Taxing the Means or the Ends? Chicago Cloud Computing Rulings' Confused Approaches Can Support Taxpayer Challenges

As technology evolves to offer new services that were unthinkable even a decade ago, state and local taxing authorities struggle to keep up. All too often, the will or ability to amend tax laws to address novel industries and technologies is lacking; instead revenue administrators aggressively interpret existing tax laws in an attempt to capture new revenue. This is pushing a square peg into a round hole, as demonstrated by the conceptual gaps of recent City of Chicago guidance: Personal Property Lease Transaction Tax Ruling #12 and Amusement Tax Ruling #5.

These sister rulings, issued simultaneously on June 9, 2015, take opposite approaches to characterizing transactions: the lease transaction tax ruling focuses on the means of providing a service using computer hardware and software; the amusement tax ruling looks at the ends of a customer's desire to be entertained. These inconsistencies are a result of extending old taxes to new services and create opportunities for taxpayers to challenge Chicago's position.

Lease Transaction Tax Ruling #12 is a bold extension of the tax to apply to most interactive websites. The lease transaction tax is basically a 9% municipal sales and use tax on leasing tangible personal property in the City or using leased property in the City.[1] At the dawn of the computer age, the tax was interpreted as applying to time-sharing on computer mainframes.[2] Technology evolved, and the tax was extended to the "nonpossessory computer lease" of using a terminal or personal computer to access a remote database, and with sourcing to the location of the user, not the computer and software theoretically subject to tax.[3]

A putative class action challenging taxation of remote computer use was dismissed,[4] and the validity of the lease transaction tax on remote computer access has never been fully litigated. In recent years, Internet-based providers of information services and software-as-a-service have seen significant audit activity as the City has extended the reach of its tax.

Ruling #12 specifically addresses an exemption from lease transaction tax for remote computer access where (1) the object of the transaction is information and (2) the user's control of the remote computer and software is de minimis.[5] While this exemption was enacted decades ago for stock ticker and other price-quotation services used by the financial industry, it is a natural fit for many Internet-based services: the object of the customer's transaction is information, and control is limited to the user's browser communicating with the provider's website server.

Ruling #12, however, narrows the exemption in two ways: First, it takes a broad interpretation of what constitutes "control," advising that having search functionality on a website is enough control to void the exemption.[6] Second, it discounts the value of public information, instead saying that the object of the transaction is more likely to be information if it is proprietary.[7] Given the narrow interpretations, "[a]s a general rule . . . a subscription to an interactive web site will be subject to the lease tax, and will not be exempt."[8]

Amusement Tax Ruling #5, in contrast, disregards the mechanics of Internet-based services and instead bases the 9% amusement tax on the purpose of the user in accessing the service: if it's fun, it's taxable. Subscriptions to audio streaming, video streaming, and computer games are specifically singled out as being taxable.[9] Temporary download rentals are also subject to tax.[10] Purchases of software or digital goods for permanent download are not subject to amusement tax.[11] Like the lease transaction tax on remote computer access, the amusement tax on online services is sourced to the end-user in Chicago.

The approaches of the rulings obviously overlap when it comes to the use of computers and software to provide audio, video, games, or other forms of entertainment over the Internet. Which 9% tax should apply? Under the City's guidance, the amusement tax trumps the lease transaction tax: "Entertainment materials such as copyrighted books, musical and other sound recordings, feature length and episodic films are not

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'data or information' as those terms are used in the definition of a 'nonpossessory computer lease'" subject to lease transaction tax.[12] Essentially, the taxability of products that are nearly identical from a technical perspective varies depending on content.

For example, two searchable video streaming services could be powered by identical hardware and software, but one provides educational and training videos, whereas the other is pure entertainment. The educational video service may have lease transaction tax exposure, whereas the technically identical entertainment video service would have no lease transaction tax exposure under Ruling #12 and would instead face the amusement tax. Indeed, if a work had dual use, access to the identical file could be "information" or not depending on the nature of the hosting website and the purposes of the site users.

The lease transaction tax exemption for information and de minimis control further confuses the issue. After defining entertaining media to not be "information," Ruling #12 goes on to provide that access to "proprietary" (and presumably non-entertaining) materials is indicative of the object of the transaction being information, not the computer's search functionality, and therefore its eligibility for exemption. Essentially, the City appears to be trying to exempt newspaper and magazine websites and other print analogs. Again, however, the City has inserted content-based criteria into what theoretically is a tax on the use of computers and software. Providers of access to public or non-proprietary information should be equally eligible for the exemption.

These inconsistencies create serious uniformity problems that taxpayers—particularly taxpayers facing lease transaction tax assessments—can use to challenge the City's position.[13] The Illinois Constitution provides that tax classifications "shall be reasonable and the subjects and objects within each class shall be taxed uniformly."[14] The City's inconsistent characterization of similar transactions is the type of arbitrary discrimination the uniformity clause is intended to forestall.

First the City defined a "lease" to mean simply communicating with a remote computer, such that computers and software are sourced and taxed differently from other forms of property. In the recent rulings the City now has defined "information" to mean only certain kinds of information. In some instances the City intends to tax the means of providing the service (computers and software); in others the City looks to the user's goal (entertainment from streaming media or computer games). In its defense, Chicago might argue that the lease transaction tax is a compensating tax to the amusement tax, but the bottom line is that fundamentally inconsistent approaches to characterizing transactions are being used.

The City's rulings highlight the difficulty of characterizing online services (and other automated services). In some instances the City says that the object of the transaction is the buyer's desired result, as in the case of online entertainment services or websites resembling traditional periodicals. In most other instances Chicago instead looks to tax the hardware and software platform by which the service is delivered. While unfair, Chicago's inconsistent approach could be its undoing, by providing support for taxpayer challenges to the tax. ■

1 Chi. Mun. Code § 3-32-030.

2 *See* Chicago Lease Transaction Tax Amended Ruling #5 (eff. Sept. 1, 2013, originally Ruling #9 eff. Feb. 1, 1987).

3 *See* Chi. Mun. Code § 3-30-020.l; Chicago Personal Property Lease Transaction Tax Ruling #9 (Jun. 1, 2004, originally Ruling #13 eff. Sept. 28, 1992).

4 *Meites v. City of Chicago*, 540 N.E.2d 973 (Ill. App. 1989).

5 Chi. Mun. Code § 3-32-050.A.11.

6 *See* Personal Property Lease Transaction Tax Ruling #12, ¶ ¶ 9, 10, 12 (eff. Jul. 1, 2015).

7 *Id.* ¶ 11.

8 *Id.* ¶ 13.

9 Amusement Tax Ruling #5, ¶ 8 (eff. Jul. 1, 2015).

10 *Id.* ¶ 10.

11 *Id.*

12 Ruling #12, at ¶ 6.

13 In addition to uniformity arguments, taxpayers also have significant Internet Tax Freedom Act, Commerce Clause, and Illinois home rule power arguments in challenging the tax.

14 Ill. Const. art. IX, § 2.