

# Maryland's Digital Advertising Tax Is Unworkably Vague

**FISCAL  
FACT**  
No. 747  
Feb. 2021

**Michael J. Semes<sup>1</sup>**

Professor of Practice, Charles Widger School of Law, Villanova University, Villanova, PA

**Jared Walczak**

Vice President of State Projects

## Key Findings

- In addition to its economic impact on Maryland businesses and the likelihood of serious legal challenges, Maryland's proposed digital advertising tax is incredibly vague on vital definitions, creating uncertainty about where revenue is sourced and when it is subject to the tax.
- The legislation's ambiguity could lead to double taxation, with multiple entities paying taxes on gross receipts from the same ad being served to a viewer, and would certainly create substantial—and costly—confusion.
- A stylized hypothetical involving an ad broker, a seller of advertising space, and an advertiser can help illustrate how lawmakers have failed to take the complexity of digital advertising into account in structuring the proposed tax.

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. We are a 501(c)(3) nonprofit organization.

©2021 Tax Foundation  
Distributed under  
Creative Commons CC-BY-NC 4.0

Editor, Rachel Shuster  
Designer, Dan Carvajal

Tax Foundation  
1325 G Street, NW, Suite 950  
Washington, DC 20005

202.464.6200

[taxfoundation.org](http://taxfoundation.org)

<sup>1</sup> Michael J. Semes is Professor of Practice in the Graduate Tax Program at the Charles Widger School of Law at Villanova University and Of Counsel at BakerHostetler. He thanks Christian Jorgensen and Jonathan Onufrak, Villanova Law students, for contributing their helpful research and comments to this article.

## Introduction

The Maryland Digital Advertising Tax,<sup>2</sup> on the verge of a veto override, remains a vague concept in search of definitions. Its legal and economic shortcomings have been documented extensively, but too little attention has been given to the legislation's maddening vagueness, and particularly—a year into this process—the foundational question of what transactions would be subject to the tax. Using a stylized hypothetical, this paper explores the extent of that uncertainty, highlighting the implications of this ambiguity for taxpayers.

As a tax on digital, but not traditional, advertising, the proposal almost certainly runs afoul of the Permanent Internet Tax Freedom Act, a federal law which prohibits discriminatory taxes on electronic commerce. By setting rates based on the worldwide gross revenues of advertising platforms—economic activity that has nothing to do with Maryland—it may fail a Dormant Commerce Clause analysis under the U.S. Constitution.<sup>3</sup> Maryland's own attorney general has raised questions about the tax's constitutionality.<sup>4</sup>

Furthermore, as a tax imposed on advertising “in the state” of Maryland, its economic incidence would fall substantially on Maryland companies advertising to Maryland residents. Given the dynamic pricing of most online advertising, with rates calculated on the basis of the demographics of the chosen advertising universe (such as age, sex, geography, interest, and purchasing patterns), passing along the costs of the tax to the advertisers themselves would be trivial for most advertising platforms, even if lawmakers also passed proposed legislation prohibiting platforms from adding a Maryland “surcharge” to advertising invoices, as has been proposed.<sup>5</sup>

All these matters have received attention in the past, as has the imprecision with which the bill was drafted. There has, however, been an insufficient focus on just how many questions remain unresolved, and how this vague language could produce double taxation and would certainly yield substantial confusion.

2 Maryland House Bill 732, 2020 Reg. Sess., <http://mgaleg.maryland.gov/mgawebiste/Legislation/Details/HB0732?ys=2020RS>.

3 Jared Walczak, “Worse Than Advertised: The Legal and Economic Pitfalls of Maryland’s Digital Advertising Tax,” Tax Foundation, Mar. 16, 2020, <https://taxfoundation.org/maryland-digital-advertising-tax/>.

4 Michael J. Semes, “Maryland’s Proposed Digital Advertising Gross Revenues Tax Should Not Be Enacted,” Bloomberg Tax, Feb. 4, 2021, <https://news.bloombergtax.com/daily-tax-report/marylands-proposed-digital-advertising-gross-revenues-tax-should-not-be-enacted>.

5 Maryland Senate Bill 787, 2021 Reg. Sess., <http://mgaleg.maryland.gov/mgawebiste/Legislation/Details/SB0787?ys=2021RS>.

## Unresolved Questions

A digital advertising tax would be a new development in state taxation, and that very newness, combined with the complexity of the tax, demands accurate and precise statutory language. Such legislation should, at a minimum, satisfactorily resolve the following questions:

### 1. Who is subject to tax?

The proposed digital advertising tax leaves substantial doubt as to which party—or parties—may be subject to tax. As a result, it may be interpreted to impose tax on multiple links in the digital advertising supply chain. The lack of legislative precision compounds the negative economic impact of tax pyramiding.

### 2. What type of transactions are subject to tax (i.e., what is the tax base)?

The Maryland tax defines digital advertising in such a broad manner that it encourages taxpayers to challenge its breadth and invites the State Comptroller to cast a nearly boundless net.

### 3. What is the tax rate?

The tax's rate escalates from 2.5 percent to 10 percent of the advertising platform's assessable base based on their annual gross revenues from all sources (i.e., not just digital advertising)—information which will often be opaque to in-state advertisers who may bear the economic incidence of the tax, and for which there is little economic justification and significant legal uncertainty. Furthermore, the escalating rate scale works to exclude from the tax any entity with less than \$1 million of gross revenues from digital advertising services in Maryland *and* \$100 million in annual gross revenues. Thus, the tax is effectively, and perhaps unconstitutionally, targeted at large players in the digital advertising world.

### 4. When is a transaction subject to the digital advertising tax “in the state”?

Rather than defining what constitutes digital advertising “in the state,” the General Assembly delegates this critical authority to the Comptroller, which is likely to be unlawful and, at the very least, invites needless and, likely, voluminous litigation.

## A Hypothetical

Imagine a company, the Lighthouse Watch Company (a product advertiser), which is in the business of manufacturing and selling nautical-themed watches. Imagine, too, Ship Shop, a company which sells boats and accessories and otherwise caters to the nautical community and has an online presence which attracts the sort of customers that Lighthouse Watch Company would like to reach. Finally, imagine a third party, an advertising brokerage service, Nile Advertising, which is in the business of connecting product advertisers like Lighthouse with website owners like Ship Shop. Nile Advertising facilitates an advertising campaign for Lighthouse that runs on Ship Shop's web portal.<sup>6</sup>

Lighthouse retains Nile to run its advertising on relevant sites. Lighthouse agrees to pay Nile a fee (\$1) for each time a potential customer clicks on one of their ads (cost-per-click). Nile in turn agrees to pay Ship Shop a fee (\$0.75) for each time the ad is displayed to a user on Ship Shop's website (cost-per-impression), or alternatively, for each time a customer clicks on the ad. In either case, Nile charges Lighthouse some fee, much of which ultimately goes to Ship Shop for displaying the ad, but some of which is retained by Nile for its services. There are therefore two digital advertising transactions here:

**Transaction #1:** Lighthouse pays Nile Advertising \$1 when a user clicks on the Lighthouse Watch ad on Ship Shop's website.

**Transaction #2:** Nile pays Ship Shop \$0.75 when that user clicks on the Lighthouse ad on Ship Shop's website.

Which transaction is taxed—or are both?

The Maryland digital advertising tax would be applied (based on a sliding scale of rates) to the “annual gross revenues of a person derived from digital advertising services in the state.”<sup>7</sup> Therefore, applying this law to our hypothetical facts, we need to determine:

- Whether the entity in each transaction is a “person” as defined for purposes of the tax;
- Whether the “person” has “gross revenues from digital advertising services”;
- Whether those digital advertising services were “in the state”; and, if so,
- How they are to be apportioned.

<sup>6</sup> In the real world, some of these hypothetical entities would likely be too small to be liable under the proposed tax, but the reader may mentally substitute whichever larger corporations they so desire.

<sup>7</sup> Md. Code, Tax-Gen. § 7.5-101 *et seq.* Citations are to the sections as proposed in HB 732.

## Analysis

With our hypothetical in place, let's consider some basic analysis.

### Is each of Lighthouse, Ship Shop, and Nile a “person” for purposes of the tax?

This is a straightforward analysis. The digital advertising tax language describes in the broadest of terms the type of entity potentially subject to be “an individual, receiver, trustee, guardian, personal representative, fiduciary, or representative of any kind and any partnership, firm, association, corporation, or other entity” derived from digital advertising services in the state.<sup>8</sup> It cannot be disputed that each party in our hypothetical—Lighthouse, Ship Shop, and Nile—is a “person.” Therefore, each of them is the type of entity that may be subject to the tax.

### Does Lighthouse, Nile, or Ship Shop have “gross revenues derived from digital advertising services?”<sup>9</sup>

In other words, are the entity’s gross revenues of the type included in the tax base? The digital advertising tax imposes tax on “the assessable base,” which in turn is defined to be “gross revenues derived from digital advertising services in the state.”<sup>10</sup> This analysis requires analyzing several different terms because “digital advertising services” is comprised of several defined (as well as undefined) terms to include:

- “advertisement services...including, advertisements in the form of banner advertising, search engine advertising and other comparable advertising services”<sup>11</sup>
- “on a digital interface [which means any type of software, including a website, part of a website, or application]”<sup>12</sup>
- “that a user [which means an individual or any other person who accesses [such software]<sup>13</sup> with a device] is able to access.”<sup>14</sup>

The digital advertising tax proposal does not define “derived from” or “advertisement services,” which creates an initial layer of uncertainty. For instance, how close must the causal link be between the digital advertising service and the revenue received for the revenue to be “derived from digital advertising services?” Without precise (or any) definitions of these terms, as we will see, it is difficult to conclude with certainty whether the advertising tax applies in many common business transactions, such as in our hypothetical scenario.

<sup>8</sup> Md. Code, Tax-Gen. § 7.5-101(f) & § 1-101(g-1)(p)(1).

<sup>9</sup> For purposes of this analysis we will assume that every amount that an entity receives in exchange for goods or services is “gross revenues.”

<sup>10</sup> Note that the tax proposal includes in the tax base revenue “derived from digital advertising services.” By failing to supply a phrase to modify “derived from,” the statute leaves much more open to interpretation than if it had, for instance, defined the tax base to be gross revenues “derived from providing digital advertising services in the state” or “derived from digital advertising services the benefit of which is received in the state” or “derived from digital advertising services viewed in the state.”

<sup>11</sup> Md. Code, Tax-Gen. § 7.5-101(d).

<sup>12</sup> Md. Code, Tax-Gen. § 7.5-101(e).

<sup>13</sup> Md. Code, Tax-Gen. § 7.5-101(c).

<sup>14</sup> Md. Code, Tax-Gen. § 7.5-101(e). It is important to note that this definition does not require a user to access the digital advertising service, but only requires that a user be “able to access” the service.

More importantly, however, the proposal does not provide any guidance to determine when gross revenues are “in the state.”<sup>15</sup> As we will see when we apply the tax to our hypothetical scenario, this is a gaping hole in the language that leaves many questions unanswered. As a result, the necessary uncertainty created by not providing a definition of the critical phrase “in the state” sows the seeds of many varietals of litigation. Let’s examine the transactions to determine which, if any, is included in the base:

## Transaction #1

### *Was the \$1 Nile received from Lighthouse “gross revenues?”*

The \$1 is clearly gross revenues.

### *Was the \$1 Nile received from Lighthouse “derived from digital advertising services?”*

To answer this, we must ask whether the Lighthouse ad on Ship Shop’s website is a “digital advertising service,” which requires asking whether the Lighthouse ad is “software, including a website, part of a website, or application.”<sup>16</sup> Setting aside that the tax proposal does not define “software,” it is not unreasonable to conclude that the Lighthouse ad is part of a website. So, we will continue our analysis having concluded that it is most likely that the Lighthouse ad on Ship Shop’s website is a “digital advertising service.”

Therefore, the key question is whether the \$1 Nile received in gross revenues was “derived from” digital advertising services.<sup>17</sup> As noted above, by not defining “derived from,” the digital advertising tax leaves open the question of how direct the causal link must be between the digital advertising and the receipt of the revenues for those revenues to be “derived from” the digital advertising.

Nile derived \$1 for providing advertising brokerage services to Lighthouse—not for providing digital advertising services. That said, Lighthouse’s payment to Nile was dependent upon the Lighthouse banner ad appearing on Ship Shop’s website. Because the legislation does not define the necessary causal connection between the digital advertising services and the gross revenues received, it is not clear whether the Maryland General Assembly intended for the \$1 Nile received for digital advertising brokerage services to be considered as having been “derived from” digital advertising services.

But for the Lighthouse banner ad appearing on Ship Shop’s website (and a user clicking on it), Nile would not have received the \$1 in gross revenues. Therefore, it can be argued that the \$1 in gross revenues Nile received from Lighthouse was at least indirectly derived from the Lighthouse ad (digital advertising services) appearing on Shop Shop’s website. Because the \$1 is only indirectly connected (and the direct result of Nile’s performance of advertising brokerage services) to the banner ad, it is uncertain that the \$1 was “derived from” the “digital advertising service.”

---

<sup>15</sup> See also footnote 8, which points out that by defining the tax base to include “gross revenues derived from digital advertising services [but failing to provide a modifier] in the state” the legislation allows for many interpretations.

<sup>16</sup> Md. Code, Tax-Gen. § 7.5-101(e).

<sup>17</sup> Assuming the banner ad is a digital advertising service, we will analyze whether the gross revenues were “in the state” in the next section.

*Assuming the \$1 Nile received from Lighthouse to broker the appearance of Lighthouse's banner ad on Ship Shop's website is "gross revenue derived from digital advertising services," were those gross revenues "in the state?"*

The tax does not define—nor does it provide any hint of guidance on—when gross revenues are “derived from” digital advertising services in the state.”<sup>18</sup>

This lack of clarity raises many questions, a sampling of which follows:

How does Nile determine from where it derived the \$1 gross revenues from its sale of brokerage services to Lighthouse?

- Is it the Lighthouse—or Ship Shop—headquarters?
- Is it the Lighthouse—Ship Shop—fulfillment center?
- Is it the Lighthouse—Ship Shop—website operations office (if there is one)?

To make this determination should Nile look to **Lighthouse** (its customer to whom it provided advertising brokerage services) or to **Ship Shop** (which is not a party to the Nile/Lighthouse transaction but on whose website the digital advertising services were viewed and clicked) or to **itself** (which provided the services from which the gross revenues were derived)? The legislation provides no guidance to make this determination and, as a result, leaves open whether Nile should make this determination by looking to:

- **Itself** (the recipient of the gross revenues), and, if so, does the determination of “in the state” turn on (1) the location at which Nile received the revenue, (2) the location from which Nile negotiated its agreement with Lighthouse, (3) the location from which Nile negotiated its agreement with Ship Shop, or (4) Nile’s headquarters;
- **Lighthouse** (the direct payer of the gross revenues to Nile), and if so, does the determination of “in the state” turn on (1) Lighthouse headquarters or (2) the place from which Lighthouse placed the order with Nile;
- **Ship Shop** (the website without which and on which the digital advertising service appeared), and, if so, does that determination turn on the location of Ship Shop’s (1) headquarters, (2) advertising department, (3) website management, (4) servers (potentially owned by third parties), or (4) anchor store.

Ship Shop may have limited information with respect to the questions above, and some functions may be performed in more than one of these locations. Nile, meanwhile, would be highly unlikely to be able to divine the answers to these questions.

---

<sup>18</sup> As noted above, see footnote 8, the digital advertising tax’s failure to specify what act causes digital advertising services to [occur, be provided in, etc.] “in the state” creates an enormous amount of ambiguity.

Apparently recognizing these sorts of evidentiary and reliability issues, the digital advertising tax legislation does provide that “the Comptroller shall adopt regulations that determine the state from which revenues from digital advertising services are derived.” This provision preliminarily raises additional questions, including whether the Maryland legislature may delegate such authority to the Comptroller and, given that expertise in digital advertising and electronic commerce are not core competencies of the Comptroller’s office, how the Comptroller will adjudicate these difficult questions.<sup>19</sup>

***Assuming the \$1 was “gross revenues derived from digital advertising services in the state,” how does the proposed legislation apportion those gross revenues?***

The final step in our hypothetical analysis with respect to Nile, putting to the side the shaky foundation upon which the determination that Nile “derived gross revenues from digital advertising in the state” rests, is to determine how the proposed legislation apportions that \$1 of gross revenues. In other words, does the law assign the entire amount of those gross revenues to Maryland or only a portion?

The tax provides “the part of the annual gross revenues of a person derived from digital advertising services in the state shall be determined using an apportionment fraction.”<sup>20</sup> That fraction is:

$$\frac{\text{annual gross revenues derived from digital advertising services in the state}}{\text{annual gross revenues derived from digital advertising services in the United States}}$$

The tax is drafted in a manner that makes it impossible to determine in even the simplest type of transaction when digital advertising services are “in the state” and, therefore, the numerator of the fraction cannot be determined with any sort of certainty. Equally vexing, however, is the question of why, if the tax is imposed on “gross revenues...in the state,” there is any need to further apportion it.<sup>21</sup> Those questions apply equally to both transactions analyzed here.

## **Transaction #2**

***Was the \$0.75 that Ship Shop received from Nile “gross revenues?”***

The \$0.75 was clearly gross revenues.

***Was the \$0.75 that Ship Shop received from Nile “derived from digital advertising services?”***

As we did in analyzing whether Nile’s \$1 for brokering services was subject to tax, we start by asking whether the \$0.75 Ship Shop received from Nile was “derived from digital advertising services.” In our analysis above, we determined that it was not unreasonable to conclude that the Lighthouse ad is part of a website and, therefore, most likely a “digital advertising service.”

<sup>19</sup> The General Assembly acknowledges that the Comptroller lacks the expertise to make this determination by including a provision requiring a taxpayer to include with the filing of its returns “an attachment that states any information that the Comptroller requires to determine annual gross revenues derived from digital advertising services in the state.” Md. Code, Tax-Gen. § 7.5-201(c). This is a penalty-worthy punt of legislative authority (and due diligence).

<sup>20</sup> Md. Code, Tax-Gen. § 7.5-102(b).

<sup>21</sup> Apportionment of multistate taxation is required in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, but the “test” employed in Maryland’s legislation is self-referential, determining the Maryland share by multiplying gross revenue attributed to Maryland by all U.S. gross revenue, which yields the initial figure—revenue attributable to Maryland.

Therefore, the key question is whether the \$0.75 gross revenues Ship Shop received were “derived from” digital advertising services. As noted above, by not defining “derived from,” the bill leaves open the question of what causal link must exist between the digital advertising and the receipt of the revenues for those revenues to be “derived from” the digital advertising. Ship Shop derived \$0.75 for allowing the Lighthouse banner ad to appear on its website. It seems difficult to argue under these facts that Ship Shop did not derive \$0.75 of gross revenues from digital advertising services.

*Assuming the \$0.75 Ship Shop received from Nile to allow the Lighthouse ad to appear on its website was “gross revenues derived from digital advertising services,” were those gross revenues “in the state?”*

The digital advertising tax proposal does not define the crucial phrase “in the state.” Further, by placing the modifier “derived from” before “gross revenues from advertising services in the state,” it is not clear whether “derived from” modifies “in the state.” As mentioned above, we need to ask: a) do the gross revenues have to be derived from (i.e., received, generated, viewed) in the state (putting aside the linguistic and grammatical incongruity of this language); b) do the digital advertising services have to “be” (i.e., occur or be performed) in the state; or c) both a) and b)?

This lack of clarity raises the question of how Ship Shop is to determine from where its \$0.75 of gross revenues from digital advertising services was derived, following the same line of analysis considered for Transaction #1.

As with Transaction #1, any answers to these questions that Ship Shop may be able to divine will be at best nebulous guesses. Furthermore, the same apportionment analysis would be applied.

## The Customer

We might further ask, given the vagueness of the statutory language, whether a customer purchasing a watch on Lighthouse’s website, having discovered the product line via a paid ad brokered by Nile on Ship Shop’s website, is also generating gross revenues “derived” in some way from digital advertising services. The drafters certainly could not have intended this more expansive definition and, therefore, it is not further analyzed here. That there is even any room to contemplate such an interpretation, however, further illustrates the lack of precision with which the digital advertising tax legislation has been drafted.

There are, however, other ways in which the user’s location clearly matters even just for viewing the advertisement itself. What is, ultimately, the location of the Lighthouse digital advertising service?

- Is it where a user viewed it, and if so, is this determined by the physical location associated with her IP address? What level of diligence is Lighthouse required to exercise to obtain this information, and how reliable will that information be, given the difficulty of determining the user’s location (geofencing) with absolute precision?
- Is it the user’s address in the state? What if she viewed the ad while on vacation elsewhere, or while flying over the state (or another state), or in-state but using a proxy server which is located outside the state?

We know that these questions may be answered in many different ways, which can lead to a variety of conclusions.

## Conclusion

This hypothetical illustrates an underappreciated failing of the Maryland digital advertising tax. Not only is the tax of dubious legality, and not only is the burden likely to fall mostly if not wholly on those advertising into the state—many of which will be in-state businesses—but the structure of the tax is so poorly designed as to make it difficult to determine which transactions would be sourced to the state. The result could easily be double taxation. It would undoubtedly be considerable uncertainty—and litigation.

-