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.
We expect activity in this area to increase, not decline. Indeed, an article in the New York Times on October 2, 2012, points out

The Illinois filing claimed that they kept more than $524 million in life insurance benefits. Based on the potential profitability of MetLife, Inc. and Prudential Life Insurance Co. for allegedly failing to turn over unclaimed life insurance proceeds to the states.

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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