



# **COST 2011 SPRING AUDIT SESSION/ INCOME TAX CONFERENCE**

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## **UNIQUE LITIGATION STRATEGIES, INCLUDING FEDERAL COURTS FOR STATE TAX CASES**

*Kendall L. Houghton*

*Alston & Bird LLP*

*(202) 239-3673*

*kendall.houghton@alston.com*

*Jeffrey M. Vesely*

*Pillsbury Winthrop Shaw Pittman LLP*

*(415) 983-1075*

*jeffrey.vesely@pillsburylaw.com*



# Creative Controversy Roadmap

- Avoid Pay-to-Play
- Making a Federal Case Out of It
- Pick-a-Judge (Complex Litigation)
- Litigation Coop (Funding a Test Case)
- Creative Resolution: Mediation/Arbitration
- Keep Your Friends (Amicus Curiae) Close...



## Avoid “Pay to Play”

- In some states, the validity of regulations, including tax regulations, may be litigated without prior payment of the tax
- For example, in California, a taxpayer may file an action seeking a declaratory judgment that a tax regulation is invalid
  - *Pacific Motor Transport Co. v. SBE*, 28 Cal. App. 3d 230 (1972)
    - “While the relief afforded may not prevent or enjoin or otherwise hamper present or future tax assessment or collection effort ... it will be presumed that the governmental agency will respect a judicial declaration concerning a regulation’s validity”



## Avoid “Pay to Play”

- If remedies for challenging a tax, fee or penalty are inadequate, declaratory relief actions may be appropriate
  - *Andal v. City of Stockton*, 137 Cal. App. 4<sup>th</sup> 86 (2006)
    - Suit for declaratory relief which raised comprehensive constitutional arguments as to the validity of telephone users surcharge permitted
    - Remedies in the ordinance did not mention constitutional challenges and thus were inadequate
  - California’s Amnesty Penalty and 20 percent Understatement Penalty
    - Both prohibit claims for refund on grounds other than computational issues
    - Violate Due Process Clause
    - *General Electric v. FTB* (2007)



## Avoid Pay-to-Play

- In the District of Columbia, you may want to “split the baby”
  - OTR denies taxpayer’s refund claims, and simultaneously issues Notice of Deficiency
  - Two options to appeal:
    - OAH: Protest deficiency without pay-to-play, but OAH may NOT consider/award a refund
    - Superior Court: May hear both protest and refund claim appeals, but payment of deficiency is prerequisite
  - At least one taxpayer has bifurcated the matters and is pursuing the protest in OAH and the refund claim in Superior Court
    - Avoid pre-payment of a retaliatory assessment while pursuing a refund to which taxpayer is entitled



# Split the Baby

- Issues to consider:
  - Dual-track litigation is time-intensive and may be more costly (also for OTR, which may be leverage for the taxpayer)
  - DC is represented by two different sets of lawyers in these matters:
    - Before OAH, OTR's General Counsel is the lawyer
    - Before Superior Court, the Office of Attorney General represents OTR
  - Strange issues may arise – disjunctive discovery schedules; ex parte communication; different views of risks of litigation – but then again, DC is not a run-of-the-mill jurisdiction



# Tax Injunction Act

- The Tax Injunction Act (TIA, 28 U.S.C. § 1341) presents significant hurdles to having a Federal district court hear your case
  - “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.”
  - Prohibits declaratory relief actions, suits for refund as well as suits seeking to directly enjoin the assessment or collection of a tax (*California v. Grace Brethren* (USSC, 1982))



## Tax Injunction Act

- Query: What is meant by plain, speedy and efficient remedy?
- *Rosewell v. LaSalle Nat. Bank* (USSC, 1981)
  - The state remedy must provide for a full hearing and judicial determination at which any and all constitutional objections to the tax can be raised
  - *FTB v. Alcan Aluminum* (USSC, 1990)
    - “A remedy that is uncertain or speculative is not adequate to bar federal jurisdiction”





## Tax Injunction Act

- Plain
  - Remedy must not be uncertain or speculative (*FTB v. Alcan*; *DMA v. Bennett* (9<sup>th</sup> Cir. 1990))
- Speedy
  - Delays are permissible (*Rosewell*)
- Efficient
  - Absence of interest on refunds permissible (*Rosewell*)



## Tax Injunction Act

Remedy does not need to be the best remedy available or even equal to or better than the remedy that might be available in federal court (*Washington v. Linebarger, et al.* (5<sup>th</sup> Cir., 2003))



## Exceptions to Tax Injunction Act

- While exceptions to the TIA are narrowly construed, they do exist (*Grace Brethen*)
- Key is to focus on the language of the TIA
  - Is a “tax” involved?
  - Does the action enjoin, suspend or restrain the assessment, levy or collection of a tax?
  - Is the state remedy plain, speedy and efficient or is it uncertain or speculative?
  - Is the taxpayer prohibited from raising any and all constitutional objections to the tax in state court?



# Exceptions to Tax Injunction Act

- TIA does not prevent a Federal court from hearing a case focused on
  - Fees
    - Query: Is money generated by the exaction put to general public use? If so, it is a tax. If money services as price of admission to a specified benefit, it is a fee.
  - Penalties
    - Failure to file, late filing, negligence, substantial understatement
    - Civil and criminal penalties
    - Purpose is deemed to be coercive, rather than revenue-generating
    - STRATEGY: Challenge only the penalty but not the underlying tax, or challenge the penalty on different grounds than the underlying tax



## Exceptions to Tax Injunction Act

- *Kathrein v. Evanston, Ill.* (7<sup>th</sup> Cir. 2011)
  - Federal court challenge to the constitutionality of an Evanston, Illinois demolition tax was not barred by the TIA because the tax was a regulatory device not intended to raise revenue
  - TIA does not apply to every transfer of money to a government
  - In determining the purpose of the “tax,” the court focused on the use of the proceeds which it concluded was to regulate behavior, not to raise revenues



## Exceptions to Tax Injunction Act

- TIA does not apply if the suit does not seek to prevent the assessment/levy/collection of a tax:
  - *Hibbs v. Winn* (USSC, 2004): challenge to tax credit does not interfere with flow of funds to the state government (Caution: Comity Doctrine may still apply)
  - *BellSouth Telecomms. v. Farris* (6<sup>th</sup> Circ. 2008): Challenge to prohibition on separately stating tax as line item on a bill is not contesting liability for the tax itself
- TIA does not apply when state seeks information that is not necessary to assess a tax:
  - *Amazon.com LLC v. Kenneth R. Lay* (W.D. Wash. Oct. 25, 2010): Declaratory judgment sought that NC's demand for customer identifying information violated First Amendment and federal Video Privacy Protection Act



## Exceptions to Tax Injunction Act

- *Direct Marketing Association v. Huber* (USDC Colorado, Jan. 26, 2011)
  - U.S. District Court issued a preliminary injunction that prohibits Colorado from enforcing its remote-seller (“Amazon Law”) requirements
  - DMA asked the Court to enjoin the Department of Revenue from enforcing the notice and reporting obligations imposed under Colorado law, not the assessment and collection of a tax
  - Court did not address the TIA
  - Court concluded that there was a substantial likelihood of prevailing on claim that the law violates the Commerce Clause
  - Without the injunction, irreparable injury to DMA’s members



## Exceptions to Tax Injunction Act

- TIA does not apply if state court does not provide “plain, speedy and efficient remedy”
  - Does the state system fail procedural due process requirements?
- States have access to Federal courts for purposes of collection actions – Taxpayer defenses to such actions may be heard, as well
  - The Federal court may certify a question to state court on substantive meaning of a state tax law, or abstain from deciding such questions





## Comity Doctrine

- Comity predates the TIA
- Doctrine of equitable restraint
- Bars federal courts from granting equitable relief in state tax matters when the state remedies are plain, adequate and complete (*Fair Assessment in Real Estate Association, et al. v. McNary, et al* (USSC, 1981))
- Terms “plain, speedy and efficient” and “plain, adequate and complete” are synonymous (*Fair Assessment*)



# Comity Doctrine

- *Levin v. Commerce Energy*, No. 09-223 (USSC, 2010)
  - Taxpayer's challenge, on equal protection and Commerce Clause discrimination grounds, to an Ohio sales tax exemption for its competitors may NOT be brought in federal court due to the comity doctrine
  - Supreme Court distinguished *Hibbs v. Winn*, where a federal-court challenge to AZ's tax credit on Establishment Clause grounds was held not to violate the Tax Injunction Act
  - Commerce Energy did not entail fundamental rights, unlike *Hibbs*
  - States have very broad powers of tax classification
  - Ohio courts are deemed to be in best position to shape remedy, if one is called for
- Comity doctrine essentially prevents the federal courts from having jurisdiction over cases that intrude on the administration of state taxes, post-*Commerce Energy*



## Standing

- Under Article III of the U.S. Constitution, federal courts have the power to resolve “cases or controversies,” not questions and issues
- Plaintiffs must assert more than a generalized interest of all citizens (*Arizona Christian School Tuition Organization v. Winn* (USSC, April 4, 2011))
- Mere fact someone is a taxpayer does not provide standing to seek relief in federal court (*Arizona Christian*)
- In *Arizona Christian*, Plaintiffs lacked standing to challenge private school tax credit
- *Flast v. Cohen* narrow exception to standing requirement inapplicable because that case involved appropriations and not tax credits
- Dissent saw no difference between appropriations and tax credits



## Other Federal Court Obstacles

### Abstention

- Federal courts apply abstention when the exercise of jurisdiction would disrupt a state's internal affairs, including the collection of taxes (*Great Lakes Dredge & Dock Co. v. Huffman* (USSC, 1943))



## Other Federal Court Obstacles

### Eleventh Amendment

- Federal courts are barred from hearing suits commenced or prosecuted against a State without its consent (*V. O. Motors v. SBE* (9<sup>th</sup> Cir. 1982))

### Ripeness Doctrine

- Courts do not entangle themselves in abstract disagreements over administrative policies. Administrative agencies are protected from judicial interference until an administrative decision has been formalized and its effects are felt in a concrete way (*Abbott Laboratories v. Gardner* (USSC, 1967))



# Complex Litigation

- In federal court, cases are assigned for all purposes to a single judge after the case is filed
- In state courts in California and elsewhere, cases are generally not assigned to a single judge for all purposes. As such, a taxpayer may have different judges deciding motions, presiding over settlement conferences and conducting the trial
- In California, some courts have a complex litigation department. For appropriate cases, the parties can request transfer of the case into such department
- There are various advantages to having a case assigned to the complex department
  - One judge hears the entire case
  - Judges in the complex litigation department are generally more highly regarded
  - Case can be better managed
  - Scheduling is generally more convenient



## Litigation Coop

- Funding a test case can be extremely expensive
  - The average state tax matter may cost as much as \$1 million to litigate through the trial court level, if full discovery and motions are involved
  - What price the principle of the matter?
- Litigants (and lawyers) have become creative in setting up litigation coalitions
  - Cost-sharing arrangements may spread the risk
  - However, some serious questions must be tackled



## Litigation Coop

- Risks to be considered in pursuing this strategy:
  - Which case is “best” to tee up an issue? Who decides?
  - How to ensure that the group-supported case remains front-of-line?
  - Will all taxpayers who “support” the effort pony up the \$\$?
  - Litigation by committee? Who controls the strategic elements of the case?
  - How to guarantee that a positive result for the test plaintiff is also obtained by the supporting cast? [e.g., state courts have upheld the retroactive elimination of refund rights]





## Litigation Coop

- New Jersey throwout rule spawned several lawsuits
  - Pfizer, General Engines, Federated Brands and Whirlpool Properties each challenged the constitutionality of the throwout rule on its face and as applied to the taxpayer at issue
- At least one – General Engines – was cast as the “best” in terms of fact pattern, and support was sought from other taxpayers
- NJ Tax Court granted summary judgment to the Director – throwout rule facially satisfied the requirements of the U.S. Constitution
- Pfizer and Whirlpool are waging an interlocutory appeal of their facial challenge to throwback
  - New Jersey Superior Court affirmed the Tax Court holding
  - Where is General Engines? Settled or waiting for as-applied challenge?



## Alternative Dispute Resolution

- Historically, states have not embraced the use of arbitration or mediation in tax cases
- Times are beginning to change
- In California, for example, two large multistate cases were resolved through the use of mediation
  - *Toys-R-Us v. FTB* (treasury function)
  - *Bayer Corporation v. FTB* (valuation of inventory)



## Alternative Dispute Resolution

- Multistate Tax Commission provides multistate arbitration/mediation services
- One of the MTC's stated purposes is to minimize duplicative taxation among the States
  - Recent success story was *Chambers v. Utah State Tax Commission* (2007)
    - The MTC conducted a mediation which resolved nonbusiness income and apportionment formula issues between the taxpayer and the States of Utah and Alabama



## Amicus Strategies

- If you are the litigating taxpayer, be creative about seeking amicus support
  - COST is an obvious amicus candidate (also TEI and IPT)
  - Also consider industry trade associations, think tanks (the Tax Foundation), similarly situated taxpayers, professors, etc.
  - Ask amici to address issues that are lower-priority and/or may not fit in your brief, based on court-imposed page/word limits



## Amicus Strategies

- If you are an interested party, consider offering amicus support
  - Has taxpayer covered your issue/concern fully (or at all)?
  - Work with taxpayer and their counsel to identify your “value add”
  - Amicus briefs have influenced the outcome of U.S. Supreme Court and state cases, at the cert stage (i.e., when court decides whether to hear an appeal) and in substantive review stage



# Amicus Strategies

- *Cuno v. Daimler Chrysler* (US 2006):
  - Standing issue was briefed by amicus Ford Motor Company and others
  - Supreme Court vacated in part the judgment of the Sixth Circuit, and remanded the cases for dismissal of plaintiffs' challenge to the franchise tax credit
- COST's recent and creative amicus successes include:
  - *Tennessee v. Pfizer* (Chancery Court, Tenn.)
  - *City of Atlanta v. Hotels.com, Expedia, Inc., Travelocity.com, et al.* (S.Ct. Georgia)



# QUESTIONS

