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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 REPLY 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

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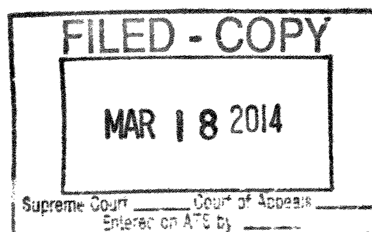

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Appellant Cable One, Inc. ("Cable One"), by its attorneys, hereby submits its Reply Brief in accordance with Idaho Appellate Rule 35(c).

INTRODUCTION

There is no basis in the law or the record of this case to justify the District Court's decision, and the Tax Commission fails to provide any legal or factual support for the District Court's conclusions. Cable One's cost of performance analysis was conducted in accordance with Idaho statutory and regulatory requirements and consistent with similar laws in other jurisdictions. The undisputed evidence in this case demonstrates that Cable One incurred more costs to provide Internet access services in 2005 due to activities outside of Idaho. As such, under well-established tax law principles in Idaho and other jurisdictions, income from the sale of those services is not subject to Idaho income tax. This Court should reverse the District Court's legal errors and set aside its erroneous factual findings.

This Court also should find that alternative apportionment is not available here as a matter of law. There is no basis for the Tax Commission's proposal to apply the relief remedy of alternative apportionment, and the Tax Commission has not met its high burden to overcome the very strong presumption in favor of the normal three-factor allocation and apportionment method. Cable One's calculation of its income tax liability in accordance with Idaho law does not lead to the type of extreme, disproportional results that might justify alternative apportionment. Cable One's results are in accord with Idaho law and with the tax treatment of other similarly-situated Idaho taxpayers. The Tax Commission has failed to meet its burden of demonstrating otherwise.

ARGUMENT

The weight of the evidence below demonstrates that the overwhelming majority of Cable One's costs to provide Internet access service were incurred outside of Idaho, and that Cable One correctly excluded its Internet access service sales income from the Idaho sales factor numerator as required under I.C. § 63-3027(r)(2). The evidence also demonstrates that the Tax Commission has not met its high burden to apply an alternative allocation and apportionment to Cable One under I.C. § 63-3027(s). If the Tax Commission believes a change in Idaho tax law is necessary, its sole recourse is the legislature, as only that body can make law. *Mead v. Arnell*, 117 Idaho 660, 664, 791 P.2d 410, 414 (1990); *see also* IDAHO CONS. art. III, §§ 1, 15; *Berry v. Koehler*, 84 Idaho 170, 177, 369 P.2d 1010, 1013 (1961) ("The wisdom, justice, policy, or expediency of a statute are questions for the legislature alone."). It is incumbent upon this Court to enforce Idaho tax statutes as written by giving effect to the intent of the legislature. *Idaho State Tax Comm'n v. Haener Bros.*, 121 Idaho 741, 743, 828 P.2d 304, 306 (1992); *Bogner v. State Dep't of Revenue and Taxation, State Tax Comm'n*, 107 Idaho 854, 856, 693 P.2d 1056, 1058 (1984). But to the extent that there is any ambiguity in the statute or the Tax Commission's implementing rules, it must be resolved in Cable One's favor. *See, e.g.*, *Canty v. Idaho State Tax Comm'n*, 138 Idaho 178, 182, 59 P.3d 983, 987 (2002) ("Where 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.'") (quoting *Dep't of Employment v. Diamond Intern. Corp.*, 96 Idaho 386, 387, 529 P.2d 782, 783 (1974)); *Kimbrough v. Idaho Bd. of Tax Appeals*, 150 Idaho 417, 420, 247 P.3d 644, 647 (2011)

("Administrative rules are interpreted the same way as statutes."). The District Court's decision is not supported by substantial and competent evidence and relies on "a strained and harsh interpretation o[f] a series of statutes that otherwise have a plain, obvious, and rational meaning." *J.R. Simplot Co., v. Idaho State Tax Comm'n*, 120 Idaho 849, 863-64, 820 P.2d 1206, 1220-21 (1991) (internal quotation marks omitted). The District Court's decision is both factually and legally incorrect, and must be reversed.

I. THE DISTRICT COURT ERRED IN DEFINING CABLE ONE'S INCOME-PRODUCING ACTIVITY

Both parties agree that the first step in determining a taxpayer's income tax liability is to properly define the income-producing activity in question. Tax Commission Br. at 11; Cable One Br. at 13. The District Court erred when it determined that the income-producing activity in this case was Cable One's "attracting and servicing *Idaho* Internet access customers." (Conc. of Law 11, R. 000343 (emphasis added)). This fundamental error infects the whole of the District Court's analysis and is not supported by substantial and competent evidence. The evidence below and applicable law make it clear that Cable One's income-producing activity is properly defined as the sale of Internet access service across its entire 19-state cable television broadband network.[1]

---

[1] During 2005, the tax year at issue in this case, Cable One's operations spanned 48 cable systems in 19 states. (Joint Stip. of Exhibits and Facts, R. 000279). Cable One's operations currently consist of 45 cable systems in 18 states. For consistency, Cable One refers herein to its operations as they existed in 2005.

A. The District Court Ignored the Plain Language of the Statute and the Rules for Defining Cable One's Income-Producing Activity

Idaho law requires multistate corporations transacting business both within and without the state of Idaho to engage in allocation and apportionment. I.C. § 63-3027(b). Cable One is a multistate business and its business income is taxable both inside and outside of Idaho. Cable One's income-producing activity or separate item of income at issue here - sales of Internet access service - is "performed both in and outside" of Idaho, which triggers the requirement that Cable One conduct a cost of performance analysis pursuant I.C. § 63-3027(r)(2).

The District Court's definition of Cable One's income-producing activity does not comport with the plain language of the statute. *See, e.g., Grand Canyon Dories v. Idaho State Tax Comm'n*, 124 Idaho 1, 5, 855 P.2d 462, 466 (1993) ("Statutory interpretation always begins with an examination of the literal words of the statute. When construing a statute, we give the language contained in the statute its plain, obvious and rational meanings. Words and phrases of a statute are construed according to context.") (internal citations omitted). If Cable One's income-producing activity were limited to "attracting and servicing *Idaho* Internet access customers" as ruled by the District Court, there would be no need to engage in any analysis under I.C. § 63-3027(r). (Conc. of Law 11, R. 000343 (emphasis added)). When an "income-producing activity is performed in [Idaho]," the sales automatically are considered to be in Idaho and no further analysis is necessary. I.C. § 63-3027(r)(1). By contrast, when an "income-producing activity is performed both in and outside [Idaho]," a cost of performance analysis is required to determine whether the sales should be included in Idaho. I.C. § 63-3027(r)(2). Cable

One's multistate income-producing activity - the provision of Internet access service - is performed both inside and outside Idaho. Tr. Feb. 25/26, p. 84, lines 20-23 ("We provide the internet access services in 48 systems in 19 states, yes."); *see also* Tax Commission Br. at 4 ("In 2005, Cable One provided Internet access to customers in 19 states . . ."); Joint Stip. of Exhibits and Facts ¶ 9, R. 000280 (noting that the Network Operations Center and Solution Center support the "provision of Internet access service by all of Cable One's 48 cable systems located in the 19 states in which Cable One is authorized to operate").

The District Court's focus on "attracting and servicing Idaho Internet access customers" also conflicts with IDAPA Rule 35.01.01.550.02, which instructs that "[t]he 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." It is the taxpayer that determines its "separate item[s] of income" based on the taxpayer's specific "trade or business." IDAPA Rule 35.01.01.550.02; *see also Microsoft Corp. v. Franchise Tax Bd.*, 212 Cal. App. 4th 78, 95 (2012) (holding that "California permits the taxpayer to rely on its own accounting methods in determining its items of income"). In the regular course of its business, Cable One directly engages in transactions and activity to provide cable television services, Internet access services, advertising, and cable modem leasing for the ultimate purpose of obtaining gains or profit. Tr. Feb. 25/26, p. 40, lines 2-9; *see also* I.C. § 63-3027(a)(1) (defining "business income" as "income arising from transactions and activity in the regular course of [Cable One]'s trade or business"). As the evidence in this case demonstrates, the regular course of Cable One's

business does not include a separate income-producing activity of "attracting and servicing Idaho Internet access customers." Conc. of Law 11, R. 000343; *see also* Joint Stip. of Exhibits and Facts ¶ 9, R. 000280 (noting Cable One's "provision of Internet access service by all of Cable One's 48 cable systems located in the 19 states in which Cable One is authorized to operate").

Cable One applied the plain language of IDAPA Rule 35.01.01.550.02 to identify its income-producing activity as the provision of Internet access service across 19 states. Cable One Br. at 16. This is the same approach taken by Cable One with respect to each of its other income-producing activities to which the Tax Commission has not objected. (Tr. Feb 25/26, p. 85, lines 1-20). The key to determining the income-producing activity is to look at the "overall" activity engaged in by the taxpayer, which is consistent with the plain language of IDAPA Rule 35.01.01.550.02. The rule "addresses what income-producing activity gave rise to a receipt" because the rule focuses on "transactions and activity having an *ultimate* purpose of obtaining gain. The focus is obviously broader than the last acts taken to realize gain. . . . [G]ain was produced by a combination of activities." *Crystal Commc'ns, Inc. v. Dep't of Revenue, State,* TC 4769, 2010 WL 2827462, at *16 (Or. T.C. July 19, 2010) (emphasis in original), *aff'd sub nom. Crystal Commc'ns, Inc. v. Dep't of Revenue*, 353 Or. 300, 297 P.3d 1256 (2013). The "overall" activity at issue here is the operation of Cable One's integrated multistate cable television broadband network from its headquarters in Arizona, which makes the provision of Internet access service possible in Idaho and in every other state in which Cable One operates. Tr. Feb. 25/26, p. 269, lines 13-24; *cf. Comm'r of Revenue v. AT&T Corp.*, 2012 WL 2865870, at *1-*2 (Mass. App. Ct. July 13, 2012) ("*AT&T Massachusetts Appeal*") (finding that it was AT&T's

"operation of its global network based in New Jersey that qualified as its income-producing activity" because AT&T "could not have provided the long-distance telephone calls to its customers without the integrated long-distance network based in New Jersey and other locations"); *Detroit Lions, Inc. v. Dep't of Treasury*, 403 N.W.2d 812, 820 (Mich. Ct. App. 1986) (looking at "plaintiff's post-season revenues in 1976 through 1979, representing consideration for its overall operation of an NFL club").

The District Court also concluded 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).[2] But the District Court found application of the "transactional" approach to Cable One would be burdensome and inappropriate. (Conc. of Law 10, R. 000342). The Tax Commission similarly admits that using the "transactional" approach is not appropriate "given the facts of this case," but nonetheless argues that it should be the rule of law in Idaho for use in "a different factual circumstance." Tax Commission Br. at 12-13, n.4.[3] If

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[2] The concept of a "transactional" approach to defining Cable One's income-producing activity was raised by the Tax Commission for the first time in response to Cable One's request for review of the Notice of Deficiency Determination from which this appeal originates. (R. 000251).

[3] The Tax Commission and its witnesses abandoned their arguments in favor of a "transactional" approach early on in this litigation. *See, e.g.*, Starkey Dep. Tr. (Trial Exhibit 36)

the District Court's decision is permitted to stand, all multistate corporations with business activity in Idaho will be forced to live with this erroneous interpretation of Idaho law.

The Tax Commission's support of the "transactional" approach incorrectly applies the plain language of IDAPA Rule 35.01.01.550.02 by focusing on only four words of the rule - "separate item of income" – which the Tax Commission asserts is "each of the monthly payments received from each of the Idaho Internet access customers in 2005." Tax Commission Br. at 12. The Tax Commission cannot pick and choose pieces of the legal framework without regard for the plain language of the statute or regulation as a whole. *Clark v. Shari's Mgmt. Corp.*, 155 Idaho 576, 314 P.3d 631, 635 (2013) ("This Court is required to 'give effect to all the words and provisions of the statute so that none will be void, superfluous, or redundant.'") (citation omitted). There is nothing in Idaho law that requires Cable One to identify its income-producing activity in the manner proposed by the Tax Commission.

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at p. 38, line 19 through p. 39, line 23 ("I don't think [Cable One is] required to do it on a customer-by-customer or a . . . transaction-by-transaction basis"). The Tax Commission openly acknowledged that a transactional approach based on each Idaho customer would result in economic or administrative burdens. Fischer Dep. Tr. (Trial Exhibit 33) at p. 33, lines 8-18 (opining that direct costs should be identified "in an economically feasible manner," meaning "without an unreasonable amount of time" or "amount of expense associated with determining that cost"); Starkey 2nd Dep. Tr. (Trial Exhibit 37) at p. 14, line 21 through p. 15, line 20 (noting that grouping transactions "may be administratively expedient").

Cable One does not engage in "numerous income-producing activities . . . to ensure that each of [its] Idaho customers would make each of their monthly payments for Internet access service throughout the 2005 taxable year." Tax Commission Br. at 13. Cable One engages in business activities and transactions that enable it to provide the income-producing activity of selling Internet access services "for the ultimate purpose of obtaining gains or profit." IDAPA Rule 35.01.01.550.02. The "activities" listed by the Tax Commission (activities at Cable One's Network Operations Center and Solution Center in Arizona, activities by Cable One employees in Idaho, activities/transactions with Qwest and AT&T, and activities constructing Cable One's network) are not the income-producing activity; they are inputs necessary to provide the income-producing activity. *Crystal Commc'ns*, 2010 WL 2827462, at *16. For example, Cable One does not purchase Internet backbone services from Qwest and AT&T for the ultimate purpose of obtaining gains or profit; those services are necessary for Cable One to provide Internet access service to customers in all 48 systems in 19 states and are used to manage the cable television broadband network. (Tr. Feb. 25/26, p. 278, lines 19-23; Tr. Feb. 25/26, p. 274, lines 4-9). This is no different than Cable One's purchase of video programming in order to provide cable television services. (Tr. Feb 25/26, p. 74, lines 2-15 (explaining that one of Cable One's direct costs for cable television services is the purchase of programming such as ESPN)). Cable One's provision of cable television services to customers is the "income-producing activity," not the purchase of the programming needed to provide the cable television service. The Tax Commission's view of Cable One's income-producing activities does not comport with the plain language of IDAPA Rule 35.01.01.550.02.

The Tax Commission's position also is inconsistent with the Tax Commission's acceptance of how Cable One applies I.C. § 63-3027(r)(2) and IDAPA Rule 35.01.01.550.02 for each of its other income-producing activities. The record demonstrates that Cable One conducted the same type of cost of performance analysis for its cable television and advertising services in 2005, both of which were performed inside and outside of Idaho. (Tr. Feb. 25/26, pp. 84-86).[4] The Tax Commission has not questioned Cable One's application of Idaho law in relation to Cable One's sales of cable television service and advertising, or its leasing of cable modems. (Tr. Feb 25/26, p. 85, lines 1-20). How Cable One defines its income-producing activity under I.C. § 63-3027(r)(2) and IDAPA Rule 35.01.01.550.02 appears to be unacceptable to the Tax Commission only when it results in the exclusion of revenue despite the fact that the plain language of the statute contemplates such a result. I.C. § 63-3027(c), (r)(2).

The Tax Commission has recognized that the "income-producing activity test" found in I.C. § 63-3027(r)(2) "is one of the most troublesome aspects of the UDITPA statute" but while the test "is by no means perfect, it remains the test set out in the Idaho statute." *Protest of [Redacted],* Tax Commission Docket No. 17740, Decision at 3, 4 (Idaho State Tax Commission 2005). The Tax Commission "has the duty to enforce the tax laws of this state as written" and "[u]nless and until the Idaho Legislature implements a new test, taxpayers providing services

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[4] Cable One did not need to conduct a cost of performance analysis for its income-producing activity of cable modem leasing because that activity was performed only in Idaho. Tr. Feb. 25/26, p. 86, lines 1-12; *see also* IDAPA Rule 35.01.01.550.05.b.

within this state must comply with the current test." *Id.* The District Court erred in its conclusion that identification of the income-producing activity under IDAPA Rule 35.01.01.550.02 requires "a transactional analysis," and the Tax Commission has provided no support for that conclusion.

B. Case Law from Other Jurisdictions Demonstrates Cable One Defined Its Income-Producing Activity in the Manner Intended by the Idaho Statute and the Tax Commission's Implementing Regulations

Case law from other states further supports Cable One's application of the plain language of I.C. § 63-3027(r) and IDAPA Rule 35.01.01.550.02 to define its income-producing activity as the provision of Internet access service in 19 states. *Curlee v. Kootenai Cnty. Fire & Rescue*, 148 Idaho 391, 396, 224 P.3d 458, 463 (2008) ("When confronted with matters of first impression involving Idaho statutes, this Court may glean insight from the interpretations of sister states concerning similar or identical statutes."). Consistent with Cable One's approach here, Massachusetts defines a taxpayer's income-producing activity based on the "overall activity" or the "totality of activities" undertaken by the taxpayer. *AT&T Corp. v. Comm'r of Revenue*, 2011 WL 2243933 at *2 (Mass. App. Tx. Bd. June 8, 2011) ("*AT&T Massachusetts Board Decision*") (finding AT&T "engaged in numerous activities . . . both within and without Massachusetts that were necessary to the overall activity of operating and managing the network"); *Boston Prof. Hockey Ass'n v. Comm'r of Revenue*, 2003 WL 21499974, at *11 (Mass. App. Tx. Bd. June 30, 2003) ("*Boston Prof. Hockey Board Decision*") (finding it was "the totality of activities" that "constituted activities whose performance created an obligation in the ultimate customers to pay consideration"), *aff'd by Boston Prof. Hockey Ass'n, Inc. v.*

Comm'r of Revenue, 820 N.E.2d 792, 799 (Mass. 2005) (professional hockey team's income-producing activity was "many subsidiary activities (including the playing of games) necessary to create a viable NHL franchise"). The "activity that gives rise to [the] sales income is [the taxpayer's] overall operation of a business." *Interface Group v. Comm'r of Revenue*, 2008 WL 4642961, at *9 (Mass. App. Tx. Bd. Oct. 17, 2008). Massachusetts specifically rejected the Tax Commission's "transactional" approach by finding, for example in the *AT&T Massachusetts* case, that "each long-distance call" did not constitute the income-producing activity because "customers were actually paying for a reliable system of telecommunications, and that it was the operation of [the] global network based in New Jersey that qualified as [the] income-producing activity." *AT&T Massachusetts Appeal* at *1.

The Tax Commission tries to distinguish the Massachusetts line of cases by arguing that the Massachusetts regulation defining "income-producing activity" has "significant differences" from the Idaho definition, and that "appears" to have been the determining factor for the Massachusetts courts' findings. Tax Commission Br. at 15.[5] There is no merit to the Tax

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[5] The Tax Commission claims Cable One advocated in its brief for an "operational" approach for identifying the income-producing activity (Tax Commission Br. at 12), but there is no discussion of "operational" in Cable One's Opening Brief. Rather, Cable One asserted that the income-producing activity at issue in this case is the provision of Internet access services in 19 states, which is consistent with Cable One's own accounting practices, Idaho law, and the law of other states. Cable One Br. at 15-16.

Commission's claim. The Massachusetts regulation uses the phrase "transaction, procedure, or operation" while the Idaho regulation uses "transactions and activity." *Compare* 830 Mass. Code Regs. 63.38.1 *with* IDAPA Rule 35.01.01.550.02. With the inclusion of "activity" and "operation," both regulations use language to suggest that a taxpayer look beyond a single event or transaction to the taxpayer's total activities or operations. "Activity" and "operation" have similar meanings, the Massachusetts courts use the terms interchangeably, and there is nothing to suggest the Massachusetts regulation means something fundamentally different because it uses the word "operation" rather than "activity." *AT&T Massachusetts Board Decision* at *10 (looking at "overall activity" to find "AT&T's income-producing activity was its operation of its global network"); *Boston Prof. Hockey Board Decision* at *5, *11 (looking at "the totality of activities" to determine the "income-producing activity was the ownership and operation of an NHL franchise").

The Massachusetts line of cases is consistent with several similar cases from Michigan, which the Tax Commission neglects to address at all. *See, e.g.*, *Detroit Lions, Inc.*, 403 N.W.2d at 820-21 ("In defining the term 'business activity,' M.C.L. § 208.3(2) refers specifically to the activity of the *taxpayer,* and thus we agree that the proper focus is not on whether the Lions themselves played in post-season games, but on the activity which gave rise to their entitlement to post-season revenue. This revenue was earned through the 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.") (emphasis in original); *Michiana Metronet, Inc. v. Michigan Dep't of Treasury*, 2011 WL 3890444, at *5 (Mich. Tax Trib. Aug. 11, 2011) (finding that the

"business activity" at issue is "providing an integrated wireless communications network that allows for the routing and completion of wireless communication transmissions including voice calls, text messages, data, and other associated services") ("*Michiana Tribunal Decision*"), *aff'd by Michiana Metronet, Inc. v. Dep't of Treasury*, 2012 WL 5854453, at *3 (Mich. Ct. App. Nov. 8, 2012). The cost of performance statute in Michigan uses the term "business activity" instead of "income-producing activity," and defines "business activity" based on the "activity of the taxpayer" similar to the Idaho regulation. *Compare* Mich. Comp. Laws § 208.3(2) (defining "business activity") *with* IDAPA 35.01.01.550.02. The Michigan decisions view income-producing activity in the same way as the Massachusetts courts despite the fact that the Michigan definition of "business activity" contains no reference to the word "operation."[6] These cases

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[6] "Business activity" is defined as: "a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction. Although an activity of a taxpayer may be incidental to another or other of his business activities, each activity shall be considered to be business engaged in within the meaning of this act." Mich. Comp. Laws § 208.3(2).

provide further support for defining Cable One's income-producing activity as the provision of Internet access service in 19 states.

II. THE DISTRICT COURT'S DECISION FAILED TO PROPERLY ANALYZE CABLE ONE'S DIRECT COSTS OF PROVIDING INTERNET ACCESS SERVICE

Once the income-producing activity is defined, both parties agree that the second step in an analysis under I.C. § 63-3027(r)(2) is to "[i]dentify the direct costs of performing the income-producing activity." Tax Commission Br. at 11; *see also* Cable One Br. at 13 (stating the second step is "identification of the costs of performance of that income-producing activity using a direct costs analysis"). As the Tax Commission previously has observed, "[u]nder Idaho law, the focus of the 'income-producing activity' inquiry is on the direct costs associated with the generation of the income in the taxpayer's regular course of business. Indirect costs relating to the generation of the income, such as compensation paid to officers and directors and other general and administrative costs, are not considered." *Protest of [Redacted],* Tax Commission Docket No. 17740, Decision at 5 (Idaho State Tax Commission 2005). The issue of "what are the direct costs" was a key "factual question" before the Court in this case. (Tr. Feb. 25/26, p. 52, lines 18-22).

Cable One looked to its profit and loss statements to determine the direct costs for producing its Internet access service income. (Tr. Feb. 25/26, p. 88, lines 19-23). IDAPA Rule 35.01.01.550.03 states that direct costs are to be determined "according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business." Consistent with the requirements of the rule, Cable One's profit and loss statements were

prepared according to generally accepted accounting principles and also were "prepared according to the accepted conditions or practices of Cable One's business." (Tr. Feb. 25/26, p. 44, lines 2-23). Cable One's profit and loss statements provide an "objective standard or set of standards for determining direct costs" as they are generated as part of "a financial accounting or externally focused process" and thus can be viewed as "a generally accepted accounting principle or industry wide practice." *AT&T Corp. v. Dep't of Revenue*, 2012 WL 119850, at *6 (Or. T.C. Jan. 12, 2012) ("*AT&T Oregon*"); *see also Microsoft Corp. v. Franchise Tax Bd.*, 212 Cal. App. 4th 78, 95 (2012) (citing to California's "costs of performance" definition in finding that "California permits the taxpayer to rely on its own accounting methods in determining its items of income").[7]

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[7] The Tax Commission takes issue with Cable One's reliance on the *Microsoft* case for the proposition that a taxpayer may rely on its own accounting methods in determining its direct costs. Tax Commission Br. at 20-21. Cable One understands that identifying "items of income" (*i.e.*, income-producing activities) is a separate step from identifying "costs of performance" (*i.e.*, direct costs). *See, e.g.*, Cable One Br. at 13. While the *Microsoft* court may have referenced "items of income," its intent is clear as reflected by its citation to the California rule defining "costs of performance." Cal. Code Regs. tit. 18, § 25136(c) (2005) ("The term 'costs of performance' means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer."). California's definition of "costs of performance" is nearly identical

IDAPA Rule 35.01.01.550.03 requires that only "direct costs" be considered when determining costs of performance. The District Court failed to engage in any legal or factual analysis to distinguish between direct and indirect costs associated with Cable One's Internet access service. The District Court was not excused from conducting this analysis because the parties stipulated to certain of Cable One's direct costs associated with its Internet access service. *Cf.* Tax Commission Br. at 19. The District Court was required to determine whether the costs were direct or indirect for any Cable One costs that were not stipulated to by the parties before including such costs in the costs of performance of Cable One's Internet access service. Cable One Br. at 20-21; *see also* IDAPA Rule 35.01.01.550.03.

Instead, without substantial and competent evidence, the District Court found that "direct costs include the costs incurred by Cable One in providing internet services to its Idaho customers." (Conc. of Law 9, R. 000342). This conclusion ignores the law requiring costs of performance to focus on direct costs only and is tantamount to interpreting "direct costs" to "swallow so many costs that 'direct costs' becomes virtually synonymous with 'all costs.'" *AT&T Oregon* at *6; *see also* IDAPA Rule 35.01.01.550.03 ("Costs of performance are the direct costs. . . ."). Direct costs cannot mean the same as the costs "incurred to engage in the general business activity." *AT&T Oregon* at *6; *see also Illuminating Co. v. Burns*, 2014 WL 585254, at *1 (Ohio Ct. App. Feb. 13, 2014) (finding that direct costs for purposes of calculating damages "are the expenses incurred as a result of the actual project and include materials, labor,

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to the one contained in Idaho's regulations. IDAPA 35.01.01.550.03.

mileage, and equipment costs" while indirect costs "are the expenses involved in running a business and are not attributable to any one project") (citations omitted).

The District Court's error was compounded further by its conclusion that "[a]llocated capitol [sic] improvement costs" should be included as a direct cost in Cable One's cost of performance analysis. (Conc. of Law 13, R. 000343). There is no legal or factual support for including capital costs or depreciation associated with Cable One's cable television broadband network as "direct costs" of providing Internet access service.[8] None of those costs were incurred specifically to provide Internet access service, and Cable One would have incurred those costs if Cable One did not offer Internet access service. (Tr. Feb. 25/26, p. 200, lines 17-23; Tr. Feb. 25/26, p. 201, lines 11-19). Cable One excluded capital costs and depreciation from its cost of performance analysis because those costs were not incurred only "because the revenue producing transaction or activity in question occurred." *AT&T Oregon* at *5; *see also* Feb. 25/26, p. 108, lines 21-25, p. 109, lines 1-25. Based on "generally accepted accounting principles and accepted conditions or practices" of Cable One's business and as directed by the applicable IDAPA rule, Cable One excluded capital costs and depreciation associated with its

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[8] The District Court's decision to utilize Cable One's 2005 qualified Broadband Tax Credit as a proxy for capitalized costs and depreciation also is not supported by substantial and competent evidence, and is unprecedented. (Conc. of Law 12, R. 000343). Idaho's Broadband Tax Credit regime is irrelevant to the questions posed here. I.C. § 63-3029I; *see also* Cable One Br. at 22-23.

cable television broadband network from its costs of performance of its Internet access service because they are not "direct costs" of that service. The District Court's conclusion is contrary to law and the record evidence, and if upheld, would affect all multistate corporations operating in Idaho.

The Tax Commission recognizes the inclusion or exclusion of capital costs and depreciation as direct costs is "inconsequential" to Cable One's cost of performance analysis, but nonetheless argues for their inclusion. Tax Commission Br. at 19. The Tax Commission offers no legal or factual basis for treating capital costs or depreciation as direct costs. The Tax Commission's own witness explained that costs relating to equipment and facilities not specifically installed and utilized exclusively for Internet access service do not constitute direct costs. *See, e.g.*, Fischer Dep. Tr. (Trial Exhibit 33) at p.42, line 10 through p. 43, line 24. The Tax Commission also agreed that depreciation is not always considered a direct cost, and that Cable One would still incur depreciation even if Cable One did not offer Internet access service. *See, e.g.*, Fischer Dep. Tr. (Trial Exhibit 33) at p. 52, lines 18-25; p. 53, lines 1-16; Starkey 2nd Dep. Tr. (Trial Exhibit 37) at p. 66, line 22 through p. 68, line 21. Tax Commission witness Starkey took this same position in the *AT&T Oregon* case. *See, e.g.*, *AT&T Oregon* at *5 (adopting the testimony of the expert witnesses in the case, including Tax Commission witness Starkey, "that direct costs are those that are only incurred because the revenue producing transaction or activity in question occurred"). There is no basis for including capital costs or depreciation as direct costs because the substantial evidence in this case demonstrates that the "assets in place and the depreciation on those would be incurred regardless of whether" the

income-producing activity (Internet access service) was offered to customers or not. *AT&T Oregon* at n.7; Hannan Dep. Tr. (Trial Exhibit 26) at p. 18, lines 5-23, p. 21, line 19 through p. 22, line 24; *see also* Starkey 2nd Dep. Tr. (Trial Exhibit 37) at p. 60, lines 10-18.

III. THE DISTRICT COURT FAILED TO PROPERLY IDENTIFY THE LOCATION OF CABLE ONE'S DIRECT COSTS

A. The Internet Backbone Services Are Arizona Costs Based on the Totality of Cable One's Activities to Provide Internet Access Service in 19 States

The Qwest and AT&T Internet backbone service costs are properly sourced to Arizona because they are costs associated with the operation of Cable One's entire cable television broadband network, which is centrally managed from Arizona. *Cf. AT&T Massachusetts Board Decision* at *10 ("Simply put, AT&T could not provide its long-distance service without operating its entire long-distance network."). Cable One realizes income from its provision of Internet access service only by virtue of its cable systems' connection to Arizona and Cable One's cable television broadband network as a whole. Tr. Feb. 25/26, p. 269, lines 13-24 (explaining how Cable One could not offer service without a connection to Arizona); *see also Detroit Lions,* 403 N.W.2d at 820-21 (finding football team earned revenue "through the plaintiff's membership in the NFL and its performance of duties which arise from that membership," and thus costs were measured not on the basis of each game, but on plaintiff's overall operation as an NFL club). This is similar to the *Michiana* case, in which a wireless carrier had "network assets" in both Indiana and Michigan, and those network assets were necessary for the carrier to provide service. Applying costs of performance, the majority of the carrier's costs were determined to be in Indiana because it was where "the infrastructure that

provided services such as internet access, e-mail delivery, billing, text messaging, and other services" was located. *Michiana Tribunal Decision* at *4. In reviewing the taxpayer's costs of performance determination, the Michigan courts looked at the entire "integrated wireless communication network" used by the carrier because the "entire wireless network, located in both Indiana and Michigan, was necessary for Petitioner to provide its services." *Michiana Tribunal Decision* at *5. Cable One cannot provide Internet access service in any location without access to its infrastructure in Arizona, which includes its Solution Center, Network Operations Center, provisioning module, LDAP module, SNMP module, DHCP module, TFTP module, DNS Module, billing module, and customer email module. (Findings of Fact 15, R. 000336-38; *see also* Tr. Feb. 25/26, p. 266 line 23 through p. 267, line 6). Cable One connects its entire cable television broadband network to Arizona using the Qwest and AT&T backbone services; the backbone services are a necessary component of the overall operation that is needed to provide Internet access service. *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).

Cable One's Arizona headquarters are essential to its Internet access service and cannot be ignored. *Cf. AT&T Massachusetts Board Decision* at *11 ("Just as it has recognized the importance of a taxpayer's Massachusetts headquarters, the Board here must equally recognize the importance of AT&T's centralized network hub, which was located outside of Massachusetts."); *see also AT&T Massachusetts Appeal* at *2 (stressing "the importance of the activities that took place at the headquarters of the company"). The District Court recognized

that "the personnel, staff, servers, equipment and software that support the operations of [Cable One's] cable systems" were "[l]ocated at Cable One's Phoenix, Arizona headquarters," and that those Arizona operations "support the internet services provided by Cable One through its 48 cable systems." (Finding of Fact 6, R. 000333). Similarly, Cable One employees located in Arizona negotiate, centrally manage, and oversee the purchase, implementation, billing, and payment relating to the backbone services contracts. *See, e.g.*, Tr. Feb. 25/26, p. 270, lines 3-16; p. 273, lines 16-23; p. 281, lines 4-13; p. 280, lines 4-13; p. 282, lines 9-11; *see also* Aff. of Bradley D. Ottley ¶¶ 13-15, R. 000163-64.[9] The importance of the activities taking place at Cable One's Arizona headquarters to the overall operation of Cable One's cable television broadband network and its Internet access service cannot be overlooked. *Boston Prof. Hockey Board Decision* at *3 (finding activities performed in Massachusetts because general manager maintained an office in Massachusetts and "negotiated contracts" from that office); *Boston Prof. Hockey*, 820 N.E.2d at 799, 800-01 (affirming importance of where "activities" took place, including where the NHL franchise was "administered and managed"); *AT&T Massachusetts Board Decision* at *11 ("[W]hile AT&T engaged in numerous subsidiary activities, both within and outside Massachusetts, that were an essential part of its income-producing activity, it provided ample evidence establishing the importance of the activities performed at its Global Network Operations Center, where employees operated and managed a network capable of routing and re-routing each transmission in order to ensure its successful completion."). There is no Internet access service (income-producing activity) to Cable One customers anywhere

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[9] Mr. Ottley's Affidavit was also used as Trial Exhibit 31.

without the connection between the cable systems in the 19 states and the Cable One Arizona headquarters. This connection is only possible by virtue of Cable One's agreements with Qwest and AT&T for interstate communications services.

B. The Internet Backbone Services Are Arizona Costs Based on Record Evidence and Legal Precedent

The District Court's decision that the costs related to the Internet backbone services Cable One purchases from Qwest and AT&T were incurred by Cable One in Idaho is contrary to substantial and competent record evidence and well-established law. (Findings of Fact 14(f), 25, R. 000336, 339). The importance of the Internet backbone services to Cable One's overall operation of its cable television broadband network from its Arizona headquarters is not at issue. (Findings of Fact 6, 15, R. 000333, 336 (listing the "Internet Backbone" as part of "Cable One's Arizona Back Office" and explaining "Located at Cable One's Phoenix, Arizona headquarters are the personnel, staff, servers, equipment and software that support the operations of its 48 cable systems. Within the headquarters is the 'Arizona back office' that consists of the Solution Center and Network Operations Center personnel, the router, servers and related equipment and software that support the internet services provided by Cable One through its 48 cable systems")). Yet both the District Court and the Tax Commission erroneously characterize the costs of the Internet backbone services as "Idaho" costs rather than costs incurred by Cable One in Arizona. There is no support for this position. The evidence of this case and applicable law demonstrate that Cable One properly categorized its Internet backbone costs for the Qwest and AT&T services as costs incurred in Arizona.

First, the services provided by Qwest and AT&T do not "involve two distinct services." (Finding of Fact 14(f), R. 000336; Tax Commission Br. at 25-26). The contracts for services do not permit Cable One to purchase a "local service connection" from Qwest or AT&T as a separate service as Cable One's witness explained: "It clearly states on page one of the contract, local access may only be purchased if also purchasing at least one of the following: Voice and data, DIA, dedicated internet access, dedicated IP transit and/or private routed network services. In our case DIA." (Tr. Feb. 25/26, p. 274, lines 4-9; p. 277, lines 22-25; p. 276, lines 1-6). All of those services are interstate long distance services. (Tr. Feb 27, p. 57, line 22 through p. 58, line 12 ("What it does tell me is that the FCC considers this service to be an interstate service. There is no way around that. And it does that because there is this whole other body of law of the FCC about Internet service and high-speed data service services. . . . the FCC . . . took primary jurisdiction of traffic that travels to the Internet under the notion that you can't tell where it's going to go, whether it's going to cross state boundaries or anything else.")). Both carrier contracts state that the local access service may only be purchased in connection with the customer's use of the carrier's long distance network services or IP services for which a local connection is required. *See*, *e.g.*, Qwest Agreement, Local Access Service Exhibit (Trial Exhibit 28) at 10 (section 4.1) ("Customer may purchase the Service only in connection with Customer's use of Qwest Interexchange carrier services or IP services on the Qwest Domestic Network for which a local loop is required."); Qwest Agreement (Trial Exhibit 28) at 1, 2 (stating the services are available in all states in which Qwest operates and noting that local access service may be purchased only if Cable One also purchases at least one other interstate service, which includes

dedicated Internet access service); AT&T Agreement, Global Addendum to Master Agreement (Trial Exhibit 29) (stating that services are to be delivered in the United States); AT&T Agreement, AT&T Managed Internet Service Addendum (Trial Exhibit 29) at 1, ¶ 5 (stating that the prices are "solely for Internet port bandwidth" and do not include local access charges that may be associated with the service). The Qwest and AT&T agreements provide an interstate communication service made available by combining several Qwest and AT&T products, including a local access element. The local access element is a small part of the overall long distance service ultimately sold to Cable One, which allows Cable One to connect its cable systems in 19 states to its Arizona headquarters and the Arizona headquarters to connect the customers of those 48 cable systems to the Internet. Aff. of Bradley D. Ottley ¶ 10, R. 000162; *see also Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 990 (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.").

Second, Qwest and AT&T are not providing Cable One with "a dedicated high-speed network connection to the Internet." Tax Commission Br. at 26. Cable One is "purchasing backbone services to obtain bandwidth to be able to communicate in Idaho with the router that's in Idaho across the Qwest or AT&T network to the route[r] in Cable One in Phoenix." (Tr. Feb. 25/26, p. 304, lines 18-22). Each of the headends in Cable One's cable television broadband network has one or more dedicated Internet access ports (with different bandwidth levels depending on the port), and each of those ports connects to similar dedicated Internet access

ports at Cable One's Arizona headquarters. (Tr. Feb. 25/26, p. 324, lines 2-25; p. 325, lines 1-16). The Qwest and AT&T services are end-to-end services. Cable One has "created a tunnel or a virtual private line between the [Cable One] router in Idaho to Cable One Phoenix" and uses "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 is a "dedicated" service, which is a point-to-point service in which Cable One determines the end points as Tax Commission witness Starkey admitted: "Mr. Ottley [Cable One's witness] described it correctly as a tunnel. . . Cable One would set that up between its two routers, this router at the headend, and then its router in Arizona and use its management system to define that virtual private network between those two facilities." (Tr. Feb. 27, p. 99, lines 1-2, 17-21). The Tax Commission's witness specifically rejected the notion that the traffic is "just being thrown out on the Internet [to] let it find its way any way it wants to get there" based on the understanding that Cable One was "defin[ing] a certain route, if you will, a logical route, that the traffic will take between two points." (Tr. Feb. 27, p. 99, lines 3-5, 13-15). The routing, as defined by Cable One using the Internet backbone services, ensures a repeated and continuous interface with Cable One's Arizona headquarters in order for Cable One's customers to use the Internet access service. (Tr. Feb. 25/26, p. 266, line 23 through p. 267, line 6).

Third, Qwest and AT&T do not provide services to Cable One by "physically providing and maintaining in Idaho the 'Idaho backbone services' for each Idaho cable system" or to Cable One "at Cable One's Idaho headend facilities." (Finding of Fact 25, R. 000339; Tax Commission Br. at 27). The backbone services purchased from Qwest/AT&T would be useless

if those services were not connected to Cable One's Arizona headquarters. (Tr. Feb. 25/26, p. 278, lines 3-14). A service always has both an origination and termination point. This concept is reflected on a typical phone bill, which provides the charges for the entire end-to-end phone call (Boise to San Francisco), and the originating and terminating points of the call. The charge to the customer for a call is based on the complete end-to-end service, not one charge for the Idaho end of the call and a separate charge for the San Francisco end of the call. Cable One's purchase of backbone services from Qwest and AT&T works in the same way. The Tax Commission's focus on only the Idaho portion of the backbone services (Tax Commission Br. at 26-27) ignores the reality of the backbone service being purchased by Cable One - an end-to-end service between each of Cable One's 48 headends and Cable One's Arizona headquarters. *Teleconnect Co. v. The Bell Tel. Co. of Penn., et al.,* 10 F.C.C.R. 1626, ¶ 12 (1995) (focusing on "the end-to-end nature" of a service or "the nature of the communications" rather than "the facilities used to complete such communications") (citing *Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC,* 746 F.2d 1492, 1498 (D.C. Cir. 1984)) (subsequent history omitted).

Fourth, the facilities used and the path chosen by Qwest and AT&T does not change the fact that Cable One purchases and utilizes the Internet backbone services for all of its 48 cable systems throughout 19 states. *Cf.* Tax Commission Br. at 23-24; *see also GTE Telephone Operating Cos. GTOC Tariff No. 1 GTOC Transmittal No. 1148,* 13 F.C.C.R. 22466, ¶ 19 (1998) (finding the "fact that the facilities and apparatus used for [a] service offering may be located within a single state does not affect [the] jurisdiction" of the service), *recon. denied*, 17 F.C.C.R.

27409 (1999).[10] The record evidence demonstrates that the Qwest and AT&T contracts cover the provision of services to all Cable One systems in its multistate service territory under a single contract with each carrier. (Tr. Feb. 25/26, p. 274, lines 4-9; p. 277, lines 22-25; p. 278, lines 1-6). The contracts are multiyear agreements with discounts, revenue commitments, and shortfall liabilities applied based on Cable One's total purchase of services for connection with all Cable One systems under a single carrier agreement. (Tr. Feb 25/26, pp. 275-76). The contracts are negotiated, managed, and services are paid for by the Arizona headquarters. *See, e.g.*, Tr. Feb. 25/26, p. 270, lines 3-16; p. 273, lines 16-23; p. 281, lines 4-13; p. 282, lines 9-11; *see also* Aff. of Bradley D. Ottley ¶¶ 13-15, R. 000163-64. There is no question that activities occurring at Cable One's Arizona headquarters, including the purchase of the Internet backbone services, "support the internet services provided by Cable One through its 48 cable systems." (Finding of Fact 6, R. 000333).

Finally, the Qwest and AT&T services cannot be divorced from their legal and regulatory treatment. The Internet backbone services provided by Qwest and AT&T are interstate services. Tr. Feb. 25/26, p. 274, lines 10-20 (explaining that the backbone services traverse state lines as

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10 This is because "the path taken by the electronic signals is often indirect and typically bears no relation to state boundaries. The number of possible paths, the nature of the electronic signals, and the system of computerized switching make it virtually impossible to trace and record the actual paths taken by the electronic signals." *Goldberg v. Sweet,* 488 U.S. 252, 255 (1989).

they permit "communication from the router in Idaho to the router in Phoenix by way of the Qwest or AT&T network"); *see also* 47 U.S.C. § 153(28) (defining "interstate communication" or "interstate transmission"); 47 C.F.R. § 36.154(a) (stating that if greater than 10% of the traffic across a circuit is interstate, all of the traffic is classified as interstate). Qwest and AT&T consider the backbone services Cable One purchases to be interstate services. *See* Aff. of Bradley D. Ottley ¶ 17, R. 000165; *see also* Qwest Agreement (Trial Exhibit 28) at 10 (requiring Qwest's service to be used for interstate purposes). Even the Tax Commission admits that the backbone services are interstate services. (Tr. Feb. 27, p. 57, lines 22-24). The Idaho portion of the backbone services is only "an intrastate strand of an interstate service." *In re Frontline Communications Corp.*, 2006 WL 776281, at *10 (N.Y. Tax App. Trib. Mar. 16, 2006). While there may be intrastate components as part of an overall interstate service offered by an entity, that service should be characterized "by reference to the nature of the data traffic carried over the provided lines and the destination of those communications." *In re Fastnet Corporation*, 2006 WL 776280, at *13 (N.Y. Tax App. Trib. Mar. 16, 2006); *see also Nat'l Ass'n of Regulatory Util. Comm'rs*, 746 F.2d at 1498 (finding the jurisdiction of a service "depends on 'the nature of the communications which pass through the facilities [and not on] the physical location of the lines'") (quoting *California v. FCC*, 567 F.2d 84, 86 (D.C. Cir. 1977)). Focusing on the physical location of equipment owned by another company from which Cable One purchases services "ignore[s] altogether the actual uses" of the Internet backbone services. *Smith v. Ill. Bell Tel. Co.*, 282 U.S. 133, 150-51 (1930); *see also Moran Towing and Transp. Co. v. New York State Tax Comm'n*, 72 N.Y.2d 166, 171 (1988) ("The focus is on what the actor does, not where he

does it.").

To source the costs relating to the Internet backbone services to Idaho because Qwest and AT&T utilize facilities that may have physical intermediate points in Idaho ignores the reality of the services purchased by Cable One and the purpose for which they are purchased. The backbone services are used to connect each of Cable One's 48 cable systems to Arizona and to each other, are an integral component to Cable One's provision of services to customers (including Internet access service), are purchased pursuant to a single contract with each carrier that covers all of the states in which Cable One operates, and are negotiated and managed from Arizona. The backbone services are a necessary component of Cable One's overall operation of its nationwide cable television broadband network, which is centrally managed from Arizona. The costs associated with the Internet backbone services should be treated as Arizona costs based on the totality of the circumstances. *See, e.g., AT&T Massachusetts Board Decision* at *11; *AT&T Massachusetts Appeal* at *1-*2; *Detroit Lions,* 403 N.W.2d at 820-21; *Michiana Tribunal Decision* at *4-*5.

IV. FAIRNESS CONSIDERATIONS AND ALTERNATIVE ALLOCATION AND APPORTIONMENT ARE NOT APPROPRIATE IN THIS CASE

A. The District Court Erred in Its Reliance on the "Fairly Represents" Standard to Review Cable One's Compliance with the Standard Allocation and Apportionment under § 63-3027(r)

The District Court correctly concluded that this case involves "calculation of the sales factor" under I.C. § 63-3027(r)(2) and the Commission's implementing rules, and thus it would be "unnecessary and improper" to make any findings regarding "an alternate allocation and apportionment under I.C. § 63-3027(s)." (Conc. of Law 5, 6, 21, R. 000342, 345). The District

Court's conclusion is consistent with the Supreme Court's determination that there is "a very strong presumption in favor of the normal three-factor apportionment and against the applicability of" alternative allocation and apportionment. *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 576, 83 P.3d 116, 120 (2004); *see also Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983) (finding the statutory three-factor formula "has become . . . something of a benchmark against which other apportionment formulas are judged").

The District Court, however, is not permitted to make determinations regarding Cable One's compliance with I.C. § 63-3027(r)(2) based on "fairness." Section 63-3027(r)(2) makes no reference to what might "fairly represent" the extent of a taxpayer's business in Idaho, and courts must implement the law as written. *See, e.g., Idaho State Tax Comm'n v. Haener Bros.*, 121 Idaho 741, 743, 828 P.2d 304, 306 (1992); *Bogner v. State Dep't of Revenue and Taxation, State Tax Comm'n*, 107 Idaho 854, 856, 693 P.2d 1056, 1058 (1984); *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.").

Despite this, the District Court determined that excluding Cable One's Internet access service revenues from the calculation of its Idaho sales factor did "not fairly represent the extent of Cable One's 2005 business activity in Idaho." (Conc. of Law 19, R. 000344).[11] The normal

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[11] Section 63-3027(s) does establish a "fairly represents" standard for reviewing whether alternative allocation and apportionment may be applied when the standard allocation and

three-factor apportionment standard under I.C. § 63-3027(r) for reporting multistate corporation income does not hinge on whether the exclusion or inclusion of the revenue will produce a result that "fairly represents" the taxpayer's business activity in the state. The sole consideration for determining inclusion or exclusion of revenue under I.C. § 63-3027(r)(2) is whether "a greater proportion of the income-producing activity is performed in [Idaho] than in any other state, based on costs of performance." I.C. § 63-3027(r)(2). The Tax Commission itself admits that the "fairly represents" standard is found only in I.C. § 63-3027(s) governing alternative allocation and apportionment. Tax Commission Br. at 29. The District Court's reliance on the "fairly represents" standard to conclude that Cable One improperly excluded its Internet access service sales is contrary to the plain language of the statute and constitutes an error of law. I.C. § 63-3027(r)(2); *see also Grand Canyon Dories v. Idaho State Tax Comm'n*, 124 Idaho 1, 5, 855 P.2d 462, 466 (1993) ("Statutory interpretation always begins with an examination of the literal words of the statute."); *Union Pacific*, 139 Idaho at 576, 83 P.3d at 120 ("There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of the relief provisions.").

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apportionment provisions of I.C. § 63-3027(r) do not fairly represent the extent of the taxpayer's business in this state. *See generally Union Pacific.* The District Court, however, correctly concluded that alternative allocation under I.C. § 63-3027(s) would be improper in this case. (Conc. of Law 19, R. 000344). Thus, the "fairly represents" standard has no application.

B. The Tax Commission Has Not Met Its Burden to Apply Alternative Allocation and Apportionment to Cable One

The Tax Commission completely fails to address the very strong presumption in favor of the use of the standard allocation and apportionment formula and against alternative allocation and apportionment. The Tax Commission's brief is replete with references to the *****START CONFIDENTIAL***** [redacted] *****END CONFIDENTIAL***** of sales revenue at issue in this case as evidence that an alternative allocation and apportionment should be applied to Cable One. *See, e.g.*, Tax Commission Br. at 29, 30, 31, 35, 37. The amount of sales Cable One generates is not a permissible reason to deviate from the strong presumption in favor of the standard three-factor apportionment formula. Any consideration of alternative allocation and apportionment must be based on Cable One's overall allocation and apportionment because "[d]istortion in one factor. . . does not necessarily result in unfair reflection of the business activity in the state." *Union Pacific*, 139 Idaho at 577, 83 P.3d at 121 ("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.") (emphasis added); *Twentieth Century-Fox Film Corp. v. Dep't of Revenue*, 700 P.2d 1035, 1043 (Or. 1985) (the "department must show not just that one factor fails to meet this standard, but the entire formula taken together does not fairly reflect taxpayer's business activity").

This fundamental flaw in the Tax Commission's analysis cannot be understated. Under the Supreme Court's controlling *Union Pacific* precedent, the Tax Commission "must show that the three-part formula does not accurately reflect the taxpayer's business in the State." *Union*

Pacific, 139 Idaho at 575, 83 P.3d at 119; *see also Twentieth Century-Fox*, 700 P.2d at 1042 ("department must demonstrate that the statutory formula as a whole does not 'fairly represent the extent of the taxpayer's business activity in this state'") (internal quotations omitted). "Merely because the use of an alternative form of computation produces a higher business activity attributable 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. July 28, 2008) (internal citations and quotation marks omitted); *see also US Bancorp v. Dep't of Revenue*, 19 Or. Tax 266, 310-11 (Or. T.C. 2007) (dismissing Department of Revenue's claim that it may "require an adjustment whenever it decides that the adjustment would render the taxpayer's return more fair and accurate" as "completely unsupported" since "[c]ourts have long recognized that apportionment is not an exact science; kicking the ball through the uprights is all that is needed, not a shot through a bulls-eye"). The Tax Commission must "establish[] 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 121 (emphasis added); *see also Twentieth Century-Fox*, 700 P.2d at 1042 (same).[12]

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[12] Cable One's 2005 income tax return is not "an inaccurate reflection" of Cable One's sales in Idaho because Cable One failed to apply costs of performance in the years between 2001 and 2004. *Cf.* Tax Commission Br. at 36 (citing *Union Pacific*, 139 Idaho at 578, 83 P.3d at 122). Determining the proper tax treatment of Cable One's sales under Idaho law for tax year 2005, including the applicability of alternative apportionment, does not depend on Cable One's

The Tax Commission has made no such showing here. The Tax Commission fails to mention the *****START CONFIDENTIAL***** ████ *****END CONFIDENTIAL***** in sales revenue that was included in Cable One's sales factor numerator (and is not at issue here),[13] or the existence of the undisputed payroll and property factors. (Joint Stip. of Exhibits and Facts ¶ 17, R. 000282). When viewed in totality as required under *Union Pacific*, over *****START CONFIDENTIAL***** ██ *****END CONFIDENTIAL***** of Cable One's 2005 total income tax obligation to the State of Idaho is undisputed by the parties. The Tax Commission's focus on such a small portion of Cable One's overall income tax liability does not begin to justify application of an alternative allocation and apportionment method here. *Union Pacific,* 139 Idaho at 578, 83 P.3d at 122 ("What must be shown is sufficient distortion that [taxpayer's] business activity in the state is not fairly reflected; simply advocating a better method than the standard formula is unavailing") (citation and internal quotation marks omitted). Exclusion of Cable One's Internet access service revenue in the Idaho sales factor numerator does not create a "sufficient distortion" from Cable One's tax return as filed to warrant deviation from the "very strong presumption in favor of the normal three-factor apportionment." *Union Pacific*, 139 Idaho at 576, 83 P.3d at 120; *see also Container Corp of Am. v. Franchise Tax Bd.*,

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historical income tax practices. Cable One Br. at n.7.

[13] Cable One included the revenues from its cable television services, advertising services, and cable modem leasing in the Idaho sales factor numerator of its Idaho income tax return for 2005. (Tr. Feb. 25/26, p. 84, line 24 through p. 86, line 12).

463 U.S. 159, 184 (1983) (finding a difference of 14% between the standard statutory formula and the alternative method did not provide sufficient distortion to pose a constitutional problem); *AT&T Teleholdings, Inc. v. Dep't of Revenue,* 978 N.E.2d 371, 385 (Ill. App. Ct. 2012) (rejecting alternative apportionment where difference in percentages was 26%); *BellSouth Adver. & Pub. Corp. v. Chumley*, 308 S.W.3d 350, 365 (Tenn. Ct. App. 2009) (upholding alternative apportionment where the distortion was close to 97%); *Tesoro Corp. v. State of Alaska Dept. of Revenue*, 312 P.3d 830, 847 (Alaska 2013) ("As we have stated in the past, [i]nherent 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).

The Tax Commission tries to support its alternative allocation and apportionment request by proffering testimony from its expert witness Mr. Peters regarding the "desire" for the sales factor to "represent the market state." Tax Commission Br. at 34.[14] Mr. Peters' opinion, however, is the exact type of analysis discredited by *Union Pacific* because it is focused solely

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[14] Mr. Peters was retained as a witness only to address whether "the allocation and apportionment provisions of section 63-3027, Idaho Code, as construed and applied by Cable One, fairly represents the extent of its business activity in Idaho and whether Cable One has correctly defined the relevant Income producing activity." Peters Expert Report (Trial Exhibit 39) at p. 1. Yet as Mr. Peters admitted, he did not undertake any analysis of Cable One's revenues and expenses or its profit and loss statements or its depreciation schedules before forming his opinions. (Tr. Feb. 27, p. 128, lines 16-21).

on Cable One's income earned in the state. Tr. Feb. 27, p. 129, lines 9-18; Peters Expert Report (Trial Exhibit 39) at 5; Tr. Feb. 27, p. 123, 1-10 (stating that Mr. Peters solely considered the income earned by Cable One in the Idaho "market"); *see also Union Pacific*, 139 Idaho at 577, 83 P.3d at 121 ("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.").

The crux of Mr. Peters' opinion is that the law is flawed. (Tr. Feb. 27, p. 132, lines 13-24). When asked whether he was "opining on whether Cable One has interpreted the Idaho State tax statute correctly," Mr. Peters conceded "I am not. They may be doing it correctly, they may be doing it incorrectly. My argument is that it comes out to a bad result. . . . My argument is more with the statute than it is than [sic] anything else." *Id.* The Tax Commission presented no other witnesses or evidence to support a finding that Cable One's income as reported did not fairly represent its business activity in Idaho for tax year 2005. The testimony of Mr. Peters is not adequate to meet the Tax Commission's high "burden of showing that alternative apportionment is appropriate." *Union Pacific*, 139 Idaho at 575, 83 P.3d at 119 (citations omitted).

Cable One's application of the standard three-factor formula is not "unusual" because it allows Cable One to exclude some of its sales revenue from the sales factor numerator. *Cf.* Tax Commission Br. at 38. Nor does Cable One's approach result in "a zero sales factor." *Cf.* Tax Commission Br. at 38. As explained above, Cable One reported *****START CONFIDENTIAL***** [REDACTED] *****END CONFIDENTIAL**** in sales revenue for its

Idaho sales factor numerator. (Joint Stip. of Exhibits and Facts ¶ 17, R. 000282). While Mr. Peters would be "embarrassed" to exclude revenues from the sales factor numerator (Tax Commission Br. at 38), the exclusion of revenue is the very result contemplated by the statute and endorsed by numerous cases in which the taxpayer did exactly that. *See* I.C. § 63-3027(r); *see also, e.g., AT&T Massachusetts Board Decision* at *14 (where the majority of costs of performance were incurred in the state from which a multistate infrastructure was managed, court held sales were properly excluded from the sales factor numerator of the market state where the customers resided); *Michiana*, 2012 WL 5854453, at *5 (same). According to I. C. § 63-3027(r), sales are either deemed "in this state" or not. The result is all or nothing. Cable One's determination that some revenue should be excluded from the sales factor numerator pursuant to I.C. § 63-3027(r)(2) does not result in a "zero sales factor" and is not an "unusual fact situation" automatically triggering alternative apportionment. *See Union Pacific,* 139 Idaho at 576-78, 83 P.3d at 120-22 (identifying an unusual fact situation to be one where the taxpayer mixed two accounting systems, which overstated sales).

C. How Cable One Is Taxed in Other Jurisdictions Does Not Justify Deviation from the Strong Presumption in Favor of the Normal Three-Factor Apportionment

How Cable One is taxed in other states makes no difference in determining whether Cable One should be subject to an alternative allocation and apportionment in Idaho. *Cf.* Tax

Commission Br. at 36.[15] The sole issue here is whether Cable One complied with Idaho law in calculating its 2005 income taxes; Cable One's tax liability in Idaho is not based on every other state where Cable One does business. Calculation of the sales factor numerator under I.C. § 63-3027(r) turns solely on costs of performance, not on what revenue was or was not taxed by another jurisdiction. I.C. § 63-3027(c)(2).

While Arizona may have statutes and regulations similar to those found in Idaho (Tax Commission Br. at 37), each state interprets its tax laws differently. *Gilmour Mfg. Co. v. Com.*, 750 A.2d 948, 955 (Pa. Commw. Ct. 2000) ("Gilmour asserts that to effectuate the purposes of

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[15] The Tax Commission alleges that "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." Tax Commission Br. at 4, 7, 36. The Tax Commission's claims are unsupported by the record. Cable One's witness testified that Internet access service sales were excluded from its Arizona income tax return because "there are interpretations of the statute that depending on the facts and circumstances could be different by state" and that Cable One applied the cost of performance approach in Arizona as interpreted by Arizona law. Tr. Feb. 25/26, p. 135, line 15 through p. 136, line 10; *see also* Tr. Feb. 25/26, p. 145, lines 21-24; p. 147, lines 9-14 (refusing to admit Cable One's Arizona tax return into evidence in response to Cable One's relevancy objection that "[w]hat Cable One filed in Arizona in 2005 for its income tax purposes is not relevant to the State of Idaho").

the UDITPA of uniformity in state taxation laws, the challenged statutory provision should be interpreted consistently with those of other states. This argument lacks merit because other states have not interpreted similar tax provisions in a uniform way."), *aff'd*, 822 A.2d 676 (Pa. 2003). The Tax Commission is not tasked with reviewing Cable One's application of another state's tax law. The sole issue in this case is whether Cable One's Idaho income tax liability is calculated properly under Idaho law. In *Oracle*, the Oregon Tax Court rejected the exact argument the Tax Commission makes here finding that the characterization of income on Oracle's California income tax return could not dictate or control how Oracle's income was to be reported in Oregon. *Oracle Corp. v. Dep't of Revenue*, 2010 WL 496945 (Or. T.C. Feb. 11, 2010). While the *Oracle* court noted that UDITPA is "premised on a *goal* of uniformity" and courts have "sanctioned *consideration* of uniformity," the court found these "aspirational goals and 'consideration' of such goals represent matters of policy, not law." *Id.* at *3 (emphasis in original). Accordingly, the *Oracle* court determined the question of how income is to be reported "must be governed by" the law of the state where the return is filed, "not by some judicially declared doctrine that may pervert the law in a given situation." *Id.* at *4; *see also id.* at *3 (rejecting a ruling that "would require the court to become an expert in the laws of 49 other states . . . not only as set forth in the various states' statutes, but as those statutes are refined and clarified by years of judicial opinions").

Similar to the positions taken in the *Oracle* case, the Tax Commission argues for application of alternative apportionment because "uniformity" requires a review of Cable One's tax liability in Arizona to ensure a "market approach" is "applied uniformly" and sales are

"included as sales in the state where each customer resided." Tax Commission Br. at 36. But that is not the law in Idaho. The Idaho Legislature chose to adopt costs of performance instead of the "market source" approach that the Tax Commission advocates here. In states that have adopted a "market source" law, for example, sales of a service are deemed to be in the state "if and to the extent the service is delivered to a location" in the state. *See, e.g.*, Ala. H.B. 434, 2011 Leg., 1st Reg. Sess. (2011) (amending Alabama law to move from costs of performance to market source). As the Tax Commission's own witness indicated, if the Tax Commission prefers the market source approach, it must lobby the Idaho Legislature, not this Court. (Tr. Feb. 27, p. 132, lines 13-24; p. 135, lines 4-7). The Tax Commission cannot use this case, or how Cable One is taxed in Arizona, to advocate a market source approach through application of an alternative apportionment. Under Idaho law as it currently stands, Cable One's income tax liability was properly calculated and the Tax Commission's speculations about what may or may not have been done in other states are irrelevant.

CONCLUSION

For the reasons stated herein and in its Opening Brief, 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: March 13, 2014

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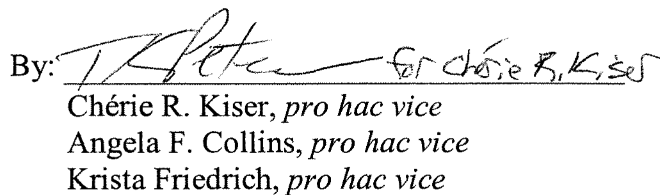
By: 

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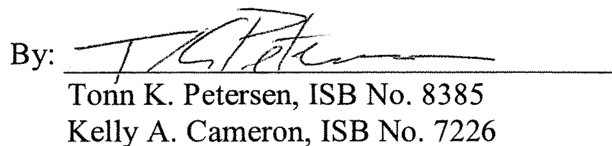
By: 

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CERTIFICATE OF SERVICE

I, the undersigned, certify that on March 13, 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):

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