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Avoiding the TIA: Not Impossible, But Close

by Clark R. Calhoun and Timothy L. Fallaw

Clark R. Calhoun Timothy L. Fallaw

The federal Tax Injunction Act (TIA), codified at 28 U.S.C. section 1341, is arguably the most important federal statute applicable to state taxes. Many people believe that it insulates state tax determinations almost entirely from federal court oversight. The federal statute reads: The district courts shall not enjoin, suspend or restrain 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.

Many taxpayer dollars have already been expended — probably unnecessarily — in unsuccessfully combating the broad reach of the TIA. There are exceptions, however, to the TIA's broad reach, and there is always the possibility that sufficiently egregious state conduct could lead to the recognition of additional exceptions to the TIA. This article serves mostly as a summary of the scope of the TIA and its exceptions, but it also offers some (we hope) insightful commentary on the statute and suggests ways to push on its boundaries when the advantage of getting into federal court seems worth the uphill battle of overcoming the TIA.[1]

[1]This article is concerned only with the TIA codified at 28 U.S.C. section 1341 and that statute's prohibition of federal

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Overview

If applicable, the TIA allows state courts to be the final arbiters of the meaning of their own tax statutes, and likely the final arbiters of federal constitutional attacks on their own tax statutes. That frequently surprises taxpayers, as well as some non-tax litigators. Unless the U.S. Supreme Court agrees to hear a constitutional challenge to a state tax (which is a relatively rare event), a state court tax decision that rules on state law and federal constitutional law issues will stand. In many cases, that ruling may not even be the decision of the state's highest court.[2]

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Although nonresident taxpayers might feel less than welcome in a state's courts when they contest their state tax liability, in many cases they will simply have to get used to it. Moreover, to whatever extent taxpayers believe that state tax administrators and courts play faster and looser with tax laws than the IRS and the federal courts, they typically will have to get used to that, too. Because of the TIA, the doors of the federal district courts and courts of

court intrusion into the states' tax collection efforts. A separate federal statute concerning tax injunctions, found at section 7421(a) of the Internal Revenue Code, is an anti-injunction act that precludes suit in any court for the purpose of restraining the assessment or collection of *federal* taxes. This article does not discuss section 7421(a).

[2]*See, e.g.*, *A&F Trademark, Inc. v. Tolson*, 167 N.C. App. 150 (2004), *cert. denied*, 546 U.S. 821 (2005) (rejecting the argument that it was unconstitutional for state to tax foreign corporation that did not have physical presence in the state). (For the court of appeals decision, see *Doc 2004-23413* or *2004 STT 239-18*.)

appeal are largely closed to state taxpayers (except in a narrow set of cases, discussed below).[3] The time may be ripe, however, for taxpayers to mount another assault on tardy and inefficient state tax refund mechanisms, starting with the recognized exceptions to the TIA (for example, the exaction is a penalty or fee rather than a tax) and moving on to the more difficult grounds of procedural or even substantive unfairness.

History of the Tax Injunction Act

The TIA is rooted in the U.S. Constitution's 11th Amendment, which states:

> The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

On its face, this prohibition found in the 11th Amendment creates a lack of parity between a state's citizens and nonresident taxpayers, because it denies only nonresidents the right to bring suit against a state in federal court. The apparent incongruity of the amendment, however, was later alleviated, because many cases recognized that a state also could not be sued by its own citizens without its consent.[4] This holding led to the development of a different type of uneven playing field: Nonresident taxpayers could sue a state in federal court based on diversity of citizenship, but citizens of the state could not.[5] Over the years, a series of measures, including the Tax Injunction Act in 1937, were enacted to correct that inequity and to give further clarification to the scope of federal court jurisdiction in cases involving suits against the states.[6]

However, even before the passage of the TIA, the federal courts were already restrained from meddling in state governmental matters because of concerns about comity and federalism.[7]

Areas Not Covered by the TIA

Because the scope of the TIA is so broad, and because most taxpayers are more interested in avoiding the TIA than being stopped by it, the most effective way to analyze the TIA's reach is to examine when it does *not* apply.

The TIA Does Not Apply When the Payment at Issue Is Not a Tax

The TIA applies only to taxes, as determined under federal law.[8] Taxes are distinguished primarily by being neither fees, penalties, nor contractual debts.[9] Distinguishing between taxes and fees can be difficult at the margins, but the ultimate test is whether the revenue generated by the amount at issue is put to a general public use (making it a tax) as contrasted with serving as the price of admission of the payer to a specified benefit (making it a fee).[10] A particularly active litigant in this area has been the American Civil Liberties Union. For example, it recently successfully attacked a $1,000 exaction on lobbyists, which the court found to be a fee (to which the TIA did not apply) rather than a tax because it was intended to defray the costs of regulating the lobbying industry.[11]

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Penalties — another category of exactions to which the TIA does not apply — can include the standard failure to file, late filing, negligence, or substantial understatement penalties commonly added by most taxing authorities to delinquent tax bills. Further, this exception to the TIA includes both civil penalties and criminal penalties.[12] Even though state laws usually discuss penalties in their tax codes, federal courts have held that the TIA does not apply to penalties.[13] The theory behind that

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[3]It is worth noting here that the TIA does not prohibit state and local governments from pursuing state tax actions in federal court. *See, e.g., Diginet, Inc. v. Western Union ATS, Inc.*, 845 F. Supp. 1237, 1241 (N.D. Ill. 1994). ("It [the TIA] does not preclude jurisdiction over claims by a state entity to enforce the collection, assessment, or levying of taxes; claims seeking to force the distribution of taxes already collected; or claims seeking to increase the amount of taxes to be collected, assessed, or levied.")

[4]*See, e.g., Hans v. Louisiana*, 134 U.S. 1 (1890).

[5]*See* S. Rep. No. 1035, 75th Cong., 1st Sess. 1-2 (1937).

[6]*See* Robert F. Williams, "The Tax Injunction Act and Judicial Restraint: Property Tax Litigation in Federal Courts," 12 *Rutgers L.J.* 653, 661-662 (1981). For example, in 1934, the Johnson Act imposed limitations on federal injunction of state utility rate-making. The TIA is occasionally referred to as the Johnson Act, but that reference is incorrect.

[7]*See Moore's Federal Practice* sections 17A-121.41 and 121.46.

[8]*Rendon v. State of Fla.*, 930 F. Supp. 601, 604 (S.D. Fla. 1996) (citation omitted).

[9]*Moore's Federal Practice* section 17A-121.42.

[10]*See, e.g., San Juan Cellular Tel. Co. v. Pub. Serv. Comm'n*, 967 F.2d 683 (1st Cir. 1992); *MCI Communs. Servs. v. City of Eugene*, 359 Fed. Appx. 692 (9th Cir. 2009) (amount charged to telephone company was a tax). (For the decision in *MCI*, see *Doc 2009-20740* or *2009 STT 179-1*.)

[11]*ACLU of Ill. v. White*, 692 F. Supp. 2d 986, 989-91 (N.D. Ill. 2010).

[12]*Lynn v West*, 134 F.3d 582 (4th Cir. 1998).

[13]*See, e.g., RTC Commer. Assets Trust 1995-NP3-1 v. Phoenix Bond & Indem. Co.*, 169 F.3d 448, 457-58 (7th Cir. 1999). *Cf. Washington v. Linebarger, Goggan, Blair, Pena &*

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exception is that penalties generally are not designed to raise revenue but are instead a special purpose regulatory device intended to coerce taxpayers into complying with the tax laws.[14]

This raises the interesting possibility that a state tax litigant might properly obtain a federal court decision on its liability for a penalty without obtaining a decision regarding its liability for the underlying tax. That could happen either by (a) simply not seeking to prevent collection of the underlying tax in the federal action or (b) attacking the penalty on a ground different from the ground on which it objected to the tax (for example, that the penalty was arbitrarily applied because the taxpayer could not have known that the state would enforce the substantive law to have a particular strained meaning). The federal court could still refuse to hear the penalty claim on grounds of comity or federalism or abstention, but at least an egregious imposition of a penalty has a chance to be heard.

The TIA Does Not Apply When the Suit Does Not Seek to Prevent the Assessment, Levy, or Collection of the Tax

Generally, if a suit does not seek to prevent the assessment, levy, or collection of a state tax, the TIA will not prevent the federal court from hearing the case.[15] Some common examples are cited below.

Discrimination Claims

Persons who contest tax benefits enjoyed by others in the form of credits or other tax reductions will not be barred from federal court by the TIA. The U.S. Supreme Court reached this conclusion in *Hibbs v. Winn*, which considered a challenge to state tax credits for contributions to parochial schools.[16] The basis for that exception is that the TIA is intended to prevent federal courts only from interfering with the flow of funds to state and local *governments* and not to other taxpayers.[17] That exception, however, is quite narrow because the courts can still refuse to hear the case on grounds of comity.[18]

The Supreme Court recently emphasized its bent toward relying on comity in these cases by creating a new term of art, writing that "the comity doctrine is more *embracive* than the TIA."[19] The rule of *Hibbs*, *Levin*, and other cases appears to be that when a tax infringes on taxpayers' fundamental rights, the Court is more likely to consider the case, but when the claim is that the tax merely creates a competitive disadvantage for a business taxpayer, the Court will invoke comity and decline to hear the case.

Claims Only Indirectly Related to a Tax

This exception to the TIA applies when the exaction at issue is only indirectly related to a tax. For example, the Sixth Circuit held that the TIA did not apply to a business's attack on a state rule that prevented it from separately stating a tax on a bill.[20] The court heard the case because the taxpayer did not contest the liability for the *tax*, but only the procedural rule.

The TIA Does Not Apply When a State Seeks Information That Is Not Necessary to Assess a Tax

On October 25 a federal court in Washington ruled that the TIA does not apply to a taxpayer's request to enjoin a state's request for information from the taxpayer when obtaining the information was not necessary for the state to calculate the alleged tax due or to issue an assessment against the taxpayer.[21] In that case, the North Carolina Department of Revenue had indicated an audit of Amazon.com concerning Amazon's remote sales to North Carolina customer. Amazon had already provided the DOR with detailed information regarding the products sold to North Carolina customers for the audit period, but the DOR continuted to seek identifying information regarding Amazon's customers.[22]

Amazon filed suit in federal court, asking the court to declare that the DOR's requests for information that would identify Amazon's customers was a violation of the First Amendment and the federal

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Sampson, LLP, 338 F.3d 442, 444 (5th Cir. 2003) (penalty found to be designed to defray cost of collection and so was part of the tax).

[14]*RTC*, 169 F.3d at 457.

[15]*Diginet, Inc. v. Western Union ATS, Inc.*, 845 F. Supp. 1237, 1241 (N.D. Ill. 1994). ("It is the majority view that the Tax Injunction Act only precludes jurisdiction over attempts to prevent or limit the collection, assessment, or levying of taxes.")

[16]*Hibbs v. Winn*, 542 U.S. 88 (2004).

[17]*Id.* at 104-109.

[18]*See, e.g., Fair Assessment in Real Estate Ass'n Inc. v. McNary*, 454 U.S. 100, 114-116 (1981); *DirecTV v. Tolson*, 513 F.3d 119, 123-128 (4th Cir. 2008) (satellite television providers asked court to reauthorize localities to apply franchise tax to their cable television competitors, but the Fourth Circuit

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refused to hear the case on comity grounds). (For the decision in *DirecTV*, see *Doc 2008-796* or *2008 STT 10-22*.)

[19]*Levin v. Commerce Energy, Inc*., 130 S.Ct. 2323 (2010) (emphasis added). This opinion appears to resolve an alleged split in the circuits regarding the scope of the comity doctrine in relation to the TIA. *See* Note, "The Tax Injunction Act and Federal Jurisdiction: Reasoning from the Underlying Goals of Federalism and Comity," 108 *Mich. L. Rev*. 795 (2010). (For the decision, see *Doc 2010-12103* or *2010 STT 105-20*.)

[20]*BellSouth Telecomms., Inc. v. Farris*, 542 F.3d 499 (6th Cir. 2008).

[21]*Amazon.com LLC v. Kenneth R. Lay*, Case No. C10-664 MJP (W.D. Wash. Oct. 25, 2010). (For the decision, see *Doc 2010-23160* or *2010 STT 207-27*.)

[22]*Id.* at 9.

Video Privacy Protection Act.[23] The DOR argued that the federal court lacked jurisdicition to consider the claims because of the TIA; the court, however, held that the TIA was not implicated, because the DOR already had all the information it needed to calculate the tax dues and issue its assessment.[24] The court therefore granted summary judment to Amazon, holding, *inter alia*, that the TIA did not bar the requested relief because granting the relief would not affect the "assessment, levy or collection" of any North Carolina tax.

The TIA Does Not Apply When a State's Courts Do Not Provide a Plain, Speedy, and Efficient Remedy

This exception is arguably both the largest *theoretical* exception and the smallest *practical* hole through which taxpayers might try to squeeze. Many practitioners privately believe that the remedies provided by many states are not plain, speedy, or efficient, as a matter of procedural due process. Although this exception to the TIA provides a means of getting into federal court to challenge a state's tax procedures, the reality is that federal courts remain reluctant to tell states how to administer their tax laws.

For example, a former provision in North Carolina law required that taxpayers who intended to seek a refund must give notice to the state within 30 days after paying the tax.[25] The Fourth Circuit said that requirement was procedurally sufficient, although it did not rule on the matter directly.[26] But when the Third Circuit found the Tax Review Board of the Virgin Islands to be meeting only infrequently, to have a large backlog of cases, and not to be maintaining reliable records, it held the available procedure to be insufficient.[27]

Even more troubling is the frustration taxpayers sometimes feel in trying to obtain substantive justice on legal issues or fact findings that can never be reviewed by a federal court. Unfortunately, the TIA provides no exception for taxpayers who are simply denied the substantive relief to which they believe they are entitled. It is possible, however, that an aggrieved taxpayer could argue that the TIA's exception for speedy and efficient remedies is met by demonstrating a pattern of substantive abuse of the state's statutes that rises to the level of procedural unfairness. Taxpayers suspecting that they will encounter a series of delaying tactics (or worse) in state tax refund procedures might seek to gather information about the state's record in handling other claims.

Moreover, if the state's procedures are sufficiently insufficient, there is precedent that the federal courts will step in. For example, when a tax had been ruled illegal and a government continued to collect it, a Ninth Circuit court ruled that the state's remedy was not efficient.[28] Taxpayers should also try to rely on the Supreme Court's 1952 ruling in *Georgia R.R. & Banking Co. v. Redwine*, which held that forcing a taxpayer to file more than 300 separate actions to remedy one tax issue was not an efficient remedy.[29]

In Rare Cases a Federal Statute Authorizes State Tax Suits in Federal Court

Bankruptcy

Many decisions confirm that a bankruptcy court's power over the bankrupt estate supersedes the TIA, as provided in 11 U.S.C. section 505.[30]

Indian Tribes

28 U.S.C. section 1362 grants the district courts original jurisdiction for tax suits by Indian tribes in some situations.[31]

Railroads

49 U.S.C. section 11501 allows railroads to sue in federal court to challenge some state property taxes.[32]

ERISA

There is a split in authority as to whether ERISA provides an exception to the TIA.[33]

The TIA Does Not Apply to State Collection Actions or Defenses Raised Therein

The Supreme Court affirmed and clarified this exception in *Jefferson County v. Acker*.[34] Thus, although taxpayers may not affirmatively bring a suit to "enjoin, suspend, or restrain" a state tax assessment or levy in a federal court, they may seek to remove a state collection action to federal court if a proper basis for removal exists (for example, diversity of citizenship), and they are free to assert any

[23] *Id.* at 16-23

[24] *Id.* at 11.

[25] *See* N.C. Gen. Stat. section 105-267 (1992) (repealed).

[26] *Swanson v. Faulkner*, 55 F.3d 956 (4th Cir. 1993).

[27] *Berne Corp. v. Government of the Virgin Islands*, 570 F.3d 130 (3rd Cir. 2009).

[28] *Patel v. City of San Bernardino*, 310 F.3d 1138 (9th Cir. 2006).

[29] 342 U.S. 299 (1952).

[30] *See, e.g., Pontes v. Cunha (In re Pontes)*, 310 F. Supp. 2d 447 (D.R.I. 2004).

[31] *Moe v. Confederated Salish & Kootenai Tribes of Flathead Reservation*, 425 US 463 (1976); *Muscogee Nation v. Okla. Tax Comm'n*, 611 F.3d 1222 (N.D. Okla. 2010) (exception to TIA applicable only to taxes on the Indian lands).

[32] *CSX Transp., Inc. v. Ga. State Bd. of Equalization*, 552 U.S. 9 (2007). (For the decision, see *Doc 2007-26569* or *2007 234-2*.)

[33] *See Moore's Federal Practice Civil* section 121.45[3].

[34] *Jefferson County v. Acker*, 527 U.S. 423 (1999).

and all defenses in opposition to the state's assertion of tax liability in federal court.[35] Taxpayers in the procedural posture of facing an offensive collection suit by a state may therefore have a greater potential for success in placing its case before a federal court, presuming that a proper basis for federal jurisdiction exists.[36] Offensive suits by state tax authorities seeking a declaratory judgment that a taxpayer is subject to a particular state tax can also avoid the bar of the TIA.[37]

The TIA May Not Apply to Territories

For example, at one point in time the TIA did not apply to the Virgin Islands,[38] although that may no longer be the case.[39]

The TIA Does Not Apply to the United States

This exception will be of assistance to private taxpayers only if they can both show that the tax is borne by the United States by virtue of its relationship as a contractor or agent, and can convince the United States to join as a plaintiff.[40] Some federal agencies can sue on their own behalf.[41]

Conclusion

To many, it is surprising how effective the TIA is at limiting taxpayers' ability to pursue state tax litigation in the federal courts. It is also surprising how inured many tax professionals have become to this state of affairs. There can, of course, be many advantages to pursuing state tax claims in federal rather than state courts; that is especially true with challenges to the validity of state tax laws, in which state judges may be loath to overturn acts of the state legislature or actions of state officials.

Nevertheless, given the competing realities of the difficulty of pursuing state tax challenges in the state courts and the broad scope of the TIA, a delicate balance is required in advising clients on whether expending money and time in pursuing a federal venue is a waste of resources, and keeping an open mind to the possibility that some route to a federal hearing — short of the grant of a writ of certiorari by the Supreme Court — can be found. ☆

Audit + Beyond, a column on state tax audits and the resolution of disagreements between business taxpayers and state revenue departments, is written by members of the Alston & Bird LLP state and local tax group. Clark R. Calhoun is an associate and Timothy L. Fallaw is a partner with the firm's Atlanta office.

[35] *Id*. at 435. The Court points out, however, that a federal court may nevertheless decline to adjudicate cases concerning the meaning and proper application of state tax laws under the abstention or stay doctrines. *Id*. at 435, n. 5. These arguments were not made by the parties in *Jefferson County*. *Id*.

[36] *See, e.g., Pitt County v. Hotels.com, L.P., et. al*., 553 F.3d 308 (4th Cir. 2009). One recent memorable situation in which the taxpayer may have been able to benefit from such a strategy was *Bridges v. Autozone Properties, Inc*., 900 So.2d 784 (La. 2005). In *Autozone*, the Louisiana Department of Revenue brought an action to recover for state income and franchise taxes against Autozone Properties in Louisiana state court. Autozone Properties was a Nevada corporation with its principal place of business in the Bahamas, and its only connection with Louisiana was its ownership interest in a REIT that owned real estate in the state. In one of the more striking examples of results-oriented jurisprudence on record, the state supreme court held that Autozone Properties was amenable to suit in the state under due process clause principles and subject to tax in the state under commerce clause principles based solely on its ownership of shares in a corporate entity that was present in the state. In a subsequent opinion concurring in the denial of a rehearing for the taxpayer, the chief judge of the Louisiana Supreme Court admitted that the holding "might have been decided incorrectly," but nevertheless the result was left undisturbed because the taxpayer's application for rehearing was not timely filed. *Id*. at 809. In situations such as *Autozone* where the taxpayer faces a collection suit by the state, possesses a proper basis for federal court jurisdiction, and the contested issues are federal in nature (federal due process clause and commerce clause protections), the time and risk of pursuing a federal forum may well be warranted. (For the decision, see *Doc 2005-6391* or *2005 STT 60-16*.)

[37] *See, e.g*., *City of Jefferson City, Mo. v. Cingular Wireless, LLC*, 531 F.3d 595 (8th Cir. 2008); *Mayor & City Council of Baltimore v. Vonage Am. Inc*., 544 F.Supp.2d 458 (D. Md. 2008). (For the decision in *Cingular*, see *Doc 2008-14736* or *2008 STT 131-18*.)

[38] *Bluebeard's Castle, Inc. v. Government of the Virgin Islands*, 321 F.3d 394, 397-398 (3rd Cir. 2003).

[39] *Berne Corp. v. Government of the Virgin Islands*, 570 F.3d 130 (3d Cir. 2009).

[40] *See Dep't of Employment v. United States*, 385 U.S. 355, 357-358 (1966).

[41] *City & County of San Francisco v. Assessment Appeals Bd*., 122 F.3d 1274, 1276-1277 (9th Cir. 1997) (permitting a federal reserve bank to bring state tax suit in federal court).