Presentation to the Multistate Tax Commission
Tax Whistleblower Programs

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Speaker Biography

- Randall Fox is a partner of Kirby McInerney LLP in New York, where his practice focuses on whistleblower matters. Until early 2014, he was Chief of the Taxpayer Protection Bureau at the Office of the New York Attorney General, which handles and investigates tax whistleblower claims brought under the New York False Claims Act. Before his promotion to Bureau Chief, he was a Special Assistant Attorney General in the Office's Medicaid Fraud Control Unit. Prior his government service, he was in private practice for 16 years, including as a partner at LeBoeuf, Lamb, Greene & MacRae LLP.

Constraints on Revenue Departments

- Revenue departments face budgetary constraints that limit enforcement efforts
  - *e.g.*, IRS enforcement staff has shrunk 15% since 2010; hiring has been frozen; Commissioner stated in 12/2014 that budget cuts will prevent IRS from collecting $2 billion through enforcement efforts
- Complexity of some arrangements discourages audits
  - *see, e.g.*, 7/22/2014 GAO testimony: "Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits"
- Enormous amounts of taxes are misreported and not paid
  - *see, e.g.*, 5/2014 GAO Report, estimating $91 billion per year of partnership and S corporation income is misreported by individuals and that IRS examinations and automated document matching not effective at finding most of it
- With small number of taxpayers being audited, some play "audit roulette" and expect only mild treatment if caught
- Some taxpayers actively seek to mislead auditors
- Out of state entities doing business in a state are often below the radar
- Non-filers are often below the radar

Benefits of Tax Whistleblowers

- Report on violations that have not come to attention of tax authorities and likely will not
- Report on violations where facts were misrepresented to tax authorities
- Give targeted information about specific misconduct (the opposite of needles in haystacks)
- Can give an "insider's view" of a potential violator
- Can provide additional resources to the government to investigate potential tax violations
- Some whistleblowers can provide expertise that revenue departments may lack
- Imposes significant deterrent effect beyond mere possibility of audits
- Promote level playing field and consistent treatment of all taxpayers

Effectiveness of Incentivizing Whistleblowers

- Fighting profit motives with profit motives
- Long history of successful whistleblower incentives
- Billions of dollars recovered by DOJ and states in *Qui Tam* cases under the False Claims Act in non-tax matters
- Congressional recognition of benefits of giving whistleblower incentives through creation of IRS Whistleblower Office and Dodd-Frank & Sarbanes Oxley

Tax Whistleblower Program Models

- ## False Claims Act model
  - Litigation process – commenced by filing complaint in court
  - Incorporate tax into previously existing whistleblower program
  - DOJ/Attorney General involvement
  - Addresses not just violations, but "knowing" violations
  - Treble damages and FCA penalties
  - Focused on the taxpayers and others who assisted or caused filing of false statements or records
  - Whistleblower can proceed on behalf of government in declined case
- ## Whistleblower Office model
  - Audit process – commenced by submitting form and substantiating materials to agency
  - Requires newly created program that builds on existing audit capabilities
  - Proceedings occur within tax agency
  - Applies to any tax violation, whether knowing or not
  - Single damages plus tax law penalties and interest
  - Generally focused on the taxpayers as the liable parties
  - Higher degree of anonymity protection for the whistleblower

Addition of Tax Language to NYS FCA

- 2010 amendment to NY False Claims Act to add tax
  - Removed the word "NOT" from prior language: "This section shall not apply to claims, records, or statements made under the tax law"
  - Added dollar thresholds for tax cases to keep focus on big-ticket cases and avoid devoting resources to smaller-value matters
    - Net income or sales greater than $1m for any year at issue
    - Damages of at least $350k
  - Required NY AG to consult with Tax Department before taking over a case from a whistleblower
  - In a declined case, whistleblower cannot make motion to compel tax records from Tax Department without authorization from NY AG
  - Other pre-existing FCA provisions (*e.g.* defining violations, knowledge, incentive awards, *etc.*) made applicable to tax matters

NYS FCA & Taxes

- Primary bases for FCA liability (pre-existing/not-tax specific)
  - "Reverse" false claims under Sec. 189(1)(g): "knowingly 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"
  - "Holding" claims under Sec. 189(1)(d): "has possession, custody, or control of property or money used, or to be used, by the state or a local government and knowingly delivers, or causes to be delivered, less than all of that money or property"
  - False tax refund claims might lead to liability for affirmative false claims for payment under Sec. 189 (1)(a) & (b): "knowingly presents, or causes to be presented a false or fraudulent claim for payment or approval" and "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim"

NYS FCA & Taxes

- NY FCA applies to claims about all forms of state and local taxes
  - Corporate franchise taxes (NYS)
  - General corporation taxes (NYC)
  - Personal income taxes (NYS, NYC, Yonkers)
  - Employment taxes
  - Sales & use taxes
  - State taxes
  - Hotel occupancy taxes
  - Property taxes
  - Real estate transfer taxes
  - Excise taxes
- The non-tax specific provisions of the NY FCA apply to tax cases
  - Liability, damages & penalties provisions
  - First to file bar
  - Public disclosure bar
  - Prior settlement bar
  - Limits on incentive awards where whistleblower planned or initiated the wrongful conduct
- New York's rules of civil procedure and rules of court apply

Administration of NY Program

- As with all NY FCA cases, matters are filed in court under seal and served on NY AG but not the defendant
- Tax claims directed to NY AG's Taxpayer Protection Bureau (TPB)
- TPB promptly notifies Tax Department of claims and coordinates with Tax Department
- TPB, with help of Tax Department, investigates while case is under seal
- Tax secrecy laws apply and are followed by TPB
- After investigation, NY AG notifies whistleblower and court of its election to decline or supersede/intervene
- If NY AG supersedes, case becomes a government enforcement action
- If NY AG declines, whistleblower can proceed on behalf of government, but cannot agree to release government claims
- In a declined case, whistleblower must serve all papers on the government, giving the government an opportunity to voice its position to the court on important issues
- Whistleblower cannot proceed *pro se* in a declined case
- NY AG has option of moving to dismiss a deficient case

NYS Experience with Tax FCA Claims

- NY tax *qui tam* settlements announced so far:
  - Mohan Custom Tailors: guilty plea and jail time plus $5.5m monetary settlement where custom tailor business in NYC charged, but retained sales taxes and understated personal income
  - BMS & Lantheus Medical Imaging: $6.2m settlement where out of state company failed to pay NYS corporate franchise taxes and NYC general corporation taxes for income from its NY business
  - Topline Appliance Center: $1.56m settlement with NJ appliance company that failed to pay NY taxes on sales it delivered in NY

NYS Experience with Tax FCA Claims

- On-going litigation of tax *qui tam* case against Sprint
  - Whistleblower raised allegations that Sprint knowingly failed to collect and remit state and local sales taxes on part of monthly flat-rate access charges for mobile phone service
  - NY AG, with help of Tax Department, investigated the allegations
  - After investigation, NY AG superseded whistleblower's case and converted it into enforcement action; filed superseding complaint alleging:
    - After previously collecting and remitting sales taxes on full access charges, starting in 2005, Sprint began to collect and remit taxes on only an arbitrary part of the access charge, unlike all other major wireless carriers, which collected tax on the full access charge
    - Sprint made the 2005 change only after examining the 2002 amendments to NY Tax Law that imposed sales tax on full amount of wireless voice access charges
    - Sprint knew its conduct was illegal from its lobbying efforts for the 2002 amendments, its review of Tax Department guidance, its manipulation of a third-party data systems so it could break up the access charge for tax purposes, its having been told by a Tax Department auditor that the practice was not allowed, and from other facts in its course of conduct

NYS Experience with Tax FCA Claims

- On-going litigation of tax *qui tam* case against Sprint
  - Sprint filed a pre-answer motion to dismiss, arguing for a different reading of the tax law or a finding of ambiguity, and arguing that it did not act knowingly as a matter of law, that federal law preempts state tax law, and that *Ex Post Facto* bars retroactive application of the tax FCA provision
  - Trial court denied Sprint's motion, and Appellate Division affirmed; Sprint appealing to NY high court with argument expected around spring 2015
  - Sprint continued its non-collection until recently, when it began to collect and remit NY sales taxes on full amount of its monthly access charges. Unpaid sales taxes at issue have increased to more than $130m, exclusive of multiples, interest or penalties

NYS Tax FCA Claims – Observations

- Limited number of NY tax *qui tam* cases filed, with no instances of multiple, repetitive cases
- Most cases concern violations that had not come to the attention of the Tax Department
- Several cases have potential for criminal prosecution
- Useful information has come from both "insider" and "outsider" whistleblowers
- Most cases concern tax obligations that are objectively clear
- Most cases are presented to the NY AG with useful factual information about potential violations
- Most cases are for damages of well over $1m
- Few cases are brought *pro se*, and NY AG urges relators to have counsel; relator cannot proceed post-declination without counsel
- Courts have diligently protected confidential information in declined cases

NYS Tax FCA Claims – Observations

- Absent unique circumstances, NY AG is unlikely to be interested in a tax *qui tam* case where defendant has made honest and complete voluntary disclosure prior to the case

- NY AG has informed relators that it will not grant authority to make motion to compel production of tax information from Tax Department until relator has made specific request after failing to obtain necessary information from other sources

NYS Tax FCA Claims – Observations

- Pursuing FCA cases has been a good investment of NYS public money

- Most expenditures are from NY AG's budget, and returns have been multiples of expenditures

- Tax Department's work on tax FCA cases has fit within its general mission, and Department does not appear to have expended additional resources as a result of the availability of tax FCA cases

Some Considerations

- Vast majority of tax violations are clear violations (*e.g.*, collecting, but not remitting sales tax, or failing to declare and pay tax on cash income), but in most instances a violator will nevertheless try to argue that the obligation is unclear and that it could not have "knowingly" violated it.

- While most state False Claims Acts are largely consistent, states have shown independence in deciding on their own Act's scope of coverage. Some limit their Acts to Medicaid claims only, some exclude tax cases and some (like NY) allow tax cases.

Some Considerations

- For tax cases, states can choose to apply an FCA model or a Whistleblower Office model, each of which would require very different statutes

- For the FCA model, the NY statute serves as a useful reference:
  - Few language changes from pre-2010 FCA to account for tax cases
  - Special protections in tax matters – including the dollar thresholds, consulting with the Tax Department and making the AG gatekeeper of requests for tax documents

Some Considerations

- States should consider whether to impose minimum dollar thresholds
  - With thresholds, there will likely be fewer, non-repetitive, higher value tax cases
  - Without thresholds, there will likely be more violations uncovered, but there may be issues of resources and the quality of claims
- States should consider the steps required to register a claim and whether *pro se* claims should be allowed
  - With an FCA model and the need to file a complaint, usually with involvement of counsel, more of the claims will be presented in a way that has been carefully considered
  - A more permissive regime may result in a larger volume of claims of lower quality, with an added level of difficulty in separating out meritorious and non-meritorious claims

Some Considerations

- States should consider the extent to which they wish to be able to call upon resources of whistleblowers to promote enforcement actions
  - With an FCA model, there is greater potential to call upon resources and expertise of whistleblowers and their counsel than under the whistleblower office model
- FCA model likely provides stronger deterrent effect than the whistleblower office model because there is greater transparency about case resolutions
- Even if states do not adopt uniform rules for tax *qui tams*, states are increasingly working together on False Claims Act matters that involve multiple states, and they may be able to do the same for tax-related cases
  - For Medicaid cases, this coordination has occurred for many years through the National Association of Medicaid Fraud Control Units
  - For non-Medicaid cases, the National Association of Attorneys General recently formed a *Qui Tam* Working Group

Questions?

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