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Let's Tame The Wild West Of State Tax Jurisprudence

Law360, New York (November 19, 2013, 5:42 PM ET) -- A recent Tenth Circuit opinion on the Tax Injunction Act demonstrates the broad reach of this federal law, and foreshadows the law's impact on the debate over the power of states to impose tax obligations on businesses that have little or no contact with a state.

The Tax Injunction Act, 28 U.S.C. 1341 ("TIA") says that the federal courts do not have jurisdiction to adjudicate controversies over the tax laws of a state as long as the taxing state provides a speedy and efficient remedy in its own court system. This rule applies to all state tax cases, even where the matter being litigated revolves around a federal constitutional issue.

The Tenth Circuit case involves a 2010 Colorado statute that imposed several requirements on e-commerce companies that are not otherwise required to collect sales tax. Under a 1992 U.S. Supreme Court case, Quill v. North Dakota, companies are not required to collect sales tax on merchandise shipped to a customer in a taxing state unless the company has a substantial physical presence in the taxing state to create nexus there. This holding is the reason that many e-commerce companies do not collect sales tax on Internet purchases. It is important to note that even though an e-commerce company might not be required to collect the tax from its customer, the customer still must pay the state's use tax at the same tax rate by filing a use tax return. Although every state imposes this use tax requirement if the tax was not collected by the merchant, consumers rarely comply with the obligation.

This loss of tax revenues has led many states to pass laws which say that a company has the required nexus if it has unrelated marketing affiliates who receive commissions for referrals, typically through "click-through" arrangements that direct a customer from the affiliate's website directly to the e-commerce company's site.

However, the Colorado legislature did not pass a similar statute — there were legislative attempts to do so, but they did not have the votes. Rather, the legislature passed a law that requires e-commerce companies who do not otherwise have nexus with the state to do the following: (1) Provide a clear statement on its website that its Colorado customers are required to pay use tax to the Department of Revenue; (2) Provide an annual statement to its Colorado customers showing the amount of purchases subject to sales tax so the customer has the information to file a use tax return; and (3) Provide an annual information return to the Colorado Department of Revenue showing the amount of purchases made by all of the company's Colorado customers. See Col. Rev. Stat. Section 39-21-112(3.5). This last requirement is the most controversial from a civil liberties standpoint, because it discloses where Coloradans have been doing their shopping, although it does not itemize the products purchased.

The Direct Marketing Association quickly brought a legal action in federal district court in Denver to

challenge the law. Although Colorado moved to dismiss the case on several grounds, lack of jurisdiction because of the TIA was not one of them. The district court went on to strike the Colorado law because it imposed information reporting obligations on e-commerce merchants who do not have nexus with the state that are not imposed on in-state merchants. The court said that this discriminated against the e-commerce merchants, in violation of the interstate commerce clause of the federal constitution. Because the Direct Marketing Association was not challenging the validity of the Colorado tax, but merely a collection enforcement provision, it appears that the district court must have felt that the TIA was not applicable.

On appeal, the Tenth Circuit reversed on procedural grounds, holding that the district court did not have jurisdiction as a result of the Tax Injunction Act. See Direct Marketing Association v. Brohl, No. 12-1175. The court found that the law involved the administration and collection of taxes, and thus was covered by the TIA. The Tenth Circuit remanded the case back to the district court, with instructions to dismiss the case. The DMA's motion to the Tenth Circuit for a rehearing en banc was denied. As of the time of this article, the DMA has indicated that it will pursue its remedies in the state courts of Colorado, rather than seeking review of the Tenth Circuit opinion by the U.S. Supreme Court. Assuming the DMA pursues its remedy in the Colorado courts, this will be the latest in a growing line of state tax case involving material federal constitutional issues that will be decided by state courts.

Decisions from the highest courts of two major states further demonstrate how state courts are framing the agenda for tax issues that will ultimately affect many segments of the population. In 2006, the Supreme Court of New Jersey ruled in Lanco v Director, Division of Taxation, that the U.S. Supreme Court's holding in Quill only applied to state sale taxes, and did not require a company to have a substantial physical presence in New Jersey in order to impose the Garden State's income tax on an intangible property holding company, which did not otherwise have nexus there. To the dismay of many in the state tax community, the U.S. Supreme Court declined to hear this case, allowing the New Jersey Supreme Court to interpret what the U.S. Supreme Court intended when it handed down its ruling in Quill.

Likewise, New York's highest court upheld the Empire State's affiliate marketing nexus law, requiring many e-commerce vendors without a physical presence in New York to collect sales tax, finding that the presence of unrelated marketing affiliates is adequate contact with the state to establish nexus under Quill's "substantial physical presence" test.

The plaintiffs in the New York case have petitioned the Supreme Court to review this case, but in light of the Supreme Court's refusal to hear the Lanco case, it is quite uncertain whether there will be ultimate closure on this question.

The TIA became law in 1948, and was probably a good idea at the time, coming long before the technology boom that resulted in electronic commerce and cloud computing. In the old pre-Internet dark ages, only large corporations with large staffs of state tax compliance personnel could do business on a 50-state level. These companies had the resources to battle state tax authorities in the state courts, where the state tax authorities enjoy a home court advantage. Now that the smallest of e-commerce and software companies are able to compete effectively all over the United States because of advances in technology, perhaps it might be time for Congress to take another look at the TIA.

The federal courts might be a more appropriate forum to adjudicate state tax cases that revolve around important federal constitutional issues, but the hands of federal judges are tied by the TIA. Federal district judges generally have a deeper understanding of federal constitutional principles because they

are directly involved in these federal issues every day. This is not to take away from state court judges, who certainly are knowledgeable, but the average federal judge likely has more experience in these issues than the average state court judge. Furthermore, we need to consider the possibility that state court judges hearing state tax cases might subconsciously be considering the impact that their decision would have on state revenue, which could impact the budgets for their court. Although all judges strive to the highest standard of blind justice, the best practice of avoiding even the appearance of partiality might be difficult to achieve when the court's budget is dependent on state revenue.

More significantly, the lack of federal appeals court cases on these issues has resulted in a lack of uniformity on these constitutional questions that impact many businesses. Once a federal circuit court of appeals has ruled on an issue, this sets a precedent for all 50 states, at least until another circuit follows a different path. And in the event of a split between the federal circuit courts, there is fair chance that the Supreme Court would resolve the issue under its conflict jurisdiction. The same cannot be said of state appellate opinions. A state court judge might not be swayed by persuasive authority from the courts of another state, so we end up with a 50-state potpourri of jurisprudence on federal constitutional issues on state tax controversies, all a direct result of the Tax Injunction Act.

Perhaps it is time for Congress to amend the Tax Injunction Act to allow federal courts to hear state tax cases where a federal constitutional provision or a federal statute is a material issue in the case. This would help tame the current Wild West atmosphere when it comes to state tax jurisprudence, and would help lead to a uniform application of federal constitutional principles that should be welcome by businesses struggling to comply with state tax rules in this era of rapidly expanding technology that has made the concept of state borders somewhat meaningless from a commercial perspective.

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