Will State Tax Matters Be Shut Out of Federal Courts?

by Steven M. Hogan


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In this article, Hogan writes about *Direct Marketing Association v. Brohl*, which is before the U.S. Supreme Court and involves a challenge by a retailing association to a law requiring retailers to report the names and purchases of potential taxpayers in the state. He argues that if the Court affirms the Tenth Circuit opinion, it could essentially close the federal courts to any challenge to state revenue raising.

The U.S. Supreme Court is hearing a case this term that could be a game changer for litigating multistate tax cases. If the Court affirms the Tenth Circuit's decision in *Direct Marketing Association v. Brohl*, its decision could render the federal courts off limits to parties challenging laws that affect state taxation and revenue collection.[1] Those challenges would have to be brought instead in state courts, which may present less attractive options for challenging state revenue laws.

Colorado's Reporting Law and *Quill*

Direct Marketing Association originated with the state of Colorado's attempt to capture tax revenue lost to remote sales. A remote sale is one in which a vendor sells a product to a customer in a different state where the vendor has no physical presence. In an age of electronic commerce, these transactions are easy and increasingly common. The problem for states such as Colorado is that there are significant legal impediments to collecting sales tax on those transactions.

In the normal case of a bricks-and-mortar retailer located in the same state as its customer, the taxing state can require the retailer to collect tax from the customer at the point of sale. Because of the U.S. Supreme Court's decision in *Quill*, however, states can't require remote sellers to collect sales tax in the same way.[2] Under the *Quill* nexus test, a state cannot legally compel a business to collect sales or use tax on transactions with state residents unless the business has sufficiently close ties to the state.[3] The commerce clause nexus test for sales tax created under *Quill* is a bright-line physical presence test.[4]

That means states must collect use taxes on these sales directly from their citizens if they are to collect them at all — an option that is both administratively difficult and politically unpalatable.

Quill has created financial problems for every state that relies on sales and use tax revenue. Every dollar spent with an online retailer that has no physical nexus with the customer's state is a dollar of taxable sales that the state cannot tax. That represents lost revenue that would have been captured in a prior era when all purchases had to be made at bricks-and-mortar establishments.[5] The *Quill* effect on state revenue has been significant. The total amount of lost state tax revenue has been estimated at more than $10 billion per year.[6]

The lost revenue has led states to take two main approaches to the problems created by *Quill*. Those approaches directly affect when and to what extent states can

[1] *Direct Marketing Ass'n v. Brohl*, 735 F.3d 904 (10th Cir. 2013), *cert. granted*, 134 S.Ct. 2901.

[2] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The *Quill* decision created two distinct nexus tests based on the U.S. Constitution's due process and commerce clauses. A state must pass both nexus tests in order to constitutionally impose tax on transactions between state residents and remote sellers. The physical presence test is based on the commerce clause. This article focuses on the commerce clause nexus test exclusively because it has been more problematic for states.

[3] The nexus test is a foundational principle of multistate taxation. A separate and distinct nexus test applies when determining whether a business's operations in a state create liability to pay state income tax. Depending on the circumstances, a business may have liability to pay state income tax without a corresponding obligation to collect sales or use taxes in that state. *See* Steven M. Hogan and Jennifer S. Ivey, "What Every Entrepreneur Should Know About Taxation of Internet Commerce," Vol. 18, No. 3 *J. of Internet L.* 12-18 (Sept. 2014).

[4] In practice, the allegedly bright-line test created by *Quill* has extremely fuzzy edges.

[5] That is not to say that every dollar spent online is a sale that otherwise would have occurred at a bricks-and-mortar retail establishment.

[6] Donald Bruce et al., "State and Local Government Sales Tax Revenue Losses From Electronic Commerce," University of Tennessee (2009).

impose collection or reporting responsibilities on remote sellers. For large Internet retailers, many states have cut deals to forgo potential past tax liabilities in return for a commitment to future tax collection.[7] In the absence of a deal, other states have enforced collection or reporting responsibilities on remote sellers by enacting click-through nexus or affiliate nexus laws.[8]

Affiliate nexus laws commonly provide that a remote vendor has nexus with the taxing state if it has business arrangements with state residents to refer potential customers to the remote vendor through links on an Internet website or otherwise. The physical presence of the remote sellet's affiliate in the state is presumed to be sufficient to trigger liability for the remote seller to collect and remit tax on its sales to state residents. New York was the first state to enact such a law.[9]

Instead of passing a click-through nexus law, Colorado opted to require remote sellers with over $100,000 in sales to Colorado residents to file a report with the Department of Revenue detailing the amounts purchased by state residents and the residents' contact information.[10] The law does not require remote sellers to collect use tax. Instead, the law requires qualifying remote sellers to "(1) provide transactional notices to Colorado purchasers, (2) send annual purchase summaries to Colorado customers, and (3) annually report Colorado purchaser information to the Department."[11] That method allows the state to target its collection efforts on state residents who have not remitted use tax on their purchases from remote sellers.

The Colorado law was challenged by the Direct Marketing Association (DMA), a group representing businesses and organizations that market products to Colorado residents through "catalogs, advertisements, broadcast media, and the Internet."[12] The DMA sued the state in federal court, alleging the law violated the commerce clause under *Quill*. The district court ruled in favor of the DMA, granting summary judgment against the state and entering a permanent injunction against enforcement of the law.[13]

On appeal, the Tenth Circuit Court of Appeals declined to address the merits of the district court's opinion. Instead, it held that the Tax Injunction Act (TIA), 28 U.S.C. section 1341, divested the district court of jurisdiction over the DMA's claims.[14] The circuit court therefore remanded the case to the district court with orders to dismiss the case for lack of jurisdiction and to dissolve the injunction.[15]

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The U.S. Supreme Court granted the DMA's petition for writ of certiorari in July.[16] The Court's decision in *Direct Marketing Association* may have significant consequences, depending on how the Court frames its decision.

Closing the Federal Courts to Challenges to State Laws?

For practitioners, the key issue in *Direct Marketing Association* is whether federal courts will remain open to parties challenging state attempts to collect taxes on remote sale transactions. If the appeals court opinion is affirmed, the TIA will serve as an effective bar to petitioning the federal courts for redress of state government action.

That is not to say that state courts are less capable of addressing questions of interstate commerce than their federal counterparts. After all, *Quill* originated in the North Dakota state court system. However, commentators have said that a perception of unfairness lingers when out-of-state corporate taxpayers are forced to litigate tax cases in a state court forum.[17]

The *Direct Marketing Association* opinion is especially significant in this context because it does not involve a challenge by a direct taxpayer to the payment of a state tax liability. Instead, it involves a challenge by a non-taxpayer to a law that requires it to report the names of other potential

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[7]High-profile deals between Amazon and several large states have garnered significant media attention. Notable examples include California, Florida, Nevada, and Texas. *See* David Streitfeld, "Amazon, Forced to Collect a Tax; Is Adding Roots," *The New York Times*, Sept. 11, 2012 (Amazon in California); Nanette Byrnes, "Sales-Tax Deal With Texas Is Amazon's Latest," Reuters (Apr. 27, 2012); Toluse Olorunnipa, "Amazon Begins Collecting Florida Taxes for Internet Sales," Bloomberg (Apr. 30, 2014); David McGrath Schwartz, "Nevada Reaches Agreement With Amazon on Collection of Sales Tax," *Las Vegas Sun*, Apr. 23, 2012. Often, those deals are coupled with a commitment to economic development and job creation. That was the case with Florida, where Amazon agreed to collect tax on its sales to Florida residents as part of a larger deal to locate distribution centers in the state. Aaron Deslatte and Sandra Pedicini, "Amazon to Bring 3,000 Jobs to Florida in Deal With State," *Orlando Sentinel*, June 16, 2013.

[8]*See* David Gamage and Devin J. Heckman, "A Better Way Forward for State Taxation of E-Commerce," 92 *B.U. L. Rev.* 483, 519 (2012). Gamage and Heckman refer to both varieties as "referrer nexus" laws.

[9]*See id.* at 520.

[10]Tyler Murray and Eric J. Zinn, "Colorado and the 'Amazon Tax' — Recent History," 41-Jun. *Colo. Law.* 43, 48 (2012) (detailing how Colorado's law differs from the New York model).

[11]*Direct Marketing Ass'n*, 735 F.3d at 907.

[12]*Id.* at 906.

[13]*Id.* at 909.

[14]*Id.* at 920. The Tenth Circuit indicated that the TIA had to be addressed because of its jurisdictional limitation regardless of whether it was raised below. *Id.* at 910.

[15]*Id.* at 921.

[16]134 S.Ct. 2901. As of the date of this article, oral arguments were scheduled for December 8, 2014.

[17]Arthur R. Rosen and Julie M. Skelton, "Desperately Seeking State Tax Fairness: The Need for Federal Adjudication," *State Tax Notes*, Aug. 8, 2011, p. 357.

taxpayers — its customers. The specter of the TIA limiting similarly situated parties from having their day in court is a potentially troubling extension of the TIA's scope.[18]

Observers of *Direct Marketing Association* must remember that the Colorado reporting requirement law is one in a long series of creative attempts by states to address the revenue problem stemming from *Quill*. Congress could have fixed the problem long ago. Instead of a fix, we have a case like *Direct Marketing Association* winding its way through a procedurally complex path to the highest court in the land. This is the antithesis of good policy. The uncertainty that *Quill* and state attempts to circumvent its consequences have created is long overdue for redress by Congress.

Remote sellers and their legal advisers should pay close attention to how the Court addresses the issues raised in *Direct Marketing Association*. The result could effectively close federal courts to remote sellers facing creative attempts by states to raise revenue from Internet commerce. ☆

[18]The TIA bars federal jurisdiction over lawsuits that seek to "enjoin, suspend or restrain the assessment, levy, or collection of any tax." 28 U.S.C. section 1341. The Colorado law at issue here does not assess, levy, or collect any tax from the remote sellers. Amicus curiae have ably explained how *Direct Marketing Association* may have expanded the TIA beyond its intended scope. *See, e.g.*, Brief of the Chamber of Commerce of the United States of America as *Amicus Curiae* in Support of Petitioner, No. 13-1032 (Sept. 16, 2014).