

No. 07-961

IN THE
Supreme Court of the United States

CENTERIOR ENERGY CORPORATION, ET AL.,
Petitioners,

v.

JEROME R. MIKULSKI, ET AL.,
Respondents.

**On Petition for Writ of Certiorari to the
United States Court of Appeals
for the Sixth Circuit**

**BRIEF OF THE TAX FOUNDATION
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONERS**

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QUESTION PRESENTED

Federal law requires petitioners to report to the Internal Revenue Service and to shareholders the amount of dividends they distribute. See 26 U.S.C. § 6042(a)(1), (c). Petitioners' shareholders (respondents here) assert that, in making those reports, petitioners incorrectly interpreted another federal tax provision that affects whether distributions to shareholders qualify as dividends for federal tax purposes. 26 U.S.C. § 312(n)(1). Respondents allege that petitioners' misstatements in the federally required reports defrauded them by causing them to overpay their income taxes. Respondents did not file a tax refund action, but instead sued petitioners in state court seeking damages measured by the amount of allegedly overpaid taxes. A divided en banc Sixth Circuit held that federal courts lacked jurisdiction over the suit.

The question presented is:

Whether a lawsuit that turns critically on the proper construction of the Internal Revenue Code and that seeks to recover overpaid income taxes on the basis of reports required by federal tax law "aris[es] under" federal law, 28 U.S.C. §§ 1331, 1340, or is completely preempted.

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INTEREST OF THE *AMICUS CURIAE*¹

The Tax Foundation is the nation's oldest tax policy research organization, founded in 1937 to

¹ Pursuant to Supreme Court Rule 37.6, *amicus curiae* certify that no counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Counsel of record for all parties received timely notice of our intention to file this brief. Letters from the parties consenting to the filing of the brief have been filed with the Clerk of the Court.

educate taxpayers about sound tax policy. As a non-partisan educational institution dedicated to raising the nation's tax I.Q., our economic and policy analysis is guided by the principles of simplicity, transparency, stability, and neutrality. We aim to make information about government finance understandable, such as with our annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning money for themselves. We further our mission by educating the legal community and the general public about economics and taxpayer protections, and by advocating that judicial and policy decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has an institutional interest in this case.

SUMMARY OF ARGUMENT

Amicus respectfully requests that this Court grant the petition for writ of certiorari to ensure a cohesive federal tax code and avoid subjecting federal tax provisions with national scope to state-by-state constructions that could conflict with a subsequent federal construction in a direct action for a refund. A fragmented interpretative approach would destroy national uniformity in the application of the tax code, undermine the congressional purpose of having such uniformity, and disrupt the national economy.

This Court's action is needed to prevent the uncertainty, ambiguity, and judicial conflicts that will follow from allowing state courts to hear actions seeking to recover allegedly overpaid taxes from business instead of government. Such state court

actions would circumvent the exclusive federal procedures for obtaining tax refunds, create problems of subrogation suits and potentially inconsistent results against companies forced to pay for and then seek recovery of taxes allegedly overpaid by third parties, and in general multiply the number of suits relating to claimed tax refunds.

This case is properly before the federal courts because a cohesive national tax system is a substantial federal interest requiring federal interpretation of the tax law in question. Respondents are seeking an indirect federal tax refund (masquerading as a state cause of action) from corporations who, if forced to pay, will then have to seek an actual refund of such taxes via subrogation (or will be forced to absorb the costs), the interpretation of federal tax law will be decisive in this case, and the exercise of federal jurisdiction will not disrupt the congressionally approved balance of federal and state judicial responsibilities.

The Sixth Circuit's ruling conflicts with other federal courts, which hold similar claims to be preempted. The results should be the same here.

ARGUMENT

I. THE NEED FOR INTERPRETATION OF AMBIGUOUS FEDERAL TAX LAWS IS COMMON AND RECURRING.

A. Taxpayers frequently must apply ambiguous tax provisions.

Respondents' claim stems from a provision of the federal income tax code, 26 U.S.C. § 312(n)(1), which

was amended in 1984 to require corporations to report interest avoided by not borrowing to finance construction projects. The statute on its face required reporting for new construction after the effective date, but it was unclear as to whether construction projects started before the effective date should be reported.²

Like many taxpayers, Petitioner was confronted with applying an ambiguous tax statute to its individual situation.³ In this case, Petitioner chose to report as profits the interest avoided on both new and ongoing construction, which consequently resulted in higher reported profits and reduced return to capital. *See Mikulski v. Centerior Energy Corp.*, 501 F.3d 555, 558 (6th Cir. 2007). Respondent argues that Petitioner should have opted for another interpretation, which would have reduced reported corporate profits and increased nontaxable return to capital. *See id.* at 558-59. Of course, such a choice

² The legislative history of § 312(n)(1) suggests that Congress expected regulatory clarification of the statute. *See* H.R. Conf. Rep. 99-841 at 4366 (1986) (“The conferees anticipate that before the end of 1989, the Secretary of the Treasury will provide guidance through regulations or rulings regarding such integration.”).

³ Frequent and ambiguous alterations of the tax code, and the confusion they cause, are a key source of the growing tax compliance burden. In 2005, the estimated time and money cost of complying with the federal income tax code was 6 billion man-hours worth \$265 billion. *See* Scott A. Hodge, J. Scott Moody & Wendy P. Warcholik, *The Rising Cost of Complying with the Federal Income Tax*, TAX FOUNDATION SPECIAL REPORT NO. 138 (Jan. 2006). The code that year stood at 7 million words in 736 code sections, up from 718,000 words in 103 code sections in 1955. *See id.* at 5.

might have led to shareholder or government litigation alleging that Petitioners were underreporting profits.

Respondents do not recognize that reasonable people can differ over what 26 U.S.C. § 312(n)(1) required. Instead, Respondents ignore this statutory ambiguity and insist that Petitioners committed fraud by preparing returns based on a misinterpretation of the statute, and committed a breach of contract by causing shareholders to overpay taxes. Respondents seek “damages” in the amount of the allegedly overpaid taxes remitted to the government.

Such a dilemma in interpreting federal tax requirements is not unique to this case, but in fact presents a national problem. A recent Tax Foundation report examined a variety of examples in the tax code which have similarly confused taxpayers. See Mark A. Robyn and Gerald Prante, *Small Problems in 2007 Tax Filing Could Be Huge in 2008*, TAX FOUNDATION FISCAL FACT NO. 107 (Oct. 2007), at <http://www.taxfoundation.org/publications/show/22697.html> (examining taxpayer confusion regarding the sales tax deduction, the alternative minimum tax, the telephone excise tax refund, Katrina exemptions, and education credits).

Because the prospect for disputes over the interpretation of ambiguous tax provisions between corporations and their shareholders is ongoing and extensive, this case presents an important issue extending beyond its own facts, and should be reviewed by this Court.

B. Unlike *Empire*, this case turns on interpretation of federal law and affects a substantial federal interest.

As discussed by the Petitioners, Pet. at 10-19, the importance of having a federal forum for the sorts of tax disputes presented by this case is comparable to the importance of a federal forum recognized by this Court in *Grable & Sons Metal Products Inc. v. Darue Engineering & Manufacturing*, 545 U.S. 308 (2005).

This Court's decision in *Empire HealthChoice Assurance, Inc. v. McVeigh*, 547 U.S. 677, 126 S.Ct. 2121 (2006), is not to the contrary. There, a private company administering a health plan for a federal contractor sought reimbursement from a federal government employee who had received a state-law tort settlement, to the extent that the employee received duplicative compensation. *See id.* at --, 126 S.Ct. at 2127. This Court characterized the dispute as "fact-bound and situation-specific," unlike the "nearly pure issue of law" in *Grable*. *See id.* at --, 126 S.Ct. at 2137. *Empire* involved "a nonstatutory issue," with the meager federal interests involved not justifying turning a dispute over contract reimbursement into a "federal case." *Id.*

This case resembles *Grable* more than it does *Empire*. In *Empire*, the federal connection was tenuous, with the federal interest amounting to the fact that the case involved a federal employee and a fund administered for a federal agency. *See id.* But the action for reimbursement was a matter of state contract law requiring little or no interpretation or application of federal law. *See id.* By contrast, the outcome in this case depends entirely on the

construction of federal tax law, and the outcome will affect the ability of the federal income tax code to function now and in the future. Similarly, like *Grable*, this case presents a nearly pure issue of law, and not primarily nonstatutory issues as in *Empire*.

While the Respondents attempt to describe this case as a state-based tort claim and thus resembling *Empire*, the dependence of their claim on interpretation of federal law belies this characterization. Preventing a fragmented interpretative approach of federal tax law is a substantial federal interest, for which a federal forum should be available.

II. FEDERAL POLICY IS FURTHERED BY UNIFORM APPLICATION OF THE FEDERAL TAX CODE.

As Petitioners correctly note, the underlying claim in this case turns on the construction of the federal tax laws, and thus, it presents a substantial federal question that should be resolved in federal court and will facilitate, rather than disrupt, the congressionally approved balance between state and federal judicial responsibilities. Pet. 9.

It is well-settled that federal courts, in addition to having jurisdiction over claims alleging violations of the Constitution or federal laws, also have jurisdiction over ostensibly state-law claims “that nonetheless turn on substantial questions of federal law, and thus justify the resort to the experience, solicitude, and hope of uniformity that a federal forum offers on federal issues.” *Grable*, 545 U.S. at 312. The test for federal jurisdiction is whether “a

state law claim necessarily raise[s] a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state judicial responsibilities.” *Id.* at 314.

A. This case “necessarily” raises a federal claim because interpretation of federal tax law will be decisive.

Rather than seeking a tax refund from the government, Respondents instead present their tax code arguments in the guise of a state-law suit against the company itself, circumventing the ordinary route for obtaining a refund and seeking an interpretation of the tax code in a context and forum not intended by Congress for the resolution of disputes concerning the meaning of the tax code. As a practical matter, the suit raises precisely the same issues that would have to be litigated in a tax refund claim, and should be resolved in the same forum as such a claim. The entire state-based claim rests on their assertion that Petitioners incorrectly interpreted the income tax code provision. For Respondents to prevail, they must demonstrate that Petitioners misinterpreted § 312(n)(1). For Petitioners to prevail, it must be the case that either § 312(n)(1) is ambiguous, or that Petitioner interpreted it correctly. Given the centrality of the tax question to the claim in this case, the “meaning of the federal tax provision is an important issue of federal law that sensibly belongs in a federal court.” *Grable*, 545 U.S. at 315.

Because resolving the actual dispute over the interpretation of federal tax law will be decisive, this

case satisfies the first part of the *Grable* test for determining federal jurisdiction.

B. The interest in a consistent tax system is a substantial federal interest necessitating federal judicial involvement.

Conflicting interpretations of federal tax law are to be expected, and in serious cases taxpayers and the government rely on federal judges to resolve these conflicts by reaching settled interpretations. *See, e.g.*, Internal Revenue Service, COMMISSIONER'S REPORT ON CIVIL TAX PENALTIES (Feb. 21, 1989) at VIII-11 ("These complexities may result in failure to recognize issues, incorrect conclusions as to the probability that a particular position will prevail, and differences of opinion regarding probability that are not resolvable short of the courthouse.").

Only the federal judiciary can hope to provide a semblance of uniformity for statutes with national scope. In the absence of such uniformity, successful state court suits against corporations would spawn derivative litigation in the federal courts as losing corporations seek reimbursement (*i.e.*, the tax refund which would be subrogated to the corporation) for the awarded damages. It is foreseeable that this could result in businesses being "whipsawed" between conflicting judgments since the federal courts are not bound by a state's interpretation of the federal tax code.⁴

⁴ The ability of tax return and informational form preparers to rely on standard interpretations of complex and ambiguous code provisions is essential to the smooth operation of the tax system. "First and foremost, both taxpayers and tax

Such confusion and inconsistency in the application of the tax code constitutes an important national problem, both economically and in terms of stability to taxpayers and businesses, and thus raises an important federal interest justifying a federal judicial forum under *Grable*, as well as supporting this Court's grant of a writ of certiorari.

The lower court stated that there is "a significant federal interest" in preventing "50 irreconcilable interpretations of the tax code, a potential race to the bottom, or diminished federal tax revenues." *Mikulski*, 501 F.3d at 561. The court nonetheless concluded that such considerations are irrelevant to the *Grable* inquiry. *See id.* ("[T]hese are not the types of consequences to be considered by courts."). Such a conclusion short-circuits the test from *Grable*, because once a court has recognized the presence of a significant federal interest, federal courts have jurisdiction unless its exercise would disturb the congressionally approved federal-state judicial balance. *See Grable*, 545 U.S. at 312 ("[I]n certain cases federal question jurisdiction will lie over state-law claims that implicate significant federal issues." Either there is a federal interest in the danger of fragmented state-by-state interpretation of federal tax laws or there is not.

administrators need certainty. The constant changing of tax laws and procedures confuses taxpayers and leads to their making errors or not claiming deductions or credits to which they are entitled under the law." NATIONAL TAXPAYER ADVOCATE'S 2007 ANNUAL REPORT at v, at <http://www.irs.gov/advocate>. If the Internal Revenue Code meant 50 different things in 50 different states, the effects could cripple tax administrative and judicial processes.

C. Exercise of federal jurisdiction in this case will not disrupt the congressionally approved balance of federal and state judicial responsibilities.

The court below expressed concern that exercise of federal jurisdiction in this case would substitute the policy preferences of judges for that of Congress. *See id.* (“[O]ur inquiry is ultimately one of congressional intent, not policy or personal preference.”). For federal jurisdiction to exist, the court wrote, an affirmative act of Congress removing jurisdiction from state courts would be required. *See id.* at 563. Because Congress has not so acted, federal courts could not exercise jurisdiction without undermining congressional intent.

But by congressional enactment, the “entire structure of tax controversy jurisdiction” is designed to ensure tax cases are heard by federal courts. *Hinck v. United States*, 550 U.S. --, 127 S.Ct. 2011, 2016-17 (2007). “[T]he Tax Court generally hears prepayment challenges to tax liability, while postpayment actions are brought in the district courts or Court of Federal Claims.” *Id.* (citations omitted). Restricting tax cases to a limited number of courts, as Congress has done, is meant to serve the goal of uniformity of interpretation of the tax laws. The potential number of different interpretations is less among the circuit courts than among the state courts, and litigants are given less opportunity for strategic forum shopping, which could arise if more numerous state courts could impose differing interpretations of federal tax laws binding within their jurisdictions.

The structure of the tax code, and the limited scope of jurisdiction over tax cases, demonstrates that federal jurisdiction over cases involving the interpretation of federal tax law would be consistent with Congress's design.

III. THE SIXTH CIRCUIT'S RULING IS IN CONFLICT WITH FEDERAL LAW AND OTHER CIRCUIT COURTS.

As Petitioners correctly note, the Sixth Circuit's ruling is in conflict with federal law and other federal courts. Pet. 24-26.

A. Respondents' claims are preempted by federal laws providing the exclusive remedy for obtaining a tax refund.

The exclusive remedy for a federal tax refund lies in 26 U.S.C. § 7422(a):

No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary....

26 U.S.C. § 7422(a). Taxpayers seeking a refund of money paid to the government must first submit their claim to the administrative process. This process enables the Internal Revenue Service to

provide input in the matter, in the context of the tax code and Treasury regulations, and remedy any overpayment before a court battle. *See Brennan v. Sw. Airlines Co.*, 134 F.3d 1405, 1411 (9th Cir. 1998). *See also Dupont Glore Forgan, Inc. v. AT&T Co.*, 428 F. Supp. 1297, 1306 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1366 (2d Cir. 1978), and *aff'd*, 578 F.2d 1367 (2d Cir. 1978), *cert. denied*, 439 U.S. 970 (1978) (stating that a purpose of § 7422 is to “afford the Internal Revenue Service an opportunity to investigate tax claims and resolve them without the time and expense of litigation.”).

Further, the statute of limitations on such claims reduces the necessity for taxpayers to preserve voluminous records past a reasonable time period, and it reduces tardy claims where evidence and testimony will be more difficult to assemble. *Cf.* 26 U.S.C. § 6511 (placing time limitation on refund claims as the later of either three years after the filing due date of the return or two years after the tax is paid).

After the administrative appeals process, the other option open to a taxpayer is to file a civil suit against the United States. *See* 26 U.S.C. § 7422(f) (“A suit or proceeding referred to in subsection (a) may be maintained only against the United States and not against any officer or employee of the United States (or former officer or employee) or his personal representative.”).

The claim in this case, however, circumvents those carefully created measures for dealing with refund claims. Respondents are making an end run around the statute of limitations, and if successful at shifting the refund burden from government to

business, those businesses may find themselves whipsawed between a state court ordering them to pay supposedly improper taxes and a federal court refusing to provide a tax refund. *See Kaucky v. Sw. Airlines Co.*, 109 F.3d 349, 351 (7th Cir. 1997). One circuit court has explained that § 7422 was designed to prevent “situations in which the collecting agent would be required to refund taxes to the taxpayer but could not recover them from the government.” *Brennan*, 134 F.3d at 1411.

While Petitioners here are not collecting agents, the same risk of whipsawing exists because Petitioners would be transformed into tax indemnifiers, and, at best, would be left with a subrogated claim for a tax refund from the federal government. This may lead to subsequent additional litigation in the federal courts as third parties seek indemnification for state court awards. Consequently, third parties such as Petitioners are placed in the same role as if they had collected and remitted the taxes to the government.

Allowing claimants to disregard the § 7422 limitations on tax refund lawsuits would complicate an already complicated tax compliance burden, and perhaps exclude the IRS from state court proceedings where definitive interpretations of the tax code will be at issue.⁵

⁵ Virtually every individual and business in America files a tax return or informational form at some point, and this often involves judgment calls about ambiguous tax provisions. If Respondents succeed, the threat of being dragged into court to face enormous damage awards about interpretive approaches going back twenty years would encourage taxpayers to seek declaratory judgments to avoid future litigation. Even if only a

The court below examined § 7422 and concluded that Respondents' claim is not preempted. See *Mikulski*, 501 F.3d at 565 (“We find no indication that Congress intended this tax refund procedure to be a security holder’s exclusive remedy for a company’s misreporting of dividends.”). Ignoring the clear tax law focus of Respondents’ claim, this conclusion would greatly narrow the application of § 7422. By its own terms, § 7422 encompasses not only collections in anticipation of a tax that ultimately was not imposed, but also assessments or collections by third parties. The statutory language sets out a broad purpose of preventing third party agents of the government, in Chief Judge Posner’s language, from being “whipsawed” by state court litigation to which the United States is not a party. See *Kaucky*, 109 F.3d at 351.

Because the heart of Respondents’ claim is the “recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected” as described in 26 U.S.C. § 7422(a), Respondents claim should be preempted as a matter of federal law, regardless from whom Respondents seek to recover such tax. To permit the claim would be contrary to the text and purpose of § 7422, as Respondents “would throw a monkey wrench in the machinery designed to confine suits for the refund of federal taxes to suits in the federal courts against the government....” *Kaucky*, 109 F.3d at 353.

fraction of the 140 million tax returns and hundreds of millions of 1099s prepared each year shifted from self-reporting to seeking declaratory judgments, the burden that would imposed on the court system would become crushing.

B. The Sixth Circuit's decision conflicts with decisions of other circuits.

As the Petition notes, Pet. 25-26, the decision in the Sixth Circuit below conflicts with the decisions of the Fifth, Seventh, and Ninth Circuits in *Brennan*, 134 F.3d at 1410; *Sigmon v. Sw. Airlines Co.*, 110 F.3d 1200, 1204-05 (5th Cir. 1997); *Kaucky*, 109 F.3d at 351 (collectively the “Airline Tax Cases”). These cases arose out of a federal excise tax on airline ticket purchases which lapsed due to congressional inaction but was nonetheless collected by the airlines who anticipated the tax’s extension. Taxpayers filed breach of contract claims against the airlines in state courts, seeking refund of the money even though the sums had been remitted to the federal government. Each court ruled for the airlines.

The Ninth Circuit explained that the passengers had effectively filed a tax refund suit, and therefore the federal courts had jurisdiction under the artful pleading doctrine. *See Brennan*, 134 F.3d at 1412. Allowing a state claim seeking damages in the amount collected by the unauthorized tax would leave § 7422 a nullity, because “almost every citizen who seeks a tax refund alleges that the tax was collected without authority.” *Id.* at 1409. Because the plaintiffs had failed to exhaust their administrative remedies and sued the wrong party, their claims were dismissed. *Id.* at 1412.

Had the plaintiffs in the *Airline Excise Tax Cases* prevailed, the defendant airlines would have been forced to pay damages in the amount of tax money they no longer had. *See id.* at 1411, *citing Sigmon*, 110 F.3d at 1205 (“If excise taxes are collected as the

result of a legal error, however, the IRS's interest in being involved in the refund decision is apparent. In the case of a legal error, the private tax collector would also risk being unable to recover the amounts refunded if the IRS determined the amount in fact was owed.”). The airlines might then seek reimbursement from the federal government, making it clear that the original claim masquerading for a tax refund. *See id.*, citing *Flora v. United States*, 362 U.S. 145, 149 (1960) (“[W]here a plaintiff sues to recover a sum that was collected as a tax, the plaintiff has sued for a tax refund, even if the sum does not literally constitute an internal revenue tax.”).

The *Airline Excise Tax Cases* are directly applicable to the case at hand. These cases and this case involve a non-governmental actor who, due to an alleged misapplication of federal law, caused the taxpayer to overpay their taxes. In both situations, the money was no longer held by the actor, but by the government. Both cases had the taxpayer seeking damages in the amount of the unpaid taxes under state law claims. The decision in both cases turns entirely on a definitive interpretation of federal law. While Petitioners did not collect the taxes, their action in preparing the 1099 forms was compelled by federal law. *See* 26 U.S.C. § 6042. The present case is comparable in nearly all respects, and thus Respondents' claims should be preempted by the exclusive remedies outlined in § 7422.

CONCLUSION

Fragmented interpretations of the federal tax code would exacerbate complexity, harm taxpayers, and inhibit commercial activity. Respondents here seek to have a state court develop a definitive interpretation of a federal tax provision, label as fraudulent any reliance on an alternative interpretation, and impose this rule retroactively for more than twenty years. If such suits are allowed to proceed in state court, the federal tax code with supposedly universal application would end up balkanized with fifty different interpretations.

Unless this Court acts, Respondents' success in having this case heard in state court will harm taxpayers, weaken the *Grable* test, and undermine the congressionally approved exercise of federal jurisdiction over cases, such as this one, where interpretation of federal tax law will be decisive.

For the foregoing reasons, *Amicus* respectfully requests that this Court grant the petition for writ of certiorari.

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