STATE+LOCAL TAX
INSIGHTS

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TRIPLE THE RISK, TRIPLE THE UNCERTAINTY: TAX FALSE CLAIMS ACT SUITS.

PART ONE OF A TWO PART SERIES

By Hollis L. Hyans and Matthew F. Cammarata

During a single hearing in March 2016, a Cook County Circuit Judge dismissed over 200 False Claims Act ("FCA") suits brought by one *qui tam* relator in Illinois against out-of-state liquor retailers.[1] As states continue to enact FCA statutes (or expand existing FCA statutes to cover tax claims), the proliferation of *qui tam* litigation has added a new layer of difficulty to managing a corporation's state and local tax risks.[2] Although the flood gates have not opened everywhere the way they have in Illinois, FCA statutes are quickly becoming a new consideration for state and local tax professionals, above and beyond the normal audit and administrative enforcement mechanisms.[3] FCA actions create uncertainty in the form of new procedures and new parties: they often

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Upcoming Speaking Engagements

September 19

Thomson Reuters Webinar

- **"What's New in State and Local Tax Law Trends?"** Nicole L. Johnson

October 24

Council on State Taxation, 48th Annual Meeting
Orlando, Florida

- **"Possibilities and Pitfalls in Acquisitions, Dispositions and Internal Reorganizations"** Mitchell A. Newmark
- **"Alternative Apportionment and Internal Consistency"** Craig B. Fields
- **"State and Local Tax Issues for Mobile Employees"** Hollis L. Hyans

November 3

California Tax Policy Conference
Carlsbad, California

- **"'Tax that fellow behind the tree' - An Update on Economic Nexus"** Nicole L. Johnson

November 6 - 8

Vanderbilt University Law School's 24th Annual Paul J. Hartman State and Local Tax Forum
Nashville, Tennessee

- **"Top Ten Income Tax Cases"** Hollis L. Hyans
- **"Unitary Returns: Building a Meaningful Audit File Before the Audit Begins"** Mitchell A. Newmark
- **"Reporting Federal RAR Charges"** Craig B. Fields

November 13

Recent Developments in Corporate Taxation
New Burnswick, New Jersey

- **"Current Developments in State and Local Taxation"** Mitchell A. Newmark

December 4 - 5

New York University's 36th Institute on State and Local Taxation
New York, New York

- **"What Your Mother Didn't Teach You About Apportionment"** Hollis L. Hyans
- **"Due Process – Significant Current Issues"** Craig B. Fields
- **"What's Happening Everywhere Today?"** Mitchell A. Newmark

permit *qui tam* litigants to bring suits alleging violations of the tax law in the name of the state, and to share in the recovery, giving individuals, known as "relators," new incentive to file lawsuits raising allegations of fraud. Relators can include not only current and former employees who claim to have inside information,[4] but also mere observers who claim to have uncovered a new theory of liability.[5] In addition to allowing the relator to recover proceeds, FCA statutes have high financial *and* nonmonetary stakes—they often provide for treble damages and they can result in negative publicity.

As FCA statutes become increasingly common, corporations can be caught off guard by claims alleging tax fraud. Tax practitioners and legislators often debate the policy issues raised by applying FCA statutes to the tax law. Deputizing tax enforcement to citizens and non-tax governmental agencies undermines some of the chief safeguards and policy goals of endowing exclusive authority for execution of the tax laws in a specialized agency with tax expertise. The certainty that comes with well-established procedural mechanisms for tax assessments and appeal rights is thrown out the window in the FCA context—as is a corporation's established strategy for evaluating its state and local tax liabilities. While a corporation normally can dispute tax assessments within the confines of the confidentiality provided by a normal administrative audit, FCA actions present the added difficulty of litigating tax issues in a public forum. These policy discussions that will continue as states, taxpayers and tax practitioners grapple with the added complexity of tax FCA suits do little to answer the most immediate question a corporation faces in this developing field: what to do when it suddenly faces a multimillion (or even a multi*billion*[6]) dollar claim that it fraudulently evaded a state or local tax obligation. In the first part of this two part series, we begin to answer that question.

GENERAL FCA OVERVIEW

The federal FCA, which serves as a model for many state FCA statutes, explicitly prohibits claims made under the Internal Revenue Code.[7] Some states, such as California and Massachusetts, follow the federal model, prohibiting tax FCA claims and vesting exclusive authority for the resolution of tax disputes in specialized

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agencies.[8] Other states have adopted a more limited approach and permit the application of FCA statutes to only certain types of tax claims. For example, the Indiana and Illinois FCAs expressly prohibit FCA claims brought under the States' income tax laws.[9] Other states, such as New York, place no subject matter limitations on tax FCA claims, leaving corporations vulnerable to attack on many fronts.

Effective only since 2010, New York's application of its FCA statute to tax claims is instructive. The basic elements of a false claim are set forth in relatively brief and less than illustrative statutory terms.[10] The statute applies to "claims" made under the tax law, if the income or sales of the person against whom the action is brought exceed $1,000,000 and the damages pleaded exceed $350,000.[11] A claim is defined, in part, as "any request or demand, whether under contract or otherwise, for money or property that is presented to an officer, employee or agent of the state or a local government."[12] A claim is "false" when it "is, either in whole or part, false or fraudulent."[13]

Of the eight different actions set forth in the New York FCA that create potential liability, seven are applicable to tax claims.[14] The most straightforward statutory application of the FCA to the tax law creates liability for "any person who 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 local government."[15] A person acts "knowingly" if that person either has "actual knowledge," "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."[16] "Knowledge" does not require a specific intent to defraud.[17]

While the New York State Attorney General is authorized to directly bring an action for alleged violations of the FCA, "any person" may also bring a *qui tam* civil action for violations of the FCA.[18] The Attorney General has the right to intervene in *qui tam* actions or to seek dismissal of a suit that the Attorney General believes is without merit.[19]

In the seven years since the New York FCA was first made applicable to tax claims, available decisions (and publicly released settlement information) demonstrate that corporations face FCA risk on many fronts. Cases have been brought by *qui tam* relators against out-of-state internet vendors under the sales tax law;[20] by *qui tam* relators that gained confidential information through an attorney-client relationship and sought damages based on alleged violations of corporate franchise tax apportionment statutes;[21] by *qui tam* relators who have no direct connection to the business of the corporation whatsoever and sought damages alleging that a corporation fraudulently used net operating losses ("NOLs") despite following federal guidance;[22] and by the Attorney General against a wide variety of taxpayers for alleged violations of sales tax laws and corporate franchise tax laws.[23]

The financial stakes are high in these cases—the New York FCA provides for treble damages.[24] Although, as described in greater detail below, some corporations have had success defending against multibillion dollar claims,[25] others remain embroiled in litigation in suits seeking damages in the hundreds of millions of dollars.[26]

WHERE TO START

FCA litigation is neither your typical state and local tax dispute nor your typical business litigation. In a regular tax dispute, a state or local revenue authority generally conducts a confidential audit, which provides both the taxpayer and the revenue authority with the opportunity to gather information and understand the other party's position. If a state tax dispute is eventually litigated, there is often several years of audit history and information gathering that provide context and inform strategy. In an FCA matter, the claim may come from the government, but it also may come from an ordinary citizen. While the claim itself may be based in the tax law, the dominant allegation is that, whatever substantive tax issue is raised, there has been an intentional fraud. When faced with an FCA matter, a taxpayer-defendant's first questions should always be: (1) *who* is making this claim; (2) *how* did the relator get the information on which the claim is based; and (3) *what* is the false claim the taxpayer has allegedly made. Failure to devote substantial attention to and analysis of these questions can be a missed opportunity to successfully dismiss FCA complaints before they become a lengthy and costly litigation.

For example, the mere fact that a *qui tam* relator played a fiduciary role in a corporation's business can be a basis for dismissal. In *State of New York ex rel. Danon v. Vanguard Group, Inc.*, a *qui tam* relator, David Danon, brought suit under the New York FCA against Vanguard Group, Inc. and several affiliates ("Vanguard") alleging that Vanguard failed to follow transfer pricing principles under federal and New York law in order to evade tax.[27] Danon had previously served as Vanguard's in-house legal counsel, and alleged in his own complaint that he brought the FCA action based on information that he obtained in the course of his employment at Vanguard.[28] The New York Supreme Court (New York's trial court) dismissed the complaint, holding that because Danon learned the information serving as the basis for the complaint in the context of a confidential attorney-client

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relationship, he had violated New York's ethical rules governing attorney conduct, and the information could not be used to form the basis of a complaint under the FCA.[29] Simply put, "Danon, Vanguard's prior in-house counsel for tax matters, may not proceed with, nor profit from, any disclosure of confidential information to bring this qui tam action in violation of New York State attorney ethics rules . . . ."[30]

A significant victory in this developing and unsettled area of the law, the *Vanguard* decision is not only important for what it says—that information gained in the course of a confidential attorney-client relationship cannot be used to form the basis of an FCA complaint—but also for what it implies. While the court's holding is clearly limited to the attorney-client relationship, its rationale is reasonably applicable to other relationships in which *any* fiduciary owes a duty to its principal. Companies facing FCA complaints should carefully analyze both the identity and role of the relator *and* the relator's source of information to determine whether any grounds for dismissal exist. Inasmuch as a dearth of interpretive authority can create uncertainty and risk, the lack of developed judicial interpretations of the FCA also opens doors for additional interpretations that are consistent with what the available authority holds.

Just as important as the identity of the relator and his source of information is a careful analysis of exactly what claim the company is alleged to have made. A "claim" on a tax return, even if arguably incorrect, is not necessarily "false" for FCA purposes, and may not have been made "knowingly" either. In *State of New York ex rel. Eric Rasmusen v. Citigroup Inc.*, for example, Citigroup Inc. ("Citigroup") was successful in achieving the dismissal of a New York FCA complaint where the relator's claims were based on a questionable interpretation of federal law and where the information serving as the basis of the complaint was based on publicly available information.[31] The relator, Eric Rasmusen, a professor at Indiana University, alleged that Citigroup improperly claimed NOL deductions on its New York State corporate franchise tax return and, therefore, fraudulently and intentionally failed to pay approximately $800 million in New York State taxes.[32] Rasmusen had no actual connection to Citigroup's business and the facts serving as the basis for his complaint were learned from publicly available sources such as the media and Citigroup's Securities and Exchange Commission filings.[33]

Rasmusen's tax claim involved a complicated interpretation of both federal and New York State law. The U.S. Treasury purchased approximately $45 billion in Citigroup stock during the 2008 financial crisis.[34] In the years following the crisis, Citigroup experienced tax losses which resulted in the generation of NOLs. Internal Revenue Code ("IRC") Section 382 generally restricts the use of NOLs where a corporation experiences an "ownership change" during the period that NOLs first arise and the time that the NOLs are actually claimed.[35] However, the Internal Revenue Service ("IRS") released several notices explicitly holding that investments by the U.S. Treasury in the stock of a company during the financial crisis would not constitute an "ownership change" for purposes of IRC Section 382.[36] Relying on this explicit authority, Citigroup claimed NOLs on its federal and New York State tax returns without regard to any limitations imposed by IRC Section 382.[37] Rasmusen, however, interpreted Citigroup's reliance on this explicit federal authority as an intentional fraud because he alleged that the IRS notices were issued erroneously and, even if valid for federal tax purposes, were not incorporated into New York State law.[38]

Citigroup sought dismissal of the claim, making three basic arguments: (1) the complaint relied on publicly available information, which serves as a bar to New York FCA actions; (2) Citigroup's New York State tax returns were not "false," as the NOLs were validly claimed under explicit IRS authority and New York State law incorporates federal law concerning NOLs; and (3) even if the returns were "false," there was no evidence to show that Citigroup knew the returns were false.[39] A New York Supreme Court justice dismissed Rasmusen's complaint in a ruling from the bench.[40] Because the ruling was oral, there is not yet a decision explaining the judge's decision. However, Citigroup's victory in this case highlights the importance of carefully parsing the alleged fraudulent "claim" to search for bases for dismissal.

For example, pursuant to *Citigroup*, where a "claim" made on a return rests on a clear and reasonable interpretation of explicit guidance from a revenue authority, the claim may not be considered "false" for FCA purposes even if there is a contrary argument that the revenue authority was possibly wrong in its own interpretation of the tax laws. In this sense, grounds for dismissal may exist where an opportunistic relator seeks to profit by alleging that a company somehow should have known that a revenue authority was incorrect in its public guidance, and that the company did not exercise discretion to not follow guidance from that revenue authority.

In addition, the *Citigroup* decision indicates that corporations may have success in attacking the "knowingly" element of the FCA. The justice in *Citigroup* seemed receptive to arguments that the mere reporting of a deduction, which is by its terms explicitly grounded in federal law, could not be "knowingly" false where a taxpayer simply reports an amount that has been reported federally. During oral

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argument, the justice asked the relator's counsel "Why does that constitute a false statement? They're not misrepresenting anything, they're just saying this is the net operating loss which we have taken under federal statute; we're taking it here."[41]

WHAT'S NEXT?

While FCA taxpayer-defendants have had some success in securing early dismissals of FCA complaints, the reality is that many FCA cases move beyond the dismissal stage. In Part Two of this series, we will examine the complexities of litigating FCA claims in the tax context.

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1 Michael J. Bologna, *Settlement Data Reveals Lawyer's False Claims Freight Train*, Bloomberg BNA (Oct. 19, 2016), https://www.bna.com/settlement-data-reveals-n57982078846/ (last visited Sept. 5, 2017).

2 The phrase "*qui tam*" refers generally to actions brought by an individual litigant on behalf of that individual and on behalf of the state against a person or entity who is alleged to have violated an FCA. *See*, *e.g.*, N.Y. State Fin. Law § 190(2)(a) (stating that "[a]ny person may bring a qui tam civil action for a violation of [the FCA] on behalf of the person and the people of the state of New York . . .").

3 The increased use of tax related *qui tam* litigation brought under the Illinois FCA has led to several legislative proposals to reform the State's FCA to either eliminate tax claims under the FCA or to limit the applicability of the FCA by, for example, prohibiting FCA claims brought under the income tax law. *See*, *e.g.*, S.B. 9, 100th Gen. Assemb., Reg. Sess. (Ill. 2017); S.B. 1250, 99th Gen. Assemb., Reg. Sess. (Ill. 2016); H.B. 1814, 94th Gen. Assemb., Reg. Sess. (Ill. 2005).

4 *State of New York ex rel. Banerjee v. Moody's Corp.*, 50 N.Y.S.3d 28 (N.Y. Sup. Ct., N.Y. Cty. 2016).

5 Complaint, *State of New York ex rel. Rasmusen v. Citigroup Inc.*, No.100175/2013 (N.Y. Sup. Ct., N.Y. Cty. Sept. 2, 2015).

6 *See id.*

7 31 U.S.C. § 3729(d).

8 Cal. Gov't Code § 12651(f); Mass. Gen. Laws ch. 12, § 5B(d).

9 Ind. Code § 5-11-5.5-2(a); 740 Ill. Comp. Stat. Ann. 175/3(c).

10 N.Y. State Fin. Law § 189(1), (4).

11 N.Y. State Fin. Law § 189(4)(a)–(b).

12 N.Y. State Fin. Law § 188(1).

13 N.Y. State Fin. Law § 188(2).

14 N.Y. State Fin. Law § 189(1)(a)–(h), 4(a).

15 N.Y. State Fin. Law § 189(1)(g).

16 N.Y. State Fin. Law § 188(3)(a)(i)–(iii).

17 N.Y. State Fin. Law § 188(3)(b).

18 N.Y. State Fin. Law § 190(1)–(2).

19 N.Y. State Fin. Law § 190(2)(b), (5)(a).

20 Press Release, New York State Office of the Attorney General, A.G. Schneiderman Announces $1.1 Million Settlement With A Minnesota Pillow Retailer For Failing to Collect New York Sales Taxes (Aug. 17, 2016) (on file with authors).

21 *State of New York ex rel. Danon v. Vanguard Group, Inc.*, 2015 N.Y. Misc. LEXIS 4239 (N.Y. Sup. Ct., N.Y. Cty. 2015).

22 Complaint, *Rasmusen*, No.100175/2013.

23 *New York v. Sprint Nextel Corp.*, 26 N.Y.3d 98 (N.Y. 2015), *cert. denied*, 136 S. Ct. 2387 (2016); Press Release, New York State Office of the Attorney General, A.G. Schneiderman Announces $4.28 Million Settlement With International Art Dealer Gagosian Gallery For Failure To Collect And Remit New York Sales Tax (July 19, 2016) (on file with authors).

24 N.Y. State Fin. Law § 189(1)(h).

25 Transcript of Oral Argument at 26, *Rasmusen*, No.100175/2013.

26 *Sprint*, 26 N.Y.3d at 105. After the denial of Sprint's motion to dismiss was upheld, Sprint has been engaged in discovery disputes with the Attorney General and has also filed a second motion to dismiss. *See State of New York v. Sprint Commc'ns, Inc.*, 148 A.D.3d 471, 471 (N.Y. App. Div. 2017) (reversing the trial court's denial of Sprint's motion to compel the Attorney General to produce documents); *State of New York v. Sprint Commc'ns, Inc.*, 2016 N.Y. Misc. LEXIS 1699, at *1 (N.Y. Sup. Ct., N.Y. Cty. 2016) (denying Sprint's second motion to dismiss certain of plaintiff's claims as time barred).

27 *Vanguard*, 2015 N.Y. Misc. LEXIS 4239, at *1-2. Danon has also acted as a whistleblower in several cases and administrative investigations arising out of the same facts as those alleged in the New York FCA litigation. *See Danon v. Vanguard Group, Inc.*, 686 F. App'x 101 (3d Cir. 2017) (non-precedential) (vacating in part the District Court's dismissal of Danon's claim that his termination from Vanguard was a retaliation in violation of the whistleblower protections of the Dodd-Frank Wall Street Reform and Consumer Protection Act). Danon also received a $117,000 payment from the Texas Comptroller of Public Accounts after it was determined that Danon provided information to the State of Texas that led to the collection of additional tax from Vanguard. David Sawyer, *Vanguard Whistleblower Finds Success With Texas Payday*, Tax Notes (Nov. 23, 2015), http://www.taxnotes.com/tax-notes-today/insurance/vanguard-whistleblower-finds-success-texas-payday/2015/11/23/g06q (last visited Sept. 5, 2017). Danon's lawyer has confirmed in public statements to the press that whistleblower investigations have also been initiated in California and before the IRS and the Securities and Exchange Commission. *Id.*

28 *Id.*

29 *Vanguard*, 2015 N.Y. Misc. LEXIS 4239, at *36.

30 *Id.* at 36. There is no publicly available record of an appeal having been filed in this case.

31 Tr. of Oral Arg. at 26, *Rasmusen*, No.100175/2013.

32 Complaint at 1, 5, 12–39, *Rasmusen*, No.100175/2013.

33 Tr. of Oral Arg. at 11–12, *Rasmusen*, No.100175/2013.

34 Memorandum of Law in Support of Citigroup Inc.'s Motion to Dismiss at 7–8, *Rasmusen*, No.100175/2013.

35 26 U.S.C. § 382.

36 *See* Notice 2008–100, 2008–44 I.R.B. 1081; Notice 2009–14, 2009–7 I.R.B. 516; Rev. Rul. 2009–38, 2009–49 I.R.B. 736; Notice 2010–2, 2010–2 I.R.B. 251.

37 Mem. of Law in Support of Citigroup Inc.'s Mot. to Dismiss at 7–8, *Rasmusen*, No.100175/2013.

38 Complaint, *Rasmusen*, No.100175/2013.

39 Mem. of Law in Support of Citigroup Inc.'s Mot. to Dismiss at 2–3, *Rasmusen*, No.100175/2013.

40 Tr. of Oral Arg. at 26, *Rasmusen*, No.100175/2013. There is no publicly available record of an appeal having been filed in this case.

41 *Id.* at 20.

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