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ALERT

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Supreme Court Limits Application of Tax Injunction Act for Certain Challenges to State Tax Reporting Regimes

A unanimous U.S. Supreme Court held on March 3, 2015, that the Tax Injunction Act (TIA) does not bar challenges to state tax information reporting regimes that are distinctly separate from the assessment or collection of state taxes. The Court's ruling only applies to whether a federal district court had jurisdiction to adjudicate whether Colorado's sales and use tax reporting requirements on out-of-state retailers are valid. But allowing the litigation to continue in federal court might ultimately result in upholding a lower court's ruling that the rules violated the U.S. Constitution's Commerce Clause. Depending on the eventual outcome, the case could have national implications as other states have contemplated similar requirements in order to increase state tax revenues arising from residents' out-of-state purchases.

Background

In 2010, Colorado passed a tax statute requiring all out-of-state Internet and mail-order vendors not currently collecting state sales and use tax to file annual information reports with the state detailing both the identity and address of in-state purchasers, as well as the amount of those purchases. The state's intent was to establish an information mechanism in order to collect use tax from consumers who were not currently voluntarily reporting their use tax liabilities. A trade association of direct marketing companies, the Direct Marketing Association (DMA), brought suit in federal district court to enjoin the law. The district court ruled that the statute was unconstitutional because it discriminated against out-of-state retailers by requiring information reporting burdens not demanded of in-state companies.

However, on appeal, the U.S. Court of Appeals for the 10th Circuit reversed,[1] holding that the federal court lacked jurisdiction under the Tax Injunction Act. The appellate court held that enjoining Colorado's notice and reporting requirements would function to restrain the assessment, levy or collection of a state tax, which is prohibited under the federal statute.

[1] 735 F.3d 904 (2013). The Tenth Circuit held that the TIA barred the litigation because it "would limit, restrict, or hold back the state's chosen method of enforcing its tax laws and generating revenue." *Id*. at 913.

The Tax Injunction Act[2] withholds jurisdiction from federal courts to entertain suits involving attempts to "enjoin, suspend or restrain the assessment, levy or collection of any tax due under State law…." The Supreme Court granted certiorari to consider whether the DMA's request for injunctive relief involved restraint of a state tax assessment or collection under the TIA.

Legal Analysis

The Supreme Court unanimously held, in an opinion by Justice Clarence Thomas, that the TIA did not block the federal district court from hearing the DMA's suit. The opinion focused closely on the nature of the DMA's request for equitable relief. Specifically, the use of the terms "assessment," "levy," and "collection" in the TIA statute should be defined by looking to federal tax law, the Court stated.[3] The types of tax proceedings covered by assessment, levy or collection are "discrete phases of the taxation process that do not include informational notices or private reports of information relevant to tax liability," Justice Thomas wrote. Rather, informational reporting is an antecedent step in tax administration before assessment, levy or collection occurs, the Court stated. All three terms are best viewed as part of an enforcement process that does not "encompass Colorado's enforcement of its notice and reporting requirements," as the state must "take further action to assess the taxpayer's use-tax liability and to collect payment from him" once the appropriate information has been reported.

Consequently, even though Colorado's rules for out-of-state retailers might improve the state's ability to assess and collect use tax from consumers, the scope of the TIA is strictly circumscribed, the Court wrote: "The TIA is keyed to the acts of assessment, levy and collection themselves, and enforcement of the notice and reporting requirements is none of these."

The Court also turned to the 10th Circuit's claim that the federal district court's injunction operated to "restrain" assessment or collection of Colorado tax in contravention of the TIA. Justice Thomas wrote that the circuit court gave too broad an interpretation to the term "restrain" in seeking to apply the TIA to equitable relief inhibiting acts of assessment or collection. To "restrain" a state tax instead carries a narrow connotation that is more akin to prohibiting assessment or collection, the Court stated, which is proper as the TIA is an equitable provision. Indeed, the Court cited several cases in which it indicated that federal courts are not constrained from giving equitable relief even if suits "would have a negative impact on States' revenues." In addition, a "narrow definition is consistent with the rule that 'jurisdictional rules should be clear,'" the Court stated.

Based on these various determinations, the Supreme Court concluded that "applying the correct definition, a suit cannot be understood to 'restrain' the 'assessment, levy or collection' of a state tax if it merely inhibits those activities." This meant that the TIA did not preclude DMA's challenge in federal court.

Hints of Unique Circumstances

A concurring opinion by Justice Ruth Bader Ginsburg explained her view that while the TIA does not prevent all federal court interference with state tax administration, Congress's main objective in enacting the legislation was to stop "litigants from using federal courts to circumvent States' 'pay without delay, then sue for a refund' regimes." Ginsburg hints that a case involving a direct challenge to a state taxing

[2] 28 U.S.C. section 1341.

[3] The opinion notes that the TIA was modeled on the Anti-Injunction Act (AIA), 26 U.S.C. section 7421, which similarly uses federal tax law concepts in defining the terms at issue.

measure that interferes with a taxpayer's reporting or collection obligations – such as an employer or in-state retailer – could lead to a different result under the TIA. Ginsburg's concurrence seems to indicate that she (as well as Justices Sonia Sotomayor and Stephen Breyer, who joined her) would view application of the TIA more favorably to circumstances in which a taxpayer sought to challenge an assessment or collection action when statutory or administrative rules required a specific process to be utilized (e.g., administrative refund claim or suit in state court after paying the assessment).

Conclusion

Although an important decision outlining the contours of the TIA, the Supreme Court ultimately did not reach the merits of the trade association's underlying litigation. Instead, the Supreme Court remanded the case back to the 10th Circuit to determine if the comity doctrine might apply to keep federal district courts from opining on the issue involving state revenue matters out of respect for their state law counterparts.

While the Supreme Court makes clear that certain types of state tax enforcement requirements involving non-taxpayers may be heard in federal courts, whether a state's particular reporting measures will be deemed to infringe on the U.S. Constitution's Commerce Clause is not addressed. But the Court's overall ruling is a favorable outcome as federal courts are often viewed as a friendlier forum to challenge state tax compliance rules.

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