

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, ...

Petitioner,

v.

South Carolina Department of Revenue, ...

Respondent.

APPENDIX
VOLUME I OF IV

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SC Court of Appeals

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**THE STATE OF SOUTH CAROLINA
In The Court of Appeals**

DIRECTV, Inc. & Subsidiaries, Appellant,

v.

South Carolina Department of Revenue, Respondent.

Appellate Case No. 2015-001509

Appeal From The Administrative Law Court
Ralph King Anderson, III, Administrative Law Judge

Opinion No. Op. 5513
Heard March 14, 2017 – Filed August 30, 2017

AFFIRMED

John C. von Lehe, Jr. and Bryson M. Geer, both of
Nelson Mullins Riley & Scarborough, LLP, of
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Nicole M. Wooten, William J. Condon, Jr., and Milton
G. Kimpson, all of the South Carolina Department of
Revenue, of Columbia, for Respondent.

WILLIAMS, J.: In this appeal from the administrative law court (ALC), DIRECTV, Inc. & Subsidiaries (DIRECTV) argue the ALC erred in (1) applying an improper burden of proof, (2) holding DIRECTV's income-producing activities (IPA) consisted solely of signal delivery into its customers' homes, (3) finding DIRECTV failed to establish the portion of its IPA occurring in South Carolina,

and (4) finding the South Carolina Department of Revenue (the DOR) properly imposed substantial understatement penalties. We affirm.

FACTS/PROCEDURAL HISTORY

This case involves the DOR's denial of DIRECTV's claims for refunds of South Carolina corporate income and license fee taxes for the tax years 2006 through 2008 and the assessment of South Carolina corporate income and license fee taxes, interest, and penalties for the tax years 2009 through 2011. To properly determine DIRECTV's IPAs, we find it instructive to briefly detail DIRECTV's business operations and its methods for soliciting and securing customers and deriving its revenue.

DIRECTV's Business Operations

DIRECTV—a California corporation with its headquarters and principal place of business located in Los Angeles, California—provides access to direct-to-home digital television entertainment via satellite to residential and commercial customers across the United States in exchange for a subscription fee. DIRECTV has four principal "value drivers" for its business: development and acquisition of content; broadcast operations and distribution; marketing and sales; and customer care.

DIRECTV targets customers through high-quality, national advertisements designed to encourage existing and potential customers to call a toll-free number, which directs customers to DIRECTV's customer service call centers, to place an order for DIRECTV's television services. The call centers—located entirely outside of South Carolina and owned and operated by DIRECTV and third parties—facilitate the installation of set-top boxes and dishes in subscribers' homes and businesses by a third-party home service provider hired by DIRECTV.¹ DIRECTV delivers programming to a subscriber only after the subscriber signs a customer agreement and installation of DIRECTV's equipment is completed. For a

¹ Customers are required to lease the set-top boxes from DIRECTV, and both parties agreed all income generated by South Carolina customers leasing the set-top boxes and purchasing tangible personal property, such as remote controls, should be included in the numerator of the gross receipts ratio.

monthly subscription fee, DIRECTV provides its subscribers access to original and acquired television programming.

DIRECTV produces several types of original programming and sporting events. Additionally, it acquires programming from third-party providers such as movie studios, broadcast television networks like NBC, local broadcast stations, and providers of cable programming like HBO and ESPN.² DIRECTV receives third-party programming content through satellite, fiber-optic cables, and over-the-air broadcasts. DIRECTV's national broadcast centers in California and Colorado receive, process, collect, and transmit these signals to one of eleven satellites in geo-stationary orbit above the earth, which then sends a wide beam of energy covering the United States. Programming from local broadcast television stations is collected at unmanned, local collecting facilities maintained by DIRECTV and located throughout the country in correspondence with each of the 210 Nielsen assigned designated market areas.³ Each of the local collecting facilities transmits signals to one of DIRECTV's six up-link facilities, located throughout the country but not in South Carolina. The up-link facilities transmit the content to one of the eleven geo-stationary satellites, which then transmits a narrow spot beam, containing only the local programming, to the designated market area from which it originated. DIRECTV's subscribers receive national and local programming from these signal beams via mounted satellite dishes on or near their homes or businesses. The signal then relays from the mounted satellite dishes to the subscribers' set-top boxes, which delivers the signal onto the subscribers' television sets.

Although DIRECTV established its four primary value drivers through testimony, DIRECTV primarily derives its revenue from "fees paid by its [approximately 20 million] customers for rentals of set-top boxes and subscriptions to its programming services." According to DIRECTV, this includes monthly fees from subscriptions to one or more video programming packages; revenue from pay-per-view programming; revenue from the sale or lease of DIRECTV's equipment; revenue from optional warranties on the leased set-top boxes; and revenue from

² DIRECTV's employees in California are responsible for the acquisition and negotiation of its third-party programming and for the development of its original programming.

³ During the tax periods at issue, four local collection facilities were located in South Carolina.

fees associated with DVR set-top boxes, high-definition set-top boxes, and multiroom viewing charges. Other than DIRECTV's local collection facilities in South Carolina, its equipment rental and sale to subscribers in South Carolina, and the one or two employees located in South Carolina during the tax periods at issue, nearly all of DIRECTV's assets, employees, and property involved in providing its services to subscribers were located outside of South Carolina.

DIRECTV's Income Tax Returns

For income tax purposes, corporations like DIRECTV apportion net income to South Carolina using a fraction in which the numerator is gross receipts from within South Carolina during the taxable year and the denominator is gross total receipts from everywhere during the taxable year. *See* S.C. Code Ann. § 12-6-2290 (2014). For the 2006, 2007, and 2008 tax years, DIRECTV originally filed corporate income tax returns in South Carolina in which it sourced 100% of its subscription receipts and 100% of its rental receipts from South Carolina subscribers to the numerator of the gross receipts ratio. This corresponded to gross receipt ratios of 1.9539% for 2006; 2.0016% for 2007; and 2.0543% for 2008, which DIRECTV used to apportion its net income to South Carolina. In 2008, the DOR conducted a field audit on DIRECTV's tax returns from 2006 through 2008. Following the audit, the DOR did not make any adjustments to DIRECTV's tax returns, and thus, accepted DIRECTV's original 2006 through 2008 corporate tax income returns as filed. However, DIRECTV subsequently filed amended corporate income tax returns for tax years 2006 through 2008, wherein DIRECTV's only change was the removal of 100% of the South Carolina customer subscription receipts that was originally sourced to the numerator of the gross receipts ratio.

As a result, the gross receipts ratio used to apportion DIRECTV's net income to South Carolina changed from the original 1.9539% to an amended 0.0246% for 2006; from 2.0016% to an amended 0.0810% for 2007; and from 2.0543% to an amended 0.1137% for 2008. DIRECTV attached the following statement, explaining the change, to each of its three amended returns:

The return is being amended to apportion sales receipts to the state under S.C. Code Ann. § 12-6-2295 which [sic] sources sales of services under a pro-rate cost of performance method. The originally filed return incorrectly apportioned satellite television subscription

receipts to South Carolina using market-based sourcing, rather than the cost of performance sourcing that is prescribed by statute.^[4]

As a result of the change in the amended returns, DIRECTV attempted to reduce its income tax and license fee liability by \$5,976,810 and sought a refund in the same amount. The DOR conducted another field audit of DIRECTV, and in its November 29, 2011 field audit report, the DOR denied DIRECTV's amended returns and refund request and accepted DIRECTV's original 2006 through 2008 tax returns as filed. In its filed original corporate income tax returns for tax years 2009 through 2011, DIRECTV used a method for calculating the gross receipt ratio similar to the one in its amended 2006 through 2008 returns,⁵ which resulted in gross receipts ratios of 0.1437% for the 2009 tax year; 0.1570% for the 2010 tax year; and 0.2962% for the 2011 tax year. Again, the DOR conducted an audit on these returns, and in its January 28, 2014 field audit report, the DOR assessed DIRECTV for income taxes and license fees for 2009 through 2011 that calculated the gross receipts ratio by attributing 100% of DIRECTV's South Carolina subscription receipts to the numerator of the ratio.

DOR Determination and ALC Hearing

On February 18, 2014, the DOR issued a department determination in which it found the gross receipts DIRECTV generated from the sale of subscriptions were directly produced from activity occurring within South Carolina, namely the delivery of the signal into South Carolina homes and businesses and onto

⁴ In its amended order, the ALC noted both parties originally erred in referencing South Carolina's apportionment statute but later agreed and clarified their positions to reflect "that South Carolina uses a method of apportionment based on the proportion of income-producing activity conducted within the State."

⁵ While DIRECTV did not include any South Carolina subscription receipts in the numerator of its gross receipts ratio in the amended 2006 through 2008 returns or on the original 2009 and 2010 returns, it did change its method slightly for the original 2011 returns by sourcing a percentage of its total subscription receipts to South Carolina based on a ratio of its South Carolina payroll to its total payroll, which ultimately resulted in approximately \$22 million of its \$410 million in South Carolina subscription receipts (approximately 5%) being included in the gross receipts ratio numerator.

customers' television sets. Accordingly, the DOR determined the revenue from DIRECTV's subscription receipts should be sourced to South Carolina. Thereafter, DIRECTV requested a contested case hearing of the DOR's determination before the ALC, seeking a determination of the extent to which DIRECTV's IPA occurred in South Carolina and whether the DOR properly assessed substantial understatement penalties against DIRECTV for taxes owed for the 2009 through 2011 tax years.

Following a hearing, the ALC issued an amended final order and decision on June 12, 2015. The ALC found (1) DIRECTV's IPA was the delivery of the signal into homes and businesses and onto the television sets of its customers; (2) the IPAs related to South Carolina customers occurred entirely within South Carolina; and (3) 100% of DIRECTV's subscription receipts from South Carolina customers must be sourced to the numerator of the gross receipts ratio. Additionally, the ALC found DIRECTV liable for substantial understatement penalties. Furthermore, the ALC denied DIRECTV's refund request for its amended 2006 through 2008 income tax returns and assessed DIRECTV \$6,646,168 in tax and license fees; \$653,425 in interest; and \$1,246,155.75 in penalties relating to its 2009, 2010, and 2011 income tax returns. This appeal followed.

ISSUES ON APPEAL

- I. Did the ALC err in (1) holding DIRECTV's IPAs consist solely of the delivery of the signal into the homes of its customers and finding that DIRECTV failed to establish the portion of its IPAs that were conducted in South Carolina, and (2) applying an improper burden of proof?
- II. Did the ALC err in finding the DOR properly imposed substantial underpayment penalties?

STANDARD OF REVIEW

The Administrative Procedures Act (APA) governs appellate review of decisions from the ALC. *Risher v. S.C. Dep't of Health & Env'tl. Control*, 393 S.C. 198, 203, 712 S.E.2d 428, 431 (2011).

The review of the [ALC]'s order must be confined to the record. The court may not substitute its judgment for the judgment of the [ALC] as to the weight of the evidence

on questions of fact. The court of appeals may affirm the decision or remand the case for further proceedings; or[] it may reverse or modify the decision 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 exercise of discretion.

S.C. Code Ann. § 1-23-610(B) (Supp. 2016).

An appellate court should only reverse the ALC's order if it is unsupported by substantial evidence in the record or contains an error of law. *Original Blue Ribbon Taxi Corp. v. S.C. Dep't of Motor Vehicles*, 380 S.C. 600, 604, 670 S.E.2d 674, 676 (Ct. App. 2008); *see also Media Gen. Commc'ns, Inc. v. S.C. Dep't of Revenue*, 388 S.C. 138, 144, 694 S.E.2d 525, 528 (2010) ("A reviewing court may reverse the decision of the ALC [when] it is in violation of a statutory provision or it is affected by an error of law."). "Substantial evidence is not a mere scintilla of evidence nor evidence viewed blindly from one side, but is evidence [that], when considering the record as a whole, would allow reasonable minds to reach the conclusion that the agency reached" *Leventis v. S.C. Dep't of Health & Env'tl. Control*, 340 S.C. 118, 130, 530 S.E.2d 643, 650 (Ct. App. 2000) (quoting *Welch Moving & Storage Co. v. Pub. Serv. Comm'n of S.C.*, 301 S.C. 259, 261, 391 S.E.2d 556, 557 (1990)). However, "[q]uestions of statutory interpretation are

questions of law, which [the appellate court is] 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, 69 (2013) (first alteration in original) (quoting *CFRE, LLC v. Greenville Cty. Assessor*, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011)).

LAW/ANALYSIS

I. DIRECTV's IPAs and Burden of Proof

A. DIRECTV's IPA

DIRECTV asserts the ALC erred as a matter of law by misinterpreting sections 12-6-2290 and 12-6-2295(A)(5) of the South Carolina Code. Further, DIRECTV argues the ALC erred in holding its IPA was the delivery of the signal into the homes and businesses of its customers and in finding DIRECTV failed to establish the portion of its IPAs that occurred in South Carolina because the ALC's findings are not supported by substantial evidence. We disagree.

"The cardinal rule of statutory interpretation is to ascertain and effectuate the intention of the legislature." *Sloan v. Hardee*, 371 S.C. 495, 498, 640 S.E.2d 457, 459 (2007). "Whe[n] the statute's language is plain and unambiguous, and conveys a clear and definite meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning." *Media Gen. Commc'ns, Inc.*, 388 S.C. at 148, 694 S.E.2d at 530 (quoting *Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000)). "Words must be given their plain and ordinary meaning without resort to subtle or forced construction to limit or expand the statute's operation." *Sloan*, 371 S.C. at 499, 640 S.E.2d at 459.

However, a court will reject the plain and ordinary meaning of the statute if the interpretation of the statute by its plain, ordinary meaning leads to an absurd result that was unintended by the legislature. *Duke Energy Corp. v. S.C. Dep't of Revenue*, 415 S.C. 351, 355, 782 S.E.2d 590, 592 (2016). "If possible, the court will construe the statute so as to escape the absurdity and carry the intention into effect." *Kiriakides v. United Artists Commc'ns, Inc.*, 312 S.C. 271, 275, 440 S.E.2d 364, 366 (1994). "In so doing, the [c]ourt should not concentrate on isolated phrases within the statute, but rather, read the statute as a whole and in a manner consonant and in harmony with its purpose." *Duke Energy Corp.*, 415 S.C. at 355, 782 S.E.2d at 592; *see also Etiwan Fertilizer Co. v. S.C. Tax Comm'n*, 217

S.C. 354, 360, 60 S.E.2d 682, 684 (1950) ("The prime object, of course, in the construction of a statute is to ascertain and give effect to the legislative intent.").

Corporate income tax in South Carolina "is imposed annually at the rate of five percent on the South Carolina taxable income of every corporation . . . transacting, conducting, or doing business within this State or having income within this State, regardless of whether these activities are carried on in intrastate, interstate, or foreign commerce." S.C. Code Ann. § 12-6-530 (2014). In South Carolina, a corporation's taxable income "is computed using the Internal Revenue Code with modifications as provided by South Carolina law, and this amount is 'subject to allocation and apportionment as provided in Article 17 of this chapter.'" *Media Gen. Commc'ns, Inc.*, 388 S.C. at 145, 694 S.E.2d at 528 (quoting S.C. Code Ann. § 12-6-580 (2014)). "If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014); *see also Lockwood Greene Eng'rs, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987) ("The purpose of the allocation statutes is to provide for imposition of South Carolina income tax 'upon a base which reasonably represents the proportion of the trade or business carried on within this State.'" (quoting *Hertz Corp. v. S.C. Tax Comm'n*, 246 S.C. 92, 95, 142 S.E.2d 445, 446 (1965))). Our supreme court has previously held that "the apportionment formula is a reasonable basis for establishing the income tax of corporations [that] . . . do business on a multistate level." *Eastman Kodak Co. v. S.C. Tax Comm'n*, 308 S.C. 415, 419, 418 S.E.2d 542, 544 (1992).

In South Carolina, the nature of the taxpayer's business in the state determines the method of apportionment a taxpayer must use. For tax years prior to 2007,⁶ the net income of a service provider such as DIRECTV⁷ was 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

⁶ In 2007, the General Assembly amended section 12-6-2290 by adding a sentence to the end of the existing statute, which included a cross reference to the new definition of "gross receipts" and took effect in the 2007 tax year. *See* Act No. 110, 2007 S.C. Acts 36–37.

⁷ The ALC identified DIRECTV as a service provider, and DIRECTV does not dispute this finding.

taxable year." S.C. Code Ann. § 12-6-2290 (1995) (amended Supp. 2007). For tax years following 2006, section 12-6-2290 of the South Carolina Code (2014) provides that "[f]or purposes of this section, items included in gross receipts are as provided in [s]ection 12-6-2295." The relevant subsection in the instant case is subsection 12-6-2295(A)(5), which states:

(A) The terms "sales" as used in [s]ection 12-6-2280 and "gross receipts" as used in [s]ection 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:

....

(5) receipts from services if the entire income-producing activity is within this [s]tate. If the income-producing activity is performed partly within and partly without this [s]tate, sales are attributable to this [s]tate to the extent the income-producing activity is performed within this [s]tate.

S.C. Code Ann. § 12-6-2295 (2014).

In the instant case, DIRECTV argues the ALC committed an error of law because it misinterpreted section 12-6-2295(A)(5) when it looked to the location of DIRECTV's customers in determining DIRECTV's IPA. Because this argument concerns statutory interpretation, it is a question of law, which we may decide without any deference to the ALC. *See CFRE, LLC*, 395 S.C. at 74, 716 S.E.2d at 881. As used in section 12-6-2295(A)(5), the term "income-producing activity" helps define gross receipts as used in section 12-6-2290, which requires taxpayers like DIRECTV to apportion its corporate income to South Carolina using a fraction wherein the numerator is gross receipts from South Carolina during the taxable year and the denominator is gross receipts from everywhere during the taxable year. *See* S.C. Code Ann. § 12-6-2290 (2014). When examining the apportionment statutes, "the statutory policy is designed to apportion to South Carolina a fraction of the taxpayer's total income *reasonably attributable* to its business activity in this State." *Duke Energy Corp.*, 415 S.C. at 356, 782 S.E.2d at 592 (quoting *Emerson Elec. Co. v. S.C. Dep't of Revenue*, 395 S.C. 481, 485–86, 719 S.E.2d 650, 652 (2011)).

As applied, section 12-6-2295(A)(5) defines gross receipts as "receipts from services if the entire income-producing activity is within this [s]tate. If the income-producing activity is performed partly within and partly without this [s]tate, sales are attributable to this [s]tate to the extent the income-producing activity is performed within this [s]tate." Giving the statutory language its plain and ordinary meaning, we find section 12-6-2295(A)(5) establishes that if a corporation generates revenue or income from activity performed exclusively within South Carolina, then its gross receipts must include that income in the numerator of the gross receipts ratio. However, if a corporation, acting on a multistate level, derives its revenue from activities occurring both inside and outside of South Carolina, then the revenue generated from its services performed within South Carolina are its gross receipts from South Carolina, and thus, must be included in the numerator of the gross receipts ratio. This interpretation keeps the legislative purpose of the allocation statutes intact. *See Lockwood Greene*, 293 S.C. at 449, 361 S.E.2d at 347.

Nevertheless, DIRECTV argues it presented substantial evidence at the ALC hearing to show how it generates income. DIRECTV's expert economist, Dr. Brian J. Cody, identified four primary value drivers—content development, marketing, broadcast operations, and customer service—that influence customers' decisions in subscribing to DIRECTV's services. Dr. Cody explained these drivers are DIRECTV's IPAs because DIRECTV engages in these activities to convert potential customers into subscribers and to create additional income from existing subscribers. Basing his formula on the methodology found in *Lockwood Greene*, Dr. Cody determined the percentage these IPAs occurred in South Carolina using a payroll and assets method, calculating DIRECTV's payroll and assets in South Carolina relative to their total payroll and assets everywhere else, as a proxy for approximating the amount of DIRECTV's total revenue occurring inside South Carolina.

In *Lockwood Greene*, the taxpayer—an engineering firm with offices, projects, and clients in numerous states, including South Carolina—sought a refund of income tax based on the argument that the then-apportionment statute required receipts to be apportioned based on where its customers were located and payments were made, which is an "origin of payment" view. 293 S.C. at 448, 361 S.E.2d at 347. The tax commission argued for a "place of activity" view, which apportions income based on the place where the services are performed. *Id.* The court of appeals noted that the taxpayer provided services to its clients through highly trained engineers and personnel and that clients paid the taxpayer for the expertise

and time of its employees. *Id.* at 449, 361 S.E.2d at 347. The court determined that the business of engineering firms, like the taxpayer, carried on in a state was reasonably measured by services rendered by its personnel in that state, which represented a "place of activity" test. *Id.* The court also noted that the taxpayer's argument regarding the tax commission's inconsistent interpretation of the statute based on the commission's guidelines was unpersuasive because the taxpayer did not operate a similar business to those businesses in which the tax commission focused on whether the services were performed in South Carolina. *Id.* at 450, 361 S.E.2d at 348.

DIRECTV asserts the "place of activity" test is still applicable, and thus, because the four primary value drivers representing its IPAs were accomplished through its employees, the payroll and assets method would reasonably represent "the proportion of gross receipts that should be sourced to South Carolina."⁸ Moreover, DIRECTV argues the ALC—in finding that all of DIRECTV's activities, outside of beaming the satellite signals to its customers, were "preparatory" activities and were "too attenuated to the production of income" to be IPAs—misinterpreted and misapplied *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964).⁹ DIRECTV argues the transactions listed by the

⁸ Dr. Cody's method resulted in an average of 0.85% of DIRECTV's gross subscriber receipts being sourced to South Carolina over the tax years at issue. Dr. Cody calculated the payroll formula by dividing DIRECTV's South Carolina-based payroll of two employees by its total payroll, which gave a weighted average of 0.07%. Dr. Cody then repeated this method by dividing the value of DIRECTV's South Carolina assets by its total assets, resulting in an average of 1.63% for the tax period at issue. Dr. Cody then averaged these two figures to obtain the 0.85% figure.

⁹ In *Mercury Motor*, the taxpayer, a multistate motor carrier, claimed the statutory apportionment formula improperly apportioned 17% of its income to South Carolina—representing 17% of its mileage in the state—when the taxpayer only generated approximately 1% of its gross revenue from delivery or picking up freight within South Carolina. 244 S.C. at 139, 135 S.E.2d at 758. Our supreme court stated the taxpayer was "engaged in income producing activity actually done and performed within" South Carolina, when the taxpayer's trucks traveled the state's highways. *Id.* at 141, 135 S.E.2d at 759. The court also listed a series of transactions—solicitation of freight, hauling of freight, picking up freight, delivering freight, and collecting charges—and stated each transaction in the series

supreme court in *Mercury Motor* are analogous to DIRECTV's activities of content development, marketing, and broadcast operations in that both series of activities contribute to the generation of gross receipts, and ultimately, to net income to be apportioned.

Upon our review of the record, substantial evidence supports the ALC's finding that DIRECTV's IPA is the delivery of signal to its customers nationwide, and accordingly, the delivery of signal to South Carolina customers is represented by 100% of its South Carolina subscription receipts. Dr. Glen W. Harrison, the DOR's expert, determined the purchase of DIRECTV's services and the delivery of television services in the customers' homes or businesses was the activity that "actually generate[d] income" for DIRECTV. We also find DIRECTV's reliance on *Lockwood Greene* for the development of its proxy method is unfounded. While we acknowledge that the court in *Lockwood Greene* utilized a "place of activity" test based on the services provided by personnel in South Carolina, the facts are distinguishable from the instant case. *Lockwood Greene* involved an engineering firm that provided its clients a service from which it derived its income by offering the time and expertise of its highly trained engineers and personnel. 293 S.C. at 448, 361 S.E.2d at 347. Here, however, while DIRECTV has highly trained engineers and personnel obtaining content and producing innovative technology, 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. The service DIRECTV provides is entirely different from *Lockwood Greene* and DIRECTV's source of income does not derive from its engineers, but rather from subscriptions to its programming packages.

Although we recognize that South Carolina law only requires a reasonable approximation for apportionment, we find Dr. Cody's method is not a reasonable

contributed to the earning 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." *Id.* The court found that the taxpayer failed to meet its burden of showing the tax was unconstitutional, arbitrary, and discriminatory because nothing indicated that its trucks, while traveling 17% of the roads, failed to contribute to the taxpayer's income or failed to earn less than 17% of the income. *Id.* at 141, 135 S.E.2d at 760.

approximation of DIRECTV's business activity in South Carolina. *See Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66, 212 S.E.2d 574, 577 (1975). Dr. Cody designed his payroll and assets method to represent "the proportion of gross receipts that *should* be sourced to South Carolina," which would generate a hypothetical figure of South Carolina subscription receipts that would result from multiplying a payroll and assets percentage for a given year by DIRECTV's total subscription revenue for that year. (emphasis added). However, while DIRECTV asserts its IPA is its four primary value drivers and the payroll and assets method is a reasonable proxy for determining how much of its IPA should be apportioned to South Carolina, we find that 0.85% of DIRECTV's total subscription revenue does not reasonably represent DIRECTV's business activity in South Carolina. The payroll and assets method cannot be a reasonable approximation of the business activity conducted in South Carolina because DIRECTV's personnel in South Carolina during the periods at issue consisted of two employees, at most, and the only assets that DIRECTV owned in South Carolina were the four local collection facilities and the equipment purchased or leased by its subscribers. Additionally, we find Dr. Harrison correctly stated that the DOR appropriately sourced DIRECTV's subscription revenue from its South Carolina customers to the numerator of the gross receipts ratio because it directly represented DIRECTV's business activity in South Carolina and calculated DIRECTV's activity in the state. Furthermore, we agree with Dr. Harrison's statement that the proxies or approximations employed by DIRECTV were unnecessary in measuring the value of DIRECTV's services in South Carolina because the subscription fee paid by DIRECTV's subscribers directly placed a value on DIRECTV's services.

We note DIRECTV states its principal aim is to "package and deliver high quality video entertainment" to subscribers, and that it is not a media broadcaster, but "is a producer of original content and a multichannel video programming distributor, whose revenue is derived from fees paid by its customers for rentals of set-top boxes and subscriptions to its programming services." Stated differently, the service DIRECTV provides to its approximately twenty million nationwide customers is the delivery of high quality television entertainment. Its clients pay DIRECTV for the delivery of its television programming packages and for the equipment to process the signal DIRECTV sends to its customers. Thus, as a service provider, DIRECTV's IPA is the delivery of its programming signal to its customers across the country and in South Carolina.

In accordance with statutory language and policy, the fees paid by South Carolina subscribers for the lease and purchase of DIRECTV's equipment and the delivery

of the signal to the subscribers represent the extent of the IPAs occurring in South Carolina; reasonably represent DIRECTV's business activity in South Carolina; and are to be included in the numerator of the gross receipts ratio as the South Carolina gross receipts for DIRECTV. See S.C. Code Ann. §§ 12-6-2290, -2295(A)(5); see also *Duke Energy Corp.*, 415 S.C. at 356, 782 S.E.2d at 592 ("[T]he statutory policy [for the apportionment statutes] is designed to apportion to South Carolina a fraction of the taxpayer's total income *reasonably attributable* to its business activity in this State." (quoting *Emerson Elec. Co.*, 395 S.C. at 485-86, 719 S.E.2d at 652)); *Eastman Kodak Co.*, 308 S.C. at 419, 418 S.E.2d at 544 ("The fact that a very small percentage of the leased assets are located in South Carolina is accounted for in the numerator of the apportionment formula in which Kodak's payroll, property, and sales in this state are computed. Therefore, the apportionment formula reflects a 'reasonable representation' of Kodak's business in this state."). Therefore, we agree with the ALC and find DIRECTV should source 100% of its South Carolina subscriber receipts to the numerator of the gross receipts ratio.

Last, we find DIRECTV's *Mercury Motor* argument unpersuasive. The "preparatory" activities that DIRECTV engages in for the production of its programming and marketing are not an IPA for the purposes of section 12-6-2295(A)(5). We note Dr. Cody testified these activities were conducted "in anticipation" of customers signing up for DIRECTV's services and DIRECTV engages in these activities "in anticipation of future profits." Accordingly, these activities cannot be IPAs because they do not produce income, but rather, are "income-anticipatory" activities. DIRECTV's primary income-producing activity is the delivery of the signal to the customer because this activity actually generates income for DIRECTV. While the other activities occurring prior to the delivery of signal are important for DIRECTV in that it can help lead to income, section 12-6-2295(A)(5) requires activities that actually produce income. Thus, we agree with the ALC and find that these activities are "too attenuated" to be considered income-producing for the purposes of section 12-6-2295(A)(5).

In conclusion, we affirm the ALC because its decision is not affected by an error of law and is supported by substantial evidence. See *Media Gen. Commc'ns, Inc.*, 388 S.C. at 144, 694 S.E.2d at 528.

B. Burden of Proof

DIRECTV next argues the ALC erred by applying an improper burden of proof because DIRECTV proved by a preponderance of the evidence it was entitled to a refund for tax years 2006 through 2008 and the DOR's assessment for the tax years 2009 through 2011 was incorrect. We disagree.

The standard of proof in an administrative hearing of a contested case is by a preponderance of the evidence. *See* S.C. Code Ann. § 1-23-600(A)(5) (Supp. 2016) ("Unless otherwise provided by statute, the standard of proof in a contested case is by a preponderance of the evidence."). In general, the party asserting the affirmative issue in an adjudicatory administrative proceeding has the burden of proof. *See Leventis*, 340 S.C. at 132–33, 530 S.E.2d at 651. "In reaching a decision in a contested violation matter, the ALC serves as the sole finder of fact in the de novo contested case proceeding." *S.C. Dep't of Revenue v. Sandalwood Soc. Club*, 399 S.C. 267, 279, 731 S.E.2d 330, 337 (Ct. App. 2012) (emphasis omitted). "The Rules of Procedure for the Administrative Law Judge Division require that the AL[C] make independent findings of fact in contested case hearings, and the [APA] clearly contemplates that the AL[C] will make [its] own findings of fact in a contested case hearing." *Reliance Ins. Co. v. Smith*, 327 S.C. 528, 534, 489 S.E.2d 674, 677 (Ct. App. 1997) (citation omitted). When conflicting evidence on an issue exists, the appellate court defers to the findings of the fact-finder in accordance with the substantial evidence standard of review. *Risher*, 393 S.C. at 210, 712 S.E.2d at 435.

In the instant case, the ALC determined DIRECTV had the burden of proof because it was challenging the DOR's determination that it must source its South Carolina subscription receipts from South Carolina customers to the numerator of the gross receipts ratio. Thus, the ALC required DIRECTV prove the DOR was incorrect for including DIRECTV's subscription receipts for its South Carolina customers in the numerator of the gross receipts ratio and that a refund of the 2006 through 2008 tax years and reassessment of 2009 through 2011 tax years was proper. However, the ALC determined DIRECTV failed to prove by a preponderance of the evidence that it was not required to source all of its subscription receipts from South Carolina customers to the numerator of the gross receipts ratio.

DIRECTV, on the other hand, relies on this court's findings in a property tax case—*Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988)—for support that it satisfied its burden of proof and is entitled to relief. In *Cloyd*, a county tax assessor assessed taxes on eight properties, which were located in a floodway and

subject to strict restrictions on use following the enactment of an ordinance, without making an allowance for the ordinance's effect on the fair market value of the land. *Id.* at 87, 367 S.E.2d at 172. On appeal, the assessor claimed his assessment carried a presumption of correctness, which could not be set aside unless the landowners proved the actual value of their property. *Id.* at 88, 367 S.E.2d at 172–73. The court of appeals determined that a contesting taxpayer, who has the burden of proving the taxing authority's valuation incorrect, could overturn that presumption of correctness and be entitled to relief if the taxpayer either proved the actual value of the property or could show other evidence to indicate the assessing authority's valuation was incorrect. *Id.* at 88–89, 367 S.E.2d at 173.

DIRECTV asserts *Cloyd* is applicable here because it has been used in other tax cases unrelated to property tax. Furthermore, based on the findings in *Cloyd*, DIRECTV contends it is entitled to appropriate relief because it satisfied its burden of proof by presenting detailed testimony and substantial evidence that showed the DOR's assessment was incorrect and because the DOR did not present credible evidence as to DIRECTV's IPA.

We find DIRECTV's reliance on *Cloyd* is misguided. While it has been used as the burden of proof in personal income tax, sales tax, and accommodation tax cases before the ALC, we note that none of these cases involved corporate income tax, or more importantly, the apportionment of corporate income. Thus, 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. Furthermore, even if we applied *Cloyd*, we find 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.

As the fact-finder, the ALC was free to weigh evidence and determine witness credibility in making its factual findings. *See MRI at Belfair, LLC v. S.C. Dep't of Health & Envtl. Control*, 392 S.C. 314, 324, 709 S.E.2d 626, 631 (2011). Both parties presented their own experts in economics and tax policy to convey their opinions on where DIRECTV's IPA occurred. In light of the evidence presented, the ALC found DIRECTV's argument unpersuasive. In particular, the ALC found Dr. Cody's methods did not provide actual values for DIRECTV's services and his proxies did not provide a reasonably approximate value of DIRECTV's IPAs in South Carolina. As previously mentioned, we agree with the ALC's assessment that DIRECTV's payroll and assets proxy is not a reasonable approximation of its

IPA in South Carolina. Moreover, because the DOR presented evidence that conflicted with DIRECTV's evidence regarding the sourcing of the IPA, our substantial evidence standard of review dictates that we defer to the findings of the fact-finder. *See Risher*, 393 S.C. at 210, 712 S.E.2d at 435. Accordingly, the ALC properly determined DIRECTV did not satisfy its burden based on the ALC's findings that "rental and sales receipts received from South Carolina customers are properly included in the numerator of the gross receipts ratio."

Additionally, DIRECTV argues the ALC ignored the substantial factual and economic evidence it presented. DIRECTV points out the ALC held that "the delivery of the signal into the homes and onto the television sets of DIRECTV's customers" was DIRECTV's IPA despite stating that it did not adopt the DOR's view 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."

We find, however, that simply because the ALC did not agree with the DOR's apportionment method does not mean DIRECTV satisfied its burden of proof. DIRECTV was still required to prove that removing South Carolina subscription receipts from the numerator reasonably represented its business activity in South Carolina. *See Lockwood Greene*, 293 S.C. at 449, 361 S.E.2d at 347. Furthermore, we agree with the ALC that the outcome of the DOR's assessment—including 100% of South Carolina subscription receipts in the numerator of the gross receipts ratio—is correct, but like the ALC, we find this is not DIRECTV's sole IPA in South Carolina. Nevertheless, while other IPAs may have occurred within the state, sourcing 100% of DIRECTV's subscriptions to the numerator of the gross receipts ratio best represents DIRECTV's activity within South Carolina.

Mindful of our standard of review and in light of the evidence presented in the record, we affirm the ALC because its findings were not "clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record." S.C. Code Ann. § 1-23-610(B)(e) (Supp. 2016). Thus, we find DIRECTV failed to meet its burden of proof and show why its South Carolina subscription receipts should not be sourced to the numerator of the gross receipts ratio.

II. Substantial Underpayment Penalties

Last, DIRECTV argues substantial evidence does not support the ALC's finding that the DOR properly imposed substantial understatement penalties. We disagree.

Section 12-54-43(A) of the South Carolina Code (2014) applies civil penalties to every South Carolina tax law that requires a return unless otherwise provided. Section 12-54-155(A)(1) of the South Carolina Code (2014) addresses substantial underpayments of taxes and provides that "[i]f there is an underpayment attributable to . . . a substantial understatement of tax for a taxable period . . . , there must be added to the tax an amount equal to twenty-five percent of the amount of the underpayment." "[T]here is a substantial understatement of tax for a taxable period if the amount of the understatement for the taxable period exceeds the greater of ten percent of the tax required to be shown on the return for the taxable period or five thousand dollars." S.C. Code Ann. § 12-54-155(B)(1)(a) (2014). As applied, the term "understatement" means "the excess of the amount of the tax required to be shown on the return for the taxable period over the amount of the tax imposed which is shown on the return." S.C. Code Ann. § 12-54-155(B)(2)(a) (2014).

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 adds that "[a] penalty must not be imposed pursuant to this section with respect to a portion of an underpayment if it is shown that there was a reasonable cause for the portion and that the taxpayer acted in good faith with respect to the portion." S.C. Code Ann. § 12-54-155(D)(1) (2014).

The ALC found the DOR was correct in its understatement and interest calculations for the 2009 through 2011 tax years. It also found no substantial authority supported DIRECTV's treatment of its subscription receipts and DIRECTV's basis for its tax treatment of the subscription receipts was unreasonable. However, the ALC reduced the understatement penalty to 25% of the original penalty because DIRECTV acted with sufficient belief in bringing its claim regarding the portion of the understated tax amounts.

DIRECTV, however, asserts it presented substantial evidence and testimony demonstrating its treatment of subscription revenue was correct. DIRECTV also asserts it had substantial authority for its treatment of the subscription revenue based on the holdings in *Lockwood Greene* and *Mercury Motor*. Finally, DIRECTV claims it demonstrated good faith by attributing a portion of its subscription revenue to South Carolina for the 2011 tax year. We affirm the ALC's decision to assess underpayment penalties.

As previously discussed, the record contains substantial evidence demonstrating DIRECTV's use of the payroll and assets method was an unreasonable approximation of its IPA in South Carolina and did not reasonably represent DIRECTV's business activity in the state. See *Duke Energy Corp.*, 415 S.C. at 356, 782 S.E.2d at 592 ("[T]he statutory policy [for the apportionment statutes] is designed to apportion to South Carolina a fraction of the taxpayer's total income reasonably attributable to its business activity in this State." (quoting *Emerson Elec. Co.*, 395 S.C. at 485–86, 719 S.E.2d at 652)); *Covington Fabrics Corp.*, 264 S.C. at 66, 212 S.E.2d at 577 (explaining only a reasonable approximation is necessary for apportionment purposes). Moreover, DIRECTV's original tax returns filed for the 2006 through 2008 tax years sourced all of its subscription receipts in South Carolina to the numerator of the gross receipts ratio, but only after filing amended returns did DIRECTV rely on the holdings of *Lockwood Greene* and *Mercury Motor*, both of which were settled law by 2006. DIRECTV's reliance on these cases is unfounded because—regardless of their holding—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. See S.C. Code Ann. § 12-6-2210(B); *Duke Energy Corp.*, 415 S.C. at 356, 782 S.E.2d at 592; *Lockwood Greene*, 293 S.C. at 449, 361 S.E.2d at 347. Because DIRECTV's treatment of its income tax did not reasonably represent its business activity in the state, DIRECTV could not have relied on substantial authority for its treatment of the subscription receipts.

Finally, subsection 12-54-155(D)(1) requires the taxpayer to both act in good faith and have a reasonable cause for the portion of an underpayment before the removal of the penalty. In the instant case, the ALC reduced DIRECTV's penalty to 25% of the original amount because DIRECTV "acted with sufficient belief in bringing its claim regarding the portion of the understated tax amounts." While the ALC found DIRECTV acted in good faith, the ALC did not, however, find a reasonable cause for DIRECTV's underpayment. Therefore, in accordance with our standard of

review, we affirm the ALC's amended order regarding substantial understatement penalties.

CONCLUSION

Based on the foregoing, we find the ALC did not err by finding DIRECTV's IPA was the delivery of its signal into the homes and businesses of its customers and DIRECTV must source 100% of its subscription receipts from South Carolina customers to the numerator of the gross receipts ratio. We likewise affirm the ALC's assessment of underpayment penalties. Accordingly, the ALC's decision is

AFFIRMED.

KONDUROS, J., and LEE, A.J., concur.

The South Carolina Court of Appeals

DIRECTV, Inc. & Subsidiaries, Appellant,

v.

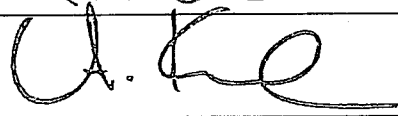
South Carolina Department of Revenue, Respondent.

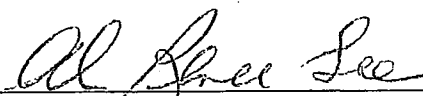
Appellate Case No. 2015-001509

ORDER

After careful consideration of the petition for rehearing, the Court is unable to discover that any material fact or principle of law has been either overlooked or disregarded, and hence, there is no basis for granting a rehearing. Accordingly, the petition for rehearing is denied.



J.


J.


A.J.

Columbia, South Carolina

cc:

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William J. Condon, Jr., Esquire
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Jason Phillip Luther, Esquire

FILED

January 11, 2018

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.

PETITION FOR REHEARING

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SEP 29 2017

SC Court of Appeals

Pursuant to Rule 221(a) of the South Carolina Appellate Court Rules, Appellant, DIRECTV, Inc. and its Subsidiaries ("DIRECTV"), hereby files this Petition for Rehearing of the above-referenced matter, which resulted in Opinion number 5513 filed August 30, 2017 (the "Opinion"). This Petition for Rehearing is based on the ground that the Court overlooked or misapprehended some factual or legal matters in this case and that the opinion conflicts with existing South Carolina law.

FACTUAL BACKGROUND

The central issue in this case is the proportion of DIRECTV's income producing activity that takes place in South Carolina versus the proportion that takes place in other states. The factual background needed to address this issue relates primarily to DIRECTV's business activities both within and without this State. The following is a brief summary of the evidence and the factual and expert testimony on these issues.

I. Factual Testimony and Evidence

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. It provides direct-to-home ("DTH") 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. 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 maintain any offices in South Carolina

during the Period at Issue,¹ 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.

The principal income producing activities of DIRECTV's business are: (1) content development (both original and acquired programming); (2) broadcast operations (including delivery of signal); (3) marketing and sales; and (4) customer service. Tr., R. pp. 174:17-23; 328:20- 329:16. The key factual testimony and evidence on these income producing activities (sometimes referred to in the testimony as "value drivers") will be briefly summarized below.

A. Content Development

DIRECTV's content development activities include the following:

- 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.
- Provision of premier sporting experience through exclusive arrangements with sports leagues such as the NFL, whereby DIRECTV subscribers are able to watch almost every NFL game. Tr., R. p. 177:18- 178:1; 180:7- 182:16
- Production 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

¹ The Period at Issue involves DIRECTV income tax periods ended December 31, 2006 through December 31, 2011 and license fee periods ended December 31, 2010 through December 31, 2012.

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.

- Development of original programming and negotiating agreements to acquire programming with sports leagues, movie studios, national broadcast networks, local television stations and cable networks. Tr., R. p. 183:9-11. Employees responsible for all content development (including production of original content and negotiation of agreements for acquired content) are located in California. Tr., R. p. 183:9-11.

B. Broadcast Operations

DIRECTV's broadcast operation activities include the following:

- Acquisition of content 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 and Colorado, which contain facilities to receive, process and transmit the programming content signals. Tr., R. pp. 190:23- 193:12.
- Collection of programming from local broadcast television stations through local collection facilities ("LCFs"), which are unmanned facilities throughout the country consisting of antennae and other receiving equipment. Tr., R. p. 186:3- 187:18. The LCFs roughly correspond to each of the 210 Nielsen assigned designated market areas ("DMAs") in the United States. *Id.* DIRECTV collects over 1500 local channels at each LCF. Tr., R. p. 186:3- 187:18. There are seven DMAs covering South Carolina, including the DMAs located in Charlotte, North Carolina, Augusta, Georgia, and Savannah, Georgia. Tr., R. p. 189:1-12. During the Period at Issue, only four LCFs were in South Carolina. Tr., R. pp. 187:19-25; 189:4-12.
- Gathering of content at the LCFs, which is then collected at uplink facilities owned by DIRECTV and located in Arizona, Georgia, Minnesota, New Hampshire, Virginia and 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. 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.

- Transmission via satellites of 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.

C. Marketing and Sales Activities

DIRECTV's marketing and sales activities include the following:

- Communication of DIRECTV's programming services to premium subscribers who want the highest-end video experience and/or a sports-centric experience. Tr., R. p. 201:11-22.
- Engagement in national advertising campaigns using the same production value and writing that usually go into feature length films. Tr., R. p. 201:23- 202:12. DIRECTV's campaigns are very distinctive to show its unique brand with the goal being to encourage customers to call and place an order for television services. Tr., R. p. 199:4-10 and p. 201:11-202:12. Employees performing marketing and sales activities are located in California. Tr., R. p. 176:14-20.

D. Customer Service Activities

DIRECTV's customer service activities include the following:

- Provision of the best possible customer care. Tr., R. p. 174:13-16. The call centers take customer orders and facilitate the installation of equipment. Tr., R. p. 200:6- 201:1. Both third party home service providers ("HSPs") and HSPs that were acquired by DIRECTV were used to install dishes and set-top boxes in customers' homes. Customer care activities are headquartered in California and organized from a center in Colorado. Tr., R. p. 198:17-21. During the Period at Issue, both internal call centers as well as third-party call centers provided customer service support, none of which were in South Carolina. Tr., R. p. 198:22- 200:5. Additionally, no DIRECTV "in-house" installers were operating in South Carolina during the Period at Issue. Tr., R. p. 482:20- 483:12-15.

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 from an economic perspective the income

producing activities of DIRECTV by analyzing its "primary value drivers;" and (2) determining the location of those income producing activities using a formula based on DIRECTV's payroll and assets. Cody Rpt., R. p. 743; Tr., R. p. 327:13-19.

1. Identify Income Producing Activities

To identify DIRECTV's income producing activities, 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 that there are four primary income producing activities, or in his terminology, "value drivers", that influence a customer's decision to subscribe to DIRECTV's programming services: (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 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; 351:3-9.²

a. Content Development

In discussing his conclusion that content is a primary value driver, 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

² 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.

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. He explained that content distinguishes DIRECTV in a highly competitive industry and allows it to charge premium prices. Tr., R. p. 332:8-18.

b. Marketing Services

Dr. Cody noted that DIRECTV’s marketing focus is to attracting new customers through increased investment in unique content and advanced broadcasting technology. Cody Rpt., R. p. 751. He found that DIRECTV’s marketing services are a primary value driver because those activities attract new customers and also produce additional income from existing customers who upgrade their accounts, as well as entice consumers to switch to DIRECTV or upgrade their accounts. *Id.*, 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.

c. Broadcast Operations

As Dr. Cody explained, DIRECTV’s broadcast operations are a value driver because acquiring customers is heavily dependent on being able to deploy “reliable technology to deliver content to a customer’s television set(s) or mobile device(s).” Cody Rpt., R. p. 750. 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 751.

d. Customer Service

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. He found that customer service also 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.

2. Identify Location of 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. 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 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 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. 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 income generating activities took place. Tr., R. p. 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. Tr., R. p. 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” 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 using the Payroll and Assets Method are summarized below:

Year	Portion of income producing activities occurring in SC: Payroll and Assets Method
2006	0.85 %
2007	0.86 %
2008	0.87 %
2009	0.87 %
2010	0.83 %
2011	0.81 %
Weighted Average	0.85 %

Cody Rpt., R. pp. 762-763.³

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 (“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 ;

³ Dr. Cody also examined the Payroll Method alone, which produced a lower portion of income producing activities occurring in South Carolina, but he believed that the Payroll and Assets Method was more “economically reasonable” as explained above. Tr., R. p. 354:3-6.

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.

LEGAL ARGUMENT

The Court appears to have overlooked or misapprehended some factual or legal matters in this case, and the opinion conflicts with existing South Carolina law. Thus, the Court should grant DIRECTV's request for a rehearing and/or issue a new opinion in the case.

I. THIS COURT'S CONCLUSION THAT DIRECTV'S INCOME PRODUCING ACTIVITIES CONSIST SOLELY OF THE DELIVERY OF THE SIGNAL INTO ITS CUSTOMERS' HOMES OVERLOOKS OR MISAPPREHENDS CERTAIN FACTUAL AND LEGAL ISSUES AND CONFLICTS WITH SOUTH CAROLINA LAW.

Even after noting the lack of evidence presented by the Department and acknowledging 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. This Court affirmed this untenable conclusion (Opinion at pp. 11-15), which gives no weight to DIRECTV's extensive income producing activities that occur out-of-state and no weight to the fact that the Department failed to present credible evidence to support its position as DIRECTV contends is required under *Cloyd*. See *infra* Legal Argument, § II. This conclusion overlooks or misapprehends certain factual and legal issues and conflicts with South Carolina law.

More specifically, the ALC rejected entirely the evidence presented by DIRECTV because it found that: (1) "Dr. Cody's proxies in identifying DIRECTV's income producing activities are so far from perfect as to be of no practical value;" (2) "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;” (3) the activities identified by DIRECTV are “‘preparatory’ activities [that] are too attenuated to the production of income to be considered ‘income producing activity’” as defined by the South Carolina Supreme Court’s decision in *Mercury Motor*; and (4) 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.

It is unclear whether this Court agreed with all of the ALC’s reasons; the Opinion appears to rely primarily on its conclusion that “substantial evidence supports the ALC’s findings that DIRECTV’s income producing activity is the delivery of signal to its customers nationwide, and accordingly, the delivery of the signal to South Carolina customers is represented by 100% of its South Carolina subscription receipts.” Opinion at p. 13. This Court further found that “DIRECTV’s reliance on *Lockwood Greene* for the development of its proxy method is unfounded” because although that case did apply a “place of activity” test, its facts are distinguishable as DIRECTV customers are paying “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” versus the engineering customers in *Lockwood Greene*, whom this Court concluded were paying for the time and expertise of the engineers. *Id.* Finally, this Court agreed with the ALC that under *Mercury Motor*, the activities of DIRECTV prior to delivery of the signal constituted preparatory activities that were too attenuated to be considered income producing activities. *Id.* at p. 15.

DIRECTV respectfully submits that the ALC and this Court’s conclusions are

erroneous as a matter of law because they (1) misinterpret 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); (2) misinterpret South Carolina case law (*i.e.* *Lockwood Greene* and *Mercury Motor*); and (3) overlook the substantial evidence showing that DIRECTV's income producing activity is not solely the delivery of the signal.

A. Legal Overview

When determining how to apportion a multi-state taxpayer's gross receipts, South Carolina law provides that receipts from services must be allocated to South Carolina if the entire income producing activity is within this State. However, "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). Thus, the statutory language establishes a two-step test: (1) identify the income producing activities; and (2) determine the portion of those activities performed in South Carolina. In other words, if a taxpayer's business activities producing income occur in multiple states, only the portion performed in South Carolina will be attributable to South Carolina.

The statute in question, S.C. Code Ann. § 12-6-2295(A)(5), is a codification of the *Lockwood Greene* decision. *Lockwood Greene* is the only published decision interpreting and applying S.C. Code Ann. § 12-6-2290 and its phrase "gross receipts from within this State." The issue in *Lockwood Greene* involved receipts of an engineering firm based in South Carolina but providing services to customers out-of-state. 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 payments (also referred to as a "market approach"), while the Department argued that the phrase should be determined based on the "place of activity," which looks to the place where the income producing activities are performed. *Lockwood Greene*, 293 S.C. at 448, 361 S.E.2d at 347. This 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. It reasoned that the customers were paying for the time and expertise of the highly trained engineers. *Id.*

B. This Court's Conclusion that DIRECTV's Income Producing Activity is Limited to the Delivery of the Signal into its Customers' Homes is Contrary to South Carolina Law, and No Substantial Evidence in the Record Supports this Conclusion.

This Court and the ALC's conclusion that the delivery of the signal is the only income-producing activity is contrary to South Carolina case law, including *Lockwood Greene*, *Mercury Motor* and S.C. Code Ann. § 12-6-2295(A)(5), and is clearly erroneous in light of the substantial evidence in the record.

1. This Court's Decision is Contrary to the Holding in *Lockwood Greene*.

The ALC and this Court rejected the "place of activity" test applied in *Lockwood Greene*. This Court explained its conclusion by saying that "the 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 at p. 13. It further stated that "DIRECTV 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 income producing activities, which among other things, produced or acquired the programming content that the subscribers received.

First, in making these statements, the Court appears to be overlooking the voluminous facts in the record that show that DIRECTV customers are not merely paying for a signal. If DIRECTV supplied a signal, but the only programming offered was, for example, cartoon channels, and no original programming, premium sports packages or unique offerings such as NFL Sunday Ticket or the Masters Experience, 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 activity of creating and/or securing these premium programming options, marketing them and providing customer support related thereto does not produce income is simply wrong and unsupported by any evidence in the record. This Court 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**" (Opinion at p. 13) (emphasis added)) and when it states that the delivery of the signal "allows customers to enjoy the **digital entertainment for which they pay DIRECTV.**" *Id.* (emphasis added).

Additionally, the fact that there may be some distinctions between engineers and DIRECTV does not mean that the "place of activity" test in *Lockwood Greene* should not be applied. Different companies may have different income producing activities, but *Lockwood Greene* requires the Court to examine all such activities. *Lockwood Greene* concluded that a

payroll factor was appropriate. In this case, as Dr. Cody explained, a payroll and assets method is more reasonable. *See supra* Factual Background, § II. What is not reasonable is ignoring income producing activities that do not take place in this State.

Moreover, even if *Lockwood Greene* could be distinguished, that does not end the inquiry. As previously stated, this decision was subsequently codified in S.C. Code Ann. § 12-6-2295(A)(5), which made it clear that all service providers are to be treated uniformly and have their income apportioned based on “income producing activity.” S.C. Code Ann. § 12-6-2295(A)(5). To the extent the question of how gross receipts of service providers were to be apportioned under S.C. Code Ann. § 12-6-2290 was unclear, the new statute set the record straight. *See infra* Legal Argument, § I(B)(3) (for full discussion of S.C. Code Ann. § 12-6-2295(A)(5)). All service providers are to have their gross receipts from South Carolina determined based on the proportion of income producing activities taking place in this State and those activities that take place out-of-state, i.e. the “place of activity” test and not based on the location of the payor, which is the result achieved by ignoring the out-of-state income producing activities.

2. This Court’s Decision is Contrary to the Holding in *Mercury Motor*.

This Court’s Opinion is also contrary to the law set forth in *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 135 S.E.2d 756 (1964), which does not say that income producing activity prior to payment is to be ignored. 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.

In the case at hand, 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*. Amended Final Order, R. pp. 43-44. This Court agreed and concluded that the primary income producing activity was the 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 at p. 15.

However, the distinction drawn by the ALC between "preparatory" activities and "incidental" and "primary" activities, both of which the ALC acknowledged are income producing activities, is 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 and this Court'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 delivery of DIRECTV's signal 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. As previously stated, if DIRECTV only offered cartoon programs and not all of its unique original programming, sports packages and other premium programming, it would obviously not be able to command a premium price for its subscription packages. The signal is clearly not the only thing South Carolina customers are paying for and the business activities that create and/or secure these premium programming options most certainly produce income. A holding that none of these activities produces income would be analogous to saying that a manufacturer that makes a product and delivers it to its customer only has one income producing activity- delivery of the product- because the customer only wants the end product. This is not the law in South Carolina.

3. This Court's Decision is Contrary to 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 of DIRECTV's customers, the ALC committed two errors of law in interpreting S.C. Code Ann. § 12-6-2295(A)(5) as requiring (1) an analysis of a customer's subjective intent and (2) a market-based sourcing methodology. It is unclear whether this Court considered the former conclusion (that a customer's subjective intent must be analyzed), but it clearly agreed on the latter conclusion (that market-based sourcing was required).

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: (1) 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;" (2) "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 (3) "[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. To the extent this Court's decision was based on this flawed interpretation of the ALC, this Court should reconsider these conclusions.

Second, although the ALC's holding (and this Court's affirmance of the same) is based on a purported identification of DIRECTV's income producing activity, the ALC and this Court, in reality, have done nothing more than interpret S.C. Code Ann. § 12-6-2295(A)(5) as requiring market based sourcing. Although couched in terms of "income producing activities," the ALC and this Court's holding will result 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, 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.”).⁴

The decision by the ALC and this Court that the end-product sale is the only income producing activity of an enterprise makes South Carolina a market based state, when the law, including *Mercury Motor* and S.C. Code Ann. § 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 industry has a substantial investment and employees in this State because the only gross receipts that will be attributed to South Carolina 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 this Court’s approach, only the receipts from sales to South Carolina customers would be captured.

In sum, by looking to the location of DIRECTV’s customer instead of the income producing activity of DIRECTV, the ALC and this Court have misinterpreted S.C. Code Ann. § 12-6-2295(A)(5) and thereby committed an error of law.

C. The Court’s Conclusion that DIRECTV’s Income Producing Activity is Limited to the Delivery of the Signal into the Homes of its Customers is Not Supported by Substantial Evidence, and this Court may have Overlooked the Evidence Presented by DIRECTV.

This Court’s conclusion 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

⁴ 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).

Carolina is not supported by substantial evidence. In arriving at this conclusion, this Court may have overlooked the evidence presented by DIRECTV on this issue.

First, DIRECTV presented substantial factual and economic evidence to establish its income producing activities. DIRECTV's Rule 30(b)(6) witness provided detailed testimony regarding the activities necessary to produce DIRECTV's 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 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. He then identified those income producing activities 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 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.

In contrast, the Department presented no evidence of DIRECTV's income producing activities. In fact, the record 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. Simply put, there is no credible evidence in the record that DIRECTV's *only* income producing activity is the delivery of the signal into customers' homes as the ALC so noted. Amended Final Order, R. p. 40 (stating that the ALC "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" 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).

In addition, even if delivery of the signal was the only income producing activity, which DIRECTV asserts is not the case, the ALC and this Court's finding that the delivery of the signal into the homes of 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). This Court appears to have overlooked this uncontested factual testimony.

In sum, this Court's conclusion that DIRECTV's only income producing activity is the delivery of the signal into the homes of customers and that this activity occurs solely in South Carolina is not supported by substantial evidence and, in fact, is entirely inconsistent with the evidence in the record. DIRECTV respectfully requests that this Court consider this evidence.

D. This Court's Conclusion that DIRECTV Failed to Establish the Portion of its Income Producing Activities Conducted in South Carolina is Contrary to South Carolina Law and is Not Supported by Substantial Evidence, and this Court may have Misapprehended or Overlooked the Evidence Presented by DIRECTV in Reaching this Conclusion.

This Court's conclusion that DIRECTV failed to establish the portion of its income producing activities conducted in South Carolina is contrary to S.C. Code Ann. § 12-6-2295(A)(5) and is not supported by substantial evidence. In arriving at this conclusion, this Court may have misapprehended or overlooked the evidence presented by DIRECTV on this issue. At the trial level, 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 (1) "the approach proposed by Dr. Cody unduly emphasizes what amounts to 'costs of performance'" and (2) 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." Amended Final Order, R. p. 47.

This Court makes no mention of any concerns that Dr. Cody's approach emphasizes "costs of performance" (which it does not as it looks to both payroll and assets). It simply concludes that Dr. Cody's method "is not a reasonable approximation of DIRECTV's business activity in South Carolina. Opinion at pp. 13-14. More specifically, this 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, DIRECTV only had two employees in South Carolina 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 income producing activity language in S.C. Code Ann. § 12-6-2295(A)(5) is to measure the income producing activities 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 the Court finds this to be inequitable in some way, then that is a problem that should be addressed by the Legislature, which has chosen to measure business activity by looking at income producing activity.

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 DIRECTV’s income producing activities: (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 income producing activities,” and that payroll and asset proxies also reflect the fundamental economics of DIRECTV’s operations. Tr., R. pp. 352:13-17; 619:14-21.⁵ His method is also consistent

⁵ See also DIRECTV’s Amended Final Brief at pp. 35-37 (discussing history of allocation and apportionment law in the United States, 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

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.” *Id.* at 449, 361 S.E.2d at 347 (emphasis added).

However, Dr. Cody decided not to place primary reliance on the payroll 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 also took assets into consideration (the “Payroll and Assets Method”) as tangible assets such as the LCFs, set-top boxes, and 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, adopted by the ALC and affirmed by this Court, 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.

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

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)).

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.

II. THIS COURT'S CONCLUSIONS REGARDING THE BURDEN OF PROOF CONFLICT WITH EXISTING SOUTH CAROLINA LAW AND MISAPPREHEND OR OVERLOOK THE EVIDENCE PRESENTED BY DIRECTV.

This Court held that the burden of proof set forth in *Cloyd* does not apply to cases involving corporate income taxes or apportionment cases and that even if it applied, DIRECTV did not meet its burden. Opinion at pp. 16-18. These conclusions conflict with existing South Carolina law and misapprehend or overlook the evidence presented by DIRECTV on this issue.

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 & Envtl. Control*, 340 S.C. 118, 132, 530 S.E.2d 643, 651 (Ct. App. 2000) (explaining that "the complaining party bears the burden of proof"); see also *DISH DBS Corp. v. S.C. Dep't of Revenue*, No. 14-ALJ-17-0285-CC (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*).

This Court 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 at p. 17. It thus found that “because the facts of *Cloyd* are far too 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. A corporate taxpayer should be equally entitled to appropriate relief.

This Court 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 income producing activities 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.” Opinion at p. 17. 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. 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).

Additionally, DIRECTV presented substantial factual and economic evidence regarding its income producing activities and the location from which those activities were conducted, and the Department presented no credible evidence as to DIRECTV’s income producing activities, including that it made no attempt to even determine them and based the assessment solely on customer location and that its tax policy expert testified that the Department was “taking a market state approach to the attribution of receipts.” *See supra* Legal Argument, § I(C) at pp. 20-21 and (D) at pp. 23-24.

Both the ALC and this Court appear to have 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 and grant the appropriate relief as required by *Cloyd*. *See Cloyd*, 295 S.C. 86, 367 S.E.2d 171.

III. THIS COURT’S CONCLUSION THAT THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS PROPER IS CONTRARY TO SOUTH CAROLINA LAW AND IS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE.

This Court’s conclusion that the imposition of substantial understatement penalties was proper is contrary to South Carolina law and is not supported by substantial evidence.

As this Court acknowledged, under South Carolina law, 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).

This Court agreed with the ALC's finding that a substantial understatement penalty was owed despite the ALC's finding that "DIRECTV acted in good faith with respect to bringing its claim regarding the portions of the understated tax amounts" and its finding that it "acted with sufficient belief" 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." *See* Opinion at p. 20; Amended Final Order, R. p. 51 (emphasis in original). This Court also agreed with the ALC's explanation for this conclusion, i.e. that DIRECTV did not have substantial authority for its position based on the holdings of *Lockwood Greene* and *Mercury Motor*. The primary rationale given for this ruling appears to be that (1) DIRECTV initially filed returns sourcing its receipts as the Department claims it should and only relied on *Lockwood Greene* and *Mercury Motor* (which pre-date DIRECTV's original filings) in its amended returns; and (2) that "**regardless of their holding**" (i.e. the holdings 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." *Id.* (emphasis added).

First, it is not disputed that a taxpayer has a right to file an amended return and should

do so once it is aware that the original return contains inaccurate or incomplete information. No negative inference should be made by the Court based on the taxpayer amending its returns.

Moreover, the relevant apportionment statutes and the holdings of both *Lockwood Green* and *Mercury Motor* cannot be ignored when evaluating whether the penalty should be upheld. As discussed in prior briefing before this Court and above, existing South Carolina law supports DIRECTV's position in every respect, and thus, DIRECTV had substantial authority for its position and there was a reasonable basis for its tax treatment of the subscription receipts.

Section 12-6-2290(A)(5) of the South Carolina Code, which this Court does not mention in its discussion of the penalty, codified *Lockwood Greene* (which outlined a "place of activity" test to determine "income producing activity" and endorsed a method based on a payroll proxy) and speaks to "income producing activity." *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 net income, and the Court did not consider the "final act" of delivering the package to the customer's residence in that case to be the primary income producing activity. Neither case focuses on the location of the customer (*i.e.* market based sourcing), which some states have adopted by statute. Moreover, the Department has no published guidance to alert taxpayers to any policy that is interpreting the existing law, and even its own auditor was not aware of such a policy. If South Carolina had adopted market based sourcing or the Department had published guidelines that set forth its position, then it would be clear to taxpayers how their income should be apportioned and failure to follow such guidance could potentially justify a penalty against a taxpayer (although no penalty would be justified if the policy was contrary to South Carolina law). But where a statute and the existing case law, by their plain

words, state one view, and the court construes those words to mean the opposite view, it is simply incredible that a penalty could be imposed. Furthermore, this Court's opinion seems to say that taxpayers should ignore the specific language of the statute and the holdings of binding precedent based on a more general statement regarding the overarching policy of apportionment statutes being "to apportion corporate income upon a basis that reasonably represents the corporation's business activity in South Carolina." Opinion at p. 20. However, the more specific language of the statute- "income producing activity" and the holdings of existing case law (i.e. *Lockwood Greene* outlining "place of activity" test and endorsing method based on a payroll proxy and *Mercury Motor* stating that each activity contributed to taxpayer's earnings and net income and that "final act" of delivering package to customer's residence was not the primary income producing activity), which tells taxpayers more specifically how to reach that policy goal, cannot be ignored and taxpayers are entitled to rely upon them.

Moreover, the ALC expressly found that the Department's method was *incorrect* and that DIRECTV did, in fact, have income producing activities outside of South Carolina. If a taxpayer protesting an assessment deemed erroneous by the lower court and proposing an alternative 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.

Based on the above, the substantial understatement penalty should be abated in its entirety.

CONCLUSION

As set forth above, DIRECTV respectfully requests that this Court grant its Petition for Rehearing as the Court's Opinion in this matter overlooked or misapprehended several factual and legal matters and also conflicts with existing state law, and thus, a rehearing and/or entry of a new Opinion is warranted.

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Charleston, South Carolina
September 29, 2017

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2015-001509

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: PETITION FOR REHEARING

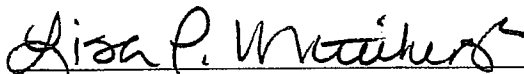
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SC Court of Appeals



Lisa P. Whitehurst, Administrative Assistant

September 29, 2017

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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

CASE NO. 14-ALJ-17-0158-CC
Appellant Case No. 2015-001509

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

v.

South Carolina Department of Revenue, ...Respondent.

RESPONDENT'S RETURN TO APPELLANT'S PETITION FOR REHEARING

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Pursuant to Rule 240(e), SCACR, Respondent South Carolina Department of Revenue (Department) files this Return to Appellant DIRECTV, Inc. and its Subsidiaries' (DIRECTV) Petition for Rehearing (Petition). As explained below, DIRECTV is not entitled to a rehearing of Opinion No. 5513 (Opinion) because it does not identify any substantive points of fact or law in the Opinion that the Court overlooked or misapprehended. Instead, DIRECTV repeats arguments previously presented to and considered by this Court. Thus, DIRECTV's Petition should be denied.

FACTUAL BACKGROUND

As confirmed in the Opinion, this Court is well-informed of the facts in this matter. However, the Department incorporates by reference its Statement of the Facts contained in the Amended Final Brief of Respondent. (Resp't Br. pp. 3-10.)

ARGUMENTS

Rule 221(a), SCACR, requires a Petition for Rehearing to "state with particularity the points supposed to have been overlooked or misapprehended by the court." Further, "[t]he purpose of a petition for rehearing is not to present points which lawyers for the losing parties have overlooked or misapprehended, nor is it the purpose of the petition for rehearing to have the case tried in the appellate court a second time." Kennedy v. S.C. Retirement Sys., 349 S.C. 531, 532, 564 S.E.2d 322, 322 (2001).

In its Petition, DIRECTV contends this Court overlooked or misapprehended substantial evidence and misinterpreted existing law in three primary ways: (1) by concluding DIRECTV's income producing activity (IPA) in this matter is the delivery of the signal into South Carolina customers' homes; (2) by concluding DIRECTV failed to meet its burden of proof; and (3) by

affirming the imposition of substantial understatement penalties in this matter. (Petition, pp. 11-12, 27, 30.)

Each one of these arguments was thoroughly briefed and argued before this Court, and this Court directly addressed and rejected these exact arguments.

Moreover, DIRECTV's Petition is premised upon three flawed positions. First, DIRECTV's interpretation of section 12-6-2295(A)(5) excludes determining the location of the IPA instead of identifying, locating, and then measuring DIRECTV's IPA in South Carolina. DIRECTV leaps to measuring the IPA because it uses cost elements (i.e. payroll and assets).

Second, section 12-6-2295(A)(5) did not codify the holding of Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). As discussed below, Lockwood Greene stands solely for the proposition that the Department may source revenues of service providers such as engineering, law, and accounting firms to the place of activity, but may source income from other service industries, such as finance companies and media broadcasters, to the location of the borrower and the advertisers, respectively. Third, this Court and the ALC did not ignore the evidence presented by DIRECTV. Rather, the ALC and this Court found DIRECTV's evidence unpersuasive because it did not focus on the transaction that created the gross receipts in South Carolina.¹

¹The Department would respectfully refer the Court to the Department's Amended Final Brief, which contains a more complete analysis of the issues outlined below, including the record evidence and relevant case law supporting the ALC's decision.

I. THE COURT CORRECTLY DISREGARDED DIRECTV'S INCOME ANTICIPATORY ACTIVITIES AND PROPERTY FOCUSED ON DIRECTV'S INCOME PRODUCING ACTIVITIES AS REQUIRED BY SOUTH CAROLINA LAW.

A. Lockwood Greene did not adopt a "Place of Activity" test for all service providers.

In its Petition, DIRECTV asserts that this Court's decision is contrary to the Court's own holding in Lockwood Greene. (Petition, p. 13.) DIRECTV's misinterprets the Lockwood Greene decision to stand for the proposition that the Income Producing Activity (IPA) for all service providers' must be sourced (i.e., measured) using a "place of activity" test (or, "payroll and assets" proxy) under the second prong of section 12-6-2295(A)(5).²

Contrary to DIRECTV's assertion, S.C. Code Ann. § 12-6-2295(A)(5) did not codify Lockwood Greene by imposing or endorsing a method for apportioning service-related income in South Carolina based on payroll and/or property proxies for *all* multi-state service-providing taxpayers. Rather, the Lockwood Greene court acknowledged and approved of the Department's use of different methods when addressing different service industries based on the activities of the companies in each industry. Lockwood Greene, 293 S.C. at 450, 361 S.E.2d at 348.

This Court correctly rejected DIRECTV's interpretation of 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 subscriptions to its programming packages." (Opinion, p. 13.) In short, DIRECTV's use of a payroll and assets proxy (i.e., cost elements) is both unnecessary (because the IPA related to the subscription receipts from

²Again, DIRECTV jumps to measuring the IPA without first locating the IPA after it has been identified. Further, the "place of activity" test does not mandate that a payroll and/or assets proxy be used to measure the IPA.

South Carolina customers occurred entirely within South Carolina) and unreasonable (because DIRECTV only has two employees in the state, and its only assets in South Carolina are four collection facilities and the equipment its subscribes lease or purchase). (Opinion, p. 14). Therefore, the actual subscription receipts received by DIRECTV from its South Carolina customers is the best, most accurate, and most transparent way to measure “the proportion of . . . business carried on within this State” by DIRECTV. S.C. Code Ann. § 12-6-2210(B) (2014). Thus, this Court’s decision is in complete accord with the Lockwood Greene decision when determining a service provider’s IPAs in South Carolina.

B. This Court properly interpreted and applied Mercury Motor.

In its Petition, DIRECTV asserts that this Court’s decision is contrary to the holding in Mercury Motor Express, Inc. v. South Carolina Tax Commission, 244 S.C. 134, 141, 135 S.E.2d 756, 759 (1964). (Petition, p. 15.) DIRECTV misinterprets Mercury Motor to require a broad construction of what constitutes an IPA, which would include any “incidental” activities. This assertion is simply incorrect.

Section 12-6-2295(A)(5) “requires activities that actually produce income.” (Opinion, p. 15.) Under this definition, not all activities of a taxpayer are IPAs—even if such activities are important to the overall service. Only IPAs should be used to source gross receipts to South Carolina.

Accordingly, in Mercury Motor the Supreme Court distinguished between a series of activities “incidental to the production of income” and the activity (hauling of freight) that was actually an “income producing activity.” Mercury Motor at 141, 135 S.E.2d at 759. The Supreme Court’s use of the phrase “incidental to the production of income” to describe the taxpayer’s

activities does not mean that each of those activities are also IPAs that should be used to source gross receipts to South Carolina.

Thus, this Court's analysis of IPAs is consistent with Mercury Motor. DIRECTV's delivery of its signal into the homes and onto the television sets of its South Carolina customers is the IPA that generated its South Carolina subscription receipts. Although DIRECTV performed many important activities prior to delivering the signal into subscribers' homes—such as content acquisition and development, satellite launches, and broadcasting and transmitting—those activities “are ‘too attenuated’ to be considered income-producing for the purposes of section 12-6-2295(A)(5).” (Opinion, p. 15.) Even DIRECTV's own expert, Dr. Cody, admitted that DIRECTV's intermediate activities are distinct from its IPAs. (R. pp. 538–41.)

C. S.C. Code Ann. § 12-6-2295(A)(5) does not require and the Department did not use market-based sourcing methodology.

In its Petition, DIRECTV asserts that this Court agreed with the ALC's misinterpretation of the language of section 12-6-2295(A)(5) to require “(i) an analysis of a customer's subjective intent and (ii) a market-based sourcing methodology.” (Petition, p. 19.)

First, although the subjective intent of the customer may be relevant to the identification of the IPA, this Court and the ALC correctly focused on the activities of DIRECTV. For example, this Court determined that “DIRECTV's IPA is the delivery of its programming signal to its customers across the country and in South Carolina.” (Opinion, p. 14.) Further, both this Court and the ALC closely analyzed Dr. Cody's “value drivers” and concluded that they consisted of pre-order and other preparatory activities, not IPAs. (Opinion, p. 15.)

This Court also specifically compared the activities of DIRECTV to the activities of the taxpayer in Lockwood Greene and concluded that some of DIRECTV's activities were in fact

“preparatory” rather than IPA as required by section 12-6-2295(A)(5). (Opinion, p. 13.) Nevertheless, several examples show that the subjective intent of the customer is relevant to the IPA: (a) the Lockwood Greene court referred to what the customer was paying for when determining the sourcing of Lockwood’s gross receipts (Lockwood Greene, 293 S.C. at 449, 361 S.E.2d at 347); (b) Dr. Cody recognized that the Lockwood Green court was “looking at what the customers of the engineering firm were actually paying for,” (R. p. 351); and (c) Dr. Harrison testified that a customer wants the programming delivered in his home and that is what creates the income. (R. p. 529.)

Second, this Court did not interpret section 12-6-2295(A)(5) as imposing a “market-based sourcing” method, and it properly interpreted and applied the IPA language of section 12-6-2295(A)(5). This Court applied section 12-6-2295(A)(5) by examining the activity and where that IPA occurred – not the location of the customer. Here, the IPA just happened to occur in the homes of its South Carolina customers.

In fact, this Court affirmed the ALC’s decision, which made numerous statements throughout its Amended Final Order that demonstrate it properly sought to identify, locate, and measure the IPA pursuant to section 12-6-2295(A)(5):

At the outset, the Court disagrees that DIRECTV has sufficiently identified its activities to be sourced. (R. p. 44.)

In sum, the payroll-and-assets method of Dr. Cody does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina (R. p. 47.)

For instance, it is possible that advertising performed within or without South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected approximately how much of its advertising was directed at

South Carolina and what impact such advertising had on revenue generated in South Carolina. (R. pp. 19-20.)

Further, contrary to a market-based sourcing method,³ the Department's witnesses testified that the Department examines the specific activities of each applicable service industry to determine where the taxpayer's income should be sourced. (R. pp. 433-434, 456, 464-468.) Finally, under this Court's interpretation of "income-producing activity" in section 12-6-2295(A)(5), sourcing revenue to the location of the taxpayer's customer would not occur in every instance. See R. pp. 434, 461-462 (Department witnesses testifying that the Department would source the income received by an engineering firm to the place where the services were performed, i.e., the location of the engineering firm); see also Lockwood Greene, at 448-50, 361 S.E.2d at 347-48 (stating that gross receipts from within the state for an engineering firm were sourced to the location where the services that generate the income are performed [i.e., at the office of the engineer]). Accordingly, this Court did not err in determining the IPA under section 12-6-2295(A)(5) and did not interpret such section to require market-based sourcing.

D. Substantial evidence in the record supports this Court's decision that delivery of the signal into the customer's home and onto the customer's television is the true IPA.

In its Petition, DIRECTV claims this Court may have overlooked the evidence presented by DIRECTV regarding its income producing activities. To the contrary, the record contains substantial evidence to support this Court's conclusion (consistent with the ALC's finding) that DIRECTV's IPA is the delivery of signal to its customers nationwide, and accordingly that the

³Section 12-6-2295(A)(5) is not like market-based sourcing. Under section 12-6-2295(A)(5), the IPA must be identified, located, and then measured. Market-based sourcing does not use income-producing language, and it looks solely to the customer's location when sourcing a taxpayer's income.

delivery of signal to South Carolina customers is represented by 100% of its South Carolina subscription receipts. (Order, p. 13) (affirming the ALC because “its decision is not affected by an error of law and is supported by substantial evidence”).

For example, the ALC considered the testimony of Dr. Harrison, who testified that it is “the provision of television services in your home” that generates the subscription receipts for DIRECTV, not the pre-order and other preparatory activities which are merely “prior, secondary, intermediate activities.” (R. pp. 527, 529, 540.) The ALC also considered the testimony of Mr. Goswitz, DIRECTV’s vice president of space, communications, and video, testified about DIRECTV’s operations. He repeatedly referenced “content and broadcast of signals,” “infrastructure” related to content and transmission, and “production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites.” (R. pp. 33-35.) He then admitted that the activities DIRECTV performs at its customers’ homes are the IPAs by stating that DIRECTV provides “direct to home” video services and must install a satellite dish, a coaxial cable, and a set-top box at each customer’s home and connect the set-top box to each customer’s television. (R. pp. 172, 196–97.)

In addition, the ALC considered the testimony of Dr. Cody, who was engaged by DIRECTV “to identify from an economic perspective the income-producing activities of” DIRECTV. (R. pp. 327.) Dr. Cody testified regarding the four so-called “value drivers” that could identify DIRECTV’s IPA, including (1) content and programming, (2) acquisition and distribution of programming content, (3) marketing and sales of its service, and (4) customer service. (R. pp. 329.) The thorough analysis contained in the Amended Order demonstrates that the ALC openly considered Dr. Cody’s testimony, but ultimately found that Dr. Cody’s payroll and asset proxy

method for identifying DIRECTV's IPAs were "of no practical value," that DIRECTV "did not sufficiently explain the effect of [Dr. Cody's] value drivers on income production in this State," and that DIRECTV's evidence was "just too nebulous" to make the connection between Dr. Cody's value drivers and IPAs. (R. p. 41.) The basic statement made by the ALC that the testimony was unpersuasive clearly indicates this Court considered the testimony given by Dr. Cody and was enough to establish the ALC properly considered the evidence in the record. (R. pp. 41, 47.)

Similarly, this Court's Opinion illustrates that it thoroughly considered the evidence presented at the ALC and did not overlook or misapprehend the evidence contained in the record. In fact, this Court specifically addressed DIRECTV's arguments but, like the ALC found those arguments unpersuasive. (Opinion, p. 13-15.) Because the ALC heard and considered extensive evidence from Dr. Cody, Mr. Goswitz, Dr. Harrison, and the Department's fact witnesses, and because the ALC found that DIRECTV failed to sufficiently prove its alleged IPAs, the ALC made a decision regarding what DIRECTV's IPA was and such decision was supported by substantial evidence in the record. Thus, this Court correctly concluded that sufficient evidence in the record exists to affirm the ALC's decision.

II. DIRECTV's FAILURE TO MEET ITS BURDEN OF PROOF DOES NOT MERIT REHEARING ON THIS MATTER.

This Court properly concluded that DIRECTV failed to meet its burden of proof because DIRECTV failed to prove by a preponderance of the evidence that (a) DIRECTV's income-producing activity extended beyond the delivery of the signal into the homes and onto the television screens of its South Carolina customers, and (b) that less than 100% of the South

Carolina subscription receipts should be sourced to South Carolina.⁴ (Opinion, p. 15). The ALC made specific findings of fact that DIRECTV's evidence was insufficient and not credible. (R. pp. 25-26, 41-42, 49-50). Thus, this Court correctly affirmed the ALC's decision.

Nevertheless, DIRECTV cites to a property tax case, Cloyd v. Mabry, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988), in support of its assertion that the ALC should have dismissed the assessment against DIRECTV. (Petition, pp. 27-30.) Even if DIRECTV could somehow establish that it met its burden of proof in this matter, DIRECTV's asserted appropriate remedy—dismissal of the determination—is improper.

Cloyd was decided in the context of a property tax matter and not with regard to corporate income tax. Cloyd, at 87, 367 S.E.2d at 172. Moreover, the Cloyd court did not conclude that "appropriate relief" included absolving the taxpayer of any property tax liability through dismissal of the assessment. Id. at 88-89, 367 S.E.2d at 173. The mere fact the ALC suggested that there may be income producing activity in South Carolina in addition to the delivery of the signal into subscribers' homes and onto their televisions does not entitle DIRECTV to a complete abatement of the assessment in this case. DIRECTV "was still required to prove that removing South Carolina subscription receipts from the numerator reasonably represented its business activity in South Carolina." (Opinion, p. 15.) Thus, dismissal of the case is not the "appropriate relief."

⁴DIRECTV continuously asserts that the Department presented no credible evidence on the identity or location of DIRECTV's income-producing activities. However, as noted by the ALC, "whether the evidence was presented by the Department or DIRECTV, the evidence as set forth in the findings, established the income-producing activities that occurred in this State." (R. p. 35.)

III. THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS APPROPRIATE AS NO SUBSTANTIAL AUTHORITY SUPPORTS DIRECTV'S POSITION AND THE BASIS OF DIRECTV'S TAX TREATMENT OF THE SUBSCRIPTION RECEIPTS WAS UNREASONABLE.

This Court's finding that the imposition of substantial understatement penalties was proper is supported by substantial evidence in the record. Nonetheless, DIRECTV claims "existing South Carolina law support's DIRECTV's position in every respect, and thus, DIRECT had substantial authority for its position and there was a reasonable basis for its tax treatment of the subscription receipts." (Petition, p. 32.)

In many ways, DIRECTV did not properly apply South Carolina statutory and case law. As noted by this Court, "the record contains substantial evidence demonstrating DIRECTV's use of the payroll and assets method was an unreasonable approximation of its IPAs in South Carolina and did not reasonably represent DIRECTV's business activity in the state." (Opinion, p. 20.) Moreover, as discussed above, the decisions of Lockwood Greene and Mercury Motor do not stand for the proposition upon which DIRECTV relies.

As discussed above, the Lockwood Greene court recognized that the Department may source revenues of service providers such as engineering, law, and accounting firms to the place of activity, while sourcing income from other service industries, such as finance companies and media broadcasters, to the location of the borrower and the advertisers, respectively. As noted by this Court, DIRECTV is not like the taxpayer in Lockwood Greene. (Opinion, p. 13.) More importantly, Lockwood Greene does not explicitly or implicitly direct taxpayers such as DIRECTV to file its corporate tax returns based on a payroll or similar method like Dr. Cody's payroll and assets method.

Next, DIRECTV claims that it had substantial authority for its position by relying upon the decision of Mercury Motor. Specifically, DIRECTV argues that Mercury “did not consider the ‘final’ act of delivering the package to the customer’s residence in that case to be the primary income producing activity.” (Petition, p. 32.) This is in fact what the Mercury court did by narrowing the IPA to “the hauling of freight . . . through and over the highways of the State of South Carolina. . . .” Mercury, 244 S.C. at 141, 135 S.E.2d at 759. As this Court noted, “DIRECTV’s Mercury Motor argument [is] unpersuasive . . . as the ‘preparatory’ activities that DIRECTV engages in for the production of its programming and marketing are not an IPA for the purposes of section 12-6-2295(A)(5).” (Order, p. 15.) Accordingly, from the plain reading of Mercury Motor, DIRECTV’s reliance upon a taxpayer’s total business activities to justify sourcing South Carolina-based subscription receipts to other states is not proper.

DIRECTV next claims this Court erred in imposing penalties because this Court ignored “the specific language of the statute” in favor of “a more general statement regarding the overarching policy of apportionment statutes being ‘to apportion corporate income upon a basis that reasonably represents the corporation’s business activity in South Carolina.’” (Petition, p. 33; Order, p. 20.) As discussed above, this Court, applying section 12-6-2295(A)(5), specifically compared the activities of DIRECTV to the activities of the taxpayer in Lockwood Greene and concluded that some of DIRECTV’s activities were in fact ‘preparatory,’ similar to the taxpayer in Mercury Motor, rather than IPA as required by section 12-6-2295(A)(5). This Court, in complete recognition of section 12-6-2295(A)(5), considered the activities of DIRECTV to determine its IPA in South Carolina and concluded that DIRECTV’s IPA in this matter “is the

delivery of its programming signal to its customers across the country and in South Carolina. (Order, p. 14.)

Further, DIRECTV's assertion that this Court relied upon an "overarching policy of apportionment statutes" is misplaced. While South Carolina courts have concluded that the goal of apportionment statutes is to apportion corporate income "upon a basis that reasonably represents the corporation's business activity in South Carolina," this "policy" has been codified in South Carolina:

If a taxpayer is transacting or conducting business partly within and partly without this State, the South Carolina income tax is imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State.

S.C. Code Ann. § 12-6-2210(B) (2014) (emphasis added). Despite DIRECTV's assertion, this Court did not rely upon a "policy" in reaching its decision; rather, this Court applied S.C. Code Ann. §§ 12-6-2210(B), 12-6-2290 and 12-6-2295(A)(5) to affirm the ALC's decision that DIRECTV's income producing activity in this matter is "the delivery of its programming signal to its customers across the country and in South Carolina." (Order, p. 14.)

DIRECTV also claims that this Court erred in affirming the ALC's imposition of penalties because "the ALC expressly found that the Department's method was incorrect" DIRECTV suggests that by protesting the Department's decision and "proposing an alternative method that closely tracks the existing law," penalties should be abated in its entirety. (Petition, p. 33.) DIRECTV misapprehends the decision of this Court and the ALC:

We agree with the ALC that the outcome of the DOR's assessment – including 100% of South Carolina subscription receipts in the numerator of the gross receipts ratio – is correct, but like the ALC, we find this is not DIRECTV's sole IPA in South Carolina. Nevertheless, while other IPAs may have occurred within the state,

sourcing 100% of DIRECTV's subscriptions to the numerator of the gross receipts ratio best represents DIRECTV's activity within South Carolina.

(Opinion, p. 18.) As discussed above, DIRECTV failed to prove whether other IPAs may have occurred within South Carolina.

Finally, it is not appropriate to propose an alternative method in this matter that "closely tracks the existing law" in South Carolina. DIRECTV does not dispute that it is a service provider and section 12-6-2290 requires service providers, like DIRECTV, to use the single gross-receipts ratio, as supplemented by section 12-6-2295(A)(5). There is simply no need to propose an alternative method in this matter.⁵

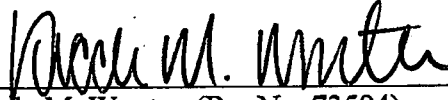
CONCLUSION

For the reasons set forth above, DIRECTV's Petition for Rehearing should be denied.

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⁵To the extent DIRECTV now asserts that it was proper for DIRECTV to propose an alternative method in this matter that "closely tracks the existing law" in South Carolina, the parties filed stipulations with the ALC confirming that "the sole issues presented for determination with respect to the sourcing of Petitioner's Subscription Revenue is how that revenue should be sourced under Section 12-6-2290." (R. pp. 950-952.) Further, the parties clarified that an alternative apportionment method pursuant to S.C. Code Ann. § 12-6-2320 was not used or should not be used to source DIRECTV's subscription receipts in this matter. Id.

Respectfully Submitted,



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THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

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OCT 16 2017

SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

CASE NO. 14-ALJ-17-0158-CC
Appellant Case No. 2015-001509

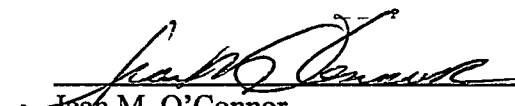
DIRECTV, Inc. & Subsidiaries, ...Appellant,

.v.

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

PROOF OF SERVICE

I, Jean M. O'Connor, hereby certify that I have caused to be mailed, a copy of the South Carolina Department of Revenue's Return to Appellant's Petition for Rehearing regarding the above-referenced case, by depositing the same in the United States Mail, postage prepaid, on October 16, 2017, addressed to the attorneys of record, John. C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, Nelson Mullins, PO Box 1806, Charleston, SC 29402, and by hand delivery to the Court of Appeals, 1205 Pendleton St., Columbia, SC 29201.


Jean M. O'Connor

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

RECEIVED

OCT 30 2017

APPEAL FROM THE ADMINISTRATIVE LAW COURT

SC Court of Appeals

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.

APPELLANT'S REPLY IN SUPPORT OF PETITION FOR REHEARING

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*Attorneys for Appellant DIRECTV, Inc. and
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Appellant, DIRECTV, Inc. and its Subsidiaries ("DIRECTV"), respectfully submits this Reply in Support of its Petition for Rehearing ("Petition") and in response to Respondent South Carolina Department of Revenue's ("SCDOR") Return to DIRECTV's Petition ("SCDOR's Return"). For the reasons presented in the Petition and below, the Court should grant the Petition.

ARGUMENT

SCDOR's Return states that DIRECTV's Petition is based on "three flawed positions." SCDOR Return at p. 3. The three alleged "flaws" are (1) DIRECTV's interpretation of S.C. Code Ann. § 12-6-2295(A)(5) because it "excludes determining the location of the IPA" (i.e. "income producing activity") "instead of identifying, locating, and then measuring DIRECTV's IPA in South Carolina; (2) DIRECTV's interpretation of S.C. Code Ann. § 12-6-2295(A)(5) as codifying the holding of *Lockwood Greene Engineers, Inc. v. South Carolina Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987); and (3) DIRECTV's failure to "focus on the transaction that created the gross receipts in South Carolina" which SCDOR says led the ALC and this Court to find DIRECTV's evidence unpersuasive (versus that it failed to consider this evidence). *Id.* As will be discussed in more detail below, these assertions are either inaccurate or do not justify a finding in favor of SCDOR. In addition, SCDOR's Return, although denying it, nevertheless, is simply advocating that this Court adopt an approach that is tantamount to a market approach (a/k/a "location of the payor" or "origin of the payment") despite clear statutory language to the contrary. The Return also continues to argue that the penalty was properly upheld when there is no justifiable basis to support one being imposed in this case.

I. DIRECTV Located the Relevant Income Producing Activities.

SCDOR's first assertion in its Return is that DIRECTV failed to locate its income

producing activity ("IPA"). This is not correct, and, respectfully, SCDOR's assertion in this regard reflects a misunderstanding of the apportionment statute. S.C. Code Ann. § 12-6-2295(A)(5) 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 within this State.**

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

Both parties and the Administrative Law Court ("ALC") agree that DIRECTV has IPA both within and without South Carolina. The issue, therefore, is the extent to which "the income-producing activity is performed within this State." *Id.* There is no question about what DIRECTV's IPAs are and where they are located. As discussed in detail in its Final Amended Brief, DIRECTV identified precisely what it did in this State versus other states and the IPAs in this State were limited.¹ In fact, the parties agree on the limited extent of DIRECTV employees and assets in South Carolina. SCDOR Return at pp. 4-5 (stating that DIRECTV only has two employees in South Carolina and its only assets here are four collection facilities and the equipment (i.e. the set-top boxes) its customers lease or purchase). Likewise, SCDOR did not

¹ More specifically, DIRECTV presented substantial factual and economic evidence regarding its IPAs, including (i) detailed testimony regarding the activities necessary to produce DIRECTV's content (Tr., R. pp. 170:14- 208:5), (ii) testimony that its IPAs are the "assets and the employees that perform the service which puts the video into the television of its customers" (Tr., R. p. 502:15-18), and (iii) testimony and report by economist identifying DIRECTV's IPAs and locating/determining the portion of those activities conducted here using a formula based on payroll and assets, which he testified resulted in a reasonable approximation of the value attributable to those activities here (Tr., R. p. 352:7- 354:18). *See also* DIRECTV's Final Amended Brief at pp. 25-27.

dispute the substantial DIRECTV employees and assets responsible for creating the premium product that DIRECTV's customers are purchasing nor did it contest that these employees and assets are located out of state. Instead, SCDOR contends that these activities do not produce income and thus neither SCDOR nor the ALC considered these activities in arriving at the portion of the subscription receipts that are earned here.

However, this interpretation is inconsistent with the apportionment statute. More specifically, ignoring all of the IPAs that created the product at issue- such as development of premium television content- directly contradicts the "partly within and partly without" statutory language. This language is identical to that used in S.C. Code Ann. §12-6-2210(B), which is the general apportionment statute at the introduction to Article 17 "Allocation and Apportionment." This language focuses on the activities of the taxpayer as a whole and seeks to determine the portion of that total business activity that should be attributed to South Carolina. SCDOR wants to ignore DIRECTV's core business activities and instead only look at the origin of the payment from its customers here in South Carolina. This improperly shifts focus from DIRECTV's activities to its customers' activities.

The only way to interpret the apportionment statute as written in a way that reaches the market result that SCDOR seeks here is to argue that delivery of the signal is somehow the only "meaningful" IPA (or, in other words, the only one to be considered). But such a holding makes no sense. Consider the following scenarios: (1) a car is detailed and serviced in South Carolina; and (2) a car is picked up from South Carolina, taken to Georgia to be detailed and serviced, and then delivered back to a South Carolina customer. Under SCDOR's position and the ALC's decision, in both scenarios the entire IPA is determined to be in South Carolina. Such a result

defies logic and produces an absurd result and thus should not be upheld by this Court. *See also infra* §IV (as to how SCDOR's position is also contrary to *Lockwood Greene*, which rejected the origin of payment approach, and *Mercury Motor*, which required apportionment of receipts).

SCDOR also claims that DIRECTV's use of payroll and assets proxies to locate its IPA in South Carolina is unreasonable because it only has two employees in South Carolina and its only assets here are four collection facilities and the equipment its customers lease or purchase. SCDOR Return at pp. 4-5.² It is precisely because DIRECTV has few employees and assets here that the payroll and assets proxies are reasonable. Fewer assets and employees mean fewer demands on South Carolina infrastructure such as roads, police and fire services and the courts, and, thus, a lower tax burden is appropriate. Consider if DIRECTV was based in South Carolina and thus had thousands of employees and millions of dollars of assets in this State. Under SCDOR's approach, this would all be ignored despite the fact that such an increase in workforce and assets would place much greater demands on South Carolina resources. This simply makes no sense under a statute that focuses on "income producing activity" and not customer location. *See S.C. Code Ann. § 12-6-2295(A)(5)*.

II. S.C. Code Ann. § 12-6-2295(A)(5) Codified the Holding of *Lockwood Greene* and Does Not Distinguish between Different Types of Service Providers.

SCDOR asserts that S.C. Code Ann. § 12-6-2295(A)(5) does not codify *Lockwood Greene*. SCDOR Return at p. 3. While the two use slightly different language- "place of activity" in *Lockwood Greene* versus "extent income producing activity is performed" in the

² SCDOR also incorrectly refers to the asset and payroll proxies as "cost elements." SCDOR Return at p. 4. However, they are not cost elements but rather, as shown by the testimony and evidence, are proxies for the IPAs of DIRECTV. *See supra* §I. DIRECTV agrees that South Carolina is not a cost of performance state where receipts would be apportioned based on costs.

apportionment statute, they are speaking to the same element— i.e. the portion of the taxpayer’s activity in this State that produces income in this State. In fact, if anything, S.C. Code Ann. § 12-6-2295(A)(5) actually goes further than the holding of *Lockwood Greene* as it makes no distinction regarding different types of service providers. Instead, it dictates that all service providers who have IPA both in this State and in other states should apportion their income by attributing sales to South Carolina only to the extent that the IPA is performed within this State. S.C. Code Ann. § 12-6-2295(A)(5). Thus, SCDOR’s argument that it may treat different service providers differently no longer has support in the law after the apportionment statute was enacted as its express and clear language would control over the language in *Lockwood Greene* (which was decided prior to the apportionment statute). Whatever the result would have been under *Lockwood Greene*, it is clear that a conclusion that the “delivery of the signal” is the only IPA that should be considered flies in the face of the language in S.C. Code Ann. § 12-6-2295(A)(5) and ignores DIRECTV’s other IPA, which occurred out of state.

III. The ALC and this Court Failed to Appropriately Consider the Evidence Presented by DIRECTV in Reaching their Conclusions that Delivery of the Signal was DIRECTV’s Only IPA in South Carolina.

The ALC and this Court’s finding that the delivery of the signal into the homes of South Carolina customers was the only IPA in South Carolina is entirely inconsistent with the evidence in the record. In its Return, SCDOR argues that this evidence was not overlooked, but rather the Court simply found it unpersuasive. SCDOR Return at pp. 3 and 8-10.

The evidence in this case could not have been fully and properly considered and yet still reach the conclusion that the entire IPA of DIRECTV is delivery of the signal. First, even SCDOR’s expert witness testified that delivery of the signal is not an IPA. *See* Tr. R. pp. at

543:23- 545:10 (testifying that delivery of the signal is a cost and not an IPA and that the only IPAs in this case are the customer's actions in "turning on the box, watching the TV, and paying the bill"). Additionally, SCDOR is mistaken as to what DIRECTV's customers are paying for; it is not delivery of a signal but rather access to premium content. SCDOR's misunderstanding on this point leads it to completely discount all of the activities that produce the premium product that is delivered to the South Carolina customers' televisions. No customer would pay the monthly fees charged by DIRECTV if they only received a test signal or what is available on free television. DIRECTV's premium product with its original programming, premium programming (such as HBO, ESPN and Starz), sports packages and unique offerings such as NFL Sunday Ticket and the Masters Experience is what induces customers to subscribe and generates income. *See* Amended Final Brief at pp. 4-5 (for a more detailed discussion of DIRECTV's content related activities).³ No one would pay DIRECTV's monthly fees if the satellite and broadcast operations did not ensure a clear, high-end video experience. *See* Amended Final Brief at pp. 5-6 (for a more detailed discussion of DIRECTV's broadcast operations). And the evidence is also clear that the marketing/sales activities as well as the customer service activities generate additional income from new and existing customers. *See* Amended Final Brief at pp. 7-8 (for a more detailed discussion of DIRECTV's marketing, sales and customer service activities). DIRECTV customers are paying for a premium product, and that product is created, acquired, developed, produced, broadcast, marketed and serviced outside the state. These out of state IPAs are directly associated with the production of the receipt and

³ To highlight the significance of content on DIRECTV's value, 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. pp. 330:24- 331:16.

cannot logically be called "too attenuated."

IV. The ALC's Conclusion that the Final Act of Delivery of the Signal is the Only IPA Adopts a Market-Based Approach that is Contrary to South Carolina Law.

By accepting SCDOR's method, which looks only to the location of the customer (or, as it now characterizes it, the "final act" of delivering the signal into the homes of the customers), the Court has adopted the "market approach" (a/k/a the "origin of payment" approach), which is contrary to S.C. Code Ann. § 12-6-2295(A)(5), *Lockwood Greene* and *Mercury Motor*. Although referencing the statute, which requires that the focus be on the "extent the income producing activity is performed within this state," SCDOR continues to ignore the plain language of the statute, abandon the "place of activity" test in *Lockwood Greene* and discount the apportionment analysis and logic set forth in *Mercury Motor*. DIRECTV has previously discussed how this interpretation is counter to S.C. Code Ann. § 12-6-2295(A)(5) (*see supra* §I) and will now address the two cases.

A. Concluding that Delivery of the Signal is the Only IPA is Contrary to *Mercury Motor*.

Concluding that the delivery of the signal is the only IPA is counter to *Mercury Motor*, and SCDOR's interpretation of this decision in the Return is flawed. *Mercury Motor* does not say "that only the hauling of freight was the IPA while excluding the other incidental activities" as SCDOR suggests. Instead, the Court states as follows:

The appellant 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 appellant. . . .*

Mercury Motor, 244 S.C. at 141, 135 S.E.2d at 759-60 (emphasis added). The Court is acknowledging that *all* of the transactions in the series, both within and without the State, contribute to the production of income. *Id.* It goes on to say that "while each transaction is necessarily incidental to the production of its income, the transaction which primarily earns the income is the hauling of the freight." *Id.* This makes perfect sense where the only issue before the Court was whether it was unconstitutional to take into account the income related to the hauling of freight. The Court did not consider or address whether it would be appropriate to ignore some income producing activities when applying a statutory apportionment method based strictly on the "income producing activities" of a taxpayer. In fact, to the extent the opinion can be read to discount "incidental" activities, that would appear to include *delivery of the freight*⁴ which would be akin to *delivery of the signal* into the customers' home here. SCDOR and the ALC's interpretation would recognize only the "delivery of the freight" at the customer's location and would completely disregard the hauling of the freight both within and without the State. This is completely contrary to *Mercury Motor*.

Moreover, even if this Court determined on some basis that delivery of the signal was the primary or only IPA, the evidence establishes that this would include a multitude of activities, including collecting of programming and transmission of programming to broadcast centers, uplink facilities, satellites and customers. *See* Tr., R. pp. 170:14- 207:25. SCDOR's Return does not even attempt to explain how these activities can be ignored even if one assumed that delivery of the signal is the only IPA.

⁴ Hauling of the freight over the highways in South Carolina, not delivery of the freight in another state, was considered to be the primary IPA in *Mercury Motor*. *Mercury Motor*, 244 S.C. at 141, 135 S.E.2d at 759-60.

B. Interpreting Delivery of the Signal as the Only IPA is also Contrary to *Lockwood Greene*.

Interpreting delivery of the signal as the only IPA is also contrary to *Lockwood Greene*, which rejects an "origin of payment" test and instead adopts a "place of activity" test that is virtually identical to the IPA language of the apportionment statute. SCDOR claims that *Lockwood Greene* "stands solely for the proposition that the Department may source revenues of service providers such as engineering, law and accounting firms to the place of activity, but may source income from other service industries, such as finance companies and media broadcasters, to the location of the borrower and the advertisers, respectively." SCDOR Return at p. 3. It also states that *Lockwood Greene* "approved of SCDOR's use of different methods when addressing different service industries." *Id.* at p. 4.

SCDOR's assertions regarding treatment of different taxpayers is based solely on dictum. The taxpayer in *Lockwood Greene* argued that a "place of activity" test should not be imposed because the Tax Commission had been inconsistent in interpreting the apportionment statute as its guidelines called for an "origin of payment" approach to be applied to media broadcasters and finance companies. *Lockwood Greene*, 293 S.C. at 450, 362 S.E.2d at 348. The Court of Appeals disagreed and adopted the "place of activity" test. In rejecting the taxpayer's argument based on the guidelines, the Court said it was not persuaded that an engineering firm was comparable to a media broadcaster or finance company but instead was more similar to a law firm, accounting firm, entertainment and sports company or hospital management company, for which the Tax Commission guidelines focus on whether the services are performed in South Carolina. The Court was not considering finance companies or media broadcasters as neither such taxpayer was

before it,⁵ and, thus, to the extent it could be read to be commenting on these businesses, such a statement is dictum.⁶ *Id.* In no way, shape or form does *Lockwood Greene* hold that an "origin of payment" test must be applied to certain taxpayers. Thus, this dictum cited by SCDOR should be ignored and cannot be used to support the adoption of an "origin of payment" test or a finding that delivery of the signal is the only IPA in this case.

C. Concluding that Delivery of the Signal is the Only IPA Improperly Requires a Market-Based Approach.

SCDOR argues in its Return that concluding that the delivery of the signal is the only IPA in this case does not interpret S.C. Code Ann. 12-6-2250(A)(5) as requiring market-based sourcing and that the IPA here "just happened to occur in the homes of its South Carolina customers." SCDOR Return at p. 7. It also states that SCDOR's witnesses testified that the Department "examines the specific activities of each applicable service industry to determine where the taxpayer's income should be sourced. *Id.* at p. 8. However, it neglected to reference the following testimony and evidence, which refutes SCDOR's implication that it conducted any such analysis in this case and shows that, instead, it simply interpreted the apportionment statute to require market-based sourcing by assigning 100% of the subscription receipts to the location of the customer:

⁵ Moreover, DIRECTV is neither a finance company nor a media broadcaster. By way of clarification, a "media broadcaster" is a term that applies to network television companies, whose primary income comes from advertising fees.

⁶ When asked for these "guidelines" in discovery, SCDOR could find nothing, its audit supervisor testified they were not in writing and its auditor testified he was not aware of them. Tr., R. p. 438:6- 439:7. Moreover, SCDOR admits that these alleged guidelines were never updated after 1983, pre-dated the existence of businesses like DIRECTV and do not address subscription revenue, the satellite industry or even cable companies. (R. p. 470:20- 472:10) Under these circumstances, the ALC correctly declined to give deference to such guidelines (*see* Am. Final Order, R. p. 46 at n. 19), and this Court should likewise give them no weight.

- SCDOR auditor's testimony that he conducted no background research and did not interview any DIRECTV employees to determine how DIRECTV's business operated. Tr., R. p. 422:13- 423:3.
- SCDOR's auditor and his supervisor's testimony that the audit determination was based solely on "customer location." Tr., R. pp. 425:4-6; 437:20-23.
- SCDOR witness's testimony that audit determination was based solely on customer location, that DIRECTV's activities conducted outside of the state 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; 472:22- 473:22.
- SCDOR's Report of Field Audit for the 2009 through 2011 tax years, which states that "market base sourcing" was used. Field Audit Report, R. pp. 902-909.
- Testimony of SCDOR's tax policy expert that SCDOR was "taking a market state approach to the attribution of receipts." Tr., R. pp. 577:10-18; 578:23-25; 580:7-21.
- Testimony of SCDOR's economist that the only IPAs are the customer's actions of "turning on the box, watching the TV, and paying the bill." He also stated that all prior activity by DIRECTV, including content development, broadcast services, marketing, customer service and *even delivery of the signal*, constitute costs, which he stated could not be considered IPAs. Tr. R. pp. at 543:23- 545:10.

The result sought by SCDOR in this case was clear- source 100% of DIRECTV's receipts to the customers' locations in South Carolina. With an apportionment statute that requires the focus to be on IPA, this could only be accomplished by completely discounting all out of state IPAs and calling delivery of the signal the only IPA (although as previously discussed, even this does not occur only in South Carolina). However, not even SCDOR's own witnesses support this theory. As set forth above, its employees looked solely to customer location, its expert economist said the signal cannot be an IPA and that the IPA is based on the customer's location (from which he is using the TV and paying the bills), and its expert in tax policy agreed that SCDOR was taking a market-based approach. If it walks like a duck and talks like a duck, it

might be a duck. SCDOR and the ALC decided the IPA here based solely on customer location, which is contrary to the statutes and improperly disregards the fact that what DIRECTV customers are purchasing is access to content, not simply delivery of a signal.

SCDOR also tried to buttress its position by arguing that DIRECTV had substantial receipts here and implying that it should have a correspondingly substantial tax bill and perhaps also implying that the General Fund was being shorted if DIRECTV's receipts were not sourced here. However, it is important to note that market-based sourcing is not on its face pro or anti-taxpayer or pro or anti-general fund. It is pro-taxpayer for businesses located here with substantial customers in other states (as in *Lockwood Greene*). On the other hand, it is anti-taxpayer with respect to out of state taxpayers with substantial customers here (as in this case). Stated differently, market-based sourcing will sometimes be pro-General Fund and generate a large tax (as it would here) and other times will be anti-General Fund (as with *Lockwood Greene*). Additionally, whether a state has a market-based statute or an activities-based statute can also impact whether and which businesses decide to invest in this State, locate their headquarters here, target customers here, etc. However, the decision as to whether South Carolina is market-based or activity-based lies with the Legislature, which can examine the pros and cons and decide which approach best supports the economic policies and goals of the State. The South Carolina Legislature has chosen to focus on IPAs and not customer location, or as SCDOR refers to it, "delivery of the signal." Thus, the Court should not interpret an IPA statute to reach a market-based approach.⁷

⁷ DIRECTV would also note that SCDOR could have attempted to impose a market-based sourcing method under the alternative apportionment statute if it believed that the IPA rule under

V. SCDOR's Argument on the Burden of Proof is Unavailing and, in any event, the Primary Issue in this Case is a Legal One.

SCDOR criticizes DIRECTV's burden of proof argument and claims that even if *Cloyd's* statement that once a taxpayer shows an assessment is incorrect, then it is entitled to appropriate relief is a correct statement of the law, the proper remedy is not dismissal. *See* SCDOR Return at p. 11. However, SCDOR fails to say what appropriate relief would be and instead tries to impose additional hoops for the taxpayer to jump through to obtain appropriate relief. Moreover, the burden of proof is almost beside the point in this case where there really are no factual issues, only legal ones. The key issue is whether South Carolina law (1) requires an apportionment of receipts and dictates that receipts be attributed to South Carolina only to the extent the IPA occurs in this State (as DIRECTV asserts), or (2) does not require apportionment of receipts but instead requires 100% of the receipts to be attributed to South Carolina based on the customer's location, i.e. where the final act of delivery to the customer occurs (as SCDOR claims). For these issues involving how the apportionment statute should be interpreted, the burden of proof is irrelevant.

VI. The Imposition of Substantial Understatement Penalties was Not Proper.

As previously argued in DIRECTV's Petition, any understatements must be reduced by the amount for which there was (1) "substantial authority" for the treatment, (2) "adequate disclosure" of the relevant facts and a "reasonable basis" for the tax treatment; or (3) there was "reasonable cause" for an understatement and the taxpayer acted in "good faith." *See* S.C. Code Ann. §12-54-155(B)(2)(b); S.C. Code Ann. §12-54-155(D)(1). *See* DIRECTV's Petition at p. 31. DIRECTV submits that it meets all three bases, even though only one is needed to justify reducing the

the gross receipts apportionment statute did not accurately reflect DIRECTV's business activities here and that market-based sourcing did. However, SCDOR chose not to do so.

penalty. The ALC in this case already determined that the substantial understatement penalty should be reduced by 25% because it found that DIRECTV acted in good faith and "appropriately disclosed relevant facts affecting subscription receipts" (*see* Am. Final Order, R. p. 51), so DIRECTV will only address whether it had substantial authority, a reasonable basis or reasonable cause.

SCDOR's Return claims that the statute, *Lockwood Greene* and *Mercury Motor* do not stand for the propositions that DIRECTV claims. DIRECTV will not repeat all of its arguments above and in its Petition but would point out the following important points for this Court to consider in evaluating whether it had substantial authority, a reasonable basis or reasonable cause to report its income as it did:

- *Lockwood Greene* requires apportionment based on "place of activity." It contrasts this with the "origin of payment" approach, which focuses on the location of the customer. It approves of the use of a payroll proxy to locate the taxpayer's activities. Its discussion of SCDOR's use of the "origin of payment" approach for certain other taxpayers like finance companies and media broadcasters (neither of which DIRECTV is) is contained in dictum and merely states that such a policy does not dictate the same result here.
- S.C. Code Ann. 12-6-2295(A)(5), which was enacted after *Lockwood Greene* and thus controls to the extent there are differences between the two, expressly requires apportionment based on "income producing activities." It does not state or imply in any way that apportionment of receipts is based on the location of the customer or the location of the final step in delivering a product.
- *Mercury Motor* acknowledges that *all* of the transactions in the series of taxpayer activities contribute to the production of its income. It holds it is not unconstitutional to take into account the income related to the hauling of freight because that transaction primarily earns the income. It does not consider or address whether it would be appropriate to ignore some IPAs (such as incidental ones) when applying a statutory apportionment method. To the extent it can be read to discount "incidental" activities, that would include *delivery of the freight*, which would be akin to *delivery of the signal* into the customers' homes here.
- SCDOR has published no guidance (regulations, policy documents or otherwise) to alert taxpayers to any policy that interprets the apportionment statute to require market-based sourcing for subscription revenue, and, in fact, its own auditor testified in his deposition that he was not even aware of such a policy or practice. Tr., R.p. 303:1-8.

In this case, a penalty is at issue for only the last three years of returns (2009-2011). DIRECTV filed its 2009 and 2010 returns based on set-top box rental receipts and its 2011 returns based on payroll. The set-top box rentals are the only income at issue that is earned in South Carolina and are the most obvious reflection of the IPAs in this State. They illustrate the footprint of DIRECTV in South Carolina and its minimal IPAs here. The 2011 return using a payroll proxy tracks *Lockwood Greene* to the letter and is also a reasonable reflection of DIRECTV's IPA here. Such positions are supported by substantial authority, a reasonable basis or reasonable cause.

To consider this issue from a different perspective, imagine if DIRECTV was based in South Carolina with thousands of employees and millions in assets and attempted to file its returns by apportioning only its receipts from South Carolina customers to this State. It is hard to imagine that it could show substantial authority for such a position when (1) the statute says "income producing activity;" (2) *Lockwood Greene* speaks to "place of activity" and endorses a payroll proxy; and (3) *Mercury Motor* views delivery of the freight (akin to delivery of the signal here) as incidental. Surely, two completely opposite filing positions cannot both result in a penalty being justified. Filing on a basis that takes into account the activities of the taxpayer in this State (versus one that looks only to the customer's location or the delivery of the product) is the position that is consistent with the law.⁸

Because the existing law supported its position in this case and there was no guidance published by SCDOR to the contrary, DIRECTV had substantial authority, reasonable cause and a reasonable basis for its tax treatment. Thus, the substantial understatement penalties for 2009-

⁸ Even the Texas case framed by SCDOR in earlier briefing as reaching the result it seeks here (though it was distinguishable) did not uphold the imposition of a penalty on the taxpayer based, in part, on fact that the case involved a complex and novel issue. *Anonymous Taxpayer v. Texas Cptr of Pub. Accts*, 2013 WL 3490605 (Tex. Cptr. Pub. Acct., May 17, 2013). See also *Ameritech*, 2010 WL 2519583, slip op. at 12 (concluding that although taxpayer's view that its IPAs to produce its directories were performed out of state was incorrect, it was still reasonable).

2011 should be dismissed.

CONCLUSION

As set forth above and in its Petition previously filed, DIRECTV respectfully requests that this Court grant its Petition for Rehearing as the Court's Opinion in this matter overlooked or misapprehended several factual and legal matters and also conflicts with South Carolina law, and thus, a rehearing and/or entry of a new Opinion is warranted.

Respectfully submitted,

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by MEC w/
express permit

Charleston, South Carolina
October 30, 2017

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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SC Court of Appeals

APPEAL FROM ADMINISTRATIVE LAW COURT

Ralph King Anderson, III, Administrative Law Judge

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

Appellate Case No. 2015-001509

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):

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October 30, 2017

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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

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

v.

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

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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. 55-56.¹

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

¹ 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.² Tr., R. pp. 190:23- 193:12.

² 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.³ 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

³ 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.⁴ 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

⁴ 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. 502:15-18.⁵

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.

⁵ 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 %
Weighted Average	0.07 %	0.85 %

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 Envtl. 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 & Envtl. Control*, 340 S.C. 118, 132, 530 S.E.2d 643, 651 (Ct. App. 2000) (explaining

that “the complaining party bears the burden of proof”); *see also* *DISH DBS Corp. v. S.C. Dep’t of Revenue*, No. 14-ALJ-17-0285-CC (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. 40.⁶

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

⁶ 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.”⁷ 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

⁷ 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.⁸ 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.

⁸ 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; 472:13-17.⁹ 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

⁹ 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.¹⁰

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; 351:3-9.¹¹

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

¹⁰ 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.

¹¹ 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.¹² 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,

¹² 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.”¹³ 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

¹³ 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

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

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

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

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

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

2011 SC APPORTIONMENT RATIO CALCULATIONS	
Total Subscription Revenue	19,689,494,914
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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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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February 9, 2017

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SC Court of Appeals

THE STATE OF SOUTH CAROLINA
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APPEAL FROM ADMINISTRATIVE LAW COURT

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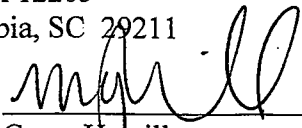
DIRECTV, Inc. & Subsidiaries, ... Appellant,
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South Carolina Department of Revenue Respondent.

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 United States Mail, postage prepaid, to the following address(es):

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THE STATE OF SOUTH CAROLINA
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CERTIFICATE OF COUNSEL	

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STATEMENT OF ISSUES ON APPEAL

- I. DID THE ADMINISTRATIVE LAW COURT APPLY THE PROPER BURDEN OF PROOF AND CORRECTLY CONCLUDE THAT APPELLANT DIRECTV, INC. & SUBSIDIARIES FAILED TO MEET ITS BURDEN OF PROOF?
- II. DID THE ADMINISTRATIVE LAW COURT APPROPRIATELY CONSIDER THE EVIDENCE IN THE RECORD AND CORRECTLY CONCLUDE THAT THE DELIVERY OF THE SIGNAL INTO THE HOMES OF APPELLANT'S CUSTOMERS WAS THE INCOME-PRODUCING ACTIVITY OF APPELLANT?
- III. DID THE ADMINISTRATIVE LAW COURT APPROPRIATELY CONSIDER THE EVIDENCE IN THE RECORD ESTABLISHING THAT 100% OF APPELLANT'S INCOME-PRODUCING ACTIVITIES OCCURRED IN SOUTH CAROLINA?
- IV. DID THE ADMINISTRATIVE LAW COURT PROPERLY FIND THAT THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS APPROPRIATE?

STATEMENT OF THE CASE

This matter came before the Administrative Law Court (ALC) in accordance with the Administrative Procedures Act, S.C. Code Ann. § 1-23-310, et. seq. (2005). DIRECTV, Inc. & Subsidiaries (Appellant or DIRECTV) requested a contested case hearing to challenge a Department Determination issued by the South Carolina Department of Revenue (Department) on February 18, 2014. (R. pp. 57-64; Resp't Ex. 13.) The Department denied a claim for refund of South Carolina corporate income taxes for the tax years 2006 through 2008; assessed South Carolina corporate income taxes, interest, and penalties for the tax years 2009 through 2011; and assessed license fees, interest, and penalties for the tax years 2010 through 2012 ("Tax Periods at Issue"). (R. p. 58; Resp't Ex. 13 p. 1.) Specifically, the Department denied the refund claim and issued the assessments because DIRECTV is required to source all of its South Carolina subscription revenue to South Carolina since all of the income-producing activity ("IPA") related to DIRECTV's South Carolina subscription revenue occurred in South Carolina. (R. p. 64; Resp't Ex. 13, p. 7.)

The ALC held a hearing on January 13 and 14, 2015, and issued its Final Order and Decision (Initial Order) on May 12, 2015, finding for the Department on all issues. (R. pp. 1-22; Initial Order pp. 2, 22.) DIRECTV filed a motion for reconsideration pursuant to Rule 59(e), SCRCF and ALC Rule 29(D). (R. pp. 65-79; Mot. for Recon., pp. 1-15.) The Department filed a response to DIRECTV'S motion for reconsideration, and DIRECTV filed a Reply to the Department's response. (R. pp. 102-123; Response pp. 1-22.) On June 12, 2015, the ALC issued a Reconsideration Order (Recon. Order) and an Amended Final Order and Decision, reflecting the changes made to the Initial Order upon reconsideration (Amended Order). (R. pp. 23-30, 31-53; Recon. Order pp. 1-8; Amended Order pp. 1-23.) The Amended Order modified certain language

from the Initial Order, partially abated the substantial underpayment penalty imposed on DIRECTV, and found for the Department on all remaining issues. (R. pp. 31-53; Amended Order pp. 1-23.) In the Amended 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. (R. pp. 31-53; Amended Order pp. 22.)

On July 14, 2015, DIRECTV filed its notice of appeal of the ALC's decision to the South Carolina Court of Appeals. (R. pp. 955-956; Notice of Appeal.)

STATEMENT OF FACTS

I. DIRECTV's Business Operations

DIRECTV is a multistate taxpayer that offers direct broadcast satellite video services to customers throughout the country. (R. pp. 172-173; Hr'g Tr. 49:18-50:1.) Its headquarters are located in Los Angeles, California. (R. p. 176; Hr'g Tr. 53:3-12.) For a subscription fee, DIRECTV grants its customers access to television programming and other audio/visual options that are transmitted nationwide to customer's homes or businesses via satellites. (R. pp. 172-173, 175-176, 184-185, 196, 197, 200-201; Hr'g Tr. 49:23-50:1; 52:24-53:2; 61:5-62:8; 73:15-21; 74:14-20; 77:10-78:1.) DIRECTV receives programming produced by third parties through satellite, fiber-optic cables, and over-the-air broadcast. (R. pp. 186-192; Hr'g Tr. 63:3-69:15.) DIRECTV collects programming from local broadcast television stations through the use of local collection facilities. (R. pp. 186-187, 194-195; Hr'g Tr. 63:3-64:18; 71:11-72:5.) During the Tax Periods at Issue, DIRECTV had four to six local collection facilities in South Carolina. (R. pp. 187, 487; Hr'g Tr. 64:19-25; 364:17-25.) The signals for the programming content are collected at broadcast and uplink centers. (R. p. 186-187; Hr'g Tr. 63:3-64:18.) The broadcast centers and

uplink facilities transmit the programming content signals to the satellites. (R. pp. 186-187, 191; Hr'g Tr. 63:3-64:18, 68:18-23.) The satellites then transmit the signals directly to DIRECTV satellite dishes mounted on or near customer homes. (R. pp. 186-187, 191, 196-197; Hr'g Tr. 63:3-64:18, 68:18-23, 73:22-74:20.) The signals are then relayed from the dish on or near the home to a set-top box (often located in the customer's living room) which delivers the signals to the customer's television set. (R. p. 196-197; Hr'g Tr. 73:22-74:20.)

Customers pay a monthly subscription fee for access to basic channels and can also purchase premium channels and pay-per-view programs for an additional fee. (R. pp. 483-484; Hr'g Tr. 360:20-361:23.) Before DIRECTV will deliver programming, it requires each customer to sign a contract, and DIRECTV must provide and install a satellite dish, remote controls, and a set-top box in order for the customer to access DIRECTV's programming in his home or business. (R. pp. 200-201, 204-205; Hr'g Tr. 77:10-78:1, 81:25-82:10.) During the Tax Periods at Issue, third-party contractors provided the services related to the installation of equipment in homes of new customers in South Carolina. (R. p. 201; Hr'g Tr. 78:2-10.) DIRECTV also had a few employees who lived and/or worked in South Carolina during the Tax Periods at Issue. (R. p. 486; Hr'g Tr. 363:1-25.)

DIRECTV is considered a "cash cow business," and its primary source of revenue was the subscription revenue it received from its approximately twenty million subscribers. (R. p. 204; Hr'g Tr. 81:10-11.) DIRECTV's revenue from customers includes monthly fees for subscribing to one or more packages of video programming; revenue from pay-per-view programming; revenue from the sale or lease of the set-top boxes; revenue from optional warranties on the leased boxes (protection plans); and revenue from fees associated with high definition set-top boxes, set-top boxes with DVR, and multi-room viewing charges. (R. pp. 483-484; Hr'g Tr. 360:20-361:23.)

The parties agree that all rental income from the set-top boxes received by DIRECTV from South Carolina customers should be sourced to the numerator of the gross receipts ratio for apportionment purposes. (R. p. 950-952; Stip. of Facts, filed January 12, 2015.)

II. DIRECTV's Income Tax Returns

On its originally filed corporate income tax returns in South Carolina for 2006-2008, DIRECTV sourced 100% of its subscription receipts and 100% of its rental receipts from South Carolina customers to the numerator of the gross receipts ratio. (R. pp. 405-406, 407, 407-408, 786-808, 835-842, 852-860; Hr'g Tr. 282:13-283:15, 284:8-19, 284:20-285:7; Resp't Ex. 1, 4, and 6.) By doing so, DIRECTV used gross receipts ratios of 1.9539%, 2.0016%, and 2.0543% for years 2006 through 2008, respectively, to apportion its net income to South Carolina. Id. The Department conducted a field audit of DIRECTV's 2006-2008 tax returns. (R. pp. 403-404; Hr'g Tr. 280:22-281:4.) As a result of the audit, the Department accepted DIRECTV's original 2006-2008 corporate income tax returns as filed (i.e., the Department did not make any adjustments to the tax returns). (R. p. 408; Hr'g Tr. 285:8-14.) DIRECTV subsequently filed amended corporate income tax returns for the 2006-2008 tax years, and the single change was the removal from the numerator of the gross receipts ratio all of the subscription receipts from South Carolina customers that DIRECTV originally included in the numerator. (R. p. 492-494; Hr'g Tr. 369:15-371:19.) DIRECTV's amended gross receipts ratios for years 2006-2008 were 0.0246%, 0.081%, and 0.1137%, respectively. (R. pp. 411, 412, 413, 816-834, 843-851, 870; Hr'g Tr. 288:21, 289:16, 290:8; Resp't Ex. 3, 5, and 7.) DIRECTV explained the amendments in a statement attached to each of the three amended returns:

This return is being amended to apportion sales receipts to the state under S.C. Code Ann. § 12-6-2295 (Supp. 2007) which sources sales of services under a pro-rata cost of performance method. The originally filed return incorrectly apportioned satellite television

subscription receipts to South Carolina using market based sourcing, rather than the cost of performance sourcing that is prescribed by statute.

(R. pp. 409-410, 833, 850, 869; Hr'g Tr. 286:21-287:7; Resp't Ex. 3, Attachment A; Resp't Ex. 5, Attachment A; and Resp't Ex. 7, Attachment A.) By amending returns for 2006-2008, DIRECTV sought to decrease its income tax and license fee liability by \$5,976,816.00 and sought a refund of this amount. (R. pp. 809-815, 816-834, 843-851, 861-870, 890-901; Resp't Ex 2,3,5,7 and 11.) In a field audit report dated November 29, 2011, the Department denied the amended returns and related refunds and accepted the original returns as filed. (R. pp. 890-901; Resp't Ex. 11.)

DIRECTV then filed its original 2009-2011 corporate income tax returns using the same cost of performance method that it used on its 2006-2008 amended returns.¹ (R. pp. 417, 418, 419, 871-882; Hr'g Tr. 294:21-23, 295:10-11, 296:1-2; Resp't Ex. 8-10.) The Department audited these returns as well, and in a field audit report dated January 28, 2014, the Department assessed DIRECTV for income taxes and license fees for 2009-2011 using a gross receipts ratio that included all of DIRECTV's subscription receipts from South Carolina customers in the numerator. (R. pp. 902-909; Resp't Ex. 12.)

The Department subsequently issued its Determination and found that the IPA of DIRECTV was its delivery of the signal into South Carolina customers' homes and onto the

¹Although on its amended 2006-2008 returns and on its original 2009 and 2010 returns, DIRECTV did not include any of the subscription receipts from South Carolina customers in the numerator of the gross receipts ratio. On its 2011 South Carolina return, DIRECTV changed its method again by including approximately \$22 million of its \$410 million subscription receipts from South Carolina customers in the numerator. (R. pp. 886, 954; Resp't Ex. 10, p. 4; Joint Stipulations, Ex. A.) DIRECTV did this by sourcing 0.11% of its total subscription receipts to South Carolina based on a ratio of its alleged payroll in South Carolina to its total payroll. (R. pp. 365, 762; Hr'g Tr. 242:3-13; Pet. Ex. 8, p. 17.) In its last amended returns from 2006-2010, DIRECTV did not source any subscription receipts to South Carolina because it claims that the vast majority of its payroll and property were located outside of South Carolina. (R. pp. 809-815, 816-834, 843-851; Resp't Ex. 2, 3, 5, 7-12.)

customers' television sets, which occurred entirely in South Carolina, and that, accordingly, DIRECTV should include 100% of the subscription receipts received from South Carolina customers in the numerator of the gross receipts ratio. (R. pp. 58-64; Resp't Ex. 13.)

III. Department's Policy Regarding Sourcing Income of Service Providers

Under the Department's longstanding policy with respect to the sourcing of gross receipts to South Carolina, the Department does not source gross receipts of all service providers to South Carolina in the same manner but examines the specific activities of each applicable service industry to determine sourcing. (R. pp. 433-434, 456, 464-466, 467-468; Hr'g Tr. 310:10-311:3, 333:2-7, 341:19-343:1, 344:12-345:9.) For example, when sourcing the income of an engineering firm, the Department looks to the actual engineering services rendered as constituting the IPA since it is the "expertise and time" of a specific engineer that the customer is purchasing. Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987). Therefore, the income is sourced to the location of the engineer rendering that specific service. (R. p. 434; Hr'g Tr. 311:4-10.) On the other hand, the Department sources income received from the licensing of intangibles and from a financing operation to the location of the sale (in the case of intangibles) and the location of the borrower (in the case of a financing company). (R. pp. 434-435, 468-469, 940-949; Hr'g Tr. 311:11-312:8, 345:10-346:20; Resp't Ex. 21.) Likewise, the Department sources subscription receipts received by a cable company and telephone company similar to the method it used in this case to source DIRECTV's subscription receipts to South Carolina. (R. pp. 435-436, 465; Hr'g Tr. 312:12-313:8, 342:9-18.)

DIRECTV originally filed its 2006-2008 income tax returns in accordance with the Department's longstanding policy by sourcing 100% of its South Carolina subscription revenue to South Carolina. (R. pp. 786-808, 809-815, 816-834; Resp't Ex. 1, 4, 6.)

IV. Dr. Glenn W. Harrison's Testimony

A. Identification Of The Income-Producing Activity

Dr. Harrison, the Department's expert economist, testified that the Department's Determination in this matter is completely appropriate from an economic perspective. (R. p. 528-530; Hr'g Tr. 405:18-407:1.) First, the "only activity that we are talking about that actually generates income is the purchase of the product in South Carolina" and that activity is the delivery of the service in South Carolina. (R. pp. 527, 528; Hr'g Tr. 404:13-15, 405:4-6.) Dr. Harrison stated that "it is the provision of television services in your home" that gives value and generates income for DIRECTV. (R. p. 529; Hr'g Tr. 406:14-18.) Customers do not want to drive to DIRECTV's headquarters in California to watch the programming. (R. p. 529-530; Hr'g Tr. 406:17-407:1).

Dr. Harrison's determination of the IPA is consistent with the broad manner in which DIRECTV's economic expert, Dr. Cody, would determine the IPA: by determining "what is really creating the value that consumers ultimately pay for." (R. p. 351; Hr'g Tr. 228:3-19.) Dr. Harrison believes that a customer is paying for DIRECTV to deliver the signal into his home and onto his television screen; however, Dr. Cody sought to find the value in a more nebulous way by "look[ing] at the important functions, risks and assets that are employed in the business." (R. p. 351; Hr'g Tr. 228:10-13.)

B. Location Of DIRECTV's Income-Producing Activities

Dr. Harrison testified, from an economic perspective, that it is appropriate to source the subscription revenue received by DIRECTV from South Carolina customers to the numerator of the gross-receipts ratio because "that's the most direct way to represent [the extent of DIRECTV's business in South Carolina] and calculate [it]." (R. p. 529; Hr'g Tr. 406:3-13.) Dr. Harrison further

testified that it is unnecessary to develop “proxies” or approximations – like payroll and assets – to measure the value of DIRECTV’s services in South Carolina. (R. p. 528; Hr’g Tr. 405:9-10.) DIRECTV and the customer have placed a direct value of the delivery of the service into homes – the amount of the subscription fee paid. (R. p. 528; Hr’g Tr. 405:3-17.) Dr. Harrison stated that the most accurate way to measure the value of the service that DIRECTV provided to its South Carolina customers is “the amount of money that the subscriber paid in South Carolina” and that such a measure was a transparent item that comes from DIRECTV’s own accounting information. (R. pp. 528, 538; Hr’g Tr. 405:10-17, 415:11-17.)

V. Professor John A. Swain’s Testimony

The Department’s tax policy expert, Professor John A. Swain, explained that the Department’s approach in this matter is good tax policy for several different reasons. (R. p. 577; Hr’g Tr. 454:5-8.) First, S.C. Code Ann. § 12-6-2290 mandates the use of a single gross-receipts ratio, and the purpose of a single gross-receipts ratio is to reflect the contribution of the market state – “to give South Carolina its due as a market state for providing a market for DIRECTV, even though DIRECTV is . . . not located [in South Carolina].” (R. p. 577, 579; Hr’g Tr. 454:10-18, 456:18-23.) Second, the General Assembly’s approach to sourcing by adopting statutes mandating the use of single sales/gross receipts apportionment ratios reflects the nationwide movement to a single-sales factor apportionment: what began as an economic development tool has now become an “economic sort of preservation tool” that allows states to “run with the pack in a competitive environment with mobile capital[.]” (R. p. 578; Hr’g Tr. 455:7-19.) Unlike the General Assembly’s approach, Prof. Swain further explained that DIRECTV’s approach to sourcing in this case is a “stealth property/payroll/expense factor” and that is “exactly the opposite of what Legislatures . . . want to do when they adopt single-sales factor. It defeats the purpose of it.” (R.

p. 579; Hr'g Tr. 456:9-14.) Third, the Department's approach promotes equity by attempting to "treat like taxpayers in a like manner" unlike DIRECTV's approach that would treat "functionally similar or very similar business competitors" differently. (R. p. 580, 582; Hr'g Tr. 457:7-21, 459:5-21.)

Prof. Swain further explained that the Department's interpretation of S.C. Code Ann. § 12-6-2295(A)(5), in addition to being good tax policy, is consistent with authority in other jurisdictions, including jurisdictions that had costs of performance statutes. (R. p. 584-585; Hr'g Tr. 461:9-462:9.) He stated that "there's room to interpret the statute "as the Department has without changing the law. (R. pp. 585, 587; Hr'g Tr. 462:15-21, 464:1-18.) Finally, Prof. Swain testified that reading section 17 of the UNIFORM DIVISION FOR INCOME TAX PURPOSES ACT'S (1957) (UDITPA) cost of performance standard into South Carolina's statute may provide "flexibility" but that flexibility leads to uncertainty for both taxpayers and the Department because the cost of performance standard is "confusing and indefinite, plagued by vagueness, ambiguity, substantial debate, lack of clear guidance, whipsawing, tremendous flexibility," and that flexibility turns into "uncertainty." (R. pp. 585-587; Hr'g Tr. 462:22-464:10.)

VI. Gross Receipts at Issue

The Department concurs with DIRECTV's statement regarding the Gross Receipts at Issue.

ARGUMENT

This Court should affirm the Amended Order of the ALC because, under the applicable standard of review, the factual findings of the ALC are supported by substantial evidence, the ALC made no errors of law, the Amended Order did not violate any of DIRECTV's constitutional rights, and the Amended Order was not arbitrary or capricious or characterized by abuse of discretion.

In an appeal from the decision of an administrative agency, S.C. Code Ann. § 1-23-610(B) provides the applicable standard of review and provides the grounds under which this Court may reverse or modify the ALC's decision. The Administrative Procedures Act states that an appellate court's review of an ALC order "must be confined to the record" and that an appellate court "may not substitute its judgment for the judgment of the ALJ as to the weight of the evidence on questions of fact." S.C. Code Ann. § 1-23-610. To affirm on the basis of substantial evidence, the South Carolina Supreme Court explained that "this Court need only find, looking at the entire record on appeal, evidence from which reasonable minds could reach the same conclusion that the ALC reached." Barton v. S.C. Dep't of Prob. Parole & Pardon Servs., 404 S.C. 395, 401, 745 S.E.2d 110, 113 (2013) (citing Hill v. S.C. Dep't of Health and Env'tl. Control, 389 S.C. 1, 9-10, 698 S.E.2d 612, 617 (2010)). "The mere possibility of drawing two inconsistent conclusions from the evidence does not prevent a finding from being supported by substantial evidence." Original Blue Ribbon Taxi Corp. v. S.C. Dep't. of Motor Vehicles, 380 S.C. 600, 605, 670 S.E.2d 674, 677 (2008) (internal citations omitted).

I. THE ADMINISTRATIVE LAW COURT APPLIED THE PROPER BURDEN OF PROOF AND CORRECTLY CONCLUDED THAT APPELLANT FAILED TO MEET ITS BURDEN OF PROOF.

The ALC applied the correct burden of proof and properly found that DIRECTV failed to meet its burden of proof because DIRECTV failed to prove by a preponderance of the evidence that DIRECTV's IPA extended beyond the delivery of the signal into the homes and onto the television screens of its South Carolina customers. (R. pp. 40-41; Amended Order pp. 10-11.) Further, the ALC properly found that, while some evidence reflected that DIRECTV's advertising may produce some income, the evidence did not reflect what portion of the advertising was

attributable to South Carolina sales leaving the ALC “to speculate.” (R. pp. 40-42; Amended Order pp. 10-12.)

The standard of proof in a contested case is by a preponderance of the evidence. Section 1-23-600(A)(5). “[T]he burden of proof rests upon him who has the affirmative of the issue and does not shift to the defendant even when aided, in the first instance, by a rebuttable presumption.” Ford v. Atl. Coast Line R. Co., 169 S.C. 41, 168 S.E. 143, 167 (1932); see also Leventis v. S.C. Dep’t of Health & Env’tl. Control, 340 S.C. 118, 132, 530 S.E.2d 643, 651 (Ct. App. 2000). The ALC properly recognized that “[b]ecause DIRECTV is challenging a determination by the Department that it must source its South Carolina subscription receipts from South Carolina customers to the numerator of the gross receipts ratio, DIRECTV has the burden of proof.” (R. p. 37; Amended Order p. 7) (citations omitted).

The ALC hears a contested case as the de novo fact finder and may draw its own conclusions. Young v. S.C. Dep’t of Health and Env’tl. Control, 383 S.C. 452, 680 S.E.2d 784 (Ct. App. 2009); Risher v. S.C. Dep’t of Health and Env’tl. Control, 393 S.C. 198, 207, 712 S.E.2d 428, 433, reh’g denied (July 21, 2011). As the finder of fact, the ALC can choose to accept, in part or in whole, the testimony of witnesses based on its own view of a witness’ credibility and the weight of the evidence. MRI at Belfair, LLC v. S.C. Dep’t of Health and Env’tl. Control, 392 S.C. 314, 324, 709 S.E.2d 626, 631. DIRECTV had the burden of proof in this matter, and as the finder of fact, the ALC is entitled to assign as much or as little weight to evidence as it wishes. Id. Furthermore, the ALC is free to reach its own conclusions of law. Engaging and Guarding Laurens County’s Environment (EAGLE) v. S.C. Dep’t of Health and Env’tl. Control, 407 S.C. 334, 344, 755 S.E.2d 444, 449 (2014).

The ALC established that DIRECTV did not satisfy its burden of proof because its evidence was insufficient to prove that there were other IPAs. (R. pp. 41-43; Amended Order pp. 11-13.) Although DIRECTV asserts that it established that the Department's assessment was incorrect, (Appellant's Br. at 17), after its review of the evidence, the ALC properly concluded that "pursuant to Section 12-6-2295(A)(5), DIRECTV's income-producing activity includes the customers' subscriptions and delivery of the signal into the location and onto the television screens of its customers," (R. pp. 40, 51; Amended Order pp. 10, 21.) Simply put, the Department established that the IPA in this matter is the delivery of the signal into South Carolina homes – without this activity – DIRECTV would not have generated the income in this matter. For instance, the Department witnesses testified that the IPA in South Carolina should include South Carolina subscription revenue and this is consistent with how similar businesses in South Carolina file their corporate tax returns.² (R. pp. 415-416, 436, 463-464, 464-466; Hr'g Tr. 292:14-293:5, 313:22-25, 340:19-341:6, 341:19-343:1.) DIRECTV is providing a service to customers in South Carolina, and the subscription revenue precisely identifies that IPA occurring in South Carolina.³ (R. p. 467; Hr'g Tr. 344:17-24.) As Dr. Harrison testified, the service being sold in South Carolina is "the provision of television services in your home." (R. p. 529; Hr'g Tr. 406:17-18.)

²In its brief, DIRECTV states the Department auditor expressly stated in his audit report that market base sourcing was used in this matter. However, as testified at trial, DIRECTV first used the phrase "market-based sourcing" in its own statement attached to the amended returns for tax years 2006, 2007, and 2008. (R. p. 426-427; Hr'g Tr. 303:16-304:1.) Moreover, as acknowledged by the ALC in its Amended Order, the Department clarified its position during trial. (R. p. 36; Amended Order p. 6, n. 5.)

³Although the Department witnesses state that the Department looked to the customer's location in apportioning DIRECTV's South Carolina subscription revenue, each witness further testified that the Department's focus in identifying and sourcing the income-producing activity of a taxpayer is the transaction itself. (R. pp. 420, 441, 467, 473; Hr'g Tr. 297:11-14, 318:16-20, 344:17-24, 350:17-22.) Any analysis related to the customer in this matter is incidental to the primary focus of DIRECTV's activity(ies).

Although the ALC stated that DIRECTV's IPAs may not be limited to this activity, DIRECTV retained the responsibility to prove its case by a preponderance of the evidence and failed to do so. (R. pp. 40, 25; Amended Order p. 10; Recon. Order p. 3.) More specifically, the ALC made the following findings of fact, stating that "DIRECTV's evidence was either insufficient or not credible":

- (1) "The 'payroll-and-assets method does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina or the value attributable to such activities.'"
- (2) "Though [DIRECTV's] evidence did reflect that its advertising probably produced some income, the evidence did not reflect what portion of DIRECTV's cost was either attributable to South Carolina customers or may have influenced South Carolina customers to subscribed to DIRECTV."
- (3) "[I]t is possible that advertising performed within or without [] South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated in South Carolina. Therefore, the Court cannot consider advertising in this case."
- (4) "DIRECTV simply did not provide sufficient information on how to apportion its subscription receipts between states in which it believes income-producing activities occur."

(R. pp. 25-26, 41-42, 49-50; Recon. Order pp. 3-4; Amended Order pp. 11-12, 19-20.) Moreover, the following excerpt from the Amended Order summarizes the ALC's view of DIRECTV's evidence:

Dr. Cody's payroll-and-assets method does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina or the value attributable to such activities. Though its evidence did reflect that its advertising *probably* produced some income, the evidence did not reflect that portion of DIRECTV's cost was attributable to South Carolina customers or may have influenced South Carolina customers to

subscribe to DIRECTV. Instead, the Court was left to speculate as to the extent to which DIRECTV's content and programming, acquisition and distribution thereof, advertising, and customer service in installing and maintaining its equipment within this State influenced customers' decision to subscribe to DIRECTV. Moreover, it does not appear that some of the activities that DIRECTV attributed to income production are actually income-producing activities.⁴

(R. pp. 40-41; Amended Order pp. 10-11 (emphasis added).)

The above discussion demonstrates that the Court properly applied the proper burden of proof in this case, DIRECTV cites to a property tax case – in which the Department was not a party – as support for its assertion that the ALC should have dismissed this case because DIRECTV allegedly met its burden of proof by showing that the Department's determination was incorrect. Specifically, DIRECTV cites Cloyd v. Mabry, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988) to incorrectly assert that if DIRECTV established that the Department's assessment was incorrect, then it met its burden of proof, and therefore, the Department's assessment should be dismissed. Even if DIRECTV could somehow establish that it met its burden of proof and proved the Department's Determination is incorrect, DIRECTV's suggestion that the appropriate remedy is dismissal of the determination is disingenuous at best.

First, DIRECTV's use of Cloyd is misguided and not applicable here. Cloyd was decided in the context of a property tax matter and not with regard to corporate income tax. Cloyd, at 87, 367 S.E.2d at 172. Second, the Court of Appeals did not conclude that "appropriate relief" included absolving the taxpayer of any property tax liability through dismissal of the assessment. Id. at 88-89, 367 S.E.2d at 173.

⁴The ALC found that many of the activities that DIRECTV says are income-producing activities, which the ALC calls pre-order and preparatory activities, are too attenuated to the production of income to be considered income-producing activities. (R. pp. 42-44; Amended Order, 12-14.) Such activities include many of the so-called "value drivers" that DIRECTV called income-producing activities. (R. pp. 41-42; Amended Order, 11-12.)

Further, the ALC had the ability to determine the proper assessed value based on the evidence presented even when the county assessor's value is deemed incorrect. See Smith v. Newberry County Assessor, 350 S.C. 572, 578-79, 567 S.E.2d 501, 504-05 (Ct. App. 2002). Dismissal of the case is not the so-called "appropriate relief."

Moreover, DIRECTV is not entitled to a complete abatement of the assessment in this case because the ALC suggested that there may be IPAs in South Carolina in addition to the delivery of the signal into subscribers' homes and onto their televisions.

Finally, remanding this matter to the ALC for DIRECTV to present additional evidence permits DIRECTV to take a second bite at the apple when it had every opportunity to present relevant evidence at the hearing before the ALC. See City of Myrtle Beach v. Tourism Expenditure Review Comm., 407 S.C. 298, 755 S.E.2d 425, n. 5 (2014) (citing Porter v. S.C. Pub. Serv. Comm'n, 333 S.C. 12, 32, 507 S.E.2d 328, 338 (1998) (citing Parker v. S.C. Pub. Serv. Comm'n, 288 S.C. 304, 342 S.E.2d 403 (1986))).

Simply put, DIRECTV failed to meet its burden of proof as it did not prove its IPA extended beyond the delivery of the signal into the homes and onto the television sets of its South Carolina customers. Furthermore, it failed to prove that less than 100% of the South Carolina subscription receipts should be sourced to South Carolina. Because DIRECTV failed to make

such a showing and evidence supports the ALC's finding that the Department's determination was correct, the ALC's decision was proper.^{5 6}

II. THE ADMINISTRATIVE LAW COURT APPROPRIATELY CONSIDERED THE EVIDENCE IN THE RECORD AND CORRECTLY CONCLUDED THAT THE DELIVERY OF THE SIGNAL INTO THE HOMES OF APPELLANT'S CUSTOMERS WAS APPELLANT'S INCOME-PRODUCING ACTIVITY.

Based on substantial evidence and in accordance with the applicable statutes, the ALC properly determined that on a subscription-by-subscription basis Appellant's IPA was the delivery of the signal into its customers' homes and onto their television sets.

A. DIRECTV Is A Service Provider

DIRECTV is a media broadcasting company, and its primary income is derived from providing direct broadcast satellite video services to subscribers throughout the country. (R. pp. 481, 890-909, Hr'g Tr. 358:22-25; Resp't Ex. 11-12.) DIRECTV acknowledges that it is a service provider. (Appellant's Br. p. 23, n. 6.)

B. Standard Apportionment Method

The purpose of the South Carolina allocation and apportionment provisions is to provide for imposition of income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." S.C. Code Ann. § 12-6-2210(B) (2014); Hertz Corp. v.

⁵"Our Supreme Court 'has long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities such as those of Appellant, and has declared that "rough approximation rather than precision" is sufficient.' Covington Fabrics Corp. v. S.C. Tax Comm'n, 264 S.C. 59, 66-67, 212 S.E.2d S.E.2d 574, 577-78 (1975). The Court also noted that '[a]lthough exactness in apportionment is desirable, all that is required is a reasonable approximation.'" (R. p. 41; Amended Order p. 11.)

⁶DIRECTV continuously asserts that the Department presented no credible evidence on the identity or location of DIRECTV's income-producing activities. However, as noted by the ALC, "whether the evidence was presented by the Department or DIRECTV, the evidence as set forth in the findings, established the income-producing activities that occurred in this State." (R. p. 35; Amended Order p. 5.)

S.C. Tax Comm'n, 246 S.C. 92, 142 S.E.2d 445 (1965). The method of apportionment to be used depends upon the nature of the taxpayer's business in this State. Because DIRECTV's principal income is not derived from manufacturing or dealing in tangible personal property, DIRECTV shall apportion its adjusted net income to South Carolina under § 12-6-2290. This provision mandates the following gross-receipts method:

If the principal profits or income of a taxpayer are derived from sources other than those described in Section 12-6-2252 or Section 12-6-2310⁷, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.

S.C. Code Ann. § 12-6-2290 (Supp. 2007).⁸

Thus, as a service provider, DIRECTV was required to use the single gross-receipts ratio, as supplemented by § 12-6-2295(A)(5) after 2006.⁹ The relevant subsection states:

(A) The terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:

* * *

⁷S.C. Code Ann. § 12-6-2310 designates the apportionment factor to use for the following specific regulated industries: railroads, motor carriers, telephone service companies, pipelines, airlines, and shipping lines. For example, telephone companies must apportion its net income using a gross-receipts factor.

⁸In 1995, the General Assembly repealed Chapter 7 and added Chapter 6 of Title 12. Accordingly, section 12-7-1190 was replaced by § 12-6-2290 as the statute that directed service providers how to apportion their net income. In 2007, the General Assembly amended § 12-6-2290 by adding an additional sentence to the end of the existing statute. That sentence reads as follows: "For purposes of this section, items included in gross receipts are as provided in § 12-6-2295." (R. p. 38; Amended Order at 8, n.9 (citing 2007 South Carolina Laws Act 110 (S.B. 91))).

⁹2007 South Carolina Laws Act 110 (S.B. 91) also added § 12-6-2295, the companion statute to § 12-6-2290. See 2007 South Carolina Laws Act 110, § 51.A; eff. June 21, 2007. These additions were effective for DIRECTV's 2007 tax year.

(5) receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State[.]

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

Section 12-6-2295(A)(5) requires DIRECTV to determine its IPAs, to identify the location of such IPAs, and then to source all of its subscription receipts based on the location of the IPAs. See id. If the entire IPA related to DIRECTV's South Carolina customers occurs in this State, then all of DIRECTV's subscription receipts from South Carolina customers must be sourced to the numerator of the gross-receipts ratio. Id.

C. ALC Holding That The Income-Producing Activity Is The Delivery Of The Signal Is Supported By The Substantial Evidence In The Record

The administrative law judge is the fact finder in this matter and has discretion. MRI at Belfair, 392 S.C. 314, 709 S.E.2d 626. While S.C. Code Ann. § 1-23-350 requires a final decision from the ALC to be in writing and include findings of fact, there is no requirement that the ALC list all witnesses and evidence and then confirm each was considered by the judge. Nevertheless, the extensive analysis contained in the Amended Order here should convince even the most skeptical reader that the ALC properly considered all of the evidence before it.

Effective in 2007, § 12-6-2295(A)(5) added the "income-producing activity" language to the sourcing statute for service providers.¹⁰ Pursuant to § 12-6-2295(A)(5), the ALC properly determined that DIRECTV's IPA was "the delivery of the signal into the homes and onto the

¹⁰Notably, when adding § 12-6-2295(A) for the 2007 tax year, the General Assembly stated the following in 2007 South Carolina Laws Act 110, § 51.A, eff. June 21, 2007: "To Amend . . . by adding §§ 12-6-2252 and 12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes by basing the determination only on a sales factor and to define the terms 'sales' and 'gross receipts' consistently and specifically for that purpose[.]"

television screens of its customers.” (R. pp. 40, 51; Amended Order pp. 10, 21.) It is this “final act,” which excludes all of the pre-order and other preparatory acts which are too attenuated to the production of income (R. pp. 43-44; Amended Order pp. 13-14), that generates DIRECTV’s monthly subscription receipts, (R. pp. 62, 529; Resp’t Ex. 13, p. 6; Hr’g Tr. 406:14-18.) As Dr. Harrison said, “[I]t is the provision of television services in your home” that generates the subscription receipts for DIRECTV, not the pre-order and other preparatory activities which are merely “prior, secondary, intermediate activities.” (R. pp. 527, 529, 540; Hr’g Tr. 404:6-12, 406:14-18, 417:9-10.)

Regarding DIRECTV’s pre-order activities, the ALC concluded that they were not IPA:

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

(R. pp. 43-44; Amended order pp. 13-14 (emphasis in original).)

Similarly, the ALC concluded that DIRECTV’s other preparatory activities also were not IPAs. The ALC found that DIRECTV “engages in other ‘preparatory’ activities that eventually lead to satellite signals being beamed into this State”, and “such other preparatory activities include, but are not limited to, gathering, editing, and distributing programming and satellite and uplink activities.” (R. p. 43; Amended Order p. 13.) Importantly, “those activities 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." Id. (Emphasis added). Simply put, it is common sense that "the national programming through the CONUS beams would exist regardless of whether there were any subscribers in South Carolina. Thus, such 'preparatory' activities are too attenuated to the production of income to be considered 'income-producing activity' for purposes of § 12-6-2295(A)(5)." Id.

Regarding the identification of the IPA as the delivery of the signal into the homes and onto the television sets of DIRECTV's customers, the Department looked at the direct broadcast satellite services industry and the sources of income within the industry. (R. pp. 415-416, 429, 435; Hr'g Tr. 292:10-293:5, 306:16-20, 312:12-20.) The Department found that the primary source of income for DIRECTV was the monthly subscription receipts that customers pay to DIRECTV in order to view selected packages of video and pay-per-view video programs in their homes and businesses. (R. pp. 415, 429; Hr'g Tr. 292:14-19, 306:14-20.) These subscription receipts relate directly to the Department's Determination that the delivery of the signal into the customer's home and onto the customer's television is the income-producing activity. (R. pp. 902-909; Resp't Ex. 12.)

Although South Carolina law does not define "income-producing activity," the Multi-State Tax Commission defines it as the transactions and activity engaged in by a taxpayer to produce an item of income and that income-producing activity applies to "each separate item of income." 1 JEROME R. HELLERSTEIN ET AL., STATE TAXATION ¶9.18(3)(b) (3d ed. 2000). Therefore, when considering what DIRECTV's IPA is, it is appropriate to look only at it on a subscription-by-subscription basis. Looking at it this way, the Department concluded that the IPA for each subscriber was the delivery of the satellite signal into his home. All of the pre-order and other

preparatory activities of DIRECTV do not create the income produced by the next subscription. The income from the next subscription is produced at the subscriber's home, which is where the value of the next subscription is delivered by DIRECTV.

The Amended Order establishes that the ALC properly considered the testimony of DIRECTV's witnesses regarding DIRECTV's IPA and sufficiently understood the operations of DIRECTV as was described by a corporate officer. (R. pp. 33-35, 39-44; Amended Order pp. 3-5, 9-14.) Specifically, the ALC considered the evidence regarding DIRECTV's operations from Mr. Goswitz, its vice president of space, communications, and video. (R. pp. 33-35, 42-43, 170-171, 172-204; Amended Order pp. 3-5, 12-13; Hr'g Tr. 47:14-48:7, 49:16-81:11.) The ALC undoubtedly considered that testimony and the operational activities of DIRECTV in its decision, as demonstrated by its references to "content and broadcast of signals," "infrastructure" related to content and transmission, and "production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites." (R. pp. 33-35; Amended Order pp. 12-13.) In addition, Mr. Goswitz admitted that the activities that DIRECTV performs at its customers' homes are the IPAs by stating that DIRECTV provides "direct to home" video services and must install a satellite dish, a coaxial cable, and a set-top box at each customer's home and connect the set-top box to each customer's television. (R. pp. 172, 196-197; Hr'g Tr. 49:16-23, 73:22-74:20.) The ALC correctly determined that DIRECTV could be generating subscription revenue from millions of other customers, but, on a subscription-by-subscription basis, the IPA for the next customer is the activity that DIRECTV performs at that next customer's home. (R. p. 43; Amended Order p. 13.)

Dr. Cody testified that he was engaged by DIRECTV "to identify from an economic perspective the income-producing activities of" DIRECTV. (R. p. 327; Hr'g Tr. 204:11-16.) The

ALC fully analyzed Dr. Cody's testimony and report but did not find it sufficient or persuasive. (R. pp. 40-41, 44, 47; Amended Order pp. 10, 11, 14, 17.) Specifically, the ALC recognized in its decision that DIRECTV presented evidence through Dr. Cody of the so-called four "value drivers" that could identify DIRECTV's IPA. (R. pp. 40-41; Amended Order pp. 10-11.) These value drivers included major components of DIRECTV's operations, including (1) content and programming, (2) acquisition and distribution of programming content, (3) marketing and sales of its service, and (4) customer service. (R. p. 329; Hr'g Tr. 206:2-16.) Dr. Cody described these activities of DIRECTV in great detail in his testimony. (R. p. 329-344; Hr'g Tr. 206:2-221:1.) Dr. Cody testified about his calculations using DIRECTV's payroll and assets as proxies in identifying DIRECTV's IPAs. (R. pp. 40-41; Amended Order pp. 10-11.) The ALC discusses in detail Dr. Cody's testimony about value drivers, and the ALC openly considered Dr. Cody's testimony to include reciting his analysis in the Amended Order. (R. pp. 40-42, 47-48; Amended Order pp. 10-12, 17-18.)

After considering the testimony of Dr. Cody, the ALC found that Dr. Cody's payroll and asset proxies for identifying DIRECTV's IPAs were "of no practical value," that DIRECTV "did not sufficiently explain the effect of [Dr. Cody's] value drivers on income production in this State," and that DIRECTV's evidence was "just too nebulous" to make the connection between Dr. Cody's value drivers and IPAs. (R. p. 41; Amended Order p. 11.) For example, Dr. Cody sought to find IPAs by looking at DIRECTV's "important functions, risks and assets." (R. pp. 351-352; Hr'g Tr. 228:3-229:21.) He did not explain why each "important" function or taking a 'risk' is necessarily an IPA. The basic statement made by the ALC that the testimony was unpersuasive clearly indicates the Court considered the testimony given by Dr. Cody and was enough to establish

the ALC properly considered the evidence in the record. (R. pp. 41, 47; Amended Order p. 11, 17.)

Because the ALC heard and considered extensive evidence from Dr. Cody, Mr. Goswitz, Dr. Harrison, and the Department's fact witnesses, and because the ALC found that DIRECTV failed to sufficiently prove its alleged IPAs, the ALC made a decision regarding what DIRECTV's IPA was and such decision was supported by substantial evidence in the record.

D. The ALC Properly Interpreted And Applied Mercury Motor Express, Inc. v. South Carolina Tax Commission, 244 S.C. 134, 141, 135 S.E.2d 756, 759 (1964).

Just as the South Carolina Supreme Court determined that the IPA of a trucking company was the actual hauling of freight over the highways, not its other "incidental" activities, Mercury Motor Express, Inc. v. South Carolina Tax Commission, 244 S.C. 134, 141, 135 S.E.2d 756, 759 (1964), the ALC properly found that DIRECTV's delivery of its signal into the homes and onto the television sets of its South Carolina customers was the IPA related to its South Carolina subscription receipts, not its pre-order and other preparatory activities, which are to attenuated to the production of income. (R. pp. 43-44; Amended Order pp. 13-14.)

In Mercury, the court addressed IPA of an interstate freight hauler. Mercury at 141, 135 S.E.2d at 759. The court listed a series of transactions that occur in the freight hauling business including solicitation of freight, picking up the freight, hauling the freight, dropping off the freight, and collecting the hauling charges and noted that many of these activities may occur outside of South Carolina. Id. The Supreme Court held that, while each of these activities is "incidental to the production of income," the IPA is the hauling of freight "through and over the highways of the State of South Carolina." Id.

By stating that only the hauling of freight was the IPA while excluding the other incidental activities, the Supreme Court adopted a narrow construction of IPAs. DIRECTV however asserts

that the Supreme Court in Mercury rejected a narrow construction of IPAs and that the ALC acknowledged that the Supreme Court considered “incidental” activities to be IPAs. (Appellant’s Br. at 29.) Both of these assertions by DIRECTV are wrong.

Likewise, the term “income-producing activities” should have a narrow meaning under § 12-6-2295(A)(5). First, the General Assembly’s use in § 12-6-2295(A)(5) of the limiting adjective, “income-producing,” to describe the noun, “activities,” means that all activities of a taxpayer, even if important to the overall service, are not IPAs and are not used to source gross receipts to South Carolina. Second, contrary to DIRECTV’s argument, the General Assembly did not say in § 12-6-2295(A)(5) that – if the taxpayer operates a unitary business – all of its activities are to be used to source gross receipts to South Carolina. See section 12-6-2295(A)(5). Third, the Supreme Court in Mercury referred to each of the activities in the identified series of activities as being “incidental to the production of income,” but it determined only that the hauling of freight was an “income producing activity.” Mercury at 141, 135 S.E.2d at 759. Fourth, the Supreme Court’s use in Mercury of the phrase “incidental to the production of income” to describe the taxpayer’s activities does not mean that each of those activities are also IPAs that should be used to source gross receipts to South Carolina. “Incidental” is defined as (1) “[s]ubordinate to something of greater importance” and (2) “having a minor role.” BLACK’S LAW DICTIONARY 765 (7th ed. 1999). Therefore, incidental activities are merely subordinate to or have a minor role with the main, primary, and principal activities. Fifth, DIRECTV’s expert, Dr. Cody, confirmed the different nature of IPAs and the other incidental activities by stating that DIRECTV performed the other incidental activities “in anticipation of – and in order to deliver that signal in anticipation of customers signing up and paying” and that these other incidental activities have “a risk” because DIRECTV has only “an anticipation of future profits.” (R. pp. 342, 343; Hr’g Tr. 219:15-19,

220:1-5.) Finally, Dr. Harrison distinguished a taxpayer's intermediate activities from its IPAs. (R. pp. 538-541; Hr'g Tr. 415:18-418:2.)

Based on the above, the ALC's analysis of IPAs was consistent with Mercury. Although DIRECTV performed many important activities connected with the IPA of delivering the signal into subscribers' homes and onto their television, activities such as content acquisition and development, satellite launches, and broadcasting and transmitting are intermediate to, incidental to, and prior to the actual IPA.

E. The ALC Properly Interpreted § 12-6-2295(A)(5)

In its brief, DIRECTV asserts that the ALC misinterpreted the language of § 12-6-2295(A)(5) to require "(i) an analysis of a customer's subjective intent and (ii) a market-based sourcing methodology." (Appellant's Br. at 31.) More specifically, DIRECTV asserts that the ALC's interpretation of § 12-6-2295(A)(5) is inconsistent with Mercury and Lockwood because those cases focus "exclusively on the activities of the taxpayers." (Appellant's Br. at 21.)

First, although the subjective intent of the customer may be relevant to the identification of the IPA, the ALC focused on the activities of DIRECTV. The ALC (and the Department) focused on DIRECTV's activities, not the activities of the customers. For example, the ALC determined that the IPA was DIRECTV's delivery of the signal into its customers' homes. Further, the ALC closely analyzed Dr. Cody's so-called value drivers and concluded that they consisted of pre-order and other preparatory activities, not IPAs.

The ALC specifically compared the activities of DIRECTV to the activities of the taxpayer in Lockwood and concluded that some of DIRECTV's activities were in fact "preparatory" – similar to the taxpayer in Mercury – rather than IPA as required by § 12-6-2295(A)(5):

Unlike the taxpayer in Lockwood Greene, a DIRECTV customer did not hire specific professionals and is not paying for those

professionals' expertise and time, or that of any other DIRECTV employee or contractor. Instead, the customer is paying for video programming to be viewed on the customer's television at the time and place the customer demands. DIRECTV does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. Rather, DIRECTV is in the business of selling television broadcast subscriptions to customers; and without the actual delivery of that broadcast signal into South Carolina homes, it would not have generated the income at issue here. Indeed, as noted above, the national programming through the CONUS beams would exist regardless of whether there were any subscribers in South Carolina; therefore, such broadcasting is preparatory activity.

(R. p. 47; Amended Order p. 17.) The ALC, in recognition of the applicable statute, considered the activities of DIRECTV to determine its IPA in South Carolina and concluded that DIRECTV's activity of delivering the signal into the homes and onto the television sets of DIRECTV's customers is the income-producing activity in South Carolina. (R. p. 51; Amended Order p. 21.)

Regardless several examples show that the subjective intent of the customer is relevant to the IPA: (a) the Lockwood court referred to what the customer was paying for when determining the sourcing of Lockwood's gross receipts, Lockwood; (b) Dr. Cody recognized that the Lockwood court was "looking at what the customers of the engineering firm were actually paying for," (R. p. 351; Hr'g Tr. 228:18-20), (c) a Texas administrative court addressed what the customer was contracting for and paying to receive in a similar case against a direct broadcast satellite provider, Anonymous Taxpayer v. Texas Comptroller of Public Accounts, 2013 WL 3490605 (Tex. Cptr. Pub. Acct), (May 17, 2013); and (d) Dr. Harrison testified that a customer wants the programming delivered in his home and that is what creates the value. (R. p. 529; Hr'g Tr. 406:14-18.)

Second, the ALC did not interpret § 12-6-2295(A)(5) as imposing a "market-based sourcing" method, and it properly interpreted and applied the IPA language of § 12-6-2295(A)(5).

In fact, the ALC made numerous statements throughout the order that demonstrate that it properly sought to identify, locate, and measure the IPAs pursuant to § 12-6-2295(A)(5) including:

At the outset, the Court disagrees that DIRECTV has sufficiently identified its activities to be sourced. (R. p. 44; Amended Order p. 14).

In sum, the payroll-and-assets method of Dr. Cody does not provide a reasonable approximation of the income-producing activities performed by DIRECTV in South Carolina (R. p. 47; Amended Order p. 17).

For instance, it is possible that advertising performed within or without South Carolina could be considered income-producing activity. However, DIRECTV did not provide any evidence that reflected approximately how much of its advertising was directed at South Carolina and what impact such advertising had on revenue generated in South Carolina. (R. pp. 49-50; Amended Order pp. 19-20).

As Prof. Swain testified, the Department's interpretation of § 12-6-2295(A)(5) reaches a "market state result," but it does not impose a market-based sourcing method on all taxpayers. (R. pp. 592; Hr'g Tr. 469:18 (emphasis added).) Contrary to a market-based sourcing method, the Department's witnesses testified that the Department examines the specific activities of each applicable service industry to determine where the taxpayer's income should be sourced. (R. pp. 433-434, 456, 464-466, 467-468; Hr'g Tr. 310:21-311:3, 333:2-7, 341:19-343:1, 344:12-345:9.)

Additionally, contrary to DIRECTV's assertion, under the ALC's holding and the Department's interpretation of "income-producing activity" in § 12-6-2295(A)(5), sourcing revenue to the location of the taxpayer's customer would not occur in every instance. For instance Mr. Donovan, an audit supervisor with the Department, testified that the Department would source the income received by an engineering firm to the place where the services were performed, i.e., the location of the engineering firm. (R. p. 434; Hr'g Tr. 311:4-10.) Likewise, Mr. Swearingen – a longtime employee of the Department – testified that architects' and engineers' income is sourced

to the state in which the engineer's or architect's services are performed. (R. p. 461-462; Hr'g Tr. 338:8-339:21.) See also Lockwood, at 448-50, 361 S.E.d2d at 347-48 (stating that gross receipts from within the state for an engineering firm were sourced to the location where the services that generate the income are performed [i.e., at the office of the engineer]); Rent-A-Center Texas, L.P. v. S.C. Dep't of Rev., Final Order & Decision, 09-ALJ-17-0206-CC (C.J. Anderson, Jan. 6, 2012) (holding that the taxpayer performed and was paid only for management services performed by skilled professional in Texas, and accordingly, its revenue from management fees must be sourced to Texas pursuant to Lockwood).

Accordingly, the ALC did not err in determining the IPA under § 12-6-2295(A)(5) and did not interpret that section to require market-based sourcing.

III. THE ADMINISTRATIVE LAW COURT APPROPRIATELY CONSIDERED THE EVIDENCE IN THE RECORD ESTABLISHING THAT 100% OF APPELLANT'S INCOME-PRODUCING ACTIVITIES OCCURRED IN SOUTH CAROLINA.

Based on substantial evidence and in accordance with the applicable statutes, the ALC properly determined that Appellant's IPA occurred entirely in South Carolina and that 100% of its subscription receipts from its South Carolina customers must be included in the numerator of the gross-receipts ratio. After performing a thorough analysis, the ALC found two main problems with DIRECTV's claim that some of its subscription receipts from South Carolina customers should be sourced to states other than South Carolina: (1) the ALC found that DIRECTV failed to sufficiently identify and prove that it had IPAs occurring outside of South Carolina, and (2) the ALC found that, "even if it had identified those activities, DIRECTV failed to sufficiently establish that those activities should be sourced elsewhere." (R. p. 44; Amended Order p. 14.)

The ALC found sufficient evidence that DIRECTV's IPA related to its South Carolina subscription receipts occurred entirely within South Carolina; therefore, it affirmed the

Department's determination that 100% of those subscription receipts should be sourced to South Carolina (i.e., included in the numerator of the gross-receipts ratio) pursuant to the first prong of § 12-6-2295(A)(5). (R. pp. 44, 52; Amended Order pp. 14, 22.) The ALC's determination of the IPA - DIRECTV's delivery of the signal into South Carolina homes - is entirely consistent with an analysis of IPA on a subscription-by-subscription basis, which is consistent with the previously mentioned Multistate Tax Commission's definition of IPA. The ALC's determination that all of the IPA for each South Carolina subscriber occurred in South Carolina is also consistent with the evidence. For example, the ALC considered DIRECTV's reliance on Lockwood, but the ALC distinguished the activities of Lockwood, an engineering firm, from the activities of DIRECTV; considered many of DIRECTV's activities to be pre-order and other preparatory activities, not IPAs; and found Dr. Cody's approach to sourcing gross receipts to be "too nebulous." (R. pp. 43-50; Amended Order pp. 13-20.) Finally, since DIRECTV's subscription receipts from South Carolina subscribers are a known amount, no costs-of-performance methodology, no proxies, and no other estimates using costs are needed to measure how much of the IPA occurred in South Carolina.

DIRECTV's misunderstanding of the Lockwood decision has led it to erroneously assume that its IPAs are determined and located and that its gross receipts are sourced (i.e., measured) on a state-by-state basis using a costs-of-performance method under the second prong of § 12-6-2295(A)(5). (R. pp. 44-45, 47, Amended Order pp. 14-15, 17.) DIRECTV's desire to measure how much of its IPA occurred in each state using costs-of-performance, proxies, or other cost elements is a red herring in this case because: (a) the IPA regarding the subscription receipts from South Carolina customers occurred entirely within South Carolina, (b) the actual subscription receipts received by DIRECTV from its South Carolina customers is the best, most accurate, and

most transparent way to measure “the proportion of . . . business carried on within this State” by DIRECTV, see S.C. Code Ann. § 12-6-2210(B) (2014), and DIRECTV’s “gross receipts from within this State,” see § 12-6-2290 and (c) even if it could be used, costs-of-performance would be used only under the second prong of § 12-6-2295(A)(5), and that prong is not applicable in this case.

DIRECTV’s position on how to determine and locate the IPA and how to measure the IPA in each applicable state is flawed in numerous ways. First, the General Assembly excluded the phrase “based on costs of performance” when it enacted § 12-6-2295(A)(5), so DIRECTV improperly used the costs-of-performance methodology to exclude its subscription receipts from South Carolina from the numerator of the gross-receipts ratio on its amended 2006-2008 and its original 2009-2011 income tax returns. Second, DIRECTV misread and misapplied the decision in Lockwood, to mistakenly assume that the Court of Appeals in Lockwood stated that the so-called “place of activity” test should be applied to all service providers and that costs-of-performance was the mandated way to measure the extent of IPA in multiple states. Third, DIRECTV fails to acknowledge that the Lockwood court recognized the Department’s longstanding policy of sourcing gross receipts on an industry-by-industry basis when it distinguished in its opinion the activities of finance companies and media broadcasters from the activities of engineering firms like Lockwood. See Lockwood, at 450, 361 S.E.2d at 348. Therefore, because DIRECTV’s use of Lockwood to apply the “place of activity” test and cost of performance methodology to all service providers is incorrect, its tax position in this case is incorrect.

A. Costs-Of-Performance Is Not Required In South Carolina

DIRECTV misinterpreted and misapplied § 12-6-2295(A)(5) by using a costs-of-performance methodology to both determine and locate the IPAs and to measure how much IPA occurred in each applicable state.

First, unlike the sourcing statute in the 1950s model act, UDITPA, the General Assembly omitted the phrase “based on costs of performance” in the second prong of § 12-6-2295(A)(5). Even Professor Pomp, DIRECTV’s tax policy expert, admitted that § 12-6-2295(A)(5) does not require costs-of-performance to be used to source gross receipts. (R. p. 645-646; Hr’g Tr. 522:20-523:5.) Accordingly, the ALC found that “[i]t is clear that South Carolina is not a UDITPA state, and it does not require apportionment of the net income of service providers based on costs-of-performance elements.” (R. pp. 47-48; Amended Order pp. 17-18.) The ALC also found that Dr. Cody’s approach “unduly emphasizes what amounts to ‘costs of performance.’” (R. p. 47; Amended Order p. 17.)

Second, costs-of-performance is not needed in this case. After holding that the IPA is the delivery of the signal into the homes and onto the television sets of DIRECTV’s customers and that all of the IPAs related to South Carolina customers occurred entirely in South Carolina, the ALC held under the first prong of § 12-6-2295(A)(5) that “100% of DIRECTV’s subscription receipts from South Carolina customers must be in the numerator of the gross receipts ratio.” (R. p. 52; Amended Order p. 22.) Accordingly, there was no need to use the second prong of § 12-6-2295(A)(5) which is used when IPAs occur in more than one state and is the only prong under which a costs-of-performance method would even be considered.

Third, DIRECTV asserts that it is not using a costs-of-performance method, which is an incredulous statement. The crux of DIRECTV’s case was that Lockwood imposed a cost of

performance method on service providers when sourcing gross receipts to South Carolina. (Appellant's Br. at 37). Further, the Department presented evidence and the Court noted in its decision that, when DIRECTV amended its South Carolina corporate income tax returns, it amended the returns to source gross receipts under a "cost of performance method" and that the cost of performance sourcing was "prescribed by statute." (R. pp. 35-36; Amended Order, 5-6.)

Fourth, when appropriate, costs-of-performance is used only to measure the extent of the IPAs occurring in more than one state. It is not used to identify the IPA or to locate the states in which the IPA occurred. DIRECTV however improperly used costs-of-performance to not only measure the extent to which IPAs occurred in multiple states but also to identify the IPAs and determine in which states they occurred. For example, when asked what DIRECTV believes that the IPA is in this case and after he testified that a payroll factor was used in Lockwood, Bill Spina, DIRECTV's Rule 30(b)(6), SCRCF witness, testified, "Well, the formula in Lockwood and also potentially adding a property factor to that." (R. p. 501-502; Hr'g Tr. 378:4-379:9.) Additionally, when asked by DIRECTV's counsel how he determined the IPA and then measured the IPA in various states, Dr. Cody, DIRECTV's expert economist, stated, "There are a number of measures that can be used to identify and then locate the income producing activities. A couple of very common factors or proxies are payroll and assets. . . . So I developed methodologies using those measures." (R. p. 352; Hr'g Tr. 229:7-9.) Responding to how he determined the location of the IPAs, Dr. Cody continued, "I did two analyses. One analysis looked just at the location of payroll. So the payroll that's in South Carolina as a proxy for the income-generating activities that takes place in South Carolina versus payroll everywhere." (R. p. 352-353; Hr'g Tr. 229:22-230:5.) Dr. Cody also took assets into account in determining the location of the IPAs. (R. p. 354; Hr'g Tr.

231:3-6.) It therefore appears that DIRECTV improperly used costs-of-performance to identify, locate, and measure IPAs.

In conclusion, the ALC properly construed DIRECTV's sourcing methodology as a costs-of-performance methodology; however, even if permitted, costs-of-performance was not necessary because the first prong of § 12-6-2295(A)(5) was applicable since all of the IPA occurred in South Carolina.

B. Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987) Did Not Adopt Place Of Activity and Costs-of-Performance On All Service Providers

Contrary to DIRECTV's argument in this case, the Court of Appeals in Lockwood did not adopt one sourcing rule (i.e., the place of activity test) for all service providers and did not impose costs-of-performance as the means to source gross receipts for all service providers. Lockwood, at 449-50, 361 S.E.2d at 347-48. The ALC acknowledged that the "Court of Appeals did not accept the taxpayer's argument that § 12-7-1190 was a one-rule statute and that all net income to be apportioned under § 12-7-1190 must be apportioned under the same method." (R. p. 45; Amended Order p. 15.)

In Lockwood, the Court of Appeals stated that the purpose of the applicable apportionment statute was to apportion net income "upon a base which reasonably represents the proportion of the trade or business carried on within this State." Id. at 448, 361 S.E.2d at 347. The Court of Appeals concluded that sourcing an engineering firm's revenues to the place where the services were performed met this purpose because the customer of an engineering firm is purchasing "the expertise and time" of an engineer and that such services were performed at the engineer's location. Id. at 449, 361 S.E.2d at 347. Unlike other service providers, an engineer renders that service that his customer is buying (i.e., giving his expertise and time to a specific customer) primarily in his

office. In the instant case, DIRECTV provides its direct-to-home video service, which is what DIRECTV's customers are purchasing, in its customers' living rooms.

The applicable apportionment statute for apportioning net income from a taxpayer whose principal profits were derived from services at the time of Lockwood was § 12-7-1190 (1976), which is the predecessor statute to the current § 12-6-2290. In applying § 12-7-1190, the Department's audit division used, and the Lockwood court acknowledged, a set of written guidelines ("Guidelines"). Lockwood, at 450, 361 S.E.2d at 348. (R. pp. 520-529; Resp't Ex. 21). In these Guidelines, the Department listed eight industries and set forth how a taxpayer should source gross receipts to South Carolina in accordance with § 12-7-1190. Id.; (R. pp. 520-529; Resp't Ex. 21). The Guidelines did not impose one manner of sourcing gross receipts to South Carolina on all industries. Based on the Court of Appeals' analysis, those Department guidelines sourced gross receipts differently by industry. See id. at 448-49, 361 S.E.2d at 347. The Court of Appeals wrote:

Lockwood refers to Tax Commission guidelines concerning computation of the gross receipts of finance companies and media broadcasters. We are not persuaded these businesses are comparable to Lockwood. By contrast, the Tax Commission guidelines concerning law firms, accounting firms, entertainment and sports companies, and hospital management companies all focus on whether the services are performed in South Carolina. These situations are analogous and consistent with the situation of Lockwood.

Id. at 450, 361 S.E.2d at 348. Accordingly, in 1987 the Court of Appeals recognized that the Department had sourcing guidelines and that such guidelines sourced gross receipts differently based on industry.

Based on the specifics of Lockwood's business, the Court of Appeals concluded, "[t]herefore, an engineering firm's business carried on in a state is reasonably measured by the

services rendered by its personnel in the state,” which “is epitomized by the ‘place of activity’ test advanced by” the Department. Id. Again, it would not have been necessary for the Court of Appeals to address the specifics of Lockwood’s business if § 12-7-1190 was a “one-rule statute.”

Despite DIRECTV’s contention, in no way did the Court of Appeals in Lockwood impose a “place of activity” test for apportioning service-related income in South Carolina on *all* multi-state service-providing taxpayers. The Court clearly supported the Department’s use of different methods for different industries and did not reject Lockwood’s “one-rule” argument only to replace it with a different one-rule requirement.

The ALC’s analysis distinguishes DIRECTV from the taxpayer in Lockwood:

Unlike the taxpayer in Lockwood Greene, a DIRECTV customer did not hire specific professionals and is not paying for those professionals’ expertise and time, or that of any other DIRECTV employee or contractor. Instead, the customer is paying for video programing to be viewed on the customer’s television at the time and place the customer demands. DIRECTV does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. Rather, DIRECTV is in the business of selling television broadcast subscriptions to customers; and without the actual delivery of that broadcast signal into South Carolina homes, it would not have generated the income at issue here. Indeed, as noted above, the national programming through the CONUS beams would exist regardless of whether there were any subscribers in South Carolina; therefore, such broadcasting is preparatory activity.

(R. pp. 47, 62; Amended Order, 17; Resp’t Ex. 13, p. 5 (stating nearly identical language.)

As a result, it is clear from a plain reading of § 12-7-1190, the Guidelines, and Lockwood that neither the South Carolina statute nor the Department imposed one method of determining whether gross receipts were from within South Carolina and sourced to South Carolina. In fact, it is apparent from the Guidelines and the Lockwood opinion that the Department used different

methods when addressing different service industries based on the *activities* of the companies in each industry.

C. The Department's Longstanding Sourcing Policy For Service Providers Has Been Consistently Applied.

The Department has had a longstanding policy to source gross receipts of business taxpayers other than manufacturers and dealers in tangible personal property to the numerator of the gross-receipts ratio on an industry-by-industry basis after reviewing the activities of the respective industry. Under this longstanding policy gross receipts of personal service firms like an engineering firm are sourced to the state in which the personal services were performed while gross receipts of firms such as finance companies and media broadcasters are sourced differently. Lockwood, at 449-50, 361 S.E.2d at 347-48. (R. pp. 940-949; Resp't Ex. 21.)

The Department's analysis and audits subsequent to Lockwood support the fact that (1) the Department continued to apply its longstanding policy of sourcing gross receipts on an industry-by-industry basis by analyzing the activity of each industry¹¹, (2) Department never interpreted Lockwood as mandating the "place of activity" test (or a cost-of-performance method) for apportioning net income of all service providers, and (3) the Department never interpreted any statutory changes after Lockwood to make the substantive change of requiring a the place of activity test and cost-of-performance on all taxpayers whose income is apportioned using the gross-receipts ratio. (R. pp. 433-436, 461, 462, 469-470; Hr'g Tr. 310:10-313:8, 338:8-17, 339:15-11, 346:21-347:5.)

¹¹In 1995 the General Assembly replaced § 12-7-1190 with § 12-6-2290. A review of the text of these statutes reveals that § 12-6-2290 closely parallels former § 12-7-1190. Consequently, the Department's existing guidelines and analysis concerning the apportionment of net income and sourcing of gross receipts of service providers, as examined, reviewed, and upheld in Lockwood, remained in place.

The 2007 enactment of § 12-6-2295(A)(5) and § 12-6-2290's reference to it also did not change the Department's longstanding sourcing policy under § 12-6-2290. First, the Department's auditors were already examining the activities of taxpayers and assessing the extent to which gross receipts should be sourced to South Carolina. Second, § 12-6-2295 certainly did not adopt the "place of activity" test (as was applied to Lockwood) for all taxpayers. If the General Assembly had intended to adopt the Lockwood "place of activity" test for all taxpayers, it would certainly have used phrases like "place of activity" or "where the service was rendered" rather than using the phrase "income-producing activity."

Third, the applicable statute that addresses how to apportion net income from services is found in the first sentence of § 12-6-2290 (added in 1995). This is the provision that continued the legislative mandate to use a "gross receipts" ratio to apportion net income from services. This mandate has not changed, and South Carolina law still requires (and has since 1958) that net income from services be apportioned based on a gross-receipts ratio. Even the statutory use of the term "gross receipts" strongly implies an emphasis on *sales* rather than on *costs*.

In conclusion, the Department has had, and consistently applied, its longstanding sourcing policy of sourcing gross receipts on an industry-by-industry basis since at least 1976, and this Court should give deference to the Department's consistent application of its sourcing policy in this case. Where the construction or administrative interpretation of a statute has been applied for a number of years and has not been changed by the General Assembly, there is created a strong presumption that such interpretation or construction is correct. Ryder Truck Lines, Inc. v. S.C. Tax Comm'n, 248 S.C. 148, 149, S.E.2d 435 (1966); Etiwan Fertilizer Cp. V. S.C. Tax Comm'n, 217 S.C. 354, 60 S.E.2d 682 (1950). Additionally, "the construction of a statute by the agency charged with executing it is entitled to the most respectful consideration and should not be

overruled without cogent reasons.” Faile v. S.C. Employment Sec. Comm’n, 267 S.C. 536, 540, 230 S.E.2d 219, 221-222 (1976); Stephenson Finance Co. v. S.C. Tax Comm’n, 242 S.C. 98, 130 S.E.2d 72 (1963).

D. Other Jurisdictions.

DIRECTV argues that its activities occurring outside of South Carolina generate the income in this matter. While § 12-6-2295(A)(5) does not include a definition of “income-producing activity,” ample authority exists to support the ALC’s and the Department’s interpretation of IPA in this case. Further, courts throughout the country have found that many important activities of a taxpayer are not necessarily IPAs.

A review of applicable South Carolina case law, as well as similar cases in other jurisdictions, illustrate that the “income-producing activity” language of § 12-6-2295(A)(5) requires the sourcing of gross receipts to a state in which the taxpayer did not incur significant costs, and courts have made this determination even when the state’s sourcing law includes costs-of-performance.

In Anonymous Taxpayer v. Texas Comptroller of Public Accounts, 2013 WL 3490605 (Tex. Cptr. Pub. Acct). (May 17, 2013), a Texas administrative court also determined that the IPA of a direct broadcast service provider occurred in the subscriber’s home. The Texas Administrative Law Judge characterized the IPA for a direct broadcast satellite service provider as follows:

The act Petitioner’s customer contracts and pays to receive and the act that produces the receipts at issue, is the act performed by the receiver (i.e., the set top box) that Petitioner sells or leases to its subscribers. Petitioner’s customers contract for the receipt of television programming. Petitioner contracts to provide the programming, and it is the microchips within the receiver that unscramble and decode the satellite’s encrypted signal that completes the transaction and produces the programming receipt.

Id. Because this IPA occurred within the receiver in the customer's home or business, the Texas ALJ concluded that the taxpayer's programming receipts at issue should be sourced to Texas. Id. at *10-11.

Importantly there is no requirement that the IPA of a taxpayer occur in the state where the taxpayer incurs its costs. Even in states that have adopted the costs-of-performance language within the applicable statutes or regulations, gross receipts are often not sourced to the state(s) in which the taxpayer incurred its costs.

In Ameritech Publishing, Incorporated v. Wisconsin Department of Revenue, 327 Wis.2d 798, 788 N.W.2d 383 (Ct. App. 2010) (unpublished), 2010 WL 2519583, the Wisconsin Court of Appeals affirmed the taxing authority's determination that the IPA of a company that received advertising revenue by placing the advertisements in telephone directories that it distributed in Wisconsin "was performed in Wisconsin when the advertisement reached its intended, Wisconsin audience." Id. at 2010 WL 2519583, 5. Although the vast majority of the taxpayer's costs to gather the advertising and to publish the telephone directory were incurred outside of Wisconsin, and (unlike the South Carolina statute) the applicable Wisconsin statute *included* the phrase "costs of performance," the court held that the entire income-producing activity was within Wisconsin although the majority of the costs were incurred in other states and the applicable sourcing statute in Wisconsin included "costs of performance." Id. at 9-10.

Similarly, in Walter E. Heller Western, Inc. v. Arizona Dep't of Revenue, 161 Ariz. 49, 51, 53, 775 P.2d 1113, 1115, 1117 (1989), the Arizona Supreme Court also determined that the IPA occurred in Arizona, despite the fact that the California-based commercial financing company that received income from loans it made to Arizona borrowers incurred much of its costs in California. Walter E. Heller, at 51, 53, 775 P.2d at 1115, 1117. Like Ameritech above, the

applicable Arizona statute *actually used* the phrase “costs-of-performance,” giving the taxpayer’s cost-of-performance argument more merit but not enough to convince the Court. The Arizona Supreme Court held, “[t]hrough borrowing of funds [in California] may be an important step in Heller Western’s financing process, the direct generation of the loans occurred in Arizona. We conclude that Heller Western’s sales activity in Arizona constituted the IPA contemplated by our tax regulations.” Walter E. Heller at 53, 775 P2d at 1117.

The Florida Department of Revenue recently issued two Technical Assistance Advisement (“TAA”) memoranda in which the IPA was determined to be located in Florida, although the taxpayers incurred significant costs outside of Florida. As in other cases cited herein, the Florida Department of Revenue made these determinations although the applicable sourcing statute included both “income producing activity” and “based on costs of performance” language.¹²

Finally, the Indiana Department of Revenue issued a decision on January 29, 2015, affirming the auditor’s determination that the tuition fees received by an out-of-state educational services company that provided online educational services to Indiana students should be sourced entirely to Indiana because the IPA occurred in Indiana: “the Taxpayer’s services were rendered here in Indiana because Indiana is the location where the students purchased the taxpayer’s services.” Indiana Department of Revenue, Letter of Findings: 02-20140455, at 8 (Jan. 29, 2015) (stating that Taxpayer does not earn money because its Indiana online students pay Taxpayer to incur out-of-state expenses or conduct out-of-state research or development activities on those

¹²See TAA 12C1-006, Fla. Dep’t of Revenue, May 17, 2012, available at https://revenue.law.state.fl.us/LawLibrarydocuments/2012/05/TAA-111027_12C1-006.pdf; TAA 13C1-011, Fla. Dep’t of Revenue, Nov. 21, 2013, available at https://revenue.law.state.fl.us/LawLibraryDocuments/2013/11/TAA-117960_13C1-011%20RLL.pdf.

students' behalf. Taxpayer earns money because it prepares online educational services and then sells those services to Indiana customers within their home state).

The applicable Indiana statute also *included* the phrase "costs of performance," and Indiana concluded that the taxpayer's IPA "consists of the individual transactions that it engaged in with Indiana residents when the residents purchased educational services from Taxpayer, and it is these receipts and only these receipts that are subject to the corporate income tax." *Id.* at 8.

Based on the foregoing highly illustrative cases and analyses, the ALC correctly determined that DIRECTV's IPA occurred in the homes and businesses of South Carolina customers, that significant authority, and the Department's longstanding policies support this view. Consequently, it is proper to source 100% of the subscription receipts from every South Carolina customer to the numerator of the gross receipts ratio because 100% of the income-producing activity for DIRECTV's transactions with South Carolina customers occurred in South Carolina homes and business. Additionally, the Department's application of its long-standing policy to source gross receipts on an industry by industry basis should be given great deference.

IV. THE ADMINISTRATIVE LAW COURT PROPERLY FOUND THAT THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS APPROPRIATE.

The ALC's finding that the imposition of substantial understatement penalties was proper is clearly supported by the substantial evidence in the record.¹³

"If there is an underpayment attributable to . . . a substantial understatement of tax for a

¹³In the Initial Order, the ALC ordered that DIRECTV be assessed \$1,661,541.00 in penalties – the original assessment of penalties as stated in the Department Determination. (R.pp. 21, 58; Initial Order, p. 21; Resp't Ex. 13, p.1.) However, in the Amended Order, the ALC ordered that DIRECTV's penalty assessment be reduced by 25%; thus, the ALC ordered that DIRECTV be assessed \$1,246,155.75 in penalties. (R. pp. 51-52; Amended Order, pp. 21-22.) The Department respectfully requests this Court to affirm the ALC's determination that DIRECTV be assessed \$1,246,155.75 in penalties as outlined in the Amended Order. *Id.*

taxable period . . . there must be added to the tax an amount equal to twenty-five percent of the amount of the underpayment.” S.C. Code Ann. § 12-54-155(A)(1) (2014) (emphasis added). For purposes of this subsection, “understatement” means the excess of the amount of the tax required to be shown on the return for the taxable period over the amount of the tax imposed which is shown on the return. Section 12-54-155(B)(2)(a).

Further, § 12-54-155 provides for the following:

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

Moreover, “[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.” Section 12-54-155(D)(1) (emphasis added).

The ALC properly found that the Department correctly calculated the amount of the understatement of taxes for 2009-2011 and found “no substantial authority for DIRECTV’s treatment of subscription receipts” and that DIRECTV’s treatment of the subscription receipts was unreasonable. (R. p. 51; Amended Order p. 21.) The ALC further found that the Department was correct to apply a substantial understatement penalty for understatement of taxes owned for 2009-2011 because “DIRECTV did not have ‘reasonable cause’ . . . for the unpaid taxes, i.e., DIRECTV’S method of calculating subscription receipts was unreasonable.” (R. p. 51; Amended Order p. 21.) (emphasis in original).

The ALC properly held that the substantial underpayment penalty was appropriate and the

following supports the ALC's holding. First, DIRECTV did not have substantial authority for how it sourced its South Carolina-based subscription receipts. It erroneously relied upon Lockwood and Mercury to support its treatment of subscription revenue even though it correctly sourced its 2006-2008 South Carolina-based subscription receipts to South Carolina on its original returns for those years.

The Lockwood decision does not explicitly or implicitly direct taxpayers such as DIRECTV to file its corporate tax returns based on a cost of performance method. As noted above, this Court recognized in Lockwood that the Department sourced revenues of service providers such as engineering, law, and accounting firms to the place of activity, while sourcing income from other service industries, such as finance companies and media broadcasters, to the location of the borrower and the advertisers, respectively. The ALC found that DIRECTV is not like the taxpayer in Lockwood finding that DIRECTV's customers do not hire specific professionals and are not paying for those professionals' expertise and time. Rather, "the customer is paying for video programming to be viewed on the customer's television at the time and place the customer demands." (R. p. 46; Amended Order p. 16.) Next, DIRECTV asserts that the decision in Mercury supports the position taken with respect to its tax returns at issue. Specifically, DIRECTV argues that Mercury "rejected a narrow view of income-producing activities . . . that would have considered only isolated 'end-point' activities." (Appellant's Br., p. 40.) The court in Mercury actually did the opposite by narrowing the IPA to "the hauling of freight 'through and over the highways of the State of South Carolina.'" (R. p. 41; Amended Order p. 11.) As the ALC properly recognized, the facts in this case "are akin" to the transactions discussed in Mercury, and that "DIRECTV failed to sufficiently identify its outside income-producing activities." (R. p. 42; Amended Order, p. 12.) Accordingly, from the plain reading of Mercury, DIRECTV's reliance

upon a taxpayer's total business activities to justify sourcing South Carolina-based subscription receipts to other states is not proper.

Finally, DIRECTV did not act in good faith to comply with §§ 12-6-2290 and 12-6-2295(A)(5). Initially, for 2006-2008 DIRECTV sourced 100% of the subscription revenue received from South Carolina customers to the numerator of the gross receipts ratio. (R. pp. 786-808, 835-842, 852-860; Resp't Ex. 1, 4, and 6.) DIRECTV subsequently changed its position, and on its amended 2006-2008 returns as well as its original 2009 and 2010 returns, DIRECTV did not include any of the subscription receipts from South Carolina customers in the numerator of the gross receipts ratio, (R. pp. 816-834, 843-851, 861-870, 871-876, 877-882; Resp't Ex. 3, 5, 7, 8, and 9) although Dr. Cody's testified that DIRECTV had both payroll and property in South Carolina, (R. p. 352; Hr'g Tr. 229:7-21.) Further, because South Carolina is not a cost of performance state, DIRECTV also did not act in good faith in 2011 when it used a payroll factor to source a small amount of subscription receipts to South Carolina.

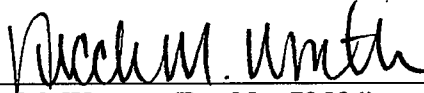
Based on the above and because the statute says that a substantial understatement penalty "must be added," DIRECTV must be assessed the substantial understatement penalties as there is no substantial authority for its position and it did not act in good faith.

CONCLUSION

As explained more fully above, this Court should affirm the ALC's decision as the decision is supported by substantial evidence in the record and the ALC did not make any errors of law.

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February 8, 2017
Columbia, South Carolina

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THE STATE OF SOUTH CAROLINA
In The Court Of Appeals

SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

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

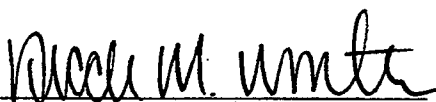
DIRECTV, Inc. & Subsidiaries, ...Appellant,

v.

South Carolina Department of Revenue, ...Respondent.

CERTIFICATE OF COUNSEL

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


Nicole Wooten

Columbia, South Carolina
February 8, 2017

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

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SC Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT COUNTY

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.

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THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT COUNTY

Ralph King Anderson, III, Chief Administrative Law Judge

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Pursuant to Rule 242(g) of the South Carolina Appellate Court Rules, Appellant, DIRECTV, Inc. & its Subsidiaries, ("DIRECTV") files this Amended Final Reply Brief¹ in response to Respondent South Carolina Department of Revenue's Final Brief ("Department Brief") in this matter. For the reasons stated in the Amended Final Brief of DIRECTV ("DIRECTV Brief") and herein, this Court should grant the relief requested in DIRECTV's Brief and as set forth more specifically in the Conclusion hereinbelow.

STATEMENT OF THE CASE AND STATEMENT OF FACTS

Please see DIRECTV's Brief at pp. 3-15 for a statement of the case and statement of facts in this matter.

ARGUMENT

I. THE ALC ERRED BY APPLYING AN INCORRECT BURDEN OF PROOF AND BY FINDING THAT DIRECTV FAILED TO MEET ITS BURDEN OF PROOF.

In its Brief, DIRECTV argued that the ALC erred in not applying the proper burden of proof as set forth in *Cloyd v. Mabry*, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988). In response, the Department claims that DIRECTV's reliance on *Cloyd* is "misguided" and "not applicable." Department Brief, p. 16.

Cloyd stands for the proposition that although a tax assessment is initially presumed correct, once a taxpayer establishes that it is incorrect, the presumption of correctness is removed, and the taxpayer is entitled to appropriate relief. *Cloyd*, 295 S.C. at 88-89, 367 S.E.2d at 173. The Department first argues that *Cloyd* is not applicable because it is a property tax case. However, as set forth in DIRECTV's Brief, multiple

¹ Similar to its Amended Final Brief filed simultaneously herewith, DIRECTV is filing an Amended Reply Brief to correct the references herein to the Record on Appeal, which was recently amended to replace the condensed trial transcript with a full transcript, which resulted in numerous changes to the pagination of the Record.

South Carolina cases have cited the presumption in *Cloyd* with approval, including personal income tax cases and a sales and accommodation tax case. See DIRECTV Brief, p. 17, citing *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*).

Next, the Department contends that even if the assessment is determined to be incorrect, the appropriate relief is not dismissal of the assessment. Department Brief, p. 17. However, the Department fails to address what the appropriate relief is, when, as in this case, the lower court determines that the assessment is incorrect. See Am. Final Order, R. p. 40 (stating that the ALC "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 the signal into the customer's home and onto the customer's television"); and Tr., R. p. 684:11-14 (wherein ALC acknowledges that the Department's position is incorrect and too "simplistic"). Surely, the appropriate relief cannot be to deny the refund in full, enforce the entire proposed assessment and assess penalties against the taxpayer as the Department requests and as the ALC has done here.

Moreover, DIRECTV met the standard burden of proof to show by a preponderance of the evidence that the income producing activity in this case occurs partly within and partly without South Carolina. Therefore, DIRECTV's income tax refund claim for tax years 2006-2008, appeal for a reduced income tax assessment for tax

years 2009-2011, and appeal for a reduced license fee assessment for tax years 2010-2012 should be granted in full. DIRECTV established through detailed factual testimony as well as expert testimony, the extent to which its income producing activity took place within South Carolina using evidence and a sourcing formula that closely tracks the controlling case law (*Lockwood Greene*). See DIRECTV Brief, p. 21. Such evidence is considered relevant in virtually every other state in the country.

Finally, if the ALC had determined that DIRECTV was entitled to relief but that dismissal was not appropriate, then it should have granted the appropriate remedy based on the evidence in the record, which presented a calculation of tax liability as shown on Exhibit A to DIRECTV's Brief that would support reducing the total income tax assessment due for tax years 2006-2011 to \$894,214.00 and reducing the total license fee assessment due to \$13,991.00 for tax years 2010-2012 for a total sum due by DIRECTV of \$908,205 plus appropriate interest. See *supra* p. 15-16 (for a more detailed discussion of the income tax and license fee liability calculations). Alternatively, the ALC should have 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, which DIRECTV would note is not set forth in existing case law or in any Department policy documents such that taxpayers have notice of and can apply such a method.² See *Cloyd*, 295 S.C. 86, 367 S.E.2d 171; DIRECTV Brief, pp. 20-21.

² The closest "guidance" that can be found is this Court's decision in *Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1986), which used payroll as a proxy. The method presented by DIRECTV at trial also used a payroll proxy but added an assets proxy, which actually increased the amount of income attributable to South Carolina.

II. THE ALC ERRED IN FINDING THAT THE ONLY INCOME PRODUCING ACTIVITY WAS THE DELIVERY OF THE SIGNAL WHEN SUCH A FINDING WAS NOT SUPPORTED BY SUBSTANTIAL EVIDENCE AND IS CONTRARY TO THE LAW.

The Department's assertion that income is earned only by the final act of delivery of the signal is unsupported by substantial evidence in the record and is contrary to South Carolina law. Consequently, the ALC erred in so finding for all the reasons set forth in DIRECTV's Brief. *See* DIRECTV Brief, pp. 22-32. In response to DIRECTV's Brief, the Department makes three main arguments: (1) that the ALC properly determined that the only income producing activity in this case is the "final act" of delivery of the signal into the homes and onto the television screens of its customers (*id.* at pp. 20-25); (2) that *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964) supports the first argument above and establishes a narrow construction of income producing activities (*id.* at pp. 25-28); and (3) that the ALC properly interpreted S.C. Code Ann. §12-6-2295(A)(5) to require market based sourcing for DIRECTV (*id.* at p. 28-31). All of these arguments were anticipated and addressed in DIRECTV's Brief and will not be repeated in full herein; however, a few additional points are warranted on these and related arguments and on the cases from other jurisdictions cited by the Department.

A. The ALC's Conclusion that the Final Act of Delivery is the Only Income Producing Activity is Contrary to the ALC's Own Findings and Analysis.

First, the conclusion by the ALC that the only income producing activity in this case is the final act of delivery of the signal into the home is inconsistent with its own findings and analysis. As previously mentioned, the ALC agreed that the Department's position was incorrect specifically stating 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 the signal into the customer's home and onto the customer's television." Am. Final Order, R. p. 40. The ALC further 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 above findings and conclusions are supported by the record and are completely inconsistent with the ALC's ultimate ruling that DIRECTV is not entitled to any relief from the erroneous assessment.

B. The ALC's Conclusion that the Final Act of Delivery is the Only Income Producing Activity is Contrary to South Carolina Law.

By accepting the Department's method, which looks only to the location of the customer (or, as it more recently characterizes it, the "final act" of delivering the signal into the homes of the customers), the Order has adopted the "market approach" or the "origin of payment" approach, which is contrary to S.C. Code Ann. § 12-6-2295(A)(5), *Lockwood Greene* and *Mercury Motor*. Although referencing the statute, which requires that the focus be on the "extent the income producing activity is performed within this state," the ALC ignores the plain language of the statute and abandons the "place of activity" test set forth therein and applied by this Court in *Lockwood Greene* as well as the analysis and logic set forth in *Mercury Motor*.

The Department's interpretation of *Mercury Motor* and *Lockwood Greene* is flawed and misled the ALC to incorrectly apply these cases when it concluded that the final act of delivery is the only income producing activity. As discussed in DIRECTV's Brief, the issue in *Mercury Motor* was whether the mileage-based apportionment formula

for motor carriers resulted in a discriminatory or unconstitutional assessment when applied to Mercury Motor where that formula apportioned 17% of its income to this state, while revenue from customers paying for freight picked up in or delivered to South Carolina only accounted for 1% of its revenue. DIRECTV Brief, p. 28; *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964). The taxpayer argued that the mileage-based formula taxed activities that did not contribute to its income in South Carolina. *Id.* The court, however, disagreed. It upheld the mileage-based formula because the Court found that the "hauling of freight" was the transaction that primarily earned the income at issue. *Id.*, 244 S.C. at 141, 135 S.E.2d at 759.

The case does *not* say "that only the hauling of freight was the IPA [income producing activity] while excluding the other incidental activities" as the Department's Brief states. Department Brief, p. 26. Instead, the Court states as follows:

The appellant 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 appellant.* . . .

Mercury Motor, 244 S.C. at 141, 135 S.E.2d at 759-60 (emphasis added). Thus, the Court is acknowledging that all of the transactions in the series contribute to the production of income. *Id.* The Court then goes on to say that "while each transaction is necessarily incidental to the production of its income, the transaction which primarily earns the income is the hauling of the freight." *Id.* This makes perfect sense where the only issue before the Court was whether it was unconstitutional to take into account the income related to the hauling of freight. The Court did not consider or address, of course, whether it would be appropriate to ignore some income producing activities when

applying a statutory apportionment method based strictly on the "income producing activities" of a taxpayer. In fact, to the extent the opinion can be read to discount "incidental" activities, that would appear to include delivery of the freight, which would be akin to the "final act" of delivering the signal into the customers' home, which is the only act that the ALC considered in this case. Thus, considering delivery of the signal to be the only income producing activity is completely contrary to *Mercury Motor*. Moreover, even if this Court determined on some basis that delivery of the signal was the primary or only income producing activity, the evidence establishes that this would include a multitude of activities, including collecting of programming and transmission of programming to broadcast centers, uplink facilities, satellites and customers. See Tr., R. pp. 170:14- 207:25.

The Department also focuses on dictum in *Lockwood Greene*, which states that the "place of activity" test might not apply to "media broadcasters." Department Brief, p. 34. It also makes the unsupported and erroneous assertion that DIRECTV is a "media broadcaster." *Id.* at p. 18. First, no evidence in the record supports this statement. DIRECTV is not a media broadcaster, but rather is a producer of original content and a multichannel video programming distributor, whose revenue is derived from fees paid by its customers for rentals of set-top boxes and subscriptions to its programming services. In contrast, media broadcasters such as CBS, NBC, ABC earn their revenue almost exclusively from advertising receipts. Advertising receipts earned by media broadcasters is the only income addressed by the policies referred to in *Lockwood Greene*, and such income is not at issue here. See R. pp. 940-949. Moreover, the Department admits that these policies pre-dated the existence of businesses like DIRECTV (Tr., R. p. 471:19-

472:12) and admits that they do not address subscription revenue, the satellite industry or even cable companies. *Id.* See also *infra* §III (for additional discussion regarding the policies).

Additionally, the *Lockwood Greene* dictum relates to the taxpayer's argument in that case that the court should adopt an "origin of payment" approach because that would be consistent with the policy of the Department at that time to apply such an approach to media broadcasters and finance companies. *Lockwood Greene*, 293 S.C. at 450, 362 S.E.2d at 348. The Court of Appeals declined to adopt the "origin of payment" approach and was likely simply conveying that it need not consider policies related to businesses that were not before it (and to the extent it could be read to be commenting on these businesses, such a statement would be dictum). *Id.* In no way, shape or form does *Lockwood Greene* dictate that an "origin of payment" test be applied to certain taxpayers. *Id.*

C. The Cases from Other Jurisdictions Cited by the Department Do Not Support its Position and are Contrary to Established South Carolina Law.

The Department cites to cases from other jurisdictions in support of its argument that it is appropriate to interpret an activities based sourcing statute to reach a market based result. See *Walter E. Heller Western, Inc. v. Wis. Dept. of Rev.*, 775 P.2d 1113 (Wis. 1989); *Ameritech Publishing, Inc. v. Wis. Dept. of Rev.*, 788 N.W.2d 383 (Wis. Ct. App. 2010); *Anonymous Taxpayer v. Texas Cptr of Pub. Accts.*, 2013 WL 3490605 (Tex. Cptr. Pub. Accts. May 17, 2013). While these cases are obviously not binding on this Court, a review of them reveals that they do not support the Department's position and are contrary to established South Carolina law.

In *Walter E. Heller Western, Inc. v. Wis. Dept. of Rev.*, 775 P.2d 1113 (Wis. 1989), the Arizona Supreme Court analyzed how interest income earned on loans made to Arizona customers should be sourced. Tr., R. pp. 569:1-14; 674:18- 675:9. In reaching its decision, the court did not consider the activities conducted by the taxpayer outside of Arizona, such as the raising of funds that were loaned to customers, to be the income producing activities. *Heller Western*, 775 P.2d at 1117. Instead, the court determined that the income producing activities consisted of "the solicitation of new customers, the investigation of potential customers' credit records, and the servicing of these contracts," all of which occurred in Arizona. *Id.* However, and in sharp contrast to the situation here, the court in *Heller Western* was interpreting detailed regulations adopted by the Department of Revenue, which, the court held, defined income producing activity by reference to solicitation, negotiation and sales activities conducted by the taxpayer. *Id.* at 1116-17.. As discussed in its Brief and §III herein, no such regulations or any other published guidance exist in South Carolina to guide this Court's interpretation of S.C. Code Ann. §§12-6-2290 and 12-6-2295(A)(5). Moreover, and quite unlike the Department's theory in this case, the Arizona Supreme Court, in reaching its decision, actually identified income producing activities conducted by the taxpayer such as the solicitation of new customers, investigation of credit reports of potential customers and servicing of contracts and did not simply look to the location of the customer as the Department does here.

Likewise, *Ameritech Publishing, Inc. v. Wis. Dept. of Rev.*, 788 N.W.2d 383, 2010 WL 2519583 (Wis. Ct. App. 2010) does not support the Department's theory. In *Ameritech*, the Wisconsin Court of Appeals analyzed how local advertising revenue

generated by the taxpayer from the placement of advertisements in telephone directories should be sourced and held that because the income producing activity was “the provision of access to a Wisconsin audience,” the local advertising revenue should be sourced to Wisconsin. *Ameritech*, 2010 WL 2519583, slip op. at 10-12. In reaching its decision, however, the court did not ignore the activities conducted by Ameritech outside of Wisconsin, as the Department does here, but instead, after analyzing the nature of Ameritech’s business, determined that providing “access” to the Wisconsin market was the income producing activity with respect to the advertising services provided. *Id.* Although the court looked to the Wisconsin “market,” the court’s conclusion was simply that, under the facts of the case, the location of the market coincided with the location of the income producing activity of a taxpayer providing advertising services. Thus, as in *Heller Western*, not only does *Ameritech* involve an entirely different type of service than is involved here, the court actually identified income producing activities and did not simply look to the location of the customer.

Although *Heller Western* and *Ameritech* both reach market-oriented results, neither case supports the legal theory advanced by the Department.³ Instead, these cases stand for nothing more than the proposition that the determination of income producing activities is a fact intensive inquiry that must be made on a case-by-case basis, which is precisely the position advanced by DIRECTV here. Defining income producing activity as providing “access” to a market may be entirely appropriate for an advertising business, but it does not support the Department’s legal theory that DIRECTV’s subscription

³ The analysis applied in both cases directly contradicts the opinion of the Department’s expert economist, Dr. Harrison, as the income producing activities identified by the courts certainly generate “costs” and therefore would not be considered to be income producing activities under Dr. Harrison’s opinion.

revenue should be sourced based on the location of the customer. As the decisions demonstrate, income producing activities will be different for different industries, and the ALC should have determined the income producing activities here based on an analysis of DIRECTV's business.

Finally, the Department also cites a case from the Texas Comptroller of Public Accounts in support of its position. *See Anonymous Taxpayer v. Texas Cptr of Pub. Accts.*, 2013 WL 3490605 (Tex. Cptr. Pub. Accts. May 17, 2013). However, because both the facts and the law in the Texas case are distinguishable from this case, it is not instructive here. First, unlike DIRECTV, the taxpayer in the Texas case only purchased the right to broadcast programming from other networks; it produced no original content. *Id.* at 7. Additionally, Texas law regarding sourcing of services is quite different than South Carolina law. The relevant Texas statute defines "gross receipts" from business done in Texas to include receipts from "each service performed in this state." *Id.* at 10, citing Tex. Tax Code §171.103(a). Service receipts are apportioned to the location where the service is performed, and if a taxpayer performs services both within and outside of Texas, then receipts are sourced to Texas "on the basis of the fair value of the services that are rendered in Texas." *Id.* citing Tex. Admin. Code § 3.549(e)(38) and 3.557(e)(33). The Texas Comptroller also states that "the focus should be on the specific, end-product acts for which the customer contracts and pays to receive, not on non-receipt producing, albeit essential, support activities." *Id.* citing Tex. Comptroller Decision no. 10,028 (1980). The Texas statute and related department guidance, which require the focus to be on the "fair value of the services" and the "final act" for which the customer contracts and pays to receive, is completely contrary to South Carolina law (*i.e.* S.C.

Code Ann. §12-6-2295, *Lockwood Greene* and *Mercury Motor*), which as discussed above, requires the focus to be on the income producing activities of the taxpayer, and thus, this case does not provide support for the Department's position. *See supra* § II(B).

III. THE DEPARTMENT'S PURPORTED LONGSTANDING POLICIES ARE NOT ENTITLED TO ANY DEFERENCE.

The Department asserts that it has longstanding policies in this case that should be given deference by this Court. Department Brief, p. 39-42. According to the Department, it has a longstanding policy of sourcing gross receipts of personal service firms (like an engineering firm) to the state in which the personal services are performed, while gross receipts of firms such as finance companies and media broadcasters are sourced differently. *Id.* at 40. Interestingly, when asked for these longstanding policies in discovery in this case, the Department could find nothing, and its audit supervisor testified at trial that these policies were not in writing. Tr., R. p. 438:24- 439:7. Moreover, the Department's auditor in this matter testified in his deposition that he was not even aware of any such policies. Tr., R. p. 438:6-21.

The *only* evidence regarding these purported policies was contained in the form of a stipulation of facts sometime prior to 1986 between two private parties in the *Lockwood Greene* case. *See* R. pp. 940-949. The Department admits that these policies were never updated after 1983 (Tr., R. p. 470:20- 471:5), admits that they pre-dated the existence of businesses like DIRECTV (R. p. 471:19- 472:10) and admits that they do not address subscription revenue, the satellite industry or even cable companies. *Id.* Under these circumstances, the ALC correctly declined to give deference to such policies (see Am. Final Order, R. p. 46 at n. 19), and this Court should likewise give them no weight.

IV. THE ALC ERRED IN FINDING THAT DIRECTV FAILED TO ESTABLISH THE PORTION OF ITS BUSINESS ACTIVITIES THAT ARE CONDUCTED IN SOUTH CAROLINA.

The Department argues in its Brief that the ALC was correct in finding that the taxpayer failed to meet its burden to show that any of its income producing activities occurred outside of South Carolina. Department Brief, pp. 23-25. The Department repeats statements from the Amended Final Order that describe the method used by DIRECTV's expert, Dr. Cody, for determining the amount of income that was produced by DIRECTV's activities in South Carolina as "too nebulous," and asserts that DIRECTV did not sufficiently establish the effect of the "value drivers" discussed by Dr. Cody on income production in this state. *Id.* at 25. The ALC acknowledged that "the evidence. . . suggested that there may be other activities, such as advertising, that influence the customer's decision to make the purchase." Am. Final Order, R. p. 41. However, the ALC found DIRECTV's proof on this insufficient because "[t]hough its 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. Instead, the court was left to speculate as to the extent to which DIRECTV's content and programming, acquisition and distribution thereof, advertising, and customer service in installing and maintaining its equipment within this State influenced customers' decision[s] to subscribe to DIRECTV." *Id.* at pp. 41-42.

The ALC's standard would require DIRECTV to establish with mathematical precision why each South Carolina customer chose to purchase a subscription to DIRECTV. Did he choose DIRECTV because of an advertisement he saw or because of

programming and quality of service? This standard would be impossible for any taxpayer to meet and, fortunately, is not required by the law. The law only requires that taxpayers use a reasonable apportionment method not one that is perfect or mathematically precise. *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 684-85 (1986) (rejecting taxpayer's challenge that formula did not accurately reflect income earned in the state because its track in North Carolina was not as profitable as its track elsewhere and explaining 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 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."); *Covington Fabrics Corp. v. S.C. Tax Comm'n*, 264 S.C. 59, 66-67, 212 S.E.2d 574, 577-78 (1975), citing *Illinois Central Railway Co. v. State of Minnesota*, 309 U.S. 157, 161 (1940) (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.").

Lockwood Greene endorsed this approach when it 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 449, 361 S.E.2d at 347. In reaching its decision, the 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. (emphasis added).

As explained more thoroughly in its Brief, DIRECTV, through its expert Dr. Cody, presented a method for determining the portion of DIRECTV's activities that took place in South Carolina using two commonly employed proxies: (1) payroll expenses, and (2) the net book value of assets (collectively, the "Payroll and Assets Method"). See DIRECTV Brief, p. 8-13; and Tr., R. p. 352:7- 354:18. This Payroll and Assets Method is both fair and reasonable as it reflects the fundamental economics of DIRECTV's business, and more specifically, the "value drivers" of the business (i.e. the factors that lead customers to subscribe to DIRECTV's programming services), which include content development, marketing, broadcast operations and customer service. DIRECTV Brief, p. 9. DIRECTV is not required to show why each individual South Carolina customer chose to subscribe to DIRECTV, but rather need only provide a reasonable formula that measures its activity in South Carolina. The Payroll and Assets Method is consistent with *Lockwood Greene* and provides a reasonable measure of the business activity carried on by DIRECTV in South Carolina.

Exhibit A to DIRECTV's Brief shows the results of applying the "value drivers" submitted by Dr. Cody. This method approximates the portion of the taxpayer's subscription receipts and license fees that are generated by its income activities as dictated by S.C. Code Ann. §12-6-2295(a)(5), which attributes receipts to this state "to the extent the income activity is performed within this state." Under Dr. Cody's calculations, which use the ratio of South Carolina payroll and net assets to total payroll and net assets as a proxy, DIRECTV overpaid its income taxes for tax years 2006-2008

and is entitled to a refund of \$2,076,540.00⁴ and underpaid its income taxes due for tax years 2009-2011 and thus owes \$2,970,754.00 of that assessment.⁵ The netting of the over and underpayments produces a net income tax due for the years under consideration of \$894,214.00. Dr. Cody's method also results in a reduction of the license fees owed for tax years 2010-2012 to \$13,991.⁶ See DIRECTV Brief at Exh. A (second chart). Thus, the total sum due by DIRECTV for both its income tax and license fee assessments under Dr. Cody's method is \$908,205.00.

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

Nothing in the record supports substantial understatement penalties being imposed in this case. In its Brief, the Department argues that such penalties are justified for tax years 2009-2011 because "DIRECTV did not have substantial authority for how it sourced its South Carolina-based subscription receipts" and "erroneously relied upon *Lockwood Greene* and *Mercury Motor* to support its treatment of subscription revenue" Department Brief, p. 47.

Under South Carolina law, 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-

⁴ This total is calculated by adding the overpayment amounts contained in the first chart on Exhibit A to DIRECTV's Brief for 2006 (\$30,265), 2007 (\$1,085,270) and 2008 (\$961,005).

⁵ This total is calculated by adding the underpayment amounts in the first chart on Exhibit A to DIRECTV's Brief for 2009 (\$927,557), 2010 (\$1,037,493) and 2011 (\$1,005,704).

⁶ This total is calculated by adding the underpayment amounts contained in the second chart on Exhibit A to DIRECTV's Brief for tax years 2010 (\$5,053), 2011 (\$4,449) and 2012 (\$4,489).

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).

Here, the ALC did determine that the substantial understatement penalty should be reduced by 25%. Am. Final Order, R. p. 51. The ALC explained that this reduction was appropriate because it found that DIRECTV acted in good faith regarding the understated amounts. *Id.* Although apparently not the basis for the reduction, the ALC also found that DIRECTV "appropriately disclosed relevant facts affecting subscription receipts." *Id.* However, it did not abate the penalties entirely because, for reasons that are not entirely clear, the ALC determined that DIRECTV had no substantial authority for its position and that DIRECTV's basis for its tax treatment of the subscription receipts was not reasonable. *Id.*

As discussed in its Brief and above, existing South Carolina law supports DIRECTV's position in every respect, and thus, DIRECTV had substantial authority for its position and there was a reasonable basis for its tax treatment of the subscription receipts. S.C. Code Ann. §12-6-2290(A)(5) speaks to "income producing activity" and *Lockwood Greene* outlines a "place of activity" test and endorses a method based on a payroll proxy. *Mercury Motor* states that each transaction in the series of activities engaged in by the taxpayer to conduct its business contributed to its earnings and net income, and the Court did not consider the "final act" of delivering the package to the customer's residence to be the primary income producing activity. Neither case focuses on the location of the customer (*i.e.* market based sourcing), which some states have adopted by statute. Moreover, the Department has no published guidance to alert taxpayers to any policy that is interpreting the existing law, and even its own auditor was not aware of such a policy. *See supra* §III. If South Carolina had adopted market based sourcing or the Department had published guidelines that set forth its

position, then it would be clear to taxpayers how its income should be apportioned and failure to follow such guidance could potentially justify a penalty against the taxpayer (although no penalty would be justified if the policy was contrary to South Carolina law). But where a statute and the existing case law, by their plain words, state one view, and the court construes those words to mean the opposite view, it is simply incredible 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 income producing activities outside of South Carolina. *See supra* §I. If a taxpayer protesting an assessment deemed erroneous by the court and proposing an alternative 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.

Even the Texas case framed by the Department as reaching the result it seeks here (though the law and facts in that case were distinguishable) did not uphold the imposition of a penalty on the taxpayer. *Anonymous Taxpayer v. Texas Cptr of Pub. Accts*, 2013 WL 3490605 (Tex. Cptr. Pub. Acct., May 17, 2013) (declining to uphold penalty imposed by Texas DOR based, in part, on fact that case involved a complex and novel issue). *See also Ameritech*, 2010 WL 2519583, slip op. at 12 (although ultimately finding in favor of the Wisconsin Department of Revenue due to the due deference standard it applied, it concluded that the taxpayer's view that its income producing activities to produce its directories were performed outside the state was reasonable). Because the existing law supported its position in this case and there was no guidance published by the Department to the contrary, DIRECTV had substantial authority for its position, a reasonable basis for

its tax treatment and, acted in good faith. Thus, the substantial understatement penalties for 2009-2011 should be dismissed.

CONCLUSION

For the reasons set forth above and in DIRECTV's Brief, DIRECTV respectfully requests that this Court (i) reverse the Amended Final Order of the ALC because DIRECTV's rights have been prejudiced by the ALC's findings, conclusions and decisions, which 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) declare that, per the computations on Exhibit A to DIRECTV's Brief, the refunds owed to DIRECTV on its income taxes paid for tax years 2006-2008 total \$2,076,540.00 plus appropriate interest, while the income tax assessments for tax years 2009-2011 should be reduced to \$2,970,754.00 plus appropriate interest such that the total amount owed on its income tax assessments is \$894,214.00 plus appropriate interest; (iii) declare that also per Exhibit A to DIRECTV's Brief, its license fee assessment for tax years 2010-2012, should be reduced to \$13,991.00 plus appropriate interest, and (iv) dismiss the substantial understatement penalties imposed by the Department.

Alternatively, if this Court determines that the evidence presented by DIRECTV is insufficient to rule as DIRECTV requested, it should not allow the Department's assessment, which the ALC properly characterized as erroneous, to stand. Instead, it 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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February 9, 2017

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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,

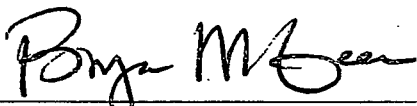
v.

South Carolina Department of Revenue, ... Respondent.

CERTIFICATE OF COUNSEL

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

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THE STATE OF SOUTH CAROLINA
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APPEAL FROM ADMINISTRATIVE LAW COURT

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

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South Carolina Department of Revenue Respondent.

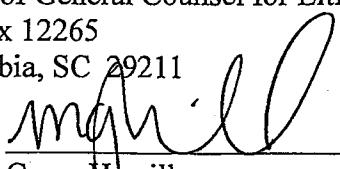
PROOF OF SERVICE

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 United States Mail, postage prepaid, to the following address(es):

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