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Comments Due by: **April 8, 2025**

SC REVENUE RULING **#25-x** [PUBLIC DRAFT 3/10/2025]

SUBJECT: Sourcing Gross Receipts from Services
(Income Tax)

EFFECTIVE DATE: Applies to all periods open under the statute.

SUPERSEDES: All previous advisory opinions and any oral directives in conflict herewith.

REFERENCES: S.C. Code Ann. § 12-6-2210(B) (2014)
S.C. Code Ann. § 12-6-2290 (2014)
S.C. Code Ann. § 12-6-2295(A)(5) (2014)

AUTHORITY: S.C. Code Ann. § 12-4-320 (2014)
S.C. Code Ann. § 1-23-10(4) (2014)
SC Revenue Procedure #09-3

SCOPE: The purpose of a Revenue Ruling is to provide guidance to the public. It is an advisory opinion issued to apply principles of tax law to a set of facts or general category of taxpayers. It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Department advisory opinion.

To apportion gross receipts¹ from services, South Carolina looks at whether and to what extent a taxpayer's "income-producing activity" occurs in this State.² Examining income-producing activity as a method of sourcing service income is unique; most states use either market sourcing or costs of performance sourcing.

The purpose of this Revenue Ruling is to provide general guidance about the Department's current position on the income-producing activity method of sourcing gross receipts from services to South Carolina—that is, including those receipts in the numerator of the gross receipts factor. As discussed below, the Department is presently a party to litigation surrounding this issue, and the Department's position may be re-evaluated as the litigation is resolved by the judicial system.

¹ For simplicity, this Revenue Ruling's use of the term "gross receipts" may refer to both sales and gross receipts. They are defined identically in section 12-6-2295 of the South Carolina Code.

² See S.C. Code Ann. § 12-6-2295(A)(5).

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This Revenue Ruling is divided into five sections. It discusses apportionment, generally; South Carolina's apportionment statutes; gross receipts; the determination and sourcing of gross receipts from services, including income-producing activity, under South Carolina law; and considerations for characterizing certain transactions as services or the use of an intangible.

I. Allocation and Apportionment of a Multistate Taxpayer's Income

The United States Constitution prevents a state from imposing an income tax on value earned outside the state's borders.³ When taxpayers conduct business in more than one state, states are limited to taxing the portion of income reasonably attributable to the taxpayer's property and activities within the state.⁴

States use allocation and apportionment to determine the proper share of a taxpayer's income that may be taxed, which is income allocated to the state plus income apportioned to the state. First, allocation assigns certain types of income (less related expenses) to specific locations based upon either the geographical source of the income or the taxpayer's principal place of business or domicile.⁵ Income that is not allocated is then apportioned, or divided, among the states where a taxpayer's business is conducted. Apportionment is accomplished using a formula.

Apportionment formulas vary by state and are comprised of one or more factors meant to reasonably reflect how a business generates income.⁶ The formula is not required to be precise; it needs only to roughly approximate the income attributable to a business's activities within the taxing state.⁷

II. South Carolina Apportionment Statutes – Single Factor Formula

South Carolina taxable income is computed according to the Internal Revenue Code (IRC) with some modifications⁸ and is subject to the allocation and apportionment provisions in Article 17 of Chapter 6 of the Income Tax Act.⁹

³ See *Container Corp of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

⁴ See *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

⁵ See S.C. Code Ann. § 12-6-2220. South Carolina defines a corporation's principal place of business in section 12-6-30(9).

⁶ See *Container Corp*, supra note 1, at 169.

⁷ See *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

⁸ See S.C. Code Ann. §§ 12-6-40 & 50, and modifications provided in Article 9 of Chapter 6.

⁹ The allocation and apportionment provisions apply to corporations (section 12-6-580); resident individuals (section 12-6-560); "S" corporations (section 12-6-590); partnerships (section 12-6-600); resident estates and trusts (section 12-6-610); and non-resident individuals, trusts, estates, and beneficiaries performing services partly within South Carolina (section 12-6-1720(b)).

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Under section 12-6-2210(B) of the South Carolina Code, a taxpayer conducting business partly within and partly without South Carolina is subject to income tax upon a base that reasonably represents the proportion of business carried on within this State. This is determined through allocation and apportionment.¹⁰

South Carolina allocates non-business income and limited business income in accordance with sections 12-6-2220 and 2230. For most businesses,¹¹ section 12-6-2240 apportions all other income among South Carolina and other states where the taxpayer's business is conducted using a single factor apportionment formula. The factor is either *sales* or *gross receipts*, depending on the nature of the taxpayer's business.

The Sales Factor

Taxpayers whose principal business in South Carolina is manufacturing or otherwise dealing primarily in tangible personal property¹² apportion income using a single sales factor formula.¹³ The sales factor is a fraction whose numerator is the *total sales of the taxpayer in South Carolina* during the taxable year, and whose denominator is the *total sales of the taxpayer everywhere* during the taxable year.¹⁴ This fraction is multiplied by the taxpayer's total income subject to apportionment to determine the amount of income apportioned to South Carolina.

South Carolina sources sales of tangible property under a place of delivery or destination rule. "Sales in this State" generally includes sales of property received in South Carolina by a purchaser after all transportation is completed.¹⁵ Other items included in "sales" are provided in section 12-6-2295.¹⁶

¹⁰ This is the purpose of South Carolina's allocation and apportionment statutes. *See Hertz Corp. v. S.C. Tax Comm'n.*, 246 S.C. 92, 142 S.E.2d 445 (1965). South Carolina's statutory apportionment method is presumed correct. However, section 12-6-2320(A) provides for use of alternative apportionment methods in certain circumstances. The party seeking relief under this provision has the burden to prove by a preponderance of the evidence that the statutory apportionment method does not fairly represent the extent of the taxpayer's in-state business activities, and that the alternative method is reasonable. *See CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, 411 S.C. 79, 767 S.E.2d 195 (2014).

¹¹ Some businesses are required to use special industry apportionment formulas found in section 12-6-2310 instead of the standard single factor apportionment formula. This includes railroad companies (section 12-6-2310(1)(a)); motor carriers (section 12-6-2310(2)); telephone companies (section 12-6-2310(3)); pipeline companies (section 12-6-2310(4)); airline companies (section 12-6-2310(5)); and shipping lines (section 12-6-2310(6)).

¹² "'Tangible property' includes real property and corporeal personal property but does not include money, bank deposits, shares of stock, bonds, credits, evidences of debt, choses in action, or evidences of an interest in property." S.C. Code Ann. § 12-6-30(11).

¹³ *See* S.C. Code Ann. § 12-6-2252.

¹⁴ S.C. Code Ann. § 12-6-2280(A).

¹⁵ *See* S.C. Code Ann. § 12-6-2280(B). A South Carolina sale also includes property delivered to a purchaser's designated recipient located in South Carolina, even if the property is subsequently transferred to another state. However, sales of tangible property to the United States government are not included in the numerator or denominator of the South Carolina sales factor. *See* S.C. Code Ann. § 12-6-2280(C).

¹⁶ S.C. Code Ann. § 12-6-2280(D).

The Gross Receipts Factor

Section 12-6-2290 prescribes a single factor formula based on gross receipts to apportion income of taxpayers whose principal profits are derived from sources *other than* those described in section 12-6-2252 (manufacturing or dealing in tangible personal property) or section 12-6-2310 (special industry formulas). The gross receipts factor is a fraction whose numerator is *gross receipts from within South Carolina*¹⁷ during the taxable year, and whose denominator is total *gross receipts from everywhere* during the taxable year. This fraction is multiplied by the taxpayer's total income subject to apportionment to determine the amount of income apportioned to South Carolina.

Items included in “gross receipts” are provided in section 12-6-2295.

III. Gross Receipts¹⁸

Taxpayers that use the gross receipts factor include those whose principal business is using intangibles or providing services. Despite a longstanding statutory requirement for these taxpayers to determine “gross receipts from within this State,” the phrase was not defined in South Carolina statutes prior to 2007.¹⁹

Prior to 2007, South Carolina courts reviewed questions surrounding how gross receipts should be determined and sourced. These decisions are discussed below.

*Lockwood Greene Engineers, Inc. v. South Carolina Tax Commission*²⁰

Lockwood Greene (Lockwood) was a multi-state engineering services firm with clients in South Carolina and other states. The South Carolina Court of Appeals considered the issue of apportioning Lockwood's “gross receipts from within this State” under section 12-7-1190.²¹ Concerning how Lockwood did business and earned income, the court found:

Lockwood provides services to its clients through highly trained engineers and personnel in its various offices. A client pays an engineering firm for the expertise and time of its employees.

¹⁷ South Carolina's gross receipts factor has not substantively changed over time. The South Carolina Court of Appeals rejected a taxpayer argument that a 1972 amendment to section 12-7-1190 (formerly section 65-279.10, 1962)—in which the phrase “gross receipts *in* this State” was changed to “gross receipts *from within* this State”—was significant. *See Lockwood Greene Engr's, Inc. v. S.C. Tax Comm'n*, 293, S.C. 447, 361 S.E.2d 346 (Ct. App. 1987). The court held the phrasing was substantively identical and was presumably changed for clarification purposes. *Id.*

¹⁸ See footnote 1 above.

¹⁹ In 2007, the legislature amended section 12-6-2290 to add a sentence stating, “[f]or purposes of this section, items included in gross receipts are as provided in Section 12-6-2295.”

²⁰ 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

²¹ Section 12-7-1190 became section 12-6-2290 upon recodification in 1995.

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Therefore, an engineering firm's business carried on in a state is reasonably measured by the services rendered by its personnel in this state.

The court concluded receipts from an engineer's expertise, skill, and time should be sourced to the state where the engineer did the work.

Geoffrey, Inc. v. South Carolina Tax Commission²²

Geoffrey was a Delaware holding company with no tangible property or payroll in South Carolina. Geoffrey licensed its intangible trademarks and symbols to affiliated Toys-R-Us retail stores, some of which were in South Carolina, for a royalty calculated as a percentage of Toys-R-Us retail sales. The retail stores displayed Geoffrey's symbols on their buildings and used them on the tags of merchandise sold in the state, as well as on advertising material distributed in the state. The relevant issue before the South Carolina Supreme Court was whether royalties paid by the Toys-R-Us stores in South Carolina to Geoffrey were "gross receipts from within this State."

The court reasoned that Geoffrey's royalty receipts were not produced by the licensing agreement, but by merchandise sales to consumers in the stores where the trademarks were used, and the receivables created. In other words, the licensees paid royalties to use the Geoffrey trademark for the purpose of making retail sales to consumers. The court held Geoffrey's royalties received from South Carolina licensees constituted gross receipts from within this State.

Gross Receipts Defined

The South Carolina Legislature enacted section 12-6-2295(A) in 2007 to define "gross receipts."²³ Regarding services, the statute provides:

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.

²² 313 S.C. 15, 437 S.E.2d 13 (1993), *cert. denied* 114 S. Ct. 550 (1993).

²³ The legislature also amended section 12-6-2290 to add a sentence stating, "[f]or purposes of this section, items included in gross receipts are as provided in section 12-6-2295."

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Section 12-6-2295(A)(5) defines gross receipts to include receipts from services to the extent the *income-producing activity* occurs within South Carolina. The statute encompasses a wide variety of taxpayers and fact patterns, but does not explicitly define income-producing activity.²⁴ As a result, South Carolina courts have continued to review these issues. The decisions discussed below show the courts' consistent approach to examining "gross receipts" and demonstrate that the enactment of section 12-6-2295 did not change how South Carolina sources gross receipts from services. In each of these cases, although the outcome is unique to the taxpayer, the analysis centers on a detailed examination of the taxpayer's business and what generates its income.

*DirecTV, Inc. v. South Carolina Department of Revenue*²⁵

DirecTV, a corporation headquartered in California, provided satellite television programming services to customers in South Carolina (and throughout the United States) for a subscription fee. DirecTV delivered the programming via satellite signals transmitted to a box at the subscribers' location.

The issue before the South Carolina Court of Appeals was whether DirecTV's subscription receipts from South Carolina subscribers were generated from income-producing activities occurring within South Carolina under section 12-6-2295(A)(5).²⁶ DirecTV claimed it provided four "value drivers" as part of the monthly subscription fee charged to customers: (1) development and acquisition of programming content; (2) broadcast operations; (3) marketing and sales; and (4) customer care. According to DirecTV's interpretation of section 12-6-2295(A)(5), its income-producing activities were the "value drivers" that were performed outside of South Carolina based on where it incurred costs to perform these activities.

The court disagreed. It examined the way DirecTV earned income and concluded that DirecTV's customers were paying for the delivery of the entertainment programming signal to their televisions—not for any other activity DirecTV performed prior to delivering the signal. Therefore, DirecTV's income-producing activity was delivering the signal, while its "value driver" activities were only preparatory activities performed in anticipation of customers signing up for services. Receipts from South Carolina subscribers were deemed gross receipts from within this state because the income-producing activity occurred where DirecTV delivered the signal to subscribers.²⁷

²⁴ Neither is the phrase defined in South Carolina regulations.

²⁵ 421 S.C. 59, 804 S.E.2d 633 (Ct. App. 2017), *aff'g*. Docket No. 14-ALJ-17-0158-CC (S.C. Admin. L. Ct. May 2015).

²⁶ As discussed below, for purposes of sourcing receipts from services, section 12-6-2295(A)(5) provides gross receipts are from within South Carolina to the extent the "income-producing activity" is within South Carolina.

²⁷ The legislature enacted section 12-6-2295(A)(7) in 2018 (and amended in 2019). That section requires satellite and cable TV businesses to source receipts to South Carolina in pro rata proportion to the costs incurred in this state for performing the service.

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Mastercard International Inc. v. South Carolina Department of Revenue²⁸

Mastercard was an out-of-state corporation providing payment processing services through a worldwide payments systems network (Network). Mastercard's Network allowed merchants and consumer cardholders of Mastercard-branded cards to complete cashless transactions for goods and services. Mastercard set and administered rules governing the Network and its parties.

Mastercard earned revenue from processing its Network transactions for a fee. The fee was calculated based upon the number and dollar amount of card transactions between merchants and cardholders. The issue before the South Carolina Administrative Law Court was whether Mastercard earned receipts from income-producing activities in South Carolina.

Mastercard claimed its income-producing activity was delivering messages to its customer banks, and that delivery occurred at points outside of South Carolina. Upon examining Mastercard's business and how it earned income, the court rejected this argument. It determined that relaying messages was necessary to the transaction, but was only one part of a larger, cohesive process—the Network. Mastercard's Network generated income by enabling cashless payment transactions between merchants and cardholders. Specifically, Mastercard established a system where it earned fees when a cardholder used, and a merchant accepted, a card bearing the Mastercard mark. The court recognized the direct relationship between the amount of revenue Mastercard earned and the volume and dollar amount of merchant-cardholder transactions consummated via Mastercard's Network. Accordingly, it held Mastercard's income-producing activity was creating and providing access to its Network. Access occurred in South Carolina to the extent the Network transactions between merchants and cardholders occurred in South Carolina.

Note: As of the date of this Ruling, *Mastercard* is pending before the South Carolina Court of Appeals.²⁹ The Department will follow the guidance set forth in the Administrative Law Court's decision and reflected in this Revenue Ruling unless there is a final appellate decision to the contrary.

U.S. Bank National Association v. South Carolina Department of Revenue³⁰

U.S. Bank, headquartered in Minnesota, was engaged in a range of banking and trust services in South Carolina and other states. It received interest and fee income from its South Carolina activities, which included originating, selling, and servicing residential mortgage loans to South Carolina borrowers; providing commercial and consumer loans for South Carolina borrowers; and certain credit card-related activities. The issue before the South Carolina Administrative Law

²⁸ Docket No. 20-ALJ-17-0008-CC (S.C. Admin. L. Ct. June 2024).

²⁹ See *Mastercard International Inc. v. S.C. Dep't of Revenue*, Appellate Case No. 2024-001252.

³⁰ Docket No. 20-ALJ-17-0168-CC (S.C. Admin. L. Ct. June 2024). See also Docket No. 20-ALJ-17-0168-CC (S.C. Admin L. Ct. Aug. 2024), reconsideration order 8/19/24.

Court was whether U.S. Bank's interest and fee income from South Carolina borrowers was "gross receipts from within this state."

U.S. Bank classified its activities as services under section 12-6-2295(A)(5) and claimed the income-producing activities occurred outside of South Carolina. The court disagreed. It found that mortgages and loans are "evidences of debt,"³¹ which are explicitly excluded from tangible property and are therefore intangible property;³² and related receipts should be sourced to the place of use under section 12-6-2295(A)(3). The court further determined that because money loaned to a borrower (debt) is used at the location of the borrower, interest and fees paid on loans/extensions of credit were receipts from within South Carolina when paid by a borrower located in this state. In addition, the court held that a mortgage is used over the life of the loan at the location of the property it secures, and the Department's use of the borrower's location was a reasonable proxy for the location of the property.³³

Importantly, the court noted that the sourcing result would be the same even if mortgages and other loans were characterized as services rather than intangibles.³⁴ Considering how U.S. Bank did business and earned income, the court stated:

Even if the loans were a service, the borrower paying to use or hold money is analogous to the DirecTV subscriber paying to receive digital television signal. Instead of subscription fees, the borrowers here pay interest. The income-producing activity is loaning money to the borrower and that occurs where that borrower who receives the loan is located. The borrower pays U.S. Bank to use or hold money. The debtor using the borrowed money creates U.S. Bank's income from mortgage lending. For loans to South Carolina borrowers, that income-producing activity occurs in South Carolina.³⁵

³¹ Section 12-6-30(11) of the South Carolina Code provides "'Tangible property' includes real property and corporeal personal property but does not include money, bank deposits, shares of stock, bonds, credits, evidences of debt, choses in action, or evidences of an interest in property."

³² "Intangible property means all property other than tangible property." S.C. Code Ann. § 12-6-30(12). Moreover, the South Carolina Supreme Court recognized "debt" as an intangible. *See M. Lowenstein Corp. v. South Carolina Tax Com'n*, 298 S.C. 93, 378 S.E.2d 272 (1989) ("The question is whether the intangible property [notes receivables] that produced the income is or is not connected with the business.").

³³ Regarding the use of mortgages under section 12-6-2295(A)(3), the court reasoned that the purpose of a mortgage is to "buy or improve a property over the life of the loan" and an "inextricable link exists among a mortgage, real property, and the location of the real property because a mortgage's value comes from the real property it secures—which is situated in a specific location/state." *See U.S. Bank N.A. v. S.C. Dep't of Revenue*, Docket No. 20-ALJ-17-0168-CC. Moreover, "[u]se of the mortgage continues over the life of the mortgage loan as the borrower repays his debt, to include principal, interest, servicing fees and all other fees associated with the life of the mortgage." Other debt (such as loans and extensions of credit) is used at the location of the borrower, because the borrower pays for the use or forbearance of money and such use generates income for U.S. Bank. *Id.*

³⁴ *See* Section V of this Ruling for a discussion on characterizing transactions.

³⁵ *U.S. Bank National Association v. S.C. Dep't of Revenue*, Docket No. 20-ALJ-17-0168-CC, Amended Final Order at 21.

Note: As of the date of this Ruling, *U.S. Bank* appealed to the South Carolina Court of Appeals.³⁶ The Department will follow the guidance set forth in the Administrative Law Court’s decision and reflected in this Revenue Ruling unless there is a final appellate decision to the contrary.

IV. South Carolina’s Income-producing Activity Standard

Section 12-6-2295(A)(5) apportions service receipts based on the proportion of *income-producing activity* within and without South Carolina.

The statute requires a two-part analysis that must be done in the context of particular facts and circumstances. First, identify income-producing activity. Second, determine where income-producing activity occurs and, specifically, the extent to which the income-producing activity occurs within South Carolina.

Income-producing Activity is Not the Same as Costs of Performance or Market Sourcing

Income-producing activity, *costs of performance*, and *market sourcing* are distinct concepts.

Costs of performance apportions service receipts based on where a taxpayer incurs costs to perform those services. Section 12-6-2295(A)(5) does not reference costs of performance, nor did previous South Carolina apportionment statutes use costs of performance as a basis to source income from services.³⁷ In fact, South Carolina apportionment statutes never used the phrase “costs of performance” in reference to taxpayers whose businesses were primarily services until section 12-6-2295(A)(7) was enacted in 2018 specifically addressing sourcing for satellite and cable tv businesses.

Market sourcing assigns service receipts to the location of the taxpayer’s *market* for the service, which is typically identified as some variation of the customer’s location or where the benefit of the service is received. South Carolina has never applied a market sourcing standard for service income; *Lockwood Greene* rejected the argument that *receipts* always refers to where a taxpayer’s customers are located or where the payments originated (a market sourcing approach).

South Carolina’s *income-producing activity* standard uniquely assigns service receipts in proportion to the place of the income-producing activity. However, this approach may yield a result that resembles either of the other methods, *depending on the particular facts*. For example, in *Lockwood Greene*, the income-producing activity was providing engineering services, because “[a] client pays an engineering firm for the expertise and time of its employees. Therefore, an engineering firm’s business carried on in a state is reasonably measured by the services rendered by its personnel in the state.”³⁸ The income was sourced to the location of the engineer providing the expertise, skill, and time. Because payroll was the engineering firm’s largest cost,

³⁶ See *U.S. Bank National Association v. S.C. Dep’t of Revenue*, Appellate Case No. 2024-001577.

³⁷ See *Dish DBS Corp. v. S.C. Dep’t of Revenue*, Appellate Case No. 2016-001642 Unpublished Opinion No. 2018-UP-404 (S.C. Ct. App. Oct. 31, 2018) (holding South Carolina “is not a pro rata cost of performance state”).

³⁸ *Lockwood Greene Engr’g, Inc. v. S.C. Tax Comm’n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

Lockwood's sourcing result resembles, and has been misinterpreted as, a costs of performance approach—even though the court's analysis did not consider *Lockwood's* costs. Instead, the court looked to how income was earned.

Not all sourcing decisions in South Carolina resemble costs of performance. Income-producing activity sourcing in *DirecTV's* facts more closely resembles a market sourcing result. DirecTV's income-producing activity was delivering a programming signal to set top boxes and televisions located in the homes and businesses of its subscriber customers. Thus, delivery occurred at the customers' location—but the customer's location was not determinative, nor was the location of *DirecTV's* costs.

What is Income-producing Activity, How is it Determined, and Where does it Occur?

Income-producing activity is the purpose or reason that participants pay³⁹ to enter a transaction (or combination of transactions) which produces income for the service provider (taxpayer). That is, income-producing activity is what participants in the transaction(s) providing the taxpayer's income want in exchange for payment.

Income-producing activity is determined by the substance rather than the form⁴⁰ of the transaction(s) related to the activity, considering all relevant facts and circumstances. *DirecTV*, *Lockwood Greene*, *Mastercard*, and *U.S. Bank* support these conclusions and are further discussed below.

For purposes of this Ruling, the term *participant* includes both those directly paying the taxpayer for the activity, like a person paying a barber for a haircut, and those whose involvement indirectly produces the taxpayer's income, as illustrated by *Mastercard*. Mastercard's entire Network and the banks, merchants, and consumer cardholders who employed it, made up an integrated system that produced Mastercard's income. Although Mastercard only directly contracted with (and received payment directly from) bank participants, its contracts and rules dictated terms for all the participants and transactions related to its Network—including the Mastercard-branded card transactions between cardholder participants and merchant participants.

³⁹ This Ruling uses the terms “pay” and “payment” to represent anything of value that is transferred and could become income, including cryptocurrency or other property or services.

⁴⁰ The tax consequences of a transaction are determined by its substance and practical effect. See *Beard v. S.C. Tax Com'n*, 230 S.C. 357, 95 S.E.2d 628, 635 (1956) (“[W]e must be governed by its substance, not its form; for the incidence of taxation depends upon the substance of a transaction” (quoting *Comm'er v. Court Holding Co.*, 324 U.S. 331, 65 S. Ct. 707 (1945))). See also *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076 (1977) (emphasizing the importance of looking past “the formal language of the tax statute [to] its practical effect.”); *Scripto Inc. v. Carson*, 80 S.Ct. 619, 622 (1960) (“To permit formal ‘contractual shifts’ to make a constitutional difference would open the gates to a stampede of tax avoidances.”); *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 249 (1940) (“A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.”).

Moreover, the facts revealed “Mastercard’s income is generated by the transaction between the merchant and cardholder when they utilize the Mastercard Network” for the purpose of buying goods and services on credit. In fact, “without merchant and cardholder transactions using Mastercard branded cards, Mastercard would earn no fees” because Mastercard established a system whereby its revenue is dependent on the amount and volume of transactions between merchants and cardholders. The court recognized that the economic reality is transactions between cardholders and merchants are integral to Mastercard earning income from its Network, *even though these participants were not directly contracting with or paying Mastercard*.⁴¹

DirecTV examined the phrase “income-producing activity” in the context of DirecTV’s business and facts and determined that what DirecTV’s subscribers wanted from the transaction—the thing for which they were contracting and paying—was the delivery of television programming. They were not paying for other activities DirecTV conducted prior to delivering the programming signal. Thus, DirecTV’s income-producing activity was delivery of the programming signal to subscribers, and it occurred at the subscribers’ location. The *Lockwood* court concluded that Lockwood’s customers wanted and were paying for the skill, expertise, and design work of its engineers. Therefore, Lockwood’s income-producing activity was the engineering design services performed by Lockwood’s engineers at their respective offices. *Mastercard’s* facts revealed participants used Mastercard’s Network for the purpose of buying goods and services on credit. Thus, Mastercard’s income-producing activity was providing access to a Network that allowed the participants to complete cashless payment transactions. And, *U.S. Bank* found that if mortgages and other loans are characterized as services rather than intangibles, “what is being paid for is the use of the loan funds” to either “purchase and/or improve real property located in South Carolina” (in the case of mortgages) or “for the purpose of obtaining money, property, labor, or services on credit” (in the case of other loans). Accordingly, U.S. Bank’s income-producing activity is loaning money to a borrower.

Ancillary and Incidental Activities are Not Income-producing

Words must be taken in their plain and ordinary sense when the statute’s language is unambiguous and conveys a clear and definite meaning.⁴² Section 12-6-2295(A)(5)’s language plainly means *income-producing activities produce income*. As such, income-producing activities are distinguishable from ancillary and incidental activities, which serve no independent

⁴¹ The court stated, “While the Issuer and Acquirer banks nominally pay these fees to Mastercard, the actual payors are the merchants and cardholders.” The evidence showed “Merchants and Cardholders are also Mastercard’s customers as they are the true fee generators from Mastercard’s income-producing activity—the Mastercard Network.” This was supported by facts surrounding the money and effort Mastercard spent advertising and incentivizing cardholders and merchants to use the Mastercard brand. The court found “Mastercard targets cardholders and merchants to increase use of Mastercard’s credit and debit cards” because the more they used Mastercard-branded cards, the more fees Mastercard earned. *See Mastercard International Inc. v. S.C. Dep’t of Revenue*, Docket No. 20-ALJ-17-0008-CC (S.C. Admin. L. Ct. June 2024).

⁴² *See Media General Communications v. South Carolina Dep’t of Revenue*, 388 S.C. 138, 694 S.E.2d 525 (2010); *see also Hodges v. Rainey*, 341 S.C. 79, 85, 533 S.E.2d 578, 581 (2000)).

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business function for the service provider⁴³ and do not produce income. *DirecTV* further explains:

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). ... Accordingly, *these activities cannot be IPAs because they do not produce income*, but rather, are “income-anticipatory” activities. DirecTV’s primary income-producing activity is the delivery of the signal to the customer because this activity actually generates income for DirecTV. While “other activities occurring prior to the delivery of the signal are important for DirecTV in that [they] can help lead to income, *section 12-6-2295(A)(5) requires activities that actually produce income.*”⁴⁴

Not every activity which has revenue assigned to it is income-producing. The substance of a transaction will determine whether an activity is income-producing or ancillary/incidental. In *Beard v. South Carolina Tax Commission*,⁴⁵ the South Carolina Supreme Court stated, “Our search is for substance, not form—for the realities of the transaction, not book entries.”

Where Does Income-producing Activity Occur?

Where income-producing activity occurs may be straight-forward once income-producing activity is determined. This was true for DirecTV. The income-producing activity—delivering a programming signal to subscribers—occurred where the signal was delivered, which was at the subscribers’ location.

Where income-producing activity occurs is also straight-forward for certain services where the income-producing activity is the specialized knowledge, skill, and/or time of the person performing the work. In this case, income-producing activity occurs where the worker is located and uses that knowledge or skill while doing the work.⁴⁶ Such services may be of an intellectual nature, such as engineering, accounting, legal, or architectural services. Or, they may be of an “in-person” nature, such as landscaping services; salon and spa services; live performances or events; or on-site medical services.

Example—A Georgia-based taxpayer provides landscaping services in Georgia and South Carolina. Taxpayer travels to South Carolina to perform in-person landscaping services

⁴³ See *Wisconsin Dep’t of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 112 S. Ct. 2447 (1992).

⁴⁴ *DirecTV*, 421 S.C. at 77, 804 S.E.2d 633 (Ct. App. 2017) (emphasis added) (indicating the *DirecTV* court relied on the plain language of the statute).

⁴⁵ 230 S.C. 357, 370, 95 S.E.2d 628 (1956).

⁴⁶ See *Lockwood Greene Engr’s, Inc. v. S.C. Tax Comm’n*, 293 S.C. 447, 361 S.E.2d 346 (Ct. App. 1987).

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totaling \$10,000 at a South Carolina vacation property owned by Customer A, a Georgia resident. Taxpayer also performs in-person landscaping services totaling \$5,000 at a Georgia property owned by Customer B, who is also a Georgia resident. 100% of the taxpayer's \$10,000 of receipts from services physically performed in South Carolina are sourced to South Carolina; and 100% of the taxpayer's \$5,000 in receipts from services physically performed in Georgia are sourced to Georgia.

On the other hand, some service industry taxpayers have complex fact patterns. Because income-producing activity is fact-dependent and is not the same for every taxpayer, determining the extent of a taxpayer's income-producing activity in a state is not always straight-forward. It must be identified from the best available information using the principles set forth above.

If income-producing activity occurs in more than one place, section 12-6-2295(A)(5) takes a proportional approach: receipts are South Carolina receipts *to the extent* the income-producing activity is in this state.

Reasonable Approximation

Gross receipts should be calculated and sourced using exact data whenever possible and practical. However, when exact data is not available or not practical, the Department or the taxpayer may reasonably approximate South Carolina gross receipts.⁴⁷ In addition, the Department and the Taxpayer may agree on a method of approximation.

The proxy methodology should be (1) reasonable for the taxpayer's business; (2) determined and applied in good faith based upon objective criteria from all sources of information available; (3) applied on a consistent basis with respect to transactions from year to year; and (4) fairly representative of the extent of the taxpayer's South Carolina business activities.

A proxy that is reasonable and fair for one taxpayer is not necessarily reasonable and fair for a different taxpayer. The Department may reject any proxy method when a more accurate method is available or when it reasonably believes the method is designed for tax avoidance purposes.

V. Characterizing Transactions

When the substance of an activity resembles both a service and the use of an intangible, receipts should be sourced according to the rules for the characterization that most closely fits the activity's economic nature, based on the facts. Generally, the activity is characterized by determining the purpose or reason that participants pay to enter the transaction which produces

⁴⁷ The taxpayer must retain records supporting the sourcing methodology used to prepare its returns and provide this information to the Department upon request. See S.C. Code Ann. §§ 12-54-100 & 210.

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income for the taxpayer. Are the participants *really* paying for services, or for the use of intangible property?

Where the taxpayer's income is generated by transactions that may be plausibly viewed as either using intangibles or providing services, the income will often be sourced to the same state regardless of the characterization under which the facts are analyzed.⁴⁸

⁴⁸ As an illustration, *DirecTV* was argued under the theory that DirecTV provided satellite television services. The court determined DirecTV earned income from delivering the programming signal and sourced that income to the location of delivery (the subscriber). However, it may be reasonable to characterize DirecTV's business as licensing the use of intangible programming to subscribers. Under that characterization, section 12-6-2295(A)(3) would source receipts to the place the intangible programming is used—which is where it is viewed by the subscriber. The ultimate sourcing result is same.