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**Stephanie Do**  
*Senior Tax Counsel*  
(202) 484-5228  
[sdo@cost.org](mailto:sdo@cost.org)

May 14, 2024

Senator Anna Caballero, Chair  
Senator Brian Jones, Vice Chair  
Senate Committee on Appropriations  
California State Legislature

*Via Position Letter Portal*

**Re: COST Opposes S.B. 1327, Creating New Data Extraction Mitigation Fee**

Dear Chair Caballero, Vice Chair Jones, and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing to express opposition to S.B. 1327, which would be amended to create a new data extraction mitigation fee. Although labeled as a “fee,” it is structured like a digital advertising and data collections tax. Governor Newsom has been steadfast in his commitment to not create any broad-based tax increases.<sup>1</sup> This bill, however, directly contravenes with the Governor’s stance.

The amendment establishes a new, controversial, and untested “fee” on gross receipts derived from “data extraction transactions” in California, which, as defined in the amendment, serves as a tax on digital advertising services and data collection. This “fee” is ultimately a tax on business inputs that burdens businesses and consumers.<sup>2</sup> On its face, the bill appears to be targeted with the negative impact limited to a few technology companies. Unfortunately, the legislation will force impacted companies to pass on the increased costs from this new “fee” on to other businesses and consumers and will place California at a competitive disadvantage with respect to encouraging businesses to maintain or expand operations in California.

This amendment violates federal law and several provisions of the U.S. Constitution. If this bill is enacted, it will be embroiled in protracted litigation like Maryland’s digital advertising gross revenues tax, which is still ongoing.

<sup>1</sup> See Governor Gavin Newsom, “[Proposed Budget Summary, Governor’s Message](#),” 2024-25 Governor’s Budget, January 10, 2024.

<sup>2</sup> Business inputs constitute intermediate, not final, goods and services because companies either resell these goods and services or use the materials, products, machinery, and services to produce other goods or services that subsequently are sold to households. See Karl A. Frieden and Douglas L. Lindholm, “[State Digital Services Taxes: A Bad Idea Under Any Theory](#),” Tax Notes States, April 10 2023, p. 89 (discussion of how digital services taxes add to the pyramiding of sales and gross receipts taxes).

These activities are also already sufficiently taxed under the State’s corporate income tax regime.<sup>3</sup> An additional tax is not warranted.

### About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 500 major corporations engaged in interstate and international business. COST’s objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Many COST members have operations in California that would be negatively impacted by this legislation.

### Negative Impact to California Businesses and Consumers

The proposed data extraction mitigation fee serves as a gross receipts tax on business inputs. The COST Board of Directors has adopted formal policy statements opposing both gross receipts taxes and sales taxes on business inputs based on sound tax policy principles. While the position on business inputs primarily concerns the states’ sales taxes, its logic also applies to the proposed data extraction mitigation fee, which serves as a gross receipts tax on business inputs. COST’s policy positions are:

*Gross receipts taxes are widely acknowledged to violate the tax policy principles of transparency, fairness, economic neutrality, and competitiveness; generally, such taxes should not be imposed on business.<sup>4</sup>*

*Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.<sup>5</sup>*

The imposition of the proposed data extraction mitigation fee is primarily focused on taxing business inputs, not consumer purchases. This disproportionate taxation of business inputs violates several core tenets of sound tax policy—transparency, economic neutrality, effective tax administration, and fairness.

- *Transparency.* A transparent tax, like the sales tax on consumer purchases, is obvious to the taxpayer, and its economic effects are easily understood. The proposed data extraction mitigation fee, on the other hand, serves as a stealth tax that will affect California businesses and residents in several unseen ways. It will impact residents as purchasers, by imposing hidden costs and thus making the products they purchase more expensive, and

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<sup>3</sup> See Karl A. Frieden and Stephanie T. Do, “[State Adoption of European DSTs: Misguided and Unnecessary](#),” Tax Notes State, May 10, 2021, p. 577; Karl A. Frieden and Douglas L. Lindholm, “[State Digital Services Taxes: A Bad Idea Under Any Theory](#),” Tax Notes State, April 10 2023, p. 89.

<sup>4</sup> COST, “[Gross Receipts Taxes, Policy Position](#)” (last visited May 3, 2024).

<sup>5</sup> COST, “[Sales Taxation of Business Inputs, Policy Position](#)” (last visited May 3, 2024).

as workers, by depressing investment and thus reducing wages and employment opportunities.

- *Economic Neutrality.* An economically neutral tax does not influence business choices (of location, of operational entity, of suppliers, *etc.*). This “fee” will force companies to either pass their increased costs on to consumers or reduce their economic activity in the State to remain competitive with other companies in other states that do not bear the burden of such taxes and fees.
- *Effective Tax Administration.* Effective tax administration is enabled by taxes that can be easily administered by a state and can facilitate voluntary compliance by all businesses. This entails tax base and sourcing rules that are comprehensible to both tax administrators and taxpayers. This proposal is anything but easy to administer. As an untested and novel tax, companies will have to adopt sophisticated accounting and recordkeeping systems to evaluate transactions on a continuous basis. This proposal also does not conform to or harmonize with any prior national or uniform state model, leading to additional complexity.
- *Fairness.* A fair tax treats similarly situated taxpayers equally. Instead of having a broad base and low tax rate, the proposed data extraction mitigation fee is imposed in a punitive manner intended to directly target a select number of technology companies.

### **Violates Federal Law and the U.S. Constitution**

The proposed data extraction mitigation fee will be immediately embroiled in protracted litigation. Since the proposal would apply to digital advertising but not to non-digital advertising, the law would likely violate the federal Internet Tax Freedom Act (ITFA). The ITFA, which was first enacted in 1998 and subsequently extended until made permanent in 2016, preempts state and local governments from levying multiple and discriminatory taxes on electronic commerce.<sup>6</sup> This proposed “fee” specifically singles out (discriminates against) digital advertising without similarly applying to traditional forms of advertising. The bill also raises valid threats of constitutional challenges.

The legality of such a “fee” under the ITFA and the U.S. Constitution is already mired in litigation challenging Maryland’s digital advertising gross revenues tax.<sup>7</sup> Although this “fee” is structured differently than Maryland’s digital advertising gross revenues tax, California would nevertheless face similar controversy and judicial review should this bill be enacted. And California would bear the costs to litigate this proposal without generating the anticipated revenue because the proposal likely violates the ITFA and the U.S. Constitution.

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<sup>6</sup> Public Law 114-125, § 922(a).

<sup>7</sup> See Michael Bologna, “[Apple, Peacock Battle for Top Position in Maryland Ad Tax Fight](#),” Bloomberg Daily Tax Report, February 13, 2024 (discussing the ongoing litigation in state court); Sanjay Talwani, “[Md. Digital Ad Tax Rule Illegally Bars Speech, Chamber Says](#),” Law360, April 10, 2024 (discussing the ongoing litigation in federal court).

### **Businesses Subject to the Data Extraction Mitigation Fee Are Already Subject to the State's Corporate Income Tax**

Businesses which would be subject to this new “fee” under S.B. 1327 are already subject to the State’s corporate income tax on their net income. California’s corporate income tax requires mandatory unitary combined reporting, and it is imposed on the privilege of exercising corporate franchises within the State. This imposition threshold gives the State expansive jurisdiction to impose its corporate income tax without requiring a physical presence in the State. As a result, the same businesses that would be subject to the proposed data extraction mitigation fee are also subject to the State’s corporate income tax. California also imposes a market-based sourcing regime for receipts from services and apportions such receipts using a single-sales factor formula. Market-based sourcing seeks to tax a receipt based on where the customer receives the benefits from the service rather than the location of the taxpayer. To the extent a business collects digital advertising revenue or revenue from data collection in California, that income is already sourced to California for corporate income tax purposes under the State’s market-based sourcing rules. Under the single-sales factor apportionment formula, the physical location of a corporation’s business now has minimal effect on how receipts are apportioned to the State. As a result, California’s corporate income tax regime sufficiently taxes the same activities that would be subject to the proposed data extraction mitigation fee.

### **The Barter Transaction Justification for the New Data Extraction Mitigation Fee Is Wrong**

The proposal uses a novel untaxed “barter” transaction theory as a justification for the new data extraction mitigation fee. This “justification,” however, is wrong and based on a false equivalency between the limited number of barter transactions historically included in the sales tax base. These are voluminous Internet-based exchanges. The exchange of free internet services and other website functionality for consumer data and viewed advertisements has the appearance of an “untaxed” non-monetized barter transaction, but they are not “retail” transactions.

Taxable barter arrangements, however, are fundamentally different from social media or digital marketplace transactions because taxable barter transactions are completed and final transactions between two parties and digital platform transactions are intermediate and not final transactions.<sup>8</sup> In other words, digital platform exchanges are part of intermediary streams of interactions where sales taxes are generally imposed at the final retail stage, *e.g.*, end user purchaser.<sup>9</sup>

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<sup>8</sup> Generally, a sales tax base does not include non-monetized transactions. The basic premise of a consumption tax is to impose a tax on receipts from a sale of monetized goods and services. However, there is a limited barter exception to this rule. A typical taxable barter transaction is the one-to-one exchange of goods or services without use of a monetary medium that would otherwise go untaxed, such as auto repair services exchanged for cleaning services or agricultural crops exchanged for tangible goods. In 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 tax unless both sides of the transaction are included in the sales tax base.

<sup>9</sup> This is evident whether the barter transaction precedes (and enhances) a business-to-consumer 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 services. For a more in-depth critique of the “barter” transaction justification, see Karl A. Frieden and Douglas L. Lindholm, “[State Digital Services Taxes: A Bad Idea Under Any Theory](#),” Tax Notes State, April 10 2023, p. 98-104.

### **Conclusion**

COST continues to agree with the California Taxpayers Association (CalTax), the Association of National Advertisers (ANA), and others who argue that the proposed data extraction mitigation fee should be rejected. We respectfully oppose S.B. 1327 as it is a direct tax on business inputs, based on a false equivalency with taxable barter transactions, and violates several key tax policy principles as well as federal law and the U.S. Constitution. Digital advertising and data collection activities are also already subject to California's corporate income tax, which would result in the proposed data extraction mitigation fee serving as a second or "double" tax.

Respectfully,

A handwritten signature in blue ink, appearing to read 'Stephanie T. Do', with a stylized, cursive script.

Stephanie T. Do

cc: COST Board of Directors  
Patrick J. Reynolds, COST President & Executive Director