The Digital Advertising Tax: An Overstep by State Taxing Jurisdictions

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THE DIGITAL ADVERTISING TAX: AN OVERSTEP BY STATE TAXING JURISDICTIONS

ABSTRACT

In 2021, the Maryland Senate voted to override the governor’s veto to pass House Bill 732, marking the enactment of the first digital advertising tax in the United States. The tax imitated existing digital services taxes that have become popular internationally. Recognizing the need for a global solution, the OECD and the G20 formed the Inclusive Framework to ensure that countries receive their fair share of taxes without subjecting businesses to double taxation. Domestically, however, no such resolution has been reached, and several other states, inspired by Maryland’s initiative, followed suit by introducing their own versions of a digital advertising tax. This tax is levied based on the proportion of a business’s gross revenue derived from digital advertising, which Maryland defines as advertisement services delivered through a digital interface. Since the enactment of the tax, the Comptroller of Maryland has faced legal challenges, such as in Maryland state court, where several trade associations—including the United States Chamber of Commerce—filed suit, and in federal court, where Comcast entities did the same. This Note argues that laws like Maryland’s, attempting to impose digital advertising taxes, go beyond a state’s taxing authority and are unconstitutional under both the Supremacy Clause and the Commerce Clause.

INTRODUCTION

State and local taxing jurisdictions have struggled for years with budgetary demands.¹ This issue has been exacerbated by the COVID-19 pandemic, with projections of state budget shortfalls increasing.² State and local governments often look to taxation to meet their budgetary demands, with over 50 percent of their revenue coming from taxes.³ While many state and local governments already impose various types of taxes, increasing budgets force states to constantly seek new avenues for generating revenue.⁴

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³. In 2020, taxes constituted 51.4 percent of revenue for state and local governments. Moore et al., supra note 1.
⁴. Id.
However, state tax legislation often lags behind technological advancements.\textsuperscript{5} Many current state tax laws were written in an age when the primary business model was that of brick-and-mortar stores.\textsuperscript{6} Traditional income tax nexus rules in the United States are generally based on where an entity has a physical connection.\textsuperscript{7} However, in the modern digital economy, businesses can operate seamlessly across the United States and globally without maintaining a physical connection in each jurisdiction.\textsuperscript{8} Similarly, much of the traditional sales and use tax rules in the United States were written to tax the sale of tangible personal property.\textsuperscript{9} While many states have continuously updated their laws to address evolving areas, such as electronically delivered software and digital goods, technology continues to advance at a faster pace than state tax laws.\textsuperscript{10} As business and commerce advance, state and local taxing jurisdictions need to evolve with it to maintain revenues sufficient to meet their budgetary needs. One rapidly growing industry that jurisdictions have turned their attention to is digital advertising.\textsuperscript{11}

In response to the new digital economy, several European countries—including France, Italy, and the United Kingdom—have introduced a new tax known as the Digital Service Tax.\textsuperscript{12} The imposition of new digital service taxes by multiple countries garnered international attention, leading to the formation of the OECD/G20 Inclusive Framework on Base Erosion and Project Shifting (Inclusive Framework) by the Organisation for Economic Co-operation and Development (OECD) and the G20.\textsuperscript{13} The Inclusive


\textsuperscript{6} Id.

\textsuperscript{7} Young Ran (Christine) Kim, Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate, 72 ALA. L. REV. 131, 134 (2020).

\textsuperscript{8} Id.

\textsuperscript{9} Le, supra note 5.

\textsuperscript{10} Id.

\textsuperscript{11} Annual digital advertising revenue in the United States has grown from $31.7 billion in 2011 to $189.3 billion in 2021. Id.; INTERACTIVE ADVERTISING BUREAU & PwC, INTERNET ADVERTISING REVENUE REPORT FULL-YEAR 2021 RESULTS 13 (2022).

\textsuperscript{12} It is important to note here that the United States government strongly opposed the imposition of such taxes by European countries. It felt these taxes would be discriminatory against the many large tech companies that find their homes in the United States. In response to France’s enactment of the Digital Services Tax, the United States government announced tariffs of up to 25 percent on goods imported from France. Kim, supra note 7, at 135.

\textsuperscript{13} The OECD is an international organization consisting of thirty-eight member countries that works to advise on international standards for the global economy. The member organizations include the United States, the United Kingdom, France, Germany, Spain, Australia, Korea, Israel, Italy, Japan, and Canada, among others. About, OECD, https://www.oecd.org/about/ (last visited Feb. 28, 2024). “The Group of Twenty (G20) is the premier forum for international economic cooperation. It plays an important role in shaping and strengthening global architecture and governance on all major international economic issues.” It is comprised of the European Union and the African Union along, with Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey,
Framework aims to introduce a consensus-based solution that allows market countries—where the consumers of the digital economy are located—to receive their fair share of tax revenues without subjecting businesses to double taxation.\textsuperscript{14} In 2020, the Inclusive Framework issued a report containing a two-pillar proposal.\textsuperscript{15} Pillar One of the report focuses on resolving nexus issues and allocating profits among different taxing jurisdictions, while Pillar Two focuses on implementing a global minimum tax.\textsuperscript{16}

Several states, led by Maryland, have attempted to follow the lead of European countries and introduce their own tax on digital advertising services.\textsuperscript{17} In February 2021, the Maryland state legislature voted to override a veto by the governor, effectively enacting the first Digital Advertising Services Tax (DAST) in the United States.\textsuperscript{18} Maryland’s DAST imposes a tax, ranging from 2.5 percent to 10 percent, on the annual gross revenue a person or business derives from digital advertising services in Maryland.\textsuperscript{19} The state defines digital advertising services as “advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services.”\textsuperscript{20} It is also important to note that the tax rate differs based on an entity’s global annual revenue rather than its state or even national annual revenue.\textsuperscript{21} If an entity’s global annual revenue is between $100 million and $1 billion, the tax rate is 2.5 percent; if between $1 billion and $5 billion, the tax rate is 5 percent; if between $5 billion and $15 billion, the tax rate is 7.5 percent; and if global annual revenue exceeds $14 billion, the tax rate is 10 percent.\textsuperscript{22}

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\textsuperscript{14} Tax Challenges from Digitalisation, supra note 13.

\textsuperscript{15} Id.

\textsuperscript{16} Id.

\textsuperscript{17} Andrew Appleby, \textit{Subnational Digital Services Taxation}, 81 Md. L. REV. 1, 6 (2021).


\textsuperscript{19} MD. CODE ANN., TAX-GEN. §§ 7.5-103, 102 (West 2021).

\textsuperscript{20} Id. § 7.5-101(c)(1).

\textsuperscript{21} Id. § 7.5-103.

\textsuperscript{22} The tax rate increases in proportion to revenue derived from interstate or foreign commerce that occurs outside of Maryland, potentially giving rise to concerns related to the Commerce Clause. Id.
After Maryland’s law was enacted, other state legislatures began to consider imposing a similar type of tax. Several jurisdictions, including New York, Nebraska, West Virginia, Washington, and the District of Columbia, have followed Maryland’s lead and introduced similar bills. However, the progress of these bills is likely to be stalled until the legal challenges surrounding Maryland’s law are resolved.

Maryland’s DAST is currently facing two separate legal challenges. In the first case, originally filed in the United States District Court for the District of Maryland, four trade associations, including the Chamber of Commerce of the United States, the Internet Association, NetChoice, and the Computer & Communications Industry Association, brought suit against the Comptroller of Maryland, Peter Franchot. In the second case, filed in Maryland state court, several Comcast entities sued the Comptroller of Maryland. Both groups of plaintiffs argue that the Maryland DAST violates the Permanent Internet Tax Freedom Act (PITFA) and the Commerce Clause of the United States Constitution.

The PITFA prohibits state and local governments from imposing any taxes on internet access or any discriminatory taxes on electronic commerce. The plaintiffs in both cases present compelling arguments that the tax is discriminatory under the PITFA. While Maryland’s DAST imposes a gross receipts tax on digital advertising, Maryland does not place a transaction or gross receipts tax on traditional advertising. This alone may be enough for courts to rule that Maryland’s DAST is preempted by the PITFA and fails under the Supremacy Clause of the United States Constitution.

The plaintiffs in both cases also argue that Maryland’s DAST violates the Commerce Clause, which prohibits states from enacting laws that discriminate against interstate commerce. Under the Commerce Clause, taxes imposed by state and local governments must be fairly apportioned to the business’s in-state activities and sufficiently related to the benefits


24. Id.


31. See U.S. CONST. art. VI, § 2.

32. Walczak, supra note 18.
provided by the state to the business on which the tax is imposed. First, the plaintiffs in both cases argue that, under the Commerce Clause, the law is unconstitutional because the tax rate is based on global annual gross revenues rather than only Maryland activity. This poses an obvious issue as Maryland imposes an increased tax rate based on activity in interstate and foreign commerce.

Second, the plaintiffs contend that the current law creates a high risk of double taxation due to sourcing issues. To source where each transaction occurs, the state aims to determine the location at which each individual views or accesses a digital advertisement. However, this approach requires the business to rely heavily on internet protocol (IP) addresses or geolocation data from each device, which is generally considered unreliable for consistently pinpointing a device’s precise location. Due to these limitations, the Comptroller’s regulations provide that when a device cannot be located, such devices are excluded from the denominator in the apportionment formula. This is problematic because it increases a business’ apportionment of the DAST to Maryland, but if other states impose a similar tax, it could lead to a disproportionately large share of the tax revenue going to Maryland.

The plaintiffs’ third argument is that the law may violate the Foreign Commerce Clause, which prohibits states from “prevent[ing] the federal government from speaking with one voice when regulating commercial relations with foreign governments.” The United States has previously opposed similar taxes levied by European countries. For example, in response to France implementing a law similar to Maryland’s DAST, the United States imposed substantial tariffs on French imports. Thus, if a state were to enact a similar law, potentially subjecting European businesses to such taxation, it would likely contradict the United States government’s efforts to prevent the imposition of such taxes by European countries.

The Maryland law attempting to impose a DAST, and others like it, go beyond the state’s taxing authority and are unconstitutional, as the law fails under both the Supremacy Clause and the Commerce Clause. State and local governments must instead defer to the federal government’s efforts to

34. Karpchuk et al., supra note 30.
36. Id.
37. Id.
38. Id.
39. Id.
40. Karpchuck et al., supra note 30.
41. Id.
42. Id.
43. See id.
implement a tax that captures the digital economy and aligns with the international community. Part I of this Note is an overview of the background that created the state’s desires for taxing digital advertising. Part II details the current proposals and enacted laws regarding digital advertising tax in the United States. Part III critiques these proposals and laws by considering ongoing legal challenges. Part IV then argues that state and local governments should defer to the federal government’s efforts to align with the international community in implementing a tax that captures the digital economy.

I. BACKGROUND: STATES’ INTEREST IN DIGITAL ADVERTISING TAXATION

A. STATE BUDGET DEMANDS

In 2020, The COVID-19 Pandemic exacerbated what has long been a battle for states: meeting their budgetary demands.\(^4^4\) The recession brought on by the pandemic led the Center on Budget and Policy Priorities to estimate aggregate state budget shortfalls as high as $555 billion from 2020 to 2022.\(^4^5\) These projections are especially concerning considering the significant federal financial aid provided to states in 2020, which has since decreased.\(^4^6\) This is in addition to the combined debt of state and local governments, which exceeded $3.3 trillion in 2020.\(^4^7\)

When states need to raise revenue, they often look to taxation for a solution.\(^4^8\) State and local government revenue from taxes accounted for 51.4 percent of their revenue in 2020.\(^4^9\) Of this amount, sales and use taxes and gross receipts taxes accounted for the highest portion at 35 percent of all tax revenue for state and local governments in 2020.\(^5^0\)

State and local governments continuously strive to modernize their existing tax laws to expand their tax base and adapt to technological advancements.\(^5^1\) Maryland, for instance, did not impose a sales or use tax on digital products or digital goods until March 2021.\(^5^2\) Through House Bill 791 and Senate Bill 723, Maryland began taxing many digital products, including

\(^{44}\) McNichol & Leachman, supra note 2.
\(^{45}\) Id.
\(^{46}\) Id.
\(^{47}\) Moore et al., supra note 1.
\(^{48}\) Id.
\(^{49}\) The remaining 48.6 percent of revenue in 2020 was made up of 25.1 percent in federal support, 16 percent for charges, and 7.5 percent of other. Id.
\(^{50}\) Property taxes came in second at 32.2 percent, individual income tax made up 22.8 percent, and other taxes made up the remaining 10 percent. Id.
\(^{51}\) Id. supra note 5.
\(^{52}\) COMPTROLLER OF MARYLAND, MARYLAND BUSINESS TAX TIP #29 SALES OF DIGITAL PRODUCTS AND DIGITAL CODES (2022).
software, cloud services, and digital books.\footnote{Id.} Maryland’s move to tax digital products aligns with the approach adopted by many other states as they seek to capture the digital economy within their tax base.\footnote{Ie, supra note 5.} Many states updated their sales and use tax laws to include software or updated their regulations to capture software within their initial statutes.\footnote{Id.} Additionally, with the growing popularity of software-as-a-service (SaaS), or cloud computing, many states have made further revisions to their tax laws to capture SaaS in their tax base or, alternatively, tried to capture it under their current software statutes and regulations.\footnote{Id.}

Maryland’s approach to capturing digital advertising revenue by creating a new DAST, rather than including additional taxes in a sales and use tax or income tax, is a novel approach at the state level.\footnote{See id. at 7.} Distinguishable from past approaches by states to add new business models or revenue streams to current tax frameworks, Maryland attempted to create an entirely new tax framework focused specifically on one business model: digital advertising.\footnote{INTERACTIVE ADVERTISING BUREAU & PWC, supra note 11, at 1.}

## B. DIGITAL ADVERTISING

Perhaps the largest beneficiary of the growing digital economy has been the digital advertising industry.\footnote{INTERACTIVE ADVERTISING BUREAU & PWC, supra note 11, at 1.} Amazon.com, Inc., defines digital advertising as “marketing through online channels, such as websites, streaming content, and more. Digital ads span media formats, including text, image, audio, and video.”\footnote{What is Digital Advertising? A Beginner’s Guide, AMAZONADS (2022), https://advertising.amazon.com/library/guides/what-is-digital-advertising.} Digital advertising represents a much newer form of advertising than traditional methods such as newspapers, magazines, radio broadcasts, and television commercials.\footnote{Id.} In 2021, digital advertising revenues in the United States sustained a 35.4 percent year-over-year growth, equating to a nearly $50 billion increase, raising total revenue to $189 billion.\footnote{Id.} This surge in revenue reflects the ongoing trend of rapid expansion within the digital advertising industry, considering that it generated only $7.2 billion in revenue in 2003 and $36.5 billion in 2012.\footnote{Id.}

According to a study by the Interactive Advertising Bureau (IAB), the internet economy has expanded seven times faster than the broader United States economy over the past four years.\footnote{"In 2020 alone, [the internet economy] contributed $2.45 trillion to the United States’ $21.18 trillion GDP. Since IAB began measuring the economic impact of the internet in 2008, the internet’s..."} The study also found that the
internet economy accounts for 12 percent of the United States’ gross domestic product (GDP). Further, in 2020, the five Big Tech companies—Alphabet, Amazon, Apple, Facebook, and Microsoft—were the five largest companies in the United States by market value. The digital advertising industry represents a vast source of revenue in the United States, and evidently, certain states feel as if the current laws do not tax them appropriately.

C. INTERNATIONAL DIGITAL SERVICES TAXES

The growth of the digital advertising industry is not limited to the United States. Other countries around the world have the same concerns as state and local taxing jurisdictions in the United States: Digital advertising is a considerable source of revenue that taxing jurisdictions are not realizing due to insufficient taxation laws. Several authoritative international bodies, including the European Union (EU), the OECD, and the G20, have gathered to develop a solution to the issue.

The EU introduced its first proposal in 2018 with the digital permanent establishment proposal, where it attempted to capture nexus in a state by considering a significant digital presence, similar to a physical presence. The proposal considered a “digital permanent establishment” to be fulfilled by: “(1) annual revenues from supplying digital services in a member state exceeding €7 million; (2) having more than 100,000 users in a member state in a taxable year; and (3) business contracts for digital services created between the company and business users exceeding 3,000 in a taxable year.” However, the EU’s second proposal was the origin of the digital services taxes. This proposal attempted to create one common digital services tax across the EU and impose a tax on digital advertising targeted at users in each member state. The proposal set a 3 percent tax rate on digital advertising and only applied to companies with global revenues in excess of €750 million, and of that, €50 million in the EU. However, this proposal was eventually rejected by the EU member states.

65. Id.
66. Appleby, supra note 17, at 3.
67. Id.
68. Kim, supra note 7, at 135.
69. Id. at 136.
70. Id. at 146.
71. Id.
72. Id.
73. Kim, supra note 7, at 146.
74. Id.
Following the EU’s rejection of the digital services tax proposal, several countries focused on implementing their own versions of the tax. For example, in 2020, the United Kingdom enacted a digital services tax that closely followed the EU’s second proposal with slight changes. The tax applies a 2 percent tax rate instead of the 3 percent tax rate suggested in the proposal and a 0 percent tax rate for companies with a net loss instead of profit. Further, the tax is only imposed on companies with global revenues of at least £500 million, with at least £25 million in the United Kingdom.

France has also passed its own version of the digital services tax. France’s digital services tax followed the EU proposal with a 3 percent tax rate and the same global annual revenue threshold of €750 million. The French law also included a provision that the tax would be applied retroactively to January 1, 2019, when the law was not passed until July 24, 2019.

Recognizing the need for a global solution, the OECD and the G20 created the Inclusive Framework, which includes over 130 countries. The Inclusive Framework was formed to ensure that countries around the world receive their fair share of taxation from profits earned in their jurisdiction without subjecting businesses to double taxation and restraining economic growth. To achieve this goal, the Inclusive Framework rejects the digital services tax framework and instead attempts to restructure the existing income tax framework. Additionally, the Inclusive Framework states that one of the most important features of any global solution is a “Unified Approach,” consisting of a commitment to enacting the solution and repealing any laws against it. In October 2020, the Inclusive Framework released a two-pillar proposal, Pillar One and Pillar Two, forming the basis for the global solution to the issues arising from the digital economy.

Pillar One is designed to focus on developing new nexus and profit allocation rules, replacing the traditional physical-presence-based allocation

75. Id. at 147.
76. Id.
77. Id. at 147–48.
78. Kim, supra note 7, at 148.
79. In addition to the countries mentioned, Italy, Spain, Czech Republic, Belgium, Austria, Hungary, and Poland have either proposed or implemented variations of the Digital Services Tax, following the second EU proposal. Id. at 148–49.
80. Id.
81. Id.
82. Tax Challenges from Digitalisation, supra note 13, at 13.
83. Id. at 8.
84. Id.
86. Tax Challenges from Digitalisation, supra note 13, at 4.
Rather than relying on physical presence, the Inclusive Framework sets out to determine nexus—or taxable presence, in other words—based on the markets in which an entity has a “significant and sustained” participation or presence. To achieve this goal, the Inclusive Framework provides “activity tests” and “threshold tests” to determine whether a business is within the tax’s scope.

First, the Inclusive Framework creates two activity tests to determine whether a business is engaged in automated digital services (ADS) or is a consumer-facing business (CFB) that would be the target of the new tax framework. The first activity test offers a general definition, accompanied by both a positive list of services falling under ADS and a negative list of excluded services. This approach seeks to provide businesses with compliance certainty while allowing taxing authorities to update the lists to adapt to evolving technologies. The second activity test defines CFBs as businesses “that generate revenue from the sale of goods and services of a type commonly sold to consumers, including those selling indirectly through intermediaries and by way of franchising and licensing.”

Once an entity is determined to meet the criteria outlined in the activity tests, it is then subjected to threshold tests. The first threshold test assesses the entity’s global gross annual revenue, with the Inclusive Framework suggesting a threshold of €750 million without specifying an exact amount. The second threshold test examines the entity’s foreign revenue. This test creates a threshold for how much revenue an entity generates in countries

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87. Id. at 3.
88. Id. at 13.
89. Id. at 21–22.
90. Id. at 11.
91. The general definition for an ADS includes:
   one where: the service is on the positive list; or the service is automated (i.e., once the system is set up the provision of the service to a particular user requires minimal human involvement on the part of the service provider); and digital (i.e., provided over the Internet or an electronic network); and it is not on the negative list.

Tax Challenges from Digitalisation, supra note 13 at 23. “The positive list currently contains the following nine categories of services. Online advertising services; Sale or other alienation of user data; Online search engines; Social media platforms; Online intermediation platforms; Digital content services; Online gaming; Standardized online teaching services; and Cloud computing services.” Id. at 24. On the other hand, the proposed negative list comprises five categories of services: “Customized professional services; Customized online teaching services; Online sale of goods and services other than ADS; Revenue from the sale of a physical good, irrespective of network connectivity (‘Internet of things’); and Services providing access to the Internet or another electronic network.” Id. at 32.
92. Id. at 23.
93. Id. at 58.
94. Id.
95. Id.
96. Id.
other than the one in which it is headquartered.\textsuperscript{97} The logic behind this test is
that if an entity’s global gross revenue is substantial, but its foreign revenue is
relatively low, it may not warrant taxation.\textsuperscript{98} Entities that satisfy both
activity tests and both threshold tests are then subjected to the Inclusive
Framework’s profit allocation methodology.\textsuperscript{99}

Pillar One of the Inclusive Framework outlines the revenue sourcing and
profit allocation methods.\textsuperscript{100} The Inclusive Framework provides a three-step
calculation method, where the first two steps provide a formula to calculate
an entity’s tax base, established using its pre-tax profits.\textsuperscript{101} The third step
involves using the Inclusive Framework’s profit allocation key, which is a
detailed set of revenue-sourcing rules.\textsuperscript{102} Each activity listed under the
positive list of ADS activities includes a revenue-sourcing method, along
with a hierarchy of indicators that should be used to source the revenue.\textsuperscript{103}
For example, for revenue from online advertising services, the Inclusive
Framework provides that the revenue should be sourced based on the “real-
time location of the viewer of the advertisement.”\textsuperscript{104} The real-time location
is determined using the geolocation of the viewer’s device.\textsuperscript{105} If the
geolocation data is unavailable, the location will be determined using the
device’s IP address.\textsuperscript{106} In the event that neither geolocation nor IP address
data is available, revenue sourcing will rely on any other accessible
information that can ascertain the viewer’s location.\textsuperscript{107} These revenue-
sourcing methodologies can be applied uniformly across different entities
and taxing jurisdictions.\textsuperscript{108}

While Pillar One focuses on nexus and profit allocation to ensure each
jurisdiction receives its fair share, Pillar Two focuses on creating a global
minimum tax to ensure the world’s largest companies contribute their fair
share of taxes.\textsuperscript{109} The Inclusive Framework states four adjacent goals: “(i)
ensure minimum taxation while avoiding double taxation or taxation where
there is no economic profit, (ii) cope with different tax system designs by
jurisdictions as well as different operating models by businesses, (iii) ensure
transparency and a level playing field, and (iv) minimize administrative and
compliance costs.”\textsuperscript{110} To achieve these objectives, Pillar Two introduces

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{97} Tax Challenges from Digitalisation, supra note 13, at 58.
\item\textsuperscript{98} Id. at 59.
\item\textsuperscript{99} Id.
\item\textsuperscript{100} Id. at 120.
\item\textsuperscript{101} Id.
\item\textsuperscript{102} Id.
\item\textsuperscript{103} Tax Challenges from Digitalisation, supra note 13, at 120.
\item\textsuperscript{104} Id. at 72.
\item\textsuperscript{105} Id.
\item\textsuperscript{106} Id. at 73.
\item\textsuperscript{107} Id.
\item\textsuperscript{108} Id.
\item\textsuperscript{109} Tax Challenges from Digitalisation, supra note 13, at 7.
\item\textsuperscript{110} Id. at 14.
\end{itemize}
\end{footnotesize}
three rules: (1) the income inclusion rule (IIR); (2) the undertaxed payments rule (UTPR); and (3) the subject-to-tax rule (STTR). Overall, the Inclusive Framework offers a novel approach to a global issue and provides a more practical and uniform taxing structure than current digital services taxes.

II. EXISTING LAWS & PROPOSALS

In 2021, the Maryland Senate voted to override the governor’s veto to pass House Bill 732, resulting in the enactment of the first digital advertising tax in the United States. Several state governments followed suit, introducing their own legislation to generate tax revenue from digital advertising. New York and the District of Columbia have attempted to imitate Maryland’s law by also introducing a new tax, while Nebraska has taken a different approach by trying to include digital advertising under their already existing sales tax.

The Maryland DAST imposes a tax on the annual gross revenue generated by an entity or person from digital advertising services within the state of Maryland. The statute defines “digital advertising services” as “advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services.” The tax rate differs based on an entity’s global annual revenue rather than annual revenue within the state or even within the United States. The tax rates are tiered as follows: for entities with global annual revenues exceeding $100 million but less than $1 billion, the tax rate is set at 2.5 percent; for those with global annual revenues between $1 billion and $5 billion, the tax rate is set at 5 percent; for entities falling within the $5 billion to $15 billion range, the tax rate is set at 7.5 percent; and if an entity’s global annual revenues surpass $15 billion, the tax rate is set at 10 percent.

111. The IIR imposes a “top-up” tax—an increase in tax to the minimum tax rate—in jurisdictions where a company has a smaller entity with an effective tax rate below the agreed minimum tax rate. Id. The UTPR acts as a complementary rule to the IIR. Whereas the IIR applies a top-up tax to a company’s subsidiaries in foreign countries where the effective tax rate is below the minimum tax rate, the UTPR applies the top-up tax when the effective tax rate in the country where the company is headquartered is below the minimum tax rate. Id. The STTR complements both the IIR and UTPR by focusing on the issues caused by existing treaties. It ensures that countries with existing income tax treaties, which might otherwise limit their ability to receive their share of a top-up tax, can still collect their fair share. Id.
112. Id.
113. Walczak, supra note 18.
114. Le, supra note 5.
115. Id.
116. MD. CODE ANN., TAX-GEN. § 7.5-102(a) (West 2021).
117. The statute also explicitly excludes “advertisement services on digital interfaces owned or operated by or operated on behalf of a broadcast entity or news media entity.” Id. § 7.5-101(e)(1).
118. Id. § 7.5-103.
119. Id.
The statute also contains an apportionment fraction to determine the amount of digital advertising revenue allocable to Maryland. In the apportionment fraction, the numerator is the entity’s annual gross revenue derived from digital advertising services in Maryland, and the denominator is the annual gross revenue derived from digital advertising services in the United States. Additionally, the statute grants the Comptroller of Maryland the authority to augment Maryland’s regulations with sourcing rules, which play a pivotal role in determining the origin of sales and whether a particular source of revenue qualifies as “derived from digital advertising services in the State.”

Maryland’s regulations provide that digital advertising services are derived in Maryland when “any portion” of the digital advertising service is accessed from a device located in Maryland. To determine a device’s location, a company can use the information it believes is most reliable. This may include IP addresses, geolocation data, device registration information, or any other data available data to determine the location.

The regulations lay out the apportionment methodology in more detail than the statutes and make it so that correctly sourcing the revenue is essential for a company to avoid double taxation and ensure its tax liability is accurate. The apportionment factor is calculated using the number of devices that accessed digital advertising services within Maryland as the numerator and the number of devices that accessed digital advertising services worldwide as the denominator. However, if the company cannot determine the location of a device, that particular device is excluded from the denominator.

To illustrate using a simple example, suppose the following are true:

1. *Company A* derived $100 in gross revenue from digital advertising services.

2. A total of 100 devices accessed *Company A’s* digital advertising services.

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120. *Id.* § 7.5-102(b).
121. *Id.*
122. *Id.* § 7.5-102(a); § 7.5-102(b)(2).
123. Md. Code Regs. 03.12.01.02(A) (2021).
124. *Id.* 03.12.01.02(C)(2).
125. *Id.* 03.12.01.02(C)(3); This sourcing method allows the company to determine the most reliable method of sourcing, which differs from the Inclusive Framework’s sourcing methodology of providing a hierarchy of reliable sourcing methods. *Tax Challenges from Digitalisation, supra* note 13, at 73.
126. Md. Code Regs. 03.12.01.02(B) (2021).
127. *Id.* This marks a significant departure from the apportionment fraction outlined in the statutes. Under the statutes, the denominator is defined as the number of devices that accessed digital advertising services in the United States. This error by the Comptroller of Maryland is confusing and avoidable, potentially adding unnecessary complexity to tax law compliance.
128. *Id.*
3. Twenty of the 100 devices that accessed Company A’s digital advertising services are located in Maryland.

Under these facts, the apportionment would be calculated as:

\[ \text{Apportionment} = \$100 \times (20/100) = \$20.129 \]

Now, suppose the previous facts remain true, but the locations of twenty of the 100 devices are unidentifiable. The denominator would then be reduced to eighty, and the apportionment would be calculated as:

\[ \text{Apportionment} = \$100 \times (20/80) = \$25.130 \]

On a much larger scale, one can see how uncertainties in device location can lead to significant differences in the tax base and overall tax liability for companies subject to the DAST, especially given that the minimum global annual gross revenue to be subject to the tax is $100 million.131

The New York Senate has attempted to imitate the Maryland law by proposing the Digital Ad Tax Act.132 The proposal includes many of the same stipulations, such as definitions, rate structure, and thresholds.133 However, a significant distinction lies in how the New York proposal defines revenue derived from digital advertising services—specifically, it applies only when a company collects or uses personal information about the users accessing the digital advertisements.134 Other states, such as Connecticut, Montana, Texas, and Washington, have also endeavored to imitate Maryland’s law.135

III. LEGAL CHALLENGES

Shortly after enacting the DAST, Maryland was met with two separate legal challenges: one in state court and another in federal court.136 In state

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129. Id.
130. Id.
131. Id.; MD. CODE ANN., TAX-GEN. § 7.5-103 (West 2021).
133. Id.
134. The statute includes the same definition of “Digital Advertising Services,” but the New York proposal extends the definition by adding the phrase the phrase: “that use personal information about the people the ads are being served to.” Id.
court, Maryland was challenged by Verizon and Comcast in Comcast of California Maryland Pennsylvania Virginia West Virginia LLC et al. v. Comptroller of The Treasury of Maryland and in federal court by the United States Chamber of Commerce and other internet trade associations in Chamber of Commerce of the United States of America et al. v. Peter Franchot et al. On October 17, 2022, the state court in Comcast granted summary judgment via an oral bench ruling in favor of the plaintiffs, striking down Maryland’s DAST. The court reasoned that the DAST violated the PITFA because it discriminates against online advertising while not taxing traditional advertising, and the DAST violates the United States Constitution under both the Commerce Clause and the First Amendment. Less than two months later, on December 2, 2022, the District Court in Franchot held that the constitutional issues decided in Comcast rendered the issues in the federal case moot and dismissed the remaining issues.

However, on May 5, 2023, the state court’s ruling in Comcast and the legal status of the DAST was again thrown into flux following a successful appeal by the Maryland Comptroller in the Supreme Court of Maryland. The court held that the plaintiffs failed to exhaust all available administrative remedies with respect to their challenge of the DAST and remanded the case back to the state trial court with directions to dismiss the action. Importantly, this decision was not based on the legal merits of the DAST, leaving the door open for further litigation.

A. SUPREMACY CLAUSE – PERMANENT INTERNET TAX FREEDOM ACT

The Supremacy Clause in the United States Constitution dictates that a federal statute will preempt any state law where Congress has expressly preempted the state law. With the growth of the internet in the late 1990s, the United States government became concerned that excessive state and local taxes may stymie progress. In 1998, Congress passed the Internet Tax

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137. The plaintiffs in the federal case include the Chamber of Commerce of the United States, the Internet Association, NetChoice, and the Computer & Communications Industry Association. Franchot, 595 F. Supp.3d at 423; Comcast, 2022 WL 20359237, at *1.
142. Id. at *12.
143. Id. at *1.
144. U.S. CONST. art. VI, cl. 2.
Freedom Act, which became permanent in 2016.\textsuperscript{146} Both lawsuits brought against Maryland argued that the PITFA preempted Maryland’s DAST.\textsuperscript{147}

The PITFA prohibits state and local jurisdictions from imposing “taxes on Internet access” and “multiple or discriminatory taxes on electronic commerce.”\textsuperscript{148} Here, the relevant piece of this law is the prohibition of “discriminatory taxes,” which is defined as a tax “on electronic commerce that . . . is not generally imposed and legally collectible at the same rate by such State or political subdivision on transactions involving similar property, goods, services, or information accomplished through other means.”\textsuperscript{149}

Courts have held that where state and local jurisdictions have imposed taxes based on online or electronic activities and did not impose the tax on the same activities when offline, the law violated the PITFA.\textsuperscript{150} In Performance Marketing Association, Inc. v. Hamer, Illinois attempted to impose sales and use tax collection and remittance requirements on companies that advertised via websites but exempted companies that advertised via traditional means.\textsuperscript{151} For instance, if a company paid to have a link on an Illinois company’s website, Illinois would enforce a sales and use tax collection and remittance requirement, but there would be no such requirement if the company advertised in an Illinois newspaper or on an Illinois radio broadcast.\textsuperscript{152} The court held that this disparate treatment constituted a discriminatory tax under the PITFA and, therefore, was expressly preempted by the PITFA.\textsuperscript{153}

Here, the Maryland DAST violates the PITFA. Analogous to Performance Marketing, where a state imposes a tax collection requirement on companies engaged in online advertising but not companies engaged in traditional advertising, Maryland’s DAST imposes a tax on companies engaged in digital advertising services but not on companies engaged in traditional advertising services. For example, under the DAST, if a car dealership decided to advertise its cars both on a website and in a Maryland newspaper, the website would have to pay tax on the revenue received from the car dealership, while the Maryland newspaper would not, despite the revenue coming from advertising in both scenarios. In Comcast, the court

\begin{itemize}
\item \textsuperscript{146} Id. at 7.
\item \textsuperscript{147} Chamber of Com. of the U.S. v. Franchot, 595 F.Supp.3d 423, 427 (D. Md. 2022); Comcast, 2022 WL 20359237, at *1.
\item \textsuperscript{148} Permanent Internet Tax Freedom Act, 47 U.S.C. § 151 note sec. 1101(a) (2016).
\item \textsuperscript{149} 47 U.S.C. § 151 note sec. 1105(2).
\item \textsuperscript{150} Performance Mktg. Ass’n, Inc. v. Hamer, 998 N.E.2d 54, 59–60 (Ill. 2013).
\item \textsuperscript{151} Id. at 56. States have the legal authority to impose sales and use tax collection requirements based on substantial nexus or a substantial presence. At the time Performance Marketing was decided, Quill was the precedent law. Quill generally required a company to have a physical presence to have substantial nexus. However, Quill has since been overturned by the Supreme Court in Wayfair. Quill Corp. v. North Dakota, 504 U.S. 298 (1992); South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2099 (2018).
\item \textsuperscript{152} Performance Mktg., 998 N.E.2d at 58.
\item \textsuperscript{153} Id. at 59–60.
\end{itemize}
correctly held that the DAST is discriminatory because it applies to digital advertising services, while no similar tax is imposed on traditional advertising services.154

B. COMMERCE CLAUSE

The United States Constitution grants Congress the power to regulate interstate commerce in a clause generally known as the Commerce Clause.155 The Commerce Clause is a central component in addressing the legality of state and local taxes.156 States are allowed to tax interstate commerce, but they are not allowed to interfere with interstate commerce.157 In Complete Auto Transit, Inc. v. Brady, the Supreme Court established a four-prong test to determine whether a tax violates the Commerce Clause.158 The Court will hold a tax is valid if it “(1) applies to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the State provides.”159

In 1992, to interpret these four prongs, the Supreme Court in Quill Corp. v. North Dakota announced a “physical presence” rule, which required a company to have a physical presence in a state to have a substantial nexus for sales tax collection and remittance requirements in that state.160 However, the physical presence standard was overturned in 2018 by the Court’s decision in South Dakota v. Wayfair, Inc.161 In Wayfair, South Dakota set out to challenge the physical presence standard established in Quill and passed legislation proclaiming that companies had substantial nexus in South Dakota if their annual sales in the state exceeded $100,000 or if they conducted 200 or more separate and distinct transactions in the state.162 South Dakota then assessed tax due on an online furniture company with the intention that it would be challenged in court.163 The Court held that the physical presence standard was outdated and effectively replaced the standard with an economic presence or economic nexus standard.164 The Court reasoned that

154. Simonetti et al., supra note 139.
155. U.S. CONST. art. I, § 8, cl. 3.
158. Id. at 279.
159. Wayfair, 138 S. Ct. at 2091 (citing Brady, 430 U.S. at 279 (1977)).
161. Wayfair, 138 S. Ct. at 2099.
162. Id. at 2089.
163. Id.
164. Since Wayfair was decided, forty-six states, the District of Columbia, and Puerto Rico have passed legislation that enacts an economic nexus standard. Many of these jurisdictions followed the model set by South Dakota, adopting the same thresholds of $100,000 or more in sales revenue or 200 or more separate and distinct transactions within their state. Other states have varied slightly by setting higher sales thresholds or eliminating the transaction threshold altogether. However, all states with economic nexus legislation have implemented some form of de minimis thresholds. Id.
the question under the first prong of Complete Auto relies on whether a company has “availed itself of the substantial privilege of carrying on business” in a state and that the quantity of the de minimis thresholds of $100,000 in sales or 200 or more transactions assures that a company will have availed itself of that substantial privilege.165

However, Maryland’s DAST requirements for who must file are distinct from the economic nexus thresholds used by other states. While Maryland’s DAST is only imposed on gross revenues from digital advertising services derived in Maryland, it requires all businesses with more than $100 million in annual digital advertising services revenues to pay the tax, regardless of the revenues they derive in Maryland.166 Furthermore, the DAST rate varies based on both in-state and out-of-state gross revenues.167 This is distinguishable from the various states’ economic nexus statutes and regulations that impose a sales tax collection and remittance requirement based on sales only in their own state.168

The plaintiff’s complaint in Franchot provides an enlightening example of why this tax structure can be burdensome to companies due to commerce outside of Maryland.169 The example uses Maryland’s 8.25 percent flat rate corporate income tax to contrast the taxes, stating:

[A] global company with $15 billion in revenue and $1 billion in profits, with 2% of its revenues and profits apportioned to Maryland, would pay a corporate income tax of $1.65 million on $20 million of Maryland-originated pre-tax profit.

If all of the revenues . . . were derived from digital advertising, the company would be liable for an additional $30 million under the Act—10% of 2% of $15 billion. That is nearly 20 times the rate of the corporate income tax. And it would more than wipe out the $20 million in profits attributable to the company’s economic activity in Maryland.170

This example highlights the burden Maryland’s DAST would impose on companies, which is caused by activities occurring almost entirely outside of Maryland. The court in Comcast agreed, holding that Maryland’s DAST was unconstitutional due to the tax rate increasing due to out-of-state activities.171

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165. Wayfair, 138 S. Ct. at 2099.
167. Id.
168. Economic Nexus State by State Chart, supra note 164.
171. Simonetti et al., supra note 139.
C. FOREIGN COMMERCE CLAUSE

Another potential legal issue of Maryland’s DAST arises from the Foreign Commerce Clause. While the Foreign Commerce Clause is not as common in discussions surrounding the constitutionality of state and local taxation, the Supreme Court has held that state and local jurisdictions must not prevent the federal government from speaking with one voice when regulating commercial relations with foreign governments.172 Maryland drafted the DAST based on existing European digital advertising taxes.173 However, the United States government previously expressed its displeasure with those European taxes, even threatening to impose additional taxes and tariffs on the countries implementing such measures.174

For example, when France enacted its digital advertising tax, which included a component of retroactivity, United States government officials and trade representatives were angered.175 The United States government felt the companies primarily affected by the tax would be United States-based tech giants like Amazon, Apple, Meta, and Google.176 The Office of the United States Trade Representative responded to France’s tax by issuing a notice on an investigation into France’s digital services tax that declared the tax “unreasonable or discriminatory and burdens or restricts U.S. commerce.”177 The notice also stated that the United States Trade Representative recommended placing a 25 percent additional tariff on products imported from France.178 However, after a meeting between officials from each country, the United States agreed to hold off on the increase in tariffs while both countries await a global solution, likely from the Inclusive Framework.179

Maryland’s DAST could throw a wrench into the federal government’s plans. If the United States threatens to impose retaliatory taxes on French imports due to France’s DAST, it will likely anger the French government if

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173. Appleby, supra note 17.
175. Kim, supra note 7, at 149.
177. Id.
178. Id.
179. France Agrees to Delay New Tax on Tech Giants, supra note 176.
French companies are subject to a similar tax by an American state. In addition to the negotiations with French officials, the United States is also a member of the Inclusive Framework, which is working towards a unified approach to taxing digital advertising services. One way the Inclusive Framework hopes to achieve a unified approach is by having member countries repeal existing digital advertising taxes and refrain from imposing new ones. Maryland’s DAST and others like it from state and local jurisdictions may prevent the United States from being considered a serious contributor to the Inclusive Framework. Therefore, Maryland’s DAST is also unconstitutional under the Foreign Commerce Clause.

IV. SOLUTION

Considering Maryland’s legal challenges and constitutional issues with imposing the DAST, state and local jurisdictions should defer taxation of digital advertising services to the federal government. Maryland’s DAST will likely fail under both the Commerce Clause and the Supremacy Clause, and other states are closely watching the litigation to see how their proposals would fare in court. If state and local jurisdictions continue to attempt to implement digital advertising taxes, there will be a long road to litigating these issues.

Proper taxation of digital advertising services and the developing digital economy is an international issue rather than an issue limited to Maryland and other state and local jurisdictions. The Inclusive Framework—of which the United States is a member—is working toward a solution that addresses the concerns of the international community. The United States government must ensure it is a prominent voice in those discussions as the largest companies impacted by these taxes are based in the United States. Furthermore, the United States government must be able to contribute to these discussions with a clear policy and unified voice, both of which may be impeded by the imposition of digital advertising taxes at the state and local levels.

The balance between federal and state taxation is often a delicate issue, as seen from the bevy of cases relating to the Commerce Clause. State and

180. Statement by the OECD, supra note 85.
181. Id.
183. Tax Challenges from Digitalisation, supra note 13.
184. Id.
185. France Agrees to Delay New Tax on Tech Giants, supra note 176; Hamilton, supra note 176.
local jurisdictions are unlikely to be satisfied with deferring the taxation of a large part of the economy to the federal government. Therefore, a potential resolution could involve federal funding agreements, where 50 percent of revenue from any federal digital advertising tax is allocated to state governments. States are much more likely to be amenable to relinquishing their taxing authority if they are promised a piece of the pie. Currently, state and local governments receive approximately 25 percent of their revenue each year from the federal government, totaling $911 billion in 2020.187 This solution ensures equitable taxation of the global digital economy and mutually benefits federal, state, and local governments. Furthermore, this solution will avoid years of litigation and, along with it, avert uncertainty in the taxation of the digital economy.

CONCLUSION

Maryland’s law attempting to impose a DAST, and others like it, goes beyond the state’s taxing authority and is unconstitutional, as the law fails under both the Supremacy Clause and the Commerce Clause. Despite the successful appeal by the Maryland Comptroller, previous failures in both federal and state courts suggest that prolonged appeals are likely to meet the same constitutional challenges. Maryland should instead defer to the federal government’s ongoing efforts with the Inclusive Framework to develop a solution that ensures states receive their fair share of tax revenues from digital advertising services.

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187. Moore et al., supra note 1.

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