Coates' Canons Blog: Internet Sweepstakes Tax Challenged in Federal Court

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Given the gaming industry's aggressive litigation strategy against criminal sanctions, it seemed only a matter of time before internet sweepstakes operators responded similarly to the growing number of municipal privilege license taxes imposed on their businesses. That time has arrived. In late April lawyers for the "Mt. Airy Business Center" filed a complaint in federal court alleging that the city of Kannapolis violated the U.S. and N.C. Constitutions as well as state law when it adopted zoning regulations and privilege license taxes aimed at internet sweepstakes operators.

When cities first began levying privilege license taxes on sweepstakes operators last fall, the response from the targeted businesses was reasonably favorable. Hendersonville initially set the standard in October with a flat-fee tax of $2,600, a figure adopted by several other cities. The sweepstakes operators seemed happy to pay these taxes if that meant they were more likely to avoid criminal prosecution. But as the taxes ratcheted up more and more sweepstakes operators began to raise objections. In April Lumberton adopted a tax that included a $5,000 flat fee plus a $2,500 per-machine fee. Elkin's recently adopted tax was even higher: a $5,000 flat fee plus a $3,000 per-machine fee. The tax challenged in Kannapolis is a flat-fee/gross-receipts hybrid: a $500 flat-fee-per-machine tax plus the same gross-receipts tax that applies to other retailers and service providers, $60 on the first $400,000 in revenue and $.60 on each additional $1,000 in revenue.

Are these taxes legal? I think so. Cities possess broad authority to levy privilege license taxes on businesses within their borders. N.C.G.S. §160A-211 authorizes such taxes on "all trades, occupations, professions, businesses, and franchises carried on within the city." This general authorization is limited by a number of caps and exemptions, none of which apply to internet sweepstakes operators. A municipal privilege license tax on these businesses should therefore survive a state law challenge unless it violates the somewhat squishy requirement in the N.C. Constitution that all taxes be "just and equitable," either because the tax is so high as to effectively eliminate a legal business or because the tax is selectively enforced. I very much doubt the taxes levied by Kannapolis and other cities violate this state constitutional mandate.

Strong support for broad privilege license authority is found in two N.C. Supreme Court decisions, *Deadwood, Inc. v. N.C. Dept. of Revenue*, 356 N.C. 407 (2002), and *Snyder v. Maxwell*, 217 N.C. 617 (1940). Both opinions upheld allegedly arbitrary privilege license tax distinctions, one between movies and live performances (*Deadwood*) and another between vending machines that sold soda and vending machines that sold other items (*Snyder*).

In *Deadwood,* the court reiterated its traditional deference to tax policy decisions made by elected officials: "In selecting subjects for taxation, narrow distinctions are sometimes invoked, and if founded on a rational basis and reasonably related to the object of the legislation, the courts will not say that a different result should have been reached or that the differentiation is arbitrary." When determining if a "rational basis" exists for a fine distinction in tax categories, a court may rely on "common knowledge of the subjects under consideration, and publicly known conditions, *economic or otherwise*, which pertain to the particular subject of the classification."

Assuming that internet sweepstakes operations are more profitable or place more of a burden on cities than other service providers or entertainment businesses, higher taxes on internet sweepstakes are justified under the holdings in *Deadwood* and *Snyder.* Both cases involved tax distinctions made by the General Assembly rather than by city councils, but courts generally show the same deference to policy decisions made by local elected bodies as they do to decisions made by the state legislature. See *Town of Atlantic Beach v. Young*, 307 N.C. 422 (1983) and *Raleigh Mobile Home Sales, Inc. v. Tomlinson*, 7 N.C. App. 289 (1970).

With these principles in mind, the state law claims aimed at the Kannapolis tax seem unlikely to succeed. First, the complaint states that Kannapolis' privilege license tax "is not connected to the health, safety or welfare of the City's citizens or to the peace and dignity of the City," but I see no requirement in statute or common law that a tax must meet

such standards. Second, the complaint argues that the tax illegally distinguishes between internet sweepstakes and similar sweepstakes (usually scratch-off card games) such as those run by McDonalds and BP gas stations. *Deadwood* implies that this argument is a loser. Third, the complaint alleges that the city has "no intention" of enforcing the tax against other internet sweepstakes operators. If true, this claim would render the tax unconstitutional, but absent unusual circumstances I think the plaintiff will have a tough time producing sufficient evidence of an intent by the city to enforce the tax selectively. Finally, the complaint suggests that the tax is too burdensome, an argument undercut by the fact that the bulk of the tax (the gross-receipts portion) is identical to that paid by other businesses in the city. I find it hard to imagine that the additional $500-per-machine tax is so high as to effectively eliminate internet sweepstakes businesses in the city.

The strongest argument raised against Kannapolis' tax arises under the federal Internet Tax Freedom Act, 47 U.S.C. §151 ("ITFA"), which prohibits state and local taxes on internet access. A gross receipts tax on revenue generated by sweepstakes operators that are (allegedly) selling internet time along with "free" sweepstakes entries could be prohibited by ITFA. But even this argument has its flaws when applied to Kannapolis' tax.

First, ITFA exempts from its prohibition taxes that were in place before 1998. If sweepstakes operators are being taxed on their gross receipts under a general service privilege license tax category that was in existence as of 1998, then I believe that tax would not violate federal law. I don't know exactly when Kannapolis first levied a privilege license tax on service providers, but almost certainly it occurred prior to 1998. Second, Kannapolis' new $500-per-machine flat tax is aimed not at the sale of internet access but at the use of computers to reveal sweepstakes entries. Kannapolis, like other cities that have created new tax categories aimed at sweepstakes operators, defined the tax category to focus on the sweepstakes activity and not the underlying sale of services. Because these flat-fee taxes are based on an activity other than the sale of internet access, I think they should pass must under ITFA.

The General Assembly is likely to moot the issue this summer by passing new criminal laws to prohibit sweepstakes entirely or by deciding that this revenue stream belongs to the state and not cities. If the legislature does not act, more legal challenges to local ordinances are likely. Either way, internet sweepstakes will remain in the headlines for months to come.

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