Proposed New Tax on Digital Advertising Services: Constitutional and Legal Concerns

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Senate Bill 2

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Dear Chair Guzzone and Members of the Committee:

My name is Joseph Bishop-Henchman, and I an attorney with the state and local tax practice at McDermott Will & Emery. I have worked for 14 years in state tax policy and state tax law, with special emphasis on proposals to impose new or expanded transactions taxes at the state level.

I am grateful for the opportunity to testify today at the invitation of the Maryland Chamber of Commerce on S.B. 2, the proposed new tax on digital advertising services. My testimony will focus on constitutional and federal law concerns with this uncharted new tax.

About S.B. 2

S.B. 2, if enacted, would make Maryland the first state or locality in the United States to impose a targeted tax on the gross revenue of digital advertising services. While no state taxes advertising revenue in the manner and extent proposed by S.B. 2 (primarily due to the constitutional and policy concerns outlined below), only two states tax advertising services under their generally applicable broad-based transaction tax (not a gross receipts tax such as the tax proposed by S.B. 2). Contradicting the clear legislative trend in the advertising space to exempt the facilitation of advertising services (but tax the consumer transactions that may result therefrom), S.B. 2 would impose a new one-of-a-kind tax on the annual gross revenue of digital advertising services that are deemed to be provided in the State. The proposed tax contains a tiered tax rate structure (based on the advertising service provider's global annual gross revenues) that would allow for up to a tax of 10% of the annual gross revenue in the State derived from digital advertising services. A filing obligation would apply for in-state advertising gross revenue of $1 million or more in a year. As introduced, S.B. 2 would take effect July 1, 2020 and apply to all taxable years beginning after December 31, 2020.

S.B. 2 Violates the Permanent Internet Tax Freedom Act (PITFA)

The Permanent Internet Tax Freedom Act ("PITFA") enacted by Congress prohibits states from imposing "discriminatory taxes on electronic commerce." *See* 47 U.S.C. § 151, note. The federal law defines "discriminatory tax" as "any tax imposed by a State . . . on electronic commerce that (i) is not generally imposed and legally collectible by such State . . . on transactions involving similar property, goods, services, or information accomplished through other means; (ii) is not generally imposed and legally collectible at the same rate by such State . . . on transactions involving similar property, goods, services, or information accomplished through other means . . . [or] (iii) 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." Id. at § 1105(2)(A).

The digital advertising tax proposed by S.B. 2 would result in a prohibited discriminatory tax on electronic commerce in violation of PITFA. For example, the new digital advertising services tax created by S.B. 2 would discriminate against digital advertising service providers because Maryland does not also tax service providers of non-digital advertising. Even if similar advertising services are alleged to be subject to the Maryland sales tax, differences in rate or incidence of the tax would independently still result in a "discriminatory tax" in violation of federal law.

PITFA has been invoked to strike down state tax laws that discriminate against digital goods and services:

- In *Alltel v. Montana Department of Revenue*, 2012 WL 1031502 (Mont. Dist. Feb. 22, 2012), a federal court struck down Montana's scheme imposing retail telecommunications excise tax on the sale of Internet access and digital products: "A tax imposed by the State on digital products sold over the Internet, but not imposed on other retailers selling similar products, violates the terms and intent of the ITFA."
- In *Performance Marketing Association, Inc. v. Hamer*, 998 N.E. 2d 54 (Ill. 2013), the Illinois Supreme Court invalidated a state law requiring tax collection by businesses entering contracts for online performance marketing, with no equivalent obligation on businesses entering contracts for offline performance marketing: "However, national, or international, performance marketing by an out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, will *not* trigger an Illinois use tax collection obligation. The relevant provisions of the Act therefore impose a discriminatory tax on electronic commerce within the meaning of the ITFA."

PITFA produces little case law because the statute is direct and clear, and few states seek to enact tax laws directly contrary to it, as the one Maryland is considering. A court analyzing the Maryland statute would ask if the law imposes a tax on electronic commerce transactions that is not generally imposed on similar transactions not involving electronic commerce. A law that does so violates the Act.

Because PITFA is a federal law, it must be respected by Maryland under the Supremacy Clause of the U.S. Constitution and if Maryland were to move forward with S.B. 2 it would likely be struck down by the courts—after costly and unnecessary litigation.

S.B. 2 Unconstitutionally Discriminates Against Interstate and Foreign Commerce

S.B. 2 would impose a punitive digital advertising gross revenues tax only on large companies based on an arbitrary threshold of global annual gross revenues. The larger and more global the company, the higher the tax rate.

While this may be politically popular, taxing out-of-state and foreign companies more heavily than in-state businesses is constitutionally suspect under the dormant Commerce Clause. A long history of federal cases have struck down efforts by states and local governments to use extraterritorial receipts to discriminate against interstate businesses and in favor of hometown businesses. See *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents); *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 342 (2015) (invalidating Maryland's denial of a full income tax credit for out-of-state investment, where a full credit was provided for in-state investment).

This is exactly what the digital advertising gross revenues tax proposed would do – by taxing larger global advertising service providers at a higher tax rate than their domestic counterparts with the exact same gross revenue attributable to Maryland. The Commerce Clause of the U.S. Constitution protects companies from taxes such as the SB 2 digital advertising gross revenues tax and is yet another example of the ripeness of litigation should the tax proposal advance.

S.B. 2 May Violate the Equal Protection Clause and the First Amendment

The digital advertising gross revenues tax may violate the Equal Protection Clause of the U.S. Constitution due to a lack of a rational basis for discriminating against advertising services provided on a digital interface—since the law does not impose the same punitive treatment on advertising services that are not on a digital interface.

The proposed digital advertising service gross revenue tax also raises significant First Amendment concerns due to the fact that the tax would in effect regulate commercial speech by forcing just digital advertising service providers in Maryland to either cease allowing Maryland customers to view ads or substantially increase fees they charge companies advertising on their platform against their will (to account for the loss they would otherwise obtain from the punitive digital advertising services tax). For example, the Maryland Court of Appeals has held that municipal taxes on advertising media were

unconstitutional for singling out for taxation newspapers and radio and television stations entitled to first amendment immunities. See *City of Baltimore v. A.S. Abell Co.*, 218 Md. 273, 145 A.2d 111 (1958). The same constitutional concerns that the court found in that case apply here, just in the context of digital advertising.

Conclusion

Because of the constitutional and policy deficiencies of S.B. 2, the enactment of this law would not create a stable revenue stream to bolster Maryland education funding and would potentially result in a net loss to the state coffers, as happened after the *Wynne* case obligated the state to refund collected revenues after the tax was declared unconstitutional by the U.S. Supreme Court.

Again, thank you for the opportunity to testify before you today. Should you have any questions, I may be reached at 202-756-8536 or jhenchman@mwe.com.