Interstate Commerce Initiative

NTUF
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The Latest Form of Discriminatory Digital Tax — Streaming Taxes

As the old Reaganism says, the government's view on the economy is: if it moves, tax it. As the most dynamic sector of the modern economy, digital services have proven to be the victim of this aphorism, with states and even foreign countries looking to profit off of the ingenuity of American digital businesses. The latest expression of this revenue fever — taxes that target digital entertainment.

Chicago recently settled a legal challenge to its first-in-the-nation tax on streaming services such as Netflix or Hulu, but that does not mean that the matter should end there. Should other states and localities follow suit on streaming taxes, it would represent yet another growing issue of state and local governments burdening interstate commerce by taxing and regulating outside their borders.

Background: Digital Taxes

As the digital sector of the economy has grown, so too have efforts to profit off of its success — including by governments that would not traditionally have the authority to tax such activity. Taking cues from European efforts to glean revenue off of the more successful American tech sector, Maryland became at the beginning of this year the first state to implement a digital tax.

NTUF warned at every stage along the way that Maryland's digital tax was not only likely to face strong legal challenges, but would also burden interstate commerce by falling upon out-of-state businesses. In effect, Maryland was importing tax revenues and exporting tax burdens.

Key Facts:

States, localities, and foreign governments continue to try to find ways to hit tech companies with special tax obligations that they do not impose on their "traditional" counterparts.

One example of this ongoing effort is Chicago's attempt to subject digital entertainment to its "amusements tax," even though the traditional counterpart of these services is subject to the normal sales tax, simply because the rate is higher.

These short-sighted efforts to try and profit off of the innovativeness of the digital economy threaten to tax away the benefits it can provide.

That's because Maryland's digital tax only began to apply to businesses with more than $100 million in *global* revenues — with rates increasing up to 10 percent of gross revenues for businesses exceeding $15 billion in global revenue. Not only is this a threshold that bears no relevance to any questions of nexus, it also ensures that only businesses with operations primarily outside of the state would be affected. What's more, the state's tax applied to digital advertising even though traditional advertising is not taxable.

That Maryland went forward with this poorly-conceived tax is bad enough, but the real danger is that more states will follow suit. As with all threats to interstate commerce, the problem of states stretching their jurisdictional authority past their borders is that other states can do the same, leaving taxpayers subjected to a confusing patchwork of overlapping state taxes and rules.

And while other states have not passed digital taxes into law, that does not mean that the risk is not present. States like New York and Massachusetts continue to consider similar proposals, while other states had proposed bills last session which ultimately failed to progress.

What's more, misguided efforts to target the digital economy for tax revenue can take many forms. California Governor Gavin Newsom and former presidential candidate Andrew Yang each floated versions of a "data dividend," by which digital companies are taxed for the value they gain from user data. Not only do these proposals represent yet another threat to interstate commerce, they also would likely only restrict the benefits of the digital economy that these users already enjoy.

Chicago's "Streaming Tax"

In this sense, Chicago's effort to tax streaming services is not a new idea, just a different angle at aiming tax burdens at the successful digital sector.

Chicago's tax actually goes back to 2015, when the city first extended its existing 9 percent amusements tax to "amusements that are delivered electronically." This includes not just streaming services, but any digital entertainment that is rented rather than purchased.

That may seem at first glance to be a good application of the principle of tax policy that similar products and services should be taxed similarly. But the traditional counterpart of digital streaming rentals is not amusements such as concerts or shows, but rentals of tangible products. In other words, streaming services should not be taxed the same as concert tickets, they should be taxed at the same 1.5 percent rate as in-person video rentals are (or were).

The reason that Chicago chose the former tax designation to apply to streaming services is not hard to discern — the city's 9 percent amusements tax rate is significantly higher than its 1.5 percent sales tax rate. Chicago has been able to glean far more revenue from this miscategorization than it could by appropriately categorizing it as a rented product. And as the streaming industry has grown, so too have Chicago's returns — jumping from $9.4 million in 2017 to $31 million in 2021.

Yet this revenue boost has come at the cost of logic and tax fairness. No reasonable person would argue that renting a movie through Amazon Prime is more akin to buying a ticket to an amusement park than renting a DVD through Redbox.

This becomes even more obvious when one considers the justification for the city's amusements tax being higher than its tax on other sales. Concerts and shows attract large crowds of people, often requiring extra efforts by city services to coordinate traffic, provide a greater law enforcement presence, and so on. Someone sitting on their couch to binge-watch a TV show, on the other hand, places no strain on public services whatsoever.

In this sense, it is hard to view Chicago's designation of digital rentals as an "amusement" as anything other than a naked cash grab. In this sense, it is little different from similar efforts by European countries and states like Maryland to grab at tech companies that are viewed as fertile sources of revenue.

An Interstate Commerce Issue

For this reason, Chicago's streaming tax is worse than just bad tax policy. It is an interstate commerce issue, as it unfairly targets out-of-state businesses for increased tax obligations. States and localities targeting goods and services for which they lack a domestic industry for special tax obligations creates a clear threat to interstate commerce.

In theory, digital commerce should be protected from such cash grabs by the federal Internet Tax Freedom Act (ITFA), which prohibits states and localities from imposing discriminatory tax burdens on digital goods and services. One part of ITFA's protections for digital commerce prohibits states and localities from levying taxes on digital goods and services "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."

Taxing streaming services at a different rate than traditional video rentals is a clear violation of this rule. Unfortunately, Chicago's settlement with Apple over Apple's legal challenge to Chicago's rule means there is no judicial precedent to block other states and cities from following suit.

Conclusion

Increasingly, states and localities are viewing the growth of the digital economy as a new source of revenue to be milked dry rather than innovation that provides benefits to Americans. Should this trend be allowed to continue unabated, it will not only hamper this innovation, but also implicitly greenlight a habit that states and localities are already prone to — targeting their tax burdens at out-of-state businesses and individuals that lack the ability to strike back through the ballot box.

But this "free revenue" for states and cities is anything but. Just as states and localities seek to impose tax obligations on other jurisdictions' taxpayers, those other jurisdictions will do the same back. The result will harm the national economy while leaving taxing jurisdictions less accountable to the individuals and businesses that they are taxing.

Intervention by the courts or Congress to reaffirm the impermissibility of discriminatory taxes against digital commerce should not be needed given the clarity of ITFA, but it evidently is. Otherwise, states seem set on taking the opportunity not to update their tax rules to appropriately reflect the reality of digital goods and services, but to tax away the potential benefits growth in the industry can bring to Americans.

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