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SHOP TALK

A Look at Maryland's Proposed Digital Advertising Tax

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In mid-March, the Maryland legislature passed House and Senate bills that would impose a tax on gross revenues from digital advertising services.[1] As of this writing, it is not clear if the governor will sign the bills into law, nor is it clear if the legislature would override a veto. Regardless of the ultimate outcome, the proposed digital advertising tax is worthy of study, both because of its novelty and because even if it is not enacted something similar may surface in the future in Maryland or elsewhere. This Shop Talk column will provide an overview of the proposed tax, highlight several of its potential constitutional defects, discusses potential sourcing challenges the tax could present, and also considers the tax's potential impact in other states.

Overview of the digital advertising tax

The House and Senate bills contain identical language. They impose "a tax...on annual gross revenues of a person derived from digital advertising services in the State."[2] The bills do not extend the Maryland sales tax to a new service—rather, this would be a new gross receipts tax imposed on one specific type of service.

The taxable service, "digital advertising services," is defined to "include advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services."[3] Notably, advertising provided on other mediums, such as print advertisements in newspapers, are not advertising services subject to the tax.

The tax only applies to large providers of digital advertising services. A person must have at least $1,000,000 in Maryland sourced digital advertising services revenue to be subject to the tax, and must also have at least $100,000,000 in global annual gross revenues.[4] "Global annual gross revenues" is not limited to revenues from advertising—it encompasses gross "revenue from all sources...before any expenses or taxes,"[5] so something like EBITDA.

Different rates apply depending on a person's global annual gross revenues. The rates range from 2.5% (for persons with $100M - $1B in gross revenue) to 10% (for persons with global revenues exceeding $15B).[6] The rates are applied to a person's gross receipts from digital advertising services sourced to Maryland.[7]

It should be clear that these tax rates are exceedingly high—most of the states that impose gross receipts taxes (Ohio, Oregon, Texas, and Washington for example) do so at rates less than 1%. The rates for the proposed Maryland digital advertising tax are multiples of the rates we are accustomed to seeing from states imposing a gross receipts tax. They are also higher than rates for state insurance premiums taxes for example.

Would the digital advertising tax be constitutional?

The legality of the digital advertising tax would unquestionably be tested. Constitutional challenges could come from a number of different angles. This section will consider challenges under the: (1) Supremacy Clause; (2) Foreign Commerce Clause; and (3) First Amendment. Other lines of attack, such as under the Dormant Commerce Clause and Due Process Clause, would also be expected, but are not addressed below.

Supremacy Clause: an ITFA problem. Under the Constitution's Supremacy Clause, federal laws are "the supreme law of the land" and inconsistent state laws must fall.[8] In other words, the states are bound to follow federal laws and cannot enact their own laws that impede or frustrate federal laws and objectives.

There is a federal law, the Internet Tax Freedom Act ("ITFA"), which prohibits discriminatory taxation of electronic commerce.[9] ITFA contains several definitions of "discriminatory tax," but they all boil down to prohibiting taxes that single out electronic commerce without imposing an analogous tax on comparable transactions made through means other than electronic commerce.[10]

It is immediately apparent that Maryland's proposed digital advertising tax singles out electronic transactions for taxation. The tax is imposed only on gross revenues from sales of digital ads and is not imposed on gross revenues from sales of non-digital ads, such as billboard or magazine advertising.

In response to this point, the Counsel to the Maryland General Assembly has argued that "a reviewing court...[could] find the relevant 'transaction' for purposes of the ITFA" is not the digital advertising services itself, but is rather "the sale of the advertising services from which the revenue subject to taxation is derived...the proposed tax applies to the revenue...regardless of whether the advertiser purchases those advertising services from the taxpayer over the internet or through some other means."[11]

While hard to understand, the argument seems to be that the tax does not treat electronic commerce differently, because a purchaser of digital ads could buy the digital ads using the internet or could purchase them over the telephone or in person. So, the argument is that there is no discrimination between alike transactions because digital ads are subject to tax regardless of how purchased. Thus, all transactions are treated the same.

But this cannot be right. It confuses the transactions subject to tax (revenue from digital advertising services) with the method of transmitting payment for those transactions. This argument is tantamount to saying that there could never be an ITFA problem so long as the transactions subject to tax could be paid for by credit card, cash, or cryptocurrency.

Plainly, the "transactions" for ITFA purposes are the digital advertisements the gross revenues from which are subject to the tax. The ITFA problem is that the digital advertising tax singles out digital transactions (i.e., advertisements provided digitally over the internet) for taxation while not imposing the tax on like transactions provided through non-digital means (e.g., advertisements provided through print media, or on billboards, or through other non-digital media).

There does not seem to be a strong defense to the ITFA argument. Anyone who thinks state courts are loath to strike a state tax down on Supremacy Clause or ITFA grounds should read or re-read the Illinois Supreme Court's opinion in *Performance Marketing Association v. Hamer.*[12]

Foreign Commerce Clause: preventing the U.S. from speaking with one voice. Although it has not received the same degree of attention as the Supremacy Clause/ITFA argument, there is also a strong Foreign Commerce Clause argument against the digital advertising tax. Under U.S. Supreme Court precedent, a state tax impacting foreign commerce must not "prevent the Federal Government from speaking with one voice when regulating commercial relations with foreign governments."[13]

The U.S.'s voice has been clear in opposing digital advertising taxes. For instance, France passed a 3% digital services tax in 2019 and several other European countries contemplated a similar tax. The U.S. response was swift and minatory—the U.S. threatened to impose massive tariffs on French goods, leading France to postpone implementation of the tax.

If Maryland enacts a tax similar to the French tax the U.S. vigorously opposed, it would seem to conflict with the U.S. voice on this issue. Also, by unwisely basing the tax rate on a person's *global* revenue, rather than the person's *U.S.* revenue, the Maryland digital advertising tax implicates foreign commerce as it considers revenues outside the U.S. in determining a person's tax rate, lending credence to the Foreign Commerce Clause argument.

A person challenging the constitutionality of the tax might want to solicit the Justice Department's support. The above arguments would be strengthened if the Justice Department would indeed confirm that the U.S. opposes taxes on digital advertising generally, and the opposition to the French tax was not an isolated case.

First Amendment: strong protections for commercial speech. The U.S. Supreme Court has recognized both that advertising is a form of "speech" and that commercial speech is subject to First Amendment protection. Anyone challenging the proposed digital advertising tax could argue that the proposed Maryland digital advertising tax singles out activity subject to First Amendment protection for taxation without imposing a parallel tax on non-speech activity.

This type of argument has been successful at the U.S. Supreme Court before. In particular, the Court struck down a Minnesota use tax on paper and ink products consumed in the production of a publication because the tax fell disproportionately on the press, implicating First Amendment concerns.[14] This language from the Court's opinion is especially striking in light of what Maryland has proposed: "Minnesota's ink and paper tax violates the First Amendment not only because it singles out the press, but also because it targets a small group of newspapers. The effect of the $100,000 exemption enacted in 1974 is that only a handful of publishers pay any tax at all, and even fewer pay any significant amount of tax."

Along the same lines, the proposed Maryland digital advertising tax singles out commercial speech (digital advertising) for the tax and likewise targets a small group of companies for the tax (only companies with at least $1M in Maryland sourced digital advertising and $100M in global annual revenues pay the tax). So, if not controlling logic, the *Minneapolis Star & Tribune* case at the very least lends support to a First Amendment attack on the proposed tax.

Difficult sourcing decisions for the Maryland Comptroller (and potentially taxpayers)

The bills state that the tax is triggered once a person has annual gross revenues "in the State of at least $1,000,000."[15] What does it mean for revenue from digital advertising services to be "in the State"? The bills leave it to the Maryland Comptroller to answer this question: "The Comptroller shall adopt regulations that determine the state from which revenues from digital advertising services are derived."[16]

This seemingly leaves the Maryland Comptroller with three choices, none of which would leave everybody happy. First, the Maryland Comptroller could use some rough and inexact sourcing proxy, such as Maryland's percentage of the global economy or percentage of the internet-using global population to source the services. It is not clear that the tax would have the desired revenue impact if this method were used.

Second, the Maryland Comptroller could attempt to more precisely source digital advertising services. But this would require a deep dive into different digital advertising services and payment models. It is hard to imagine a thorough, thoughtful sourcing regulation that considers all the sourcing complexities being completed by the effective date of the tax under the bills (December 31, 2020).

Third, the Maryland Comptroller could choose to source digital advertising services based on "where the benefit of the service is received" or a similar market-based sourcing approach, potentially defaulting to billing address. This approach would present the same challenges and complexities as state market-based sourcing statutes do generally when applied to services provided online (multiple points of use problems, question of whether the provider of the services should source based on where the benefit is provided to its customer or to its customer's customer, etc.).

Impact in other states

Draft bills in a handful of other states would tax digital advertising in some way. However, to the best of this author's knowledge, the draft bills in other states are not as far along in the legislative process as the

Maryland bills and do not create a new tax, but rather expand the already-existing state sales tax to also tax digital advertising services.

As a rule, the states do not like to go out on a limb. Safety in numbers is preferred. This author's best guess is that other states would not immediately pass a similar tax if the Maryland tax is enacted, but would rather wait to see how the tax is received and how it fares in the courts before taking action. Of course, states facing budgetary difficulties would be more likely to throw caution to the wind, something to keep in mind if federal legislation providing relief to the states is not passed in this challenging year.

Conclusion

Maryland has proposed a new and unique digital adverting services tax. There is at present no similar tax in any other state. Despite considerable opposition from the business community, the tax has sailed through the legislature and, as of this writing, is on the governor's desk for signature. It is not currently known what Maryland's governor will do. Even if the tax is not ultimately signed into law, it is worthy of study as it may surface again in Maryland or elsewhere.

[1] Maryland House Bill 732 (2020); Maryland Senate Bill 2 (2020).

[2] 7.5-102 (references are to the proposed sections of a new Title 7.5 that would be added to Md. Code Ann. Tax-Gen.)

[3] 7.5-101(D).

[4] 7.5-201; 7.5-201(A), (B).

[5] 7.5-101(B).

[6] 7.5-103(1)-(4).

[7] 7.5-101(C), defining "assessable base" as the "annual gross revenues derived from digital advertising services in the State."

[8] U.S. Const. art. VI, cl. 2.

[9] *See* 47 U.S.C. section 15147 U.S.C. section 151.

[10] *Id.* at section 1105(2).

[11] Letter from Sandra Benson Brantley, Counsel to the General Assembly, to Senator Andrew Serafini, February 7, 2020, page 4.

[12] *Performance Mktg. Ass'n v. Hamer*, 998 N.E.2d 54 (Ill. 2013).

[13] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979).

[14] *Minneapolis Star & Tribune Co v. Minnesota Commissioner of Rev.*, 460 U.S. 575 (1983).

[15] 7.5-201(A).

[16] 7.5-102(B)(2).