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PERSPECTIVES

A DISTURBING TREND: APPLYING FALSE CLAIMS ACTS TO TAX MATTERS

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The use of False Claims Act (FCA) statutes with *qui tam* provisions as a basis to challenge a taxpayer's tax return filing position continues to be a disturbing trend in state and local taxation. Such statutes permit private individuals (i.e., 'whistleblowers') to sue taxpayers on behalf of the government by alleging that the taxpayer 'knowingly' failed to comply with a state or local tax obligation.

When a whistleblower files an FCA lawsuit, it is done 'under seal', which means it is not publicly disclosed. This gives the state's attorney general time to issue subpoenas for testimony and records, investigate the claim, and decide whether the state wishes to prosecute the case itself. If the attorney general declines to prosecute the case personally, the attorney general may still permit the whistleblower to proceed with the lawsuit.

In addition to other penalties, taxpayers found liable under an FCA statute may be penalised for damages of up to three times the taxes that are allegedly owed, along with fines for specific violations. Most FCA statutes contain an expansive statute of limitations (frequently up to 10 years) that allows the whistleblower or state to pursue damages even if the time period for the state to conduct an audit has expired. Moreover, FCA statutes provide a financial incentive for whistleblowers to come forward by rewarding them with a portion of the damages recovered, along with attorneys' fees and expenses.

Supporters of FCA statutes claim they are a vital tool to the government in identifying and prosecuting 'fraud'. FCA statutes are not, however, limited to fraud. While such statutes require proof that the defendant 'knowingly' made a false tax claim, the term 'knowingly' is often broadly defined to include acts involving a 'deliberate ignorance' or 'reckless disregard' of the truth or falsity of information. In other words, taxpayers may be found liable even if their allegedly incorrect tax return position was not the result of an actual intent to defraud the government. This frequently leads to FCA actions being used against taxpayers who have taken reasonable positions regarding ambiguous areas of the tax law.

Several states, including New York, Illinois and Delaware, have adopted state-level FCAs that permit whistleblowers to file lawsuits in connection with alleged tax violations. This article provides an update on recent developments in these states and provides some practical advice for dealing with this risk.

New York State

In 2010, New York amended its FCA statute to explicitly include tax claims as an area subject to FCA lawsuits. In 2012, New York's Attorney General made headlines when he unsealed a $300m FCA lawsuit against Sprint-Nextel Corporation. The lawsuit alleges that Sprint under-collected and underpaid over $100m in sales taxes on the company's flat-rate wireless calling plans. Sprint vigorously denies the allegations and is currently fighting the lawsuit in state court. It is also worth noting that the FCA lawsuit against Sprint has been allowed to proceed despite the fact that Sprint was under audit by the state for the issue in question at the time the lawsuit was filed.

In July 2014, an FCA lawsuit against Vanguard Group, Inc., the management company that services the Vanguard family of mutual funds, was also unsealed. The lawsuit was filed by a former in-house attorney who alleges that the company evaded at least $20m in New York corporate income taxes over the last 10 years. The lawsuit primarily alleges that Vanguard's at-cost pricing structure for related-party services resulted in an illegal shifting of income from the management company to the funds it owns. According to the lawsuit, this allowed Vanguard to illegally evade taxes by artificially reducing its income and shifting income to tax-exempt or tax-deferred investments. Vanguard strongly contests the allegations and commentators have taken particular note of the fact that the company's structure has been in place for over 40 years without the federal or state taxing authorities taking issue with the arrangement.

Most recently, in August 2014, New York's Attorney General announced that Topline Appliance Center has agreed to pay $1.56m to settle an FCA lawsuit that accused the company and its owner of illegally failing to collect and pay New York sales

taxes and corporate franchise taxes for nearly 10 years. According to the Attorney General, Topline Appliance Center was 'doing business' in New York and sought to gain a competitive advantage by 'cheating' on its taxes. While the exact facts of the case are not known, it is worth noting that the question of whether an out-of-state corporation is 'doing business' in a particular state is frequently a contested and unclear matter of law.

Illinois

In Illinois, more than 200 FCA cases have been filed. Most of these cases allege that vendors have fraudulently failed to collect and remit sales tax on the portion of their charges for internet sales to Illinois customers attributable to shipping. Enterprising whistleblowers and plaintiffs' attorneys are seeking to impose treble tax, penalty and interest on internet sales in which the defendant/retailer collected use tax on the item sold, but not on the shipping charges.

The disturbing aspect of these cases is that the Illinois Department of Revenue's (the 'Department') regulations expressly provide for no tax to be collected on shipping charges on such sales because the charges are deemed to be separately negotiated and contracted for when separately stated, notwithstanding the Illinois Supreme Court's 2009 decision in *Kean v. Wal-Mart Stores, Inc.*, 253 Ill. 2d 351 (2009). In *Kean*, the Court held, without invalidating the regulation, that an online sale, of necessity, includes shipping. Thus, the Court held that a charge for shipping associated with an online sale is taxable because it is inseparable from the underlying transaction for the purchase of tangible personal property. Since the Department has not revised its regulations in response to *Kean*, it should be obvious that FCA lawsuits on this issue are inappropriate because the current state of the law is in question.

Even more disturbing is the fact that some of the defendant/retailers in the pending FCA cases had their Illinois tax treatment of shipping charges approved under audit by the Department. Other defendant/retailers have undergone general Illinois sales and use tax audits by the Department that have been completed, although it is not clear whether the retailers' treatment of shipping charges was specifically considered as part of the completed audits. Yet other defendant/retailers have pending audits where the shipping charge issue has been raised, but not resolved because of the intervening FCA litigation. In general, the Illinois attorney general has refused to join as a party in these whistleblower lawsuits, and, but for a handful of cases early on, has refused to intervene to request a dismissal, even in the lawsuits that include years that have already been audited by the Department.

Delaware

The irregularity of a state or a relator being able to ignore a prior or current audit is not an issue that only applies to FCA defendants in New York or Illinois. In Delaware, a whistleblower and the state have brought a claim against Card Compliant, LLC and the companies that utilised Card Compliant, LLC's services in implementing a gift card program. The plaintiffs brought two claims under the Delaware FCA asserting that the defendants knowingly refused to fulfil their obligations to the state under the Abandoned Property Law in failing to report and deliver unclaimed gift card and gift certificate funds to the state.

"The continued rise of FCA lawsuits in tax matters presents unique challenges to taxpayers that are struggling to comply with ambiguous state and local tax laws."

Many of the companies named as defendants in the Delaware FCA matter have undergone multi-state unclaimed property audits in the past, are currently undergoing multi-state unclaimed property audits or are willing participants in the current Delaware voluntary disclosure program. As in New York and Illinois, these lawsuits detract from the understanding that an audit settlement indicates the review is complete. Companies are on edge, in that these audits are never really over.

Practical considerations and advice

The continued rise of FCA lawsuits in tax matters presents unique challenges to taxpayers that are struggling to comply with ambiguous state and local tax laws. For example, the participation of taxpayers in the system of voluntary tax compliance, tested through selective audits, relies in great part on the finality that an audit brings to a given tax period for all issues. Record retention guidelines, under most tax laws, exist to enable the documentation of positions in an audit and related proceedings, and no further. Taxpayer must now wonder whether they should ever rely on a settlement in a tax audit, especially where the audit did not involve a review of all the taxpayer's records or transactions.

When dealing with a potential FCA claim, taxpayers should engage counsel experienced in state and local tax matters and litigation. These FCA claims are based in state and local tax laws, so a specific knowledge of such laws is crucial to mounting a successful defence. Additionally, since these claims generally begin with subpoenas issued to the defendant, it is important to engage experienced state and local tax counsel early in the subpoena process so that any response to the subpoenas may be handled with an eye toward defending against the merits of the tax claim.

To avoid or mitigate potential FCA liability, taxpayers should review their past and future tax return filing positions. In this regard, state and local tax counsel can help determine whether the risks associated with a potential FCA lawsuit are different from those related to a traditional administrative tax audit. Taxpayers should also consider, in appropriate cases, obtaining formal written guidance from state taxing authorities. If properly relied upon, such guidance may provide a defence to liability or damages in an FCA action. Finally, taxpayers may wish to avail themselves of state voluntary disclosure programs, which may provide for limited look-back periods, penalty abatement and a reduction in any interest associated with potential prior-year liabilities. Disclosing potential liabilities through a voluntary disclosure may provide a defence or mitigate damages in a future FCA lawsuit. CD

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