Analysis: Federal Court Suspends Colorado Use Tax Reporting Requirements; Neutral Forum Reinvigorates Quill

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A federal district court recently granted a motion for preliminary injunction filed by The Direct Marketing Association, thereby enjoining the Colorado Department of Revenue from enforcing its sales and use tax notification and reporting regime against out-of-state retailers. The decision sends a clear signal to state legislatures that the physical presence standard remains and reminds taxpayers that federal courts may provide a more neutral forum than state courts.

On January 26, 2011, the U.S. District Court for the District of Colorado granted a motion for preliminary injunction filed by The Direct Marketing Association (DMA), thereby enjoining the Colorado Department of Revenue (CDOR) from enforcing its sales and use tax notification and reporting regime against out-of-state retailers. *The Direct Marketing Association v. Huber*, No. 10-cv-01546-REB-CBS (D. Colo., Jan. 26, 2011) (Order Granting Motion for Preliminary Injunction). The court's decision sends a clear signal to state legislatures that the physical presence standard remains and reminds taxpayers that federal courts may provide a more neutral forum than state courts.

Background

In 2010 the Colorado Legislature adopted a new law imposing sales and use tax notification and reporting requirements on retailers that sell products to Colorado consumers, but do not collect and remit Colorado sales or use tax on those transactions. Under this notification and reporting regime, retailers must notify their Colorado customers of the customer's obligation to self-report Colorado use tax, provide each of their Colorado customers with a summary of the customer's annual purchases by January 31 of each year, and file an annual report with the CDOR by March 1 of each year listing information about the purchases made by their Colorado customers. Colo. Rev. Stat. § 31-21-112(3.5); Code Colo. Regs. § 39-21-112.3.5. If a retailer fails to provide these required notices, a penalty may be imposed in the amount of $5 per failure, $10 per failure and $10 per purchaser, respectively. The final regulations clarify that non-collecting retailers are not required to send an annual notice to any Colorado purchaser whose total purchases for the prior calendar year are less than $500, provided that the retailer makes commercially reasonable business efforts to identify multiple purchases made by a single Colorado purchaser. Code Colo. Regs. § 39-21-112.3.5(3)(c).

DMA brought an action in federal district court this past June on behalf of its affected members and their customers seeking a declaration that Colorado's use tax notification and reporting requirements are unconstitutional, and seeking an injunction preventing the CDOR from enforcing these requirements. DMA subsequently filed a motion

seeking a preliminary injunction preventing the CDOR from enforcing the use tax notification and reporting requirements pending the court's final determination in this matter.

Preliminary Injunction

The court stated DMA's motion for a preliminary injunction could only be granted if the association proved there is a substantial likelihood that it will prevail on the merits; it will suffer irreparable harm unless the preliminary injunction is issued; the threatened injury to the plaintiff outweighs the harm the preliminary injunction might cause the defendant; and the preliminary injunction is in the public interest. After analyzing each of these factors, the court concluded that all four factors weigh in favor of issuing a preliminary injunction enjoining Colorado from enforcing its use tax notification and reporting requirements with respect to out-of-state sellers.

The first factor addressed by the court was the substantial likelihood of DMA's success on the merits. Although DMA had asserted a number of claims in its initial complaint, it had relied upon only two of its constitutional claims in support of its motion for preliminary injunction. First, DMA asserted that the Colorado use tax notification and reporting requirements discriminate against interstate commerce in violation of the Commerce Clause of the U.S. Constitution. Second, DMA asserted that the use tax notification and reporting requirements impose an undue burden on interstate commerce in violation of the Commerce Clause of the U.S. Constitution.

With respect to DMA's discrimination claim, the court concluded that DMA had a substantial likelihood of success on the merits. While the sales and use tax notification and reporting requirements do not explicitly target out-of-state retailers, the court concluded that the law has a discriminatory effect because it will, as a practical matter, impact only out-of-state retailers.

The court based its conclusion on the fact that in-state retailers have a statutory obligation to collect and remit sales and use taxes, and are subject to civil and criminal penalties if they fail to do so. On the other hand, out-of-state retailers that do not have a physical presence in Colorado are not obligated to collect and remit tax on their sales to Colorado customers pursuant to *Quill v. North Dakota*, 504 U.S. 298 (1992) (a case in which our Firm represented the taxpayer). Because the notice and reporting requirements apply only to retailers that do not collect and remit sales and use tax, the court concluded that the reporting requirements necessarily fall upon out-of-state retailers and not in-state retailers (except for the very few in-state retailers who defy their statutory obligations), thereby creating a burden on interstate commerce that is not imposed on in-state commerce.

The court then concluded that it is "unlikely" the state would be able to surmount this finding by showing a lack of nondiscriminatory alternatives to preserve its interest in raising revenue because it could seek to collect use tax directly from Colorado purchasers through, for example, using the state's income tax return. Thus, the court

concluded that DMA had demonstrated a "substantial likelihood of success" with respect to its discrimination claim.

With respect to DMA's undue burden claim, the court similarly concluded that DMA had a substantial likelihood of success on the merits. The provisions at issue do not impose a sales or use tax collection obligation on out-of-state retailers per se; instead, they require out-of-state retailers to gather, maintain and report information about their Colorado customers for use tax purposes. Nevertheless, the court noted that "the sole purpose of the [use tax reporting requirements] is to enhance the collection of use taxes by the State of Colorado" and as a result, the burdens imposed on interstate commerce by the use tax notification and reporting requirements were tantamount to the burdens imposed by a use tax collection obligation.

Therefore, the court concluded that the physical presence standard employed by the Supreme Court of the United States in *Quill* for purposes of determining if a use tax collection obligation imposes an undue burden on interstate commerce should be employed for purposes of determining if Colorado's reporting requirements impose an undue burden on interstate commerce. Applying this standard, the court found that the imposition of use tax notification and reporting requirements on out-of-state retailers that have no connection with Colorado other than by common carrier or U.S. mail would likely impose an undue burden on interstate commerce. Thus, the court concluded that DMA had demonstrated a "substantial likelihood of success" with respect to its undue burden claim.

The court then concluded that the remaining three factors all weighed in favor of granting DMA's motion for preliminary injunction. The court concluded that DMA's members would suffer irreparable harm unless a preliminary injunction were issued because their Commerce Clause rights would likely be violated and they would incur significant unrecoverable compliance costs. The court also found that the threatened injury to DMA and its members outweighs any harm that the preliminary injunction might cause the state because the state would, at most, suffer a delay in implementing the reporting requirements and recovering the resulting use tax. Lastly, the court found that the public interest supports the issuance of a preliminary injunction because the enforcement of a law that is likely unconstitutional does not serve the public interest.

Looking Ahead

Based on the court's analysis of the "substantial likelihood of success" prong of the preliminary injunction standard, we believe there is a good likelihood DMA will ultimately succeed in litigation with respect to its Commerce Clause claims. Thus, other states, such as Oklahoma, that have followed Colorado's lead and states that are considering imposing similar use tax notification and reporting requirements on out-of-state sellers in an attempt to avoid *Quill's* physical presence standard should heed the federal court's analysis in this case because it is indicative of the likely outcome in this matter.

In addition, the court's application of *Quill*'s physical presence standard to Colorado's sales and use tax notification and reporting requirements is a significant victory for taxpayers. There is no doubt Colorado was attempting to circumvent *Quill*'s physical presence requirement but still enhance its sales and use tax collections by imposing a use tax reporting obligation, rather than a use tax collection obligation, on out-of-state retailers selling to Colorado customers. In fact, many viewed these reporting requirements as an attempt by the state to economically coerce out-of-state businesses into collecting Colorado sales and use tax because taxpayers that could not otherwise comply with the rigorous notification and reporting requirements, for example due to budgetary or operating system constraints, would be forced to voluntarily collect and remit sales and use tax or face significant non-compliance penalties. The court's application of *Quill's* physical presence standard to sales and use tax reporting requirements that impose the same (if not greater) burdens on interstate commerce than a sales and use tax collection obligation helps ensure states cannot skirt *Quill's* physical presence requirement by attempting to enhance sales and use tax collections through indirect means.

Finally, this decision represents another example of a federal court reviewing state tax matters in an apparently more objective and purely legal manner than state courts generally do. Taxpayers throughout the country have been so concerned about the seemingly unfair treatment they receive in state courts, many are considering asking Congress to not only repeal the Tax Injunction Act, but to affirmatively provide federal court jurisdiction in interstate tax matters.