# *Illinois Supreme Court rules click-through nexus law pre-empted by Internet Tax Freedom Act*

*October 22, 2013*

## *In brief*

On October 18, 2013, in a 6-1 decision, the Illinois Supreme Court affirmed the circuit court's summary judgment finding that the state's click-through nexus law is pre-empted by the federal Internet Tax Freedom Act's prohibition against 'discriminatory taxes on electronic commerce.' The court did not reach the issue regarding whether the click-through nexus provision violated the US Commerce Clause. [*Performance Marketing Association, Inc. v. Hamer*, Ill. Sup. Ct., #114496 (10/18/13)]

## *In detail*

### *Background*

Effective July 1, 2011, Illinois amended the definition of a "retailer maintaining a place of business in this State" for sales tax purposes to include "a retailer having a contract with a person located in this State under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link on the person's Internet website" (the 'click-through' nexus law). Accordingly, such retailers are required to collect and remit Illinois use tax on sales made to Illinois customers. Click here for our summary of Illinois' click-through nexus law.

In an action initiated by the Performance Marketing Association, an Illinois trial court found that the click-through nexus law violated the US Commerce Clause and was pre-empted by the Internet Tax Freedom Act. Click here for our summary of the May 7, 2012, trial court opinion. The Department appealed directly to the Illinois Supreme Court.

### *Performance marketing activity*

The Illinois Supreme Court recognized that the contractual relationship taxed under the click-through nexus law is known as 'performance marketing.' Performance marketing occurs when a person publishing or displaying an advertisement is paid by a retailer when a specific action (e.g., a sale) is completed. Such arrangements are not limited to the Internet, they are also used in print and broadcast media.

### *Federal pre-emption and the Internet Tax Freedom Act*

The Illinois Supreme Court found that, pursuant to the US Supremacy Clause, state law is null and void if it conflicts with federal law. The federal Internet Tax Freedom Act, 47 U.S.C. sec. 151 note, prohibits a state from imposing 'discriminatory taxes on electronic commerce.' The Act defines a discriminatory tax, in part, as:

> "any tax imposed by a State or political subdivision thereof on electronic commerce that . . imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions

involving similar property, goods, services, or information accomplished through other means"

A 'tax' is further defined under the Act as including a retailer's obligation to collect and remit a tax. Additionally, 'electronic commerce' means "any transaction conducted over the Internet comprising the sale of property, goods, or services."

***Click-through nexus law discriminates against electronic commerce***

The discrimination resulting from the click-through nexus law results from the different treatment of the following out-of-state retailers:

- Out-of-state retailers contracting with Illinois Internet affiliates are required to collect use tax. These Internet affiliates provide advertising that is available and disseminated worldwide.
- Out-of-state retailers contracting with similar Illinois 'offline' affiliates are not required to collect use tax. An example of activity performed by an Illinois 'offline' affiliate would be publishing print media (e.g., catalogs, magazines, newspapers, etc.) or broadcasting television or radio messages that are directed at a national or international audience.

The Department argued that no discrimination existed because Illinois requires out-of-state retailers to collect and remit sales and use tax when they contract with Illinois publishers and broadcasters for advertising disseminated primarily *locally*. However, this was not enough to satisfy nondiscrimination concerns because Illinois does not require out-of-state retailers that contract for *nationally or internationally* disseminated 'offline' advertising to collect use tax.

Accordingly, by singling out retailers with Internet performance marketing arrangements for use tax collection, and not requiring use tax collection for similar 'offline' marketing, the court held that the click-through nexus law imposes a discriminatory tax on electronic commerce in violation of the federal Internet Tax Freedom Act and is therefore void and unenforceable.

***Providing Internet links is not 'active' solicitation***

The Department asserted that in-state affiliates providing Internet links pursuant to performance marketing contacts were engaged in "active efforts to solicit sales on behalf of out-of-state retailers," which would subject the out-of-state retailers to a use tax collection obligation. The court held that no interaction between an in-state affiliate and a customer occurred, and no 'active' solicitation occurred, for reasons including:

- the Internet affiliate did not receive or transmit orders, process customer payments, deliver purchased products, or provide presale or postsale customer services
- the Internet affiliate did not know the identity of Internet users who click on a link
- after a user connects with a retailer's website, the Internet affiliate had no further involvement with the user.

***Commerce Clause issues not reached***

Because the court voided the click-through nexus provisions based on pre-emption, the court did not reach the issue whether click-through nexus violates the Commerce Clause of the US Constitution.

## The takeaway

The Illinois Department of Revenue should be enjoined from collecting sales and use tax on out-of-state retailers that have nexus solely due to the click-through nexus law. Any such retailers that previously paid sales or use tax to the state should seek refund claims.

The court's opinion is significant as it is the first state appellate court decision to strike down a click-through nexus law on the basis of pre-emption under the Internet Tax Freedom Act. As noted in the dissent, state-wide challenges of click-through nexus laws have centered on Commerce Clause matters and no appellate level court has struck down such a law on the basis of a Commerce Clause violation. Following the *Performance Marketing* decision, future challenges may include an Internet Tax Freedom Act pre-emption argument, depending on the particulars of the respective state's law.

The court's dissent raises several issues that may arise on appeal or in subsequent litigation. What is the effect of a pre-empted statute? Is it invalidated or is it suspended and perhaps reinstated should the federal law cease to be in conflict – for example, if the Internet Tax Freedom Act sunsets under current law on November 1, 2014? Would click-through nexus withstand pre-emption scrutiny if the state expanded use tax collection obligations to retailers contracting with 'offline' global marketing businesses? Because the court failed to consider Commerce Clause challenges, and because of the potential to cure pre-emption defects, this may not be the last Illinois taxpayers see of click-through nexus.

Our understanding is that the Department is reviewing the decision and is considering several options, including further court review of the law and whether amending the law could address the court's concerns.

## *Let's talk*

If you have any questions regarding the *Performance Marketing Association* decision, please contact:

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