State Leader Policy Brief

Innovative Revenue Models
About This Brief

The Council of State Governments (CSG) Healthy States National Task Force State Leader Policy Briefs are informational resources for state leaders to improve understanding of policy issues and empower policy conversations. Included in each brief are introductions to the policy problem, a survey of state policy options and analysis and recommendations for state leaders.

The policy options presented in this guide are not endorsement of a particular policy by CSG or members of the Healthy States National Task Force, but rather are intended to assist state leaders in their assessment within their specific state contexts.

Rapidly changing technologies and emerging industry sectors in state economies and workforces present both opportunities and challenges for states to build fiscal resilience, capture additional revenue and align taxation models that match these trends. The COVID-19 pandemic has amplified this need as states assess their resilience during the continued economic pressures resulting from the pandemic.¹

As part of these conversations, states may consider how innovative revenue models related to taxation of remote work, digital advertising, recreational cannabis and sports gambling may be a part of a state’s overall strategy.

The Need for Innovative Revenue Models

The COVID-19 pandemic’s negative effect on state budgets, while significant, was less than feared.² Key factors helped soften the fiscal impact on state budgets, including the use of rainy day funds, aggressive and continuing federal support, state tax structures and the diversification of state economies. As states continue to recover, new and innovative revenue models will more commonly represent incremental, rather than large scale, efforts to boost state budgets and cannot be relied upon alone to address structural deficits, long-term debt obligations and risks to fiscal resiliency. However, they can be a part of a larger, comprehensive policy conversation and strategy by states to ensure their tax codes reflect current state trends, capture currently unrealized tax revenue and provide another avenue to broaden tax bases.

Digital Taxation

Digital taxation represents an emerging policy strategy for states to better align revenue policies with the increasing digitization of the United States economy. Since the 2018 Supreme Court decision in *South Dakota v. Wayfair*, states have been able to collect sales tax from businesses without a physical presence within their jurisdiction. However, other components of the digital economy, such as advertising, social media and data, represent opportunities for states to collect additional revenue that matches the specific value creating business sectors.

While these policy options are presently more common in other countries, they are seeing consideration in states. For example nine states have proposed some version of digital advertising, social media and data tax proposals. A tenth state, Maryland, enacted a digital advertising tax in 2021, *House Bill 0732*, though it has yet to be implemented.

- **Policy Option | Digital Advertising Taxation**
  
  Digital advertising taxation models are designed to garner revenue from search engine, banner and other means of online advertising. The states that have attempted to impose digital advertising taxes have commonly set a rate based on a company’s amount of in-state or global revenues. For example, *New York Senate Bill 1124 (2021)*, if enacted, would have a tax on the annual gross revenues of a company from the provision of digital advertising services in New York at a rate based on the taxpayer’s overall global annual revenues.


• **Policy Option | Social Media Taxation**

States may consider a variety of taxes on social media platforms including a tax on the advertising revenue received through a platform and a surcharge on each account. For example, **Indiana House Bill 1312** (2021), would levy a surcharge on qualifying social media companies equal to the annual gross revenue derived from social media advertising services in Indiana in a calendar year multiplied by 7%, plus the total number of the social media provider’s active Indiana account holders in a calendar year multiplied by $1.

• **Policy Option | Data Taxation**

Taxes on data vary, with some state policymakers focusing their proposed tax on the sale of consumer data, while others focus on the possession of that data. For example, **Oregon House Bill 2392** (2021), would have imposed a 5% gross receipts tax on the sale of personal information at retail in the state.

**Considerations for State Leaders**

“Big Tech” has become big business and personal information has become one of its most valuable commodities, especially during the COVID-19 pandemic, when people were seeking connection, essential services and entertainment virtually as their only safe option. The combined revenues of the five largest technology industries grew by 20% in 2020 alone to over $7.5 trillion.⁵

As a result, the regulation of this industry, and the ethical concerns over the large sums of data collected and sold in it, have become sources of intense public debate on both sides of the political aisle.

**Legal Challenges**

So far, attempts to levy special taxes on digital services and products have been met with legal challenges. For example, **Maryland’s Digital Advertising Tax**, which the state legislature passed by overriding the governor’s veto in February 2021, will need to overcome a court challenge raised by groups representing the digital industry before it can be implemented. The U.S. Chamber of Commerce also filed a federal lawsuit against Maryland’s bill. Of the legal concerns with this tax, the fact that it might violate the federal Permanent Internet Tax Freedom Act (PITFA) rises to the top. PITFA prohibits states from applying a higher tax on a product or service sold on the internet as is applied to the same product or service in a physical store.⁶

**Costs to Consumers**

Aside from the legal debates these taxes raise, taxes on digital advertising and social media are likely to increase costs for businesses and consumers.⁷ Taxes on data, or rather the sale of consumer data, carry additional challenges. Policymakers seeking to tax data transfers will have to define what kinds of data will be taxed, they will also have to assess what that data is worth. Policymakers must also consider the risk of double taxation when creating different digital advertising and/or digital data tax regimes for products and services that are not bound by geography.⁸

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Taxing Remote Work

The sharp increase in remote work during the COVID-19 pandemic, and the uncertain future of brick-and-mortar infrastructure even after the pandemic ends, has challenged more businesses, workers and state policymakers to think about the future of income tax remittance.

States typically tax income (if they tax income at all) by where a person lives or where they work. Workers who live in one state but work in another avoid double taxation through tax credits that states provide to eliminate the tax liability in one of those jurisdictions. These tax credits are established through reciprocity agreements between neighboring jurisdictions. For more information on how these agreements operate, the Tax Foundation has provided this explainer.

However, in seven states, “convenience rules” exist that tax the income of individuals based on where their employer is located, regardless of whether the employee ever works in that location. Under this arrangement, for an individual who is domiciled in one state but works for an employer in another, the “convenience rule” state is now potentially subject to double taxation.

States do not offer an offsetting tax credit in this situation because the individual’s income was earned in the domicile state, often at the worker’s home or remote office. The individual working never left their domicile state to earn their income, so the domicile state does not recognize that individual’s income as taxable anywhere else and does not offer a credit for tax liability accrued elsewhere. The “convenience rule” state taxes that individual’s income anyway because the employer that they work for is physically located within its jurisdiction. The seven states with convenience rules are: Arkansas, Connecticut, Delaware, Massachusetts, Nebraska, New York and Pennsylvania.

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For the duration of the COVID-19 pandemic, states can continue to consider the following measures to respond to increase prevalence of remote work across state lines.  

- **Policy Option** | Provide that the presence of an employee working in a state due to shelter-in-place restrictions will not create nexus for tax purposes in that state unless the business elects otherwise.\(^\text{12}\)

- **Policy Option** | Provide the option for newly remote workers sheltering in place to continue to have the business withhold income tax based on the state where the employer is located.\(^\text{13}\)

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\(^{12}\) ibid

\(^{13}\) ibid
7 States provide that newly remote workers because of COVID-19 will not count against companies taking Public Law 86-272 positions unless the business elects otherwise.

Considerations for State Leaders

The COVID-19 pandemic upended the way many people work, and there is a good chance these changes, especially the prevalence of remote work, are here to stay. More employees are expressing interest in remote work. A 31,000-person study conducted by Microsoft found that 73% of workers want flexible remote options to continue and remote job postings increased by more than 500% during the pandemic. That same study found that 46% of workers were planning on moving to a new location now that they can work remotely. States looking at convenience rules as a response to this change should proceed with caution, as they create the possibility of double taxation and leave states vulnerable to court challenges.

14 Public Law 86-272 (15 USC Section 381) is a federal statute that allows a business to solicit orders for tangible goods in another state without being subject to net income tax. For more info, visit: https://www.law.cornell.edu/uscode/text/15/381
15 ibid
Cannabis Taxation

As of 2021, 18 states, two territories and the District of Columbia have legalized recreational marijuana use for adults over the age of 21. Prior to the COVID-19 pandemic, states were projected to raise $1.8 billion in tax revenues from marijuana in 2020. While it is unclear how the ongoing COVID-19 outbreak will impact cannabis tax revenues in Fiscal Year 2021, the Tax Foundation estimates an increase in tax revenue from cannabis in all the states highlighted below (Alaska, Colorado, Illinois, Massachusetts and Oregon).

State cannabis taxation typically falls within one of three designs: tax on price, tax on weight and/or tax on potency.

- **Policy Option | Price-based (ad valorem) tax**
  This is the most popular tax option for states. The tax is applied as a percentage of cannabis price and can be done at the retail or wholesale level. Massachusetts, for example, levies a 10.75% tax on the retail price of cannabis products.

- **Policy Option | Weight-based tax**
  Refers to the tax rate on cannabis products dependent on the weight category of the product. Weight-based taxes on wholesale products could set rates for different parts the plant such as the bud, trim, seeds or entire plant. In Alaska, for example, mature buds/flowers are taxed at $50 per ounce; immature or abnormal buds are taxed at $25 per ounce; trims are taxed at $15 per ounce; and clones are taxed at a flat rate of $1 per clone.

- **Policy Option | Potency tax**
  A tax on the amount of Tetrahydrocannabinol (THC), the psychoactive property of cannabis, sold in the product. Illinois, for example, collects a retail tax on cannabis at a rate of 10% for products with an adjusted THC level at 35% or less and 25% for anything with an adjusted THC level above 35%.

- **Policy Option | Sales tax**
  In addition to an excise tax (price-, weight- or potency-based), most states also levy a general sales tax on cannabis. Exceptions include Alaska, Colorado and Oregon.

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Consideration for State Leaders

While a price-based (ad valorem) tax model is currently the most popular option across the states, the Tax Foundation warns that while this option is the easiest to implement, it also is the most unstable over time in terms of its ability to generate revenue.24 Policymakers risk imposing too high a tax upon legalization — an act which might deter consumers from the legal market — or a tax rate that is too low as the legal market matures and consumers enter. Similarly, the Tax Foundation warns that license fees, caps on licenses awarded and other factors that impact a consumer’s access to cannabis in the legal market will affect how successful legalization will be at overtaking illegal cannabis.

The best method for taxing the externalities (additional costs to society) of the use of cannabis, the Tax Foundation argues, is to implement a weight-based and potency-based (THC content) tax in excess of the standard sales tax where applicable. This is contingent on THC, the main psychoactive property of cannabis, being a good proxy for a product’s potency.25

25 ibid
Sports Betting Taxation

While the terms *sports wagering* and *sports betting* can include different activities from state to state, sports betting is referred to here as a framework through which citizens can legally bet on live sports outcomes, online poker and fantasy sports contests. As of 2021, 30 states and the District of Columbia have legalized sports betting either through statute or ballot measure. Despite COVID-19, which temporarily closed betting markets in some states like Arkansas, more than $21 billion was wagered on sports in 2020 (a 62% increase from 2019), which produced more than $210 million in state and municipal tax revenues.

In general, states may consider legalizing sport betting in-person, mobile/remote or both.

- **Policy Option | In-person Betting**
  
  In a 2018 referendum, voters in Arkansas approved the creation of four retail casinos and legalized sports betting at each site. The referendum language did not include authorization of online betting. Arkansas taxes the first $150 million of net casino gaming receipts at 13% and receipts over $150 million at 20%.

- **Policy Option | Mobile Betting**
  
  New Hampshire House Bill 480 (2019) allows the state Lottery Commission to build a system for legal sports betting, including online betting. While the bill allows up to 10 retail establishments with sports betting books in the state, most of the betting is done online. New Hampshire has two locations for in-person betting that opened during the COVID-19 pandemic. DraftKings is the sole operator of sports betting and must remit to the New Hampshire Lottery Fund 51% of gross revenue for online bets and 50% of in-person bets at the two casino locations.

- **Policy Option | In-person and Mobile Betting**
  
  In 2019, Michigan Gov. Gretchen Whitmer signed the Lawful Sports Betting Act, which allows licenses casinos to offer sports betting at their facilities and online. Unless the sports betting operator is a Native American Indian tribe, the operator is required to remit an 8.4% tax on adjusted gross sports betting receipts.

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Consideration for State Leaders

It is important to note that sports betting, in the states that have in some way legalized and taxed this activity, has not been a large source of new revenue. For example, New Jersey sports betting represents only a small portion of total casino gambling revenue and is 20 times smaller than the state’s lottery proceeds.30

For states considering legal sports betting, the tax design most used is one that levies a tax on revenues from sports wagering, minus the winnings paid. The three state examples on the previous page show a wide range of applied tax rates, and while there is no ideal rate across all states, policymakers should consider the implications of a tax that is too high (keeps consumers in the illegal market) or too low (does not properly account for the externalities associated with betting).

Additionally, sports betting taxation can be used to address the negative externalities, or harm, that may be caused by gambling, where a price-based (or ad valorem) tax can serve as a proxy for the potential harm caused. States accruing revenue from sports gambling can also direct a portion of the funds to programs that support gambling addictions or other externalities.31

References


