Should the MTC Take On a Model False Claims Act?

by Jennifer Carr

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On March 6 and 7 the Multistate Tax Commission held its winter committee meetings in St. Louis. Among the items on the agenda was a discussion of whether the commission should consider and draft a model false claims act (FCA). An FCA, also known as a *qui tam* statute, is a law that authorizes private citizens to bring claims on behalf of the government in exchange for a portion of the damages eventually recovered by the government. In *qui tam* litigation, individuals who sue on behalf of the government are known as relators. They are also commonly referred to as whistleblowers. The federal FCA was enacted during the Civil War as a way to combat the rampant fraud and abuse associated with the Union Army's procurement efforts. Tax fraud was maintained in a separate law and the use of the federal law as related to taxes developed slowly.[1] However, since the enactment in 2006 of statutory amendments that increased whistleblower awards and made the process easier for the whistleblower, tax recovery under the federal statute has increased considerably.[2]

In the states, there are a couple of FCA approaches. In his presentation to the MTC, commission counsel Sheldon Laskin noted that although 24 states and the District of Columbia have FCAs, 10 of the states limit recovery under the statutes to Medicaid-related fraud. One state that has no limitation is New York, which has been at the forefront of the *qui tam* lawsuit news in recent months. In 2010 the state expanded its FCA to include tax enforcement against businesses that have $1 million in net income for any tax year and whose alleged total fraud exceeds $350,000.[3] The New York FCA does not require the taxpayer to commit the FCA tax underpayment knowingly; "reckless disregard" is sufficient under the statute. Those found to have violated a statute and who are prosecuted under the FCA are liable for treble damages, and relators are eligible for an award of between a 10 percent and 30 percent.[4] The FCA recently prevailed in its first big test as a New York City tailor pleaded guilty to felony tax evasion of sales and income taxes.[5] In addition to the criminal conviction, the tailor will also pay $5.5 million in treble damage civil penalties. Presumably the whistleblower in his case will be eligible for a portion of that, though the attorney general's press release on the case did not say what that amount will be.

MTC Proposal

In his presentation, Laskin also offered several questions that were identified in a November 2012 staff memo to the sales and use tax committee. Those questions were about the appropriateness of the MTC considering FCAs, the proper scope of the law, and whether FCAs should be applied to tax situations. A February memo to the subcommittee also raised the possibility of using a proposed Illinois bill as the basis for a model FCA. The questions raised by the memo provide an ideal starting point for analyzing the FCA questions for the MTC.

The first question in the memos is whether FCA lawsuits are so important in state and local taxation that model legislation should be considered and developed. That is a close question. FCAs' use for tax collection is not especially widespread, but in states where FCAs have come up, such as Illinois, New York, and Nevada, they can be significant for taxpayers. And it appears that the resources needed to

[1]Billy Hamilton, "New York's *Qui Tam* Law: Jackpot Justice or Creative Tax Tool — or Both?" *State Tax Notes*, Jan. 10, 2011, p. 109.

[2]Bradley D. Kay, "Suggested Amendments to the Tax Whistleblower Statute," *Tax Notes*, June 11, 2012, p. 1367.

[3]New York FCA section 187.4.

[4]For analysis and criticism of the New York FCA, see Timothy P. Noonan and William Comiskey, "Calling All Tax Whistleblowers — New York Wants You!" *State Tax Notes*, Jan. 31, 2011, p. 349.

[5]Attorney General Eric T. Schneiderman, press release.

develop a model statute, especially if the Illinois bill is deemed a good starting point, would be relatively low. Thus, even if the FCA and tax collection question is not especially problematic in most states, it is difficult to see the downside of the MTC at least considering the question and developing some guidance for the states.

The second question raised in the memos is whether the commission is the appropriate body to draft model *qui tam* legislation regarding taxes. As with the first matter, it is a close question. According to its charter, the purpose of the compact is to facilitate proper determination of state and local tax liability, promote uniformity, facilitate taxpayer convenience, and avoid duplicative taxation. FCAs arguably do not fit within those purposes because they do not deal with tax collection as it is generally thought of and do not create a significant uniformity problem. Obviously, FCAs can affect taxpayers, and the more consistency there is in all tax administration, the easier it is for taxpayers to comply with the state laws and regulations. But FCAs aren't like other tax questions in that they don't arise in the course of normal tax calculation and payment — they come up only in the case of some alleged impropriety. And it's not as if the way New York uses its FCA in a tax context is likely to affect a taxpayer's activities in another jurisdiction. Also, unlike with the sales tax, having different rules in different jurisdictions is unlikely to create a compliance problem. Therefore, FCAs don't appear to implicate the core mission of the MTC.

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That said, it's appropriate for the MTC to consider this question because it does affect taxpayers in different jurisdictions. And consistency and uniformity on any tax matter is always helpful. One of the main criticisms for using FCAs to enforce a state's tax statutes is that activities requiring application of such specialized knowledge ought to remain within the authority and expertise of the state's taxing authority. Helping to keep tax administration matters within the state's department of revenue is definitely within the MTC's mission. Finally, if states are considering changing how their FCAs deal with taxes, having an easily accessible resource for their consideration would be useful. If a helpful model can be created with a minimal use of resources, there is no reason for the MTC not to provide it, even if it's not within core MTC functions.

Illinois Bill

That leaves the more substantive questions identified by the MTC. For instance, the memo questions whether the FCA should be limited to cases in which tax liability is clear. It also asks whether prosecution should be limited to cases in which it is alleged the taxpayer acted knowingly. The memo further wonders whether the statute should carve out instances in which the state has elected to pursue the alleged false claim. Although it's possible to consider those questions in the abstract, the MTC has also cited the Illinois bill as a potential starting point for its proposed model statute. Let us keep the above questions in mind as we consider the Illinois proposal.

Illinois has been one of the primary FCA tax suit states in recent years — most claims have been brought by a single law firm. The current state FCA authorizes relators to bring tax claims on behalf of the state. Two relatively recent cases, however, have somewhat limited the relator's power under the statute. In *State ex rel. Beeler, Schad and Diamond PC v. Burlington Coat Factory*, the First District Court of Appeals held that a case could be dismissed by the state's attorney general over the relator's objections as long as the relator was given notice and an opportunity to be heard.[6] The court rejected the relator's assertion that the government must show a valid purpose for seeking the dismissal and rational relationship between the dismissal and the purpose. In *Ritz Camera et al.*, the First District Court of Appeals answered several questions regarding the FCA and held that a remote retailer could not meet the "knowingly" requirement under the act if the retailer disclosed that no use tax was due or collected under a reasonable interpretation of the law.[7] However, the court also held that the Illinois Department of Revenue was not the sole entity authorized by the General Assembly to assess and collect use tax when there are allegations of fraudulent records and statements.

Now the General Assembly has the opportunity to further limit the FCA as applied to taxes in HB 0074, which was filed in the Illinois House of Representatives in January. The bill would amend the application of the state's FCA to an alleged tax underpayment. Under the new provision, no Illinois court has jurisdiction over a claim brought by a private party regarding a tax administered by the department unless the action is brought by the attorney general. The bill also grants the department sole authority to bring an administrative action resulting from alleged tax underpayment. If a

[6]860 N.E.2d 423 (2006) (leave for appeal denied Mar. 28, 2007).

[7]*State ex rel. Beeler, Schad and Diamond PC v. Ritz Camera Centers Inc. et al.*, 878 N.E. 2d 1152 (Ill. App. 2007).

whistleblower notifies the department of a potential false claim situation, the department is to notify the attorney general of the allegation within 60 days, conduct an investigation of the allegation, and then make a recommendation regarding whether the attorney general should bring an action. Under the proposed law, the attorney general has the ultimate authority to accept or reject the department's recommendation.

If the department decides the allegations are best handled within its normal audit processes, the department should proceed in that manner. However, if the attorney general decides to file a suit related to the tax claim, the department's normal administrative processes are stayed until resolution of the judicial action. If the attorney general recovers in a judicial action, the whistleblower shall receive an award of between 15 and 30 percent of the amount collected. If the department recovers under its administrative procedures, the person who brought the information shall receive between 10 and 15 percent of the collected amounts, including penalties, interest, and additional amounts. The whistleblower is not entitled to receive expenses, attorney fees, or costs.

If the whistleblower made his case primarily from publicly available documents or other information, he may be awarded up to 10 percent of the collected proceeds at the discretion of the department. But if the department determines that the person who brought the claim was involved in planning or initiating the problematic behavior, it may reduce the award without limitation. And no person who is convicted of criminal conduct regarding the tax fraud may be rewarded as a result. Individuals may appeal their awards to the state's court of claims.

Good Starting Point?

Overall, the Illinois proposal appears to be a good idea and a fine starting point for any potential MTC model statute. When the New York FCA tax provision was pending, a former deputy tax commissioner described it as "the most powerful tool that the government has for penetrating complex tax schemes."[8] Although that comment was perhaps overly enthusiastic, there is no question that giving citizens an incentive to report tax fraud will likely lead to more revenue collection and less undetected fraud. After all, the state and its auditors can only do so much because of the number of taxpayers and the complexity of potential tax evasion schemes. Increasing the ability of the state to detect and eliminate tax fraud is a positive for law-abiding taxpayers whose tax burdens are bigger because of scofflaws.

However, authorizing private citizens to enforce the state's tax laws is problematic for several reasons. For starters, allowing tax prosecution under the state's FCA gives some individuals a considerable financial interest in bringing in as much revenue for the state as possible. State revenue officials may also desire revenue collection, but they don't have a personal financial incentive for seeing the tax laws enforced. There is always a significant potential for abuse when enforcers of the law are given a personal financial incentive. Second is the question of expertise. FCA tax cases can often turn on whether the tax is even owed in the first place. That is precisely the sort of situation that calls for the expertise of the department of revenue and not a *qui tam* relator. And that is why the MTC memo questions whether the FCA tax claims should be limited to situations in which there is clear liability. The Illinois bill overcomes that potential problem by placing the revenue department in control of the process after the whistleblower comes forward.

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Another point that recommends the Illinois bill is that requiring the revenue department to be involved in the litigation is likely to lead to more consistency in application of the law and fairer outcomes compared with private enforcement actions. Also, even though the claims will initially be raised by third parties who will likely know some confidential taxpayer information, the bulk of the tax prosecution under the Illinois bill will be done by state agencies bound by the laws regarding taxpayer privacy. Moreover, improper claims brought by a relator, either out of misunderstanding of the law or some ill motive, will be curtailed by requiring early intervention and later prosecution by the state authorities, thus saving taxpayers who have not done wrong some expense and inconvenience in defending their claim. Finally, the scienter in the Illinois FCA generally is knowingly.[9] That is more consistent with the idea of the FCA historically and how it ought to be applied to taxes. It is a definite improvement on the New York statute with its reckless disregard standard.

Whether the MTC should take up FCAs is a matter for debate because that does not fit within

[8]William Comiskey, former deputy tax commissioner, New York Department of Taxation and Finance, Office of Tax Enforcement, quoted in Hamilton, *supra* note 1.

[9]Illinois False Claims Act 740 ILCS 175/3(a)(1).

the organization's primary mission and focus. However, there is nothing about an FCA that should cause the MTC to shy away. That is especially true now that the commission has the Illinois statute as a starting point for its model statute. Overall, the Illinois bill does a fine job of harnessing the power of citizens to stop tax evasion while also maintaining revenue department control over the process. That is far better than the New York law, which, like a typical FCA, authorizes the relator to pursue the claim in court on behalf of the state rather than requiring the litigation to be turned over to the department of revenue. Should the MTC proceed with a model FCA, the Illinois law is a good starting point. ✰

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