State Law & State Taxation Corner

Chicago Opportunistically Extends Existing Taxes to Cloud Computing Services and Streaming Services to Raise More Revenue

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Introduction

Running a city can be an expensive endeavor. Local governments throughout the United States have been searching for additional tax revenues to fund their operations, particularly chronically underfunded defined benefit pension plans for their employees. The City of Chicago might well be the poster child of financially challenged American municipalities, so two years ago, Chicago political leaders cast their ravenous eyes on cloud computing services like Amazon Web Services ("AWS") and video and music streaming services like Netflix, Hulu and Spotify as an untapped source of new tax revenue. The Chicago Mayor's office predicted that these two taxes would raise $12 million of additional revenue for the city in their initial year.

It probably would have worked better conceptually if Chicago had added cloud computing services and streaming services as enumerated services subject to a sales tax, but that was not possible here because the 1.25-percent Chicago Retailers' Occupation Tax ("ROT")—the city's sales tax—can only apply to retail sales of tangible personal property in the City of Chicago.[1] Payments for services themselves are not subject to either the Chicago ROT or its accompanying Service Occupation Tax ("SOT"), which imposes a 1.25-percent tax on the charge for or cost price of items of tangible personal property transferred to the consumer as an incident to the service transaction.[2] Cloud computing services and streaming services do not provide any tangible personal property to the consumer that the city could tax with its ROT or its SOT.

The solution, the Chicago Department of Finance concluded, was to bring cloud computing services and streaming services within the reach of the existing Chicago Personal Property Lease Transaction Tax (the "Lease Transaction Tax") and Amusement Tax. This administrative action surprised the Chicago business, tax and consumer communities because these two taxes, at least as described in the city tax ordinances and as applied over the years, did not fairly apply to cloud computing services and streaming services. Critics argued that, without legislative

action by the Chicago City Council, the Department had overreached its administrative authority.

The Chicago Lease Transaction Tax and Cloud Computing Services

Since 1974, the City of Chicago has imposed its Lease Transaction Tax on the lease or rental of personal property within the city, as well as to the privilege of using personal property in the city that was leased or rented at a location outside the city.[3] The term "lease" or "rental" is defined in the Lease Transaction Tax Ordinance to mean "any transfer of the possession or use of personal property, but not title or ownership, to a user for consideration, whether or not designated as a lease, rental, license or some other term, and includes a 'nonpossessory lease.'"[4] The application of the Lease Transaction Tax to leases or rentals of tangible personal property is pretty straight forward. As long as the lessee takes possession or delivery of the tangible personal property within the boundaries of the City of Chicago, or the lease transaction occurred outside the city, but the lessee is primarily using (more than 50 percent) the tangible personal property within the city boundaries, the Lease Transaction Tax applies to the lessee's payment for the right to use the tangible personal property in the city.[5]

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However, since its inception, the Chicago Lease Transaction Tax has also applied to "nonpossessory leases" of time on or use of a lessor's addressing machines, billboards, calculators, computers, computer software, copying equipment or data processing equipment, pursuant to which the customer has received the use but not possession of such personal property.[6]

Since 1994, taxable nonpossessory leases also include a "nonpossessory computer lease," which means a nonpossessory lease in which the customer obtains access to the provider's computer and uses that computer or its software to input, modify or retrieve data or information, without the intervention of personnel acting on behalf of the provider. According to the Lease Transaction Tax Ordinance, nonpossessory computer leases include, but are not limited to, time sharing or other uses of a computer with other users. The location of the terminal or other device with which the customer accesses the provider's computer and software is considered to be the place of lease or rental for purposes of applying the Lease Transaction Tax to the customer's payments to the provider for the nonpossessory computer lease.[7]

Nonpossessory leases and nonpossessory computer leases were included in the Lease Transaction Tax Ordinance so that Chicago could tax financial institutions on their payments under time-sharing agreements to use a provider's computer system to process the financial institution's transaction data. Going back to the early 1970s, the Chicago Department of Finance issued a series of rulings that leased time or usage time on a provider's computer, data processing equipment, copying machines or similar equipment was a nonpossessory lease subject to the Lease Transaction Tax, to the extent the customer was making use of the provider's equipment from an access terminal or device within the City of Chicago.[8] In a 1992 ruling, the Department concluded that the Lease Transaction Tax applied to a Chicago customer accessing a consumer credit reporting company's computerized database *via* a computer terminal or similar device in Chicago to request or retrieve credit reports.[9] In the 1989 case of *Mietes v. Chicago,* the Department successfully imposed the Lease Transaction Tax on both usage time and search charges for online Lexis/Nexis database services provided to terminals at a Chicago law firm.[10] It is fair to say that the Department was treating searchable database services as nonpossessory leases subject to the Lease Transaction Tax because the search function was considered to be a significant use or control of the provider's computer.

The Chicago Lease Transaction Tax Ordinance provides a number of exceptions, including the so-called "Exemption 11" dating back to 1995 for "the nonpossessory lease of a computer in which the customer's use or control of the provider's computer is *de minimis* and the related charge is predominantly for information transferred to the customer rather than the customer's use or control over the computer."[11] The Ordinance cites "the nonpossessory lease of a computer to retrieve current price quotations or other information having a fleeting or transitory character" as examples of transactions that qualify for Exemption 11.[12]

The Chicago Lease Transaction Tax generally applies at a rate of nine percent to the price that the customer pays on such lease or nonpossessory lease transactions involving personal property located or used within the City of Chicago.[13] The burden of paying the tax falls on the customer, as would be the case with a sales or use tax, and the lease or rental of the personal property is considered to take place at the location where the customer takes possession or delivery of the personal property. As noted earlier, if the customer takes possession or delivery of the personal property at a location outside Chicago, but primarily uses the property within the City boundaries, the transaction is subject to the Lease Transaction Tax.[14] Lessors or providers having nexus within the City of Chicago are required to collect the Lease Transaction Tax from the customer and remit those tax funds to the city.[15]

In Personal Property Lease Transaction Tax Ruling # 12, the Department announced that it is extending the nonpossessory computer lease concept to the use of a provider's computer "to perform functions such as word processing, calculations, data processing, tax preparation, spreadsheet preparation, presentations and other applications available to a customer through online access to a provider's computer and its software."[16] The Department explained in this ruling that it intends to apply the Lease Transaction Tax to what are commonly referred to as cloud computing, cloud services, hosted environment, software as a service ("SaaS"), platform as a service ("PaaS") or infrastructure as a service ("IaaS") transactions. The Department has concluded that with respect to each of these services, the customer is making use of the provider's computer and software to input, modify or retrieve data or information, giving rise to a taxable nonpossessory computer lease. To determine the Lease Transaction Tax liability, the customer's payment to the provider to obtain those services can be apportioned to Chicago based on the percentage of the customer's employees or other individuals having online access to the provider's computer and software who are located in Chicago. Alarmingly, the Department initially intended to use a four-year lookback period ending September 1, 2015, when auditing businesses to determine their liability for Lease Transaction Tax on cloud computing services.

The Department's Lease Transaction Tax Ruling # 12 provides a number of exceptions to the application of Lease Transaction Tax to cloud computing services. For example, the tax does not apply to a provider's charges for writing a report, article or document consisting primarily of the provider's own observations, opinions, ideas or analysis, or for creating an electronically accessible database for the customer, apparently because the Department would view the customer as having obtained a service rather than having made use of the provider's computer and software in these scenarios.[17] Similarly, a provider's charges for the mere storage of a Chicago customer's information on the provider's computer *located outside Chicago* are not subject to the Lease Transaction Tax because the customer is not making meaningful use of the provider's computer to store the information on the provider's computer. However, the Lease Transaction Tax will apply at a later date when the customer uses a terminal or device in Chicago to access the stored information on the provider's computer located outside Chicago.[18]

The Department clearly struggled to draw lines for how Exemption 11 will apply to cloud computing services. As discussed earlier, Exemption 11 is intended to apply where a customer's use or control of the provider's computer is *de minimis* and the customer's primary purpose is to obtain information rather than to use or exercise control over the provider's computer. The Department announced in Lease Transaction Tax Ruling # 12 that a customer's passive access to information, such as a one-way "ticker-tape" of stock market price quotations, or the customer's access to a provider's database of proprietary materials, such as copyrighted newspapers, newsletters or magazines, will be exempt from the Lease Transaction Tax, even if the database has a search function, because the Department views the customer as being primarily interested in obtaining information rather than use or control of the provider's computer.[19]

Meanwhile, the City of Chicago continues to face significant fiscal challenges that these taxes on cloud computing services and streaming services have certainly not solved.

However, the Department included online legal research databases like Lexis/Nexis and interactive databases of financial research, information and analytical tools in the taxable bucket because in those instances the Department treats the customer has having made sufficient use of the provider's computer software to search for and download a desired subset of information in the provider's database to make the transaction taxable.[20] A customer's online access to the provider's database to search for credit reports, real estate listings and prices, car prices, stock prices, economic statistics, weather statistics, job listings, resumes, company

profiles, consumer profiles, marketing data and similar information is also treated in Lease Transaction Ruling # 12 as a taxable nonpossessory computer lease.[21]

The Department further explained in Lease Transaction Tax Ruling # 12 that a provider is *not* required to collect the Lease Transaction Tax if the provider has no reason to believe the customer is accessing the provider's computer from a location in Chicago. However, if the customer has employees within and without Chicago accessing the provider's computer, the provider is allowed to apportion its charges to the customer based on actual data or estimates provided by the customer of the portion of the customer's usage of the provider's computer that is taking place in Chicago.[22]

The Department faced significant criticism from the business and tax communities over the way it was extending the existing Lease Transaction Tax to cloud computing services in Lease Transaction Tax Ruling # 12. Many people questioned whether cloud computing services really presented a situation where the customer was exercising use or control of the provider's computer and software to process the customer's data or information, the essence of a nonpossessory computer lease. The nascent Chicago high tech business community was particularly vocal, complaining that requiring them to pay the nine-percent Lease Transaction Tax on their purchases of cloud computing services for use in their business, and to collect that tax on subscription payments from customers of their online software apps and other cloud computing services, would cripple their early stage businesses.

The Chicago City Council took heed, amending the Lease Transaction Tax Ordinance on October 28, 2015, to provide a lower 5.25-percent tax rate for cloud computing services involving a customer's use of the provider's computer to input, modify or retrieve the customer's own data or information. However, online database services remain subject to the general nine-percent Lease Transaction Tax rate.[23] In addition, the City Council added a "small business exemption" from the Lease Transaction Tax on cloud computing services when the provider or the customer holds a valid and current business license issued by the City of Chicago or another jurisdiction, that provider or customer had less than $25 million of gross receipts in the previous calendar year, and that provider or customer has been in operation for less than 60 months.[24] This exemption relieves a small business provider from the obligation to collect the Lease Transaction Tax on its cloud computing services or a small business customer from having to pay tax on those services.

The Department issued an Information Bulletin in November 2015, to provide further guidance on how it intends to apply the Lease Transaction Tax to nonpossessory computer leases. The Department observed:

> While the plain language of the Lease Tax Ordinance has remained the same for decades, the means by which use takes place has undergone significant transformation, with advances in computer, connectivity and other technology. Software and capacity that were once located on the customer's premises are now more often hosted remotely. Business are increasingly make use of arrangements commonly referred to as Platform as a Service (PaaS), Infrastructure as a Service (IaaS), and Software as a Service (SaaS), where the customer pays for a shared platform, infrastructure or software. This evolution in the access to or delivery of "usage" does not put usage (or access to usage) in Chicago beyond the scope (and plain language) of the Lease Tax Ordinance.[25]

The Department also acknowledged in this Information Bulletin that its Personal Property Lease Transaction Tax Ruling # 12 had significantly pared back the scope of Exemption 11 to passive receipts of information by the customer:

> The Department recognizes that Ruling # 12 represents a change, in certain situations, from its prior interpretation of Exemption 11. In the past, the Department has generally interpreted the reference to "fleeting and transitory" information as exempting certain products that provide financial marketing data. Ruling # 12 clarified that such uses are exempt only if the receipt (and any usage) is simply the passive receipt of information. Thus, the Ruling stated: "As a general rule, this means that a subscription to an interactive web site will be subject to the lease tax, and will not be exempt, even if most or all of the information available on the web site is fleeting or transitory. This would include, for example, a web site that provides financial research, information and analytical tools."[26]

Because this new interpretation of Exemption 11 represented a change in the Department's administration policy, the Department announced it was applying this new interpretation prospectively to periods beginning on or after the extended effective date of January 1, 2016. However, the Department will apply most of its other pronouncements in Personal Property Lease Transaction Tax Ruling # 12, such as that online legal research and customer credit reports and other searchable databases and interactive websites are taxable to all open tax periods.

The Department has been actively auditing Chicago businesses to determine their compliance with the collection and payment of Lease Transaction Tax on cloud computing services. It is not surprising that these audits have raised difficult questions as to whether various database products and cloud-based services should be taxed.

The Chicago Amusement Tax and Streaming Services

The Chicago Department of Finance's decision in 2015 to extend the Chicago Amusement Tax to video and music streaming services and electronically delivered video games was even more audacious.

The Chicago Amusement Tax is imposed at a rate of nine percent on the admission fees or other charges paid by patrons "for the privilege to enter, to witness, to view or to participate in … every amusement within the City" of Chicago.[27] The term "amusement" is defined to mean:

(1) Any exhibition, performance, presentation or show for entertainment purposes, including but not limited to, any theatrical, dramatic, musical or spectacular performances, promotional show, animal act, circus, rodeo, athletic contest, sport, game or similar exhibition such as boxing, wrestling, skating, dancing, swimming, racing or riding on animals or vehicles, baseball, basketball, softball, football, tennis, golf, hockey, track and field games, bowling or billiard or pool games;
(2) Any entertainment or recreational activity offered for public participation or on a membership or other basis including, but not limited to, carnivals, amusement park rides and games, bowling, billiards and pool games, dancing, tennis, racquetball, swimming, weightlifting, body building or similar activities; or
(3) Any paid television programming whether transmitted by wire, cable, fiber optics, laser, microwave, radio, satellite or similar means.[28]

This third category of "paid television" is defined to mean programming that can be viewed on a television or other service and is transmitted by wire, cable, fiber optics, laser, microwave, radio, satellite or similar means to members of the public for consideration.[29]

Every owner, manager or operator of an amusement, or of a place where an amusement is being held, and every reseller of tickets or licenses to an amusement are required to collect the nine-percent Amusement Tax from the patron or buyer of the amusement and remit that tax to the Department.[30]

Traditionally, the Amusement Tax has applied to situations where a person visited a venue to watch or participate in an amusement, as described in the first two categories of amusements above. The Amusement Tax has been applied to in-home cable or satellite television services, but that portion of the statutory definition of "amusement" does not mention other types of media, such as movies or music, let alone the delivery of paid television services *via* the Internet to a computer, smart phone or other device.

In Amusement Tax Ruling # 5, the Department announced that, starting September 1, 2015, it will begin applying the Amusement Tax to charges a person pays to witness, view or participate in amusements *that are delivered electronically* to the person's home or place of business in Chicago.[31] Specifically, the Amusement Tax will be imposed on (1) charges paid for the privilege of watching electronically delivered television shows, movies or videos; (2) charges paid for the privilege of listening to electronically delivered music; and (3) charges paid for the privilege of participating in games, online or otherwise. In each of these instances, the video or music entertainment or games will have to be electronically delivered to the customer at a television, radio, computer, tablet, cell phone or other device belonging to the customer in the City of Chicago in order for the Amusement Tax to apply to the streaming services.[32]

The Department is requiring the provider of this electronically delivered entertainment to collect the Amusement Tax as an owner or operator of the amusement (as opposed to an owner or operator of a place of amusement).

The Department explained in Amusement Tax Ruling # 5 that the tax will *not* be imposed on *sales* of shows, movies, videos, music or games normally accomplished by a permanent download of that content because the customer has purchased the content instead of temporarily being granted the privilege to watch, listen or participate in the amusement to which the Amusement Tax would apply.[33] But other Chicago taxes like the ROT might apply to such downloads of electronically delivered amusements to Chicago customers.[34]

The Department's decision to extend the Amusement Tax to streaming services created a firestorm of protest from residents of Chicago. The legal analysis in Amusement Tax Ruling # 5 was skimpy, to be charitable, and the ruling presented a strained interpretation of the statutory definition of an "amusement." Treating video or music streaming services as an "exhibition, performance or presentation" of "entertainment or recreational activity offered for public participation" in the customer's own home or place of business was a questionable interpretation of the ordinance. And it was difficult to view the streaming of movies and videos, not to mention musical content, to computers, tablets, smart phones or radios as "paid television programming."

In September 2015, seven residents of Chicago filed a lawsuit in the Cook County Circuit Court challenging the Department's extension of the Amusement Tax to streaming services.[35] In January 2016, the City of Chicago filed a motion to dismiss the plaintiffs' amended complaint. In light of the Chicago City Council having amended the Amusement Tax Ordinance two months after the filing of this lawsuit to provide a sourcing provision for "amusements that are delivered electronically to mobile devices … in the case of video streaming, audio streaming and on-line games," the Circuit Court dismissed the first three counts in the amended complaint alleging that the Department had exceeded its authority by extending the Amusement Tax to streaming services.[36] However, the Circuit Court allowed the plaintiffs to litigate their other claims that the City of Chicago is imposing a discriminatory tax on electronically delivered video, music and gaming content in violation of the Internet Tax Freedom Act, the Uniformity Clause of the Illinois Constitution, and the Commerce Clause of the U.S. Constitution. Nearly two years after that order, the Circuit Court is considering a motion for summary judgment in the case.

Meanwhile, the City of Chicago continues to face significant fiscal challenges that these taxes on cloud computing services and streaming services have certainly not solved.

ENDNOTES

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1 *See* Illinois Home Rule Municipal Retailers' Occupation Tax Act, 65 ILCS 5/8-11-1. The Chicago Retailer's Occupation Tax is codified as Chicago Mun. Code §3-40-010 *et seq*.

2 Chicago Mun. Code §3-40-430.

3 Chicago Mun. Code §3-32-030(A).

4 Chicago Mun. Code §3-32-020(I) (first paragraph).

5 Chicago Mun. Code §3-32-030(C) and §3-32-050(A)(1).

6 Chicago Mun. Code §3-32-020(I) (second paragraph).

7 Chicago Mun. Code §3-32-020(I) (third paragraph).

8 *See, e.g.*, Chicago Department of Finance, Personal Property Lease Transaction Ruling # 3 (June 1, 2004, replacing Ruling # 7, eff. Nov. 15, 1974); Chicago Department of Finance, Personal Property Lease Transaction Ruling # 4 (June 1, 2004, replacing Ruling # 8, eff. Feb. 1, 1987); Chicago Department of Finance, Personal Property Lease Transaction Ruling # 5 (June 1, 2004, replacing Ruling # 9, eff. Feb. 1, 1987).

9 Chicago Department of Finance, Personal Property Lease Transaction Ruling # 9 (June 1, 2004, replacing Ruling # 13, eff. Sept. 28, 1992).

10 *Mietes v. Chicago*, 184 Ill. App. 3d 887, 540 N.E.2d 973 (1st Dist. 1989).

11 Chicago Mun. Code §3-32-050(11).

12 *Id.*

13 Chicago Mun. Code §3-32-030(B).

14 Chicago Mun. Code §3-32-030(A) and (C); §3-32-050(A)(1).

15 Chicago Mun. Code §3-32-070.

16 Chicago Dept. of Finance, Personal Property Lease Transaction Tax Ruling # 12 (July 1, 2015).

17 *Id.*, at ¶ 7.

18 *Id.*, at ¶ 8.

19 *Id.*, at ¶¶ 10 and 11.

20 *Id.*, at ¶¶ 12 and 13.

21 *Id.*, at ¶ 6(b) and (c).

22 *Id.*, at ¶ 19.

23 Chicago Mun. Code §3-32-030(B.1).

24 Chicago Mun. Code §3-32-050(13).

25 Chicago Department of Finance, Information Bulletin on Nonpossessory Computer Leases at 3 (Nov. 2015).

26 *Id.*

27 Chicago Mun. Code §4-156-020(A).

28 Chicago Mun. Code §4-156-010.

29 *Id.*

30 Chicago Mun. Code §4-156-030(A).

31 Chicago Department of Finance, Amusement Tax Ruling # 5 (June 9, 2015).

32 *Id.* ¶ 8.

33 *Id.* ¶ 10.

34 *Id.* ¶ 11.

35 *Labell v. City of Chicago,* No. 2015 CH 13399 (Cook Cty. Cir. Ct., filed Sept. 9, 2015).

36 *Labell v. City of Chicago,* No. 2015 CH 13399 (Cook Cty. Cir. Ct. July 21, 2016) (order granting part of defendant's motion to dismiss).