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Indirect Tax Alert

US states Maryland and Nebraska propose taxing revenues from digital advertising

Executive summary

In the first weeks of 2020, legislators in both Maryland and Nebraska introduced bills seeking to tax revenues from digital advertising. The Maryland bill proposes creating a new tax on digital advertising revenue, while the Nebraska bill would expand the scope of the state's sales tax to include gross receipts from digital advertising.

Such state action may mark the beginnings of legislative attempts in other states to expand the state taxation of digital revenue and may mimic similar actions taken by governments around the world, highlighted by the French digital services tax enacted in 2019.

Businesses should be aware of these developments and understand the direction and nuances of the two proposals. They raise an assortment of complex and novel federal and state constitutional and statutory questions that will have to be answered.

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Detailed discussion

Maryland's proposed bill

Maryland Senate Bill 2 (SB 2), introduced on 8 January 2020, would create a new state tax called the Digital Advertising Gross Revenues Tax (DAGRT). Under SB 2:

- The DAGRT would apply to a person's[1] annual gross revenues[2] (if the person has revenues of at least US$100 million[3]) from digital advertising services in Maryland.
- "Digital advertising services" would be defined 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."
- A progressive tax rate schedule would apply, ranging from 2.5% of the annual gross revenues derived from digital advertising services in Maryland (i.e., the assessable base) for persons with annual gross revenue of $100 million through $1 billion, and to 10% of the assessable base for persons with global annual gross revenues exceeding $15 billion.
- Persons that reasonably expect their annual gross revenues from digital advertising services in Maryland to exceed $1 million would be required to file a declaration of estimated tax, and then file a tax return on or before 15 April of the next year if the assessable base exceeds $1 million.
- Penalties consistent with existing Maryland tax law would be imposed for failure to file a return and for failure to pay the estimated tax.

If enacted as currently drafted, the DAGRT would apply to tax years beginning after 31 December 2020.

Nebraska's proposed bill

The Nebraska bill (LB 989) takes a different approach. Introduced on 14 January 2020, LB 989 would amend Nebraska's existing sales and use tax law by expanding the definition of taxable gross receipts to include retail sales of digital advertisements.[4] This provision would specifically define "digital advertisement" for these purposes to mean "an advertising message delivered over the Internet that markets or promotes a particular good, service, or political candidate or message."

This change, if enacted, would become effective 1 October 2020.

Implications

The states' proposals are novel in that they propose to tax the revenue earned by businesses engaging in the digital economy and depart from the recent trend of states seeking to expand their sales and use tax bases to include digital goods. If enacted as currently drafted, the Maryland and Nebraska proposals raise federal and state constitutional issues and other legal questions that would not arise from similar taxes enacted in non-US jurisdictions.

Arguments could be made that because these proposed taxes single out digital advertising, but not advertising in print or other media, they constitute discriminatory state taxation prohibited by the federal *Internet Tax Freedom Act*.[5]

Alternatively, because these taxes focus on content of speech (i.e., advertising, including the promotion of goods, services, or political candidates) they raise interesting questions as to whether they unconstitutionally regulate speech under the First Amendment to the United States (US) Constitution as well as similar provisions of state constitutions.

Considering US foreign trade issues challenging the enactment of similar taxes in Europe, most notably the French Digital Services Tax, such taxes may be challengeable under the dormant Foreign Commerce Clause because they undercut American foreign policy in dealing with trade disputes (arguably because these state taxes operate identically to digital service taxes other nations are enacting and to which the US has vigorously objected).

Moreover, these taxes appear to run counter to over a century of US state tax policy by imposing a tax on an intermediate good or service and not on end retail consumption, which has long been a hallmark of American state sales and use tax.

Lastly, Nebraska is a member of the Streamlined Sales and Use Tax Agreement (SSUTA), so its expansion of its sales tax to cover digital advertising would have to be made consistent with the SSUTA principles.

The taxation of digital services has received much attention by foreign nations as well. The European Union (EU) Member States have considered an EU proposal for a harmonized digital services tax as an interim measure until they can agree on coordinated international income tax reforms of the type currently being developed through a process led by the Organisation for Economic Co-operation and Development (OECD), in which 137 countries participate.

In the meantime, several European jurisdictions have already taken unilateral action by enacting similar taxes targeting digital services businesses. European implementation of a similar tax on digital services as those proposed in Maryland and Nebraska vary in scope and application thresholds. Digital services taxes adopted in France, Austria, and Italy were largely inspired by the long-discussed EU proposal and only tax persons with global revenues of at least €750 million and local revenues falling under the definition of their national digital service tax of at least €25 million (€5.5 million for Italy).

Maryland's proposal is similar to the French digital services tax in that it creates a new tax, while Nebraska's proposal is more akin to the digital services tax implemented in Austria by simply expanding an existing tax to cover digital advertising. Austria has long imposed its transactional taxes on print and television advertising, so the recent legislation on digital advertising can be thought of as simply expanding the scope of the existing tax to new means of providing advertising services. In contrast, the French tax raises a more interesting issue in that advertising services were generally not subject to such a tax, so the French digital service tax is viewed as a new tax focused solely on the digital economy. On the other hand, the scope of the French digital services tax appears to be much broader than that proposed in Maryland or Nebraska. The French tax taxes services provided to advertisers enabling them to purchase targeted advertising space on a digital interface, as well as taxing the supply, by electronic means, of a digital interface that allows users to contact and interact with other users, including for the delivery of goods or services between those users. (For more on the French tax, see EY Global Tax Alerts, *France's Parliamentary Commission agrees on Digital Services Tax*, dated 3 July 2019 and *French President signs bill on Digital Services Tax and partial freeze of corporate income tax rate decrease*, dated 25 July 2019 and for more on the Austrian tax, see EY Global Tax Alert, *Austrian Parliament approves digital advertising tax bill* , dated 18 October 2019).

The momentum in Europe and other countries to tax digital activity is increasing. In addition to France and Austria, Italy and Turkey have adopted digital services taxes (effective 1 January 2020, and 1 March 2020, respectively). (See EY Global Tax Alerts, *Italy approves 2020 Budget Law*, dated 9 January 2020 and *Turkey's 7.5% Digital Services Tax to be effective 1 March 2020*, dated 15 January 2020). Similar taxes are being considered in other countries, including the Czech Republic, Spain, and the United Kingdom, among others.

If digital services tax proposals gain momentum at the state level, the *Digital Goods and Services Fairness Act of 2019* (S.765) (*Digital Fairness Act*), reintroduced 13 March 2019 in the US Congress, could gain momentum or alternate legislation could be introduced. The *Digital Fairness Act* would prohibit states from imposing multiple or discriminatory taxes on "digital goods and services." A version of the *Digital Fairness Act* have been introduced several times in the past with limited traction but may garner greater attention and interest if more states enact taxes specifically targeting digital activity. Certainly, as the widely varying approaches to taxing digital advertising by just these two states suggests, a chaotic compliance environment could emerge from a lack of uniformity among the states.

Companies engaged in digital advertising will have to consider whether their current systems can accommodate such taxes both from a collection and a reporting standpoint. In the dynamic area of digital advertising, it's becoming increasingly difficult to identify exactly who is responsible for the placement of advertising. In addition, with sales tax rules expanding collection responsibilities to marketplace providers, it becomes practically difficult to determine which party will be held accountable and responsible for collecting and remitting these taxes.

Endnotes

1. The term "person" includes individuals, partnerships, firms, associations, corporations, and other entities.
2. "Annual gross revenues" is defined as "income or revenue from all sources, before any expenses or taxes, computed according to generally accepted accounting principles."
3. Currency references in this Alert are to the US$.
4. Neb. Rev. Stat. §77-2701.16 would be amended by adding new paragraph (11).
5. 47 U.S.C. §151 note (Sec. 1101 (a) ("No State or political subdivision thereof may impose any of the following taxes: ... (2) [multiple or discriminatory taxes on electronic commerce."), Sec. 1105(2) ("For purposes of [the Internet Tax Freedom Act (see Sec. 1100)] ... The term 'discriminatory tax' means - (A) any tax imposed by a State or political subdivision thereof on electronic commerce that - (i) is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means; (ii) is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; ...)") See e.g., Performance Mktg. Ass'n v. Hamer, 998 N.E.2d 54, 57-60 (Ill. 2013).

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