Calling All Tax Whistleblowers — New York Wants You!

by Timothy P. Noonan and William Comiskey

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As frequent commentators on issues of tax practice and tax policy, we often find ourselves getting excited about new programs[1] or troubling developments.[2] This time, however, we really mean it! Just this past August, New York's State Legislature unanimously passed a new tax whistleblower statute that has the potential to radically change the landscape for all taxpayers and their advisers. So sit up and listen. You won't want to miss this.

The new law amends New York's False Claims Act to authorize private citizen whistleblowers, subject to some oversight by the attorney general, to bring on behalf of the state treble damage false claims lawsuits against high-end taxpayers that have engaged in tax fraud or knowingly filed false tax returns. To encourage whistleblowers to come forward, the law offers potentially huge rewards for successful whistleblowers and further includes strong protective measures to insulate whistleblowers from retaliation. With the adoption of this new law, New York took a step rejected by the federal government and most states that have a false claims act.[3] The law became effective in August and is immediately applicable to any false tax returns knowingly filed by taxpayers (that meet the financial thresholds of the statute described below) within reach of the false claims act's generous 10-year statute of limitations.[4]

With these changes, New York has the "strongest set of fraud fighting tools in the nation."[5] A press release issued by then-Sen. (now Attorney General)

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[1]*See* William Comiskey, "New York's Voluntary Disclosure and Compliance Program Strikes Gold," *State Tax Notes*, Sept. 28, 2009, p. 669, *Doc 2009-19210*, or *2009 STT 171-21*.

[2]*See* Timothy P. Noonan and Mark S. Klein, "Information Services: Taxation by Administrative Fiat in New York," *State Tax Notes*, Oct. 4, 2010, p. 63, *Doc 2010-20524*, or *2010 STT 191-7*. *See also* Timothy P. Noonan and Joseph N. Endres, "Watch Out for New York's Accrual Rule," *State Tax Notes*, Aug. 4, 2008, p. 343, *Doc 2008-15529*, or *2008 STT 151-4*.

[3]The federal False Claims Act prohibits cases based on a violation of the federal tax laws, and most states with false claims acts have similar provisions. 31 U.S.C. 3729(d). The IRS does, however, have a whistleblower rewards program that was strengthened in 2006 to make it more attractive to whistleblowers reporting significant tax liabilities. The IRS program is fundamentally different from New York's tax false claims act provisions. The IRS program applies to any tax liability and is not limited to false claims that are knowingly filed (required under the False Claims Act), and it does not impose treble damages on wrongdoers. Moreover, cases under the IRS program are handled internally by the IRS, subject to all the IRS rules of secrecy, and the IRS whistleblower is thus not kept informed of the progress of the IRS examination or investigation. The IRS program also does not impose liability on conspirators who help taxpayers file false claims. More information on the IRS program can be found at http://www.irs.gov/irm/part1/irm_01-001-026.html.

[4]The statute of limitations for New York's False Claims Act was extended to 10 years in the same legislation that expanded the reach of the act to cover claims under the tax law. Given that statute of limitations, a whistleblower would be authorized to bring an action on returns that are outside the normal statute of limitations governing audits by the tax department.

[5]Jeb White, acting director, Taxpayers Against Fraud, quoted in a press release issued by then-Sen. Eric Schneiderman on July 1, 2010, *available at* http://www.nysenate.gov/press-release/senator-eric-t-schneiderman-shepherds-historic-anti-fraud-taxpayer-protection-measure-.

Eric Schneiderman trumpeting the passage of the law, described its new tax whistleblower provisions in the following enthusiastic terms:

> With this strengthened law, New York will . . . be able to recover millions of dollars stolen by tax cheats. Because New York is a major financial center, we think the state will be a bellwether for the nation in the arena of tax recovery. Without a doubt, the New York law will be used as a cat's paw to illuminate national tax fraud cases that have tentacles in New York.[6]

Holy smokes!

This article will outline some of the nuts and bolts of the new statute to help practitioners become familiar with the law and its potential implications for their practice.[7]

Hypotheticals

Let's start by considering some cases in which tax whistleblowers might find fertile ground.

Hypothetical 1

You work as an accountant, bookkeeper, or CFO (or another person with an insider's view) for a corporation that operates a handful of well-known, high-end restaurants. For the past half-dozen years the corporation has reported in its tax returns that it has made more than $30 million in royalty payments to a related Luxembourg corporation for the use of a trademark-protected family name in the operation of the New York restaurants. Those royalty payments were deducted from taxable earnings and reduced the corporation's state and city tax liability by more than $10 million. Based on your position, you know that the claimed deductions were false and that no royalty payments were ever made.[8]

Hypothetical 2

You work for an accounting firm, investment firm, bank, law firm, or similar business and you are involved in putting together investment opportunities that are sold to high-end taxpayers. You know that the investments, which are based on a series of complicated business transactions, are designed to appear legitimate but in reality the investments are without economic substance or business purpose and their only true purpose is to generate large paper losses that investors will use to falsely reduce their taxable incomes.

Hypothetical 3

You do accounting and tax work for a mid-size information-services company. For years, the company has not charged sales taxes on sales of its services, believing them to be exempt under New York's rules. Every few years, the sales tax issue has arisen in company meetings at which other employees were present. In most of those meetings, the company's CFO would insist that under his view of the law, sales tax should be charged. But you and the company's owner thought that because the rules were unclear and ambiguous, the company could continue to not collect sales taxes. Just recently, however, the CFO was fired as a result of unruly behavior. In connection with a lawsuit for improper termination, the CFO has threatened to "blow the whistle" on the sales tax issue.

Hypothetical 4

You are employed by (or married to, or otherwise connected with) a wealthy taxpayer who has a house in Long Island and an apartment in New York City, which he rents in another person's name. You know that the taxpayer is in the city five days a week (Monday through Friday) and on some weekends. You also know, because the taxpayer likes to talk about it, that he does not pay city taxes on the millions he earns each year and that he takes steps to avoid leaving evidence of his presence in the city.

Hypothetical 5

Your wealthy boss uses an offshore account to hide income and assets from the government. The account is not disclosed on your boss's federal return, and the income deposited into the account and earned by the account is not included in the taxpayer's federal and state returns.

Hypothetical 6

You are a bookkeeper for a retail business that has millions of dollars in annual sales. You know that the owner of the business and his accountant have for years come up with a false but "safe" sales figure that the owner can report on the business's monthly sales tax return without triggering a sales tax audit.

By now, I'm sure you get the point. Simply stated, when you start thinking about it, the list of scenarios that might lead to whistleblower cases is breathtaking. Given the volume of returns that New York processes each year and the relatively limited audit and investigative resources devoted to identifying and investigating fraud, New York is not equipped to find all the tax fraud that is occurring, and even when the state uncovers a problem, it is often difficult to develop evidence to prove wrongful intent. With its new statute, New York is betting

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[6] *Id.*

[7] For an assessment of the wisdom of the new law, see Billy Hamilton, "New York's Qui Tam Law: Jackpot Justice or Creative Tax Tool — or Both?" *State Tax Notes*, Jan. 10, 2011, p. 109, *Doc 2010-27565*, or *2011 STT 6-4*.

[8] *See People v. Arrigo and Giuseppe Cipriani*, described in a press release issued by Manhattan District Attorney Robert Morgenthau, *available at* http://manhattanda.org/whatsnew/press/2007-07-31.shtml.

that a credible whistleblower, equipped perhaps with some first-hand or documentary evidence of the fraud, will go a long way toward filling that gap. And we're betting that this is something *all* practitioners need to be looking out for.

A General Overview of the False Claims Act

Like its federal counterpart, the New York False Claims Act[9] — which was enacted only in 2007 — is an anti-fraud statute that authorizes the state,[10] or a private citizen whistleblower (a qui tam plaintiff) acting on behalf of the state, to sue and seek treble damages from anyone who knowingly presents false claims for payment from the state or who knowingly avoids paying an obligation to the state by making or using false statements or records.

As originally enacted in New York in 2007, the act barred claims based on violations of the tax law. In a complete reversal, the 2010 amendments lifted that bar if the tax claim meets some financial thresholds designed to limit the reach of the statute to high-end taxpayers with significant liabilities.

State Finance Law section 189(4)(a) now provides:

> This section shall apply to claims, records, or statements made under the tax law only if (i) the net income of sales of the person against whom the action is brought equals or exceeds one million dollars for any taxable year subject to any action brought pursuant to this article; and (ii) the damages pleaded in such action exceed three hundred and fifty thousand dollars.

For tax cases, the law further requires the attorney general to consult with the Department of Taxation and Finance before filing or intervening in the case and limits the ability of a qui tam plaintiff to obtain records from the tax department by requiring the plaintiff to get the attorney general's approval before making any motion to compel production of those tax records.

What Are False Claims?

Under the statute, a false claim is any request or demand for money or property presented to the state, local government, or to a contractor acting on their behalf that is, either in whole or part, false or fraudulent.[11] The statute also covers false statements or records made or used by a person that are material to an obligation to pay the state or local government money.[12] Those types of claims are often referred to as "reverse-false claims." False tax returns seeking a refund would, for example, constitute a false claim, while a false return understating a liability but not seeking a refund would be a reverse-false claim.

Penalties

The statute imposes severe financial penalties on any person found liable of violating the act. Those persons must pay *three times* the amount of damages sustained by the state, and they must further pay a penalty of at least $6,000 and no more than $12,000 for each false claim, record, or statement involved in the case. Also, persons found liable must pay the plaintiff's costs for investigating and bringing the lawsuit, including the plaintiff's attorney fees.[13]

Whistleblower Rewards

Not only are the financial penalties imposed on wrongdoers severe, but to encourage those with inside knowledge of the falsity to come forward, the rewards for whistleblowers are potentially great. By rewarding whistleblowers, New York hopes that those with inside knowledge and evidence of knowingly false schemes will come forward.

> ***Even individuals who participated in the planning or implementation of the scheme to file false claims or to use or make false records can be awarded a share of the proceeds.***

Under New York's act, whistleblowers can collect rewards of at least 10 percent and, in some cases, as much as 30 percent of the full amounts paid by a defendant found liable for violating the act, including treble damages and penalties. Even individuals who participated in the planning or implementation of the scheme to file false claims or to use or make false records can be awarded a share of the proceeds, in an amount to be determined by the court, unless the whistleblower has been criminally convicted for his role in presenting the false claims or in making or using the false records.[14]

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[9]The state act is codified in article 13 of the State Finance Law, sections 187 to 194.

[10]The statute also authorizes a local government, such as the city of New York, that has sustained losses as a result of a false claim to bring a false claims lawsuit. References in this article to the "state" are intended to include, unless otherwise indicated, references to local governments as well.

[11]State Finance Law section 188(1)(a) and (2).

[12]State Finance Law section 189(1)(f).

[13]State Finance Law section 189(3).

[14]State Finance Law section 190(8). State Finance Law section 190(6) sets out the rules the courts must use to determine the whistleblower's percentage. The whistleblower award may be capped at 10 percent if the court finds that the action was based on specific information that did not originate from the whistleblower and that was disclosed in a criminal, civil, or administrative hearing or investigation or

(Footnote continued on next page.)

Knowledge and Intent

The law does not require the plaintiff to prove that the defendant intended to defraud the government. Instead, the plaintiff has only to prove that the person knowingly, as that term is broadly defined in the act, submitted a false claim. Section 188(3)(a) provides that a person acts knowingly regarding information if that person (1) has actual knowledge of the falsity, (2) acts in deliberate ignorance of the truth or falsity of the information, or (3) acts in reckless disregard of the truth or falsity of the information.

Under that definition, a person can be held responsible for a false claim and required to pay treble damages even if he did not actually know that the claim was false and even if he were not deliberately trying to defraud the government. To the contrary, liability can be imposed if he should have known that the claim was false but did not because he deliberately ignored or recklessly disregarded the truth of the matter asserted. Although intentional deception is not required, the act also makes clear that false claims that are the result of mistake or mere negligence are excluded from its reach.[15] Something more is required than merely making a mistake, but that something is less than deliberate deception.

> ***Cautious taxpayers or practitioners who believe that guidance is wrong might be well advised to challenge that guidance directly rather than by taking a contrary but undisclosed position on a return.***

These standards will be a challenge to apply in the tax area, where, as all practitioners know well, the law and rules are not a model of clarity, and where mistakes occur even when taxpayers and practitioners act in good faith. Courts interpreting the knowledge requirements of the federal False Claims Act have held that a person who reasonably relies on an interpretation of an ambiguous statute or regulation should not face liability under the act.[16] But when the agency responsible for administering the applicable law or regulation has publicly issued a definitive interpretation intended to resolve that ambiguity, a claim that does not comply with that definitive interpretation could lead to False Claims Act liability.[17] Indeed, it has been observed that if "the defendant is aware of the government's interpretation or policy, and submits claims in violation of that interpretation or policy — even if she genuinely believes her interpretation to be superior — the defendant is likely to be found liable" under the act.[18]

Will that type of analysis apply to cases involving alleged violations of the tax law? Our answer is a firm maybe, depending, perhaps, on the nature, relevance, and clarity of the definitive interpretation. Cautious taxpayers or practitioners who believe that guidance or an interpretation issued by the IRS or by the Department of Taxation and Finance is wrong might be well advised to challenge that guidance directly rather than by taking a contrary but undisclosed position on a return. Given the broad definition of a knowing false claim under the act, taking the latter path might well lead to a situation in which they find themselves on the wrong end of a false claims lawsuit. So practitioners themselves have to be careful here.

Conspirators and Others Who May Be Liable

Persons who knowingly conspire with or cause another to file a false claim or use a false statement are just as liable under the act as the person who presented or used the false claim and who presumably benefitted most directly from the false claim. Section 189 of the act provides that any person[19] who knowingly presents or who "causes to be presented" a false claim or who knowingly "makes, uses or causes to be made or used" a false record or statement material to an obligation to pay money to the state "shall be liable." Section 189(1)(c) provides that any person who "conspires" to knowingly present a false claim or knowingly use or make a false record or statement to avoid an obligation to the state is also liable under the act.

In the tax context, those provisions are significant. As practitioners know well, when a taxpayer is audited and a tax liability based on a false return is revealed, it is the taxpayer that owes the liability and not the practitioner. If the practitioner engaged in misconduct, the practitioner may face his own penalties, but the liability for the tax remains with the taxpayer.

It will be a different world order for tax claims brought under the False Claims Act. If the false

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in the news media. The court is also authorized to dismiss the qui tam suit, unless opposed by the state, if substantially the same allegations or transactions as alleged in the action were previously publicly disclosed. State Finance Law section 190(9)(b).

[15]State Finance Law section 188(3)(b).

[16]*See, e.g.*, *Hagood v. Sonoma County Water Agency*, 81 F.3d 1465, 1477-1478 (9th Cir. 1996).

[17]*See, e.g.*, *Visiting Nurse Ass'n of Brooklyn v. Thompson*, 378 F. Supp 2d 75, 96 (E.D.N.Y. 2004).

[18]*Health Care Fraud and Abuse: Practical Perspectives*, 246 (Linda A. Bauman ed., 2d ed. 2007).

[19]A person includes any natural person, partnership, corporation, association, or any other legal entity or individual, other than the state or a local government. State Finance Law section 188(8).

claims plaintiff can prove that the accountant, adviser, attorney, or other person conspired with the taxpayer to knowingly, as that term is liberally defined, present a false tax return, the practitioner could be held liable for a penalty that is three times the amount of the tax. Think back to the hypothetical situations set forth earlier in this article. Many of the accountants, lawyers, advisers, bankers, and others described in those examples arguably knowingly helped the taxpayer prepare and file false returns. Under the False Claims Act, those practitioners will likely be defendants, especially if they have deep pockets.

We'll say it again: Holy smokes! For practitioners who guide taxpayers through the complex thicket of tax regulation, this new statute unquestionably raises the stakes, especially given the statute's broad definition of acting knowingly.

A Few Words About Procedure

The attorney general plays a critical role in false claims litigation. First, the attorney general has been granted broad authority to investigate false claims violations and to bring a civil enforcement action under the act.[20]

Second, the attorney general has oversight responsibility for qui tam suits filed by whistleblowers. The statute provides that any person can bring a qui tam civil action under the act on behalf of the state or a local government.[21] The qui tam complaints are filed under seal and then reviewed and investigated by the attorney general while the case remains under seal. Once the review and investigation is complete, the attorney general can (1) take over the case by filing his own complaint;[22] (2) provide assistance to the qui tam plaintiff by intervening in the lawsuit;[23] (3) decline to participate in the action but permit the qui tam plaintiff to pursue the suit alone;[24] or (4) move to dismiss the complaint or settle the action, even over the objections of the qui tam plaintiff.[25]

Whistleblower Protections

The act also includes strong measures to protect whistleblowers from retaliation by their employers or prospective employers for filing a claim or for engaging in any lawful act to further a false claims case. Under the same 2010 amendments that expanded the act to cover tax violations, the law was further amended to provide that a protected "lawful act" includes obtaining and transmitting "documents, data, correspondence, electronic mail, or any other information, even though such an act may violate a contract, employment term or duty owed to the employer or contractor, so long as the possession and transmission of such documents are for the sole purpose of furthering efforts to stop" a violation of the False Claims Act.

Let that sink in. Under this new rule, an employee who pilfers documents from his employer to establish a false claim is protected from retaliation even if the employee violated a rule, contract, or duty owed to his employer when he took the documents. This aspect of the new law has already generated some criticism.[26]

Conclusion

There is every reason to believe that New York will vigorously use this new statute in its effort to expose and curtail tax fraud. Given New York's unprecedented financial crisis and further given Attorney General Schneiderman's enthusiastic support for the new law,[27] practitioners should brace themselves for a new reality. Because almost anyone may become a whistleblower with a financial incentive to report questionable transactions, practitioners will have to be more vigilant than ever to protect themselves and their clients. Once again, and for a final time: Holy smokes! ✰

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[20] State Finance Law section 190(1). Under the same section, local governments may also investigate and bring false claims enforcement actions to recover damages sustained by the local government.

[21] State Finance Law section 190(2)(a).

[22] State Finance Law section 190(2)(b), (c)(i), and (d).

[23] State Finance Law section 190(2)(b) and (c)(ii).

[24] State Finance Law section 190(2)(f).

[25] State Finance Law section 190(5)(b)(i) and (ii).

[26] Hamilton, *supra* note 7. The statute does not, however, excuse criminal conduct, and if the employee commits a crime to get the records, the employee is still subject to possible prosecution by a law enforcement agency. State Finance Law section 191(2).

[27] In his former role as state senator, Schneiderman was the primary sponsor of the new tax whistleblower laws. He is an avid proponent of the efficacy of the False Claims Act in general and of its potential role in curbing tax fraud. Indeed, he is so confident of the law's value that he has predicted that adoption of the tax whistleblower provisions will produce millions in recovery for the state. As attorney general, Schneiderman is uniquely positioned to make his predictions a reality.