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No. 57491-4

**DIVISION I OF THE COURT OF APPEALS  
FOR THE STATE OF WASHINGTON**

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Community Telecable of Seattle, Inc., Comcast of Washington I, Inc., and  
Comcast of Washington IV, Inc.,

*Respondents,*

vs.

City of Seattle,

*Appellant,*

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**Appellant's Reply Brief**

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## I. ARGUMENT

### A. Comcast Is Subject To Seattle's Telephone Utility Tax Because Comcast Engages In Telephone Business In The City.

Comcast attempts to avoid the City's telephone utility tax by bundling the charges for the use of its cable transmission system with the charges for the internet service transmitted over the system. Comcast does not dispute that it operates a cable transmission system in the City.

Indeed, Comcast acknowledges that it owns and operates the infrastructure involved in transmitting internet services from its customers' homes to its head end in Burien. (Comcast Brief, p. 4.) Comcast instead argues that it is not subject to the utility tax because Comcast provides internet services as well as a transmission network and charges "one all-inclusive price."

Comcast is liable for the telephone utility tax even if it bundles its services into one price. Under the City's tax code, two separate taxes apply to Comcast's in-city activities. Comcast's operation of a cable transmission system is subject to the six percent telephone utility tax under *SMC 5.48.050A*. And the providing of internet services is subject to the City's business and occupations ("B&O") service tax at a rate of .415 percent under *SMC 5.45.050G*.

The City defines "telephone business" to include the business of transmitting via a cable or similar transmission system. *SMC 5.30.060C*. The definition of "telephone business" specifically includes transmission "to

and from the site of an internet provider via a local telephone network, toll line or channel, cable, microwave, or similar communication or transmission system.” SMC 5.30.060C. The undisputed facts establish that Comcast transmits data via a cable transmission system in the City. Comcast, which considers itself an internet provider, transmits to and from the site of an internet provider via its transmission system. (Comcast Brief, pp. 4-5.) These activities are covered by the definition of “telephone business” and Comcast is therefore subject to the telephone utility tax.

B. The State Statutes Distinguish Between Internet Services And Telephone Business And Permit The City To Impose Its Utility Tax On Telephone Business Activities In The City.

It is undisputed that Comcast engages in data transmission in the City. The State Internet Tax Moratorium, RCW 35.21.717, distinguishes between data transmission and internet services and permits taxation of data transmission.<sup>1</sup> Per the statute, the State restricted a city’s right to impose taxes on internet service only. The Moratorium applies to “internet service,” which is defined in RCW 82.04.297(3) and does not include data transmission activities:

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<sup>1</sup>RCW 35.21.717 states: Until July 1, 2006, a city or town may not impose any new taxes or fees specific to internet service providers. A city or town may tax internet service providers under generally applicable business taxes or fees, at a rate not to exceed the rate applied to a general service classification. For the purposes of this section, "internet service" has the same meaning as in RCW 82.04.297.

"Internet service" means a service that includes computer processing applications, provides the user with additional or restructured information, or permits the user to interact with stored information through the internet or a proprietary subscriber network. "Internet service" includes provision of internet electronic mail, access to the internet for information retrieval, and hosting of information for retrieval over the internet or the graphical subnetwork called the world wide web.

RCW 82.04.297(3). This definition does not cover the data transmission activities that are covered by the City's telephone utility tax.

Indeed, the state legislature specifically distinguishes between taxable telephone business (data transmission) and internet services. Comcast concedes that under RCW 35.21.714 the City is authorized to tax "telephone business" as defined by RCW 82.04.065. (Comcast Brief, p. 14-15.) In RCW 82.04.065, the State defines "telephone business" as the "business of providing network telephone service." The definition of "network telephone service" includes data transmission and specifically excludes "internet service":

"Network telephone service" means the providing by any person of access to a telephone network, telephone network switching service, toll service, or coin telephone services, or the providing of telephonic, video, data, or similar communication or transmission for hire, via a telephone network, toll line or channel, cable, microwave, or similar communication or transmission system. "Network telephone service" includes the provision of transmission to and from the site of an internet provider via a telephone network, toll line or channel, cable, microwave, or similar communication or transmission system. "Network

telephone service" does not include the providing of competitive telephone service, the providing of cable television service, the providing of broadcast services by radio or television stations, nor the provision of internet service as defined in RCW 82.04.297, including the reception of dial-in connection, provided at the site of the internet service provider.

RCW 82.04.065(2) (emphasis added).

The Washington Department of Revenue has acknowledged that data transmission falls within this definition of network telephone services. The Department of Revenue issued an Excise Tax Advisory on February 24, 2006 that disagrees with Comcast's argument and confirms that the 1997 amendment to RCW 82.04.065 explicitly includes data transmission used to provide customers with internet services. Excise Tax Advisory 2029.04.25 (available at <http://taxpedia.dor.wa.gov>; attached as Appendix A.) The Advisory states:

This includes services used to connect an ISP to the Internet backbone or to ISP customer locations, such as the provision of transmission capacity over dial-up connections, coaxial cables, fiber optic cables, T-1 lines, frame relay service, digital subscriber lines (DSL), wireless technologies, or other means.

Washington has traditionally taxed the sale of these network telephone services to a consumer under the retailing classification of the business and occupation (B&O) tax and required the seller to collect retail sales tax. In 1997, RCW 82.04.065 was amended to explicitly include "the provision of transmission to and from the site of an internet provider via a local telephone network, toll line or channel, cable, microwave, or similar

communication or transmission system" as taxable network telephone service.

ETA, p. 1. The Advisory confirms that the Department of Revenue concurs with the City in that network telephone services include data transmission over cable networks to internet customer locations.

The definition of network telephone services in RCW 82.04.065 is virtually the same as the City's definition of "telephone business" in SMC 5.30.060. Contrary to Comcast's argument, the definition distinguishes between internet service and data transmission. The definition includes data transmission, including "transmission to and from the site of an internet provider." In RCW 82.04.065(2) the State specifically recognized that "network telephone services" include data transmission, which are taxable and distinct from internet services. Thus, the limitation in RCW 35.21.717 on taxing internet service providers does not apply to the telephone business activity of data transmission. Comcast's data transmission services conducted in Seattle do not fall within the definition of internet services. When engaged in data transmission activities, Comcast is engaging in telephone business under SMC 5.48.050A and is subject to the City's tax on that activity.

C. The City Requires Companies That Engage In Telephone Business And That Also Provide Internet Services To Pay The Telephone

Utility Tax Based On The Revenue Attributable To The Telephone Business Activities.

Comcast argues that it should not be required to apportion its gross income between telephone business and internet services. This is an attempt to avoid the telephone utility tax by combining income from different taxable activities. The City's tax code prevents this by defining "gross income" as "the value proceeding or accruing from the sale of tangible property or service" and includes receipts "however designated." SMC 5.48.020B. Under this definition, a company cannot evade taxes by designating its revenue in a particular way on its books or in its customer bills. The utility tax is based on income "however designated." SMC 5.48.020B. Comcast cannot avoid the telephone utility tax by charging one price for the transmission services and internet services.

Under the Seattle Municipal Code, if a taxpayer engages in an activity covered by the utility tax and another activity covered by the B&O tax, the City taxes each activity separately. (CP 43-45.) This is true for companies covered by the telephone utility tax as well as companies covered by other utility taxes such as the solid waste utility tax. For example, under SMC 5.48.055B, a company engaged in the collection of solid waste is subject to a tax of 11.5% of the gross income from collecting solid waste. But the solid waste company also must pay the

lower B&O tax under SMC ch. 5.45 for other activities such as selling or renting waste containers, collecting recyclable waste, and collecting bulky items. SMC 5.48.055C. According to Comcast's argument, a solid waste company could avoid the solid waste utility tax by charging its customers a high container-rental fee and by charging nothing for collecting the waste. The tax code does not permit this type of activity. Solid waste companies cannot avoid the higher utility tax on their collection activities by bundling their charges. CP 641-642. Similarly, Comcast cannot avoid the telephone utility tax by bundling the telephone business revenues with revenues that are subject to the lower B&O tax rate such as ISP services.

Comcast argues that the repeal of Seattle Business Tax Rule 5-44-155 ("Rule 155") at the end of 2001 relieves them of the apportionment requirement. CP 658. This is incorrect because, as explained above, the apportionment requirement is based on the Seattle Municipal Code as well as Rule 155. The repeal of Rule 155 after the first year of the audit period did not relieve Comcast of its obligation under SMC 5.48.050A to pay the telephone utility tax based on the revenues attributable to the telephone business.

D. Comcast Did Not Provide Records Requested By The City During The Audit And Is Barred Under SMC 5.55.060 From Challenging The Assessment.

It is undisputed that Comcast refused to provide the City with access during the audit to Comcast's contracts with Excite@home and its successors. CP 40, 46-47. The City attempted to obtain these contracts in order to determine the amount of revenue related to the internet services received by Comcast's customers. CP 40, 46-47. Comcast refused to provide those agreements and the City was forced to finalize the audits without the contracts. Thus, under SMC 5.55.060, Comcast is barred from challenging the assessment as a result of its refusal to produce documents.

Comcast now claims that it provided the City with "the information" during the audit. (Comcast Brief, p. 10.) This is incorrect. The information sought by the City was the contracts. CP 40, 46-47, 831 lines 3-9. Comcast gave the auditor only an approximate oral figure, which the auditor was never able to confirm by viewing the written contracts. CP 40, 832. During the audit, Comcast never provided the contracts requested by the City. Consequently, Comcast failed to comply with SMC 5.55.060, which requires Comcast to "provide or make available records." Comcast is attempting to dictate how the City's auditors obtain and verify information. The tax code requires the taxpayer to provide records and does not require the auditor to rely on unsubstantiated oral representations.

In addition, Comcast contends that it met its obligation to provide records to the auditor by producing the documents during discovery in this lawsuit. Comcast's Brief, p. 11; CP 47, line 11. Comcast produced the documents nearly two years after the City issued the assessment letters in July 2003. The purpose of SMC 5.55.060 is to provide documents to the auditor during the audit, not two years later during litigation. In order to have a functioning tax system, a taxing authority must be able to obtain taxpayers' records without resorting to litigation.

The State of Washington has a virtually identical provision. Under RCW 82.32.070(1), a taxpayer that fails to allow the Department of Revenue to examine its books and records "shall be forever barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes . . ." Similarly to the City's system, a taxpayer that fails to provide the State with tax records is estopped from challenging the tax assessment in court.

These production of records requirements do not interfere with the court's jurisdiction. The taxpayer is simply estopped from challenging an assessment if the taxpayer refuses to produce records. The court relied on a similar provision in *Lacey Nursing Home v. Dept. of Revenue*, 128 Wn.2d 40, 54-55, 905 P.2d 338 (1995). In *Lacey*, the court ruled that a group of taxpayers could not file a class action lawsuit because they could

not comply with the requirement of RCW 82.32.180 to “keep and preserve books, records, and invoices.” *Lacey*, 128 Wn.2d at 55. *See also Coluccio v. King County*, 82 Wn. App. 45, 917 P.2d 145 (1996) (no refund of property tax where taxpayer failed to avail himself of the statutory remedies of paying under protest or filing a claim for an administrative refund).

The fact that the City is enforcing an ordinance rather than a state statute does not affect the City’s authority. The ability to require the production of records is an integral part of the City’s tax system, which is authorized by the State.<sup>2</sup> The legislature would not have granted the City the power to tax without granting the power to obtain tax records in the same manner that the state obtains its taxpayers’ records. For example, in *American Legion Post No. 32 v. City of Walla Walla*, 116 Wn.2d 1, 802 P.2d 784 (1991), the taxpayer argued that the city had no power to impose penalties and interest to enforce a gambling tax. The court ruled that the legislature’s grant of authority included such power:

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<sup>2</sup> Seattle is authorized by statute to impose taxes. RCW 35.22.280(32); RCW 35.23.440(8); RCW 35.22.570. *See Pacific Telephone and Telegraph Co. v. City of Seattle*, 172 Wash. 649, 653, 21 Pac. 721 (1933) (power to license for any lawful purpose includes power to impose tax on telephone business).

It cannot seriously be contended that the Legislature intended to provide municipalities with the authority to impose a tax but deprive them of the power to enforce the tax. We will not ascribe such an absurd interpretation to the gambling act.

*Id.* at 12. Here, the legislature’s authorization to impose taxes includes the authority to enact the basic provisions of a tax code, including the requirement that a taxpayer produce relevant records. The City is exercising this authority under SMC 5.55.060D.

The City is not violating Comcast’s due process rights by creating a “conclusive presumption.” The City is not attempting to impose “a tax upon an assumption of fact which the taxpayer is forbidden to controvert.”

*Henier v. Donnan*, 285 U.S. 312, 53 S.Ct. 358, 76 L.Ed. 772 (1932).

Instead, Comcast is estopped from challenging the assessment because it failed to produce records. Comcast had an opportunity to controvert its refusal to produce records and did not do so. It is undisputed that Comcast failed to produce contracts sought by the City’s auditor. Consequently, in light of that uncontroverted fact, Comcast is estopped from contesting the assessment.

Tax refund suits are suits in equity, not law. *Dexter Horton Building v. King County*, 10 Wn.2d 186, 116 P.2d 507 (1941). Refunds, therefore, should be allowed only when a taxpayer has properly complied with its obligations under the tax code.

E. The City Is Allowed To Tax Comcast's Transmission Activities Under The Grandfather Clause Of The Federal Internet Tax Freedom Act.

1. The City is authorized by the State to tax telephone business.

Comcast mistakenly contends that the State withdrew the City's ability to tax Comcast's data transmission activities in the 1997 State Internet Tax Moratorium. In reality, as discussed above, the State Moratorium applies to internet service and does not apply to telephone business. The Department of Revenue confirmed this in its February 24, 2006 Excise Tax Advisory in which it concluded that the State of Washington met the ITFA grandfather clause for taxation of network telephone services. Excise Tax Advisory 2029.04.25 (attached as Appendix A.) The Advisory states:

In Washington, B&O and retail sales taxes on the sale of network telephone service used to provide Internet access were generally imposed and actually enforced prior to October 1, 1998. Taxpayers also had a reasonable opportunity to know of this practice due to the fact that RCW 82.04.065 explicitly stated that "the provision of transmission to and from the site of an internet provider via a local telephone network . . . or similar communication or transmission system" was taxable as network telephone service.

ETA, p. 2 (emphasis added). The Department acknowledges that data transmission to internet users is included in the definition of network telephone services and is distinct from internet services. The State's

interpretation of the statute is directly contrary to Comcast's contention that the State excluded data transmission activities from the definition of network telephone service.

The City is authorized to tax telephone business, which the State has defined in RCW 82.04.065 to include transmissions used to provide internet services. RCW 35.21.714. The City is therefore authorized to tax data transmission activities in the City.

2. The City meets the requirements of the ITFA grandfather clause because it notified taxpayers of the taxes before October 1998.

The City's telephone utility tax is exempt from the ITFA because prior to October 1, 1998, the City gave notice by "rule or other public proclamation" that the City "has interpreted and applied such tax to Internet access services." ITFA (2001), § 1101 (d).

The Washington Department of Revenue stated in its Excise Tax Advisory that the State's taxation of data transmission to internet customers is covered by the ITFA grandfather clause. Excise Tax Advisory 2029.04.25, p. 2. The Department concluded that taxpayers received notice by virtue of the amendments to the definition of network telephone service in RCW 82.04.065. ETA, p. 2. The amendments to that statute, which is part of the enabling legislation for the City's telephone

utility tax, applied equally to City taxpayers. The definition of network telephone service encompasses Comcast's data transmission.

The Pennsylvania Supreme Court has held that Pennsylvania's sales and use taxes qualified for the grandfather clause under ITFA. *Concentric Network Corp. v. Commonwealth of Pennsylvania*, 897 A.2d 6, 15 (Penn. 2006). In *Concentric*, the taxpayer, an internet service provider, purchased data transport services and equipment to transmit internet services to its customers. The taxpayer objected to the imposition of the sales and use tax on its purchases. The court ruled that the taxes were permissible under the ITFA because "the tax code provisions in question were generally imposed and actually enforced prior to October 1, 1998." *Concentric*, 897 A.2d at 15. The court relied on the Department of Revenue's publication of a policy and tax code provision that stated that "telecommunications services were taxable under the sales and use tax." *Concentric*, 897 A.2d at 15. Similarly, the City of Seattle generally imposed and actually enforced its taxes prior to 1998.

In addition to the tax code, the City provided notice through Seattle Business Tax Rule 5-44-155. CP 438. Comcast presents collateral attacks on the application of Rule 155. However, it is undisputed that Rule 155 was in effect prior to 1998. Thus, the Rule served as notice of the City's intent to impose its utility tax on data transmission companies such as

Comcast. As stated by the Director of the City's Revenue and Consumer Affairs ("RCA") Division:

The RCA amended Seattle Business Tax Rule 5-44-155 ("Rule 155") in October 1995 in order to establish that companies that provide internet service are subject to the service classification under the B&O tax and that companies that use data transmission networks in the City to transmit internet-related data are subject to the telephone utility tax. Under Rule 155, an internet service provider or other such company that is transmitting data in the City is required to pay the telephone utility tax based on revenue from its data transmission activities. The rule permits the City to apportion the company's revenue between the revenue received for data transmission and the revenue received for internet services. The RCA amended Rule 155 in 1995 following an audit of an internet company in order to confirm that companies using transmission systems in Seattle to transmit internet-related data were required to pay the telephone utilities tax based on the revenue from those transmission activities.

One of the purposes of Rule 155 was to make sure that all companies carrying on a telephone business that involved the transmission of internet-related data were treated equally and taxed on the same basis. Therefore, companies that provide data transmission service and also provide internet services such as e-mail or web pages, are required to apportion the revenue related to each activity. If this were not the case, telephone businesses could evade the telephone utility tax by bundling the transmission services with a small amount of revenue from internet services and claiming that all of the revenue was due to its activities as an internet service provider.

CP 43-44 (emphasis added). A reviewing court gives considerable deference to the construction of an ordinance by those officials charged with its enforcement. *General Motors v. Seattle*, 107 Wn. App. 42, 57, 25

P.3d 1022 (2001). Comcast's collateral attacks on Rule 155 are not applicable. The rule and tax code were in effect prior to 1998 and provided notice that companies engaged in data transmission were subject to the telephone utility tax.

3. In addition to providing notice, the City generally collected its telephone utility tax and B&O tax prior to October 1998.

The City is qualified for the ITFA grandfather clause because the City generally collected its telephone utility tax on internet-related transmissions prior to October 1998. (CP 45.) The City was not alone in collecting tax on this activity. The Washington Department of Revenue states in its Excise Tax Advisory that the State is subject to the grandfather clause because "B&O and retail sales taxes on the sale of network telephone service used to provide Internet access were generally imposed and actually enforced prior to October 1, 1998." ETA 2029.04.245, p. 2.

Similarly, the Director of the City's RCA Division stated that the City has enforced and collected the telephone utility tax from companies providing transmission systems to transmit internet-related data:

During my tenure as Director [since 1994], the City has conducted audits of taxpayers who have paid the telephone utility tax under SMC 5.48.050A for transmitting data over cable or other transmission system in the City. The RCA has applied this tax to a variety of companies, including traditional telephone companies, hotels that provide telephone service to their guests, companies that provide switchboard and telephone services to office suites, and to

other companies that use their transmission systems to transmit internet-related data. The RCA interprets the telephone utility tax under SMC 5.48.050A as applying to cable companies such as plaintiffs that use their transmission systems to transmit internet-related data. The RCA has imposed, enforced, and actually collected the telephone utility tax from these types of companies.

...

Since the amendment of Rule 155 in 1995, the RCA has enforced the tax code so that if a telephone business, internet service provider, or internet access provider business provides transmission activities to an end user (consumer) the telephone utility tax is due based on revenue from those activities. The RCA has enforced the tax code so that a company that owns transmission capability through wires, cable, microwave or other medium are considered a telephone businesses under SMC 5.30.060C and are subject to the telephone utility tax under SMC 5.48.050. The RCA enforced the tax code in this fashion prior to October 1, 1998.

CP 43-44 (emphasis added). The City generally imposed and actually enforced its telephone utility tax on internet-related data transmissions prior to 1998. The ITFA does not require that a taxing jurisdiction collect and enforce the tax with 100 percent accuracy. That would be impossible in a self-reporting system like the City's. CP 47, ¶ 16. The City generally collected utility taxes from companies transmitting data and collected B&O taxes from companies providing services. The City generally enforced its tax code and therefore qualifies for the ITFA grandfather clause.

F. The City Telephone Utility Tax Is Not Discriminatory Under The ITFA Because It Is Imposed Upon, And Legally Collectible From, Companies Engaged In Telephone Business In The City.

The ITFA's moratorium on discriminatory taxes does not apply to the City's telephone utility tax because the tax applies to all companies engaged in telephone business in the City. ITFA (2001) § 1104(2); ITFA (2003) § 1105(2). A company that engages in both telephone business and providing internet services will be taxed on both activities. A company engaged in only one activity will be taxed only on that activity. CP 658. Comcast contends that other companies providing internet services are taxed at the lower B&O rate. However, those companies do not provide data transmission to their customers.

The Pennsylvania Supreme Court recently held that Pennsylvania's sales and use taxes did not discriminate under the ITFA. *Concentric Network Corp. v. Commonwealth of Pennsylvania*, 897 A.2d 6, 15 (Penn. 2006). In *Concentric*, an internet service provider that purchased data transport services and equipment to transmit internet services appealed the state's imposition of a sales and use tax on its purchases. The taxpayer made the reverse argument made by Comcast here. Concentric contended that the code "gave a preference to cable based and facilities based Internet service providers to the detriment of non-facilities based Internet service providers." *Id.* at 14. The court rejected the argument and stated:

Moreover, Taxpayer pays sales and use tax because it uses other companies' wirelines to provide its services. Taxpayer is not prohibited by the Tax Code from installing its own wirelines or from using some other technology to provide its service. If it chooses an alternate solution, it will not pay sales and use tax on purchases of telecommunications services. In short, the tax at issue here results not from a discriminatory tax on electronic commerce but from Taxpayer's business decisions.

*Concentric*, 897 A.2d at 15. The court ruled that Concentric was not subject to discrimination under the ITFA merely because Concentric paid sales and use tax on the purchase of data transmission services which other ISPs did not have to purchase.

In the present case, Comcast must pay the City's telephone utility tax because it provides data transmission services to its customers. Any other company providing those services is subject to the same tax. There is no discrimination.

G. The City Telephone Utility Tax Does Not Tax "Internet Access" As Defined By The ITFA.

The ITFA does not bar the City's taxation of Comcast's data transmission activities because those activities do not fall under the definition of "internet access" under the ITFA. 47 U.S.C.A. § 151 (note) § 1104(5) (2001). Comcast argues that the amendments to the ITFA definition of "internet access" that took effect in 2003 affect the City's

telephone utility tax.<sup>3</sup> First, those amendments took effect after the audit period, so they do not affect the assessed taxes. Second, the 2003 amendments to the definition of “internet access” establish that, prior to the amendments, transmission services or other such telecommunications services were not included in the definition of “internet access.” Congress specifically amended the ITFA to state that telecommunications services were excluded from the definition except to the extent the services were used to provide internet access. ITFA § 1105(5) (2003). The fact that Congress made the amendment indicates that, prior to the amendment, any such services were not included in the definition of internet access. Congress distinguishes in the ITFA between telecommunications and internet access. Similarly, the transmission of data over a cable network is not included in the definition of internet access.

## **II. CONCLUSION**

The undisputed facts establish that Comcast operates a cable transmission system in the City. The operation of this system is a telephone business under 5.30.060C and is subject to the City’s telephone utility tax under SMC 5.48.050A. The state moratorium on taxing internet

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<sup>3</sup> Effective November 1, 2003, the ITFA’s definition of “internet access” stated that the term “does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access.” ITFA § 1105(5) (2003).

service providers does not apply to the taxation of network telephone services, which includes Comcast's activities in the City. Comcast cannot avoid the telephone utility tax by bundling its internet service revenue with its telephone business revenue. In addition, the Internet Tax Freedom Act does not prohibit the City's tax because the City's tax was generally imposed and actually enforced prior to October 1998. Indeed, prior to 1998, the City notified Comcast and the other cable company operating in Seattle that they would be subject to the telephone utility tax. Accordingly, the Court should reverse the trial court.

DATED this 14 day of July, 2006.

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**CERTIFICATE OF SERVICE**

I, certify that on this date I caused a copy of appellant City of Seattle's Reply Brief to be filed with the court and served by first class U.S. Mail, postage prepaid on:

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Signed at Seattle, Washington, this 14 day of July, 2006.

  
\_\_\_\_\_  
Marisa Johnson

## **APPENDIX A**



# Excise Tax Advisory

Excise Tax Advisories (ETAs) are interpretive statements issued by the Department of Revenue under authority of RCW 34.05.230. ETAs explain the Department's policy regarding how tax law applies to a specific issue or specific set of facts. They are advisory for taxpayers; however, the Department is bound by these advisories until superseded by Court action, Legislative action, rule adoption, or an amendment to or cancellation of the ETA.

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## Taxation of network telephone service used to provide Internet access services

On December 3, 2004, President Bush signed the Internet Tax Nondiscrimination Act of 2004, P.L. 108-435. This legislation reinstated and extended the moratorium on taxes on Internet access by amending the Internet Tax Freedom Act (ITFA). The legislation expanded the definition of tax-exempt Internet access by including telecommunications services that are purchased, used, or sold by an Internet service provider (ISP) to provide Internet access to its customers. This expanded definition of Internet access is thought by some taxpayers to include the type of services provided by network telephone service businesses to ISPs and their customers. This includes services used to connect an ISP to the Internet backbone or to ISP customer locations, such as the provision of transmission capacity over dial-up connections, coaxial cables, fiber optic cables, T-1 lines, frame relay service, digital subscriber lines (DSL), wireless technologies, or other means.

Washington has traditionally taxed the sale of these network telephone services to a consumer under the retailing classification of the business and occupation (B&O) tax and required the seller to collect retail sales tax. In 1997, RCW 82.04.065 was amended to explicitly include "the provision of transmission to and from the site of an internet provider via a local telephone network, toll line or channel, cable, microwave, or similar communication or transmission system" as taxable network telephone service. To the extent that these services are included within the federal definition of "Internet access" (see below), ITFA appears to preempt the State's authority to apply B&O and retail sales taxes to the purchase of network telephone service used to provide Internet access, as well as the ISP's provision of traditional Internet access itself.

However, P.L. 108-435 also included two relevant grandfather clauses in section 3 of the Act. The first clause (subsection (a)(1)) grandfathers a state's right to continue assessing taxes on Internet access that were imposed and actually enforced as of October 1, 1998 if the tax was authorized by statute and the State had issued a public proclamation that such taxes were being imposed **or** the state generally collected tax on Internet access. This right continues through November 1, 2007, the date the moratorium is scheduled to end. P.L. 108-435 also included a second grandfather clause (subsection (b)) that applies to taxes imposed and enforced as of November 1, 2003. It grandfathers a state's right to continue imposing such taxes if the state had issued a public proclamation that taxes on Internet access were being imposed **and** the state generally collected such taxes. The right to continue imposing taxes under the second grandfather clause expires November 1, 2005. The language in the two grandfather clauses is substantively identical except for the different time periods (the first applies to pre-October 1998 taxes and the second applies to pre-November 2003 taxes) and the fact that the two provisos are written in the disjunctive for the first clause and in the conjunctive in the second clause.

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Some taxpayers believe that the second grandfather clause applies – to the exclusion of the first grandfather clause – to all taxes imposed on network telephone service used to provide Internet access services. These taxpayers point to statements made in the Congressional record that suggest that members of Congress thought that all state taxation of DSL services used to provide Internet access would cease as of November 1, 2005. Therefore, these taxpayers believe that they no longer need to collect and remit retail sales tax on sales of network telephone service used for Internet access after November 1, 2005.

The actual statutory language of ITFA does not, however, support this interpretation of the law. The first grandfather clause, effective until November 1, 2007, applies to any "tax on Internet access that was generally imposed and actually enforced prior to October 1, 1998." The term "Internet access service" is defined to include "telecommunications services . . . purchased, used, or sold by a provider of Internet access to provide Internet access." To the extent this modified definition includes purchased telecommunications used to provide Internet access, the first grandfather clause clearly applies to allow Washington State's taxation of these telecommunications services used to provide Internet access, because these taxes were imposed and enforced before October 1998. There is no indication in the statutory language that Congress intended the separate clauses to apply to different types of services, as opposed to covering taxes imposed in different time periods -- the language describing the applicable service is identical in both clauses. The applicable rule of statutory interpretation is that if the statutory language is unambiguous, a court will not consider the legislative history of the statute to reach a contrary conclusion. *Whitfield v. U.S.*, 543 U.S. 209, 215 (2005). Even if a court were to look to the legislative history of the act, however, the record is far from definitive and contains statements that could be seen to support either reading of the statute.

Finally, Washington meets the technical requirements of the first grandfather clause. In Washington, B&O and retail sales taxes on the sale of network telephone service used to provide Internet access were generally imposed and actually enforced prior to October 1, 1998. Taxpayers also had a reasonable opportunity to know of this practice due to the fact that RCW 82.04.065 explicitly stated that "the provision of transmission to and from the site of an internet provider via a local telephone network . . . or similar communication or transmission system" was taxable as network telephone service. Finally, the State generally collected B&O and retail sales taxes on the purchase of such network telephone service.

For these reasons, Washington's taxation of network telephone service used to provide Internet access qualifies under the first grandfather clause of ITFA and will continue as described above until at least November 1, 2007. This conclusion makes it unnecessary for the department to adopt a position with respect to the interpretation of the term "Internet access" advanced in the January 2006 Government Accountability Office report "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State." The department may, before the expiration of the grandfather period, consider whether the amended definition allows the continued taxation of telecommunications services used to provide Internet access services, but does not do so at this time.

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