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THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT
HONORABLE SHIRLEY C. ROBINSON, ADMINISTRATIVE LAW JUDGE

Case No. 14-ALJ-17-0285-CC
Appellate Case No. 2016-001642

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

v.

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

BRIEF OF RESPONDENT

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STATEMENT OF THE CASE

This matter came before the Administrative Law Court (ALC) when Dish DBS Corporation, f/k/a EchoStar, DBS Corp., and Affiliates (Appellant or Dish DBS) requested a contested case hearing on June 12, 2014 to challenge a Department Determination issued by the South Carolina Department of Revenue (Department). (R. pp. 3077-3083; Resp't Ex. 4.) In its May 13, 2014 Department Determination, the Department assessed Dish DBS for South Carolina corporate income taxes, license fees, interest, and penalties for tax years 2004 through 2010 ("Tax Periods at Issue"). (R. p. 3077; Resp't Ex. 4, p. 1.) Specifically, the Department issued the assessment because Dish DBS is required to source all of its South Carolina subscription revenue to South Carolina since all of the income-producing activity related to Dish DBS's South Carolina subscription revenue occurred in South Carolina. (R. p. 3083; Resp't Ex. 4 p. 7.)

On July 11, 2016, the ALC issued its Amended Final Order ("Amended Order"). On August 8, 2016, Dish DBS served and filed its Notice of Appeal of the ALC's decision to the South Carolina Court of Appeals. (R. pp. 410-411; Notice of Appeal.)

STATEMENT OF FACTS

I. Dish DBS's Business Operations

Dish DBS is a multistate taxpayer that offers direct broadcast satellite video services to subscribers throughout the country. (R. pp. 472-473, 2192-2380, 3077-3083; Hr'g Tr. 33:11-34:11; Pet'r Ex. 25; Resp't Ex. 4.) Its headquarters are located in Englewood, Colorado. (R. pp. 473; Hr'g Tr. 34:21-23.) For a subscription fee, Dish DBS grants its subscribers access to hundreds of television programming channels and other audio/visual options that are transmitted nationwide to subscriber's homes or businesses. (R. pp. 472, 477, 479-480, 494-499; Hr'g Tr. 33:15-20, 38:1-20, 40:12-41:3, 55:14-60:19.) Dish DBS receives programming – the vast majority are licensed from third parties – through satellite, fiber-optic cables, and over-the-air broadcast. (R. pp. 477-478, 494-499; Hr'g Tr. 38:22-39:1, 55:14-60:10.) Dish DBS collects programming from local broadcast television stations through the use of "local receive facilities." (R. pp. 494-495, 510-511; Hr'g Tr. 55:14-56:8, 71:11-72:5.) The signals for all the programming content are ultimately collected at broadcast and uplink centers. (R. p. 495-496; Hr'g Tr. 56:21-57:6.) The broadcast and uplink centers transmit the programming content signal to one of two types of satellites: Continental United States "CONUS" satellites or spot beam satellites. (R. pp. 495-496; Hr'g Tr. 56:21-57:15.) The satellites then transmit the signal to Dish DBS satellite dishes mounted on or near subscriber homes. (R. pp. 495-498; Hr'g Tr. 56:21-59:1.) The signals are then relayed from the dish on or near the home to a set-top box (often located in the subscriber's living room) which delivers the signal to the subscriber's television set. (R. pp. 497-499; Hr'g Tr. 58:15-60:17.)

Because Dish DBS encrypts the signal, it cannot be viewed by the subscriber until the set-top box in the home descrambles the signal into a viewable format on the subscriber's television screen. (R. pp. 498-499; Hr'g Tr. 59:2-60:10.)

Subscribers 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. 476-77, 479-480; Hr'g Tr. 37:23-38:10, 40:12-41:3.) Before Dish DBS will deliver the programming, Dish DBS and the subscriber must execute a contract for the service, and Dish DBS must install or provide a satellite dish, remote controls, and set-top box at the subscriber's home in order for Dish DBS to deliver its programming to the subscriber's home. (R. pp. 484, 487-488, 547, 551; Hr'g Tr. 45:1-11, 48:4-49:16, 108:19-25, 112:1-9.) The set-top box is a vital part of Dish DBS's business and ultimate receipt of subscription-related revenue. (R. pp. 547-548, 549-550; Hr'g Tr. 108:19-109:5, 110:19-111:4.)

Dish DBS's primary source of revenue is the subscription revenue it receives from its approximately fourteen million subscribers. (R. pp. 533, 543; Hr'g Tr. 94:9, 104:10-16.) Dish DBS's total revenue from subscribers includes the following: monthly fees for subscribing to one or more packages of video programming (including pay-per-view programming); revenue from the sale or lease of the set-top boxes; revenue from optional warranty on the leased boxes (protection plans); and revenues from fees associated with high definition set-top boxes, set-top boxes with DVR, multi-room viewing charges, and in-home services (installation of TVs, surround sound, etc). (R. pp. 528, 543-544, 547, 576; Hr'g Tr. 89:3-11, 104:10-105:4, 108:1-7, 137:8-22.) The parties do not dispute the treatment of the various income associated with the set-top boxes and agree that all such income (installation, rental, repair and/or warranty) from the set-top boxes received by Dish DBS from South Carolina subscribers should be included in the numerator of the

gross receipts ratio for apportionment purposes. (R. pp. 577, 630-633; Hr'g Tr. 138:3-21, 191:13-194:1.)

II. Dish DBS's Income Tax Returns

For the periods at issue, Dish DBS filed its corporate income tax returns with little or no consistency. (R. pp. 814, 3052; Hr'g Tr. 375:4-7; Resp't Ex. 1.) For some years, it sourced subscription receipts to the origin of its subscribers. Id. In other years, it utilized a sourcing method based upon its cost of performance, sourcing its South Carolina revenues outside the State of South Carolina. Id. Dish DBS also oscillated between using the four-factor apportionment method and the gross receipts method for the tax years at issue. (R. pp. 578, 598, 801-814, 1015-1150, 3052; Hr'g Tr. 139:18-23, 159:18-20, 362:5-375:7; Pet'r Ex. 1-12; Resp't Ex. 1.) By doing so, Dish DBS used final gross receipts ratios of 0.2384%, 0.2086%, 0.1258%, 0.2400%, .03086%, and 0.2717% for years 2005 through 2010, respectively. (R. pp. 1015-1150, 3052; Pet'r Ex. 1-12; Resp't Ex. 1.)

In 2011, the Department audited Dish DBS. (R. p. 796; Hr'g Tr. 357:3-4.) As a result of the audit, the Department's Audit Division issued a field audit report dated January 28, 2014 and assessed Dish DBS for income taxes and license fees for 2005 through 2010 using a gross receipts ratio that included all of the subscription receipts from South Carolina subscribers in the numerator. (R. pp. 817-821, 3053-3074; Hr'g Tr. 378:8-382:3; Resp't Ex. 2.) In doing so, the Department used gross receipts ratios of 1.3467%, 1.3563%, 1.4537%, 1.4075%, 1.4982%, and 1.6144% for years 2005 through 2010, respectively.[1] (R. pp. 3056-3057; Resp't Ex. 2, Bates stamp pp. 332-333.)

[1]Dish DBS's witness, Mr. Sheers, conceded that the number of subscribers in South Carolina over nationwide subscribers is approximately 1.6% and in fact based some of Dish DBS's calculations upon the 1.6%. (R. pp. 614, 798-799; Hr'g Tr. 175:13-19; 359:6-360:15.)

The Department subsequently issued its Department Determination and found that the income-producing activity of Dish DBS was the delivery of the signal into the South Carolina subscriber's house and onto the subscriber's television sets, that this income-producing activity occurred entirely in South Carolina, and that, accordingly, Dish DBS should include 100% of the subscription receipts received from South Carolina subscribers in the numerator of the gross receipts ratio. (R. pp. 818-819, 3077-3083; Hr'g Tr. 379:22-380:1; Resp't Ex. 4.) Dish DBS challenged the Department Determination asserting that its South Carolina subscription receipts "should not be sourced to South Carolina for income tax or capital tax or 'licensing fee' apportionment purposes." (R. pp. 656-657, 3146; Hr'g Tr. 217:15-218:24; Resp't Ex. 14, p. 2.)

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

Pursuant to the Department's longstanding policy, the Department examines the specific activities of each applicable industry to determine sourcing. (R. pp. 871, 894-895, 897-898; Hr'g Tr. 432:2-12, 455:11-456:23, 458:19-459:1.) For example, when sourcing the income of an engineering firm, the Department looks to the actual engineering services as constituting the income-producing activity; therefore, the income is sourced to the location of the engineer. (R. pp. 871; Hr'g Tr. 432:13-20.) The Department also sources income received from the licensing of intangibles and from a financing operation to the location of the sale that generates the license fee (in the case of intangibles) and the location of the borrower (in the case of a financing company). (R. pp. 871-872, 893; Hr'g Tr. 432:21-433:14, 454:13-20.) The Department sources gross receipts related to cable companies and telephone companies similar to the method it used to source Dish DBS's gross receipts from South Carolina subscription revenue. (R. p. 896; Hr'g Tr. 457:20-25.)

In an appeal from the decision of an administrative agency, the Administrative Procedures Act provides the appropriate standard of review. Olson v. S.C. Dep't of Health & Envtl. Control,

379 S.C. 57, 63, 663 S.E.2d 497, 500-501 (Ct. App. 2008). S.C. Code Ann. § 1-23-610(B) (Supp. 2014) provides the applicable standard of review and provides the grounds under which this Court may reverse or modify the ALC's decision:

> The review of the administrative law judge's order must be confined to the record. 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. 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.

This Court may not reverse the ALC's decision unless it is clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record. To affirm the ALC, "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 Envtl. Control, 389 S.C. 1, 9–10, 698 S.E.2d 612, 617 (2010)). See also 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).

Additionally, this Court should not reverse the ALC's decision unless there is an error of law. "Questions of statutory interpretation are questions of law, which [this Court is] free to decide without any deference to the court below." Centex Int'l, Inc. v. S. C. Dep't of Rev., 406 S.C. 132, 139, 750 S.E.2d 65, 69 (2013), reh'g denied (Sept. 20, 2013).

Finally, "the admissibility of evidence is within the sound discretion of the trial judge." State v. Rice, 375 S.C. 302, 314, 652 S.E.2d 409, 415 (2007) (internal citations omitted). Thus, "[e]videntiary rulings of the trial court will not be reversed on appeal absent an abuse of discretion or the commission of legal error which results in prejudice to the defendant." Rice, 375 S.C. at 314, 652 S.E.2d at 415 (internal citation omitted). Therefore, this Court may not reverse the ALC's evidentiary ruling unless the ruling is based on an error of law or a factual conclusion that is without evidentiary support.

ARGUMENTS

This Court should affirm the ALC because the factual findings of the ALC are supported by substantial evidence, the ALC made no errors of law, and the ALC's decision was not arbitrary or capricious or characterized by abuse of discretion.

I. THE ADMINISTRATIVE LAW COURT CORRECTLY ADMITTED THE TESTIMONY OF DR. GLENN W. HARRISON.

Dish DBS erroneously argues the ALC erred in allowing the testimony of Dr. Glenn Harrison, an expert qualified in applied economics, and also erred in denying Dish DBS's Pre-Trial Motion in Limine regarding Dr. Harrison. (R. p. 694; Hr'g Tr. 255:20-22.) Dr. Harrison, "an expert by knowledge, skill, experience, training, or education," assisted the ALC in understanding the evidence or determining a fact in issue. See Rule 702, SCRE.

The "[q]ualification of an expert and the admission . . . of his testimony is a matter within the sound discretion of the trial court." Fields v. Reg'l Med. Ctr. Orangeburg, 363 S.C. 19, 25, 609 S.E.2d 506, 509 (2005). The trial court's qualification of an expert and admission of his testimony "will not be disturbed on appeal absent an abuse of discretion." Id. (citations omitted). "An abuse of discretion occurs when the ruling is based on an error of law or a factual conclusion that is without evidentiary support." Id. at 26, 609 S.E.2d at 509.

The evidence shows that Dr. Harrison was qualified to testify in this matter. Dr. Harrison is a professor at Georgia State University where he holds two positions: the C.V. Starr Chair in Risk Management and Insurance and the Director of the Center for the Economic Analysis of Risk. (R. pp. 675, 3084-3099; Hr'g Tr. 236:15-23; Resp't Ex. 5.) Dr. Harrison teaches and researches in numerous areas in the field of economics, to include applied economics:

> Applied economics is that part of economics that uses theories from economics but applies them, whether it's in environmental economics, it's in international trade, it's in public finance or in applications to the law. So it uses economic theories and ties them to real world data and activities that you see in the economy usually using statistics.

(R. pp. 676-678; Hr'g Tr. 237:3-7, 237:23-238:7, 238:25-239:7.) Most of his courses have "dealt with applied economics" and most of his publications "in a sense would be applied economics." (R. p. 682; Hr'g Tr. 243:2-3, 243:10-11.) After hearing Dr. Harrison's testimony regarding his educational and professional background, accompanied by his extensive C.V., the ALC qualified Dr. Harrison as an expert in applied economics. (R. pp. 696, 3084-3099; Hr'g Tr. 257:17-24, Resp't Ex. 5.)

Pursuant to Rule 702, SCRE, Dr. Harrison provided information to the ALC that assisted it in the evaluation of the facts. For example, Dr. Harrison assisted the ALC in understanding Dish DBS's testimony about its activities by distinguishing between Dish DBS's intermediate or prior activities and its income producing activities. (R. pp. 693, 702-705, 708-709, 712, 714-715; Hr'g Tr. 254:11-21, 263:18-265:9, 266:16-23, 269:21-270:14, 273:18-20, 273:20-22, 275:13-17, 276:10-12.) Dish DBS argued that its income should be apportioned based upon cost-of-performance factors, and Dish DBS's lay and expert witnesses testified that the cost activities it performs outside of South Carolina are the income producing activities in this matter. (R. pp. 577, 630-633, 763-766; Hr'g Tr. 138:3-21, 191:13-194:1; 324:1-327:25.) Dr. Harrison's testimony

aided the ALC in understanding the economic impact or significance of these necessary, but intermediate, activities and how these activities may differ from the "income-producing activities" referenced in S.C. Code Ann. § 12-6-2295(A)(5) (2014).

Further, because neither § 12-6-2295(A)(5) nor any other South Carolina apportionment statute define the term "income-producing activity," Dr. Harrison assisted the ALC to "determine a fact at issue." Rule 702, SCRE. As noted by the ALC in its Order Denying Cross Motions for Summary Judgment ("Summary Judgment Order"), "at this stage in the litigation, there are insufficient facts to determine what [Dish DBS's] income-producing activities are and the extent to which those activities take place in South Carolina." (R. p. 71; Summ. J. Order, p. 10.) Dr. Harrison provided significant insight and understanding from an economic perspective of the activities of Dish DBS and which activities were income-producing.

Contrary to Dish DBS's argument, the Department did not ask Dr. Harrison to provide an opinion – and Dr. Harrison did not testify – as to what apportionment or sourcing method should be utilized in this matter. The ALC previously determined in its Summary Judgment Order that "South Carolina is, at the very least, not a strict cost of performance state." (R. p. 68, Summ. J. Order, p. 7.) Further, the ALC noted that § 12-6-2295(A)(5) "focuses solely on the extent the 'income-producing activity' is performed in this State." (R. p. 69; Id. at 8.) This determination is entirely consistent with the Department's position in this matter: the focus is and has always been on the income producing activity of the business or industry at issue. To that end, Dr. Harrison's expertise in applied economics was relevant and helpful to the ALC in evaluating the economic activities of Dish DBS and how those activities relate to the income producing activity of Dish DBS, as required by § 12-6-2295(A)(5).

Dr. Harrison recently testified as an expert witness in the similar case of DIRECTV, Incorporated & Subsidiaries v. South Carolina Department of Revenue, Docket No. 14-ALJ-17-0158-CC, (Appellate Case No. 2015-001509), and Chief Judge Anderson qualified Dr. Harrison as an expert witness in general economic and law principles.[2] (R. pp. 194-195.)

Based upon Dr. Harrison's testimony in DIRECTV, Dish DBS asserts that the ALC erred in denying its Motion in Limine to exclude Dr. Harrison because any testimony from Dr. Harrison regarding the "economic reasonableness" of an apportionment statute is not relevant in the matter. However, the Department did not ask *any* questions to Dr. Harrison as to whether South Carolina's apportionment statute is "economically reasonable." In fact, the only questions or reference to the "economic reasonableness" of any relevant statute in this matter came from Dish DBS's counsel. (R. pp. 693, 695; Hr'g Tr. 254:14-18; 256:9-14.) Accordingly, the ALC did not err in denying Dish DBS's Motion in Limine to exclude Dr. Harrison's testimony on "economic reasonableness."

II. THE ADMINISTRATIVE LAW COURT CORRECTLY CONCLUDED THAT SOUTH CAROLINA IS NOT A PRO RATA COST OF PERFORMANCE STATE.

Dish DBS next argues that the ALC erred in concluding that South Carolina is not a pro rata cost of performance state. As discussed in detail below, the ALC correctly concluded that South Carolina is not a pro rata cost of performance state. (R. p. 19; Amended Order, p. 15.)

A. Standard Apportionment Method Requires Apportionment Based on Income-Producing Activity, Not Cost of Performance.

[2]Dr. Harrison has been qualified and provided expert testimony in the following corporate income tax cases before the ALC: ESA Services, LLC v. S.C. Dep't of Rev., Docket No. 08-ALJ-17-0047-CC (C.J. Kittrell, Feb. 9, 2009); Carmax Auto Superstores West Coast, Inc. v. S.C. Dep't of Rev., Docket No. 09-ALJ-17-0160-CC (J. Matthews, Apr. 22, 2010); Rent-A-Center West, Inc. v. S.C. Dep't of Rev. and Rent-A-Center Texas, L.P. v. S.C. Dep't of Rev., Docket Nos. 14-ALJ-17-0204-CC (C.J. Anderson, Jan. 6, 2012) and 14-ALJ-17-0206-CC (C.J. Anderson, Jan. 6, 2012); and DIRECTV, Inc. and Subsidiaries v. S.C. Dep't of Rev., Docket No. 14-ALJ-17-158-CC (C.J. Anderson, January 13-14, 2015).

The purpose of the South Carolina allocation and apportionment provisions is to provide for imposition of income tax "upon a base which reasonably represents the proportion of the trade or business carried on within this State." Hertz Corp. v. S.C. Tax Comm'n, 246 S.C. 92, 142 S.E.2d 445 (1965); S.C. Code Ann. § 12-6-2210(B). Furthermore, a statutory provision must be given a reasonable and practical construction consistent with the purpose and policy expressed in the statute. Hay v. S.C. Tax Comm'n, 273 S.C. 269, 255 S.E.2d 837 (1979).

The method of apportionment that a taxpayer must use depends upon the nature of the taxpayer's business in this State. If a taxpayer's principal income is not derived from manufacturing or dealing in tangible personal property, as in the case of service providers, the applicable statute to apportion adjusted net income to South Carolina is S.C. Code Ann. § 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 12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.

S.C. Code Ann. § 12-6-2290 (2014).[3]

Thus, a taxpayer, who is a service provider,[4] is required to use the single factor gross-receipts apportionment formula. The final sentence of § 12-6-2290 directs taxpayers to § 12-6-

[3]In 1995, § 12-7-1190 was replaced by § 12-6-2290. In 2007, the General Assembly added an additional sentence to the end of the existing statute. That sentence reads as follows: "For purposes of this section, items included in gross receipts are as provided in section 12-6-2295." 2007 South Carolina Laws Act 110 (S.B 91).

[4]Dish DBS does not challenge that it is a service provider. (R. p. 564; Hr'g Tr. 125:8.)

2295 for a non-exclusive list of the items to be sourced to South Carolina by including that item in the numerator of the gross-receipts apportionment formula.[5] The relevant subsection in this matter is § 12-6-2295(A)(5):

> (A) The terms "sales" as used in Section 12-6-2280 and "gross receipts" as used in Section 12-6-2290 include, but are not limited to, the following items if they have not been separately allocated:
>
> * * *
>
> (5) receipts from services if the entire income-producing activity is within this State. If the income-producing activity is performed partly within and partly without this State, sales are attributable to this State to the extent the income-producing activity is performed within this State[.]

Because Dish DBS is a service provider, § 12-6-2290 applies and mandates the gross-receipts method for apportioning Dish DBS's net income to South Carolina. Further, § 12-6-2295(A)(5) requires Dish DBS to source service-related receipts from South Carolina subscribers to South Carolina based on the taxpayer's income-producing activities.

B. South Carolina is Not a Cost of Performance State.

As shown above, South Carolina's standard formulary apportionment method for service providers requires an analysis of income-producing activities, and not cost of performance. Dish DBS erroneously argues that under applicable law, South Carolina is a pro-rata cost of performance state. Consequently, Dish DBS contends the Department must use cost of performance elements, such as property and payroll, when sourcing the gross receipts from services to South Carolina. The ALC correctly determined that South Carolina is not a cost of performance state.

1. Historical Perspective Demonstrates that South Carolina Is Not a Cost of Performance State.

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[5]2007 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 Dish DBS's 2007 income tax year.

South Carolina's apportionment statutes related to service providers have *never* dictated the use of either a cost of performance *or* a pure market-based sourcing method.[6] The one mention of cost of performance in South Carolina apportionment law, which was deleted by the General Assembly in 2006, related to manufacturers and dealers in tangible personal property, not to service providers like Dish DBS.[7]

It is vitally important to note that South Carolina's statute related to service providers, like Dish DBS, is unlike the statutes of many other states that mandate a specific method. See S.C. Ann. §§ 12-6-2290 (Supp. 2007); 12-6-2290 (1995); 65-279.10 (1976). For example, some states have adopted § 17 of the Uniform Division of Income for Tax Purposes Act 1966 ("UDITPA")

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[6]See S.C. Code Ann. §§ 12-6-2290 (Supp. 2007); 12-6-2290 (1995); 12-7-1190 (1976); 65-279.10 (1976); see also R. p. 3129; Resp. Ex. 9 at 17 (excerpt from the South Carolina Corporate Income Tax manual):

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

[7]Unlike the gross-receipts ratio for service providers since the late 1950s, from 1958 until 2006 the sales factor in the three-factor apportionment formula for manufacturers and dealers in tangible personal property included cost-of-performance language, S.C. Code Ann. § 12-6-2280(C)(2) (1995); see S.C. Code Ann. § 12-6-2250 (1995), but that costs of performance language, which has since been deleted by the General Assembly, never applied to a taxpayer, like Dish DBS, which earned its income principally from providing services. See e.g., S.C. Code Ann. § 12-6-2290. However, even with regard to manufacturing and dealers in tangible personal property, since 2007 South Carolina law has mandated the use of a single sales factor, not a three-factor formula and has omitted cost of performance language. S.C. Code Ann. §§ 12-6-2252 (2007) and 12-6-2280 (2007). Importantly, the sales factor discussed here for manufacturers and dealers in tangible personal property, and hence any mention of cost of performance, did not relate to the apportionment of net income of *service providers* under § 12-6-2290 and its predecessor statutes; thus, unlike in many states and in UDITPA § 17, the applicable South Carolina statutes do not include cost of performance language.

which mandates that the apportionment be made "based on costs-of-performance," while other states have adopted market-based sourcing.

UDITPA was enacted in 1957 as a model act that apportions the income a corporation receives if such corporation conducts business or is taxable in more than one state. UDITPA provides that all business income shall be apportioned using an equally-weighted three-factor formula to include a sales factor, property factor, and payroll factor. See R. pp. 3122; 3124; Resp't Ex. 8, pp. 9 and 11 (UDITPA § 15 describing the sales factor of the three-factor formula.) Section 17 of UDITPA, applicable to service providers, is the sourcing statute for the sales factor within the three-factor formula, and it has remained unchanged since 1957:

> Sales, other than sales of tangible personal property, are in this state if: (a) the income-producing activity is performed in this state; or (b) the income producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs-of-performance.

UDITPA, § 17 (1966) (emphasis added). UDITPA, § 17 specifically includes the phrase "based on costs of performance"; thus, within UDITPA's sales factor gross receipts from service providers must be apportioned based solely on cost of performance.

UDITPA's § 17, however, does not apply to South Carolina. South Carolina is *not* a UDITPA state. Although South Carolina's § 12-6-2295(A)(5) is very similar to UDITPA's § 17, the General Assembly, while aware of UDITPA § 17, *specifically chose not* to include the phrase "based on costs-of-performance." See § 12-6-2295(A)(5). South Carolina's applicable statutes merely require the apportionment of a service provider's net income using a gross-receipts ratio pursuant to § 12-6-2290 and the sourcing of gross receipts to South Carolina based on the location of the income producing activity as delineated in § 12-6-2295(A)(5). In fact, as Professor Swain testified, it would be inconsistent with the purpose of a single-gross receipts factor to mandate that

the gross receipts factor be determined by cost of performance. (R. pp. 926-928, 940-941; Hr'g Tr. 487:16-488:3, 489:2-13, 501:10-502:2.) As a result, unlike UDITPA § 17, South Carolina law does not mandate sourcing of a service-provider's gross receipts to be *based* on cost of performance.

Dish DBS's confusion in this case is created by the inclusion of both income producing activities and cost of performance in UDITPA § 17, while South Carolina's § 12-6-2295(A)(5) omitted "based on costs of performance" from an otherwise UDITPA-like provision. Under UDITPA § 17, a taxpayer would first identify its income-producing activity and, if the identified income-producing activity occurred in more than one state, then use cost of performance as a "geographically identifiable metric for determining the state in which income-producing activities are carried on." HELLERSTEIN, ¶9.18(3)(b). In fact, courts and administrative tribunals discuss these two concepts as if they were the same, HELLERSTEIN, ¶9.18(3)(b), causing taxpayers, including Dish DBS, to use cost of performance to determine their income-producing activities, which is not compliant with South Carolina law.

2. Gross Receipts Formula Focuses on Sales, Not Costs.

Applicable South Carolina law has always mandated the use of a gross-receipts formula to apportion net income of service providers, and a gross-receipts formula on its face implies a focus on sales, not costs. See e.g., S.C. Code Ann. § 65-279.10 (1962); S.C. Code Ann. § 12-7-1190 (1976); § 12-6-2290 (1995 and Supp. 2007); § 12-6-2295 (Supp. 2007). First, relatively new § 12-6-2295(A)(5) sources gross receipts for service providers based on the location of its "income-producing activities." Section 12-6-2295(A)(5). Second, in general finance and accounting terminology, receipts (or income) generally represent cash being received by a business (often from sales) while costs represent cash being paid to others by a business. The primary

apportionment statute here is § 12-6-2290, which requires the use of a gross-receipts ratio. Being a gross-receipts ratio, it focuses on cash being received, not cash being paid by a taxpayer. Therefore, when a taxpayer uses its cost of performance (e.g., payroll and property costs) to determine to which state(s) its gross receipts should be sourced; it converts the gross-receipts ratio into a cost ratio thereby changing the statutory formula. The leading treatise recognized this and stated, "[I]ncome-producing activities and costs of performance are conceptually different." 1 JEROME R. HELLERSTEIN ET AL., STATE TAXATION ¶9.18(3)(b) (3d ed. 2000).

Either way, receipts (or income) and costs are diametrically opposite of each other, and applicable South Carolina law references only receipts and income, not costs.

3. Cost of Performance is Not Relevant to this Case.

Cost of performance is simply not relevant to this case for two primary reasons. First, the South Carolina General Assembly omitted the phrase "based on costs of performance" in § 12-6-2295(A)(5); thus, cost of performance is neither required to identify a taxpayer's income-producing activities nor required to be the metric by which a taxpayer determines how much income-producing activity occurs in this State. Second, cost of performance is only used in UDITPA states when the income producing activity occurs in more than one state. Here, Dish DBS's income producing activity related to its South Carolina subscribers occurred entirely in South Carolina (i.e., the first prong of § 12-6-2295(A)(5)), so cost of performance, even if mandated, still would not apply in this case.

4. *Lockwood Greene* Does Not Hold that South Carolina is a Cost of Performance State and Does Not Impose Cost of Performance Sourcing on all Service Providers.

In its brief, Dish DBS asserts that the Court of Appeals in Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987) held "that South Carolina

is a cost of performance state," and Dish DBS argues that pursuant to this case and South Carolina law, its subscription receipts should be sourced where the service is performed (the "place of activity"), and not according to the location of the subscriber. Dish DBS essentially argues that its income should be sourced based upon cost factors, similar to how payroll costs were used as a proxy to estimate the gross receipts from within South Carolina in Lockwood Greene. Appellant's analysis of Lockwood Greene is incorrect and completely mischaracterizes the Court of Appeals' holding and analysis in the case. In fact, the Court of Appeals did not even use the phrase "cost of performance" in its Lockwood Greene decision.

Contrary to Dish DBS's argument, Lockwood Greene *neither* mandated that the net income of *all* service providers must be apportioned based on the "place of activity" test nor that gross receipts from within South Carolina must be quantified by a cost-based factor. See Lockwood Greene, 293 S.C. 447, 450, 361 S.E. 2d 346, 348 (Ct. App. 1987).

In Lockwood Greene, 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 *time* and *expertise* of an engineering *professional* and that such services were performed at the engineer's location. Id. at 449, 361 S.E.2d at 347 (emphasis added).

The applicable apportionment statute for a taxpayer whose principal profits were derived from services at the time of Lockwood Greene was § 12-7-1190 (1976), which stated:

> If the principal profits or income of a taxpayer . . . are derived from sources other than manufacturing, producing, collecting, buying, assembling, processing, or selling, distributing or dealing in tangible personal property such taxpayer shall make returns and pay annually

> an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

S.C. Code Ann. § 12-7-1190 (1976). This statute is the predecessor statute to § 12-6-2290.

In applying § 12-7-1190, the Department's Audit Division used, and the Lockwood Greene court acknowledged, a set of written Department guidelines ("Guidelines"). Lockwood Greene, at 450, 361 S.E.2d at 348. (R. pp. 777, 887-896; Hr'g Tr. 338:19-22, 448:14-457:7.) These Guidelines were approved by the South Carolina Tax Commission (the governing administrative agency at the time). (R. pp. 890, 3135-3136; Hr'g Tr. 451:13-19; Resp't. Ex. 12.) In these Guidelines, the Department listed eight industries and set forth how a taxpayer should determine when gross receipts are from within South Carolina in accordance with § 12-7-1190. (R. pp. 891-892, 897; Hr'g Tr. 452:16-453:6, 458:13-18.) The Guidelines did not impose one manner of sourcing revenues to South Carolina on all industries. On the contrary, the Department looked at the specifics of each industry and each revenue source to determine the manner in which it should be sourced[8]: finance companies and media broadcasters source gross receipts to the location of the borrower or advertiser, respectively, and an engineering business or the business of other professional personal service providers (e.g., law firms, accounting firms, entertainment and sports companies, and hospital management companies) source gross receipts to the "place of activity."

[8]Dish DBS' tax policy expert, Mr. Stevens, represented the South Carolina Tax Commission (predecessor to the Department of Revenue) in the Lockwood Greene case. During the Dish DBS hearing, Mr. Stevens acknowledged ;lthe following: (1) the state put together a list of how it sourced gross receipts for different industries; (2) list was submitted, in the form of stipulations of fact, to the Court; and (3) the Court of Appeals concluded that the activities of an engineering company are not comparable to the activities of media broadcasting and finance companies. (R. pp. 777-782; Hr'g Tr. 338:15-343:3.)

Id.[9] As a result, it is clear from a plain reading of § 12-7-1190 and the Lockwood Greene opinion that the Department sourced gross receipts to South Carolina on an industry-by-industry basis based on the *activities* of the companies in each industry.

Finally, the payroll factor that was used by the Department to quantify Lockwood's gross receipts in South Carolina was *used merely as a proxy* for Lockwood's actual gross receipts from within South Carolina. If the Department had all of Lockwood's time and billing records, the Department would not have had to use the payroll proxy, but could have examined all of Lockwood's invoices and added the fees billed for the work of South Carolina engineers. (R. pp. 895-896; Hr'g Tr. 456:24-457:7.) In the instant case, Dish DBS's actual subscription receipts from South Carolina subscribers for the applicable tax years are known; therefore, no cost-based proxy is needed to estimate the gross receipts from within South Carolina.

5. Recent Decisions and Other Authority Confirm that South Carolina is Not a Cost of Performance State.

Recent decisions by the Administrative Law Court and other authority confirm that South Carolina is not a cost of performance state. In an Order Denying Dish DBS's Motion for Summary Judgment, the ALC noted that § 12-6-2295(A)(5) and UDITPA § 17 are "more different than similar" and that they are "different in two important ways":

> First, unlike in section 17 in [UDITPA], the South Carolina legislature chose not to include the phrase "cost of performance" in § 12-6-2295(A)(5). Second, unlike section 17 of [UDITPA], our statute does not include language indicating the sourcing of receipts to South Carolina is all-or-nothing based on whether "a great portion of the income-producing activity is performed in this state than in any other state." The only real similarity between the two statutes

[9]Dish DBS' tax policy expert, Mr. Stevens, conceded that the Court of Appeals "did engage in the analysis" of how the activities of an engineering company are distinguishable from the activities of media broadcasting and finance companies. (R. p. 781; Hr'g Tr. 342:3-11.)

> is that they both rely on "income-producing activity" as a measure of sales.

(R. p. 68; Summ. J. Order, p. 7.) The ALC further noted – just as the Department concluded in its Department Determination and established at the hearing – that "section 12-6-2295(A)(5) focuses solely on the extent the 'income-producing activity' is performed in this State." (R. p. 69; Summ. J. Order, p. 8.) The ALC's emphasized Dish DBS's income-producing activity, not its costs of performance. Accordingly, Dish DBS's continued reliance upon a cost analysis to source its South Carolina subscription receipts is misplaced.

Similarly, in DIRECTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, a similarly-situated taxpayer to Dish DBS asserted that South Carolina is a cost of performance State. See generally DIRECTV, Inc. & Subsidiaries v. South Carolina Department of Revenue, Amended Final Order and Decision, 14-ALJ-17-0158-CC, (C.J. Anderson, Jun. 12, 2015), *appeal docketed*, No. 2015-001509 (Ct. App. Jul. 14, 2015). That court wholly rejected the taxpayer's attempt to source the subscription receipts from South Carolina subscribers to other states based upon cost of performance elements or factors. Id. Specifically, the DIRECTV court noted the taxpayer's approach "unduly emphasizes what amounts to 'costs of performance.'" (R. p. 89; DIRECTV Amended Order, p. 17.) It is clear that South Carolina is not a UDITPA State, and it does not require sourcing of the gross receipts of service providers based upon costs-of-performance elements. (R. pp. 89-90; Id. at 17-18.) The DIRECTV court also noted that "South Carolina courts have never imposed a costs-of-performance approach to sourcing receipts of service providers to South Carolina." (R. p. 90; Id. at 18.) Finally, the DIRECTV court concluded that South Carolina's apportionment statutes, specifically § 12-6-2295(A)(5), focus solely on the extent the income producing activity is performed in this State. (R.pp. 89-90; Id. at 17-18.)

Dish DBS next argues that the ALC's recent decision in Rent-A-Center Texas, L.P. v.

South Carolina Department of Revenue, Docket No. 09-ALJ-17-0206-CC (filed January 6, 2012) "reaffirmed the 'COP' test as the proper means of sourcing sales from services." (Appellant's Brief, p. 18.) The Department disagrees. In Rent-A-Center Texas, the ALC addressed the sourcing of management fees to South Carolina but had to factor in and consider § 12-6-2295(A)(5), which had not been enacted at the time of Lockwood Greene in 1987. The ALC noted that the Court of Appeals found 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. Rent-A-Center Texas, L.P., v. S.C. Dep't of Rev., Final Order & Decision, at 8 (citing Lockwood Greene, at 448-50, 361 S.E.2d at 347-48). The evidence showed that Rent-A-Center Texas ("RAC Texas") performed and was paid only for management services performed by skilled professionals in Texas, and accordingly, its revenue from management fees must be sourced to Texas pursuant to Lockwood Greene. Id.

In Rent-A-Center Texas, the ALC did not assert that § 12-6-2295(A)(5) imposed a "place of activity" test on all service providers, but that § 12-6-2295 required sourcing of gross receipts to South Carolina to the extent that the income-producing activity is in South Carolina. The ALC found that Rent-A-Center East (RAC East) contracted for and received management services from RAC Texas' skilled professionals and that those skilled professionals performed all of their work in Texas. Therefore, as in Lockwood Greene, the income-producing activity was the rendering of the time and expertise of the management professionals who were directly hired by the customer. Rent-A-Center Texas, Final Order & Decision, 09-ALJ-17-0206-CC, p. 9-11. The decisions in Rent-a-Center Texas and Lockwood Greene sourced receipts to South Carolina based on the "place of activity" only for personal professional services, not for subscription-based services provided by a taxpayer like Dish DBS.

Dish DBS next incorrectly asserts that the *Hellerstein* treatise has indicated that South Carolina is a cost of performance state. Professor Swain, one of the co-authors of the treatise, specifically testified:

> [T]he treatise hasn't made any declaration about, nor can we make South Carolina a cost of performance state. We've reported on the most recent litigation . . . . it would be unfair to the extent anyone left the impression that [the authors] have declared South Carolina to be a cost of performance state or that there is one clear way to read the UDITPA language is – would be inaccurate – would be inaccurate.

(R. p. 920; Hr'g Tr. 481:8-24.)[10]

Dish DBS cites to the South Carolina Corporate Income Tax Manual, co-authored by senior members of the Policy section of the Department, for a discussion regarding the Lockwood Greene case. Even the passage cited by Dish DBS acknowledges that the Department does not apply one sourcing rule to all providers:

> [c]onsidering *Lockwood Greene* and *Geoffrey*, together, it appears that gross receipts are sourced to the state which is most significantly associated with the production of the income, *e.g.*, personal services, where those services are performed; intangibles, where those intangibles are used in a business for the production of income. This conclusion is consistent with the longstanding administrative policy of the Department, which was referenced in the Lockwood Greene case, that the gross receipts of loans from finance companies are sourced to the location of the companies' customers.

(R. p. 3132; Resp. Ex. 9 at 20.) Moreover, although Dish DBS cites to the Department's Corporate Tax Manual, it neglects to include other comments within the Manual:

> **Comment:** South Carolina is not a "cost of performance state;" *i.e.*, a state where receipts are always sourced to the state where the costs

[10]Appellant also states in its brief that Prof. Swain "flatly testified 'South Carolina has a proportionate rule.'" (Appellant's Br. p. 20.) However, this statement is taken out of context as it was used in an example. Prof. Swain later clarified his statement: "let's assume that South Carolina is a cost of performance state just to --- or let's take another state that has the proportionate rule." (R. p. 932; Hr'g Tr. 493:15-18.)

> to produce the receipts are incurred. It is also not a "market state;" *i.e.*, a state where receipts are always sourced to the state where the item or service is consumed or the location of the payer.

(R. p. 3129; Resp. Ex. 9 at 17.) Accordingly, the Dish DBS's arguments are without merit, and the ALC correctly concluded that South Carolina is not a pro rata cost of performance state.

Finally, Dish DBS asserts that the Department, "in PLR #13-3 . . . reiterated that South Carolina is a cost of performance state." Again, Dish DBS is incorrect and mischaracterizes the analysis and conclusion of Private Letter Ruling #13-3. The taxpayer in PLR #13-3 is an engineering service business similar to the taxpayer in Lockwood Greene. Identical to the analysis in Rent-A-Center Texas and Lockwood Greene, the Department concluded in PLR #13-3 that § 12-6-2295 requires sourcing of gross receipts to South Carolina to the extent that the income-producing activity is in South Carolina. The ALC found in Rent-A-Center Texas and the Court of Appeals found in Lockwood Greene that their customers contracted for and received services from skilled professionals; thus, the income-producing activity was the rendering of the time and expertise of the professionals who were directly hired by the customer.

Accordingly, South Carolina is not a UDITPA state, and its laws do not require apportionment of a service provider's net income based upon its costs of performance. Although South Carolina's § 12-6-2295(A)(5) is similar to UDITPA's § 17, the General Assembly omitted the phrase "based on costs of performance." South Carolina's applicable statutes require the apportionment of a service provider's net income using a gross-receipts ratio, and the gross receipts are sourced to South Carolina based on the location of the income–producing activity. As a result, gross receipts are sourced to South Carolina based on the location of the income-producing activity and are specifically not sourced to South Carolina based on cost of performance.

III. THE ADMINISTRATIVE LAW COURT CORRECTLY CONCLUDED THAT SOUTH CAROLINA HAS ADOPTED AN INCOME-PRODUCING ACTIVITY APPROACH TO APPORTIONING INCOME.

Dish DBS asserts that the ALC erred in adopting a market share approach to apportioning income. The Department asserts that Appellant's argument is completely without merit and has been abandoned because it failed to cite any supporting authority. See First Sav. Bank v. McLean, 314 S.C. 361, 444 S.E.2d 513 (1994) (holding that Appellant was deemed to have abandoned issue for which he failed to provide any argument or supporting authority).

Appellant's argument is without merit because the ALC did not adopt a market share approach to apportioning income. First, a result similar to the result if a market share approach had been used is proper as long as the facts and the law are followed, which the ALC did as demonstrated by its Order. Second, the ALC properly interpreted § 12-6-2295(A)(5) and related statutes and correctly identified the income-producing activity based on the evidence before it. The ALC sourced the income of Dish DBS based upon the location of its income-producing activity as required by § 12-6-2295(A)(5) and case law from South Carolina:

> Rather, section 12-6-2295(A)(5) focuses solely on the 'income producing activity', and where that activity takes place.

(R. p. 18; Amended Order, p. 14.)

> Section 12-6-2295(A)(5) focuses exclusively on *income-producing activity* and where it takes place without requiring or referencing a proxy to measure income-producing activity.

(R. p. 19; Amended Order, p. 15.)

Based on this income-producing activity language that excluded mandates to use either cost of performance or market-share approaches, the ALC found that "South Carolina's apportionment statute provides a flexible standard based upon the income-producing activity for a given industry." (R. p. 20; Amended Order, p. 16.) The ALC followed the flexible standard of §

12-6-2295(A)(5) by first identifying the income-producing activity. The ALC considered the activities that Dish DBS asserted were income-producing, but it found that these activities were merely "preparatory activities." (R. pp. 23-25; Amended Order, pp. 19-21.) The ALC addressed Dish DBS's claim that advertising is an income-producing activity, but rejected that claim because Dish DBS "presented no evidence as to how this advertising affected its revenue generated in South Carolina." (R. p. 26; Amended Order, p. 22.) The ALC considered the testimony of the Department's economic expert and other evidence and found that the income–producing activity was "the delivery of [Dish DBS's] signal into the subscriber's home and onto the subscriber's television." (R. pp. 24-25, 27; Amended Order, pp. 20-21, 23.)

Dish DBS points to the Department's Determination as evidence that it imposed a market based sourcing method or "audience approach" method in this case. The Department has explicitly maintained and established, in its Determination and throughout the ALC hearing that the Department did not adopt or implement a market based sourcing method or audience approach in this matter. The Department first complied with South Carolina law by *identifying* the income-producing activity – the delivery of the signal into a Dish DBS subscriber's home or business – and then *determining the location* of the income-producing activity – in the homes and businesses located in South Carolina. (R. p. 3081; Resp't Ex. 4, p. 5.) Only after making these determinations did the Department reference in its Department Determination the specific market based sourcing or "audience approach" adopted by other states. Importantly, the references to these approaches were included as support for the reasonableness of the Department's Determination because the tax result under the Department's income-producing activity approach would be similar to the tax result reached under a market based sourcing method or "audience approach" as referenced in other states. In fact, Dish DBS's expert acknowledged that the Department's income-producing

activity approach does not result in a market-based result for every taxpayer. (R. pp. 1006, 1009-1010; Hr'g Tr. 567:2-23, 570:12-571:4.)

Accordingly, the ALC did not adopt a market share approach to apportioning income, and the ALC properly interpreted § 12-66-2295(A)(5) and related statutes and correctly identified the income producing activity based upon the evidence presented at the hearing.

IV. THE ADMINISTRATIVE LAW COURT APPROPRIATELY CONSIDERED THE EVIDENCE IN THE RECORD AND CORRECTLY CONCLUDED THAT THE DELIVERY OF THE SIGNAL INTO THE HOMES OF DISH DBS'S SUBSCRIBERS IS THE INCOME-PRODUCING ACTIVITY OF THE APPELLANT.

First, and most importantly, Dish DBS has confused the sourcing standard with the determination of the income producing activity. The *identification* of the income-producing activity is not the same as determining the *location* – or the sourcing – of the income-producing activity. First, the income-producing activity must be identified. Second, only after identifying the income-producing activity is there a need to determine in what state(s) the income-producing activity occurred and then to quantify the gross receipts from within South Carolina.

A. ALC Holding That The Income-Producing Activity Is The Delivery Of The Signal into the Subscribers' Homes 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. 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 and that substantial evidence exists to affirm the ALC.

1. Dish DBS's income producing activity is the delivery of its signal into subscribers' homes, not its preparatory or other prior activities.

Effective for the 2007 tax year, § 12-6-2295(A)(5) was applicable and supplemented § 12-6-2290.[11] Section 12-6-2295(A)(5) added the "income producing activity" language to the apportionment statute for service providers. Pursuant to the income-producing-activity language of § 12-6-2295(A)(5), the ALC properly concluded that Dish DBS's income producing activity is the delivery of the signal into the homes and onto the television screens of its subscribers. In identifying the income-producing activity, the ALC considered the activities of businesses in the direct broadcast services industry and the sources of income within the industry. The primary, and by far most substantial, source of income for Dish DBS is the monthly subscription receipts that subscribers pay to Dish DBS in order to view in their homes and businesses the selected packages of video programs and pay-per-view video programs. (R. p. 3068; Resp't Ex. 2, Bates stamp p. 344.)

These subscription receipts relate directly to the ALC's determination that the delivery of the signal into the subscriber's home and onto the subscriber's television is the income-producing activity. Dish DBS provides, and the subscriber pays for, direct broadcast satellite services so that the subscriber can watch the programs on a television in his home or business. It is the delivery of the signal into the home and onto a television screen that the subscriber is purchasing.

Although Dish DBS argues its income-producing activity should be identified similar to the taxpayer in Lockwood Greene, the Department disagrees. Unlike the taxpayer in Lockwood

[11]Notably, when adding § 12-6-2295(A) for the 2007 tax year, the General Assembly stated the following in 2007 Act No. 110, § 51.A, eff. June 21, 2007, S.C. Acts: "To Amend . . . by adding Sections 12-6-2252 and 12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes by basing the determination only on a sales factor and to define the terms 'sales' and 'gross receipts' consistently and specifically for that purpose[.]"

Greene, a Dish DBS subscriber did not hire a specific engineer and is not paying for the expertise and time of a particular professional, or any other employee or contractor, of Dish DBS.[12] Instead the subscriber is paying for video programing to be viewed on the subscriber's television at the time and place the subscriber demands.[13] Dish DBS does not sell contract negotiations. It does not sell network management services. It does not sell broadcast infrastructure or satellite triangulation. Dish DBS is in the business of selling television broadcast subscriptions to subscribers, and without the actual delivery of that broadcast signal into South Carolina homes it would not have generated the income at issue here. It is for this act alone that South Carolina subscribers sign contracts and pay their monthly fees.

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), preparatory or other prior activities of a taxpayer were not deemed to be income-producing activities. In Heller Western, the income-producing activity issue for determination was whether the borrowing of money in California to make loans to customers in Arizona constituted its income-producing activity. Id. at 161 Ariz. at 50, 775 P2d at 1114. The Arizona Supreme Court held, "[t]hough borrowing of funds [in California] may be an important step in Heller Western's financing process, the direct generation of the loans occurred in Arizona. We conclude that Heller Western's sales activity in Arizona constituted the income producing activity contemplated by our tax regulations." Id. 161 Ariz. at 53, 775 P2d at 1117.

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[12]See R. p. 782; Hr'g Tr. 343:4-15 (stating that a Dish subscriber is not purchasing the time and expertise of any particular Dish engineer or attorney).

[13]See R. pp. 504, 705, 2192-2380; Hr'g Tr. 65:6-9, 266:16-23; generally, Pet'r Ex. 25; see also R. pp. 669-670; Hr'g Tr. 230:15-231:6. Dish DBS's 10-K and the collective testimony by Dish DBS's own witnesses establish that the Department's analysis is correct: Dish DBS's focus remains on the subscriber as the subscriber produces the income for Dish DBS.

This holding is consistent with the Department Determination in this case even though the phrase "costs-of-performance" was in the applicable Arizona statute while the cost-of-performance language was omitted by the South Carolina Legislature.

Likewise, 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 court affirmed the taxing authority's determination related to the income-producing activity of a company that received advertising revenue by placing the advertisements in telephone directories distributed in Wisconsin "was performed in Wisconsin when the advertisement reached its intended, Wisconsin audience. Id. at 2010 WL 2519583, 5. 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 of Appeals concluded that the taxpayer's income-producing activity was "the provision of access to a Wisconsin audience." Id. at *9-10. The Wisconsin court's holding is also consistent with the ALC's decision in this case.

2. The set-top box in the subscriber's home is critical to the income-producing activity.

Another jurisdiction similarly found that incidental activities, although essential, of a direct broadcast satellite service provider did not constitute that taxpayer's "income-producing activity." In that case, a Texas administrative court determined that the income-producing activity of a direct broadcast satellite service provider occurs in the customer's home. Anonymous Taxpayer v. Texas Comptroller of Public Accounts, 2013 WL 3490605 (Tex. Cptr. Pub. Acct.) (May 17, 2013). In that case, the Texas Administrative Law Judge stated, "[t]he focus should be on the specific end product acts for which the customer contracts and pays to receive, not on nonreceipt-producing, albeit essential support activities. Looking at property and payroll based on the theory that no

activity of a corporation generating receipts is any more important than another is misguided." Id. at 2013 WL 3490605, 11. Accordingly, the Texas Administrative Law Judge characterized the income-producing activity 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 income-producing activity occurs within the receiver in the subscriber's home or business, the Texas ALJ concluded that the taxpayer's subscription receipts from its Texas subscribers should be sourced to Texas. Id. at *10-11.

Here, Dish DBS produces income in South Carolina by delivering the signal to the subscribers' homes in South Carolina, which is essentially the same determination made by the Texas Comptroller. Dish DBS produces income in South Carolina by delivering a satellite signal to set-top boxes that interpret and unencrypt the broadcast signal in the homes and businesses of its South Carolina subscribers. The satellite signal, not the uplink centers, and the contract negotiations to acquire video rights are useless to Dish DBS's subscribers without this income-producing activity that takes place in each subscriber's home. In complete consistency with §§ 12-6-2290 and 12-6-2295(A)(5), the delivery of the signal into the homes and businesses of its South Carolina subscribers is the income-producing activity.

3. Dish DBS's Other Activities.

a) Dish DBS's Activities Outside of South Carolina Are Not Income-Producing Activities.

Dish DBS argues that its activities occurring outside of South Carolina are its income-producing activities with respect to its South Carolina subscription revenues. While § 12-6-2295(A)(5) does not include a definition of "income-producing activity," ample authority exists to support the Department's interpretation of income-producing activity in this case. For instance, 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).

In a recent decision, AT&T Corp & Includible Subsidiaries v. Department of Revenue, 357 Or. 691, 358 P.3d 973 (Sept. 11, 2015), the Oregon Supreme Court concluded that the income-producing activity of a telephone service company occurred in Oregon, although the taxpayer's network is managed primarily in New Jersey.[14] Similar to the Arizona and Wisconsin cases discussed above, the applicable Oregon statute included the phrase "based on costs of performance," yet the income producing activity did not follow the costs. Id. at 694-95, 358 P.3d at 974. The income-producing activity issue for determination related to AT&T's sale of interstate and international phone and data transmissions. Id. at 693, 358 P.3d at 973. The Oregon Supreme Court concluded that "AT&T did not use a correct definition of 'income-producing activity.' AT&T's proposed interpretation is network-based; it focused on the operation of its network as a whole. The correct understanding, however, is transaction-based; it examines individual sales to

[14]Notably, Oregon is "traditionally a UDITPA state. It has UDITPA regs; it's got the UDITPA statute by and large." (R. p. 949; Hr'g Tr. 510:12-14.)

customers." Id. at 693, 358 P.3d at 973 (emphasis added). This holding is consistent with the Department Determination in this case even though the phrase "costs-of-performance" was in the applicable Oregon statute while such language was omitted by the South Carolina Legislature.[15] Accordingly, when considering what Dish DBS's income-producing activity is, it is appropriate to look only at it on a subscription-by-subscription basis. Looking at it this way, the Department appropriately concluded that the income-producing activity for each subscriber was the delivery of the satellite service into his home.

Moreover, Dish DBS's income-producing activity is the final act of delivering the signal into the subscribers' homes rather than the pre-order and preparatory acts. The ALC noted that Dish DBS's preparatory and pre-order activities that it attributes to income production do not actually produce income. Relying upon Mercury Motors Express, Inc. v. South Carolina Tax Commission, 244 S.C. 134, 135 S.E.2d 756 (1964), the ALC differentiated income-producing activities from those activities that are merely preparatory to the production of income. (R. pp. 25-27; Amended Order, p. 21-23.)

In Mercury Motor, the South Carolina Supreme Court addressed income-producing activity of an interstate freight hauler. The Supreme 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 that many of these transactions may occur outside of South Carolina. Id. at 141, 135 S.E.2d at 759. The Supreme Court held that, while each of these transactions are "incidental to the production of income," the

[15]See Prof. Swain's testimony regarding AT&T, 357 Or. 691, 358 P.3d 793. (R. pp. 948-950; Hr'g Tr. 509:10-511:24.)

income-producing activity is the hauling of freight "through and over the highways of the State of South Carolina." Id.

The ALC's analysis affirms activities that are incidental to the production of income are not income-producing activities. (R. pp. 25-27; Amended Order, p. 21-23.) Further, ALC in DIRECTV found that pre-order and other "'preparatory' activities are too attenuated to the production of income to be considered income-producing activities for the purposes of Section 12-6-2295(A)(5)." (R. p. 85; DIRECTV Amended Order and Decision, p. 13.)

Quoting the DIRECTV court's analysis of pre-order activities, the ALC in this matter noted the following comparable activities and concluded that Dish DBS's pre-order activities were not income-producing activities:

> [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.

(R. pp. 25-26; Amended Order 21-22 (emphasis in original).)

Regarding other preparatory activities, the DIRECTV court acknowledged that the taxpayer "engages in other 'preparatory' activities that eventually lead to satellite signals being beamed into this State." (R. p. 85; DIRECTV Amended Final Order, p. 13.) Such other preparatory activities include gathering, editing, distributing programming, and satellite and uplink activities. The DIRECTV court noted that "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." (R. p. 85; DIRECTV Amended Final Order, p. 13 (emphasis added).) Simply put, "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)." (R. p. 85; DIRECTV Amended Final Order, p. 13.)

In conclusion, the pre-order and other preparatory activities of Dish DBS, which include, but are not limited to, programming and content activities, satellites and uplink activities, and its call centers, are not income-producing activities of Dish DBS. Rather, the income-producing activity in this matter is the delivery of the signal into the homes and onto the television screens of Dish DBS's South Carolina subscribers.

b) Dish DBS's View of its Income Producing Activity.

Although Dish DBS asserts seven specific items are its income producing activities in this matter, these items are either "pre-order" activities of Dish DBS or activities it has conceded are income producing activities in South Carolina. (R. pp. 577, 630-633, 8; Appellant's Br., p. 26; Hr'g Tr. 138:3-21, 191:13-194:1; Amended Order, p. 4.)

First, Dish DBS conceded that the income received from subscriber equipment, installation, and in-home repair are certain non-subscription revenue and such revenue stream is already sourced 100% to South Carolina. (R. pp. 577, 630-633, 8; Hr'g Tr. 138:3-21, 191:13-194:1; Amended Order, p. 4.) Simply put, these items clearly do not fall within the revenue stream generated by subscription revenue, and as acknowledged by Dish DBS, the dispute in this matter is limited to the proper apportionment of subscription revenue. (R. p. 8; Amended Order, p. 4.) (emphasis added):

With respect to programming/content, satellites/uplink, and advertising, Dish DBS failed to show any impact these "activities" may have had upon a potential South Carolina subscriber; hence, Dish DBS did not prove that these activities produced any of the South Carolina subscription revenues. The Department requests this Court to refer above, supra Part VI (A), for the Department's detailed positions in this matter regarding the identification of Dish DBS's income-producing activity.

With respect to advertising, although Dish DBS argues that its advertising activities are income-producing activities, advertising is a "pre-order" activity of Dish DBS, not an income-producing activity. In DIRECTV, the ALC found that DIRECTV's pre-order activities were "too attenuated to be considered income-producing." (R. p. 85; DIRECTV, Amended Final Order, p. 13.) The DIRECTV's court's "too attenuated" analysis is correct because, assuming advertising even prompts a potential subscriber to respond, there are numerous steps a subscriber must engage in with Dish DBS after viewing such advertising before the subscriber actually views the programming on his television set in his home: 1) speak to a customer service representative at a call center (R. p. 484; Hr'g Tr. 45:1-11); 2) arrange time to meet with installer (R. p. 487; Hr'g Tr. 48:6-12); 3) meet installer and sign contract that obligates the subscriber to pay the subscription receipts at issue in this case (R. p. 487; Hr'g Tr. 48:20-22); 4) purchase or lease set-top box, remote controls, and related items (R. p. 793; Hr'g Tr. 54:15-20); and 5) installation and configuration of satellite dish, set-top box, and cables installed and configured at subscriber's home (R. pp. 487-488; Hr'g Tr. 48:6-49:16). All of these pre-order or other preparatory activities must be fulfilled after any such advertising activity was viewed by the potential subscriber. Simply put, advertising is only one pre-order activity in a long list of activities engaged in by Dish DBS prior to the income-

producing activity in this matter: delivery of the signal into the subscriber's home and onto the television set in the subscriber's home.

Further, the ALC declined to accept Dish DBS's argument that its advertising activity is an income-producing activity in this matter because the ALC was forced to speculate as to the calculation, weight, and impact any advertising had on revenue generated in South Carolina and the extent to which such advertising was directed at South Carolina as Dish DBS failed to provide any evidence or testimony related to such argument. Such speculation would distort the gross-receipts ratio, which has always been mandated by applicable South Carolina law for use in apportioning net income of service providers. Moreover, the gross-receipts formula on its face implies a focus on *sales*, not *costs*. Because Dish DBS quantifies any income-producing activity from advertising based upon costs, finding advertising to be an income-producing activity would distort the sales focus in the gross receipts factor. By including advertising as an income-producing activity in this matter, Dish DBS would essentially convert the statutory gross receipts ratio into something it was clearly not meant to be.

Finally, with respect to call centers, the ALC did not err in its determination that call centers are not an income-producing activity, and Dish DBS has not cited any authority or support for its assertion. Nevertheless, Dish DBS's interpretation of income-producing activities is inconsistent with applicable law in South Carolina, and the Department requests this Court to refer to the discussion of Mercury Motor in the Department's Brief, supra pp. 32-34. To the extent Dish DBS argues that the call center's taking a subscriber's order and collecting the subscription fee is the ultimate income-producing activity, Dish DBS confuses the activity of collections with the activity of earning income. If Dish DBS never delivered that video service to a subscriber who had already paid, a refund would surely be due to the subscriber.

c) The ALC Properly Interpreted Dish DBS's 10-K.

Finally, Dish DBS in its audited financial statements that are included within its Form 10-K stated, "[w]e recognize revenue when an arrangement exists, prices are determinable, collectability is reasonably assured, and the good and services are delivered. Revenue from our subscription television services is recognized when programming is broadcast to subscribers." (R. pp. 2192-2380, 707-708; Pet'r Ex. 25, pp. 108-09; Hr'g Tr. 268:21-269:2.) Dish DBS argues that the ALC misinterpreted this statement. This argument is without merit. The ALC used various testimony and other evidence to determine that Dish DBS's sole income-producing activity was the delivery of its signal into the homes and televisions of its South Carolina subscribers.

The ALC recognized that Dish DBS's own revenue recognition policy, as stated in Form 10-K, acknowledged that the key to Dish DBS's revenue is the delivery of the video service to its subscribers. (R. p. 24; Amended Order, p. 20.) Without such delivery of the video services into each subscriber's home, Dish DBS would have no subscription revenue. Dish DBS's revenue recognition policy is a clear statement that it records revenue in its accounting records only when the video programming service is delivered to the subscribers. Dish DBS does not recognize its subscription receipts as revenue at some prior time when the subscriber and Dish DBS execute the service contract (i.e., when the contractual arrangement is established), when the Dish DBS publishes its rates (i.e., when prices are determinable), or when the preparatory acts (e.g., negotiating contracts with television content providers, gathering and manipulating signals to be sent to the satellites, launching satellites, advertising) occur.

Regarding Dish DBS's argument that the Form 10-K supports other income-producing activities, Dish DBS did not present sufficient evidence that these activities are income-producing

activities. For example, when considering advertising as an income producing activity, the Court stated:

> Accurately measuring the effect advertising had on Petitioner's South Carolina revenue as opposed to its national revenue would be a difficult task and highlights one of the problems associated with using cost-based factors to estimate income-producing activity. Based on the lack of evidence of the effect adverting had on Petitioner's South Carolina revenue, I decline to include adverting in this Court's analysis.

(R. p. 26; Amended Order, p. 22.) Similarly, Dish DBS did not produce sufficient evidence that its call centers are an income-producing activity. See supra, pp. 32-24. Accordingly, the ALC did not err in relying upon the statements contained in Dish DBS's 10-K.

B. Sourcing of the Income-Producing Activity.

After properly determining – based on the law and the evidence – that Dish DBS's income producing activity was its delivery of the signal into the homes of its South Carolina subscribers and not its pre-order and other preparatory activities, the ALC properly determined that all of the income producing activity related to the South Carolina subscription receipts must therefore be sourced to the numerator of the gross receipts ratio. Dish DBS wrongly argues otherwise because, based upon Dish DBS's brief, it confuses the sourcing standard with the determination of the income-producing activity. Dish DBS argues that the majority of its South Carolina subscription receipts should be sourced to a location outside of South Carolina, but South Carolina law and the evidence require Dish DBS to source the subscription receipts of South Carolina subscribers to South Carolina.

A service provider's gross receipts are sourced to South Carolina based on the location of the income-producing activity under one of two prongs: (1) all of the gross receipts are sourced to South Carolina if the entire income-producing activity is within this State or (2) if the income-

producing activity is performed partly within and partly without this State, gross receipts are sourced to South Carolina to the extent the income-producing activity is performed in this State. § 12-6-2295(A)(5).

1. Subscription Receipts.

Dish DBS's subscription receipts from South Carolina subscribers should be sourced to South Carolina (i.e., to the numerator of the gross-receipts ratio) under the first prong, because the entire income-producing activity (i.e., the delivery of the signal into South Carolina subscribers' homes) occurred entirely in South Carolina. See Anonymous Taxpayer, 2013 WL 3490605, *10-11. This is entirely consistent with an analysis of income-producing activity on a subscription-by-subscription basis. See also AT&T Corp., at 693, 358 P.3d at 973 (holding that focus related to definition of "income-producing activity" of a telephone service company is "transaction-based"). All of the income-producing activity for each South Carolina subscriber occurred in South Carolina.[16] Additionally, since Dish DBS's subscription receipts from South Carolina subscribers are a known amount and no income-producing activity occurred in another state related to its South Carolina subscribers, no proxies or estimates using Dish DBS's costs are needed to quantify how much of the income-producing activity occurred in South Carolina.

[16]With regard to the second prong, the income-producing activity could be viewed more broadly as occurring in homes and businesses of all subscribers throughout the United States. Under this broad, non-transactional view of the income-producing activity, gross receipts must be attributed to any applicable state to the extent that income-producing activity occurred in that state. Importantly, there would still be no need for a cost of performance type proxy or analysis to determine how much income-producing activity occurred in South Carolina. The extent of income-producing activity occurring within South Carolina would still be best measured by the sum of the subscription receipts from South Carolina subscribers. As a result, even under the second prong of § 12-6-2295(A)(5), 100% of gross receipts from South Carolina are also included in the numerator of the gross receipts ratio.

2. Even if Advertising Is an Income-Producing Activity, It Occurred in South Carolina.

Even if the Court agreed with Dish DBS's argument that its advertising is an income-producing activity in this matter, such activity occurred entirely within South Carolina, and thus, 100% of the subscription receipts of South Carolina subscribers should be sourced to South Carolina by including them in the numerator of the gross-receipts ratio.

In Ameritech Publishing, 327 Wis.2d 798, 788 N.W.2d 383 (unpublished), 2010 WL 2519583, the court affirmed the taxing authority's determination that the income-producing activity of a company that received advertising revenue by placing the advertisements in telephone directories distributed in Wisconsin "was performed in Wisconsin when the advertisement reached its intended, Wisconsin audience." Id. at 2010 WL 2519583, *5. 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 concluded that the taxpayer's income-producing activity was "the provision of access to a Wisconsin audience." Id. at *9-10.[17] The Wisconsin court's holding is consistent with the Department's Determination in the instant case.

Like Ameritech, any income generating effect of Dish DBS's advertising occurred in South Carolina when the advertisement reached its intended South Carolina audience. This may occur at a kiosk in a shopping mall in South Carolina, in a local retail store when the clerk places a Dish DBS flyer in a subscriber's shopping bag, by sending direct mail to an individual's mailbox in South Carolina, when viewing a billboard along a South Carolina road, while listening to a radio

[17]See Prof. Swain's discussion of Ameritech, a case in which the court, "even under a cost of performance standard . . . reached a market state result." (R. pp. 947-948; Hr'g Tr. 508:24-509:5; see also R. pp. 918-920; Hr'g Tr. 479:24-481-8.)

station in the State of South Carolina, or when viewing a television advertisement on the potential subscriber's television set in South Carolina. (R. p. 626; Hr'g Tr. 187:12-16.) Accordingly, advertising affecting South Carolina subscribers occurred wholly within South Carolina, and 100% of the subscription receipts of South Carolina subscribers would be sourced to South Carolina and included in the numerator of the gross receipts ratio.

3. Location of the Costs May Differ From Location of Income-Producing Activity.

Importantly, there is no requirement that the income-producing activity of a taxpayer occur in the state where the taxpayer incurs its costs, even in states that have adopted the cost-of-performance language within the applicable statutes or regulations. In Walter E. Heller Western, the Arizona Supreme Court also determined that the income-producing activity 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. 116 Ariz. at 51, 53, 775 P.2d at 1115, 1117. Like Ameritech above, the applicable Arizona statute was similar to § 12-6-2295(A)(5) *except* that the applicable sourcing statute in Arizona *actually used* the phrase "costs-of-performance," giving Heller Western's cost-of-performance argument more merit but not enough to convince the Court. This holding is consistent with the Department Determination in this case even though the phrase "costs-of-performance" was in the applicable Arizona statute while the cost-of-performance language was omitted by the South Carolina Legislature.

Based on the foregoing, the ALC correctly determined that Dish DBS's income-producing activity related to its South Carolina subscription receipts occurred entirely in the homes and businesses of South Carolina subscribers. Consequently, it is proper to source 100% of the

subscription receipts from every South Carolina subscribers to the numerator of the gross receipts ratio.

V. 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.

Civil penalties are applied to every South Carolina tax law which requires a return unless otherwise provided. S.C. Code Ann. § 12-54-43 (2014). Such penalties are considered a tax owed this State. Id. S.C. Code Ann. § 12-54-155(A)(1) (2014) imposes a penalty for a substantial underpayment of tax. It states that "[i]f there is an underpayment attributable to . . . a substantial understatement of tax for a taxable period . . . there **must** be added to the tax an amount equal to twenty-five percent of the amount of the underpayment." Id. (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. S.C. Code Ann. § 12-54-155 (2014). "There 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).

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." § 12-54-155(D)(1) (2014) (emphasis added).

A. Dish DBS Did Not Have Substantial Authority for the Positions Taken on its Returns.

The ALC properly found that the Department correctly calculated the amount of the understatement of taxes for 2004-2010 and found "no substantial authority for [Dish DBS's] treatment of subscription receipts." (R. p. 29; Amended Order p. 25.)

Dish DBS did not have substantial authority for how it sourced its South Carolina-based subscription receipts. Dish DBS asserts that IRC Treasury Regulation § 1.6662-4 governs the interpretation of "substantial authority" in this case, and that it provides additional guidance on how to accord weight to the authority and types of authority typically relied upon by a taxpayer. (p. 20.) While Treas. Reg. § 1.6662-4 may apply in proceedings before the Internal Revenue Service, it is not applicable in this instant matter.

Internal Revenue Code (IRC) § 6664(a) defines "underpayment" and the corresponding regulation – Treas. Reg. § 1.6662-4 – provides for the substantial understatement penalty of income tax "[i]f any portion of an underpayment, as defined in section 6664(a) and section 1.6662-4 . . . ." Treas. Reg. § 1.16662-4(a). However, IRC § 6664(a) is specifically not made applicable to South Carolina State taxes. S.C. Code Ann. § 12-6-50 (2014) provides:

> For purposes of this title and all other titles that provide for taxes administered by the department, except as otherwise specifically provided, the following Internal Revenue Code Sections are specifically not adopted by this State:
>
> * * *
>
> (16) Sections 2001 through 7655, 7801 through 7871, and 8001 through 9602, except for Sections 6015 and 6701, and except for

> Sections 6654 and 6655 which are adopted as provided in Section 12-6-3910 and Section 12-54-55. However, Section 6654(d)(1)(D) relating to estimated tax payments for qualified individuals as defined in that item is not adopted.

Accordingly, neither IRC § 6664(a) nor Treas. Reg. § 1.6662-4 is applicable in this matter.

Nevertheless, even if Treas. Reg. § 1.6662-4 applies in this matter, the regulation states there is "substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." Section 1.6662-4(3)(i) (emphasis added). Dish DBS's reliance on the regulation is misplaced because it has confused quality of authority with sheer quantity of authority. Simply because Dish DBS has cited more authorities than the Department does not support its assertion that it had substantial authority for the positions taken on the returns.

Moreover, the case Dish DBS cites as support for its position in this matter are inapplicable and distinguishable from the issues in this case. For instance in some cases, the applicable statute is identical to UDITPA, § 17 in that the sales factor (i.e., gross receipts) includes the "greater proportion" language as well as "based on costs of performance"; the state's statutory scheme clearly defines "income-producing activity"; and/or the taxpayer raises constitutional apportionment issues. See Boston Professional Hockey Association, Inc. v. Comm'r of Rev., 433 Mass. 276, 820 N.E.2d 792 (2005). See also Bellsouth Advertising & Publishing Corporation v. Chumley, 308 S.W.3d 350 (Tenn. Ct. App. 2009); Commissioner of Revenue v. AT&T Corporation, 82 Mass.App.Ct. 1106, 970 N.E.2d 814 (2012) (unpublished); Interface Group v. Commissioner of Revenue, 918 N.E.2d 97, 75 Mass.App.Ct. 1116 (2009) (unpublished); Communications Satellite Corporation v. Franchise Tax Board, 156 Cal.App.3d 726, 203 Cal.Rptr. 779 (1984) (determining whether taxing authority may deviate from the standard statutory apportionment formula (payroll, property, and sales) in which the "sales" statute mirrors UDITPA,

§ 17); Storer Communications, Incorporated v. Limbach, 1986 WL 28659 (1986); State of Illinois Letter No. IT 90-045 (1990), 1990 WL 99829; State of Illinois Letter No. IT 2004-0041-GIL, 2004 WL 2732081 (also addressing whether taxpayer has nexus with the taxing authority); State of Illinois Letter No. IT 2005-0046-GIL, 2005 WL 3258794; Commonwealth of Virginia (P.D.) 08-134, 2008 WL 3538253.

In other cases, the issue for determination involved whether the taxpayer has sufficient income-producing activity to create "nexus" or "minimum connection" between the activities sought to be taxed and the jurisdiction seeking to impose such tax. See Pan American World Airways, Inc. v. Government of Virgin Islands, 315 F.Supp. 746, 8 V.I. 82 (1970) (holding that Virgin Islands' application of tax statute to taxpayer's gross receipts did not violate the due process or commerce clauses of the US Constitution); Howard Cotton Company v. Olsen, 675 S.E.2d 154 (Tenn. 1984) ("income-producing activity" was used in determining whether other jurisdictions could impose corporate tax upon taxpayer); Commonwealth of Virginia (P.D.) 12-36, 2012 WL 1257362.[18]

In some cases, the issue for determination concerned whether or not a taxpayer and a related entity were a unitary business, and thus, should combine their net income for tax purposes in the respective jurisdiction. See Dental Insurance Consultants, Inc. v. Franchise Tax Board, 1 Cal.App.4th 343, 1 Cal Rptr.2d 757 (1991) (concluding that a taxpayer and its wholly owned subsidiary were engaged in a unitary enterprise and their net incomes should be combined for franchise tax purposes); General Mills, Inc. v. Commissioner of Revenue, 795 N.E.2d 552, 440

[18]Virginia's relevant statute is also identical to UDITPA, § 17.

Mass. 154 (2003)[19]; Arkla Industries, Inc. v. Franchise Tax Board, 233 Cal.Rptr. 495 (1986) (review denied and ordered not to be officially published) (concluding that taxpayer operated a separate business from its parent company).

Finally, one case cited by Dish DBS aligns with the Department's interpretation of the holdings in Lockwood Greene and Rent-A-Center Texas – that the analysis in those cases apply only to personal professional service providers that perform services such as engineering or management services. See Schonwetter v. Commissioner of Revenue, 316 N.W.2d 273 (Minn. 1982) (determining whether taxing authority could impose tax upon income from business consisting principally of the performance of personal or professional services).

While the Department does rely upon cases and administrative rulings from other jurisdictions that have cost of performance language with that state's relevant statute(s), those cases and administrative rulings do not use cost of performance to identify and locate the income-producing activity of the taxpayer.

Next, Dish DBS wrongly argues that its position is supported by substantial authority because the Department's "own expert witness" agrees that South Carolina is a pro rata cost of performance State. (Appellant's Br., p. 44.) Professor Swain, co-author of the *Hellerstein* treatise, explained that the authors of the treatise did not state that South Carolina is a cost of performance State. (R. pp. 915-920; Hr'g Tr. 476:8-481:24.)

Dish DBS also incorrectly states that the ALC's recent decision in Rent-A-Center Texas, L.P. v. South Carolina Department of Revenue, Docket No. 09-ALJ-17-0206-CC (filed January 6,

[19]General Mills also dealt with the sourcing of income related to the sale of intangibles. Notably, the Massachusetts statutory scheme mirrored UDITPA, § 17 (greater proportion and based on cost of performance language). Moreover, unlike Massachusetts law, § 12-6-2295(A)(3) explicitly requires the sourcing of intangibles based upon where those intangibles are used in a business for the production of income.

2012) "reaffirmed the 'COP' test as the proper means of sourcing sales from services." (Appellant's Br, p. 44.) The Department requests the Court to refer to its discussion of that case in its Brief, supra at pp. 21-22.

To the extent Dish DBS argues that Lockwood supports its treatment of subscription revenue, the Department disagrees and respectfully requests this Court to refer to the numerous discussions of that case in its Brief, passim. Simply put, Dish DBS is not like the taxpayer in Lockwood Greene: Dish DBS's subscribers do not hire specific professionals and are not paying for those professionals' expertise and time. Dish DBS and its operations are not comparable to the taxpayer in Lockwood Greene, and there is no basis in Lockwood Greene upon which Dish DBS may rely when filing its corporate income tax returns.

Likewise, Mercury Motor does not support the position taken with respect to Dish DBS's tax returns at issue, and the Department requests the Court to refer to its analysis of that case, supra p. 32-34. Dish DBS's reliance upon a taxpayer's total business activities to justify sourcing South Carolina based subscription receipts to other states is simply not proper.

B. Dish DBS Did Not Have Reasonable Cause And Did Not Act In Good Faith.

Finally, Dish DBS asserts that the position it has taken demonstrates that it was acting in good faith to comply with South Carolina law. The ALC found there was "no reasonable basis for [Dish DBS's] tax treatment of the subscription receipts," and Dish DBS's "wildly different treatments of its income in its multiple original and amended returns suggests no good faith belief in any particular method of apportionment. (R. p. 29, 3052; Amended Order p. 25; Resp't Ex. 1.) Thus, the ALC was correct to uphold the substantial understatement penalty for the underpayment of taxes owed. This is specifically evidenced by the fact that Dish DBS filed its original (and amended) 2004-2010 income tax returns with little or no consistency: for some years, it filed

sourcing its subscription receipts to the origin of its subscribers, while in other years, it sourced its revenue to Dish DBS's corporate headquarters (based upon cost of performance). (R. pp. 814-815, 1015-1150, 3052; Hr'g Tr. 375:8-376-8; Pet'r Ex. 1-12; Resp't Ex. 1.)

Moreover, Dish DBS also oscillated between using the standard four-factor apportionment method and the gross receipts method for the tax years at issue. (R. pp. 658-659, 1015-1150, 3052; Hr'g Tr. 219:19-220:21; Pet'r Ex. 1-12; Resp't Ex. 1.) Finally, as clearly shown through testimony and evidence at the hearing of this matter, Dish DBS's "theory" or "new methodology" behind the filing of its returns in this matter continues to evolve. (R. pp. 662-663, 3052; Hr'g Tr. 223:13-224:4, 224:20-23; Resp't Ex. 1.)[20] It is hard to fathom that Dish DBS had a "reasonable basis" or "acted in good faith" in its treatment of the subscription receipts in this matter when: 1) the theory(ies) it relies upon for its position(s) in this matter continues to evolve since the filing of the initial returns in 2005; 2) the Department's long-standing policy with respect to sourcing of gross receipts of service providers requires a taxpayer like Dish DBS to source gross receipts from South Carolina subscribers to South Carolina; 3) the Court of Appeals' decision in Lockwood Greene distinguished the activities of an engineering firm from the activities of finance companies and media broadcasting companies; and 4) the General Assembly omitted the phrase "based on costs of performance" in § 12-6-2295(A)(5).

As stated above, South Carolina is absolutely not a cost of performance State and this is clearly established, in addition to the case law recited above, by the actions of our General

[20]See also R. p. 3146; Resp't Ex. 14, p. 2 (stating in Dish DBS's request for a contested case hearing, that none of the subscription revenue from South Carolina subscribers should be sourced to South Carolina because the "subscription related income-producing activities are not performed in South Carolina and their receipts from these activities should not be sourced to South Carolina for income tax or capital tax, licensing fee apportionment purposes.").

Assembly. As noted by the ALC in its Order, while South Carolina's § 12-6-2295(A)(5) is similar to UDITPA's § 17, "[t[he General Assembly, while aware of section 17 of UDITPA, *specifically chose not* to include the phrase 'based on costs-of-performance' in section 12-6-2295(A)(5)." (R. p. 18; Amended Order, p.14) (emphasis in original). Moreover, 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 Sections 12-6-2252 and 12-6-2295 so as to further provide for allocation and apportionment of business income for state income tax purposes by basing the determination only on a sales factor and to define the terms 'sales' and 'gross receipts' consistently and specifically for that purpose[.]" The statutory amendment does not include the language "based on costs of performance" and there are no references to cost of performance elements, such as property and payroll. As such, Dish DBS's reliance upon property and payroll factors to justify its position with regard to its position on its tax returns is unpersuasive.

C. The ALC Did Not Err by Not Waiving or Reducing Penalties Under S.C. Code Ann. § 12-54-160 (2014).

Finally, Dish DBS argues that the ALC erred by not waiving or reducing penalties because, by relying upon the decision of Lockwood Greene, it had reasonable cause for the tax positions it took with regard to the returns at issue. However, as discussed above, Lockwood Greene did not make South Carolina a cost of performance state. Further, Dish DBS has not shown that it had substantial authority for how it sourced its South Carolina based subscription receipts. Moreover, Dish DBS did not act in good faith to comply with §§ 12-6-2290 and 12-6-2295(A)(5), as evidenced by its evolving position since the filing of the tax returns at issue. Specifically, during the course of this single Audit Period, Dish DBS utilized three different sourcing methodologies and presented a fourth method at trial. Moreover, Dish DBS utilized a cost of performance method

and/or elements, and the cases relied upon by Dish DBS do not apply a cost of performance method – implicitly or explicitly – to services providers such as itself. Finally, the General Assembly's statutory amendments and additions in 2006 and 2007 to the relevant statutory scheme, clearly do not envision the use of a cost of performance method in light of the distinct deletion of "based on costs-of-performance" from UDITPA, § 17.

Based on the above and because § 12-54-155 (2014) says that a substantial understatement penalty "must be added," Dish DBS must be assessed the substantial understatement penalties.

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, the ALC did not make any errors of law, and the ALC's decision is not characterized by an abuse of discretion.

Respectfully Submitted,

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Columbia, South Carolina

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM THE ADMINISTRATIVE LAW COURT
HONORABLE SHIRLEY C. ROBINSON, ADMINISTRATIVE LAW JUDGE

Case No. 14-ALJ-17-0285-CC
Appellate Case No. 2016-001642

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

v.

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

CERTIFICATE OF COUNSEL

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

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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 Final Brief regarding the above-referenced case, by depositing the same in the United States Mail, postage prepaid, on February 7, 2017, addressed to the attorneys of record, Burnet R. Maybank, III, Esquire and James P. Rourke, Esquire, Nexsen Pruet, LLC, PO Drawer 2426, Columbia, SC 29202-2426, and by hand delivery to the Court of Appeals, 1220 Senate Street, Columbia, SC 29201.

Jean M. O'Connor