Federal litigation and state tax systems

Winter meeting

Multistate Tax Commission

March 11, 2015

State Tax (anti) Injunction Act

"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." *28 U.S.C. § 1341*

Also barred in federal court:

- declaratory–relief suits
- § 1983 damages suits as to validity of state tax systems. *FAIR v. McNary*, 454 U.S. 100 (1981) (based on principle of comity).

Tax injunction act (exceptions)

- **does not restrict 4-R act.** 49 U.S.C. §11501(c)
- **does not bar suits by U.S. government to protect itself or its instrumentalities.** *Dep't of Employment v. U.S.*, 385 U.S. 355, 358 (1966).
- **does not bar suits by Indian tribe on a federal question.** *Moe v. Confederated Tribes*, 425 U.S. 463, 475 (1976).

Direct Marketing Association v. Brohl

No. 13-1032 (March 3, 2015)

The TIA does not bar federal-court jurisdiction over a suit by noncollecting retailers to enjoin the informational notice-and-reporting requirements of a state law that serves only as a phase of state tax administration.

Tenth circuit ruling (***reversed***)

The TIA bars federal-court jurisdiction of DMA's suit against the constitutionality of a Colorado law imposing informational notice and reporting requirements, with substantial penalties for noncompliance, on out-of-state retailers that do not collect Colorado sales tax.

DMA v. Brohl, 735 F.3d 904 (10th Cir. 2013).

conflict with First circuit

Butler Act, 48 U.S.C. 872 – Puerto Rico's TIA – does not bar a suit that "did not challenge the amount or validity of the [Puerto Rican] excise tax, nor the authority of the Secretary to assess or collect it. Not every statutory or regulatory obligation that may aid the Secretary's ability to collect a tax is immune from attack in federal court...."

United Parcel Service Inc. v. Flores-Galarza, 318 F.3d 323, 330-32 (1st Cir. 2003)

conflict with Second circuit

Wells v. Malloy, 510 F.2d 74, 77 (2d Cir. 1975) (Friendly, J.).

the TIA does not preclude jurisdiction over every suit that seeks to enjoin any state law that "could possibly secure tax payment."

cited in ***Hibbs v. Winn***, 542 U.S. 88, 109 (2004).

DMA: Notice-and-reporting ≠ "assessment. levy or collection"

Based on the federal Anti-Injunction Act,

26 U.S.C. § *7421(a)*

- "assessment" = official recording of tax liability after relevant information is reported to taxing authority
- "levy" = official governmental action imposing, determining the amount of, or securing payment on a tax*
- "collection" = act of obtaining payment of taxes

*using dictionary, because "levy" is not in AIA

DMA: notable…

"assessment, levy or collection" are

"discrete phases of the taxation process that do not include informational notices or private reports of information relevant to tax liability"

DMA: notable…

"the Federal Tax Code has long treated information gathering as a phase of tax administration procedure that occurs before assessment, levy, or collection"

"the TIA is not keyed to all activities that may improve a State's ability to assess and collect taxes"

DMA: restrain?

- 10th circuit – "limit, restrict, or hold back"
- Supreme Court – not "merely inhibit"
  - "[t]o prohibit from action; to put compulsion upon . . . to enjoin," which captures only those orders that stop (or perhaps compel) acts of assessment, levy and collection.

based on equity practice, Black's Law Dictionary

DMA: odds-and-ends

- Comity?
  - "federal courts refrain from "interfer[ing] . . . with the fiscal operations of the state governments . . . in all cases where the Federal rights of the persons could otherwise be preserved unimpaired."
- Justice Kennedy – reconsider *Quill Corp. v. N.D.*
- Justice Ginsburg – TIA covers "claims suitable for a refund action (with Breyer and Sotmayor, JJ.)
- No per se rules from *Hibbs v. Winn*, 542 U.S. 88 (2004)

Oral argument

Ronald Mann,

Argument analysis: Justices look for a third way in Colorado's tax injunction dispute with online retailers,

SCOTUSblog (Dec. 9, 2014, 3:06 PM).

http://www.scotusblog.com/2014/12/argument-analysis-justices-look-for-a-third-way-in-colorados-tax-injunction-dispute-with-online-retailers/

Summons power – IRS

- IRS may examine any books, papers, records, or other data "relevant and material" to a tax inquiry section 7602
- enforced in federal district court sections 7402, 7604
- can suspend statute of limitations section 6503(j)
- higher standard to summons tax-related computer software source code section 7612

Summons power – states

- Most state statutes give the taxing authorities authority to request any information relevant to the preparation of a tax return or tax liability.

- State courts interpret these statutes based on the concepts in leading cases from the U.S. Supreme Court.

Morton Salt Co.

338 U.S. 632 (1950)

- summons power like "grand jury" power
- standards for administrative summons
  1. within agency's authority
  2. not indefinite
  3. information sought "reasonably relevant"

United States v. Powell

379 U.S. 48 (1964)

- "probable cause" not required under § 7602
- four requirements
  - 1. legitimate purpose
  - 2. inquiry relevant to purpose — "throw light upon"
  - 3. new information
  - 4. administrative steps followed

  But not while Justice Department referral for criminal prosecution is in effect. § *7602(d)*

  But not to harass taxpayer, coerce settlement of another dispute, or otherwise act in bad faith

Tax accrual workpapers

- documents about tax reserve for current, deferred, and potential or contingent tax liabilities

- analysis of
  - tax pool
  - tax liability contingency
  - tax cushion
  - tax contingent reserve

Why create tax accrual workpapers?

ASC Topic 740-10 – FASB Interpretation No. 48
"Accounting for Uncertainty in Income Taxes"
(2006)

- previously, FASB 5 – three categories:

  "probable" = reasonably estimated,
  "reasonably possible = disclosed," *or*
  "remote" = not disclosed.

- Now, "more likely than not" success for taxpayer must be recognized and measured.

Arthur Young & Co.

465 U.S. 805 (1984)

- Tax accrual workpapers prepared by corporation's independent CPA in course of regular audit are "highly relevant" and may be summoned.

- Independent auditor has "a *public* responsibility," "public trust."

- "§ 7602 is subject to traditional privileges and limitations"

IRS policy

- "restraint" in summonsing tax accrual workpapers
- "no restraint" -- can routinely request tax reconciliation workpapers, or the existence/amount of total tax reserve
- *Arthur Young* case commends the IRS's "administrative sensitivity" for its internal requirements for issuing summonses

IRS – Uncertain Tax Positions form

- Schedule UTP (Uncertain Tax Position Statement)— by all corporations with over $10 million in assets.

- "UTP"—includes any federal income tax position with a corresponding financial statement reserve, or no reserve because the position will be litigated.

Work-product doctrine

- Adversary may not see documents and tangible things

  “prepared in anticipation of litigation”

- Qualified protection only –

  “substantial need” and “undue hardship” allow discovery

- Requestor has burden to show need and hardship

- Legal opinions are most protected

  - *Federal Rule of Civil Procedure* 26(b)(3) derived from Hickman v. Taylor, 329 U.S. 495 (1947)

Work Product—State Courts

- All the states have work product rules; most mirror the federal rule.

- State courts generally look to U.S. Supreme Court decisions and other federal case law to interpret their state rules on work product protection.

Work Product—
Mixed Purposes

The root issue:

- In tax cases, many documents are prepared partly in anticipation of litigation *and* partly for other purposes

Work Product—Circuit Split

- **What does "prepared in anticipation of litigation" mean?**
  - **Most Circuits** -- **"because of"** test: Documents protected if one purpose for creating them was to prepare for litigation
  - **5th Circuit** -- **"primary purpose"** test: Documents protected if the primary purpose for creating them was to prepare for litigation. ***Narrower test***
  - **1st Circuit** -- **"actually prepared for use in possible litigation"** test: Documents protected if they were actually prepared for use in possible litigation. ***Narrowest test***

El Paso Co. – 5th circuit test

682 F.2d 530 (1982)

- "tax pool analysis" of contingent liability for more taxes than on return, holding company with 67 subsidiaries — 4-5 pages long
- not used to prepare returns
- not source document of actual transaction
- not made for "primary motivating purpose" of litigation
- Summons meets 4-part *Arthur Young* test.
- Summons enforced.

Work Product — 1st Circuit test

United States v. Textron Inc., 577 F.3d 21 (1st Cir. 2009), *cert den.*, 130 S.Ct. 3320 (2010)

- Tax accrual workpapers are ***not*** protected work product, because:
  they are required by audit/statute,
  and **not** prepared for use in litigation.

- That they related to items that might be litigated does not make them protected work product.

Commissioner v. Comcast Corp.

901 N.E.2d 1185 (Mass. March 3, 2009)

- 16-page memos between in-house lawyer and outside accountant as to structure of stock sale; capital gains not on state return
- Attorney-client privilege does not apply to advice about state tax law from CPA.
- Work-product doctrine does protect memos that were prepared "because of" anticipated litigation, citing *Textron* lower-court decisions that were reversed..

Preemption

- Article VI, U.S. Constitution

  U.S. Constitution, U.S. laws, and treaties are the "Supreme Law of the Land."
- If state or local law conflicts with federal law, then the state or local law is preempted.
- Two types of preemption
  - –express
  - –implied

Express preemption (plain)

- when Congress expressly says so
- plain – *All States Tax Guide*, ¶¶ 831-915
- U.S. government, U.S. bonds, Direct-to-home satellite service, interstate bus tickets, Indians, nonresidents' pensions, mobile phone, credit unions, non-home-office national bank, 4-R law, air fares, military/transportation-worker nonresidents, direct solicitation only, internet access

Express preemption (ambiguous)

- Congress says "preempt" but meaning is ambiguous
- "[ERISA] shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." *29 U.S.C. 1144(a)*.
- ERISA does NOT preempt gross-receipts tax on hospitals run by ERISA plans. *DeBuono v. NYSA-ILA Med. Fund*, 520 U.S. 806 (1997)

Preemption (Constitution)

- Commerce clause – negative/dormant
  - State tax may not prohibit or discriminate against interstate commerce
- Due process clause
  - State may not tax out-of-state property, misapportioned income, twice ("double tax"), without notice, without chance for hearing
- Equal protection clause
- Privileges and immunities clauses (only real people)

Implied preemption

- key is Congress's intent about state law
- two types

    1. *field preemption* – federal regulation is so pervasive that Congress leaves no room for the states

    2. *conflict preemption* – complying with both federal and state rules is impossible, or state law obstructs Congress's purposes

Presumption against implied preemption

- generally true in all preemption cases
- but particularly so in areas traditionally occupied by states
- “historic police powers of the States”
- state power to tax is often equated with police powers of state.