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With Veto Override, Maryland Becomes First U.S. State to Enact Digital Advertising Tax.

Amidst significant economic and legal concerns, on February 12, 2021, the Maryland Senate joined the House in voting to override Republican Gov. Larry Hogan's veto of House Bill 732 (HB 732) to adopt a Digital Advertising Gross Revenues Tax (Tax), the nation's first tax targeting digital advertising. The override was successful despite significant pushback from a coalition of more than 200 businesses and Republican legislators who sought to sustain the veto. HB 732 is intended to provide significant revenues to support education reforms in the state.

The Tax is likely to affect large technology-based and online companies that derive revenue from advertisements on their websites and platforms (rather than companies deriving their revenues entirely from subscription services). Thus such companies, as well as their owners and sponsors, should carefully consider the information below and the impact of the Tax on their business models.

The Tax

The Tax is not a net income tax; rather, it is imposed on the "annual *gross revenues* of a person derived from digital advertising services in the state."1 "Digital advertising services" include "advertisement services on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services."2 The determination of annual gross revenues derived from services in Maryland ultimately subject to the Tax is calculated based on a fraction that compares the annual gross revenues derived from digital advertising services in Maryland to the annual gross revenues derived from digital advertising services in the United States.3

The Tax is imposed on a graduated rate scale, based on the taxpayer's *global* annual gross revenues, as follows:

- 2.5% for companies with global annual gross revenues of $100 million through $1 billion
- 5% for companies with global annual gross revenues greater than $1 billion through $5 billion
- 7.5% for companies with global annual gross revenues greater than $5 billion through $15 billion
- 10% for companies with global annual gross revenues exceeding $15 billion4

Initial Observations and Considerations

Despite the passage of HB 732 by the Maryland General Assembly, a number of significant questions have been raised as to the legality and economic impact of the Tax

- Because the Tax is imposed only on *digital* advertising activities and not traditional advertising activities that take place in print, over the radio, or on TV, it has been asserted that the Tax violates the federal Internet Tax Freedom Act and is therefore void.
- Because the Tax is imposed only on digital *advertising* activities, it has also been asserted that the Tax violates several federal Constitutional provisions, including the Commerce Clause, the Supremacy Clause, the Equal Protection Clause and the First Amendment.5

- Opponents of HB 732 argue that the Tax will be ultimately borne by the customers of the vendors on whom the Tax is imposed, as nothing in the current legislation prevents the taxpayer from passing the cost of the Tax onto its customers. While the General Assembly is considering a proposal to revise the legislation to prohibit passing on the Tax to customers, it is expected that the taxpayers subject to this Tax will still account for the Tax in determining their pricing for digital advertisement sales (which pricing is generally dynamic and individualized).
- The Tax is imposed based on U.S.-based revenue from “digital advertising services” as apportioned to Maryland, but the tax rates are based on a company’s global (i.e., worldwide) annual revenues. There is no guidance on how intercompany revenues between members of an affiliated group will be considered for either of these calculations.
- The statute does not define when digital advertising services take place “in the state”; instead, the General Assembly delegated this authority to the Comptroller, which may be an unlawful delegation of authority that is likely to invite challenge.
- The Tax is to be effective for all taxable years beginning after December 31, 2020. HB 732 includes a general effective date of July 1, 2020. However, under Maryland law, bills that are enacted via legislative override of the Governor’s veto generally take effect 30 days after the override, which would be March 14, 2021. It is unclear how the purported retroactivity and concomitant Due Process issues, legislative delay, and veto override process will ultimately affect implementation of the Tax.
- Other states have taken notice of Maryland’s efforts. Jurisdictions that have recently considered or are considering a digital advertising services tax include Connecticut, the District of Columbia, Montana, Nebraska, and New York.6

The Tax is intended to apply to large technology-based and online companies with advertising-based revenue models (as opposed to companies with subscription-based revenue models). Thus, pending the outcome of expected legal challenges, such companies, as well as their owners and sponsors, will need to consider the impact of the Tax on their business models and their potential tax obligations to Maryland, while at the same time protecting any and all refund opportunities should any of the expected legal challenges that have been and likely will be filed against the Tax in the coming weeks and months prove successful.

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1 Md. Code, Tax-Gen. § 7.5-102(a). Citations are to the sections as proposed in HB 732.
2 Md. Code, Tax-Gen. § 7.5-101(d).
3 Md. Code, Tax-Gen. § 7.5-102(b).
4 Md. Code, Tax-Gen. § 7.5-103.
5 On February 18, 2021, the U.S. Chamber of Commerce, the Internet Association, NetChoice, and the Computer and Communications Industry Association filed suit in federal court in Maryland, asserting that the Tax is “illegal in myriad ways and should be declared unlawful and enjoined.”
6 The potential proliferation of digital advertising taxes at the state level is especially interesting considering the recent conflict between the United States and France over France’s digital services tax, as well as the calls for global negotiations to create a uniform system governing taxation of digital services.

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