A Supreme Victory: Supreme Court Opens the Door to Federal Challenges of State Tax Law

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On March 3, 2015, the United States Supreme Court unanimously held that the Tax Injunction Act (TIA) did not bar a federal court challenge to Colorado's use tax notification and reporting rules.[1] This case represents a significant step forward for out-of-state retailers in the battle to stay sales and use tax collection and enforcement burdens in states where the seller has no physical presence. **The opinion** may also present opportunities for businesses that have certain tax-related disputes to have these types of state and local controversies heard in federal court which, under certain circumstances, may be viewed as a more optimal forum. Certainly to the extent that a state attempts an end run around federal constitutional constraints with strategies similar to those of Colorado, this case indicates that taxpayers may have recourse in federal courts.

The Problematic Law

In 2010, Colorado enacted its current use tax notification and reporting regime. Under Colorado law, out-of-state vendors who were not required to collect sales tax but whose gross sales in Colorado totaled $100,000 or more (noncollecting retailers) were nonetheless required to notify their Colorado customers of potential sales and use tax obligations and to report certain information about these sales to the state Department of Revenue. Specifically, noncollecting retailers were required to provide a notice to each Colorado purchaser stating that the retailer did not collect Colorado sales or use taxes and that the purchaser would be required to remit the necessary Colorado taxes on each purchase. Noncollecting retailers were also required to send an annual report of purchases to certain customers. Finally, the noncollecting retailers were required to provide a list of customer information to the Department of Revenue each year.

All of these obligations are ordinarily handled by the Department of Revenue as part of its mission and this law could be seen as requiring out-of-state retailers with no connection to Colorado to do the state's job. In fact, some have argued that these notification and reporting obligations are actually more onerous than collecting and remitting the tax. Regardless, the obligations were being imposed on vendors who otherwise had no legal obligation to take any action whatsoever to assist the state of Colorado in collecting its own taxes from its citizens.

How the Issue Reached the Supreme Court

Direct Marketing Association (DMA), a trade association for catalog, online, and other direct marketing businesses, challenged the constitutionality of this law in federal court in the District of Colorado. The district court granted DMA's motion for summary judgment and enjoined the imposition of the notification and

reporting requirements, holding that the law violated the Commerce Clause.[2] On appeal, the Tenth Circuit Court of Appeals held that the federal district court lacked jurisdiction to hear the case as it was barred from federal court under the TIA.[3]

The Supreme Court Weighs In

DMA then appealed the Tenth Circuit's decision to the Supreme Court. In its decision, Justice Thomas, writing unanimously for the Court, held that the notification and reporting requirements did not "enjoin, suspend, or restrain the assessment, levy, or collection of any tax."[4] Thus, suits concerning Colorado's law were not barred from federal courts under the TIA.[5] In its opinion, the Court held that the notification and reporting requirements did not constitute an "assessment, levy, or collection" activity under the TIA as the notice and reporting requirements "precede" such activity.[6] In addition, the Court adopted a narrower definition of "restrain" than the Tenth Circuit and found that the notification and reporting requirements did not rise to restraint under the TIA merely because they might "inhibit" assessment, levy, or collection activities.[7]

While the Court reversed the Tenth Circuit's decision, they did leave DMA's federal challenge vulnerable to attack on other grounds. In its opinion, the court noted that they were not deciding whether DMA's case might be barred by the doctrine of comity—a doctrine which generally holds that fiscal operations should be left to the states as long as no federal rights are implicated—and remanded the issue of comity back to the Tenth Circuit.[8]

Justice Kennedy Would Like to Overturn Quill

While all nine justices concurred in the opinion and the judgment, Justice Kennedy authored a concurring opinion to highlight his concerns with the current constitutional standards for state tax jurisprudence. In his concurrence, Kennedy wrote that he believes the physical presence nexus standard enunciated in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*[9] and upheld in *Quill Corporation v. North Dakota*[10] is outdated given the nature of commerce in today's world and has resulted in "extreme harm and unfairness on the States."[11] His concurrence expressed less concern for the significant burden on businesses operating in interstate commerce posed by the multiplicity of taxing jurisdictions. Based on principles of sovereignty, state and local tax jurisdictions continue to legislate, enact and promulgate a decidedly nonuniform crazy quilt of laws and regulations with which remote vendors would have to comply if *Bellas Hess* and *Quill* are overturned. Any such change must be accompanied by the imposition of uniformity obligations on state and local governments. Despite significant advances in technology and legitimate concerns about the erosion of state and local tax bases, Kennedy's concurrence shortchanges the compliance hardships that multistate businesses face. Subnational tax rules are constantly in transition and even the best compliance software cannot completely keep up with the ever-changing state tax landscape.

Any Attempt to Overturn Quill Either Judicially or Legislatively Must Take Into Account Uniformity Concerns in Fairness to Taxpayers

While Justice Kennedy noted that DMA's case did not present a proper opportunity to address the holdings of *Bellas Hess* and *Quill*, he nonetheless urged the "legal system to find an appropriate case" for such reexamination.[12] The question remains whether this concurrence signals a renewed interest at the Court in streamlining state tax jurisprudence or whether it only signals Justice Kennedy's viewpoint. If the Supreme Court is to revisit the issues addressed in *Bellas Hess* and *Quill*, any such decision that takes into account fairness for both sellers and states as well as the changing world of commerce would be a step forward that could help both

states and taxpayers gain greater clarity relating to state tax obligations. To the extent that Justice Kennedy's views take root in the court, this development might serve as a wake-up call to the business community to call for action by Congress in the form of the Marketplace Fairness Act or other legislation which takes both state and business interests into account.

Back to DMA …Final Observations

This case represents a significant victory for DMA and other similar noncollecting retailers potentially subject to Colorado's burdensome notification and reporting requirements. As a result, the case is now being remanded back to the Tenth Circuit for a decision on the merits of DMA's claims. However, the Court left the door open for the Tenth Circuit to again reverse the district court on jurisdictional grounds by failing to decide whether the suit could be blocked by principles of comity. If the Tenth Circuit determines that comity should apply, it would be a significant loss for out-of-state vendors who would then be forced to raise similar challenges in state court, a forum generally considered to be less fair to out-of-state participants. Furthermore, remote vendors would have to comply with a clearly unconstitutional and burdensome law whiles such state litigation was ongoing.

- 1 Direct Marketing Ass'n v. Brohl, 575 U.S. ____ (2015).
- 2 Direct Marketing Ass'n v. Huber, 2012 WL 1079175 (D. Colo. Mar. 30, 2012).
- 3 Direct Marketing Ass'n v. Brohl, 735 F.3d 904 (10th Cir. 2013).
- 4 Direct Marketing Ass'n v. Brohl, 575 U.S. ____ (2015), at 5.
- 5 Id. at 8.
- 6 Id. at 10-12.
- 7 Id. at 12.
- 8 Id. at 13.
- 9 386 U.S. 753 (1967).
- 10 504 U.S. 298 (1992).
- 11 Direct Marketing Ass'n v. Brohl, 575 U.S. ____ (2015) (Kennedy, J.), at 2.
- 12 Id.