Taxing the Digital Frontier

Litigation, Impact on Small Advertisers Among Concerns

There is a trending effort sweeping across state legislatures to tax digital advertising as a response to the rapidly expanding online advertising industry and its role in the global economy. Several states, including California, have introduced bills or are considering such taxes to address the fact that major digital platforms generate significant profits from online advertising.

DIGITAL AD TAX

A digital ad tax is a levy imposed by governments on companies that generate revenue through online advertising. Such a tax usually targets large digital platforms, such as social media platforms and networks, search engines, and other online service providers that profit from online advertising.

Typically, the tax is applied to the revenue that companies earn from advertising to local consumers. However, the implementation of digital ad taxes has sparked debate over constitutional issues, fairness, potential market distortions, and the challenges of regulatory oversight in an increasingly digital economy.

INTERNET TAX FREEDOM ACT

In 1998, the Clinton administration implemented the Internet Tax Freedom Act (ITFA); the Obama administration subsequently made the tax permanent in 2016. The ITFA prohibits discriminatory taxes on electronic commerce, defined as "any transaction conducted over the internet or through internet access, comprising the sale, lease, license, offer or delivery of property, goods, services, or information, whether or not for consideration."

Specifically, the ITFA prohibits federal, state and local governments from imposing taxes on internet access or online transactions. The ITFA's primary goal is to ensure that the internet remains an open and accessible platform for commerce and communication, without being handicapped or hindered by taxation. The law also bans discriminatory taxes targeting e-commerce, attempting to facilitate the growth of the digital economy.

While it has been extended and amended over time, the ITFA remains a foundational piece of legislation supporting the development of the digital economy by preventing restrictions that could hinder online activity.

DIGITAL AD TAX LEGISLATION

Maryland's Digital Ad Tax

The "Maryland Digital Advertising Services Tax" was enacted in 2021 and attempted to impose a tax on the gross revenue generated by digital advertising services in the state. The tax specifically targeted businesses with significant digital advertising revenue, including major platforms like Google, Amazon and Facebook. It applied to companies with annual global revenue exceeding $100 million and was calculated based on the revenue companies earn from digital ads directed at Maryland consumers. The tax rate was tiered, starting at 2.5% for businesses with between $100 million and $1 billion in global revenue, and increasing up to 10% for companies with revenue exceeding $15 billion.

Maryland's Subsequent Litigation

Maryland's digital ad tax resulted in lawsuits at both the state and federal levels. A coalition of industry groups, including major tech companies, filed lawsuits arguing that the tax was unconstitutional and violated the ITFA, the Commerce and Due Processes Clauses of the U.S. Constitution, and the First Amendment to the U.S. Constitution.

The litigation resulted in a federal court ruling in the plaintiffs' favor, agreeing that the tax violated the Commerce Clause by imposing unfair burdens on interstate commerce. The court concluded that the tax was discriminatory because it specifically targeted companies involved in digital advertising, primarily affecting out-of-state businesses.

Additionally, the state court ruled that the state tax violated the ITFA, which prohibits taxes on electronic commerce that discriminate against online services. As a result, the tax was prevented from being implemented.

California's Digital Ad Taxes

The California Legislature introduced two separate bills in 2024 attempting to implement digital ad taxes. AB 2829 was authored by Assemblymember Diane Papan (D-San Mateo), while SB 1327 was authored by Senator Steve Glazer (D-Contra Costa). Both bills failed to reach the Governor's desk, but they did communicate to the business community that the state legislature has the penchant to tax digital ad tax revenue.

AB 2829 sought to tax businesses with annual global revenue of at least $100 million at a rate of 5% of the revenue derived from digital ad services. The bill was nearly identical to Maryland's digital ad tax.

SB 1327 aimed to tax businesses 7.25% on the revenue generated from the sale of digital advertising. The tax increase proposed in SB 1327 would have been separate from and in addition to income taxes already paid from income generated from sales of digital advertising.

Opponents of both bills argued that they ran afoul of the ITFA, the Commerce and Due Processes Clauses of the U.S. Constitution, and the First Amendment to the U.S. Constitution — just like the Maryland legislation. Furthermore, opponents of the taxes stated that businesses already pay corporate income taxes on their profits from conducting business. Any revenue collected from a digital ad tax is already captured in their income. Additionally, much of the economic activity that results from consumer purchases of advertising result in the collection of sales and use taxes in the states on the products purchased. Thus, the revenue these bills sought to generate was already being taxed and captured by the state and there was no need for their implementation.

Opponents also asserted that a digital ad tax would increase costs for small California advertisers and raise prices for consumers. While the bills were aimed at large advertising providers, the economic burden of the digital advertising tax would have fallen squarely on California purchasers because it was limited to revenue from advertising services in California.

Advertising service providers subject to the tax would immediately raise prices for California advertisers or add the tax to their invoices, like a sales tax. The tax would make otherwise affordable and effective digital advertising channels prohibitively expensive. Small California businesses, nonprofits, places of worship, civic organizations and others that advertise on digital platforms would be priced out of the market in an already-inflationary economy. In addition, the tax would raise costs for small businesses buying digital advertising services, causing them to raise prices for consumers, where the ultimate burden of any tax always falls.

Also, the bills lacked language regarding the sourcing or apportionment of receipts for the tax. Rather, the Franchise Tax Board would have been responsible for prescribing "rules, guidelines, procedures, or other guidance" to carry out the provisions of the bill. Leaving important sourcing rules to the regulatory process ignores the important policy implications of a broad-based digital advertising tax.

CALIFORNIA'S EFFORT TO FUND TRADITIONAL MEDIA OUTLETS

While legislators failed to enact a digital ad tax, Assemblymember Buffy Wicks (D-Oakland) led an effort where digital media platforms agreed to pay struggling traditional media outlets.

Specifically, the deal outlines a five-year plan where $242.5 million will be distributed to California media outlets. $180 million will go to the University of California, Berkeley School of Journalism, with oversight provided by a board made up of diverse and independent media member groups. $110 million will be paid by Google and its partners, and $70 million will come from the state.

The plan outlines that Google will pay $15 million to the journalism fund in 2025 and a minimum of $10 million a year through 2029, for a total of $55 million. California will pay $30 million in 2025 and then $10 million a year through 2029, for a total of $70 million.

The funds will be distributed to qualifying California news organizations, with the intent of funding journalism jobs. Tech companies will pay $62.5 million, with the intent of creating a nonprofit organization to administer an artificial intelligence (AI) accelerator project.

CALCHAMBER POSITION

Implementing new taxes on digital advertising will result in interminable litigation for the state and likely affect California's small advertisers when the costs of the tax are passed on to them. The Legislature should avoid imposing new taxes and instead focus on limiting obstacles to the state's economic prosperity. This includes addressing housing shortages and high housing prices, unaffordable cost of living conditions, and persistently highest-in-the-nation gas prices.

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January 2025