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Changes to Streaming Media Monetization Could Affect State Taxes.

As more streaming services start to offer lower-cost, ad-supported plans, there's been plenty of chatter about what these developments may mean from a competitive and product point of view. But this shift could also prompt changes on state and local taxes, says Avalara's Toby Bargar.

The last few months have ushered in a string of new developments around the changing landscape of streaming entertainment: mergers and bundling, rising availability of free alternative services, and—perhaps biggest of all—the imminent arrival of cheaper, ad-supported plans from some of the biggest names in the business. There has been no shortage of chatter about what these developments may mean from a competitive and product point of view. However, a significant and overlooked dimension to this area is what these shifts could mean for the tax purses of state and local governments.

New Streaming Models Are Upon Us
With economic uncertainty prominent in the news and customers emerging from pandemic lifestyles, streaming platforms are looking to make their offerings more financially attractive. Not only are streaming media companies having to compete again with outside entertainment like theaters, restaurants, and in-person concerts—there also is an ever-growing universe of competitors within the space.

The major brands are not sitting still. Most notably, Disney+ and Netflix are in the process of adding multiple pricing tiers with lower-cost, ad-supported plans. In theory, these cheaper offerings will help retain newly price-sensitive customers. Not to be outdone, several completely free, ad-supported services like Tubi and Amazon Freevee have stormed onto the scene. Peacock offers a free, ad-supported tier as the entry point, with an available buy up to a paid, ad-free service. This proliferation of free and lower-cost services has a hidden cost: State and local tax receipts stand to suffer as a result.

The Taxman Was Already Struggling to Keep Up
Cord-cutting and the overall move to streaming services has already shown a propensity to take a bite out of tax revenue. Cable television services have historically been subject to sales tax as well as a menu of alternative and additional communications or utility taxes, regulatory fees, economic activity taxes, and municipal franchise fees.

Tax authorities are struggling to keep up. Most streaming services are offered "over-the-top" of the customer's internet connection, which poses a potential problem in relation to many of the various taxes and fees associated with cable. Utility taxes, regulatory, and franchise fees associated with pay TV are often imposed on the basis of public policy rationales around the actual physical cable lines using public rights of way and traditional communications infrastructure to reach the customer. Most streaming providers can avoid directly using any of this infrastructure and, in the process, sidestep the associated taxes and fees.

State and local authorities have not sat idly by while cable revenue shifted toward streaming. Florida has leaned into a generous definition of pay TV to assert that streaming services are subject to state and local communications taxes, which were historically collected from phone and cable companies. Chicago applies its historic amusement tax to streaming, and a raft of California cities have fought with streaming providers over whether the services are subject to municipal utility taxes. Perhaps most aggressively, a series of class-action lawsuits have been filed in various states on behalf of municipalities claiming that streaming companies should be subject to cable franchise fees due to their use of other companies' physical internet infrastructure to reach the customer. These arguments may be eyebrow-raising, but if nothing else, they demonstrate the degree to which the changes in consumer spending have put municipal revenue streams under extreme pressure.

However, if consumers migrate toward ad-supported services that either are free or significantly cheaper, all of this maneuvering around extending taxability to cover retail streaming bills may be too little, too late. The math is pretty simple: At free or reduced cost, ad-supported services are likely to result in an even further reduction in the already stressed tax base.

So Where Do They Turn?

If free and reduced-cost streaming does take a bite out of retail receipts—and by extension, tax collections—state and local legislators may already have a model solution in front of them: tax the ads themselves. In February 2021, Maryland enacted a first-of-its-kind "digital ads tax" targeting the revenue of technology platforms that generate a substantial amount of receipts from advertising in the state.

The rollout of the digital ad tax in Maryland has still had some challenges. The state has faced a daunting amount of litigation over whether the tax is an unconstitutional violation of due process and commerce clause protections, as well as challenges over vagueness, sourcing, and implementation. In addition, it has been argued that the tax falls afoul of federal Internet Tax Freedom Act restrictions against discrimination. Nearly everything about the Maryland tax has been controversial and subject to dispute—not least of all, who is even subject to it. That said, the stakes for states and cities are high enough that this model likely cannot be ignored.

Major streaming companies like Netflix and Disney+ clearly are hoping to make up for any eroding growth in consumer receipts with ad revenue. Perhaps the litigation and controversy in Maryland would ordinarily scare legislators in other states away from the concept entirely. But can they really afford to ignore advertising receipts? Not only does a tax on advertising revenue match the direction the industry appears to be headed; it also offers the political benefit of being largely invisible to the consumer. Look for more news about more states tinkering with taxes aimed at advertising revenue in the future.

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