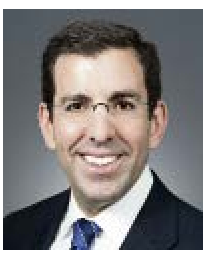
Insight: Tax Qui Tams Reach Maturity

New York's False Claims Acts allow individuals to pursue qui tam whistleblower suits against delinquent taxpayers. In this article, Kirby McInerney LLP's Randall M. Fox discusses New York's tax qui tam experience and how it aids tax enforcement and compliance.



By Randall M. Fox

Randall M. Fox is a partner at Kirby McInerney LLP in New York. His practice focuses on representing whistleblowers in cases under the federal and state False Claims Acts and matters in the IRS, SEC and CFTC whistleblower programs. Prior to joining the firm, he was the first Bureau Chief of the New York Attorney General's Taxpayer Protection Bureau.

Thanks to 2010 amendments to New York's False Claims Act, whistleblowers can receive incentive awards of 15 to 30 percent of the government's recovery for bringing actions—called "*qui tam*" actions—on behalf of the government to help recover tax monies lost by fraud. After the amendments, Attorney General Schneiderman promptly set up a new bureau in his office to handle these tax-related cases, called the Taxpayer Protection Bureau.

Now that New York has had tax *qui tams* for almost eight years, it is fair to say that this type of case has reached a level of maturity. A number of cases have worked their way through the system, with some judicial decisions, some settlements, and some cases in active litigation. Other states can now look to New York to see the benefits they and their citizens are missing.

The need to add such new tools for tax enforcement is indisputable. On the federal level, the IRS has measured an annual “tax gap” of $458 billion. Late compliance and tax enforcement efforts only bring the gap down to $403 billion. While states have not all reported on their own tax gaps, it can be assumed that a similar percentage of state and local taxes are not getting paid, and that much of that shortfall is from knowing, big-ticket tax law violations that can be addressed under False Claims Acts like New York’s.

The Breadth and Focus of New York Tax Qui Tams

New York is unique in explicitly allowing tax *qui tams* for the full array of state and local tax law violations. Cases have been brought and made public in multiple areas of tax law, including personal income taxes, New York State corporate franchise taxes, New York City general corporation taxes and state and local sales taxes. Recently, a case was unsealed concerning New York estate taxes. In that case, the claim is that a decedent’s estate and his family falsely claimed that the decedent (a New York doctor) was domiciled in Florida to avoid all New York estate taxes.

Unlike New York, most states do not allow any tax violations to be raised under their False Claims Acts. Instead, they include a specific bar to tax-related cases. A few states allow some, but not all, tax violations to be brought forward under their False Claims Acts. Illinois, Indiana and Rhode Island allow tax *qui tams*, but not if they relate to income taxes. Two states, Delaware and Nevada, have False Claims Acts that are simply silent as to whether they apply to tax violations.

In adding tax violations to its False Claims Act, New York did not allow the Act to apply to violations of any size. Instead, it caused the focus to be only on big-ticket cases by imposing dollar thresholds for tax-related cases. The Act applies only to tax violations where the defendant had net income or sales of more than $1 million in any tax year at issue and where the damages pled exceed $350,000. Accordingly, it is unlikely that the Act can apply to nanny tax violations, but it should apply where, say, a hedge fund has cheated on taxes.

The Initial Objections

Once New York started to allow and even encouraged tax *qui tams*, there were some howls of objection from tax and defense counsel. My first speech as Bureau Chief of the Taxpayer Protection Bureau was to a joint meeting of the tax sections of the New York State and New York City bar associations. I received an earful of their negative reactions.

Many of the objections had to do with concerns about how and if the Attorney General's Office would work with the Department of Taxation and Finance and how the more complex tax issues would be handled under the law. With the benefit of hindsight, we now know that the two agencies have developed a partnership to handle the tax *qui tams*; we have seen that most of the tax violations raised are quite straight-forward; and we have seen that even the more complicated issues can readily be tackled.

Nearly Eight Years of Tax Qui Tams

False Claims Act *qui tam* cases are filed under seal and served on the government so that it can investigate and decide whether to intervene in an action and take it over from the whistleblower, or decline the case, leaving the whistleblower with the choice of proceeding on the government's behalf. Accordingly, the cases are not publicly disclosed for a period of time. By now, most of the early tax *qui tams* in New York have likely been made public, and the record demonstrates both that the government has taken the cases seriously and that the Act's incentives for citizens to report on false or fraudulent conduct has resulted in greater enforcement for the benefit of the government and the taxpayers who fund it.

These nearly eight years have seen seven settlements of tax *qui tams* for a collective total of $56.7 million. These dollars would have been lost to the government had the whistleblowers not come forward.

The settled cases have included, for example, claims that businesses used classic two-sets-of-books tax schemes. They also included claims against out-of-state businesses with operations in New York that were alleged to have falsely avoided their New York tax obligations.

There are also several tax *qui tams* being actively litigated after the government completed its investigation and the cases were unsealed. These include a case in which the government intervened against mobile carrier Sprint, for failing to collect and remit over $100 million in sales taxes on its monthly cell phone access charges. That case has already gone up to New York's highest court, which rejected Sprint's arguments to limit the use of the False Claims Act in tax cases. In another case being litigated (by my firm), the whistleblower alleged that Moody's Corp. knowingly used sham insurance products to illegally shield millions of dollars in income from New York taxes. By my count, there are eight tax *qui tams* currently being litigated.

It can be assumed that the success of several tax *qui tam* cases has increased awareness of the opportunities for whistleblowers and that an even larger number of the cases have been filed and are being investigated, but are not yet public. It can similarly be assumed that the amounts of the government's recoveries will only increase over time.

Why Tax Qui Tams Work

Tax *qui tams*, like other *qui tams*, work on the fundamental principle of providing whistleblowers with financial incentives and protection from retaliation to counter the financial motives of fraudsters who victimize the government. By encouraging whistleblowers, the government gains insights into violations that would otherwise go unnoticed.

The concept of whistleblower incentives has been around since at least Medieval England and came to our shores during the Civil War. Since 1986, the federal government has used the federal False Claims Act to recover over $56 billion, with annual recoveries in recent years of about $3 to $4 billion. Representatives of the federal government have repeatedly referred to the False Claims Act as one of its most important fraud fighting tools.

In the New York tax arena, whistleblowers can report on violations that would likely evade detection. Compare the whistleblower scenario to the traditional tax audit scenario. A tax whistleblower case often starts an enforcement effort with facts about a particular scheme, and the whistleblower might come forward with direct, specific information about the scheme, how it was accomplished, who was involved and what evidence proves it.

Tax audits are a more random tool. First, not everyone is audited, and some cheaters are more than willing to play “audit roulette” by committing violations in the expectation that they will not be audited. Even when a tax audit is conducted, it usually starts from the outside and works its way in. Government auditors cast a broad net to look for violations in a variety of areas, and will dig in on any anomalies they find. They will not necessary find a violation known to insiders. In fact, some audit targets engage in deflection or misrepresentation during the course of an audit to try to shield their misconduct from discovery.

Empowering whistleblowers has the added beneficial impact of changing the risk/reward calculus for the would-be tax cheater. A business is much less likely to engage in misconduct if it knows that its associates might gain a financial benefit by blowing the whistle. The result is greater tax compliance.

Maximizing the Positive Impact of Tax Whistleblower Programs

The New York experience over the last nearly eight years demonstrates that tax *qui tams* work best when both the government and whistleblowers are committed to the success of the overall program.

For the government, that means encouraging good whistleblower claims that benefit the government’s enforcement of tax laws. The government does this by taking whistleblower claims seriously, acting upon them with a sense of urgency, and vigorously enforcing the law. This commitment includes appreciating the risks whistleblowers have taken by coming forward and giving fair consideration to the whistleblowers’ contributions in working out the incentive award.

For whistleblowers, commitment to the success of the program consists of choosing cases wisely and serving as a resource to the government’s investigation. Whistleblowers should bring only those cases that, after dispassionate analysis, are reasonably certain to make out a tax violation that can be addressed under the False Claims Act. They should also lay out clearly all of the relevant information they have about the violations, whether it be documents, data or recordings, and they should lay out their knowledge about internal processes and evidence in the defendant's possession. Moreover, the whistleblower should continue to serve as a resource for the government as it conducts its investigation.

The incentive program underlying tax *qui tams* unites the interests of the government and the whistleblowers in rooting out tax violations and recovering from the violators. The example of New York, and its success, can and should be readily duplicated by other states.