Testimony Before the Maryland Senate Budget and Taxation Committee
State Digital Advertising Taxes: A New Trend that Should End Quickly
January 29, 2020

Mr. Chair, Mr. Vice Chair, and members of the committee, thank you for the ability to submit written and oral testimony regarding Maryland Senate Bill 2. The National Taxpayers Union Foundation was founded in 1978 to provide nonpartisan research and education to illustrate the impact of taxes on Americans and the U.S. economy.

Senate Bill 2 would create a new gross receipts tax on digital advertising. While proponents claim that it will raise significant revenue to help finance the Kirwan Commission's recommendations, collecting any revenue is unlikely due to the bill's multitude of legal issues. The bill violates the federal Permanent Internet Tax Freedom Act and is constitutionally suspect, with likely violations of the Commerce Clause and First Amendment. Even if the bill was legally sound, its structure is flawed. If adopted, the tax would create significant economic and legal ramifications for the state.

The Bill's Structure

The bill would create a digital advertising gross receipts tax, imposed on a company's annual gross revenue in the state. Similarly structured as France's new digital services tax, the bill's broad definition of digital advertising includes banner ads, search engine ads, and others posted on a website, an application, or within a piece of software.

The tax rate would increase with a company's global revenues. A company with revenue between $100 million and $1 billion would pay 2.5 percent of taxable receipts, rising as high as 10 percent for companies with $15 billion or more in sales.

Table 1. Tax Rates Under Maryland SB2

Total Global Revenues	Tax Rate
$100 million to $1 billion	2.5%
$1 billion to $5 billion	5%
$5 billion to $15 billion	7.5%
$15 billion or more	10%

This structure raises several economic concerns. By taxing digital advertising but not other types of advertising, the bill creates a tax code that is not neutral between similar businesses. Only one narrow industry is taxed, while other competitors are left untaxed. Advertisers would be encouraged to shift their advertising placements from one medium to another not based on sound business reasons, but as a result of tax policy.

The tax violates a second core principle of tax policy: business inputs should be exempt from sales taxes. Taxing a business input leads to what is called tax pyramiding, where the same transaction is taxed multiple times. Companies that host digital advertising would be encouraged to raise their prices to offset the impact of the tax on their profit margin. By taxing gross receipts instead of profits (which allows a company to deduct its costs), effective tax rates skyrocket. A $15 billion company would need to exceed a 10 percent profit margin to surpass the break-even point on such a tax. Firms would look to offset their revenue hit with higher prices for consumers.

Imagine a small Maryland-based retailer decides to place online ads to encourage shoppers to choose their store over a large retailer. That digital ad would be subject to a tax, raising the cost of the ad. The small retailer would be forced with a difficult choice. Should the retailer then pass that cost along to their consumers, meaning they raise the price of their goods? If they don't think they can raise prices because they'll lose the customer to the large retailer, they might instead have to consider passing the tax to their employees in the form of fewer job opportunities, or by limiting hours, benefits, or wages.

The tax in many ways would function similar to a tariff on digital advertising, limiting the sale within the state. While this seems positive at first blush, it is the businesses placing the ads, not the companies hosting the ads, that are hurt as the price of digital advertising space rises. The bill's impact would be felt by many. Local restaurants, gyms, bakeries, or any Maryland business that uses advertising to complete could be affected.

The Bill's Legal Future is Uncertain

If adopted, any revenue forecasted for the tax would be unlikely to be collected due to the numerous legal hurdles ahead. As written, the legislation is a clear violation of the federal Permanent Internet Tax Freedom Act (PITFA). Signed into law in 2016 by President Barack Obama, the law prohibits states and localities from assessing taxes on internet access. Second, it prohibits "discriminatory taxes on electronic commerce." Maryland's proposal appears to be an obvious violation of this component of PITFA.

Similar to most states, Maryland does not currently include advertising in its sales tax base, and for very good reasons. State sales tax bases should only include final personal consumption. Taxing business inputs, such as advertising, leads to higher prices for consumers. While both digital and traditional physical advertising activities would be subject to the state's 8.25 percent corporate income tax, only digital advertising would be additionally subjected to a gross receipts tax as high as 10 percent.

Even if the tax survived a PITFA challenge, it suffers from additional constitutional flaws as well. Because the tax is assessed on annual global revenues, larger global advertising providers would face a higher tax burden than Maryland-only providers, raising questions about whether the law could survive a challenge alleging that it violates the U.S. Constitution's Commerce Clause, which functionally prohibits state laws that discriminate against interstate commerce.

The bill also likely violates the First Amendment. In *Grosjean v. American Press Co*. and *Minneapolis Star Tribune Co. v. Commissioner*, the U.S. Supreme Court considered the impact of taxes on the news media, ruling that industry-specific taxes violate the First Amendment's speech protections. In a similar case, the Maryland Court of Appeals ruled that advertising taxes were unconstitutional violations of the First Amendment. Taxing digital advertising, a key revenue stream for media companies, would raise similar challenges.

Conclusion

Legislators in Maryland are searching for new revenue to pay for the Kirwan Commission's educational recommendations, but the digital advertising tax does not pass the smell test. Even though it was proposed by a Nobel Prize winning economist and strikes some as a good idea, the tax violates federal law and is also likely unconstitutional. Instead of collecting $100 million from the tax, the state is more likely to find itself spending a pretty penny on legal fees to defend an indefensible proposal.