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IN FOCUS

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The Internet Tax Freedom Act and Federal Preemption

Congress enacted the Internet Tax Freedom Act to establish a moratorium on the imposition of state and local taxes that would interfere with the free flow of interstate commerce over the internet. The permanent Internet Tax Freedom Act (ITFA), 47 U.S.C. §151 note, preempts state and local governments from levying (1) taxes on internet access and (2) multiple and discriminatory taxes on electronic commerce. State court lawsuits challenging state and local taxes under the ITFA indicate that courts have narrowly interpreted the ITFA's preemption provisions.

This In Focus summarizes the ITFA's legislative history and major preemption provisions and discusses ITFA jurisprudence.

Legislative History

As first enacted on October 21, 1998, the ITFA imposed a three-year moratorium on the ability of state and local governments to impose taxes on internet access and certain internet transactions to the extent permitted by the Constitution and any other federal law in effect on that date. According to Senate Report 105-184, Congress exercised its legislative authority under the Constitution's Commerce Clause to establish a moratorium on transactions that were "inherently interstate in nature" to "facilitate the development of a fair and uniform taxing scheme." Congress sought to prevent a patchwork of "unpredictable and overly burdensome" state and local internet-specific taxes that would hamper the growth of the internet and electronic commerce. Following the initial moratorium, a number of laws amended and extended the moratorium until it became permanent on February 24, 2016, as part of the Trade Facilitation and Trade Enforcement Act of 2015.

Taxes on Internet Access

The initial three-year moratorium included a grandfather clause permitting states that imposed and enforced taxes on internet access prior to October 1, 1998, to continue taxing internet access. The Trade Facilitation and Trade Enforcement Act of 2015 set a June 30, 2020, expiration date for the grandfather clause. The ITFA now prohibits all state and local taxes on internet access. The ITFA defines the term "internet access" as a "service that enables users to connect to the [i]nternet to access content, information, or other services offered over the [i]nternet." The term excludes "voice, audio or video programming, or other products and services . . . that utilize [i]nternet protocol or any successor protocol and for which there is a charge."

Multiple and Discriminatory Taxes

The ITFA also prohibits multiple and discriminatory taxes on electronic commerce. The term electronic commerce is broader than internet access. It embraces "any transaction conducted over the [i]nternet or through [i]nternet access."

A multiple tax exists when one state, or a political subdivision thereof, imposes a tax "on the same or essentially the same" electronic commerce as another state, or political subdivision thereof, without a credit for the tax paid in the other jurisdiction. A multiple tax is present even where the state or political subdivision's tax uses a different tax rate or basis than the other state or political subdivision's tax. A state's sales and use tax on electronic commerce is not a multiple tax when a political subdivision within that state also imposes a sales and use tax on the same electronic commerce. Additionally, a tax imposed on persons engaged in electronic commerce that is also subject to a sales or use tax is not a multiple tax.

In general, the ban on discriminatory taxes means that the same tax obligations and tax rates must apply to electronic commerce transactions and nonelectronic commerce transactions (e.g., mail-order and brick-and-mortar store sales) involving the same, or similar, property, goods, services, or information. Under the ITFA, a tax discriminates against electronic commerce when (1) there is no analogous tax levied on nonelectronic commerce transactions involving similar property, goods, services, or information; (2) an analogous tax levied on nonelectronic commerce transactions involving similar property, goods, services, or information is imposed at a different rate (subject to a limited exception for phaseouts); (3) an analogous tax levied on nonelectronic commerce transactions involving similar property, goods, services, or information imposes a tax collection or payment obligation on a different person or entity; and (4) the tax establishes a classification of internet or online service providers to subject them to a higher tax rate than the rate that generally applies to "providers offering similar information services delivered through other means."

Taxes on Digital Goods and Services

As more state and local governments pass laws to tax digital goods and services, courts have had to address novel issues concerning ITFA preemption. Often, these cases turn on whether an analogous tax involving a comparable nondigital good or service exists, and if so, whether the good or service is taxed in the same manner. If a court finds an analogous tax exists, then it typically holds that the ITFA does not preempt the state or local government's tax on electronic commerce.

In 2013, in *Performance Marketing Association, Inc. v. Hamer*, the Illinois Supreme Court considered whether the ITFA preempted an Illinois use tax collection obligation on internet "performance marketing" contracts. In general, a performance marketing contract is one under which a person or organization publishes or displays an advertisement and is paid when a specific action, such as a sale, occurs. Illinois enacted a "click-through" nexus law that required out-of-state (remote) internet retailers and servicemen to collect a use tax if they had a performance marketing contract with a person or organization, an "affiliate," in Illinois that advertised or displayed a link on a website connecting an internet user to that remote retailer or servicemen's website.

A trade group challenged Illinois's law on the grounds that it was a discriminatory tax on electronic commerce in violation of the ITFA, as it applied to internet performance marketing contracts, but not to print and broadcast media performance marketing contracts. The state acknowledged that the law did not apply to offline performance marketing contracts. However, the state argued that the law was not a discriminatory tax under the ITFA because a "click-through" link was similar to active solicitation, which was subject to a use tax collection obligation.

The court disagreed with the state's reasoning. It concluded that a click-through link was not similar to active solicitation because there was no interaction between an affiliate and a customer. It also determined a click-through link was no different from print and broadcast advertisements with promotional codes, because they could be used to track and generate sales and be disseminated nationally and internationally. Thus, the court held, "by singling out retailers with [i]nternet performance marketing arrangements for use tax collection, the [law] imposes discriminatory taxes within the meaning of the ITFA." The court did not consider the trade group's alternative argument that the law violated the Commerce Clause.

In 2019, in *Labell v. City of Chicago*, an Illinois appellate court examined whether the City of Chicago's amusement tax was a discriminatory tax under the ITFA. Chicago extended its 9% tax on charges paid for the privilege of witnessing, viewing, or participating in Chicago amusements (e.g., sporting events, motion picture shows) to include Chicago customers watching electronically delivered television shows, movies, and videos, listening to electronically delivered music, and participating in online games. Relying on *Performance Marketing*, the taxpayers in *Labell* argued that the extension of the tax to streaming services was a discriminatory tax under the ITFA because Chicago taxed automatic amusement devices (e.g., jukeboxes and pinball machines) and live cultural performances with a limited seating capacity (e.g., fine art performances) in a different manner. The Illinois appellate court ruled that *Performance Marketing* was not dispositive and the tax did not violate the ITFA because, unlike in *Performance Marketing*, the services at issue were not "identical." The court explained, "Streaming services are primarily used privately in the home or on devices owned and maintained by the patron" while "automatic amusement devices are used publicly, outside the home and are owned and maintained by businesses." *Labell* does not include a similar comparative analysis of streaming services and live cultural performances.

In 2020, in *Gartner, Inc. v. Department of Revenue*, a Washington appellate court considered whether the ITFA preempted a higher combined rate of tax on "digital automated services." Under Washington's tax regime, a business selling digital automated services was generally subject to the retailing business and occupation (B&O) tax rate and a retail sales tax collection obligation. A business selling "professional services" that involved "human effort" originating after a customer request was subject to the higher service B&O rate, but was generally not required to collect the retail sales tax. In *Gartner*, the taxpayer sold "licenses" or "subscriptions" to client-customized subsites that permitted clients to view research content in the taxpayer's research library via software. Citing *Performance Marketing*, the taxpayer argued that the higher combined rate on digital automated services was discriminatory and its services were subject to the higher rate only because they were "electronically transferred." The taxpayer contended that selling access to information in its research library was the same as providing research reports to clients via email or CD, which remained subject to the service B&O tax. The court held Washington's tax regime did not violate the ITFA, explaining that

> simply sending its clients Research Content by e-mail is not the equivalent of Gartner selling access to its Research Library. . . . [A]ccess to Gartner's Research Library is a digital automated service that is transferred electronically *and* uses one or more software applications.

Preemption of State Taxing Authority

From the inception of the ITFA, state government advocates have argued that restrictions on the ability of state and local authorities to levy internet-specific taxes are unconstitutional infringements on state sovereignty. There are few cases discussing the intersection of the Tenth Amendment's anti-commandeering doctrine and Congress's power to preempt state taxes under the Commerce Clause because Congress rarely exercises this power. In addition, potential plaintiffs may be reluctant to bring lawsuits based on the Supreme Court's past statements in state taxing power cases underscoring a presumption against preemption.

Courts may give Tenth Amendment challenges to the ITFA more credence after the Supreme Court's 2018 decision in *Murphy v. NCAA*. In *Murphy*, the Court held that a provision in the Professional and Amateur Sports Protection Act that made it "unlawful" for a state to authorize sports betting violated the Tenth Amendment's anti-commandeering doctrine. Some legal scholars expansively construe *Murphy* to extend the anti-commandeering doctrine to statutes like the ITFA that prohibit state legislatures from taking a specific action. Other legal scholars read *Murphy* narrowly—*Murphy* does not suggest that the anti-commandeering doctrine should be applied to invalidate a valid federal preemption provision under the Supremacy Clause. Thus, the doctrine might not invalidate a valid exercise of an enumerated power conferring a federal right on private actors to be free from a specific state law that conflicts with federal law. As applied to the ITFA, a court might view the ITFA as a valid exercise of the Commerce Clause that confers rights on private actors to be from specific state taxes interfering with interstate commerce.

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