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## Tax Fraud And The FCA: 4 Takeaways From NY's Sprint Ruling

Law360, New York (November 3, 2015, 10:49 AM ET) -- On Oct. 20, 2015, the New York Court of Appeals affirmed that the New York attorney general could continue a whistleblower-initiated tax False Claims Act case alleging that Sprint Corp. knowingly failed to collect and pay more than \$100 million in New York state and local sales taxes on its flat-rate monthly cell phone charges.[1] The decision brought to a close the motion practice about the sufficiency of the pleadings in the first tax-related case under the New York False Claims Act to go public.



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New York's False Claims Act explicitly applies to knowing violations of state and local tax laws. Like other False Claims Acts, it mandates treble damages where a defendant's knowingly false or fraudulent conduct has impaired the government's funds, along with civil penalties. It also allows whistleblowers to file suit on behalf of the government and receive an award of between 15 and 30 percent of the proceeds.

The New York act became applicable to tax violations in August 2010, when it was amended to remove an explicit tax bar, replacing it with explicit application to tax violations. The Sprint case has been closely watched for a number of reasons: it was the first public tax case under the New York False Claims Act; it was initiated by a whistleblower; it involves large sums of money (the attorney general has stated that Sprint's liability could be \$400 million); and Sprint's legal arguments suggested a fundamentally narrow scope of the False Claims Act in general.

In April 2012, the New York attorney general took over the whistleblower's case against Sprint and converted it into a government enforcement action, adopting the whistleblower's False Claims Act allegations and adding claims for violations of the New York Tax Law for failing to pay taxes (after obtaining a referral from the tax department) and the New York Executive Law for repeated fraudulent or illegal acts. Sprint's motion to dismiss asserted that it had not violated the tax law, but that even if it had, (1) it could not have violated the False Claims Act by "knowingly" violating the law because there was a reasonable interpretation of the law that allowed Sprint to engage in the tax practice at issue, and (2) the False Claims Act could not be applied retroactively before 2010 without running afoul of the ex post facto clause of the United States Constitution. The trial court and the Appellate Division rejected Sprint's motion and Sprint was granted leave to appeal to the Court of Appeals.[2]

In addition to ruling that Sprint's tax liability was unambiguous, the court held that the attorney general adequately alleged that Sprint knowingly violated the False Claims Act and that the act was not so punitive as to implicate the ex post facto clause to bar its

retroactive application. Four judges joined the majority decision written by Chief Judge Jonathan Lippman, with one judge dissenting in part, but agreeing that the attorney general's causes of action should proceed beyond the pleading stage.

The conclusion of this hard-fought motion to dismiss has several implications for tax enforcement and tax compliance using the False Claims Act, which are addressed in this article.

### ***1. Knowing Tax Violations Are Subject to the Same Rules as Other Knowing Violations Claimed to Deprive the Government of Funds***

The New York False Claims Act was amended in 2010 to add tax claims. As a result, alleged tax schemes are subject to the same rules and standards as other claimed rip-offs of government money. There are a few special tax rules built into the act, such as minimum dollar thresholds for tax claims,<sup>[3]</sup> but the elements of a violation are the same as they are in other cases involving, for example, Medicaid rules and procurement rules, whether they be simple rules or complex ones.

In the Sprint case, some of the defense-side amici argued that a different set of rules should apply to taxes, largely because tax policy and authority should reside in the administrative agency with expertise on the subject (even though the same can presumably be said for issues involving Medicaid and procurement issues). The court, however, did not create any new set of rules for tax cases. It applied the same set of rules that apply generally.

In its decision, the Court of Appeals recognized that the government has a "high burden to surmount" to demonstrate violations of the False Claims Act because simply proving that there was a tax violation is not enough. Rather, as in all False Claims Act cases, the government (or a whistleblower pursuing claims on its behalf) must plead and eventually prove that the violations were "knowing." Under the act, a violation is "knowing" when it was done with actual knowledge, reckless disregard for the truth or deliberate ignorance of the truth. The court concluded that the attorney general's complaint against Sprint satisfied this pleading burden and the case can move forward.

### ***2. Proving "Knowledge" in a False Claims Act Case, Including Tax Cases, Requires an Inquiry into the Defendants' Mind Set at the Time of the Claimed Violations, Not into Later Interpretations***

Sprint argued in its motion that the attorney general could not plead a "knowing" violation because Sprint offered a current interpretation of the sales tax provision at issue that it described as reasonable. Sprint did not assert that it relied on this interpretation when it stopped collecting the sales taxes at issue in 2005.

The Court of Appeals rejected Sprint's attempt to create a "safe harbor" divorced from an evaluation of Sprint's mind set at the time it made its decisions about the sales tax. It ruled that "Sprint will have to substantiate in further proceedings that it actually held such reasonable belief and actually acted upon it."<sup>[4]</sup>

### ***3. There are Plenty of Clear Tax Obligations That Can Be the Subject of Tax False Claims Act Cases***

Some commentators have argued that, as a policy matter, the False Claims Act should not apply to tax violations because tax law is riddled with gray areas. The Court of Appeals demonstrated that not every tax law is so riddled. In the Sprint case, it concluded that the sales tax provision was unambiguous and thus that Sprint is held to its terms.

Some tax rules may be ambiguous. Depending on the specific facts of a case, ambiguity

might or might not serve to obviate proof of a “knowing” violation and scuttle a False Claims Act cause of action. Many tax rules, however, are quite clear and unambiguous. Some of these straightforward rules have already been at play in publicly announced resolutions of tax whistleblower cases under the New York False Claims Act. These include the criminal plea and \$5.5 million civil settlement by a custom tailor who was claimed to have charged sales taxes that he kept for himself and who understated his personal income on his tax returns,[5] and a medical imaging company that had New York operations but nevertheless failed to allocate any of its income to New York and paid no New York taxes.[6] It is notable that there has not been a deluge of tax False Claims Act cases, which suggests that the dollar thresholds are keeping the cases focused on bigger frauds and that the attorney general’s office, together with the tax department, is carefully vetting the whistleblower filings before converting claims into government enforcement actions.

#### **4. Tax Enforcement Has an Important New Tool**

The court’s decision removes uncertainty that had surrounded tax claims under the False Claims Act, including what standards might apply to establishing the elements of violations when taxes are involved and whether retroactive claims are barred. Now that the court has ruled, it is clear that whistleblowers can play an important role in bringing out the most serious tax violations — the ones that were done with knowledge and that involve larger dollar amounts.

The pivotal advantage that whistleblowers can provide over tax agency-based audit and enforcement programs is access to knowledge and information. It is one thing for an enforcement agency to rely on audits of certain taxpayers and on tips from the public. It is another thing entirely for persons with a window into knowing tax violations to have a clear whistleblower incentive to bring forward specific information about particular tax schemes. Whistleblowers can, for example, provide enforcers with information about secret bank accounts or data systems that can establish fraud. Others can give the inside view on ways that a business might have been misleading tax auditors in an effort to avoid focus on its misconduct. Moreover, the mere possibility that persons, whether from inside or outside an organization, might raise tax violations can serve as a check on those who might engage in them in the first place. The chances of being caught are now much higher.

—By Randall M. Fox, Kirby McInerney LLP

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***DISCLOSURE: While at the New York attorney general’s office, the author worked on the Sprint case discussed here.***

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[1] People of the State of New York v. Sprint-Nextel Corp., 2015 NY Slip Op. 07574 (Oct. 20, 2015) (the “Sprint Decision”).

[2] See People of the State of New York v. Sprint-Nextel Corp., 114 A.D.3d 622 (1st Dep’t 2014); People of the State of New York v. Sprint-Nextel Corp., 41 Misc. 3d 511 (N.Y. Cty. Supreme 2013). While the trial court largely denied the motion to dismiss, it did dismiss

False Claims Act conspiracy claims on the ground that Sprint entities could not conspire among themselves.

[3] See N.Y. State Fin. Law § 189(4).

[4] Sprint Decision at 14.

[5] New York Attorney General Press Release, "A.G. Schneiderman Announces Arrest, Conviction And \$5.5 Million Settlement In Tax Fraud Case Against Prominent Tailor," March 5, 2013, available at <http://www.ag.ny.gov/press-release/ag-schneiderman-announces-arrest-conviction-and-55-million-settlement-tax-fraud-case>.

[6] New York Attorney General Press Release, "A.G. Schneiderman Announces \$6.2 Million Settlement with Lantheus Medical Imaging & Bristol-Myers Squibb For Failing To Pay New York Corporate Income Taxes," March 14, 2014, available at <http://www.ag.ny.gov/press-release/ag-schneiderman-announces-62-million-settlementwith-lantheus-medical-imaging-bristol>.

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