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Cable One v. Idaho State Tax Commission Appellant's Brief Dckt. 41305

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IN THE SUPREME COURT OF THE STATE OF IDAHO

CABLE ONE, INC., *Plaintiff-Appellant,* v. IDAHO STATE TAX COMMISSION, *Defendant-Respondent.*	SUPREME COURT NO. 41305 Ada County No. CV OC 11-03406

APPELLANT'S OPENING BRIEF

On Appeal from the District Court of the Fourth Judicial District of the State of Idaho, in and for the County of Ada The Honorable James F. Judd, Senior Judge, Presiding

Erick M. Shaner
Phil Skinner
DEPUTY ATTORNEYS GENERAL
STATE OF IDAHO
P.O. Box 36
Boise, Idaho 83722-0410
Telephone: (208) 334-7530
Facsimile: (208) 334-7844

Attorneys for Defendant-Respondent

Kelly A. Cameron, Bar No. 7226
Tonn K. Petersen, Bar No. 8385
PERKINS COIE LLP
1111 West Jefferson Street, Suite 500
Boise, Idaho 83702-5391
Telephone: (208) 343-3434
Facsimile: (208) 343-3232

Chérie R. Kiser, DC Bar No. 415009, *pro hac vice*
Angela F. Collins, DC Bar No. 473891, *pro hac vice*
Krista Friedrich,* NY Bar No. 4620795, *pro hac vice pending*
CAHILL GORDON & REINDEL LLP
1990 K Street, NW, Suite 950
Washington, DC 20006
Telephone: (202) 862-8900
Facsimile: (866) 255-0185

Attorneys for Plaintiff-Appellant

*Resident in New York

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1111 West Jefferson Street, Suite 500
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1990 K Street, NW, Suite 950
Washington, DC 20006
Telephone: (202) 862-8900
Facsimile: (866) 255-0185

Attorneys for Plaintiff-Appellant

*Resident in New York

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A. Nature of the Case

This is a case of first impression concerning the proper calculation of Idaho income tax owed by a multistate corporation. Appellant Cable One, Inc. ("Cable One") is headquartered in Phoenix, Arizona and operates 45 cable systems providing cable television, voice, and high-speed Internet access services in 18 states, including Idaho.[1] This appeal relates solely to the Internet access services that Cable One provides ancillary to its cable television business in Idaho. The District Court below held that income from the sale of these Internet access services should be included when calculating the Idaho income tax owed by Cable One, despite the fact that the overwhelming majority of the costs of providing such services were incurred outside of Idaho – specifically, at Cable One's headquarters in Arizona. This decision was incorrect and must be reversed.

Idaho courts have yet to issue definitive decisions interpreting the "costs of performance" language of Idaho Code § 63-3027(r) and the related administrative rules at issue here. Allowing the District Court's decision to stand would be detrimental not just to Cable One, but to the larger group of multistate businesses that also are Idaho taxpayers and depend upon some clarity and consistency in the law's application when calculating and submitting their yearly income tax payments and making economic decisions about investments in this State. Given the double-weighting of the sales factor in Idaho's statutory formula and the ever-growing numbers of companies employing a multistate or even a multinational infrastructure, the disputed issues here are both significant and likely to recur.

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[1] Cable One's operations previously consisted of 48 cable systems in 19 states.

The Uniform Division of Income for Tax Purposes Act ("UDITPA") is a model statute that has been adopted by numerous states, including Idaho, in order to promote "uniformity or compatibility in significant components of tax systems" across jurisdictions. I.C. § 63-3701. *See Albertson's, Inc. v. State, Dept. of Revenue, State Tax Comm'n*, 106 Idaho 810, 811, 683 P.2d 846, 847 (1984). UDITPA "contains rules for determining the portion of a corporation's total income from a multistate business which is attributable to this state and therefore subject to Idaho's income tax." *Albertson's*, 106 Idaho at 811, 683 P.2d at 847. Idaho's codification of UDITPA's provisions relating to a multistate corporation transacting business both inside and outside of the state is found in Idaho Code § 63-3027.

Idaho Code § 63-3027(b) provides that as a taxpayer "having income from business activity which is taxable both within and without this state," Cable One "shall allocate and apportion such net income" according to a formula set forth in § 63-3027(i), which consists of a payroll factor, a property factor, and a double-weighted sales factor. Like the other two factors, "[t]he sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period." § 63-3027(p). Cable One's Idaho business income tax liability is determined by an average of the property, payroll and sales factors (double-weighting the sales factor). That calculation yields an apportionment percentage; the apportionment percentage is applied to Cable One's total business income everywhere to determine the percentage of it which may be taxed by Idaho.

There is no dispute over Cable One's computation of its 2005 property and payroll factors in Idaho, nor over its income tax liability attributable to its sales of cable television service, sales of advertising, and leasing of cable modems. The income-producing activity at issue in this case is Cable One's provision of Internet access services during taxable year 2005. (Tr. Feb. 25/26, p. 49, lines 20-25) The primary question on appeal is whether Cable One was required to include the sales revenue generated by providing Internet access services to Idaho residents when calculating the Idaho sales factor. The answer to this question is "no."

Idaho Code § 63-3027(r), the key provision at issue in this case, provides that if a greater proportion of the taxpayer's income-producing activity (based on costs of performance, measured by direct costs) occurs outside of Idaho, then the related sales receipts are not to be included in the sales factor numerator. I.C. § 63-3027(r); IDAPA 35.01.01.550.[2] Based on costs of performance, a greater proportion of Cable One's 2005 income-producing activity in providing Internet access services was performed outside Idaho than in Idaho. The District Court erred when it found otherwise.

The District Court seems to have been driven largely by considerations of what might "fairly represent" Cable One's business activity in Idaho in this particular case. (Conc. of Law 19-20, R. 000344) The Tax Commission likewise has promoted its own view as to a fair representation of Cable One's business activity in Idaho. But "[w]hen construing the provisions of the Idaho Income Tax Code, [this Court] must enforce the law as written." *Idaho State Tax Comm'n v. Stang*, 135 Idaho 800, 802, 25 P.3d 113, 115 (2001). The Idaho Legislature chose, through enacting UDITPA, to join other states in promoting uniformity and to base Idaho's taxation of a multistate corporation's income-producing activity performed both inside and outside the state on a costs of performance analysis. This is the law that must be applied. "If the provisions of the tax code are socially or economically unsound, the power to correct it is legislative, not judicial." *Id.* at 803, 25 P.3d at 116. The Tax Commission is not free to re-write

[2] IDAPA references are to the 2005 Idaho Administrative Code, as was used by the District Court below. (R. 000063)

or disregard the law to suit its own policy agenda or perceptions of "fairness."

Also at issue on this appeal are the alternative apportionment provisions of UDITPA found in Idaho Code § 63-3027(s), which apply only where their proponent overcomes the "very strong presumption in favor of the normal three-factor apportionment," *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 576, 83 P.3d 116, 120 (2004). For the reasons set forth below, Cable One submits that this Court should find alternative apportionment pursuant to I.C. § 63-3027(s) inapplicable as a matter of law on these facts.

This Court should reverse the decision of the District Court.

B. Course of Proceedings

For tax year 2005, Cable One's Idaho income taxes were *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****.[3] (Trial Exhibit 2 at line 38) After conducting an audit of Cable One's Idaho income tax return for tax year 2005, on December 16, 2008, the Income Tax Audit Bureau of the Tax Commission issued its initial Notice of Deficiency Determination asserting a tax and interest deficiency for taxable year 2005 of *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. (R. 000016) On December 22, 2009, the Notice of Deficiency Determination against Cable One was modified by lowering the taxes owed, but the overall deficiency increased because of interest to *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. (R. 000016-17)

On February 1, 2010, Cable One filed a Petition for Redetermination with the Tax Commission. (R. 000201) On November 18, 2010, the Tax Commission issued its decision

[3] Due to various Idaho tax credits enacted to encourage business activity beneficial to Idaho consumers, this tax liability was reduced. This subsequent application of any such tax credits, however, is irrelevant to the question of the proper calculation of Cable One's tax liability in the first instance.

affirming the modified Notice of Deficiency Determination. (R. 000202) Cable One appealed the Tax Commission's decision to the District Court pursuant to Idaho Code § 63-3049, contesting (1) the decision's finding that Cable One's Internet access services income for taxable year 2005 should be included in the Idaho sales factor numerator when calculating Idaho income taxes owed by Cable One for taxable year 2005, and (2) the decision's assertion that an alternative apportionment method under Idaho Code § 63-3027(s) may be used to determine Cable One's income tax liability. (R. 000030-31)

The case was assigned to the Honorable James F. Judd. After a *de novo* bench trial, on May 22, 2013, Judge Judd issued his Findings of Fact, Conclusions of Law and Order determining that Cable One's Internet access services revenue should have been included in calculating its Idaho sales factor. (Conc. of Law 19, 20, R. 000344) The District Court therefore did not need to decide, and did not address, whether an alternative apportionment method under Idaho Code § 63-3027(s) may be used to determine Cable One's income tax liability. (Conc. of Law 21, R. 000345) On July 2, 2013, Judge Judd issued a Judgment finding that Cable One owed an additional *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** for taxable year 2005. (R. 000125) Cable One timely filed a Notice of Appeal on August 9, 2013. (R. 000127) On August 12, 2013, Judge Judd issued an Amended Judgment including costs for a total amount of *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. (R. 000136)

C. Statement of Facts

Cable One, a Delaware corporation headquartered in Phoenix, Arizona, operated 48 cable systems in 19 states pursuant to local franchise agreements. (Joint Stip. of Exhibits and Facts, R. 000279) Six of those cable systems are located in Idaho. (Joint Stip. of Exhibits and Facts, R.

000279) Cable One acquired its Idaho cable systems in 2001. (Joint Stip. of Exhibits and Facts, R. 000279; Tr. Feb. 25/26, p. 40, lines 14-16)

Cable One provides its Internet access services through its cable television broadband network, which is used primarily to provide cable television services. (Tr. Feb. 25/26, p. 40, lines 10-13, 22-25) It operates no stand-alone network dedicated specifically to Internet access services. *See* Hannan Dep. Tr. (Trial Exhibit 26) at p. 22, lines 17-20. Cable One received business income from four types of income-producing activities in Idaho in 2005: cable television services, Internet access services, advertising services, and cable modem leasing. (Tr. Feb. 25/26, p. 40, lines 2-9) There is no dispute over Cable One's computation of its 2005 property and payroll factors, nor over computation of the sales factor attributable to its sales of cable television service, sales of advertising, and leasing of cable modems. The only issue in this case is the sales factor as respects Cable One's Internet access services revenues. (Tr. Feb. 25/26, p. 49, lines 20-25)

Cable One's provision of Internet access services in 2005 was performed both in and outside of Idaho. Within Idaho, Cable One maintained local offices and employees in order to provide and maintain its cable system and Internet access services. (Trial Exhibit 21; Aff. of Patrick Dolohanty[4] ¶12, R. 000171; Tr. Feb. 25/26, p. 263, lines 9-12) Outside of Idaho, Cable One maintained a Solution Center and a network operations center ("NOC") in Arizona. These facilities supported the provision of cable television and Internet access services to all of the states in which Cable One operated its cable systems. (Joint Stip. of Exhibits and Facts ¶9, R. 000280) The Solution Center provided technical and customer support for cable television and Internet access services customers and the NOC monitored the overall health of Cable One's 48

[4] The Dolohanty affidavit was also used as Trial Exhibit 12.

cable systems. (Joint Stip. of Exhibits and Facts ¶9, R. 000280; Tr. Feb. 25/26, p. 263, lines 5-25; p. 264, lines 1-2)

Cable One also purchased long distance communications services known as Internet backbone services from third-party vendors, Qwest and AT&T, to support its multistate provision of Internet access services. (Tr. Feb. 25/26, p. 273, lines 24-25; p. 274, lines 1-9; Aff. of Bradley D. Ottley[5] ¶6, R. 000161) These long distance communications services were used to route and deliver Cable One's Internet access services traffic from Cable One's cable systems in various states to Cable One's Arizona headquarters to obtain broadband features and functions needed for the use of Internet access services and to connect with the public Internet (world wide web). (Tr. Feb. 25/26, p. 314, lines 4-15; Aff. of Bradley D. Ottley ¶7, R. 000161) Indeed, Cable One could not offer Internet access services in any state without the connection to its Arizona headquarters, which is facilitated by the backbone services. (Tr. Feb. 25/26, p. 269, lines 13-24)

These backbone services were also a critical component of Cable One's own internal administrative and operational communications between the 48 cable systems and the public Internet and Cable One's Arizona headquarters. (Aff. of Bradley D. Ottley ¶10, R. 000162) They provided Cable One's customers with billing support, customer service support, and network monitoring for cable television services, and have been necessary even if Cable One did not offer Internet access services. (Tr. Feb 25/26, p. 79, lines 7-24; Aff. of Bradley D. Ottley ¶¶10, 14, R. 000162, 64)

These Internet backbone services were provided under contracts negotiated from Cable One's Arizona headquarters, were purchased from Cable One's Arizona headquarters, were

[5] Ottley's affidavit was also used as Trial Exhibit 31.

billed to Cable One's Arizona headquarters, and were paid from Cable One's Arizona headquarters. (Tr. Feb. 25/26, p. 79, lines 3-6; Aff. of Bradley D. Ottley ¶13, R. 000163) These backbone services are not specific to Idaho, but rather the services are purchased for all states in which Cable One operates pursuant to a single contract with each vendor that covers multiple states. (Tr. Feb. 25/26, p. 274, lines 4-9; Qwest Agreement (Trial Exhibit 28); AT&T Agreement (Trial Exhibit 29)) Because the Internet backbone services were an essential component of Cable One's overall operations in its 19-state territory, Cable One's employees located in Arizona centrally managed and oversaw the purchase, implementation, billing and payment relating to the Internet backbone services. (Aff. of Bradley D. Ottley ¶14, R. 000164)

Cable One in 2005 computed its Idaho taxable income in accordance with Idaho Code § 63-3027. (Tr. Feb. 25/26, p. 49, lines 8-19) As noted above, the statute requires an analysis of the costs of performance, because only the direct costs incurred to provide the income producing activity – Internet access services in this case – are included to determine if a greater proportion of the income producing activity was performed in Idaho or outside of Idaho. Idaho Code § 63-3027(r)(2). Cable One analyzed its costs of performance related to its provision of Internet access services using two different methods. (Aff. of Patrick Dolohanty ¶11, R. 000170) Both methods were based on Cable One's regular accounting practices used in the day-to-day operation of its business. *See* IDAPA Rule 35.01.01.550.03 ("Costs of performance are the direct costs determined according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business."). First, Cable One identified its total direct costs associated with the provision of Internet access services as reflected under the "Internet Costs" header on its profit and loss statement for its Idaho cable systems. (Tr. Feb.

25/26, p. 91, lines 11-25; p. 92, lines 1-6; Trial Exhibit 8[6]; Aff. of Patrick Dolohanty ¶12, R. 000170-71) This figure included costs incurred both inside and outside of Idaho. (Tr. Feb. 25/26, p. 77, lines 8-17; Aff. of Patrick Dolohanty ¶12, R. 000171) Slightly more than one third of the total *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** related to the employees supporting the Internet access services in Idaho and the operation of Cable One's offices physically located in Idaho. (Trial Exhibit 8; Aff. of Patrick Dolohanty ¶12, R. 000171) All the other direct costs on the profit and loss statement were incurred in Arizona, including the cost of the Solution Center and NOC *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****, and the Internet backbone services *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. (Trial Exhibit 8; Aff. of Patrick Dolohanty ¶12, R. 000171) Under this analysis, Cable One found that *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of its direct costs were incurred in Idaho, while *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of them were incurred in Arizona. (Aff. of Patrick Dolohanty ¶12, R. 000171) As an alternative method, Cable One looked at its total direct costs related to the provision of Internet access services as reported on its consolidated profit and loss statements for all of its 48 cable systems in 19 states. (Tr. Feb 25/26, p. 92, lines 7-25; p. 93, lines 1-11; Aff. of Patrick Dolohanty ¶14, R. 000172) Those costs totaled *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. Cable One subtracted from that figure *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** in direct local costs incurred in the various cable systems (including the Idaho systems), yielding a sum of *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** in direct costs incurred in

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6 Trial Exhibit 8 is a summary of information contained in Exhibits 6 and 7. (Tr. Feb. 25/26, p. 90, lines 7-23)

Arizona for its provision of multistate Internet access services. (Trial Exhibit 8; Aff. of Patrick Dolohanty ¶14, R. 000172) Cable One then allocated the direct costs incurred in Arizona across the 19 states where it provides such services, based on the percentage of Internet access services revenues Cable One earned in each state as compared to its total revenues from Internet access services across all 19 states. (Aff. of Patrick Dolohanty ¶15, R. 000172) Based on this calculation, ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of Cable One's direct costs for the provision of Internet access services allocable to Idaho were incurred in Arizona, while ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** were incurred in Idaho. (Trial Exhibit 8; Aff. of Patrick Dolohanty ¶15, R. 000172-73) Under this analysis, ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of Cable One's direct costs were incurred in Idaho, while ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** were incurred in Arizona. (Aff. of Patrick Dolohanty ¶15, R. 000173)

Therefore, in determining the sales factor pursuant to Idaho Code § 63-3027(r), Cable One did not include revenues from its sales of Internet access services in the numerator because Cable One's costs of performance analyses demonstrated that Cable One incurred more direct costs, such as the Solution Center, NOC, and Internet backbone services, outside of Idaho (in Arizona) than in Idaho in relation to its provision of Internet access services. Cable One also did not include capital costs or depreciation associated with its cable television broadband network because those are not considered direct costs associated with the provision of Internet access services. (Tr. Feb 25/26, p. 108, lines 21-25; p. 109, lines 1-25)

Under Cable One's calculation excluding the income from sale of Internet access services, ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of its

2005 nationwide business income is taxable in Idaho. The treatment of the sales factor endorsed by the Tax Commission would render *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Cable One's nationwide business income taxable in Idaho. (Findings of Fact 29-30, R. 000340)

II. ISSUES PRESENTED ON APPEAL

1. Did the District Court err in concluding that Cable One's Internet access services income from taxable year 2005 should be included when determining the sales factor used to calculate Cable One's Idaho income tax, even though the costs of performance of that income were incurred primarily outside of Idaho?

2. Did the District Court err by basing its determination of Cable One's income tax liability under Idaho Code § 63-3027(r) on considerations of what would "fairly represent the extent of Cable One's 2005 business activity in Idaho" rather than on the standards set forth in the statute?

3. Did the District Court err in its identification and analysis of the income-producing activity at issue and by basing its legal conclusions on a determination of "the location of Cable One's income producing activity," when the statutory standard is the location of the incurred costs of performance?

4. Did the District Court err by failing to conduct the direct costs analysis required by Idaho Code § 63-3027(r) and IDAPA Rule 35.01.01.550.03?

5. Is alternative allocation and apportionment pursuant to Idaho Code § 63-3027(s) justified in this case, where the asserted distortion of income is minimal and given that the presumption is against such alternative allocation and the Tax Commission failed to meet its burden of demonstrating that this is a unique and non-recurring case justifying alternative allocation?

III. ARGUMENT

A. Standard of Review

Cable One appealed the Tax Commission's decision to the District Court pursuant to Idaho Code § 63-3049, resulting in a *de novo* bench trial. At that trial, Cable One bore the burden of showing that it had properly excluded Internet access services revenues from its Idaho sales factor when calculating its 2005 income tax, while the Tax Commission bore the burden of establishing the appropriateness of an alternative apportionment method. *See Parker v. Idaho State Tax Comm'n*, 148 Idaho 842, 845, 230 P.3d 734, 737 (2010); *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 575, 83 P.3d 116, 119 (2004).

Cable One now appeals the District Court's ruling to this Court pursuant to I.C. § 63-3049(c). On appeal, this Court "exercises free review over the district court's conclusions of law," *Idaho Power Co. v. Idaho State Tax Comm'n*, 141 Idaho 316, 321, 109 P.3d 170, 175 (2005), including "the conclusions of law reached by stating legal rules or principles and applying them to the facts found." *Staggie v. Idaho Falls Consol. Hospitals, Inc.*, 110 Idaho 349, 351, 715 P.2d 1019, 1021 (Ct. App. 1986). This Court may set aside as "clearly erroneous" findings of fact not "supported by substantial and competent evidence." *PacifiCorp v. Idaho State Tax Comm'n*, 153 Idaho 759, 767, 291 P.3d 442, 450 (2012); *see also* Idaho R. Civ. P. 52(a).

B. Under Idaho Law, Cable One's Internet Access Services Income from Taxable Year 2005 Should Not be Included when Calculating Cable One's Idaho Income Tax

1. The District Court Erred by Basing its Application of the Statute on What Would "Fairly Represent the Extent of Cable One's 2005 Business Activity in Idaho"

There is no real dispute between the parties here as to the appropriate legal framework. *See* Tr. Feb. 25/26, p. 21, lines 22-25; p. 22, lines 1-6; Tax Commission's Post-Trial Brief at 4, R. 000075. Under § 63-3027(r), a District Court's mandate on a trial *de novo* is simply to engage in a three-step analysis: 1) identification of the income-producing activity in question; 2) identification of the costs of performance of that income-producing activity using a direct costs analysis; and 3) identification of where geographically those direct costs were incurred by the taxpayer. To determine which sales are attributable to Idaho, the standard of I.C. § 63-3027(r) is as follows:

> Sales, other than sales of tangible property, are in this state, if:
> (1) The income-producing activity is performed in this state; or
> (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

The parties do not dispute that the income-producing activity in question here is performed both in and outside the state of Idaho, and that therefore § 63-3027(r)(2) is implicated. *See* Starkey Expert Report (Trial Exhibit 34) at 4 ("there is no dispute that some portion of the 'income producing activity' relative to Cable One's Internet sales receipts is undertaken 'outside this state'"). Sales by Cable One of Internet access services, thus, are considered to be "in Idaho" only if a greater proportion of the income-producing activity that generated those sales was performed in Idaho than outside of Idaho, based on costs of performance.

The District Court appears to have based its conclusions largely on a standard found nowhere in Idaho law, namely, what might "fairly represent the extent of Cable One's 2005 business activity in Idaho." (Conc. of Law 19-20, R. 000344) Throughout this proceeding, the Tax Commission has advocated positions structured around its own perception of what would be a "fair" tax treatment of Cable One.[7] Indeed, the Tax Commission went so far as to put on an expert witness, James Peters, who had no position as to whether Cable One had interpreted the Idaho tax statute and rules correctly, and testified that "[m]y argument is more with the [UDITPA] statute than it is than [sic] anything else." (Tr. Feb. 27, p. 132, lines 15-25; p. 133, lines 1-5) The Tax Commission's quarrel is with the law itself, not with Cable One's proper application of that law.

Section 63-3027(r) contains the "normal three-factor apportionment" presumed to apply to the vast majority of taxpayers. *Union Pacific*, 139 Idaho at 576, 83 P.3d at 120. It makes no reference to what might "fairly represent" the extent of the taxpayer's business activity in Idaho. The rule of law requires that taxpayers be able to apply the relevant statutes, determine their income tax liability, and reasonably rely upon the standards provided in the law. *See Oracle Corp. v. Dep't of Revenue*, 2010 WL 496945, at *4 (Or. T.C. Feb. 11, 2010) (finding that the question of how income is to be reported "must be governed by" the law of the state where the

[7] The Tax Commission's view apparently has been colored by the fact that Cable One failed to conduct a costs of performance analysis in the years between 2001 (when Cable One began doing business in Idaho) and 2004, thereby overpaying its Idaho income tax. *See* Tr. Feb. 25/26, p. 86, lines 13-25; p. 87, lines 1-4. Similarly, the Tax Commission tries to make something out of the fact that Cable One does not include Idaho Internet access services revenues in calculating its Arizona income tax. *See* Tr. Feb. 27, p. 141, lines 18-25; p. 142, lines 1-3. These facts are wholly irrelevant to the issues before this Court. I.C. § 63-3027(c) ("For purposes of allocation and apportionment of income under this section, a taxpayer is taxable in another state if...[t]hat state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not."); *see also United States v. Parkinson*, 2001 WL 169318, at *8 (D. Idaho Feb. 12, 2001) ("[T]axpayers are permitted to reduce their tax burden by any lawful means available."). The proper tax treatment of Cable One's sales under Idaho law for tax year 2005 depends neither on its historical practices nor on how Cable One's income is taxed in Arizona. *See Oracle Corp. v. Dep't of Revenue*, 2010 WL 496945, at *3-*4 (Or. T.C. Feb. 11, 2010). Further, the fact that Arizona does not presently tax Cable One's Idaho Internet access services revenues does not mean that Arizona in the future will not adopt an income tax approach that imposes tax on these revenues, resulting in double taxation under the Tax Commission's arguments.

return is filed, "not by some judicially declared doctrine that may pervert the law in a given situation."). Applying arbitrary notions of what a particular state believes is "fair," unlinked to any statutory framework, runs counter to these bedrock principles.

2. The District Court Erred in Concluding that Revenues from Internet Access Services Should be Part of Cable One's Idaho Income

a) The District Court Erred in its Determination of the Income-Producing Activity under Idaho Law

The first step to any inquiry under I.C. § 63-3027(r) is the identification of the income-producing activity in question. Costs of performance of an income-producing activity may only be analyzed once that activity is identified. *See AT&T Corp. v. Comm'r of Revenue*, 2011 WL 2243933, at *1 (Mass. App. Tax Bd. June 8, 2011) ("[W]hen a taxpayer is engaged in the sale of services, calculation of its sales factor requires a determination first of the taxpayer's so-called 'income-producing activity.'"). Yet the District Court's decision assumed away this initial issue without engaging in any analysis or explanation of its conclusions as to the income-producing activity. *See* Conc. of Law 10 (R. 000342-43) (referring to "costs of performance analysis on Cable One's provision of Internet access to all Idaho customers in 2005"); Conc. of Law 11 (R. 000343) (describing the income-producing activity as "attracting and servicing Idaho Internet access customers").

Under the governing legal standards, the income-producing activity at issue here is Cable One's provision of Internet access services both inside and outside of Idaho. Specifically, IDAPA Rule 35.01.01.550.02 provides:

> The term income producing activity applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit.

Cable One is a multistate corporation engaged in the business of providing Internet access services in nineteen states, utilizing a central operation based at its Arizona offices. The regular course of its business includes no separate income-producing activity of "attracting and servicing Idaho Internet access customers." (Conc. of Law 11, R. 000343) The income-producing activity is the provision of Internet access services in nineteen states. This identification of the income-producing activity at issue is consistent with decisions interpreting like provisions in other jurisdictions. *See, e.g., Comm'r of Rev. v. AT&T Corp.*, 2012 WL 2865870, at *1 (Mass. App. Ct. July 13, 2012) (upholding decision that "it was the operation of [AT&T's] global network based in New Jersey that qualified as its income-producing activity"); *Boston Professional Hockey Ass'n v. Comm'r of Revenue*, 2003 WL 21499974, at *5 (Mass. App. Tax Bd. June 30, 2003) ("the Board found that with respect to the game revenues it received, [Boston Professional Hockey Association's] income-producing activity was the ownership and operation of an NHL franchise" as opposed to each individual game), *aff'd*, 820 N.E.2d 792 (Mass. 2005); *Michiana Metronet, Inc. v. Dep't of Treasury*, 2012 WL 5854453, at *3 (Mich. Ct. App. Nov. 8, 2012) (finding where the "service is performed through the completion of wireless' calls and the provision of the network to the subscriber" the costs of performance "include the use of the network equipment and the manpower to support the wireless services") (citing *Michiana Metronet, Inc. v. Michigan Dep't of Treasury,* 2011 WL 3890444, at *6 (Mich. Tax. Trib. Aug. 11, 2011)); *Detroit Lions, Inc. v. Dep't of Treasury*, 403 N.W.2d 812, 820 (Mich. Ct. App. 1986) (applying statute using the term "business activity" in place of "income-producing activity" and concluding that the activity was "plaintiff's membership in the NFL and its performance of duties which arise from that membership, such as taking part in football games, both home and away"). Under I.C. § 63-3027(r) and IDAPA Rule 35.01.01.550.02, the income-producing activity is Cable One's multistate provision of Internet access services. Cable One offers to consumers in nineteen states Internet access services all of which rely upon and operate through the Arizona back office in order to provide an integrated service to the consumer. *See* Part III.B.2.c, *infra*. The totality of that service provision is the income-producing activity in question here. *See Crystal Commc'ns, Inc. v. Dep't of Revenue, State, TC 4769*, 2010 WL 2827462, at *16 (Or. T.C. July 19, 2010) (holding that for the income-producing activity inquiry "[t]he focus is obviously broader than the last acts taken to realize gain") *aff'd sub nom. Crystal Commc'ns, Inc. v. Dep't of Revenue*, 353 Or. 300, 297 P.3d 1256 (2013).

The Internet backbone services provided by Qwest and AT&T, entities with which Cable One contracted, did not constitute the income-producing activity itself. *See Ameritech Publ'g, Inc. v. Wis. Dep't of Revenue*, 788 N.W.2d 383, ¶ 36 (Wis. Ct. App. 2010) (holding that use of a third party distributor was an activity necessary to the provision of a service but was "not the income-producing activity itself"); *Interface Grp. v. Comm'r of Revenue,* 918 N.E.2d 97 (Mass. App. Ct. 2009) (noting "the regulations place an emphasis on the 'direct activity by the taxpayer'"). Therefore the fact that certain Qwest and AT&T networks and facilities utilized in contracts with Cable One may have been located in Idaho should not have influenced the District Court's assessment of the income-producing activity. Nor was the nature of any Qwest or AT&T bills (*see* Finding of Fact 26, R. 000339; Trial Exhibits 14, 16) relevant to the determination of the income-producing activity where Cable One is the taxpayer at issue.

The District Court's Conclusion of Law 21 (R. 000345) reflects its error in the application of I.C. § 63-3027(r)(2). It refers to a "determination of the location of Cable One's income producing activity pursuant to I.C. § 63-3027(r)(2)." But I.C. § 63-3027(r)(2) does not call for a determination of "the location of the income-producing activity." I.C. § 63-3027(r)(2) applies only where the income-producing activity at issue is performed both in and outside the state of Idaho (a fact undisputed in this case) and calls for a determination of whether a greater proportion of the income-producing activity is performed in Idaho than in any other state, *based on costs of performance*. "[I]ncome-producing activities and costs of performance are conceptually different in principle. Costs of performance are the geographically identifiable metric for determining the state in which income-producing activities are carried on." 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.18[3][b], at 9-310 (3d ed. 2013). As described in further detail below, the District Court failed to conduct the proper costs of performance analysis.[8]

As described above, the analyses conducted by Cable One for purposes of its 2005 Idaho income tax return were appropriate under the plain language of Idaho Code § 63-3027 and the related administrative rules. This Court "need only determine the application of the words to the facts of the case." *Hopkins Northwest Fund, LLC v. Landscapes Unlimited, LLC*, 151 Idaho 740, 744, 264 P.3d 379, 383 (2011) (quoting *L & W Supply Corp. v. Chartrand Family Trust*, 136 Idaho 738, 743, 40 P.3d 96, 101 (2002)); *see also Hayden Lake Fire Protection Dist. v. Alcorn*, 141 Idaho 307, 312, 109 P.3d 161, 166 (2005) ("Where a statute is unambiguous, statutory construction is unnecessary and courts are free to apply the plain meaning."); *Kimbrough v. Idaho Bd. of Tax Appeals*, 150 Idaho 417, 420, 247 P.3d 644, 647 (2011) ("Administrative rules

[8] The closest the District Court's decision comes to providing analysis on the issue of the income-producing activity is its conclusion that "[a] literal reading of the IDAPA Rule 35.01.01.550.02 definition of 'income producing activity' would require a transactional analysis of the cost of performance for Cable One receiving each Idaho customer's monthly payment for Internet access." (Conc. of Law 10, R. 000342) This legal conclusion too was error. No Idaho authority supports a conclusion that IDAPA Rule 35.01.01.550.02 requires a transactional analysis. Even the Tax Commission and its witnesses abandoned any arguments in favor of a transactional approach by the time the trial was held. *See* Starkey Dep. Tr. (Trial Exhibit 36) at 38:19-39:23 ("I don't think [Cable One is] required to do it on a customer-by-customer or a . . . transaction-by-transaction basis"); *see also* Conc. of Law 10 (R. 000342) ("Tax Commission concedes the burdensomeness of such an analysis.").

are interpreted the same way as statutes."). But to the extent that there is any ambiguity in the relevant statute and rules concerning what constitutes the relevant income-producing activity, it must be resolved in Cable One's favor. This Court has held that "[w]here an ambiguity is found in tax statutes, the statutes are generally 'strictly construed against the taxing authority and in favor of the taxpayer and ambiguities therein are to be resolved in favor of the taxpayer.'" *Canty v. Idaho State Tax Comm'n*, 138 Idaho 178, 182, 59 P.3d 983, 987 (2002) (quoting *Dep't of Employment v. Diamond Intern. Corp.*, 96 Idaho 386, 387, 529 P.2d 782, 783 (1974)). The Tax Commission's own expert called the definition of "income producing activity" under IDAPA Rule 35.01.01.550.02 "ambiguous at best." Peters Expert Report (Trial Exhibit 39) at 5.

This Court should hold that the income-producing activity at issue in this case was Cable One's provision of Internet access services both inside and outside of Idaho.

b) The District Court Erred in its Determination of Costs of Performance under Idaho Law

(1) The District Court Erred by Failing to Conduct the Required Direct Costs Analysis

After identification of the taxpayer's income-producing activity, the next step in the Idaho Code § 63-3027(r) analysis is the identification of the costs of performance of that income-producing activity. "Costs of performance" are defined in IDAPA Rule 35.01.01.550.03 as "the direct costs determined according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business." Thus Idaho, like other jurisdictions, is clear in its direction that taxpayers rely on their own standard accounting methods in determining their direct costs. *See Microsoft Corp. v. Franchise Tax Bd.*, 212 Cal. App. 4th 78, 95 (Ct. App. 2012) (interpreting language nearly identical to Idaho's rule to authorize "the taxpayer to rely on its own accounting methods in determining its items of income").

Neither the statute nor the regulations provide further definition of what are "direct costs." Generally speaking, direct costs are costs that are incurred solely in order to offer a given service: for example, Cable One's programming costs are direct costs of providing its cable television services. *See* Tr. Feb. 25/26, p. 88, lines 8-18. As the Tax Commission's own expert witness agreed, there must be a distinction between direct costs and common (or indirect) costs; costs of equipment and facilities that Cable One would have incurred regardless of its provision of Internet access services do not constitute direct costs of providing Internet access services. *See* Fischer Dep. Tr. (Trial Exhibit 33) at pp. 42-43; *see also AT&T Corp. v. Dep't of Rev.*, 2012 WL 119850, at *5-*6 (Or. T.C. Jan. 12, 2012) (finding that direct costs are limited to "those that are only incurred because the revenue producing transaction or activity in question occurred" and rejecting the argument that "direct costs" are "all costs that must be incurred to engage in the general business activity."). But much like its conclusions with respect to the income-producing activity at issue, the District Court's decision presupposes the answer to one of the areas of greatest dispute in this case. The decision below contains no analysis actually addressing the question of what are the direct costs associated with the income-producing activity here. Instead, the District Court offers an unsupported conclusion, that "direct costs include the costs incurred by Cable One in providing internet services to its Idaho customers." (Conc. of Law 9, R. 000342) The District Court failed to distinguish "direct" costs from common costs.

In preparing its 2005 income tax return, Cable One looked to its own profit and loss statements in conducting its costs of performance analysis. It thus determined its "direct costs... according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business." IDAPA Rule 35.01.01.550.03. As noted, Cable One employed two different methods, in order to analyze its costs of performance. (Aff. of Patrick Dolohanty ¶11, R. 000170) Whether Cable One compared its total direct costs of providing Internet access services incurred outside of Idaho with those incurred in Idaho, or used a methodology allocating direct costs to Idaho based on Internet access services revenue from Idaho, the result was the same in that the bulk of the costs were incurred in Arizona, not Idaho. *See supra* Part I.C (describing in detail Cable One's costs of performance analysis); Trial Exhibit 8. Under Idaho Code § 63-3027(r), the sales at issue here were not attributable to Idaho.

The District Court's decision fails to explain why Cable One's methodology did not comport with the direction in IDAPA Rule 35.01.01.550.03 to determine direct costs "according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business." The plain language of the Idaho rule and decisions from jurisdictions with near-identical tax provisions support the taxpayer's reliance on its own accounting methods in its determination of direct costs. *See Microsoft Corp.* 212 Cal. App. 4th at 95 ("California permits the taxpayer to rely on its own accounting methods in determining its items of income."); *AT&T Corp. v. Dept. of Rev.*, 2012 WL 119850, at *6 (Or. T.C. Jan. 12, 2012) (finding that an "objective standard or set of standards for determining direct costs" as generated as part of "a financial accounting or externally focused process" can be viewed as "a generally accepted accounting principle or industry wide practice").

Again, Cable One maintains that Idaho Code § 63-3027 and the related administrative rules are clear in their authorization of the direct costs analysis that it performed. *See Hopkins Northwest Fund, LLC v. Landscapes Unlimited, LLC*, 151 Idaho 740, 744, 264 P.3d 379, 383 (2011) ("[I]nterpretation should begin with an examination of the literal words of the statute, and this language should be given its plain, obvious, and rational meaning.") (citation and internal quotation marks omitted). But to the extent that there is ambiguity in the Rule's use of the undefined term "direct costs," it must be construed in favor of Cable One here. This Court has held that "[w]here an ambiguity is found in tax statutes, the statutes are generally 'strictly construed against the taxing authority and in favor of the taxpayer and ambiguities therein are to be resolved in favor of the taxpayer.'" *Canty v. Idaho State Tax Comm'n*, 138 Idaho 178, 182, 59 P.3d 983, 987 (2002) (quoting *Dep't of Employment v. Diamond Intern. Corp.*, 96 Idaho 386, 387, 529 P.2d 782, 783 (1974)). The law required the District Court to categorize Cable One's costs of providing Internet access services into direct and indirect costs, taking into consideration the evidence that Cable One presented based on the accepted conditions and practices of its own trade or business. Again, the District Court did not do this. This Court should hold that Cable One conducted its costs of performance analysis appropriately under the statute in calculating its 2005 Idaho income tax sales factor by comparing its direct costs incurred within the State of Idaho to its costs incurred everywhere else.

(2) The District Court Erred by Considering Cable One's Capital Costs, Depreciation Expense, and 2005 Qualified Broadband Tax Credit to be Direct Costs

In 2005, Cable One made certain capital expenditures in order to expand its broadband cable television network in Idaho. It received a 2005 Qualified Broadband tax credit[9] for those expenditures. In conducting its costs of performance analysis pursuant to the instructions provided by Idaho Law, Cable One included neither those capital costs nor depreciation associated with those capital costs as direct costs of its Internet access services. (Tr. Feb. 25/26, p. 108, lines 21-25; p. 109, lines 1-25) Even the Tax Commission's own witness believed "that costs incurred for broadband equipment are capitalized" and not an appropriate cost to include on that basis. *See* Fischer Report (Trial Exhibit 32) at 6; *see also* Fischer Dep. Tr. (Trial Exhibit 33)

[9] The broadband tax credit is a mechanism the Idaho legislature has adopted to incentivize investment in broadband networks within the state; under it Cable One received tax credit in 2005 for purchases of certain qualified broadband equipment in Idaho. *See* I.C. § 63-3029I; Trial Exhibit 3.

at p. 42, lines 10-25; p. 43, lines 1-24. The reason for this was simple: as established by substantial evidence in the record, Cable One would have incurred those costs for purposes of its provision of video services even if it furnished no Internet access services at all. (Tr. Feb. 25/26, p. 64, lines 23-25; p. 65, lines 1-5; p. 200, lines 4-23; p. 201, lines 5-14; p. 203, lines 3-6) Therefore, they were not direct costs of the Internet access services at issue here under IDAPA Rule 35.01.01.550.03. *See* Part III.B.1, *supra*.

Despite this, the District Court erroneously considered both capital costs and depreciation to be direct costs, without any explanation as to how or why they might meet the standard. It concluded that "[a]llocated capitol [sic] improvement costs" related to Cable One's extension of its high-speed cable network are direct costs of performing the income-producing activity at issue in this case (Conc. of Law 13, R. 000343), and that "that portion of the yearly depreciation expense of 2005 costs attributable to [high speed data] capacity should be applied each year to the direct costs calculation in determining the Idaho Sales Factor for internet sales." (Conc. of Law 11, R. 000343) Further, Conclusions of Law 11 and 12 (R. 000343) appear to use Cable One's 2005 Qualified Broadband tax credit as a proxy for depreciation expense. But from either a factual or a legal perspective, a percentage of Cable One's broadband tax credit has nothing to do with its "yearly depreciation expense." Even the Tax Commission challenged the relevancy of information about Cable One's broadband tax credit to the questions before the court. (Tr. Feb. 25/26, p. 54, lines 10-22) Conclusion of Law 12 (R. 000343) reflects a calculation that neither of the parties contemplated or advocated.

There is no support in the law for a conclusion that depreciation expense may constitute a "direct cost" under IDAPA Rule 35.01.01.550.03. *See AT&T Corp. v. Dept. of Rev.*, 2012 WL 119850, at *9 n.7 (Or. T.C. Jan. 12, 2012) ("It is not clear that depreciation on assets is, in any case, a direct cost . . . . The assets in place and the depreciation on those would be incurred regardless of whether any particular call was or was not made."). *See also Lason Sys., Inc.* v. *Mich. Dep't of Treasury*, 2012 WL 247768, *5 (Mich. Ct. App. Jan. 26, 2012) (quoting *Random House Webster's College Dictionary* (2001) and holding that direct costs are "incurred to provide the services [the taxpayer] promised to its customers under its business contracts" or "'the price paid' for the 'execution or accomplishment of' [taxpayer's] business activity"). Deployment or investment of capital that Cable One would have undertaken regardless of whether it was providing Internet access services cannot be considered direct costs of that income-producing activity under the law. The District Court improperly considered costs of the broadband network, which Cable One would use for provision of video services even if it furnished no Internet access services (Tr. Feb. 25/26, p. 203, lines 3-6), in its analysis of Cable One's direct costs of providing Internet access services. The figures in Findings of Fact 34 and 35 (R. 000340-41) relate to extensions and upgrades to Cable One's cable television broadband network and are not direct costs of providing Internet access services, because the investments were not specific to the provision of Internet access service. (Tr. Feb. 25/26, p. 64, lines 10-25; p. 65, lines 1-5) Thus, the implications of this error for the larger group of Idaho taxpayers are significant; letting the District Court's decision stand would authorize double-counting such that expenses properly considered direct costs of one income-producing activity might be counted again as direct costs of another.

Cable One's capital costs, depreciation expenses, and its 2005 Qualified Broadband Tax Credit have no place in the calculation of its direct costs of performing the income-producing activity at issue in this case. The inclusion of ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** in capital costs in the direct costs table provided in Conclusion of Law 13 (R. 000343) was an error and should be reversed by this Court.

c) The District Court Erred by Disregarding Substantial Evidence as to the Location of Cable One's Direct Costs

After identification of the costs of performance of the taxpayer's income-producing activity by way of a direct costs analysis, the final step in the I.C. § 63-3027(r) analysis is to locate those direct costs geographically. *See* 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.18[3][b][iii], at 9-318 (3d ed. 2013) ("After the income-producing activities with respect to the taxpayer's service income are identified, the taxpayer must determine what its costs of performance are and where such costs were incurred."). The District Court made clearly erroneous factual findings as to where Cable One's direct costs at issue in this case were incurred. It mistakenly treated costs incurred by Cable One at its headquarters in Arizona as having been incurred in Idaho.

Specifically, Findings of Fact 14(f) and 25 (R. 000336, 339) relating to the nature of the Internet backbone services that Cable One purchased from Qwest and AT&T reflect disregard of the substantial and competent evidence presented at trial. Contrary to the District Court's findings, that evidence reflected that the Internet backbone costs were not specific to Idaho and were costs incurred by Cable One in Arizona under single contracts necessary to operate all of its 48 cable systems nationwide. *See, e.g.*, *Michiana Metronet, Inc. v. Michigan Dep't of Treasury,* 2011 WL 3890444, at *4, 6 (Mich. Tax. Trib. Aug. 11, 2011) (finding that while some "network assets" that enabled a wireless carrier to provide its services were located in both Indiana and Michigan, the majority of the carrier's costs were determined to be in Indiana because it is where "the infrastructure that provided services such as internet access, e-mail delivery, billing, text messaging, and other services" was located). The District Court apparently relied on the notion that Cable One was purchasing distinctly local services, but Cable One did not purchase "two distinct services" (Finding of Fact 14(f), R. 000336) from Qwest and AT&T. Cable One purchased dedicated interstate services from Qwest and AT&T to connect each of its 48 cable systems to each other and to its Arizona headquarters. (Tr. Feb. 25/26, p. 277, lines 12-25; p. 278, lines 1-23) What is termed a "local service connection" in the factual findings had to be purchased in connection with at least one other interstate service, and could not have been purchased separately. (Tr. Feb. 25/26, p. 274, lines 4-9; p. 277, lines 20-25; p. 278, lines 1-6; Qwest Agreement (Trial Exhibit 28) at 1, 2; AT&T Agreement (Trial Exhibit 29))[10] Further, Cable One did not contract for high speed data access to the World Wide Web from Qwest and AT&T. Cable One created a "tunnel or a virtual private line between the router in Idaho and Cable One Phoenix" and used "the Qwest or AT&T network to facilitate that transmission from the Idaho router to the Cable One Phoenix router." (Tr. Feb. 25/26, p. 310, lines 17-25) The service provided by Qwest and AT&T was a dedicated, point-to-point service between routers. (Tr., Feb. 27, p. 99, lines 1-2, 17-21) The description in Finding of Fact 14(f) (R. 000336) ignores the connection between the router in Arizona and the router in Idaho that was facilitated by the Qwest and AT&T services. These findings of fact fail to reflect the uncontroverted evidence establishing that Cable One could not have operated its Idaho cable systems without connecting to its headquarters in Arizona, a connection facilitated by the Internet backbone services. (Tr. Feb. 25/26, p. 235, lines 11-14; p. 269, lines 5-24) Cable One's Arizona operations and systems continually interacted with each of the 48 cable systems in order to

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[10] Qwest and AT&T also view the backbone services Cable One purchases as interstate services. *See* Aff. of Bradley D. Ottley ¶17, R. 000165; *see also, e.g.*, Qwest Agreement (Trial Exhibit 28) at 10 (requiring Qwest's service to be used for interstate purposes); Qwest Bill Sample (Trial Exhibit 14) at TC 003565 (imposing federal universal service charges, but not state taxes and surcharges, on the backbone services); Tr. Feb. 25/26, p. 286, lines 21-24 (stating the backbone service bills routinely have federal universal service charges on them). Federal universal service charges apply only to interstate services. *See* 47 C.F.R § 54.706(a) ("Entities that provide interstate telecommunications to the public, or to such classes of users as to be effectively available to the public, for a fee will be considered telecommunications carriers providing interstate telecommunications services and must contribute to the universal service support mechanisms."). Even the Tax Commission admits that the backbone services are interstate services. (Tr. Feb. 27, p. 57, lines 22-24)

deliver Internet access services to subscribers in others states. Cable One would have been unable to provide Internet access services in any state without its connection to Arizona. (Tr. Feb. 25/26, p. 269, lines 13-24); *see also AT&T Corp. v. Comm'r of Revenue*, 2011 WL 2243933, at *10 (Mass. App. Tax Bd. June 8, 2011) ("Simply put, AT&T could not provide its long-distance service without operating its entire long-distance network" and thus "AT&T's income-producing activity was its operation of its global network."); *cf. General Mills, Inc. v. Comm'r of Revenue*, 795 N.E.2d 552, 570 (Mass. 2003) (finding "that it was the business operations (including billing and customer relations) and management of Talbots" that was the income-producing activity).

Substantial and competent evidence was presented that Cable One had only one contract with each of AT&T and Qwest for all the states it operated in, and these contracts were negotiated and managed out of Arizona. (Tr. Feb. 25/26, p.78, lines 18-25; p. 79, lines 1-5; p. 272, line 4 through p. 274, line 9) The location of the negotiation and administration of contracts was critical to the determination of where the direct costs related to those contracts were incurred. *Cf. Boston Prof. Hockey Ass'n v. Comm'r of Revenue*, 2003 WL 21499974, at *3 (Mass. App. Tax Bd. June 30, 2003) (considering location of office from which contract negotiations were conducted), *aff'd*, 820 N.E.2d 792 (Mass. 2005). The factual finding supported by all of this evidence is that the costs of the Internet backbone services contracted for by Cable One through Qwest and AT&T were direct costs of providing Internet access services that are incurred by Cable One in Arizona, not Idaho.

The District Court's finding that "almost all customer Internet Traffic initially uses the DNS Module in the Arizona back office" (Finding of Fact 16, R. 000338) is unsupported by substantial evidence. Instead, substantial and competent evidence presented by Cable One at trial demonstrated that *all* customer Internet traffic *always* used the DNS Module in the Arizona Back Office. Bradley Ottley, Cable One's Director of Internet Operations, testified about the function of the Domain Name Server (DNS):

> [I]n order for a customer to . . . go to a website like Amazon.com, while they would type Amazon.com on their keyboard on their computer, that information is – is sent in a series of numbers, in a series of IP addresses for Amazon.com and it will send those numbers again from the cable modem up through the plant to the CMTS to the router in Idaho across the Qwest or AT&T network to the router in Phoenix. From the router in Phoenix it will communicate with the DNS server asking what is the domain name for this IP address. The domain name server would then respond back to the router stating this IP address is Amazon.com. Now the router knows where to send that customer's traffic and that traffic would go back out to the Qwest or AT&T network up to Amazon.com and that would complete the transmission.

(Tr. Feb. 25/26, p. 257, lines 8-25; p. 258, line 1) Ottley further clarified that DNS was necessary for an Idaho customer to receive Internet access services (Tr. Feb. 25/26, p. 258, lines 2-4), and that the same process took place whenever a customer navigates to a different page of the same domain, such as navigated from Amazon.com to Amazon.com Books. (Tr. Feb. 25/26, p. 258, lines 12-25; p. 259, line 1)

In addition, substantial and competent evidence presented at trial established that the DNS Module was only one of numerous applications in Arizona that an Idaho customer had to access in order to receive Internet access services. Ottley testified that "[t]he Qwest or AT&T network connection that we have to – from Phoenix to all of our 48 systems is only part of the – part of the puzzle. These applications in terms of provisioning; LDAP; SNMP; THCP; DNS; customer email; billing are all integral to our internet service. And if there is no access to Phoenix, there's no access to these applications, therefore, no access to the internet." (Tr. Feb. 25/26, p. 266, lines 23-25; p. 267, lines 1-6)[11]

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[11] Although not erroneous as a factual matter, the District Court's Finding of Fact 18 is irrelevant to the legal analysis demanded by the statute. The fact that the exceedingly rare and hypothetical Idaho

These clearly erroneous factual findings as to the Internet backbone costs and the role of Cable One's Arizona operations in Cable One's provision of Internet access services in all other states, including Idaho, led the District Court to erroneously place *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of "Idaho backbone costs for Idaho customers" in the "Idaho Costs" column in the direct costs table provided in Conclusion of Law 13. (R. 000343) Those costs were in fact "Arizona Costs." Moving the costs to that column confirms that Cable One incurred more direct costs of providing Internet access services in Arizona than in Idaho. Reversing the District Court's error and upholding Cable One's own direct costs analysis would yield revisions to the District Court's Conclusion of Law 13 (R. 000343) as summarized in the chart below: *****START CONFIDENTIAL*****

	Total Costs	Idaho Costs	Arizona Costs
Allocated Solution Center & Network Operation Center (NOC) costs (Arizona Back Office)	[Redacted]		[Redacted]
~~Allocated capitol [sic] improvement costs~~	[Redacted]	[Redacted]	
Idaho Employee and local office costs	[Redacted]	[Redacted]	
Idaho backbone costs for Idaho customers	[Redacted]	------------>	[Redacted]
Total direct costs	[Redacted]	[Redacted]	[Redacted]

customer who happened to know the IP address of every web site he or she wanted to access might still be able reach those web sites in the event of an outage in Cable One's Arizona back office has nothing to do with the analysis of the role of Cable One's Arizona back office in providing Internet access services overall. *See Nat'l Cable & Telecomms. Assn'n v. Brand X Internet Servs.*, 545 U.S. 967, 970 (2005) ("It is common usage to describe what a company 'offers' to a consumer as what the consumer perceives to be the integrated finished product, even to the exclusion of discrete components that compose the product."). The average customer seeks to access Amazon.com by name, not by typing out the IP address of 176.32.98.166. And Cable One's Internet access services customers everywhere are dependent on the Arizona operations to use Internet access services. (Tr. Feb. 25/26, p. 269, lines 17-20)

END CONFIDENTIAL

C. Under This Court's Controlling Precedent, the Tax Commission Has Failed to Demonstrate that Alternative Allocation and Apportionment is Justified in this Case

Idaho Code § 63-3027(s) is an equitable provision which permits alternative allocation and apportionment in the calculation of a multistate business' income tax liability under certain narrow circumstances. *See Union Pacific*, 139 Idaho at 575, 83 P.3d at 119. Though it erred in its application of the statute, the District Court correctly determined that the standard allocation and apportionment provisions of I.C. § 63-3027(r) should apply here, rather than any alternative contemplated in I.C. § 63-3027(s). In the event that this Court agrees with Cable One's analysis under the standard allocation and apportionment provisions of I.C. § 63-3027(r), this Court should further hold that the Tax Commission's request for alternative apportionment pursuant to I.C. § 63-3027(s) is not justified in this case.

This Court may decide issues of law not addressed by the District Court that have been fully briefed and argued by the parties. *See First Fed. Sav. Bank of Twin Falls v. Riedesel Eng'g, Inc.*, 154 Idaho 626, 631, 301 P.3d 632, 637 (2012) (resolving issue not addressed by the trial court where "the parties have briefed and argued the [issue] on appeal and have admitted that resolution of the issue involves only an issue of law and not any issue of fact"); *cf. Cucinotta v. Deloitte & Touche, LLP*, 302 P.3d 1099, 1101 (Nev. 2013) (exercising discretion to address issues not reached by the district court); *Budd-Falen Law Offices, P.C. v. Rocky Mountain Recovery, Inc.*, 114 P.3d 1284, 1289 (Wyo. 2005) (considering matter of law not addressed by the court below). The Tax Commission had a full opportunity before the District Court to marshal and present its evidence in support of alternative apportionment. While the District Court declined to reach the issue (Conc. of Law 21, R. 000345), it was fully briefed and argued by the parties below. The relevant facts are undisputed. Therefore, this Court should reach the issue of alternative apportionment and hold that it is not justified in this case as a matter of law. The Tax Commission may not achieve the effect of a statutory modification to I.C. § 63-3027(r) by employing alternative apportionment whenever a taxpayer's cost of performance analysis under that statute results in certain income being excluded from the sales factor for a multistate business.

Under this Court's precedent in *Union Pacific*, there exists "a very strong presumption in favor of the normal three-factor apportionment and against the applicability of" alternative apportionment pursuant to I.C. § 63-3027(s). 139 Idaho at 576, 83 P.3d at 120. This strong presumption dictates that alternative apportionment is not available unless its proponent – here, the Tax Commission – meets its burden of showing that such alternative apportionment is appropriate. *Id.* That burden demands a showing both that the standard allocation and apportionment provisions of I.C. § 63-3027 fail to fairly represent the extent of Cable One's business in Idaho, and that the Tax Commission's proposed alternative apportionment is itself reasonable. *Union Pacific*, 139 Idaho at 575, 83 P.3d at 119.

> The three factors, sales, payroll and property, are used to balance each other, each reflecting a different type of contribution to the business activity and income of the unitary business as a whole. Distortion in one factor, therefore, does not necessarily result in unfair reflection of the business activity in the state; the other two factors may well mitigate the distortive effect of the third, so that, ultimately, the taxpayer's business activity in the state is fairly represented through the combination of the three factors in the apportionment formula. It is necessary to establish that the application of the three factors does not fairly represent business activity, not merely that one factor fails to meet this standard. It must also be established that statutory apportionment does not adequately reflect business activity, not merely that it does not adequately reflect income earned in the state.

Union Pacific, 139 Idaho at 577, 83 P.3d at 121 (internal citations omitted). *Union Pacific* requires a showing of a "sufficient distortion" in order to assess whether a taxpayer's business activity in the state is not fairly reflected by the standard three-factor apportionment calculations.

Id. at 578, 83 P.3d at 122; *see also Tesoro Corp. v. State of Alaska Dept. of Revenue*, 312 P.3d 830, 847 (Alaska 2013) ("As we have stated in the past, inherent in the use of formula apportionment is the legislative decision that a certain degree of distortion will be tolerated.") (citation and internal quotation marks omitted); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 184 (1983) (finding a difference of 14% between the standard statutory formula and the alternative method advocated for by the taxpayer insufficiently distortive to pose a constitutional problem). Alternative apportionment is not available in Idaho unless "sufficient distortion" is apparent in the results of the standard three-factor apportionment.

To be clear, over *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Cable One's 2005 total income tax obligation to the State of Idaho is undisputed by the parties to this appeal. Therefore, the Tax Commission has not approached meeting its burden to justify the application of an alternative apportionment method here. As a matter of law, it could never meet that burden in this case, because a differential of less than three percent (in this case *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****) fails to justify any departure from the presumption in favor of the standard statutory apportionment method. "'Merely because the use of an alternative form of computation produces a higher business activity attributed to . . . [the state], is not in and of itself a sufficient reason from deviating from the . . . formula." *Washington Federal, Inc. v. Idaho State Tax Comm'n*, 2008 WL 4600356 (Idaho Dist. Ct. July 28, 2008) (quoting *Union Pacific*, 139 Idaho at 576, 83 P.3d at 120).

Further, alternative apportionment is permitted in Idaho "only when unusual fact situations that ordinarily are unique and nonrecurring produce incongruous results pursuant to the apportionment and allocation provisions contained in Section 63-3027." IDAPA Rule

35.01.01.560.01; *see Union Pacific*, 139 Idaho at 576-77, 83 P.3d at 120-21 (holding that "the mixing of the two accounting systems to represent but one group of sales is the unusual fact situation that led to incongruous results in . . . [the] application of the standard formula"). The Tax Commission did not even attempt to establish that an "unusual fact situation" justifying alternative apportionment exists here. Nor could it – the fact situation here is neither unique nor nonrecurring – and far from producing incongruous results, the results are precisely those contemplated by the legislative scheme. Cable One employed a single accounting system and based its costs of performance analysis on its financial statements prepared according to generally accepted accounting principles. (Tr. Feb. 25/26, p. 44, lines 2-23; p. 75, lines 4-6) As Cable One's Vice President and Treasurer testified at trial, Cable One's decision to exclude its Internet access service revenues based on costs of performance does not present an unusual fact situation:

> There's nothing unusual about it that I see. I mean, we provide service in the State of Idaho. We follow the rules that say if there's activity that occurs inside and outside the state that you do a cost of performance. We did a cost of performance. It turned out the cost of performance said that there were more costs incurred outside the State of Idaho and that's – that's how we followed it.

(Tr. Feb. 25/26, p. 111, lines 19-25; page 112, lines 1-2)

The Tax Commission's arguments below for alternative allocation and apportionment were based solely on the opinion of its witness, James Peters, whose report and testimony failed to even address the *Union Pacific* presumption and its standard. (Tr. Feb. 27, p. 100, line 5 through p. 135, line 15; Trial Exhibit 39) Peters' testimony made clear that his opinion was based only on his own view as to what would be "reasonable," and he admitted that in forming that view he failed to consider first whether application of all three factors under the standard allocation and apportionment provisions of I.C. § 63-3027 would fairly represent the extent of

Cable One's business in Idaho, as required by *Union Pacific*. In response to the question "in order to reach that conclusion [that the statute as construed by Cable One reached an incongruous result], you didn't think you needed to know anything more than there was a zero numerator, and how many customers Cable One served, and how much revenue it generated for Internet access services?" Peters agreed "I think basically that's correct." (Tr. Feb. 27, p. 129, lines 3-18) The Tax Commission failed to put on any case at all to meet its burden of showing that alternative apportionment is appropriate on these facts and that the presumption in favor of the standard three-step analysis should be overcome. *Union Pacific* makes clear that the extraordinary remedy of alternative apportionment is appropriate only when the Tax Commission can demonstrate that the standard allocation formula has led to a truly anomalous and unusual result. In this case, the result reached by Cable One in calculating its income tax liability is precisely what is expected, and similar results would be expected each year – there are no one-time anomalies or other unusual circumstances affecting the tax calculation. Moreover, there is nothing that the Tax Commission *could have* presented to satisfy the *Union Pacific* standard here, because of the undisputed fact that the application of the Tax Commission's advocated-for alternative here would result in a change to Cable One's Idaho apportionment factor of only ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL***. This type of minor variation cannot constitute the sort of "distortion" that would justify alternative allocation, as contemplated by *Union Pacific*. For this reason and all of the reasons set forth in Cable One's briefing in the court below, this Court should hold as a matter of law that alternative apportionment pursuant to I.C. § 63-3027(s) is not available here.

IV. CONCLUSION

Cable One respectfully submits that this Court should reverse the District Court's legal errors and set aside its clearly erroneous factual findings, and find that alternative apportionment is not available here as a matter of law, holding that Cable One correctly calculated its 2005 Idaho income tax liability.

DATED: January 23, 2014

CAHILL GORDON & REINDEL LLP

By: ______________________________
Chérie R. Kiser, *pro hac vice*
Angela F. Collins, *pro hac vice*
Krista Friedrich, *pro hac vice pending*

PERKINS COIE LLP

By: ______________________________
Tonn K. Petersen, Idaho Counsel, Idaho Bar No. 8385
Kelly A. Cameron, ISB No. 7226

Attorneys for Plaintiff-Appellant Cable One, Inc.

CERTIFICATE OF SERVICE

I, the undersigned, certify that on January 23, 2014, I caused a true and correct copy of the foregoing to be forwarded with all required charges prepaid, by the method(s) indicated below, in accordance with the Idaho Rules of Procedure, to the following person(s):

Erick M. Shaner Phil Skinner Deputy Attorneys General State of Idaho P.O. Box 36 Boise, ID 83722-0410 FAX: 208-334-7844 Erick.Shaner@tax.idaho.gov Phil.Skinner@tax.idaho.gov *Attorneys for Defendant Idaho State Tax Commission*	Hand Delivery U.S. Mail Facsimile Overnight Mail Electronic Mail	____ X ____ ____ ____