

Applying False Claims Acts In State Taxation

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A disturbing trend is developing in state and local taxation: the use of false claims acts (FCAs) with *qui tam* provisions as a basis for challenging taxpayers' tax return filings. On April 19 the New York state attorney general unsealed a \$300 million FCA lawsuit against Sprint-Nextel Corp. (and related companies) for allegedly undercollecting and underreporting sales tax on flat rate plans.¹ Furthermore, law firms in Illinois, at times with support from the state,² have actively pursued FCA lawsuits against taxpayers claiming undercollection of sales taxes on Internet purchases and shipping charges.³

FCA and *qui tam* actions vary, but generally impose significant penalties for "knowingly" failing to comply with a state (or federal) law. As discussed below, New York's FCA imposes treble damages — tripling allegedly due taxes — in addition to other penalties. Moreover, New York's FCA contains an expansive, 10-year statute of limitations.

FCAs provide a financial incentive for private persons to initiate an FCA lawsuit by rewarding them with a portion of recovered damages in ex-

change for uncovering information that results in liability under the act. Proponents of using FCAs in tax matters claim that they aid in the pursuit of those who have defrauded the government. This article discusses the operation of FCA statutes, explains that they are not limited to cases of fraud, and describes why they should not be applied to state and local taxes.

Background of FCAs and *Qui Tams*

FCA statutes allow private persons to bring civil actions against alleged wrongdoers on behalf of the government. At the federal level, the False Claims Act⁴ is perhaps best known for its use in combating the perceived epidemic in Medicaid fraud.⁵

Twenty-nine states, along with New York City, Chicago, and Allegheny County, Pa., have adopted state or municipal-level FCAs with *qui tam* provisions.

Though actively applied in Medicaid and other areas, the federal law contains a "tax bar" that prohibits *qui tam* actions from being brought against defendants who have allegedly violated the Internal Revenue Code.⁶ Unfortunately, many states have not followed suit. Currently, 29 states, along with New York City, Chicago, and Allegheny County, Pa., have adopted state or municipal-level FCAs with *qui tam* provisions.⁷ Of those state and local governments, only California, Hawaii, Massachusetts, New Mexico, North Carolina, Tennessee,

¹See press release, Office of the New York State Attorney General (Apr. 19, 2012), available at <http://www.ag.ny.gov/press-release/ag-schneiderman-files-groundbreaking-tax-fraud-lawsuit-against-sprint-over-300-million>.

²See, e.g., *State ex. rel. Beeler, Schad & Diamond, P.C. v. Ritz Camera Ctr., Inc.*, 878 N.E.2d 1152 (Ill. App. Ct. 2007).

³The authors represent taxpayers who are the subject of false claims act lawsuits in Illinois and New York.

⁴1 U.S.C. sections 3729-3733.

⁵Its success in this area led Congress to pass the Deficit Reduction Act of 2005, which provided an incentive for the states to adopt statutes similar to the federal FCA. See 42 U.S.C.A. section 1396h(a).

⁶*Id.* at section 3729(d).

⁷The False Claims Act Legal Center, available at <http://www.taf.org/statefca.htm>.

Virginia, the District of Columbia, and New York City have a tax bar that excludes tax cases from *qui tam* actions.⁸ Those *without* a tax bar include Delaware, Florida, Nevada, New Hampshire, New Jersey, and New York.⁹ Illinois, Indiana, and Rhode Island have partial tax bars, disallowing *qui tam* actions only for income tax claims.¹⁰

How New York's FCA Works: No Fraud Required

FCA claims often start as “whistleblower” lawsuits. To establish liability under New York's FCA, the *qui tam* plaintiff or the government must satisfy specific statutory elements. Generally, New York's FCA imposes liability on any person who “knowingly” does any of the following:

- presents, or causes to be presented, a false or fraudulent claim for payment or approval;
- makes, uses, or causes to be made or used a false record or statement material to a false or fraudulent claim;
- makes, uses, or causes to be made or used a false record or statement material to an obligation to pay or transmit money or property to the state or a local government; or
- conspires to commit any of these violations.¹¹

Although the statute requires a showing that the defendant knowingly made a false statement or claim, “knowingly” is broadly defined to mean something more than actual knowledge. Under the act, it also means acting in *deliberate ignorance* of the truth or falsity of information or acting in *reckless disregard* of the truth or falsity of information.¹² Purposeful intent does not have to be shown.

New York's FCA statute provides that there does not have to be any showing of a specific intent to defraud the government for FCA liability to attach.

More importantly, the statute provides that there does not have to be any showing of a specific intent

⁸Calif. Gov't Code sections 12650-56; D.C. Code section 2-308.14(d)(3); Hawaii Rev. Stat. section 661-21(f); Mass. Gen. Laws ch. 12, section 5B(12); N.M. Stat. section 44-9-3(E); N.Y.C. Admin. Code section 7-804(d); N.C. Gen. Stat. section 1-607(c); Tenn. Code section 4-18-103(f); Va. Code Ann. section 8.01-216.3(D).

⁹6 Del. Code sections 1201, et seq.; Fla. Stat. section 68.081, et seq.; Nev. Rev. Stat. sections 357.010, et seq., N.H. Rev. Stat. section 167:61-b; N.J. Stat. sections 2A:32C-1, et seq.; N.Y. State Fin. Law sections 187-194.

¹⁰740 Ill. Comp. Stat. 175/3(c); Ind. Code section 5-11-5.5-2(a); R.I. Gen. Laws section 9-1.1-3(d).

¹¹N.Y. State Fin. Law section 189(1)(a), (b), (c), and (g).

¹²*Id.*, at section 188(3)(a).

to defraud the government for FCA liability to attach.¹³ All that is required is for the *qui tam* plaintiff or the government to prove that the taxpayer made a tax claim that it “knew” was false. The states' view often appears to be that they only have to prove that the taxpayer's position is incorrect. As discussed further below, this has led to FCA actions against taxpayers who took reasonable positions regarding unsettled areas of the tax law.¹⁴

How the Whistle Is Blown: Procedural Considerations

Under the New York FCA, whistleblowers who initiate a *qui tam* lawsuit must serve a copy of the complaint, along with a written disclosure of “substantially all material evidence and information” the plaintiff possesses, to the attorney general.¹⁵ The *qui tam* plaintiff files the complaint in court, under seal, where it remains for at least 60 days. During this period — which can be extended at the request of the attorney general — the case is reviewed and investigated by the state, but the complaint is *not* served on the defendant.¹⁶

As part of his investigation, the attorney general must decide whether to take on the case. The attorney general has broad authority to take proof and make determinations of fact.¹⁷ Most notably, the attorney general may issue subpoenas for testimony or documents.¹⁸ If a person subpoenaed to attend an inquiry or provide records refuses to comply, the attorney general may institute civil contempt proceedings or make a motion in court to compel cooperation.¹⁹

Once the attorney general completes his investigation of the *qui tam* allegations, the government must decide whether to “take the case.” If it wants to proceed, the government may supersede the *qui tam* plaintiff, which means that the state is substituted as the plaintiff, thereby converting the lawsuit into an enforcement action fully controlled by the government.²⁰ Alternatively, the government may proceed by intervening in the *qui tam* action, in which

¹³*Id.*, at section 188(3)(b). Absent this statutory language, a court could conceivably absolve a defendant from FCA liability if the court determined that the defendant did not intend to cheat the government. At the federal level, this was the holding of some courts before 1986, when the federal FCA was amended to make it clear that fraud did not have to be proved for liability to attach. *See, e.g., U.S. v. Davis*, 809 F.2d 1509 (11th Cir. 1987); *U.S. v. Mead*, 426 F.2d 118 (9th Cir. 1970).

¹⁴*See, e.g., State ex. rel. Beeler, Schad & Diamond, P.C. v. Ritz Camera Ctr., Inc.*, 878 N.E.2d 1152 (Ill. App. Ct. 2007).

¹⁵N.Y. State Fin. Law section 190(2)(b).

¹⁶*Id.*

¹⁷9 NYCRR section 400.2(a).

¹⁸*Id.*

¹⁹*Id.* at section 400.2(b).

²⁰N.Y. State Fin. Law section 190(2)(c)(i).

case the state and the *qui tam* plaintiff will share responsibility for prosecuting the action.²¹ The government may also decline to intervene, leaving the *qui tam* plaintiff to prosecute the case alone.²² Often, a decision by the government not to intervene is a signal to plaintiff's lawyers that their claim has little merit. The attorney general retains the right, however, to intervene at a later date on a showing of good cause.²³

The attorney general is also authorized to dismiss the *qui tam* plaintiff's action,²⁴ but must do so by motion to the court so that the *qui tam* plaintiff is given an opportunity to be heard should he object to the dismissal.²⁵ Similarly, the government may settle the action, over the objections of the *qui tam* plaintiff, if the court determines that the proposed settlement is "fair, adequate, and reasonable, with respect to all parties under all the circumstances."²⁶

The Role of the Tax Department

New York's FCA requires the attorney general to "consult" with the state commissioner of taxation and finance before filing or intervening in a tax-related FCA lawsuit.²⁷ This provision ostensibly gives the commissioner — the custodian of most tax records — some authority as a gatekeeper to influence the attorney general in deciding whether to proceed with a case. It is conceivable that the attorney general, who is an independently elected official in New York, may advance a case over the objection of the Department of Taxation and Finance.

Also, note that the tax department could be a whistleblower. Although one could read the *qui tam* provisions in the law to exclude the department as an appropriate whistleblower (since the agency does not appear to meet the statutory definition of a person who may file a *qui tam* action),²⁸ the department may be permitted to *refer* a case to the attorney general for investigation. In that case, the attorney general could proceed with a FCA lawsuit on his own, rather than superseding or intervening in a whistleblower action. One could argue, however, that FCA lawsuits that arise in this manner are

subject to dismissal on the grounds that the matter was or is already the subject of an administrative action.²⁹

FCA Liability

If a *qui tam* plaintiff or the government is successful in proving that a taxpayer knowingly made a false tax claim, the taxpayer is likely to face significant penalties. Under the New York FCA, a taxpayer found liable is subject to treble damages, meaning a penalty of three times the damages sustained by the government (for example, three times the amount of tax deemed owing and not paid).³⁰ Also, New York's FCA imposes a statutory penalty of no less than \$6,000 and no more than \$12,000 *per claim*.³¹ The statute requires anyone found liable under the FCA to pay for the costs, including attorney fees, of bringing the action.³²

Some FCA lawsuits have proceeded in an attempt to collect large, multimillion-dollar statutory penalties that far exceeded the government's actual damages.

If a tax case involves numerous transactions, invoices, or billings, each of those documents can be considered a false claim. In fact, some FCA lawsuits have proceeded in an attempt to collect large, multimillion-dollar statutory penalties that far exceeded the government's actual damages. For example, in one case a jury imposed statutory penalties under the federal FCA for each of the 9,136 invoices submitted by the defendant under an allegedly fraudulent contract, even though there was no evidence that the government suffered *any* actual damages.³³

Statutes of Limitations and Related Issues

Other key provisions and questions that can arise when FCAs are applied to tax matters include:

- *Statute of Limitations.* Like other state-based FCAs, the New York FCA provides for a 10-year

²¹*Id.*, at sections 190(2)(c)(i) and 190(5).

²²*Id.*, at section 190(2)(f).

²³*Id.*, at section 190(5)(b)(i).

²⁴Some states like Illinois do not permit the state to dismiss a plaintiff's claims. In Illinois, the state is free to not pursue a matter or withdraw from the case; however, the state cannot dismiss the *qui tam* plaintiff's action.

²⁵N.Y. State Fin. Law section 190(5)(b)(i).

²⁶*Id.* at section 190(5)(b)(ii).

²⁷*Id.* at section 189(4)(b).

²⁸*See id.* at sections 188(8) and 190(2)(a).

²⁹*See id.* at section 190(9)(a)(i).

³⁰N.Y. State Fin. Law section 189(1)(g). In some circumstances in which the defendant cooperates with the government, the court may limit this penalty to two times the damages sustained by the government. *See id.*, at section 189(2).

³¹*Id.*

³²*Id.* at section 189(3).

³³*U.S. ex rel. Bunk v. Birkart Globalistics GmbH & Co.*, No. 1:02-cv-1168 (E.D. Va. Feb. 14, 2012). The statutory damages, which exceeded \$50 million, were ultimately held to be punitive in nature and in violation of the U.S. Constitution's Eighth Amendment's excessive fines clause. *Id.*

statute of limitations to bring a claim.³⁴ This is significantly longer than the statutes of limitation that typically govern tax matters and means that an FCA claim may be brought for tax years that are closed for administrative audit purposes. And although the New York FCA was adopted in 2011, it was made effective retroactive to April 1, 2007, which means that FCA lawsuits for New York tax claims could include years going back to before the law's adoption.

- *Confidentiality of Taxpayer Records.* In New York, as in most states, taxpayer information that is obtained during an administrative audit is protected by taxpayer confidentiality provisions. In the case of an FCA action, however, the case becomes public once the seal is lifted on the complaint. Thus, the allegations of fraud, along with the taxpayer's confidential information, may be disclosed before the taxpayer even has a chance to review the complaint or discuss the matter with the *qui tam* plaintiff or the attorney general.
- *Conspirator Liability.* New York's FCA imposes liability on anyone who knowingly conspires with a taxpayer to file a false claim. Potential targets may include tax professionals.
- *Voluntary Disclosure.* New York has a statutory voluntary disclosure program that eliminates penalties and provides immunity from criminal prosecution to any taxpayer who comes forward and discloses tax liabilities that are unknown to the state. It is unclear whether participating in the voluntary disclosure program will protect a taxpayer from liability under the New York FCA.

Other States' FCAs

Because the New York FCA is relatively new, it is still unclear how whistleblowers or the state intends to use it in tax matters. The New York state attorney general's recent actions regarding Sprint, however, suggest an aggressive interpretation and application of the law. Though the attorney general describes the action as a "groundbreaking tax fraud lawsuit,"³⁵ Sprint is confident that its tax position is consistent with New York law and anything but fraudulent.³⁶

In other states, we have seen FCA statutes used to attack good-faith tax positions taken in the face of unclear law. In Illinois, for example, many of the recent FCA claims have involved a Chicago-based,

class action plaintiffs' firm that has filed hundreds of *qui tam* lawsuits after conducting its own "investigation" and concluding that some companies were not properly collecting and remitting use tax to the state. In many of these cases, the state intervened as a plaintiff, demonstrating its support for using the Illinois FCA to enforce the government's preferred reading of an unclear area of law.

In the first set of cases, the *qui tam* plaintiff filed a lawsuit under the Illinois FCA, claiming that a number of out-of-state retailers had "fraudulently" failed to collect use tax from Illinois customers who had made purchases over the Internet. This alleged fraud came to light after the plaintiff law firm made Internet purchases from the defendants and was not charged sales tax. Many of the targets of the *qui tam* suits did not establish the required constitutional nexus and could not be compelled to collect and remit sales tax. The plaintiffs attempted to assert an affiliate nexus theory (the defendants had affiliated in-state bricks-and-mortar stores), but they were unsuccessful. The court ruled that liability cannot attach under the Illinois FCA when it is premised on a violation of an unsettled area of law because, in such cases, the taxpayer cannot be said to have made a "knowingly" false claim.³⁷

FCAs encourage unnecessary litigation against taxpayers who have taken justifiable positions in the face of what are often ambiguous state and local tax provisions.

Nonetheless, the same law firm has recently come back for more, in what is widely considered to be another unsettled area of the law. The current cases, which number over 200, involve Illinois FCA claims that some retailers are "fraudulently" failing to charge tax on shipping charges to Illinois customers. Many view this as yet another unsettled area of Illinois's tax law.

Whistleblowers have also attempted to bring *qui tam* actions in unsettled areas of the law regarding unclaimed property matters. In one California case, the *qui tam* plaintiff filed a California FCA complaint against Pacific Bell Telephone, alleging that the company had failed to remit, as unclaimed property, unused amounts on prepaid calling cards.³⁸ Again, the complaint was eventually dismissed on the grounds that it was unclear whether

³⁴N.Y. State Fin. Law section 192(1).

³⁵*Supra* note 1.

³⁶See press release, Sprint-Nextel (Apr. 19, 2012), available at http://newsroom.sprint.com/article_display.cfm?article_id=2247.

³⁷*State ex. rel. Beeler, Schad & Diamond, P.C. v. Ritz Camera Ctr., Inc.*, 878 N.E.2d at 1158.

³⁸*California ex rel. Grayson v. Pac. Bell Tel. Co.*, 142 Cal. App. 4th 741, review denied, 2006 Cal. LEXIS 14195 (2006).

unclaimed balances on prepaid phone cards were actually unclaimed property under the law. A similar lawsuit, brought in the District of Columbia, was dismissed under the district's FCA, but not under its Consumer Protection and Procedures Act.³⁹

The cases discussed above raise the question (beyond the scope of this article) whether class action law firms should be restricted or even prohibited from bringing *qui tam* actions based on their own "investigation" of publicly available information. In the Illinois cases discussed above, the law firm was certainly not your traditional corporate insider capable of bringing to light information that the government would not otherwise have learned on its own. All it did was "report" information that was publicly available on the taxpayers' websites. Arguably, this does not comport with the intent of FCA statutes, which are supposedly designed to give government a tool to uncover fraud that might otherwise go undiscovered.

Conclusion

FCAs and *qui tam* provisions should not be applied to state and local taxation. Rather than providing an incentive for whistleblowers to step for-

ward with information that uncovers real fraud, FCAs encourage unnecessary litigation against taxpayers who have taken justifiable positions in the face of what are often ambiguous state and local tax provisions. Most troubling, taxpayers who fall prey to FCA lawsuits are faced with choosing between expensive litigation, the threat of treble damages and statutory penalties, and a public court proceeding, or settling with the government to avoid that spectacle. This gives an attorney general (often an elected official with aspirations to higher office) too much power — a bludgeon to coerce taxpayers into paying "damages" and abandoning tax positions the government does not like, even if there is support in the law for the position taken. New York and other states with FCAs should impose a tax bar similar to that in the federal FCA. At the very least, the statute should be amended to make it clear that a showing of fraud is an FCA requirement. ☆

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³⁹*Grayson v. AT&T Corp.*, 980 A.2d 1137 (D.C. 2009), *reh'g granted en banc*, 989 A.2d 709 (D.C. 2010).