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Litigation | Tax

Taxing Digital Advertisements Face Stiff Legal Challenges

The Bottom Line

- Attempts to tax various forms of digital activity is widespread as states look for ways to raise revenue to offset state and local budgets caused by COVID-19. Companies that engage in digital advertising and industry groups should closely monitor these developments.
- If Maryland is successful in the state or federal challenge, other states may be emboldened to seek to replicate the Maryland law in their states.
- Even if the Maryland law is not upheld, other states are looking at alternative ways to collect revenue from digital advertising and marketing services.

The economic impact of COVID-19 cannot be understated; one impact has been to local and state budgets. States have experienced significant budget shortfalls due to limited economic activity and, as a result, state legislatures are searching for ways to raise revenue in order to fill the economic void. Some states have determined that one way to respond to the immediate budget crisis caused by COVID-19 is to tax digital advertising. Even though their efforts are laudable, these new proposals face serious constitutional questions.

Maryland's Digital Advertising Tax Law

As detailed in our recent tax alert, Maryland passed the first ever digital tax in the United States earlier this year. Though the legislation was objected to by the Governor and the Attorney General, the legislature overrode the Governor's veto, placing a graduated tax on annual global gross revenues of large digital platforms – like Google, Amazon and Facebook – that gross over $100 million in revenue derived from digital advertising in Maryland.

On April 12, the Maryland legislature passed several amendments to the Act, including:

- Establishing the Act's effective date, January 1, 2022;
- Exempting broadcasters and news media entities from the tax; and
- Preventing companies subject to the tax from passing the cost of the tax on to their customers.

State and Federal Legal Challenges to the Law

Just days after the legislature overrode the Governor's veto, the law was met with a legal challenge in Maryland's federal court. The case, *Chamber of Commerce, et al. v. Peter Franchot*, brought by the U.S. Chamber of Commerce and other industry groups, challenge the new law on several grounds.

Plaintiffs' assert that the law is:

1. Preempted by the Internet Tax Freedom Act, which forbids states from imposing discriminatory penalties on electronic commerce, because the law only applies to digital advertising and not advertising of other means.

2. Violates the Dormant Commerce Clause and the Due Process Clause of the Fourteenth Amendment, which prohibits states from regulating or burdening out-of-state commerce or discriminating against interstate commerce. The basis of this argument is that the law arguably imposes greater liability on companies for revenue the companies earn outside of Maryland – revenue that is not attributable to economic activity in Maryland.

3. Violates the Commerce Clause because it creates a substantial risk of conflict with foreign governments and could undermine the federal government's ability to "speak with one voice with respect to foreign affairs." Plaintiffs point to potential foreign policy disputes between the United States and European countries over conflicting digital advertising tax laws.

Overall, the complaint presents serious constitutional and statutory challenges that could alter, amend or eliminate the law in its current form. The challenges raised mirror the objections put forward by the Governor and the Attorney General prior to the law's passage. Coincidentally, because the plaintiffs' sued the State Comptroller, the Attorney General is tasked with defending the very law he objected to just months ago. Since the passage of the recent amendments to the law, the plaintiffs have indicated their intent to file an amended complaint to account for the changes made to the statute. To that end, the defendant's response to the lawsuit, likely a motion to dismiss, and the parties' proposed schedule for the filing of the amended complaint and any briefing or other motions relevant to the amended complaint are due April 30, 2021.

It is worth noting that the plaintiffs' challenge may be dismissed on jurisdictional grounds under the Tax Injunction Act, 28 U.S.C. §1341, which prohibits federal district courts from enjoining a state tax if the state provides a speedy and adequate remedy. This could mean that the first legally substantive challenge might come, not through this case, but through a challenge to an actual assessment of the Maryland tax or through a challenge in state court. To the latter point, on April 15, Comcast and Verizon sued the Maryland Comptroller in state court, seeking an declaration that the law is unconstitutional and violative of state law. The defendant's response to this lawsuit is likely due in the coming weeks.

Other States are Considering Similar Laws

Maryland is not alone in its attempt to tax the digital advertising and marketing industry. For example, in New York and Connecticut there are several proposals that would subject digital advertising services to a tax. These proposed laws would use the revenue to provide zero-interest refinancing of eligible education loans or to make one-time direct payments of $500 to individuals who have experienced economic hardship due to COVID-19, respectively.

In contrast to the Maryland law, which is aimed at large digital platforms, some states are considering more far-reaching proposals. New York is considering imposing a tax on the collection of consumer data of individual New York consumers by commercial data collectors. Oregon is considering a similar tax aimed at businesses that generate revenue from selling personal information of individuals in Oregon. In Indiana, the legislature is considering placing a tax on social media providers who have more than one million active Indiana account holders and at least $1 million in annual gross revenue from social media advertising in Indiana.

For More Information

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