SB 2

Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

Senate Bill 2 (Senators Miller and Ferguson)
Budget and Taxation

Taxation – Tobacco Tax, Sales and Use Tax, and Digital Advertising Gross Revenues Tax

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This bill imposes a tax on the gross revenues of specified digital advertising. The bill also (1) increases the taxes imposed on cigarettes, electronic smoking devices (ESD), and other tobacco products (OTP) and (2) requires the Governor to include at least $18.25 million in annual funding for the Tobacco Use Prevention and Cessation Program beginning in fiscal 2022. **The bill takes effect July 1, 2020, except for the tax on digital advertising which takes effect July 1, 2021, and applies to taxable years beginning after December 31, 2020.**

Fiscal Summary

State Effect: General fund revenues increase by approximately $100.5 million in FY 2021 and by approximately $80.9 million in FY 2025 due to additional cigarette, OTP, and net sales and use tax revenue. Special fund revenues may increase by a significant amount beginning in FY 2022 due to the tax on digital advertising. Special fund expenditures increase by $2.0 million in FY 2022 and by $731,300 in FY 2025. Future year expenditures reflect annualization and inflation. General fund expenditures increase by $8.3 million beginning in FY 2022. **This bill increases a mandated appropriation beginning in FY 2022**.

Local Effect: Local health departments in all counties may receive additional funding beginning in FY 2022 due to the increased funding for the Tobacco Use Prevention and Cessation Program. The bill may prevent local government revenue increases in Baltimore City, Baltimore County, and Montgomery County.

Small Business Effect: Meaningful.

Analysis

Bill Summary:

Digital Advertising Gross Revenues Tax

The bill imposes a tax on the annual gross revenues of a person derived from digital advertising services in the State. The bill provides for the filing of the tax returns and making tax payments.

The part of the annual gross revenues of a person derived from digital advertising services in the State are to be determined using an apportionment fraction based on the annual gross revenues of a person derived from digital advertising services in the State and the annual gross revenues of a person derived from digital advertising services in the United States. The Comptroller must adopt regulations that determine the state from which revenues from digital advertising services are derived.

The digital advertising gross revenues tax is imposed at the following rates:

- 2.5% of the assessable base for a person with global annual gross revenues of $100.0 million through $1.0 billion;
- 5% of the assessable base for a person with global annual gross revenues of $1.0 billion through $5.0 billion;
- 7.5% of the assessable base for a person with global annual gross revenues of $5.0 billion through $15.0 billion; and
- 10% of the assessable base for a person with global annual gross revenues exceeding $15.0 billion.

Revenues from the digital advertising gross revenues tax are distributed to the Blueprint for Maryland's Future Fund (BMFF), after the Comptroller's costs to administer the tax are deducted.

Tax Returns

Each person that has annual gross revenues derived from digital advertising services in the State of at least $1.0 million in a calendar year must complete, under oath, and file a return with the Comptroller on or before April 15 the next year.

Each person that reasonably expects annual gross revenues derived from digital advertising services in the State to exceed $1.0 million must complete, under oath, and file with the Comptroller a declaration of estimated tax, on or before April 15 of that year.

A person required to file a declaration of estimated tax for a taxable year must complete and file a quarterly estimated tax return on or before June 15, September 15, and December 15 of that year.

A person required to file a return must include an attachment with the return that states any information that the Comptroller requires to determine annual gross revenues derived from digital advertising services in the State. A person must maintain records of digital advertising services provided in the State and the basis for the calculation of the digital advertising gross revenues tax owed.

Payment of Digital Advertising Gross Revenues Tax

Each person required to file a return must pay the digital advertising gross revenues tax with the return that covers the period for which the tax is due. A person filing an estimated digital advertising gross revenues tax return must pay (1) at least 25% of the estimated digital advertising gross revenues tax shown on the declaration or amended declaration for a taxable year with the declaration or amended declaration that covers the year and with each quarterly return for that year and (2) any unpaid digital advertising gross revenues tax for the year shown on the person's return.

Penalties

A person who willfully fails to file a digital advertising gross revenues tax return is guilty of a misdemeanor and, on conviction, is subject to a fine of up to $5,000 and/or imprisonment of up to five years.

Definitions

Annual gross revenues are defined as income or revenue from all sources, before any expenses or taxes, computed according to generally accepted accounting principles.

Assessable base is defined as the annual gross revenues derived from digital advertising services in the State.

Digital advertising services includes advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services.

Digital interface is defined as any type of software, including a website, part of a website, or application, that a user is able to access. A user is an individual or any other person who accesses a digital interface with a device.

Tobacco Taxes

The bill increases the tobacco tax rate from $2.00 to $3.75 per pack of 20 cigarettes; increases from 10 cents to 17.5 cents the tax rate for each cigarette in a package of more than 20 cigarettes; and increases the OTP tax rate for all products other than cigars from 30% to 53% of the wholesale price. The tax rate remains at 15% for premium cigars and 70% for all other cigars.

The bill increases the sales and use tax imposed on electronic smoking devices (ESD). These devices are commonly known as e-cigarettes or vaping products. An ESD does not include a battery or battery charger when sold separately.

The state sales and use tax imposed on ESD is increased to 12%; except the tax rate is increased to 60% for vaping liquids sold in containers of 5 milliliters or less.

The bill also imposes a one-time floor tax on cigarettes and OTP in fiscal 2021.

The bill states that it is the intent of the General Assembly that the Comptroller distribute, as necessary, fiscal 2021 tobacco taxes, including the sales tax imposed on ESD, to the Revenue Stabilization Account (Rainy Day Fund) and to the expenditure accounts of the appropriate units of State government to fund costs associated with the Coronavirus Disease 2019 (COVID-19).

A local government may impose a tax on ESD only if the tax was established as of January 1, 2020, and at a rate that was in effect at this time.

OTP means a product that is intended for human consumption or likely to be consumed, whether smoked, heated, chewed, absorbed, dissolved, inhaled, or ingested in any manner that is made of, derived from, or contains tobacco or nicotine. OTP includes cigars, premium cigars, pipe tobacco, chewing tobacco, snuff, snus, filters, rolling papers, pipes, and hookahs. OTP excludes cigarettes, ESDs, or a drug, device, or combination product authorized for sale by the United States Food and Drug Administration (FDA) under the federal Food, Drug, and Cosmetic Act.

Beginning in fiscal 2022, the Governor must include at least $18.25 million in annual funding for the Tobacco Use Prevention and Cessation Program.

Current Law:

Tobacco Product Taxes

Cigarettes are taxed at a rate of $2.00 per pack. Generally, the tax rate for OTP is 30% of the wholesale price, which is the price for which a wholesaler buys OTP, exclusive of any discount, trade allowance, rebate, or other reduction. The tax rate for cigars is 70% of the wholesale price of the cigars. The tax rate for premium cigars is 15% of the wholesale price of the premium cigars. OTP is defined as any cigar or roll for smoking, other than a cigarette, made in whole or in part of tobacco or any other tobacco or product made primarily from tobacco, other than a cigarette, that is intended by smoking or chewing or as a snuff.

Cigarette and OTP tax revenues accrue to the general fund. In fiscal 2021, cigarette tax revenues are projected to total $299.0 million, and OTP tax revenues are projected to total $42.6 million. In addition, the State sales tax rate of 6% is imposed on the final retail price of cigarettes and OTP.

Recent State and federal legislation generally raises the minimum age, from 18 to 21, for an individual to purchase or be sold tobacco products.

Electronic Smoking Devices

ESD and their components are subject to the State sales and use tax but are not subject to a State excise tax. Montgomery County imposes a 30% tax on the wholesale value of vaping products. Montgomery County estimates that the tax generated $1.3 million in fiscal 2019 and projects that revenues will total $1.9 million in fiscal 2020.

Chapter 396 of 2019 renamed "electronic nicotine delivery system" to be "electronic smoking device" and defined "electronic smoking device" as a device that can be used to deliver aerosolized or vaporized nicotine to an individual inhaling from the device. ESD includes (1) an electronic cigarette, an electronic cigar, an electronic cigarillo, an electronic pipe, an electronic hookah, a vape pen and vaping liquid and (2) any component, part, or accessory of such a device regardless of whether or not it is sold separately, including any substance intended to be aerosolized or vaporized during use of the device. ESD excludes a drug, device, or combination product authorized for sale by FDA under the Food, Drug, and Cosmetic Act.

Local Government Taxing Authority and Tobacco Products

Local governments may only impose taxes if the State confers this power on them. Local governments may not impose a tax on OTP or cigarettes. Subject to specified exceptions, local governments may not impose a retail sales or use tax on products for sale. While still subject to these restrictions, Baltimore City, Baltimore County, and Montgomery County generally have greater authority to impose local taxes.

Tobacco Use Prevention and Cessation Program

The Tobacco Use Prevention and Cessation Program aims to reduce the use of tobacco products and to reduce the burden of tobacco-related morbidity and mortality in the State. The Governor's proposed fiscal 2021 budget includes $10.0 million in funding for the program.

Background:

Digital Advertising

Generally, a digital advertising gross revenues tax proposes to tax the gross online advertising revenues of large multinational corporations, such as Alphabet/Google, Amazon, Facebook, and others that have a large presence in digital advertising. Several European countries have proposed or implemented laws to tax digital services including advertising. Great Britain, Italy, Spain, and Turkey are among the countries that have proposed a tax, while only France and Hungary have implemented such a tax. The European Union considered a proposal to impose a tax on digital advertising, but a final agreement was not reached.

Maryland is the first state in the country to introduce legislation imposing a tax on digital advertising. Legislation in Nebraska has been introduced (LB 989) expanding the state's sales tax to include digital advertising.

Proponents of a digital advertising or digital services tax argue that many digital companies are undertaxed or are not paying their fair share of taxes. It is argued that some digital companies are able to reduce taxable assets through a number of mechanisms, such as assigning ownership of income producing sources to affiliates in low tax jurisdictions. As such, a digital advertising tax could be considered a type of tax on corporate profits in the digital economy.

Opponents of this type of tax cite potential conflicts with existing law. The federal Internet Tax Freedom Act includes a prohibition on state and local governments from taxing Internet access and from imposing multiple and discriminatory taxes on electronic commerce. In addition, as the tax will be assessed on global revenues, it may lead to large multinational businesses having a higher tax burden in Maryland than Maryland-only providers. This could lead to challenges that the tax violates the Commerce Clause of the U.S. Constitution, which prohibits state laws that interfere with interstate commerce.

It should also be noted that past efforts to impose taxes on the news media or advertising revenues have been rejected by the U.S. Supreme Court on First Amendment grounds. In addition, the Maryland Court of Appeals ruled in 1958 that a 4% sales tax on television, newspaper, and radio advertising that was proposed by Baltimore City was an unconstitutional violation of the First Amendment.

Tobacco Taxes

For more information on tobacco taxes, see the background section of the fiscal note for *SB 3* of 2020.

The Blueprint for Maryland's Future

BMFF is a special nonlapsing fund that may be used only to assist in providing adequate funding for early childhood education and primary and secondary education based on the recommendations of the Commission on Innovation and Excellence in Education, including revised education funding formulas. Chapter 771 of 2019 established in statute the policy framework for a world-class education system in Maryland based on the commission's recommendations. When fully phased-in, the commission's recommendations are expected to require an additional $2.8 billion in State funding and $1.2 billion in local funding by fiscal 2030.

State Revenues:

Digital Advertising Revenues

The bill requires businesses that have at least $100.0 million in global annual gross revenues to pay a tax on gross revenues derived from digital advertising in the State. After a deduction for administrative costs for the Comptroller's Office, revenue from the tax is distributed to the BMFF. As a result, State special fund revenue may increase by a significant amount beginning in fiscal 2022.

Under one set of assumptions, special fund revenues could increase by as much as $250.0 million in the first full year that the tax is imposed and collected. The assumptions used in the estimate are outlined below:

- Maryland represents 1.84% of the total U.S. population;
- digital advertising revenues in the United States totaled $107.5 billion in 2018 and $57.9 billion in the first half of 2019, according to the Interactive Advertising Bureau;

- approximately 90% of large companies that receive digital advertising revenues have global revenues over $15.0 billion and almost 8.0% have global revenues of between $100.0 million and $5.0 billion (according to industry source eMarketer); and

- digital advertising revenues increased by 21.8% from 2017 to 2018 and by 16.7% in the first half of 2019 compared to the first half of 2018.

However, there are two factors that may significantly impact the amount of tax revenue the State collects, particularly in the short term: (1) litigation and (2) compliance issues.

Potential Litigation

As previously mentioned, the imposition of the tax could face legal challenges on several fronts. While it is not possible to determine when potential legal challenges may arise, and how long they would take to resolve, this could limit the amount of any revenues collected from the tax while litigation is pending.

Potential Compliance Issues

The bill requires the Comptroller to adopt regulations that determine the state from which revenues from digital advertising are derived. In order to determine the amount of gross advertising revenues in Maryland, companies will have to track user IP addresses to determine whether a user is in Maryland when they are viewing an advertisement. This could pose problems when a user is near or crossing the State border while receiving an advertisement on a mobile device, or using a virtual private network to alter their location. This could make tax compliance more difficult.

Also, the Comptroller's Office advises that it may not be able to assess or enforce the tax owed by a foreign company that meets the gross revenue threshold and who has Maryland users but does not pay any taxes in the United States.

Tobacco Taxes

The bill (1) increases the taxes imposed on cigarettes, ESD, and OTP and (2) requires the Governor to include at least $18.25 million in annual funding for the Tobacco Use Prevention and Cessation Program beginning in fiscal 2022. **Exhibit 1** shows the fiscal impact of the provisions.

Exhibit 1
Fiscal Impact of Tobacco Product Provisions
Fiscal 2021-2025
($ in Millions)

	FY 2021	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**
General Fund Revenues					
Cigarette tax	$87.3	$79.7	$75.6	$71.7	$67.9
OTP Tax	7.3	7.2	7.4	7.6	7.9
Net Sales and Use Tax	5.9	5.7	5.5	5.3	5.2
Total Revenues	**$100.5**	**$92.6**	**$88.5**	**$84.6**	**$80.9**
General Fund Expenditures					
Tobacco cessation	$0	$8.3	$8.3	$8.3	$8.3
Total Expenditures	**$0.0**	**$8.3**	**$8.3**	**$8.3**	**$8.3**
Net Impact	**$100.5**	**$84.4**	**$80.3**	**$76.4**	**$72.7**

[1] Includes impact of one-time floor tax in fiscal 2021.

Tobacco Tax Revenues

The estimated increases in OTP and tobacco tax revenues are based on past cigarette tax increases in Maryland and an examination of the additional OTP revenues generated through recent tax increases in other states, adjusted for Maryland. The estimated revenue increase resulting from imposing an ESD tax is based on similar taxes collected in other states and in Montgomery County, adjusted for Maryland. The Department of Legislative Services (DLS) advises that there is considerable uncertainty about the impact the recent FDA restrictions on the sale of certain flavored vaping products will have on consumption and therefore the taxes imposed.

DLS further advises that due to the emerging threat to public health and the economy posed by the COVID-19 pandemic and national emergency, revenue increases will likely be less than estimated.

Tobacco Use Prevention and Cessation Program

The Maryland Department of Health (MDH) advises that the increased funding in fiscal 2022 will be expended on contracts for statewide tobacco prevention, health communication activities, and evaluation activities. In addition, MDH may hire additional staff and provide funding to local health departments for tobacco prevention and control activities.

State Expenditures: The bill requires the Comptroller to distribute funds necessary to administer the digital advertising gross revenues tax to an administrative cost account. As a result, special fund expenditures increase by $2.0 million in fiscal 2022. Future year expenditures increase by $683,212 in fiscal 2023 and by $731,335 in fiscal 2025.

The Comptroller's Office advises that it is currently in the process of implementing a new tax system named Compass. However, due to the bill's effective date, the computer mechanisms needed to administer the new tax proposed by the bill, such as creating forms and processing returns and payments, will have to be done on the current Legacy tax system as well as the new Compass system. In addition, the Comptroller's Office will need additional personnel to administer the tax, which includes identifying businesses subject to the tax, processing returns and payments, auditing returns and payments, enforcing compliance, and handling expected litigation.

This estimate reflects the cost of hiring one assistant Attorney General, two administrative officers, two tax consultants, three revenue specialists, and one financial compliance auditor to administer the new tax. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses and computer programming and modification charges.

Position(s)	9
Salaries and Fringe Benefits	$661,825
Computer Programming and Modification	1,250,000
Operating Expenses	49,725
Total FY 2022 State Expenditures	**$1,961,550**

Revenue Transfers

The bill states that it is the intent of the General Assembly that the Comptroller distribute, as necessary, fiscal 2021 tobacco taxes, including the sales tax imposed on ESD, to the Rainy Day Fund and to the expenditure accounts of the appropriate units of State government to fund costs associated with COVID-19. Accordingly, transfers and expenditures to these funds may increase in fiscal 2021, resulting in a corresponding decrease in general fund revenue increases shown in Exhibit 1.

Local Fiscal Effect: Local health departments in all counties may receive additional funding beginning in fiscal 2022 due to the increased funding for the Tobacco Use Prevention and Cessation Program. Under the bill, a local government may impose a tax on ESD only if the tax was established as of January 1, 2020, and at a rate that was in effect at that time. Only Montgomery County has imposed a tax on ESD as of this date. Accordingly, the bill eliminates the authority under current law for Montgomery County to increase its tax and for Baltimore City and Baltimore County to establish a tax.

Small Business Impact: Small OTP, cigarette, and ESD businesses or small businesses that sell these products will be negatively impacted by the proposed tax changes. The actual impact depends on the extent to which the tax increases decrease sales of these products and the extent to which the tax increases are passed on to customers.

Additional Information

Prior Introductions: None.

Designated Cross File: HB 695 (Delegate Washington) - Ways and Means.

Information Source(s): Comptroller's Office; Congressional Research Service; Interactive Advertising Bureau; eMarketer; Department of Legislative Services

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Analysis by: Michael Sanelli and Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510