Maryland's Digital Advertising Tax Debacle

Posted on Jul. 24, 2023

By Nikki E. Dobay and DeAndré R. Morrow

Nikki E. Dobay is a shareholder at Greenberg Traurig LLP in Sacramento, California, and DeAndré R. Morrow is of counsel in the firm's Washington office.

In this installment of SALT Policy Pickles, Dobay and Morrow examine Maryland's ongoing digital advertising tax saga and the significant amount of time and resources that will undoubtedly be put into challenging its constitutionality.

NIKKI E. DOBAY

DEANDRÉ R. MORROW

Maryland's digital advertising tax (DAT) saga is one of the biggest SALT policy pickles that has been unfolding over the past three years. And while the Maryland Supreme Court could have put this one to bed, the court took an extremely narrow view of the constitutional exception to Maryland's exhaustion doctrine, seemingly slamming that door shut as an option for challenging constitutionally questionable laws in Maryland.

For the purposes of this article, we will put a pin in that, except to say that it is a missed opportunity by the Maryland Supreme Court since it is almost certain that the Maryland DAT will be found to violate the U.S. Constitution and the Internet Tax Freedom Act at some point. Despite that, taxpayers and the state alike will be required to invest significant time and resources in both administrative efforts and on the litigation front to get there. It is this needless waste of time and resources that will be the focus of this article. Considering that, we will walk through how this SALT policy pickle came to be, where the Maryland Supreme Court's order leaves taxpayers, what, if anything, this all means for the federal case pending before the Fourth Circuit, and why other states should avoid going down this same path.

What a Long, Strange Trip It's Been

Maryland's DAT journey began in early 2020 with the introduction of S.B. 2 in the Maryland General Assembly. The bill's introduction and the DAT's creation seemed to have two purposes: (1) raise money for education and (2) change the behavior of a targeted group by imposing a punitive tax

regime. S.B. 2 was based on a proposal Nobel laureate NYU professor Paul Romer put forward in 2019.[1] He authored an op-ed targeting Big Tech, which discussed a type of sales tax on the revenue collected by companies displaying digital ads.[2] The purpose for this tax, according to Romer, was to provide more transparency and restore competition.[3] And while Romer's aim may have been true, the fact of the matter is that any company receiving revenue from digital advertising would be taxable under a state's corporate income tax, including Maryland's.

Nevertheless, with Romer's stated goals in mind, Maryland's DAT proposal targeted companies with more than $100 million in global annual revenues of which at least $1 million were derived from digital advertising. The DAT in S.B. 2 was also not a traditional retail sales tax but rather a gross receipts tax on receipts from digital advertising with rates ranging from 2.5 percent to 10 percent depending on the business's global annual gross revenues.[4] S.B. 2 lacked detail, leaving it to the Maryland comptroller to fill in the gaps. And while the stated goals for this proposal may have resonated with some, the revenue thresholds and rates reek of a punitive tax, targeting and discriminating against a group of taxpayers. Also, the lack of details in the proposal made it difficult to understand many of the administrative nuances.

But How Did We Really Get Here?

Considering the blatantly discriminatory nature of this tax and the lack of detail compared with other tax legislation, one would have thought that the DAT proposed in S.B. 2 would have fallen flat or at least have been amended to address the numerous stakeholder concerns. But COVID-19 played a significant role because it caused Maryland's General Assembly to break with standard procedures designed to encourage an inclusive, deliberative, and bipartisan process for evaluating tax proposals as critical as this first-in-the-nation tax.

In response to COVID-19, on March 15, 2020, the General Assembly announced that the 2020 session would end on March 18, instead of April 6, and the possibility of S.B. 2 passing seemed unlikely. The Senate, however, logrolled the DAT, as initially proposed in S.B. 2, into H.B. 732, which had previously focused on the taxation of cigarettes, electronic smoking devices, and other tobacco products. Yet, as passed on March 18, 2020, H.B. 732 included the Maryland DAT language.

That spring, a groundswell of grassroots opposition activity, which in some ways also seemed to have benefitted from the shift in technology that came along with the COVID-19 pandemic, erupted, and the governor vetoed H.B. 732 on May 8, 2020. Those efforts and the governor's veto, however, were thwarted when the General Assembly voted to override the veto on February 11, 2021. With that action by the General Assembly, the Maryland DAT was resurrected.

Seeming to understand that the newly enacted DAT was complicated, the General Assembly quickly passed H.B. 787, which delayed its effective date to tax years beginning after December 31, 2021. S.B. 787 also responded to the litany of potential compliance and legal issues raised by stakeholders during the 2021 legislative session, and what started out as a simple three-page bill meant to clarify the General Assembly's intent regarding the DAT, morphed into a 25-page monster that would have made Dr. Victor Frankenstein proud. Regardless of those amendments, the DAT still circularly defines

a "digital advertising service" as "an advertising service on a digital interface" and fails to provide any explanations as to the meaning or scope of critical terms, such as "advertisement" or "advertising" services — the very items on which the tax is imposed. The complexities of digital advertising generally, in conjunction with the vague, loosely written legislation, are front and center in the creation of this pickle. And while those concerns pale in comparison to the constitutional issues raised by the DAT, it appears these are issues that will need to be dealt with for the next several years.

Litigation Galore — The Timeline!

Less than two weeks after the General Assembly's veto override (on February 18, 2021), a lawsuit was filed in the U.S. District Court for the District of Maryland seeking a declaration and injunction against enforcement of the DAT. Specifically, the litigants asserted the DAT was unconstitutional under the First Amendment, the commerce and the due process clauses, and the supremacy clause since it violated the ITFA. Then, on April 15, 2021, a separate suit was filed in the Maryland state court challenging the DAT on grounds similar to those in the federal lawsuit. Also, the state case asserted various claims under the Maryland Constitution.

In March 2022, the district court dismissed the federal case, finding it was barred by the Tax Injunction Act.[5] Specifically, the court concluded the DAT was a tax and not a penalty within the meaning of TIA and that Maryland law provides a plain, speedy, and efficient remedy to challenge the DAT in state court. The court did, however, allow the case to proceed as it related to the DAT's passthrough prohibition.

While the passthrough prohibition issue proceeded in federal court, the state case came to a head in October 2022 when a Maryland circuit court judge struck down the DAT. Denying the comptroller of Maryland's motion to dismiss and granting the plaintiffs' motion for summary judgment, the circuit court declared the DAT violated ITFA, the commerce clause, and the First Amendment.

Shortly after the court issued its decision, the federal district court dismissed the remaining issues in the federal case as moot, and the litigants filed a timely appeal to the Fourth Circuit. And, in the state case, the comptroller's office appealed the circuit court's judgment to the Supreme Court of Maryland, which agreed to hear the case.

With the respective appeals pending, early 2023 was a tremulous time for taxpayers potentially affected by the DAT. With a court concluding the tax was unconstitutional but appeals pending, it was difficult for taxpayers to navigate potential compliance burdens as the first return due date approached.

But even more troublesome was the realization that the state appeal would turn on a procedural issue. In that case, the comptroller was asserting that the taxpayers were precluded from judicial review, even on the question of whether the DAT was constitutional, because the plaintiffs had failed to exhaust their administrative remedies. The taxpayers' position was that this case was covered by the constitutional exception to the exhaustion doctrine, which allows for judicial review without

administrative exhaustion where there is a direct attack upon the power of the General Assembly to adopt the legislation based on constitutional issues.

In May of 2023 — just four days after oral argument — the Supreme Court of Maryland rejected the taxpayers' arguments, agreeing with the comptroller that administrative exhaustion was a prerequisite to seeking judicial review — even in this matter in which the constitutional issues were front and center. The court's order summarily vacated the circuit court's order granting the taxpayers' motion for summary judgment, stating that the court lacked jurisdiction because administrative remedies had not been exhausted. The court subsequently explained the basis for its order in an opinion issued on July 12, 2023. Notably, the court made clear its decision was not based in any way on its views on the merits of the case.

What Does It All Mean?

The Maryland Supreme Court's decision will result in additional years of needless litigation. While some academics have asserted this tax can withstand a constitutional challenge, it is hard to imagine a world in which the DAT's explicit focus on digital advertising would be found to be anything other than a blatant violation of ITFA.

The federal appeal remains pending, and we will have to see if the supreme court's determination has any effect on that appeal. Considering the lower court's comment regarding Maryland's "deemed denial" provision providing "a plain, speedy and efficient remedy," a reversal pursuant to TIA would appear to be an uphill battle. So the fight must continue in state court, and we must wait for a taxpayer to fully exhaust their administrative remedies.

Where Do We Go From Here?

Again, unless there is a change in course in the federal case, the state supreme court's ruling means that no taxpayer may challenge the DAT outside the normal administrative process, and before April 17, 2023, when the first DAT returns became due, no administrative remedy was available.

Following that deadline, a challenge to the DAT may proceed in one of two ways. A taxpayer could decline to file a return and pay the tax and wait for the comptroller to assess a deficiency; the taxpayer would then file an appeal with the comptroller's office. This option, however, is questionable because of the DAT's criminal penalty component.

Alternatively, a taxpayer could pay the tax and file a refund claim with the comptroller's office. This process could involve a hearing before the Compliance Division's Hearings and Appeals Section. If the refund denial is upheld or if the comptroller does not act within six months of the appeal, then the taxpayer may appeal the denial to the Maryland Tax Court. If the comptroller's action is upheld at tax court, then the taxpayer will have access to Maryland's courts.

Considering the general administrative appeals process for other taxes in Maryland, a taxpayer that appeals a DAT assessment or files a refund claim, asserting constitutional issues, may have to endure an audit wherein it may need to defend its DAT calculation. In other words, taxpayers will likely need

to get in the weeds on a DAT calculation long before any arbitrator will again review the constitutional issues raised by the DAT. Indeed, these are the types of inefficiencies that the federal and state litigants sought to avoid by seeking declaratory judgments.

Because taxpayers will likely need to calculate the DAT, another set of issues that taxpayers will need to tackle are the comptroller's sourcing and apportionment rules. As noted above, the DAT's statutory provisions do not deal with sourcing. Instead, those provisions instruct the comptroller to draft regulations to determine the state from which revenues from digital advertising services are derived. The comptroller's response to this mandate was to adopt a device-based sourcing rule. The regulation specifies that taxpayers may use internet protocol, geolocation data, device registration, cookies, metrics standard to the taxpayer's industry, or "any other comparable information" to determine "by a totality of the facts and circumstances" whether a device is within the state, in another state, outside of the United States, or whether the location is indeterminate. The regulation also requires that the DAT gross revenue derived from the digital advertising amount be based on devices rather than actual revenue figures. Finally, the comptroller's DAT regulations contain a throwout rule, which requires that all the unlocated devices be excluded from the apportionment factor. The effect of these rules is that, irrespective of any real economic activity, more gross revenue may be apportioned to Maryland.

The irony created by the sourcing and apportionment rules in the regulation is also worth mentioning. To "properly" calculate the DAT under Maryland's sourcing and apportionment approach, digital advertisers will likely need to increase the amount of data they are tracking to ensure that unlocated devices aren't thrown out. This raises significant questions for businesses that do not keep or have device-based information. To put an even finer point on it, complying with a tax premised on stopping a behavior may require a greater engagement in that behavior.

Let This Be a Lesson . . . For Other States

One thing that has been true since the DAT was enacted is that other states have been watching Maryland very closely to see what will happen with the court challenges. In its current form, the tax is likely unconstitutional despite the Maryland Supreme Court's recent ruling, and there will almost certainly be several more years of hard-fought audits and appeals regarding the DAT before it is ultimately deemed to violate ITFA and other provisions of the U.S. Constitution.

Thus, any state considering enacting something like the DAT should think about the time and effort that Maryland has and will be required to expend to implement and defend this constitutionally suspect tax. If the General Assembly's original revenue projections were close, then the DAT has the potential to saddle that state with billions in debt when a court inevitably finds the tax violates federal or state laws. Considering this, why would any state want to step or even dip their toes into this quagmire?

But these are not the only reasons for other states to stay away from DATs and other types of data taxes. First and foremost, states that impose general corporate income or gross receipts taxes are already taxing the revenue of businesses that have been targeted by the DAT. Thus, any new tax

specifically focused on receipts from digital advertising or data is unfounded, discriminatory, and likely to result in double taxation. If states are somehow unsatisfied with the revenues being collected by these taxes, then those taxes should be addressed. But it is not as if a large company, which almost certainly has nexus with every state, is somehow escaping tax on digital advertising revenue. That income would be picked up through the corporate income tax or general gross receipts tax on an apportioned basis.

Years down the road, the Maryland DAT will most likely be considered a failed experiment. Nevertheless, taxpayers affected by the DAT will be required to suffer through compliance and endure audits and appeals as the saga unfolds. At the end of the day, Maryland's DAT does not seem to have any obvious solutions that aren't fairly painful. Other states, however, can easily avoid this pickle by rejecting similar discriminatory proposals that attempt to target and "correct" perceived behaviors of certain taxpayers through the tax code.

FOOTNOTES

[1] *See* testimony of Senate President Bill Ferguson on January 29, 2020, before the Maryland General Assembly Budget and Taxation Committee.

[2] Paul Romer, "A Tax That Could Fix Big Tech," *The New York Times*, May 6, 2019.

[3] *See* testimony of Paul Romer on January 29, 2020, before the Maryland General Assembly Budget and Taxation Committee.

[4] The General Assembly also overrode the governor's veto for H.B. 932, which expanded Maryland's sales and use tax base to digital products. That bill is beyond the scope of this article.

[5] *Chamber of Commerce of United States v. Franchot*, No. 21-CV-00410-LKG, 2022 WL 971010, at *10 (D. Md. Mar. 30, 2022), *dismissed as moot* (D. Md. Dec. 2, 2022).

END FOOTNOTES