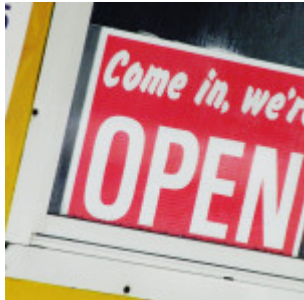

Coates' Canons Blog: Internet Sweepstakes, One Year Later

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Article: <https://canons.sog.unc.edu/internet-sweepstakes-one-year-later/>

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Just over a year ago the North Carolina Supreme Court upheld the constitutionality of G.S. 14-306.4, the law that was intended to ban all video and internet sweepstakes parlors. My colleagues and I blogged about the ruling here, here, and here, predicting that the court's decision would not eliminate the state's internet sweepstakes industry entirely. We thought there was enough wiggle room and ambiguity in the ban to allow creative sweepstakes operators to tweak their systems enough to (arguably) avoid the statute's reach.

Recent newspaper articles suggest that our predictions were on the money. While the majority of sweepstakes businesses shut down after the Supreme Court ruling, plenty still remain open across the state. State attorney general Roy Cooper likens the effort to ban sweepstakes to a game of "whack-a-mole": "They come up in different kinds of forms. They come up with a different kind of nuance."

My criminal law expert colleague Jeff Welty reports that late last month two sweepstakes operators from Tarboro may have been the first to be successfully prosecuted under G.S. 14-306.4. Previously, a number of operators charged under the statute were found innocent because their systems either revealed winning entries without the use of "entertaining displays" or because their games involved skill or dexterity rather than simple luck. Using these same arguments, sweepstakes operators have filed lawsuits in several counties seeking to prohibit enforcement of the ban on their businesses.

Legal issues involving internet sweepstakes were not limited to the criminal law ban. The taxation of these businesses made headlines last spring when the state's highest court struck down the privilege license taxes levied by Lumberton on sweepstakes businesses as unconstitutionally high. Two months later the state court of appeals relied on that ruling to find similar taxes levied by Fayetteville also to be unconstitutionally high. In the months that followed, some cities lowered their privilege license taxes on sweepstakes or eliminated them entirely. Others continued to tax the sweepstakes that remained open.

So where does all of this legislation and legal activity leave us? How should local governments deal with existing or new sweepstakes businesses?

Criminal law is not my forte, so I'll focus my advice on the privilege license tax issues involved with internet sweepstakes.

May cities that levy privilege license taxes on internet sweepstakes businesses continue taxing these businesses?

Yes. The court decisions that struck down the taxes levied on internet sweepstakes businesses by Lumberton and Fayetteville did not conclude that all local privilege license taxes on these businesses are unconstitutional. The courts were careful to point out that their findings of unconstitutionality concerned only the specific taxes levied by those two cities (\$5,000 per location/\$2,500 per machine in Lumberton and \$2,000 per location/\$2,500 per machine in Fayetteville). The courts' opinions confirmed that North Carolina cities have the authority to levy privilege license taxes on internet

sweepstakes and that the constitutionality of each city's taxes would need to be evaluated on a case-by-case basis.

How high may a city set its privilege license taxes on internet sweepstakes before they become unconstitutional?

Unclear. The courts have not provided a bright-line upper limit for these taxes. Obviously, taxes at levels near those struck down in Lumberton and Fayetteville are at the greatest risk being successfully challenged by taxpayers.

As I pointed out in my analysis of the Lumberton decision, I think a city that taxes its retail businesses on a gross receipts basis may have a strong argument to defend similarly high taxes on internet sweepstakes businesses. But I understand why cities that are taxing internet sweepstakes at levels similar those in Lumberton and Fayetteville might consider lowering those taxes going forward to lower the risk of a successful legal challenge. Cities that are already taxing these businesses at lower levels should feel confident to continue doing so.

If a city lowers or eliminates its privilege license taxes on internet sweepstakes businesses, should the city provide retroactive refunds to businesses who paid those taxes in prior years?

Absent actual litigation or the legitimate threat of litigation challenging a tax, retroactive refunds are likely illegal. As I explain in this blog post, such a refund could violate the constitutional requirement that public funds be used only for public purposes and not for the benefit of private individuals.

That said, local governments have reasonable discretion to settle litigation. A refund of prior years' taxes might be an acceptable response to an actual or threatened legal challenge to those taxes if the city reasonably concludes that such a challenge would likely be successful.

Should a city refund taxes to an internet sweepstakes business that closed mid-year due to the court decision upholding G.S. 14-306.4?

No, unless the city's privilege license tax ordinance calls for refunds to businesses that shut down mid-year. Otherwise, such refunds would present the same constitutional concerns as those discussed in the previous question.

Should cities be issuing privilege licenses to new internet sweepstakes businesses?

Yes, if the business pays the required tax. A privilege license is simply a receipt demonstrating payment of a privilege license tax. It is emphatically *not* the city's stamp of legal approval for a particular business.

From a tax perspective, it's important to remember that it's not the job of the privilege license tax collector to determine if a particular internet sweepstakes business is legal or is banned by GS 14-306.4. That's the job of the police or the sheriff or the district attorney.

It seems prudent for the privilege license tax collector to remind a new applicant of the ban on internet sweepstakes and that the city will not refund any portion of the tax if the applicant's business is later shut down by law enforcement (assuming, of course, that the city's tax ordinance does not authorize such refunds). But I do not think the privilege license tax collector has the authority to require the applicant to somehow prove that its business is legal before issuing a privilege license.

Nor do I think that a city may conclude that all internet sweepstakes are illegal and therefore refuse to issue any new privilege licenses for these businesses. As the many acquittals across the state under G.S. 14-306.4 prove, it's clearly possible for these businesses to utilize systems that escape the reach of the sweepstakes ban.



Links

- canons.sog.unc.edu/wp-content/uploads/2014/01/open_sign.jpg
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_14/GS_14-306.4.html
- canons.sog.unc.edu/?p=6971
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