite frankly I don't understand the
21 cost-to-performance and the methodology there
22 as it's used. Is payroll a cost? Yes, payroll
23 is a cost; no question about that. But it's a
24 proxy for the contribution that labor makes to
25 DIRECTV's income-producing activities.



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1 The assets on the books, they're not a flow.
2 They're not a cost, all right? They're an
3 asset. And so, no, I don't think that --
4 economically they're proxies for economic
5 measures, as I said, for labor on the effort
6 and assets on the resources that DIRECTV brings
7 to bear in its economic activities,
8 income-producing activities.

9 Q: For the payroll, you mentioned that third-party
10 installers were not -- their payroll was not
11 included in your analysis; is that correct?

12 A: That's correct.

13 Q: For South Carolina.

14 A: For -- for either. The payroll was not
15 included for either South Carolina or for --
16 nor for the total DIRECTV, Inc. payroll. So
17 there's a one for one correspondence there.

18 Q: Do you know if these third-party installers are
19 South Carolina residents?

20 A: I do not.

21 **MS. WOOTEN:** Your Honor, if I may have a moment,
22 please? Thank you.

23 (Off the Record)

24 **MS. WOOTEN:** Thank you, Your Honor. Just a few more
25 follow-up questions.



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1 Q: You said earlier in your testimony that you
2 could -- in calculating the gross receipts that
3 you could have stopped after calculating the
4 payroll ratio of .07 percent; is that correct?

5 A: If you -- if I felt that -- and I do believe
6 that payroll is a reasonable proxy for -- for
7 the contribution of the labor and the
8 income-producing activities.

9 So much like in *Lockwood Greene* which just
10 looked at a payroll approach, I could have just
11 stopped there. And, in fact, in my analysis,
12 I really consider that payroll calculation as
13 a sanity check on my preferred approach, which
14 is -- uses both labor or payroll and assets.

15 Q: So your calculations are subjective, right? I
16 mean, you went a step further than the payroll
17 factor.

18 A: Well, as I -- as I think I said, I really
19 considered what I thought was the economically
20 sound approach for determining the location of
21 DIRECTV'S -- DIRECTV, Inc.'s income-producing
22 activities.

23 There are many approaches that could be taken
24 and I felt that there were two reasonable
25 approaches, using payroll and assets as proxies



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1 for the economic activity. One used both.
2 That's my preferred method for the reasons I
3 explained, because DIRECTV is both very asset
4 and labor intensive. But I also think that
5 payroll, just a labor factor, is also
6 reasonable.

7 And so it is in my mind a confirmatory method.
8 It's consistent with methods that have been
9 used in the past. I think it has some merit in
10 this case, but I think there's a better measure
11 which is the one that I used, ultimately relied
12 upon which is payroll and assets.

13 Q: So you -- you know, you stated that there were
14 several reasonable approaches. You would agree
15 that having only one method of measuring a
16 taxpayer's gross receipts can't be used for
17 every taxpayer.

18 A: I couldn't agree more. The method -- the
19 method should follow from the facts and
20 circumstances of the case. As we look at
21 the -- because it goes back to, as we said, the
22 income-producing activities. And so we need to
23 develop the method that comes out of the -- and
24 as an economist, out of the analysis, the
25 economic analysis that I do.



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1 Businesses certainly are different. And it
2 could be a different measure would be better
3 for a different taxpayer. But they're all
4 based upon the same fundamental approach, which
5 is let's look at the income-producing
6 activities, let's look at the functions, the
7 risks, the assets and resources that are
8 involved with those activities and that will
9 lead us then to what the proper measure is.

10 Q: And just going back, I know a couple of times
11 you have mentioned that your view is that the
12 Department was focusing on the customer in
13 determining the income-producing activity; is
14 that correct?

15 A: I thought -- yes, I -- yes, absolutely. As I
16 read the different materials that have been
17 provided and listened to -- and go through the
18 deposition, it's clear to me that that's the --
19 as I look at it from an economic perspective,
20 they're clearly focused upon the customer.

21 Q: But isn't the Department's view of the
22 income-producing activity as set forth in the
23 Department's Determination that it's the
24 delivery of the signal, of DIRECTV's signal
25 into the homes of South Carolina customers



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1 that's the income-producing activity?

2 A: As I've read it, it has -- that certainly is
3 sometimes described that way. It's often -- I
4 think in the deposition testimony of the --
5 Mr. Harrison talks about the actual turning on
6 of the set, viewing of the signal, paying of
7 the invoice.

8 So it gets described many ways depending on the
9 documents that we're particularly looking at.
10 But one of the constant theme that comes
11 through is that it's the customer, where the
12 customer is, that tells me where the
13 income-producing activity is.

14 That's why no matter how you look at it, I
15 believe, what -- the issue as it's been
16 developed in this case, it comes down a
17 question of: Is the customer location --
18 however you describe it -- the
19 income-producing -- the location of the
20 income-producing activity?

21 Q: Again, going back to the third-party
22 installers, the technicians that you're not
23 including in the payroll factor, I mean, is it
24 your view that there's no value in those
25 individuals and those individuals installing



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1 the set-top boxes into the homes of the South
2 Carolina customers?

3 A: No, not at all. But, rather, the -- there is
4 value there, certainly. DIRECTV, Inc. has paid
5 those installers for the value that they're
6 bringing, for the service that they're
7 providing to DIRECTV, Inc. and DIRECTV, Inc.'s
8 subscribers.

9 So the payment that DIRECTV, Inc. gives to
10 those third-party contractors represents that
11 value and represents the income of those
12 contractors.

13 So to include it in DIRECTV's payroll would
14 essentially be double accounting. They've
15 already paid for that activity, whether it's in
16 South Carolina or really across the entire
17 country, because that's -- I would have to do
18 it on an equal basis there.

19 So, economically, it doesn't make sense,
20 because they've already paid for that value and
21 it being reported by the contractors
22 themselves.

23 MS. WOOTEN: Sorry, one more -- one more moment.

24 (Off the Record)

25 MS. WOOTEN: Nothing further from the Department,



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1 Your Honor.

2 **THE COURT:** Redirect?

3 **MR. VALLEJO:** I only have a couple questions, Your
4 Honor.

5 **DR. CODY - REDIRECT EXAMINATION BY MR. VALLEJO:**

6 Q: Dr. Cody, when DIRECTV -- you just heard the
7 Department say that their position is that the
8 income-producing activity is the delivery of
9 the signal. When DIRECTV delivers the signal,
10 is it incurring a cost?

11 A: Yes.

12 Q: Okay. You've also heard the Department
13 saying -- and you've said it yourself based on
14 your reading of the materials -- that the
15 Department's position is that an activity that
16 generates a cost cannot be an income-producing
17 activity. On that basis, can the delivery of
18 the signal be an income-producing activity?

19 A: No, no, and that goes to the entire point that
20 I was making, that if you follow that logic, in
21 the end nothing is an income-producing
22 activity.

23 **MR. VALLEJO:** Thank you. I have no further
24 questions.

25 **THE COURT:** Recross on those questions?



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1 MS. WOOTEN: No, Your Honor.

2 THE COURT: I've got a few for you.

3 THE WITNESS: Sure.

4 THE COURT: Some of them I'm just trying to figure
5 things out here. You said that -- and you
6 started with the principles of logic. So, you
7 should know that when you say that to a judge,
8 you're going to start getting questions.

9 THE WITNESS: I understand the peril, Your Honor.
10 Thank you.

11 THE COURT: You said you focused just on the
12 taxpayer, but to focus just on the taxpayer
13 leaves out a very important aspect, or at least
14 from -- and I'm asking you, so you correct me
15 if I'm wrong on all this -- but it leaves out
16 an important aspect you, yourself, were talking
17 about and that is, you were emphasizing the
18 value drivers, the importance of the content,
19 the fact that the customer service and all
20 that.

21 So what I'm -- that brings me to the question
22 of, if you focus just on the taxpayers, do you
23 not miss an analysis of what is important to
24 the customer in determining what is actually
25 produces the income in South Carolina?



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1 **THE WITNESS:** No, I think -- that's a very excellent
2 question, Your Honor, and let me clarify what
3 I meant there.

4 Is that certainly the transaction that we
5 have -- I pay DIRECTV for my subscription. I
6 feel it's worth it -- worthwhile for me to pay
7 a hundred dollars a month for my -- for my
8 subscription. And they've priced the service
9 for that; great. So for that hundred dollars
10 a month, they deliver a signal to me.

11 In making that decision, if I'm -- if we take
12 it from the customer -- from the subscriber's
13 point of view for a minute, I say, okay, well,
14 why am I willing to pay it, all right? Well,
15 they've got the content that I like and I have
16 access to that. The signal is clear and it's
17 reliable, all right? They come out with
18 innovative things, things I hadn't thought
19 about, you know. I'm a sports fan or I'm a
20 movie fan, so I'm -- and I want to be able to
21 tap into those, all right, and things go wrong.
22 Things -- customer service is always important,
23 so I'm willing to pay that hundred dollars a
24 month for that; and that's the customer side.
25 From DIRECTV's side -- and so I pay, all right?



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1 And that's my part of the transaction. I've
2 made all these things. I've looked at what
3 DIRECTV is doing and I've made an evaluation
4 it's worth it to me and I pay, okay?
5 DIRECTV, through all those activities, as well,
6 as I said, has tried to induce me to make that
7 payment, all right, through all these
8 activities. And my willingness to pay shows
9 that, yeah, the content is important; great.
10 The continuity and quality of the signal is
11 important. I count on that, all those things
12 that I've just said, all right? So that's the
13 deal.
14 What I was -- what I meant to say then, and
15 what I meant to get across is that, at that
16 point it simply says: What's valuable?
17 Content, broadcast services, so forth. But if
18 I don't look then at the operations of the
19 taxpayer, the simple fact that I pay doesn't
20 tell me anything about the location of the
21 activities that have then produced that
22 payment, that produced that income.

23 **THE COURT:** Can I stop you there? Because --

24 **THE WITNESS:** Certainly.

25 **THE COURT:** -- if you look solely at what the



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1 taxpayer did from a payroll and a asset
2 analysis, you also don't take into
3 consideration what is important from the
4 customer's standpoint in determining what
5 actually produced the income, do you?

6 **THE WITNESS:** I think you do in a very important
7 way, Your Honor.

8 **THE COURT:** All right.

9 **THE WITNESS:** Because it goes back to the decisions
10 about how I run my business. So, for instance,
11 DIRECTV, let's say they weren't doing any of
12 their own broadcast -- any of their own content
13 development, all right? They were just simply
14 repackaging everybody's service, all right?
15 And then they said, "Oh, well, you know what?
16 I think our -- our customers would find
17 this -- an NFL Sunday Ticket kind of an
18 attractive package to subscribe to, but it's
19 going to take us time to develop that."
20 So now we're going to need to incur additional
21 costs, additional technicians, additional
22 marketing folks, additional lawyers to
23 negotiate contracts and so forth.
24 And so the value that -- they think the value
25 that the customer is going to place on that,



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1 now they -- now they're having to hire in
2 additional people. So payroll will go up in --
3 where those folks are located.

4 **THE COURT:** All right. NFL Ticket requires
5 additional assets and additional payroll.

6 **THE WITNESS:** Yes.

7 **THE COURT:** But I've heard no testimony telling me
8 how many South Carolina citizens actually use
9 NFL Ticket, so I don't know how that value is
10 apportioned to South Carolina at all, do I?

11 **THE WITNESS:** I would say not specifically, no,
12 because you haven't looked at the individual
13 subscriber to know exactly what they're paying.
14 However, I would say that by looking at the --
15 it goes back to the idea that the payroll and
16 the assets are really proxies, that they're
17 reasonable measures.

18 **THE COURT:** Oh, but all I'm doing is testing your
19 proxies --

20 **THE WITNESS:** Yes, of course.

21 **THE COURT:** -- is what I'm asking you here is --

22 **THE WITNESS:** Right.

23 **THE COURT:** -- if -- for all I know, there may be
24 only ten South -- I know this may be absurd,
25 but there may be only ten South Carolina



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1 citizens that have the NFL Ticket, whereas
2 opposed -- or NFL, whatever it's called,
3 programming --

4 **THE WITNESS:** Right.

5 **THE COURT:** -- but; whereas it could be, you know,
6 tens of thousands in another state. So if I'm
7 just doing an across-the-board payroll and
8 asset, I'm missing an analysis of the value of
9 various aspects -- and that's just one of
10 them --

11 **THE WITNESS:** Uh-huh (affirmatively responds).

12 **THE COURT:** -- of your service, aren't I?

13 **THE WITNESS:** Well, I think we're making --
14 potentially. But I don't think that it's -- it
15 would be significant and here's why. Is that,
16 that would only have an impact if I really felt
17 that -- and I -- and if I knew that the -- the
18 composition of the packages, right, that folks
19 are buying in South Carolina really differ in
20 a significant way from the other markets in
21 which DIRECTV operates.

22 If not, then the average, if you will,
23 subscriber is the same, right? And I think
24 that is an underlying assumption. But I think
25 you also have that same type of assumption



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1 whenever we're applying -- as Professor Pomp
2 was saying in these other situations where
3 we're applying various kinds of factor
4 analyses. So there are certain assumptions
5 we're making that are part of it.

6 Quite frankly, the assumption that the average
7 demographics in the major markets in South
8 Carolina, which -- in the markets of South
9 Carolina -- I live in Missouri. I feel
10 comfortable with the assumption that that the
11 markets are similar in terms of probably what
12 the interests of folks.

13 And so I think it's -- unless you've got a real
14 reason to believe that's not true, I don't
15 think that that would give you a systematic
16 bias to say that income is either being
17 arbitrarily -- under this method has been
18 missed in South Carolina or -- meaning under
19 reported or over reported.

20 **THE COURT:** Well, then let me ask you about another
21 area. You were talking about customer service
22 and you said it's incredibly important and one
23 of the examples you gave was getting service
24 out quickly.

25 **THE WITNESS:** Uh-huh (affirmative response).



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1 **THE COURT:** Which that would occur in South
2 Carolina, I would assume, from your analysis or
3 the way you presented it. If that is a very
4 important aspect of DIRECTV, should that not be
5 given a higher consideration into whether or
6 not that's an important part of the
7 income-producing activity and it is something
8 that occurs within South Carolina?

9 **THE WITNESS:** Right.

10 **THE COURT:** Simply -- because all you did is
11 simply -- actually, I know you even excluded
12 payroll from that aspect of the
13 income-producing in South Carolina. So I feel
14 like there's a hole there.

15 **THE WITNESS:** Okay. Well, I -- again, I go back to
16 the idea of what I'm picking up in my assets
17 and payroll. So one of the things that
18 certainly enables that quick service is the
19 maintenance of inventory, say of set-top boxes
20 and controllers and dishes, and the assets that
21 I use do pick up that inventory and that's in
22 the state, right, and that contributes to the
23 ability to provide service --

24 **THE COURT:** It picks up the inventory of the set
25 boxes.



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1 **THE WITNESS:** Well, set-top boxes --

2 **THE COURT:** Yeah.

3 **THE WITNESS:** -- satellites, coaxial cables that are
4 used to connect it, those are important
5 components to the customer service, whether
6 it's installation or if there's a problem and
7 you need to swap out the boxes. So I think I
8 am picking up in the assets part of it.

9 **THE COURT:** Well, I agree you're picking it up. My
10 question to you is, is your picking it up
11 distinguishing whether or not it has a higher
12 valuation in producing income in South
13 Carolina?

14 **THE WITNESS:** Right.

15 **THE COURT:** Let's say -- and I could back up to
16 moving for a minute or maybe even keeping in
17 line with it and the value of local
18 programming, that would occur in South
19 Carolina, if customer service, the repair of
20 their set boxes and everything else that would
21 occur here, and local programming would
22 contribute to 80 percent of the decision that
23 a South Carolina citizen may make into whether
24 or not to go with DIRECTV, then that 80 percent
25 would be 80 percent of the income-producing



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1 activity in South Carolina, would it not?

2 **THE WITNESS:** Well, I -- potentially. But I would
3 say that I am picking up that activity through
4 DIRECTV's, Inc.'s local collection facilities,
5 which are integral to the delivery of that
6 local -- of those local signals, as well as
7 through the set-top boxes.

8 **THE COURT:** So you didn't do a specific analysis
9 then on the value of the installation of the
10 dishes, the value of installation of the
11 set-top boxes, the value of someone coming out
12 to your home. You just used the proxies for
13 the payroll and assets to attribute to those
14 values.

15 **THE WITNESS:** That's right, Your Honor. And that's
16 why -- when I said that there are a number of
17 approaches that could be used, certainly making
18 an individual valuation of the different asset
19 classes and activities is something that could
20 be done; entails, you know, considerable
21 effort. And I think it's for that -- and some
22 uncertainty, all right? Because we need to
23 associate returns with each, right? So --

24 **THE COURT:** I don't know if I -- I don't want to
25 interrupt you.



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1 **THE WITNESS:** No, go ahead.

2 **THE COURT:** Stay on your path, but I don't think
3 I've ever had a tax case that didn't involve
4 some uncertainties.

5 **THE WITNESS:** Yes, there you go. Very good.

6 **THE COURT:** We can all agree on that.

7 **THE WITNESS:** Indeed. Indeed. And so I think -- I
8 think the important thing to keep in mind is
9 that these are proxies, right? And so how
10 close can we get to what we think is a
11 reasonable basis?

12 And that's where I keep coming back to the idea
13 of, well, if I go to assets, underlying
14 economics of what I'm doing is, by taking all
15 the assets and just adding them up, I'm
16 essentially assigning the same return to all
17 the assets, all right?

18 So, fine, at the margin, you know, assets might
19 have different returns, but I'm saying on
20 average, I'm assigning that return to all the
21 assets.

22 It's -- it really is a simplifying assumption,
23 but it's -- it's one that's often used in
24 economics, very reasonable when we're talking
25 about these kinds of activities, particularly



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1 when we've got a very complex network that's
2 operating simultaneously here, where to be able
3 to isolate, you know, the contribution that the
4 El Segundo up-link center provides to DIRECTV's
5 customers in South Carolina versus New Mexico
6 when it's sending signals everywhere, all
7 right?

8 To do that kind of detailed analysis just is
9 really not practical and that's why I come back
10 to this approach which is, on average, I'm
11 giving the same return because I've got this
12 complicated network and I need to find some
13 reasonable approach, something that I can
14 actually implement.

15 And I think that that's really what's
16 underlying -- you go back to the
17 three-factor -- three-factor formula. I have
18 some sympathy for that -- for that Nobel Prize
19 professor who made the comment about the
20 three-factor formula. I also, quite frankly,
21 don't think he ever did a report where he
22 actually then maybe put a value on activities
23 and actually made those calculations within
24 a -- within some reasonable time frame --
25 speculating, all right -- that he would make



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1 some simplifying assumptions based on sound
2 reasoning, but nonetheless something that's
3 getting you a reasonable answer that you can
4 have confidence in, that's not systematically
5 distorting the answer, and I think that's
6 what -- kind of at the heart of my analysis.
7 I've tried to take that approach that it's not
8 biasing it one way -- one way or the other.

9 **THE COURT:** All right. Follow-up questions on what
10 I have asked?

11 **MR. VALLEJO:** I don't have any further questions.
12 Thank you, Your Honor.

13 **MR. CONDON:** No, yours.

14 **MS. WOOTEN:** Nothing from the Department, Your
15 Honor.

16 **THE COURT:** You may step down.

17 **THE WITNESS:** Thank you, Your Honor.

18 (Witness excused.)

19 **THE COURT:** We're going to take a break for the day
20 or ...

21 **MR. ROBERTS:** If Your Honor is --

22 **THE COURT:** That's what I would prefer.

23 **MR. VALLEJO:** That was our last witness, Your Honor,
24 so it's up to the Court and -

25 **THE COURT:** Well, you mentioned something about



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1 reading.

2 **MR. ROBERTS:** I think in the morning we have some --
3 yeah.

4 **MS. GEER:** Yeah, let's just do those in the morning.

5 **THE COURT:** Read it in the morning, in the
6 afternoon, whenever, just we'll do it tomorrow.

7 **MR. ROBERTS:** That works.

8 **THE COURT:** And we'll be back here at 9:00 o'clock.

9 (Whereupon, the hearing adjourned at 5:15 p.m.)

10 **THE COURT:** All right. Where were we? Had y'all
11 rested yet?

12 **MR. ROBERTS:** No, Your Honor, we have not rested.

13 **MS. GEER:** Your Honor, one small procedure issue
14 before we get started. We -- I've handed to
15 Ms. Fair earlier the amended joint designation.

16 **THE COURT:** Uh-huh (affirmatively responds).

17 **MS. GEER:** And so that is now filed. We do not
18 believe that it needs to be read. We just want
19 it in the record. And so we would like to
20 offer as our next exhibit a marked copy that is
21 consistent with the joint designations --

22 **THE COURT:** All right.

23 **MS. GEER:** -- into evidence.

24 **THE COURT:** Any objections?

25 **MR. CONDON:** No objection, Your Honor, but we would



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1 like in our case to read the portions that are
2 marked in into the record.

3 **THE COURT:** Well, then if that occurs, I assume you
4 have the choice of whether you want your
5 portions read, too, so.

6 **MS. GEER:** Okay. Your Honor, thank you.

7 **MR. CONDON:** Yes.

8 **(Off the Record)**

9 **(Joint Exhibit One was marked and admitted into**
10 **evidence.)**

11 **MS. GEER:** Thank you, Your Honor.

12 **MR. ROBERTS:** Your Honor, we rest our case.

13 **THE COURT:** All right.

14 **MR. CONDON:** Your Honor, the Department would like
15 to make a motion for directed verdict at this
16 point.

17 **THE COURT:** Well, then that's denied because we
18 don't hear directed verdicts. You want to make
19 a shot at involuntary nonsuit, I'll hear it.

20 **MR. CONDON:** Make a shot at what?

21 **THE COURT:** Involuntary nonsuit I'll hear it.

22 **MR. CONDON:** No. All right. Thank you, Your Honor.

23 **THE COURT:** I don't know if you caught my humor. In
24 this Court, we don't hear directed verdicts.

25 **MR. CONDON:** Right.



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1 **THE COURT:** But we do hear Motions for Involuntary
2 Nonsuit. So if you want to make a Motion for
3 Involuntary Nonsuit, I'll hear it; that's what
4 I was getting at. It's somewhat the same
5 thing, but a little different standard.

6 **MR. CONDON:** No, Your Honor. No thank you.

7 **THE COURT:** Okay.

8 **MR. CONDON:** We won't do that.

9 **THE COURT:** Well, then call your first witness.

10 **MS. WOOTEN:** Thank you, Your Honor. At this time we
11 call Robert King to the witness stand.

12 **ROBERT KING,** having been duly sworn, testifies and
13 examines as follows:

14 **MR. KING - DIRECT EXAMINATION BY MS. WOOTEN:**

15 Q: Good morning, Mr. King. Could you please state
16 your full name for the record?

17 A: Robert Norman King, Jr.

18 Q: And where are you currently employed?

19 A: The South Carolina Department of Revenue.

20 Q: In what area of the Department do you work?

21 A: Foreign audit.

22 Q: Could you had please explain to the Court
23 foreign audit?

24 A: It handles multi-state corporations.

25 Q: Let's discuss the audit process in general.



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1 Let's say you go to a corporation and issue
2 them an audit report and that taxpayer
3 disagrees with your audit. What can the
4 taxpayer do at that point?

5 A: They have 90 days to appeal that and usually
6 goes through my supervisor, and if they can't
7 resolve that, it goes to appeal.

8 Q: And when you say "appeal," what do you mean
9 when it goes to appeal?

10 A: Appeal the findings of the audit itself.

11 Q: What section of the Department handles the
12 audit appeal?

13 A: That would be litigation.

14 Q: Okay. And what does the litigation section
15 issue in response to an appeal?

16 A: A Department Determination.

17 Q: Are you familiar with the taxpayer in this
18 matter?

19 A: Yes.

20 Q: And what is the nature of your involvement with
21 the taxpayer?

22 A: I performed a field audit on the 2006 through
23 2008 tax returns for DIRECTV, Inc.

24 Q: Where did you conduct this field audit?

25 A: Los Angeles, California, El Segundo is



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1 technically where it was.

2 Q: And that is the --

3 A: Headquarters or corporate accounting
4 headquarters for DIRECTV.

5 Q: And were you the only auditor present at this
6 field audit?

7 A: No.

8 Q: Who was present with you?

9 A: Don Dennis and Don Hennif (phonetic).

10 Q: And what is their role with the Department?

11 A: Don Hennif is now retired. Don Dennis has the
12 same position as I do.

13 Q: And what was your role during the audit?

14 A: I helped compile the information and research
15 and so forth during the audit.

16 Q: And what was the basis of that particular
17 audit?

18 A: We were looking at intercompany expenses and
19 other affiliates that were not following with
20 the South Carolina Department of Revenue for
21 nexus issues.

22 Q: And after consideration of the nexus issue,
23 what did you determine?

24 A: That we had no nexus on the other entities.

25 Q: All right. If you will, please --



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1 MS. WOOTEN: May I approach, Your Honor?

2 THE COURT: Yeah.

3 Q: If you will grab the Respondent's exhibit
4 notebook up here at the top.

5 A: (Indicating.)

6 Q: Uh-huh (affirmative response). Okay. Just use
7 that to refer. If you will refer to Exhibit
8 One, Respondent's Exhibit One.

9 A: (Witness complies.)

10 Q: And do you recognize this document?

11 A: Yes.

12 Q: What is it?

13 A: That is the 2006 corporate return for DIRECTV,
14 Inc., and Subsidiaries.

15 Q: And have you had an opportunity to review this
16 return?

17 A: Yes.

18 Q: Okay. If you will refer to page four, I
19 believe, of that exhibit, the section
20 designated as Scheduled H-2.

21 A: (Witness complies.)

22 Q: Do you have that?

23 A: Yes.

24 Q: Okay. And in that section, what does line four
25 refer to?



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1 A: Line four in the Schedule G?

2 Q: I believe it's been cut off, but if you will
3 look down one, two, three, four -- it looks
4 like the fourth line, starts with "ratio."

5 A: Okay.

6 Q: What does this line refer to?

7 A: That is the apportionment ratio that represents
8 their percentage in South Carolina.

9 Q: And how is that ratio calculated?

10 A: It's determined by South Carolina receipts over
11 everywhere receipts.

12 Q: And what is your understanding of what has been
13 included in the South Carolina gross receipts
14 on this return?

15 A: Subscription revenues, set-top revenues.

16 Q: Okay. If you'll please refer to Exhibit Number
17 Two.

18 A: (Witness complies.)

19 Q: Excuse me, Exhibit Number Three. Again, if
20 you'll -- excuse me. I apologize, Exhibit
21 Four.

22 A: (Witness complies.)

23 Q: Do you recognize --

24 **THE COURT:** So we started with Two, now at Three,
25 and we're at Four?



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1 MS. WOOTEN: We've got so many --

2 THE COURT: Any more --

3 MS. WOOTEN: We have quite a few returns in front of
4 us, Your Honor.

5 Q: Do you recognize this document?

6 A: Yes.

7 Q: And what is this document?

8 A: That is the 2007, 12/31/2007 tax return for
9 DIRECTV, Inc.

10 Q: And you will refer to the same H-2 schedule,
11 it's a couple pages back, there's a number six
12 at the bottom of that page.

13 A: (Witness complies.) Okay.

14 Q: What is the ratio reported on this return?

15 A: 2.0016 percent.

16 Q: And is it your understanding -- is the method
17 DIRECTV used to calculate this ratio consistent
18 with the ratio calculated for 2006?

19 A: Correct.

20 Q: All right. And if you will please refer to
21 Exhibit Six.

22 A: (Witness complies.)

23 Q: And, again, if you will flip to a couple pages
24 back. It's number seven designated on the
25 bottom of the page.



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- 1 A: (Witness complies.) Okay.
- 2 Q: What is the ratio reported on this return?
- 3 A: 2.0543 percent.
- 4 Q: And is this method DIRECTV used to calculate
- 5 the ratio consistent with the ratios calculated
- 6 for 2006 and 2007?
- 7 A: Yes.
- 8 Q: Okay. After conducting the field audit and
- 9 reviewing the information of the taxpayer, what
- 10 did you do next?
- 11 A: For the original returns, we had no issue with
- 12 the way they filed the returns.
- 13 Q: Did you accept the original returns as filed?
- 14 A: We would have accepted those as filed.
- 15 Q: And when were you next contacted or had any
- 16 involvement with the DIRECTV audit?
- 17 A: 2010.
- 18 Q: And what was the nature of that contact or
- 19 assignment?
- 20 A: They had sent amended returns in for those tax
- 21 years and I was asked to review those.
- 22 Q: And what is your understanding of the basis or
- 23 purpose of these amended returns for tax years
- 24 2006 to 2008?
- 25 A: That they didn't feel their original filing of



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1 and sourcing their receipts to South Carolina
2 was correct and that they didn't think the
3 subscription revenues should be sourced to
4 South Carolina in the manner that they were.

5 Q: Did DIRECTV include with these amended returns
6 to the Department any statement to support the
7 amended returns?

8 A: The last page of the return had a statement on
9 there that they wanted to change.

10 Q: If you will --

11 **THE COURT:** Hold on a second.

12 Q: -- refer to Exhibit Three.

13 **THE COURT:** Wait a second. Can you speak up a
14 little bit louder?

15 **THE WITNESS:** I'll try to. I'm sorry, I have a low
16 voice. I apologize.

17 Q: If you will -- I'm sorry. If you'll please
18 refer to Respondent's Exhibit Three and the
19 last page.

20 A: (Witness complies.)

21 Q: Is this the statement you were referring to?

22 A: (Reading.) Yes.

23 Q: Could you please read that statement?

24 A: "The return is being amended to apportion sales
25 receipts to the state under SC Code 12-6-2295,



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1 which sources sales of services under a
2 prorated cost-to-performance method. The
3 originally filed return incorrectly apportioned
4 satellite subscription receipts to South
5 Carolina using market-based sourcing rather
6 than cost-to-performance sourcing that is
7 prescribed by statute."

8 Q: Thank you. And just to clarify, let's go back
9 to Exhibit Two.

10 A: (Witness complies.)

11 Q: Do you recall -- or have you seen this
12 document?

13 A: Yes.

14 Q: What is this document?

15 A: That is the 12/31/2006 amended return for
16 DIRECTV, Inc., and Subsidiaries.

17 Q: And do you know the purpose of this amendment?

18 A: That was to change the apportionment ratio in
19 South Carolina.

20 Q: If you will flip to page three of that
21 document.

22 A: (Witness complies.)

23 Q: Is there any ratio reported on this tax return?

24 A: No.

25 Q: Did DIRECTV file two amended returns for 2006?



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1 A: I don't recall that they did.

2 Q: Okay. All right. If you will flip to Exhibit
3 Three.

4 A: (Witness complies.)

5 Q: And do you know what this -- or what is this
6 document?

7 A: That is the 12/31/2006 amended return for
8 DIRECTV and Subsidiaries.

9 Q: And have you had an opportunity to review this
10 return?

11 A: Yes.

12 Q: Okay. If you will flip to page four of the
13 exhibit.

14 A: (Witness complies.)

15 Q: What is the ratio reported on this return?

16 A: On page four or five?

17 Q: It's number four in the document, but I believe
18 it's number five on the actual page number.

19 A: Okay. And your question?

20 Q: What is the ratio reported on this page?

21 A: .0246 percent.

22 Q: And what is your understanding of how DIRECTV
23 calculated this ratio for the 2006 amended
24 return?

25 A: In the South Carolina ratio, they included



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1 set-top box rentals and that was it.

2 Q: Did they include the South Carolina
3 subscription revenue?

4 A: I do not think so.

5 Q: Okay. If you'll now flip to Exhibit Five.

6 A: (Witness complies.)

7 Q: Do you recognize this document?

8 A: Yes.

9 Q: And have you had an opportunity to review it?

10 A: Yes.

11 Q: Okay. If you will flip several pages back to
12 the Schedule H-2 section. It's page six at the
13 bottom.

14 A: (Witness complies.)

15 Q: What is the ratio reported on this document?

16 A: .0810 percent.

17 Q: And is this method DIRECTV used to calculate
18 the ratio consistent with the ratios calculated
19 for the amended 2006 return?

20 A: Yes.

21 Q: Flip to Exhibit Seven, please.

22 A: (Witness complies.)

23 Q: And, again, turn -- or do you recognize this
24 document?

25 A: Yes.



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1 Q: What is this document?

2 A: That is the 12/31/2008 amended return for
3 DIRECTV, Inc.

4 Q: And if you will flip back to the third page.
5 It's marked number seven at the bottom.

6 A: (Witness complies.)

7 Q: What is the ratio reported on this document?

8 A: .1137 percent.

9 Q: Is the method DIRECTV used to calculate this
10 ratio consistent with the ratios calculated for
11 the amended 2006 and 2007 returns?

12 A: Yes.

13 Q: And, again, what is your understanding the
14 result of DIRECTV amending these returns to
15 source South Carolina subscription revenue
16 outside of South Carolina?

17 A: It significantly reduced the apportionment
18 ratio and therefore reduced the tax liability
19 for the taxpayer.

20 Q: Okay. All right. If you will now look at
21 Exhibit Number Eleven.

22 A: (Witness complies.)

23 Q: Do you recognize this document?

24 A: Yes.

25 Q: What is this document?



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- 1 A: That is the revenue -- the audit report that's
2 sent to the taxpayer.
- 3 Q: Did you draft or complete?
- 4 A: No.
- 5 Q: You did not? If you will flip to the second
6 page of this exhibit.
- 7 A: (Witness complies.)
- 8 Q: What is this document?
- 9 A: That is the billing page for the audit report.
- 10 Q: Did you draft this document?
- 11 A: Yes.
- 12 Q: And what does this document describe?
- 13 A: That describes what we have billed the taxpayer
14 for.
- 15 Q: Are there any other pages that you would have
16 completed or drafted in conjunction with this
17 billing document?
- 18 A: Yes.
- 19 Q: And what are those?
- 20 A: The recomp sheet for income and the license fee
21 sheet for the license fee.
- 22 Q: And are those included with this exhibit?
- 23 A: Yes.
- 24 Q: And what are the purpose -- what is the purpose
25 of the recomp sheets?

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1 A: It's to show in detail the returns and what is
2 due per year.

3 Q: Okay. Are the gross receipt ratios for years
4 2006 through 2008 included on this report?

5 A: Yes.

6 Q: Okay. And does it reflect the gross receipt
7 ratio reported by DIRECTV on its original
8 returns for tax years 2006 through 2008?

9 A: Yes.

10 Q: And what are the findings of your audit report?

11 A: That we felt like the original returns as filed
12 were the correct ratio for South Carolina.

13 Q: And what is the basis for that finding?

14 A: We felt like the subscription revenue was the
15 income-producing property or activity in South
16 Carolina and therefore they should be
17 sourced -- the customers that received those
18 subscriptions should be sourced to South
19 Carolina.

20 Q: And did you consider the satellites or other
21 infrastructure outside of South Carolina in
22 determining the income-producing activity for
23 South Carolina?

24 A: I did not.

25 Q: Why didn't you consider those activities?



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1 A: I hadn't -- I've done that in the past and that
2 was -- the way they were originally filed was
3 consistent with communications type businesses
4 in South Carolina and how they file their
5 returns.

6 Q: Okay. Is tax year 2009 included in this audit
7 report?

8 A: It is.

9 Q: Why is it included in the 2006 through 2008
10 audit report?

11 A: It was -- at the time of the write-up, the 2009
12 return had been filed and -- with a zero ratio,
13 but we used the same ratio, estimated the ratio
14 from the 2008 return but we included 2009.

15 Q: What happens after your audit report is
16 completed?

17 A: It is sent to my supervisor for review and then
18 they send the audit to the taxpayer.

19 Q: Okay. After you submitted this audit report to
20 your supervisor, when was your next involvement
21 or contact regarding this taxpayer's audit?

22 A: During the appeals process, I was asked to do
23 the 2009, 2010, 2011 to get the audit up to
24 date through that date that the appeal section
25 was handling the audit.



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1 Q: Did you conduct another field audit for the
2 2009 --

3 A: I did not.

4 Q: -- through 2011 period?

5 A: I did not.

6 Q: Okay. Why did you not conduct another field
7 audit?

8 A: I was asked to just (sic) at the ratios in line
9 with -- for the -- the appeals.

10 Q: If you will please refer to Exhibit Number
11 Eight.

12 A: (Witness complies.)

13 Q: Do you recognize this document?

14 A: Yes.

15 Q: What is it?

16 A: That is 12/31/2009 South Carolina tax return
17 for DIRECTV, Inc.

18 Q: And if you will flip a couple pages in to the
19 page that's marked seven at the bottom.

20 A: (Witness complies.)

21 Q: What is the ratio that is reported on this
22 return?

23 A: .1437 percent.

24 Q: All right. And if you will now refer to
25 Exhibit Nine.



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- 1 A: (Witness complies.)
- 2 Q: Do you recognize this document?
- 3 A: Yes.
- 4 Q: What is it?
- 5 A: That is 12/31/2010 South Carolina tax return
- 6 for DIRECTV, Inc.
- 7 Q: If you will please flip a few pages in, as
- 8 well, to the page marked number seven.
- 9 A: (Witness complies.)
- 10 Q: And what is the ratio reported on the return?
- 11 A: .1570 percent.
- 12 Q: And now if you will refer to Exhibit --
- 13 **THE COURT:** .15 what?
- 14 **THE WITNESS:** 1570 percent.
- 15 **THE COURT:** Okay.
- 16 Q: If you will please refer to Exhibit Ten.
- 17 A: (Witness complies.)
- 18 Q: Do you recognize this document?
- 19 A: Yes.
- 20 Q: What is it?
- 21 A: It is the 12/31/2011 South Carolina return for
- 22 DIRECTV, Inc.
- 23 Q: And, again, if you will flip a few pages in to
- 24 the page marked seven.
- 25 A: (Witness complies.)



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1 Q: And what is the ratio reported on this return?

2 A: .2962 percent.

3 Q: Are DIRECTV's original returns for tax years
4 2009 through 2011 consistent with the method of
5 filing for the amended returns for 2006 through
6 2008?

7 A: Correct.

8 Q: How are they consistent?

9 A: They sourced the set-top box rental as the only
10 receipts in South Carolina.

11 Q: All right. And if you will now refer to
12 Exhibit Number Eleven.

13 A: (Witness complies.)

14 Q: There are several documents in this exhibit.
15 Collectively, could you tell the Court what is
16 this exhibit?

17 A: That is the audit package for 2009, 2010, 2011
18 that was sent to the taxpayer.

19 Q: Okay. And in this exhibit, there are billing
20 schedules and recomp schedules. Did you draft
21 or complete those schedules?

22 A: Yes.

23 Q: And what do those documents describe?

24 A: That shows the taxable income that this
25 taxpayer had in the State of South Carolina.



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1 Q: And what are the findings contained in your
2 audit report?

3 A: Those -- using the receipts for subscription
4 and set-top box in South Carolina. So
5 we -- the ratio was changed from what was --
6 they filed to including those in South
7 Carolina, which were consistent with 2006
8 through 2008 original returns filed.

9 Q: And, again, what is the basis for your audit
10 findings in the second audit report?

11 A: We felt like in the -- same as 2006 to --
12 through 2008, we felt like the income-producing
13 activity in South Carolina should include
14 subscription revenue.

15 Q: Okay. And if you will refer to the third page
16 of Exhibit Eleven.

17 A: (Witness complies.)

18 Q: There is a section entitled "explanation of
19 adjustments." What was the explanation given
20 in your report?

21 A: That was the third page you said, I'm sorry?
22 Did you say third page?

23 Q: Yes, third page.

24 A: Okay. I'm sorry. I included the statute that
25 includes corporate income tax for who is liable



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1 to file in South Carolina.

2 Q: Is the basis of your decision in the first
3 audit report consistent with the basis of your
4 decision in the second audit report?

5 A: Yes.

6 Q: And on the second audit report, did you include
7 the gross receipt ratios for years 2009 through
8 2011?

9 A: Yes.

10 Q: Okay. Where did you obtain those ratios?

11 A: I obtained them through an e-mail from my
12 supervisor, Tim Donovan.

13 Q: Were these ratios consistent with the ratios
14 reported by DIRECTV on the original 2006
15 through 2008 returns?

16 A: Yes.

17 Q: Were any penalties assessed against DIRECTV
18 during the audit periods?

19 A: For the 2009 through 2011.

20 Q: What were those penalties?

21 A: Substantial understatement.

22 Q: Did you recommend those penalties be applied?

23 A: Those were applicable to that audit, so yes.

24 **MS. WOOTEN:** Okay. No further questions from the
25 Department.



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MR. KING - CROSS-EXAMINATION BY MR. ROBERTS:

Q: Mr. King, it's nice to see you again.

A: Yeah.

Q: Just have a few questions for you this morning.

A: Okay.

Q: So you mentioned that you conducted two audits.

You conducted one on 2006 to 2008 period --

A: (Nods head affirmatively.)

Q: -- you reviewed the amended returns, and then you -- you did a follow-up audit for 2009 through '11?

A: Yes.

Q: During the time that you were conducting those audits and the review of the amended returns and the original returns for 2009 through '11, were you aware of how DIRECTV's business actually operated? Had you done any background research to figure out how it conducted its business?

A: No.

Q: During your deposition, you discussed that -- and again here today, you discussed that you did a field audit out at -- with DIRECTV.

A: (Nods head affirmatively.)

Q: Did you meet with anyone outside the tax



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1 department to talk about the operations of
2 DIRECTV?

3 A: No.

4 Q: I'd like you -- I'd like to refer to
5 Respondent's Exhibit Twelve. It's the field
6 audit report, 2009 through '11.

7 A: Okay.

8 Q: And I'm just a little concerned here, Mr. King,
9 since the story seems to have changed a little
10 since we were last together at your deposition.
11 Can you just take a look at -- just look at --
12 this is the 2009 through '11 field audit
13 report. Can you just take a look at the recomp
14 sheet?

15 A: Okay.

16 Q: On -- it just says page one at the bottom, but
17 the schedule has 2011, '10 and '9 at the top.
18 And you see at the bottom there, there's an
19 explanation of adjustments. Can you just --
20 there's a heading right below that, says
21 "sourcing of receipts."

22 A: Okay.

23 Q: Can you just read that to -- out loud, please,
24 into the record?

25 A: "It is Department's position that DIRECTV



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1 receipts from South Carolina customers pursuant
2 to their contract with DIRECTV are the receipts
3 which are the income-producing activity. The
4 apportionment ratios determine on a
5 market-based sourcing of South Carolina
6 customer receipts over all receipts as provided
7 by the taxpayer."

8 Q: Great. And in your deposition, you explained
9 to me that market-based sourcing, quote, "looks
10 to where the customer resides; that's kind of
11 where the market-based is based on." So the
12 field audit report is based on the location of
13 the customer, right?

14 A: Yes.

15 Q: Thank you. Now, just now, you testified
16 that -- this is what troubled me because --

17 A: Okay.

18 Q: -- clearly you just testified that the audit
19 was based on customer location. And now you --
20 just now you were talking about the
21 income-producing activities and you said that
22 the income-producing activity is, quote, the --
23 "the income-producing activity should include
24 subscription revenue." What does that mean?

25 A: We felt like the subscriptions were for -- were



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1 for the customers in South Carolina and that we
2 felt like that's where the activity took place
3 is -- is in South Carolina.

4 Q: And so, again, you're just -- you're just
5 basing it solely on customer location?

6 A: I am.

7 Q: Okay. Thank you. You also mentioned -- and
8 this kind of struck me as odd, too, given our
9 deposition --

10 A: Okay.

11 Q: -- that your determination here was consistent
12 with how communications companies were taxed.

13 A: Yeah.

14 Q: Can you just explain that a little more for me,
15 please?

16 A: We felt like that was consistent with how other
17 similar communications companies, as well as
18 cell phone, that type of stuff, which would be
19 in communication, also.

20 Q: But you just acknowledged that you didn't know
21 how DIRECTV's business operated, right?

22 A: That's correct.

23 Q: Okay. So it's probably difficult to make that
24 conclusion?

25 A: Just in going with what I knew.



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1 Q: Okay. Now, in your deposition, I -- you know,
2 I asked you if the Department had any practice
3 or policy with respect to sourcing subscription
4 revenue and you said that, no, you're not aware
5 of any. So this kind of seems to contradict
6 that. Did you just forget that guidance at the
7 deposition?

8 A: Yeah.

9 MR. ROBERTS: Okay. I have no further questions,
10 Your Honor.

11 THE COURT: Redirect?

12 MR. KING - REDIRECT EXAMINATION BY MS. WOOTEN:

13 Q: Mr. King, if you will refer to Exhibit Twelve
14 again.

15 A: (Witness complies.) Okay.

16 Q: Mr. Roberts was asking you regarding the
17 explanation of adjustments and he had you read
18 a section entitled "sourcing of receipts."

19 A: Yes.

20 Q: The phrase "market-based sourcing" was used in
21 this report; is that correct?

22 A: Yes.

23 Q: Did the taxpayer use this phrase on their
24 amended 2006 through 2008 returns in the
25 statement attached at the end of the document?



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1 A: Yes.

2 MS. WOOTEN: Thank you, Your Honor.

3 MR. ROBERTS: I have no further questions, Your
4 Honor.

5 THE COURT: All right. You may step down.

6 (Witness excused.)

7 THE COURT: Call your next witness.

8 MS. WOOTEN: Thank you. The Department calls Tim
9 Donovan to the stand.

10 TIMOTHY S. DONOVAN, having been duly sworn, testifies
11 and examines as follows:

12 MR. DONOVAN - DIRECT EXAMINATION BY MS. WOOTEN:

13 Q: Good morning, Tim.

14 A: Good morning.

15 Q: Could you please state your full name record?

16 A: Timothy S. Donovan.

17 THE COURT: Spell that last name for me.

18 THE WITNESS: D-O-N-O-V-A-N.

19 THE COURT: Pretty simple.

20 Q: How long -- or where are you currently
21 employed?

22 A: The South Carolina Department of Revenue.

23 Q: How long have you been employed with the
24 Department?

25 A: A little over 24 years.



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1 Q: And what positions have you held during that
2 time?

3 A: I've been a domestic auditor, a foreign
4 auditor. I worked in -- for eight years in the
5 Office of Appeals. I was the foreign audit
6 supervisor for four years and I'm currently the
7 foreign audit manager over nexus and discovery
8 and foreign audit.

9 Q: What are the general job duties of your current
10 position?

11 A: Currently, I manage the foreign audit function,
12 as well as the nexus and discovery section.

13 Q: Are you familiar with the taxpayer in this
14 case?

15 A: I am.

16 Q: How are you familiar with DIRECTV?

17 A: We conducted audits, you know, for the
18 2006-2008 period; at that time I was the audit
19 supervisor. For the second period, I was
20 basically the audit manager.

21 Q: Let's just break those out for a second. How
22 were -- what was your involvement in the first
23 audit period of DIRECTV?

24 A: In the first audit, as the audit supervisor, I
25 would have had discussions probably with the



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1 auditor, kind of overseeing audits of basically
2 all the auditors in the state. And I really
3 became involved in it once the appeal was filed
4 by DIRECTV. I would've received the appeal and
5 myself, as well as our appeals analyst,
6 would've handled the appeal.

7 Q: And what was the nature of your involvement
8 with the second audit?

9 A: Again, the second audit, we were still
10 reviewing the appeal of the first audit. I
11 basically would've given Mr. King information
12 in order to send out the second assessment to
13 bring it up to date.

14 Q: What is your understanding of the taxpayer's
15 sources of income in this case?

16 A: The taxpayer's sources of income are --
17 typically come from subscriber -- the majority
18 come from subscriber fees, leases of set-top
19 boxes, installation fees and so on and so
20 forth.

21 Q: Mr. King testified earlier regarding both audit
22 reports and the findings and basis for those
23 audit reports. Do you agree with the findings
24 and basis in those -- contained in those audit
25 reports?



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1 A: I do.

2 Q: Why?

3 A: It's consistent with how we apportion income of
4 the taxpayer.

5 Q: Were any new policy decisions made prior to the
6 issuance of the first audit report?

7 A: Any policy decisions? No..

8 Q: Was the auditor carrying out long-standing
9 Department policy?

10 A: He was.

11 Q: And do you recall why there is a gap of
12 approximately three years between the first and
13 second audit report in this matter?

14 A: The appeal was rather lengthy. Once we
15 couldn't reach a resolution at the field audit
16 level, the file was transferred to the Office
17 of General Counsel for the issuance of a
18 Department Determination. Once that
19 determination was drafted and approved, that's
20 when we decided to go ahead and bring the audit
21 up to date and send the assessment for the '09
22 through '11 years.

23 Q: In completing the second audit report, Mr. King
24 testified earlier that he retained (sic) the
25 gross receipts ratios from you in calculating



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1 the tax liability; is that correct?

2 A: That's correct.

3 Q: Did you compute those ratios?

4 A: I did not.

5 Q: Where did you receive those ratios?

6 A: I received those ratios from the taxpayer's
7 representative.

8 Q: And did you verify that those ratios were
9 accurate before giving them to the auditor?

10 A: I didn't do any calculation or verification of
11 the ratio, no.

12 Q: And why did you not verify those ratios?

13 A: They were received from the taxpayer
14 representative and we had no reason to believe
15 that -- that those ratios were incorrect.

16 Q: Generally speaking, Mr. Donovan, what is an
17 apportionment method?

18 A: An apportionment method?

19 Q: Uh-huh (affirmatively responds).

20 A: It's essentially a method of determining what
21 portion of income should be sourced to a state
22 or jurisdiction, you know, for taxation.

23 Q: Is one of those methods the gross receipts --

24 A: It is.

25 Q: -- method? Is the gross receipts method



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1 provided for by statute?

2 A: It is.

3 Q: Okay. If you will please refer to Exhibit
4 Number -- I apologize -- Thirty in our book.

5 A: One moment. (Witness complies.) Okay.

6 Q: Are you familiar with this statute?

7 A: Yes, this is 12-6-2290.

8 Q: And are you familiar with the Department's
9 application of this statute?

10 A: I am.

11 Q: Okay. And if you will flip to Exhibit Number
12 Thirty-two.

13 A: (Witness complies.)

14 Q: Are you familiar with this statute?

15 A: Yes, this is 12-6-2295.

16 Q: And are you familiar with the Department's
17 application of this statute?

18 A: I am.

19 Q: In your position at the Department, are you
20 familiar with the types of taxpayers who
21 utilize 12-6-2295, specifically A(5)?

22 A: Yes.

23 Q: In general, what types of business activities
24 do taxpayers utilize -- utilizing this method
25 engage in?



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- 1 A: Generally, they would be engaged in providing
2 services. You know, previously, before this
3 statute, you know, we were broken down between
4 gross receipts and a three-factor formula.
5 Three-factor form dealt with people that were
6 dealing in tangible personal property. Once it
7 was consolidated, you know, this basically just
8 deals with service companies, companies that
9 don't sell tangible personal property.
- 10 Q: And are you familiar with the Department's
11 practices on the sourcing of income from
12 service providers?
- 13 A: I am.
- 14 Q: Does the Department always source a taxpayer's
15 income to the location of its employees?
- 16 A: No.
- 17 Q: Would the Department sometimes source a
18 taxpayer's income to the location of the
19 delivery of services?
- 20 A: I believe so, yes.
- 21 Q: In applying Section 12-6-2295A(5), what does
22 the Department look at when determining how a
23 taxpayer's income should be sourced to South
24 Carolina?
- 25 A: We would look at how the business operates and



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1 essentially the transaction, you know, what
2 is -- what is transpiring under the
3 transaction.

4 Q: How would the Department source the income from
5 services received by an engineering firm?

6 A: In *Lockwood*, we basically -- the Court looked
7 at the actual engineering services as being the
8 income-producing activity and, therefore,
9 sourced it on a -- basically a proxy of
10 payroll.

11 Q: How would the Department source the income from
12 the licensing of intangibles?

13 A: Intangibles are licensed to South Carolina
14 based on where the accounts receivable is
15 created. Basically, the transaction of
16 producing -- you know, like in *Geoffrey*, the
17 licensing of an intangible, there wasn't a
18 receivable due until a sale took place in South
19 Carolina. And so, therefore, once that took
20 place in South Carolina, that receipt was
21 sourced to South Carolina.

22 Q: How would the Department source the income from
23 a financing operation?

24 A: Financing operations, we basically look at
25 what's being financed and where it's being



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1 financed and the customer that is basically
2 paying those finance fees of interest and
3 principal.

4 Q: And in viewing those situations that we just
5 discussed, was -- to your knowledge, was there
6 any calculation of the company's assets in
7 determining the income-producing activity?

8 A: No.

9 Q: Why not?

10 A: That just hasn't been our long-standing
11 procedure.

12 Q: What is the Department's practice in
13 apportioning income of cable companies?

14 A: Cable companies, again, we look at the
15 transaction that transpires and we basically go
16 by a gross receipts method of subscriber
17 service to income everywhere.

18 Q: Is that similar to the practice in -- or the --
19 what is being done with DIRECTV in this case?

20 A: It is.

21 Q: Are telephone companies treated the same as
22 cable and satellite companies with regard to
23 apportioning income?

24 A: They are. We do have a specific statute in
25 12-6-2390 or 20 -- I don't know the statute off



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1 the top of my head, but -- you know, telephone
2 companies, again, we would source based on the
3 receipts of the customer.

4 Q: Okay. And are all of these examples consistent
5 with the Department's long-standing
6 administrative policy regarding the sourcing of
7 corporate income?

8 A: It is.

9 Q: For the audit period at issue, did the taxpayer
10 provide any information regarding expenses
11 related to business activities in other states?

12 A: Not that I'm aware of.

13 Q: To your knowledge, was that information
14 requested by the auditor or anyone at the
15 Department?

16 A: Not to my knowledge.

17 Q: If the information had been provided, would
18 that have changed the Department's
19 determination in this matter?

20 A: I don't believe so, no.

21 Q: Why not?

22 A: Again, you know, we look at the transaction as,
23 you know, what the income-producing activity
24 and we would've looked at receipts of DIRECTV
25 for their subscription and their set-top boxes.



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1 Q: Mr. King testified earlier that penalties were
2 imposed in this case, specifically substantial
3 understatement penalties. Who makes the
4 determination of whether or not to apply
5 penalties in an audit?

6 A: I believe it's done by statute.

7 **MS. WOOTEN:** Okay. That's all from the Department,
8 Your Honor.

9 **MR. DONOVAN - CROSS-EXAMINATION BY MR. ROBERTS:**

10 Q: Good morning, Mr. Donovan.

11 **THE COURT:** Hold on one moment.

12 **MR. ROBERTS:** I'm sorry, Your Honor.

13 **THE COURT:** All right. Proceed ahead.

14 **MR. ROBERTS:** Thank you, Your Honor.

15 Q: All right. Mr. Donovan, Ms. Wooten asked you
16 if you agreed with the basis of the audit
17 report, which Mr. King testified about and you
18 said you did.

19 A: Uh-huh (affirmatively responds):

20 Q: So you would also agree, then, that the audit
21 determination was based on the location of the
22 customer, correct?

23 A: That is -- that's correct.

24 Q: Thank you. Okay. And I was -- there was lots
25 of testimony about the long-standing policy in



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1 this case and I guess -- I guess I'm just a
2 little confused.

3 **MR. ROBERTS:** And I'd like to approach the bench and
4 provide the witness with a copy of the
5 deposition transcript; copy for Your Honor.

6 Q: So you and -- you testified that the result in
7 this audit was consistent with long-standing
8 policy. This is the deposition transcript from
9 Mr. King's deposition. Can you just -- can you
10 just read the question and the answer starting
11 with line 20 and going to line 23? And read it
12 out loud, please.

13 A: Line 20, Question: "Does the Department have
14 any practice or policy with respect to sourcing
15 this type of revenue, subscription revenue?"
16 Answer: "Not that I'm aware of."

17 Q: So this long-standing policy, the auditor
18 conducting the audit wasn't aware of the
19 long-standing policy; that's what this says,
20 right?

21 A: That's -- that's what the deposition says --

22 Q: Thank you. All right.

23 A: -- yes.

24 Q: So -- and where -- where can I go about finding
25 this long-standing policy? I have been asking



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1 people for six months to find this
2 long-standing policy and I can't find it
3 anywhere.

4 A: It -- we don't have a policy or procedurals
5 manual.

6 Q: So it's not written down anywhere, correct?

7 A: Right.

8 Q: Okay. So if I'm a taxpayer and I want to find
9 out about the Department's policy, who do I
10 call? Because I've done discovery and I've
11 deposed four witnesses and no one I've spoken
12 to can tell me. So if I'm a taxpayer and I
13 want to find out about these guidelines, who do
14 I call?

15 A: Well, I mean, as far as call somebody in the
16 agency?

17 Q: I'm a taxpayer. I just wanted to know how the
18 Department thinks I should file my return and
19 I've -- we just heard 20 minutes of testimony
20 about these long-standing guidelines and
21 these --

22 A: Right.

23 Q: -- long-standing guidelines. But how am I as
24 a taxpayer supposed to find out about these
25 long-standing guidelines that aren't written



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1 down anywhere and I can't even find them out
2 through discovery?

3 A: You -- you can essentially request a letter
4 ruling from our policy section.

5 Q: So the burden's on the taxpayer to figure out
6 the secretive policies that the Department has.

7 A: I don't -- it's not a secret policy.

8 Q: But it's not published anywhere, correct?

9 A: Other than the -- I guess the court cases,
10 basically the long-standing of *Lockwood* and all
11 the way up through *Rent-A-Center Texas*.

12 Q: And, again, I mean, I just go back to this
13 long-standing policy. It's not only that --
14 it's not only that a taxpayer and taxpayer's
15 counsel can't figure out these long-standing
16 policies, but you just read a deposition
17 transcript that your auditor doesn't even know
18 of these long-standing policies. It's just
19 mind boggling me. It's not written down
20 anywhere, right? Just ...

21 A: Correct.

22 Q: And Ms. Wooten also asked many questions about
23 how various businesses -- how the Department
24 sources the revenue from lots of different
25 businesses and I assume those were also based



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1 on these long-standing guidelines that aren't
2 written down anywhere?

3 A: Correct.

4 Q: Okay. And you mentioned that the one special
5 apportionment formula for telephone companies
6 was actually in a statute, right?

7 A: That's correct.

8 MR. ROBERTS: Okay. I have no further questions,
9 Your Honor.

10 THE COURT: Redirect?

11 MS. WOOTEN: One moment, Your Honor.

12 THE COURT: That's fine.

13 MS. WOOTEN: Just a couple of follow-up questions,
14 Your Honor.

15 MR. DONOVAN - REDIRECT EXAMINATION BY MS. WOOTEN:

16 Q: When you refer to the location of the customers
17 in your decision, are you still considering the
18 income-producing activity in reaching that
19 conclusion?

20 A: Yes.

21 Q: And with regard to the telephone companies in
22 the statute that was just referenced, is that
23 a special statute that regulated public
24 utilities?

25 A: It -- I believe the original statute probably



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