THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Shirley C. Robinson, Administrative Law Judge

Docket No. 14-ALJ-17-0285-CC

Dish DBS Corporation f/k/a EchoStar, DBS Corp. and Affiliates ..... Appellant,

v.

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

FINAL REPLY BRIEF OF APPELLANT

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ARGUMENTS

I. The ALC erred in denying Appellant's Motion in Limine and Objections and allowing the Testimony of Dr. Glen Harrison.

Appellant and Respondent agree that Appellant is a service provider taxed under the following sentence under section S.C. Code Ann. Section 12-6-2295 (A)(5), "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." Dr. Harrison testified at length as to what Appellant's income-producing activities were, and whether Appellant's various activities qualified as "income-producing" under the statute. The ALC Order relies heavily on Dr. Harrison's testimony. The Order states, for example, that "I agree with Dr. Harrison and the Department's description of Appellant's income-producing activity." (ALC Amended Final Order; R. p. 25). Respondent's Brief (p. 8) states that "Dr. Harrison assisted the ALC in understanding DISH DBS's testimony about its activities by distinguishing between DISH DBS's intermediate or prior activities and its income-producing activities." The Brief further notes that "Dr. Harrison's testimony aided the ALC in understanding the economic impact or significance of these necessary, but intermediate activities *and how those activities may differ from the 'income-producing activities' referred to in S.C. Code Ann. § 12-6-2295(A)(5)(2014).*" *Id.* (Emp. added). Dr. Harrison testified his opinions were based upon scientific principles. (R. p. 710, lines 5–7). South Carolina Rule of Evidence 702 requires a scientific expert to be qualified by "knowledge, skill, experience, training, or education." In *State v. Council*, 335 S.C. 1, 515 S.E.2d 508 (1999) the Supreme Court held that scientific expert testimony is considered admissible under the following factors: (1) publications and peer review; (2) prior application of the method to the type of evidence involved in the case; (3) the quality

control procedures used to ensure reliability; and (4) the consistency of the method with recognized scientific laws and procedures, *Id*, at 19, 151 S.E.2d at 517.

Dr. Harrison's testimony in summary was that Appellant's sole income-producing activity was the delivery of the signal into the homes and businesses of its South Carolina subscribers. He testified that for purposes of state tax law, and specifically § 12-6-2295(A)(5), its other activities (e.g. programming, installation, satellites, advertising and call centers) were merely necessary but intermediate or prior activities.

What is the basis for Dr. Harrison opining on what is an income-producing activity under § 12-6-2295(A)(5)? How is he qualified, for example, in testifying that the receipt of subscriber funds at a call center is not an income-producing activity under § 12-6-2295(A)(5)?

As stated above, Rule 702 lists five qualifying factors for an expert witness. The first is education. Dr. Harrison has a PhD in Economics. He is a Professor at Georgia State University where he holds two positions: The C.V. Stair Chair in Risk Management and Insurance and the Director of the Center for the Economic Analysis of Risk. (Respondent's Brief at pp. 7-8). Respondent's Brief (p. 3) notes that he "teaches and researches in numerous areas in the field of economics, including applied economics." What is Applied Economics and what is its relation to the calculation of state corporate income taxes? Investopedia defines it as follows:

> DEFINITION of 'Applied Economics'
>
> The application of economic theories and principles to real world situations with the desired aim of predicting potential outcomes. The use of applied economics is designed to analytically review potential outcomes without the "noise" associated with explanations that are not backed by numbers. Applied economics can involve the use of economics and case studies.

BREAKING DOWN 'Applied Economics'

> Because economics relies on the interpretation of historical events in its theories, applied economics can lead to "to do" lists for steps that can be taken to ensure stability in real world events. Although applied economics uses economic theory and principles, it is itself not a field of economics, such as neoclassical economics or the Austrian school.

Wikipedia defines "Applied Economics" as:

> Applied Economics is the application of economic theory and econometrics in specific settings. As one of the two sets of fields of economics (the other set being the core), it is typically characterized by the application of the core, i.e. economic theory and econometrics, to address practical issues in a range of fields including demographic economics, labour economics, business economics, industrial organization, agricultural economics, development economics, education economics, health economics, monetary economics, public economics, and economic history.

Wikipedia further states:

> Modern mainstream economics holds the view that there is a body of abstract economic theory – the "core" – and applied economics involves the practitioner in the lowering some elements of the abstraction of this to examine particular issues. This lowering of the level of abstraction may involve:
>
> - Relabeling variables as more specific concepts;
> - Providing some structure to allow the drawing of more detailed conclusions;
> - Producing numerical estimates for some of the parameters;
> - Using the analysis to interpret the real world phenomenon which are interpreted as examples of some more general class of events that the core theory might be used to examine.

Investopedia and Wikipedia are silent on how an education in applied economics has any relevance to the calculation of state income taxes or the categorization of income-producing activities. Dr. Harrison provided no such testimony to such relevance. Nothing jumps to mind.

Rule 702 also references "knowledge, skill, experience [or] training." Dr. Harrison

has never taken,[1] or taught,[2] a course in the area of state taxation, apportionment of income for multi-state taxpayers or the calculation of the numerator in a state income tax apportionment scheme. He has also never taken a course,[3] or taught a course,[4] on the calculation or definition of "income producing activities" for state tax purposes. He provided no testimony of his knowledge, skill, experience or training in these areas.

The Supreme Court in *State v. Council*, *supra*, references publications and peer review. He has never published in the area of state taxation, apportionment of income for multi-state taxpayers or the calculation of the numerator in a state tax apportionment scheme.[5] He has also never published an article on the calculation or definition of "income producing activities" for state tax purposes.[6] He provided no testimony regarding any such publications or peer review.

State v. Council also lists prior application of the scientific method to the type of evidence involved in the case. Dr. Harrison provided no such testimony.

State v. Council also requires the quality control procedures used to ensure reliability. Dr. Harrison provided no such testimony.

Lastly, *State v. Council* requires evidence of the consistency of the method with recognized scientific laws and procedures. Dr. Harrison provided no such basis. At his deposition, Dr. Harrison cited two treatises that he based his opinion on: *Welfare Economics* and *Advanced Economic Theory*.[7] At trial, he conceded neither treatise

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[1] R. p. 691, lines 3–11.
[2] R. p. 691, lines 12–24.
[3] R. p. 693, line 23–p.694, line 1.
[4] R. p. 694, lines 6–13.
[5] R. p. 691, line 25–p. 692, line 6.
[6] R. p. 694, lines 10–13; R. p. 694, lines 15–18.
[7] R. p. 726, lines 20–25.

discussed income producing activities.[8] He further conceded no economic treatise supports his testimony that Appellant's only income producing activity was the mailing of the bill (or receipt of payment).[9]

The Court of Appeals recently discounted Dr. Harrison's testimony in *Rent-A-Center West, Inc. v. SCDOR* (Op. No. 5447) (2016). The DOR in that case argued that the taxpayer had diluted its sales/gross receipts ratio by including the retail sales of RAC West in the denominator because no retail sales were in the numerator. The Court of Appeals summarized Dr. Harrison's testimony as follows:

> The DOR argued RAC West diluted the sales/gross receipts ratio by including the retail sales of RAC West in the denominator because no retail sales are in the numerator, as RAC West's only activity in South Carolina is the licensing of the intellectual property. According to testimony from Dr. Glenn Harrison, the DOR's expert witness on law and economics, the gross receipts ratio did not provide an accurate reflection of the economic connection of RAC West to South Carolina. Dr. Harrison indicated including royalty receipts in the numerator of the ratio while including both total royalty and total retail receipts in the denominator was like putting apples in the numerator and apples and oranges in the denominator. He further testified the DOR's alternative method was economically reasonable and excluding the retail operations from the calculations was essential in order to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina." Additionally, Dr. Harrison indicated even if RAC West was a unitary business, it should still be able to separate its accounts. (*Id.* at ____, ____S.E.2d at ____, Op. pg. 44.)

The Court discounted, and then essentially dismissed, his testimony as follows:

> Additionally, the DOR's expert, Dr. Harrison, indicated excluding the retail operations from the calculations was essential to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina.
>
> ****
>
> Dr. Harrison testified that using the standard apportionment method would be like having apples in the numerator, while having apples and oranges in the denominator. However, this is how the apportionment method is intended to work, as Professor Pomp testified. A very small amount of RAC West's business comes from the royalties; therefore, this

[8] R. p. 726, line 24–p. 727, line 12.
[9] R. p. 728, line 21–p. 729, line 14.

should only comprise a small amount of its taxes.

****

Accordingly, substantial evidence does not support the ALC's finding the DOR met its burden. (*Id.* at ____, ____S.E.2d at ____.)

Dr. Harrison is a frequent expert witness for the DOR. In addition to this case, he has testified as an expert for the Department in another five ALC cases (Respondent's Brief at p. 10) and presumably retained in numerous others. Given that Dr. Harrison has testified in six state tax cases on behalf of the Department, it is imperative that the Court address the admissibility of the testimony of an Economics Professor who teaches in areas of Risk Management and Insurance and Economic Analysis of Risk in state tax cases.

II. The ALC erred in Holding that South Carolina is not a Pro-Rata Cost of Performance State

South Carolina has two sourcing rules, one for sales of tangible personal property, and the other for sales of services.

Since 2007 manufacturers and sellers of tangible personal property use the market or audience method advocated by the DOR in this case. *South Carolina Tax Incentive for Economic Development* (2016) states:

> Single Sales Factor Apportionment Method. South Carolina Code §12-6-2252 (*i.e., the new single sales factor apportionment method*) provides that a taxpayer whose principal business in South Carolina is manufacturing or any form of collecting, buying, assembling, or processing goods and materials in this state *** shall apportion income to South Carolina by multiplying the net income *** by the sales factor defined in South Carolina Code §12-6-2280.

Section 12-6-2280 accordingly apportions income of sellers of personal property to the location of the customer, i.e. the method adopted by the DOR and the ALC in this case. Section 12-6-2280 adopts the audience method as follows:

> (B) The term "sales in this State" includes sales of goods, merchandise, or property received by a purchaser in this State. The place where goods are *received by the purchaser after all transportation is completed is*

considered the place at which the goods are received by the purchaser.

Hellerstein, ¶ 9.18[1][a] notes:

> "The identification of the destination of a sale presents a number of problems. The statutes of some states, including Louisiana, North Carolina, and South Carolina, set forth rather detailed descriptions of the sales destination test."

As Appellant's expert Ray Stevens testified, the General Assembly knows how to adopt the market or audience method for income apportionment purposes – it did so in 2007 for manufacturers.[10] It did not do so for service providers – and the General Assembly passed both statutes at the same time in the same Act.[11]

By contrast, there are two predominant apportionment methods for sourcing income from the sales of services: the "cost of performance" method and the "market share" method. Hellerstein, ¶ 9.18[3][b], states the rule as follows:

> Despite the theoretical and practical objections to UDITPA's "income-producing activity"/"costs of performance" rule for attributing receipts from services to the numerator of a state's sales factor, most states with corporate income taxes still take this (or closely analogous) approach. *Unless modified by statute or regulation*, this approach requires the taxpayers first to determine which of its activities are the income-producing activities for its service income and then to determine where the costs of performing those income-producing activities were incurred. The taxpayer then compares the amount of costs of performance incurred in the taxing state to the amount of such costs in the other individual states. (Emp added).

There is a modified version of cost of performance known as pro rata cost of performance, which Appellant utilized in filing its amended returns. This approach eliminates the "all-or-nothing" factor associated with strict cost of performance and allocates the costs of performance between states. See Sutton et al., *The Increasingly Complex Apportionment Rules for Service-Based Businesses: Basic Issues*, 17-OCT JMTAX 24, 30-31 (2007 WL

[10] R. p. 1004, line 4–p. 1005, line 3.
[11] R. p. 1004, lines 4–12.

3201540) ("Under the pro rata cost-of-performance approach, in contrast to the 'all-or-nothing' methodology, gross receipts derived from the performance of a service are prorated among multiple states based on the cost of performing the service in each state.").

The only case to address the meaning of Section 12-6-2295(A)(5) to any extent is the South Carolina Court of Appeals' decision in *Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346, (Ct. App. 1987), which holds that South Carolina is a cost of performance state.

The Respondent's Brief repeatedly states that South Carolina is not a pro-rata cost of performance state and that *Lockwood Greene* is limited to personal service providers. That's not what the Department's most recent pronouncement (2016) states. The Department's publication, South Carolina Tax Incentive for Economic Development (2016) states:

> The income remaining after allocation is apportioned in accordance with South Carolina Code §12-6-2240. South Carolina generally requires the use of one of the following apportionment methods:
>
> ****
>
> A "gross receipts" apportionment method for taxpayers not dealing in tangible personal property. *This method is typically used by financial businesses and service businesses, including businesses that install or repair tangible personal property, and contractors.* See South Carolina Code §§12-6-2290 and 12-6-2295. (Emp added).

The Book further states:

> Gross Receipts Apportionment Method. South Carolina Code §12-6-2290 provides for the "gross receipts" formula and states:
>
> If the principal profits or income of a taxpayer are derived from sources other than those described in South Carolina Code §§12-6-2252 or 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 South Carolina Code §12-6-2295.

> The "gross receipts" ratio is most commonly used by service businesses. *The proper sourcing of gross receipts* was reviewed in *Lockwood Greene Engineers v. South Carolina Tax Commission*, 361 S.E.2d 346 (1987). The court held that in sourcing income of a multistate engineering firm, "gross receipts from within this State" were to be determined according to where the services were performed rather than according to where the customers were located. See also, *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) *cert. denied* 114 S.Ct. 550 (1993) and SC Private Letter Ruling #13-3. (Emp added).

The most recent version of Hellerstein (a supplement co-authored by the Department's expert witness, John Swain), states in ¶9.18[3][c], Supplement 59-84:

> Although South Carolina is not a state that generally follows UDITPA or the MTC regulations (see supra ¶ 9.05 (Table 9-4)), its single-factor sales formula, as applied to receipts for services, generally resembles UDITPA's income-producing activity rule for attributing receipts from services. See S.C. Code Ann. § 12-6-2295(A)(5) (Westlaw 2016) (attributing receipts from services to the state "if the entire income-producing activity is within this State," and if the income-producing activity is performed partly within and partly without this state, receipts are attributable to the state "to the extent the income-producing activity is performed within this State") The South Carolina Department of Revenue has ruled that the work of independent contractors must be considered in applying this rule. Priv. Ltr. Rul. 13-3, SC Dep't of Revenue, Aug. 7, 2013, available at www.checkpoint.thomsonreuters.com. (Emp added).

Hellerstein also notes in FN 1187 of ¶ 9.18:

> According to two knowledgeable observers, as of late 2010 "[f]our states use a proportionate costs-of-performance method: Arkansas, Mississippi, North Carolina (services only) *and South Carolina* (services only)." P. Mata & M. Smith, "The Implementation of 'Market' Sourcing Rules: Practical Concerns," State Tax Notes, Sept. 6, 2010, p. 649 (citing statutes and regulations). (Emp added.)

The Department's own expert witness, Prof. John Swain, flatly testified "South Carolina has a proportionate rule." (R. p. 932, line 12). Just three years ago, in PLR #13-3, the DOR reiterated that South Carolina is a cost of performance state.

Furthermore, the Administrative Law Court's decision in *Rent-A-Center Texas, L.P. vs. South Carolina Department of Revenue*, Docket No. 09-ALJ-0206-CC (filed January 6, 2012) reaffirmed the "COP" test as the proper means of sourcing sales from

services. Therefore, the Court found that by applying the ruling of *Lockwood Greene* to the facts the revenue received by Rent-A-Center Texas, L.P. for work performed in Texas must be sourced to Texas. The ALC decision plainly states: "In conclusion, the revenue received by RAC Texas from the Management Services Agreement must be apportioned to Texas pursuant to *Lockwood Greene*. RAC Texas provided its management services to RAC East stores through skilled professionals located in Texas."

Hellerstein, ¶ 10.05[1] states, "Most states have modified their general apportionment rules for apportioning the income of radio and television broadcasters. Many states have done so by adopting regulations identical or similar to the Multistate Tax Commission's (MTC's) special rule for radio and television broadcasting and, in particular, the "audience factor" for assigning receipts from programming and advertising." The South Carolina General Assembly has not.

Hellerstein, at ¶ 10.05[2][a], also noted:

> The "audience factor" is based upon a presumed economic correlation between revenues derived from advertising over the taxpayer's network and the size and location of its viewing and listening audiences. It would constitute a fair and appropriate method for allocating revenues. *The actual determination to use such an allocation method, however, requires implementing regulations and recourse to rule-making procedures.* (Emp added).

By contrast, the SCDOR has not adopted a single Regulation, Policy Document or instructions in the Corporate income tax form indicating that income for a satellite television provider is sourced to the location of customers.

Note that market or audience apportionment method is not on its face pro- or anti-taxpayer (or pro- or anti-General Fund.) It is pro-taxpayer for domestic South Carolina businesses with many customers in other states (e.g. Lockwood Greene). Cost of Performance is pro-General Fund in many situations. For example, if Dish (with its

approximately 22,000 employees, its $13,327,671,707 in gross revenue, its $5,916,869,000 in investment of property and equipment, and its $1,087,225,687 in income) was located in South Carolina instead of Colorado, it would apportion only 1.6% of its income to South Carolina under a market share apportionment theory. DOR Auditor Sharpe conceded that this would be the result. (R. p. 838, line 20–p. 839, line 12).

III. The ALC erred in Adopting a Market Share Approach to Apportioning Income

The DOR's Brief states, "Dish DBS asserts that the ALC erred in adopting a market share approach to apportioning income." The Brief further states, "Dish DBS points to the Department's Determination as evidence that it imposed a market based sourcing method or "audience approach" method in this case. The Department has explicitly maintained and established, in its Determination and throughout the ALC hearing that the Department did not adopt or implement a market based sourcing method or audience approach in this matter." (Appellant's Brief at p. 25). Did the Department adopt a market share or audience approach in this matter? The Department Determination plainly states:

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

The Department Determination in fn 4 cites the statutes in 23 other states which have adopted market share for the television industry. While repeatedly citing that South

Carolina is not a market share state, the ALC Order verbatim adopts the DOR market share Department Determination, which exclusively focuses on the location of the customer.

IV. The ALC erred in Disregarding all the Appellant's Income Producing Activities

The MTC defines "income-producing activities" as "the transactions and activity engaged in by the taxpayer in the regular course of business for the ultimate purpose of providing that item of income [e.g. subscriber's receipts.]" (See Appellant's Brief at p. 25).

Appellant identified what it believes are its income producing activities and where such activities occur, and produced a chart summarizing these activities and the expense attributed to these activities. *See* Petitioner's Exhibit 36; R. p. 3148. The income producing activities were: (1) Programming/Content; (2) Satellites/Uplink; (3) Call centers; (4) Advertising; (5) Subscriber Equipment; (6) Installation; and (7) In-home repair. As described at length in the Brief of Appellant, Respondent's witnesses acknowledged throughout the hearing that "income producing activities" covers more than the mere collection of revenue from the customer. *See* Appellant's Brief at pp. 26-36.

With respect to Programming/Content, Satellites/Uplink, and Call Centers, Appellant argues, and both Respondent and the ALC agree, that many of these activities occurred outside South Carolina. At its most fundamental level, Appellant's argument is that because these activities occur both inside and outside South Carolina, and because these activities produce income, only a portion of its South Carolina subscription revenue should be factored into its apportionment ratio based on § 12-6-2295(A)(5).

Respondent now argues in its Brief that Appellant failed to establish that the activities cited above were "income producing." To the contrary, Appellant's witnesses

described the effect of these income producing activities in great detail.

(1) Programming/Content

As described at length in its Brief (p. 5), Appellant licenses virtually all of its programming from third parties, and in 2010, it paid over $1.4 billion to just two entities (ESPN and Fox). (R. p. 603, lines 2–4).

Appellant's witness Rex Povenmire stressed how important Appellant's programming and content is to attracting and retaining a customer base. He testified: "So your local teams have done quite well . . . So those sports programs are keenly important to our customer base, so we pay what we have to be able to provide those . . . programs."[12] (R. p. 504, lines 2–9). In describing an impasse in negotiations with Fox News, he indicated: "[W]e eventually took Fox News from our service. And all hell broke loose...It was very disruptive.... So we were quite concerned about churn." (R. p. 514, lines 8–19). Mr. Povenmire testified that a change or reduction in programming would have the immediate effect of creating churn—that is, "a customer decides that they're going to leave [Dish] and go find some other source for their [programming]," like DirecTV. (R. p. 514, lines 23–25). Activities to obtain and maintain programming surely contribute to the production of income because those activities attract and help retain Appellant's customer base, thereby reducing churn.

Appellant Matthew Sheers also explained the Appellant's rationale why it included programming/content in its income producing activities:

> So I think one of the things was we thought it was specifically listed in the [DirecTV] court case, so we thought that that defined it. But then just as general it seemed like it would make sense that programming content would

[12] Mr. Povenmire described the extent of the programming: "According to our . . . 10-K, we provide programming which includes more than 280 basic video channels, 60 Sirius satellite radios, 30 premium movie channels, 35 regional and specialty sports channels, 2,800 local channels, 250 Latino and international channels, and 55 channels with pay-per-view content." (R. p. 477, lines 2–10).

> be -- we've got to sit there and I think as we've kind of said before we've got to convince the customer that we've got something to sell when they can get a lot of the things that we provide for free, as well, either ... at the library or over ... the air TV. So we go out and try to get programming that they want. We try to combine it with the things that are free and making a special experience for the customer, and ... once they get that experience and find out they can DVR all the shows that they want to watch and things like that they're much more likely to -- to buy the free stuff from us so that they can DVR and watch it at their convenience. (R. p. 602, lines 2–21).

Mr. Sheers testified that program offerings are based in part on South Carolina demographics—including ethnic programs, religious programming, sports and outdoors. (R. p. 605, lines 4–6). He then described the method for calculating the extent to which programming expenses were allocated to South Carolina. (R. p. 619, line 17–p. 623, line 13). That programming is an income-producing activity is particularly true given that Dish's competition is either free (local television) or low cost (internet, Netflix, etc.)

Department Witness Dr. Harrison (Appellant's Brief p. 27), Tim Donovan (*Id.* at 27-8) and Orville Sharpe (*Id.* at 28) agreed that programming/content were income-producing activities.

(2) Satellites/Uplink

As described in Appellant's Brief (pp. 5, 28), in 2010, Dish expanded $1.6 billion for satellite and Uplink facilities. The DOR contended and the ALC Order even holds "that the delivery of the signal into the customer's home and onto the customer's television is the only income-producing activity." (ALC Amended Final Order; R. p. 27). In its Brief, Respondent even agrees that "[t]he income-producing activity was "the delivery of [Dish DBS's] signal into the subscriber's home and onto the subscriber's television," (Respondent's Brief p. 25) and that "[t]he ALC properly concluded that Dish DBS's income producing activity is the delivery of the signal into the homes and onto the television screens of its subscribers." (*Id.* at 27). Furthermore, Respondent characterized

Appellant's business operations in South Carolina as: "Dish DBS is in the business of selling television broadcast subscriptions to subscribers, 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 for this act alone that South Carolina subscribers sign contracts and pay their monthly fees." (Respondent's Brief at p. 28) (This, of course, is an absurd statement, given the multiple free sources of television and movies.)

Moreover, as Respondent points out in its Brief (p. 37), the ALC recognized that Appellant's own revenue recognition policy, as stated in Form 10-K, acknowledged that the key to its revenue is the delivery of the video service to its subscribers. (citing ALC Amended Final Order; R. p. 24). As Respondent noted, "[w]ithout such delivery of the video services into each subscriber's home, Dish DBS would have no subscription revenue." (Respondent's Brief at p. 37) (Dish would also have no subscription revenues without programming and call centers which exclusively signed up subscribers and took their money.)

Appellant certainly agrees with Respondent and the ALC that the "delivery of the signal into the home" is an income producing activity under Satellite/Uplink. In his testimony, Mr. Sheers provided "If we didn't have satellites we really wouldn't have anything to deliver to our customers. So that's involved in the delivery of the service to the customers." (R. p. 580, lines 15–18). Mr. Sheers then proceeded to describe the billions of dollars associated with the licensing of satellites, from construction, to launch, to ongoing maintenance, including the substantial regulatory approvals required. (R. p. 592, line 11–p. 595, line 13). Appellant described its costs both in testimony (R. p. 623, line 14–p. 625, line 7), and by referring back to its Form 10-K, from which the costs related to satellite/uplink were derived.

The ALC and virtually every Department witness agreed that satellites/uplink were income producing.

(3) Call Centers

Like the activities described above, Respondent's own witnesses (namely Dr. Harrison) acknowledged that the call centers – which were literally collecting monthly subscription revenues via credit card payments – were income producing activities. *See* Appellant's Brief at pp. 35-36. At the hearing, Mr. Povenmire testified that:

> [c]all centers are there to sell our product, service our customers, support them so that they don't churn and go to somebody else. So without them, we don't have any revenue, so everything that – in my view, everything we do to nurture those relationships and maintain that quality of service and product is income producing.[13]

(R. p. 546, lines 14–21). During the periods at issue, customers could not sign up online. (R. p. 484, lines 12–15). Instead, customers would either call the call centers directly or establish a relationship with a third party retailer, who would then call the call center and facilitate a new customer sign-up. (R. p. 484, lines 1–11). So the call center was absolutely vital to the initial creation of the relationship between the customer and Appellant. Next, once a customer was on the phone, Mr. Sheers testified that a significant role of the call center is to "try to upsell [potential and current customers] and sell them additional services...." (R. p. 581, lines 14–16). Additionally, the call center would field calls from customers seeking to purchase pay-per-view and then send a command to the set top box authorizing access to the pay-per-view channel. (R. p. 520, lines 8–21). Without the call center, Appellant could not provide the service for which it charged a fee.

[13] Appellant's expert witness, Ray Stevens, offered a similar summary: "The call centers play an integral role because, as we've been told numerous times, the call center is an important aspect in getting me to upgrade my services, be sure that I'm a satisfied customer. It eliminates the process of churning. It keeps me a satisfied Dish customer." (R. p. 766, lines 19–25).

As another example of direct bill collection, during the periods at issue there was an entire section of the call center that was responsible for tracking down customers who failed to pay their bill. These agents would attempt to resolve late bills by collecting payments, and also modifying bills based on extraordinary circumstances. (R. p. 521, lines 12–25).

(4) Advertising

Advertising is crucial to recruiting customers. Without customers, Appellant has no subscription revenue in South Carolina.[14] Mr. Povenmire testified at length about Appellant's advertising department located in Colorado and its activities and associated expenses:

> Well, we typically have advertising that we do in print, in radio. We have television advertising. We have direct mail advertising. We also enlist the services of a number of different companies across the United States. We've got local and regional consumer electronics companies. We have what we call independent satellite retailers... But every community has a satellite and television retailer that typically carries our product, and we reimburse them for their efforts and pay for some of their advertising as well. So they're a local component. And then we also deal with national firms such as Best Buy and Walmart and Costco. And while they may have different regions that they carry our product in different stores, nationally they handle all of that. And then we also have relationships with other providers such as telcos that don't necessarily offer video services. We may very well give them a commission for bringing us customers so that -- and vice versa. They may give us a commission for bringing them customers when they're contacted.

(R. p. 482, line 11–p. 483, line 10). The Dish 10-K states:

> **Acquisition of New Subscribers**
> *We incur significant upfront costs to acquire subscribers, including advertising, retailer incentives, equipment and installation....*[15]

[14] Not surprisingly, Mr. Sheers testified that Appellant is "always interested in finding new customers and adding value stream. (R. p. 582, lines 7–9).

[15] Petitioner's Exhibit 19 (hereinafter "Dish 10-K"); R. p. 1283.

Advertising
We use print, radio, television and Internet media, on a local and national basis to motivate potential subscribers to call Dish Network, visit our website or contact independent third party retailers.[16]

The costs estimates provided by Mr. Sheers were derived from the advertising department and were allocated 100% to South Carolina. (R. p. 627, line 9–p. 628, line 5).

DOR witnesses Dr. Harrison (Appellant's Brief at p. 27, and Orville Sharpe (*Id.* at 28)) agreed that advertising was income producing.

(5) Subscriber Equipment

Dish produced extensive testimony at trial regarding the importance of their subscriber equipment. It is undisputed that the revenue earned from South Carolina customers from the rental of the subscriber equipment – that is, the receiver box. However, Appellant also argued the expenses associated with the maintenance and operation of the receiver box should be included as an "income producing activity." Mr. Sheers summarized the "income producing" qualities of the receiver box as follows:

> I think that while the customer does lease the equipment, and we do have a separate revenue stream related to that, there's a lot more that that box does. It helps you pick which programing you're going to buy. It helps upsell the programming. You can pay your bill actually through your box. And it monitors what's going on. We push -- I think as Rex had mentioned previously -- we push off software uploads every night to that box. And so it monitors everything that takes place within the customer relationship.

(R. p. 582, lines 12–23). Later, Mr. Sheers added:

> [B]ut I think we used the box to do a lot more than just what we leased the box for. It gives us the ability to get the customer to pay the bill; it gives the customer the ability to upgrade to a pay-per-view movie at the last minute. And so there is some functionality to the box that it does seem like it affects our ability to sell the programming and the content. So we included it in for purposes of the calculation.

[16] *Id.*; R. p. 1283.

(R. p. 637, line 19–p. 638, line 3).

DOR witnesses Sharpe (Appellant's Brief at pp. 29, 31-2) and John Swearingen (*Id.* at 39-40) agreed that subscriber equipment was income producing.

(6) Installation

Installation plays a critical role in acquiring new subscribers as well as installing equipment. Dish witnesses testified that independent third party installers were actually a significant source of producing new customers, and were financially incentivized to do so. Dr. Harrison conceded that the number of third party installers and suppliers affected the Appellant's ability to generate income. According to Mr. Sheers, Appellant "offer[s] the installation basically for free." (R. p. 583, lines 6–7).

Mr. Sheers testified Appellant did not keep exact records regarding costs of installation, but instead estimated $140 per truck roll, and then estimated the number of truck rolls using the South Carolina population percentage. (R. p. 631, lines 5–12). For purposes of Appellant's income producing activities analysis, 100% of the installation activities occurred in South Carolina. (R. p. 631, lines 13–17).

DOR witness Sharpe (Appellant's Brief at p. 29) and Dr. Harrison agreed that installation was income producing.

(7) In-Home Repair

The Dish 10-K states:

> ***Installation and Other In-Home Service Operations.***
> *High-quality installations, upgrades, and in-home repairs are critical to providing good customer service. . . .*

(Dish 10-K; R. p. 1283). In-home repair is vital to ensuring customers can actually use the set-top boxes and satellite dishes provided. Because all activities occurred in South Carolina, 100% of these expenses were allocated to South Carolina.

V. The ALC erred in Upholding the Imposition of Substantial Understatement Penalties

S.C. Code Ann. § 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." However, under § 12-54-155(B)(2)(b):

> (B) The amount of the understatement under subparagraph (A) must be reduced by that portion of the understatement which is attributable to (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment or (ii) any item 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.

Moreover, under subsection (D)(1), "[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."[17]

A. Appellant Had Substantial Authority for the Positions Taken on its Returns.

Other commentators (including Respondent's own expert witness, Prof. Swain), agree with Appellant that South Carolina is a pro rata cost of performance state. Hellerstein, in FN 1227 of ¶ 9.18, states:

> Although South Carolina is not a state that generally follows UDITPA or the MTC regulations . . . its single-factor sales formula, as applied to receipts for services, generally resembles UDITPA's income-producing activity rule for attributing receipts from services.

Hellerstein also notes in FN 1187 of ¶ 9.18:

> According to two knowledgeable observers, as of late 2010 "[f]our states use a proportionate costs-of-performance method: Arkansas, Mississippi,

[17] In addition to the waiver mandate in § 12-54-155(D)(1), the Department is granted general authority to "waive, dismiss, or reduce penalties provided for" under Chapter 54. § 12-54-160.

North Carolina (services only) *and South Carolina* (services only)."

Furthermore, the Administrative Law Court's decision in *Rent-A-Center Texas, L.P. vs. South Carolina Department of Revenue* reaffirmed the "COP" test as the proper means of sourcing sales from services. Appellant's expert witness, Ray Stevens, testified that South Carolina was a pro-rata cost of performance state, based upon the above authorities. (R. p. 774, line 21–p. 775, line 1).

B. Appellant Had Reasonable Cause and Acted in Good Faith

Department fails to cite to a single Regulation, Policy Document, Publication or Instruction in its tax form which states it is the Department's position that "income producing activities" should be interpreted as market share.

To find ambiguity and lack of clarity in the law and the basis on which Appellant should have filed its returns, one needs to look no further than the Respondent's Brief. Throughout its Brief, Respondent acknowledges that neither apportionment statutes nor the guidance has ever mandated or even suggested the particular apportionment method for service providers.

First, Respondent provides that "South Carolina's apportionment statutes related to service providers have *never* dictated the use of either a cost of performance *or* a pure market-based sourcing method." (Respondent's Brief at pp. 7). Nor have the statutes told service taxpayers how to apportion income!

Next, Respondent notes: "It is vitally important to note that South Carolina's statute related to service providers, like Dish DBS, is unlike the statutes of many other states that mandate a specific method." (*Id.* at 7). South Carolina statutes do not mandate or tell a taxpayer what "specific" method to use! Nor does the corporate income tax form.

Finally, Respondent cites to an excerpt from the South Carolina Corporate Income

Tax Manual (which, by the way, is no longer accessible on Respondent's website and thus only available to the lucky few who printed a copy before it was removed):

> **Comment**: South Carolina is not a "cost of performance state;" i.e., a state where receipts are always sourced to the state where the costs to produce the receipts are incurred. It is also not a "market state;" *i.e.*, a state where receipts are always sourced to the state where the item or service is consumed or the location of the payer. (*Id.*)"

The Corporate Income Tax Manual tells you what methods not to use – but don't tell taxpayers what method to use!

Next, Respondent argues: "In fact, courts and administrative tribunals discuss these two concepts [income-producing activities and cost of performance] as if they were the same, Hellerstein, causing taxpayers, including Dish DBS, to use cost of performance to determine their income-producing activities, which is not compliant with South Carolina law." (*Id.* at 15). Why should Appellant be subject to penalties when it follows the discussion of courts and administrative tribunals?

Next, Respondent acknowledges that each industry has special sourcing rules based on the facts and circumstances of the particular industry, none of which are published in any guidance or regulation. "The Guidelines [of the Former Tax Commission in *Lockwood Greene*] did not impost one manner of sourcing revenues to South Carolina on all industries. On the contrary, the Department looked at the specifics of each industry and each revenue source to determine the manner in which it should be sourced." (*Id.* at 18) "As a result, it is clear from a plain reading of § 12-7-1190 and the *Lockwood Greene* opinion that the Department sourced gross receipts to South Carolina on an industry-by-industry basis based on the *activities* of the companies in each industry." (*Id.* at 19). If the Department sources revenues on an industry-by-industry basis, shouldn't it be required to publish Regulations, or at least include instructions in the Corporate income tax form, on

how various industries should source their income before imposing penalties?

"The decisions in *Rent-a-Center Texas* and *Lockwood Greene* sourced receipts to South Carolina based on the "place of activity" only for personal professional services, not for subscription-based services provided by a taxpayer like Dish DBS." (*Id.* at 22). Of course, subscription-based services were not the taxpayers in either decision, so obviously this was not an issue. Television subscription services did not exist at the time of *Lockwood Greene*. Incidentally, the taxpayer in *Rent-A-Center Texas* provided management services to the South Carolina stores exactly like Dish Corporate headquarters. They were not "personal professional services" (e.g. doctors, lawyers, CPAs) any more than Dish's corporate headquarters.

"Dish DBS cites to the South Carolina Corporate Income Tax Manual, co-authored by senior members of the Policy section of the Department, for a discussion regarding the *Lockwood Greene* case: '[c]onsidering *Lockwood Greene* and *Geoffrey*, together, it appears gross receipts are sourced to the state which is most significantly associated with the production of the income where those intangibles are used in a business for the production of income.'" (*Id*). Dish considered the state which held the great majority of its 22,000 employees and $5.9 billion in capital investment as "the state which is most significantly associated with the production of the income."

"The ALC found that "South Carolina's apportionment statute provides a flexible standard based upon the income-producing activity for a given industry." (*Id.* at 25). Fair enough, but the Department has never published this "flexible standard" for any industry, much less satellite service providers.

"Pursuant to the Department's longstanding policy, the Department examines the specific activities of each applicable industry to determine sourcing." (*Id.* at 5). There was

no testimony regarding any such policy. As stated below, the DOR witnesses testified to the contrary. The Department's Brief is silent regarding any published Regulations or Policy Statements disclosing such "longstanding policy."

"The Department's long-standing policy with respect to sourcing of gross receipts of service providers requires a taxpayer like Dish DBS to source receipts from South Carolina subscribers to South Carolina." (*Id.* at 48). The Department's "Long standing policy" is published nowhere. The DOR auditor, Orville Sharpe, testified:

> Q. But your definition [of income-producing activity] is not found in any regulation, correct?
> A. No
> Q. Not found in any DOR Policy document?
> A. No
> Q. It's not found in any DOR Policy document?
> A. No
> Q. It's not found in any DOR Publication?
> A. No
> Q. Not found in any MTC Reg?
> A. No.[18]

DOR audit Supervisor Tim Donovan testified:

> Q. The Department obviously doesn't have any written guidelines or rules or policy documents on what's income-producing for satellite TV?
> A. I'm not aware of any.[19]

DOR Audit Supervisor John Swearingen testified:

> Q. Okay. And income-producing activity is not defined in statute or regulation in South Carolina?
> A. I am not aware that it's defined, no, sir.[20]

Swearingen also testified:

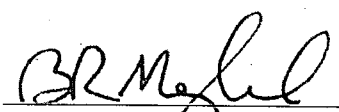
> Q. What audit guidelines related to the apportionment of net income of a service provider does the Department use?

[18] R. p. 847, lines 14–22.
[19] R. p. 876, lines 23–p. 877, line 2.
[20] R. p. 899, lines 22–25.

A. We really don't have any published ones.[21]

Lastly, the Department argues that Dish should have known it was not correctly apportioning its income based upon three cases: *Walter E. Heller Western, Inc. v. Arizona Dep't of Revenue*, 161 Ariz. 49, 775 P2d 1113 (1989), an Arizona Supreme Court decision; *Ameritech Publishing, Inc. v. Wisconsin Dep't of Revenue*, 327 Wis. 2d 798, 788 N.W.2d 383 (Ct. App. 2010), an unpublished decision; and *Anon. Taxpayer v. Texas Comptroller*, 2013 W.L. 3490605 (2013), a decision by the Texas Comptroller. For a taxpayer like Dish which files taxes in 50 states, these are not likely sources for a taxpayer filing returns in South Carolina.

Respectfully submitted,



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[21] R. p. 887, lines 14–17.

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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Shirley C. Robinson, Administrative Law Judge

Case No. 14-ALJ-17-0285-CC

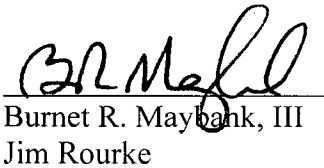
Dish DBS Corporation f/k/a EchoStar, DBS Corp. and Affiliates.....Appellant,

v.

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

CERTIFICATE OF COUNSEL

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



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