

## Supreme Court to Hear Tax Injunction Act Case

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On August 20, 2013, in *Direct Marketing Association v. Brohl*, the U.S. Court of Appeals for the Tenth Circuit held that the federal Tax Injunction Act (TIA) prohibited the U.S. District Court for the District of Colorado from ruling on the Direct Marketing Association's (DMA) challenge to Colorado's use tax notice and reporting requirements. 735 F.3d 904 (10th Cir. 2013). The Supreme Court of the United States has granted certiorari and will hear the case during its October 2014 term.

### State Court Bias and the Tax Injunction Act

Among state and local tax practitioners there exists the perception that state court judges, despite their sincere efforts, have difficulty remaining unbiased when hearing state tax cases. The concern is that the judges may be unconsciously biased against the claims of taxpayers because the judges themselves are inextricably entwined with state government. Every decision in favor of a taxpayer results in a reduction of revenue for the state—the ultimate payor of the judge's salary—and perhaps a slap in the face of the judge's colleagues in state government. As a result, they may improperly take the loss of state government revenue and power into consideration when determining case outcomes.

Taxpayers can point to numerous examples of state courts considering the loss of state government revenue when issuing a ruling. For example, in *Exelon Corp. v. Illinois Department of Revenue*, the taxpayer successfully convinced the Illinois Supreme Court that electricity was tangible personal property, and thus the taxpayer was entitled to the investment credits for taxpayers engaged in retailing tangible personal property. 917 N.E.2d 899 (Ill. 2009). However, following a motion for rehearing, the court limited its holding to prospective application only. In *Miller v. Johnson Controls, Inc.*, the Kentucky Supreme Court upheld legislation retroactively prohibiting refunds resulting from the change from separate unitary filing to unitary combined filing. 296 S.W.3d 392 (Ky. 2009). The court held that the retroactive application did not violate the taxpayer's due process and equal protection rights because the legislation was rationally related to the legitimate governmental purpose of preventing the loss of revenue. See Arthur R. Rosen & Julie M. Skelton, "Desperately Seeking State Tax Fairness: The Need for Federal Adjudication," 61 *State Tax Notes* 357 (Aug. 8, 2011). Based on these decisions, taxpayers' worries about state court bias may be for good reason.

Taxpayers have long desired a way to engage in federal court adjudication to receive impartial treatment. Despite concerns about state court bias, the TIA and its common law basis, comity,

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prohibit taxpayers from petitioning federal courts for the adjudication of most state tax controversies. The TIA prohibits federal district courts from “enjoin[ing], suspend[ing] or restrain[ing] 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.” 28 U.S.C. § 1341. Such actions may be pursued only in state courts.

The Supreme Court of the United States has previously commented on the scope of the TIA in *Hibbs v. Winn* and *Levin v. Commerce Energy, Inc.* In *Hibbs v. Winn*, the Supreme Court determined that the TIA does not apply to a third party challenging a state tax credit’s constitutionality under the Establishment Clause. 542 U.S. 88 (2004). The TIA only prohibits federal courts from hearing cases that interfere with the state’s collection of revenue. The Supreme Court also noted 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. Nowhere does the legislative history announce a sweeping congressional direction to prevent ‘federal-court interference with all aspects of state tax administration.’” *Id.* at 104 – 05.

In *Levin v. Commerce Energy, Inc.*, the Supreme Court distinguished *Hibbs v. Winn*, holding that the comity doctrine, separate and apart from the more narrow TIA, barred the “taxpayer’s complaint about allegedly discriminatory state taxation framed as a request to increase a competitor’s tax burden.” 560 U.S. 413, 425 – 26 (2010). The Supreme Court indicated three factors that gave rise to the application of comity: (1) the respondent sought “federal-court review of commercial matters over which Ohio enjoys wide regulatory latitude; [the] suit [did] not involve any fundamental right or classification that attract[ed] heightened judicial scrutiny,” (2) respondents sought “federal-court aid in an endeavor to improve their competitive position,” and (3) the state courts were better positioned to correct any violation because of a greater familiarity with “state legislative preference and because the TIA does not constrain their remedial options.” *Id.* at 431 – 32.

One could argue that the TIA evidences Congress’ desire to narrow the common law comity principle. Justice Ruth Bader Ginsburg has stated that “the [TIA] may be best understood as but a partial codification of the federal reluctance to interfere with state taxation.” *Id.* at 414 (quoting *Nat’l Private Truck Council v. Okla. Tax Comm’n*, 515 U.S. 582, 590 (1995)). Treating the TIA as having a narrower jurisdictional bar than the pre-existing common law comity principle renders the TIA superfluous. Therefore, it may be more sensible to see the TIA as Congress narrowing comity.

## **Direct Marketing Association v. Brohl**

As noted below, in *Direct Marketing Association v. Brohl*, the Tenth Circuit held that the TIA prohibited a federal district court from ruling on the constitutionality of Colorado’s remote seller use tax reporting laws despite the provisions neither imposing nor requiring the collection of a tax. 735 F.3d 904 (10th Cir. 2013).

Colorado’s use tax requires Colorado purchasers that have not paid sales tax on the purchase of tangible goods to pay a 2.9 percent use tax on the “storage or acquisition charges or costs for the privilege of storing, using, or consuming in [Colorado] any articles of tangible personal property purchased at retail.” Colo. Rev. Stat. § 39-26-202(1)(b). The use tax compensates for the loss of sales tax revenue resulting from residents purchasing property from other states with lower sales tax rates (or no sales tax at all) and bringing the property back into Colorado for its use. Colorado requires individuals to self-report their use tax liabilities. See Colorado DR 0252, Consumer Use Tax Return and Instructions. However, the extremely low compliance rate has resulted in the loss of state tax revenue.

In 2010, Colorado attempted to capture this revenue by adopting Colorado Revised Statutes sections 39-21-112(3.5)(c) and (d) and Colorado Code of Regulations section 39-21-112.3.5, requiring certain retailers that have not collected sales tax from Colorado purchasers, such as remote sellers, to: (1) provide transactional notices to Colorado customers stating that the retailer does not collect Colorado tax and that the purchase is not exempt solely because it is made over the internet or by other means, (2) send annual purchase summaries to Colorado customers, and (3) annually report Colorado customer information to the Colorado Department of Revenue (Department). See also *Direct Marketing Assoc.*, 735 F.3d at 907; Brief Amicus Curiae of Council on State Taxation in Support of Petitioner, *Direct Marketing Assoc. v. Brohl*, 2014 WL 1285844 (U.S. 2014) (No. 13-1032). Many observers believe that the Colorado legislature hoped that these onerous requirements, which would require sellers to invent and implement totally new systems, would economically coerce sellers into collecting and remitting the tax.

In June 2010, the DMA sued the Colorado Department of Revenue's executive director in the U.S. District Court for the District of Colorado, arguing that the notice and reporting requirements were unconstitutional under the Commerce Clause. The district court granted the DMA's motion for summary judgment, holding that the notice and reporting requirements facially discriminated against interstate commerce and placed burdens on out-of-state retailers that would unconstitutionally interfere with interstate commerce. The court reached this conclusion because it placed an obligation only on sellers with no physical presence in Colorado (since those with Colorado presence would be collecting the tax and thus not subject to the reporting requirements). *Direct Marketing Assoc. v. Huber*, 2012 WL 1079175, No. 10-cv-01546-REB-CBS (D. Colo. Mar. 2012).

The Department appealed to the Tenth Circuit, arguing that the TIA barred the federal court from hearing the case. First, the DMA argued that the TIA did not apply because the DMA is not a taxpayer seeking to avoid a tax. In rejecting this argument, the Tenth Circuit took an expansive view of the TIA, stating that it "applies to federal court relief that 'would ... operate[ ] to reduce the flow of state tax revenue.'" *Direct Marketing Ass'n*, 735 F.3d at 911 (quoting *Hibbs v. Winn*, 542 U.S. at 106). The court limited *Hibbs v. Winn* to the holding that the TIA does not apply to a petitioner contesting a tax benefit provided to a third party because the suit did not attempt to reduce the flow of state tax revenue. Citing to Tenth Circuit case law and Congress' "state-revenue-protective objectives," including prohibiting "taxpayers, with the aid of a federal injunction, from withholding large sums, thereby disrupting state government finances," the Court of Appeals held that the TIA does not apply only to taxpayers challenging their own state tax liabilities, but also to plaintiffs seeking to prevent "the State from exercising its sovereign power to collect ... revenues." *Hill v. Kemp*, 478 F.3d 1236, 1249 (10th Cir. 2007).

The DMA also argued that the TIA did not apply because it sought to avoid notice and reporting obligations, not a tax, and thus did not seek to restrain the assessment, levy or collection of any tax. *Direct Marketing Assoc.*, 735 F.3d at 912. The court read "restrain" broadly to apply to not just the direct challenge of a tax, but to a lawsuit concerning a procedure that operates to enforce and increase tax collection. For instance, the court found that "the annual customer information reports sent to the Department would aid the Department's auditing of taxpayers" and be a significant tax collection mechanism. *Id.* at 914.

Under the Tenth Circuit's interpretation of the TIA, taxpayers would not be able to challenge any aspect of taxation that would operate to hamper, even indirectly, a state's ability to raise revenue. The Tenth Circuit's opinion has resulted in a circuit court split with the First, Second and Sixth Circuits. These courts have each viewed the TIA as not applying to a tax agency's administration functions that serve to indirectly aid in the collection of tax. See *United Parcel Serv., Inc. v. Flores-*

Galarza, 318 F.3d 323 (1st Cir. 2003); Wells v. Malloy, 510 F.2d 74 (2nd Cir. 1975); BellSouth Telecommunications, Inc. v. Farris, 542 F.3d 499 (6th Cir. 2008).

## Supreme Court of the United States

On July 1, 2014, the Supreme Court granted certiorari in *Direct Marketing Association v. Brohl*. The court will determine “whether the TIA bars federal court jurisdiction over a suit brought by non-taxpayers to enjoin the informational notice and reporting requirements of a state law that neither imposes a tax, nor requires the collection of a tax, but serves only as a secondary aspect of state tax administration.” See *Direct Marketing Assoc. v. Brohl* [Question Presented](#).

The Supreme Court will have the chance to revisit *Hibbs* and *Levin*, clarify the limits of the TIA and the common law comity principle, and remedy the federal circuit court split regarding whether the TIA applies to secondary elements of state tax administration that only indirectly affect the collection of tax. The Tenth Circuit has broadly interpreted the TIA’s purpose, prohibiting taxpayers from challenging practically any aspect of tax administration in federal court if the challenge would hamper the state’s ability to raise revenue, even indirectly. A ruling against the DMA would expand the reach of the TIA to encompass nearly all state tax-related lawsuits and extinguish state taxpayers’ hopes of receiving unbiased treatment from the judiciary.

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