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Making A Federal Case Out Of State Taxes

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The U.S. Supreme Court will have an opportunity to clarify the circumstances under which state taxes may be challenged in federal court. On July 1, 2014, the Supreme Court granted certiorari in Direct Marketing Association v. Brohl. Direct Marketing addresses the scope of the Tax Injunction Act, a law that limits federal court jurisdiction over state tax cases. The TIA provides that:

The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under state law where a plain, speedy and efficient remedy may be had in the courts of such state.[1]

In Direct Marketing, the Tenth Circuit held that the TIA prevented a trade association from challenging a Colorado notice and reporting requirement in federal court because the Tenth Circuit viewed the challenge as "restraining the ... collection" of Colorado's sales and use tax. TIA decisions in certain other federal circuit courts suggest that those courts would have reached a different result. Accordingly, Direct Marketing offers the Supreme Court an opportunity to clarify the meaning of "restrain the … collection" under the TIA.

A key starting point for the Supreme Court could be defining "collection" for TIA purposes. Currently, the courts are not using a uniform definition, which has produced inconsistent decisions.

One example of this inconsistency is the division among circuit courts over whether cases brought by nontaxpayers (i.e., parties that are not challenging a specific tax assessment) can restrain the collection of tax. For instance, the D.C. Circuit has held that collection "is the actual imposition of a tax against a plaintiff, and does not concern third parties trying to contest the validity of a tax or to stop its collection."[2] Under this view, a case could not "enjoin, suspend or restrain" a collection within the meaning of the TIA if the case is brought by a nontaxpayer. On the other hand, the Tenth Circuit in Direct Marketing appears to have defined "collection" as any action that potentially increases a state's revenue, such that any challenge to a tax — whether by a taxpayer or a nontaxpayer — could be a restraint on collection.

If the Supreme Court defines "collection," and thereby clarifies the meaning of "restraining … the collection," its guidance could have a significant impact on federal court challenges to state taxes. This article reviews the Tenth Circuit's Direct Marketing decision and identifies guidance the Supreme Court might provide in connection with its review of that decision.

Direct Marketing Dispute

Many states have recently enacted laws intended to increase sales and use tax compliance on sales to state residents by out-of-state, primarily online, retailers who have historically taken the position that they do not have tax nexus with the state and therefore do not have tax collection responsibilities. One such law in Colorado requires out-of-state retailers with more than $100,000 in Colorado sales during a calendar year and who do not collect sales or use tax to comply with three notice and reporting requirements: (1) provide transactional notices to Colorado customers informing them of their potential tax obligations, (2) send annual purchase summaries to Colorado customers and (3) annually report the Colorado customer information to the Colorado Department of Revenue.[3] Colorado law imposes penalties on retailers who do not comply with these reporting requirements. In Direct Marketing Association v. Brohl, a trade association challenged the constitutionality of this law in federal court.

The U.S. District Court for the District of Colorado held that Colorado's law violated the Commerce Clause of the U.S. Constitution because it discriminates against out-of-state retailers by placing undue burdens on interstate commerce. The Colorado Department of Revenue did not argue to the district court that the TIA prevented the court from hearing the case. The Colorado Department of Revenue's appeal to the Tenth Circuit likewise did not raise the TIA jurisdictional issue, and the appellate court did not request briefing on the issue. Nevertheless, the Tenth Circuit remanded with instructions for the district court to dismiss the case on the grounds that it lacked jurisdiction under the TIA.[4]

Guidance the Supreme Court Might Provide

What is the definition of collection and where might the Supreme Court look in defining it?

Of critical importance to Direct Marketing is the meaning of "collection" for TIA purposes. If the Supreme Court decides to define "collection," it may look to its most thorough recent examination of the TIA in Hibbs v. Winn for guidance.

In Hibbs, Arizona residents sought to enjoin an Arizona law authorizing income tax credits for payments to organizations that provide financial support to private school students on Establishment Clause grounds. The court considered whether the TIA precluded federal court jurisdiction of this lawsuit. After reviewing case law and the legislative histories of the TIA and the Anti-Injunction Act,[5] the court held that the TIA did not bar the suit because it was both: (1) brought by a nontaxpayer and (2) challenging a tax credit, or "benefit," instead of a tax, which would generate additional state revenue.

This holding, by itself, could suggest that "collection" for TIA purposes means any action that increases tax revenue. Under this approach, a federal court suit would be barred under the TIA if it challenges a law that, if upheld, would lead to an increase in state revenue. A significant portion of the analysis in Hibbs, however, is arguably inconsistent with such a reading. For example, Hibbs contains the following quote from Judge Henry Friendly's opinion in Wells v. Maloy:

The [TIA's] context and the legislative history lead us to conclude that, in speaking of 'collection,' Congress was referring to methods similar to assessment and levy, e.g., distress or execution … that

would produce money or other property directly, rather than indirectly through a more general use of coercive power. Congress was thinking of cases where taxpayers were repeatedly using the federal courts to raise questions of state or federal law going to the validity of the particular taxes*imposed upon them*.[6]

The Tenth Circuit's decision in Direct Marketing is arguably in line with the narrow holding in Hibbs, but is less consistent with the foregoing analysis from Wells. The Tenth Circuit found that Direct Marketing Association's lawsuit restrained the collection of use tax, but it did not define or analyze what "collection" means under the TIA. Given that the Colorado Department of Revenue had not assessed or levied a tax against Direct Marketing Association, and was therefore not attempting to collect a tax against the party to the suit, the Tenth Circuit appears to have read "collection" broadly (e.g., as an action that increases tax revenue generally).

Under Judge Friendly's analysis cited in Hibbs, however, collection of a tax must be direct, not indirect and coercive. Colorado's notice and reporting requirements are not direct. They do not result in "distress or execution … that would produce money."[7] Rather, Colorado is attempting to increase use tax compliance by forcing an unrelated party with no responsibility to collect sales and use tax to provide notices and reports, and failure to comply results in substantial penalties. This is arguably both indirect and coercive.

Further, the Tenth Circuit's broad view of "collection" as anything that increases tax revenue could be viewed as rendering the surrounding TIA terms, "assessment" and "levy," superfluous, as they are also actions that can be used to increase tax revenue. Accordingly, it could be argued that collection must have a more specific meaning.[8] The D.C. Circuit has interpreted Hibbs as giving collection a more specific meaning — it defines collection under Hibbs as "the actual imposition of a tax against a plaintiff, and does not concern third-parties trying to contest the validity of a tax or to stop its collection." This language, however, does not come verbatim from Hibbs; rather, it is the D.C. Circuit's interpretation of the Supreme Court's rationale in Hibbs.

A plain reading of the TIA might also call for a narrowing of the Tenth Circuit's approach. The TIA restrains the "collection of a tax," and the notice and reporting requirements are not a tax. Customers who purchase from out-of-state retailers are liable for Colorado use tax, whether or not the retailer is subject to the notice and reporting requirements. Direct Marketing Association is not challenging the collection of the use tax, nor is it contesting a use tax liability.

Are Lawsuits Brought by Nontaxpayers Subject to the TIA?

Defining "collection" to address the above issues would likely resolve the disagreement among circuit courts on whether lawsuits brought by nontaxpayers could be subject to the TIA. If collection is defined as the pursuit of a specific assessment, rather than any action that could lead to a revenue increase, then lawsuits by nontaxpayers challenging the validity of a state taxes would appear to fall outside the scope of the TIA.

In addition to the apparent endorsement of Judge Friendly's approach above, other analysis in Hibbs could support such a definition. In Hibbs, the Supreme Court found that "in enacting the TIA, Congress trained its attention on taxpayers who sought to avoid paying their tax bill by pursuing a challenge route other than the one specified by the taxing authority."[9] Consistent with this congressional intent, the Supreme Court "interpreted and applied the TIA only in cases Congress wrote the TIA to address (i.e., cases in which state taxpayers seek federal court orders enabling them to avoid paying state taxes").[10]

In line with this analysis, the Tenth Circuit acknowledged that under Hibbs, the TIA is "triggered when 'state taxpayers seek federal court orders enabling them to avoid paying state taxes.'"[11] But it still held that

Hibbs did not exclude all nontaxpayer lawsuits from the TIA's reach, a result that could be viewed as conflicting with this quote. The Tenth Circuit acknowledged the breadth of the Supreme Court's analysis in Hibbs, but nonetheless limited Hibbs' precedential power to its narrow holding that the TIA permits lawsuits brought by nontaxpayers challenging the validity of tax benefits.

If the Supreme Court instead applies the same framework it outlined in Hibbs — that the TIA precludes federal jurisdiction only in cases brought by "taxpayers who [seek] to avoid paying their tax bill" — it will likely rule in favor of Direct Marketing Association as it's not contesting its own tax liability.

Direct Marketing provides an opportunity for the Supreme Court to define collection for purposes of the TIA, and thereby resolve whether the TIA applies to any lawsuits brought by nontaxpayers. If the Supreme Court takes this opportunity, it will provide greater clarity for parties considering challenging a state tax in federal court.

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[1] 28 U.S.C. Section 1341

[2] Cohen v. United States, 650 F.3d 717 (D.C. Cir. 2011)

[3] Colo. Rev. Stat. Section 39-21-112(3.5)(c) and (d); Colo. Code Regs. Section 201-1:39-21-112(3.5).

[4] Direct Marketing Association v. Brohl, 735 F.3d 904, 920-21 (10th Cir. 2013).

[5] The Supreme Court looked at the history of the Anti-Injunction Act because the TIA was modeled on it. Hibbs, 542 U.S. at 102.

[6] Hibbs, 542 U.S. at 109 (quoting Well, 510 F.2d at 77) (emphasis in original).

[7] Wells, 510F.2d at 77.

[8] See Hibbs, 542 U.S. at 101 (explaining the rule against superfluities).

[9] Id. at 105.

[10] Id. at 107.

[11] Direct Marketing Association, 735 F.3d at 910.
