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by Hayes R. Holderness

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In this article, Holderness argues that state digital advertising taxes should not be labeled as consumption taxes and that the barter transactions used to justify that characterization are questionable.

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Earlier this year, an article by professors Christine Kim and Darien Shanske supporting the adoption of state-level digital advertising taxes¹ gained traction in state legislative circles.² They recently reiterated many of their arguments in this publication.³ In their articles, the professors contend that digital advertising taxes can be justified as taxes on the interactions between users of digital services and the providers of those services. They further argue that those interactions are properly characterized as barter transactions representing untaxed consumption and that digital advertising taxes are permissible vehicles for taxing that consumption.

This article challenges the professors' characterization of the interactions between users and providers of digital services as barter transactions

and their conclusion that digital advertising taxes can be justified as consumption taxes on those barter transactions. These positions are problematic for several reasons. First, the interactions do not fit the traditional understanding of barter transactions and are more properly characterized as digital service providers offering an attraction and observing their clientele. Second, even if the interactions are barter transactions, the value of the exchange is minimal and not reasonably represented by the returns from advertising services sold by the digital service provider to third parties. Measuring the taxes by those returns and imposing them on the provider negates their characterization as consumption taxes. Finally, justifying a digital advertising tax as something other than an income tax on the returns from advertising services obscures legislative action by hiding the true nature of the tax from taxpayers.

The tax at issue is imposed on receipts from digital advertising services. Notably, Maryland is the only state to have enacted such a tax.⁴ As a practical matter, these taxes are targeted principally at the largest providers of digital services, such as Google, Microsoft, Amazon, and Facebook.⁵ The question is whether such a tax can or should be justified as a consumption tax on the users of those providers' non-advertising digital services. This query arises because digital service providers use information they gather about the users of those services to create the advertising services they offer to other parties. This article does not evaluate other potential justifications for digital advertising taxes; rather, it addresses the contention that they are consumption taxes based

¹Young Ran (Christine) Kim and Darien Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You May Have Heard)," 98 *Notre Dame L. Rev.* 741 (2022).

²See California Senate Committee on Revenue and Taxation, "Informational Hearing: Sustaining Journalism in California: Tax and Tax Credit Options," Background Paper (Mar. 13, 2024).

³Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *Tax Notes State*, June 10, 2024, p. 765.

⁴Md. Code Ann., Tax-Gen. section 7.5-101 et seq.

⁵See David McCabe, "Maryland Approves Country's First Tax on Big Tech's Ad Revenue," *The New York Times*, Feb. 12, 2021.

on a barter between users and providers of digital services.

The Interactions Between Users and Providers of Digital Services

As Kim and Shanske observe, when a user takes advantage of a provider's digital services, that provider may collect information about the user and the user receives the services.⁶ When a user opens Google Maps on their smartphone to search for the nearest coffee shop, for example, the app provides that information.⁷ Unless the user opts out, Google Maps collects information about the user's location and about places that the user visits or searches for. The app then uses that information to provide better services both to the user and to third parties who wish to advertise to the user. Knowing that the user likes coffee, Google Maps could automatically highlight nearby coffee shops. Also, perhaps Starbucks would like to advertise to people who frequent coffee shops; and because Google Maps has information about who those people are, it could provide Starbucks with more efficient advertising services than someone without that information.

At the most general level, a barter is a noncash exchange between two parties.⁸ At first glance, the interaction between users and providers of digital services appears to fit this general definition: The providers exchange digital services in return for users' personal information. This is precisely the barter that the professors say happens in these interactions, and they argue that these transactions should be subject to tax.⁹ The problem with their characterization is that there does not appear to be an actual exchange occurring between the parties. Instead, the interaction is more properly characterized as digital service providers simply observing the uses of their services, which are free attractions.

This description is supported by the facts of the interactions between users and providers of digital services. First, and perhaps most

importantly, digital service providers provide their services regardless of whether the user agrees to have information about them collected, negating the assertion that an exchange is taking place between the users and providers.¹⁰ Rather, digital service providers are offering a free service to those who wish to use it, similar to broadcast radio and television. Radio and television providers collect information about their users, then process that information to provide advertising services that support the providers financially.¹¹ Digital service providers may be different in scale, but they run on a similar model.

Unlike radio and television services, many digital service providers allow users to opt out of having their information collected.¹² Users who select that option are still permitted to use the digital service. While the service may be less refined, the provider still offers the core service, demonstrating that there is no barter for it. One might counter that the more refined service shows that there is some exchange occurring between the parties. However, this is no different than obtaining care services for a loved one. Imagine hiring a nurse to care for an elderly parent. The nurse provides routine care, but if you tell the nurse that your parent loves chocolate, the nurse will include a special treat with dinner. Or even more simply, the more information that you give your doctor, the better service she can provide you. More refined services? Yes. Barter of information for services? Hardly. The services, which depend on the information collected, are not given in exchange for the provision of information. In the same way, a user of Google Maps who allows the provider to collect information is no more engaged in a barter with the provider than the user who refuses to have their information collected.

Digital service providers offer their services to users for free to draw in more users and collect information that can be processed and monetized through advertising services. In other words, the

⁶ Kim and Shanske, *supra* note 1, at 745.

⁷ This service is available online with Google Maps or by app.

⁸ See, e.g., *Black's Law Dictionary*, which defines barter as "a contract by which parties exchange goods or commodities for other goods."

⁹ Kim and Shanske, *supra* note 1, at 745-746.

¹⁰ See, e.g., Google, "Terms of Service"; Google, "Privacy Policy."

¹¹ See Karl A. Frieden and Douglas L. Lindholm, "State Digital Services Taxes: A Bad Idea Under Any Theory," *Tax Notes State*, Apr. 10, 2023, p. 89, 101 ("[television and radio media] also provided viewers/readers free or heavily subsidized content in exchange for a consumer's willingness to view advertisements.").

¹² See Google, *supra* note 10.

providers are creating an attraction to collect a resource they value: information. But the attraction is provided regardless of whether the user gives anything in return. It is like a gas station providing free access to a petting zoo to draw customers in.¹³ Customers do not engage in an exchange when the gas station observes the license plates and demographics of the customers to better understand its clientele.

The gas station example raises the second issue with characterizing the interactions between users and providers of digital services as barter. In these interactions, providers are observing external information about the customers — where they are, what they are searching for, when they use the internet — rather than internal information that they would have to ask the users to provide in order to learn it, such as gender identity, religion, or opinions.¹⁴ Digital service providers might find it easier than a counterpart in the physical world to observe users' activities, but this does not change the nature of what digital service providers do. Digital service providers are simply observing their clientele as best they can, not requiring an exchange for users to access their services.

For another illustration of this point, consider a shopping mall offering free entertainment — such as bands, performers, and the occasional Santa Claus impersonator — for visitors. The mall also hires observers to note the general demographics of the people visiting the mall and what parts of the mall and stores those people frequent. The mall uses that information to improve its entertainment, determine what types of stores to lease space to, and decide which stores to promote in advertisements. The people have not bartered for access to the mall and the entertainment; rather, they have simply been observed as they enjoy free offerings.

Now consider a theme park offering free admission to testers who agree to provide their opinions on its attractions. Here, there is a clear exchange of information for a service. The park

cannot observe the testers' opinions externally and the testers have to offer those opinions up. And unlike digital services, the testers cannot get the service without providing that information. The provision of the service is contingent on the provision of information, demonstrating a barter that does not exist in the case of digital services.

It should be noted, however, that many exchanges that appear to be barter for consumer information have not typically been treated as taxable. When a Starbucks customer offers information about their birthday for a free coffee, states have not taxed that transaction. The same result occurs in grocery store loyalty programs, in which a customer provides information in exchange for discounts. Thus, interactions in which customers receive some benefit in exchange for their information are not commonly understood to be taxable barter transactions.

Because interactions between users and digital service providers are not taxable either technically or by common understanding, they should generally not be characterized as barter. Instead, the interactions represent the observation and collection of external information by digital service providers who draw in people to be observed with a free attraction. Such observation and collection of information is not a taxable transaction for digital services, and digital advertising taxes should not be justified as taxes on nonexistent barter.

If Users Do Barter for Digital Services, What Is the Tax Base?

Another challenge of treating interactions between users and digital service providers as barter is valuation. If users are bartering for the digital services, what is the cost of the information they offer to providers in these interactions? While this issue is more practical than theoretical, it highlights the problem of justifying digital advertising taxes as consumption taxes on digital services. This is because administrative solutions for the valuation problem transform digital advertising taxes from consumption taxes (assuming the barter characterization is accepted) into income taxes.

Consumption taxes are designed to tax individuals for their consumption as a government-imposed cost of using resources.

¹³ Lest the reader find this example fanciful, I assure you I have visited just such a gas station in my travels. One could easily substitute the petting zoo attraction for the world's largest ball of twine or something similarly grandiose.

¹⁴ *Id.*

Because these taxes increase the cost of consumption, they can be used to discourage harmful activities (so-called sin taxes on cigarettes and alcohol, for example) or they can reflect a normative view that those who take resources from society should owe something back to it.¹⁵ They might also be justified as administratively more efficient than income taxes.¹⁶ Consumption taxes typically fall on the end consumer of the product,¹⁷ which is accomplished at the state level by imposing sales taxes on retail transactions.¹⁸ Sellers typically collect that tax and are permitted (if not required) to pass its cost on to consumers, usually as a separately-stated charge.¹⁹ The consumption tax base is typically the value of the individual's consumption as measured by the fair market cost of what is consumed.²⁰

If there is a barter between users and providers of digital services, then the cost of digital services should be equal to the value of the user's information. However, there are difficulties in determining the value of that information. Because there are not established markets for user information or digital services, the fair market cost of either side of the barter is not immediately apparent. Indeed, digital service providers may be charging too much or too little in the form of information for their services. Thus, the value of the consumption must be determined by other means.

Kim and Shanske address this difficulty by concluding that the value of the advertising services the digital service providers offer to third parties is a reasonable estimate of the value of the users' information.²¹ In their view, digital services are costly, and the advertising services must roughly cover those costs.²² Many businesses have

multiple operations, some of which are expensive — like research and development — and others that are profitable. For a successful business, the profit centers will make up the losses of the cost centers (and then some), but that does not imply that the business's returns are a good proxy for the costs.

In line with this, the proposed proxy is problematic because advertising services are different than the digital services at issue. At a high level, advertising services include the values of collecting the raw user information, of processing that information, and of delivering the advertising. The digital service providers' charges for their advertising services are thus likely to be different (and much higher) than the value of the raw user information as a business input. For the same reason that the value of raw flour sold to a bakery is less than the value of the cupcakes it sells, the value of raw user information is less than advertising services that depend on processing that information. The cost of the advertising services is not a reasonable estimate of the value of the raw information provided in exchange for the digital services; it is inherently upwardly distortive.

Supporting this conclusion, the value of any individual's consumption of digital services is likely miniscule. Digital service providers collect a massive amount of information to provide advertising services, and their digital services are provided in about the same manner regardless of whether users consent to having their information collected.²³ This demonstrates that any one piece of information lacks significant value; rather, it is the service provider's ability to aggregate and process users' information that creates the value reflected in the cost of the provider's advertising services.

On the other side of the barter, the marginal cost of providing digital services to users would be a fraction of a cent at most. These free services are offered so broadly because the providers have the capacity to scale up their services. This is not to claim that costs are not incurred in providing their services or that providers could not sell their services for a markup, but rather to highlight the

¹⁵ See, e.g., Barbara H. Fried, "Fairness and the Consumption Tax," 44 *Stan. L. Rev.* 961, 962-963 (1992) (noting common normative justifications for consumption taxes); Richard D. Pomp, *State Taxation*, at 6-8 to 6-14 (same) (1998).

¹⁶ See Fried, *supra* note 15.

¹⁷ See Pomp, *supra* note 15, at 6-7.

¹⁸ *Id.* at 7-1 to 7-2.

¹⁹ *Id.*

²⁰ *Id.*

²¹ Kim and Shanske, *supra* note 1, at 764.

²² Kim and Shanske, *supra* note 3, at 766 ("If the gross receipts generated from all the ads did not roughly pay for all the 'free' services, then why would the platforms offer those services?").

²³ See Google, *supra* note 10.

small cost to providers of doing business with any particular user. If there's a barter transaction between the user and the provider (which this article disputes) and a proxy must be used to determine that transaction's value, it is reasonable to consider the costs to both parties to the transaction. Costs to the users are small, while those to the provider become asymptotic as the number of users increases.²⁴

Understanding that the value of a user's consumption of digital services may be too difficult to determine or too small to pursue the user for tax,²⁵ the professors propose that the consumption tax be paid at the aggregate level by imposing the digital advertising taxes on the digital service providers — again based on the cost of their advertising services.²⁶ While administratively appealing, at least relative to collecting tax from individual users, this model would flip the consumption tax paradigm on its head. Rather than taxing the consumer at the time of consumption, taxes would be levied on the service provider for the consumption of other people by looking to an aggregate value determined by the provider's later activities (the provision of advertising services, which require many valuable inputs, such as substantial R&D investments). Crucially, the service provider would lack a meaningful opportunity to collect the consumption tax directly from the consumer. Instead, by aggregating all the users' consumption to form a tax base, the tax burden would fall on the providers or the providers' advertising customers — who are even further removed from the users' consumption.

Essentially, a consumption tax would be transformed into a gross income tax by shifting

who the taxpayer is and the activity being taxed. The tax would be imposed on the value that the service provider generates only partially from collecting the user information; it would also be imposed on the value that the provider generates from processing that information and engaging in other activities supporting the advertising services, which are unrelated to the value of the users' consumption. That is an income tax, which is imposed on the taxpayer's change in accumulated value over a particular period.²⁷ Of course, legislators have framed the digital advertising taxes as designed to target the returns that the digital service providers earn from their advertising services,²⁸ so it is not damning to claim that they function as income taxes. But it does refute the idea that these taxes are justifiable as consumption taxes on the users' consumption of digital services.

Given how digital advertising taxes are imposed and calculated, they look increasingly like income taxes on the providers and less like consumption taxes on the users. If that's the case, and the interactions between users and digital service providers are truly barter, there should be corresponding income to the users equal to the income received by the providers (assuming neither party has basis in the information or services provided).²⁹ No one seems to be arguing that this is an appropriate result. In contrast, if the interactions are not characterized as transactions, then the users receive something free for which they have no income. The providers in turn have no income when they collect information on the users, but they do have income when they sell advertising services incorporating that information after processing. Whatever the mechanics of the income tax model would be, digital advertising taxes should not be justified as consumption taxes when they work as income taxes.

²⁴ Kim and Shanske do observe that "there could also be an argument that the increased value of the ads renders using them as a proxy . . . discrimination under the [Internet Tax Freedom Act] as a matter of law." Kim and Shanske, *supra* note 1, at 798, n.281. They conclude that in such a case, a discount of some percentage — such as 20 percent if deemed appropriate by a court — may be required. *Id.* However, the discount would likely have to be orders of higher magnitude, demonstrating the unsuitability of advertising revenues as a proxy for the values users consume.

²⁵ As noted by Kim and Shanske, there is an argument that if the value of the consumption is de minimis, it might be appropriately deemed untaxable to avoid the administrative cost of collecting taxes from individuals. See Kim and Shanske, *supra* note 1, at 780, citing Leigh Osofsky and Kathleen DeLaney Thomas, "The Surprising Significance of De Minimis Tax Rules," 78 *Wash. & Lee L. Rev.* 773, 832 (2021).

²⁶ Kim and Shanske, *supra* note 1, at 763-767.

²⁷ See, e.g., Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* 50 (1938) (defining personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.").

²⁸ See Tony Romm, "U.S. Eyes Flurry of New Taxes on Amazon, Facebook and Google, Trying to Force Tech to Pay Its 'Fair Share,'" *The Washington Post*, Feb. 12, 2021 (detailing state efforts to make large digital service providers pay their "fair share" in taxes).

²⁹ See Rev. Rul. 79-24, 1979-1 C.B. 60.

Hiding Consumption Taxes Behind the Digital Advertising Tax Label

Taking a step back from the difficulties of identifying a barter transaction in the interactions between users and providers of digital services and the barter's value, a broader issue exists with justifying digital advertising taxes as consumption taxes on digital services. As the above discussion alludes to, doing so obscures the nature of the taxes and undermines legislative action and taxpayer notice.

Calling an income tax a consumption tax is not problematic simply because it's the wrong label. It is also problematic because it obscures what the law is and how it works. Generally, taxpayers should be notified of their obligations so that they can comply with and provide input on the law.³⁰ When legislators obscure the nature of the laws they pass, they inhibit taxpayers' abilities to do that, which removes accountability from elected officials and may lead to the law being out of line with societal preferences.³¹ The democratic process is far from perfect, but those issues should be avoided.

Kim and Shanske argue that because tax law often must resort to proxies to achieve goals, it is permissible to use digital advertising taxes to target users' consumption of digital services.³² For example, they say that the federal personal income tax can be viewed as a proxy for taxing an individual's ability to pay.³³ Similarly, they claim that digital advertising taxes can be viewed as proxies for taxing users' consumption of digital services. Effectively, the contention is that rather than obscuring the nature of the law, digital advertising taxes simply adopt a proxy to administer the law's public objective to tax users' consumption.

However, as noted, the proxy does obscure the nature of digital advertising taxes as consumption taxes (if that is what they are meant to be). The proxy here is different than the income

tax proxy. Income itself is inherently a measure — albeit an imperfect one — of a person's ability to pay.³⁴ Advertising services are not inherently a measure of someone else's consumption. The measure is unrelated to the purported goal, so to say that a digital advertising tax is a consumption tax measured by advertising revenues obscures the nature of the tax.

In other words, the federal personal income tax exists because Congress felt it appropriate to tax individuals on their ability to pay. Taxing income does not obscure the fact that the goal of the tax is to impose higher obligations as one's ability to pay increases. In contrast, there is not the same connection between advertising and consumption in the context of a digital advertising tax. Levying a tax on providers' returns from advertising services is not so clearly related to users' consumption of digital services. The measure of the tax demonstrates, at least in the first instance, that it is a tax on advertising income, not consumption.³⁵

Likewise, the structure of digital advertising taxes places their legal incidence on digital service providers. Without a clear way to collect the taxes from users of the digital services, the incidence of the taxes does not clearly pass along to the consumer in the way that a state sales tax would.³⁶ If these are meant to be consumption taxes on the user, that goal is further obscured when it falls on the producers.

While the theory of a tax might be described in many ways given the difficulty of determining the

³⁴ See, e.g., *id.* at 765; Walter J. Blum and Harry Kalven Jr., "The Uneasy Case for Progressive Taxation," 19 *U. Chi. L. Rev.* 417, 480-483 (1952) (discussing income and progressive income taxation relative to the ability-to-pay principle).

³⁵ The U.S. Supreme Court has confirmed that the measure of a tax determines its characterization for purposes of legal analysis. See, e.g., *Trimova Corp. v. Michigan Department of Treasury*, 498 U.S. 358, 374 (1991) (rejecting efforts to recharacterize Michigan's value added tax as a tax on business activity while observing that a "tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes."); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981) (finding a tax measured by coal extracted in the state was a tax on the mining of coal); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444-446 (1940) (finding that Wisconsin's privilege dividend tax measured by corporate income was a tax on corporate income rather than a tax on dividends received by shareholders).

³⁶ See Fried, *supra* note 15; Pomp, *supra* note 15.

³⁰ See Hayes R. Holderness, "Crack Taxes and the Dangers of Insidious Regulatory Taxes," 95 *S. Cal. L. Rev.* 483, 511-513 (2022) (discussing the harms of obscuring the nature of tax laws).

³¹ *Id.*

³² Kim and Shanske, *supra* note 1, at 765-766.

³³ *Id.*

true incidence of the tax,³⁷ labels matter for taxpayers, voters, and legal interpretation.³⁸ Characterizing a tax on digital advertising services as a tax on the consumption of digital services masks the nature of the tax to taxpayers. This result should be avoided. Lawmakers should reject the consumption tax label and justification if they wish to enact these taxes.

Conclusion

As legislators consider adopting digital advertising taxes, questions of the nature of — and justification for — these taxes arise. Relying on their finding of barter transactions between users and providers of digital services, Kim and Shanske argue that these taxes are a permissible and appropriate means of taxing users' consumption of digital services. However, both the existence of barter transactions and the professors' characterization of digital advertising taxes as consumption taxes are questionable. The taxes should be viewed and justified as what they purport to be: taxes on the providers' returns from their advertising services. It is neither necessary nor appropriate to recharacterize these taxes as consumption taxes. ■

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³⁷ See Kim and Shanske, *supra* note 3 (arguing for multiple theoretical bases for the taxes).

³⁸ See *supra* notes 29 and 34.