ARIZONA TAX COURT

TX 2004-000722 02/15/2006

HONORABLE MARK W. ARMSTRONG

CLERK OF THE COURT
L. Slaughter
Deputy

FILED:_____

THE TOWN OF GILBERT AND
THE TOWN OF PARADISE VALLEY

GARY L. BIRNBAUM
DAVID J. OUIMETTE

v.

COXCOM, INC.

DAVID B. ROSENBAUM

UNDER ADVISEMENT RULING

This matter was taken under advisement after oral argument held December 22, 2005. The Court has considered the Defendant's Motion for Summary Judgment, Plaintiffs' Cross-Motion for Summary Judgment and arguments of counsel.

I. THE ISSUES

The primary issues in this case are (1) the applicability of the Supreme Court's decision in *People's Choice TV Corp. v. Tucson*, 202 Ariz. 401, 46 P.3d 412 (2002), and (2) whether Cox's failure to segregate its revenues as interstate vs. intrastate defeats its claim of non-taxability.

II. FACTUAL BACKGROUND

Cox provides cable television services to subscribers who pay monthly fees to view one of Cox's program packages. Because Cox's programming is primarily interstate in origin, after the *People's Choice* decision, Cox sought a refund for the transaction privilege taxes it claims were illegally imposed by the Towns on cable television subscriber revenues.

On January 17, 2003, Cox filed two tax refund claims with each Town. One set of claims, requesting $450,232.71 plus interest from the Town of Gilbert and $163,799.72 plus interest from the Town of Paradise Valley, was for taxes paid for the period December 1998 through November 2002 ("1998-2002 Claims"). The other set of claims, requesting $79,206.48 plus interest from the Town of Gilbert and $12,270.33 plus interest from the Town of Paradise Valley, was for taxes paid on or about January 29, 2001, before the ruling in *People's Choice*,

under an audit assessment issued on December 15, 2000 by the Department of Revenue ("Audit Claims").

Six months later, in July 2003, each Town denied Cox's two refund claims with substantially similar letters. First, the Towns asserted that Cox's 1998-2002 Claims were "deficient" because they failed to include certain information. The Towns also asserted that the statute of limitations barred Cox's Audit Claims.

Cox petitioned for administrative review of these denials. After a two-day hearing, the hearing officer issued his Decision, which granted Cox's 1998-2002 Claims but denied the Audit Claims on a procedural ground. The hearing officer also found that Cox was entitled to attorneys' fees under Model City Tax Code ("MCTC") § 578, as Cox "prevailed as to the most significant issue or set of issues" and the Towns' position "was not reasonable . . . ." Cox then filed with each Town an itemization of its fees and other costs. Both Towns denied Cox reimbursement.

III. ARGUMENTS OF THE PARTIES

- Coxcom, Inc.'s Arguments -

A. *PEOPLE'S CHOICE*.

The Supreme Court held in *People's Choice* that A.R.S. § 42-6004(A)(2)[1] "categorically prohibits cities, towns, and special taxing districts from levying a transaction privilege tax on interstate telecommunications services." 202 Ariz. at 404, 46 P.3d at 415. This prohibition, the Court held, extended to all subscriber revenues of both cable television and microwave television systems, including any associated intrastate services, because subscriber revenues from both systems derive primarily from "interstate telecommunications services." *Id*.

The Towns asserted to the hearing officer that *People's Choice* does not control their taxation of revenues of cable television systems, only those of microwave television systems, because People's Choice was a microwave television provider. However, both Cox and People's Choice are in the business of providing "interstate telecommunications services" – the business upon which A.R.S. § 42-6004(A)(2) prohibits local tax.

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[1] A.R.S. § 42-6004(A)(2) reads, in full, as follows:

A. A city, town or special taxing district shall not levy a transaction privilege, sales, use or other similar tax on:

. . .

2. Interstate telecommunications services, which include that portion of telecommunications services, such as subscriber line service, allocable by federal law to interstate telecommunications service.

A.R.S. § 42-6004(A)(2) (West 2005).

A.R.S. § 42-6004(A)(2) leaves undefined the phrase "interstate telecommunications services." Thus, the Supreme Court looked elsewhere for conclusive guidance that it found in A.R.S. § 42-5064(A)(1),[2] which prohibits state (as opposed to local) taxation of "[s]ales of intrastate telecommunications services by a cable television system . . . or by a microwave television transmission system. . . ." A.R.S. § 42-5064(A)(1). Then, because A.R.S. § 42-5064(A)(1) prohibits state taxation of both cable and microwave television systems, the Supreme Court examined and relied on federal cases holding that *cable* television services involved "primarily" interstate programming. *People's Choice*, 202 Ariz. at 404, 46 P.3d at 415 (citing *United States v. SW Cable Co.*, 392 U.S. 157, 168-69 (1968) (observing that cable systems generally engage in interstate communication); *TV Pix, Inc. v. Taylor*, 304 F. Supp. 459, 463 (D. Nev. 1968), *aff'd without opinion*, 396 U.S. 556 (1970) (community antenna system constitutes "one continuous interstate transmission to the viewer's television set"). Based on these cable television decisions, the Supreme Court concluded that microwave television services also must involve interstate telecommunications.

By equating cable television and microwave television services, and relying on their equal treatment in A.R.S. § 42-5064, the Court well knew that its holding applied equally to cable television services. Indeed, an *amicus curiae* brief filed by the Towns warned the Court of the "widespread impact" of a ruling that state law prohibited local transaction privilege taxes on subscriber revenue from microwave television services. The Towns' brief advised that such a ruling would invalidate their own taxes on pay television services and those of many other Arizona cities and towns that currently taxed cable or microwave television services under MCTC § 470.[3] The widespread impact to which the Towns alerted the Court is exactly what the Supreme Court held should occur.

Although the taxpayer in *People's Choice*, like Cox, provided both intrastate and interstate programming, the Court held that A.R.S. § 42-6004(A)(2) barred taxation on all of its revenue because it was in the business of transmitting programming that was predominantly interstate in origin. *People's Choice*, 202 Ariz. at 404, 46 P.3d at 415.

B. STATE LAW PROHIBITS LOCAL TAXATION OF CABLE TELEVISION SUBSCRIBER REVENUE.

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[2] A.R.S. § 42-5064(A)(1) reads, in full, as follows:

> A. The telecommunications classification is comprised of the business of providing intrastate telecommunications services. The telecommunications classification does not include:
>
> 1. Sales of intrastate telecommunications services by a cable television system as defined in A.R.S. § 9-505 or by a microwave television transmission system that transmits television programming to multiple subscribers and that is operating pursuant to 47 Code of Federal Regulations parts 21 and 74.

A.R.S. § 42-5064(A)(1) (West 2005).

[3] MCTC § 470 imposes a tax on the "gross income from the business activity upon every person engaged or continuing in the business of providing telecommunication services to consumers within the City."

A.R.S. § 42-6004(A)(2) prohibits towns from imposing a transaction privilege tax on subscriber revenue for a business or system that offers programming that originates primarily from outside of Arizona. In *People's Choice*, the taxpayer provided microwave television services to subscribers. 202 Ariz. at 402, 46 P.3d at 413. Like Cox's subscribers, those in *People's Choice* paid monthly fees to view one of a variety of offered programming packages, all of which offered both local and interstate programming. And, like the Towns here, the local municipality tried to tax subscriber revenues under MCTC § 470. Just as A.R.S. § 42-6004(A)(2) prohibits the subscriber revenues in *People's Choice* from being taxed under MCTC § 470, so too does it bar taxation of Cox's subscriber revenues under that same provision.

The majority of Cox's programming content, like that in *People's Choice*, originates out of state. Over 90% of Cox's customers subscribe to the expanded basic service package, which contains 73 channels. The majority of these channels (71%) are delivered by satellite, with most (97%) of their programming content originating outside of Arizona. The other channels, while not delivered by satellite, still transmit programming content that is over 60% interstate in origin. Even the small minority of Cox customers who do not receive "expanded basic service" and subscribe only to the "limited basic service" package, receive programming that originates primarily out of state. The "limited basic package" includes 24 channels. Four of these channels are satellite delivered, with 97% of their programming content interstate in origin. Even the remaining non-satellite delivered channels transmit programming content that is over 60% interstate in origin. Therefore, regardless of which programming package a customer subscribes to, the programming viewed on Cox's cable television system is overwhelmingly interstate in origin. And, more decisively, Cox's overall cable television "business" transmits programming that is "primarily" interstate in origin. *People's Choice*, 202 Ariz. at 404, 46 P.3d at 415.

C. THE TOWNS CANNOT REQUIRE COX TO KEEP BOOKS AND RECORDS OF A SEPARATE INTRASTATE BUSINESS ACTIVITY THAT THE TOWNS DO NOT DEFINE IN THEIR TAX CODES.

Refusing to accept the *People's Choice* "majority origin" test, the Towns insist that an "intrastate component" of Cox's programming, which they never define, nonetheless remains subject to tax as a post-*People's Choice* vestige. The Towns then leap to claim that Cox's failure to segregate and separately bill and report revenues from this taxable intrastate business activity prevents Cox from receiving a refund of all taxes paid to the Towns on revenues from its non-taxable interstate business activity.

However, the *People's Choice* "majority origin" test allows no tax on the remaining minority pieces of the "business" or "system." But even if one accepted the Towns' argument that *People's Choice* allows taxation of a minority intrastate "component" of Cox's programming, the Towns have never imposed such a tax or defined the intrastate business or specified how a business is to measure the intrastate portion of its revenues.

> In construing tax statutes, it is the rule that the act must be certain, clear and unambiguous as to the subject of taxation, and doubtful tax statutes are given a strict construction against the taxing power.

State v. Superior Court, 113 Ariz. 248, 249, 550 P.2d 626, 627 (1976) (citations omitted). This bedrock principle of construction of tax provisions was integral to the decision in *People's Choice*, 202 Ariz. 401, 403, 46 P.3d 412, 414 ("when interpreting tax statutes, we resolve ambiguities in favor of the taxpayer"), and is central to numerous decisions on taxing authority. *See, e.g.*, *Energy Squared v. Arizona Dep't of Revenue*, 203 Ariz. 507, 510, 56 P.3d 686, 689 (App. 2002) ("Uncertainty about the scope and meaning of a taxing provision is to be resolved in favor of the taxpayer and against the taxing authority."); *Arizona Dep't of Revenue v. Capitol Castings*, 207 Ariz. 445, 447, 88 P.3d 159, 161 (2004) ("In the tax field, we liberally construe statutes imposing taxes in favor of taxpayers and against the government.").

The municipal tax codes in this case imposed tax on the "gross income from the business activity upon every person engaging or continuing in the business of providing telecommunication services to consumers within this City." MCTC § 470(a). Then, in a series of subparts the tax codes identified various elements of telecommunications, see MCTC §§ 470(A)(1) and (2), but these codes did not differentiate between programming content that originates inside or outside Arizona. And, the tax codes never provided, in MCTC § 470 or elsewhere, a deduction or exemption or credit for programming that originates outside Arizona. Thus, Cox's billing and record keeping was in fully compliance with the requirements of MCTC § 470.

Similarly, the Towns' tax codes demonstrate that they knew exactly how to create an exemption for interstate programming when they wanted. In subpart (c) of MCTC § 470, titled "Interstate transmissions," the Towns created an express exemption for "transmissions originating in the City and terminating outside the State." *Id*.

D. THE TOWNS CREATED NO EXEMPTION OR EXCLUSION REQUIRING DOCUMENTATION.

The Towns also argue that Cox was required under MCTC § 360(a) to "document the revenues attributable to the claimed exemption or exclusion." However, Cox has never claimed an exemption or exclusion. Rather, the Arizona Supreme Court has stated that local taxation of interstate telecommunications revenues violates a state-law prohibition on local taxing power.

People's Choice does not insert a state-law based exemption or exclusion into the municipal tax codes. Indeed, *People's Choice*, 202 Ariz. at 404, 46 P.3d at 415, ruled that "A.R.S. § 42-6004(A)(2) prohibits the City from imposing a transaction privilege tax on [People's Choice's] gross income from connection, access, subscription, or membership fees." *See also State ex rel. Ariz. Dep't of Revenue v. Capitol Castings, Inc*., 207 Ariz. 445, 448 n.3, 88 P.3d 159, 162 n.3 (2004) (the statute in *People's Choice* was one "prohibiting the imposition of a

tax, not a provision exempting an otherwise taxable item"). Thus, although the Towns argue that A.R.S. § 42-6004(A)(2) is codified under a section heading called "exemption," the Supreme Court has now told us twice that the statute does not create an exemption. *Id.*; s*ee also* A.R.S. § 1-212. Rather, the statute prohibits municipalities from doing exactly what they did here.

The Towns rely extensively on the *Holmes & Narver* doctrine. This familiar doctrine applies only when a taxpayer seeks to separate income from one lawful taxable business category into another. *State Tax Comm'n v. Holmes & Narver, Inc.*, 113 Ariz. 165, 548 P.2d 1162 (1976) (deciding whether design and engineering services fell under the lawful taxable business category of "contracting business"); *Advo System, Inc. v. City of Phoenix*, 189 Ariz. 355, 942 P.2d 1187 (App. 1997) (deciding whether mailing or postage revenue fell under the lawful taxable business category of "local advertising"). Here, Cox agrees that all of its subscriber revenues fall under MCTC § 470 because all are revenues from the "business of providing telecommunication services to consumers within this City." MCTC § 470(a). There is only one business, with nothing to separate or segregate, and state law prohibits the Towns from imposing this tax on any of the revenues.

E. THE RECENT AMENDMENT TO A.R.S. § 42-5064 SUPPORTS COX'S REFUND REQUESTS.

The Towns make the assertion that the Legislature has somehow retroactively overturned the majority origin test of *People's Choice*. However, the Towns cite a recent amendment to A.R.S. § 42-5064, not A.R.S. § 42-6004. This amendment leaves unimpaired the majority origin test that applies to the prohibition on local taxation of cable companies in A.R.S. § 42-6004. *Cf. Zamora v. Reinstein*, 185 Ariz. 272, 276 n.2, 915 P.2d 1227, 1231 n.2 (1996) (noting that when the Legislature intends to overturn judicial interpretation of a statute, it so states in the legislative history of subsequent amendments to that statute); *State v. Fell*, 209 Ariz. 77, 81-82, 97 P.3d 902, 906-07 (2004), *aff'd*, 210 Ariz. 554, 115 P.3d 594 (2005) (rejecting argument that Legislature intended to overturn judicial interpretation of a statute by enacting a new provision because, among other things, no legislative history indicated such an intent).

Indeed, the legislative history of the amendment to A.R.S. § 42-5064 makes its purpose clear. For many decades, separate companies provided intrastate and interstate telephone services, the first taxable by State law, the second not taxable by State law. Since enactment of the federal Telecommunications Act of 1996, to a greater and greater degree those separately regulated and billed services have been provided by the same company. Still more recently, single providers of telephone services have begun providing both services for a single charge. That is, they have started to "bundle" these services at a single price to reflect the overall convergence in telecommunications services. House Summary for SB 1288, dated April 13, 2004.

The amendment of A.R.S. § 42-5064 enables a company that has combined two historically separate businesses into a single business to maintain the non-taxable status of one of

those businesses, but only if it can "reasonably identify the portion of the sales price of the bundled transaction derived from charges for nontaxable services." A.R.S. § 42-5064 (D)(1). This legislative compromise, which is nothing more than a legislative statement of how a telephone provider that has bundled two historically separate businesses may maintain its entitlement to a deduction, reflects no intent to either overrule *People's Choice* or the prohibition against local taxes that the Supreme Court found in A.R.S. § 42-6004.

Cable television, on the other hand, has always been treated as a single business under federal and state law. The license fees that Cox pays to cities and towns derive from all revenue, just as MCTC § 470 purports to tax all revenue. Now, the Towns wish to re-characterize this single business as two businesses and then accuse Cox of "bundling." The Supreme Court provided no basis for such an approach in *People's Choice*. Instead of supporting the Towns' position, the amendment to A.R.S. § 42-5064(D)(1) shows that the Towns, as the parties that wish to make the change, must in their tax codes "reasonably identify" the portion of the sales price that is attributable to the taxable business activity. It is not for the taxpayer to invent and then comply with a new tax structure nowhere described in the Towns' tax codes.

F. COX'S AUDIT CLAIMS WERE TIMELY FILED.

With respect to the Audit Claims at issue, the Towns maintained to the hearing officer, and assert here, that Cox's claims are barred even though filed well within the applicable four-year statute of limitations. As adopted by the Towns, MCTC § 560 provides the proper procedures for seeking a tax credit or refund. Specifically, MCTC § 560(a) in Appendix I states as follows: "(a) Except as provided in MCTC § 565, the period within which a claim for credit may be filed, or refund allowed or made if no claim is filed, shall be as provided in A.R.S. §§ 42-1106 and 42-1118."

A.R.S. § 42-1106, in turn, incorporates by reference the statute of limitations period within which the Arizona Department of Revenue ("ADOR") may make an assessment, as specified in A.R.S. § 42-1104. Under A.R.S. § 42-1104(A), Cox was required to file its refund claim "within four years after the report or return is required to be filed or within four years after the report or return is filed, whichever period expires later." Cox met the time limit. However, because Cox had not appealed the December 15, 2000 audit assessment, the hearing officer determined that despite Cox's having timely filed its Audit Claims, "there were no excess taxes paid" for which Cox could claim a refund.

Nothing within the applicable MCTC sections, or any of the state statutes incorporated by those sections, makes a taxpayer's failure to appeal an audit assessment an absolute bar on that taxpayer's right to file a refund claim. Indeed, the state legislature recognized that enacting additional statutory provisions was required to provide a shorter limitation period for seeking a refund where a taxpayer did not appeal an audit assessment. *See* A.R.S. § 42-1251(B) (providing for shorter limitations period where taxpayer pays the entire audit assessment instead of filing an appeal).

The Towns, unlike the Legislature, chose not to enact such additional statutory provisions. At its best, the hearing officer's position rested on a perceived ambiguity in the MCTC. However, since nothing in the MCTC's plain language supports the Towns' position, it must be rejected. *See Ebasco Servs. Inc. v. Arizona State Tax Commission*, 105 Ariz. 94, 97, 459 P.2d 719, 722 (1969) (holding that the scope of an ambiguous revenue statute "should be construed liberally in favor of the taxpayer and strictly against the state).

Besides interpreting the code incorrectly, the hearing officer overlooked that the taxes at issue were illegal and, therefore, never due. It would be a harsh and inequitable result to misinterpret the MCTC and to allow the Towns to keep what they wrongfully took, especially where Cox sought a refund not only within the applicable limitations period, but also soon after it paid the assessment and soon after the Supreme Court issued its holding in *People's Choice*. "An honorable government would not keep taxes to which it is not entitled . . . ." *Pittsburgh & Midway Coal Mining Co. v. Ariz. Dept. of Revenue*, 161 Ariz. 135, 776 P.2d 1061 (1989).

- The Town of Gilbert's and the Town of Paradise Valley's Arguments -

A. REVENUES DERIVED FROM INTRASTATE TELECOMMUNICATIONS SERVICES ARE SUBJECT TO TRANSACTION PRIVILEGE TAXATION BY THE TOWNS.

The tax which is the focus of this case is a "transaction privilege tax" imposed upon the privilege of doing business within the taxing jurisdictions. It is triggered by the taxpayer's business presence, property, activities and transactions within the jurisdiction. The measure of the levy, however, is based upon the gross revenues of the taxpayer resulting from that business and those transactions and activities.

1. As a general rule, revenue derived from the provision of "telecommunications services" to customers within the taxing jurisdictions may be subjected to transaction privilege taxation.

Revenue derived from "telecommunications services" is subject to municipal transaction privilege taxation. Nothing in federal or state law generally prohibits a privilege tax levy upon revenues derived from such activities. Indeed, A.R.S. § 9-240(B)(18) grants to the Towns broad authority to impose transaction privilege taxes. The relevant inquiries are simply: (i) has the taxing authority elected to include such activities within the tax base; and (ii) has the taxing authority elected to exempt any portion of those activities from the tax base? *See People's Choice*, 202 Ariz. at 404 n.3, 46 P.3d at 415 n.3. There is no question here that the Towns have elected to include revenues from telecommunications services, including cable television services, in their tax base, and that the only portion even arguably exempted from the tax is the interstate portion.

2. "Telecommunications services" may have both interstate and intrastate components. Both components may lawfully be subjected to state and local transaction privilege taxation.

A "telecommunications service" may have both interstate and intrastate components. Both components are subject to state and local taxation in appropriate circumstances. Nothing in federal law prohibits a state or municipality from taxing interstate telecommunication services. *Goldberg v. Sweet*, 488 U.S. 252, 260-68 (1989); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

3. The Arizona Legislature has elected to exempt the interstate component of telecommunications services from both state and local transaction privilege taxation.

In *Goldberg v. Sweet*, *supra*, the US Supreme Court confirmed that even the interstate activities of telecommunications service providers may be subjected to state and local transaction privilege taxation without violating federal law. However, the Arizona Legislature has elected not to do so. First, at the state level, the Legislature has elected to limit the state transaction privilege tax to only "intrastate telecommunications services." A.R.S. § 42-5064(A). Second, at the local level, A.R.S. § 42-6004(A)(2) precludes imposition by the Towns or other municipalities of a transaction privilege tax on "interstate telecommunications services."

4. The Arizona Legislature has elected to impose a state transaction privilege tax upon intrastate telecommunications services generally, but it has exempted intrastate cable television services from the state tax. Nonetheless, the Legislature has authorized the taxation of such services by municipalities, including the Towns.

The State's transaction privilege tax is imposed generally upon "intrastate telecommunication services." A.R.S. § 42-5064(A). However, the Legislature has elected to exclude from the general category of state taxable "intrastate telecommunication services," the specific business of "sales of intrastate telecommunications services by a cable television system . . . or by a microwave television transmission system . . . ." *Id*. The State transaction privilege tax thus does not apply to revenue derived from cable television services, whether characterized as interstate or intrastate.

However, state statutes do not prohibit a city or town from imposing a municipal transaction privilege tax on "intrastate telecommunication services," including services of a "cable television system." Indeed, while A.R.S. § 42-6004(A)(2) expressly prohibits municipalities from levying a transaction privilege tax on "interstate telecommunication services," by obvious implication it permits the imposition of such municipal taxes on "intrastate telecommunication services."

5. The MCTC imposes a transaction privilege tax upon revenue derived from the provision of telecommunications services, including cable television services, within a city or town. The Towns have each adopted municipal tax codes based upon the MCTC.

The MCTC does not exempt cable television services from the municipal transaction privilege tax on "telecommunications services." Cox's cable television revenues are subject to the tax imposed by the MCTC, unless they are classified in their entirety as revenues derived from "interstate telecommunications services," and thereby exempt under A.R.S. § 42-6004(A)(2).

All revenues, including cable television revenues, are presumed to be subject to the transaction privilege tax imposed by the MCTC. MCTC § 400(c); *accord* A.R.S. § 42-5023. MCTC § 470(a) imposes a transaction privilege tax on "any person engaging or continuing in the business of providing telecommunications services to consumers within this City." Thus, under the MCTC, Cox's gross revenues from the provision of cable television services to consumers in the Towns are subject to the transaction privilege tax, both presumptively and expressly.

There is also no question that the drafters of the MCTC intended to include at least intrastate cable television revenues within the tax base. Aside from the language of MCTC § 470(a)(1)(B) itself, the MCTC provides an alternative provision (Local Option # DD) which, if adopted, expressly exempts all cable television system revenues:

> However, gross income from the providing of telecommunications services by a cable television system, as such system is defined in A.R.S. § 9-505, shall be exempt from the tax imposed by this Section.

MCTC § 470(e) (optional provision). However, neither of the Towns has adopted Local Option # DD.

6. When a taxpayer engages in both taxable and non-taxable activities, it is incumbent upon the taxpayer to segregate and separately invoice and report its taxable and non-taxable revenues. Absent such segregation and separate billing and reporting, all of the income derived from the "bundled" activities is subject to tax.

Many cases recognize that a single activity may be comprised of both interstate and intrastate components, without precluding local taxation. *See, e.g., McCaw v. Fase*, 216 F.2d 700 (9th Cir. 1955); *Beard v. Vinsonhaler*, 215 Ark. 389, 221 S.W.2d 3, *appeal dismissed*, 338 U.S. 363, *rehearing denied*, 338 U.S. 896 (1949); *see also Pacific Telephone & Telegraph Co. v. Tax Commission*, 297 U.S. 403 (1936) (occupation tax on telephone company's intrastate/local business upheld despite the claim that local and interstate branches of the business were "inseparable"). The same principle applies here.

Whether characterized as an "exemption," an "exclusion," or otherwise, a party who seeks to avoid transaction privilege taxation must document the revenues attributable to the claimed exemption or exclusion. MCTC § 360(a) provides that:

> All deductions, exclusions, exemptions and credits provided in [the MCTC] are conditioned upon adequate proof and documentation of such as may be required either by [the MCTC] or [MCTC] Regulation.

Stated differently, as a matter of law, a taxpayer can overcome the presumption of taxability and can segregate the non-taxable component of its business activities from the taxable component. However, in order to do so, the taxpayer must keep and produce the records necessary to evidence and support the segregation of revenues. In this case, Cox actually considered segregating its intrastate and interstate revenues and/or services, but did not do so, even though it could have been done, at least by channel; thus, no such records exist and no segregation has been made.

Furthermore, the Arizona Supreme Court held in *State Tax Commission v. Holmes & Narver, Inc., supra*, that non-taxable income can be separated from taxable income in order to reduce the taxable amount only where: (1) it can be readily ascertained without substantial difficulty which portion of the business is for non-taxable activities; (2) the non-taxable amounts in relation to the taxpayer's total taxable business activities are not inconsequential; and (3) those non-taxable services are not incidental to the taxable business. *Id*. at 169, 548 P.2d at 1166.

Advo System Inc. v. City of Phoenix, 189 Ariz. 355, 942 P.2d 1187 (App. 1997) demonstrates the application of the *Holmes & Narver* test to a case arising under the MCTC and illustrates the consequence of the taxpayer's failure to segregate and separately invoice and report taxable and non-taxable income. In *Advo*, the court found that income received from the reimbursement of postage was so intertwined with the taxpayer's taxable advertising and direct marketing revenues that it constituted taxable income. Furthermore, as the taxpayer had not separately stated the postage charges on its customer invoices or in its own books and records, segregation of the income for transaction privilege tax purposes was not appropriate.

During the 2004 legislative session, the Arizona Legislature reaffirmed these principles. A.R.S. § 42-5064 was amended to address the taxation of "bundled telecommunications services" and specifically to clarify the taxability of otherwise non-taxable interstate telecommunications services when billed to customers jointly with taxable intrastate telecommunications services. Although the statute may not directly apply to Cox's cable television services revenues, the recent legislation nonetheless confirms the general principle that the taxpayer has the burden of segregation, and that if the burden is not satisfied, all of the "bundled" revenues are subject to taxation.

Specifically, Senate Bill 1288 (effective August 25, 2004), added the following definition to the state transaction privilege tax code in A.R.S. § 42-5064, which perfectly describes Cox's "bundled" services:

> "Bundled transaction" means a sale of multiple services in which both of the following apply:
>
> (a) The sale consists of both taxable and nontaxable services.
>
> (b) The telecommunications service provider charges a customer one sales price for all services that are sold instead of separately charging for each individual service.

The amended statute goes on to provide that (i) the telecommunications service provider/taxpayer may segregate and separately report its taxable and non-taxable activities, in which case only income derived from the taxable component will be subject to transaction privilege taxation; but (ii) the burden of proof of non-taxability rests with the taxpayer, so that absent segregation and separate reporting and remittance, the gross income or gross proceeds of sale derived from the entire "bundled transaction" will be subject to taxation:

> The gross proceeds of sales or gross income derived from a bundled transaction of services that are taxable pursuant to A.R.S. § 42-5023 are subject to the following:
>
> 1. A telecommunications service provider who can reasonably identify the portion of the sales price of the bundled transaction derived from charges for nontaxable services is subject to tax only on the gross proceeds of sales or gross income derived from the taxable services. For the purposes of this section, the telecommunications service provider may elect to reasonably identify the portion of the sales price of the bundled transaction derived from charges for nontaxable services by using allocation percentages derived from the telecommunications service provider's entire service area, including territories outside of the state. . . .
>
> 3. The burden of proof is on the telecommunications service provider to establish that the gross proceeds of sales or gross income is derived from charges for nontaxable services.

A.R.S. § 42-5064(c); *see* also, to the same effect, the federal Mobile Telecommunications Sourcing Act of 2000, 4 U.S.C. § 123(b).

In sum, when a taxpayer provides a service with both taxable and non-taxable components, it is incumbent upon the taxpayer to separately invoice and report its taxable and non-taxable activities. Absent such segregation, billing, and reporting, or at least a "reasonable" allocation, all of the income from the "bundled" services becomes subject to tax.

7. The amendments to A.R.S. § 42-5064 are even more significant insofar as they undermine the rationale for the decision in *People's Choice.*

The amended statute, A.R.S. § 42-5064, evidences a legislative intent completely contrary to the rationale of the *People's Choice* decision which, ironically, was based on the Court's attempt to determine legislative intent in A.R.S. § 42-6004 by reference to the former version of A.R.S. § 42-5064.

In attempting to fashion a definition for those "interstate telecommunications services" which are exempted from municipal taxation under A.R.S. § 42-6004(2), *People's Choice* turned to the prior iteration of A.R.S. § 42-5064, concluding that "interstate telecommunications services" meant any such services which are "primarily" interstate in nature. As recently restated, however, A.R.S. § 42-5064 now makes it clear that "interstate" service refers only to that component of service which is truly interstate in nature, and that if there is any intrastate component of the service, and the taxpayer charges its customer for "bundled" services without segregation, then the entire revenues are taxable as intrastate revenues.

B. COX'S REVENUES ARE DERIVED, AT LEAST IN PART, FROM INTRASTATE TELECOMMUNICATIONS SERVICES.

It is clear from the Declaration of Ivan Johnson that Cox's programming includes "local channels," "local advertising inserted into satellite channels" and "local" programming. When it is in Cox's interest to emphasize the local nature of its cable system and services, the same system and services are described as such. A copy of a March 2005 Petition by Cox to the Federal Communications Commission in an unrelated matter, verified by Mr. Johnson, emphasized the "local" focus of Cox's cable service in the Phoenix area.

As further reflected in its FCC Petition, Cox does not merely choose to provide local television broadcasting service through its cable system, it is required to do so under the "must carry rules" of the Federal Communications Commission. While it is not possible to determine on the present record what percentage of Cox's bundled services should properly be characterized as "local" or "intrastate" in nature in the event of segregation, clearly such services comprise a portion of Cox's service package. Again, there is no dispute that Cox's revenues are based on "bundled" interstate and intrastate services, which are not separately billed or otherwise segregated. The legal consequence is that all revenues from the bundled services are therefore taxable.

C. *PEOPLE'S CHOICE'S* COMMENT REGARDING CABLE TELEVISION IS *DICTUM*.

The sole issue before the court in *People's Choice* was the taxability of the operation of a microwave system, not a cable television system. The two technologies are fundamentally different: a microwave system relays a microwave signal which is picked up from a satellite or local transmission and then forwarded through the ether to a receiver at each customer's residence. A cable system, in contrast, collects either a satellite or local broadcast signal at a substantial local "head end" facility, stores, processes and re-formats it, edits and/or supplements it as the cable company chooses, and transmits the revised signal through a substantial local physical cable network over public rights of way to the ultimate customer. Cox's cable system also produces and inserts its own programming and advertising.

These and other factual distinctions between the two different types of systems were not before the *People's Choice* Court, nor were they significant at the time, because the distinctions between microwave and cable systems were completely irrelevant to the issues then before the Court. The offhand remark in one line of the entire opinion, lumping cable and microwave systems together for the generalized conclusion that A.R.S. § 42-5064 applies to both because they each provide "primarily interstate programming," is clearly dictum, completely unnecessary to the decision in that case, and contrary to the letter of the Tax Code and the fundamental concepts underlying that Code: taxable revenues do not become non-taxable because they are commingled with non-taxable revenues. To the contrary, non-taxable revenues become taxable if they are commingled and not separately billed and reported.

"A statement should be considered *dictum* when it 'could have been deleted without seriously impairing the analytical foundation of the holding – [and] being peripheral, may not have received the full and careful consideration of the court that uttered it.'" *Gochicoa v. Johnson*, 238 F.3d 278, 286 (n. 11) (5th Cir. 2000), quoting *In Re Cajun Elec. Power Coop, Inc.*, 109 F.3d 248, 256 (5th Cir. 1997).

Cox's reference to the *People's Choice* Court's comment regarding taxation of cable television systems as "considered" *dictum* is inaccurate; there is no suggestion anywhere in the Court's decision that it gave any thought or analysis to whether a cable system might present different issues than a microwave system; the decision also gave no indication of any intent to change the law regarding taxation of "bundled" transactions.

Cox argues that *People's Choice* requires this Court to apply a test based upon origin of programming in determining applicability of municipal taxation to its cable television system revenues. Again, any suggestion in *People's Choice* as to the applicability of such a test to a cable system operator is *dictum*. While, as suggested in *People's Choice*, a test based on the origin of programming may be appropriate with regard to a microwave system, given its nature

as essentially just a relay or conduit for programming, it does not follow that the same test would be appropriate as to the different nature and operation of a local cable television system like Cox's.

Various provisions of Arizona and federal law also underscore the distinctions between cable and microwave television system operations. For example, A.R.S. § 9-505 *et seq*. authorizes municipalities to impose licensing/franchising requirements and fees on cable television operators for their use of public rights of way for their physical facilities, a local licensing regime which is entirely inapplicable to microwave television systems. Indeed, A.R.S. § 42-5064(A) notes that microwave system operators are subject to federal regulation, by the Federal Communications Commission, under 47 Code of Federal Regulations, parts 21 and 74. In light of these and other factual and legal distinctions between microwave and cable systems, it remains to be determined whether the two must be treated the same for municipal taxation purposes. *People's Choice* is not controlling as to taxation of cable services, which were not involved in that case.

D. *PEOPLE'S CHOICE* IS NOT DISPOSITIVE BECAUSE IT DID NOT ADDRESS THE ISSUE OF SEGREGATION OF "BUNDLED" SERVICES.

Independent of the fact that any comment in *People's Choice* regarding the taxability of a cable television system was merely non-binding *dictum*, the second and more fundamental reason why *People's Choice* does not control here is that, as noted above, it did not involve the very different issue of the effect of Cox's failure to segregate and separately report the taxable and non-taxable components of its business activity. The continued vitality of this principle, including the taxpayer's obligation to properly "allocate" between the taxable and non-taxable components of a "bundled" telecommunications transaction, has been affirmed by the Legislature's recent amendments to A.R.S. § 42-5064.

Also supporting the validity of the concept of "segregation" or "apportionment" of the taxable and non-taxable components of a unitary business activity is the decision in *City of Prescott v. Town of Chino Valley*, 163 Ariz. 608, 790 P.2d 263 (App. 1989), affirmed in part, reversed in part, 166 Ariz. 480, 803 P.2d 891 (1990). That case involved a municipal transaction privilege tax imposed by Chino Valley on the business of operating a water pipeline within the Town. The City of Prescott operated a water pipeline which originated within the Town of Chino Valley and also extended a number of miles outside the Town to Prescott's water system facilities in Prescott. The Court held that while the tax as imposed by Chino Valley was improperly apportioned as between the segment of the pipeline within the Town and the larger segment of the pipeline outside the Town, the consequence of the improper apportionment was not to void the tax, but instead to require Prescott, as the taxpayer desiring a more favorable apportionment, to bear the burden of proving a proper apportionment and paying the tax accordingly: "On remand the burden will be upon Prescott to show the proper extent of its benefit from apportionment." *Id.*, 790 P.2d at 275. Moreover, the Court also noted that the line of authority represented by *State Tax Commission v. Holmes & Narver, Inc.*, 113 Ariz. 165,

548 P.2d1162 (1976), regarding the requirement of segregation and separate reporting, might well be applicable under the facts and circumstances of that case. *Id*.

The Towns do not mean to suggest that either the *Prescott v. Chino Valley* decision or the recent amendments to A.R.S. § 42-5064 control the decision in this case. However, each of those authorities clearly supports the general principles requiring segregation of "bundled" transactions, which are the basis of the Towns' argument; and there is nothing in *People's Choice* to the contrary. Indeed, *People's Choice* itself looked to the prior version of A.R.S. § 42-5064 in search of an appropriate definition of "interstate telecommunications" for purposes of the application of A.R.S. § 42-6004, which provides no definition of the term. It thus appears clear that if the amended version of A.R.S. § 42-5064 had been considered by the Supreme Court at the time it was deciding *People's Choice*, the Court could not have come to the same conclusion that a telecommunications business is immune from tax in its entirety, irrespective of whether a portion of its activities are "intrastate" in nature, merely because its activities could be characterized as "primarily" interstate. In other words, the statute relied upon by the Court in *People's Choice* has been materially amended in the interim, on the very issue which is central to the instant case, making it even less appropriate for this case to be decided on the basis of d*ictum*.

Cox also suggests that, read in light of *People's Choice*, A.R.S. § 42-6004 "prohibits" municipal taxation of even the intrastate component of cable television service. However, that is inconsistent with what Cox contends the *People's Choice* case means. According to Cox, *People's Choice* says that the "test" for whether the revenues of a cable television system are subject to municipal transaction privilege tax is whether the origin of the programs provided by the cable service is "primarily" from outside the state. Implicit in that "test," however, is the corollary conclusion that if a cable system's programs were "primarily" local in origin, then all of its revenues would be fully taxable. Thus, even under Cox's analysis of the *People's Choice* case, there would be nothing in A.R.S. § 42-6004 constituting a "prohibition" against municipal taxation of the revenues of a cable television system, even if some portion of its programming were of "interstate" origin. No statutory or case authority supports Cox's novel conclusion.

Finally with regard to the issue of what was and was not the "holding" of *People's Choice*, Cox inaccurately describes the case as establishing a "test" for municipal taxability, turning upon whether the microwave system at issue disseminated programming which "primarily" originated elsewhere. In fact, *People's Choice* makes no suggestion of any kind regarding a "test" for taxability of either microwave or cable television systems. The entirety of the discussion in the case on this point is included in the following sentence:

> In accordance with that prohibition [by which A.R.S. § 42-5064 "implicitly precludes taxation of interstate telecommunication services"], A.R.S. § 42-5064(A) specifically exempts cable and microwave television systems from interstate taxation because such systems, like PC TV, primarily provide interstate programming.

46 P.3d at 415. This is not the statement of a "test" for the legality of municipal taxation, it is merely a statement of the Court's understanding as to the rationale of the Legislature's decision not to tax certain activities as a matter of state tax law.

This is a simple "failure to segregate" case. Even under Cox's analysis, Cox's activities include taxable intrastate and non-taxable interstate components. Absent segregation, separate billing, and separate reporting, all of the revenues from those activities are taxable. *People's Choice* did not alter this established principle, nor did it even address "bundled" services at all.

E. COX'S REFUND CLAIM FOR THE 1994-1998 PERIOD IS TIME-BARRED.

Cox's refund claim for the 1994-1998 period was not timely asserted. Cox cites no authority for its contention that the date of its payment of an audit assessment, years after the taxes were due, should be regarded as a "return" for purposes of timeliness of its refund claims. There is no dispute that during the 1994-1998 period Cox routinely filed regular reports of its revenues with ADOR. Even if those filings did not report revenues in the "telecommunications" classification, they nonetheless constituted "returns" for present purposes. It simply makes no sense that Cox's payment, years later, of an audit assessment based on the inaccuracy of those reports/returns, should be regarded as a "return" to give Cox even more years to seek a refund.

Moreover, under the facts of this case Cox's refund claims for the 1994-1998 period are also barred by the finality of the audit assessment under A.R.S. § 42-1251(B). That section establishes that the amount determined to be due under an audit assessment "becomes final" unless appealed within 45 days. If, notwithstanding this provision, a taxpayer could indirectly appeal an audit assessment simply by making a refund claim up to four years following the assessment, the concept of "finality" would be essentially meaningless.

Cox argues that A.R.S. § 42-1251(B) is not applicable to Cox because this is a state statute, not part of the MCTC. Cox is wrong as a matter of law, since the statutory scheme applicable to the ADOR's collection of municipal taxes on behalf of a city or town expressly incorporates the state procedures. A.R.S. § 42-6002.

IV. THE COURT'S FINDINGS AND CONCLUSIONS

A. THE APPLICABILITY OF *PEOPLE'S CHOICE*.

As a threshold matter, the Court finds as follows:

1. The vast majority of Cox's programming originates out-of-state.

2. There are genuine issues of material fact as the precise extent to which the programming is interstate vs. intrastate.

3. The Towns' codes impose a transaction privilege tax on "any person engaging or continuing in the business of providing telecommunications services to consumers within this City." They do not expressly require providers to itemize or distinguish between intrastate and interstate services or revenues.

4. Cox has never itemized or distinguished between intrastate and interstate services or revenues in its reporting to taxing authorities.

This case presents a close call. The Court appreciates that the *People's Choice* case involved a microwave television system rather than a cable television system, and to that extent, the Court's discussion of cable television systems may have been dictum. However, it is a Supreme Court decision that this court is bound to follow, and its holding, while perhaps more sweeping than necessary, seems clear: "In accordance with that prohibition, A.R.S. § 42-5064 (A) specifically exempts cable and microwave television systems from interstate taxation because such systems, like PC TV, primarily provide interstate programming." 46 P.3d at 415.

Further, while the *Holmes & Narver* doctrine might be persuasive in a different context, it does not apply here in light of the *People's Choice* decision. This is particularly the case since the Towns' codes impose a transaction privilege tax on "any person engaging or continuing in the business of providing telecommunications services to consumers within this City," while not expressly requiring providers to itemize or distinguish between intrastate and interstate services or revenues. Similarly, Cox has never itemized or distinguished between intrastate and interstate services or revenues in its reporting to taxing authorities. Cable television, as the record reflects for Cox and as the Towns have licensed and regulated it, has always been treated as a single business under federal and state law. The license fees that Cox pays to cities and towns derive from all revenue, just as MCTC § 470 purports to tax all revenue. Cable services therefore should not be considered bundled for tax purposes now.

The recent amendment of A.R.S. § 42-5064 does not alter this result since it does not apply to cable television services. This legislation reflects no intent to either overrule *People's Choice* or the prohibition against local taxes that the Supreme Court found in A.R.S. § 42-6004. Indeed, instead of supporting the Towns' position, the recent amendment to A.R.S. § 42-5064 (D)(1) shows that the Towns, as the parties that wish to make the change, should in their tax codes "reasonably identify" the portion of the sales price that is attributable to the taxable business activity.

The Court therefore agrees with the Municipal Tax Hearing Officer ("Hearing Officer") on the application of *People's Choice*. The *People's Choice* Court found that People's Choice offered customers programming packages that contained both intrastate and interstate programs as is the case here. The *People's Choice* Court also determined that ARS § 42-6004(A)(2) prohibited cities and towns from taxing interstate

telecommunications services. Finally, the *People's Choice* Court concluded that the transaction privilege taxation of interstate and intrastate revenues of People's Choice was prohibited pursuant to ARS § 42-6004(A)(2) because People's Choice primarily provided interstate programming just as Cox does here.

While the *People's Choice* Court did not define what it meant by "primary," the evidence in this case clearly supports a conclusion that Cox "primarily" provided interstate programming since the vast majority of its programming originated out-of-state. Therefore, the Hearing Officer properly determined pursuant to *People's Choice* that Cox's revenues from its cable television system were not taxable during the refund periods.

B. COX'S REFUND CLAIM FOR THE 1994-1998 PERIOD.

The Court is in agreement with the Towns and the Hearing Officer that Cox's refund claim for the 1994-1998 period was not timely asserted. There is no authority for Cox's argument that the date of its payment of an audit assessment should be regarded as a "return" for purposes of timeliness of its refund claims. During the 1994-1998 period Cox routinely filed regular reports of its revenues with ADOR. And, as argued by the Towns, even if those filings did not report revenues in the "telecommunications" classification, they nonetheless constituted "returns" for present purposes. Therefore, Cox's payment, years later, of an audit assessment based on the inaccuracy of those reports/returns, should not be regarded as a "return" for the purpose of tolling the statute of limitations to give Cox additional years to seek a refund.

Further as argued by Towns, under the facts of this case Cox's refund claims for the 1994-1998 period are also barred by the finality of the audit assessment under A.R.S. § 42-1251(B). That section establishes that the amount determined to be due under an audit assessment "becomes final" unless appealed within 45 days. And, contrary to Cox's argument that A.R.S. § 42-1251(B) is not applicable to Cox because this is a state statute not part of the MCTC, the statutory scheme applicable to the ADOR's collection of municipal taxes on behalf of a city or town expressly incorporates the state procedures. A.R.S. § 42-6002.

C. ATTORNEYS' FEES AND COSTS

The decision whether to award attorneys' fees is governed by MCTC § 578(a) which states:

> A taxpayer who is a prevailing party may be reimbursed for reasonable fees and other costs related to any administrative proceedings brought by the taxpayer pursuant to Section 570(b). For purposes of this section, a taxpayer is considered to be the prevailing party only if both of the following are true:
>
> (1) The tax collector's position was not substantially justified.

(2) The taxpayer prevails as to the most significant issue or set of issues.

The Court concurs with the position of the Towns and affirms the decisions of both Taxpayer Problem Resolution Officers. Here the taxpayer, Cox, prevailed as to the most significant issue. However, the Towns' position in the Administrative Tax Hearing proceedings was substantially justified. The Towns' position is a reasonable one given the long-standing interpretation of Arizona law to allow local taxation of cable services, and Cox's acquiescence in this interpretation until recently. The Towns reasonably believed they had full legal authority to assess and collect taxes on cable services. Furthermore, the Towns made reasonable, good faith arguments that the *People's Choice* case does not apply to Cox.

IT IS THEREFORE ORDERED granting in part and denying in part Cox's Motion for Summary Judgment as set forth above.

IT IS FURTHER ORDERED granting in part and denying in part the Towns' Motion for Summary Judgment as set forth above.

IT IS FURTHER ORDERED that the Towns shall grant the refund requests filed by Cox for the period December 1998 through November 2002.

IT IS FURTHER ORDERED that the Towns need not grant the refund requests filed by Cox for the period June 1, 1994 through September 30, 1998.

IT IS FURTHER ORDERED denying the Towns' Motion to Consolidate.