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In this article, Frieden and Lindholm analyze California's proposed digital advertising tax (DAT), comparing it with the existing Maryland DAT, and provide their rebuttal to Young Ran (Christine) Kim and Darien Shanske's flawed characterization of and justification for the California DAT legislation as a digital barter tax.

Introduction

The first and only state digital advertising tax (DAT) was enacted in Maryland in 2021.[1] Since then, the Maryland DAT has operated under a cloud of uncertainty, beset by continuous litigation challenging its legality on both federal preemption (Internet Tax Freedom Act) and U.S. constitutional grounds (the commerce clause and First Amendment). Indeed, one lower Maryland state court found that the Maryland DAT violated both federal statutory and constitutional requirements, but the decision was reversed by the state's highest court on procedural grounds (failure to exhaust administrative remedies).[2] Now a new cycle of litigation is occurring in Maryland (based on refund applications), but we may not know the ultimate outcome until 2025.

In the interim, DAT or similar digital services tax proposals have been introduced in about 20 states.[3] None have been enacted, in part because of the issues surrounding the legality of such statutes, and in large measure because of serious questions raised about the policy implications of DATs. In 2024 the California DAT legislation has progressed further than in any of the other states. The proposed California legislation, S.B. 1327, which would create a new "data extraction mitigation fee," recently passed the California Senate by a two-thirds vote and was transmitted to the Assembly for consideration.[4]

The California DAT legislation reflects in large part the intellectual contributions of Darien Shanske, a California-based law professor, and Young Ran (Christine) Kim, a New York-based law professor. Over the last few years, Kim and Shanske have laid out an elaborate justification for

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[1] Md. Code Ann., Tax-Gen. section 7.5-101 to 103.

[2] *Comptroller of Maryland v. Comcast of California, Maryland, Pennsylvania, Virginia, West Virginia LLC, per curiam*, 294 A.3d 1108 (Md. 2023).

[3] See COST study of state DST proposals, in Karl A. Frieden and Douglas L. Lindholm, "State Digital Services Taxes: A Bad Idea Under Any Theory," *Tax Notes State*, Apr. 10, 2023, p. 90. A DAT generally refers to a gross receipts or sales tax exclusively on digital advertising services. A DST generally refers to a gross receipts or sales tax on digital advertising services, but also may include other digital platform revenues in the tax base.

[4] *See* Paul Jones, "California Digital Ad Tax Revived, Passed by Senate," *Tax Notes State*, July 8, 2024, p. 109.

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a DAT based on the premise that it is not really a tax on digital advertising, but rather a tax on what they characterize as "digital barter" transactions.[5]

We previously provided a detailed critique of Kim and Shanske's thesis after their lengthy law review article on this topic appeared in 2022.[6] But the situation has markedly changed as these ideas are now not just academic theories but actually have a chance of enactment in the largest state in the country. To that end, this article analyzes California's proposed DAT, compares it with the existing Maryland DAT, and reiterates our key rebuttals to Kim and Shanske's flawed characterization of and justification for the California DAT legislation as a digital barter tax. We also identify other tax policy weaknesses of their approach.

DAT Is a Consumption Tax on B2B Transactions, Not a Proxy for a Digital Barter Tax

The California DAT is labelled a "Data Extraction Mitigation Fee Law." It refers to "data extraction" transactions both in the title of the law and within the text of the law's provisions and definitions. The legislative findings in Section 1 also indicate the legislative intent to adopt Kim and Shanske's digital barter theory (which includes a data extraction element) as the primary justification for the DAT.[7]

But it immediately becomes clear that references in the legislation to a "data extraction fee" are just window dressing, a perfunctory effort to obscure that this fee is just a gross receipts (consumption) tax on digital advertising services. The statute states:

> Gross receipts shall be deemed to be derived from data extraction transactions *if they derive from the sales of advertising services on a digital interface*, including, but not limited to advertisements in the form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services that use personal information about the people to whom the ads are being served.[8]

The fact that California's proposed legislation is a consumption-type tax on business-to-business (B2B) transactions becomes abundantly clear when the tax base of the proposal is compared with that of the Maryland DAT. There are certainly differences between the two taxes. California S.B. 1327 applies only to companies with applicable in-state digital advertising revenues of over $2.5 billion, while the Maryland DAT applies to companies with over $1 million of such revenues. The proposed California rate structure is a flat 7.25 percent compared with a range of 2.5 to 10 percent in the Maryland statute.

On the most critical measures of the tax, however, the statutes are nearly identical. Both taxes are imposed on gross receipts, not net income. The California proposed legislation is on "annual gross receipts," while the Maryland DAT statute is similarly imposed on "annual gross revenues." The Maryland DAT uses terminology similar to the California proposal defining "digital advertising services" to 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."[9] Neither the California proposal nor Maryland statute includes in the tax base any type of digital goods or services other than digital advertising services. Additionally, neither includes in the tax base any nonmonetized "barter" transactions between businesses or

[5] Young Ran (Christine) Kim and Darien Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)," 98 *Notre Dame L. Rev.* 741 (2022); Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *Tax Notes State*, June 10, 2024, p. 765; Kim and Shanske, "Digital Barter Taxes: A Legal Defense," *Tax Notes State*, June 17, 2024, p. 865.

[6] Frieden and Lindholm, *supra* note 3.

[7] Section 1 of California S.B. 1327, in setting out legislative findings, makes clear that the Legislature is using the terminology of a digital barter transaction as a justification for taxing the gross receipts of digital advertising services:

> However, many digital transactions are hard to bring into the digital sales tax base because instead of paying a monetary fee, customers sometimes barter their personal information for access to digital platforms and services. Corporations then use this data to target advertisements on digital platforms. To tax this consumption, leading tax economists have suggested using the receipts earned from data extraction transactions as a proxy for the value of the barter.

[8] S.B. 1327 (Glazer), Cal. Leg. Sess. 2023-2024, Part 10.9, c. 1, section 21201 (b)(2) (emphasis added).

[9] Md. Code Ann., Tax-Gen. section 7.5-101(e)(1) (emphasis added).

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individuals, or any type of data extraction revenue streams. Finally, both the California proposed DAT and the Maryland DAT include in the tax base only digital advertising services and no other types of advertising services (newspaper, television, radio, or billboard).

A Gross Receipts or Sales Tax on Business Inputs Is Bad Tax Policy

From the above analysis, it is clear that the gross receipts tax bases of both the proposed California and enacted Maryland DATs include exclusively B2B purchases (and not business-to-consumer (B2C) purchases). Almost by definition, a digital advertising service constitutes the sale of space on a digital platform or website to another business that seeks to use that space to promote its products or services to potential customers.

It is equally clear that a gross receipts or sales tax on B2B transactions (commonly referred to as "business inputs") is bad tax policy.[10] Few state tax issues garner more widespread agreement among tax experts and public finance economists than on the optimal design of the sales tax. There is near-universal belief among sales tax experts that a well-designed sales tax should exempt all or most B2B transactions to avoid tax "pyramiding."[11] Academic support for excluding business inputs from the sales tax base dates to the earliest decades of general sales tax enactments and has continued uninterrupted since then.[12]

The criticism of a sales tax design that includes extensive taxation of business inputs is not limited to the retail sales tax — the U.S. states' chosen form of a general consumption tax. Indeed, virtually all other advanced nations that enacted different types of sales and gross receipts taxes beginning after World War I eventually transitioned to a value-added tax in the mid-to-late 20th century. This design change from one form of a general consumption tax to another, unrivaled by any similarly sweeping tax structure reform in history, was done primarily to avoid the sales taxation of business inputs, at least to the extent their inclusion in the tax base resulted in the pyramiding of sales tax.[13]

The anti-pyramiding principle associated with an efficient and effective consumption tax is so widely accepted that even leading DAT proponents accept its vitality. For instance, Kim and Shanske acknowledge that a DAT that imposes a gross receipts tax on digital advertising involves some tax pyramiding:

> To be sure, digital ads are a business input and so there would be some pyramiding if the costs are shifted back to the advertising businesses. But our point is that as a tax only on one later stage of production, it should not cause great pyramiding and it is unfair to compare its economic effects to broad-based taxes.[14]

[10]"Gross receipts" taxes and "retail sales" taxes are used somewhat interchangeably here. Historically, retail sales taxes are a form of gross receipts taxes, which can also include other types of sales taxes (manufacturing and wholesale sales taxes) and value-added taxes. Both gross receipts taxes (sometimes referred to as "turnover taxes") and sales taxes can apply to a broad base of goods and services (typically referred to as a "general" consumption tax) or just to one or a narrow range of goods and services (typically referred to as a "selective" consumption tax). In the context of DATs, a gross receipts tax on digital advertising services can be a selective consumption tax like the Maryland or proposed California DAT, or can be included as part of a general (broad-based) sales tax. For discussion of a DAT proposal using an existing sales tax, see Andrew Appleby, "Subnational Digital Services Taxation," 81 *Md. L. Rev.* 1, 15 (2021).

[11]Some sales tax experts prefer the word "cascading" to "pyramiding" because unlike a pyramid, which narrows at the top, cascading effects grow larger with each level. *See* Richard D. Pomp, "Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising," State Tax Research Institute, at 27-28 (July 2022). Generally, the words "pyramiding" and "cascading" are used interchangeably when referring to the negative impact of including business inputs in the sales tax base.

[12]Frieden, "Wearing Blinders in the Debate Over Business's 'Fair Share' of State Taxes," *Tax Notes State*, Apr. 8, 2024, p. 91, 99-100.

[13]*Id.* at 100; Joseph Ganderson and Julian Limber, "The Rise of General Consumption Taxes," in *Global Taxation: How Modern Taxes Conquered the World* (2022).

[14]Kim and Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)," *supra* note 5, at 801. And Kim and Shanske double down in their latest article:

> There are sound reasons to believe the pyramiding will not be too great as to this tax. These are narrow gross receipts taxes imposed at a late stage in production. Because these taxes are imposed on one input (ads) at a late stage of production (compare ads to fuel), the amount of pyramiding ought not to be too great.

Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *supra* note 5, at 769. While minimizing the impact of pyramiding in this instance, Shanske is consistent in recognizing that taxing business inputs is a deviation from retail sales tax principles. See Shanske, testimony to the California Assembly Revenue and Taxation Committee on Feb. 22, 2023 (at 1:22.30), concurring with the generally accepted academic view that taxing business inputs is a deviation from retail sales tax principles; *see also* Gladriel Shobe et al., "Why States Should Consider Expanding Sales Taxes to Services, Part 1," *Tax Notes State*, Dec. 21, 2020, p. 1353.

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Thus, Kim and Shanske excuse the inefficient pyramiding of a DAT because it applies to only one additional level, making it more benign than a traditional gross receipts tax that imposes a tax on multiple stages of a supply chain. Several problems are implicated by this defense of limited pyramiding. First, the one extra layer of pyramiding they reference — the DAT imposed on digital advertising — is quite significant. It is precisely because of the DAT's revenue-raising potential that this tax policy option is so attractive to its proponents.[15]

Further, Kim and Shanske's assertion that one additional level of pyramiding is relatively harmless ignores the excessive pyramiding of sales tax already overwhelming state sales tax systems. A selective gross receipts tax on digital advertising can't be viewed in isolation; its cumulative impact must be measured in conjunction with the existing retail sales tax. When viewed as part of a larger consumption tax system, a DAT adds another layer of tax pyramiding to the taxation of business inputs that is already rampant in U.S. state sales tax systems.[16]

The Fallacy of the Digital Barter Theory Justification for a DAT

To their credit, Kim and Shanske are concerned about whether a DAT constitutes sound tax policy. To that end, they have developed an elaborate justification for a DAT based on the notion that it is not really a consumption tax on B2B transactions but a "proxy" for a consumption tax[17] on untaxed digital barter transactions.[18]

According to Kim and Shanske:

> Tax systems have been struggling to adapt to the digitalization of the economy. At the center of the struggles is taxing digital platforms, such as Google or Facebook. These immensely profitable firms have a business model that gives away "free" services, such as searching the web. The service is not really free; it is paid for by having the users watch ads and tender data. Traditional tax systems are not designed to tax such barter transactions,

[15] Appleby, in an article on DATs, observed: "Possibly a stronger motivating factor, digital advertising taxes are enormous revenue sources at a time when many state and local governments are facing shortfalls. . . . If every state adopted a digital advertising tax, the aggregate annual state tax revenue could approach $14 billion." Appleby, *supra* note 10, at 7. *See also* Kim, Reuven S. Avi-Yonah, and Karen Sam, "A New Framework for Digital Taxation," 63 *Harv. Int'l L.J.* 273, 336 (2022). California S.B. 1337 starts with a high threshold for taxpayers subject to the DAT (in-state revenues of at least $2.5 billion), but that could be lowered in future legislation to align more with the Maryland approach (in-state revenues of at least $1 million).

[16] This point is amplified by looking closely at the level of pyramiding already rampant in the digital marketplace that DST proponents seek to increase. The only industries in the United States favored by robust business input exemptions are manufacturing and agriculture. Commercial, retail, service-oriented, and digital businesses have few built-in sales tax exemptions for business inputs other than the sale-for-resale exemption. For instance, two of the key levels of the digital marketplace supply chain — digital platforms and retailers — are already subject to a sales tax on a significant share of their business inputs. Most states offer no commercial sales tax exemption for purchases of computer hardware, computer software, electric and gas services, telecommunications services, and tangible property supplies — all inputs that are used extensively by digital businesses and retailers. *See* Frieden and Fredrick J. Nicely, "Digital-Business Input Exemptions: Lessons From Sales Tax History," *Tax Notes State*, Jan. 29, 2024, p. 357; Frieden, Nicely, and Priya D. Nair, "Down the Rabbit Hole: Sales Taxation of Digital Business Inputs," *Tax Notes State*, July 18, 2022, p. 265.

[17] We agree with Kim and Shanske's characterization of a DAT or DST as a consumption tax but disagree with their nonchalance regarding its impact on B2B purchases. *See* Frieden and Lindholm, *supra* note 3, at 91-94, 98-104. While we agree in large part with Hayes Holderness's recent critique of Kim and Shanske's digital barter tax justification, we disagree with its conclusion that the DATs are best viewed as "taxes on the providers' returns from their advertising services." Hayes R. Holderness, "Misconstruing Digital Advertising Taxes as Consumption Taxes," *Tax Notes State*, July 1, 2024, at 7, 13. We believe Holderness conflates the refutation of Kim and Shanske's digital barter tax justification for a DAT with a misreading of the underlying nature of the gross receipts tax — which is still best characterized as a B2B consumption tax on digital advertising. Under either scenario, however, the DAT does not satisfy the criteria of good state tax policy. When viewed as a consumption tax, it is essentially a tax on business inputs. When viewed as an income tax, it inappropriately taxes gross revenues, not net income.

[18] While the "barter tax as consumption tax gap filler" is Kim and Shanske's primary justification for a DAT, they also provide several other justifications for a DAT, including as a tax on excess profits and as a regulatory tool. Kim and Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)," *supra* note 5, at 767-772; Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *supra* note 5, at 766-768. For our rebuttal of these other justifications for a DAT, see Frieden and Lindholm, *supra* note 3, at 94-98. Several other academics have expressed some level of support for a digital barter tax analysis. See Frieden and Lindholm, *supra* note 3, for our critique of their perspectives.

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> leaving a gap in taxation. . . . A DST is a tax on consumption from the barter side of platforms that is not currently taxed.[19]

The problem with this "untaxed barter transaction" justification for a DAT (or DST), however, is that the nonmonetized arrangement arising from the digital platform business model is wholly dissimilar from barter transactions that are typically included in the statutory sales (and income) tax base. Generally, state sales tax bases do not include nonmonetized transactions. The basic premise of a consumption tax is to impose a tax on receipts from the sale of monetized goods and services. However, there is a limited barter exception to this rule. A typical *taxable* barter transaction satisfies two criteria:

1. it applies to a one-to-one exchange of goods or services without use of a monetary medium; and
2. the transaction would otherwise go untaxed if the tax is not imposed on the nonmonetized barter exchange (examples include auto repair services exchanged for cleaning services, landscaping swapped for house painting, or agricultural crops exchanged for machine tools).

In each of these circumstances, assuming the goods or services would otherwise be included in the sales tax base if sold directly to a consumer, the barter transaction avoids sales (and income) tax unless the value of both sides of the transaction is included in the tax base.[20]

However, these taxable barter arrangements are fundamentally different from the digital marketplace transactions targeted by Kim and Shanske. First, the digital platform transactions are not "one-to-one" but rather "one-to-many" exchanges (for example, the platform's interaction with millions of consumers), which are infinitely more complex and less conformable to the traditional barter model. A key feature of a one-to-one barter arrangement is the ability of both parties to determine the value of the transaction and use it for sales and income tax reporting purposes. By contrast, the valuation of nonmonetized transactions between a digital platform and individual consumer-users is impeded by the absence of a direct link between the services provided and consideration received. The valuation is not only highly uncertain but varies infinitely depending on the scope of free internet services or other functionality provided and used, the quantity of personal data aggregated or provided, and the number of digital advertisements posted and viewed.[21]

The digital barter transaction theory completely falls apart upon recognition that there is no fixed barter arrangement — but rather a new business model with nonmonetized transactions of all different stripes and outcomes. Digital platforms typically allow consumers to opt out of providing personal data and yet still allow the same amount of "free" internet services. A consumer may use a digital platform to search a digital map, look up synonyms for a commonly used word, or conduct extensive historical research for a school project. A consumer may provide none, some, or a significant amount of access to personal data. It is nearly impossible to determine what either side is offering or the

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[19] Kim and Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)," *supra* note 5, at 741-742. Kim and Shanske renewed their "digital barter tax" justification for a DAT in a June 2024 *Tax Notes State* article in which they stated:

> But what about digital barters? As a formal matter, one cannot escape sales tax (or income tax) through bartering. In the usual case, the tax base would be the fair market value of the good received. But what is the FMV in the case of bartering for a "free" service like Google Maps? If these barters represented a small amount of consumption, then perhaps we should not spend too much time worrying about this, but this is neither a small area of consumption nor one likely to go away. . . . In this case, a reasonable and administrable proxy for the value of the barters currently avoiding tax is the gross receipts generated by ads sold by the very same platforms. The logic is the following: If the gross receipts generated from the ads did not roughly pay for all the "free" services, then why would the platforms offer those services?

Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *supra* note 5, at 765-766.

[20] A Washington state publication, "Bartering Transactions Are Taxable," gives an example of the retail sales tax implications of a barter transaction involving the trade of accounting services for plumbing services. We focus here on the sales tax implications of barter transactions. But there are also similar income tax consequences of a nonmonetized exchange of goods or services. *See generally* IRS Pub. 525, "Taxable and Nontaxable Income," at 20-21.

[21] *See* Adam B. Thimmesch, "Transacting in Data: Tax, Privacy, and the New Economy," 91 *Denver L. Rev.* 145, 174-177 (2016).

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relative value of billions of nonmonetized transactions.[22]

The good news, and the fatal flaw in Kim and Shanske's characterization, is that there is no need to calculate the value of these transactions or rely on some esoteric digital barter tax concept, because there is still a subsequent monetizable transaction in the supply chain that is (or can be) includable in the sales tax base. Digital platform transactions, unlike one-to-one barter arrangements, are intermediate and not final transactions. If a one-to-one barter exchange is not treated as taxable, no tax monetization event occurs. Digital platform exchanges, by contrast, are part of a stream of related transactions whereby a sales tax can be imposed at a later, monetized retail stage. This is evident whether the "barter" transaction precedes (and enhances) a B2C sale on the digital platform itself or paves the way for a targeted digital advertisement, which then is followed by a "downstream" purchase by a consumer of the advertised good or service.[23]

It should be obvious that nonmonetized transactions on a digital platform eventually result in monetized transactions. For-profit businesses are not organized to lose money or engage solely in public charity. In the case of digital platforms that earn income from user-advertisers, the significant investments made to provide free internet services to attract consumers who share their data and watch the platforms' advertisements increase the value of the digital advertising sales. The user-advertisers then use the targeted digital advertising to enhance the value of their B2C sales to customers. In the case of digital platforms that make most of their income from their own B2C sales or those of hosted third-party sellers, the nonmonetized "barter" transactions with user-consumers are monetized primarily through increasing the value and volume of their own sales or those of the third-party sellers (who pay a commission or some other revenue split with the platform).

Kim and Shanske argue that digital advertising is a "proxy" for the value of all nonmonetized digital platform activities and therefore should be included in a gross receipts or sales tax base. But their argument fails because the value of nonmonetized digital platform activities and of monetized digital advertising (an intermediate business input) is reflected in the price of B2C goods and services sold over the internet. Indeed, if digital advertising (as a proxy) is added to a gross receipts or sales tax base along with the monetized value of subsequent sales of goods and services, then tax pyramiding results.[24]

The False Notion of 'Untaxed' Transactions and a 'Consumption Tax Gap'

A second and interrelated component of Kim and Shanske's "digital barter tax" justification for a DAT is that such a tax is needed to avoid a "consumption tax gap." Kim and Shanske assert that failure to tax nonmonetized barter transactions (including valuable data extraction activities) creates a large "gap" in the sales tax base. Kim and Shanske observe: "But the barter transactions are not recognized or taxed in any

[22] For an excellent discussion of the absence of connectivity or parity between digital websites' provision of free internet services and consumers' provision of personal data, see Holderness, *supra* note 17, at 8-11.

[23] The significant divergence of digital platforms from the traditional taxable barter model underscores the impracticality and impropriety of trying to shoehorn the two together. It also explains why, to date, no U.S. taxing authority has applied taxable barter transaction rules to digital platforms. To make the analogy work necessitates imposing sales and income tax rules on both sides of the transaction and devising methods for valuing the barter arrangements. The former is politically unviable, as no taxing jurisdiction is likely to require a digital platform to charge consumers a sales tax for free internet services, nor require an individual consumer to charge a sales tax (or pay an income tax) on the imputed receipts from selling data to a digital platform. The latter is highly capricious, imprecise, and unworkable because of the absence of a direct one-to-one link between the platform and individual consumers. Importantly, for sales tax purposes, no such manipulation is necessary because there is a future monetization event that can be included in the tax base — the downstream retail sale of the B2C good or service. For an excellent description of the difficulty of taxing nonmonetized data transactions, from a law professor sympathetic to doing so, see Thimmesch, *supra* note 21, at 174 (and, generally, Part II).

[24] Kim and Shanske like to cite the example of an internet consumer using a Google map in exchange for providing some personal data or viewing a digital advertisement. They ask, "Why should the monetized sale of a tangible map in a store be taxed, but not the nonmonetized barter of a digital map?" *See* Kim and Shanske, "Digital Barter Taxes Are Good Tax Policy," *supra* note 5, at 765. The answer is quite straightforward. Whether a business charges for a digital map or other digital content is simply a choice of business models and pricing. If a business chooses to monetize a transaction, such as charging for streaming services (versus providing "free" television) or the sale of a map (versus providing it for "free" on the internet), then a monetization event occurs that can be included in the sales tax base. In that case, the price of the "free" service no longer needs to be reflected in a future monetizable transaction (such as advertising or future product sales). The notion that the choice and timing of sales tax base inclusion should supersede the monetizable transaction is as irrational as it is impractical.

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state, resulting in a large and growing gap in the sales (consumption) tax."[25]

The notion of a consumption tax gap has appeal to legislators because it sounds like a so-called loophole that ought to be closed. The fundamental flaw of the consumption tax gap thesis, however, is that nonmonetized data extraction transactions and monetized digital advertising are untaxed because in a retail sales tax system, intermediate inputs are *supposed* to be untaxed. The appropriate stage to impose a tax is at the retail level, when the consumer purchases a monetized good or service either directly from a digital platform or later, after viewing the digital advertisement. The digital platform transactions are untaxed intentionally, not inadvertently, to avoid the pyramiding of tax on both intermediate and retail-stage transactions. Ironically, if the proponents succeed in persuading more states to enact DATs, the result would not just tax some untaxed transactions but would create "double-taxed" transactions at both the intermediate and retail consumer levels.

The fallacy of the consumption tax gap is clear when its application is extended to other untaxed intermediate business input transactions. In the sales tax context, many transactions are exempt, such as sales of equipment used in manufacturing; raw materials and component parts incorporated into finished goods; sales of equipment used in providing telecommunications services; and sales for resale. These business inputs are all part of a related stream of transactions in which the final good or service is (or could be) subject to sales tax. And yet no new tax is imposed on the intermediate transactions under the theory that they are untaxed.

In a broader sense, these transactions are untaxed only if the subsequent retail sales that are included (or could be included) in the sales tax base are ignored. Only if an "upstream" business input transaction is viewed in isolation, ignoring downstream retail sales, does an intermediate transaction appear untaxed. Otherwise, all sales tax exemptions for production equipment or sales for resale would be pejoratively labeled "untaxed."

Although a digital platform exchange of free internet content for consumer personal information and viewed advertisements constitutes a novel nonmonetized transaction, it still essentially creates an intermediate business input (consumer data aggregation) that either facilitates digital advertising or enhances the subsequent sale of a monetized B2C good or service. The same is true of monetized advertising on a digital platform that is followed by a subsequent sale of the advertised good or service. To the extent a state doesn't tax the retail B2C transaction, it is a function of the breadth of its sales tax base and not because there is no potential for a monetized transaction. To avoid a sales tax that pyramids the tax inappropriately to multiple levels of the supply chain, the intermediate transactions, whether monetized or not, should be exempt. Otherwise, the DAT or sales tax equivalent violates one of the core principles and a defining characteristic of an effective consumption tax.

This is not a new issue. A similar issue, to a lesser extent, has always existed with television, radio, and print advertising. This earlier generation of mass media also provided viewers or readers with free or heavily subsidized content in exchange for a consumer's willingness to view advertisements (albeit typically no additional provision of individualized consumer data[26]). These earlier "barter" transactions were similarly untaxed because subsequent transactions (that is, the purchase of the advertised goods or services by the end-use consumer) were (or could be) included in the sales tax base.[27]

[25] Kim and Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)," *supra* note 5, at 746.

[26] DAT proponents argue that the targeted nature of online advertisements, keying off of personal information, is a novel departure from traditional advertising, thereby warranting a differing approach. However, such targeting has always occurred, although with less precision. Examples include toy advertisements on kids' shows; analgesics and other specialized medications advertised on golf broadcasts; or housewares advertised on daytime TV.

[27] Using Kim and Shanske's logic, a gross receipts or sales tax should be imposed on television or radio advertising as a "proxy" for the "free" television or radio services received by consumers. These other forms of advertising, however, have always been viewed appropriately as monetized B2B sales between the communication providers and advertisers, not as some nonmonetized barter transaction between communication providers and consumers.

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Other Tax Policy Objections to the DAT

Three other tax policy objections to the DAT serve to amplify the problems with state-level adoption. First, enactment of DATs will exacerbate the currently flawed design of sales taxes in the United States. The U.S. retail sales tax system, without a built-in mechanism for exempting sales tax pyramiding (as exists in a VAT system), includes business inputs in the sales tax base more than virtually any other country. Indeed, business inputs account on average for about 42 percent of the overall state and local sales tax base in the United States.[28]

What is different and particularly troubling about DATs is that they represent an atypical base expansion that *exclusively* targets a business input (digital advertising). Historically, the sales taxation of business inputs generally occurs less overtly, as both B2C and B2B transactions are included in the sales tax base without an exemption for the business inputs. With DATs, this process is turned upside down by adding only business purchases to the gross receipts or sales tax base.[29]

The DAT debate is taking place in the context of a larger discussion about the appropriate sales tax base for digital products.[30] Kim and Shanske (and many others) are keenly interested in expanding the sales tax base to include more digital B2C goods and services.[31] However, their committed advocacy for a DAT is counterproductive to this goal. The proliferation of DATs would stiffen business opposition to digital sales tax base expansion and fuel skepticism that the states' goal is not simply to broaden and modernize the B2C digital sales tax base, but to continue the historically inefficient and unfair pattern of taxing both B2B and B2C transactions.[32]

Second, the strong opposition by the federal government to foreign DSTs is improperly ignored in state-level considerations, creating a schism between federal and state approaches to DSTs (and DATs). Under both the Trump and Biden administrations, the Office of the U.S. Trade Representative initiated section 301 investigations and actions against France and other nations that enacted DSTs and threatened to impose trade sanctions.[33] The United States found that DSTs discriminate against digital companies based in the United States, are inconsistent with the principles of international taxation, and burden or restrict U.S. commerce. For instance, the trade representative concluded that 90 percent of the tax burden of the French DST falls on U.S.-based multinationals.[34] Similarly, California's S.B. 1327 apparently applies to only three digital advertising platforms, all U.S.-based multinationals.[35]

The controversy between the U.S. government and foreign governments over the enactment of foreign country DSTs has been somewhat muted or delayed because of postponements of foreign DST implementation, and because almost all parties view the DSTs as temporary taxes that will be withdrawn once a broader and more permanent multilateral solution is adopted as

[28]Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," prepared for the State Tax Research Institute and COST, EY (May 2019).

[29]*See* Frieden and Nicely, *supra* note 16 (especially Part 4).

[30]*See* Multistate Tax Commission, "Sales Tax on Digital Products" (last reviewed July 10, 2024).

[31]*See* Shobe et al., "How States Should Now Consider Expanding Sales Taxes to Services, Part 2," *Tax Notes State*, Jan. 4, 2021, p. 45.

[32]*See* Frieden and Lindholm, *supra* note 3, at Part 3.

[33]Title III of the Trade Act of 1974 (sections 301-310, codified at 19 U.S.C. sections 2411-2420), titled "Relief from Unfair Trade Practices," is often collectively referred to as "section 301." It grants the trade representative a range of responsibilities and powers to impose trade sanctions on foreign countries that violate U.S. trade agreements or engage in acts that are "unjustifiable," "unreasonable," or "discriminatory," and that burden U.S. commerce. *See* Congressional Research Service, "Section 301 Investigations: Foreign Digital Services Taxes (DSTs)" (updated Mar. 1, 2021).

[34]For a discussion of U.S. government opposition to foreign DSTs, see Frieden and Stephanie T. Do, "State Adoption of European DSTs: Misguided and Unnecessary," *Tax Notes State*, May 10, 2021, p. 577.

[35]Jones, *supra* note 4 (noting the bill's sponsor said the DAT applied only to Amazon, Google, and Meta).

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part of the OECD's pillar 1 project.[36] Nonetheless, the adoption of state-level DATs contravenes federal policy against unilateral tax measures that discriminate against U.S. businesses, undermines the United States' position opposing foreign DSTs, and arguably prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments.[37]

Third, since the California data extraction mitigation fee is clearly a DAT masquerading as a digital barter tax, if enacted, it would immediately become embroiled in protracted litigation similar to the travails of the Maryland DAT. The proposed California legislation applies to digital advertising but not to nondigital forms of advertising (such as billboards, newspapers, and television ads), likely violating the federal ITFA. The ITFA, first enacted in 1998 and subsequently extended until it was made permanent in 2016, preempts state and local governments from levying multiple and discriminatory taxes on electronic commerce.[38] Indeed, the only state court that has ruled on this issue, Circuit Court for Anne Arundel County, held that the Maryland DAT violated the ITFA (and the U.S. Constitution). This ruling was later overturned by the Maryland Supreme Court on procedural grounds (the failure of the taxpayers to exhaust administrative remedies), but the issue is in litigation again in the Maryland Tax Court.[39]

Kim and Shanske attempt to distinguish the California-style DAT, using the same faulty digital barter tax and consumption tax gap analogy they use as a justification for the tax itself. They argue:

> Because a digital barter tax is a tax on untaxed consumption that is otherwise generally taxed, there is no discrimination because untaxed consumption is simply being subjected to the same tax as other consumption — namely the sales tax.[40]

However, as discussed above, the digital barter tax justification fails under analytical scrutiny and the consumption tax gap theory is just a clever subterfuge to tax additional business inputs. While the outcome is uncertain, California or any other state that adopts a DAT similar to Maryland's risks losing all the DAT revenue collected if a state court subsequently determines the statute violates the ITFA's antidiscrimination provision or the U.S. Constitution.

Conclusion

In developing their justification for a DAT, Kim and Shanske take seriously the importance of sound tax principles. The proposed California DAT, however, fails to qualify as sound tax policy on multiple fronts: It lacks transparency (mislabeled as a data extraction fee), results in extensive sales tax pyramiding (imposed exclusively on business inputs), ignores countervailing national tax policy goals opposing foreign DSTs, and likely violates the antidiscrimination prong of the ITFA. The bottom line is that the California Legislature (and future state legislatures) should resist Kim and Shanske's beguiling (but flawed) digital barter justification and reject proposed DAT legislation as contradictory to sound state tax policy. ■

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[36] *See* Frieden and Barbara M. Angus, "Convergence and Divergence of Global and U.S. Tax Policies," *Tax Notes State*, Aug. 30, 2021, p. 937 (especially at 968-970). For an analysis of why the European rationale for a DST, as a temporary "income tax gap" replacement for national corporate income taxes that lack economic nexus and market sourcing rules, does not pertain to state corporate income taxes (that apply to companies with no physical presence), see Frieden and Do, *supra* note 34.

[37] *See Japan Line Ltd. v. Los Angeles County*, 441 U.S. 434, 444-445 (1979) (establishing the two-part test for determining when a state tax violates the foreign commerce clause). In their legal defense of DSTs, Kim and Shanske question the one-voice factor thusly:

> Say the president wishes for the states to cease a certain tax practice but fails to get Congress to preempt it. If a federal court finds that state practice unconstitutional because of an amicus brief filed by the solicitor general or other executive branch communications, then a federal court is allowing the president to bypass Congress and accomplish through litigation what he could not accomplish through legislation.

Kim and Shanske, "Digital Barter Taxes: A Legal Defense," *supra* note 5, at 871.

This overtly tendentious argument reflects a fundamental misunderstanding of the application of the one-voice factor under the (dormant) foreign commerce clause. The Constitution imbues the executive branch, not Congress, with plenary authority to speak with one voice in foreign affairs. *See* U.S. Constitution Art. II, section 2, cl. 4; and *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304 (1936) (characterizing the president as the "sole organ of the nation in its external relations.").

[38] P.L. 114-125, section 922(a).

[39] *Google LLC v. Comptroller*, Dkt. No. 23-DA-OO-0649 (2024).

[40] Kim and Shanske, "Digital Barter Taxes: A Legal Defense," *supra* note 5, at 870.

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