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Gail Cole • Nov. 09, 2021

Transitioning from cable to streaming services can increase choice and reduce costs for consumers, but the more people cut the cord, the less tax revenue local governments receive. That's the crux of ongoing David-versus-Goliath-style battles in Texas and several other states over whether Hulu and Netflix are liable for

Hulu and Netflix moved to dismiss the suit "for failure to state a claim upon which relief can be granted." They argue Texas Utilities Code § 66.005(a) doesn't apply to them because they don't hold a state-issued certificate of franchise authority.

The court found the companies' argument compelling and on September 30, 2021, Judge Robert Schroeder of the United States District Court for the Eastern District of Texas dismissed the case. He wrote, "before the Court can decide whether a party owes franchise fees, that party must hold a certificate of authority." The case can be refiled if Hulu and Netflix "become holders of state-issued certificates of franchise authority."

In his analysis, Schroeder wrote, "this is a case about franchise fees," not whether Texas Utilities Code § 66.005(a) applies to video service providers. He said the statute was clear: "The holder of a state-issued certificate of franchise authority shall pay each municipality in which it provides cable service or video service a franchise fee of five percent based upon the definition of gross revenues as set forth in this chapter" (emphasis theirs).

Neither defendant holds a state-issued certificate of franchise authority, and so neither can be liable for the franchise fee.

The judge is aware of the broader ramifications of this case. He wrote, "If the Court were to modify the concept of a holder of a state-issued certificate of franchise authority in § 66.005, it would impact not only that instance in the statute, but every instance that phrase appears, introducing possible inconsistencies and ambiguities."

It could also have a ripple effect throughout the country. Many localities in many states are interested in extending the franchise fees paid by cable companies to streaming service providers. To date, they're not having much luck.

Cases dismissed in Arkansas, California, and Nevada

California, determined the state's Digital Infrastructure and Video Competition Act of 2006 (DIVCA) did not give the City of Lancaster the right to extend a 5% tax on gross revenues to streaming service providers. Cable television providers pay the tax on their cable system, but the court decided it didn't apply to Netflix and Hulu because they reach customers over wires owned by an internet service provider (ISP).

According to the court, "Neither Netflix nor Hulu constructed or asked for the construction of the ISP networks delivering its service to subscribers. Netflix and Hulu do not control where the ISPs' network cables lines go or how its signal travels over the ISPs' network."

For now, at least, it seems Hulu, Netflix, and similar streaming service providers won't be required to pay franchise or similar fees to local governments to use public rights of way or utilities. Yet local governments are unlikely to stop trying to collect more tax revenue from companies that are disrupting a once-secure source of revenue from cable companies.

Toby Bargar, senior tax strategist at Avalara, thinks localities will get creative if streaming companies continue to prevail. "I suspect jurisdictions will not give up on taxing these services. At least a few will look at modifying or replacing their cable franchise fee ordinances altogether with something that has a more neutral public policy purpose able to withstand scrutiny." This playbook was proven years ago when Illinois successfully undertook a similar strategy after failed litigation against wireless phone providers over what it means to be in the public right of way.

Hat tip to Bloomberg Tax for making the court documents public.

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