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

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IN THE SUPREME COURT OF THE STATE OF IDAHO

CABLE ONE, INC.,)	
)	
Plaintiff-Appellant,)	
)	
v.)	Supreme Court No. 41305
)	
IDAHO STATE TAX COMMISSION,)	RESPONDENT'S BRIEF
)	
Defendant-Respondent.)	

COPY

RESPONDENT'S BRIEF

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

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Attorney General

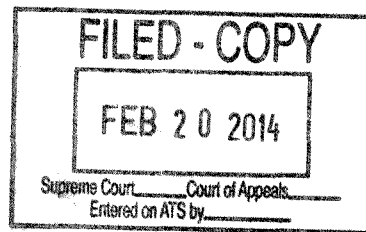
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I. STATEMENT OF THE CASE

A. Nature of the Case

This case is a state corporate income tax case. The issue in this case focuses on whether Cable One's *****START CONFIDENTIAL [Redacted] END CONFIDENTIAL***** of sales revenue from Idaho Internet service customers in 2005, should be considered "Idaho sales" that belong in the Idaho sales apportionment factor.

Idaho Code § 63-3027(r) instructs that sales, that are not sales of tangible personal property, are "in Idaho" if "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 Internet backbone costs

The dispute in this case is whether the greater proportion of Cable One's income-producing activity (providing Internet access service to Idaho customers) is performed in Idaho or at the corporate headquarters in Arizona. Cable One's own costs of performance analysis identified three categories of direct costs that were required to provide Internet access service to Idaho customers: *****START CONFIDENTIAL*****

[Redacted]

*****END CONFIDENTIAL***** Affidavit of Patrick A. Dolohanty (trial exhibit 12) at p. 4. The Tax Commission does not dispute the Idaho employee and office costs. The Tax Commission also does not dispute the portion of the Solution Center and NOC service costs required to provide Internet access in Idaho. The primary dispute in this case is about whether the Internet backbone service costs (a.k.a. the "long distance communications services" purchased from Qwest and AT&T) should be considered to be Idaho or Arizona costs when conducting the costs of performance analysis.

The pivotal factual question in this case is whether the activities giving rise to the Internet backbone costs (i.e. the dedicated internet access and local access services provided by Qwest and AT&T at Cable One's six Idaho headend facilities) were performed in Idaho or Arizona. If these activities were performed in Idaho, then, using Cable One's own cost of performance analysis, the Internet backbone costs shift from the Arizona column to the Idaho column and the greater amount of costs of performance are in Idaho. *****START CONFIDENTIAL*****

[Redacted]

*****END CONFIDENTIAL***** Affidavit of Patrick A. Dolohanty (trial exhibit 12) pg. 4 (circle and arrow added). This one factual finding concludes the entire case, deeming the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales receipts received by Cable One to be "Idaho sales" that must be included in the Idaho sales numerator.

The Idaho network costs

Another, less consequential, dispute in this case has been whether some portion of the costs of building and maintaining Cable One's Idaho network should also be included as direct costs of providing Internet to Idaho customers. Cable One only included the three cost amounts, identified above, as the "direct costs" of providing Internet access in Idaho in 2005. See chart in Affidavit of Patrick A. Dolohanty (trial exhibit 12) at pg. 4; also see Summary of Cable One's Direct Costs (trial exhibit 8). Cable One did not include any portion of the costs arising out of the activities of constructing and maintaining Cable One's Idaho broadband network systems, which are required to deliver Internet access service to customer's homes.¹ The parties have interest in knowing, for future years, whether some portion of the network should be included as direct costs of providing Internet access to Idaho customers. However, with regard to the 2005 year at issue in this case, the amount of network costs that the Tax Commission asserts should be included is not significant enough to change the outcome of the costs of performance analysis.² Thus, as stated above, the key factual question is whether the activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs arose from activities performed in Idaho or Arizona.

Alternative apportionment

The Tax Commission also asserted that even if the district court were to find that Cable One had correctly applied Idaho Code § 63-3027(r), Cable One's interpretation and application of

¹ Both Mr. Hannan and Mr. Otley testified about how the Idaho networks are used to deliver Internet access to the homes of Idaho customers. See Tr. Feb. 25/26, pgs. 187, 236-237.

² The Tax Commission argued that a reasonable amount of network costs to include in the costs of performance analysis would be somewhere in the range of *****START CONFIDENTIAL*****[Redacted] *****END CONFIDENTIAL***** to *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. See Tax Commission's Post Trial Brief (R. 000078); also see Supplemental Expert Report of Michael Starkey (trial exhibit 11) at TC 004617-004620. The district court ended up using its own calculations to come up with *****START CONFIDENTIAL*****[Redacted]*****END CONFIDENTIAL***** of network costs to be included in the costs of performance analysis. Find. of Fact 12-13 (R. 000343).

Idaho Code § 63-3027(r), which treated all of the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales receipts from Idaho customers as sales that were “in Arizona,” does not “fairly represent” Cable One’s business activity in Idaho in 2005; thus the Tax Commission has authority under Idaho Code § 63-3027(s) to require a reasonable alternative. In 2005, Cable One received *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of revenue from approximately *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** customers in Idaho. *See* Stipulated facts No. 18 (R. 000282). In 2005, Cable One provided Internet access to customers in 19 states and received *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** percent of its total Internet access revenue from Idaho customers (significantly more Internet access income came from Idaho than any other state). *See* Internet Cost Analysis (trial exhibit 9) at pg. 5; also *see* stipulated fact #18 (R. 000282). Cable One calls these sales “Arizona sales” in their Idaho return and does not include them; they then take the exact contradictory position and call these sales “Idaho sales” in their Arizona return and do not include them. *See* Tr. Feb. 25/26, pgs. 50, 135-137, 139-140, 145. Arizona Code § 43-1147 and the related regulation, AZ ADC R15-2D-806(1), are virtually identical to Idaho Code § 63-3027(r) and its related tax rule, IDAPA 35.01.01.550.02. Both states have adopted the same UDITPA provisions. Cable One’s interpretation and application of the law is an unusual approach, producing an incongruous result where *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** percent of Cable One’s Internet access income is not included in the sales numerator of any state. It is reasonable, and reflects the economic reality of Cable One’s business activity in Idaho, for these sales to Idaho customers to be treated as Idaho sales that are included in the Idaho sales numerator.

B. Course of Proceedings

Pursuant to Idaho Code § 63-3049, Cable One appealed the November 18, 2010, Decision of the Tax Commission (Decision) to the District Court of the Fourth Judicial District of the State of Idaho, in and for the county of Ada. (R. 000009-000013). Cable One challenged (1) the Decision's finding that Cable One's Idaho Internet access service income for taxable year 2005 should be included in the Idaho sales factor numerator when calculating Idaho income tax 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 applied to require the Internet access sales to Idaho customers to be included as Idaho sales. (R. 000009-000013).

A de novo bench trial was held in district court February 25 – 27, 2013. The court issued its Findings of Fact, Conclusions of Law and Order on May 22, 2013. (R. 000331). The court found/concluded that:

- Cable One had six cable network systems located in Idaho and that each of these systems had their own distinct Internet backbone service provided by Qwest or AT&T. Find. of Fact 4 & 14(f) (R. 000333, 000336).
- “Cable One contracted with Qwest and AT&T for them to provide the ‘Idaho backbone services’ (local service fiber optic connection from the local Idaho headend to the local Qwest or AT&T facility and a DIA port at the local Qwest or AT&T facility) for the connection of the Cable One Idaho's internet customers to the internet. Qwest and AT&T performed their contracts by physically providing and maintaining in Idaho the ‘Idaho backbone services’ for each Idaho Cable One system.” Find. of Fact 25 (R. 000339).
- “Qwest and AT&T billed Cable One for each Idaho specific local service fiber optic connection and DIA port.” And the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs included in Cable One's own costs of performance analysis represented the total amount of all these Idaho specific bills for 2005. Find. of Fact 25 (R. 000339).
- “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. Tax Commission concedes the burdensomeness of such an analysis and the appropriateness to conduct the

costs of performance analysis on Cable One's provision of Internet access to all Idaho customers in 2005 taken as a group." Conc. of Law 10 (R. 000342-000343).

- "Some portion of Cable One's costs of additional plant hardware and extension of its high speed cable network is attributable to Cable One's direct cost of its income producing activity of attracting and servicing Idaho Internet access customers." Conc. of Law 11 (R. 000343).
- A portion of the Idaho cable network capital improvement costs and the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs should both be included as "Idaho costs" in the costs of performance analysis. Conc. of Law 13 (R. 000343).
- "As it relates to the Idaho Internet access income and based upon cost of performance, the greater part of Cable One's 2005 Internet access services income producing activity was performed in Idaho." Conc. of Law 14 (R. 000344).
- "Cable One's *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue from Idaho Internet access service customers should be included [as Idaho sales] in calculating the Idaho Sales Factor numerator." Conc. of Law 15 (R. 000344).
- Using Cable One's interpretation and application of the Idaho Code § 63-3027(r), which failed to include Cable One's 2005 sales revenue from Idaho Internet access service customers in calculating the Idaho Sales Factor, would not "fairly represent" the extent of Cable One's 2005 business activity in Idaho. Conc. of Law 19 (R. 000344). (This is the finding needed for the Commission to be authorized to require a reasonable alternative under Idaho Code § 63-3027(s). The court noted, however, that "it is unnecessary and improper to consider Tax Commission's request for an alternate allocation and apportionment under Idaho Code § 63-3027(s)" because the court had already found in the Tax Commission's favor based on the "Court's determination of the location of Cable One's income producing activity pursuant to Idaho Code § 63-3027(r)(2)." Conc. of Law 21 (R. 000345).)
- "Tax Commission is determined to be the I.R.C.P. 54 prevailing party and shall be entitled to recover its costs." Conc. of Law 24 (R. 000345).

C. Statement of Facts

In 2005, Cable One received *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet access service revenue from approximately *****START CONFIDENTIAL*****[Redacted]*****END CONFIDENTIAL***** customers in Idaho. *See* Stipulated fact #18 (R. 000282). In Cable One's 2005 Idaho income tax return it treated the

*****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales as "Arizona sales" and included none of these sales as "Idaho sales." *See* Tr. Feb. 25/26, pgs. 50, 135-137, 139-140, 145. In Cable One's 2005 Arizona income tax return it treated the same *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales as "Idaho sales" and included none of these sales as "Arizona Sales." *Id.* Cable One took contrary positions in each state such that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** internet access revenue from Idaho customers was not included as sales in the sales factor numerator for any state. *Id.*

Cable One's six Idaho cable network systems were a necessary component used to deliver Internet access service to the Idaho customers. *See* Tr. Feb. 25/26, pgs. 187, 236-237; Tr. Feb. 27, pgs. 36:22-39:22. Cable One did not include any amount of the costs of building and maintaining the cable networks in Idaho as a direct cost of providing Internet access to Idaho customers. *See* Affidavit of Patrick A. Dolohanty (trial exhibit 12) pg. 4; also *see* Summary of Cable One's Direct Costs (trial exhibit 8).

Cable One identified three categories of direct costs incurred by Cable One to provide Internet service to its Idaho customers in 2005 (the Commission does not dispute these amounts and agrees that they are direct costs of providing Internet service to Idaho customers): *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of allocated Solution Center and Network Operations Center (NOC) costs; *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** for employees and local offices in Idaho; *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** for Internet backbone service costs (a.k.a. phone data line costs). *See*

Stipulated facts 13, 14, 15 (R. 000281-000282); also *see* Affidavit of Patrick A. Dolohanty (trial exhibit 12) pg. 4.

The activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Idaho employee and office costs were performed in Idaho. *See* Stipulated facts #13 (R. 000281).

The activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of allocated solution center and NOC costs were performed in Arizona where these two centers are located. *See* Stipulated facts #14 (R. 000281).

The activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone service charges were performed in Idaho at the headend facilities where Qwest and AT&T provided the dedicated internet access and local access connections that Cable One was paying for. Find. of Fact 25 (R. 000339). The *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** Internet backbone service amount is comprised of individual charges specifically billed for the services provided at each of the Idaho system headend locations during 2005. Find. of Fact 25 (R. 000339). Cable One's Vice President, Mr. Dolohanty, discussed and explained the general ledger detail for the phone data line costs for the six Idaho systems. *See* General Ledger Detail (trial exhibit 13) TC 003868-003871; also *see* Tr. Feb. 25/26, pgs. 122-123. The "grand total" on the last page of this general ledger excerpt is *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** Mr. Dolohanty confirmed that this is where the backbone cost amount seen on the profit and loss statement (and used in the costs of performance analysis) came from. *See* Tr. Feb. 25/26, pgs. 123-124. A few monthly bills from Qwest were shown to Mr. Dolohanty, he confirmed that the charges on each of these matched up with specific line

entries in the general ledger. *See* Tr. Feb. 25/26, pgs. 124-128; *see also* Qwest Invoices (trial exhibit 14) TC 003565, 003566, 003569. Two of the sample invoices show that the charges were for "Circuit Location, 2-261 Eastland Dr, Twin Falls;" the other sample invoice shows that the charge was for "Circuit Location, 2-205 W. Alameda Rd, Pocatello." *See* Qwest Invoices (trial exhibit 14) TC 003565, 003566, 003569. Another Qwest bill (trial exhibit 16) was presented to Mr. Dolohanty, he confirmed that the charges in this bill for Lewiston, Twin Falls, Pocatello, and Idaho Falls all matched up with specific line entries on the general ledger. *See* Tr. Feb. 25/26, pgs. 128-130; *see also* Qwest Invoice (trial exhibit 16) TC 003592-003595. The general ledger (trial exhibit 13) demonstrates that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** cost amount is comprised of individual monthly bills for charges incurred at the specific Idaho headend locations. Each of these Idaho headends had a separate identifiable port; and there were different levels of bandwidth provided by Qwest or AT&T at each of these Internet access ports in the Idaho headends. *See* Tr. Feb. 25/26, pgs. 323-325, 329-331.

The specific elements of the Internet backbone service that Cable One paid AT&T and Qwest for are "direct internet access" (DIA) and "local access" services. Cable One's Director of Internet Operations, Mr. Ottley, was asked questions about one of the Qwest bills (trial exhibit 16) and explained that the "Qwest Total Advantage" service identified in the bill was "both local access as well as DIA for each of these locations." *See* Tr. Feb. 25/26, pg. 289:12-17. Mr. Ottley also explained that Qwest or AT&T installs equipment in the Cable One headend "in order for us to access their network;" explaining further, "they provide dedicated internet access into our headend, dedicated internet access as well as local access being the entire picture for internet access from Qwest or AT&T." *See* Tr. Feb. 25/26, pgs. 307:1-308:15. Cable One

submitted a contract into evidence titled "Qwest Total Advantage Agreement." *See* Qwest Total Advantage Agreement (trial exhibit 28). The contract provides further insight about what the service is that Cable One purchases from Qwest and AT&T.

The Qwest Total Advantage Agreement (trial exhibit 28) confirms that the Internet backbone service purchased from Qwest and AT&T consists of dedicated internet access and local access services provided at each of the Cable One headend facilities in Idaho. On the first page of the agreement, Cable One is identified as the customer and the agreement states "customer shall purchase the services checked below..." *See* Qwest Total Advantage Agreement, (trial exhibit 28) pg. 1. The two boxes "checked below" are "Domestic Standard DIA" and "Local Access." *Id.* On page seven of the agreement there is a section titled "Service Description;" in paragraph 2.1 it describes the DIA service as "a dedicated, high-speed network connection to the Internet." *Id.* at 7. Mr. Starkey confirmed that DIA service "is a basic service that's purchased in the industry for purposes of accessing the World Wide Web." *See* Tr. Feb. 27, pg. 44:17-24. Mr. Starkey also explained how the DIA and local access services work. Referring to an "Internet Backbone Services" diagram that Cable One had prepared and provided during discovery (trial exhibit 27), Mr. Starkey explained that the local access channel picks up all the internet traffic that is coming out of the Cable One headend in Idaho; from that point, Qwest transports the traffic a couple of miles away to its nearest central office where it then connects the traffic to its own backbone network and carries the traffic out to the Internet. *See* Tr. Feb. 27, pgs. 46:1-49:15/26. The Internet backbone service that Cable One paid *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** to Qwest and AT&T for, was comprised of a local channel and a port on the Qwest network that provided access to the

World Wide Web for each of Cable One's six Idaho network systems; all of these components and facilities were located in Idaho. *Id.*

II. ARGUMENT

A. Applicable Law

Idaho Code § 63-3027(p) explains that "the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in [Idaho] during the tax period." Idaho Code § 63-3027(r) instructs that sales, that are not sales of tangible personal property, are "in Idaho" if "the income-producing activity is performed both inside 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."

IDAPA 35.01.01.550.02 instructs that "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."

The goal of the statute is to determine where, geographically, the income-producing activity was performed, if more of the income-producing activity was performed in Idaho than in any other state, the sales generated by that income-producing activity are considered to be Idaho sales which are included in the Idaho sales numerator. The "costs of performance" method is the tool for measuring and assigning weight to the various components of the income-producing activity.

IDAPA 35.01.01.550.03 states, "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."

Thus, the steps in the analysis are:

1. Identify the income-producing activity.
2. Identify the direct costs of performing the income-producing activity.

3. Identify where, geographically, the activities giving rise to these costs were performed.

B. Cable One's income-producing activity: providing Internet access to Idaho customers.

The district court correctly identified Cable One's income-producing activity at issue: providing Internet access to Idaho customers. Idaho law does not support the "operational approach" advocated by Cable One in its brief to this Court (i.e. that Cable One's income-producing activity is the overall operation of providing Internet access services in 19 states).

1. Identifying the income-producing activity: the "transactional" approach

Idaho law requires a focus on "each separate item of income" and an analysis of the transactions and activities engaged in by the taxpayer to produce those gains; as opposed to the high level "operational" focus that Cable One advocates in its brief to this Court.³ IDAPA 35.01.01.550.02 instructs that "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." The question, then, is what is the income producing activity (or activities) that produced the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue which is at issue in this case?

IDAPA 35.01.01.550.02 says that "the term income producing activity applies to each separate item of income..." The separate items of income that add up to the total *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue, are each of the monthly payments received from each of the Idaho Internet access customers in 2005. Mr. Dolohanty testified that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue was received in the form of monthly payments from the

³ Cable One asserts in its brief to this Court, "The regular course of [Cable One's] business includes no separate income-producing activity of 'attracting and servicing Idaho Internet access customers.' The income-producing activity is the provision of Internet access services in nineteen states." Appellant's Opening Brief, pgs. 15-16.

Idaho customers. *See* Tr. Feb. 27, pgs. 117:10-119:3. The language of the rule requires a costs of performance analysis to examine the activities and costs that were required to produce each monthly payment from each customer. However, given the facts of this case, the activities (and the costs of those activities) required to provide Internet access and produce the monthly payments from Idaho customers in 2005 appear to be consistent for all the monthly payments from all the Idaho customers throughout the year. So whether the costs of performance analysis is conducted looking at all the Idaho customer's monthly payments taken as a whole, or looking at them individually, the result is the same in this case.⁴

The district court agreed 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;" but agreed with the Commission that it was appropriate, in this case, "to conduct the costs of performance analysis on Cable One's provision of Internet access to all Idaho customers in 2005 taken as a group." Conc. of Law 10 (R. 000342-000343). Thus, there are numerous income-producing activities in this case that produced the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue at issue; those income-producing activities are the transactions and activities engaged in by Cable One to ensure that each of their Idaho customers would make each of their monthly payments for Internet access service throughout the 2005 taxable year. However, as suggested by the Commission, and agreed upon by the district court, one costs of performance analysis could be performed in this case focusing on the provision of Internet access service to Idaho customers in 2005 taken as a whole; this one costs of

⁴ Under a different factual circumstance, where the activities (and costs of the activities) varied for each separate item of income, Idaho law would require the costs of performance analysis to be done at a level of granularity that focuses on each separate item of income by itself.

performance analysis provided the same result that would have been produced by performing a costs of performance analysis on each separate item of income.

IDAPA 35.01.01.550.02 instructs that “the term income producing activity... 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.” The transactions and activities Cable One engaged in to provide Internet access to Idaho customers include: (1) a portion of the activities of the Network Operations Center and Solutions Center at Cable One headquarters in Phoenix; (2) the activities of Cable One employees and local offices located in Idaho; (3) the activities/transactions with Qwest and AT&T for the ongoing provision of Internet backbone service at Cable One’s Idaho headend facilities, and (4) the activities of constructing and maintaining Cable One’s Idaho broadband network systems, which are required to deliver Internet access service to customer’s homes. *See* Stipulated facts 6-9, 13, 14, 15 (R. 000280-000282); also *see* Tr. Feb. 25/26, pgs. 71:7-72:24, 78:5-13, 81:7-82:20, 227:2-5, 240:8-15, 262:25-265:20, 313:15-320:21.

Thus, Cable One’s income producing activity, that produced the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue at issue in this case, is the combination of the four activities identified above that were required to provide Internet access service to Idaho customers so as to ensure those customers would continue to make their monthly payments that totaled *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** in 2005.

2. Idaho law does not provide the possibility for an “operational approach” to identifying the income-producing activity; Cable One errs by citing Massachusetts case law to support this approach.

Cable One cites the Massachusetts *AT&T* case for support of the “operational approach” (i.e. that Cable One’s income-producing activity is the overall operation of providing Internet access

services in 19 states). The Appeals Court of Massachusetts upheld the Appellate Tax Board's holding that "it was the operation of [AT&T's] global network based in New Jersey that qualified as its income-producing activity." *Comm'r of Revenue v. AT&T Corp.*, 82 Mass. App. Ct. 1106, 970 N.E.2d 814 review denied, 463 Mass. 1112, 979 N.E.2d 224 (2012). However, the definition of "income-producing activity" in Massachusetts has significant differences from Idaho's definition. Massachusetts definition is as follows:

For purposes of 830 CMR 63.38.1(9)(d)2., an income-producing activity is a transaction, procedure, or operation directly engaged in by a taxpayer which results in a separately identifiable item of income.

830 Mass. Code Regs. 63.38.1. Whereas, Idaho's definition states:

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.

IDAPA 35.01.01.550.02. The Massachusetts definition contains the words "or operation," which appears to have been the key to its courts concluding that the "operational approach" to identifying the income-producing activity should be used in the *AT&T* case. Their Appellate Tax Board analyzed as follows (and emphasized the word "operation" with bold print in its decision):

The regulation might appear to offer a choice between a transaction or a procedure or an operation. However, it does not offer a choice. Instead, the statute requires a determination of the correct income-producing activity, based on a close analysis of the particular facts presented.

....

The Board thus found and ruled that, in accordance with the statute and the regulations, AT&T's income-producing activity was its operation of its global network. This finding:

fits comfortably within the text of the regulation that states that "an income-producing activity is a transaction, procedure, or **operation** directly engaged in by a taxpayer which results in a separately identifiable item of income".... [quoting 830 CMR § 63.38.1 (9)(d)(2)(emphasis provided by Supreme Judicial Court)].

AT&T Corp. v. Comm'r of Revenue, C293831, 2011 WL 2243933 (Mass. App. Tax. Bd. June 8, 2011) *aff'd*, 82 Mass. App. Ct. 1106, 970 N.E.2d 814 (2012).

Idaho provides one specific "transactional approach" for identifying the income-producing activity, as opposed to the Massachusetts definition that provides the possibility for the income-producing activity to be "a transaction or a procedure or an operation." Under Idaho law, the term income-producing activity "applies to each separate item of income" and it "means the transactions and activity" engaged in to produce those gains; there is no possibility provided in the Idaho definition for the income-producing activity to be the taxpayer's entire operation of a line of business. The Idaho analysis starts by identifying a separate item of income and then asks, "what transactions and activities did the taxpayer engage in to produce the identified gain?" Cable One's vice president testified that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue at issue in this case was received in the form of monthly payments from Idaho customers; thus the separate items of income in this case are each of the monthly payments from each of the Idaho customers. *See* Tr. Feb. 27, pgs. 117:10-119:3.

C. The direct costs of providing Internet access service to Idaho customers.

- 1. The direct costs of consequence were stipulated to in this case, leaving the court with very little to address regarding direct costs.**

For the most part, the parties stipulated to the direct costs in this case; the only dispute was whether some portion of the costs of installing and maintaining the Idaho network systems should be included as a direct cost of providing Internet access to Idaho customers.

Cable One calculated that *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of the 2005 Solution Center and Networks Operations costs were incurred to support and provide Internet access in Idaho. *See* Stipulated facts 14 (R. 000281). In 2005, Cable One incurred *****START CONFIDENTIAL***** [Redacted] *****END**

CONFIDENTIAL*** of costs for the activities of Cable One employees and local offices located in Idaho. *See* Stipulated facts 13 (R. 000281). The total cost for AT&T and Qwest to provide the Internet backbone service at all six of the Idaho system headends in 2005 was *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** *See* Stipulated facts 15 (R. 000282). The Tax Commission did not (and still does not) dispute that these three amounts were direct costs of providing Internet access in Idaho during 2005.

Some portion of the costs of building and maintaining Cable One's Idaho network should also be included as direct costs of providing Internet to Idaho customers. Cable One only included the three cost amounts, identified in the preceding paragraph, as the total "direct costs" of providing Internet access in Idaho in 2005. *See* Affidavit of Patrick A. Dolohanty (trial exhibit 12) pg. 4; also *see* Summary of Cable One's Direct Costs (trial exhibit 8). Cable One did not include any portion of the costs arising out of the activities of constructing and maintaining Cable One's Idaho broadband network systems, which are required to deliver Internet access service to customer's homes. Both Mr. Hannan and Mr. Ottley testified about how the Idaho networks are used to deliver Internet access to the homes of Idaho customers. *See* Tr. Feb. 25/26, pgs. 187:4-188:1, 236:5-240:15. Mr. Starkey also identified all the portions of Cable One's network that were required to provide Internet access to Idaho customers. *See* Tr. Feb. 27, pgs. 37:6-39:22. Mr. Fischer testified, regarding the Idaho networks, that:

[T]here are costs that can be traced to the high speed internet service. You can trace some sort of capacity that's dedicated to providing that service. So that's the portion that should be considered a direct cost of the service.

See Tr. Feb. 25/26, pgs. 398:7-22. Mr. Starkey explained that Cable One had identified some specific traceable amount of the Idaho network that was dedicated solely to providing "high speed data" (a.k.a. Internet access); the specific traceable amount was represented by the "yellow

dot" in trial exhibit 22, which was prepared by Cable One. *See* Tr. Feb. 27, pgs. 39:17-22. Using the information provided by Cable One, Mr. Starkey suggested that a reasonable amount of network costs to include in the costs of performance analysis would be somewhere in the range of *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** to *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL*****. *See* Supplemental Expert Report of Michael Starkey (trial exhibit 11) at TC 004614-004620.⁵

Because the three major identified direct costs were stipulated to, the district court was not tasked with engaging in a significant amount of analysis about the definition of direct costs or the question of what were the direct costs in this case. The court simply held that "Although the term 'direct costs' is defined by neither Idaho law nor by any of the standard methods of accounting, the above regulations read together indicate that direct costs include the costs incurred by Cable One in providing internet services to its Idaho customers." Conc. of Law 9 (R. 000342). Taking into account the testimony presented at trial, the court held that a portion of the Idaho cable network capital improvement costs should be included as "Idaho costs" in the costs of performance analysis. Conc. of Law 12, 13 (R. 000343).

2. Cable One's assertion that the district court failed to conduct the required direct costs analysis is unfounded.

Cable One incorrectly criticizes the district court for "failing to conduct the required direct cost analysis," suggesting that the court's decision "contained no analysis actually addressing the question of what are the direct costs," and asserting that the district court's decision "presupposes the answer to one of the areas of greatest dispute in this case." *See* Appellant's Opening Brief, pgs. 19-20. As explained above, Cable One initially set forth its own costs of performance analysis,

⁵ The district court ended up using its own calculations to come up with *****START CONFIDENTIAL*****[Redacted] *****END CONFIDENTIAL***** of network costs to be included in the costs of performance analysis. Find. of Fact 12-13 (R. 000343).

which identified three categories of direct costs incurred to provide Internet access to Idaho customers: *****START CONFIDENTIAL*****

[Redacted]

*****END CONFIDENTIAL***** Affidavit of Patrick A. Dolohanty (trial exhibit 12) at p. 4. Although the Tax Commission disputed that the “long distance communications” amount (a.k.a. Internet backbone cost) should be in the Idaho column (because that is where Qwest and AT&T actually performed the services that Cable One was paying for), the Tax Commission agreed that the three amounts identified by Cable One were direct costs of providing Internet access to Idaho customers in 2005. *See* Stipulated facts 13, 14, 15 (R. 000281-000282). The district court did not need to provide a detailed “analysis actually addressing the question of what are the direct costs” because the direct costs were stipulated to in this case; with the exception of the inconsequential debate about whether some portion of Cable One’s Idaho cable network system costs should be considered a direct cost of providing Internet access to Idaho customers.⁶

The district court did perform the required costs of performance analysis to the extent it was necessary. The court started with the direct costs of consequence all being stipulated to. From

⁶ The Tax Commission argued that some amount of the costs of building and maintaining the Idaho cable network systems should be included as a direct cost of providing Internet access service to Idaho customers in 2005; however, the amount that the Tax Commission asserted to be included as a direct cost was not large enough, in comparison to the three big stipulated direct costs, to be of consequence to the outcome of this case. *See* footnote 2, above.

there, the court only needed to decide two disputed issues to complete the required costs of performance analysis: (1) whether the Internet backbone costs should be in the Idaho costs column; and (2) whether some portion of the costs of building and maintaining the Idaho cable network systems should be included as a direct cost. The district court held that “Qwest and AT&T performed their contracts by physically providing and maintaining in Idaho the ‘Idaho backbone services’ for each Idaho Cable One system” and “billed Cable One for each Idaho specific fiber connection and DIA port,” and therefore, the ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of Internet backbone costs should be included as “Idaho costs” in the costs of performance analysis. Find. of Fact 25 (R. 000339); Conc. of Law 12, 13 (R. 000343). And based on the testimony and evidence presented at trial, the court held, “Some portion of Cable One’s costs of additional plant hardware and extension of its high speed cable network is attributable to Cable One’s direct cost of its income producing activity of attracting and servicing Idaho Internet access customers.” Conc. of Law 11 (R. 000343).

3. Cable One incorrectly cites the *Microsoft* case.

In its brief to this Court, Cable One erroneously cites the California Court of Appeal’s *Microsoft* decision to support Cable One’s assertion that “Idaho, like other jurisdictions, is clear in its direction that taxpayers rely on their own standard accounting methods in determining their direct costs.” See Appellant’s Opening Brief, pg. 19 (emphasis added). But then in the parenthetical summary included with the *Microsoft* citations, Cable One writes, “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.’” See Appellant’s Opening Brief, pg. 19 (emphasis added). Cable One, in its brief to this Court, cites *Microsoft* a second time to support the assertion that “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 Appellant's Opening Brief, pg. 21 (emphasis added). But then in the parenthetical summary included with this *Microsoft* citation, Cable One writes, "California permits the taxpayer to rely on its own accounting methods in determining its items of income." See Appellant's Opening Brief, pg. 21 (emphasis added).

"Identifying items of income" is a completely separate step of the analysis from identifying the costs of performance (i.e. the "direct costs"). "Identifying items of income" is part of the analysis for identifying the income producing activity where IDAPA 35.01.01.550.02 instructs that "the term income producing activity applies to each separate item of income." "[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." Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.18[3][b], at 9-130 (3d ed. 2013); also see Appellant's Opening Brief, pg. 18.

In *Microsoft* there was a dispute about whether sales of PowerPoint software were separate items of income. *Microsoft Corp. v. Franchise Tax Bd.*, 212 Cal. App. 4th 78, 95, 150 Cal. Rptr. 3d 770, 783 (2012), reh'g denied (Jan. 15, 2013). Microsoft pointed out that PowerPoint software was licensed as part of a bundle of products. *Id.* And therefore, "the revenue attributable to PowerPoint... was not separately paid for nor separately accounted for in its business records." The court seemed to agree with *Microsoft* that "California permits the taxpayer to rely on its own accounting methods in determining its items of income." *Id.*

If this *Microsoft* analysis were applied to Cable One's case it would simply confirm that Cable One's separate items of income are each of the monthly payments from each of the Idaho customers during 2005. Applying *Microsoft* means that we look at Cable One's own accounting

and business records to see that the sales at issue are received, and recorded, in the form of monthly payments from each of the Idaho customers.⁷ Therefore, the separate items of income, to which the term "income producing activity" applies, are the individual monthly payments from each of the Idaho customers. Applying *Microsoft* to Cable One's case provides no guidance on defining or identifying direct costs.

D. Identifying where, geographically, the activities giving rise to the direct costs were performed.

The district court correctly based its legal conclusions on a determination of the location where Cable One's income producing activity was performed. Idaho Code § 63-3027(r) seeks to determine where, geographically, the income-producing activity was performed; if more of the income-producing activity was performed in Idaho than in any other state, then the sales from that income-producing activity are to be included as Idaho sales in the sales numerator. After identifying the income-producing activity and the direct costs incurred to perform that income-producing activity, the final step in the analysis is to determine where, geographically, the activities giving rise to each of the direct costs were performed.

The location of the activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of 2005 Solution Center and Networks Operations Center costs were performed in Arizona; the parties do not dispute this. See Stipulated facts 14 (R. 000281).

The location of the activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of costs for the activities of Cable One employees

⁷ The separate items of income that add up to the total *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue at issue in Cable One's case, are each of the monthly payments received from each of the Idaho Internet access customers in 2005. Mr. Dolohanty testified that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue was received in the form of monthly payments from the Idaho customers. See Tr. Feb. 27, pgs. 117:10-119:3.

and local offices located in Idaho were performed in Idaho; the parties do not dispute this. *See* Stipulated facts 13 (R. 000281).

Although the parties dispute whether or not some portion of the costs of constructing and maintaining the Idaho network systems should be considered to be direct costs, it is undisputed that these activities were performed in Idaho. From the headend facilities, down to Idaho customers' homes, the six Idaho network systems are located entirely in Idaho. Mr. Hannan testified that the headends for the six Idaho network systems are all located in Idaho. *See* Tr. Feb. 25/26, pgs. 174:17-175:12, 223:12-23.

The activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone service charges were performed in Idaho at the headend facilities where Qwest and AT&T provided the dedicated internet access and local access connections that Cable One was paying for. This is the pivotal dispute in this case. Cable One treated these costs as Arizona costs in its costs of performance analysis. *See* Affidavit of Patrick A. Dolohanty (trial exhibit 12) pg. 4; *also see* Summary of Cable One's Direct Costs (trial exhibit 8). The evidence at trial established that the activities giving rise to the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs were performed in Idaho.

1. The activities giving rise to the Internet backbone costs were performed in Idaho.

The *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone service charges are comprised of individual charges specifically billed for the services provided at each of the Idaho system headend locations. Mr. Dolohanty discussed and explained the general ledger detail for the phone data line costs for the six Idaho systems. *See* General Ledger Detail, TC 003868-003871 (trial exhibit 13); *see also* Tr. Feb. 25/26, pgs. 122-

123. The "grand total" on the last page of this general ledger excerpt is *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** Mr. Dolohanty confirmed that this is where the backbone cost amount seen on the profit and loss statement (and used in the costs of performance analysis) came from. *See* Tr. Feb. 25/26, pgs. 123:13-124:5. A few monthly bills from Qwest were shown to Mr. Dolohanty, he confirmed that the charges on each of these matched up with specific line entries in the general ledger. *See* Tr. Feb. 25/26, pgs. 124:6-128:13; *see also* Qwest Invoices, TC 003565, 003566, 003569, (trial exhibit 14). Two of the sample invoices show that the charges were for "Circuit Location, 2-261 Eastland Dr, Twin Falls;" the other sample invoice shows that the charge was for "Circuit Location, 2-205 W. Alameda Rd, Pocatello." *See* Qwest Invoices, TC 003565, 003566, 003569, (trial exhibit 14). Another Qwest bill (trial exhibit 16) was presented to Mr. Dolohanty, he confirmed that the charges in this bill for Lewiston, Twin Falls, Pocatello, and Idaho Falls all matched up with specific line entries on the general ledger. *See* Tr. Feb. 25/26, pgs. 128:25-130:16; *see also* Qwest Invoice, TC 003592-003595 (trial exhibit 16). The general ledger (trial exhibit 13) demonstrates that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** cost amount is comprised of individual monthly bills for charges incurred at the specific Idaho headend locations. Each of these Idaho headends had a separate identifiable port; and there were different levels of bandwidth provided by Qwest or AT&T at each of these Internet access ports in the Idaho headends. *See* Tr. Feb. 25/26, pgs. 323:18-325:16, 329:10-331:3.

Cable One and its witnesses have inaccurately characterized the Idaho Internet backbone service costs as a cost that occurs in Arizona; they claim that it is only for "internal budget and accounting purposes" that they have allocated *****START CONFIDENTIAL***** [Redacted]

END CONFIDENTIAL to Idaho. *See* Affidavit of Patrick A. Dolohanty, (trial exhibit 12) paragraph 13. The general ledger, the sample Qwest invoices, along with the testimony of Mr. Dolohanty show that the total ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of Internet backbone service costs is made up of the charges in the monthly bills, each of which identified the specific Idaho headend location where AT&T or Qwest had provided the services for which Cable One was being charged.

Understanding exactly what the Internet backbone services are solidifies that the activities giving rise to the ***START CONFIDENTIAL*** [Redacted] ***END CONFIDENTIAL*** of Internet backbone service costs were performed in Idaho. In the profit and loss statement these costs are referred to as "phone data line" costs. *See* Idaho All – Profit and Loss Detail, (trial exhibit 7) CB 000124. Cable One has frequently used the term "Internet backbone services," and in its costs of performance analysis also used the term "long distance communication services." *See* Affidavit of Patrick A. Dolohanty, (trial exhibit 12) page 4; *also see* Summary of Cable One's Direct Costs (trial exhibit 8). At one point, when asked about the services that Cable One purchases from Qwest and AT&T, Mr. Ottley stated, "We strictly want the backbone access to the World Wide Web. We take care of everything else." *See* Tr. Feb. 25/26, pg. 320:8-21. Further testimony explained that the specific services that Cable One is paying AT&T and Qwest for are "direct internet access" (DIA) and "local access" services. Mr. Ottley was asked questions about one of the Qwest bills (trial exhibit 16) and explained that the "Qwest Total Advantage" service identified in the bill was "both local access as well as DIA for each of these locations." *See* Tr. Feb. 25/26, pg. 289:12-17. Mr. Ottley also explained that Qwest or AT&T installs equipment in the Cable One headend "in order for us to access their network;" explaining further, "they provide dedicated internet access into our headed, dedicated

internet access as well as local access being the entire picture for internet access from Qwest or AT&T." See Tr. Feb. 25/26, pgs. 307:1-308:15. Cable One submitted a contract into evidence titled "Qwest Total Advantage Agreement." See Qwest Total Advantage Agreement (trial exhibit 28). The contract provides further insight about what the service is that Cable purchases from Qwest and AT&T.

The Qwest Total Advantage Agreement (trial exhibit 28) confirms that the Internet backbone service purchased from Qwest and AT&T consists of dedicated internet access and local access services provided at each of the Cable One headend facilities in Idaho. On the first page of the agreement Cable One is identified as the customer and the agreement states "customer shall purchase the services checked below..." See Qwest Total Advantage Agreement, pg 1 (trial exhibit 28). The two boxes "checked below" are "Domestic Standard DIA" and "Local Access." *Id.* On page seven of the agreement there is a section titled "Service Description;" in paragraph 2.1 it describes the DIA service as "a dedicated, high-speed network connection to the Internet." *Id.* at 7. Mr. Starkey confirmed that DIA service "is a basic service that's purchased in the industry for purposes of accessing the World Wide Web." See Tr. Feb. 27, pg. 44:17-24. Mr. Starkey also explained how the DIA and local access services work. Referring to an "Internet Backbone Services" diagram that Cable One had prepared and provided during discovery (trial exhibit 27), Mr. Starkey explained that the local access channel picks up all the internet traffic that is coming out of the Cable One headend; from that point, Qwest transports the traffic a couple of miles away to its nearest central office where it then connects the traffic to its own backbone network and carries the traffic out to the Internet. See Tr. Feb. 27, pgs. 45:17-47:25. Along with explaining the function of the DIA and local access services, Mr. Starkey provided the reason for including the *****START CONFIDENTIAL***** [Redacted]

*****END CONFIDENTIAL***** of Internet backbone costs as costs that were in Idaho. Mr.

Starkey explained:

So the service they were buying and paying for was this local channel, which is an actual physical facility that sits in Idaho, and then also for a port on the Qwest network that provides access to the World Wide Web.

So it became clear from this data response and then also from the bills that all of this [referring to trial exhibit 27] -- and I'm circling all of these headends and all of these central offices and all of the lines right before the cloud, everything right up when you get to the cloud -- all of that equipment sits in Idaho...

So it became clear through all that analysis, including the bills, that all of these facilities actually sat in Idaho, and they were purchased for use in Idaho, specifically because they had to carry the traffic of those Idaho customers.

That was the basis for us saying, "We don't understand why Cable One would attribute those as Arizona costs, when clearly all the geographic nexus of those facilities and service sits in Idaho."

See Tr. Feb. 27, pgs. 47:25-49:15.

Cable One's counsel has erroneously asserted that when Cable One purchases the Backbone service from Qwest or AT&T, Cable One is not purchasing one end; but that Cable One is purchasing a service which goes from one end to the other end (the "other end" being Phoenix). *See* Tr. Feb. 25/26, pg. 340:19-22. The general ledger (trial exhibit 13) demonstrates that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** Internet backbone cost amount included in Cable One's costs of performance analysis is the total of all the monthly bills issued by Qwest and AT&T for providing DIA and local access services specifically at Cable One's Idaho headend facilities. Mr. Ottley testified that the Phoenix headquarters has its own dedicated Internet access port. *See* Tr. Feb. 25/26, pg. 324:2-12. If Cable One does pay Qwest for DIA and local access services at the Phoenix headquarters (as seems to be depicted on trial exhibit 27), then those Qwest bills specific to the services being provided at the Phoenix headquarters exist separate and apart from the Idaho specific bills that

add up to *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** If the Qwest bills for DIA and local access services in Phoenix were analyzed and some traceable percentage of the Internet traffic going in and out of the Phoenix headquarters could be identified as being traffic that is specifically related to providing Internet access in Idaho, then it would probably be appropriate to include that amount in the "Arizona column" of the costs of performance analysis; however, no such evidence has been presented. The evidence that has been presented establishes that the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone cost amount included in Cable One's costs of performance analysis is the total amount that Cable One paid to AT&T and Qwest in 2005 for the provision of DIA and local access services at the six headend facilities in Idaho.

The activities giving rise to the Internet backbone service costs were performed in Idaho. Using Cable One's own cost of performance analysis (see page 4 of trial exhibit 12), the Internet backbone costs must be shifted from the Arizona column to the Idaho column and the greater amount of the costs of performance are in Idaho. *****START CONFIDENTIAL*****

[Redacted]

*****END CONFIDENTIAL***** Affidavit of Patrick A. Dolohanty, (trial exhibit 12) page 4 (circle and arrow added). This one factual finding concludes the entire case; pursuant to Idaho Code § 63-3027(r) the *****START CONFIDENTIAL***** [Redacted] *****END**

CONFIDENTIAL*** of sales receipts received by Cable One are "Idaho sales" that must be included in the Idaho sales numerator.

E. The district court correctly conducted the costs of performance analysis; no consideration as to what would "fairly represent the extent of Cable One's 2005 business activity in Idaho" influenced the court's analysis and application of Idaho Code § 63-3027(r).

Cable One incorrectly asserts that the "District Court erred by basing its application of [Idaho Code § 63-3017(r)] on what would 'fairly represent the extent of Cable One's 2005 business activity in Idaho.'" *See* Appellant's Opening Brief, pg. 11, 12. Cable One explains that "section 63-3027(r) contains the 'normal three-factor apportionment'" and points out that subsection (r) "makes no reference to what might 'fairly represent' the extent of the taxpayer's business activity in Idaho." *Id.* at 14. Cable One asserts that "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.'" *Id.* at 13. The "fairly represents" standard is found in Idaho law. It is found in Idaho Code § 63-3027(s), which has been the legal source for the Tax Commission's secondary argument throughout this case: even if the district court were to find that Cable One had correctly applied Idaho Code § 63-3027(r), Cable One's interpretation and application, which treated all of the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales receipts from Idaho customers as sales that were "in Arizona," does not "fairly represent" Cable One's business activity in Idaho in 2005; thus the Tax Commission has authority under Idaho Code § 63-3027(s) to require a reasonable alternative.

The district court's conclusion that "the failure to include Cable One's 2005 sales revenue from Idaho Internet access service customers. in calculating the Idaho Sales Factor would not fairly represent the extent of Cable One's 2005 business activity in Idaho..." addressed the Tax

Commission's secondary legal argument. This conclusion was stated in the district court's conclusions of law paragraph 19, after the court had already walked through the costs of performance analysis of Idaho Code § 63-3027(r) and made the following findings and conclusions:

- "Cable One contracted with Qwest and AT&T for them to provide the 'Idaho backbone services' (local service fiber optic connection from the local Idaho head end to the local Qwest or AT&T facility and a DIA port at the local Qwest or AT&T facility) for the connection of the Cable One Idaho's internet customers to the internet. Qwest and AT&T performed their contracts by physically providing and maintaining in Idaho the 'Idaho backbone services' for each Idaho Cable One system." Find. of Fact 25 (R. 000339).
- "Qwest and AT&T billed Cable One for each Idaho specific local service fiber optic connection and DIA port." And the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs included in Cable One's own costs of performance analysis represented the total amount of all these Idaho specific bills for 2005. Find. of Fact 25 (R. 000339).
- "Some portion of Cable One's costs of additional plant hardware and extension of its high speed cable network is attributable to Cable One's direct cost of its income producing activity of attracting and servicing Idaho Internet access customers." Conc. of Law 11 (R. 000343).
- A portion of the Idaho cable network capital improvement costs and the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of Internet backbone costs should both be included as "Idaho costs" in the costs of performance analysis. Conc. of Law 13 (R. 000343).
- "As it relates to the Idaho Internet access income and based upon cost of performance, the greater part of Cable One's 2005 Internet access services income producing activity was performed in Idaho." Conc. of Law 14 (R. 000344).
- "Cable One's *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue from Idaho Internet access service customers should be included [as Idaho sales] in calculating the Idaho Sales Factor numerator." Conc. of Law 15 (R. 000344).

Even though the court found that Cable One's method "would not fairly represent the extent of Cable One's 2005 business activity in Idaho," the court noted that it was unnecessary to rule that the Commission had the authority to require a reasonable alternative under Idaho Code § 3027(s)

because the court had already found that the greater proportion of the income-producing activity was performed in Idaho under the analysis of Idaho Code § 3027(r):

Based upon this Court's determination of the location of Cable One's income producing activity pursuant to I.C. § 63-3027(r)(2) it is unnecessary and improper to consider Tax Commission's request for an alternate allocation and apportionment under I.C. § 63-3027(s).

Conc. of Law 21 (R. 000345).

F. The testimony and evidence presented at trial supports the district court's finding that Cable One's interpretation and application of Idaho Code § 63-3027(r) did not "fairly represent the extent of Cable One's 2005 business activity in Idaho."

Even if Cable One's costs of performance methodology was found to be a correct application of Idaho Code § 63-3027(r), the district court would still have found in favor of the Tax Commission based on Idaho Code § 63-3027(s); because Cable One's methodology, which excluded the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales revenue from Idaho Internet access service customers, did not "fairly represent the extent of Cable One's 2005 business activity in Idaho." Conc. of Law 19 (R. 000344). However, the district court noted that it was unnecessary to consider granting the request to apply Idaho Code § 63-3027(s), because the court had already found in favor of the Tax Commission based on the application of Idaho Code § 63-3027(r). Conc. of Law 21 (R. 000345).

1. Idaho Code § 63-3027(s), alternative apportionment.

Idaho Code § 63-3027(s) is known as the "alternative apportionment" provision (aka "section 18 relief"), this code section provides:

(s) If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

....

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The application of Idaho Code § 63-3027(s) was the central issue in the Union Pacific Corp. v Idaho State Tax Commission case before the Idaho Supreme Court. Union Pacific Corp. v Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004). The court stated:

Idaho Code section 63-3027(s) provides that the Tax Commission may require alternative apportionment (a) if the allocation and apportionment provisions of the statute do not fairly represent the extent of the taxpayer's business and (b) if the alternative apportionment is reasonable. Before the statutory apportionment can be rejected in favor of an alternative apportionment, either the Commission or the taxpayer must show that the three-part formula does not accurately reflect the taxpayer's business in the State. The party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate.

Id. at 575 (citations omitted).

The Idaho Supreme Court discussed the requirement that the proposed alternative be reasonable, stating:

In the words of the draftsman of the uniform act, William J. Pierce explaining the purpose of the relief clause:

[I]t gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires.

“Reasonableness” has been defined as being made up of three elements:

(1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state.

Id. at 576-77 (citations omitted).

IDAPA 35.01.01.560.01 provides additional instruction for applying the alternative apportionment provision:

A departure from the allocation and apportionment provisions of Section 63-3027, Idaho Code, is permitted only in limited and specific cases. Section 63-3027(s), Idaho Code, may be invoked 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, Idaho Code.

In the Idaho district court's decision in the Union Pacific case, it discussed the "unique and non-recurring" language of the rule:

The parenthetical phrase "(which ordinarily will be unique and non-recurring)" does not further limit what is an "unusual fact situation", it simply explains that ordinarily an unusual fact situation will be unique and non-recurring. It does not require the unusual fact situation be unique and non-recurring.

Union Pacific Corp. v. Idaho State Tax Commission, Case No. CV OC 9704812D, pg. 10 (Idaho 4th Dist. June 03, 2002) (Partial Summary Judgment Decision). (A copy of this decision was attached to the Commission's post trial brief as "Exhibit A." See R. 000105)

California courts have expressed the same rationale regarding the "unique and non-recurring" language. A California court of appeals recently explained:

Finally, General Mills also argues that its hedging activity is not the sort of unusual, atypical fact situation for which section 25137 was designed. It cites California Code of Regulations, title 18, section 25137, which provides in part, "[Revenue and Taxation Code] [s]ection 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in these regulations." The Supreme Court, however, specifically rejected a similar argument in *Microsoft*: "Systematic oversights and undersights are equally a matter of statutory concern. Nothing in the language of [California Code of Regulations, title 18,] section 25137 persuades us otherwise. While Revenue and Taxation Code section 25137 'ordinarily' applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula 'fairly represent[s]' a unitary business's activities in a given state, and when it does not, the relief provision may apply. [Citations.]" (*Microsoft, supra*, 39 Cal.4th at p. 770, 47 Cal.Rptr.3d 216, 139 P.3d 1169, fn. omitted.)

Gen. Mills, Inc. v. Franchise Tax Bd., 208 Cal. App. 4th 1290, 1307, 146 Cal. Rptr. 3d 475, 489 (2012)

The Idaho Supreme Court seemed to follow this logic in its Union Pacific opinion. The court actually cited the expected recurring nature of Union Pacific's accounting method as a reason as to why it was appropriate to intervene with alternative apportionment. Stating:

What is clear, however, is that UPC's reporting system, which overstates sales, was to be used every year hence, the long-term consequence of which would be an inaccurate reflection of UPC's sales in Idaho and income from sales escaping taxation. The district court properly exercised its discretion in adopting the Commission's alternative apportionment.

Union Pacific, 83 P.3d at 122.

The steps in the Idaho Code § 63-3027(s) analysis are: (1) Does the taxpayer's interpretation and application of the allocation and apportionment provisions of Idaho Code section 63-3027 fairly represent the taxpayer's business activity in Idaho (i.e. is it an unusual fact situation that produces an incongruous result)? (2) If it does not "fairly represent," then is the alternative being proposed by the Tax Commission is reasonable?

2. Does it fairly represent Cable One's business activity in Idaho to treat all of the 2005 sales of Internet access to Idaho customers as sales that were in Arizona?

The purpose of the sales factor in the apportionment formula is to represent the market state's contribution to the taxpayer's production of income. Mr. Peters testified that during the creation of the three factor apportionment formula there was a desire to represent the market state, and this is where the sales factor came from.⁸ See Tr. Feb. 27, pgs. 112:1-113:17. Mr. Peters explained further:

[L]et me tell you that nobody that I know of -- and, you know, I have been in this field for 50-some years, and I have read everything and been involved in about everything that's been done.

I have never seen anybody say -- that's knowledgeable in the field -- say anything other than that the market state is the reason you have a sales factor in the three-

⁸ James Peters was retained as an expert witness by the Tax Commission to address the alternative apportionment issues in the case. See Report of James H. Peters, (Trial exhibit 39) pg. 1.

factor formula, and I could cite 50 other references if I were asked to, where that is said by tax practitioners, by tax lawyers, by economists, by whatever.

See Tr. Feb. 27, pgs. 130:18-131:4.

Cable One operates in 19 states; it received *****START CONFIDENTIAL*** [Redacted] *****END CONFIDENTIAL***** percent of its Internet access revenue from Idaho in 2005, yet included none of that amount in the Idaho sales numerator. *See* Tr. Feb. 25/26, pg. 95:2-7. Including none of those sales in the Idaho sales numerator does not fairly represent Cable One's business activity in Idaho, the state where it does more Internet access business than any other. Mr. Peters also testified that failure to include the *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of sales to Idaho customers "produces what I would call an incongruous result... [b]ecause it does not reflect at all the market for the product... it totally ignores the market provided by Idaho for Internet access, which is... the only reason for the sales factor to exist at all in the formula." *See* Tr. Feb. 27, pgs. 122:10-123:10.

If Cable One's interpretation and application of Idaho Code § 63-3027(r) was correct, then this would be exactly the kind of case and scenario that the alternative apportionment provision of Idaho Code § 63-3027(s) was meant to apply to. Professor William J. Pierce, the "father" of UDITPA, noted the deficiency in this cost of performance area and the need for a variance under Section 18 (*see* Idaho code § 63-3027(s)) to deal with certain situations not covered by Section 17 (*see* Idaho Code § 63-3027(r)) as follows:

Another problem arises in conjunction with sales other than sales of tangible personal property. Section 17 of the uniform act attributes these sales to the state in which the income-producing activity is performed. If the activity is performed in more than one state, the sales are attributed to the state in which the greater proportion of the activity was performed, based upon costs of performance. In many types of service functions, this approach appears adequate. However, there are many unusual fact situations connected with this type of income and probably the general provisions of Section 18 should be utilized for these cases.

BellSouth Adver. & Pub. Corp. v. Chumley, 308 S.W.3d 350, 365 (Tenn. Ct. App. 2009).

The approach taken by Cable One to exclude its Idaho Internet service revenue from the Idaho sales factor was a new position they began taking in their 2005 tax return. *See* Tr. Feb. 25/26, pgs. 137:18-138:7. Just like in Union Pacific, Cable One's approach is "to be used every year hence, the long-term consequence of which would be an inaccurate reflection of [Cable One's] sales in Idaho and income from sales escaping taxation." Union Pacific, 83 P.3d at 122.

3. Is the Tax Commission's proposed alternative reasonable?

The Tax Commission's recommended alternative is reasonable; it is simply to include the Idaho Internet access sales as Idaho sales, just as Cable One had done in the years before 2005. *See* Tr. Feb. 25/26, pgs. 137:18-138:7. This method satisfies the three measures of reasonableness described in Union Pacific. Union Pacific, at 576-77.

First, the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income. Including the sales in the Idaho sales numerator fairly represents Cable One's business activity of selling Internet access service to customers in Idaho and receiving income from those customers. If this market approach were applied uniformly, it would result in taxation of no more or no less than 100 percent of the taxpayer's income; the sales would simply be included as sales in the state where each customer resided. Currently, Cable One inconsistently calls the Idaho customer sales "Arizona sales" in its Idaho tax returns, and calls these same Idaho customer sales "Idaho sales" in its Arizona return. *See* Tr. Feb. 25/26, pgs. 50:1-8, 135:11-137:17, 139:20-140:1, 145:2-16. In a self-serving fashion, the sales are currently not included in the calculation of income tax in either state, and are escaping taxation altogether. When asked why Cable One had not included the Idaho Internet access sales in their Arizona sales factor numerator, Mr. Dolohanty

suggested that "we basically reviewed the Arizona laws and determined that it was not taxable." See Tr. Feb. 25/26, pg. 50:9-17. This position seems hard to justify; Arizona Code § 43-1147 and the related regulation, AZ ADC R15-2D-806(1), are virtually identical to Idaho Code § 63-3027(r) and its related tax rule, IDAPA 35.01.01.550.02. Both states have adopted the same UDITPA provisions.

Second, the division of income does not create or foster lack of uniformity among UDITPA jurisdictions. As has been discussed, the purpose of the sales factor is to represent the market state. Treating sales to customers residing in Idaho, as sales that "are in" Idaho, follows the goal of UDITPA and fosters uniformity among the states that have adopted its provisions. As pointed out above, both Arizona and Idaho have adopted the UDITPA provisions for "sales other than sales of tangible property." Cable One currently treats the sales to Idaho customers as "Idaho sales" on their Arizona return and does not include them in the Arizona sales numerator; including these sales as "Idaho sales" in the Idaho numerator fosters uniformity between these two UDITPA jurisdictions.

Third, the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state. In 2005, Cable One received *****START CONFIDENTIAL***** [Redacted] *****END CONFIDENTIAL***** of revenue from approximately *****START CONFIDENTIAL*****[Redacted*****END CONFIDENTIAL*****] customers in Idaho. See Stipulated fact #18 (R. 000282). In 2005, Cable One provided Internet access to customers in 19 states and received *****START CONFIDENTIAL*****[Redacted]*****END CONFIDENTIAL***** percent of its total Internet access revenue from Idaho customers (significantly more Internet access income came from Idaho than any other state). See Internet

Cost Analysis, (trial exhibit 9) pg. 5. It reflects the economic reality of Cable One's business activity in Idaho for these sales to Idaho customers to be treated as Idaho sales.

Cable One's application of the statute does not fairly represent its business activity in Idaho. This unusual approach produces an incongruous result where *****START CONFIDENTIAL****^[Redacted]****END CONFIDENTIAL***** percent of Cable One's Internet access income is not included in the sales numerator of any state. During the deposition of Tax Commission expert witness, Jim Peters, he was asked about the period of time (1965 through 1984) during which he worked for AT&T as their attorney responsible for filing state income tax returns, handling audits, handling appeals, and litigation. He was asked if he had ever looked at this cost of performance statute and considered zeroing out a line of income in a state based on more costs being performed out of state. Mr. Peters stated in his answer:

So my answer to you is that in my time, this sort of thing never occurred. We never went to any state with a zero sales factor. I would be embarrassed to go to a state with a zero sales factor, to tell you the truth. If you really want my opinion, I would have been ashamed to go to New York and say you have a zero sales factor or California, you have a zero sales -- I'd get nowhere. And any time that I dealt with a state, it was always recognized by the state and by me as a public utility large in every state, probably the largest state taxpayer in the country, that we had to come to some reasonable way, method of handling the situation...

See Deposition Transcript of James H. Peters, (trial exhibit 41) pgs. 95-97.

III. CONCLUSION

The district court correctly applied Idaho Code § 63-3027(r) to conclude that more of the income-producing activity of providing Internet access to Idaho customers was performed in Idaho than in any other state. One factual finding, that the Internet backbone service cost arose from activities performed in Idaho by Qwest and AT&T, settled this case in favor of the Tax Commission. Using Cable One's own costs of performance analysis, the Internet backbone service cost is reassigned from the Arizona costs column to the Idaho costs column, resulting in more of the costs of performance being in Idaho.

Additionally, sufficient evidence and testimony was presented at trial to support the district court's finding that it would not fairly represent Cable One's business activity in Idaho to treat the *****START CONFIDENTIAL***** \$30,019,045 *****END CONFIDENTIAL***** of sales to Idaho customers as sales that were "in Arizona" and thus exclude them from the Idaho sales numerator. However, it was unnecessary for the court to apply this finding and grant the authority to use an alternative under Idaho Code § 63-3027(s) because the court had already found in favor of the Commission under the application of Idaho Code § 63-3027(r).

DATED this 20 day of February 2014.



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CERTIFICATE OF SERVICE

I hereby certify that on the 20 day of February 2014, I caused to be served a true and correct copy of the foregoing RESPONDENT'S BRIEF, by the method indicated below and, addressed to each of the following:

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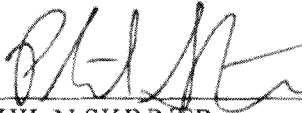
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The undersigned does hereby certify that the electronic brief submitted is in compliance with all of the requirements set out in I.A.R. 34.1, and that an electronic copy was served on each party at the following email addresses:

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