City of Chicago Expands Tax Reach to Internet Services

Skadden

07/13/15

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Eric B. Sensenbrenner
Washington, D.C.
202.371.7198
eric.sensenbrenner@skadden.com

Carl R. Erdmann
Washington, D.C.
212.735.0000
carl.erdmann@skadden.com

Sarah Beth Rizzo
Chicago
312.407.0674
sarahbeth.rizzo@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On June 9, 2015, the city of Chicago released two rulings that significantly expand the city's 9 percent gross receipt tax to charges for cloud computing and other services delivered over the Internet. The first ruling (City of Chicago, Department of Finance, Amusement Tax Ruling #5 (June 9, 2015)) interprets Chicago's "amusement tax" to apply to watching videos, listening to music, playing games and similar streaming activities Chicago residents enjoy online, regardless of the entertainment provider's location or where the resident is physically located while using the service. The other ruling (City of Chicago, Department of Finance, Personal Property Tax Ruling #12 (June 9, 2015)), released on the same day, interprets Chicago's "personal property lease transaction tax" to apply to a wide variety of online services, including purchasing consumer credit reports, real estate listings, car prices, weather statistics, job listings, and marketing data, and using legal research databases.

In addition to the extraordinary breadth of the services that would be subject to tax under these rulings, the effect of the rulings could be particularly severe due to the bundling rules that apply to both taxes. If the provider or "lessor" fails to separately charge for other services it provides along with the taxed services, the entire amount could be taxed if the lessor cannot prove that greater than 50 percent of the charge is attributable to a nontaxable activity.

Amusement Tax Ruling. The amusement tax ordinance initially was designed as a tax on the sale of tickets to the theater, sporting events and amusement parks. It also contains a provision that subjects paid television programming to the amusement tax. The language of the ordinance targets patrons who are buying a ticket or a license for the privilege of entering, witnessing, viewing or participating in an amusement. The ruling applies this language to streaming entertainment content over the Internet on the customer's own device. The tax does not apply to sales of content that is permanently downloaded by the customer.

Lease Transaction Tax Ruling. The ruling interpreting the personal property lease transaction tax appears to reach even further than the first ruling's interpretation of the scope of the amusement tax, in that the ruling specifically includes "cloud computing, cloud services, hosted environment, software as a service, platform as a service, [and] infrastructure as a service" in its laundry list of exemplative transactions to which the ruling applies. The relevant tax is imposed on the lease of personal property within Chicago or the privilege of using personal property in Chicago that is leased outside Chicago. Subject leases include those that are nonpossessory (allowing use but not possession of the property), and the ordinance refers to accessing a provider's computer to input, modify and retrieve data involving little or no interaction with employees of the provider. The location of the device whereby the user accesses the computer is deemed to be the place of rental under the ordinance. The ruling states that if the charge to the user is primarily for the use or control of the computer and not for a service of the provider, such as writing a report or creating a database for the user, then the charge is subject to the personal property lease transaction tax. Thus, for example, because payment for the use of a legal research database is primarily for the search functionality the software provides and not for substantive content provided by the employees of the business, the use of a legal research database is subject to the personal property lease transaction tax.

Potential Challenges. Both rulings fail to articulate a factual basis for the city's nexus with the relevant transactions in justifying the tax, instead merely stating that the taxes are imposed on the consumer based on the consumer's activity taking place in Chicago. They specifically note that the issue of whether a provider has sufficient nexus with the city such that it would have an obligation to collect the tax is beyond the scope of the rulings, but that providers should consult their attorneys. The city ordinances, however,

City of Chicago Expands Tax Reach to Internet Services

ordinarily require a lessor or provider to collect the tax at the time of each payment and remit the amount to the city, and lessors and providers can be held liable if they fail to comply. The rulings note that the ordinances require consumers to self-assess and remit the tax to the city if the provider or lessor fails to collect it.

Nexus is one aspect of the rulings that could be subject to challenge under the Illinois Constitution and/or the U.S. Constitution, particularly in the case of the lease transaction tax, as the property of the provider that is purportedly being "leased" according to the ruling need not ever be in Chicago for the rental amounts under the lease to be subject to tax. The rulings also could require a provider to collect a tax even if it does not have a physical presence in the city. However, any challenge based on a provider's lack of physical presence may be difficult. In *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015), Supreme Court Justice Anthony Kennedy suggested in his concurrence that the requirement laid out in prior cases that a retailer have a physical presence in order for a state to require the retailer to collect tax may need to be re-evaluated in light of the many ways the Internet has changed the economy, and he invited a test case. None of the other justices joined Kennedy's concurrence, but state and local tax administrators, including Chicago, are likely to continue to aggressively challenge the physical presence requirement in light of Kennedy's statement. Furthermore, there is also proposed federal legislation that would effectively overrule the physical presence requirement for certain remote providers (*e.g., Marketplace Fairness Act of 2015*, S. 698, 114th Cong. (2015)).

Chicago's new rulings also could potentially be challenged under the Internet Tax Freedom Act, extended again in 2014, which prohibits discriminatory taxation of online services compared with the equivalent offline services. The rulings also could possibly be subject to a challenge that they are beyond the city's powers to tax under the Illinois Constitution.

Effective Date. While the effective date of both rulings was July 1, 2015, the rulings state that their effect will be limited to periods on or after September 1, 2015, to allow affected businesses sufficient time to make required system changes. The rulings go on to note that this limitation will not affect the liability of those who failed to comply with existing law prior to July 1, 2015. In response to an outcry by technology companies, Chicago has indicated it may limit the scope of the rulings to exempt start-up companies based on a revenue threshold, but we expect large, established providers of Internet services to be significantly impacted.