

South Carolina: DIRECTV denied request for \$8.5M refund



David M. Kall | Thursday, September 7, 2017

In an [opinion](#) issued on Aug. 30, 2017, the South Carolina Court of Appeals affirmed the Administrative Law Court's (ALC) denial of DIRECTV and its subsidiaries' (DIRECTV) claims for an \$8.5 million refund. The amount is the sum of \$6,646,168 in tax and license fees; \$653,425 in interest; and \$1,246,155.75 in penalties relating to the companies' 2009, 2010, and 2011 income tax returns. The case turned on the scope of DIRECTV's income producing activities in South Carolina, namely the delivery of the signal, from which subscribers receive national and local programming, into South Carolina homes and businesses and onto customers' television sets.

Background

DIRECTV is a California corporation with headquarters and its principal place of business located in Los Angeles. It provides access to direct-to-home digital television entertainment via satellite to residential and commercial customers across the United States in exchange for a subscription fee.

DIRECTV'S customer service call centers are all located outside of South Carolina, and owned and operated by it, as well as third parties. The call centers facilitate the installation of set-top boxes and dishes in subscribers' homes and businesses by a third-party home service provider that DIRECTV hires.

DIRECTV's revenue comes primarily from the fees that its approximately 20 million customers pay for set-top box rentals, and subscriptions to its programming services. The latter includes a number of things, such as:

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- Monthly fees from subscriptions to one or more video programming packages
- Revenue from pay-per-view programming
- Revenue from the sale or lease of DIRECTV's equipment
- Revenue from optional warranties on the leased set-top boxes; and
- Revenue from fees associated with DVR set-top boxes, high-definition set-top boxes, and multi-room viewing charges

Nearly all of DIRECTV's assets, employees, and property involved in providing its services to subscribers were located outside of South Carolina. Exceptions to this are DIRECTV's local collection facilities in South Carolina, its equipment rentals and sales to subscribers in South Carolina, and the one or two employees located in South Carolina during the tax periods at issue.

For income tax purposes, DIRECTV, like other corporations, apportions its net income to South Carolina using a formula in which the numerator is gross receipts from within South Carolina during the taxable year, and the denominator is gross total receipts from everywhere during the taxable year.

In January 2014, when the South Carolina Department of Revenue audited DIRECTV's returns, it assessed DIRECTV for income taxes and license fees for 2009 through 2011 using a formula that calculated the gross receipts ratio by attributing 100 percent of DIRECTV's South Carolina subscription receipts to the numerator of the apportionment ratio.

In so doing, the department determined that the revenue from DIRECTV's subscription receipts should be sourced to South Carolina. DIRECTV contested this decision, and sought a determination of the extent to which DIRECTV's income producing activities occurred in South Carolina, and whether the department properly assessed substantial understatement penalties against DIRECTV for taxes owed for the 2009 through 2011 tax years.

The appellate court's rationale

The main issue before the court was whether the Administrative Law Court was wrong when it held that DIRECTV's income producing activities consisted solely of the delivery of the signal into its customers' homes, and when it found that DIRECTV failed to establish the portion of its income producing activities that were conducted in South Carolina. Ancillary questions were related to DIRECTV's burden of proof, and whether the Department of Revenue's underpayment penalties were proper.

Early in its analysis, the court pointed out that generally, the nature of the taxpayer's business in the state is what determines the method of apportionment that taxpayer must use. DIRECTV asserted that the ALC should not have looked to the location of DIRECTV's customers in determining DIRECTV's income producing activities. However, upon reviewing the record and evidence, the appellate court was satisfied with the ALC's finding that that DIRECTV's income producing activity is the delivery of signal to its customers nationwide. Accordingly, the court found that delivery of signal to South Carolina customers is represented by 100 percent of its South Carolina subscription receipts.

The court relied in part on the Department of Revenue's expert, who concluded that the purchase of DIRECTV's services, and the delivery of television services in the customers' homes or businesses, were the activities that actually generated income for DIRECTV. Said another way, the service that DIRECTV's customers are paying for is the delivery of the signal that allows them to enjoy the digital entertainment for which they pay DIRECTV, by way of subscriptions to its programming packages.

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The court thus rejected DIRECTV's position that "place of activity," i.e., cost of performance, should determine the proportion of gross receipts that should be sourced to South Carolina. Under this theory, the company argued, its four primary value drivers represent its income producing activities, so its payroll and assets should stand for the proportion of gross receipts that should be sourced to South Carolina. But the court instead held that DIRECTV's source of income does not derive from its engineers and other personnel, but rather from subscriptions to its programming packages.

Ultimately, the court reasoned, the four primary value drivers and the payroll and assets method simply do not reasonably represent DIRECTV's business activity in South Carolina.

Burden of proof

With respect to the question of the proper burden of proof, the court acknowledged that because the parties presented conflicting evidence, it was required to defer to the findings of the fact-finder, the ALC in this case. Thus, it affirmed the ALC's findings, because they were not clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record.

Understatement penalties

Finally, DIRECTV claimed that the Department of Revenue improperly imposed understatement penalties. The court cited statutory law calling for a penalty equal to 25 percent of the amount of the underpayment when the understated amount is the greater of either ten percent of the required tax, or \$5,000, unless there was good faith and reasonable cause for the underpayment.

The court agreed with the department that there was no substantial authority to support DIRECTV's use of the payroll and assets method. The court characterized this method as an unreasonable approximation of DIRECTV's income producing activities in South Carolina, which did not reasonably represent DIRECTV's business activity in the state. Even though the ALC found that DIRECTV acted in good faith, it did not find a reasonable cause for its underpayment.

For all of these reasons, the court of appeals affirmed the Department of Revenue's \$8.5 million assessment.



David M. Kall

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