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THE STATE OF SOUTH CAROLINA  
In The Court of Appeals

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

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Case No. 14-ALJ-17-0158-CC  
Appellate Case No. 2015-001509

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DIRECTV, Inc. and its Subsidiaries,..... Appellant,  
v.  
South Carolina Department of Revenue,..... Respondent.

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**AMENDED FINAL BRIEF OF APPELLANT**

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its Subsidiaries*

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### **STATEMENT OF ISSUES**

- I. DID THE ADMINISTRATIVE LAW COURT (“ALC”) ERR BY APPLYING AN IMPROPER BURDEN OF PROOF?
- II. DID THE ALC ERR IN HOLDING THAT THE INCOME-PRODUCING ACTIVITIES OF APPELLANT, DIRECTV, INC. & SUBSIDIARIES (“DIRECTV”), CONSIST SOLELY OF THE DELIVERY OF THE SIGNAL INTO THE HOMES OF DIRECTV’S CUSTOMERS?
- III. DID THE ALC ERR IN FINDING THAT DIRECTV FAILED TO ESTABLISH THE PORTION OF ITS INCOME-PRODUCING ACTIVITIES THAT WERE CONDUCTED IN SOUTH CAROLINA?
- IV. DID THE ALC ERR IN FINDING THAT THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS PROPER?

### **STATEMENT OF THE CASE**

This case involves a protest by DIRECTV of: (i) a denial of corporate income tax refund claims filed for the tax periods ended December 31, 2006 through December 31, 2008; (ii) a protest of an assessment asserting a corporate income tax deficiency for the tax periods ended December 31, 2009 through December 31, 2011; and (iii) a protest of an assessment asserting a license fee deficiency for the tax periods ended December 31, 2010 through December 31, 2012. Following a conference with Appellant, the South Carolina Department of Revenue (“Department”) issued a Department Determination, dated February 18, 2014 (“Determination”), to DIRECTV for income tax periods ended December 31, 2006 through December 31, 2011, and license fee periods ended December 31, 2010 through December 31, 2012 (collectively, the “Period at Issue”), which: (i) denied corporate income tax refund claims in the amount of \$3,784,934 for the 2006 through 2008 tax years; (ii) sustained a corporate income tax deficiency of \$6,613,067, interest of \$651,397 and penalties of \$1,653,266 for the 2009 through 2011 tax years; and

(iii) sustained a license fee deficiency of \$33,101, interest of \$2,028 and penalties of \$8,275 for the 2010 through 2012 periods. R. pp. 57-64. DIRECTV timely requested a contested case hearing of the Determination before the ALC pursuant to South Carolina Code Ann. § 1-23-600 (2015) and §12-60-460 (2015).

The ALC held a hearing on January 13 and 14, 2015, and issued a Final Order and Decision on May 12, 2015 finding for the Department on all issues (the “Original Order”). R. pp. 1-22. On May 22, 2015, DIRECTV filed a Motion for Reconsideration pursuant to South Carolina Rule of Civil Procedure 59(e) and ALC Rule of Procedure 29(D). R. pp. 65-101. On June 1, 2015, the Department filed a Response to Petitioner’s Motion for Reconsideration (R. pp. 102-123), and on June 5, 2015 DIRECTV filed a Reply to the Department’s Response.

On June 12, 2015, the ALC issued (i) a Reconsideration Order (R. pp. 23-30), which addressed the issues raised in DIRECTV’s Motion for Reconsideration, and (ii) an Amended Final Order and Decision , which reflected changes made to the Original Order upon reconsideration (the “Amended Final Order”) (R. pp. 31-53). The Amended Final Order modified certain language from the Original Order, partially abated the substantial underpayment penalty imposed on DIRECTV and found for the Department on all remaining issues. *Id.* Through the Amended Final Order, the ALC ordered that DIRECTV’s refund claims be denied and 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 through 2011 income tax returns. *Id.*

On July 9, 2015, DIRECTV filed a bond with the ALC in the amount of \$7,604,589, representing the tax and interest through July 12, 2015 shown as due in the Amended Final Order. R. pp. 981-987. On July 14, 2015, DIRECTV timely filed a Notice of Appeal. R. pp. 955-980. On August 11, 2015, DIRECTV was granted a 30-day extension of time, until September 9, 2015, for serving and filing its initial brief and designation of record. R. p. 54. On September 11, 2015, DIRECTV was granted a second 30-day extension, until October 9, 2015 to serve and file its initial brief and designation of record. R. pp. 55-56.<sup>1</sup>

## **STATEMENT OF FACTS**

### **I. DIRECTV's Business Activities**

DIRECTV is a California corporation with its headquarters and principal place of business in California. Transcript of ALC Hearing ("Tr."); R. p. 176:3-12. DIRECTV is a leading provider of direct-to-home ("DTH") digital television entertainment, and is engaged in acquiring, promoting, producing, and distributing high-quality digital entertainment programming primarily via satellite to residential and commercial subscribers throughout the United States, including South Carolina. Tr.; R. pp. 172:21-174:23; pp. 186:3- 187:18. Almost all of the activities related to the provision of its programming services occur outside of South Carolina. Expert Report of Dr. Brian J. Cody ("Cody Rpt."), R. pp. 743-769; Tr., R. pp. 172:16- 204:11. DIRECTV did not

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<sup>1</sup> After all briefing had been filed, the Court requested that the parties correct the Record on Appeal such that a full versus condensed trial transcript was included therein. DIRECTV then filed an Amended Record on Appeal. Due to the resulting changes to the pagination of the Record, DIRECTV is filing this Amended Final Brief as well as an Amended Reply Brief to conform all citations to the Amended Record on Appeal.

maintain any offices in South Carolina during the Period at Issue, and almost all of the employees and assets involved in the provision of its programming services were located outside of South Carolina. Cody Rpt., R. pp. 743-769; Tr., R. pp. 172:16- 204:11; 486:16- 487:1; 487:17- 488:8. In fact, during the Period at Issue, only two of DIRECTV's employees worked in South Carolina. Tr., R. p. 486:16- 487:1.

DIRECTV packages and delivers high-quality video entertainment to subscribers throughout the United States. Tr., R. p. 172:21- 173:1. Testimony at trial established that the principal value drivers of DIRECTV's business are: (i) content development (both original and acquired programming); (ii) broadcast operations; (iii) marketing and sales; and (iv) customer service. Tr., R. pp. 174:17-23; 328:20- 329:16.

**A. Content Development Activities**

Mr. Philip Goswitz, Senior Vice President of Space, Communications and Video at DIRECTV, explained that development of high-quality and unique programming is of paramount importance to DIRECTV. Tr., R. pp. 171:5-7; 172:16-183:8. DIRECTV's content development activities include the acquisition of content from third-party providers such as movie studios, broadcast television networks (*e.g.*, ABC, FOX, and NBC), local broadcast stations, and providers of cable programming (*e.g.*, HBO, STARZ, and ESPN). Tr., R. p. 177:8- 178:6. DIRECTV also provides a premier sporting experience through exclusive arrangements with sports leagues such as the National Football League ("NFL"), with which it has an exclusive agreement whereby DIRECTV subscribers are able to watch almost every NFL game. Tr., R. p. 177:18- 178:1; 180:7- 182:16. DIRECTV employees in California negotiate the agreements with the sports

leagues, movie studios, national broadcast networks, local television stations, and cable networks. Tr., R. p. 183:9-11.

DIRECTV also produces several types of original programming, including musical specials, original series such as “Friday Night Lights” (a television series about high school football), and original sporting events such as pay-per-view boxing and DIRECTV’s own branded version of ultimate fighting called “Bare Knuckle Boxing.” Tr., R. p. 178:7-24. DIRECTV also produces original content that enhances content acquired from third-parties. Tr., R. pp. 177:8- 178:6 and 179:3-20; 180:7- 181:18. For example, DIRECTV developed the “Masters Experience” to enhance traditional network coverage of the Masters golf tournament by placing additional cameras throughout the golf course, providing subscribers with the ability to watch play at particular holes, and/or follow particular groups of players throughout their round. Tr., R. p. 179:3-20. DIRECTV employees in California are responsible for developing DIRECTV’s original programming. Tr., R. p. 183:9-11.

#### **B. Broadcast Operations**

DIRECTV receives content acquired from third-parties in several ways, including by satellite, fiber-optic cable, and over-the-air broadcast. Tr., R. pp. 183:18- 187:18 The signals for national programming content are collected at national “broadcast centers” in California, Denver, and Colorado, which contain facilities to receive, process, and transmit the programming content signals.<sup>2</sup> Tr., R. pp. 190:23- 193:12.

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<sup>2</sup> A separate legal entity, DIRECTV Operations, owned the broadcast centers. Tr., R. p. 194:6-7.

DIRECTV collects programming from local broadcast television stations through local collection facilities (“LCFs”), which are unmanned facilities consisting of antennae and other receiving equipment. Tr., R. p. 186:3- 187:18. DIRECTV maintains LCFs throughout the country, roughly corresponding to each of the 210 Nielsen assigned designated market areas (“DMAs”) in the United States. *Id.* DIRECTV collects over 1500 local channels at LCFs that it maintains in each DMA. Tr., R. p. 186:3- 187:18. There are seven DMAs covering South Carolina, including the DMAs located in (i) Charlotte, North Carolina, (ii) Augusta, Georgia, and (iii) Savannah, Georgia. Tr., R. p. 189:1-12. During the Period at Issue, there were only four LCFs in South Carolina. Tr., R. pp. 187:19-25; 189:4-12.

DIRECTV’s provision of local programming services is inherently national in scope. For example, because federal law mandates that customers can only view local programming within their respective DMA, a South Carolina customer living in the Charlotte, North Carolina DMA may only watch Charlotte, North Carolina local programming that is collected from an LCF in North Carolina. Tr., R. p. 189:16- 190:22. Similarly, a South Carolina customer living in the Savannah, Georgia DMA may only watch Savannah, Georgia local programming. Tr., R. p. 190:9-11.

During the Period at Issue, content gathered at the LCFs was collected at uplink facilities owned by DIRECTV and located in (i) Arizona, (ii) Georgia, (iii) Minnesota, (iv) New Hampshire, (v) Virginia, and (vi) Washington. Tr., R. p. 187:3-18.

The uplink facilities and broadcast centers transmit the programming content signals to the satellites in geo-stationary orbit above the earth.<sup>3</sup> Tr., R. pp. 187:10-18; 194:11- 195:23. Each satellite occupies a federally assigned orbital slot. Cody Rpt., R. p. 755. Those orbital slots are a “vital crown jewel” of the business because they are centrally located and provide a clear view of the entire United States, which permits programming to be delivered by beams covering the entire United States (“CONUS” beams). Tr., R. p. 196:4-21. National programming is transmitted by these so-called CONUS beams. Tr., R. p. 194:15- 195:5. Local programming is transmitted in narrow beams that may cover multiple DMAs. Tr., R. p. 194:15- 195:23.

The satellites transmit the signals received from the broadcast centers and regional uplink facilities directly to customers, who receive the signals by a small “satellite dish” mounted on or near their homes. Tr., R. p. 196:22- 197:20. The signals are then relayed from the dish to a “set-top box,” which delivers the signals to the customers’ television sets. Tr., R. p. 197:14-20. During the Period at Issue, DIRECTV began leasing the set-top boxes to customers in exchange for a lease fee. Tr., R. p. 198:4-11.

### **C. Marketing and Sales Activities**

The purpose of DIRECTV’s marketing and sales activities is to communicate its programming services to premium subscribers that want the highest-end video experience, as well as a sports-centric experience. Tr., R. p. 201:11-22. DIRECTV

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<sup>3</sup> DIRECTV used 11 satellites that were owned by a separate legal entity, DIRECTV Enterprises, during the Period at Issue. Tr., R. pp. 195:24- 196:3.

engages in national advertising campaigns that use the same production value and writing that usually go into feature length films. Tr., R. p. 201:23- 202:12. DIRECTV tries to have very distinctive marketing activities that show its unique brand. Tr., R. p. 201:11-202:12. The goal of DIRECTV's print and television advertising is to encourage customers to call an 800-number and place an order for television services. Tr., R. p. 199:4-10.

**D. Customer Service Activities**

DIRECTV spends significant time and effort to provide the best possible customer care. Tr., R. p. 174:13-16. DIRECTV's customer care activities are headquartered in California and organized from a center in Denver, Colorado. Tr., R. p. 198:17-21. During the Period at Issue, customer service support was provided to customers through both owned and operated internal call centers, as well as third-party call centers.<sup>4</sup> Tr., R. p. 198:22- 199:16. The internal call centers were located in Alabama, Colorado, Idaho, Montana, Oklahoma, and Virginia. Tr., R. p. 199:17-23. None of the internal or third-party call centers were located in South Carolina. Tr., R. pp. 199:24- 200:5.

The internal and third-party call centers took customer orders and facilitated the installation of equipment. Tr., R. p. 200:6- 201:1. During the Period at Issue, DIRECTV hired third-party home service providers ("HSPs") to install dishes and set-top boxes in customers' homes. Tr., R. p. 482:20- 483:7. Beginning in 2008, DIRECTV began

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<sup>4</sup> The internal call centers were owned by DIRECTV Customer Services, Inc. Tr., R. p. 199:11-12.

acquiring certain of those HSPs. *Id.* There were no DIRECTV “in-house” installers operating in South Carolina during the Period at Issue. Tr., R. p. 483:12-15.

## **II. Dr. Brian J. Cody’s Expert Report and Testimony**

DIRECTV’s expert economist, Dr. Brian J. Cody, performed a two-step analysis of DIRECTV’s business activities. Cody Rpt., R. p. 743; Tr., R. p. 327:13-19. First, Dr. Cody identified from an economic perspective the income-producing activities of DIRECTV by analyzing DIRECTV’s “primary value drivers.” Cody Rpt., R. p. 743; Tr., R. p. 327:13-16. Second, Dr. Cody determined the location of those income-producing activities for the Period at Issue using a formula based on DIRECTV’s payroll and assets. Cody Rpt., R. p. 743; Tr., R. p. 327:16-19.

### **A. Identification of Income-Producing Activities**

To identify DIRECTV’s income-producing activities, Dr. Cody “[u]ndertook a wide range of activities,” which included reviewing public documents on DIRECTV, reviewing DIRECTV’s Securities and Exchange Commission 10-K Reports and financial data, and speaking with employees at DIRECTV. Tr., R. p. 328:2-19. Dr. Cody explained that, to determine DIRECTV’s income-producing activities, “you need to look at each of those activities I described and get behind what is really creating the value that consumers ultimately pay for,” and “[s]o it goes back to that basic economic functional analysis where I look at the important functions, risks and assets that are employed in the business.” Tr., R. p. 351:6-13. Based on his analysis, Dr. Cody found that there are four primary value drivers that influence a customer’s decision to subscribe to DIRECTV’s programming services: (i) content development (both original and acquired

programming); (ii) marketing; (iii) broadcast operations; and (iv) customer service. Cody Rpt., R. pp. 749 and 760; Tr., R. p. 329:2-16.

Dr. Cody concluded that these primary value drivers are DIRECTV's income-producing activities because they are "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., R. pp. 342:1-3; 344:6-11; 351:3-9. Dr. Cody's conclusion is consistent with testimony from DIRECTV's Rule 30(b)(6) witness, who testified that DIRECTV 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., R. p. 502:15-18.<sup>5</sup>

In discussing his conclusion that content is a primary value driver for DIRECTV, Dr. Cody explained that "[c]ontent is what the subscriber ultimately receives from DIRECTV" and that "as I was doing my research and I looked at DIRECTV's ability to charge premium prices, it really kept bringing me back to that premium content that was there." Tr., R. p. 329:23- 330:23. To highlight the significance of content on DIRECTV's value, Dr. Cody pointed out that AT&T's acquisition of DIRECTV was contingent upon the renewal of DIRECTV's exclusive deal with the NFL for Sunday Ticket. Cody Rpt., R. p. 750; Tr., R. p. 330:24- 331:16. Dr. Cody explained that content distinguishes DIRECTV in a highly competitive industry and allows DIRECTV to charge premium prices. Tr., R. p. 332:8-18.

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<sup>5</sup> Portions of the testimony of DIRECTV's 30(b)(6) witness were designated for use at trial and were read into the record during the trial.

Similarly, Dr. Cody determined that DIRECTV's broadcast operations are a primary value driver because they "allow[] for delivery of the video entertainment content to customer's [sic] homes." Cody Rpt., R. p. 750; Tr., R. p. 332:24- 333:12. Further emphasizing the importance of content and broadcast operations to DIRECTV in particular, Dr. Cody noted that, although deep subscription discounts have historically been used by cable and satellite companies to attract new customers, DIRECTV has shifted its marketing focus to attracting new customers through increased investment in unique content and advanced broadcasting technology. Cody Rpt., R. p. 751.

Dr. Cody found that DIRECTV's marketing services are a primary value driver for DIRECTV because those activities attract new customers and also produce additional income from existing customers who upgrade their accounts, as well as advertise DIRECTV's content to entice consumers to switch to DIRECTV or upgrade their accounts. *Id.*, R. pp. 750-751. Dr. Cody explained that marketing "has a direct impact on the amount of money that customers are willing to pay." Tr., R. p. 336:1-6.

Finally, Dr. Cody identified customer service as a primary value driver because such activities improve customer retention and attract new subscribers. Cody Rpt., R. p. 752. Dr. Cody also found that customer service helps generate additional income from existing customers who are more likely to upgrade their accounts because they are happy with DIRECTV's service. Tr., R. p. 339:5-22. In analyzing the importance of customer service to DIRECTV, Dr. Cody noted DIRECTV's extensive efforts to improve customer service, including negotiating and establishing agreements with other service providers to offer bundled internet and telephone services in conjunction with DIRECTV's satellite

television services, as well as investing in a cross-functional learning lab dedicated to generating and testing ideas to improve customer service. Cody Rpt., R. p. 752.

**B. Location of DIRECTV's Income-Producing Activities**

After identifying DIRECTV's income-producing activities, Dr. Cody determined the location where those activities took place by using a formula based on payroll and assets, two widely accepted and economically reasonable measures of economic activity. Tr., R. p. 352:7- 354:18.

The first method used DIRECTV's total payroll expense as a proxy to determine the portion of the income-producing activities occurring inside and outside South Carolina (the "Payroll Method"). Tr., R. p. 352:22- 353:24. Dr. Cody explained that it was reasonable to use payroll as a proxy because for "each of those value-generating or income-producing activities I described, there's a very large labor content, [such as] negotiating contracts, building and maintaining [a] broadcast network, marketing, and providing customer service." Tr., R. p. 352:25- 353:14. Dr. Cody noted that *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), also used payroll as a proxy to determine where the taxpayer's income generating activities took place. Tr., R. p. 353:15-19.

The second method, which Dr. Cody determined to be the most appropriate (Tr., R. p. 354:3-6), used a combination of (i) DIRECTV's total payroll expense and (ii) the net book value of certain of DIRECTV's assets as proxies to determine the portion of the income-producing activities occurring inside and outside of South Carolina (the "Payroll and Assets Method"). Tr., R. p. 352:7- 353:24. Dr. Cody explained that he believed the

Payroll and Assets Method was more “economically reasonable” because “[p]ayroll alone for a company like DIRECTV . . . misses the asset intensity.” Tr., R. p. 354:3-6. Dr. Cody explained that DIRECTV has broadcast centers, fiber optic networks, large call centers, set-top boxes and local collection facilities, “[s]o assets are clearly an important part . . . of the whole operation” and “[s]o I felt it was appropriate to take assets into account when I was determining the location of those income-producing activities.” Tr., R. p. 354:7-15.

Dr. Cody’s conclusions are summarized below: Year	Portion of income-producing activities occurring in S.C.: Payroll Method	Portion of income-producing activities occurring in S.C.: Payroll and Assets Method
2006	0.09 %	0.85 %
2007	0.07 %	0.86 %
2008	0.06 %	0.87 %
2009	0.03 %	0.87 %
2010	0.06 %	0.83 %
2011	0.10 %	0.81 %
<b>Weighted Average</b>	<b>0.07 %</b>	<b>0.85 %</b>

Cody Rpt., R. pp. 762-763.

### **III. Professor Richard D. Pomp’s Expert Report and Testimony**

DIRECTV’s tax policy expert, Professor Richard D. Pomp, explained that the term “income-producing activity” that appears in S.C. Code Ann. § 12-6-2295(A)(5) is taken from Section 17 of the Uniform Division of Income for Tax Purposes Act (“UDITPA”), which was created in 1957 by the Uniform Law Commission as a model statute for the division of income for income tax purposes, but that S.C. Code Ann. § 12-6-2295(A)(5) makes two “positive” improvements to the test used in UDITPA Section

17. Tr., R. pp. 213:8-13; 226:12-22 ; 227:10- 231:17; 234:11- 236:1; Pet. Ex. No. 16, R. pp. 770-781. First, South Carolina adopts a proportional approach that sources receipts based upon the relative amount of income-producing activities occurring in South Carolina versus other states. Tr., R. pp. 226:12- 227:9; 234:25- 235:23. “[W]e’re looking to try to figure out the extent to which income-producing activity is performed within South Carolina. . . . And we are told here’s what we do. We’ve got to figure out the extent to which the income-producing activity is performed within South Carolina.” Tr., R. p. 226:23- 227:9. Second, instead of dictating one method (*e.g.*, “cost of performance”) for determining the amount and location of income-producing activities, S.C. Code Ann. § 12-6-2295(A)(5) provides “flexibility” in determining the relative amount of income-producing activities in the State. Tr., R. p. 234:16-24.

Professor Pomp rejected the Department’s claim that there is only one income-producing activity (delivery of the signal) as an artifice to apply a market-based sourcing method based entirely on customer location without explicitly adopting a market-based method. Tr., R. p. 248:8-21. He further explained:

And what I say is, look, 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 other words, you might want to quibble about how we’re going to take into account those income-producing activities of getting content and programming. But to say they have no value at all, to say they’re not income-producing activity is where you and I disagree.

Tr., R. p. 293:9-20.

#### IV. Gross Receipts at Issue

The parties stipulated to the following gross receipts relating to DIRECTV's provision of programming services:

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

Stip. ¶ 7, R. p. 951; Stip. Ex. A, R. p. 954.

#### STANDARD OF REVIEW

The Administrative Procedures Act (“APA”) establishes the standard of review in an appeal related to the decision of an administrative agency. S.C. Code Ann. § 1-23-380 and § 1-23-610; *see also CarMax Auto Superstores West Coast, Inc. v. Dep’t of Revenue*, 411 S.C. 79, 85, 767 S.E.2d 195, 198 (2014). The APA provides that review of an administrative law judge’s order must be confined to the record and the court may not substitute its judgment for the judgment of the administrative law judge as to the weight of the evidence on questions of fact. *Id.* The reviewing court may (i) remand the case for further proceedings, or (ii) reverse or modify a decision of the administrative law judge if the substantive rights of the petitioner have been prejudiced because the finding, conclusion, or decision is: (a) in violation of constitutional or statutory provisions; (b) in excess of the statutory authority of the agency; (c) made upon unlawful procedure;

(d) affected by other error of law; (e) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or (f) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted discretion. S.C. Code Ann. § 1-23-380(5) and § 1-23-610(B); *CarMax*, 411 S.C. at 85, 767 S.E.2d at 198; *Brownlee v. S.C. Dep't of Health and Env'tl. Control*, 382 S.C. 129, 136, 676 S.E.2d 116, 119-120 (2009) (holding that an administrative law judge may be reversed based on error of law or if the findings were not supported by substantial evidence).

The South Carolina Supreme Court has explained that “[t]he decision of the Administrative Law Court should not be overturned unless it is unsupported by substantial evidence or controlled by some error of law,” and that “questions of statutory interpretation are questions of law, which we are free to decide without any deference to the court below.” *Centex Int'l, Inc. v. S.C. Dep't of Revenue*, 406 S.C. 132, 139, 750 S.E.2d 65, 68-69 (2013) (internal citations and quotations omitted); *see also Allen v. S.C. Pub. Emp. Benefit Auth.*, 411 S.C. 611, 769 S.E.2d 666 (2015) (reversing the decision of the ALC after finding that the ALC erred in its interpretation of the relevant statute).

## ARGUMENT

### **I. THE ALC ERRED BY APPLYING AN IMPROPER BURDEN OF PROOF.**

The standard of proof in administrative proceedings is a preponderance of the evidence. *See Anonymous v. State Bd. of Med. Exam'rs*, 329 S.C. 371, 375, 496 S.E.2d 17, 19 (1998). In general, the party asserting the affirmative issue in an adjudicatory administrative proceeding has the burden of proof. *See Leventis v. S.C. Dep't of Health & Env'tl. 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 (S.C. Admin. Law Ct. 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.”). Thus, DIRECTV has the burden of proof to show by a preponderance of the evidence that it is entitled to a refund for the 2006 through 2008 tax years and that the Department’s tax assessment for the 2009 through 2011 tax years was incorrect. *Id.*; *Scarborough v. S.C. Dep’t of Revenue*, No. 08-ALJ-17-0563-CC (S.C. Admin. Law Ct. Mar. 23, 2009).

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 (S.C. Admin. Law Ct. Aug. 23, 2007), *Lawton v. S.C. Dep’t of Revenue*, No. 08-ALJ-17-0118-CC (S.C. Admin. Law Ct. Sept. 5, 2008) and *Travelscape, LLC v. S.C. Dep’t of Revenue*, No. 08-

ALJ-17-0076-CC (S.C. Admin. Law Ct. Feb. 12, 2009) (involving personal income tax (*Anonymous* and *Lawton*) and sales and accommodation tax (*Travelscape*) assessments and each citing to the burden of proof set forth in *Cloyd*).

Through detailed testimony and substantial evidence presented at the trial, DIRECTV established that the Department's assessment was incorrect. The Department's position in this case is that DIRECTV's only income-producing activity is "the delivery of the signal into the homes and onto the television screens of its customers" and therefore, 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." Amended Final Order, R. p. 40.<sup>6</sup>

In support of its position, the Department presented *no* credible evidence as to DIRECTV's income-producing activities. In fact, the record clearly establishes that no attempt was made by the Department to determine DIRECTV's income-producing activities and that the Department's assessment was based solely on customer location. For example, the Department's auditor, Robert King, testified that he conducted no background research and did not interview any DIRECTV employees to determine how

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<sup>6</sup> As set forth in more detail below beginning on page 23, taxpayers like DIRECTV are required to apportion their 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." S.C. Code Ann. § 12-6-2290. For tax years beginning after 2006, "gross receipts from within" South Carolina consisted of "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).

DIRECTV's business operated. Tr., R. p. 422:13- 423:3. Likewise, another Department witness, John Swearingen, testified that DIRECTV's activities conducted outside of South Carolina were not relevant and that "[w]e're only looking at what they would charge their South Carolina customer." Tr., R. p. 468:6-9. In addition, the Report of Field Audit for the 2009 through 2011 tax years expressly provides that "market base sourcing" was used. Field Audit Report, R. pp. 902-909.

Similarly, the Department's auditor and his supervisor both testified that the audit determination was based solely on "customer location." Tr., R. pp. 425:4-6; 437:20-23. Mr. Swearingen likewise testified that the audit determination was based solely on customer location. Tr., R. p. 472:22- 473:22. Finally, the Department's tax policy expert, Professor John Swain, testified that the Department was "taking a market state approach to the attribution of receipts." Tr., R. pp. 577:10-18; 578:23-25; 580:7-21.

In contrast, DIRECTV presented substantial factual and economic evidence regarding its income-producing activities and the location from which those activities were conducted, including (i) Mr. Goswitz's detailed testimony regarding the activities necessary to produce DIRECTV's programming (Tr., R. pp. 170:14- 208:5), (ii) testimony from DIRECTV that its income-producing activities are the "assets and the employees that perform the service which puts the video into the television of its customers" (Tr., R. p. 502:15-18), and (iii) testimony and a report by Dr. Cody identifying DIRECTV's income-producing activities and determining the portion of those activities conducted in South Carolina using a formula based on payroll and assets, which he determined resulted in a reasonable approximation of the value attributable to those

activities in South Carolina (Tr., R. p. 352:7- 354:18).

Based on the evidence presented and arguments made, the ALC acknowledged that the Department's assessment was incorrect. For example, the ALC expressly stated 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." Amended Final Order, R. p. 40. Similarly, the ALC agreed with Professor Pomp that "opinions can differ on how to measure the extent to which income-producing activities take place in South Carolina, *but answering that question by simply ignoring the outside activities is unacceptable.*" *Id.* (emphasis added).

The ALC also noted that, in *Walter E. Heller W., Inc. v. Dep't of Revenue*, 161 Ariz. 49, 775 P.2d 1113 (1989), "the Arizona Supreme Court did not simply look to the location of the customer *as the Department does here*" to determine how interest income on loans should be sourced. Amended Final Order, R. pp. 40-41 (emphasis added). Relying on *Heller*, the ALC further 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." *Id.* at 41.

Nevertheless, because the ALC concluded that the evidence presented by DIRECTV was insufficient to satisfy its burden of proof (*Id.* at 41), the ALC held that "DIRECTV's income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV's customers" (*Id.* at 51). Thus, despite acknowledging that the Department's position was incorrect and too "simplistic" (Tr., R.

p. 684:11-14), the ALC adopted that *exact* position and in so doing completely ignored the substantial factual and economic evidence presented by DIRECTV.

The ALC should not have simply disregarded the substantial evidence in the record with respect to how DIRECTV's programming services are developed and delivered and default to the Department's simplistic and obviously erroneous conclusion that the only income-producing activity is the delivery of the signal to the customer, a conclusion that the ALC acknowledged is incorrect. Instead, the ALC should have fashioned an appropriate remedy based on the evidence in the record or ordered a supplemental hearing requesting that the parties present additional evidence so that the ALC could determine the actual revenue properly attributable to South Carolina under the ALC's construction of the statute. *See Cloyd*, 295 S.C. 86, 367 S.E.2d 171. By failing to do so, the ALC applied an improper burden of proof.

If this Court upholds the decision of the ALC and thereby accepts a method that the ALC acknowledged is erroneous, this Court is setting a precedent that, at best, lacks guidance for taxpayers and, at worst, allows an admittedly erroneous assessment to stand.

As the record makes clear, it 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. It is also beyond dispute that DIRECTV presented detailed factual evidence and expert economic analysis that tracked closely the evidence and analysis approved in the only published decision to consider this issue, *Lockwood Greene*. Moreover, the evidence presented by DIRECTV

and the resulting sourcing formula proposed by Dr. Cody, reflect evidence virtually every state in the country considers relevant to sourcing income. If such evidence is not sufficient, this Court should provide guidance for the parties and remand the case to the ALC so that the parties may supplement the record with the appropriate evidence. Otherwise, DIRECTV and other taxpayers are left with trying to imagine criteria that could be used to file corporate income tax returns reporting the taxable income to be apportioned to the State.

**II. THE ALC ERRED IN HOLDING THAT DIRECTV'S INCOME-PRODUCING ACTIVITIES CONSIST SOLELY OF THE DELIVERY OF THE SIGNAL INTO THE HOMES OF DIRECTV'S CUSTOMERS.**

Despite the lack of evidence presented by the Department and the ALC's acknowledgement that the Department's approach was incorrect and too "simplistic," the ALC nevertheless adopted the Department's position that DIRECTV's only income-producing activity is the delivery of the signal into the homes of customers. Amended Final Order, R. p. 51. In so doing, the ALC rejected entirely the evidence presented by DIRECTV because it found that: (i) "Dr. Cody's proxies in identifying DIRECTV's income-producing activities are so far from perfect as to be of no practical value;" (ii) "DIRECTV did not sufficiently explain the effect of its value drivers on income production in this State" and its "evidence is just too nebulous to properly identify whether DIRECTV's value drivers are income producing and the extent to which such production occurs;" (iii) the activities identified by DIRECTV are "'preparatory' activities [that] are too attenuated to the production of income to be considered 'income-producing activity'" under the South Carolina Supreme Court's decision in *Mercury*

*Motor*; and (iv) DIRECTV failed to establish the extent to which the activities it identified as income-producing activities “influenced customers’ decision[s] to subscribe to DIRECTV.” Amended Final Order, R. pp. 41-44.

The ALC’s findings, however, are not supported by substantial evidence and the ALC’s holding is erroneous as a matter of law because the ALC misinterprets S.C. Code Ann. §§ 12-6-2290 and 12-6-2295(A)(5) as requiring sourcing on a market-basis (*i.e.*, location of the customer).

#### **A. Legal Overview**

S.C. Code Ann. § 12-6-2290 provides that the income of taxpayers like DIRECTV (*i.e.*, service providers) is to be apportioned “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.”<sup>7</sup> For tax years beginning after 2006, S.C. Code Ann. § 12-6-2290 further provides that “[f]or purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.”

S.C. Code Ann. § 12-6-2295 provides that the term “gross receipts” as used in Code Ann. § 12-6-2290 includes, but is not limited to, the following items if they have not been separately allocated:

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

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<sup>7</sup> The ALC properly determined that DIRECTV is a service provider. Amended Final Order, R. p. 39.

within this State.

S.C. Code Ann. § 12-6-2295(A)(5).

Thus, the statutory language establishes a two-step test. The first step is the identification of income-producing activities. The second step is determining the portion of those activities performed in South Carolina.

The only published decision interpreting and applying S.C. Code Ann. § 12-6-2290 is this Court's decision in *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987), in which this Court analyzed two views regarding the meaning of the phrase "gross receipts from within this State," as used in the prior version of S.C. Code Ann. § 12-6-2290 in the context of an engineering firm with employees and customers in South Carolina and in other states.<sup>8</sup> In *Lockwood Greene*, the taxpayer argued that the phrase "gross receipts from within this State" should be determined based on the "origin of payment," which looks to the location of the taxpayer's customers making payment. *Lockwood Greene*, 293 S.C. at 448, 361 S.E.2d at 347. The Department argued that the phrase should be determined based on the "place of activity," which looks to the place where the services are performed. *Id.* The court held that "gross receipts from within the State" should be determined based on the "place of activity," and that the place of activity should be determined by comparing Lockwood Greene's payroll expense for South Carolina employees to the firm's total payroll expense for all employees. *Lockwood Greene*, 293 S.C. at 448-49, 361 S.E.2d at 347.

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<sup>8</sup> The statute involved in *Lockwood Greene* was S.C. Code Ann. § 12-7-1190, which was repealed and replaced by S.C. Ann. Code § 12-6-2290, which is the same in all material respects as S.C. Code Ann. § 12-7-1190.

**B. The ALC's Holding that DIRECTV's Income-Producing Activity is Limited to the Delivery of the Signal into the Homes of DIRECTV's Customers is Not Supported by Substantial Evidence.**

The ALC's holding that DIRECTV's only income-producing activity is the delivery of the signal into the homes of customers and that such activity occurs entirely within South Carolina is not supported by substantial evidence.

First, the ALC's holding that DIRECTV's only income-producing activity is the delivery of the signal into the homes of customers is entirely inconsistent with the evidence in the record. DIRECTV presented substantial factual and economic evidence to establish its income-producing activities. Mr. Goswitz provided detailed testimony regarding the activities necessary to produce DIRECTV's programming services, which include (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., R. pp. 170:14- 207:25. Cody explained that the income-producing activities of DIRECTV are "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., R. p. 344:6-11. Dr. Cody then identified those income-producing activities as (i) content development, (ii) broadcasting operations, (iii) marketing, and (iv) customer service because these activities are "what is really creating the value that consumers ultimately pay for." Cody Rpt., R. pp. 749 and

760; Tr., R. pp. 329:2-16; 351:3-9.

Similarly, testimony from DIRECTV's Rule 30(b)(6) witness established 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., R. p. 502:14-18.

The Department presented no evidence of DIRECTV's income-producing activities. In fact, the record clearly establishes that the Department looked solely to the location of the customer to source DIRECTV's subscription revenue. Tr., R. pp. 425:4-6; 437:20-23; 472:13-17.<sup>9</sup> Simply put, there is no credible evidence in the record that DIRECTV's *only* income-producing activity is the delivery of the signal into the homes of customers.

Second, the ALC's finding that the delivery of the signal into the homes of South Carolina customers occurs entirely within South Carolina is likewise entirely inconsistent with the evidence in the record, which unequivocally establishes that delivery of the signal occurs both inside and outside of South Carolina. *See* Tr., R. pp. 170:14- 207:25 (describing the collecting of programming and the transmission to broadcast centers, uplink facilities, satellites and customers).

Third, the ALC entirely misconstrues the economic evidence and testimony presented by Dr. Cody and conflates his analysis in *identifying* DIRECTV's income-producing activities (step one) with his analysis in determining the portion of those activities that were conducted in South Carolina (step two). Simply put, Dr. Cody did not

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<sup>9</sup> For a detailed discussion, please see Section I, *supra*, pp. 18-19.

use proxies to *identify* DIRECTV's income-producing activities. The only proxies used by Dr. Cody were used to determine the portion of DIRECTV's income-producing activities conducted in South Carolina *after* those activities were identified.<sup>10</sup>

As discussed above, Dr. Cody identified DIRECTV's income producing activities by undertaking "a wide range of activities," which included reviewing public documents on DIRECTV, reviewing DIRECTV's Securities and Exchange Commission 10-K Reports and financial data, and speaking with employees at DIRECTV. Tr., R. p. 328:2-19. Based on his analysis of DIRECTV's business, Dr. Cody concluded that DIRECTV engages in four primary activities that generate value, and thus income, for DIRECTV: (i) content development; (ii) marketing; (iii) broadcast operations; and (iv) customer service. Cody Rpt., R. pp. 749 and 760; Tr., R. p. 329:2-16. Dr. Cody then provided detailed testimony as to why those value drivers are DIRECTV's income-producing activities. Tr., R. pp. 329:23-25; 330:20- 331:16; 332:8-18; 342:1-4; 332:24- 333:12; 336:1-6; 339:5-22; 344:7-11; 351:3-9.<sup>11</sup>

Finally, in rejecting DIRECTV's evidence that programming and content are income-producing activities, the ALC explained that the provision of programming cannot be an income-producing activity because "national programming through the CONUS beams would exist regardless of whether there were any subscribers in South

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<sup>10</sup> As described below, proxies such as those used by Dr. Cody are not only necessary to determine where the income producing activities of a multistate business are conducted, they are employed by every state in the country in making that determination.

<sup>11</sup> DIRECTV's Rule 30(b)(6) witness confirmed that DIRECTV's income-producing activities are the "assets and the employees that perform the service which puts the video into the television of its customers." Tr., R. p. 502:14-18.

Carolina.” Amended Final Order, R. p. 43. The opinion cites to nothing in the record to support this statement because there is absolutely no evidence in the record to support such a conclusion.

Thus, the ALC’s holding that DIRECTV’s income-producing activity is the delivery of the signal into the homes of customers is not supported by substantial evidence and, in fact, is entirely inconsistent with the evidence in the record.

**C. The ALC Misinterprets and Misapplies *Mercury Motor*.**

The ALC found that all of DIRECTV’s activities, other than the beaming of satellite signals to the homes of customers, are “preparatory” activities that “have no bearing on a customer’s decision to subscribe to, *i.e.*, solicit, [DIRECTV’s] services, nor do they occur as a result of that decision to subscribe.” Amended Final Order, R. p. 43. As a result, the ALC concluded that such activities were “too attenuated to the production of income to be considered income-producing activit[ies]” under the analysis applied by the South Carolina Supreme Court in *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964). Amended Final Order, R. pp. 43-44. This conclusion not only reflects a misinterpretation of *Mercury Motor*, but also a fundamental misunderstanding of DIRECTV’s business, and such conclusion is inconsistent with the evidence in the record.

In *Mercury Motor*, a freight company challenged the State’s apportionment formula for motor carriers on the ground that application of a mileage-based formula produced a discriminatory result that taxed income earned outside of South Carolina and was therefore unconstitutional. In support of its argument, the taxpayer explained that

whereas the statutory formula apportioned 17% of its income to the State (reflecting that 17% of its mileage was in the State), revenue from freight either originating in or delivered to South Carolina accounted for only 1% of its gross revenue. *Mercury Motor*, 244 S.C. at 139, 135 S.E.2d at 758. The taxpayer asserted that the statutory mileage-based formula produced an unconstitutional result because it was not engaged in activities that contributed to its net income when its trucks traveled through South Carolina. Instead, the taxpayer argued that only the pick-up or delivery of freight in the State produced income. *Id.* at 138-39, 135 S.E.2d 758.

The Supreme Court rejected that narrow construction of income-producing activities:

The [taxpayer] operates a unitary business and its gross income and, therefore, its net income, is derived from a series of transactions . . . . Here the series of transactions consists of the solicitation of freight, the picking up of freight, the hauling of freight, the delivery of the same and the collections of charges therefor. Each transaction in the series contributes to the earnings and net income of the [taxpayer], and, while each transaction is necessarily incidental to the production of its income, the transaction which primarily earns the income is the hauling of the freight. It seems to us to follow that as the trucks of the [taxpayer] move along, through and over the highways of the State of South Carolina, the [taxpayer] is engaged in income producing activity actually done and performed within the borders of the State of South Carolina.

There is nothing in the record to even indicate that the trucks of the [taxpayer], while traveling seventeen per cent of its total mileage within the State of South Carolina, are failing to contribute to [taxpayer's] income, or that, while so traveling, they are earning a lesser percentage of [taxpayer's] net income than seventeen per cent.

*Id.* at 141, 135 S.E.2d at 759-60.

The distinction drawn by the ALC between “preparatory” activities and “incidental” and “primary” activities, both of which the ALC acknowledges are income-producing activities, is simply not supported by *Mercury Motor*. The solicitation, picking up, hauling and delivery of freight and the collection of charges therefor that the Supreme Court identified as income-producing activities in *Mercury Motor* are no different than DIRECTV’s activities of content development, marketing and broadcast operations (transmission and delivery).

Moreover, the ALC’s distinction between “preparatory” and other activities reflects a fundamental misunderstanding of the nature of DIRECTV’s business as established by the substantial evidence in the record. DIRECTV does not operate a static business for which a distinction can be made between “preparatory” pre-solicitation activities and “incidental” and “primary” solicitation and post-solicitation activities. DIRECTV is constantly engaged in acquiring, developing and improving its content, broadcasting operations, marketing, and customer service, and each of these activities are conducted to generate revenue by attracting new subscribers and retaining and upgrading current subscribers.

As in *Mercury Motor*, the series of transactions engaged in by DIRECTV to provide its programming service contributes to the generation of gross receipts and ultimately to the net income to be apportioned under S.C. Code Ann. § 12-6-2290 and § 12-6-2295(A)(5). Thus, as the Supreme Court in *Mercury Motor* rejected the taxpayer’s argument that the only income-producing activity was the pick-up or delivery of freight for which the company was actually paid, this Court should reject the ALC’s conclusion

that the pick-up of DIRECTV's signal by set-top boxes in South Carolina is the only income-producing activity and that DIRECTV's content development, marketing, broadcast operations and customer service are "too attenuated" to be considered income-producing activities.

**D. The ALC Misinterpreted S.C. Code Ann. § 12-6-2295(A)(5).**

In holding that DIRECTV's income-producing activity is the delivery of the signal into the homes and onto the television sets of DIRECTV's customers, the ALC committed two errors of law in interpreting S.C. Code Ann. § 12-6-2295(A)(5) as requiring (i) an analysis of a customer's subjective intent and (ii) a market-based sourcing methodology.

First, in rejecting the substantial factual and economic evidence presented by DIRECTV, the ALC repeatedly noted that DIRECTV failed to produce evidence with respect to its customers' subjective intent. For example, the ALC found that: (i) although 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;" (ii) "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;" and (iii) "[e]ven 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.” Amended Final Order, R. pp. 41-42 and 44.

The ALC's interpretation of S.C. Code Ann. §§ 12-6-2290 and 12-6-2295(A)(5) is inconsistent with the plain language of the statutes, which require the focus to be on the activities of the *taxpayer* and not on the subjective intent of third parties (*i.e.*, DIRECTV's customers). The ALC's interpretation is also inconsistent with both *Mercury Motor* and *Lockwood Greene*, in which the courts focused exclusively on the activities of the *taxpayers*. A standard such as the one adopted by the ALC that requires a taxpayer to prove the subjective intent of third parties is completely unworkable and imposes an impossibly high burden on taxpayers.

Second, although the ALC's holding is based on a purported identification of DIRECTV's income-producing activity, the ALC, in reality, has done nothing more than interpret S.C. Code Ann. § 12-6-2295(A)(5) as requiring market-based sourcing.<sup>12</sup> Although couched in terms of “income-producing activities,” the ALC's holding results in sourcing revenue to the location of the taxpayer's customer in *every* instance. *See* Amended Final Order, R. p. 51.

This result is inconsistent with the plain language of the statute, which requires sourcing revenue based on the taxpayer's income-producing activities. Although many states have done so, South Carolina is not among the states that have adopted statutes sourcing revenue on a market-basis. *See, e.g.*, Mass. Gen. Laws, ch. 63, § 38(f) (“Sales,

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<sup>12</sup> As noted above, Professor Swain testified that the Department was “taking a market state approach to the attribution of receipts.” Tr., R. pp. 577:10-18; 578:23-25; 580:7-21.

other than sales of tangible personal property are in the Commonwealth if the corporation's market for the sale is in the Commonwealth.”); Minn. Stat. § 290.191, subd. 5(j) (“Receipts from the performance of services must be attributed to the state where the services are received.”); Neb. Rev. Stat. § 77-2734.14(3)(a) (“Sales of a service are in this state if the sales are derived from a buyer within this state.”); 72 Pa. Stat. § 7401(3)2(a)(16.1)(C)(I) (“Sales from the sale of service, if the service is delivered to a location in this State.”).

Moreover, when the Legislature has intended to source receipts on a destination basis, the Legislature has explicitly done so, as it has done with respect to sales of tangible personal property. S.C. Code Ann. § 12-6-2280(B) (providing that the term “sales in this State” includes sales of goods, merchandise, or property received by a purchaser in South Carolina).

Thus, by looking to the location of DIRECTV's customer, the ALC adopted an improper interpretation of S.C. Code Ann. § 12-6-2295(A)(5) and thereby committed an error of law.

**III. THE ALC ERRED IN FINDING THAT DIRECTV FAILED TO ESTABLISH THE PORTION OF ITS INCOME-PRODUCING ACTIVITIES THAT ARE CONDUCTED IN SOUTH CAROLINA.**

In reaching its decision, the ALC rejected the Payroll and Assets Method applied by Dr. Cody to determine the portion of DIRECTV's income-producing activities performed in South Carolina on the basis that (i) “the approach proposed by Dr. Cody unduly emphasizes what amounts to ‘costs of performance’” and (ii) the Payroll and Assets Method is “too nebulous” and “does not provide a reasonable approximation of

the income-producing activities performed by DIRECTV in South Carolina, and the value attributable to such activities.”<sup>13</sup> Amended Final Order, R. p. 47. The ALC’s conclusions are not supported by substantial evidence and reflect an error of law in the interpretation of S.C. Code Ann. § 12-6-2295(A)(5).

DIRECTV does not assert that South Carolina is a cost of performance state, and the Payroll and Assets Method is not a cost of performance methodology. In fact, DIRECTV presented evidence that South Carolina is *not* a cost of performance state, including testimony by Professor Pomp that was adopted by the ALC, 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 Ann. § 12-6-2295(A)(5) provides ‘flexibility’ in determining the relative amount of income-producing activities in the State.” Amended Final Order, R. p. 48.

Rather than using a cost of performance methodology, Dr. Cody testified that he employed two common proxies using data from DIRECTV’s financial records to source

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<sup>13</sup> The term “cost of performance” is a term of art that derives from Section 17 of the UDITPA. Pet. Ex. No. 16; R. pp. 779. UDITPA’s cost of performance approach “requires the taxpayer first to determine which of its activities are the income-producing activities for its service income and then to determine where the costs of performing those income-producing activities were incurred. The taxpayer then compares the amount of costs of performance incurred in the taxing state to the amount of such costs in the other individual states. The sales are attributed to the state with the greatest amount of costs of performance. . . . [I]ncome-producing activities and costs of performance are conceptually different in principle. Costs of performance are the geographically identifiable metric for determining the state in which [i]ncome-producing activities are carried on.” Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.18[3][b] (3d ed. 2014).

DIRECTV's 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., R. p. 352:7-21. Dr. Cody explained 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., R. pp. 352:13-17; 619:14-21.

The formula used by Dr. Cody to determine the portion of income-producing activities performed in South Carolina, and thus, the income earned in the State, is not only entirely consistent with sound principles of economics, but is also consistent with how the U.S. Supreme Court and every other state determines income earned in a jurisdiction.

The U.S. Supreme Court has wrestled with the problem of attempting to separately value activities occurring in a particular state and has explained that "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice," and that "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164, 192 (1983).

As a result of such complexities, states abandoned attempts to separately account for the value of a business conducted, and income earned, in their particular state. The U.S. Supreme Court addressed these complexities in *Norfolk & Western Railway Co. v. North Carolina*, 297 U.S. 682, 684-85 (1936), in the context of a challenge by the taxpayer to North Carolina's mileage-based apportionment formula. In rejecting the

taxpayer's challenge that the formula did not accurately reflect the income earned in the state because its track in North Carolina was not as profitable as its track elsewhere, the Court explained that "division of revenues and costs in accordance with state lines can never be made for a unitary business with more than approximate correctness," and that the "[t]axpayer and state would be swamped with administrative difficulties if left to struggle through every case without the aid of a formula of ready application." *Id.*

To address these problems, states adopted formulas to apportion values and income as a means of reaching a reasonable and reliable approximation of the value and income of an enterprise within the state. The U.S. Supreme Court has explained that formulary apportionment "rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the 'unitary business' . . . and then apportioning the total income of that 'unitary business' . . . on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Container Corp.*, 463 U.S. at 165. The Supreme Court went on to explain, however, that "[b]oth geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." *Container Corp.*, 463 U.S. at 182.

The South Carolina Supreme Court has similarly acknowledged that "[a]lthough exactness in apportionment is desirable, all that is required is a reasonable approximation." *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66, 212 S.E.2d 574, 577 (1975). Citing to *Illinois Central Railway Co. v. State of Minnesota*, 309 U.S. 157, 161 (1940), the Court expanded on this, explaining that "this Court has long

realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of appellant, and has declared that 'rough approximation rather than precision' is sufficient." *Covington Fabrics*, 264 S.C. at 66-67, 212 S.E.2d at 577-78.

The use of a formula such as that used by Dr. Cody is also consistent with this Court's decision in *Lockwood Greene*. As discussed above, in *Lockwood Greene*, this Court was faced with the question of how to determine "gross receipts from within this State," in the context of an engineering firm with employees and customers in South Carolina and in other states. This Court ultimately held that "gross receipts from within this State" should be determined based on the "place of activity," and that the place of activity should be determined by use of a formula that compared Lockwood Greene's payroll expense for South Carolina employees to the firm's total payroll expense for all employees. *Lockwood Greene*, 293 S.C. at 448-49, 361 S.E.2d at 347. In reaching its decision, this Court explained that "an engineering firm's business carried on in a state is *reasonably measured* by the services rendered by its personnel in the state." *Id.* at 449, 361 S.E.2d at 347 (emphasis added).

Dr. Cody determined the portion of DIRECTV's income-producing activities in South Carolina using the same formula applied in *Lockwood Greene*. Based on that formula, Dr. Cody determined that, on average, 0.07% of DIRECTV's income-producing activities occurred in South Carolina and thus, that 0.07% of its total subscription revenue was properly attributable to the State (*i.e.*, included in the numerator of the receipts factor). Tr., R. p. 365:14-19.

However, Dr. Cody decided not to place primary reliance on that formula because he felt that, in contrast to the engineering firm at issue in *Lockwood Greene*, the income-producing activities of DIRECTV were better reflected by use of a formula that took into consideration *both* payroll and assets (the “Payroll and Assets Method”) since tangible assets such as (i) the LCFs, (ii) set-top boxes, and (iii) regional uplink facilities play an important role in the generation of DIRECTV’s subscription revenue. Tr., R. pp. 352:7-354:18. Based on this formula, Dr. Cody determined that, on average, 0.85% of DIRECTV’s income-producing activities were performed in South Carolina and thus, that 0.85% of its total subscription revenue for the Period at Issue was attributable to South Carolina. Cody Rpt., R. p. 763.

The Payroll and Assets Method used by Dr. Cody provides a reasonable approximation of the value of the income-producing activities performed by DIRECTV in South Carolina. This is in sharp contrast to the approach advanced by the Department and adopted by the ALC, which simply looks to the location of the customer without making any attempt to determine the activities actually conducted by DIRECTV inside and outside of South Carolina, or the value attributable to such activities.

Therefore, the ALC’s rejection of the Payroll and Assets Method and its adoption of the Department’s position are not supported by substantial evidence and reflect an error of law in the interpretation of S.C. Code Ann. § 12-6-2295(A)(5).

If this Court finds that the Payroll and Assets Method is not sufficient under the relevant statutes to determine the portion of DIRECTV’s income-producing activities performed in South Carolina, this Court should not simply reject that method, which is

consistent with the only published authority addressing the issue, and adopt the admittedly flawed approach used by the Department and adopted by the ALC. Instead, at the very least, this Court should articulate an appropriate standard and remand the case for additional proceedings consistent with that standard.

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

The ALC's finding that the imposition of substantial understatement penalties was proper is not supported by substantial evidence.

As relevant to this matter, S.C. Code Ann. § 12-54-155 provides, in part, 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 statute further provides 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).

The ALC upheld a portion of the substantial understatement penalty despite finding that “DIRECTV acted in good faith with respect to bringing its claim regarding the portions of the understated tax amounts,” because the ALC found that “DIRECTV did

not have ‘**reasonable** cause’ . . . for the underpaid taxes, i.e., DIRECTV’s method of calculating subscription receipts was unreasonable.” Amended Final Order, R. p. 51 (emphasis in original). Nevertheless, the ALC abated a portion of the substantial understatement penalty because it found that “DIRECTV acted with sufficient belief in bringing its claim regarding the portion of the understated tax amounts.” *Id.*

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 Greene*, the only published decision on point, and also with *Mercury Motor*, which rejected a narrow view of income-producing activities—similar to the view adopted by the Department and the ALC in this case—that would have considered only isolated “end-point” activities. 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 S.C. Code Ann. §§ 12-6-2290 and 12-6-2295(A)(5).

Thus, the substantial understatement penalty should be abated in its entirety.

## CONCLUSION

For the reasons set forth above, DIRECTV respectfully requests that this Court (i) reverse the Amended Final Order of the ALC because DIRECTV's rights have been prejudiced because the ALC's findings, conclusions and decisions are in violation of statutory provisions, affected by errors of law and/or clearly erroneous in light of the reliable, probative and substantial evidence in the record, (ii) recalculate DIRECTV's income tax and license fee liability based on the computations set forth in the attached Exhibit A, (iii) grant the requested refund for the 2006 through 2008 tax years based on the computations set forth in the attached Exhibit A, and (iv) dismiss the substantial understatement penalties imposed by the Department.

If this Court determines that the evidence presented by DIRECTV is insufficient, this Court should not simply allow the admittedly erroneous assessment of the Department to stand, but should either articulate the proper standard and remand this case for additional findings consistent with that standard, or fashion an appropriate remedy based on the evidence in the record.

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Charleston, South Carolina

February 9, 2017

Calculation of Income Tax Using Payroll & Assets Method of Apportionment

	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011
APPORTIONABLE INCOME AS AUDITED*	2,046,048,751	1,985,980,778	1,720,390,607	1,941,088,649	2,237,452,053	2,156,455,041
SC APPORTIONMENT RATIO (see next page)	0.008647	0.009087	0.009371	0.009557	0.009274	0.009327
SC NET INCOME	17,691,340	18,045,997	16,121,872	18,551,144	20,749,854	20,114,078
SC NOL	(39,372,439)	0	0	0	0	0
TAXABLE INCOME	0	18,045,997	16,121,872	18,551,144	20,749,854	20,114,078
TAX RATE	0.05	0.05	0.05	0.05	0.05	0.05
TAX DUE	0	902,300	806,094	927,557	1,037,493	1,005,704
TAX PREVIOUSLY PAID	(30,265)	(1,987,570)	(1,767,099)	0	0	0
UNDERPAYMENT (OVERPAYMENT)	(30,265)	(1,085,270)	(961,005)	927,557	1,037,493	1,005,704

Calculation of License Fee Using Payroll & Assets Method of Apportionment

	12/31/2010	12/31/2011	12/31/2012
TOTAL CAPITAL STOCK & PAID IN SURPLUS AS AUDITED*	527,141,071	577,536,594	558,299,222
SC APPORTIONMENT RATIO (see next page)	0.009557	0.009274	0.009327
SC PROPORTION	5,037,931	5,356,003	5,207,470
LICENSE FEE RATE	0.001	0.001	0.001
LICENSE FEE DUE	5,038	5,356	5,207
ADDITIONAL LICENSE FEE	15	15	15
TOTAL LICENSE FEE	5,053	5,371	5,222
LICENSE FEE PAID	0	(922)	(733)
UNDERPAYMENT (OVERPAYMENT)	5,053	4,449	4,489

\* Resp. Exs. 11 and 12.

EXHIBIT A

EXHIBIT A

Calculation of Apportionment Ratio Using Payroll & Assets Method

2006 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	13,583,081,711
Portion of IPA in SC (Payroll & Assets Method)	0.0085
SC Subscription Revenue	115,456,195
SC Set Top Box Lease/Sale Revenue	3,376,851
Total SC Revenue	118,833,046
Total SC Revenue	118,833,046
Total Revenue	13,743,345,649
2006 APPORTIONMENT RATIO	0.008647

2009 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	17,348,388,812
Portion of IPA in SC (Payroll & Assets Method)	0.0087
SC Subscription Revenue	150,930,983
SC Set Top Box Lease/Sale Revenue	26,702,174
Total SC Revenue	177,633,157
Total SC Revenue	177,633,157
Total Revenue	18,586,546,795
2009 APPORTIONMENT RATIO	0.009557

2007 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	14,900,247,218
Portion of IPA in SC (Payroll & Assets Method)	0.0086
SC Subscription Revenue	128,142,126
SC Set Top Box Lease/Sale Revenue	12,547,540
Total SC Revenue	140,689,666
Total SC Revenue	140,689,666
Total Revenue	15,483,044,020
2007 APPORTIONMENT RATIO	0.009087

2010 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	18,654,864,389
Portion of IPA in SC (Payroll & Assets Method)	0.0083
SC Subscription Revenue	154,835,374
SC Set Top Box Lease/Sale Revenue	31,565,700
Total SC Revenue	186,401,074
Total SC Revenue	186,401,074
Total Revenue	20,099,585,214
2010 APPORTIONMENT RATIO	0.009274

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2008 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	16,321,615,758
Portion of IPA in SC (Payroll & Assets Method)	0.0087
SC Subscription Revenue	141,998,057
SC Set Top Box Lease/Sale Revenue	19,605,211
Total SC Revenue	161,603,268
Total SC Revenue	161,603,268
Total Revenue	17,244,942,010
2008 APPORTIONMENT RATIO	0.009371

2011 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	19,689,434,914
Portion of IPA in SC (Payroll & Assets Method)	0.0081
SC Subscription Revenue	159,484,423
SC Set Top Box Lease/Sale Revenue	42,129,631
Total SC Revenue	201,614,054
Total SC Revenue	201,614,054
Total Revenue	21,615,290,596
2011 APPORTIONMENT RATIO	0.009327

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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.

CERTIFICATE OF COUNSEL

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

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