

Chicago's Digital Amusement Tax

By: Jeffrey Michalik, Kiersten Hansen, Andrew Joseph, Kristin Opal, and Courtney Rodman

September 9, 2016

The City of Chicago's amusement tax was extended to electronic amusements when the Department of Finance issued Amusement Tax Ruling #5 on June 9, 2015.¹ On October 14, 2015, the City Council approved Mayor Rahm Emanuel's 2016 revenue ordinance,² affirming the Department of Finance's June 2015 ruling.³ The ruling states "[t]he amusement tax applies to charges paid for the privilege to witness, view or participate in an amusement. This includes . . . charges paid for the privilege to witness, view or participate in amusements that are *delivered electronically*"⁴ (emphasis in original). As a result, services that stream electronic content such as movies, television, and music are subject to a nine percent amusement tax.⁵ Netflix, Hulu, Amazon, and Spotify are some streaming services affected by the extension.⁶

Proponents of the extension cite unfairness to companies that deliver amusements non-electronically as a reason for the tax. These businesses have been incurring costs due to the amusement tax for years, while companies that deliver electronic amusements have been

¹ Michael J. Wynne et al., *The City of Chicago Moves Aggressively to Tax 'The Cloud'*, REED SMITH (June 17, 2015), <http://www.reedsmith.com/The-City-of-Chicago-Moves-Aggressively-to-Tax-The-Cloud-06-17-2015/>; see also City of Chicago, Department of Finance, Amusement Tax Ruling #5 (June 9, 2015), available at http://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling5-06092015.pdf.

² City of Chicago, City Council, Substitute Revenue Ordinance As Amended (October 14, 2015), available at <http://www.insidesalt.com/files/2015/11/2016-Chicago-Revenue-Ordinance-sub.pdf>.

³ Stephen P. Kranz, Catherine A. Battin & Eric Carstens, *Chicago Mayor's Tax-Heavy Budget Passes: Lease and Amusement Tax Implications*, MCDERMOTT WILL & EMERY (Nov. 4, 2015), <http://www.insidesalt.com/2015/11/chicago-mayors-tax-heavy-budget-passes-lease-and-amusement-tax-implications/>.

⁴ City of Chicago, Department of Finance, Amusement Tax Ruling #5 (June 9, 2015), available at http://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling5-06092015.pdf.

⁵ Steven Titch, *Cities, states keep piling on the Internet taxes*, R STREET, July 28, 2015, available at <http://www.rstreet.org/op-ed/cities-states-keep-piling-on-the-internet-taxes/>.

⁶ *Id.*

avoiding the tax. The City of Chicago asserts that the extension is not a change in the law but a clarification on the definition of “amusement.”⁷ The tax became fully effective September 1, 2015.⁸

Chicago is the first jurisdiction to expand its amusement tax to electronically delivered amusements.⁹ Some other jurisdictions have established taxes on data processing and storage, but these taxes are more similar to the personal property lease transaction tax, which taxes the cloud.¹⁰ On July 31, 2012, the Texas Comptroller of Public Accounts issued a letter ruling¹¹ regarding the taxation of electronic data storage. However, this ruling did not concern the electronic streaming of amusements; rather, it focused on the taxation of information technology infrastructure services, including computing power and storage—also referred to as “cloud computing” services.¹² Further, Texas’s amusement tax¹³ does not specifically include electronic amusements,¹⁴ as Chicago’s now does.

Chicago is the vanguard of taxing electronic amusements. In this paper, we assess the legality of the electronic amusement tax by examining it against the federal Constitution, the

⁷ Jonathan Bilyk, *Lawsuit: City sidestepped law in enacting ‘Cloud Tax’ via administrative ruling on streaming media*, COOK COUNTY RECORD (Sept. 11, 2015); see also The Kumar Law Firm PLLC, *Start-Ups & Tech Businesses Fear Impact of New “Cloud Tax”*, AUSTIN TX BUS. L. BLOG (August 14, 2015), https://thekumarlawfirm.com/lawyer/2015/08/14/Business-Law/Start-Ups--Tech-Businesses-Fear-Impact-of-New-%E2%80%9Ccloud-Tax%E2%80%9D_bl20763.htm.

⁸ Titch, *supra* note 5.

⁹ Karsten Strauss, *While Most Cities Are Trying To Build Startup Ecosystems, Chicago Introduces A ‘Cloud Tax’*, FORBES, Aug. 4, 2015, available at <http://www.forbes.com/sites/karstenstrauss/2015/08/04/while-most-cities-are-trying-to-build-startup-ecosystems-chicago-introduces-a-cloud-tax/#6eec63d176e9>.

¹⁰ City of Chicago, Department of Finance, Personal Property Tax Ruling #12 (June 9, 2015).

¹¹ Texas Comptroller of Public Accounts, Letter Ruling (July 31, 2012) available at <http://aixtcp.cpa.state.tx.us/pendocs/open32/2012075331.html>.

¹² *Id.*; see also Grant Thornton’s Washington National Tax Office, *United States: Texas Comptroller Ruling Addresses Sales Tax On Internet And Cloud Computing Services*, MONDAQ, Sept. 27, 2012, available at <http://www.mondaq.com/unitedstates/x/198760/sales+taxes+VAT+GST/Texas+comptroller+ruling+addresses+sales+tax+on+Internet+and+cloud+computing+services>.

¹³ 34 Tex. Admin. Code § 3.298 (eff. Feb. 12, 2016), available at [http://texreg.sos.state.tx.us/public/readtac\\$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=34&pt=1&ch=3&rl=298](http://texreg.sos.state.tx.us/public/readtac$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=34&pt=1&ch=3&rl=298).

¹⁴ Glenn Hegar, Texas Comptroller of Public Accounts, *Taxable Services*, July 2015, available at http://comptroller.texas.gov/taxinfo/taxpubs/tx96_259.pdf.

Internet Tax Freedom Act, and the Illinois Constitution, in turn. We also explore the policy justifications, economic concerns, and scope of the tax. We hope to aid other jurisdictions going forward by providing this overview of Chicago’s electronic amusement tax.

I. The Federal Constitution

The billing address associated with accounts for electronically-delivered amusements is used to determine whether Chicago’s nine percent tax is applicable to that particular account. The provider of an online amusement does not have to be physically present in Chicago, and the subscriber does not have to be present in Chicago to view or experience it. This alternative method of determining the tax’s applicability, which necessarily results from the differences between online amusements and in-person amusements, potentially creates an issue: whether Commerce Clause of the United States Constitution allows Chicago to tax subscription fees for online amusements that are streamed by out-of-state providers and can be consumed exclusively outside of Chicago.

A. Applicable Law

Many online streaming amusement providers are located outside of Illinois, so issues of interstate commerce are inevitably implicated when Chicago residents pay subscription fees to these providers. Article I, Section 8, Clause 3 of the United States Constitution (the “Commerce Clause”) grants Congress the power to regulate interstate commerce, but also prohibits state interference with interstate commerce.¹⁵ Analysis of the Amusement Tax, then, must focus on whether the tax unconstitutionally interferes with interstate commerce.

¹⁵ See *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787, 1790 (2015) (recognizing that the grant of power to Congress in the Commerce Clause contains “a further, negative command, known as the dormant commerce clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject.”).

Despite the Commerce Clause’s restriction on state interference, interstate commerce is not entirely immune from local taxation.¹⁶ Additionally, the Supreme Court explicitly rejected the proposition that a local tax on the "privilege of doing business" is *per se* unconstitutional when it is applied to interstate commerce.¹⁷ “It was not the purpose of the [Commerce Clause] to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business.”¹⁸

The Supreme Court has outlined a four-prong test to determine whether a local tax that applies to interstate commerce is permitted under the Commerce Clause. A local tax is valid under the Commerce Clause where the tax “[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.”¹⁹ As a result, the Amusement Tax must satisfy this test, the *Complete Auto* test, or it violates the Commerce Clause. Additionally, the tax cannot result in multiple taxation.

B. The Amusement Tax and the *Complete Auto* Four-Prong Test

First, the activity being taxed has a substantial nexus with the taxing city. “[T]he crucial factor governing nexus is whether the activities performed in [the taxing] state on behalf of the [entity required to collect the tax] are significantly associated with the [entity's] ability to establish and maintain a market in th[e] state for the sales.”²⁰ The Supreme Court has interpreted this prong to be met if the taxed entity has a billing address within the taxing state’s jurisdiction. Thus, the “provision of services has the requisite nexus to the taxing state if the service is billed

¹⁶ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288 (1977).

¹⁷ *Id.* at 289.

¹⁸ *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

¹⁹ *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (citing *Complete Auto Transit*, 430 U.S. at 279).

²⁰ *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250 (1987).

or charged to an address, or paid by an addressee, within that state.”²¹ In *Goldberg*, the Supreme Court upheld an Illinois tax on interstate phone calls charged to a service address within Illinois.²² Because the tax applied only to people with an Illinois billing address, the tax had a sufficiently substantial nexus to Illinois for purposes of the *Complete Auto* test.²³ Similarly, Chicago’s Amusement Tax applies only to subscribers of online amusements with a billing address in Chicago. Under current Supreme Court precedent, then, the first prong of the *Complete Auto* test is therefore satisfied.

Next, the amusement tax is fairly apportioned. “The central purpose of the fair apportionment prong of the *Complete Auto* test is to prevent multiple taxation by ‘ensuring that each State taxes only its fair share of an interstate transaction.’”²⁴ Chicago taxes only its fair share of the interstate transaction because the Amusement Tax does not tax any consumption of amusements that occurs outside of Chicago. The tax applies to charges paid for the *privilege of viewing amusements in Chicago* and whether the customer actually takes advantage of that privilege is irrelevant. For example, if a customer buys a ticket to watch the Cubs play at Wrigley Field, the tax applies to the ticket price, even if the customer ends up not going to the game. Similarly, if a Chicago resident pays Netflix \$8 a month, the charge provides that person with the privilege of enjoying Netflix’s streamed amusements in Chicago. The Amusement Tax applies to that charge regardless of whether the person chooses to watch the videos exclusively in Chicago, partly in Chicago, or not at all.

This uniform application is important because it demonstrates that the consumption of an amusement outside of Chicago is not subject to the Amusement Tax. The applicability of the tax

²¹ *Vill. of Rosemont v. Priceline.com Inc.*, No. 09 C 4438, 2011 U.S. Dist. LEXIS 119231, at *20 (N.D. Ill. Oct. 14, 2011) (citing *Okla. Tax Comm’n v. Jefferson Lines*, 514 U.S. 175, 184 (1995)); see also *Goldberg v. Sweet*, 488 U.S. 252, 263 (1989).

²² 488 U.S. at 254.

²³ *Id.* at 263.

²⁴ *Brown's Furniture v. Wagner*, 665 N.E.2d 795, 804 (1996) (quoting *Goldberg*, 488 U.S. at 261).

is determined by the subscriber's billing address instead of by individual instances of amusement consumption (which might occur outside of Chicago's limits). Because a subscriber lists only one address as his or her billing address and it is this address that determines whether or not the tax applies, there is no possibility of multiple taxation. If every state enacted an identical amusement tax, no multiple taxation that would injure interstate activity can occur and the second *Complete Auto* prong is satisfied.

A separate "multiple taxation" issue might arise if another state implemented an online amusement tax that used something other than billing address to determine the tax's applicability. For example, if Indiana taxed online amusement subscriptions based on where the amusements were consumed, such a tax could apply to the same transaction subject to Chicago's amusement tax. A person who has a Chicago billing address but consumes his amusements in Indiana would see his subscription fee subject to both states' taxes. The possibility of this situation does not automatically defeat Chicago's amusement tax, though. First, the limited possibility of multiple taxation does not necessarily mean that a tax is unconstitutional.²⁵ Where one state's tax might cause a duplicative tax if other states taxed the same transaction by determining the tax's applicability with a different standard, courts would look to whether the specific tax challenged attempts to prevent the possibility of multiple taxation.²⁶ For example, a tax can sufficiently counteract the possibility of multiple taxation by offering credits for entities that were taxed in another state.²⁷

It is not clear whether Chicago's Amusement Tax offers credits for entities paying in other states. Although city officials describe the tax as applying to the privilege of consuming amusements within Chicago, the very real issue of multiple taxation may result from the tax's

²⁵ *Goldberg v. Sweet*, 488 U.S. 252, 264 (1989).

²⁶ *See id.*

²⁷ *Id.*

applicability standard. If Chicago offered tax credits to people who might be taxed on the same subscription fees elsewhere, the tax would likely survive a multiple taxation challenge.

Finally, the Amusement Tax does not discriminate against interstate commerce. The Supreme Court has developed the “internal consistency” test to determine whether a tax discriminates against interstate commerce.²⁸ This test “looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.”²⁹ The Amusement Tax applies to all live cultural performances that are streamed to people in Chicago. Neither the location of the performance nor the fact that the person or entity that streams the performance from in-state or out-of-state has any bearing on whether the Amusement Tax applies. If an entity streamed its amusements from a location in Chicago, any fees paid to enjoy those amusements would be subject to the same tax as fees paid to enjoy amusements streamed from outside of Chicago. Every State adopting a tax similar to the Amusement Tax would not encourage online amusement providers to conduct their business intrastate versus interstate. By using billing address to determine the tax’s applicability, each State enforcing the tax would affect only people within their own boundaries but would affect subscriptions to all streaming entities regardless of their location. As a result, the Amusement Tax does not discriminate against interstate commerce³⁰ and the third prong of the *Complete Auto* test is likely satisfied, assuming that Chicago offered credits for people who paid the tax elsewhere.

²⁸ *Wynne*, 135 S. Ct. at 1803.

²⁹ *Id.*

³⁰ The concerns of the third *Complete Auto* prong are not implicated here because Chicago’s unique Amusement Tax actually incentivizes local streaming service providers to seek interstate commerce rather than intrastate commerce, if it provides any incentive at all. Until other jurisdictions begin enforcing a similar tax, streaming service providers in Chicago do not have to deal with the hassle of collecting the tax from out-of-state subscribers whereas the same provider must collect the tax from a subscriber who lives in Chicago.

Finally, the Amusement Tax is fairly related to benefits provided by the city to the taxpayer. Under the fourth prong of the Complete Auto Transit, “the measure of the tax must be reasonably related to the extent of the contact [determined in the first prong], since it is the activities or presence of the taxpayer in the State that may properly be made to bear a ‘just share of state tax burden.’”³¹ When a tax is assessed in proportion to a taxpayer's activities or presence in a State, the taxpayer is shouldering its fair share of supporting the State's provision of “police and fire protection, the benefit of a trained work force, and ‘the advantages of a civilized society.’”³² As a result, “the incidence of the tax as well as its measure [must be] tied to the earnings which the State . . . has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes.”³³ Generally, the appropriate measure of the tax is left to determination by the political process.³⁴

Courts have interpreted the fourth prong of the Complete Auto test to be satisfied if the “taxpayer has the advantage of the state's police and fire protection, ‘along with the usual and usually forgotten advantages conferred by the State's maintenance of a civilized society,’ which together ‘are justification enough for the imposition of a tax.’”³⁵ Generally, an entity has availed itself of the benefits of a taxing state if it has some physical presence within that state.³⁶ The physical presence need not be “substantial,” but must be more than the “slightest presence.”³⁷ By determining the tax applicability based on the subscriber’s billing address, the amusement tax ensures that the person identifies with some physical location within the state. With property (or

³¹ *Commonwealth Edison Co. v. Mont.*, 453 U.S. 609 (citing *Western Live Stock v. Bureau of Revenue*, 303 U.S., at 254).

³² *Id.* (citing *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S., at 228).

³³ *Id.* (citing *Wisconsin v. J. C. Penney Co.*, supra, at 446).

³⁴ *Id.*

³⁵ *Priceline.com Inc.*, No. 09 C 4438, 2011 U.S. Dist. LEXIS 119231, at *24 (citing *Jefferson Lines*, 514 U.S. at 200).

³⁶ *Priceline.com Inc.*, No. 09 C 4438, 2011 U.S. Dist. LEXIS 119231, at *21.

³⁷ *Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795 (Ill. 1996).

at least an existing home address) within Chicago, a subscriber has availed itself of the traditional societal benefits that satisfy this prong.

Additionally, though, Chicago provides infrastructure to access the internet and electricity, which Chicago subscribers to online amusements would need in order to access the amusements in the first place. Without cooperation from and benefits provided by Chicago, the market for online amusement providers would not exist in Chicago. Chicago thus renders services and benefits that make online amusement consumption possible, which justifies Chicago's tax on those amusements. The fourth prong of the Complete Auto test is therefore satisfied. As a result, Chicago's Amusement Tax likely does not violate the Commerce Clause, unless courts found the possibility of multiple taxation constitutionally significant.

II. The Internet Tax Freedom Act

Though Chicago's Amusement Tax does not violate the Commerce Clause, it must also survive federal legislation, such as Internet Tax Freedom Act's provision prohibiting discriminatory taxes on electronic commerce.

A. Background

The Internet Tax Freedom Act (ITFA) prohibits a state or its political subdivision from imposing taxes on Internet access or multiple or discriminatory taxes on electronic commerce.³⁸

The ITFA defines discriminatory tax, in part, as any tax imposed by a state or its political subdivision on electronic commerce that:

(i) is not generally imposed and legally collectible by such State or such 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 such political subdivision on transactions involving similar property, goods, services, or

³⁸ 47 U.S.C. § 151 note (2015).

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.³⁹

On September 9, 2015, the Liberty Justice Center filed a lawsuit against the city of Chicago and its comptroller on behalf of six Chicago residents who subscribe to paid Internet-based streaming media services, alleging that Chicago's Amusement Tax violates the ITFA's provision prohibiting discriminatory taxes on electronic commerce.⁴⁰ However, close examination of the facts and reliance on case law suggests that Chicago's Amusement Tax does, in fact, comply with the ITFA.

B. Chicago Amusement Tax

In the case at issue, the plaintiffs allege that Chicago's Amusement Tax violates the ITFA's provision prohibiting discriminatory taxes on electronic commerce because "it applies to Netflix's video streaming service but does not apply to Netflix's video-by-mail service."⁴¹ In general, the City of Chicago imposes a 9% amusement tax on charges paid for the privilege to witness, view or participate in an amusement, including amusements that are delivered electronically.⁴² Thus, "charges paid for the privilege of watching electronically delivered television shows, movies or videos... listening to electronically delivered music... and... participating in games, on-line or otherwise" are subject to the 9% amusement tax if the amusements are delivered to a customer in Chicago.⁴³ In addition to imposing a 9% tax on

³⁹ *Id.*

⁴⁰ Plaintiffs' Amended Complaint, *Labell v. City of Chicago*, (No. 2015 CH 13399).

⁴¹ *Id.* at ¶ 80.

⁴² Chi. Mun. Code 4-156-020(A).

⁴³ City of Chicago, Department of Finance, Amusement Tax Ruling #5 (June 9, 2015), available at http://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/AmusementTaxRuling5-06092015.pdf.

amusements, Chicago also imposes a 9% tax on the lease of personal property used in the City.⁴⁴ Chicago's personal property lease transaction tax applies to "(1) the lease or rental in the City of personal property, or (2) the privilege of using in the City personal property that is leased or rented outside the City."⁴⁵ Personal Property Lease Transaction Ruling #6 confirms that the tax "applies to the lease or rental of audio and/or visual tapes."⁴⁶

Plaintiffs are correct in their assertion that Chicago's Amusement Tax applies to Netflix's video streaming service but does not apply to Netflix's video-by-mail service.⁴⁷ However, the fact that this distinction exists is not a violation of the ITFA's provision prohibiting discriminatory taxes on electronic commerce. The ITFA defines discriminatory tax, in part, as any tax imposed by a state or its political subdivision on electronic commerce that "is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means."⁴⁸ While Netflix's video-by-mail service is not subject to Chicago's 9% amusement tax, it is subject to the city's 9% personal property lease transaction tax.⁴⁹ Therefore, the 9% amusement tax imposed on Netflix's video streaming service is "generally imposed and legally collectible at the same rate" as the 9% personal property lease transaction tax imposed on Netflix's video-by-mail service.⁵⁰ Furthermore, Netflix's video streaming service and video-by-mail service involve similar services, namely the granting of

⁴⁴ Chi. Mun. Code 3-32-030(A).

⁴⁵ *Id.*

⁴⁶ City of Chicago, Department of Revenue, Personal Property Lease Transaction Ruling #6 (June 1, 2004), available at http://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/TransTaxRuling6.pdf.

⁴⁷ See Plaintiffs' Amended Complaint at ¶ 80.

⁴⁸ 47 U.S.C. § 151 note (2015).

⁴⁹ See City of Chicago, Department of Revenue, Personal Property Lease Transaction Ruling #6 (June 1, 2004), available at http://www.cityofchicago.org/content/dam/city/depts/rev/supp_info/TaxRulingsandRegulations/TransTaxRuling6.pdf.

⁵⁰ 47 U.S.C. § 151 note (2015).

access to Netflix’s library of movies and television shows. Accordingly, Chicago’s Amusement Tax does not violate the ITFA’s provision prohibiting discriminatory taxes on electronic commerce merely because it applies to Netflix’s video streaming service but not to Netflix’s video-by-mail service.

Plaintiffs also allege that Chicago’s Amusement Tax violates the ITFA’s provision prohibiting discriminatory taxes on electronic commerce because “it imposes a higher tax rate on theatrical, musical, and cultural performances that are delivered through an online streaming service than it imposes on those same performances if they are consumed in person.”⁵¹ While the City of Chicago generally imposes a 9% tax on amusements, live cultural performances at venues in the city with a maximum seating capacity of more than 750 persons are taxed at a reduced 5% rate, and the same performances at venues in the city with a maximum seating capacity of 750 persons or less are exempt from the tax altogether.⁵²

The ITFA defines discriminatory taxes as taxes that treat electronic commerce less favorably than “transactions involving similar property, goods, services, or information accomplished through other means.”⁵³ Thus, any alleged violation of the ITFA’s provision prohibiting discriminatory taxes on electronic commerce rests on the assumption that “similar” products are being taxed at different rates.⁵⁴ The ITFA does not define the term “similar,” but case law suggests that cultural performances delivered through an online streaming service are not sufficiently similar to live cultural performances such that imposing a higher tax rate on the streamed performances would violate the ITFA’s provision prohibiting discriminatory taxes on electronic commerce. For example, in *Pooh-Bah Enterprises, Inc. v. County of Cook*, the Illinois

⁵¹ Plaintiffs’ Amended Complaint at ¶ 81.

⁵² Chi. Mun. Code 4-156-020(D)(1); (E).

⁵³ 47 U.S.C. § 151 note (2015).

⁵⁴ *See id.*

Supreme Court upheld the live cultural performance exemption noting that the goal of the exemption "is to encourage live fine arts performances in small venues" and that this goal would not be advanced by "movies, television, [or] promotional shows."⁵⁵ The court's emphasis on the distinction between attending live cultural performances and watching the performances through alternative means suggests that the court is likely to find that cultural performances delivered through an online streaming service are not sufficiently similar to live cultural performances such that imposing a higher tax rate on the streamed performances would violate the ITFA's provision prohibiting discriminatory taxes on electronic commerce.

III. The Illinois Constitution

Just as it is unlikely that Chicago's Amusement Tax violates the Internet Tax Freedom Act, it is equally unlikely that the tax violates the Illinois Constitution.

A. Home Rule Unit

The 1970 Illinois Constitution, art. VII, § 6(a) states that a home rule unit is a "County which has a chief executive officer elected by the electors of the county and any municipality which has a population of more than 25,000." There is no debate that Chicago is a home rule unit.⁵⁶

A home rule unit "may exercise any power and perform any function pertaining to its government and affairs including, but not limited to, the power to regulate for the protection of the public health, safety, morals and welfare; to license; to tax; and to incur debt."⁵⁷

B. Uniformity Clause

⁵⁵ *Pooh-Bah Enterprises, Inc. v. City of Cook*, 232 Ill. 2d 463, 496 (2009).

⁵⁶ See e.g., *Condominium Ass'n of Commonwealth Plaza v. City of Chicago*, 399 Ill. App. 3d 32, 39 (Ill. App. 1st 2010).

⁵⁷ Ill. Const. 1970, art. VII, § 6(a).

The uniformity clause provides that, “in any law classifying the subjects or objects of non-property taxes or fees, the classes shall be reasonable and the subjects and objects within each class shall be taxed uniformly. Exemptions, deductions, credits, refunds and other allowances shall be reasonable.”⁵⁸ The Illinois Supreme Court has stated that to be constitutional under the uniformity clause, “[i]t is well established that a classification of a non-property tax [1] must be based on a real and substantial difference between the people taxed and not taxed, and [2] must bear some reasonable relationship to the object of the legislation or to public policy.”⁵⁹ Additionally, statutes and ordinances are strongly presumed constitutional.⁶⁰

The Illinois Supreme Court addressed the parties’ burdens in challenging a tax using the uniformity clause:

A taxpayer raising a uniformity challenge ‘is not required to prove that every conceivable explanation for the tax is unreasonable. Rather, the taxing body must “produce a justification for its classifications.”’ *Arangold*, 204 Ill. 2d at 156 (quoting *Geja's*, 153 Ill. 2d at 248). This does not mean, however, that the taxing body has an evidentiary burden or is required to produce facts to justify the classification. *Arangold*, 204 Ill. 2d at 156. The court’s inquiry regarding the proffered justification is narrow, and “[i]f a set of facts “can be reasonably conceived that would sustain it, the classification must be upheld.”’ *Empress Casino Joliet Corp. v. Giannoulis*, 231 Ill. 2d 62, 73 (2008) (citing *Geja's*, 153 Ill. 2d at 248). Once the taxing body has offered a justification for the classification, the plaintiff then has the burden to persuade the court that the defendant’s explanation is insufficient as a matter of law or unsupported by the facts.” *Arangold*, 204 Ill. 2d at 156; *Sun Life Assurance Co. of Canada v. Manna*, 227 Ill. 2d 128, 136-37 (2007).⁶¹

In this tax, the classification that potentially raises a uniformity clause issue is the different taxation rates between live and streamed cultural performances. The city justified the taxation between live and streamed cultural performances as being more favorable to live cultural performances in order to “foster a healthy and vibrant artistic atmosphere for residents

⁵⁸ Ill. Const. 1970, art. IX, § 2.

⁵⁹ *Geja's Café v. Metropolitan Pier & Exposition Authority*, 153 Ill. 2d 239, 247 (1992) (citing *Searle Pharmaceuticals, Inc. v. Department of Revenue*, 117 Ill. 2d 454, 468 (1987)).

⁶⁰ See e.g. *Arangold Corp. v. Zehnder*, 204 Ill. 2d 142, 146 (2003) (citing *People ex rel. Ryan v. World Church of the Creator*, 198 Ill. 2d 115, 120 (2001)).

⁶¹ *Wirtz v. Quinn*, 2011 IL 111903, ¶ 83.

and visitors.”⁶² A party challenging the tax has an opportunity to persuade the court otherwise, but it is likely that the city’s justification will suffice.

It seems clear that there is a "real and substantial difference" between live and streamed cultural performances. Physically attending a theater for a performance is not the same as watching a performance online. Additionally, Illinois courts have found differences in a number of classifications that seem much more closely related than the current one.⁶³ For example, in *Midwest Gaming*, the appellate court upheld a classification between gambling devices (i.e. slot machines) and video gaming terminals (i.e. video poker).⁶⁴ In *Empress Casino*, the Illinois Supreme Court upheld a classification of river boat casinos with annual gross revenues over and under \$200 million.⁶⁵ Finally, in *Geja’s*, the Illinois Supreme Court upheld a tax on carry-out food purchased at restaurants and full service bars but not at other establishments.⁶⁶

Finally, the stated justification as creating a "vibrant artistic atmosphere" is obviously achieved by a lower tax on live cultural performances. Therefore, because the city provided a justification for the different taxation rate and there is a real and substantial difference between live and streamed cultural performances, the tax likely does not violate the uniformity clause.

IV. Justifications, Scope, and Limitations

Separate from questions about whether the City of Chicago’s expanded interpretation of the Amusement Tax will stand up against the legal challenges facing it, there remain pressing concerns about whether taxing “electronically delivered” amusements is sensible from a policy perspective. The city defends the tax as sound policy, arguing that is a necessary step toward modernizing its revenue streams in light of the fact that streaming services now constitute an

⁶² Motion to Dismiss, 17.

⁶³ See Motion to Dismiss, 18.

⁶⁴ *Midwest Gaming & Entm’t, LLC v. Cnty. of Cook*, 2015 IL App (1st) 142786, ¶ 107.

⁶⁵ *Empress Casino Joliet Corp. v. Giannoulis*, 231 Ill. 2d 62, 80 (2008).

⁶⁶ *Geja’s*, 153 Ill. 2d at 249.

economically significant means of consuming amusements. Naturally, the most vocal opponents of the tax are those most directly affected by it: consumers, and streaming service providers. Both of these groups are affected by the amusement tax ruling, and each brings their own grievances to the table.

With this controversy in mind, even if Chicago's Amusement Tax ruling can survive the legal challenges against it, the city must still address residents' and businesses' concerns that the tax is bad policy if it seeks to win popular support for the measure. This section raises the policy interests and concerns from both sides of this conflict, and assesses their respective merit to provide guidance as to how these tensions might be resolved.

A. Policy Justification for the Tax

Despite vocal opposition to the ruling, the city's rationale is relatively uncontroversial. Streaming is big business, and Chicago wants its piece of the pie. Indeed, the city expects the tax to bring in approximately \$12 million per year, as part of Mayor Rahm Emanuel's plan to address Chicago's glaring budget deficit.⁶⁷

Traditionally, municipal governments justify taxing local commerce on the grounds that the city provides services that facilitate and protect commercial activity. The city government justifies taxing those who benefit from these services because otherwise it could not afford to provide them, and the business community would suffer. Chicago's justification for taxing electronically delivered amusements is no different, as evidenced by the text of the ruling, which

⁶⁷ See Jeff John Ross, *Netflix and Amazon Users Sue to Stop Chicago's 9% Streaming Tax*, FORTUNE (Sep. 14, 2015), available at <http://fortune.com/2015/09/14/netflix-tax-lawsuit/>; see also Karen Pierog and Karl Plume, *Chicago Mayor Pushes Massive Tax Hike Over Crippling Cuts*, REUTERS (Sep. 22, 2015), available at <http://www.reuters.com/article/us-usa-chicago-budget-idUSKCN0RM1T320150922> (Some estimates place Chicago's budget deficit at over \$700 million).

provides that the “the amusement tax applies to charges for the *privilege* to witness, view or participate in an amusement.”⁶⁸

Accordingly, a common policy criticism voiced by opponents of the ruling is that while it might make sense for the city to tax in-person amusements, the same rationale does not extend to online amusements consumed within city limits. Whereas in-person amusements take place in buildings that benefit from city services, like fire and safety inspections, electronically delivered amusements are not comparably supported by city services, and thus it is unfair to tax them. From this perspective, even if the tax is legal, it is arbitrary and unjust. Taking this position to its logical extreme, one Chicago Tribune opinion piece argued that the ruling amounts to a tax on “how Chicagoans choose to spend their free time.”⁶⁹

The City attempts to address these concerns in the pending litigation against the tax. The plaintiffs in the suit contend that “Internet-based streaming video, audio, and gaming services from providers that have no connection to the City of Chicago” cannot rightfully be taxed because those providers “receive no protection, opportunities or benefits from the City of Chicago or the State of Illinois.”⁷⁰ In its motion to dismiss the lawsuit, the city rebuts this contention, arguing that “Whether a company that streams video, audio or games to people in Chicago receives any protection, opportunities or benefits from the City or the State of Illinois is irrelevant because the Amusement Tax is imposed not on them but rather on their customers who, as residents of the City, do receive protection, opportunities and benefits from the City and the State.”⁷¹ Even if the amusement providers do not benefit directly from city services as the

⁶⁸ Chicago, Ill., Amusement Ruling 5: Electronically Delivered Amusements (June 9, 2015) (Emphasis added).

⁶⁹ Gary Shapiro, *No One's Smiling About Chicago's 'Amusement Tax'*, CHICAGO TRIBUNE (Aug. 24, 2015), <http://www.chicagotribune.com/news/opinion/commentary/ct-amusement-tax-streaming-netflix-hulu-perspec-0825-20150824-story.html>.

⁷⁰ Plaintiffs' Amended Complaint at ¶ 103, *Labell v. City of Chicago*, (No. 2015 CH 13399).

⁷¹ Defendant's Memorandum in Support of Motion to Dismiss Amended Complaint at 24, *Labell v. City of Chicago*, (No. 2015 CH 13399).

owner of a theater might, the consumers who reside within city limits certainly do. And by providing protection, opportunities, and benefits to consumers, the city creates a hospitable environment for commercial activity, from which streaming service providers are able to find customers for their products.

Although taxing electronically streamed amusements may not fall neatly into a pre-existing category of taxation, that does not necessarily mean the tax should be rejected outright. The traditional justifications for municipal taxation do generally apply to the new amusement tax ruling, and ultimately provide a reasonable way for the city to modernize its revenue streams.

B. Economic Concerns

Opponents of the ruling have also pointed to the fact that the estimated \$12 million dollar revenue increase amounts to little more than a drop in the bucket in terms of addressing Chicago's budget issues.⁷² Further, critics argue that the projected revenue increase does not take into account the anti-streaming incentive the tax creates for consumers, which could potentially decrease subscribership to streaming services.⁷³ Thus, the tax could produce a less impressive revenue stream than the city's optimistic estimate.

Although businesses and consumers are understandably unhappy about having to pay more for streamed content, many arguments raised against the tax do not stand up to scrutiny. First, if the city is struggling to balance its budget, taking measures to tax new and evolving industries seems like an eminently reasonable means of working toward that goal. That the

⁷² \$12 million would constitute just over one-tenth of one-percent of Chicago's \$7.3 billion total budget. Fran Spielman, *Finance Committee Approves Emanuel's \$62.4 Million tax package*, CHICAGO SUN-TIMES (Nov. 11, 2014), <http://chicago.suntimes.com/politics/7/71/154153/finance-committee-approves-emanuels-62-4-million-tax-package>.

⁷³ Gary Shapiro, *No One's Smiling About Chicago's 'Amusement Tax'*, CHICAGO TRIBUNE (Aug. 24, 2015), <http://www.chicagotribune.com/news/opinion/commentary/ct-amusement-tax-streaming-netflix-hulu-perspec-0825-20150824-story.html>.

expected revenue from the amusement tax only partly solves Chicago's drastic budget crisis is no reason to undermine the effort.

Incentive concerns do pose a legitimate challenge for the city, according to some evidence. A Huffington Post online poll showed that almost 1 out of 5 Netflix subscribers polled would cancel their subscription if the price increased by one dollar, and nearly half those polled said they would cancel if the price rose by two dollars.⁷⁴ However, analyzing these concerns more closely reveals that the tax will likely not have a substantial negative effect on the online streaming business.

For example, a standard Netflix streaming plan costs \$7.99 monthly. The nine percent cost increase under the amusement tax ruling would add an additional 72 cents per month. This is a less extreme cost increase than the one- and two-dollar hypothetical increases surveyed in the Huffington Post poll. Over the course of a year, the tax would create an added cost of \$8.62 for Netflix subscribers. Because the cost of online streaming services remains relatively low compared to other common media consumption options, like cable television bundles, a nine percent increase in cost is unlikely to deter the average consumer. And further, the problem has yet to be studied in a rigorous and scientific manner. Online polls are inherently self-selecting, and thus prone to unreliable or imprecise results from which to draw conclusions. People who are most angry about their Netflix bill becoming more expensive are more likely to participate in an online poll on that subject than someone who did not have a firm opinion. Accordingly, the polling data likely over represents the actual percentage of people who would cancel their subscriptions over a one or two dollar price increase.

C. Scope

⁷⁴ *Id.*

Streaming service providers and customers have also criticized the tax because of potential line drawing problems. In a client alert publication, law firm Reed Smith described the ruling as “staggering in [its] breadth.”⁷⁵ The publication states that the ruling extends the tax’s reach to “streaming services for music, movies, games, and the like, as well as satellite TV.” The notice also states that the ruling “does not differentiate between news, current events, sports, movies, music or other types of television programming.”⁷⁶ However, it also acknowledges some limits to the ruling’s scope, clarifying that “the ruling does not impose the Amusement Tax on the same content when it is permanently downloaded by a consumer.”⁷⁷

The potential line-drawing problems arise with “bundled” services that include electronically delivered streamed amusements along with other products or services not subject to the tax. For example, Amazon Prime charges an annual fee for membership. Through Prime membership, members have access to Amazon Video, a video streaming service. However, Prime members also derive other benefits from membership such as free or reduced shipping on certain items. In this sense, members’ annual fee pays for a set of bundled services, only some of which are electronically delivered amusements subject to the tax.

The question becomes, how should bundled services be taxed under the ruling? Anticipating this concern, the city attempted to directly address how the tax applies to bundled charges in the body of the amusement tax ruling. Essentially, “if a bundled charge is primarily for the privilege to enter, to witness, to view or to participate in an amusement, then the entire

⁷⁵ Client Alert, *The City of Chicago Moves Aggressively to Tax ‘The Cloud’* (June 17, 2015), <http://www.reedsmith.com/The-City-of-Chicago-Moves-Aggressively-to-Tax-The-Cloud-06-17-2015/>.

⁷⁶ *Id.*

⁷⁷ *Id.*

charge is taxable.” However, if it is “clearly proven” that at least 50% of the price is not for a taxable amusement, the tax will not apply.⁷⁸

A corollary issue the city has yet to address is that this construction of the tax may unfairly benefit some service providers at the expense of others. If Amazon can show that its streaming service constitutes less than 50 percent of its Amazon Prime membership fee, then Amazon customers would not be required to pay the tax. Conversely, all Netflix streaming subscribers will see their bills increase by 9 percent. Theoretically, this regime could cause some Netflix users to view Amazon’s streaming service as a better value, costing Netflix customers. However, in practice the city’s method of taxing bundled services seems unlikely to influence most customers’ choice of streaming providers. Although price is undeniably a factor streaming consumers consider in choosing their providers, most are probably making their decision based almost exclusively on the provider’s content offerings. A fan of Netflix’s House of Cards series is unlikely to convert to Amazon Prime over a less than one dollar per month price increase if they cannot continue to watch the show with Amazon’s streaming service.

A second issue the city has yet to address is that under this construction of the tax, Chicago loses a potentially substantial amount of revenue by exempting companies from paying the tax if they fall beneath the 50 percent cut off. Returning to the Amazon example, why should Amazon be completely exempted from paying the tax if 49 percent of the Amazon Prime membership fee goes to taxable streaming services, rather than being taxed pro rata? Viewed in this light, the 50 percent provision creates an incentive for service providers to structure their services to avoid the tax altogether. Now that Netflix produces its own content rather than merely providing a medium for its customers to stream pre-existing content, perhaps Netflix could argue that 51% of the subscription price goes toward content production rather than taxable streaming.

⁷⁸ Chicago, Ill., Amusement Ruling 5: Electronically Delivered Amusements (June 9, 2015).

By doing so, they could circumvent the tax and save their Chicago customers 9 percent of their subscription price, and simultaneously deprive the city of much needed revenue. In structuring the tax with the 50 percent provision, Chicago may have inadvertently created a large loophole that could undermine the its goals in creating the tax.

However, given the most likely alternatives, Chicago probably decided upon the most prudent course of action. If the city drafted the tax to perfectly balance the burden on every conceivable streaming company, each with its own unique business model that might attribute a different percentage of its product's price to taxable amusements, the result would be unworkable. If the ruling was drafted such that it taxed streaming businesses pro rata based on the percentage model, the city would have to hold a hearing or similar process for every streaming company. Additionally, the city might well lose revenue on this model as well. In addition to the administrative costs of making a legal determination for each business, it is likely that few companies, if any, would be taxed on 100 percent of its sale price. Even Netflix might be taxed on only 80 or 90 percent (or less) of its subscription fee, since surely not 100 percent of its fee goes toward providing taxable amusements.⁷⁹ In sum, although the tax creates an imperfect incentive structure, it does seem to have balanced the costs and benefits and arrived at a generally reasonable way of producing revenue from a burgeoning industry.⁸⁰

D. Conclusion

The city's new amusement tax regime does impose a burden on both customers and service providers. The Reed Smith client alert bulletin notes that as a result of the bundling provision, "an establishment that charges patrons for access to television programming of any sort, plus other goods and services (e.g., a bar that imposes an admission charge for a pay-per-

⁷⁹ In addition to producing its own content, Netflix also offers a mail-order DVD service, among others.

⁸⁰ It is worth noting, however, that most jurisdictions have walked away from the digital tax.

view event that includes food and beverages) may have to navigate the bundling rules.”⁸¹

However, the bundling scheme also grants customers and service providers options. If a service providers believes its products are being improperly taxed, it can delineate what portion of its fees are specifically for electronically delivered amusements subject to the tax, and only that portion would be taxed. Alternatively, if it can show that less than 50% of the fee can be attributed to streamed amusements, the tax will not apply at all. Finally, if customers and service providers feel that a large portion of the price is for the privilege to access electronically delivered amusements, the entire price can properly be taxed.

The exact boundaries of what types of amusements may be taxed under the ruling will probably become more clearly defined in coming years. The boundaries may additionally change over time, as new types of electronically delivered amusements evolve that the city did not anticipate in drafting the ruling. However, the ruling allows for flexibility in making these determinations, and most consumers and service providers will not be unduly burdened by adapting to the new regime, and participating in the process of defining its outer limits.

⁸¹ Client Alert, The City of Chicago Moves Aggressively to Tax ‘The Cloud’ (June 17, 2015), <http://www.reedsmith.com/The-City-of-Chicago-Moves-Aggressively-to-Tax-The-Cloud-06-17-2015/>.