

THE STATE OF SOUTH CAROLINA
In The Supreme Court

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

S.C. SUPREME COURT

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

Opinion No. 5513 (S.C. Ct. App. Filed Aug. 30, 2017)
Appellate Case No. 2018-000211

DIRECTV, Inc. & Subsidiaries,Petitioner,

v.

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

Return To Petition For a Writ of Certiorari

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This Court should not issue a Writ of Certiorari to review *DIRECTV, Inc. & Subsidiaries v. South Carolina Department of Revenue*, 421 S.C. 59, 804 S.E.2d 633 (Ct. App. Aug. 30, 2017), in which a Panel of the South Carolina Court of Appeals unanimously affirmed the Administrative Law Court's (ALC) decision of June 12, 2015. (App., pp. 1-21.) The Court of Appeals correctly held that DIRECTV, Inc. & Subsidiaries' (DIRECTV) income-producing activity (IPA) is the delivery of the signal into the homes and onto the television sets of DIRECTV's customers. (App. p. 21.) Because all of the IPA related to South Carolina customers occurred entirely within South Carolina, the South Carolina Department of Revenue (Department) properly sourced 100% of DIRECTV's subscription receipts from South Carolina customers to the numerator of the gross receipts ratio. (R. p. 51.) The Court of Appeals also correctly held that DIRECTV is liable for substantial understatement penalties. (App. p. 21.) Because the Court of Appeals' decision is a straightforward application of this Court's precedent and South Carolina statutes, the Petition should be denied.

COUNTER QUESTIONS PRESENTED FOR REVIEW

- I. Did the Court of Appeals Correctly Disregard DIRECTV's Income Anticipatory Activities and Properly Focus on DIRECTV's Income Producing Activities as Required by South Carolina law?
- II. Did the Court of Appeals Correctly Conclude that DIRECTV's Method of Measuring Income Producing Activity in South Carolina is Unreasonable?
- III. Does DIRECTV's Failure to Meet its Burden of Proof Merit This Court Granting DIRECTV's Petition for Writ of Certiorari?
- IV. Did the Court of Appeals Correctly Conclude that the Imposition of Substantial Understatement Penalties was Appropriate as no Substantial Authority Supports DIRECTV's position and the Basis of DIRECTV's Tax Treatment of the Subscription Receipts was Unreasonable?

COUNTER STATEMENT OF THE CASE

Procedural History

The Department concurs with DIRECTV's statement regarding the procedural history in this matter. (Petition, pp. 2-3.)

Summary of Facts

A. DIRECTV's Business Operations

DIRECTV is a multistate taxpayer that offers direct broadcast satellite video services to customers throughout the country. (R. p. 172-3; Hr'g Tr. 49:18-50:1.) Its headquarters are located in Los Angeles, California. (R. p. 176; Hr'g Tr. 53:3-12.) For a subscription fee, DIRECTV grants its customers access to television programming and other audio/visual options that are transmitted nationwide to customer's homes or businesses via satellites. (R. pp. 172-173, 175-176, 184-185, 196, 197, 200; Hr'g Tr. 49:23-50:1, 52:24-53:2, 61:5-62:8, 73:15-21, 74:14-20, 77:10-78:1.) DIRECTV receives programming produced by third parties through satellite, fiber-optic cables, and over-the-air broadcast. (R. pp. 186-192; Hr'g Tr. 63:3-69:15.) DIRECTV also receives programming from local broadcast television stations through the use of local collection facilities. (R. pp. 186-187, 194-195; Hr'g Tr. 63:3-64:18, 71:11-72:5.) During the Tax Periods at Issue, DIRECTV had four to six local collection facilities in South Carolina. (R. pp. 187, 487; Hr'g Tr. 64:19-25, 364:17-25.) The signals for the programming content are collected at broadcast and uplink centers. (R. p. 186-187; Hr'g Tr. 63:3-64:18.) The broadcast centers and uplink facilities transmit the programming content signals to the satellites. (R. pp. 186-187, 191; Hr'g Tr. 63:3-64:18, 68:18-23.) The satellites then transmit the signals directly to DIRECTV satellite dishes mounted on or near customer homes. (R. pp. 186-187; 191, 196-197; Hr'g Tr. 63:3-64:18, 68:18-

23, 73:22-74-20.) The signals are then relayed from the dish on or near the home to a set-top box (often located in the customer's living room) which delivers the signals to the customer's television set. (R. p. 196-197; Hr'g Tr. 73:22-74:20.)

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

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

from South Carolina customers should be sourced to the numerator of the gross receipts ratio for apportionment purposes. (R. p. 950-954; Stip. of Facts, filed January 12, 2015.)

B. DIRECTV's Income Tax Returns

On its originally filed corporate income tax returns in South Carolina for 2006-2008, DIRECTV sourced 100% of its subscription receipts and 100% of its rental receipts from South Carolina customers to the numerator of the gross receipts ratio. (R. pp. 405-406, 407, 407-408, 486-807, 835-841, 852-859; Hr'g Tr. 282:13-283:15, 284:8-19, 284:20-285:7; Resp't Ex. 1, 4, and 6.) By doing so, DIRECTV used gross receipts ratios of 1.9539%, 2.0016%, and 2.0543% for years 2006 through 2008, respectively, to apportion its net income to South Carolina. *Id.* The Department conducted a field audit of DIRECTV's 2006-2008 tax returns. (R. pp. 403-404; Hr'g Tr. 280:22-281:4.) As a result of the audit, the Department accepted DIRECTV's original 2006-2008 corporate income tax returns as filed (i.e., the Department did not make any adjustments to the tax returns). (R. p. 408; Hr'g Tr. 285:8-14.) DIRECTV subsequently filed amended corporate income tax returns for the 2006-2008 tax years, and the single change was the removal from the numerator of the gross receipts ratio all of the subscription receipts from South Carolina customers that DIRECTV originally included in the numerator. (R. p. 492, 494; Hr'g Tr. 369:15-23, 371:619.) DIRECTV's amended gross receipts ratios for years 2006-2008 were 0.0246%, 0.081%, and 0.1137%, respectively. (R. pp. 411, 412, 413, 816-833, 843-850, 861-869; Hr'g Tr. 288:21, 289:16, 290:8; Resp't Ex. 3, 5, and 7.) DIRECTV explained the amendments in a statement attached to each of the three amended returns:

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

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

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

DIRECTV then filed its original 2009-2011 corporate income tax returns using the same cost of performance method that it used on its 2006-2008 amended returns.¹ (R. pp. 417, 418, 419, 871-875, 877-881, 883-889; Hr'g Tr. 294:21-23; 295:10-11; 296:1-2; Resp't Ex. 8, 9, 10.) The Department audited these returns as well, and in a field audit report dated January 28, 2014, the Department assessed DIRECTV for income taxes and license fees for 2009-2011 using a gross receipts ratio that included all of DIRECTV's subscription receipts from South Carolina customers in the numerator. (R. pp. 902-909; Resp't Ex. 12.)

¹On its amended 2006-2008 returns and on its original 2009 and 2010 returns, DIRECTV did not include any of the subscription receipts from South Carolina customers in the numerator of the gross receipts ratio. On its 2011 return, DIRECTV changed its method again by including approximately \$22 million of its \$410 million subscription receipts from South Carolina customers in the numerator. (R. pp. 886, 954; Resp't Ex. 10, p. 4; Joint Stipulations, Ex. A.) DIRECTV did this by sourcing 0.11% of its total subscription receipts to South Carolina based on a ratio of its alleged payroll in South Carolina to its total payroll. (R. pp. 365, 762; Hr'g Tr. 242:3-13; Pet. Ex. 8, p. 17.) In its last amended returns from 2006-2008, DIRECTV did not source any subscription receipts to South Carolina because it claims that the vast majority of its payroll and property were located outside of South Carolina. (R. pp. 816-833, 843-850, 861-869; Resp't Ex. 3, 5, 7.)

The Department subsequently issued its Determination finding that the IPA of DIRECTV was its delivery of the signal into South Carolina customers' homes and onto the customers' television sets, which occurred entirely in South Carolina, and that, accordingly, DIRECTV should include 100% of the subscription receipts received from South Carolina customers in the numerator of the gross receipts ratio. (R. p. 64; Resp't Ex. 13, p. 7.)

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

Under the Department's longstanding policy with respect to the sourcing of gross receipts to South Carolina, the Department does not source gross receipts of all service providers to South Carolina in the same manner but examines the specific activities of each applicable service industry to determine sourcing. (R. pp. 433-434, 456, 464-466, 467-468; Hr'g Tr. 310:10-311-3, 333:2-7, 341:19-343:1, 344:12-345:9.) For example, when sourcing the income of an engineering firm, the Department looks to the actual engineering services rendered as constituting the IPA since it is the "expertise and time" of a specific engineer that the customer is purchasing. Lockwood Greene Engineers, Inc. v. S.C. Tax Comm'n, 293 S.C. 447, 449, 361 S.E.2d 346, 347 (Ct. App. 1987). Therefore, the income is sourced to the location of the engineer rendering that specific service. (R. p. 201; Hr'g Tr. 311:4-10.) On the other hand, the Department sources income received from the licensing of intangibles and from a financing operation to the location of the sale (in the case of intangibles) and the location of the borrower (in the case of a financing company). (R. pp. 434-435, 468-469, 940-949; Hr'g Tr. 311-11-312:8, 345:10-346:20; Resp't Ex. 21.) Likewise, the Department sources subscription receipts received by a cable company and telephone company similar to the method it used in this case to source DIRECTV's subscription receipts to South Carolina. (R. pp. 435-436, 465; Hr'g Tr. 312:12-313:8, 342:9-18.)

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

D. Dr. Glenn W. Harrison's Testimony

1. Identification of the Income-Producing Activity

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

Dr. Harrison's determination of the IPA, from an economic standpoint, is consistent with the relevant statutes and case law. Dr. Harrison believes that a customer is paying for DIRECTV to deliver the signal into his home and onto his television screen. (R. pp. 526-530; Hr'g Tr. 403:8-407:1.) To the contrary, Dr. Cody sought to find the value in a more nebulous way by "look[ing] at the important functions, risks and assets that are employed in the business." (R. p. 351; Hr'g Tr. 228:10-13.) Thus, as the Court of Appeals correctly concluded, Dr. Cody never connected or linked the "value drivers" to DIRECTV's business activity in South Carolina. (App. pp. 13-14.)

2. Location of DIRECTV's Income-Producing Activities

Dr. Harrison testified, from an economic perspective, that it is appropriate to source the subscription revenue received by DIRECTV from South Carolina customers to the numerator of the gross-receipts ratio because “that’s the most direct way to represent [the extent of DIRECTV’s business in South Carolina] and calculate [it].” (R. p. 529; Hr’g Tr. 406:3-13.) Dr. Harrison further testified that it is unnecessary to develop “proxies” or approximations – like payroll and assets – to measure the value of DIRECTV’s services in South Carolina. (R. p. 528; Hr’g Tr. 405:9-10.) DIRECTV and the customer have placed a direct value of the delivery of the service into homes – the amount of the subscription fee paid. (R. p. 528; Hr’g Tr. 405:3-17.) Dr. Harrison stated that the most accurate way to measure DIRECTV’s IPA in South Carolina is “the amount of money that the subscriber paid in South Carolina” and that such a measure was a transparent item that comes from DIRECTV’s own accounting information. (R. pp. 528, 538; Hr’g Tr. 405:10-17, 415:11-17.)

E. Professor John A. Swain’s Testimony

The Department’s tax policy expert, Professor John A. Swain, explained that the Department’s approach in this matter is good tax policy for several different reasons. (R. p. 577; Hr’g Tr. 454:5-8.) First, S.C. Code Ann. § 12-6-2290 mandates the use of a single gross-receipts ratio, and the purpose of a single gross-receipts ratio is to reflect the contribution of the market state – “to give South Carolina its due as a market state for providing a market for DIRECTV, even though DIRECTV is . . . not located [in South Carolina].” (R. p. 577, 579; Hr’g Tr. 454:10-18, 456:18-23.) Second, the General Assembly’s approach to sourcing by adopting statutes mandating the use of single sales/gross receipts apportionment ratios reflects the nationwide movement to a

single-sales factor apportionment: what began as an economic development tool has now become an “economic sort of preservation tool” that allows states to “run with the pack in a competitive environment with mobile capital[.]” (R. p. 578; Hr’g Tr. 455:7-19.) Unlike the General Assembly’s approach, Prof. Swain further explained that DIRECTV’s approach to sourcing (by using costs-of-performance measures) in this case is a “stealth property/payroll/expense factor” and that is “exactly the opposite of what Legislatures . . . want to do when they adopt single-sales factor. It defeats the purpose of it.” (R. p. 579; Hr’g Tr. 456:9-14.) Third, the Department’s approach promotes equity by attempting to “treat like taxpayers in a like manner” unlike DIRECTV’s approach that would treat “functionally similar or very similar business competitors” differently. (R. p. 580, 582; Hr’g Tr. 457:7-21; 459:5-21.)

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

SUMMARY OF GROUNDS FOR DENYING CERTIORARI

The Petition should be denied because the Court of Appeals' decision is a routine application of this Court's precedent, the Court of Appeals' prior decision, and the relevant South Carolina statutes. The Court of Appeals correctly interpreted and applied the relevant statutes by determining that DIRECTV's subscription receipts from South Carolina customers should be included in the numerator of the gross receipts ratio based on the plain meaning and purpose of the apportionment statutes. Because the Department found in its Department Determination that the sole IPA here was DIRECTV's delivery of its signal into the homes of its South Carolina customers, DIRECTV could only prevail if it proved by a preponderance of the evidence that its IPA included more than the delivery of the signal into the homes of DIRECTV's South Carolina customers and the location of such IPA. The ALC found that DIRECTV failed to meet these burdens of proof, and the Court of Appeals affirmed that finding based on the substantial evidence in the record. Consistent with the Court of Appeals' and ALC's decisions, this Court already has held that not every activity a taxpayer engages in is IPA. *Mercury Motor Express, Inc. v. S.C. Tax Comm'n*, 244 S.C. 134, 135 S.E.2d 756 (1964). Finally, as concluded by the ALC and affirmed by the Court of Appeals, there is substantial evidence in the record demonstrating DIRECTV's use of the payroll and assets method to measure its IPA in South Carolina was an unreasonable approximation and did not reasonably represent DIRECTV's business activity in the state. On all these issues, the Court of Appeals' decision was perfectly consistent with applicable case law, relevant statutes, and the Department's long-standing administrative policy.

Certiorari therefore is not warranted because this case does not involve novel questions of law. The Court of Appeals applied existing South Carolina law and interpreted the applicable statutory language. The decision also does not conflict with prior decisions of this Court. Accordingly, the Petition should be denied.

ARGUMENTS

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

A. *Lockwood Greene* provides a flexible standard for sourcing gross receipts and did not adopt a one-size-fits-all "Place of Activity" test for all service providers.

In its Petition, DIRECTV asserts that the Court of Appeals' decision is "patently erroneous and contrary to South Carolina law," to include the Court of Appeals' own holding in *Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). (Petition, p. 10.) DIRECTV misinterprets the *Lockwood Greene* decision to stand for the proposition that the IPA for all service providers must be sourced (i.e., measured) using a "place of activity" test (or, "payroll and assets" proxy).²

Contrary to DIRECTV's assertion, § 12-6-2295(A)(5) did not codify *Lockwood Greene* by imposing or endorsing a method for apportioning service-related income in South Carolina based on payroll and/or property proxies for *all* multi-state service-providing taxpayers. Rather, the *Lockwood Greene* court acknowledged and approved of the Department's use of different methods

² In 2007, the General Assembly adopted § 12-6-2295(A)(5) which requires gross receipts to be sourced to the location of the IPA. If DIRECTV is correct in its interpretation of *Lockwood Greene*, it seems the General Assembly would have required gross receipts to be sourced to the "place of activity," but the General Assembly adopted a flexible standard instead.

when addressing different service industries based on the activities of the companies in each industry. *Lockwood Greene*, 293 S.C. at 450, 361 S.E.2d at 348.

The Court of Appeals correctly rejected DIRECTV's interpretation of *Lockwood Greene* because "[t]he service DIRECTV provides is entirely different from *Lockwood Greene* and DIRECTV's source of income does not derive from its engineers, but rather from subscriptions to its programming packages." (App., p. 13.) In short, DIRECTV's use of a payroll and assets proxy (i.e., cost elements) is both unnecessary (because the IPA related to the subscription receipts from South Carolina customers occurred entirely within South Carolina) and unreasonable (because DIRECTV only has two employees in the state, and its only assets in South Carolina are four collection facilities and the equipment its subscribers lease or purchase). (App., p. 14). Therefore, the actual subscription receipts received by DIRECTV from its South Carolina customers is the best, most accurate, and most transparent way to measure "the proportion of . . . business carried on within this State" by DIRECTV. S.C. Code Ann. § 12-6-2210(B) (2014). Thus, the Court of Appeals' decision is in complete accord with the *Lockwood Greene* decision when determining a service provider's IPAs in South Carolina.

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

In its Petition, DIRECTV asserts that the Court of Appeals "committed an error of law in interpreting the language of § 12-6-2295(A)(5) to "require market-based sourcing." (Petition, p. 12.)

The Court of Appeals did not interpret § 12-6-2295(A)(5) to impose a "market-based sourcing" method, and it properly interpreted and applied the IPA language of § 12-6-2295(A)(5). The Court of Appeals applied § 12-6-2295(A)(5) by examining the IPA and where that IPA

occurred – not by blindly sourcing subscription receipts to the location of the customer. Here, the IPA just happened to occur in the homes of its South Carolina customers. In fact, the Court of Appeals affirmed the ALC’s decision in which the ALC made numerous statements throughout its Amended Final Order demonstrating that it properly identified, located, and measured the IPA pursuant to § 12-6-2295(A)(5):

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

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

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

Further, contrary to a market-based sourcing method,³ the Department’s witnesses testified that the Department examines the specific activities of each applicable service industry to identify the IPA and to determine where the taxpayer’s income should be sourced. (R. pp. 433-434, 456, 464-468; *see also* R. pp. 434, 461-462) (Department witnesses testifying that the Department would source the income received by an engineering firm to the place where the services were performed, i.e., the location of the engineering firm); *see also Lockwood Greene*, at 448-50, 361 S.E.2d at 347-48 (stating that gross receipts from within the state for an engineering firm were

³Section 12-6-2295(A)(5) is not a market-based sourcing provision. Under § 12-6-2295(A)(5), the IPA must be identified, located, and then measured. Market-based sourcing does not use IPA language, and it looks solely to the customer’s location (or destination of the service) when sourcing a taxpayer’s income.

sourced to the location where the services that generate the income are performed [i.e., at the office of the engineer]). Accordingly, the Court of Appeals did not err in determining the IPA under § 12-6-2295(A)(5), and it did not interpret such section to require market-based sourcing.

C. This Court properly interpreted and applied *Mercury Motor*.

In its Petition, DIRECTV asserts that the Court of Appeals' decision is contrary to the holding in *Mercury Motor Express, Inc. v. South Carolina Tax Commission*, 244 S.C. 134, 141, 135 S.E.2d 756, 759 (1964). (Petition, p. 13.) DIRECTV misinterprets *Mercury Motor* to require a broad construction of what constitutes an IPA, which would include any "incidental" activities. This assertion is simply incorrect.

Section 12-6-2295(A)(5) "requires activities that actually produce income." (App., p. 15.) Accordingly, not all activities of a taxpayer are IPAs - even if such activities are important to the overall service. Only IPAs should be used to source gross receipts to South Carolina. In *Mercury Motor*, this Court distinguished between activities "incidental to the production of income" and IPAs. *Mercury Motor* at 141, 135 S.E.2d at 759. This Court found activities such as picking up and dropping off freight to be "incidental to the production of income," while only hauling the freight was an IPA. *Id.* This Court's distinction of activities "incidental to the production of income" and IPAs means that "incidental" (although important) activities are not IPAs and should not be used to source gross receipts to South Carolina. In *Mercury Motor*, only the IPA of hauling freight was used to source gross receipts to South Carolina. *Id.*

Thus, the Court of Appeals' analysis of IPAs is consistent with *Mercury Motor*. DIRECTV's delivery of its signal into the homes and onto the television sets of its South Carolina customers is the IPA that generated its South Carolina subscription receipts. Although DIRECTV

performed many important activities prior to delivering the signal into subscribers' homes - such as content acquisition and development, satellite launches, and broadcasting and transmitting - those activities "are 'too attenuated' to be considered income-producing for the purposes of section 12-6-2295(A)(5)." (App., p.15.) Even DIRECTV's own expert, Dr. Cody, admitted that DIRECTV engages in these intermediate activities in "anticipation of generating income" which is patently distinct from IPA as required by § 12-6-2295(A)(5). (R. pp. 342, 343, 346-347, 373-374; Hr'g Tr. 219:15-19, 220: 1-5, 223:6-224:11, 250:9-251:22.)

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

In its Petition, DIRECTV claims the Court of Appeals' decision is not supported by the evidence presented by DIRECTV regarding its IPAs. To the contrary, the record contains substantial evidence to support the Court of Appeals' conclusion (consistent with the ALC's finding) that DIRECTV's IPA is the delivery of signal to its customers nationwide, and accordingly that the delivery of signal to South Carolina customers is represented by 100% of its South Carolina subscription receipts. (App., p. 13) (affirming the ALC because "its decision is not affected by an error of law and is supported by substantial evidence").

For example, the Court of Appeals found Dr. Harrison's testimony persuasive when he testified that "the purchase of DIRECTV's services and the delivery of television services in the customers' homes or businesses was the activity that 'actually generate[d] income' for DIRECTV." (App. p. 13.) *See also* Dr. Harrison's testimony, R. pp. 527, 529, 540; Hr'g Tr. 404:13-15, 406:14-18, 404:1-12 ("[It's] the provision of television services in your home" that generates the subscription receipts for DIRECTV, not the pre-order and other preparatory activities

which are merely “prior, secondary, intermediate activities.”) The ALC also took into account the testimony of Mr. Goswitz, DIRECTV’s vice president of space, communications, and video, who testified about DIRECTV’s operations. He repeatedly referenced “content and broadcast of signals,” “infrastructure” related to content and transmission, and “production and collection of programming content signals and transmission to broadcast centers and uplink facilities and then to the satellites.” (R. pp. 33-35.) The Court of Appeals’ decision is supported by Mr. Goswitz’s testimony admitting that the activities DIRECTV performs at its customers’ homes are the IPAs by stating that DIRECTV provides “direct to home” video services and must install a satellite dish, a coaxial cable, and a set-top box at each customer’s home and connect the set-top box to each customer’s television. (R. pp. 172, 196–97; Hr’g Tr. 49:21-23, 73:22-74:20.)

In addition, the ALC considered the testimony of Dr. Cody, who was engaged by DIRECTV “to identify from an economic perspective the income-producing activities of” DIRECTV. (R. pp. 327; Hr’g Tr. 13-16.) Dr. Cody testified regarding the four so-called “value drivers” that could identify DIRECTV’s IPA, including (1) content and programming, (2) acquisition and distribution of programming content, (3) marketing and sales of its service, and (4) customer service. (R. pp. 329; Hr’g Tr. 206:2-6.) The thorough analysis by the ALC contained in its Amended Order demonstrates that the ALC openly considered Dr. Cody’s testimony, but ultimately found that Dr. Cody’s payroll and asset proxy method for identifying DIRECTV’s IPAs were “of no practical value,” that DIRECTV “did not sufficiently explain the effect of [Dr. Cody’s] value drivers on income production in this State,” and that DIRECTV’s evidence was “just too nebulous” to make the connection between Dr. Cody’s value drivers and IPAs. (R. p. 41.) Further, the Court of Appeals’ discussion regarding Dr. Cody’s testimony that DIRECTV’s view of its

IPAs were conducted “in anticipation” of customers signing up for DIRECTV’s services clearly indicates the Court of Appeals considered all the testimony given by Dr. Cody and therefore, sufficient evidence supports the Court of Appeals’ decision. (App. pp. 11-15.)

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

II. THE COURT OF APPEALS CORRECTLY CONCLUDED THAT DIRECTV’S METHOD OF MEASURING INCOME PRODUCING ACTIVITY IN SOUTH CAROLINA IS UNREASONABLE.

In its Petition, DIRECTV next argues that the Court of Appeals erred in concluding Dr. Cody’s flawed method of measuring IPA in South Carolina resulted in DIRECTV’s failure to establish its IPA conducted in South Carolina. (Petition, p. 18.) However, there is substantial evidence in the record to support the Court of Appeals’ decision that Dr. Cody’s method did not reasonably approximate its IPA in South Carolina and therefore did not establish DIRECTV’s IPA in South Carolina.

Dr. Cody testified that he was engaged by DIRECTV “to identify from an economic perspective the income-producing activities of” DIRECTV; however, he failed in this endeavor.

(R. p. 327; Hr'g Tr. 204:11-16.) The ALC fully analyzed Dr. Cody's testimony and report but did not find it sufficient or persuasive. (R. pp. 40-41, 44, 47; Amended Order pp. 10, 11, 14, 17.) Specifically, the ALC recognized in its decision that DIRECTV presented evidence through Dr. Cody of the so-called four "value drivers" that could identify DIRECTV's IPA. (R. pp. 40-41; Amended Order pp. 10-11.) These value drivers included major components of DIRECTV's operations, including (1) content and programming, (2) acquisition and distribution of programming content, (3) marketing and sales of its service, and (4) customer service. (R. p. 329; Hr'g Tr. 206:2-16.) Dr. Cody described these activities of DIRECTV in great detail in his testimony, and he testified about his calculations using DIRECTV's payroll and assets as proxies in an unsuccessful attempt to locate and measure DIRECTV's IPAs. (R. pp. 40-41, 329-344; Hr'g Tr. 206:2-221:1; Amended Order pp. 10-11.) The ALC discussed in detail Dr. Cody's testimony about value drivers, and the ALC openly considered Dr. Cody's testimony to include reciting his analysis in the Amended Order. (R. pp. 40-42, 47-48; Amended Order pp. 10-12, 17-18.)

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

the IPA of delivering the signal into the homes of DIRECTV's South Carolina customers. (R. pp. 41, 47; Amended Order p. 11, 17.)

Dr. Cody contradicted his own testimony about IPAs by, like the *Mercury Motor Court*, distinguishing incidental activities from IPAs. According to Dr. Cody, incidental activities anticipate income, while IPAs produce income. Specifically, he stated that DIRECTV performed the incidental activities "in anticipation of – and in order to deliver that signal in anticipation of customers signing up and paying" and that these incidental activities have "a risk" because DIRECTV has only "an anticipation of future profits." (R. pp. 342, 343; Hr'g Tr. 219:15-19, 220:1-5.)

Finally, when asked by DIRECTV's counsel how he determined the IPA and then measured the IPA in various states, Dr. Cody stated, "[t]here are a number of measures that can be used to identify and then locate the income producing activities. A couple of very common factors or proxies are payroll and assets. . . . So I developed methodologies using those measures." (R. p. 352; Hr'g Tr. 229:7-9.) Responding to how he determined the location of the IPAs, Dr. Cody continued, "I did two analyses. One analysis looked just at the location of payroll. So the payroll that's in South Carolina as a proxy for the income-generating activities that takes place in South Carolina versus payroll everywhere." (R. p. 352-353; Hr'g Tr. 229:22-230:5.) Dr. Cody also took assets into account in determining the location of the IPAs. (R. p. 354; Hr'g Tr. 231:3-6.) It therefore appears that DIRECTV improperly used costs-of-performance elements to identify, locate, and measure IPAs.

Because the ALC heard and considered extensive evidence from Dr. Cody and found that DIRECTV failed to sufficiently prove its alleged IPAs, the ALC made a decision regarding what

DIRECTV's IPA was and such decision was supported by substantial evidence in the record. Thus, there is substantial evidence in the record to support the Court of Appeals' conclusion that DIRECTV'S method of measuring IPA in South Carolina is unreasonable.

III. DIRECTV'S FAILURE TO MEET ITS BURDEN OF PROOF DOES NOT MERIT THIS COURT GRANTING DIRECTV'S PETITION FOR WRIT OF CERTIORARI.

The Court of Appeals properly concluded that DIRECTV failed to meet its burden of proof because DIRECTV failed to prove by a preponderance of the evidence that (a) DIRECTV's income-producing activity extended beyond the delivery of the signal into the homes and onto the television screens of its South Carolina customers, and (b) that less than 100% of the South Carolina subscription receipts should be sourced to South Carolina.⁴ (App., p. 15). The ALC made specific findings of fact that DIRECTV's evidence was insufficient and not credible. (R. pp. 25-26, 41-42, 49-50). Thus, the Court of Appeals correctly affirmed the ALC's decision.

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

Cloyd was decided in the context of a property tax matter and not with regard to corporate income tax. *Cloyd*, at 87, 367 S.E.2d at 172. Moreover, the *Cloyd* court did not conclude that

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

“appropriate relief” included absolving the taxpayer of any property tax liability through dismissal of the assessment. *Id.* at 88-89, 367 S.E.2d at 173. The mere fact the ALC suggested that there **may** be IPA in South Carolina in addition to the delivery of the signal into subscribers’ homes and onto their televisions (although not proven by a preponderance of the evidence by DIRECTV) does not entitle DIRECTV to a complete abatement of the assessment in this case. DIRECTV “was still required to prove that removing South Carolina subscription receipts from the numerator reasonably represented its business activity in South Carolina.” (App., p. 15.)

Here, DIRECTV failed to meet its burden of proof to overcome the Department’s Determination, and dismissal of the assessment under *Cloyd* is illogical.

IV. THE COURT OF APPEALS CORRECTLY CONCLUDED THAT THE IMPOSITION OF SUBSTANTIAL UNDERSTATEMENT PENALTIES WAS APPROPRIATE AS NO SUBSTANTIAL AUTHORITY SUPPORTS DIRECTV’S POSITION AND THE BASIS OF DIRECTV’S TAX TREATMENT OF THE SUBSCRIPTION RECEIPTS WAS UNREASONABLE.

The Court of Appeals’ finding that the imposition of substantial understatement penalties was proper is supported by substantial evidence in the record. Nonetheless, DIRECTV claims that it had substantial authority for its position and there was a reasonable basis for its tax treatment of the subscription receipts. (Petition, p. 22-24.) Because substantial evidence in the record supports the Court of Appeals’ finding, DIRECTV’s claim is without merit.

Simply put, DIRECTV did not properly apply South Carolina statutory and case law. As noted by the Court of Appeals, “the record contains substantial evidence demonstrating DIRECTV’s use of the payroll and assets method was an unreasonable approximation of its IPAs in South Carolina and did not reasonably represent DIRECTV’s business activity in the state.”

(Opinion, p. 20.) Moreover, as discussed above, the decisions of *Lockwood Greene* and *Mercury Motor* do not stand for the proposition upon which DIRECTV relies.

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

Next, DIRECTV claims that it had substantial authority for its position by relying upon the decision of *Mercury Motor*. Specifically, DIRECTV argues that *Mercury Motor* "states that each transaction in a series of activities engaged in by a taxpayer to conduct its business contributed to its earnings, and the Court did not consider the 'final' act of delivering the package to the customer's residence to be the primary IPA." (Petition, p. 24.) However, the Court of Appeals considered this argument but found it "unpersuasive . . . as the 'preparatory' activities that DIRECTV engages in for the production of its programming and marketing are not an IPA for the purposes of section 12-6-2295(A)(5)." (App., p. 15.); *see also* R. p. 42; Amended Order, p. 12 (ALC recognizing that the facts in this case "are akin" to the transactions discussed in *Mercury Motor*, and that "DIRECTV failed to sufficiently identify its outside income-producing activities."). Accordingly, from the plain reading of *Mercury Motor*, DIRECTV's reliance upon a

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

As discussed above, this Court, applying § 12-6-2295(A)(5), specifically compared the activities of DIRECTV to the activities of the taxpayer in *Lockwood Greene* and concluded that some of DIRECTV's activities were in fact 'preparatory,' similar to the taxpayer in *Mercury Motor*, rather than IPA as required by § 12-6-2295(A)(5). This Court, in complete recognition of § 12-6-2295(A)(5), considered the activities of DIRECTV to determine its IPA in South Carolina and concluded that DIRECTV's IPA in this matter "is the delivery of its programming signal to its customers across the country and in South Carolina." (Order, p. 14.)

DIRECTV also claims that the Court of Appeals erred in affirming the ALC's imposition of penalties because "the ALC expressly found that the Department's method was incorrect" (Petition, p. 24.) DIRECTV seems to suggest that by protesting the Department's decision and "using an alternative method that closely tracks the existing law," penalties should be abated in its entirety. (Petition, p. 24.) DIRECTV misapprehends the decision of the Court of Appeals and the ALC:

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

(Opinion, p. 18.) Accordingly, as discussed above, the Court of Appeals' decision to affirm the imposition of substantial understatement penalties is supported by substantial evidence in the record as there is no substantial authority for DIRECTV's position and it did not act in good faith.

CONCLUSION

For the reasons explained above, this Court should deny DIRECTV's Petition for a Writ of Certiorari.

Respectfully Submitted,



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Columbia, South Carolina
March 14, 2018

THE STATE OF SOUTH CAROLINA
In The Supreme Court

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APPEAL FROM THE ADMINISTRATIVE LAW COURT

MAR 14 2018

Honorable Ralph King Anderson, III, Chief Administrative Law Judge

S.C. SUPREME COURT

Opinion No. 5513 (S.C. Ct. App. Filed Aug. 30, 2017)
Appellate Case No. 2018-000211

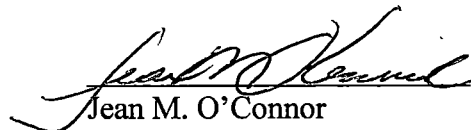
DIRECTV, Inc. & Subsidiaries,Petitioner,

v.

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

PROOF OF SERVICE

I, Jean O'Connor, do hereby certify that I have caused to be mailed, via United States Postal Service, postage prepaid, a copy of the Department's Return to Petition for a Writ of Certiorari in the above referenced matter to John C. von Lehe, Jr., Esquire and Bryson M. Geer, Esquire, Nelson Mullins Riley & Scarborough LLP, 151 Meeting Street, Sixth Floor, Charleston, SC , 29401-2239 on this 14th day of March 2018.


Jean M. O'Connor