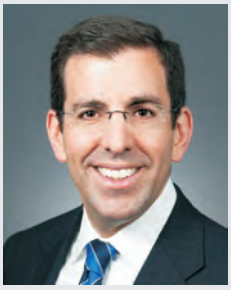
6 Years of Tax *Qui Tams* in New York

by Randall M. Fox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In this viewpoint, Fox looks back at six years of New York tax enforcement through *qui tam* lawsuits. He concludes that the abuses predicted by opponents of the law have failed to materialize and that the statute, which allows tax recovery suits by private citizens, appears to have generated a good return on the investment.

Happy sixth birthday to tax whistleblower lawsuits in New York state! After gaining unanimous approval by both houses of the New York State Legislature on June 30, 2010, and Gov. David Paterson's signature on August 13, 2010, the New York False Claims Act (FCA) was amended to remove the bar to applying the legislation to tax violations. While the FCA previously said that it did *not* apply to tax cases, the amended law explicitly permits them and thereby puts out the welcome mat for tax whistleblowers to take part in the FCA's incentive program to fight fraud committed against the government. As a result of the amendment, New York is the only state that explicitly invites whistleblowers to file *qui tam* claims about tax law violations.

To further welcome tax whistleblowers, in early 2011, New York Attorney General Eric Schneiderman (D) (who sponsored the amendment when he was a state senator) created a new bureau in his office — the Taxpayer Protection Bureau — which is charged with handling FCA cases concerning tax and other violations that victimize New York state and local treasuries (other than Medicaid-related violations, which are handled by the Medicaid Fraud Control Unit).[1] The bureau can initiate tax-related cases on its own or take on cases initiated by whistleblowers.[2]

In the past six years, much has been written supporting or decrying the tax provision, mostly based on predictions of things to come. After six years, we can now look back at some actual results and draw some early conclusions about what allowing tax FCA cases has meant in practice. This article first draws those early conclusions and then catalogs the tax *qui tam* cases that have been made public.

I. Lessons From 6 Years of Tax Whistleblowers

First, the sky has not fallen. Those who predicted huge numbers of abusive cases can find no support in the record for this result. In six years, 13 New York FCA tax-related whistleblower cases have gone public. This modest number suggests that the claims are not being filed thoughtlessly and that they are being carefully vetted by the attorney general's office. It is true that the number of publicly disclosed cases does not tell us directly how many cases have been filed, for some may still be under court-ordered seal, but the number suggests that the volume of filings is not excessive and abuses are not overwhelming the purpose of the law to fight against fraud.

Second, the investment of enforcement dollars has yielded substantial returns for the New York state and local governments and thus for taxpayers. The primary public cost of enforcement from these cases is the cost of investigating tax cases and operating the Taxpayer Protection Bureau. That cost has been only a fraction of the amounts

[1] *See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Launches New Initiative to Bolster Recovery of Taxpayer Dollars & Fight Government Fraud" (Jan. 27, 2011).

[2] On May 3 the attorney general's office announced two settlements worth $7.21 million in non-whistleblower matters concerning the failure to pay sales and use taxes on purchases of artworks that were falsely claimed to have been for resale and exempt from the tax, when, in fact, the art was displayed in the residences and offices of the targets. *See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces $7 Million Settlement With Art Collector Aby J. Rosen for Failing to Pay Sales and Use Taxes on Art Acquisitions" (May 3, 2016); and Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces Agreement With Art Sales Executive for Re-Payment of Taxes on Artwork Acquisitions" (May 3, 2016).

recovered under the FCA.[3] Specific numbers for the cost of the bureau and the percentage of that cost devoted to tax cases are unavailable, but if we assume that since 2011 the AG's office has spent about $5 million on the bureau and recognize that 34.5 percent of the bureau's recoveries in that time have been from tax cases,[4] we can then figure that roughly $1.725 million (34.5 percent of $5 million) was spent pursuing the tax cases. The bureau has so far recovered $21.68 million in tax cases. That means that the investment of about $1.725 million has generated a return of over 1,000 percent in tax cases (specifically, 1,257 percent). For every dollar spent, $12.57 was recovered.[5]

Third, an effect of empowering whistleblowers is that fewer people will dare to cheat on their taxes because the risk-reward calculus has changed. Would-be violators know it is easier to get caught if whistleblowers are motivated to report violations. Many of them make the sound choice to refrain from cheating even if they are not motivated by morals or legality. While this impact is difficult to measure, it is supported by evidence such as articles by tax attorneys advising clients to more fully disclose tax positions that they might have kept secret in the past.[6]

Fourth, tax whistleblowers are adding significant value by raising violations that would not have been caught had whistleblowers not come forward. The four tax settlements announced by the AG's office demonstrate this point, as they have been about issues that would likely have been below the radar. Two of them involved out-of-state companies that failed to pay New York taxes at all, and two were about taxpayers who falsely represented their sales or deductions to conceal their true tax liabilities.

Fifth, the attorney general's office has demonstrated a willingness to take on and vigorously fight in support of tax whistleblower claims. The office has taken over one case — that against mobile carrier Sprint Corp. for failing to collect and pay over $100 million in New York state and local sales taxes. Three levels of New York courts have rejected Sprint's motion to dismiss and found that the underlying tax provision was unambiguous.

Sixth, when the claims of tax whistleblowers have been dismissed, the dismissals have mostly been for reasons unrelated to substantive tax law, thus revealing little about the concept of having tax whistleblowers. For example, one was dismissed on attorney ethics grounds, another on statute of limitations grounds, and a third because a *pro se* plaintiff is not permitted to represent the interests of the government.

II. The Publicly Disclosed Tax *Qui Tam* Cases

A. The Settlements

Since New York amended the FCA to permit tax whistleblower cases, four such cases have been settled, yielding recoveries of $14.36 million (and an additional $7.21 million in non-whistleblower tax matters) and whistleblower incentive awards of $2.75 million.[7]

The first tax whistleblower settlement disclosed was against "tailor to the stars" Mohanbhai "Mohan" Ramchandani and his business Mohan's Custom Tailors Inc. The defendants allegedly engaged in a 10-year scheme to collect sales taxes from their customers but not remit all of the tax monies to the government. Mohan was also alleged to have underpaid his personal income taxes. In March 2013 — less than a year after the case was filed — the attorney general's office announced that it had reached a settlement, with Mohan and his business pleading guilty to felony charges and agreeing to pay $5.5 million. The whistleblower received a 20 percent incentive award of $1.1 million.[8]

The second settlement involved claims that out-of-state company Lantheus Medical Imaging Inc., which was previously owned by Bristol-Myers Squibb Co., completely avoided its obligation to pay New York state corporate franchise taxes and New York City general corporation taxes even though it clearly had a tax nexus to New York and earned income allocable to the state. After an investigation, the attorney general announced a $6.2 million settlement on March 14, 2014. The whistleblower received an 18.35 percent incentive award of just over $1.1 million.[9]

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[3]The New York State Department of Taxation and Finance (DTF) has partnered with the attorney general's office on the tax whistleblower cases, but it is not believed that the DTF has reallocated its budget in the process of doing so.

[4]The $5 million in costs is a rough estimate of the salaries and benefits paid to employees in the bureau for 2011-2016. Since the beginning of 2011, the office has recovered $62.84 million in non-healthcare FCA matters, including $21.68 million in tax-related cases.

[5]If we reduce the recoveries by the amounts paid to whistleblowers as incentive awards in the tax cases, then New York recovered $10.97 for every dollar invested (or more if it is recognized that the incentive awards to the whistleblowers are themselves taxable income). In 2010, when the FCA was amended, the DTF predicted that allowing the FCA to apply to tax matters would contribute an additional $1 million in tax revenue in the first year and $2 million in subsequent years. The recoveries to date have exceeded those predictions, with an average annual contribution of about $3.6 million.

[6]*See, e.g.*, Mary Kay Martire and Lauren A. Ferrante, "A Decade of Lessons From Litigating State Tax False Claims Act Cases," *State Tax Notes*, Oct. 14, 2013, p. 127.

[7]Under the New York FCA, whistleblower cases are filed under seal and remain under seal while the government has an opportunity to investigate the claims and decide whether to take over the whistleblower's claims. The number of cases under consideration is not public, and New York's FCA regulations permit a whistleblower to choose to discontinue a case and keep it under seal if the government has declined to take on the case. *See* 13 NYCRR section 400.4(c)(2). Further, in appropriate circumstances, a court may have discretion to keep a seal in place even after a case it has been declined or taken over by the attorney general.

[8]*See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces Arrest, Conviction and $5.5 Million Settlement in Tax Fraud Case Against Prominent Tailor" (Mar. 5, 2013).

[9]*See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces $6.2 Million Settlement With Lantheus

(Footnote continued on next page.)

The third settlement, announced on August 22, 2014, was of whistleblower claims against New Jersey appliance business Top Line Appliance Center and its owner, Michael Moretti, who were alleged to have engaged in substantial business in New York but failed to pay business taxes due. The case settled for $1.56 million, and the whistleblower received a 20 percent incentive award of $313,984.[10]

The fourth settlement involved a whistleblower's claim that New York real estate developer Asher Roshan Zamir of Zamir Equities had knowingly underpaid personal income taxes by falsely claiming tax deferral from a purported like-kind exchange of one real estate investment for another and disguising equity contributions as loans. On March 22 the attorney general's office announced a $1.1 million settlement, with a $200,000 incentive award (18.2 percent) going to the whistleblower.[11]

B. The Sprint Case: Active Litigation by the Attorney General's Office

On March 31, 2011, a whistleblower filed a case against mobile carrier Sprint claiming that it had failed to collect and remit about 25 percent of the sales taxes due on its sales of flat-rate wireless calling plans.[12] In April 2012 the AG's office took over the case and filed a superseding complaint in which it asserted that Sprint had knowingly failed to pay over $100 million in such taxes and was liable under the FCA for three times that amount plus penalties for each violation. The attorney general also added claims under the New York Executive Law and, with a referral from the state Department of Taxation and Finance, under the New York Tax Law. Sprint has fought the claims. It unsuccessfully moved to dismiss the complaint and then appealed that result to the New York Court of Appeals. In an October 20, 2015, decision, the court of appeals concluded that the interpretation of the underlying tax obligations presented by Sprint ran counter to the unambiguous statute and that the attorney general had sufficiently pleaded the violations.[13] The case is in discovery, although Sprint has filed a *certiorari* petition to the U.S. Supreme Court based on its federal preemption argument.

C. Declined Cases in Active Litigation

Under the FCA, a whistleblower can proceed with a case that the attorney general has declined. By doing so, he steps into the shoes of the government in pursuing the case and, if successful, can receive a larger incentive award. There are two publicly disclosed tax *qui tam* cases that were declined by the attorney general's office and are being litigated.

The first is a suit filed on January 24, 2013, by a whistleblower asserting that Citigroup Inc. knowingly violated New York tax laws by improperly using losses to offset income to lower its New York corporate franchise tax liability.[14] The claims arose out of the financial crisis of 2008 and the government bailout of the large banks. While the bailout of Citigroup caused a change of control that would ordinarily have wiped out the net operating losses the company used to offset its income, the IRS controversially waived that rule, allowing it to apply the offsets. The whistleblower alleges that Citigroup knowingly and falsely applied that waiver also to reduce its New York taxes. After the attorney general declined to pursue the case, the whistleblower went forward with it, and Citigroup moved to dismiss the complaint. The argument on the motion has not yet been scheduled.

The second ongoing declined tax *qui tam* case was brought by a whistleblower against credit processing company Post Integrations Inc. and related persons and entities.[15] The whistleblower filed the case in 2014, claiming that the out-of-state defendants failed to satisfy their obligation to pay New York business income taxes. The attorney general declined, and the whistleblower chose to proceed. The defendants' motion to dismiss has been briefed and argued and is awaiting a decision by the court.

D. Declined Cases That Have Been Dismissed

Motions to dismiss have been granted in six tax-related New York FCA cases that whistleblowers continued after the attorney general declined to pursue them.

The case that has perhaps received the most news coverage is one filed on May 8, 2013, by an attorney-whistleblower against the mutual fund company Vanguard Group Inc. and other entities based on claims that Vanguard knowingly violated its tax obligations to New York. Vanguard is accused of avoiding taxable profits by offering services at cost to related entities when it was required to charge fair market prices. The whistleblower also alleged that Vanguard cheated on taxes by improperly sheltering profits from taxes by labeling them as a contingency reserve. The attorney general declined the case on May 28, 2014, and the whistleblower chose to proceed.

Vanguard moved to dismiss the case based largely on the argument that the attorney-whistleblower should be punished for violating attorney ethics in that he used confidential client information to sue his former client. In its decision on November 13, 2015, the court agreed with

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Medical Imaging & Bristol-Myers Squibb for Failing to Pay New York Corporate Income Taxes" (Mar. 14, 2014).

[10]*See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces $1.56 Million Settlement With New Jersey Appliance Retailer for Failing to Pay New York Taxes" (Aug. 22, 2014).

[11]*See* Press Release, New York Attorney General's Office, "A.G. Schneiderman Announces $1.1 Million Settlement With Real Estate Mogul for Tax Abuses" (Mar. 22, 2016).

[12]*People of the State of New York ex rel. Empire State Ventures LLC v. Sprint Nextel Corp.*, Index No. 103917/2011 (N.Y. Cty. Supreme).

[13]*See New York v. Sprint Nextel Corp.*, 26 N.Y.3d 98 (2015).

[14]*New York State ex rel. Rasmusen v. Citigroup Inc.*, No. 1:15-cv-7826 (N.D.N.Y.) (removed from New York State Supreme Court).

[15]*New York State, City of New York ex rel. Campagna v. Post Integrations*, Index No. 100516/2014 (N.Y. Cty. Supreme Court).

Vanguard and ordered a dismissal, explicitly following analogous federal precedent.[16] The court focused on the attorney ethics issue and did not address the merits of the tax claims. The whistleblower has indicated that he intends to appeal.

Another dismissed case was brought by a whistleblower on November 19, 2012, against Wells Fargo National Bank. The whistleblower claimed that Wells Fargo falsely claimed New York tax benefits from real estate mortgage investment conduits while knowing that the benefits were not available because the REMICs were loaded with defective, nonqualifying mortgages.[17] The whistleblower chose to proceed with the case after the attorney general declined it near the end of 2013. Wells Fargo moved to dismiss the claims, and the court granted its motion, reasoning that the whistleblower had not adequately pleaded that Wells Fargo used false statements or records because Wells Fargo acted in compliance with tax statutes and regulations concerning the consequences of having nonqualifying mortgages in a REMIC. The whistleblower appealed the dismissal, and the appeal was argued in November 2015.[18]

A third dismissed case was brought by a whistleblower on August 30, 2012, against Fannie Mae and Flagstar Bank, alleging that the companies failed to pay New York mortgage recording taxes concerning refinancings through the Home Affordable Refinance Program.[19] On November 9, 2012, the attorney general declined, and the whistleblower chose to proceed. The defendants moved to dismiss on numerous grounds, both procedural and substantive. On September 30, 2014, the court granted the motions to dismiss, mostly "for the reasons stated" in the defendants' memoranda of law.[20]

Another banking institution — Credit Suisse — was sued by a tax whistleblower in 2013, on allegations that it violated New York tax laws by falsely allocating to foreign countries income from two 1999 transactions that should have been allocated to New York. The whistleblower proceeded with the case after the attorney general declined, and the defendant moved to dismiss. On July 17, 2015, the court granted the motion to dismiss on statute of limitations grounds, without addressing the substance of the claims.

A fifth case involved allegations of a catering company's use of hundreds of off-the-books employees, with the whistleblowers claiming that the company failed to withhold the workers' personal income taxes and pay employment taxes.[21] The whistleblowers filed the case on August 6, 2012. After the attorney general declined, they proceeded with the case, and the defendant moved to dismiss. The court granted the dismissal motion based on the whistleblowers' procedural failure to allege in the complaint that the court had ordered them to serve the complaint on the defendants.[22]

The final dismissed case is a *pro se* tax *qui tam* case against the bartering network ITEX Corp. and related entities, filed on May 31, 2013.[23] There, the whistleblower alleged that foreign corporations failed to pay New York taxes that were due. The attorney general declined on August 9, 2013, and the whistleblower chose to pursue the action but without counsel. The court granted defendants' motion to dismiss for several reasons, including that a *pro se* plaintiff is not permitted to serve in a representative capacity on behalf of the government.[24]

III. The Under Seal Docket

Because New York FCA cases exist for a time under court-ordered seals, any examination of the current state of the record is always a bit outdated. The publicly disclosed tax *qui tam* cases were all filed between 2011 and 2013, and it can be expected that many more have been filed since then. Their results will be known and can be evaluated over time. In the meantime, the results from nearly six years demonstrate positive developments for New York citizens who responsibly pay their taxes. ☆

[16] *State of New York ex rel. Danon v. Vanguard Group Inc.*, No. 100711/2013 (N.Y. Cty. Supreme, Nov. 16, 2015).

[17] *State of New York and City of New York, ex rel. Jacobson v. Wells Fargo Nat'l Bank and Wells Fargo Asset Securities Corp.*, No. 14-CV-914 (S.D.N.Y.) (removed from New York County Supreme Court).

[18] *State of New York ex rel. Jacobson v. Wells Fargo Nat'l Bank*, No. 15-1152-cv (2d Cir.).

[19] *Knight v. Fed. Nat'l Mort. Ass'n*, No. 1:13 Civ. 183 (N.D.N.Y.) (removed from New York State Supreme Court).

[20] *Knight v. Fed. Nat'l Mort. Ass'n*, No. 1:13 Civ. 183 (N.D.N.Y. Sept. 30, 2014).

[21] *State of New York ex rel. Mateo v. TAR Catering Corp. d/b/a Russo's on the Bay*, Index No. 702119/2013 (Queens Cty. Supreme).

[22] *State of New York ex rel. Mateo v. TAR Catering Corp.*, No. 702119/2013 (Queens Cty. Feb. 10, 2014).

[23] *Business Watchdog & Bal v. ITEX Corp.* Index No. 400879/2013 (N.Y. Cty. Supreme).

[24] *Business Watchdog & Bal v. ITEX Corp.*, slip op. (June 26, 2015); *see also* 13 NYCRR section 400.4(d) (barring non-lawyer *pro se* whistleblowers from representing the government's interests in declined FCA cases).