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U.S. Supreme Court Raises the Bar For State Tax Cases in Federal Court

On June 1, 2010, the U.S. Supreme Court issued its decision in *Levin v. Commerce Energy, Inc.*, 2010 U.S. LEXIS 4380 (2010) holding that the doctrine of comity precludes federal courts, independently from the Tax Injunction Act (TIA), from considering a taxpayer challenge to a competitor's alleged unconstitutionally favorable tax treatment.

Background

Ohio grants three tax exemptions to regulated local gas distribution companies (LDCs) that independent gas marketers (IMs) do not receive: (1) the natural gas sales of LDCs are exempt from sales and use taxes and instead a gross receipts excise tax applies at a lower rate; (2) LDCs are not subject to the commercial activities tax imposed on an IM's gross receipts; and (3) sales of natural gas between LDCs are exempt from the gross receipts tax, but the tax applies to sales from an LDC to an IM. Commerce Energy, Inc., and Interstate Gas Supply, Inc., two IMs that market and sell natural gas to Ohio consumers, filed suit in the U.S. District Court for the Southern District of Ohio alleging that the differential treatment of the LDCs violates the Equal Protection and Commerce Clauses of the United States Constitution. The plaintiffs asked the district court to invalidate the tax exemptions and permanently enjoin the State from enforcing them. The Ohio Tax Commissioner challenged the district court's jurisdiction under both the TIA and the principles of comity.

The District Court and Court of Appeals Decisions

The district court concluded that TIA did not apply because the IMs were not seeking to reduce their own tax burden; however, the court agreed with the state that comity barred the federal suit.

On appeal, the U.S. Court of Appeals for the Sixth Circuit reversed the district court's opinion, holding that neither TIA nor comity precluded federal jurisdiction. The court held that comity bars federal suits only in cases which seek to thwart state tax collection. For this holding, the appellate court relied on *Hibbs v. Winn*, 542 U.S. 88 (2004), which involved a challenge to an Arizona tax credit for contributions to provide financial aid for children attending religious schools. In *Hibbs*, Justice Ruth Bader Ginsburg delivered the opinion of the U.S. Supreme Court holding that the challenge did not fall within TIA's jurisdictional bar. The *Hibbs* opinion also included a footnote regarding the application of comity stating that the Court "has relied upon 'principles' of comity to preclude original federal-court jurisdiction only when plaintiffs have sought district-court aid in order to arrest or countermand state tax collection." *Hibbs*, 542 U.S. at 107, n.9. The Sixth Circuit opined that the *Hibbs* footnote constricted the scope of the comity doctrine and emphasized that the state's broad view of comity would render TIA essentially "superfluous."

After the *Hibbs* decision, the circuit courts were split on the issue of whether the reach of comity was limited only to cases that seek to hinder state tax collection. The Sixth Circuit's decision joined the majority of circuits – including the First, Seventh and Ninth Circuits – in holding that *Hibbs* restricts comity

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to cases that could impede tax revenues. See, e.g., *Coors Brewing Co. v. Mendez-Torres*, 562 F.3d 3 (1st Cir. 2009); *Levy v. Pappas*, 510 F.3d 755 (7th Cir. 2007); *Wilbur v. Locke*, 423 F.3d 1101 (9th Cir. 2005). The Fourth Circuit on the other hand had adopted the contrary position that *Hibbs* had no effect on the scope of the comity bar.

The U.S. Supreme Court granted certiorari in *Commerce Energy* to decide the proper interpretation of the scope of the comity bar after *Hibbs*.

Majority Distinguishes *Hibbs*

The majority opinion, authored by Justice Ginsburg, concludes that comity precludes federal courts from considering the IMs' challenge and justifies dismissal of the action because the state courts are better positioned than the federal courts to remedy state tax issues. The Court found that comity is broader than the TIA. The Court explained that the purpose of the TIA was to constrict the willingness of federal courts to grant relief in state tax cases. In footnote 3 of the opinion, the Court noted that prior to the enactment of TIA, federal courts "construing strictly the requirement that the remedy available at law be 'plain, adequate and complete,' had frequently concluded that the procedures provided by the State were not adequate." Therefore, Congress passed the TIA to reverse that trend and secure the comity doctrine against diminishment. The Court noted that nothing in the TIA or the *Hibbs* decision affected the application of the comity doctrine to cases outside the purview of the TIA.

Sutherland Observation: Federal court jurisdiction in state tax cases may still be upheld where the remedy provided by state courts is not "plain, adequate and complete." The Court noted that comity may be inappropriate where such a remedy does not exist and TIA would not serve as a bar to Federal jurisdiction if the state court remedy is not "plain, speedy, and efficient." In 1981, the U.S. Supreme Court in *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503 (1981), held that a "2-year delay [does not] fall outside the boundary of a 'speedy' remedy." But see *Northwest Airlines, Inc. v. Tennessee State Bd. of Equalization*, 11 F.3d 70 (6th Cir. 1993). (holding that the lack of *de novo* factual review of the Board's decision coupled with unrelated litigation that could influence the Board's factual findings did not constitute a "plain, speedy, and efficient" remedy). Almost 20 years later, what constitutes a "speedy" remedy under TIA or an "adequate" or "complete" remedy under comity principles remains at issue. Numerous examples exist in which state courts offer remedies that appear neither plain, adequate and complete nor speedy and efficient.

The Court disagreed with the Sixth Circuit's interpretation of the *Hibbs* footnote. The Court distinguished *Hibbs* on the grounds that *Commerce Energy* concerned commercial matters over which Ohio enjoys wide regulatory latitude, rather than a fundamental right or classification, such as separation of church and state at issue in *Hibbs*, which is subject to heightened judicial scrutiny. The majority further emphasized that while the plaintiffs in *Hibbs* were third parties to the tax credit, the very premise of the IMs' challenge was to seek federal aid to improve their competitive advantage. The Court explained that the *Hibbs* footnote was intended to affirm that federal jurisdiction in *Hibbs* was not precluded by TIA or comity, and the footnote had no bearing on the scope of the comity doctrine.

Sutherland Observation: The U.S. Supreme Court’s decision in *Commerce Energy* makes clear that, even though TIA does not bar federal court intervention in cases involving constitutional challenges to state taxation brought by third parties, as a matter of comity principles, federal courts do not have jurisdiction over state tax suits styled as a request to increase a competitor’s tax burden. Following *Commerce Energy*, a taxpayer may pursue a challenge to discriminatory state taxation in a federal forum only under the following circumstances: (1) when expressly authorized by Congress, e.g., the Railroad Revitalization and Regulatory Reform Act, 49 U.S.C § 11501(c), or the Anti-Head Tax Act, 49 U.S.C. § 40116, 49 U.S.C. § 46101 *et seq.*; (2) when the challenge concerns a fundamental right or suspect classification subject to heightened judicial scrutiny, e.g., similar to the fundamental interest at stake in *Hibbs*; or (3) when the state does not afford a remedy that is “plain, adequate and complete” or “plain, speedy, and efficient.”



Please contact Sutherland if you are interested in learning additional information about the effort to oppose taxation of electronically delivered products and services.

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