Can You Hear Me Now? The Voice of a Whistleblower under State False Claim Acts [1]

Much has been written in recent weeks about the $104-million windfall that Bradley Birkenfeld, a former UBS employee, received under the federal Whistleblower Act for divulging to the IRS massive avoidance of federal income taxes by U.S. citizens with Swiss bank accounts, a practice that the whistleblower himself participated in. We have previously highlighted the federal whistleblower rules in A&M Tax Advisor Weekly Issue 4, 2012, "If You See Something, Say Something ---- Are the Secret Police in Your Tax Department?" Not surprisingly, the states are not far behind ---- in some instances, perhaps a little bit ahead.

In a world where more iPhones are sold per day than babies born, one would think that the only wireless provider of flat-rate unlimited data plans would already have sufficient competitive advantage. Yet "in an attempt to give itself a price advantage over its rivals," Sprint-Nextel Corp has allegedly failed to collect and pay more than $30,000 per day ---- $100 million over the past seven years ---- in sales taxes to the state of New York. That's what New York State Attorney General Eric Schneiderman stated in recently announcing that the New York Attorney General's office was joining a potential $300-million whistleblower lawsuit against Sprint for alleged tax fraud. This is the first whistleblower tax case the New York Attorney General's office has joined under New York's False Claims Act (FCA), which allows whistleblowers and prosecutors to take legal action against companies or individuals that defraud the government.

Schneiderman asserts that Sprint was "deliberately under-collecting and underpaying millions of dollars in New York state and local sales taxes on flat-rate access charges for wireless calling plans." If the state's case is proven, Sprint could be liable for treble damages (i.e., three times the damages sustained by the state) amounting to $300 million, as well as interest, penalties and attorneys' fees. And you thought your overage charges were hefty.

In addition to these damages, Schneiderman's office is seeking to allow Sprint's current New York customers to end their contracts early without having to pay termination fees. Yet the trouble doesn't end there. While Sprint may well be vindicated, it has already seen some damage ---- its stock declined 5.2 percent when these news reports first surfaced. Separately, if Sprint loses, the whistleblower in the case stands to earn a windfall of between 15 percent and 25 percent of the total damages as determined by a court.

What Is a False Claims Act?

A false claims act is a law that imposes liability on persons or organizations that make a false record or file a false claim with the government. A key feature of an FCA is what is known as a "qui tam" provision, which allows private persons (i.e., whistleblowers) to file civil actions on behalf of the government against alleged wrongdoers and recover a portion of the damages.

The federal FCA includes a "tax bar," which specifically carves out tax fraud claims from the operation of the FCA. Therefore, under federal law, tax-related qui tam actions cannot be brought under the FCA, but are instead brought under a separately codified whistleblower statute, the Tax Relief and
Health Care Act of 2006, which formalized a rewards process under IRC Section 7623(b) for informers who detect tax underpayments or report tax fraud. Therefore, while *qui tam* actions cannot be brought under the federal FCA, they may be brought under the separately codified whistleblower statute.

At the state level, 30 states have their own FCAs, which generally tend to be modeled after the federal FCA. Many of these states have express tax bars similar to that in the federal FCA, but Delaware, Florida, Nevada, New Hampshire and New Jersey courts have permitted tax-related *qui tam* actions, as their FCAs do not expressly permit or prohibit such actions. Illinois, Indiana and Rhode Island have partial tax bars allowing *qui tam* actions, but only for income tax claims. However, New York is the only state that specifically permits false claims actions for tax matters within its FCA.

**New York's FCA: A True Collect Call**

As demonstrated by the Sprint case, the New York FCA authorizes private citizen whistleblowers to bring, on behalf of the state, false claim lawsuits against taxpayers that are alleged to have engaged in tax fraud or knowingly filed false tax returns. Thus, the New York FCA has the potential to empower someone (e.g., an employee, or worse, a competitor) to report fraud, whether for moral or pecuniary gain. Either way, an audit for the business and a large cash payout for a successful whistleblower could result.

A few highlights from the New York FCA and other considerations:

- **No Intent to Defraud Needed:** New York's FCA imposes liability on persons who "knowingly" present a false or fraudulent claim for payment or approval, make a false record or statement material to a fraudulent claim or to an obligation to pay money or property to the state or local government, or conspire to commit any of these violations (N.Y.S. Fin. Law section 189(1)(a);(b);(c)). While the "knowing" threshold involves something more than actual knowledge, purposeful intent does not have to be shown; nor is there any showing of a specific intent to defraud the government. Therefore, simply "knowing" that a tax claim was false appears sufficient to trigger liability.

- **Large Payouts and Hefty Penalties:** Under the federal FCA, whistleblowers are rewarded with 15 to 30 percent of the recovered damages at the discretion of the Whistleblower Office, but only if the "collected proceeds" exceed $2 million. Alternatively, for New York purposes, while the defendant's net income must exceed $1 million and damages to the state exceed $350,000 for the action to be brought, the New York FCA does not require a minimum recovery for the whistleblower to be compensated. Instead, provided the Attorney General elects to intervene in the *qui tam* action, the whistleblower is entitled to collect between 15 to 25 percent of the recovered damages. Thus, there is a great financial incentive for whistleblowers in New York.

From a penalty perspective, the person or organization committing the violation faces severe financial penalties, including liability for treble damages plus the cost of bringing the action. Furthermore, New York's FCA imposes additional penalties of between $6,000 and $12,000 per claim. Yes, per claim. In the case of numerous transactions (evidenced by multiple invoices or phone bills to customers, cough, cough Sprint), each of the documents can be considered a false claim.

- **Extended Statute of Limitations:** The New York FCA allows for a 10-year statute of limitations to bring a claim. This exceeds the statute of limitations that would otherwise govern assessments of New York sales and use taxes (i.e., three years from the date the return is filed) and even federal income taxes (i.e., six-year statute of limitations triggered by omissions of
more than 25 percent of gross income).

- **Protection from Retaliation:** Under the federal rules, the IRS can only do so much to protect the identity of a whistleblower. The Internal Revenue Manual acknowledges that privacy may not always be possible in a judicial hearing. The New York FCA concedes the same, but also lays out certain protections for the whistleblower.

Specifically, if any current or former employee is discriminated against because of lawful acts (i.e., whistleblowing), the New York FCA provides for the reinstatement of full fringe benefits and seniority rights, payment of two times back pay plus interest, and compensation for any special damages as a result of discrimination. Moreover, the whistleblower remains anonymous until the seal on the case is lifted by the Attorney General. At that point, the retaliatory protection applies.

**Why It Is Important: It's up to You, New York, New York**

While *qui tam* actions in connection with FCAs have historically been applied in cases of Medicaid fraud, New York broke new ground in expressly extending application of *qui tam* actions to tax cases. From a policy perspective, there are a number of reasons the extension of an FCA to taxes could be viewed as overreaching by the state.

First, a mechanism that allows for litigation outside the context of pre-existing tax administration procedures could add an additional layer of complexity to tax administration. Currently, taxpayers and tax administrations are the two parties at issue, and taxpayers generally understand their rights and the established tax appeals processes. Although the New York FCA requires that the Attorney General consult with the Department of Taxation and Finance, the ultimate oversight responsibilities and authority with regards to the litigation still lie with the Attorney General, a significant departure from rules that have been established over decades to resolve tax disputes.

Second, in light of existing tax enforcement efforts, the utility of devoting a state's finite resources to a new whistleblower initiative is a fair point to raise. For federal purposes, according to the Government Accountability Office report released in 2011, over 9,500 claims have been made under the federal whistleblower statute since its inception in 2006. Despite these numbers, the first-ever award under the new program was paid in April 2011. In fact, the average federal whistleblower case takes approximately 7.5 years on average to complete, which suggests these types of initiatives can be time-consuming. Moreover, it is interesting that states have chosen not to enact rewards programs to encourage whistleblowers to report tax fraud and tax evasions despite having the authority to do so. The California legislature passed legislation many years ago that would enable both the Franchise Tax Board and Board of Equalization to reward whistleblowers for information leading to the recovery of unpaid income tax and sales or use taxes, but the programs have never been launched. While the Franchise Tax Board and Board of Equalization acknowledge that "Tax evasion is a crime that hurts all of us," they have nevertheless delayed implementation of a whistleblower program for decades.

Lastly, the provisions of the New York FCA allow for employees to steal confidential information or sensitive documents for purposes of bringing *qui tam* claims against employers, because the FCA defines a lawful act to include "obtaining or transmitting to the state, a local government, a *qui tam* plaintiff, or private counsel solely employed to investigate, potentially file, or file a cause of action under [the FCA], documents, data, correspondence, electronic mail, or any other information" even if removing such materials violates "a contract, employment term, or duty owed to the employer or contractor." Whether this type of broad allowance is irresponsible is another policy issue raised by the New York FCA.
Nevertheless, despite any tax policy concerns, the Sprint case is a significant development because it represents the first-ever tax enforcement action filed under the New York FCA. Moreover, the Attorney General's intimate prior political involvement with the New York FCA in drafting the legislation as a state senator suggests continued tax enforcement actions could follow.

The result of the Sprint case bears watching, as the success of the Attorney General's office could certainly affect the amount of tax-related qui tam claims by spurring on other New York whistleblowers to report actions that they perceive as fraudulent. Moreover, in response to New York success, other states could adopt either New York-type qui tam tax fraud provisions in their respective state FCAs or enact separate whistleblower statutes modeled after the federal statute, as Hawaii has just proposed. Either could be a frightening proposition for businesses.

Alvarez & Marsal Taxand Says:

While this article has focused on the recent developments in New York, state activity in the FCA realm extends beyond New York. In Illinois, there are efforts to amend the state FCA to remove all tax administration (including sales taxes) from the provisions of the FCA, which currently only bars claims related to income tax. An increasing number of qui tam actions under the current Illinois FCA have required businesses to defend their sales tax compliance through costly litigation. Hundreds of FCA claims have been filed by a Chicago-based plaintiff's law firm with regards to sales and use taxes. In the first tranche of cases, the qui tam plaintiff used the Illinois FCA to bring suit against out-of-state retailers, alleging that they fraudulently failed to collect use tax on purchases by Illinois customers made over the Internet. The same qui tam plaintiff has more recently filed hundreds of FCA claims alleging fraud against retailers for not collecting Illinois tax on shipping charges.

In addition, FCA cases have been brought to administer state unclaimed property laws as well. Here, qui tam litigants will claim that by failing to escheat alleged unclaimed property to the State, the holders of that property made a false claim against the State. Earlier this year, a Michigan "asset recovery" company brought qui tam suits under the Illinois and Minnesota FCA against MetLife, Inc. and Prudential Life Insurance Co. for allegedly failing to turn over unclaimed life insurance proceeds to the states. The Illinois filing claimed that they kept more than $524 million in life insurance benefits. Based on the potential profitability of such qui tam suits for unclaimed property claims, it appears reasonable to expect continued qui tam activity in the state unclaimed property arena.

We expect activity in this area to increase, not decline. Indeed, an article in the New York Times on October 2, 2012, points out that tort lawyers see this area as a real gravy train. The potential exposure resulting from these recent FCA developments could vary depending on the profile of the business. For some, the financial exposure and the potential for national press headlines may be enough for senior executives to insist on taking immediate preemptive actions. However, all businesses will need to establish internal controls to ensure that non-compliance issues are addressed in a way that most effectively mitigates against potential whistleblower lawsuits.

In furtherance of these efforts, companies may want to consider, along with their advisors, a risk review and an update to processes and documentation, with due consideration to audit defense, nexus, SOX controls, and FIN 48 and FAS 5 positions. Tax departments may want to also consider increased communication and collaboration with their internal audit groups and other risk-containment groups in the organization.

Footnotes:

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