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# **The Netflix Tax: Chicago's Extension of Its Amusement Tax To Include Electronically Delivered Entertainment Faces Numerous Challenges And Sets the Stage For Taxing on Streaming-Based Entertainment**

*Stephanie Cueman\**

## **I. THE INTERNET AGE PRESENTS NEW AVENUES AND CHALLENGES FOR CITIES AND STATES TO TAX CITIZENS**

Americans have moved their lives onto the Internet. We use the Internet to connect with friends, share important (and trivial) life moments, order food, and entertain ourselves.<sup>1</sup> The rise of Internet streaming services, such as Netflix and Spotify, has meant the death of many main street staples.<sup>2</sup> Once omnipresent stores, like Blockbuster or f.y.e., have all but disappeared.<sup>3</sup> Americans are now consuming entertainment through the Internet. This move has caused devastating losses in tax revenue for cities and states around the country.<sup>4</sup> Chicago, to raise revenue for a city plagued by budget problems, began taxing Internet-based streaming services.<sup>5</sup>

On June 9, 2015, Chicago adopted Amusement Tax Ruling No. 5 to take effect on July 1, 2015; yet, companies did not have to start paying

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1. See FACEBOOK, <https://www.facebook.com> (last visited Feb. 11, 2017); INSTAGRAM, <http://instagram.com> (last visited Feb. 11, 2017); GRUBHUB, <http://grubhub.com> (last visited Feb. 11, 2017); NETFLIX, <http://netflix.com> (last visited Feb. 11, 2017).

2. Abha Bhattarai, *After 33 Years, Washington's Last Video Store Closes Its Doors*, WASH. POST (Apr. 27, 2014), [https://www.washingtonpost.com/business/capitalbusiness/after-33-years-washingtons-last-video-store-closes-its-doors/2014/04/25/49e82536-c1ad-11e3-b574-f8748871856a\\_story.html?utm\\_term=.865ae1df0aba](https://www.washingtonpost.com/business/capitalbusiness/after-33-years-washingtons-last-video-store-closes-its-doors/2014/04/25/49e82536-c1ad-11e3-b574-f8748871856a_story.html?utm_term=.865ae1df0aba).

3. See FOR YOUR ENTERTAINMENT, [www.fye.com](http://www.fye.com) (last visited Feb. 11, 2017); BLOCKBUSTER, [www.blockbuster.com](http://www.blockbuster.com) (last visited Feb. 11, 2017) (Blockbuster has closed all rental stores and moved to a Blockbuster On Demand model).

4. See Mark Peters & Greg Bensinger, *States Eye Taxes on Streaming Video and Cloud Computing*, WALL ST. J. (Aug. 20, 2015, 3:13 PM), <https://www.wsj.com/articles/states-eye-taxes-on-streaming-video-and-cloud-computing-1440095146>.

5. *Id.*

the tax until September 1, 2015.<sup>6</sup> The ruling extends the tax to include electronically delivered amusements.<sup>7</sup> Chicago is one of the more recent legislatures to explore the idea of taxing cloud-based streaming services. Other states, including California, Vermont, Tennessee, and Alabama, have explored the idea of taxing Internet services.<sup>8</sup>

In Chicago's case, the language of the ruling states Chicago will tax the companies that provided the amusement; unfortunately for consumers, Netflix already confirmed it would pass the additional cost onto consumers.<sup>9</sup> Other companies affected by the tax are likely to pass the burden to the consumers as well. Through this extension, consumers of streaming video, music, and gaming services now pay an additional tax of 9% on their subscriptions.<sup>10</sup> Chicago expects that the tax will raise twelve million dollars a year.<sup>11</sup> Almost immediately, the amusement tax ruling was challenged in court by the Liberty Justice Center on behalf of Internet streaming service users in Chicago.<sup>12</sup> At the time of publication, the suit against Chicago is currently ongoing.

This Comment will explore Illinois's home rule as it relates to amusement taxes with a focus on the evolution of the Chicago Amusement Tax.<sup>13</sup> It will look at the judicial response to past amusement tax challenges to better understand the claims made against Chicago's amusement tax expansion to Internet streaming services and how past precedent will weigh in the upcoming lawsuit.<sup>14</sup> Additionally, this Comment will examine how other state legislatures are dealing with taxes on cloud-based streaming services.<sup>15</sup>

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6. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf); John Byrne & Amina Elahi, *Chicago Extends Taxing Power To Online Movies, Music, More*, CHI. TRIB. (July 2, 2015 6:30 AM), <http://www.chicagotribune.com/news/local/breaking/ct-chicago-cloud-tax-met-0702-20150701-story.html>.

7. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

8. Peters & Bensinger, *supra* note 8; Mike McPhate, *California Today: Fretting Over the 'Netflix Tax'*, N.Y. TIMES (Nov. 28, 2016), [http://www.nytimes.com/2016/11/28/us/california-today-netflix-tax-video-streaming.html?\\_r=0](http://www.nytimes.com/2016/11/28/us/california-today-netflix-tax-video-streaming.html?_r=0).

9. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

10. *Id.*

11. Byrne & Elahi, *supra* note 6.

12. Complaint at ¶¶ 5-10, *Labell v. City of Chicago*, No. 2015-CH-13399 (Ill. Cir. Ct. Sept. 9, 2015), 2015 WL 5316414.

13. *See infra* Part II.B.

14. *See infra* Part III.

15. *See infra* Part VII.

## II. ILLINOIS'S HOME RULE IS KEY TO UNDERSTANDING WHAT MUNICIPALITIES CAN TAX AS AN AMUSEMENT

The Illinois Constitution established home rule units.<sup>16</sup> This grant of power allows more autonomy in local governance.<sup>17</sup> “If it is a local issue that has not been pre-empted by the state, then it is likely that a home rule unit has the authority to impose a regulation.”<sup>18</sup> In Illinois, home rule units can tax an amusement; however, the power is not unlimited.

### A. Home Rule Units in Illinois

To better understand how municipalities can impose taxes and the legality of the amusement tax extension, one must understand the Illinois “home rule unit.”<sup>19</sup> Home rule units are counties with a chief executive officer elected by the electors of the county and any municipality with a population of more than 25,000.<sup>20</sup> Home rule units “may exercise any power and perform any function pertaining to its government and affairs including . . . to tax.”<sup>21</sup> However, home rule units can only license for revenue or impose taxes upon occupations if the General Assembly grants them the power.<sup>22</sup> Without qualifying as a home rule unit, a municipality can only exercise forty powers, and the rest of the powers are retained by the state.<sup>23</sup> Illinois authorized local municipalities to exert a broad range of powers associated with complete self-governance.<sup>24</sup> This power allows home-rule communities “to incur debt, borrow money, or levy taxes” without a grant by the legislature.<sup>25</sup>

Illinois home-rule municipalities have some of the broadest powers in the United States.<sup>26</sup> The Supreme Court of Illinois recently gave home-rule municipalities a boost: unless the Illinois General Assembly expressly exercises exclusive control over a particular subject matter of the law, municipalities may enact local ordinances with different

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16. ILL. CONST. art. VII, § 6.

17. See CITIZEN ADVOCACY CTR., HOME RULE AND YOU 1 (2004), <http://www.citizenadvocacycenter.org/uploads/8/8/4/0/8840743/homerulebrochure.pdf>.

18. *Id.*

19. ILL. CONST. art. VII, § 6.

20. *Id.* § 6(a).

21. *Id.*

22. *Id.* § 6(e).

23. Joseph A. Kearney, *Stubhub's Tug at the Municipal Purse String: Why the Home-Rule Taxing Powers Enumerated in the Illinois Constitution Must Remain Broad and Strong*, 48 J. MARSHALL L. REV. 37, 40 (2014).

24. *Id.* at 43.

25. *Id.*

26. *Id.* at 38.

requirements than the state statute.<sup>27</sup> As Justice Kilbride stated in his majority opinion, *Palm v. 2800 Lake Shore Drive Condo Ass'n*, for the Illinois Supreme Court, “[h]ome rule is based on the assumption that municipalities should be allowed to address problems with solutions tailored to their local needs.”<sup>28</sup>

The Illinois General Assembly granted municipalities, like Chicago, the ability to create their taxes. Taxing is one power Chicago has not been shy about exercising. In 2016 alone, Chicago increased in property taxes, taxi fares (by 15%), as well as, a new tax on electronic cigarettes.<sup>29</sup> However, the taxing power has limits. The General Assembly has not granted municipalities the authority to enact a service occupation tax. A service occupation tax is imposed on sales transactions other than sales of tangible property.<sup>30</sup> Where a product and service are provided together, the courts examine the totality of the transaction to determine whether it can be taxed.<sup>31</sup>

### B. *Illinois Limits Municipalities' Taxing Power*

Illinois municipalities have no inherent power to tax amusements.<sup>32</sup> The state legislature must give local municipalities the authority to levy such taxes.<sup>33</sup> Here, the Illinois General Assembly authorized municipalities to impose their taxes on businesses.<sup>34</sup> Specifically, “[t]he corporate authorities of each municipality may license, tax, regulate, or prohibit . . . theatricals and other exhibitions, shows, and amusements and may license, tax, and regulate all places for eating and amusement.”<sup>35</sup> Through this grant of power, municipalities, like Chicago, can tax amusements.

Illinois municipalities have frequently exercised their right to tax amusements.<sup>36</sup> Chicago Code of Ordinances defines amusement as:

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27. Adam W. Lasker, *Home Rule Rules, Says the Illinois Supreme Court*, 101 ILL. B.J. 278 (2013), <http://www.isba.org/ibj/2013/06/lawpulse/homerulerulesaystheillinoisupreme>.

28. *Id.*; see also *Palm v. 2800 Lake Shore Drive Condo Ass'n*, 2013 IL 110505, ¶ 29.

29. Hal Dardick, *2016 Brings Tax Hikes For Chicago, Cook County, City Schools*, CHI. TRIB. (Dec. 31, 2015), <http://www.chicagotribune.com/news/local/politics/ct-illinois-new-taxes-fees-20151231-story.html>.

30. See *Comm'ns. & Cable of Chi., Inc. v. Dep't of Revenue of Chi.*, 655 N.E.2d 1078, 1082 (Ill. 1995).

31. *Id.*

32. SANDRA M. STEVENSON, *ANTIEAU ON LOCAL GOVERNMENT LAW* § 64.22, at 4-64 (2nd ed. 2009).

33. *Id.*

34. Thomas P. Bayer et al., *Finance and Tax*, in *MUNICIPAL LAW (ILLINOIS): FINANCING, TAX, AND MUNICIPAL PROPERTY* § 1.30 (2012) (ebook).

35. 65 ILL. COMP. STAT. 5/11-42-5 (2015).

36. See *Chi. Health Clubs, Inc. v. Picur*, 528 N.E.2d 978, 980 (Ill. 1988) (The original amusement tax was imposed on organizers of events. In 1980, the ordinance was amended and shifted

(1) any exhibition, performance, presentation or show for entertainment purposes, including, but not limited to, any theatrical, dramatic, musical or spectacular performance, promotional show, motion picture show, flower, poultry or animal show, animal act, circus, rodeo, athletic contest, sport, game or similar exhibition such as boxing, wrestling, skating, dancing, swimming, racing, or riding on animals or vehicles, baseball, basketball, softball, football, tennis, golf, hockey, track and field games, bowling or billiard or pool games; (2) any entertainment or recreational activity offered for public participation or on a membership or other basis including, but not limited to carnivals, amusement park rides and games, bowling, billiards and pool games, dancing, tennis, racquetball, swimming, weightlifting, bodybuilding or similar activities; or (3) any paid television programming, whether transmitted by wire, cable, fiber optics, laser, microwave, radio, satellite or similar means.<sup>37</sup>

While this definition may seem all inclusive, Illinois courts have limited the extent to which municipalities may tax amusements. The Illinois Supreme Court previously held an extension of the amusement tax unconstitutional when the tax was applied to health clubs and racquetball clubs because the tax was a service occupation tax.<sup>38</sup>

### III. HOME RULE UNITS' TAX EXTENSIONS AND THE JUDICIAL RESPONSE SO FAR: HOW FAR CAN THE AMUSEMENT TAX REACH?

Illinois courts have answered many questions regarding home rule powers and the types of taxes municipalities have imposed on its residents. The following case studies illustrate exactly how the Illinois courts have handled these issues.

#### A. *Chicago Health Clubs, Inc. v. Picur*

In *Chicago Health Clubs, Inc. v. Picur*, various health clubs in Chicago brought suit against Chicago and city officials, including Ronald Picur, in his capacity as Comptroller, challenging an amendment to Chicago's Amusement Tax Ordinance.<sup>39</sup> The amendment at issue in *Picur* was "any entertainment or recreational activity offered for the public participation or *on a membership or other* basis including but not limited to *racquetball or health clubs*, carnivals, amusement park rides or games, bowling, billiard and pool games, dancing, tennis, rac-

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the tax to patrons. Today, the tax is on patrons for the "privilege of witnessing, viewing or participating in such amusements.")

37. CHI., ILL., CODE OF ORDINANCES § 4-156-010.

38. *Picur*, 528 N.E.2d at 984.

39. *Id.* at 979.

quetball, swimming, weightlifting, body building or similar activities.”<sup>40</sup>

The defendant argued that the amendment was an amusement tax because it was imposed upon the patrons, as opposed to the operators, of the health and racquetball clubs.<sup>41</sup> However, the owners, operators, and managers were responsible for collecting and remitting the tax.<sup>42</sup> The Illinois Supreme Court found that a tax placed on the club members is not dispositive of whether the tax is an unauthorized service tax.<sup>43</sup> The “mere recitation in the ordinance that the tax is upon purchasers does not transform an occupation tax into a tax upon the purchaser.”<sup>44</sup> The court focused on the broad range of activities that health clubs offered.<sup>45</sup> In viewing the transaction as a whole, the health clubs services were both “amusement” and “non-amusement,” such as nutritional instructions, weight loss counseling, and weightlifting and fitness classes.<sup>46</sup> The court held taxing the membership fees was not a tax on “amusements” or “places of amusements,” and therefore unconstitutional.<sup>47</sup>

### B. *Kerasotes Rialto Theater Corp. v. Peoria*

Chicago is not the only city to grapple with courts over the definition of “amusement.”<sup>48</sup> Movie theater owners in Peoria, Illinois also challenged the Peoria amusement tax, which imposed a 2% tax on movie theatergoers.<sup>49</sup> The Illinois Supreme Court heard two issues in the case: (1) whether the tax on the theaters was unreasonable, arbitrary, and unrelated to the purposed of the ordinance; and (2) whether the city was engaging in intentional discrimination against the corporations.<sup>50</sup> The corporations had to overcome a presumption favoring the validity of classifications made by legislative bodies in taxing matters.<sup>51</sup>

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40. *Id.* at 980 (quoting Amusement Tax Ordinance).

41. *Id.* at 981.

42. *Id.* at 980.

43. *Id.* at 981.

44. *Picur*, 528 N.E.2d at 981-82 (quoting *Commercial Nat'l Bank v. City of Chicago*, 432 N.E.2d 227, 237 (Ill. 1981)) (internal quotations omitted).

45. *Id.*

46. *Id.* at 983.

47. *Id.* at 984.

48. *See Kerasotes Rialto Theater Corp. v. City of Peoria*, 397 N.E.2d 790 (Ill. 1979).

49. *Id.* at 791.

50. *Id.*

51. *Id.* at 792 (citing *Williams v. City of Chicago*, 362 N.E.2d 1030, 1035 (Ill. 1977)).

Under the ordinance at issue, two categories were exempted from the tax: non-profit organizations and schools.<sup>52</sup> The court held that burden of proof was on the theater owners to establish that the city's tax classification scheme was arbitrary and unreasonable and that the city engaged in intentional discrimination against the theater owners, neither of which they proved in this case.<sup>53</sup> The evidence indicated laxity in enforcing the statute, instead of intentional discrimination by not collecting the tax from previously exempt corporations.<sup>54</sup> The amusement tax, in this case, was constitutional.<sup>55</sup>

Theater owners also argued the tax was an illegal occupation tax, instead of an amusement tax.<sup>56</sup> Home rule units do not have inherent power to tax occupations; the General Assembly must grant home rule units permission to levy occupational taxes.<sup>57</sup> The court looked to precedent and found, once again, that because the ordinance places responsibility on the retailer for collecting and remitting the tax, it is not dispositive that the tax is an occupation tax.<sup>58</sup> The Peoria city ordinance were not illegal occupation taxes.<sup>59</sup>

### C. *Communications & Cable of Chicago v. Department of Revenue*

The Appellate Court of Illinois addressed the issue of what constitutes a sufficiently pleaded complaint of an unauthorized tax.<sup>60</sup> Chicago cable companies brought suit against the Chicago Department of Revenue claiming the Department of Revenue assessed an unauthorized transaction tax against the companies.<sup>61</sup> The Department of Revenue issued a notice of liability against the cable companies seeking over \$4.6 million in unpaid taxes, penalties, and interest.<sup>62</sup> The tax was assessed following the cable companies' installation of telecommunications converters and remote control devices near customers' televisions sets to enable better cable transmission reception.<sup>63</sup> The cable companies claimed this was unauthorized under the Chicago Transaction Tax Ordinance and the home rule unit provision of the

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52. *Id.*

53. *Id.* at 795.

54. *Kerasotes*, 397 N.E.2d at 794.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Commc'ns. & Cable of Chi., Inc. v. Dep't of Revenue of Chi.*, 655 N.E.2d 1078, 1081 (Ill. App. Ct. 1995).

61. *Id.* at 1080.

62. *Id.*

63. *Id.*



Illinois Constitution.<sup>64</sup> On appeal, the court stated that “in order to sufficiently claim a tax is ‘unauthorized by law’ . . . the complaint must allege that the tax itself was invalid, or that the assessor lacked authority or discretion to impose the tax.”<sup>65</sup> Since the cable companies sufficiently alleged the tax was unauthorized under Chicago Municipal Code § 3-32-030, the court was able to address both claims.<sup>66</sup>

The court pointed out that the Illinois Supreme Court determined a taxation of commercial services constitutes an “occupation tax” which does not fall under home rule unless sanctioned by the state legislature.<sup>67</sup> “‘Service’ has been defined as all ‘sales’ transactions other than sales of tangible property.”<sup>68</sup> As Illinois courts address taxes on Internet-based streaming services, they will have to determine if the tax is on a service or tangible good. Internet-based streaming services will present a unique issue because the courts must examine the totality of the transaction to determine its taxability as the product, in this case, is provided in conjunction with a service.

#### D. *The StubHub! Cases*

The amusement tax took center stage again in 2010, this time regarding the Internet age. Illinois enacted a statute that required electronic, web-based intermediaries either to “(1) collect and remit amusement taxes arising from ticket resales from the individual ticket resellers; or (2) publish a warning to prospective sellers on the website that the seller’s failure to collect and remit applicable taxes could subject the seller to criminal and civil liability.”<sup>69</sup> Chicago passed an ordinance following the enactment of the state statute that required electronic intermediaries to collect and remit the tax.<sup>70</sup> The case made its way to the Seventh Circuit Court of Appeals (*Stubhub I*); however, the Seventh Circuit noted that the Supreme Court of Illinois never addressed the question of “whether [Illinois] municipalities may require electronic intermediaries to collect and remit amusement taxes on resold tickets.”<sup>71</sup> The Seventh Circuit certified the question

64. *Id.*

65. *Id.* at 1081.

66. *Comm’ns. & Cable of Chi., Inc.*, 655 N.E.2d at 1082.

67. *Id.*

68. *Id.* (citing *Waukegan Cmty. Unit Sch. Dist. No. 60 v. City of Waukegan*, 447 N.E.2d 345, 349 (Ill. 1983)).

69. Kearney, *supra* note 23, at 38.

70. *Id.*

71. *City of Chicago v. Stubhub, Inc. (Stubhub II)*, 979 N.E.2d 844, 845 (Ill. 2011).

for the Supreme Court of Illinois to address in *Stubhub II* under Illinois Supreme Court Rule 20.<sup>72</sup>

i. *Stubhub I* and the Internet Tax Freedom Act<sup>73</sup>

The City of Chicago brought suit against Stubhub, Inc. seeking a judgment that Stubhub is responsible for collecting and remitting the tax.<sup>74</sup> The district court judge dismissed the claim as preempted under Illinois's Preemption Act.<sup>75</sup> The case was appealed to the Seventh Circuit where Stubhub asserted that the Internet Tax Freedom Act blocks Chicago from imposing a tax on Internet auction sites.<sup>76</sup>

In evaluating if the tax was blocked under the Internet Tax Freedom Act, the Seventh Circuit analyzed if the tax was discriminatory.<sup>77</sup> The Act "forbids 'multiple or discriminatory taxes on electronic commerce.'"<sup>78</sup> Here, because the tax ordinance in question applied equally to both ticket resales at physical auction houses and online venues like Stubhub, the ordinance was not discriminatory.<sup>79</sup> Since Stubhub's federal claims did not apply in this case, the Seventh Circuit certified the state law claims to the Supreme Court of Illinois.<sup>80</sup>

ii. *Stubhub II* and the balancing of state and local interests in taxing

In *Stubhub II*, the Supreme Court of Illinois set the standard of review as a threshold question, in which it declares a subject off-limit to local government control where the state has a vital interest and an exclusive role.<sup>81</sup> Stubhub was found to be a "reseller's agent" within the meaning of the Chicago ordinance.<sup>82</sup> Chicago did not have to follow common law agency principles and was free to define terms in its codes.<sup>83</sup> Since Stubhub provided services that help users sell tickets and Stubhub is compensated for the services, it fit within Chicago's Municipal Code § 4-156-010 of a reseller's agent.<sup>84</sup>

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72. *City of Chicago v. Stubhub, Inc. (Stubhub I)*, 624 F.3d 363, 367 (7th Cir. 2010); *see also* ILL. SUP. CT. R. 20.

73. *See infra* Part IV.

74. *Stubhub I*, 624 F.3d at 365.

75. *Id.*

76. *Id.*

77. *Id.* at 366.

78. *Id.*

79. *Id.* at 367.

80. *Stubhub I*, 624 F.3d at 367.

81. *City of Chicago v. Stubhub, Inc. (Stubhub II)*, 979 N.E.2d 844, 852 (Ill. 2011).

82. *Id.* at 850.

83. *Id.*

84. *Id.*

Next, the Illinois Supreme Court weighed the interests of the city and state in its determination of whether Chicago had the ability to force electronic intermediaries to collect and remit taxes.<sup>85</sup> The court held that even though the city has an interest in collecting its amusement tax, “the state has an interest in who does the collecting, which is related to its vital interest in preserving and regulating the emerging market for online ticket resales across Illinois.”<sup>86</sup> Therefore, “Illinois municipalities may not require electronic intermediaries to collect and remit amusement taxes on resold tickets.”<sup>87</sup>

#### IV. HISTORY OF INTERNET TAX FREEDOM ACT AND THE FUTURE OF THE PERMANENT INTERNET TAX FREEDOM ACT

The Internet Tax Freedom Act (ITFA) was enacted in 1998.<sup>88</sup> When enacted, ITFA set a three-year moratorium on discriminatory taxes.<sup>89</sup> Since 1998, ITFA was extended numerous times to keep the moratorium active.<sup>90</sup> Congress, however, recently passed, and President Obama signed into law, the Permanent Internet Tax Freedom Act (PITFA).<sup>91</sup> PITFA was initially introduced in September 2013 to extend the original ITFA but did not pass because it was attached to the controversial Marketplace Fairness Act.<sup>92</sup> The ITFA sought to create a federal policy that promotes the Internet as a tool for communication and trade.<sup>93</sup> PITFA permanently extends a moratorium where no state or political subdivision thereof may impose (1) taxes on Internet access or (2) multiple or discriminatory taxes on electronic

85. *Id.* at 853.

86. *Id.* at 853.

87. *Stubhub II*, 979 N.E.2d at 857.

88. Sally J.T. Necheles, Annotation, *Construction and Application of Internet Tax Freedom Act*, 47 U.S.C.A. § 151 note, 72 A.L.R. FED. 2d 283, § 1 (2013).

89. *Id.* at § 2.

90. Jeremy Bui, *The Permanent Internet Tax Freedom Act*, H.R. 3086, 113th Congress (2014), 23 COMM.LAW CONSPECTUS 528, 536 (2015); see John Eggerton, *Groups Push for Permanent Internet Tax Freedom Act*, BROADCASTING & CABLE, (Jan. 21, 2016, 3:50 PM), <http://www.broadcastingcable.com/news/washington/groups-push-permanent-internet-tax-freedom-act/147171> (The Marketplace Fairness Act allows for local taxation of online purchases.).

91. Trade Facilitation and Trade Enforcement Act of 2015, Pub. L. No. 114-125, 130 Stat. 280 (amending 47 U.S.C. § 151 note (2012) to permanently extend the moratorium of the Internet Tax Freedom Act) (as a result of the amendment the Act has now become known as the Permanent Internet Tax Freedom Act); Patrick S. Campbell, *President Signs Permanent Internet Tax Ban into Law*, LEXOLOGY (Mar. 2, 2016, 3:42 PM), <http://www.lexology.com/library/detail.aspx?g=d241fbfa-3f0a-4ecd-ae9a-7af255319062> (Seven states were “grandfathered” into the INTA; but under PITFA, their exemption ends in 2020 and prohibit further Internet access taxes. Illinois is one of the “grandfathered” state, but not for taxes on streamed goods.).

92. Bui, *supra* note 90, at 536.

93. *Id.*

commerce.<sup>94</sup> ITFA's case law has mostly dealt with the taxing of Internet access; there is not much case law on the prohibition of discriminatory taxes on goods and services acquired through the Internet.<sup>95</sup> Even though the Act does not bar taxes on goods and services sold via the Internet, it prohibits a discriminatory tax from being imposed on goods offered through the Internet.<sup>96</sup> PITFA defines discriminatory tax, in part, as a tax imposed on electronic commerce by a State or political subdivision thereof that:

- (i) is not generally imposed and legally collectible by such State or political subdivision on transactions involving similar property, goods, services, or information accomplished through other means;
- (ii) is not generally imposed and legally collectible at the same rate by such State or political subdivision on transactions involving similar property, goods services or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; [or]
- (iii) imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means.<sup>97</sup>

The Seventh Circuit addressed the issue of discriminatory taxes under the Internet Tax Freedom Act in *Stubhub I*.<sup>98</sup> The defendants claimed that Chicago's amusement tax ordinance is superseded by the ITFA; however, the court held that the tax was not discriminatory under the meaning of the statute because the ordinance was applied equally to ticket resales at physical auction houses, not just on the electronic web-based resale sites.<sup>99</sup> It is necessary to understand what courts have interpreted as discriminatory taxes to analyze the challenge to Chicago's amusement tax extension.<sup>100</sup>

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94. Campbell, *supra* note 91.

95. Eriq Gardner, *Chicago's Tax on Netflix, Spotify Subscriptions Challenged in Court*, HOLLYWOOD REPORTER (Sept. 11, 2015, 6:48 AM), <http://www.hollywoodreporter.com/thr-esq/chicagos-tax-netflix-spotify-subscriptions-822122>; see also Bui, *supra* note 90, at 537-38 ("For example, Montana law states should the IFTA's moratorium on Internet Taxation expire, Internet access would be then taxed at 3.75%.").

96. *City of Chicago v. Stubhub, Inc. (Stubhub I)*, 624 F.3d 363, 367 (7th Cir. 2010).

97. Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a), 112 Stat. 2681-719 (1998) (codified as amended at 47 U.S.C. § 151 note (2012)) (The reference to PITFA is actually a reference to the Internet Tax Freedom Act adopted in 1998. PITFA was never adopted as it was proposed to be, but the main part of it – permanent extension of the tax prohibition – was enacted as part of an omnibus legislation and signed by President Obama.); Complaint, *supra* note 12, at ¶¶ 76-77.

98. *Stubhub I*, 624 F.3d at 366-67.

99. *Id.*

100. See *infra* Part V.B.

V. IS CHICAGO'S TAX DISCRIMINATING AGAINST STREAMED SERVICES? ANALYSIS OF LIBERTY JUSTICE CENTER'S FIGHT AGAINST CHICAGO'S AMUSEMENT TAX EXTENSION

Liberty Justice Center (LJC) promptly filed a lawsuit after Amusement Tax Ruling No. 5 took effect in September 2015.<sup>101</sup> LJC represents Chicago residents affected by the tax, including Michael Labell, Jared Labell, Silas Pepple, Natalie Bezek, Emily Rose, and Bryant Jackson-Green.<sup>102</sup> Each of the plaintiffs has a subscription to an Internet-based streaming service now taxed under the tax extension.<sup>103</sup> LJC is a libertarian think-tank that describes itself as “a non-profit, non-partisan litigation center that fights to protect economic liberty, private property rights, free speech, and other fundamental rights in Illinois.”<sup>104</sup>

“In order to sufficiently claim that a tax is ‘unauthorized by law’ . . . the complaint must allege that the tax itself was invalid, or that the assessor lacked authority or discretion to impose the tax as applied to the taxpayers.”<sup>105</sup> In its complaint, LJC alleges both.<sup>106</sup> The complaint alleges that the city of Chicago and the Comptroller exceeded his authority in extending the tax to include streaming services. Chicago did not enact a new law in applying the amusement tax to streaming services; but rather, it reinterpreted the old law to include streaming services, and the measure was not voted on by the city council.<sup>107</sup> Additionally, LJC claimed the extension violated the ITFA.<sup>108</sup>

A. *Liberty Justice Center's Claim that Chicago's Comptroller Exceeded His Authority By Extending Amusement Tax Ruling No. 5*

The lawsuit names Chicago and Dan Widawsky, in his official capacity as Comptroller of the City of Chicago.<sup>109</sup> The complaint alleges that Widawsky “exceeded his authority” when he reinterpreted the

101. See Complaint, *supra* note 12.

102. *Id.* at ¶¶ 5-10.

103. *Id.*

104. *About: The Liberty Justice Center Mission*, LIBERTY JUSTICE CTR., <http://libertyjusticecenter.org/about> (last visited Apr. 14, 2016).

105. *Comm'ns. & Cable of Chi., Inc. v. Dep't of Revenue of Chi.*, 655 N.E.2d 1078, 1081 (Ill. App. Ct. 1995).

106. See Complaint, *supra* note 12.

107. Gardner, *supra* note 95.

108. Complaint, *supra* note 12, at ¶¶ 75-86.

109. *Id.* at ¶ 16(A).

definition of “amusement” in Chicago’s Municipal Code to include “charges paid for the privilege to witness, view or participate in amusements that are delivered electronically.”<sup>110</sup> LCJ contends that this tax should have been put to a vote to “let Chicagoans have their voices heard through the democratic process.”<sup>111</sup> The complaint lists four separate counts.

LJC alleges in counts one through three that Chicago’s Comptroller exceeded his authority by applying the tax to video, music, and streaming services, respectively.<sup>112</sup> The Comptroller is authorized by the Chicago Municipal Code to “adopt, promulgate and enforce rules and regulations pertaining to the interpretation, administration and enforcement” of Chicago’s Amusement Tax.<sup>113</sup> The complaint alleges that Amusement Tax Rule No. 5 is inconsistent with or exceeds the specific language in the ordinance that authorizes his rulemaking power.<sup>114</sup>

Chicago only has the authority to tax what is expressly granted to it in the Illinois Municipal Code.<sup>115</sup> If the Comptroller levies a tax outside the Code, he exceeds his authority.<sup>116</sup> The Code grants Chicago the right to “license, tax, regulate, or prohibit hawkers, peddlers, pawnbrokers, itinerant merchants, transient vendors of merchandise, theatricals and other exhibitions, shows and amusements and may license, tax, and regulate all places for eating or amusement.”<sup>117</sup> The Chicago Code of Ordinances initially defined amusement as “any exhibition, performance . . . any paid television programming, whether transmitted by wire, cable, fiber optics, laser, microwave, satellite, or similar means.”<sup>118</sup>

Labell, through LJC, argues that until June 9, 2015, the definition of amusement did not include video, audio, and gaming services streamed from the Internet and provided to a customer on a computer, mobile device, or other electronic devices.<sup>119</sup> Now, under the new definition, an “amusement” includes Internet-based streaming services for video, audio, and gaming and Chicago residents are now

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110. *Id.* at ¶ 16.

111. Jessica Corso, *Chicago’s Internet Streaming Tax Is Illegal, Suit Says*, LAW360 (Sept. 10, 2015, 4:14 PM), <https://www.law360.com/articles/701335> (quoting attorney for the plaintiffs, Jeffrey Schwab).

112. Complaint, *supra* note 12, at ¶¶ 35-74.

113. *Id.* at ¶ 36.

114. *Id.* at ¶ 37.

115. STEVENSON, *supra* note 32, §64.22; 65 ILL. COMP. STAT. 5/11-42-5 (2015).

116. *See id.*

117. 65 ILL. COMP. STAT. 5/11-42-5 (2015).

118. CHI., ILL., CODE OF ORDINANCES § 4-156-010.

119. Complaint, *supra* note 12, at ¶¶ 40, 52, 64.

taxed on “charges paid for the privilege to witness, view or participate in amusements that are *delivered electronically*.”<sup>120</sup>

Further, the ordinance applies a nexus stating

because the amusement tax is imposed on the patron, and applies only to activity (*i.e.*, the amusement) that takes place within Chicago, there is no question that the tax applies whenever the amusement takes place in Chicago. The issue of nexus arises, at most, with regard to the question of whether a given provider has an obligation to *collect* the tax from its customer.<sup>121</sup>

In other words, the ordinance does not explicitly decide on how the tax will be imposed on the consumer,<sup>122</sup> though it will most likely be added to the costumer’s subscription fee.<sup>123</sup> Some see this as a way to hold online businesses to the same standard as “bricks-and-mortar stores in Chicago.”<sup>124</sup> Chicago Alderman Pawar does not see this as the Comptroller exceeding his authority at all.<sup>125</sup> “He said the Emanuel administration has been clear that it was looking for ways to use existing statutes to try to even the playing field.”<sup>126</sup>

According to LJC, the ordinance’s imposition of a tax on amusements “within the city” does not authorize a tax on Internet streaming services.<sup>127</sup> These services can be provided anywhere; however only those with billing addresses in Chicago are subjected to the tax.<sup>128</sup> Chicago residents living elsewhere are subjected to the tax, while those living within the city limits with billing addresses outside Chicago are free from paying the tax.<sup>129</sup> This application differs drastically from the amusement tax placed on in-city physical vendors: whether or not the purchaser is a Chicago resident, he must pay the tax on the amusement enjoyed within the city limits.<sup>130</sup> For example, an Indiana resident that visits Chicago to see a musical will pay the tax

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120. Chi., Ill., Dep’t Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

121. *Id.*

122. *Id.*

123. Byrne & Elahi, *supra* note 6 (“A Netflix spokeswoman confirmed that the company will pass the additional cost onto subscribers but said no other details were available.”).

124. *Id.*

125. *Id.*

126. *Id.*

127. Complaint, *supra* note 12, at ¶ 41.

128. *Id.*

129. *Id.*

130. Chi., Ill., Dep’t Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

on his ticket price.<sup>131</sup> However, an Indiana citizen with a billing address in Indiana but living in Chicago will not pay a tax on his Netflix subscription.<sup>132</sup>

For LJC's suit to be successful, it needs to persuade the court to follow the *Picur* logic that Internet-based streaming services are a mix of amusements and non-amusements.<sup>133</sup> The court in *Picur* determined that the city was acting outside its scope of statutory authority when it taxed memberships that covered a wide variety of amusements and non-amusements.<sup>134</sup> *Picur* focused more on the services offered at the health clubs than the goods being taxed.<sup>135</sup> To convince the court to follow the ruling in *Picur*, LJC's argument must rely on the services offered by Netflix, Spotify, Xbox and other streaming-based services and the means in which the tax is assessed.<sup>136</sup> The service occupation tax is "imposed upon 'all persons engaged in the business of making sales of services' and is measured by the cost of the tangible property transferred as an incident to the sale of the service."<sup>137</sup> However, as noted by amusement tax precedent, the collector of the tax is not dispositive of whether the tax is an occupation tax.<sup>138</sup> If the tax applied to the streaming services can be classified as a service occupation tax, as the tax in *Picur* was classified, then the tax will be held unconstitutional. Service occupation taxes are not a home-rule power.<sup>139</sup> Therefore, municipalities cannot enact service occupation tax.<sup>140</sup> This case will turn on whether Netflix, Spotify, and Xbox are classified as services providers.

The arguments, in this instance, will rely on whether Internet-based streaming services provide a good or service. Under the *Communications & Cable of Chicago* test, Chicago will have a hard time applying taxes to the services offered through the Internet.<sup>141</sup> Home-rule power grants municipalities the ability to tax tangible goods.<sup>142</sup> The amusement tax only applies to the streaming services, but not to ser-

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131. *See id.*

132. *See id.*

133. *See Chi. Health Clubs, Inc. v. Picur*, 528 N.E.2d 978, 983-84 (Ill. 1988).

134. *Id.*

135. *Id.* at 984.

136. *Id.*

137. *Commercial Nat'l Bank v. City of Chicago*, 432 N.E.2d 227, 234 (Ill. 1982) (citing Ill. Rev. Stat. 1979, ch. 120, par. 439.103).

138. *Kerasotes Rialto Theater Corp. v. City of Peoria*, 397 N.E.2d 790 (Ill. 1979).

139. ILL. CONST., art. VII, § 6(e).

140. *See STEVENSON*, *supra* note 32, §64.22.

141. *See Commc'ns. & Cable of Chi., Inc. v. Dep't of Revenue of Chi.*, 655 N.E.2d 1078, 1082 (Ill. App. Ct. 1995).

142. *Id.*



vices where consumers buy or rent films and albums through the Internet.<sup>143</sup> Arguably, the video-by-mail service does more to provide the consumer with a tangible good than the streaming service because consumers possess a tangible good, a DVD, at the end of the transaction. Courts have held that when a tax is meant to tax a service, as opposed to a tangible good, the tax is held to be a service occupation tax.<sup>144</sup> Unless expressly sanctioned by the legislature, home-rule power does not authorize Chicago to tax services.<sup>145</sup>

### B. *Liberty Justice Center's Claim Under the Internet Tax Freedom Act*

LJC's second argument claims the tax is barred under the Internet Tax Freedom Act<sup>146</sup> because this interpretation of the amusement tax creates a discriminatory tax.<sup>147</sup> The ITFA does not ban taxes on Internet transactions; it merely regulates how taxes can be applied to online transactions.<sup>148</sup> Under ITFA, "no state or political subdivision thereof shall impose . . . multiple or discriminatory taxes on electronic commerce."<sup>149</sup> The amusement tax is discriminatory in two ways: (1) it does not apply to Netflix's video-by-mail service and (2) the amusement rate is different for in-person live theatrical, live musical or other live cultural performances.<sup>150</sup>

LJC's claim depends on the interpretation of a discriminatory tax under the ITFA, specifically Section 1105(2)(A)(i)-(ii).<sup>151</sup> The amusement tax only applies to the services delivered electronically, but not to services where consumers rent films through the Internet-based ser-

143. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

144. *See* Chi. Health Clubs, Inc. v. Picur, 528 N.E.2d 978, 983 (Ill. 1988).

145. *Id.*

146. The Permanent Internet Tax Freedom Act was not enacted at the time LJC filed its complaint. This section will be analyzed under the Internet Tax Freedom Act's language. Permanent Internet Tax Freedom Act permanently extends the moratorium on Internet taxes.

147. Complaint, *supra* note 12, at ¶¶ 75-86.

148. City of Chicago v. Stubhub, Inc. (*Stubhub I*), 624 F.3d 363, 366 (7th Cir. 2010).

149. Internet Tax Freedom Act, Pub. L. No. 105-277, § 1101(a), 112 Stat. 2681-719 (1998) (codified as amended at 47 U.S.C. § 151 note (2012)) (The reference to PITFA is actually a reference to the Internet Tax Freedom Act adopted in 1998. PITFA was never adopted as it was proposed to be, but the main part of it – permanent extension of the tax prohibition – was enacted as part of an omnibus legislation and signed by President Obama.).

150. Complaint, *supra* note 12, at ¶¶ 80-86.

151. Internet Tax Freedom Act § 1105(2)(A)(i)-(ii).

vices.<sup>152</sup> Additionally, though not raised by LJC in the complaint, the tax ruling only applies to streamed content.<sup>153</sup> The tax does not apply when consumers permanently download movies or music through services like iTunes or Netflix rentals-by-mail.<sup>154</sup> Under the plain language of ITFA, this is discriminatory because it imposes a tax that “is not generally imposed and legally collectable by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means.”<sup>155</sup>

Furthermore, in-person live theatrical, musical or other cultural performances that take place in an auditorium, theater, or space that does not exceed 750 persons is exempt from the statute.<sup>156</sup> LJC argues that many theatrical, musical, or cultural events will be consumed over streaming services; yet, they will not exceed 750 persons when streaming entertainment in their homes.<sup>157</sup> Under this interpretation of the statute, the tax imposed on streaming entertainment is taxed at a different rate than similar transactions through different means.<sup>158</sup> ITFA explicitly states this is discriminatory.<sup>159</sup>

*Stubhub I* provides context for Illinois courts in determining if the extended amusement tax is discriminatory or not. Under the theory of *Stubhub I*, a tax is not discriminatory if it is evenly applied to both the Internet and physical locations.<sup>160</sup> Through this interpretation, the new amusement ruling is discriminatory. Judge Easterbrook noted in *Stubhub I*, “[t]he statute does not create ‘tax freedom’ for transactions on the Internet but instead forbids ‘[m]ultiple or discriminatory taxes on electronic commerce.’”<sup>161</sup> In order to show the tax is discriminatory, LJC needs to persuade the court that the amusement tax on streaming services amounts to multiple and discriminatory taxes.<sup>162</sup>

The tax is not evenly applied to all rental services or means of entertainment consumption. *Stubhub I*'s determination turned on the

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152. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

153. *Id.*

154. Michael H. Wynne et al., *The Staggering Breadth of Chicago's New 'Cloud' Tax*, LAW360 (June 24, 2015).

155. Internet Tax Freedom Act § 1105(2)(A)(i).

156. CHI., ILL., CODE OF ORDINANCES § 4-156-020(e).

157. Complaint, *supra* note 12, at ¶¶ 75-86.

158. *Id.*

159. Internet Tax Freedom Act § 1105(2)(A)(ii).

160. *City of Chicago v. Stubhub, Inc. (Stubhub I)*, 624 F.3d 363, 367 (7th Cir. 2010).

161. *Id.* at 366.

162. *Id.*

equal applicability of the ordinance.<sup>163</sup> “Because the ordinance applies equally to ticket resales at physical auction houses, the Chicago Board of Trade, and venues such as Stubhub the tax is not ‘discriminatory.’”<sup>164</sup> LJC claim rests on the tax not applying evenly to online and physical amusements because small theaters are taxed at a different rate than electronically delivered content.<sup>165</sup> Because the tax does not apply to Netflix’s video-by-mail service, along with a higher tax rate on theatrical, musical, and cultural performances streamed than performances that are consumed in person, it is a discriminatory tax under ITFA.

One interesting note in LJC’s complaint is that the amusement tax provides an exemption for live musical or other live cultural performances in auditoriums or theaters with a capacity of less than 750 persons.<sup>166</sup> It is unclear how the court will have to deal with a tax exemption. The Illinois Supreme Court addressed exemptions to the amusement tax in *Kerasotes Rialto Theater Corp. v. Peoria*; however, that case happened well before the Internet age.<sup>167</sup> While the *Kerasotes* court held that legislative bodies have broad powers to create certain classifications in a taxation scheme, the classifications in question in Amusement Tax Ruling No. 5 are likely not within Chicago’s legislative power because it creates a discriminatory scheme on streamed Internet content.<sup>168</sup> The *Stubhub I* court did not have to look at this issue as it relates to the ITFA because the ordinance in question did not give an exception.<sup>169</sup>

ITFA case law has mostly been applied to online hotel-booking sites.<sup>170</sup> The Act is often used as invoked against city or state ordinances attempting to tax goods or services on the Internet.<sup>171</sup> For the most part, the ordinances were not preempted by ITFA.<sup>172</sup> Since the enactment of PITFA, not many cases have challenged state or local tax ordinances. The recent permanent extension to the discriminatory

163. *Id.* at 367.

164. *Id.*

165. Complaint, *supra* note 12, at ¶¶ 75-86.

166. *Id.*; *see also* CHI., ILL., CODE OF ORDINANCES § 4-156-020(e).

167. *Kerasotes Rialto Theater Corp. v. City of Peoria*, 397 N.E.2d 790, 791 (1979).

168. *Id.* at 792.

169. *City of Chicago v. Stubhub, Inc. (Stubhub I)*, 624 F.3d 363, 367 (7th Cir. 2010).

170. *See* *District of Columbia v. Expedia, Inc.*, 2012 D.C. Super. LEXIS 14 (D.C. Super. Ct. 2012); *Village of Rosemont v. Priceline.Com Inc.*, 2011 U.S. Dist. LEXIS 119231 (N.D. Ill. 2011)

171. *See* *Stubhub I*, 624 F.3d 363; *Expedia, Inc.*, 2012 D.C. Super. LEXIS 14; *Priceline.Com Inc.*, 2011 U.S. Dist. LEXIS 119231.

172. *See id.* [Courts have viewed such ordinances as a way to stop online agents from evading taxes that physical agents must pay].

tax moratorium under PITFA may bring more cases to the courts, starting with *Labell v. City of Chicago*.

## VI. ARE THE DAYS OF TAX-FREE INTERNET STREAMING COMING TO AN END THANKS TO CHICAGO?

The decline of DVD and CD sales in the past decade has caused a decrease in revenue for cities and states.<sup>173</sup> In the previous ten years, both DVD/Blu-ray and video game sales and rentals have dropped by nearly fifty percent.<sup>174</sup> The decline in sales of DVD/Blu-ray, video games, and CDs has caused states to lose an estimated \$1 billion in tax revenue.<sup>175</sup> Sales tax is applied to tangible items, such as DVDs, CDs, and video games.<sup>176</sup> Taxes, however, have been levied on some online purchases.<sup>177</sup> Goods purchased through Internet-based marketplaces, such as Amazon or eBay, are taxed according to state sales tax.<sup>178</sup> It seems that the next logical step for states to recover this lost revenue is to move into the Internet-based streaming services.<sup>179</sup>

### A. *Compliance Costs Create a Barrier to Entry for Consumers and New Services*

For the consumer, the monthly subscription cost will rise as these services pass the tax onto consumers. A family subscription to Netflix in Chicago will now cost a family over \$13 per month.<sup>180</sup> At over \$156 per year, this could be enough to drive some families out of the marketplace for the streamed content. The taxes begin to add up with subscriptions to multiple services. Internet-based streaming services were once seen as a less expensive alternative to cable,<sup>181</sup> but as taxing regimes catch up to streaming, these will be regarded as a luxury item for many families. If other Internet-based streaming services also pass

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173. Peters & Bensinger, *supra* note 4.

174. *Id.*

175. *Id.*

176. *Id.*

177. *See id.*

178. *See* Betty Liu, *Why Chicago Is Being Sued Over 'Netflix Tax'*, BLOOMBERG (Sept. 14, 2015, 11:25 AM), <http://www.bloomberg.com/news/videos/2015-09-14/why-chicago-is-being-sued-over-netflix-tax->.

179. *Id.*

180. *See* Rachel Grozanick, *How Much Does Netflix Cost These Days? Here the Lowdown*, DIGITAL TRENDS (May 14, 2016, 5:00 PM), <http://www.digitaltrends.com/movies/netflix-cost-pricing-plan-breakdown>.

181. *See* Jason Henry, *Pasadena Will Tax Netflix, Hulu and Your City Might Be Next*, PASADENA STAR-NEWS (Sept. 23, 2016, 5:08 PM), <http://www.pasadenastarnews.com/government-and-politics/20160923/pasadena-will-tax-netflix-hulu-and-your-city-might-be-next>.

the tax onto the consumer, these services might see drastic drops in subscriptions simply due to the rising costs.

Chicago's amusement tax "applies only to activity (*i.e.*, the amusement) that takes place within Chicago."<sup>182</sup> For patrons attending a live event, it is easy to determine if the event falls within the city limits. However, Internet-based streaming services can be streamed anywhere. This raises issue of a nexus within the city.<sup>183</sup> The amusement tax ruling seems to skirt the issue of nexus.<sup>184</sup> "The issue of nexus arises, at most, with regard to the question of whether a given provider has an obligation to *collect* the tax from its customer. That issue is beyond the scope of this ruling."<sup>185</sup> Providers, however, may begin collecting the tax despite lacking a sufficient nexus to the City of Chicago.<sup>186</sup> Only consumers paying for these services with a Chicago billing address will have to pay the tax.<sup>187</sup> If other municipalities in Illinois do not adopt the tax, consumers might begin shopping for favorable billing addresses.

Internet-based streaming services will face another hurdle if other states and municipalities begin implementing different taxes. Currently, Netflix has three different streaming packages, based on the number of screens a customer needs.<sup>188</sup> The monthly price ranges from \$8 to \$12 depending on which package the customer chooses.<sup>189</sup> Since Netflix's streaming service has not been previously taxed, the rates are consistent to consumers across the country.<sup>190</sup> However, as states begin setting different tax rates, it will be on Netflix, and similar services, to assess and collect the various taxes, thereby increasing the compliance costs of streaming services.<sup>191</sup> Internet-based streaming

182. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf).

183. See Wynne et al., *supra* note 154.

184. Chi., Ill., Dep't Fin., Amusement Tax Rul. #5 (June 9, 2015), [https://www.cityofchicago.org/content/dam/city/depts/rev/supp\\_info/TaxRulingsandRegulations/AmusementTaxRuling\\_5\\_06\\_09\\_2015.pdf](https://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling_5_06_09_2015.pdf) [The Amusement Tax Ruling states that the issue of nexus "is beyond the scope of this ruling, and any provider with a question about that topic should consult its attorneys." Effectively, the ruling imposes on the provider to disprove a nexus.]

185. *Id.*

186. Wynne et al., *supra* note 154 ("[O]nce the department begins to audit and assess customers located within the city, many of those customers are likely to demand that providers collect the tax going forward.").

187. *Id.*

188. Grozanick, *supra* note 180.

189. *Id.*

190. See *id.*

191. See CONG. BUDGET OFFICE, ECONOMIC ISSUES IN TAXING INTERNET AND MAIL-ORDER SALES 9 (2003).

services that engage in business nationwide could deal with more than 6,000 tax regimes across state and municipal ordinances.<sup>192</sup> Compliance with taxing regimes could potentially cause the base prices of these services to rise to accommodate the calculations. Even more worrisome, a start-up streaming service could also see the different taxing regimes as a barrier to entry into the market.

However, not all cities across the country will be able to follow Chicago's lead in taxing Internet-based streaming services. Illinois home-rule powers are among the broadest in the nation.<sup>193</sup> Not all state legislatures will grant this vast power to their municipalities. Instead, some states may keep the power for themselves and apply the tax evenly across the state.<sup>194</sup> Tax extensions to Internet services could very well be the next hotly litigated issue across the country under PITFA.

### B. *States Vary in Response to Taxing Internet-based Streaming Services or Cloud-based Services Thus Far*

States have differed in their approach to tapping into this potential tax gold mine.<sup>195</sup> With Chicago alone standing to gain \$12 million a year in tax revenue from its extended amusement tax, other states will likely want to capitalize on this significant of an increase in tax revenue.<sup>196</sup> So far, states have mixed results in the application of their proposed Internet or cloud-based taxes.<sup>197</sup> Not all states are using an amusement tax like Chicago; Pennsylvania uses a sales tax, and California uses a utility tax on streaming services.<sup>198</sup> Notably, Vermont chose not to tax cloud-computing services because the technology was more of a service than a good.<sup>199</sup>

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192. *Id.* at vii.

193. Kearney, *supra* note 23, at 38.

194. See TENN. DEP'T OF REVENUE, ARE STREAMING MOVIES, EBOOKS AND DOWNLOADABLE MUSIC SUBJECT TO TAX? (2015), <https://revenue.support.tn.gov/hc/en-us/articles/204898759-Are-streaming-movies-eBooks-and-downloadable-music-subject-to-tax->.

195. See *id.*

196. Byrne & Elahi, *supra* note 6.

197. See *id.* ("Tennessee extended its 7% sales tax to software and digital games that are accessed remotely. . . . But Alabama lawmakers recently shelved its own 'Netflix tax.'").

198. Henry Grabar, *The Netflix Tax Is Coming, and Why Not?*, SLATE (Sept. 27, 2016, 3:32 PM), [http://www.slate.com/blogs/moneybox/2016/09/27/netflix\\_taxes\\_have\\_grown\\_popular\\_in\\_states\\_and\\_cities\\_as\\_entertainment\\_moves.html](http://www.slate.com/blogs/moneybox/2016/09/27/netflix_taxes_have_grown_popular_in_states_and_cities_as_entertainment_moves.html).

199. Nat Rudarakanchana, *Lawmakers Vote To End Moratorium on Cloud Computing Tax*, VTDIGGER (May 14, 2013, 8:50 PM), <http://vtdigger.org/2013/05/14/lawmakers-vote-to-end-moratorium-on-cloud-computing-tax>.

State taxing power differs from the federal government's power to tax.<sup>200</sup> States have been able to levy taxes, and survive commerce clause challenges, where they have a substantial nexus.<sup>201</sup> States "have sustained a tax against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state."<sup>202</sup> As long as a state tax on Internet-based streaming services is not discriminatory under the Permanent Internet Tax Freedom Act, the tax will likely fit within the state's ability to levy taxes, much like state sales taxes apply to goods purchased over the Internet.

### i. California

Cities across California instituted taxes on streaming services.<sup>203</sup> The tax rate will vary by city, ranging from 4.5% to 11%.<sup>204</sup> California cities are applying the tax using the cities' existing tax rate for cable providers.<sup>205</sup> "As companies begin to provide services that look more and more like cable services, those fall under taxable services."<sup>206</sup> Consumers who get video through cable television are taxed, but those who use Internet streaming services were not subjected to the same tax.<sup>207</sup> Currently, California's tax only applies to video streaming services, such as Hulu, Netflix, Amazon Video, and HBO.<sup>208</sup> The tax does not include music or video game services.<sup>209</sup>

The taxing schemes throughout California may face legal challenges as well. "In California, voters are the only ones who can increase their taxes, but in this case, Pasadena and other cities are saying previous votes already included these services."<sup>210</sup> The tax, however, had not been collected on these services until now.<sup>211</sup> Some of the tax ordinances in question were purposefully left open-ended to tax video service suppliers "whatever their technology."<sup>212</sup> Don Maynor, an

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200. See U.S. CONST. art. I, § 8, cl. 2.

201. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

202. *Id.*

203. See Henry, *supra* note 181.

204. *Id.*

205. *Id.*

206. *Id.*

207. McPhate, *supra* note 8.

208. *Id.*

209. *Id.*

210. Henry, *supra* note 181.

211. *Id.*

212. *Id.* (quoting an amendment to Pasadena city ordinance).

attorney for MuniServices,<sup>213</sup> noted there is no way to write ordinances today to know how technology will look down the road.<sup>214</sup> Maynor stated, “[t]he goal is to treat everyone the same, regardless of technology.”<sup>215</sup> The Howard Jarvis Taxpayers Association is looking into potential legal challenges to the tax, noting that if it is an extension then under California’s constitution, the tax needs voter approval.<sup>216</sup>

## ii. Alabama

Alabama’s “rental tax” is not new.<sup>217</sup> Traditionally the tax was applied to video store rentals and put on each transaction.<sup>218</sup> To make up for the lost revenue, Alabama Department of Revenue (ADOR) proposed some new ideas.<sup>219</sup> One idea included taxing “digital transmissions,” where cable customers will be taxed for movies and television shows accessed on-demand through their digital video recorders (DVR).<sup>220</sup> “The [Alabama] Legislative Council has the ability to reject any propos[al by the Department of the Revenue].”<sup>221</sup> The State Legislature sent a letter to ADOR expressing its disapproval with the tax and effectively halting the ADOR from taxing DVRs and multi-purpose cable boxes that function as DVRs.<sup>222</sup>

While the legislature has fought back on the tax, the ADOR claims this is not a new tax and well within their authority to enact.<sup>223</sup> “Commissioner Magee is responding to those lawmakers on the Legislative Council, saying the Alabama Code allows the definition of ‘tangible personal property’ to be expanded to streamed content.”<sup>224</sup> The Alabama Rental Tax defines “tangible personal property” as “anything which may be ‘seen. . . or otherwise perceptible to the senses.’”<sup>225</sup>

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213. See *id.* (MuniServices is the company that collects the taxes for some California municipalities.).

214. *Id.*

215. *Id.*

216. Henry, *supra* note 181.

217. Elizabeth Beshears, *Alabama Dept. of Revenue Leader Attempts to Defend Netflix Tax*, YELLOWHAMMER (July 2, 2015, 12:56 PM), <http://yellowhammernews.com/politics-2/alabama-dept-of-revenue-leader-attempts-to-defend-netflix-tax>.

218. *Id.*

219. *Id.*

220. *Id.*

221. Elizabeth Beshears, *Alabama Legislative Leaders Reject Proposed Tax Hike on Cable TV Customers*, YELLOWHAMMER (Apr. 14, 2015, 1:05 PM), <http://yellowhammernews.com/politics-2/alabama-legislative-leaders-reject-proposed-tax-hike-on-cable-tv-customers>.

222. *Id.*

223. Beshears, *supra* note 217.

224. *Id.*

225. *Id.*



Since digital media can be seen and perceptible to the senses, it fits within the definition of tangible personal property.<sup>226</sup>

The proposed tax expansion in Alabama caused a heated discussion. The President and CEO of the Business Council of Alabama weighed in and claimed the proposed regulation exceeds ADOR's authority.<sup>227</sup> Even after the back and forth between the Alabama Department of Revenue and the Alabama Legislature, the rental tax has not been expanded to include content accessed on-demand through DVRs.<sup>228</sup>

### iii. Tennessee

Unlike its neighbor, Tennessee has no qualms about extending its taxing scheme.<sup>229</sup> In 2015, Tennessee extended its 7% sales tax to software and digital games accessed remotely.<sup>230</sup> "The sale, lease, licensing and use of digital audio-visual works, digital audio works and digital books are subject to sales and use tax. This group of products is referred to in the law as specified digital products."<sup>231</sup> In addition to the 7% state tax rate, the specified digital goods are subject to a standard local tax rate of 2.5%.<sup>232</sup>

### iv. Idaho

In 2015, Idaho clarified its statute on digital goods.<sup>233</sup> The amended law states that streaming services are not subject to tax.<sup>234</sup> The Idaho sales and use statute took the opposite approach than the Chicago Amusement Tax Extension. Sales and use taxes apply to "digital goods when the purchaser acquires the permanent right to use the digital goods."<sup>235</sup> This tax would include permanent downloads bought from services like Amazon or iTunes.<sup>236</sup> It does not apply to

226. *Id.*

227. *Id.*

228. Beshears, *supra* note 221.

229. Peters & Bensinger, *supra* note 8.

230. *Id.*

231. TENN. DEP'T OF REVENUE, *supra* note 194.

232. *Id.*

233. Jennifer Jensen, *US – The Disparate State and Local Tax Treatment of Digital Streaming Services*, PwC (Sept. 9, 2015), <http://ebiz.pwc.com/2015/09/us-the-disparate-state-and-local-tax-treatment-of-digital-streaming-services-2>.

234. *Id.*

235. *Id.*

236. *Id.*

streaming services, like Netflix or Hulu.<sup>237</sup> However, the tax does not apply when the right to use is temporary, like in streaming services.<sup>238</sup>

#### v. Vermont

Vermont flirted with the idea of taxing cloud-computing services. In 2010, Vermont's tax department levied retroactive sales taxes on businesses that used cloud-computing services.<sup>239</sup> But, the software and technology industries successfully lobbied for a moratorium on the taxes that extended until July 2013.<sup>240</sup> The Wall Street Journal reported in 2015 that Vermont will not tax cloud computing because technology is more of a service than a tangible good.<sup>241</sup>

### VII. CONCLUSION

Taxes on movie tickets and cable are not new. But in today's world, most consumers are moving to the Internet to find their entertainment. This move leaves states that depend on tax revenue struggling to keep up in the digital age. As the shift from tangible goods to streaming services continues, cities and states will continue to try to find a way to make up for lost revenue.<sup>242</sup>

Chicago Amusement Tax Ruling No. 5 is currently being challenged in court. The suit is still in the pleading stages, but as it moves forward the court will have to determine many complicated issues. At the heart of the complaint is Illinois home rule power and federal preemption under the Internet Tax Freedom Act. The courts must decide if the tax extension taxes services or goods before it can determine the constitutionality of the tax under the home rule unit provision in the Illinois Constitution. Chicago will also have to show that it is not discriminating against Internet-based streaming services and that its tax is applied evenly to the Internet and physical taxes to survive its challenge under the Internet Tax Freedom Act. If this tax is constitutional, other municipalities in Illinois are likely to enact their taxes on Internet-based streaming services.

As states enacting streaming taxes or expand existing ordinances to include the services, compliance costs will burden the services. Differing taxing regimes will potentially deter new streaming services from entering the market. Additionally, families and individuals that relied

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237. Byrne & Elahi, *supra* note 6.

238. Jensen, *supra* note 233.

239. Nat Rudarakanchana, *supra* note 199.

240. *Id.*

241. Peters & Bensinger, *supra* note 8.

242. *Id.*

on the services may no longer be able to afford them. Subscriptions could begin to fall as states start taxing the services.

So far, states have had very mixed reactions to taxing streamed content, but the issue is gaining popularity with California also taxing streamed services under its utility tax. While the Alabama legislature fiercely opposes a tax on streamed content, Tennessee expanded their sales tax to include streamed content. Idaho, on the other hand, amended its statute to ensure that streamed services are not subject to tax. The sources of revenue from these taxes appear to be very lucrative. Only time will tell the future of taxing Internet-based streaming services.