THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Chief Administrative Law Judge

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

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

v.

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

PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 242 of the South Carolina Appellate Court Rules, petitioner DIRECTV, Inc. and its Subsidiaries ("DIRECTV"), petitions the Court to issue a writ of certiorari to review the decision of the Court of Appeals styled DIRECTV, Inc. and its Subsidiaries v. South Carolina Department of Revenue, Op. No. 5513 (Ct. App. August 30, 2017) (the "Opinion"), which found in favor of the South Carolina Department of Revenue (the "Department"). Appendix ("App.") p. 1. For the reasons set forth below, the petition should be granted, and the decision of the Court of Appeals should be reversed.

CERTIFICATION REGARDING REHEARING

The undersigned hereby certifies that a Petition for Rehearing (App. p. 23) was made, and it was ruled on by the Court of Appeals on January 11, 2018. *Id.* at 22.

QUESTIONS PRESENTED FOR REVIEW

I. **Did the Court of Appeals Err in Holding that DIRECTV's Income Producing Activities Consist Solely of the Delivery of the Signal into its Customers' Homes and by Disregarding Undisputed Evidence of other Substantial Income Producing Activities?**

II. **Did the Court of Appeals Err in Finding that DIRECTV Failed to Establish the Portion of its Income Producing Activity that Took Place in South Carolina?**

III. **Did the Court of Appeals Err in Applying the Wrong Burden of Proof?**

IV. **Did the Court of Appeals Err in Finding Substantial Understatement Penalties Proper where DIRECTV's Filing, which was Based on All of Its Income Producing Activities and Not Just Delivery of the Signal into its Customers' Homes, Tracked Existing Law?**

STATEMENT OF THE CASE

Procedural History and Case Issues

This case involves a protest by DIRECTV of: (a) denial of corporate income tax refund claims filed for tax years 2006-2008; (b) protest of an assessment asserting a corporate income tax deficiency for tax years 2009-2011; and (c) protest of an assessment asserting a license fee deficiency for tax years 2010-2012. The Department issued a Department Determination dated February 18, 2014 to DIRECTV for income tax years 2006-2011 and license fee periods 2010-2012 (collectively, the "Period at Issue"), which: (a) denied corporate income tax refund claims of $3,784,934 for the 2006-2008 tax years; (b) sustained a corporate income tax deficiency of $6,613,067, interest of $651,397 and penalties of $1,653,266 for 2009-2011 tax years; and (c) sustained a license fee deficiency of $33,101, interest of $2,028 and penalties of $8,275 for 2010-2012. R. pp. 57-64. DIRECTV timely requested a contested case hearing before the ALC pursuant to S.C. Code Ann. § 1-23-600 (2015) and §12-60-460 (2015).

The ALC held a hearing on January 13-14, 2015 and issued a Final Order and Decision

on May 12, 2015 finding for the Department on all issues. R. pp. 1-22. On May 22, 2015, DIRECTV filed a Motion for Reconsideration. *Id.* at 65-101. On June 1, 2015, the Department filed a Response (*id.* at 102-123), and on June 5, 2015, DIRECTV filed a Reply.

On June 12, 2015, the ALC issued a Reconsideration Order (*id.* at 23-30) and an Amended Final Order and Decision ("Amended Order") (*id.* at 31-53). The Amended Order modified certain language of the original Order, partially abated the penalty and found for the Department on all remaining issues. R. pp. 31-53. The ALC ordered that DIRECTV's refund claims be denied and that it be assessed $6,646,168.00 in tax and license fees, $653,425.00 in interest and $1,246,155.75 in penalties as to its 2009-2011 income tax returns. *Id.*

DIRECTV then filed the appropriate bond and timely filed a Notice of Appeal on July 14, 2015. R. pp. 981-987; 955-980. After briefing and oral argument, the Court of Appeals issued its decision affirming the ALC's decision in full. Opinion, App. p. 1.

Summary of Facts

The central issue in this case is the proportion of DIRECTV's income producing activities (each an "IPA" and multiple "IPAs") that take place in South Carolina versus the proportion that take place in other states. The following is a brief summary of the evidence and the factual and expert testimony on these issues.

I. Factual Testimony and Evidence

DIRECTV was a California corporation with its headquarters and principal place of business in California during the Period at Issue. Transcript of ALC Hearing ("Tr."), R. p. 176:3-12. It provides direct-to-home digital television entertainment and is engaged in acquiring, producing, promoting, and distributing high-quality digital entertainment programming primarily

via satellite to residential and commercial subscribers throughout the United States, including South Carolina. *Id.* at 172:21-174:23; 186:3-187:22.

The principal IPAs of DIRECTV's business are: (1) content development (both original and acquired programming);[1] (2) broadcast operations (including delivery of signal);[2] (3) marketing and sales;[3] and (4) customer service.[4] Tr., R. pp. 174:17-23; 328:20-329:16. DIRECTV did not maintain any offices in South Carolina during the Period at Issue, and almost all of the employees and assets involved in providing its programming services were located outside of South Carolina. Expert Report of Dr. Brian J. Cody ("Cody Rpt."), R. pp. 743-769;

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[1] Content development activities include acquisition of content from third parties (Tr., R. pp. 177:8-178:6); negotiation of exclusive arrangements with sports leagues such as the NFL (*id.* at 177:18-178:1; 180:7-182:16); production of original programming (*id.* at 178:7-24); and production of original content that enhances content acquired from third parties (such as the "Masters Experience," which allows subscribers to watch play at particular holes and follow particular groups of players throughout their round). *Id.* at 177:8-178:6; 179:3-20; 180:7- 181:18. All of these activities take place out of State. *Id.* at 178:25-179:2; 179:21-180:25; 183:9-11.

[2] Broadcast operation activities include acquisition of content from third parties (Tr., R. pp. 183:18-187:18); collection of programming content signals at broadcast centers and local collection facilities ("LCFs") (*id.* at 190:23-193:12; 186:3-189:12)(with only four LCFs in this State), and the signals are then (1) collected at uplink facilities (none of which are located in this State) (*id.* at 187:3-18); (2) transmitted to satellites in geo-stationary orbit above the earth (*id.* at 187:10-18; 194:11-195:23); and (3) transmitted to satellite dishes at customers' homes, which relayed the signal to "set-top boxes" and then onto customers' televisions. *Id.* at 196:22-197:20. Most of these activities took place outside this State. *Id.* at 185:17-189:12; 197:23-298:3.

[3] Marketing and sales activities include sophisticated and unique national advertising campaigns to encourage customers to call and place an order for television services. Tr., R. pp. 199:4-10; 201:11-202:12. All such activities took place outside South Carolina. *Id.* at 176:13-20.

[4] Customer service activities include call centers, which take customer orders and facilitate the installation of equipment. Tr., R. pp. 200:6-201:1. All such activities took place outside South Carolina. *Id.* at 198:17-200:5; 482:20-483:15.

Tr., R. pp. 172:16-204:11; 486:16-487:1; 487:17-488:8. In fact, during the Period at Issue, only two DIRECTV employees worked in South Carolina. Tr., R. pp. 486:16-487:1.

II. Expert Testimony and Reports

A. Dr. Brian J. Cody, Expert Economist

DIRECTV's expert economist, Dr. Brian J. Cody, performed a two-step analysis of DIRECTV's business activities: (1) identifying DIRECTV's IPAs from an economic perspective by analyzing its "primary value drivers;" and (2) determining the location of those IPAs using a formula based on DIRECTV's payroll and assets. Cody Rpt., R. p. 743; Tr., R. p. 327:13-19.

To identify DIRECTV's IPAs, Dr. Cody examined "important functions, risks and assets that are employed in the business" to determine "what is really creating the value that consumers ultimately pay for. . . ." Tr., R. p. 351:6-13. He found four primary IPAs, or in his terminology "value drivers," that influence a customer's decision to subscribe to DIRECTV: (1) content development (both original and acquired programming); (2) marketing; (3) broadcast operations (including delivery of signal); and (4) customer service. Cody Rpt., R. pp. 749 and 760; Tr., R. p. 329:2-16. He concluded that these value drivers are DIRECTV's IPAs because DIRECTV engages in these activities "to convert potential customers into subscribers and to retain and drive additional income from existing subscribers." Tr., R. pp. 342:1-3; 344:2-11; 351:3-9.[5]

As Dr. Cody explained, content is a primary value driver because that "is what the subscriber ultimately receives from DIRECTV" and the premium content is what distinguishes DIRECTV in a highly competitive industry and allows it to charge premium prices. Tr., R. pp.

[5] Dr. Cody's conclusion is consistent with testimony from DIRECTV's Rule 30(b)(6) witness, who testified that DIRECTV's IPAs were 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.

329:23-332:18. He 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, which illustrates the significant value of content. Cody Rpt., R. p. 750; Tr., R. pp. 330:24-331:16.

Dr. Cody found that DIRECTV's marketing services are also a primary value driver because those activities attract new customers (through increased investment in unique content and advanced broadcasting technology) and produce additional income from existing customers who upgrade their accounts. Cody Rpt., R. pp. 750-751. The marketing services have "a direct impact on the amount of money that customers are willing to pay." Tr., R. p. 336:1-6.

Dr. Cody also found DIRECTV's broadcast operations to be a primary value driver because acquiring customers is heavily dependent on being able to deploy "reliable technology to deliver the content to a customer's television set. . . ." Cody Rpt., R. p. 749. This is accomplished through DIRECTV's satellite networks (which digitally deliver content to subscribers), the broadcast centers and uplink facilities (which receive, process and transmit programming content) and the optimally located orbital slots (which allow DIRECTV to provide high quality signals across the United States). *Id.* at 750.

Finally, Dr. Cody identified customer service as a primary value driver because such activities improve customer retention, attract new subscribers and help generate additional income from existing customers who are more likely to upgrade their accounts because they are happy with DIRECTV's service. Cody Rpt., R. p. 752; Tr., R. p. 339:5-22.

After identifying DIRECTV's IPAs, 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. This method

uses a combination of (1) DIRECTV's total payroll expense; and (2) the net book value of certain of DIRECTV's assets as proxies to determine the portion of the IPAs occurring inside and outside of South Carolina (the "Payroll and Assets Method"). *Id.* at 352:7-353:24. Dr. Cody explained that it was reasonable to use payroll as a proxy because for each of the IPAs, "there's a very large labor content, [such as] negotiating contracts, building and maintaining [a] broadcast network, marketing, and providing customer service." *Id.* at 352:25-353:14. He also noted that *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987) used payroll as a proxy to determine where the taxpayer's IPAs took place. *Id.* at 353:15-19. However, because "[p]ayroll alone for a company like DIRECTV. . . misses the asset intensity," Dr. Cody also looked at the assets of the company. *Id.* at 354:3-6. He 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" which made it appropriate to take assets into account in determining the location of the IPAs. *Id.* at 354:7-15; Cody Rpt., R. pp. 762-763.

B. Professor Richard D. Pomp, Tax Policy Expert

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, which was created in 1957 by the Uniform Law Commission as a model statute for the division of income for income tax purposes. Tr., R. pp. 213:8-13; 226:12-22; 227:10-232:17; 234:11-236:1; Pet. Ex. No. 16, R. pp. 770-781. He testified that South Carolina's statute makes two "positive" improvements: (1) it adopts a proportional approach that sources receipts based on the relative amount of IPAs

occurring in South Carolina versus other states (Tr., R. pp. 226:12-227:9; 234:25-235:23); and (2) instead of dictating one method (*e.g.*, "cost of performance") for determining the amount and location of IPAs, it provides "flexibility" in determining the relative amount of IPAs in the State. *Id.* at 234:16-24.

Professor Pomp rejected the Department's claim that delivery of the signal is the only IPA as an artifice to apply a market-based sourcing method based entirely on customer location without explicitly adopting a market-based method. *Id.* at 248:8-21. He further explained:

> [O]pinions can differ on how to measure the extent to which [IPAs] 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 [IPAs] of getting content and programming. But to say they have no value at all, to say they're not [IPAs] is where you and I disagree.

Id. at 293:9-20.

SUMMARY OF GROUNDS FOR CERTIORARI

Rule 242 of the Appellate Court Rules lists the circumstances that weigh in favor of issuing a writ of certiorari. Two of the reasons listed are applicable here: (a) novel questions of law are at issue; and (b) the Court of Appeals' decision conflicts with a prior decision of this Court. SCACR Rule 242; State v. Lyles, 2009 S.C. LEXIS 39 (S.C. Sup. Ct. Feb. 19, 2009). Although at first blush, it might seem contradictory to say that this case involves both novel issues and conflicts with existing law, both are true in this case.

First, this case involves novel issues related to the interpretation of S.C. Code Ann. § 12-6-2295(A)(5) (regarding determining gross receipts); *Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988) (regarding the burden of proof); and S.C. Code Ann. §§ 12-54-155(B)(2)(b) and

12-54-155(D)(1) (regarding imposition of penalties). No published decision has interpreted § 12-6-2295(A)(5), which provides that where a taxpayer's IPA is performed partly within and partly without this State, then sales are attributable to this State to the extent the IPA is performed within this State. The Court of Appeals has improperly construed IPA in a way that is inconsistent with the plain language of the statute as well as *Lockwood Greene* (which speaks to the "place of activity"), which § 12-6-2295(A)(5) codified, which led the Court of Appeals to reach the erroneous conclusions that delivery of the signal was DIRECTV's only IPA and that DIRECTV failed to sufficiently establish its IPAs. *See infra* Argument at § I (A), (B) and (D) and II. In addition, although the burden of proof set forth in *Cloyd* has been applied in cases involving property taxes, personal income taxes, sales taxes and accommodations taxes, no decision has applied it in the context of corporate income taxes. Consequently, the Court of Appeals refused to apply it here; which presents yet another novel issue for this Court to consider. *See infra* Argument at § III. Finally, no court has examined the question of whether a penalty is appropriate under S.C. Code Ann. §§ 12-54-155(B)(2)(b) or 12-54-155(D)(1) where a taxpayer files its returns based on all of its IPAs and not just delivery of the end product (in this case, the signal), which tracks existing law. *See infra* Argument at § IV.

In addition, the Court of Appeals' decision conflicts with a prior decision of this Court, *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964). This case was decided prior to the enactment of S.C. Code Ann. § 12-6-2295(A)(5) and prior to *Lockwood Greene* but addressed what taxpayer activities produce income, which is relevant in determining IPAs. The taxpayer in *Mercury Motor* claimed that a statutory mileage based formula had reached an unconstitutional result because it taxed income earned outside of

this State. This Court rejected the taxpayer's argument that the only activity that led to income was the pick-up or delivery of freight and instead espoused a broad view of the activities that earn income to include the series of transactions a taxpayer engages in to produce income. The Court of Appeals' decision in this case, on the other hand, interprets IPAs very narrowly to include only delivery of the end-product (i.e., delivery of the signal in South Carolina) thus ignoring DIRECTV's content development, marketing, broadcast operations and customer service (i.e., the series of transactions engaged in by DIRECTV to provide its programming services, all of which contribute to the generation of income). *See infra* Argument at § I (C).

In sum, "special and important reasons" (including novel issues and a conflict between the Court of Appeals' opinion and a prior decision of this Court) weigh in favor of this Court granting DIRECTV's Petition for Certiorari. SCACR 242.

ARGUMENT

I. THE COURT OF APPEALS ERRED IN CONCLUDING THAT DIRECTV'S IPAs CONSIST SOLELY OF THE DELIVERY OF THE SIGNAL AND BY DISREGARDING UNDISPUTED EVIDENCE OF OTHER SUBSTANTIAL IPAs.

The Court of Appeals' conclusion that the only activity that produces income for DIRECTV is the delivery of the signal to the customers' homes (Opinion, App. p. 13) is patently erroneous and contrary to both South Carolina law (including *Lockwood Greene, Mercury Motor* and § 12-6-2295(A)(5)) and the undisputed evidence in the case regarding the substantial IPAs that take place outside of South Carolina.

A. The Court of Appeals' Decision is Contrary to *Lockwood Greene.*

The Court of Appeals rejected the "place of activity" test applied in *Lockwood Greene* because "[t]he service DIRECTV provides is entirely different from *Lockwood Greene* and

DIRECTV's source of income does not derive from its engineers, but rather from its subscriptions to its programming packages." Opinion, App. p. 13. It further stated that "DIRECTV's customers are paying DIRECTV for the end result of the personnel's work- the delivery of the signal that allows customers to enjoy the digital entertainment for which they pay DIRECTV" (*id.*), thereby ignoring all out-of-state IPAs, which among other things, produced or acquired the programming content that the subscribers receive.

First, in making these statements, the Court of Appeals appears to be overlooking the undisputed, voluminous facts in the record showing that DIRECTV customers are not merely paying for a signal. If DIRECTV supplied a signal, but only shopping channels were offered, and no additional programming (network or original), premium sports packages or unique offerings such as NFL Sunday Ticket or the Masters Experience, fewer customers would subscribe and those customers would obviously not pay the same amount for subscription packages. The signal is clearly not the only thing for which South Carolina customers are paying, and to say that the business activities of creating, securing, delivering and marketing these premium programming options and providing customer support related thereto does not produce income is simply wrong and unsupported by any evidence in the record. The Court of Appeals even appears to acknowledge the importance of content when it points out that "DIRECTV's source of income. . . derive[s]. . . from subscriptions **to its programming packages**" and when it states that the delivery of the signal "allows customers to enjoy the **digital entertainment for which they pay DIRECTV.**" Opinion, App. p. 13 (emphasis added). However, it completely ignores these facts in reaching its ultimate conclusion.

Additionally, the fact that there may be some distinctions between an engineering firm and a direct-to-home television service provider does not mean that the "place of activity" test in *Lockwood Greene* should be abandoned. Different companies may have different IPAs, but *Lockwood Greene* and *Mercury Motor* require the Court to examine all such activities. *Lockwood Greene* concluded that a payroll factor was appropriate. Here, Dr. Cody explained that a payroll and assets method, which results in a higher apportionment to South Carolina, is more reasonable. *See supra* Summary of Facts, § II. What is not reasonable is ignoring all IPAs that do not take place in this State as the Department and the Court of Appeals have done.

B. The Court of Appeals' Decision is Contrary to § 12-6-2295(A)(5).

Even if *Lockwood Greene* could be distinguished, that does not end the inquiry. This decision was subsequently codified in S.C. Code Ann. § 12-6-2295(A)(5), which requires that the gross receipts of all service providers be apportioned based on the proportion of their income producing activity that takes place in this State. S.C. Code Ann. § 12-6-2295(A)(5). This is the same as the "place of activity" test in *Lockwood Greene* and is not based on the location of the payor, which is the result achieved by ignoring the out-of-state IPAs.

In holding that DIRECTV's only IPA is the delivery of the signal into its customers' homes, the Court of Appeals committed an error of law in interpreting S.C. Code Ann. § 12-6-2295(A)(5) to require market-based sourcing. Although couched in terms of identifying IPAs, the Court of Appeals holding will result in sourcing revenue to the location of the taxpayer's customer in *every* instance. *See* Am. Order, R. p. 51.

This result is inconsistent with the plain language of the statute, which requires sourcing revenue based on the taxpayer's IPAs. Although many states have done so, South Carolina is not

among the states that have adopted statutes sourcing revenue on a market basis.[6] Moreover, when the Legislature has intended to source receipts on a destination basis, it 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*) (emphasis added).

The Court of Appeals' holding that the delivery of the end product is a taxpayer's only IPA makes South Carolina a market based state, when the law, including *Lockwood Greene, Mercury Motor* and § 12-6-2295(A)(5) says precisely the opposite. The effect of making South Carolina a market based state will have grave consequences when a service provider has a substantial investment and employees in this State because the only gross receipts that will be attributed here will be the subscription receipts from South Carolina customers. Even if the taxpayer has thousands of employees performing services in this State and millions of dollars of assets in this State being used to provide those services, under the Court of Appeals' approach, only the receipts from sales to South Carolina customers would be captured. This defies the language of the statute, which clearly states that IPA is the measuring rod.

C. The Court of Appeals' Decision is Contrary to *Mercury Motor.*

The Court of Appeals' Opinion is also contrary to this Court's decision in *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964). 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

[6] *See, e.g.*, Mass. Gen. Laws, ch. 63, § 38(f) ("Sales, 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.").

result that taxed income earned out-of-state and was therefore unconstitutional. The taxpayer stated that whereas the statutory formula apportioned 17% of its income to the State (reflecting that 17% of its mileage was in-State), revenue from freight either originating in or delivered to South Carolina accounted for only 1% of its gross revenue; therefore, it 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. *Id.*, 244 S.C. at 139, 135 S.E.2d at 758. 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 what activities earn income:

> 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 [IPA] 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 percent.

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

Here, the Court of Appeals concluded that DIRECTV's primary IPA was delivery of the signal "because this activity actually generates income" and the activities prior to delivery of the

signal while "important. . . in that it can help lead to income" are "'too attenuated' to be considered income producing. . . ." Opinion, App. p. 15. However, the distinction between "preparatory" activities (which the Court of Appeals claims are too "attenuated") and "primary" activities (both of which the ALC acknowledged are IPAs) is not supported by *Mercury Motor*. The solicitation, picking up, hauling and delivery of freight and the collection of charges therefor that *Mercury Motor* identified as IPAs in are no different than DIRECTV's activities of content development, marketing and broadcast operations (transmission and delivery). And even if these activities are "preparatory" or "incidental," the ALC has acknowledged that all of these activities are IPAs, and the statute does not differentiate between "preparatory" and "primary" activities.

Moreover, the Court of Appeals' 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 generate revenue by attracting new subscribers and retaining and upgrading current subscribers.

As in *Mercury Motor*, the series of transactions DIRECTV engages in to provide its programming service contributes to the generation of gross receipts and ultimately to the net income to be apportioned under § 12-6-2290 and § 12-6-2295(A)(5). Thus, as it rejected the taxpayer's argument in *Mercury Motor* that the only IPA was the pick-up or delivery of freight, this Court should reject the lower courts' conclusion that delivery of DIRECTV's signal in South

Carolina is the only IPA and that its content development, marketing, broadcast operations and customer service are "too attenuated" to be IPAs. As previously stated, if DIRECTV only offered shopping channels, fewer customers would subscribe and those customers would not pay premium prices for their subscriptions. The signal is clearly not the only thing driving South Carolina customers to subscribe to DIRECTV and pay premium prices for their subscriptions, and the business activities that create, secure, deliver, market and support DIRECTV's premium programming most certainly produce income.

D. The Court of Appeals' Conclusion that DIRECTV's Only IPA is Delivery of the Signal and that Delivery of the Signal Takes Place Solely in South Carolina is Not Supported by Substantial Evidence, Which is in Stark Contrast to the Substantial Evidence DIRECTV Provided in Support of its Multiple IPAs that Take Place In and Outside of South Carolina.

The Court of Appeals' conclusions that DIRECTV's only IPA is the delivery of the signal into its customers' homes and that this occurs entirely in South Carolina are not supported by substantial evidence. DIRECTV presented substantial factual and economic evidence to establish its IPAs. DIRECTV provided detailed testimony regarding the activities necessary to produce its programming services, which include (1) procuring and developing premium quality video entertainment, including the development of original programming and acquisition of programming from third parties, (2) operation of local collection facilities, uplink centers, broadcast centers, and satellites that are used to collect and deliver the programming services to customers, and (3) customer service and marketing activities that allow DIRECTV to maintain and enhance its brand and brand awareness. Tr., R. pp. 170:14-207:25. Dr. Cody explained that DIRECTV's IPAs 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." *Id.* at 344:6-11. He then identified those IPAs as (1) content development, (2) broadcasting operations, (3) marketing, and (4) 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 its 30(b)(6) witness established that DIRECTV's IPAs 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.

In contrast, the Department presented no evidence of DIRECTV's IPAs. In fact, the record establishes that the Department looked solely to the location of the customer to source DIRECTV's subscription revenue. *Id.* at 425:4-6; 437:20-23; 472:13-17. Simply put, there is no credible evidence in the record that DIRECTV's *only* IPA is delivery of the signal into customers' homes as the ALC so noted. Am. Order, R. p. 40 (stating that the ALC "does not adopt the view of the Department that [the IPA] 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" and agreeing 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.*") (emphasis added). Instead, the Court of Appeals made an erroneous legal conclusion that it need not consider all of DIRECTV's IPAs. *See supra* Argument, § I (A)-(C).

In addition, even if delivery of the signal was the only IPA, which DIRECTV asserts is not the case, the Court of Appeals' finding that delivery of the signal to South Carolina customers occurs entirely within this State is, likewise, entirely inconsistent with the evidence. The record 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 as well as the location of these activities, most of which occur out-of-state).

In sum, the Court should grant certiorari on the issues in I (A)-(D) based on (a) the novel issues related to the interpretation of § 12-6-2295(A)(5) (regarding determination of gross receipts and codifying *Lockwood Greene*), which has not been previously addressed by an appellate court; and (b) the fact that the Court of Appeals' decision conflicts with a prior decision of this Court, *Mercury Motor*, which although it pre-dates the statute, examines what taxpayer activities generate income, which is relevant to determining IPAs.

II. THE COURT OF APPEALS ERRED IN CONCLUDING THAT DIRECTV FAILED TO ESTABLISH THE PORTION OF ITS IPAs CONDUCTED IN SOUTH CAROLINA BECAUSE THIS CONCLUSION IS CONTRARY TO SOUTH CAROLINA LAW AND IS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE.

The Court of Appeals erred in concluding that DIRECTV failed to establish the portion of its IPAs conducted in South Carolina because this conclusion is contrary to S.C. Code Ann. § 12-6-2295(A)(5) and is not supported by substantial evidence. The Court of Appeals concluded that Dr. Cody's method "is not a reasonable approximation of DIRECTV's business activity in South Carolina." Opinion, App. pp. 13-14. More specifically, the Court found that the payroll and assets method, which sourced .85% of DIRECTV's total subscription revenue to South Carolina, cannot reasonably represent DIRECTV's business activity in South Carolina because during the Period at Issue, it only had two employees here and its assets consisted of only four local collection facilities and the equipment purchased or leased by its customers. *Id.* at p. 14.

However, this is precisely the point of the apportionment statute. It is because DIRECTV

has few employees and minimal assets in South Carolina that the percentage of gross receipts is a correspondingly small number. The goal of the "place of activity" test in *Lockwood Greene* and the IPA language in § 12-6-2295(A)(5) is to measure the IPAs in this State as compared to those activities in other states and then apportion a proportional amount of the taxpayer's gross receipts to this State. If a court finds this to be inequitable in some way, then such a problem should be addressed by the Legislature, which has chosen to measure business activity by looking at IPA.

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 its IPAs: (1) payroll expense inside and outside of South Carolina; and (2) 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 [IPAs]," and that payroll and asset proxies also reflect the fundamental economics of DIRECTV's operations. *Id.* at 619:14-21; 352:13-17.[7] His method is also consistent with *Lockwood Greene*, which found that "an engineering firm's business carried on in a state is *reasonably measured* by the services rendered by its personnel in the state." 293. S.C. at 449, 361 S.E.2d at 347 (emphasis added).

However, Dr. Cody decided not to place primary reliance on the payroll formula because, in contrast to the engineering firm at issue in *Lockwood Greene*, the IPAs of DIRECTV were better reflected by use of a formula that also took assets into consideration (the "Payroll and

[7] *See also* DIRECTV's Am. Final Brief at App. pp. 134-136 (discussing history of allocation and apportionment law, including adoption by states of 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 and concept 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)).

Assets Method") as assets such as the LCFs, set-top boxes and uplink facilities also play a role in generating 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 IPAs were performed in South Carolina and thus, 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 provides a reasonable approximation of the value of the IPAs performed by DIRECTV in South Carolina as permitted under applicable law. This is in sharp contrast to the approach advanced by the Department and affirmed by the Court of Appeals, 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 of such activities. And this Court should grant certiorari on this issue as well as it involves the same novel issue and conflicting law problem as set forth in § I above.

III. THE COURT OF APPEALS ERRED IN APPLYING THE WRONG BURDEN OF PROOF.

The Court of Appeals erred in applying the wrong burden of proof. Although a tax assessment is initially presumed correct, once a taxpayer establishes that it is incorrect (by proving the actual value or showing by other evidence that it 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); *see also Anonymous Taxpayer v. S.C. Dept. of Rev.*, No. 07-ALJ-17-0189-CC (S.C. Admin. Law Ct. Aug. 23, 2007), *Lawton v. S.C. Dept. of Rev.*, No. 08-ALJ-17-0118-CC (S.C. Admin. Law Ct. Sept. 5, 2008) and *Travelscape, LLC v. S.C. Dept. of Rev.*, 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*).

The Court of Appeals found that *Cloyd* did not apply because although it has been recited in cases involving property taxes, personal income taxes, sales taxes and accommodations taxes, it has not previously been applied in a corporate income tax or apportionment of corporate income taxes cases. Opinion, App. p. 17. It thus found that "because the facts of *Cloyd* are too far removed from the facts of the instant case, the application of the *Cloyd* burden of proof is inapplicable here." *Id.* The Court provided no policy rationale or other reason why once a taxpayer has shown that a corporate income tax assessed is incorrect, it should not be entitled to appropriate relief just as a taxpayer who is assessed with an incorrect property tax, personal income tax, sales tax or accommodations tax would be.

The Court of Appeals also stated that "even if we applied *Cloyd*, we find that DIRECTV failed to satisfy its burden of proof because it did not demonstrate an actual value for its IPAs and did not present other evidence proving the DOR incorrectly included 100% of DIRECTV's subscription receipts from South Carolina customers in the numerator of the gross receipts ratio." *Id.* This is completely counter to the language in *Cloyd* which states that "[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." *Cloyd*, 295 S.C. at 88-89, 367 S.E.2d at 173.

Moreover, DIRECTV met its burden as the ALC acknowledged that the assessment was incorrect. *See* Am. Order, R. p. 40 (wherein ALC states that it "does not adopt the view of the Department that [IPA] 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" and agreeing with Professor Pomp that "opinions can differ on how to measure the extent to which IPAs take place in South Carolina, but answering that question by simply ignoring the outside activities is unacceptable.").

Additionally, DIRECTV presented substantial factual and economic evidence regarding its IPAs and the location from which those activities were conducted, and the Department presented no credible evidence as to DIRECTV's IPAs (it made no attempt to even determine them) and based the assessment solely on customer location (and its tax policy expert testified that the Department was "taking a market state approach to the attribution of receipts."). *See supra* Argument, § I(D).

The Court of Appeals appears to have disregarded the substantial evidence in the record with respect to how DIRECTV's programming services are developed and delivered and defaulted to the Department's simplistic and obviously erroneous conclusion that the only IPA is the delivery of the signal to the customer, a conclusion that the ALC acknowledged is incorrect. Instead, the Court of Appeals should have remanded the case to the ALC to determine the appropriate relief as required by *Cloyd* based on the evidence in the record or a supplemental hearing. *See Cloyd*, 295 S.C. 86, 367 S.E.2d 171.

In sum, the Court should grant certiorari on the burden of proof issue because it is novel as *Cloyd* has not been previously applied in a case involving corporate income taxes.

IV. THE COURT OF APPEALS ERRED IN FINDING SUBSTANTIAL UNDERSTATEMENT PENALTIES PROPER WHERE DIRECTV'S FILING, WHICH WAS BASED ON ALL OF ITS IPAs AND NOT JUST DELIVERY OF THE SIGNAL INTO ITS CUSTOMERS' HOMES, TRACKED EXISTING LAW.

As the Court of Appeals acknowledged, substantial understatement penalties may not be

imposed for tax treatment of items where there "is or was substantial authority for that treatment" or where the relevant facts affecting the tax treatment "are adequately disclosed in the return" and there is a "reasonable basis for the tax treatment of the item. . . ." S.C. Code Ann. §12-54-155(B)(2)(b). Additionally, no penalty may be imposed where there was "reasonable cause" for an understatement and the taxpayer acted in good faith. S.C. Code Ann. §12-54-155(D)(1).

The Court of Appeals found substantial understatement penalties were proper despite the ALC's findings that "DIRECTV acted in good faith with respect to bringing its claim regarding the portions of the understated tax amounts" and that it "acted with sufficient belief" because the Court found that "DIRECTV did not have '**reasonable** cause'. . . for the underpaid taxes, i.e., its method of calculating subscription receipts was unreasonable." Opinion, App. pp. 20-21; Am. Order, R. p. 51 (emphasis in original). The Court appears to believe that *Lockwood Greene* and *Mercury Motor* do not constitute substantial authority for DIRECTV's position because (1) DIRECTV initially filed returns sourcing its receipts as the Department claims it should and relied on *Lockwood Greene* and *Mercury Motor* for the first time in its amended returns; and (2) regardless of the holding of these two cases, "established law dictates the purpose of the apportionment statutes is to apportion corporate income upon a basis that reasonably represents the corporation's business activity in South Carolina." Opinion, App. p. 20.

First, it is not disputed that a taxpayer has a right to file an amended return, and no negative inference should be made by the Court based on DIRECTV amending its returns. Moreover, the relevant apportionment statutes, *Lockwood Green* and *Mercury Motor* cannot be ignored when evaluating whether the penalty should be upheld. Section 12-6-2290(A)(5), which the Court did not mention in discussing the penalty, codified *Lockwood Greene* (which outlined a

"place of activity" test to determine IPA and endorsed a method based on payroll proxy) and speaks to IPAs. *Mercury Motor* states that each transaction in a series of activities engaged in by a taxpayer to conduct its business contributes to its earnings, and the Court did not consider the "final act" of delivering the package to the customer's residence to be the primary IPA. Neither case supports a location of the customer test (*i.e.* market based sourcing), which some states have adopted by statute. Furthermore, the Department has no published guidance to alert taxpayers to any policy interpreting the existing law in such a manner, and even its own auditor was not aware of such a policy. Tr., R. p. 438:6-21. Where a statute and the existing case law, by their plain words, state one view (IPA), and the court construes those words to mean the opposite view (customer location), it is inconceivable that a penalty could be imposed. Moreover, the ALC expressly found that the Department's method was *incorrect* and that DIRECTV did, in fact, have IPAs outside of South Carolina. If a taxpayer protesting an assessment deemed erroneous by the lower court and using a method that closely tracks the existing law does not qualify as having substantial authority for its position and a reasonable basis for its tax treatment, then it is difficult to see how any taxpayer could ever meet that standard.

In sum, the Court should grant DIRECTV's Petition based on the issue regarding the interpretation and application of S.C. Code Ann. §§ 12-54-155(B)(2)(b) and (D)(1) because whether a substantial understatement penalty should be imposed in a situation where a taxpayer calculates its gross receipts based on all of its IPAs and not just delivery of the end product (here, the signal) is a novel issue that has not been addressed in South Carolina.

CONCLUSION

The Court of Appeals' decision in this case, which concludes that delivery of the signal is DIRECTV's only IPA, is contrary to *Mercury Motor*, *Lockwood Greene* and S.C. Code Ann. §

12-6-2295(A)(5) as well as all evidence in the case. Certiorari is appropriate because there are "special and important reasons" under SCACR 242, including that the case involves several novel issues and that the decision of the Court of Appeals conflicts with a prior decision of this Court. Review of this decision by this Court is critical to ensure that S.C. Code Ann. § 12-6-2295(A)(5), which delineates how a multi-state taxpayer calculates its gross receipts and applies to hundreds if not thousands of multi-state taxpayers filing in South Carolina, is being properly interpreted and applied by the Department and lower courts. This is particularly important here where no court has previously ruled on this issue, the Department has no written policy (and its auditor was not aware of any policy) on this issue, and the Department has issued no guidance to taxpayers on how it is applying this statute. Based on the above, DIRECTV respectfully requests that this Court issue a writ of certiorari to review the Court of Appeals' decision in this matter.

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February 12, 2018

THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

DIRECTV, Inc. & Subsidiaries, ... Appellant,

v.

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

PROOF OF SERVICE

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

Pleadings: PETITIONER'S PETITION FOR A WRIT OF CERTIORARI

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