

A Conversation on False Claims Act Expansion — Does It Make Sense?

by Nikki E. Dobay and Stephanie T. Do

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Dobay and Do interviewed four state and local tax experts who have experience with the ramifications of state false claims acts: Helen Hecht is uniformity counsel and Brian Hamer is counsel to the Multistate Tax Commission, Marilyn Wethekam is partner at Horwood Marcus & Berk Chtd., and David Pope is partner at Baker McKenzie.

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Nikki E. Dobay: David, can you kick us off with a quick overview of the False Claims Act (FCA) and *qui tam* cases in the context of state taxes?

David Pope: Sure. What we're talking about are claims raised by third parties under a state statute that permits false claims or "frauds" to be brought against others on behalf of the government. What the state statutes typically do are provide for damages to be recovered, heightened damages, usually treble, and a longer lookback period. In

New York, the lookback is 10 years. In Illinois, it's seven years. These two states have a lot of FCA cases [brought on state tax issues]. And, the relator, the person bringing the lawsuit on behalf of the government, is entitled to a percentage of the recovery, usually between 15 and 30 percent, depending on whether the government steps in.

Most states have exceptions that prevent the FCA from being raised for tax matters similar to the federal FCA, which prohibits tax lawsuits, but New York and Illinois do not. And we've been seeing a lot of cases over the last several years in Illinois and New York.

Stephanie T. Do: Marilyn and David, could you share what your experience has been dealing with these types of cases?

Pope: I have, and had, cases that are in litigation in both Illinois and New York, and one of the big distinctions between the two states is that the [attorney general] steps in New York and has more investigative powers than the average third-party plaintiff. And to me, that investigative authority changes the tenor of the case.

Marilyn Wethekam: The fundamental thing that I have had to understand, getting into this probably 15 years ago, is that you can't approach these in the same way you approach a tax case where there is an assessment. That mind-set has to go out the window because these are not like tax cases. Effectively what you're litigating is a fraud case. That's not the type of tax work we typically do. We don't litigate fraud cases. The fundamental lesson I learned was I had to take my tax hat off and really become a civil litigator in a fraud case. Interestingly, however, I don't think I've ever been involved in one [case] where there was an actual true claim that you would normally bring [under the FCA] or where someone really did come in and defraud the state.



Helen Hecht

Pope: I agree with you. I find in all these cases, whether it's in New York or Illinois, these should be tax cases brought by the [Department of Revenue]. There's rarely actual fraud occurring in any of them. I've never had a case where someone knew what the law was and purposely violated it. These are complex tax rules that the average company has to digest. In many cases, they get it right and still get hit with a lawsuit, and now they have to defend against both a tax and a fraud claim. With FCA cases, you have to first prove that you were right on the tax law, which would end the case, but, if not, then you have to prove that it wasn't fraud.

Do: Brian, what has your experience been being part of the Illinois taxing agency and dealing with these cases?

Brian Hamer: Let me preface my remarks with two comments. First, my remarks will be based on my experience at the Illinois Department of Revenue; I don't necessarily speak for the Multistate Tax Commission or its members today. And, second, I think this will be helpful to understand as we get into the details, I want to

emphasize that I support robust tax enforcement. All taxpayers should be subject to the same rules and pay their fair share. The question is what is the best and fair way to enforce the tax laws?

To answer your specific question, during my time at the department, which was 12 years, we saw hundreds of FCA cases. They were brought almost entirely by one law firm, and some of the cases lasted for a decade or more. During my tenure, the attorney general typically elected not to intervene in these cases and also did not attempt to dismiss cases. The vast majority of FCA defendants elected to settle, even if the allegations asserted by the relator were highly questionable, because the cost of mounting a defense was so great.

Do: Brian, you mentioned some of these cases going on for years and years, as long as a decade. From the department's perspective, what is the cost of participating or litigating these cases?

Hamer: Well, the cost to the Department of Revenue itself was actually modest. The department's Audit Bureau often had to determine if audits had been conducted and, if so, what issues had been addressed in those audits. Although ultimately in the [FCA] litigation, that may not have made a difference. Our attorneys in the department would often advise and engage in discussions with the attorney general's office about particular claims. But all things considered, there was not a great deal of costs imposed on the department.

However, the torrent of FCA lawsuits imposed other costs on the state. I can think of a couple of particularly troubling situations. Early in my tenure, a large group of remote sellers approached the department and proposed to enter into voluntary disclosure agreements (VDAs) like they had in other states. But when they got wind of the *qui tam* plaintiffs in Illinois, they backed away. And as I recall we were never able to bring in the prospective revenue that would have resulted from those VDAs. There was also a major remote retailer that delayed establishing a physical presence in Illinois until an FCA lawsuit against them was dismissed, which caused the state to lose substantial revenue. There's also the more general point that delegating tax enforcement to private attorneys that may not be experts in tax law may result in

the making of bad law, which will limit revenues going forward.

Do: Thanks Brian. David and Marilyn, what are the costs that you're seeing on your clients to litigate these cases? And we've heard distinctions regarding frivolous versus non-frivolous claims. Any insights on that?

Wethekam: Whether they were frivolous or non-frivolous cases, the cost was basically the same. The cost quickly becomes astronomical, which is why you see a lot of settlements.

Pope: As to frivolous claims, New York does have a de minimis threshold, but even with that you still have to file a motion, you still have to go through motion practice, all to demonstrate that the case should be dismissed on the de minimis aspect. It's still expensive to do that.

One thing I wanted to point out is in New York, [the FCA cases] are all public and that's not the case in a standard tax litigation, which is often protected by taxpayer confidentiality rules. But the second the FCA suit is filed by the AG, there's a press release that goes out and it effectively says XYZ Company is a tax fraud and we're suing them for recovery. Now you must defend against that too. It's one thing to defend against a tax discrepancy. Now, you're also looking at a public relations issue.

Do: Thank you for those insights on Illinois and New York. We are seeing FCA expansion proposals in California and the District of Columbia. The District has considered some type of FCA expansion to include tax matters since 2013. We're now in 2020 and this is the fourth go at it. The council members recently considered it for a vote in late January, but several members had questions and concerns about the bill and so the vote was cancelled. And it was postponed again when the coronavirus hit. But if history tends to repeat itself, I suspect that the D.C. Council will reconsider this. The 2020 version included some "safeguards" to potentially reduce the number of frivolous claims. Specifically, to have a tax matter go forward within the FCA, you have to have a person that reports net income, sales or revenue totaling a million dollars or more for that tax filing and damages pled of \$350,000 or more.

Nikki do want to share what you're seeing in California?



Marilyn Wethekam

Dobay: Sure. The California bill, which is A.B. 2570, passed the Assembly in June. Last year, a similar bill also made it out of the Assembly but was stopped in the Senate. The sponsor of this bill is the California attorney general, and so the administration is very much behind the bill. The bill does include what have been described as the "safeguards," including that the damages pled have to exceed \$200,000 and the tax at issue has to be more than \$500,000. This bill also covers income as well as sales tax issues. Do the safeguards included in the D.C. and California bills fix the problems you all have seen in Illinois and New York?

Pope: I don't think that the minimum threshold solves the problem. I think it's a step in the right direction, but it's definitely not solving the issue. There's nothing preventing anyone from *filing* a lawsuit. You still have to defend yourself against these cases — argue that you don't meet the threshold amount, which will require a motion to dismiss at a minimum.



Brian Hamer

Dobay: In addition, the California bill also includes a provision, which has been described as a kind of “silver bullet.” Specifically, the provision provides that the attorney general is required to confer or consult with the taxing agency — either the Franchise Tax Board or the California Department of Tax and Fee Administration. My concern with this provision is that it will become perfunctory, meaning the AG will do as little as possible to satisfy this provision and there will be no meaningful dialogue with or participation from the taxing agency.

Brian, I’ll start with you. What are your thoughts on this provision?

Hamer: As a general matter, it’s always important that the attorney general and the Department of Revenue work together on tax matters. But ultimately, I believe that primary responsibility for tax enforcement should rest with revenue departments. Revenue departments are the tax experts. They are in the best position to understand the broader picture and ensure that the tax laws are administered in an equitable way. My experience in Illinois suggests that inserting a

provision into the FCA that simply requires consultation would not significantly change the way the statute actually operates.

Do: Brian, I’ve heard from proponents of the D.C. bill that expanding the FCA to include tax matters and requiring the AG’s involvement is like icing on the cake — it’s another avenue to deal with fraud, and the involvement of the AG’s office is an added tool to combat tax fraud versus keeping primary responsibility within the revenue departments.

Hamer: Well, my view of this subject is colored by the experience in Illinois. At least during the time I was at the revenue department, the attorney general did not typically get involved in *qui tam* cases. So as a practical matter, the statute operated to delegate tax enforcement to a private party whose goal was not to administer the tax laws in a fair and accurate manner, but rather to extract maximum payments from taxpayers, some of which did not have the resources to defend themselves.

Dobay: At the end of the day, these are tax issues that should be left to the purview of the taxing agency. It doesn’t seem like creating a whole other mechanism within the government to try to figure out whether or not a taxpayer is compliant is necessary. Would you agree?

Wethekam: I agree. I don’t think the AG’s office is where a determination should be made on a gray area of tax. They don’t have the expertise. They don’t have the historic knowledge of what went down, necessarily, and the policies that have been developed over the years. So I can understand maybe why someone who’s not a tax person might think this is a great idea, but it’s not going to result in uniform enforcement of the tax laws necessarily.

Pope: I agree, and I think once you start turning to discovery and investigations, the defense costs add up quickly, such that if the amount at issue is less than what the fees are going to cost to defend it, a lot of taxpayers may say, “I’ll just pay; I’ll consider this a cost of doing business” and pay the liability to move on.

Hamer: Perhaps it doesn’t have to be this way, but the reality is that the sanctions for tax violations [under the FCA] are over the top. Taxpayers are subject to treble damages *plus* substantial civil penalties, *plus* paying the

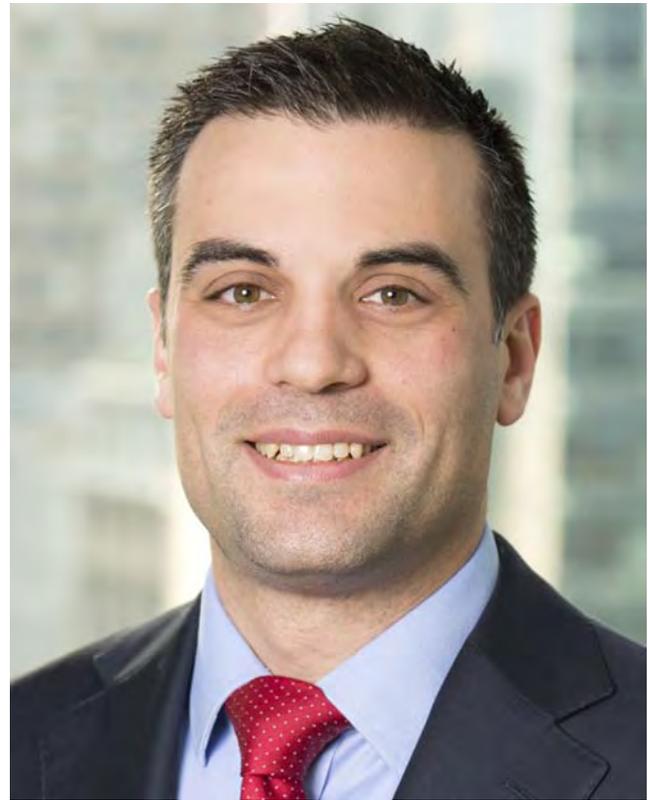
attorney's fees of the relator. The potential exposure is so high that many businesses, particularly smaller businesses, felt compelled to settle even if they did not violate the tax laws. Businesses in Illinois also faced substantial litigation costs because the relator was very adept at stringing out litigation and imposing discovery burdens.

The result was not to expose tax fraud, but in many cases, in effect, to shake down businesses. Now it may be that additional safeguards can be inserted into FCA statutes, but this is how it has played out in many cases in Illinois, and that's distressing.

Do: Let's pivot to some of the policy considerations. I've always thought that before you even consider expanding the FCA as a solution, you first have to consider whether there's really a problem. Brian and Helen (you have been very patient), can you weigh in on this concept of whether there is a problem of tax fraud?

Hamer: I believe that most taxpayers, both individuals and businesses, try to do the right thing. However, taxes are complicated and sometimes taxpayers get it wrong, and there's no question that some taxpayers engage in tax evasion. For both reasons, I would say it's important for every state to have a well-funded and highly trained tax department.

Helen Hecht: I would second what Brian is saying. I've been sitting here being patient (actually, it hasn't been that hard), thinking about what is the policy behind all this? And I'm remembering that we had discussions about the policy back as part of our Uniformity Committee work as well. Back then, we did think that fraud was a big concern. That is, is there fraud going on that the tax agency can't find? And understanding that fraud is hard even for financial auditors to find. So do we have people keeping two sets of books? Or do we have people who are not complying with the law in order to get an advantage over competitors? In that case, maybe the only way you will find that kind of fraud is by having somebody on the inside provide you with information. And following up on what Brian said, you're still going to need the tax agency to have the resources in order to address those issues and respond to fraud generally.



David Pope

Hamer: If I can just react briefly to what Helen said, at least the experience in Illinois has been that it's not insiders that have utilized the FCA to help ferret out tax fraud or bad conduct. The relator who brought the vast majority of actions certainly was not an insider.

Do: I'd also like to touch upon the notion that there is a tax gap. This concept seems to come from an annual report that's issued by the federal Treasury Inspector General for Tax Administration, and it estimates the difference between what the taxpayers owe and what is timely paid. Do you have any thoughts on whether there is any relationship between the tax gap and rampant fraud?

Hecht: Yeah, I studied the tax gap as part of the project we had to draft a model statute for sales and use tax notice and reporting, prior to *Wayfair*. One of the things that the IRS data has shown is that where you have a W-2 and withholding, or even a 1099 without withholding, noncompliance goes way down. So information reporting is a fairly simple tool to address fraud.

And I think another thing that comes out of sales and use tax compliance is that it's going to be pretty transparent whether or not the business is charging the tax, assuming there is a requirement to separately state the tax. So I don't know that I would call that "fraud" when a seller doesn't include the tax on the bill — since it's done openly. But what about on the income tax side? I know, for example, the IRS believed there was a fair amount of aggressive tax planning going on in partnerships. And that was one of the reasons for the partnership audit provisions that came out of the Bipartisan Budget Act. So that's another way to address fraud — make sure the state has the proper audit mechanisms.

But if, despite these tools, there's still fraud, I guess I wonder whether the FCA or whistleblower statutes really address the underlying problem and make the system better — or just accept the problems that give rise to fraud, without fixing them.

Dobay: So if the problem we are trying to fix is fraud, how do we do that? Helen or Brian, are either of you aware of any states that have an effective whistleblower program? My sense is that there isn't anything out there since the MTC, when it was looking at this issue, was looking at the IRS's whistleblower program.

Hecht: That's my recollection as well. We haven't looked at this issue closely since 2016, when we stopped our work on the issue. Then, we had looked at two approaches — the approach used by New York and by the IRS. We had officials from both New York and the IRS speak to us. At that time, the IRS whistleblower program was going through some changes to make it better. As I recall, those changes were meant to reduce the backlog of potential cases and to have a better process for sorting through information received by the IRS going forward — based on past experience.

What I took away from the IRS whistleblower program was that states would need to adapt it to their situation. And while the experience of the IRS was valuable, and its program is certainly the most developed, every state would need to think about how best to use that kind of program. Again, things like this take resources. And so at that time we said, well, the IRS is certainly far and away out in front of any of the states that might

have done something formally in this area and so that should be the thing that folks look at if they want to adopt something like that.

Dobay: I would think it would take much longer to get folks in a nontax agency up to speed on how to deal with fraud in the tax arena and that the better process is to have the folks within the tax agency, who already understand these issues on a fundamental level, take them on. Brian or Helen, do you have any thoughts on that?

Hecht: Someone has to weed out the disgruntled, you know, whatever you want to call them, and the competitors, and the people who don't really understand the law — and all the complaints that aren't really credible to begin with. Then, when someone comes forward with a credible claim and has documentation or information to back it up, you need to be able to decide whether it justifies putting audit resources on that case, rather than all the other places you could be putting your audit resources. And once you figure out which claims are credible and justify effort, then you'll have a taxpayer who has committed or is continuing to engage in significant fraud and, chances are, that's not going to be the easiest taxpayer to wrestle to the ground. These will be difficult cases to pursue. That's why I keep going back to this idea that if you believe fraud is inevitable, then these are the kinds of things you have to build into the system to address that fraud.

If, on the other hand, you believe as Brian and I do that most taxpayers want to do the right thing, or at least don't want to get into trouble, then you want a system where they know what to do and if they don't do it, it will be more obvious. So you build a system in which the rules are clear, where there is good transparency in reporting, and where you've got an agency that has enough staff to make sure that they can answer questions and tell taxpayers what they need to do. The alternative is trying to chase people down after the fact.

Do: Helen, those things that you're posing, do you think they also address noncompliance issues as well as tax fraud issues?

Hecht: Probably every situation of noncompliance has its own problems. It's an overused word, but every kind of noncompliance has some systemic underlying cause or context. In

the olden days, it was cash businesses that could easily keep two sets of books. And with technology, it's even easier to keep two sets of books. If that's the underlying issue, then we know what we have to do to attack that. But different types of fraud arise in different settings and you may need different tools to go after that fraud. For example, one area where states have experienced a lot of fraud is in tobacco taxes. There are a whole separate set of tools for addressing fraud in that area. But having private parties involved in fraud enforcement seems like a last resort. If you don't have any other tools or solutions, then this is perhaps the best tool you have. In other words, you might employ a whistleblower program in places where you don't have any other good options to address fraud.

Dobay: Before we move into the final thoughts, Helen, can you give us a brief recap on the MTC's prior work in this area?

Hecht: Right. So COST and the telecom industry came to us and said, when businesses have to charge taxes and then can be sued by customers either because they think tax was overcharged or charged incorrectly (the wrong rate, for example) — that makes their job a lot harder. And at the time (and I think it's less the case now) it wasn't always clear what the refund process was in every state for those kinds of taxes. Did the customer have to go to the seller first and get the tax back? Did the seller then have to claim a refund from the state? Did the seller have to give the tax back first before claiming the refund? All of those kinds of issues.

This was 2012 and the [American Bar Association] had a drafting group working on a model statute to take care of this issue. Under that model, if there was a question about the tax that was charged, there was a mechanism for getting that tax either refunded to the customer or clarifying that the right amount of tax was charged. We reviewed the model, and one of our members, Commissioner [Bruce] Johnson of Utah, was a member of that ABA working group. Ultimately, we decided that the model was a really good approach. And one of the things it did was to exempt sellers from any other legal action by customers who felt the wrong tax had been charged. Because there was a good refund mechanism, there didn't need to be any kind of *qui*

tam or false claims action. And the commission then adopted a resolution in 2015 recommending the ABA model — a five-year resolution that expires this year.

But that ABA model really works only for indirect taxes. It left open questions of what to do about underpaid direct taxes. And we looked at those issues for another year or so after we agreed to endorse the ABA model. But we didn't really expand beyond what I talked about earlier, which was getting both New York and the IRS to come in and give us presentations on their approaches. Ultimately, the staff recommended to the Executive Committee that if they did anything, it should pursue the whistleblower approach the IRS used. And in the end, we decided there wasn't a whole lot of interest in doing more than saying, "If you want to have a whistleblower program, you should look to what the IRS is doing."

Dobay: I've "heard" the Executive Committee will be taking this issue up as an agenda item at its next meeting in July. Obviously, COST would be very supportive of renewing that resolution and even strengthening it. Anything you can add on that?

Hecht: At the Executive Committee meeting in April, COST came forward and noted that our 2015 resolution on the ABA model was about to expire and asked whether we would consider extending and maybe expanding it. And the Executive Committee said, "Why don't you draft what you would like to see." And now we're looking at that draft. We expect to be able to go back to the Executive Committee and say, "This is what we've been asked to support" and then they can discuss. I'm glad you all have raised this issue, and I think this is the right approach.

Do: This has been such a great interview. Before we wrap this all up, does anyone have any predictions for what you think FCA expansion will be like in the future?

Hamer: I think it's going to be appealing to policymakers, I have to say. Something of a vicious circle may develop as revenue department budgets are reduced in response to fiscal pressures, although that may sound counterintuitive. So I will close by encouraging COST and other business organizations to advocate for adequate funding for revenue departments. Because if departments become less

effective, we will likely see more pressure to enact false claims statutes around the country to address the resulting noncompliance.

Hecht: I guess I can only second that and say I don't just think it's likely, I think it's inevitable. What we're hearing right now from the agencies around the country is they're having hiring freezes, and they have people who can't work very well remotely, and audits are on hold because taxpayers can't be in the office to deal with the audits, and legislators are saying we're going to have to make cuts.

And when you are faced with a situation like that, and someone says — “Hey, I've got an idea how we can deal with tax fraud without any government resources whatsoever. We can do these FCA cases where anybody can bring a case. And if they win, great, we get part of it. And if they lose, no skin off our back. And remember, these are all people who are supposedly committing fraud anyway, so let's get 'em.” I guess I can see half of the states saying that sounds like a good idea.

Wethekam: There is certainly a need for revenue. And as you look at the need for revenue, that departments are going to have their budgets cut, I think you're going to see a movement into this area; we need to put some safeguards in these statutes that really address tax.

Pope: I agree with what everyone is saying. Although I think the benefits claimed in supporting FCAs are oversimplified when compared to the detriments that will adversely affect taxpayers.

Dobay: So for the final question: Is the expansion of the FCA really the right approach to dealing with this issue?

Wethekam: Short answer, no, it is not. It is not the right approach to this.

Hamer: The right approach is to adequately fund revenue departments. That's in the interest of taxpayers collectively. And it's also in the interest of individual businesses, most of whom are trying to do the right thing since they benefit when their competitors come into compliance with the tax laws.

Hecht: Well, I'm reminded of a quote that I think has been misattributed to Churchill — that “America can be counted on to do the right thing after they've tried everything else.” That's like

saying the thing I found was in the last place I looked for it. Maybe what happens is that you learn what a bad idea something is by trying it, and then you do something that actually works. That's the only thing I know to explain it. Everyone I talked to in Illinois thinks their FCA system as it applies to tax issues is awful, but then they're the ones who have actually tried it. So maybe this is a sort of inevitable detour on the way to the right approach. Sorry!

Pope: I'll give a resounding no. ■