



# MULTISTATE TAX REPORT

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## **Tax Policy**

New York's False Claims Act was amended in August 2010 to allow "whistleblower" lawsuits over alleged violations of state and local tax law, as long as the annual income or sales of the defendant are \$1 million or more and the pleaded damages exceed \$350,000. Patterned in part on the federal False Claims Act, the New York law appears to be the first in the nation to specifically authorize *qui tam* actions over tax law violations. In this article, authors Matthew C. Boch, Catherine A. Battin, and Jane Wells May, of McDermott Will & Emery, analyze the new law and discuss its implications for tax enforcement in New York.

## **Taxpayer Hunting Season in the Empire State: New York Expands Its False Claims Act to Include Tax Enforcement**

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In August 2010, the New York False Claims Act (NY-FCA) was amended to allow "whistleblower" suits in connection with state and local taxes.<sup>1</sup> While courts in a handful of states—Illinois, Nevada, and Tennessee—have considered *qui tam* whistleblower actions in connection with tax matters, New York appears to be the first state where the Legislature made a clear

<sup>1</sup> The New York False Claims Act is codified at N.Y. State Fin. Law §§ 187–194. The recent amendments were enacted as 2010 N.Y. Laws 379 (A.B. 11568), with an effective date of Aug. 27, 2010.

and specific choice to allow whistleblower suits to enforce tax statutes. The NYFCA now applies to “claims, records, or statements made under the tax law,” as long as the annual income or sales of the defendant are \$1 million or more and the pleaded damages exceed \$350,000.<sup>2</sup> This legislative decision to allow whistleblower tax suits undermines fair and efficient tax enforcement by sending unlucky taxpayers into high-stakes litigation instead of the normal audit and appeal processes. The New York Department of Taxation and Finance and the New York Attorney General now have the opportunity to help prevent tax enforcement in New York from becoming a risky, political game.

## Background: Whistleblower Statutes

New York, like most states, models its whistleblower statute after the federal False Claims Act (USFCA).<sup>3</sup> Congress enacted the USFCA in 1863 to combat fraud on the part of Civil War federal contractors that the U.S. Attorney General had been slow in prosecuting.<sup>4</sup> The core concept of this 1863 law is still the heart of federal and state false claims acts today: A whistleblower can file a *qui tam* action on behalf of the state to recover damages from a fraudulent claim on the government, and, if successful, the whistleblower is entitled to share in the recovery.

The federal definition of fraudulent activity subject to whistleblower statutes has been expanded over the years. The USFCA was amended significantly in 1986 and more recently in 2009 and 2010. States have followed and the recent amendments to the NYFCA were, with the exception of the tax suit provisions, largely to conform the NYFCA to the current federal statute.

The NYFCA, using the language of the USFCA almost verbatim, applies to any person who:

- knowingly presents, or causes to be presented a false or fraudulent claim for payment or approval;
- knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim;
- 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;
- 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; or
- engages in a conspiracy related to any of the above.<sup>5</sup>

<sup>2</sup> N.Y. State Fin. Law § 189(4)(a). Previously, this provision had specified that the False Claims Act did *not* apply to claims, records, or statements made under the tax law.

<sup>3</sup> Sponsor’s Memorandum of Assemblyman Sheldon Silver (Rules Committee), A.B. 11568.

<sup>4</sup> For a discussion of the history of the USFCA, see generally, Malcolm Harkins, *The Ubiquitous False Claims Act: The Incongruous Relationship Between a Civil War Era Fraud Statute and the Modern Administrative State*, 1 St. Louis U. J. Health L. & Pol’y 131 (2007).

<sup>5</sup> N.Y. State Fin. Law § 189(1)(a)-(d), (g). Similarly, see 31 U.S.C. §§ 3729(a)(1)(A)-(D), (G). Both the New York and federal statutes also list two other scenarios, subparagraphs (e) and (f) involving misappropriation of public property, which are not relevant to tax proceedings.

The statute thus applies not only to affirmative claims on the government, but also to claims where the defendant failed to pay money to which the government was entitled or made or used false records or statements in connection with an obligation to pay the government. “Knowingly” is defined broadly to mean that a person “has actual knowledge of the information,” “acts in deliberate ignorance of the truth or falsity of the information,” or “acts in reckless disregard of the truth or falsity of the information”; and does not require “proof of specific intent to defraud. . . .”<sup>6</sup> If the defendant loses, it is liable for treble damages, a fine of up to \$12,000 under New York law or slightly less under federal law, and, potentially, the expenses, costs, and attorney fees of the whistleblower.<sup>7</sup>

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### Once a suit is filed, New York has authority to substitute itself for the whistleblower and convert the action from a *qui tam* case to a direct action.

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Most whistleblower statutes authorize suits on behalf of the government both by the government itself in a direct action or by a private person (a whistleblower) as a relator in a *qui tam* action. If a *qui tam* action is successful, the whistleblower receives a share of the proceeds, up to 30 percent, plus expenses, costs, and attorney fees under the NYFCA and USFCA,<sup>8</sup> with the percentage varying according to the degree to which the whistleblower contributes to the lawsuit.

For a whistleblower suit to be valid, the whistleblower should be the original source of information asserted in the action. The information on which the allegations are based must not be publicly available information. For the USFCA, this requirement is jurisdictional. A suit based on publicly available information may not be brought unless the whistleblower is the “original source” of the information that was voluntarily provided to the government.<sup>9</sup> New York is more lenient. The requirement does not appear to be jurisdictional, and while a court generally is required to dismiss a suit based on public information of which the whistleblower is not the original source, the government may oppose dismissal at its discretion.<sup>10</sup>

Once a suit is filed, the state has authority to substitute itself for the whistleblower and convert the action from a *qui tam* case to a direct action.<sup>11</sup> New York also provides an option for the state to intervene to “aid and assist” the whistleblower.<sup>12</sup> If the state concludes that the case lacks merit, it may file a motion to dismiss.<sup>13</sup> Further, in particularly vexatious situations, both the state and the defendant have a right to request that the court limit a whistleblower’s discovery or other partici-

<sup>6</sup> N.Y. State Fin. Law § 188(3); 31 U.S.C. § 3729(b)(1).

<sup>7</sup> N.Y. State Fin. Law §§ 189(1), 190(7); 31 U.S.C. §§ 3729(a), 3730(d).

<sup>8</sup> N.Y. State Fin. Law §§ 190(6), (7); 31 U.S.C. § 3730(d).

<sup>9</sup> 31 U.S.C. § 3730(e)(4).

<sup>10</sup> N.Y. State Fin. Law § 190(9)(b).

<sup>11</sup> N.Y. State Fin. Law § 190(2)(c); 31 U.S.C. § 3730(b)(4).

<sup>12</sup> N.Y. State Fin. Law § 190(2)(c)(ii).

<sup>13</sup> N.Y. State Fin. Law § 190(5)(a)(i); 31 U.S.C. § 3730(c)(2)(A).

pation on a showing that such participation would interfere with the case.<sup>14</sup>

## Inclusion of Tax Matters In Whistleblower Statutes

Whistleblower statutes have a broad applicability to any activity involving government money or finance. But tax matters present a special case: Administration of tax systems is almost always performed by specialized agencies using dedicated audit staffs and supporting personnel. Discovery and trial is a poor and expensive substitute for an on-the-ground audit. On the other hand, allowing tax whistleblower suits is “free money” for cash-strapped states, at least if one ignores the long term adverse effects on the tax system and on the business climate. Thus, while restraint has been the rule so far, New York may be the harbinger of a new era of tax disputes.

### Most Whistleblower Statutes Specifically Exclude Tax Suits

Most jurisdictions specifically limit general whistleblower statutes so as to prevent suits relating to taxes. The federal government is the leading example of a specific prohibition. Congress amended the USFCA in 1986 expressly to exclude “claims, records, or statements made under the Internal Revenue Code of 1986.”<sup>15</sup> The 1986 amendment did not change the law. Even prior to 1986, federal courts refused to apply the USFCA to tax matters, reasoning that Congress’s adoption of a specific statute, the Internal Revenue Code, setting forth detailed procedures for addressing tax matters demonstrated its intent that tax matters be handled under the statute instead of under the USFCA, which had a different statutory purpose of preventing fraud.<sup>16</sup>

That is not to say that the federal government determined that there is no place for a tax whistleblower program. I.R.C. § 7623 provides for awards of up to 30 percent of a recovery resulting from information provided by a whistleblower to the IRS. The statute was liberalized in 2006 to provide for greater recoveries. While still a work in progress,<sup>17</sup> this program has the merit of placing a whistleblower incentive system within the tax administration framework, so that the tax laws continue to be enforced uniformly.

Other jurisdictions that specifically exclude taxes from their whistleblower statutes include California, Illinois (income tax only), Indiana (income tax only), Massachusetts, Minnesota, Montana, New Jersey, New Mexico, North Carolina, Rhode Island (personal income tax only), Tennessee, Virginia, and the District of Co-

lumbia.<sup>18</sup> Additionally, some states’ whistleblower statutes are limited to medical programs and cannot implicate tax matters. Those states include Colorado, Connecticut, Georgia, Louisiana, Maryland, Michigan, Oklahoma, Texas, and Wisconsin.<sup>19</sup>

## Courts Interpreting General Whistleblower Statutes Have Narrowly Allowed Tax Suits

While most whistleblower statutes exclude tax matters, several statutes leave the issue open to judicial interpretation. In the limited cases that have been decided, courts generally allowed whistleblower tax suits to proceed, but only within narrow limits and with substantial deference being given to the judgment of state attorneys general as to the merits of the claims. The result is that political considerations can affect the outcome much more significantly than in conventional tax disputes.

One of the earliest decided cases was in Tennessee, where the trial court ruled against a relator’s attempt to proceed with a tax claim. In *Tennessee ex rel. Beeler, Schad & Diamond P.C. v. Target Corp.* (unpublished),<sup>20</sup> a Chicago law firm purchased goods from out-of-state online merchants, observed that they were not collecting use tax, and then filed whistleblower suits alleging tax fraud. The Tennessee Attorney General moved to dismiss the cases, and the court granted the motion after concluding that the alleged tax violations were due to differing legal interpretations, not deception.<sup>21</sup> Further, the court held more broadly that the Tennessee False Claims Act does not apply to tax cases, finding that the Legislature had intended that the Taxpayer Remedies Act<sup>22</sup> be the method for resolving tax disputes and that proceeding under the Tennessee False Claims Act would violate taxpayers’ rights.<sup>23</sup>

A similar outcome ultimately resulted in Nevada, after a decision by the Nevada Supreme Court in *International Game Tech. Inc. v. Second Judicial Dist. Ct.*<sup>24</sup> The same relator who commenced the action in Tennessee had continued its shopping spree using a Nevada shipping address and then brought suit in that state using the same approach as in Tennessee.<sup>25</sup> Meanwhile, a conventional tax fraud fact pattern had also ripened: James McAndrews brought a whistleblower suit alleg-

<sup>18</sup> Cal. Govt. Code § 12651(f); 740 ILCS 175/3(c); Ind. Code § 5-11-5-5-2(a); Mass. Gen. L., ch. 12, § 5B(12); Minn. Stat. § 15C.03; Mont. Code Ann. § 17-8-403(4); N.J. Stat. Ann. § 2A:32C-2 (defining “claim”); N.M. Stat. Ann. § 44-9-3.E; N.C. Gen. Stat. § 1-607(c); R.I. Gen. L. § 9-1.1-3(7)(d); Tenn. Code Ann. § 4-18-103(f); Va. Code Ann. § 8.01-216.3.D; D.C. Code Ann. § 2-308.14(c)(3).

<sup>19</sup> Colo. Rev. Stat. § 25.5-4-305; Conn. Gen. Stat. § 17b-301b; Ga. Code Ann. § 49-4-168.1; La. Rev. Stat. Ann. § 46:438.3; Md. Code Ann., Health § 2-602; Mich. Comp. Laws § 400.610a; Okla. Stat. tit. 63, § 5053.1; Tex. Hum. Res. Code Ann. § 36.002; Wis. Stat. § 20.931.

<sup>20</sup> *Tennessee ex rel. Beeler, Schad & Diamond P.C. v. Target Corp.*, No. 02-3764-III, slip op. (Tenn. Chancery Ct. Dec. 1, 2003).

<sup>21</sup> *Id.* at 2.

<sup>22</sup> Tenn. Code Ann. § 67-1-1801 *et seq.*

<sup>23</sup> Slip op. at 2-3.

<sup>24</sup> *International Game Tech. Inc. v. Second Judicial Dist. Ct.*, 127 P.3d 1088 (Nev. 2006).

<sup>25</sup> *Id.* at 1095.

<sup>14</sup> N.Y. State Fin. Law § 190(5)(a)(iii); 31 U.S.C. § 3730 (c)(2)(C).

<sup>15</sup> See 31 U.S.C. § 3729(e).

<sup>16</sup> See, e.g., *Olson v. Mellon*, 4 F. Supp. 947, 950 (W.D. Pa. 1933) *aff’d sub nom., United States ex rel. Knight v. Mellon*, 71 F.2d 1021 (3d Cir. 1934), *cert. denied*, 293 U.S. 615 (1934).

<sup>17</sup> The IRS issues an annual report that provides an explanation of its whistleblower program and the status of its implementation. The most recent report issued is “FY 2009 Annual Report to Congress on the Use of Section 7623” (Dec. 15, 2010), available at <http://www.irs.gov/pub/irs-utl/whistleblowerfy09rtc.pdf>.

ing tax fraud, primarily underreporting of sales, in the gaming industry.<sup>26</sup> The Nevada Attorney General intervened and moved to dismiss in both cases. The district courts denied the motions, and the defendants and the attorney general filed writs of mandamus in each matter.<sup>27</sup>

The Nevada Supreme Court ruled that the state whistleblower act indeed could apply to tax matters.<sup>28</sup> However, the court also held that the attorney general's motions for dismissal required "good cause" only in the sense that the attorney general needed to meet a rational basis test.<sup>29</sup> Further, it held that administrative considerations could constitute such good cause,<sup>30</sup> and therefore held that as applied in the cases before the court, the motions to dismiss met the rational basis test and should have been granted.<sup>31</sup>

In Illinois, whistleblower suits asserting the same use tax collection obligations asserted in Tennessee and Nevada were brought by the same relator. The relator had found a willing ally in the Illinois Attorney General, who eagerly pursued whistleblower actions against e-commerce retailers. On interlocutory appeal, the cases were heard by the Illinois appellate court in *Illinois ex rel. Beeler Schad and Diamond P.C. v. Ritz Camera Centers Inc.*<sup>32</sup> The court held that the Illinois whistleblower statute was constitutional and applied to tax matters.<sup>33</sup> In interpreting the whistleblower law, however, the court stated that "a remote retailer cannot make a 'knowingly' false record or statement to create liability under the Act if the retailer discloses that no use tax is due or collected based on the taxpayer's reasonable interpretation of the law."<sup>34</sup> It further held that knowingly false statements or records must exist to result in liability, even if they were not submitted to the state.<sup>35</sup> The court remanded for further proceedings in accord with its decision. Some of these claims continue to this day.

### **New York: A Whistleblower Statute Including Tax Claims**

The NYFCA stands alone as a general whistleblower statute that specifically envisions tax whistleblower cases. In addition to the general provisions discussed above, there are additional tax-specific provisions. As noted above, tax whistleblower suits may be brought only if:

- the annual income or sales of the defendant are \$1 million or more, and
- the pleaded damages exceed \$350,000.<sup>36</sup>

Additionally, for tax cases, the New York Attorney General must consult with the state Department of Taxation and Finance in deciding how to proceed—whether to substitute, intervene, move to dismiss, or simply let a

whistleblower proceed on its own.<sup>37</sup> This provision should provide at least some coordination between the NYFCA and general tax administration. The NYFCA contains one additional taxpayer protection: If the state declines to participate in a case, then the whistleblower cannot compel production of Department of Taxation and Finance records without the attorney general's consent.<sup>38</sup>

In general, one effect of the amended NYFCA is to encourage circumvention of New York's system for adjudicating tax disputes. Ordinarily, the Department of Taxation and Finance audits a taxpayer. Any disputes can be adjudicated in the Division of Tax Appeals,<sup>39</sup> and then appealed by the taxpayer to the Third Department of the Appellate Division of the Supreme Court, which is in Albany.<sup>40</sup> New York has spent decades with this arrangement and the resulting development of tax expertise and consistency. But under the NYFCA, a whistleblower suit may be brought in any trial court. It remains to be seen what sort of case volume will result, but, if the federal experience is an indication, many claims may be forthcoming.

## **Conclusion and Comment**

New York's amended whistleblower act raises difficult issues for taxpayers. Will the next five years see a number of claims and copycat statutes, or will New York prove to be an outlier? Regardless of the volume of activity, however, the encroachment of whistleblower statutes into the state tax world has already eroded taxpayer confidence in state enforcement processes. Perhaps most disconcerting is the discretion granted to the politicians who constitute the majority of state attorneys general. Where conventional tax administration is performed on the front lines by civil servants to some extent removed from politics, the discretion accorded to attorneys general puts political considerations into the center of enforcement. Though the courts in Illinois and Nevada had similar analyses in the tax whistleblower cases, query to what extent, if any, the different outcome relates to the difference between a pro-business attorney general who moved to dismiss the cases in Nevada and a populist attorney general in Illinois who chose to prosecute similar cases.

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We have yet to see how the NYFCA will be applied in practice against taxpayers. The amended NYFCA gives the state some discretion with respect to the information it provides to the whistleblower, and it further provides the state with the power to move to dismiss whistleblower suits.<sup>41</sup> One would hope that, in an effort

<sup>26</sup> *Id.* at 1094.

<sup>27</sup> *Id.* at 1095-96.

<sup>28</sup> *Id.* at 1105.

<sup>29</sup> *Id.* at 1100.

<sup>30</sup> *Id.* at 1106.

<sup>31</sup> *Id.* at 1107-08.

<sup>32</sup> *Illinois ex rel. Beeler Schad and Diamond P.C. v. Ritz Camera Centers Inc.*, 878 N.E.2d 1152 (Ill. Ct. App. 2007).

<sup>33</sup> *Id.* at 1165-70.

<sup>34</sup> *Id.* at 1159.

<sup>35</sup> *Id.* at 1160-64.

<sup>36</sup> N.Y. State Fin. Law §189(4)(a).

<sup>37</sup> N.Y. State Fin. Law §189(4)(b).

<sup>38</sup> *Id.*

<sup>39</sup> N.Y. Tax Law §2008.

<sup>40</sup> N.Y. Tax Law §2016.

<sup>41</sup> N.Y. State Fin. Law §190(5)(b)(i).

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to maintain a fair state tax system, the Department of Taxation and Finance and the attorney general will

adopt a policy of opposing whistleblower actions except in truly meritorious instances.