
South Carolina – Income-producing activity of satellite video provider is delivering signal to customers, no cost-of-performance sourcing

May 15, 2015

In brief

An Administrative Law Court determined that the primary income-producing activity of a satellite video provider includes customer subscriptions and delivery of a signal into customers' homes. The taxpayer failed to meet its burden to prove, by a preponderance of the evidence, that 'incidental' services such as collecting programming content and beaming signals to satellites influenced customer decisions to purchase its services. The court reaffirmed South Carolina's position that it does not adopt a cost-of-performance sourcing methodology. Rather, it applies a 'flexible' income-producing activity standard.

This decision continues a trend involving states with an income-producing activity or cost-of-performance sourcing statute arriving at a market-based conclusion by focusing on the final act provided to a customer and minimizing the impact of other substantial activities necessary to deliver the service. South Carolina taxpayers sourcing receipts from services or intangibles should be aware of the state's income-producing activity interpretation. Additionally, similar taxpayers should monitor developments contributing to this trend of reaching market-based conclusions in cost-of-performance states.

[[*DIRECTV, Inc. & Subsidiaries v. South Carolina Department of Revenue*](#), S.C. Admin. Law Court, No. 14-ALJ-17-0158-CC (May 12, 2015)]

In detail

Facts and procedural history

For tax years 2006 through 2011, DIRECTV, Inc. & Subsidiaries, provided direct broadcast satellite video services to customers across the United States, including South Carolina. DIRECTV accomplishes this through four major types of activities, which DIRECTV referred to as 'value

drivers.' DIRECTV's value drivers included: (1) marketing and sales; (2) content development, including original and acquired programming; (3) broadcast operations; and (4) customer service.

To access DIRECTV's offerings, its customers paid a monthly subscription fee for basic channels and were able to pay additional fees for premium channels and pay-per-view

programs. To receive DIRECTV programming, its customers were required to use DIRECTV provided satellite dish, remote control and set-top box. Signals for programming content were collected at broadcast and uplink centers, transmitted to satellites, and beamed directly to DIRECTV satellite dishes at customer locations.

On audit of DIRECTV's amended and original returns

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for tax years 2006 through 2011, the South Carolina Department of Revenue rejected the cost of performance apportionment approach used by DIRECTV to source receipts from its satellite video services. DIRECTV appealed the Department's decision to the South Carolina Administrative Law Court.

Taxpayer's burden of proof

Because DIRECTV challenged a determination by the Department that it must source its South Carolina subscription receipts from South Carolina customers to the numerator of its receipts ratio, it had the burden of proof. This burden required DIRECTV to prove that the Department's determination was errant by a preponderance of the evidence.

South Carolina is not a strict cost of performance state

The court determined that South Carolina has never imposed a cost-of-performance approach to sourcing receipts of services to South Carolina. The court noted South Carolina's apportionment statute provides that:

"[South Carolina] 'gross receipts' . . . include . . . 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."

Finding that South Carolina's apportionment statute does not provide a specific method for determining the amount and location of income-producing activities, the court concluded that South Carolina's statute provides 'flexibility' in determining the relative amount of income-producing activities in the state.

Taxpayer's position – cost of performance

DIRECTV initially referred to its position as applying a cost of performance apportionment method. It subsequently clarified its position to be consistent with South Carolina's apportionment method based on the proportion of income-producing activity conducted in the state.

DIRECTV argued that its income-producing activities were its four 'value drivers' – content and programming, acquisition and distribution of the content to customers, marketing and sale of its service, and customer service. DIRECTV asserted that because such activities took place outside of South Carolina, it was not required to source its related subscription revenue to South Carolina.

Department's position – income-producing activity is only signal delivery

The Department argued that DIRECTV's income-producing activity was the delivery of the signal into the home and onto the television screens of its customers and that 100 percent of DIRECTV's subscription receipts from its South Carolina customers should be sourced to South Carolina.

Income-producing activity includes taxpayer's primary activity that directly produces income and excludes incidental activity

Finding that only a company's primary activities are relevant for purposes of determining the company's income-producing activities, the court agreed with the Department that DIRECTV's primary income-producing activity was the delivery of the signal into the home and onto the television set of DIRECTV's customers. Specifically, the court noted DISHTV's primary

activity was "[t]he beaming of the satellite signal 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."

The court found that because all of DIRECTV's income-producing activity related to South Carolina customers occurred entirely within South Carolina, 100 percent of DIRECTV's subscription receipts from South Carolina customers should be sourced to South Carolina.

With respect to the other value drivers identified by DIRECTV, the court determined those activities were merely incidental to DIRECTV's primary income generating activities. The court noted that these activities all took place before transmission of the signal and the activities would exist regardless of whether there were any subscribers in South Carolina. The court did acknowledge these activities were necessary to DIRECTV's ability provide video satellite to its customers, but found these activities were not services that directly produced income for DIRECTV.

Other potential income-producing activities that might influence a customer's decision to make the purchase

Although the court ultimately determined that DIRECTV's other value drivers were not primary income-producing activities, it also addressed the weight of the evidence that had been provided by the taxpayer to support its position. The court first determined that DIRECTV's evidence was insufficient, stating "DIRECTV's evidence is just too nebulous to properly identify whether [its] value drivers are income-producing to the extent to which such production occurs."

The court recognized that income-producing activities of direct broadcast services are not limited to signal delivery. Consideration may reach to other outside activities, such as advertising, that influence the customer's decision to make the purchase. The court acknowledged that DIRECTV's marketing and advertising activities 'probably' produced income, but concluded that DIRECTV's evidence also did not support a finding as to what portion of those costs were attributable to South Carolina customers or what portion of those costs may have influenced DIRECTV's South Carolina customers to subscribe. Without such evidence, the court found it was left to speculate the extent to which DIRECTV's value drivers influenced a customer's decision to subscribe to DIRECTV.

Substantial understatement penalty

According to the court, the Department was correct to apply a substantial understatement penalty for underpayment of taxes and the court concluded DIRECTV must be assessed the substantial understatement penalty.

The takeaway

This case continues a trend involving states with a cost-of-performance sourcing statute arriving at a market-based conclusion by focusing on the final act provided to a customer and minimizing the impact of other substantial activities necessary to

deliver the service. Decisions in Oregon and Massachusetts rendered in 2012 involving the same fact pattern with the same telecommunications provider arrived at different conclusions. ([click here](#) for our summary). Since then, we have seen similar decisions in Florida, Texas, Indiana, and other states.

DIRECTV comes just months after the *Dish DBS* ALJ decision was released, which held that South Carolina is not a strict cost of performance state but rather sourcing of services is measured by a taxpayer's income-producing activities. *Dish DBS* did not identify the taxpayer's income-producing activities, but rather remanded the decision and directed the lower court to determine the taxpayer's income-producing activities ([click here](#) for our summary of *Dish DBS*).

The *DIRECTV* court stopped short at providing a clear test for what constitutes an income-producing activity. The court, however, seemed to have seriously considered the identified activities of the taxpayer and asked whether such activity 'produced income' or influenced the customer's activity to make the purchase. In this case, one of DIRECTV's activities was delivering video to customers. The court essentially found that such activity resulted in direct income from customers and, therefore, constituted income-producing activity. Conversely, DIRECTV could not prove

that the act of developing content, marketing, or providing customer service resulted in direct income from customers. In other words, those activities exist independent of subscription income from customers.

As noted above, the court determined that the 'value drivers' were not substantiated as income-producing activities in this case. However, the opinion suggests that had DIRECTV provided support that such activities directly produced income or influenced a customer's purchase, the activities may have qualified as income-producing. Accordingly, the opinion may be instructive to South Carolina taxpayers seeking to identify income-producing activities in their business.

The court appeared to view a DIRECTV customer transaction as a singular event – focusing on what impacted 'the purchase' of its services. However, a DIRECTV customer purchases an ongoing subscription, paying a fee for receiving services on a continuous basis. Although DIRECTV's acquisition and broadcast of content may not impact a customer's initial purchase of DIRECTV services, it remains open whether the court considered whether such activities have an effect on a customer's continuing purchase of DIRECTV services. This question may be addressed should DIRECTV appeal.

Let's talk

If you have any questions regarding the *DIRECTV* decision, please contact:

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