

# PRATT'S GOVERNMENT CONTRACTING LAW REPORT

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# Federal Judge Approves Tax Settlement Between Taxpayer and New York State Over Objections of Qui Tam Plaintiff

*By Irwin M. Slomka\**

*In this article, the author discusses a recent decision by a federal district court in New York that demonstrates the potential benefits of working with the New York State Tax Department to resolve qui tam claims, even where the qui tam plaintiff objects to the settlement.*

A recent decision by the U.S. District Court for the Southern District of New York, under the New York False Claims Act, offers good news to New York taxpayers that may be facing qui tam actions from private party litigants making questionable and frequently onerous tax claims.

A federal judge granted New York State's motion for court approval of a corporate tax settlement between the state and a New York corporate taxpayer for \$100,000, over the objections of a qui tam plaintiff that claimed millions of dollars of taxes were allegedly owed by the corporation.

The decision, in *State v. Egon Zehnder Int'l, Inc.*,<sup>1</sup> demonstrates the potential benefits of working with the New York State Tax Department to resolve qui tam claims, even where the qui tam plaintiff objects to the settlement, as courts tend not to second guess the state's settlement judgment.

## **BACKGROUND**

Under the New York False Claims Act,<sup>2</sup> a defendant can be subject to treble-damages liability owed to New York State or a locality if the defendant "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." This law extends to New York tax liabilities. It allows a qui tam action to be brought by "any person" (a "relator") for violation of the law and, if successful, entitles the relator to 25 to 30 percent of the amounts recovered.

Needless to say, the law provides a financial incentive that encourages qui tam actions which, if New York State does not intervene, allows the relator and its lawyers to, in effect, take on the role of state tax enforcer.

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<sup>1</sup> *State v. Egon Zehnder Int'l, Inc.*, No. 21-cv-6883 (LJL) (S.D.N.Y., Aug. 31, 2022).

<sup>2</sup> N.Y. Fin. Law § 189(1).

## THE FACTS

The taxpayer is the U.S. subsidiary of a Swiss corporation that, through affiliates, operates a worldwide executive search business. The relator, an alter-ego entity for a “whistleblower” who was formerly the taxpayer’s controller, brought a False Claims Act claim against the taxpayer in the New York courts alleging that the taxpayer’s failure to include in its New York taxable income fees that it sourced to its non-U.S. affiliates constituted the making and using of “false statements” in the taxpayer’s state and city tax returns, and the underreporting of “tens of millions of dollars” of taxable income.

In considering whether to intervene in the *qui tam* action, New York State—the Attorney General and the Tax Department—conducted a lengthy investigation into the relator’s allegations and ultimately decided not to intervene. The state learned that the relator had previously made a whistleblower claim with the Internal Revenue Service (“IRS”) concerning the same alleged underreporting and the IRS had concluded that no adjustments were warranted.

Thereafter, the taxpayer successfully removed the *qui tam* action from state court to federal court, over the relator’s objections, persuading the court that the dispute largely depended on a federal tax question (i.e., the computation of the taxpayer’s federal taxable income). The state and the taxpayer then reached a settlement agreement in principle for a payment of \$100,000, \$30,000 of which would be held for payment to the relator or its lawyer.

The relator filed an opposition to the settlement.

Under New York law, the state is authorized to settle *qui tam* actions, over a relator’s objections, if the “proposed settlement is fair, adequate, and reasonable with respect to all parties under all the circumstances.”<sup>3</sup>

## THE DECISION

The issue before the court was whether the proposed settlement was “fair, adequate, and reasonable.” In interpreting that undefined phrase, the court needed to determine (i) whether the state reasonably concluded that the settlement was in its best interests (and not confined to maximizing recovery against the taxpayer), and (ii) whether the settlement unfairly reduced the relator’s potential *qui tam* recovery.

Applying these criteria, the court held that the state made a reasonable judgment that a \$100,000 settlement was “fair, adequate and reasonable” to all parties and approved the settlement. The court found there was considerable

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<sup>3</sup> N.Y. Fin. Law § 190(5)(b)(ii).

risk to the relator that there was no “obligation”—a critical element of a qui tam action—to pay New York tax on amounts the IRS had determined, after an audit, were not includable in federal taxable income.

The court also found that a decision on the merits could have a detrimental effect on “unsettled questions” regarding the interplay between federal and state tax reporting. The court noted that a decision for the relator could lead to the enactment of similar statutes nationwide, resulting in investigations “instigated by private persons intrigued by the prospect of personal recovery.”

Recognizing that the state had the greatest interest in recovery, the court concluded that the state would not compromise the case “on the cheap” if it thought the case “had great merit.”

## **CONCLUSION**

While taxpayers may sometimes disagree with state audit determinations, it is clear that the New York State Tax Department is in a far better position to administer the tax laws than are private parties frequently incentivized to bring qui tam actions.