Interstate Commerce Initiative

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Digital Tax Legislation is a Road to Ruin for States

Prior to the onset of the pandemic, it seemed a wave of digital tax legislation was poised to sweep the country. At that time, Maryland was involved in an ongoing battle over its proposed digital tax, while states like New York and Nebraska appeared poised to soon follow suit. Though the pandemic forced states to shift priorities over the past year, growing anti-tech sentiment and budget shortfalls have put digital taxes back on the docket in several states.

Other nations have been pushing for digital taxes for some time, in large part because digital taxes primarily affect American businesses. Countries in Europe and in the Organization for Economic Cooperation and Development (OECD) often see digital taxes as a means of raising revenue by poaching the American tax base.

But that by no means makes them good policy. Digital taxes discriminate against digital commerce, unfairly targeting commerce that takes place outside of traditional settings. The ostensible justification for this discrimination is that digital firms supposedly are able to avoid traditional taxes, but this claim is not backed up by the facts. In truth, average effective tax rates of digital and traditional firms are roughly the same.

At the same time, digital taxes often end up falling upon small businesses and consumers more than the tech giants they are

Key Facts:

Digital advertising tax proposals that are popping up in states across the country are unconstitutional and legal challenges are likely to render them incapable of generating revenue.

Maryland's first-in-the-nation digital tax is now the subject of a lawsuit less than a week after it became law, putting the state in legal jeopardy as it navigates the difficulties of COVID-19 and associated budget challenges.

State lawmakers should resist the urge to use tax policy as revenge for grievances against big tech companies, since small businesses and consumers will bear the brunt of digital tax proposals.

meant to target. A 2019 Deloitte/Taj study analyzing the impact of a French digital advertising tax proposal found that just 5 percent of the burden of the tax would be borne by large internet companies — instead, consumers would bear 55 percent of the costs, and businesses using digital platforms, such as newspapers or review crowd-sourcers like Yelp, would bear the remaining 40 percent.

Despite the widespread interest among other nations in discriminatory taxation of American tech companies, American states had historically avoided implementing such targeted measures until now. The environment state legislatures find themselves in in 2021 could prove even more conducive to the passage of digital taxes at the state level than ever before.

As of right now, Maryland's effort to institute a digital tax is at the most advanced stage. Though Governor Larry Hogan vetoed digital tax legislation last year, the state's legislature just voted to override his action, thus making it the first state in the nation with such a tax.

It took less than a week for Maryland's law to be subject to a lawsuit challenging its constitutionality. On February 17, a suit was filed in federal court alleging that the state law violates the federal Internet Tax Freedom Act and the Commerce Clause of the U.S. Constitution, and that it interferes with foreign commerce and is unacceptably vague. This suit is one of several that industry watchers expect to be filed, which is why NTUF has questioned whether Maryland's law would raise *any* revenue given its legal infirmities.

In addition to the aforementioned proposals in Maryland, New York, and Nebraska, digital tax legislation has also been introduced in Connecticut, Indiana, Montana, and Oregon. While this trend is gaining steam, these states are likely to run into the same legal challenges currently tying up Maryland.

A Tax Push Not Justified By State Budget Realities

For much of 2020, state budget projections were exceedingly dire. State revenue projections were down by an average of 8 percent, with some states anticipating revenue decreases as high as 20 percent. Panicking state governors begged Congress to shell out $500 billion in state and local aid on top of $189 billion already appropriated, warning that states may have to resort to severe cutbacks should Congress fail to pay up.

But thus far, the doomsday scenario has not come to pass. State revenue for FY 2020 has decreased on average compared to FY 2019, but only by 1.6 percent. States and localities are also experiencing a V-shaped recovery — though FY 2020 Q2 state and local government revenue decreased by about 4.5 percent year-over-year, and Q3 collections actually increased by 3.2 percent year-over-year. In fact, states like California have found themselves with significant budget surpluses despite the dire predictions.

Nevertheless, the mentality of impending budget doom remains among many states, particularly those that are not faring as well as their fellows. The 27 states which have seen March-November revenues decline this year compared to last include Connecticut, Indiana, Montana, and Oregon, all the states which are all considering new digital tax legislation. Oregon and Montana are among the 8 states that have seen revenues decline by more than 5 percent over that period.

Though rosier-than-expected budget outlooks may dissuade some states from attempting to implement digital taxes of their own, those still facing budget shortfalls may still see digital taxes as an untapped source of revenue. This view overestimates the potential revenue to be gleaned from a digital tax.

A Legally and Administratively Dubious Proposition

Many digital tax proposals thus far have failed to appreciate the legal minefield they are stumbling into. Just as foreign digital tax proposals have often stood upon shaky legal ground, so too have domestic state-based proposals.

Maryland's legislation, which spearheaded the state digital tax movement, now faces a strong legal challenge in federal court. Recently enacted over Governor Hogan's veto, the Maryland legislation imposes a gross receipts tax ranging from 2.5% to 10% on the annual revenues derived from digital advertising services in Maryland. The tax applies to any company with global revenues from all sources of $100 million or more, and no deductions for expenses are permitted. The tax must be paid on a quarterly basis throughout the year, with the first payment due April 15, 2021, and fines and penalties for failure to file up to five years' imprisonment.

The lawsuit, *Chamber of Commerce*, *et al*. *v. Franchot*, Docket No. 21-cv-410, challenges the Maryland legislation on four independent grounds:

- **Violates the Permanent Internet Tax Freedom Act (PITFA)**. Signed into law by President Obama in 2016, PITFA bans state taxes that discriminate against interstate commerce. The law defines a discriminatory tax as any levy imposed on internet-based goods and services that is not imposed on non-digital equivalents. The Maryland tax does exactly that, being imposed on digital advertising but not non-digital advertising. In his memo diplomatically describing the Maryland tax as "not clearly unconstitutional," Maryland Attorney General Brian Frosh expressed the most concern about a challenge under PITFA.
- **Impermissibly burdens interstate commerce in violation of the U.S. Constitution's Dormant Commerce Clause.** Under Supreme Court precedent, states cannot impose taxes that burden interstate commerce by taxing or otherwise penalizing out-of-state activity while leaving identical in-state activity untaxed or unpenalized. Maryland is seeking to do this, importing tax revenues while exporting tax burdens by designing its tax to apply only to digital advertising service companies with large global revenues and thereby excluding in-state competitors.
- **Harms diplomatic negotiations on global digital taxes in violation of the U.S. Constitution's Foreign Commerce Clause.** American officials are currently enmeshed in negotiations over the French digital service tax and proposed Europe-wide or global digital taxes. Maryland enacting a similar tax while our diplomats are resisting foreign attempts to oppose them is counterproductive. In 1979, the U.S. Supreme Court held that state taxes that prevent the United States from "speaking with one voice when regulating commercial relations with foreign governments" violate the Foreign Commerce Clause.
- **Violate the U.S. Constitution's Due Process Clause**. The lawsuit alleges that because the conduct targeted by the law is almost exclusively undertaken by out-of-state companies, it amounts to Maryland impermissibly regulating extraterritorial conduct in violation of due process.

One immediate hurdle that the lawsuit will face is the reluctance of federal judges to halt the collection of state taxes. A federal law, the Tax Injunction Act (TIA), essentially states that in most cases a taxpayer must pay a tax before bringing a suit to challenge it, unless the tax is not a tax for TIA purposes or unless the state has no "plain, speedy and efficient remedy." The lawsuit argues that the TIA should not apply to protect Maryland because of the severity of the rate (10% of gross revenues, some 20 times the rate of the corporate income tax on other businesses), its focus on extraterritorial conduct, that the proceeds do not go to the state's general fund, and generally that the legislation seems to be less about taxation and more that "Maryland lawmakers disapprove of large advertising companies and intended to punish them." There are plenty of examples from the legislative record to support this contention, including the sponsors unveiling the bill alongside Professor Paul Romer, who has urged increasingly punitive policies on companies that "persist with the targeted ad model," and statements by legislative supporters that the bill makes sure that "Big Tech winners" "suffer" and that the act successfully "targeted" "Amazon, Facebook, and Google."

Legislators were aware of these legal flaws, but the sponsors responded that questions of constitutionality were a matter for the courts. One sponsor observed that economic nexus laws were unconstitutional before *South Dakota v. Wayfair*, and thus legislators should not concern themselves with the potential for litigation. But that is a flawed comparison, one which would only serve to justify an expensive yet likely quixotic legal battle.

When it comes to *Wayfair*, members of the Supreme Court had specifically requested an opportunity to revisit the existing precedent in the light of new economic circumstances, and South Dakota crafted a law that was best designed to endure a constitutional review. Here, the Supreme Court has given no indication that it wishes to weaken its enforcement of First Amendment protections, and Maryland's law does a poor job of avoiding PITFA or Commerce Clause obstacles — rather, it crashes into them headlong.

Along with underestimating the legal barriers to such a tax, legislators appear also in some cases to have misunderstood the administrative difficulty of implementing such a tax. New York's first iteration of digital tax legislation, which imposed a five percent tax on digital firms which "derived income" from New Yorkers' "data," failed to define either "derived income" or "data." This would practically lead to a situation where just about everything was taxable under New York's law as written. Everything from restaurants collecting personal information for online reservations to businesses offering free wireless internet to insurance companies would potentially be liable under such a law.

A Product of Sentiment, Not Good Policymaking

State legislators should also be wary of allowing the sentiments of the moment to cloud their judgment on good policymaking. The increased momentum surrounding digital taxation has coincided with a wave of conservative anger about social media censorship — but however conservatives feel about their treatment on social media, it should not have any bearing on how they view a potential digital tax.

After all, as the aforementioned Deloitte study shows, digital taxes do not do a good job of targeting the large tech companies that conservatives are upset with. Imposing digital taxes to punish social media companies might feel cathartic, but the impact would fall upon consumers and other businesses.

Legislators angry at tech censorship would be wise not to conflate the two issues. The legislative impact that state representatives wield is too far-reaching to indulge in tax policy as revenge for unrelated grievances.

Conclusion

Digital taxes may appear to state legislators to be a tempting source of revenue at a time where state revenue is at a premium. Yet revised budget estimates should temper any impulses to rush to institute new taxes, even for those states in a worse fiscal position than others. After all, a tax that primarily impacts small businesses and consumers should be avoided at all costs in the midst of a fragile economic recovery.

Even aside from being bad policy, any state digital tax legislation would have difficulty surviving constitutional tests. Though Maryland's legislature successfully overrode Governor Hogan's veto, it now likely faces a gauntlet of legal challenges under PITFA, the Commerce Clause, and the First Amendment.

State legislators concerned about their budget situations should look elsewhere to get back into the black. More than likely, efforts to impose digital taxes will create nothing but uncertainty for businesses and unproductive legal efforts for taxpayers to fund.

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