

Analysis of Legal Risks of SB 1327

As of August 1, 2024

This brief addresses the legal risks associated with Section 5 of SB 1327 and provides recommendations to mitigate these risks while preserving the legislative intent. The primary focus will be on potential challenges under the Commerce Clause and the Permanent Internet Tax Freedom Act (ITFA).

CONCERN	RISK	ANALYSIS
<p>INTERNET TAX FREEDOM ACT (ITFA)</p>	<p>The bill could violate the ITFA if it imposes a discriminatory tax on electronic commerce.</p>	<p>The ITFA prohibits states from taxing electronic goods or services unless the same tax applies to their physical counterparts. A digital advertising tax that does not apply to non-digital media could be considered discriminatory. The tax on the collection of consumer data by commercial collectors must not be discriminatory under ITFA.</p>
<p>COMMERCE CLAUSE</p>	<p>The bill may violate the Commerce Clause by imposing a tax that discriminates against or unduly burdens interstate commerce if courts find that the mechanism for determining when a user is in the State is not reasonable or accurate, or if courts find that, were a similar law to be passed in another state, it would lead to double taxation.</p>	<p>Under Complete Auto 's four-part test, a tax may be upheld against a Commerce Clause challenge so long as 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." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 278 (1977).</p>
<p>FIRST AMENDMENT</p>	<p>No potential First Amendment risk.</p>	<p>The bill does not include a prohibition on passing the tax on to the users and the First Amendment case against Maryland's law was dismissed.¹</p>

¹ Chamber of Commerce of United States v. Lierman, 2024 U.S. Dist. LEXIS 117223.

Recommended Mitigations to Reduce Risks

ADDRESSING ITFA CONCERNS

Clarify Tax Basis

Explicitly state that the tax is on the barter data exchange, not on digital advertising per se. This reinforces that the tax is not discriminatory and rather aims to tax currently untaxed consumption.

Remove Distinctions Between Digital and Physical Advertising

Ensure that the tax applies to all forms of advertising -including billboards, newspaper ads, radio ads, junk mail, or many other forms of tangible advertising - to avoid ITFA challenges.²

Remove Distinctions Between Digital and Non-digital Data Extraction Transactions

As long as the tax is not based on the distinction between the online/internet use nature of the business, it is less likely to be determined as “discriminatory”.³

ADDRESSING COMMERCE CLAUSE CONCERNS

Substantial Nexus

Continue to establish tax thresholds based on state-level revenues. This would ensure the tax applies to entities with a significant economic presence in the state.⁴ Tax thresholds based on state-level revenues are more likely to pass the substantial nexus test.

Fair Apportionment

The tax as currently written seems to meet the test for external consistency, but it will still depend on whether the court agrees that the mechanism for determining when a user is in the State is reasonable and accurate. For internal consistency, if courts were to find that other states adopting a similar bill would likely lead to double taxation then it could be nullified.⁵

REDUCING THE LIKELIHOOD OF LENGTHY LITIGATION

To control the jurisdiction and expedite the legal process, the state should consider including a clause in the bill that...

Provides for Direct Appeal

Allow direct appeals within a specified number of days: e.g. “Any appeal under this section must be filed within [specify number of days].”

Directs Appeals to be Sent Directly to the California Supreme Court

E.g. "To expedite the resolution of legal challenges, any party to a legal challenge under this statute shall have the right to a direct appeal to the California Supreme Court."

Provides for Expedited Review by California Supreme Court

E.g. "The California Supreme Court shall prioritize and expedite the hearing and determination of any appeal brought under this section."

Including these provisions can reduce the likelihood or protracted litigation, providing a quicker resolution.

Likelihood of Success Against Legal Challenges

ITFA CHALLENGES

Mitigations addressing the discriminatory nature of the tax significantly reduce the risk of ITFA challenges. Historical precedence supports the state's position if the tax is non-discriminatory.⁶

COMMERCE CLAUSE CHALLENGES

If the tax base remains gross receipts from data transactions in the state, then the likelihood of a successful commerce clause challenge is very low. Courts have upheld similar tax structures that meet the Complete Auto four-part test.

RESOLUTION TIMELINE

Legal challenges could take several months to years, depending on the court's schedule and the complexity of the case. Initial injunctions or stays could delay implementation.

² See *City of Chicago, Ill. v. StubHub!, Inc.*, the court held that a city's authority to tax the resale of tickets by an Internet auction house was not superseded by the ITFA, finding that the challenged tax was neither a multiple nor a discriminatory state tax on electronic commerce.

³ To comply with the ITFA mandate, the specific taxation on such entities has to be not solely based on the fact that such business is engaged in the internet use, and is instead because of other reasons. *ADP, LLC v. Arizona Dep't of Revenue*, 254 Ariz. 417, 426, 524 P.3d 278, 287 (Ct. App. 2023)

⁴ *South Dakota v. Wayfair, Inc.*, 585 U.S. 162.

⁵ Internal consistency: looks at whether its identical application by every State would place interstate commerce at a disadvantage as compared with intrastate commerce. *Id.*, at 185. State taxing schemes that impose multiple layers of taxes on out-of-staters are found to fail this test. See *Mississippi Dep't of Revenue v. AT & T Corp.*, 202 So. 3d 1207, 1221 (Miss. 2016). External consistency looks at the economic justification of the state tax to discover whether it reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State. *Id.* It seems that the tax threshold based on state-level revenues is likely to pass the fair apportionment test since it will be hard to argue that there is either internal or external inconsistency in this situation.

⁶ N.M. Code R. § 3.2.206.13

Analysis of Legal Risks of AB 886

As of August 1, 2024

This brief addresses the legal risks associated with AB 886 and provides recommendations to mitigate these risks while preserving legislative intent. The primary focus will be on potential challenges under the First Amendment, Supremacy Clause, and Commerce Clause.

CONCERN	RISK	ANALYSIS
<p>FIRST AMENDMENT</p>	<p>I. The bill requires online platforms to either pay a set amount or participate in arbitration to determine the payment amount. This could be seen as compelled speech, forcing platforms to financially support specific content.</p> <p>II. The provisions for how funds are to be distributed and the requirement for platforms to list the journalism providers they have accessed may raise concerns about content neutrality. The First Amendment prohibits the government from favoring or disfavoring particular viewpoints or types of speech.</p> <p>III. The prohibition against platforms retaliating against journalism providers for asserting their rights could conflict with the platforms' editorial discretion. Platforms may argue that their decisions about how to display and prioritize content are a form of protected speech.</p>	<p>Restricting platforms' ability to limit content distribution is presumptively unconstitutional and subject to strict scrutiny. This requires showing a compelling state interest, narrowly tailored measures, and the least restrictive means to achieve the interest. The role of content moderation by platforms is not fully settled, with both <i>Moody v. NetChoice</i> and <i>NetChoice v. Paxton</i> going back to the lower courts.</p>
<p>COMMERCE CLAUSE</p>	<p>The bill could be seen as imposing burdens on platforms operating across state lines.</p>	<p>The usage fee could be interpreted as a tax-like burden on interstate commerce, particularly considering that it remains unclear whether the platform would have to pay the fee for links shown to out-of-state users.</p>

CONCERN	RISK	ANALYSIS
<p>SUPREMACY CLAUSE</p>	<p>The bill may conflict with federal copyright law, potentially violating the Supremacy Clause.</p>	<p>The CJPA could violate the Supremacy Clause if read as requiring payment for the display of headlines, ledes, facts, and other elements non-copyrightable under federal law. The U.S. Copyright Act provides that facts, ideas, procedures, processes, systems, methods of operation, concepts, principles, or discoveries cannot be copyrighted. Therefore, any state law requiring payment for these elements could be preempted by federal law.</p>
<p>EQUAL PROTECTION AND DUE PROCESS</p>	<p>There is a low risk that the mandatory arbitration provision could be read as violating the procedural due process clause under the Fourteenth Amendment.</p>	<p>Case law indicates that mandatory arbitration provisions have been upheld in certain conditions.⁷</p>

Mitigations

FIRST AMENDMENT

- I. The restrictions on platforms' ability to limit content distribution will be presumed unconstitutional and subject to strict scrutiny. If the government is able to demonstrate a compelling state interest, and the bill is narrowly tailored to achieve that interest and the least restrictive means to do so, then the bill will survive a constitutional challenge. The state may argue that platforms are common carriers;⁸ and that by limiting content moderation the law combats censorship.⁹ The constitutional status of online platforms' content moderation is still not fully decided as the Supreme Court has vacated both *Moody v. NetChoice* and *NetChoice v. Paxton*.^x
- II. Add language to ensure that the distribution of funds is based solely on objective criteria unrelated to content type or viewpoint. E.g., "Funds distributed under this act shall be allocated based on objective criteria such as ..., without regard to the type or viewpoint of the content."

Mitigations continued

FIRST AMENDMENT

- III. While Section 3272.85 already clarifies that providers can and are exempt from liability for enforcing their terms of service, explicitly reinforcing the right to refuse to link to certain content can help strengthen the text against First Amendment Challenges: e.g. “Notwithstanding any other provision of this title, a covered platform retains the right to refuse to link to, display, or distribute content that violates its terms of service. This title shall not be construed to mandate the distribution of content that the platform deems to violate its policies.”

COMMERCE CLAUSE

Clarify the scope of the usage fee, further specifying what “a California audience” means to ensure that platforms do not have to pay the usage fee for content shown to out-of-state users.

SUPREMACY CLAUSE

Explicitly state that payment is for the access and comprehensive use of the digital journalism providers’ websites, not for individual non-copyrightable elements. This ensures compliance with federal copyright law and avoids any conflict over non-copyrightable elements: e.g. “The compensation required under this section is for the access and comprehensive use of digital journalism providers’ websites as a whole. This includes the aggregation, indexing, and display of their content to users within California. The payment required under this title is not for the display or use of non-copyrightable elements such as headlines, ledes, and facts, which are deemed freely accessible under the U.S. Copyright Act. The compensation structure under this title shall be designed to reflect the value derived from the overall access to and use of the digital journalism providers’ comprehensive content, rather than the use of any individual non-copyrightable elements.”

Likelihood of Success Against Legal Challenges

FIRST AMENDMENT CHALLENGES

The state has a moderate likelihood of success, though much depends on the ongoing development of jurisprudence in this space (e.g. updated treatment of Moody and Paxton). The narrow tailoring and compelling state interest will need to be clearly demonstrated. These challenges could take several months to years.

COMMERCE CLAUSE CHALLENGES

Clarifying the terminology to ensure that the text is in line with the Complete Auto test increases the likelihood of success in case of legal challenge. Nevertheless, a resolution could take months to years.

Likelihood of Success Against Legal Challenges continued

SUPREMACY CLAUSE CHALLENGES

Addressing copyright concerns can significantly reduce the risk, leading to a higher likelihood of success. If federal preemption issues are clearly addressed, legal challenges may be resolved relatively quickly.

REDUCING THE LIKELIHOOD OF LENGTHY LITIGATION

To control the jurisdiction and expedite the legal process, the state should consider including a clause in the bill that:

Allows direct appeals within a specified number of days: e.g. “Any appeal under this section must be filed within [specify number of days].”

Ensures that appeals are sent directly to the California Supreme Court: e.g. “To expedite the resolution of legal challenges, any party to a legal challenge under this statute shall have the right to a direct appeal to the California Supreme Court.

Provides for expedited review by California Supreme Court: e.g. “The California Supreme Court shall prioritize and expedite the hearing and determination of any appeal brought under this section.”

Including these provisions can reduce the likelihood of protracted litigation, providing a quicker resolution.

⁷ In *Bd. of Trustees of W. Conf. of Teamsters Pension Tr. Fund v. Thompson Bldg. Materials, Inc.*, 749 F.2d 1396 (9th Cir. 1984), an action was filed under the Multiemployer Pension Plan Amendments Act. The Court of Appeals in California held that: (1) Congress did not violate due process by imposing funding liabilities on employers who, after enactment of the MPPAA, withdrew from plans inadequately funded to meet their pension benefit obligations; (2) employers are not denied an impartial tribunal by giving the fund's trustees initial responsibility to determine the withdrawal liability; (3) employer was afforded all the process to which it was due; (4) the mandatory arbitration provisions are not unconstitutional; (5) the Act does not effect an uncompensated taking of the employer's property; and (6) Congress could rationally defer a decision on whether to adopt special liability rules for involuntary employer withdrawals caused by union action. This case may be analogous to the CJPA approach to some extent.

⁸ See John Villasenor, *Social media companies and common carrier status: a primer*, Brookings (Oct. 27, 2022), <https://www.brookings.edu/articles/social-media-companies-and-common-carrier-status-a-primer/>.

⁹ This was the original 5th circuit holding in *Netchoice, L.L.C. v. Paxton* - 49 F.4th 439 (5th Cir. 2022). Note that the U.S. Supreme Court has voided the judgement and sent the case back to the lower courts.

^x *Moody v. NetChoice, LLC*, 2024 U.S. LEXIS 2884.