

Digital Services Tax Battles Are Coming to a Head

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In this article, Wilford analyzes the status of the Maryland digital advertising tax, which is about to be decided on its merits after overcoming several procedural hurdles in the legal system.

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Ever since the Maryland General Assembly overrode then-Gov. Larry Hogan's veto of its first-in-the-nation digital advertising tax in February 2021, businesses and policymakers in other states have been on a rollercoaster ride waiting for the court system to weigh in on whether the tax is constitutional. More than two years later, that long-delayed merits determination may finally be on the way.

A Circuitous Legislative and Legal Battle

Maryland lawmakers first passed H.B. 732 in March 2020, overriding Hogan's veto a year later.¹ The law imposed a four-tiered tax ranging from 2.5 percent to 10 percent of a business's gross receipts from digital advertising. Controversially, the tax rate businesses are subject to is based on their global revenues, not those specifically sourced to Maryland.²

After the veto override, the tax's implementation was delayed until the start of 2022. In the meantime, follow-up legislation was passed to exempt digital advertising receipts by news media from the tax. This follow-up measure also prohibits businesses from passing on the tax to consumers via a separate fee or line item, though the tax will inevitably be passed on to consumers in some form.³

Not long after the tax took effect, lawsuits challenging its constitutionality were filed at both the state and federal levels. But the plaintiffs have struggled to get their day in court on the merits, with challenges being diverted by procedural issues.

Like many cases seeking a remedy to alleged unconstitutional state actions in federal court, the federal case soon ran into the Tax Injunction Act, which bars federal courts from issuing injunctions against state-level tax assessments in which a “speedy and efficient” remedy is available at the state level.⁴ That determination is now on appeal to the Fourth Circuit.⁵ The Maryland Office of the Comptroller then threw up barriers to this supposedly available “speedy and efficient” remedy at every stage.

The state-level case initially had more success, with Anne Arundel County Circuit Court Judge Alison Asti striking down the tax in October 2022.⁶ But the Maryland Supreme Court reversed that decision in May, deciding that the plaintiffs had failed to exhaust their available administrative remedies first, including challenging the state’s decision to deny refunds in Maryland Tax Court.⁷

While these state and local suits were bogged down, Apple Inc. filed a refund claim in Maryland Tax Court for \$756,000 in estimated tax payments it had made in the first three quarters of 2022. The comptroller’s office argued that Apple’s case could not proceed because it had not filed the correct form (which would not be available until 2023, months after the refund claim’s filing). On November 17 Judge Anthony Wisniewski rejected the comptroller’s arguments, allowing Apple’s case to proceed.⁸ That refund request has now been joined by a dozen others.⁹

Now, a year and a half after a federal court cited an available speedy and efficient remedy in invoking the TIA to dismiss the federal case, the plaintiffs liable for paying Maryland’s digital advertising tax up to this point may finally receive their day in court on the merits.

Why Might the Tax Be Unconstitutional?

It is little wonder that Maryland’s strategy to this point has been to bog down challenges in procedural hurdles. Now that the cases are reaching the merits, Maryland’s digital advertising tax faces serious legal and constitutional issues.

The clearest problem for Maryland is the Internet Tax Freedom Act.¹⁰ ITFA (a sunset law extended several times before being made permanent by the Permanent Internet Tax Freedom Act of 2016) explicitly prohibits states and their subdivisions from imposing discriminatory taxes against digital transactions, defined as taxes “not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means.”

It is difficult to see how Maryland’s digital advertising tax does *not* violate ITFA. Traditional forms of advertising such as billboards offer a clear counterpart to digital advertising, yet do not face the digital advertising tax — or any other advertising tax, for that matter. If there was ever a cut-and-dried example of discriminatory taxation against digital services, Maryland’s digital advertising tax is it.

But that’s not the only potential legal pitfall. Courts have not been willing to interpret the commerce clause of the U.S. Constitution very strictly of late, but there is a strong argument that Maryland’s tax

violates the commerce and due process clauses by impermissibly burdening interstate commerce.

The tax's aforementioned structure bases the rates that apply on businesses' global — rather than Maryland-sourced — digital advertising receipts. This structure, along with the high starting threshold of \$100 million in global receipts, effectively ensures that the tax will exclude all Maryland-based businesses and apply exclusively to out-of-state businesses.

Much like with past European digital tax proposals,¹¹ Maryland's goal is rather transparently to export tax burdens across its borders. That is precisely the kind of harmful activity that the commerce clause and, more broadly, the Constitution itself exist to prevent.

A less commonly invoked portion of the commerce clause may also present issues for Maryland. While the commerce clause is primarily relevant to states in granting Congress the power to regulate interstate commerce, it also grants Congress the power to regulate commerce with foreign nations. Past U.S. Supreme Court decisions have interpreted this provision to bar states from preventing the nation from "speaking with one voice" in foreign trade.¹²

This is notable in the context of Canada's recent announcement that it intends to unilaterally impose a digital services tax in the wake of stalled OECD negotiations that include an international ban on DSTs.¹³ By enacting a similar tax that applies to multinational corporations, Maryland's digital advertising tax could be seen to be undermining the federal government's position in international negotiations that these taxes are impermissible.

Bad Policy to Boot

While that leaves Maryland's attorneys with a gauntlet of legal problems to navigate, it's worth noting that there remain significant policy reasons that this was (and is, for other states considering following suit) a path best avoided.

The fact that Maryland does not tax traditional advertising opens the state up to a challenge under ITFA, but the policy reasons not to tax traditional advertising are just as good as those not to tax digital advertising. Advertising — whether traditional or digital — is primarily a business-to-business transaction and, as such, should not be taxable.

B2B transactions are generally best left untaxed, because they are intermediate transactions along the way to the final transaction with the customer. Taxing intermediate transactions like advertising leads to tax pyramiding and hidden taxes on the final consumer.

Also best avoided are gross receipts taxes, which Maryland's digital advertising tax is structured as. Gross receipts taxes are blind to taxed businesses' expenses, meaning they are arbitrarily more burdensome for businesses that have lower profit margins.

At a top rate of 10 percent, the Maryland tax makes it unprofitable to do business in the state for companies with even moderate digital advertising profit margins. While local small businesses

seeking to buy advertising space would not face the digital advertising tax itself, it would hit them indirectly. As the companies offering digital advertising services clear out of Maryland or raise the price of advertising space to offset the tax, local businesses would ultimately pay.

A 2019 study of a proposed French DST found that just 5 percent of the burden of the tax would fall upon large digital multinationals.¹⁴ The remainder would be borne by consumers (55 percent) and businesses using digital platforms (40 percent).

The justification for these taxes also merits further scrutiny. The European predecessors of Maryland's digital tax were based on the premise that multinational digital firms were paying lower effective tax rates than their non-digital counterparts. However, there remains little evidence to back up this premise, with one landmark study finding that there is "no systematic difference in income taxes paid by digital corporations compared to their traditional peers."¹⁵

Conclusion

While Maryland has allowed itself to be tempted by the promise of a "free," untapped revenue source with the costs shipped across state lines, policymakers in other states considering similar measures should realize that the reality is different. Not only are similar taxes in other states likely to get bogged down in the same legal battles that Maryland is currently stuck fighting, they are likely to harm their local businesses in indirect ways.

State policymakers also must recognize the endgame of using the excuse of the interconnected digital economy to justify exporting tax burdens. What one state can do to another state's businesses, that state can do to theirs — a truism that applies to taxes of all stripes in an environment of states recklessly pursuing the power to expand their tax jurisdictions. A short-term revenue boost is likely to end up as a shell game with no winners — only losers, as taxpayers increasingly are required to pay taxes to states where they do not vote and face mounting multistate tax obligations.

Challenges to Maryland's digital advertising tax are finally getting their day in court. With any luck, Maryland's first-in-the-nation digital advertising tax will also be the last.

FOOTNOTES

¹ H.B. 732 (Md. 2020).

² Statement of Nicole Kaeding, vice president of policy promotion and economist, National Taxpayers Union Foundation, "State Digital Advertising Taxes: A New Trend That Should End Quickly Before the Maryland Senate Budget and Taxation Committee," 441st Session of Maryland General Assembly (2020).

³ Joe Bishop-Henchman, "Maryland Digital Tax Sponsor Proposes Law Banning the Tax From Being Passed Forward," National Taxpayers Union Foundation, Feb. 11, 2021.

- ⁴ Tyler Martinez, "Give Taxpayers Access to Federal Courts," National Taxpayers Union Foundation, Aug. 7, 2023.
- ⁵ Andrea Muse, "[Fourth Circuit Weighs Maryland Digital Ad Tax's Constitutionality](#)," *Tax Notes State*, Sept. 25, 2023, p. 1047.
- ⁶ Andrew Wilford, "Maryland's Discriminatory Digital Ad Tax Found Unconstitutional," National Taxpayers Union Foundation, Oct. 20, 2022.
- ⁷ Nikki E. Dobay and DeAndré R. Morrow, "[Maryland's Digital Advertising Tax Debacle](#)," *Tax Notes State*, July 24, 2023, p. 297.
- ⁸ Sanjay Talwani, "Md. Court Lets Apple's Digital Ad Tax Case Proceed," Law360, Nov. 17, 2023.
- ⁹ Amy Hamilton, "[Practitioners Preview ITFA Fights Brewing on Digital Front](#)," *Tax Notes State*, Nov. 20, 2023, p. 604.
- ¹⁰ 47 U.S.C. section 151.
- ¹¹ Pete Sepp, "France Gears Up For 'Digital Tax' That Will Harm Their Own Taxpayers," National Taxpayers Union Foundation, Mar. 6, 2019.
- ¹² *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).
- ¹³ Amanda Athanasiou, "[Canada Reaffirms Its Plans for Unilateral DST](#)," *Tax Notes Int'l*, Nov. 22, 2023, p. 1277.
- ¹⁴ Julien Pellefigue, "The French Digital Service Tax: An Economic Impact Assessment," Deloitte/Taj (Nov. 22, 2019).
- ¹⁵ Matthias Bauer, "Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions," European Centre for International Political Economy (Feb. 2018).

END FOOTNOTES