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DISTRICT COURT, LARIMER COUNTY, COLORADO

Court Address: Larimer County Justice Center
201 La Porte Ave., St. 100
Fort Collins, CO 80521

Plaintiff(s): NETFLIX, INC.

v.

Defendant(s): DEPARTMENT OF REVENUE OF THE CITY OF LOVELAND, COLORADO; and BRENT WORTHINGTON, FINANCE DIRECTOR for the CITY OF LOVELAND, COLORADO

_ COURT USE ONLY _

Case No.:

Div./Ctrm.:

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COMPLAINT AND NOTICE OF APPEAL

Plaintiff Netflix, Inc. ("Plaintiff" or "Netflix"), hereby files this Complaint and Notice of Appeal ("Complaint"). This Complaint constitutes an appeal of a sales and use tax assessment issued to Plaintiff by the City of Loveland, Colorado, by and through its Finance Department.

Plaintiff alleges as follows:

PARTIES

1. The Plaintiff is a Delaware corporation with its headquarters and principal place of business at 100 Winchester Circle, Los Gatos, California 95032.

2. Defendant City of Loveland, Colorado ("Loveland" or "City") is a political subdivision of the State of Colorado. Loveland is and was at all relevant times empowered to assess and collect sales and use taxes under the City Sales and Use Tax Code ("City Code") and as a result of a grant of authority by Article 20, §6 of the Colorado Constitution.

3. Defendant Brent Worthington is the Director of the Finance Department for Loveland ("Finance Director"). Plaintiff names Brent Worthington as a defendant in this action in his official capacity as the Finance Director. Upon information and belief, the Finance Director's principal office is located at 500 East Third Street, Loveland, CO 80537. (Hereinafter, Plaintiff refers to Loveland and Finance Director collectively as "Defendants.")

JURISDICTION AND VENUE

4. Jurisdiction in this Court is proper in accordance with C.R.S. §§ 29-2-106.1(8)(c) and 39-21-105.

5. Venue in this Court is proper in accordance with C.R.S. § 29-2-106.1(8)(d) because Loveland is located in Larimer County.

FACTUAL ALLEGATIONS

Loveland's Audit and Assessment and Subsequent Procedural History

6. The City's Revenue Division ("Revenue Division") conducted a sales tax audit of the Plaintiff for the periods September 1, 2012 through August 31, 2015 ("Audit Period").

7. On August 23, 2016, the Revenue Division issued a Notice of Determination, Assessment and Demand for Payment ("Notice") to Plaintiff assessing unpaid City sales tax in the total amount of $116,508.22 (the "Assessment"), comprised of $85,504.43 in sales tax, $8,550.49 in penalty and $22,453.30 in interest. A copy of the Notice (without enclosures) is attached hereto at Exhibit 1.

8. The Notice states that sales tax is due from the Plaintiff on "sales/rental of tangible personal property" for which the sales tax was not charged to the customers, or remitted to the City.

9. On September 21, 2016, Plaintiff timely filed a Petition for Review and Modification of Notice of Determination ("Petition") to protest the Assessment and request a hearing on the Petition.

10. The City responded to the Petition by letter dated November 10, 2016, in which the City's Revenue Manager acknowledged receipt of the Petition, elected to "review" the Petition and granted Plaintiff's request for a hearing.

11. On January 17, 2017, the hearing was held in Loveland, Colorado before the City's Hearing Officer.

12. As of the date of this appeal, the City has not issued a decision or otherwise informed Plaintiff in writing that it does not intend to issue a decision.

13. Pursuant to C.R.S. § 29-2-106.1(8)(a), "if a deficiency notice or claim for refund involves only one local government . . . the taxpayer may appeal such deficiency or denial of a claim for refund in the district court."

14. Plaintiff timely requested a hearing in writing on September 21, 2016 and although a hearing was held within 180 days (*i.e.,* by March 20, 2017), the City has not yet issued a decision or otherwise informed the taxpayer in writing that it does not intend to issue a decision. Therefore, this appeal is timely and proper under C.R.S. § 29-2-106.1(8)(c).

15. Plaintiff, within 15 days of the filing of this complaint, will make a deposit pursuant to C.R.S. § 39-21-105(5), under protest and under duress, in the total amount of sales tax, interest, and penalty asserted in the Notice.

Nature of the Dispute

16. The City's sales tax is imposed only upon sales of tangible personal property that are also subject to the Colorado sales tax.

17. Section 3.16.020(A) of the City Code imposes the tax on the sale of tangible personal property and certain services at retail, provided that the "tangible personal property and services taxable under this chapter shall be the same as the tangible personal property and services taxable pursuant to § 39-26-104, Colorado Revised Statutes ["C.R.S."] . . . ."

18. Colorado imposes the sales tax upon the "purchase price paid or charged upon all sales and purchases of tangible personal property at retail." C.R.S. § 39-26-104(1)(a).

19. Colorado also imposes sales tax on certain enumerated services, none of which apply to Plaintiff. C.R.S. § 39-26-104(1)(a).

20. "Sale" or "sale and purchase" is statutorily defined to include "every such transaction, conditional or otherwise, for a consideration, constituting a sale. . . ." C.R.S. § 39-26-102(10).

21. The Colorado Department of Revenue ("Department") further defines "sale" to mean "any transaction . . . whereby a person, in exchange for any consideration . . . (a) transfers or agrees to transfer all or part of his interest . . . in any tangible personal property to any other person. . . . Whether the transaction is absolute or conditional, it shall be considered a sale if it transfers from a seller to a buyer the ownership or possession of tangible personal property. . . ." Colo. Code Regs. 26-102.10.

22. A sale also includes "any right to the continuous possession or use for three years or less of any article of tangible personal property under a lease or contract," if the lessor has not paid sales or use tax on the tangible personal property upon acquisition. C.R.S. § 39-26-713(1)(a); *Colorado General Information Letter No. GIL-11-002* (03/23/2011) (Section 39-26-713(1)(a) imposes a sales tax on lease payments).

23. While neither of the terms "possession" or "use" are defined in the sales tax statute, the taxable "use" of tangible personal property is described by the Department as "such use as is made by the owner or purchaser in exercising control. Use shall be deemed sufficient for the imposition of the tax when the article purchased is actually used . . . or performing any other act by which dominion or control over the property is assumed by the purchaser." Colo. Code Regs. 39-26-202.

24. "Tangible personal property" means "corporeal personal property." C.R.S. § 39-26-102(15)(a)(I).

25. In its regulation, the Department states that tangible personal property "embraces all goods, wares, merchandise, products and commodities, and all tangible or corporeal

things or substances which are dealt in, capable of being possessed and exchanged. . . ." Colo. Code Regs. 26-102.15.

26. The longstanding rule of construction in Colorado is that tax statutes "will not be extended beyond the clear import of the language used, nor will their operation be extended by analogy. . . . All doubts will be construed against the government and in favor of the taxpayer." *City of Boulder v. Leanin' Tree, Inc*., 72 P.3d 361, 367 (Colo. 2003) (quoting *Transponder Corp. v. Property Tax Admin.*, 681 P.2d 499, 504 (Colo. 1984)).

27. Plaintiff contends that Plaintiff's Streaming Service is not subject to the City sales tax.

Plaintiff's Business – The Netflix Streaming Service

28. All of the facts below refer to the Audit Period, unless otherwise noted.

29. Plaintiff holds a sales tax license in the City.

30. Beginning in 2010, due to increasing demand, advancements in technology, the long-term vision of the company, and other business dynamics, Plaintiff began offering its streaming video service as a standalone monthly subscription (the "Streaming Service").

31. From its California headquarters, Plaintiff enters into licensing agreements with content providers, including movie and television studios, to obtain the right to provide content, including original content, to subscribers.

32. The video content is uploaded to a set of Internet cloud servers ("Servers") owned and managed by Amazon Web Services.

33. Plaintiff then processes and prepares the video content for use with various subscriber-viewing devices, each of which requires a different format.

34. Plaintiff also provides a unique user interface that employs complex computer algorithms to present customized content choices most likely to appeal to a subscriber based on past choices and expressed preferences and that allows a subscriber to search for, select, and view entertainment content (*e.g.*, movies) from Plaintiff's website using a personal computer or other personal device (*e.g.*, iPhone or Roku Box).

35. Plaintiff controls and coordinates the Streaming Service, user interface, and algorithms through the Servers.

36. None of the Servers are located in the City.

37. Video content is also stored on another set of Internet servers ("Cache Boxes") owned by third parties such as Internet service providers ("ISPs") or in some cases owned by Plaintiff.

38. Plaintiff did not own any Cache Boxes in the City.

39. Plaintiff does not charge for any individual pieces of content and instead charges a monthly subscription fee regardless of whether or not the subscriber views any video content.

40. Plaintiff retains exclusive control over all aspects of the Streaming Service, including content, at all times.

41. Plaintiff makes no guarantee as to the availability of any particular content at any particular time.

42. Plaintiff can remove content from the Streaming Service for any reason, at any time, even while a subscriber is in the middle of watching it.

43. A single movie on the Servers and/or Cache Boxes may be streamed simultaneously by hundreds, if not thousands, of subscribers.

44. Subscribers could not download any content on the Streaming Service.

45. The process by which the video content is streamed to subscribers is entirely controlled by Plaintiff.

46. The underlying technology that Plaintiff employs to deliver the Streaming Service is virtually identical to the technology used to provide video on demand and pay per view services.

FIRST CLAIM FOR RELIEF

(Review of Sales and Use Tax Assessment Pursuant to C.R.S. § 29-2-106.1)

47. Plaintiff incorporates herein by reference the allegations in paragraphs 1–46 of this Complaint.

48. The City's Assessment alleges that the Streaming Service is subject to the sales tax as the lease or rental of tangible personal property.

The Streaming Service is a Nontaxable Service

49. Plaintiff incorporates herein by reference the allegations in paragraphs 1-48 of this Complaint.

50. The Streaming Service is a nontaxable service.

Netflix provides a service that begins when Netflix sources entertainment content from movies and television studios, and continues as Netflix optimizes that content for

viewing, creates unique and personalized interfaces for every single subscriber, and provides a seamless viewing experience.

51. Therefore, the Streaming Service constitutes a nontaxable service under the City Code and Colorado law.

The Streaming Service Content is Not Tangible Personal Property

52. In Colorado, tangible personal property is statutorily defined as "corporeal personal property." C.R.S. § 39-26-102(15)(a)(I). Thus, tangible personal property must not only be "corporeal" but also "personal property" to satisfy the statutory definition. Neither term is further defined in the sales tax statute.

53. In its regulation, the Department states that tangible personal property "embraces all goods, wares, merchandise, products and commodities, and all tangible or corporeal things or substances which are dealt in, capable of being possessed and exchanged. . . ." Colo. Code Regs. 26-102.15.

54. During the streaming process, subscribers view a reflection of Plaintiff's video content. The reflection is streamed to a subscriber's device using pulses of light and data packets that are sent through the Internet, hit the screen of the subscriber's device for a split second (or fraction thereof) in succession, and then immediately disappear.

55. The reflection of the content streamed to a subscriber's device is neither personal nor corporeal property. The light pulses and data packets that allow subscribers to view that reflection on their screen are not possessed or exchanged but simply viewed (as a fleeting image) as part of the larger, customized Streaming Service.

56. The only court that has addressed this issue determined that a service using the same underlying technology as the Streaming Service does not constitute tangible personal property or physical personal property that can be possessed or exchanged. *Normand v. Cox Communications Louisiana*, LLC, 167 So. 3d 156 (La. App. 5 Cir. 2014).

57. The technology that Plaintiff employs to deliver the Streaming Service is virtually identical to the technology used to provide Video-On-Demand and Pay-Per-View services.

58. The video content streamed to subscribers does not constitute tangible personal property.

The Streaming Service is Not the Sale, Lease, or Rental of Tangible Personal Property

59. Even assuming, *arguendo*, that the content of the Streaming Service constitutes tangible personal property (it does not), no taxable sale or lease/rental of tangible personal property occurs under Colorado law or the Department's own interpretations of Colorado Law.

60. To be taxable *as a sale* of tangible personal property, there must be a "transfer" from Plaintiff to its subscriber of "the ownership or possession of tangible personal property. . . ." Colo. Code Regs. 26-102.10.

61. Plaintiff does not transfer ownership of its video content, or any other aspect of the Streaming Service, to its subscribers.

62. Plaintiff did not transfer, nor did any subscriber obtain, possession of the content, because subscribers never received either the content or a copy of the content. Instead, subscribers received a reflection of the content streamed using light pulses and data packets that disappear upon reaching their personal device.

63. Thus, the Streaming Service is not a "sale" of tangible personal property.

64. To be taxable as a "lease" (or rental) under Colorado law, Plaintiff must give its subscribers "continuous possession or use" of tangible personal property. In this context, "use" means "exercising control" or assuming "dominion or control" over the tangible personal property.

65. Plaintiff's subscribers do not exercise or assume dominion or control over the video content because Plaintiff retains control over the video content as well as the entire process used to stream a reflection of that content to subscribers.

66. Further, Plaintiff has the ability to remove video content at any time and for any reason, even while subscribers are in the middle of watching it.

67. Subscribers are dependent upon Plaintiff's Servers and algorithms to perform simple functions like pausing, rewinding, or fast-forwarding the video content.

68. Thus, the Streaming Service is not a "lease" (or rental) of tangible personal property.

The True Object of the Streaming Service is the Service that Netflix Provides

69. Even if some small aspect of the Streaming Service is found to be tangible personal property (it is not), and the transaction constitutes a lease (it does not) the essence of the Streaming Service is the nontaxable service that Netflix provides to its customers. *See, e.g., City of Boulder v. Leanin' Tree, Inc*., 72 P.3d 361 (Colo. 2003); Colorado Private Letter Ruling No. PLR-11-007 (12/20/2011).

No Penalties Should be Assessed

70. Plaintiff incorporates herein by reference the allegations in paragraphs 1-69 of this Complaint.

71. Plaintiff challenges the assessment of penalties as part of the City's Assessment.

72. Plaintiff did not collect and remit the City's sales tax on the Streaming Service based upon good cause and its good-faith belief that the City sales tax was not legally due, as shown by the arguments set forth herein to support Plaintiff's Claims for Relief.

73. The City's Code makes permissive—not mandatory—the imposition of penalties. City Code § 3.16.330 ("the City manager may assess. . . .").

74. Accordingly, the City Manager abused its discretion here by not waiving the penalties.

SECOND CLAIM FOR RELIEF

(The Assessment Violates the Internet Tax Freedom Act)

75. Plaintiff incorporates herein by reference the allegations in paragraphs 1-74 of this Complaint.

76. In 1998, Congress enacted the federal Internet Tax Freedom Act (the "ITFA"), which bars federal, state, and local governments from imposing "multiple or discriminatory taxes on electronic commerce." 47 U.S.C. § 151, note at ITFA § 1101(a)(2) originally enacted by Pub. L. No. 105-277, Title XI, 112 Stat. 2681 (1998).

77. A "discriminatory tax" means "any tax imposed by a state or political subdivision thereof on electronic commerce [*i.e.* transactions conducted through the Internet] that is not generally imposed or legally collectible … on transactions involving similar property, goods, services, or information accomplished through other means." ITFA § 1105(2)(A).

78. The ITFA was adopted specifically to foster services, like the Streaming Service, provided over the Internet and to protect them from taxation different or more burdensome than similar products not provided over the Internet, like DVDs.

79. In order for the City to tax the rental of DVDs, the DVD customers must both obtain possession or control over the DVDs and the DVDs must be located in the City. However, Streaming Service subscribers do not obtain possession of or control over any video content or tangible personal property, and none of such content or any property involved in the Streaming Service was located in the City.

80. Further, unlike customers that purchase or rent DVDs in the City, Plaintiff's subscribers can and do use the Streaming Service anywhere in the world on their portable devices, and neither the City nor the Plaintiff can accurately source these transactions to the City.

81. Therefore, the City sales tax is being discriminatorily imposed on Internet transactions and assessment violates the "multiple or discriminatory taxes on electronic commerce" prong of the ITFA.

THIRD CLAIM FOR RELIEF

(The Assessment Violates the United States Constitution)

82. Plaintiff incorporates herein by reference the allegations in paragraphs 1-81 of this Complaint.

83. The United States Constitution requires that a taxing jurisdiction have nexus or a sufficient connection with the transaction being taxed. *See, e.g.*, *Goldberg v. Sweet*, 488 U.S. 252 (1989); *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

84. The United States Supreme Court interprets the Constitution to limit the taxation of transactions to those where both the customer and the transaction (in whole or part) are located within the taxing jurisdiction.

85. As shown above, Plaintiff's subscribers do not possess or have any control over the content or property involved in the Streaming Service and none of the content or property accessed or viewed by the subscribers is located in the City.

86. Neither the City nor Plaintiff can accurately source the Streaming Service transactions actually occurring within the City.

87. Therefore, applying the City's sales tax to the Streaming Service does not satisfy the limits set by the United States Constitution.

88. Thus, the Assessment violates the United States Constitution.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff prays that this Court:

1. Docket this matter as a civil action and hold a trial de novo on all questions of law and fact raised by the Deficiency Notice and this Complaint;

2. Order Defendants to cancel all sales and use taxes imposed in the Assessment, together with any interest and penalty associated therewith;

3. Order the release of payments made by Plaintiff in accordance with C.R.S. §§ 29-2-106.1(8) & 39-21-105;

4. Order that Defendants pay Plaintiff those costs that may be awarded to a prevailing party under any relevant provision of the law;

5. For such other relief as the Court may deem appropriate.

Dated: October 3, 2017

Respectfully submitted,

By: /s/ Scott F. Llewellyn
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