

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