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Things Not Worth Doing Are Especially Not Worth Doing Poorly: The Maryland and Nebraska Taxes of Digital Advertising

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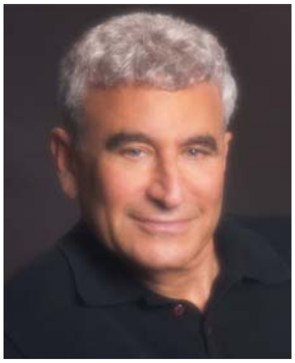

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Many, many decades ago, when I was young and naive, I gave a talk calling for an apportioned global corporate income tax on the multinationals, administered by the United Nations, based on the companies consolidated accounting returns. This was an (over)reaction by me, responding to my work for some developing countries, which were struggling with policing arm's length pricing and the abuse of tax treaties by their major taxpayers, the natural resource companies.

I received quite a tongue lashing for that glib suggestion from my colleague and mentor, Stan Surrey. Older readers will remember Stan as the Assistant Secretary of the Treasury for Tax Policy under Presidents Kennedy and Johnson, and an icon and legend in the tax world. (One of his few failures was trying to teach me tax). Younger readers might know him as the father of the tax expenditure budget. He was also the leading apostle of the arm's length methodology and proselytized for its use in tax treaties, many of which he participated in during his Washington days.

Today, we see the foibles of that combination of arm's length pricing and tax treaties in the fiscal battles with Google, Apple, Facebook, and their kindred spirits. I have no idea how Stan would have reacted to the digital age, which exposed many of the fissures and fractures in the system that he adored and promoted. Stan was brilliant, pragmatic, and nimble, and also a friend of the developing countries. But we know how Maryland has reacted.

Maryland, perhaps inspired by events abroad like the French Digital Services Tax, or those adopted by Austria, Turkey, and Italy, has proposed a gross revenue tax (not a sales tax like in Nebraska — more about that later) using a progressive rate peaking at 10 percent. The tax has a $100 million exemption based on global revenue and a $1 million exemption based on Maryland revenue.

Presumably, the tax is targeted at Google and Facebook, which account for more than half of the digital ad market. The tax is based on Maryland revenue — that part is unsurprising — but the progressive rate, ranging from 2.5 percent to 10 percent, has been attacked because it is based on global revenue and not Maryland gross revenue.

This approach, known as exemption with progression, is common in some state income taxes (and tax treaties) where the rate on nonresidents is determined by their total income, but once determined, that rate is levied on only the income sourced to the taxing state.

The best defense in the income tax for this approach is that the source state is applying the principle of ability-to-pay in determining the rate. That is, nonresidents cannot be characterized as rich or poor in terms of their appropriate rate without a state knowing their total income.

A resident with $50,000 of income earned entirely within the state of residency has less ability to pay than a nonresident with $50,000 sourced in that same state but having $1 million of total income. Similarly, if there were a special provision granting relief to low- and middle-income persons, that nonresident should not benefit from these provisions even if she had the same total income sourced to the state as the resident's total income.

The analogy is not perfect. Unlike the way exemption with progression usually operates, the higher Maryland rates apply to all Maryland revenue and not just marginal revenue so there are notch effects. And the higher rates are based on global revenue and not advertising revenue.

The best attack on exemption with progression is that this approach discriminates against interstate commerce — the more out-of-state income the nonresident has the greater her income tax in the source state. For example, a nonresident with $50,000 of taxable income sourced to the taxing state and a resident with total taxable income of $50,000, all of which is earned in the taxing state, will not pay the same amount of tax if the nonresident has out-of-state income. The more out-of-state income the nonresident has, the greater the source state's income tax.

A gross receipts tax like Maryland's gross revenue tax does not incorporate a concept of ability-to-pay. True, gross receipts taxes can incorporate a multiple rate structure, like Washington's B&O tax, but this is to deal with the problem of cascading, not to measure ability-to-pay. A gross receipts tax on manufacturing, for example, will typically have a lower rate than retailing. The tax on manufacturing will cascade through the production and distribution chain, and the lower rate takes that into account.

Ability-to-pay plays a critical role in an income tax; it has no role to play in a gross revenue tax.

But a more severe problem exists with Maryland's tax. Having worked on the misnamed Internet Tax Freedom Act (ITFA), it is never far from my mind; unfortunately, that was not the case for Maryland legislators. Without a similar tax on off-line advertising in newspapers and magazines, the proposed Maryland tax on digital advertising would seem to violate ITFA's nondiscrimination clause. (Congress has recently introduced bills to ban discriminatory state taxes on digital goods and services.) That is certainly remediable, however; simply redraft the tax to apply to all advertising.

But that would not solve another problem. The lesson from *Jefferson Lines*[40] and its treatment of *Central Greyhound*[41] is that gross receipts taxes have to be apportioned. *Jefferson Lines* spawned numerous cases exploring this requirement. In theory, sales taxes also have to be apportioned but that requirement has more bark than bite. The Maryland tax has no meaningful apportionment provision, despite most of the content of advertising and its production occurring outside the state. The Comptroller is required to formulate some approach.

Maryland estimates the tax would raise more than $100 million, and would be dedicated to public school reform. I assume they have not taken into account the years of litigation that will result should the bill be adopted. Affected parties will try to kill the tax to discourage other states from following suit.

Should Maryland look to Nebraska for inspiration? Nebraska is proposing expanding its existing sales tax to include gross receipts from digital advertising. This approach does not solve the possible discrimination argument under ITFA, but could if all advertising were covered.

The apportionment issue, severe under a gross receipts tax, is greatly mitigated under a sales tax. In *Jefferson Lines*, the Court held that an interstate bus ticket satisfied the apportionment requirement despite it being obvious from the face of the ticket that an interstate trip was purchased. Apportionment is simply a more relaxed requirement when it comes to sales taxes.

The Nebraska approach, however, violates one of the fundamental policy goals that justifies a sales tax in the first place. Business inputs should not be taxed under a sales tax in order to eliminate the cascading issue. Yet, advertising is a quintessential business input, which should not be taxable. Indeed, Nebraska knows better. It has numerous provisions to eliminate the tax on business inputs, such as exemptions for purchases for resale, ingredients and components, and special exemptions for manufacturers.

Nebraska's taxing the sale of digital advertisements also runs the risk of driving such sales to neighboring states or elsewhere, which do not tax this. There are simply too many available safe havens in which to purchase digital advertising. The question then becomes whether Nebraska can design an administrable use tax. Florida's sweeping and ultimately failed attempt to improperly bring myriad business services, including advertising, into its sales tax base is sobering and should be mandatory reading for Nebraska politicians and their staff.

[40] *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175, 187 (1995).

[41] *Central Greyhound Lines Inc. v. Mealy*, 334 U.S. 653 (1948).