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SHOP TALK

New York's Tax Whistleblower Law: The Current State of Play

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On April 18, the New York Attorney General's Office announced a $40,000,000 settlement with a hedge fund stemming from a lawsuit filed by a whistleblower under New York's False Claims Act. The complaint alleged that the hedge fund's offshore feeder fund wrongly sourced performance fees to Alabama rather than New York. The whistleblower will receive $8,800,000, plus the opportunity to seek expenses, attorney's fees, and costs. This marks the largest tax settlement to date under New York's False Claims Act.[1] Given the size of the recovery it would not be surprising to see an uptick in New York tax whistleblower suits filed under the False Claims Act and an increased eagerness for the New York Attorney General's Office to pursue such claims.

Extension of New York's False Claims Act to tax fraud is still relatively recent, dating from an August 2010 amendment. There have only been a handful of decisions addressing tax issues, so there is relatively little judicial gloss on statutory terms. But, as discussed below, there have now been enough litigated cases and public settlements to have a sense of how key terms are likely to be interpreted and to classify the suits being filed. This article examines the major issues and discusses the announced public tax settlements since the August 2010 amendment.

Background

New York is the only state with a False Claims Act statute broadly authorizing lawsuits by whistleblowers against taxpayers that have presented false tax claims. Penalties for violating the law are significant, including treble damages, with a ten-year statute of limitations. Rewards for whistleblowers are likewise significant, ranging from 15%–30% of any amount recovered. Procedurally, the New York Attorney

General's Office is empowered to investigate tax suits filed under the statute and decide whether it wishes to take over the case.

Restrictions on who can be a whistleblower

A threshold issue in any tax whistleblower suit is determining whether the person bringing the suit is a legally permissible plaintiff.

On its face, New York's False Claims Act statute imposes few restrictions on who can blow the whistle. It provides that "*any person* may bring a qui tam civil action for a [false claims act] violation . . . ."[2] The only statutory restriction is the "public disclosure bar," which restricts a person from bringing a lawsuit under the False Claims Act if the person is not an "original source of information" and is basing allegations on publicly disclosed information.[3]

But case law has created an additional restriction. An in-house tax attorney cannot blow the whistle on his or her employer. A decision squarely addressing this issue holds that an in-house attorney violates attorney ethics rules by blowing the whistle and revealing confidential information to his or her employer's detriment; this ethical misconduct is grounds for dismissing the case.[4] The courts have not created any other restrictions, although it is possible that they could do so in the future.

To date, whistleblowers have included: (1) an employee of a tailor that failed to pay New York personal income tax and sales tax, (2) an accountant performing due diligence for a transaction, (3) a former employee of a Fortune 1000 company, (4) someone familiar with a "busted 1031" transaction, and (5) a law and economics professor. In at least one case, the named plaintiff is an entity rather than a natural person.[5] This wide range of plaintiffs contrasts with Illinois qui tam sales tax litigation, in which one "whistleblower" is the plaintiff for the vast majority of cases.

Triggering a False Claims Act violation

A New York False Claims Act violation is triggered under eight circumstances. Relevant to tax claims, a violation occurs when an individual "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 a state or a local government."[6] Following the August 2010 amendment, this language applies to tax claims, records, or statements.[7]

Based on present case law, effectively any erroneous tax position can constitute a false claim, record, or statement. Failing to file a return, claiming excessive deductions, under-reporting income, all are sufficient to trigger a violation. It is not necessary that some affirmative misstatement be made to an auditor or government official—simply taking an erroneous position is enough to constitute a false claim, record, or statement. If there is an erroneous tax position, it must be determined if the tax position was taken "knowingly."

The "knowingly" requirement

The "knowingly" requirement is at the heart of New York's False Claims Act. A false claim, record, or statement does not violate the False Claims Act unless submitted "knowingly." The term "knowingly" involves more than "mere negligence."[8] It means: (1) actual knowledge, (2) deliberate ignorance of the truth or falsity of the information, or (3) reckless disregard of the truth or falsity of the information.[9]

For many tax cases, the chief point of contention will be whether the taxpayer acted "knowingly." The burden is on the plaintiff (i.e., the whistleblower or the government) to prove that the "knowingly" requirement is satisfied.[10] The presence of the "knowingly" requirement is leading to investigations with a different focus than tax audits.

In tax audits, auditors generally request that the taxpayer submit documents to substantiate various positions. In False Claims Act cases, because of the "knowingly" requirement, the Attorney General's Office is requesting information often considered outside the scope of usual tax audits, such as requests for internal emails or demands that executives submit to depositions. These searching examinations are directed at determining the taxpayer's contemporaneous thinking as of the time returns were filed (or not filed) such that a determination can be made about whether the taxpayer acted "knowingly."

It will fall on the courts to determine whether the "knowingly" requirement is satisfied in situations where the law is ambiguous and the taxpayer is taking an aggressive (although legally supportable) position. At present, this is the leading interpretive statement from New York's highest court on the "knowingly" requirement: "The False Claims Act is certainly not to be applied in every case where taxes were not paid. Further, notice of a contrary administrative position alone is not nearly enough to prove fraud or recklessness under the FCA. There can be no doubt the AG will have to prove the allegations of fraud, that [the taxpayer] knew the AG's interpretation of the statute was proper, and that [the taxpayer] did not actually rely on a reasonable interpretation of the statute in good faith."[11]

Under this interpretation, the "knowingly" requirement would appropriately seem limited to instances in which the taxpayer consciously takes an erroneous tax position, thereby screening out cases where the taxpayer acted in reliance on a reasonable interpretation of the law. Time will tell whether this interpretation is followed in future cases-this is a key issue to watch.

Allegations and settlements

A diverse array of New York False Claims Act tax cases have to date been revealed in litigation and public settlements. One case, the very first announced, involved clear fraud. The taxpayer collected sales tax from customers based on the full retail price for the service but consciously under-reported the revenue he generated for sales tax and personal income tax purposes.[12]

Other cases concern allegedly aggressive state tax positions taken by taxpayers. In several settled cases, the whistleblower alleged that the taxpayer committed fraud by claiming that it did not have nexus with New York and therefore was not required to collect New York sales tax and/or pay New York corporate income tax.[13] A case is currently pending in which the chief allegation is that the taxpayer erroneously formed a captive insurance company for tax-avoidance purposes.[14] These cases are not surprising—it was widely anticipated that state tax planning and nexus would be subjects of tax whistleblower lawsuits.

Less predictably, some whistleblowers have been relying on New York's False Claims Act to challenge federal income tax positions that also have a New York component due to New York conformity to the federal income tax treatment of the transaction or item. A law and economics professor is challenging a bank's net operating losses under IRC § 382. As the professor himself notes, there is no mechanism to challenge the availability of the losses for federal income tax purposes, so the New York False Claims Act is being used to challenge them, at least as reflected on New York state tax returns.[15] In a similar instance of the New York False Claims Act being used to challenge a federal tax position, a settlement was reached in a case in which a major claim was that there was an invalid IRC § 1031 exchange.[16]

Besides these cases, and others brought by whistleblowers, there have also been several instances in which the Attorney General's Taxpayer Protection Bureau has launched investigations into taxpayer misconduct on its own, which it is empowered to do under the False Claims Act statute. A wide-ranging investigation into failure to pay sales tax on art purchases resulted in several settlements with art dealers and collectors.[17]

Conclusion

The addition of tax fraud to New York's False Claims Act has altered New York's tax landscape. Now, besides ordinary New York tax audits, companies and individuals also face the specter of whistleblower lawsuits alleging tax fraud. Suits to date have targeted classic state tax issues such as nexus, as well as federal income tax issues that also, because of federal conformity, are reflected on New York income tax returns. A crucial issue to watch is how broadly or narrowly the courts interpret the critical "knowingly" statutory requirement. At present, it appears that the courts will appropriately limit the reach of the False Claims Act to intentional fraud such that it does not cover situations in which taxpayers have taken aggressive, but legally supportable, tax positions.

[1] *See generally* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $40 Million Settlement With Investment Management Company For Tax Abuses, Marking Largest Tax Whistleblower Recover In Office's History* (April 18, 2017).

[2] N.Y. State Fin. Law § 190(2) (emphasis supplied).

[3] N.Y. State Fin. Law § 190(9). Additionally, the net income or sales of the defendant must exceed one million dollars for any taxable year subject to the action and the damages pleaded must exceed $350,000.

[4] *State ex rel. Danon v. Vanguard Group, Inc.,* No. 100711/13 (N.Y. Sup. Ct. Nov. 13, 2015).

[5] "Empire State Ventures LLC" is the named plaintiff for the False Claims Act case initially filed against Sprint Nextel Corp. The New York Attorney General's Office has intervened in the lawsuit and the lead plaintiff in the case is now "People of the State of New York, *ex rel.* Empire State Ventures, LLC."

[6] N.Y. State Fin. Law § 189(g).

[7] N.Y. State Fin. Law § 189.4(a).

[8] N.Y. State Fin. Law § 189(b).

[9] N.Y. State Fin. Law § 188.3(a).

[10] N.Y. State Fin. Law § 192.2.

[11] *People of the State of New York v. Sprint Nextel Corp.*, 26 N.Y.3d 98, 113 (N.Y. 2015).

[12] *See* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces Arrest, Conviction and $5.5 Million Settlement in Tax Fraud Case Against Prominent Tailor* (March 5, 2013).

[13] *See* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $1.56 Million Settlement with New Jersey Appliance Retailer for Failing to Pay New York Taxes* (August 22, 2014); New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $6.2 Million Settlement with Lantheus Medical Imaging & Bristol-Myers Squibb for Failing to Pay New York Corporate Income Taxes* (March 14, 2014); New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $1.1 Million Settlement With a Minnesota Pillow Retailer for Failing to Collect New York Sales Taxes* (August 17, 2016).

[14] *See New York ex rel. Banerjee v. Moody's Corp.*, No. 103997/2012 (N.Y. Sup. Ct. December 8, 2016).

[15] *See* TaxProf Blog op-ed: Eric Rasmusen, *How I Came To Be Suing Citigroup for $2.4 Billion as a Tax Whistleblower* (October 21, 2015) ("One of the points of our article, though, was that nobody could do anything about it . . . . I then came across the New York State False Claims Act.")

[16] New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $1.1 Million Settlement with Real Estate Mogul for Tax Abuses* (March 22, 2016).

[17] *See* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $7 Million Settlement With Art Collector Aby J. Rosen for Failing to Pay Sales and Use Taxes on Art Acquisitions* (May 3, 2016); New York Attorney General's Office Press Release, *A.G. Schneiderman Announces Agreement With Art Sales Executive for Re-Payment of Taxes on Artwork Acquisitions* (May 3, 2016); New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $4.28 Million Settlement With International Art Dealer Gagosian Gallery For Failure to Collect and Remit New York Sales Tax* (July 19, 2016).