IN THE COURT OF APPEALS OF IOWA

No. 8-258 / 07-1792
Filed October 1, 2008

AOL, L.L.C.,
Petitioner-Appellee,

vs.

IOWA DEPARTMENT OF REVENUE,
Respondent-Appellant.

Appeal from the Iowa District Court for Polk County, Robert B. Hanson, Judge.

The Iowa Department of Revenue appeals from the ruling on judicial review reversing the final agency decision and concluding that gross receipts received by America Online, LLC, from its Iowa customers were not subject to Iowa sales tax. **AFFIRMED.**

Thomas J. Miller, Attorney General and Marcia Mason and Jim Miller, Assistant Attorneys General, for appellant.

Bruce Baker of Nyemaster Goode West Hansell & O'Brien, P.C., Des Moines, and Peter Brann and Martin Eisenstein of Brann & Isaacson of Lewiston, Maine, for appellee.

Heard by Sackett, C.J., and Miller and Potterfield, JJ.

POTTERFIELD, J.

The Iowa Department of Revenue appeals from the ruling on judicial review reversing the final agency decision and concluding that gross receipts received by America Online, LLC (AOL), from its Iowa customers were not subject to Iowa sales tax. We affirm.

Background Facts and Proceedings.

AOL is a service that offers its members internet access, email, instant messaging, and a variety of original content features. In order to retrieve the content of the AOL service, a member residing in Iowa has its modem-equipped computer place a call to a local telephone number. One of a cluster of modems at this local exchange answers this call, thus completing a local telephone connection between the member and the modem. The modem that answers the call then passes along a digital signal, which is routed to one of AOL's call centers located in Virginia. Before the customer can receive any content from AOL, "authentication" of the customer's information must occur in Virginia, at which time the session begins. Without a local connection between the user's computer and the AOL call center in Virginia, no services can be provided.

The Iowa Department of Revenue (Department), on June 14, 2001, issued an assessment seeking to collect unpaid sales taxes, which it claims are owed for the internet-related communication services provided by AOL, during a period from July 1, 1995, until June 30, 1999, (at which point, the legislature enacted a statute which expressly exempted the services from the sales tax). AOL filed a protest of the assessment.

The administrative proceedings resulted in a ruling favoring the Department. The Director of the Department (Director), among other things, held that "AOL's gross receipts from its internet connection services or access as assessed in the audit are communication services subject to Iowa sales tax." In reaching that conclusion, the Director expressly found that the internet access is a "local service" and that AOL's claim that its access is an interstate service was without merit. On judicial review, the district court agreed with AOL. It held that because it is impossible for AOL members to access AOL without connecting through servers in Virginia, AOL is not a communication service provided "in this state." As such, the court determined AOL is not a taxable service, and reversed the agency ruling to the contrary. The Department appeals from this judicial review ruling.

Scope and Standard of Review.

Our review of agency action is governed by the standards set forth in Iowa's Administrative Procedure Act. *Grimm v. Iowa Dep't of Revenue*, 331 N.W.2d 137, 139-40 (Iowa 1983). "In exercising its judicial review power, the district court acts in an appellate capacity." *Mycogen Seeds v. Sands*, 686 N.W.2d 457, 463 (Iowa 2004). When we review the district court's decision, "we apply the standards of chapter 17A to determine whether the conclusions we reach are the same as those of the district court." *Id.* at 464. "If they are the same, we affirm; otherwise we reverse." *Id.*

Iowa Code section 17A.19(11)(c) (2007) provides that we should give appropriate deference to the view of the agency "with respect to particular matters that have been vested by a provision of law in the discretion of the

agency." Iowa Code § 17A.19(11)(c). A statutory provision provides that "[t]he director [of revenue and finance] shall have the power and authority to prescribe all rules not inconsistent with the provisions of this chapter, necessary and advisable for its detailed administration and to effectuate its purposes." *Id.* § 422.68(1). We therefore conclude that the interpretation of Iowa Code section 422.43(1) (1997) has been vested in the agency. Consequently, we must give the agency's interpretation of this statute through its administrative rules the deference directed by Iowa Code section 17A.19(11)(c). *See City of Marion*, 643 N.W.2d at 206-07. That deference requires us to uphold the agency's interpretation unless that interpretation is "irrational, illogical, or wholly unjustifiable." Iowa Code § 17A.19(10)(*l*).

Regarding the agency's factual determinations, the court may grant relief if the taxpayers' substantial rights have been prejudiced because the agency action is "[b]ased upon a determination of fact clearly vested by a provision of the law in the discretion of the agency that is not supported by substantial evidence in the record before the court when that record is viewed as a whole." *Id.* § 17A.19(10)(f*)*. For purposes of our review,

> "*[s]ubstantial evidence"* means the quantity and quality of evidence that would be deemed sufficient by a neutral, detached, and reasonable person, to establish the fact at issue when the consequences resulting from the establishment of that fact are understood to be serious and of great importance.

Id. § 17A.19(10)(f)(1). We can therefore reverse the agency's application of the law to the facts only if we determine such application was "irrational, illogical, or wholly unjustifiable." Iowa Code § 17A.19(10)(m).

Statutory and Regulatory Scheme.

During the time relevant to the dispute, section 422.43(1) imposed a sales tax on “gross receipts from the sales, furnishing, or service of . . . communication service . . . when sold at retail in the state to consumers or users.” In implementing this statute, the Department promulgated Iowa Administrative Code Rule 701-18.20, which begins: “The gross receipts from the sale of all communication services provided in this state are subject to tax.” The rule goes on with the following pertinent provisions:

> 18.20(1) Definitions.
>
> a. Communication service shall mean the act of providing, for a consideration, any medium or method for, or the act of transmission and receipt of, information between two or more points. Each point must be capable of both transmitting and receiving information if “communication” is to occur . . . .
>
> b. Communication service is provided “in this state” only if both the points of origination and termination of the communication are within the borders of Iowa. Communication service between any other points is “interstate” in nature and not subject to tax . . . .
>
> . . . .
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> 18.20(5). Prior to July 1, 1999, charges for access to or use of what is commonly referred to as the “Internet” or charges for other contracted on-line services are the gross receipts from the performance of a taxable service if access is by way of a local or in-state long distance telephone number and if the predominant service offered is two-way transmission and receipt of information from one site to another as described in paragraph “a” of subrule 18.20(1). If a user’s billing address is located in Iowa, service provider should assume that Internet access or contracted on-line service is provided to that user in Iowa unless the user presents suitable evidence that the site or sites at which these services are furnished are located outside this state.

Analysis.

As noted above, the agency first determined that the service provided by AOL is a “communication service” as contemplated in section 422.43(1). It next determined that the service is a “local service,” because it is accessed via a local

telephone number located in the State of Iowa. Therefore, the agency concluded, AOL's service is taxable. On judicial review, the district court concluded that even assuming AOL provides a "communication service," it nonetheless is not taxable because it is an "interstate" service and thus not provided "in this state."

Now on appeal, the Department contends that rule 18.20(1)(b), defining the requirement that a communication service be provided "in this state," pertains to traditional communication services and is inapplicable to taxation of Internet access charges. It further claims that subrule 18.20(5) controls the taxation of AOL's receipts from service to Iowa's customers, because their access to AOL's service was by way of local or in-state long distance telephone numbers, and the predominant service offered was two-way transmission and receipt of information. The Department contends it is irrelevant that all communications were eventually routed through AOL's data center in Virginia, arguing that rule 18.20(5) does not require that the entire network being accessed be located within Iowa. The Department points out that Iowa customers would dial a local number and connect to AOL's private network through a modem located in Iowa.

AOL counters that the only way an Iowa AOL member could access its services was by establishing a connection with the AOL data center in Virginia. Consequently, AOL's service was interstate in nature and was not "provided in this state" under rule 18.20. AOL alternately defends the district court ruling on grounds related to the second requirement of rule 18.20(5), that it raised, but which were not relied on by the district court. AOL contends that the "predominant service" it offered was not access to the internet, i.e. a "two-way

transmission and receipt of information from one site to another," but rather the supplying of original informational content to its customers. AOL further argues that the Department made no effort to establish that the "predominant service" was not the supplying of original informational content. Thus, AOL contends rule 18.20(5) is inapplicable.

The starting point in our analysis is Iowa Code section 422.43(1), the general authorizing statute imposing a tax on "communication service . . . when sold . . . in the state . . . ." The Department has set forth certain rules implementing the statute. We must therefore view the rules implementing that statute through the prism created by that statute. *See* Iowa Code § 17A.23 ("An agency shall have only that authority or discretion delegated to or conferred upon the agency by law and shall not expand or enlarge its authority or discretion beyond the powers delegated to or conferred upon the agency."). As is clear, in order to be taxable, this overarching code provision requires a communication service to be provided "in the state."

As noted, because section 422.43(1) does not define the terms "communication service" or "in the state," the Department promulgated rules clarifying them. Rule 18.20, entitled "Communication Services," initially restates the language found in the code provision regarding the taxation of communication services "in this state." It then contains a more specific subsection specifically authorizing a tax on internet and other online services. Iowa Admin. Code r. 701-18.20(5). That rule provides that an internet service is taxable if (1) access is by way of a local or in-state long distance telephone number, and (2) the predominant service is two-way transmission and receipt of

information. Read alone, these two elements appear to have been met, thus making the service taxable. Indeed, this is how the agency resolved the issue.

However, rule 18.20(1)(b) clarifies the phrase "in this state," indicating that "[c]ommunication service is provided 'in this state' only if both points or origination and termination of the communication are within the borders of Iowa. Communication service between any other points is 'interstate' in nature and not subject to tax." Although rule 18.20(5), pertaining specifically to internet services, does not reference paragraph "b" of subrule 18.20(1), it does specifically reference subparagraph "a." Accordingly, the Department argues that subrule "b" is inapplicable, and that only the two elements of 18.20(5) need be met in order to be taxable. We cannot agree. We conclude subparagraph "b" is applicable to *all* communication services, of which internet services are clearly included by virtue of its inclusion under rule 18.20.

The Department would also have us read and interpret rule 18.20(5) exclusively, with reference to language of that subrule alone. We cannot, however, read that rule in a vacuum, and instead must interpret it with reference to and in the context of the chapter in which it resides as well as the statutory authority for it in the code. *See State v. Byers*, 456 N.W.2d 917, 919 (Iowa 1990) (noting we will consider the challenged statute in para materia, or together, with other pertinent statutes). The defining characteristic of both of these authorities, including section 422.43(1) and the prefatory language to rule 18.20, is that the transaction must occur "in this state." Although this term of art is not found in the subrule pertaining specifically to the internet, rule 18.20(5), the requirement must be read into it in order to harmonize the subrule with its setting in the statutory

scheme. For the Department to have concluded otherwise was "irrational, illogical, [and] wholly unjustifiable." Iowa Code § 17A.19(10)(*l*). The district court, therefore, correctly reversed the agency on this issue.

We therefore review the Department's fact-finding that AOL provides a "local" as opposed to an "interstate" service. In reviewing the record, we conclude this finding is not supported by substantial evidence. *See Wal-Mart Stores, Inc. v. Caselman*, 657 N.W.2d 493, 499 (Iowa 2003) (noting courts must not simply rubberstamp the agency fact finding without engaging in a fairly intensive review of the record to ensure that the fact finding is itself reasonable) (quoting Arthur A. Bonfield, *Amendments to Iowa Administrative Procedure Act,* at 68 (1998)).

It is undisputed that the only method for AOL subscribers to access its services is through a connection with AOL's data centers in Virginia. Simply placing a local call to a local access point in Iowa would not provide any service whatsoever. Moreover, when a member requests termination from an AOL session, the AOL servers in Virginia make the actual disconnection. This is contrary to the Director's finding that, unlike a traditional telephone call, there is no *termination* of the communication. Thus, the transmission is between two points—the member's computer in Iowa and the AOL servers in Virginia—and as such the communication does not occur "in this state" as is required by rule in order to be taxable. As the service is an interstate one, the district court correctly reversed the Director's ruling. We therefore affirm the district court's conclusion that the agency's final determination that AOL service is a communication service

provided “in this state” is a wholly unjustifiable application of law to fact. This was an interstate service and not subject to taxation.

AFFIRMED.