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INFORMATIONAL HEARING

Sustaining Journalism in California: Tax and Tax Credit Options

1021 O Street, Room 1200 Wednesday, March 13, 2024

BACKGROUND

This background paper prepares the members of the Committee on Revenue and Taxation for the March 13, 2024, informational hearing: "Sustaining Journalism in California: Tax and Tax Credit Options."

This paper:

- Provides information regarding the rise of digital news, and the concomitant decline in local news;
- Discusses some tax options to support local journalism;
- Describes digital services and advertising taxes, including information regarding Maryland's tax and proposals in other states;
- Identifies potential legal and Constitutional barriers for states seeking to impose advertising, digital advertising, or digital barter taxes;
- Considers policy tradeoffs of such taxes.

Key Questions

- How have advertising revenues changed in recent years?
- To what degree have these changes caused the decline in local news and journalism nationally and in California?
- What tax measures should legislators consider if they want to arrest the decline in local journalism, and foster its recovery?
- Is an advertising, digital advertising, or digital barter tax an effective way to mitigate for changes in advertising revenues?
- What are the legal and Constitutional barriers and policy issues states should consider if they want to impose advertising, digital advertising, or digital barter taxes?
- When defined as digital barter, are the policy arguments for imposing a tax that applies solely to digital commerce stronger, and the legal and Constitutional arguments against it weaker?

The Rise of Digital News

According to TIME magazine, one of the earliest precursors to online news was a project called "Viewtron," which was launched by newspaper company Knight-Ridder in 1983.[1] While this project failed, Internet provider Prodigy began offering news updates straight to subscribers' home computers in 1988. With the ascent of the World Wide Web in the mid to late 1990s, the shift in news consumption from print journalism to digital media commenced. According to TIME, the shift quickly accelerated:

> "By the turn of the century, more families subscribed to Internet services than to actual newspapers, one factor in the rapid decline in advertising and circulation dollars that continues today. But as the fortunes of the newspaper industry fell, those of online news services skyrocketed — millions who had Yahoo! as their home page had immediate access to stories every time they logged on, and Google News became the first news portal to organize articles. A few years later, mobile devices like the iPhone not only changed how and where people read the news but how they interacted with it, making it easy for almost anyone to become a journalist by being able to quickly take photos and video. That sense of instant interaction, which had started decades before with online message boards, grew rapidly alongside the popularity of social media services like Facebook and Twitter. Both have allowed news organizations to get immediate feedback on stories and let readers share news with others instantly."[2]

The Decline of Print and Local Journalism

The popularity of online news also coincided with a decline in circulation in print news. Daily news circulation in the United States hovered between 60 million and 64 million for the 1970s and 1980s, but then began falling sharply in the 1990s.[3] Since 2005, the country has lost more than 25 percent of its newspapers, or over 2,500 publications.[4] By 2017, daily circulation had decreased to 31 million and 34 million for weekdays and Sundays, respectively.[5]

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[1] Sanburn. "*A Brief History of Digital News*," TIME (Feb 1, 2011): https://content.time.com/time/business/article/0,8599,2045682,00.html

[2] *Ibid.*

[3] Pew Research Center., *Newspaper Fact Sheet* (June 29 2021): https://www.pewresearch.org/journalism/fact-sheet/newspapers/

[4] Abernathy, "*The State of Local News 2022*," Northwestern Medill Local News Initiative (Jun. 29, 2022), https://localnewsinitiative.northwestern.edu/research/state-of-local-news/report/.

[5] Pew, *Supra.*

Coinciding with print circulation, advertising has also declined.[6] Publicly traded U.S. print media firms experienced an average decrease of 9% per year in print advertising revenue from 2010 to 2017.[7] Although digital advertising revenue makes up an increasingly large portion of total advertising revenue, the amount is still relatively small compared to that of print advertising.[8] Digital advertising revenue accounted for only 29% of the total advertising revenue of publicly traded U.S. print media firms in 2017.[9] Furthermore, the growth in digital advertising revenue has not offset the decline in traditional advertising revenue, as the U.S. newspaper industry's total advertising revenue fell from $26 billion in 2010 to $18 billion in 2017.[10]

Newspaper closures disproportionately affect smaller communities and, in most cases, no digital or print replacement comes to fill the gap, leaving these communities without a reliable source of local news.[11] Northwestern University's Medill School of Journalism reports that more than one-fifth of the country's population lives in a news desert or in communities at risk of becoming news deserts.[12] Northwestern data also shows that four California counties do not have a local news source, 11 have only one, and the San Francisco Bay Area is one of 20 metro areas nationwide that have lost the most on a per capita basis. Many of the surviving papers "have cut staff and circulation significantly as print revenues and profits evaporated." [13]

Tax Credit Options to Support Local Journalism

In recent years, proposals to enact tax incentives to support local journalism have emerged as a potential option for policymakers to arrest the decline in local journalism, and foster its recovery. At the federal level, the Local Journalism Sustainability Act (H.R. 7640 of the 116th Congress; H.R. 3940 and S. 2434 of the 117th Congress) and the Community News & Small Business Support Act (H.R. 4756 in the 118th Congress) included proposals such as:

- A non-refundable income tax credit for individuals to subscribe to local news.
- A refundable payroll tax credit for local newspapers to hire new journalists.

[6] Chung, Kim, & Song, "*The Comprehensive Effects of a Digital Paywall Sales Strategy,"* Harvard Business School Working Paper 19-118 (2019): https://www.csulb.edu/sites/default/files/document/19-118_c8363c6a-6de4-45b7-8736-8da819b644ec.pdf
[7] *Ibid.*
[8] *Ibid.*
[9] *Ibid.*
[10] *Ibid.*
[11] Abernathy, *Supra.*
[12] Abernathy, *Supra.*
[13] Abernathy, *Supra.*

- A non-refundable income tax credit for small- to medium-sized businesses to advertise with local newspapers, as well as local radio and television stations.

While the above proposals would apply for federal tax purposes, California's tax system is less flexible in two key ways. First, the California Constitution precludes the Legislature from enacting a Budget Act where expenditures exceed estimated revenues, whereas the federal government consistently operates at a deficit. Tax credits reduce General Fund revenues available to the Legislature to fund other priorities, and with the Legislative Analyst's Office forecasting a $58 billion budget deficit, tax credit proposals to support local journalism will face even more competition from other priorities this year than in the past.

Second, employers both pay and withhold federal unemployment, social security and Medicare taxes, in addition to withholding federal income taxes from employees, generating billions of revenue annually for these programs. The Internal Revenue service administers both employment-based taxes as well as those that apply to income. Congress has enacted credits against these payroll taxes, including the recent Employment Retention Credit. However, California's only employment taxes do note generate General Fund revenues, and are instead specifically dedicated to fund unemployment insurance and employment training (although employers must also withhold state income taxes and state disability insurance payments from employees.) While the Franchise Tax Board administers income taxes in California, and state law contains a myriad of credits against the tax, the Employment Development Department administers payroll taxes, where no comparable credits apply.

The Legislature has fewer options than Congress to enact tax credit options. However, many options are available, such as:

- Allow nonrefundable Personal Income and Corporation Tax credits similar those in the above proposal to subscribe to or advertise in local news.
- Enact a Personal Income and Corporation Tax credit for newspapers to retain currently employed journalists, and hire new ones. Until recently, all tax credits for business taxpayers in California were nonrefundable; however, the Legislature recently authorized taxpayers claiming the motion picture and television production credit to receive refunds (SB 132, Committee on Budget & Fiscal Review, 2023).
- The California Competes Tax Credit Program, administered by the California Competes Tax Credit Committee and the Governor's Office of Business and Economic Development or GO-Biz, allocates $180 million annually for businesses that want to locate in California or stay and grow in California. The Legislature can either expand the current authorization amount, and allocate the increase solely to news entities, or create a category solely for news entities within the current authorization.
- The 2021 Budget Act additionally allowed grants under the California Competes Program for firms that do not have sufficient liability to apply a nonrefundable tax credit. Governor Newsom's Proposed 2024-25 Budget requests an additional $50 million for the

Program. Should the Legislature include the Governor's Proposal in the Budget Act, it could reserve some of the allocation solely for news entities.

- Generally, the sale of newspapers and periodicals is subject to sales and use tax like other tangible personal property, including sales by third party retailers. While property purchased that becomes part of a newspaper or periodical and some subscriptions are exempt, the Legislature could fully exempt the sales of newspapers.

Additionally, the Legislature has previously established a journalism fellowship program administered by the University of California at Berkeley, which can be expanded or otherwise strengthened. The program pays fellows a salary between $60,000 and $65,000, based on experience, plus benefits, for a two-year fellowship.

Digital Services and Digital Advertising Taxes

The loss in advertising revenues for newspapers has been to the gain of large Internet companies such as Amazon, Meta, and Google/Aplhabet. Amazon's U.S. ad revenue in 2020 grew to $15.73 billion, up 52.5% from 2019, eMarketer estimates.[14] Amazon's U.S. digital ad share is still small relative to Google/Alphabet and Facebook's (now Meta's), which accounted for 28.9% and 25.2% of the business, respectively, in 2020[15]

In response, the United Kingdom, France, and other European Countries have imposed Digital Services Taxes on digital services. These taxes ensure that countries can adequately tax companies generating large amounts of advertising revenue based on collecting data from and targeting advertisements to its citizens.[16] The taxes vary, but generally are imposed on a company's gross receipts, unlike income taxes which allow firms to deduct their expenses before the tax rate is applied on its net income.[17] Some countries only count a firm's revenues from digital advertising, while other include revenues from the provision of a digital interface, targeted advertising, and the transmission of data collected about users for advertising purposes.[18] According to the Congressional Research Service:

> "DSTs are structured as a selective tax on revenue (akin to an excise tax) and not as a tax on corporate profits. A tax on corporate profits taxes the return to investment in the corporate sector. Corporate profit is equal to total revenue minus total cost. In contrast,

[14] Bruell, Alexandra," *Amazon Surpasses 10% of Digital Ad Market Share*," Wall Street Journal, April 6, 2021: https://www.wsj.com/articles/amazon-surpasses-10-of-u-s-digital-ad-market-share-11617703200

[15] *Ibid.*

[16] William Morris and Pat Brown, "*Digital Services Taxes: Are they here to stay?*" PricewaterhouseCoopers: https://www.pwc.com/us/en/services/tax/library/digital-service-taxes.html

[17] Elke Asen and Daniel Bunn, "*What European OECD Countries Are Doing About Digital Services Taxes*," Tax Foundation Europe, November 22, 2021

[18] *Ibid*.

DSTs are 'turnover taxes' that apply to the revenue generated from taxable activities regardless of costs incurred by a firm."[19]

Digital Services and Advertising Taxes have similarities and differences with current state taxes. Most states, including California, apply sales and use taxes to the sale of tangible personal property, and apply personal income and corporation taxes on the net income of a business. Some states include some digital services and products within their sales tax base. New Mexico applies its business tax as a gross receipts tax, which it recently applied to digital advertising.

In the United States, the State of Maryland became the first, and currently only, state to impose a specific digital advertising tax in 2021, when its Legislature overrode Governor Larry Hogan's veto of House Bill 732. Maryland's tax is imposed a four-tiered tax ranging from 2.5% to 10% of a business's gross receipts from digital advertising. The tax applies only to companies with at least one million in digital advertising revenues. The tax rate businesses are subject to is based on their global revenues, not those specifically sourced to Maryland. Soon after enacting the tax, Maryland enacted subsequent legislation to exempt digital advertising receipts by news media from the tax, and prohibit businesses from passing on the tax to consumers via a separate fee or line item. When enacted, Maryland expected that the tax would generate $250 million in revenue annually. While Maryland is the only state to impose a Digital Advertising Tax thus far, Legislatures in many other states have seen similar proposals introduced:

Figure 1.
State Digital Advertising Services and Data Mining Tax Proposals (2020-2023)

Source: Council On State Taxation research. Proposals include both digital services taxes and their sales tax equivalents.

[19] Sean Lowry, *"Digital Services Taxes: Policy and Economic Analysis,"* Congressional Research Service, February 25, 2019: https://crsreports.congress.gov/product/pdf/R/R45532

Potential Legal and Constitutional Barriers to State Digital Services Taxes.

Soon after Maryland enacted its tax, litigation ensued. First, in the U.S. District Court for the District of Maryland, taxpayers argued that the tax was unconstitutional under the First Amendment, the Commerce and Due Process Clauses, and the supremacy clause since it violated the Internet Tax Freedom Act (ITFA). Second, taxpayers challenged the tax in Maryland state court on similar grounds, and that the tax violated the Maryland Constitution.

In March 2022, the U.S. District Court dismissed the federal case, finding that the Tax Injunction Act barred the case, and that the better remedy was available in state court. However, the Court did allow the federal case to proceed as it related to the tax's prohibition on passing through the tax to consumers as a First Amendment violation. In October 2022, a Maryland circuit court judge struck down the tax, stating that it violated ITFA, the commerce clause, and the First Amendment. The U.S. District Court then dismissed the remaining issues in the federal case as moot, which litigants appealed to the Fourth Circuit, which remains pending. Then, in May 2023, the Maryland Supreme Court vacated the Maryland circuit court judgment, stating that the court lacked jurisdiction because taxpayers had not yet exhausted their administrative remedies.

Soon after, the Apple Corporation paid the tax, and filed a claim for refund, triggering the administrative process. The Maryland Comptroller denied the claim, but the Maryland Tax Court ruled in December 2023 that Apple's case could proceed, finding that it satisfied the requirements for a valid refund claim. Meanwhile, more than a dozen large technology companies filed similar litigation in the Maryland Tax Court in November protesting similar refund denials of estimated digital advertising tax payments.

While there are others, tax experts generally identify two major barriers to states imposing digital services taxes:

> ***The Internet Tax Freedom Act.*** In 1998 Congress passed ITFA to prohibit state and local governments from imposing "multiple or discriminatory taxes on electronic commerce" Public Law 105-277, Title XI, 112 Stat. 2681 (1998). Under that law, a discriminatory tax is one that is "imposed on electronic commerce that is not generally imposed on transactions involving similar services accomplished through other means."
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> ***The Commerce Clause.*** The Commerce Clause of the United States Constitution requires that state taxes, among other things, be fairly apportioned and not "discriminate against interstate commerce." *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977).

Tax experts argue that likely unconstitutional, and states thinking of enacting something similar should contemplate the costs associated with implementation and time required to defend the tax in litigation.[20] While Courts will determine whether Maryland's tax complies with these potential legal and Constitutional barriers, Digital Advertising Taxes are among the most hotly debated tax policy issues today. As a policy matter, opponents of digital advertising taxes argue that states should avoid applying taxes to business-to-business transactions, which can lead

[20] Nikki Dobay and Deandré R. Morrow, "*Maryland's Digital Tax Debacle*," State Tax Notes, July 24, 2023.

to tax pyramiding and hidden taxes on the final consumer.[21] Opponents also disfavor gross receipts taxes because taxpayers cannot deduct their businesses' expenses, making the tax more burdensome on low-margin businesses.

Digital Barter.

Young Ran Kim and Darien Shanske argue that Maryland's tax and other similar proposals provide meaningful taxation of a new kind of consumption.[22]

> For digital advertising platforms, the user data contribution occurs in barter transactions. For example, Google provides search engine services to users for free in exchange for the ability to show them ads and collect user information. The user is not receiving the service at no expense; rather, the value offered by the user-customers' contribution is collected in lieu of traditional payment. Though far from perfect, tax regimes know how to tax payments in cash. Taxing a barter is another matter, and, thus, as economic activity conducted through digital platforms has grown, so has the problem of how to tax transactions that are in part a barter.

Kim and Shanske argue that the transactions unique to the digital world generate tremendous profits for very few companies that have no comparison in the non-digital world, where traditional advertisers have little to no data about potential customers.[23] Kim and Shanske add that because neither international nor multistate tax rules were designed with this structure in mind, these barter transactions are essentially untaxed consumption that escapes traditional mechanisms like sales and use taxes.[24]

In California, sales and use taxes generally only apply to the transfer of tangible personal property, so do not apply to advertising regardless of whether it is an internet advertisement or a highway billboard. Additionally, sales and use taxes are measured based on the purchase price of an item, so that more tax is paid the higher the price paid for it, but do not apply to barter transactions because no money changes hands. While advertising revenues are income for general net income tax purposes, taxpayers can offset these revenues by deducting business expenses, applying tax credits, or adopting tax planning techniques where firms source receipts from certain sales or intellectual property to subsidiaries and affiliates in foreign countries with minimal tax rates.

As a result, California may want to consider a different method of taxation to address the specific dynamics of these barter transactions, including its specific impact on the decline of local journalism. A recent proposal in Tennessee, HB 2234 (Behn), imposes a tax similar to Maryland's, with some key differences. The tax applies to annual gross revenues derived from

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[21] Karl Frieden and Douglas Lindholm, "*State Digital Services Taxes: A Bad Idea Under Any Theory,*" State Tax Notes, April 10, 2023 and Andrew Wilford, "*Digital Services Tax Battles Are Coming to a Head*," State Tax Notes, December 11, 2023.

[22] Young Ran Kim and Darien Shanske, "*State Digital Services Taxes: A Good and Permissible Idea (despite what you may have heard)*," Notre Dame Law Review, November 2022.

[23] Kim and Shanske, *Supra*

[24] Kim and Shanske, *Supra*

data transactions from digital advertising services in the state, imposed at a rate of 9.5% - the same as Tennessee's state and local sales and use tax rate. While Maryland's tax applies to gross receipts above $1 million, Tennessee's tax only applies to firms with more than $50 million in annual gross revenues, based on its definition. The measure's findings and declarations state:

> "The largest internet corporations use their monopolistic control of essential online platforms to extract economic rents from their users in the form of personal data. This personal data is highly valuable and acquired at a steep discount, as demonstrated by the massive profit these corporations make selling this information to digital advertisers. For the purposes of stability and equity in the tax base, such economic rents are a favorable target for taxation. Tennessee sales and use tax statutes provide that specified digital products are taxed at the state rate of seven percent (7%) and a standard local tax rate of two and one-half percent (2.5%), instead of the local tax rate in effect in a county or municipality. However, many digital transactions are hard to bring into the digital sales tax base because instead of paying a monetary fee, customers sometimes barter their personal information for access to digital platforms. This personal information is in turn sold for use in targeted advertisements on digital platforms. To tax this consumption, leading tax economists have suggested using the receipts earned from digital data transactions as a proxy for the value of the barter."

Policymakers across the globe are wrestling with a new form of commerce innovated by technologies that do not align neatly with traditional mechanisms of taxation, resulting in potential under-taxation. Californians benefit from these innovations everyday. While the overall impacts of these technologies is unclear, the demise of local journalism is undeniable. While not an explicit tax, Governor Gavin Newsom in his first State of the State address spoke to these new forms of commerce while calling for a more equitable distribution of its benefits:

> "California is proud to be home to technology companies determined to change the world. But companies that make billions of dollars collecting, curating and monetizing our personal data have a duty to protect it. Consumers have a right to know and control how their data is being used. I applaud this Legislature for passing the first-in-the-nation digital privacy law last year. But California's consumers should also be able to share in the wealth that is created from their data. And so I've asked my team to develop a proposal for a new Data Dividend for Californians, because we recognize that your data has value and it belongs to you."