False Claims Amendment Act of 2017,

Bill 22-166

Before the

Committee of the Whole
Council of the District of Columbia
The Honorable Phil Mendelson, Chair

December 20, 2018, 9:30 A.M.
John A. Wilson Building, Room 412

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Good morning, Chairman Mendelson, and members of the Committee of the Whole. I am Alan C. Levine, Chief Counsel for the Office of Tax and Revenue ("OTR"). I am pleased to present testimony today on Bill 22-166, the "False Claims Amendment Act of 2017" (the "Bill").

The District's False Claims Act ("FCA") allows court actions to be taken against those making false claims to the District Government for the purpose of improperly obtaining or retaining government funds. The District's FCA, enacted in 1986, is "based on a similar California statute which in turn was derived in large part from the federal false claims and qui tam statutes." *Report on Bill 11-705, The Procurement Reform Amendment Act of 1996,* at page 8 (September 24, 1996). Tax matters are expressly exempted in the Federal False Claims Act. *See* 31 U.S.C. Section 3729(d). The legislative history of the Federal False Claims Act clearly indicates that Congress did not think it appropriate to include taxation within the reach of the *Federal False Claims Act. Senate Report* (Judiciary Committee) 99–345, at 5283 (1986).

The Bill amends the FCA to make it applicable to taxation matters above certain thresholds. False claims actions would be allowed only where the taxpayer has net income, sales, or revenue of $1 million or more and the damages alleged are $350,000 or more. OTR anticipates administrative and legal issues to implement the Bill as written. A number of these issues have been addressed in the tax press and in various law review articles over the years, several of which are attached to my testimony.

First, expanding the FCA to include "taxation" infringes on the Chief Financial Officer's exclusive authority for "levying and collection of all taxes," granted under Section 424(d)(10) of the Home Rule Act. As the Chief Financial Officer's authority to collect taxes arises from the Home Rule Act, it may require Congressional legislation to amend this authority.

Second, including taxation in the FCA could create parallel enforcement actions for tax cases. For example, when the Office of the Attorney General ("OAG") accepts an FCA matter there could be both an audit and an FCA case. OTR's Audit Division, with industry specific-ability to efficiently process large and complex tax matters, may be able to resolve the audit and settle with a taxpayer with minimal time and effort, or, alternatively, issue a proposed notice of assessment. However, OAG may not be as familiar with auditing the complex tax matters at issue, delaying the resolution of the case, which could be expensive and burdensome to both the District and the taxpayer. As pointed out in one of the articles attached to my testimony:

> Tax Department audits of large corporations are usually conducted by teams of auditors who know the industry and who may have audited the particular

> taxpayer in previous audit cycles. The tax auditors are experienced and know the law, the regulations, and the other authorities. They are familiar with the issues that are likely to be presented by a corporation's tax returns. The [New York Attorney General's Office ("AGO")], in contrast, typically will not be familiar with those issues and, as a result, its investigations is likely to be inefficient and time-consuming.… [resulting in] a separate administrative structure for enforcing the tax law that is expensive and burdensome and that is wholly unnecessary.
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> *Extending State False Claims Acts to Tax Matters Is a Bad Idea*, Bloomberg Daily Tax Report: State, April 26, 2017.

The Multistate Tax Commission ("MTC") and the American Bar Association ("ABA") both oppose including tax matters in false claims actions since they result in non-tax agencies conducting tax administration. The MTC and the ABA have expressed the view that false claims statutes encourage under-collection by vendors in order to avoid a false claim action against them. As the ABA noted:

> Sellers collecting state and local transaction taxes face two main liability risks: First, if sellers fail to collect sufficient tax, they face liability risks attributable to audit assessments. Second, if sellers over-collect or collect for the wrong jurisdiction, they face potential actions and lawsuits filed on

> behalf of purchasers or pursuant to consumer protection statutes….
> Exposure to lawsuits will increase the cost of collection and will discourage some retailers from voluntarily collecting state and local transaction taxes.
>
> *American Bar Association Transaction Tax Overpayment Model Act Report* at page 6 (February 2011).

Third, allowing tax matters to be subject to false claims actions has led to numerous questionable lawsuits in other jurisdictions. For example, in Illinois, "[a] single Chicago-based law firm brought approximately 62 actions claiming each defendant taxpayer violated the Illinois Whistleblower Act[.]" *A Recipe For Bad Tax Policy: False Claims Acts And State Taxation*, Journal of Multistate Taxation 14, January 2013. Tax officials in Illinois have stated that number has expanded to approximately 1,000 lawsuits of questionable validity. *Court Tosses Fees for 'King of Qui Tam,' Business Model Done?*, Bloomberg Daily Tax Report: State, June 16, 2017. New York tax officials have indicated that many suits have been brought by "relators"[1] or "whistleblowers" with questionable motives.

Fourth, the Bill may be unnecessary since the District already offers a reward of up to 10 percent of the proceeds collected for supplying information regarding tax violations. *See* D.C. Official Code Section 47-4111. This approach is

[1] The term or definition of "relator" as used in the qui tam provision of the False Claims Act means one who relates to the government the fraud being committed against the government.

similar, in some respects, to the method used at the federal level. The Internal Revenue Service ("IRS") administers a "whistleblower awards program" which provides rewards to individuals that report to the IRS detailed information about tax violations. The reward for this information is between 15 and 30 percent of the amount collected. *See* IRC Section 7623(b)(1). This approach places the review of tax information under the purview of the IRS and it decides which whistleblower cases to pursue. Thus, this program acknowledges that the taxing authority has unique expertise in tax matters and is the most appropriate agency to handle these cases. The IRS statute permits a whistleblower the right to contest the award in U.S. Tax Court.

Thank you, Chairman Mendelson for the opportunity to comment on the Bill. I am happy to answer any questions at this time.

ATTACHMENTS

News

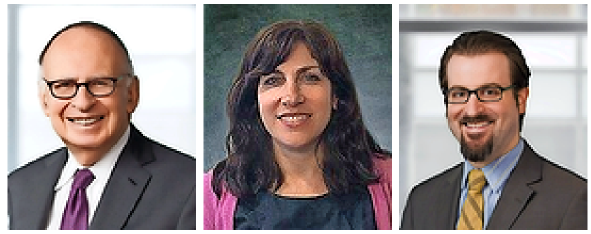
April 26, 2017

Viewpoint: Extending State False Claims Acts to Tax Matters Is a Bad Idea

From Daily Tax Report: State

Tax Policy

A number of state False Claims Acts allow individuals to pursue “qui tam” whistleblower suits against delinquent taxpayers. In this article, McDermott Will & Emery's Peter Faber, Alysse McLoughlin and Mark Yopp discuss these actions and argue that False Claims Act proceedings are expensive, burdensome and wholly unnecessary as an added enforcement mechanism.



By Peter L. Faber, Alysse McLoughlin and Mark W. Yopp

Peter L. Faber, Alysse McLoughlin, and Mark W, Yopp are partners in McDermott Will & Emery's state and local tax practice.

An article in the April 19 *Daily Tax Report: State* about New York's settlement of a large tax whistleblower case quotes a number of attorneys who recommend that other states should follow New York's lead in applying False Claims Act statutes to tax cases. This is a bad idea.

While it is true that New York State has raised significant amounts of money in pursuing whistleblower suits against taxpayers, the issue is whether using False Claims Acts to pursue delinquent taxpayers is an appropriate means of enforcing the tax laws. The same dollars might have been raised by audits of the taxpayers by the Department of Taxation and Finance following normal audit procedures. All of the states have competent departments of revenue and laws that provide for collecting taxes from delinquent taxpayers, including civil fraud and criminal penalties where appropriate. Are False Claims Acts needed as additional enforcement mechanisms? We submit that they are not.

As state and local tax specialists, we handle tax audits, appeals, and litigation around the Country. We can testify from personal experience that state revenue departments vigorously enforce the tax laws. Their auditors and other professionals are competent and hard-working. They conduct tax proceedings professionally and efficiently. Moreover, state tax statutes typically provide not only for enforcement procedures but for significant penalties for negligence and fraud and taxpayers that engage in criminal tax conduct can and do go to jail.

Cumbersome, Burdensome, Wholly Unnecessary

The extension of New York State's False Claims Act to tax cases in 2010 has produced a separate enforcement structure that exists alongside the normal tax audit structure. This structure is cumbersome and expensive and is wholly unnecessary. Let's look at how the structure works.

Under the New York State False Claims Act, a whistleblower, or the Attorney General on his own initiative, can commence a legal action against an individual or a company that they believe has not complied with the tax law. Whistleblower cases typically begin with a complaint filed under seal by an individual whistleblower. The Attorney General is notified about the complaint and may intervene and take over the case if he feels that this would be appropriate. If he does not, the individual whistleblower is free to continue the action separately. This is what has happened in a case involving Citicorp, in which a whistleblower alleging a violation of federal tax law that became a New York State tax issue because New York State generally conforms to the federal definition of taxable income has sued Citicorp for hundreds of millions of dollars under the False Claims Act despite the fact that both the Internal Revenue Service and the New York State Department of Taxation and Finance felt that his claim was wholly without merit. Even if the Attorney General decides to take over a case, the Attorney General's Office (AGO) lacks substantial tax expertise. While the AGO has been willing to consult with the New York State Department of Taxation and Finance and the New York City Department of Finance in particular cases, it has maintained control over the handling of those cases. We have had cases in which the AGO has conducted extensive and costly investigations of issues that the State and City tax authorities would have immediately recognized were routine matters to be handled in audits without any suggestion of penalties.

High Stakes, Treble Damages

The stakes are high in False Claims Act proceedings. A taxpayer can be liable for treble damages in these cases, even if its conduct was not fraudulent. The standard for liability under New York's False Claims Act is whether there was a “reckless disregard” of the tax laws, and the AGO in several cases has taken the position that a mere failure to seek outside tax advice indicated such a “reckless disregard” even though the taxpayer's in-house tax people were confident, based on past practice and prior audits, that the tax returns that they were filing were correct. The New York State Court of Appeals, the State's highest court, has held in People ex rel Schneiderman v. Sprint Nextel Corp., 42 N.E.3d 655 (N.Y. CT. App. 2015) that the fact that a taxpayer's position is objectively reasonable is no defense against False Claims Act liability if it turns out that the Tax Department and the courts disagree with that position, even though the position was adopted in a good faith belief that it was correct.

The New York False Claims Act has a ten-year statute of limitations. Since a corporation must show that it made a good faith effort to determine that its tax treatment of an item was correct to avoid being charged with a “reckless disregard” of the tax law, this may place an impossible burden on corporations when the people who made the decisions years before have died or are no longer employed by the taxpayer.

Tax Audit No Bar

The fact of a prior State Tax Department audit that addressed the issues and approved the taxpayer's positions does not bar a False Claims Act proceeding. We have had cases in which the fact that the taxpayer was currently being audited by the State Tax Department did not stop the AGO from conducting its own independent investigation.

False Claims Act proceedings are more formal and adversarial than are Tax Department audits. Information is often requested through formal subpoenas that may be sweeping in scope because the AGO may be unfamiliar with the kinds of records that taxpayers typically keep. Tax Department audits of large corporations are usually conducted by teams of auditors who know the industry and who may have audited the particular taxpayer in previous audit cycles. The tax auditors are experienced and know the law, the regulations, and the other authorities. They are familiar with the issues that are likely to be presented by a corporation's tax returns. The AGO, in contrast, typically will not be familiar with those issues and, as a result, its investigation is likely to be inefficient and time-consuming.

Fatal Blow to Voluntary Disclosure

Most states have a voluntary disclosure agreement procedure under which a company that believes that it may have understated its tax liabilities for prior years can come forward voluntarily and reach agreement with the state tax department that it will begin filing returns, or file them correctly, going forward with liabilities for prior periods being limited to the last few years and with a waiver of penalties. State revenue departments have encouraged these procedures because they get delinquent taxpayers back on the rolls. Under the New York False Claims Act, getting a voluntary disclosure agreement does not shield a taxpayer from False Claims Act liability for treble damages with a 10-year statute of limitations. This could deal a fatal blow to the State's voluntary disclosure agreement process. Would a company that had not filed tax returns in New York because of a good faith belief that it lacked taxable nexus with the State but that was concerned about whether that position was correct come forward and request a voluntary disclosure agreement if it knew that, even though the State Tax Department would only assess liabilities for the past three years, the Attorney General could assess liabilities, including treble damages, for the past ten years?

right answer is that they should report their suspicions to the state department of revenue and the department should determine whether the taxpayer in question should be audited and should pay additional taxes, using its normal audit procedures and applying, if appropriate, the civil and criminal penalties set forth in the tax laws. If the revenue department chooses to compensate a whistleblower, that would be fine, but the revenue department, not the AGO or some private party, should make the determination as to whether to proceed against the taxpayer. This is how the federal system works. If someone feels that a company has not been paying its correct federal taxes, he or she notifies the Internal Revenue Service and the Service, if it feels it appropriate, takes enforcement action under the regular tax law procedures. The whistleblower may be entitled to compensation. In other words, there is no need to set up a parallel enforcement structure with draconian penalties and cumbersome and expensive procedures to accommodate a scheme in which people are encouraged to blow the whistle on delinquent taxpayers.

If people feel that state revenue departments are not doing an adequate job of enforcing the tax laws, the remedy is to give them more resources to do so. Giving state revenue departments the funds to expand their audit staffs and modernize their auditing and collection procedures is the right way to do this. Setting up a parallel enforcement

New York State Tax Department audits are conducted with due regard for taxpayer privacy concerns. In fact, the Department itself has insisted on having tight non-disclosure provisions in closing agreements that conclude audits. This enables the parties to have frank and candid discussions of issues, with taxpayers feeling free to disclose to Tax Department auditors documents and other materials that are highly confidential. The AGO is under no such constraints. In fact, when the AGO has been asked to agree to the same privacy standards that apply to the Department, it has explicitly refused to do so. A False Claims Act investigation typically ends with a press release and perhaps a press conference by the AGO. We can testify from personal experience that this can affect the conduct of a proceeding.

We do not mean to be critical of the attorneys in the New York AGO's Taxpayer Protection Bureau. They are smart, conscientious professionals, and they are carrying out their responsibilities effectively. But we are critical of the law that has created a separate administrative structure for enforcing the tax law that is expensive and burdensome and that is wholly unnecessary.

Parallel Enforcement Not Needed

We are not suggesting that whistleblowers be discouraged or that they do not play a significant role in enforcing the tax laws. The issue is: how should whistleblower matters be handled administratively and how should the whistleblowers be compensated? The

AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT TO THE HOUSE OF DELEGATES

<u>RESOLUTION</u>

1 RESOLVED, That the American Bar Association adopts the Model Transactional Tax Overpayment Act, dated February 2011, and recommends its adoption by appropriate legislative bodies.

TRANSACTION TAX OVERPAYMENT MODEL ACT PROJECT

Section 1. Title.

This Act may be cited as the Transaction Tax Overpayment Act.

Section 2. Statement of Purpose and Scope.

This Act applies to state and local taxes that a seller is required to collect from a purchaser on taxable sales. The Act outlines procedures a purchaser may use to seek a refund of an overpayment of those state and local taxes; limits the ability of a purchaser to assert claims against a seller arising from or in any way related to an overpayment; and establishes rights and obligations of purchasers, sellers, and the taxing jurisdiction with respect to such overpayments.

Section 3. Definitions.

As used in this Act:

(a) (1) The term "overpayment" means an amount charged by a seller to a purchaser as tax, paid by the purchaser to the seller, and remitted by the seller to a taxing jurisdiction, if and to the extent that such amount was paid by the purchaser--

(A) in error, including those instances in which the transaction would not have been subject to tax if the purchaser had presented an exemption or resale certificate or other documentation at the time of sale,

(B) when no tax was lawfully due to such taxing jurisdiction at the time of sale, or

(C) in an amount greater than the amount of tax that was lawfully due to such taxing jurisdiction at the time of sale.

(2) The term "overpayment" shall not include a payment of tax to a seller for which an exemption may be available but where entitlement to the exemption is conditioned on the purchaser paying the tax at the time of sale and seeking a refund directly from the taxing jurisdiction.

(b) The term "purchaser" means a person who has been charged an amount by the seller as tax and who has paid, or who is responsible for another person's having paid, such amount to the seller.

(c) (1) The term "refund" means the payment by the seller or the taxing jurisdiction to the purchaser of an overpayment, or by the taxing jurisdiction to the seller of an amount representing an overpayment.

(2) In the case of a refund paid by the seller to the purchaser, or by the taxing jurisdiction to the seller, the term “refund” shall include a credit if and to the extent that—

(A) there is, at the time the credit is issued, a balance on the recipient’s account against which to apply the credit, or

(B) the recipient consents to a credit applied to such recipient’s account.

(d) The term “purchase” or “sale” means any transaction on which the seller charges the purchaser an amount as tax, collects such amount from or on behalf of the purchaser, and remits such amount to the taxing jurisdiction.

(e) The term “seller” means a person licensed or registered under applicable law to make taxable sales and with respect to such taxable sales is required to collect tax from purchasers and remit such tax to the taxing jurisdiction.

(f) The term “tax” means the tax imposed by *[identify by statutory reference the tax or taxes to which this Act applies]*.[1]

(g) The term “taxing jurisdiction” means the State of _________, or the city, county or other local jurisdiction of such State,[2] that imposes the subject tax; provided, however, that in the event the governmental entity imposing the subject tax is different from the governmental entity responsible for administration of such tax, the term “taxing jurisdiction” shall include, as the context requires, the governmental entity that is responsible for administration of such tax.

Section 4. Purchaser Recourse.

(a) The provisions of this Act apply to any claim by a purchaser against a seller arising from or in any way related to an overpayment, regardless of whether or not such claim is characterized as a tax refund claim.

(b) The relief with respect to any claim by a purchaser against a seller related to an overpayment shall be limited to a refund claim pursuant to Section 5(a)(1).

(c) In any action that arises from or relates to an overpayment, the seller shall not be named as a party to such action by either the purchaser, the taxing jurisdiction or any other party to such action. Nothing in this Act shall preclude a government agency or official from exercising any powers such agency or official possesses to take action to prevent continuing over-collection of tax.

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[1] It is intended that this Act would apply to all transaction taxes that the seller is required to add to the sales price of taxable goods, products or services, collect from the purchaser, and remit to the taxing jurisdiction. The Act could also apply to fees and other impositions that have these characteristics.

[2] This Act could be adopted by any U.S. jurisdiction that imposes a transaction tax; and therefore the term “State” is intended to include not only any state of the United States but also other jurisdictions, such as the District of Columbia and Puerto Rico.

(d) Nothing in this Act shall limit any rights or remedies the purchaser may have against the taxing jurisdiction arising from any overpayment under tax refund statutes or other applicable law.

Section 5. Refund Procedures.

(a) (1) A purchaser seeking a refund of an overpayment may, within *[applicable limitations period]* of payment of such amount to the seller, file a refund claim with such seller by providing the seller written notice of the claim, and including with such notice information reasonably necessary for the seller to determine whether all or part of the amount claimed constitutes an overpayment. The seller may, within ninety (90) days following receipt of such notice, refund the amount claimed by the purchaser or such other amount that the seller has determined to be an overpayment. If the seller has not, within ninety (90) days of receiving notice of a refund claim from the purchaser, refunded the amount claimed by the purchaser, the seller shall be deemed to have denied the claim with respect to such amounts not refunded to the purchaser. Notwithstanding any provision of law to the contrary, no interest shall accrue or be paid with respect to amounts refunded by a seller to a purchaser except as provided in Section 5(d)(2).

(2) A purchaser seeking a refund of an overpayment may, within *[limitations period]*, file a refund claim with the taxing jurisdiction pursuant to subsection (b) if—

(A) Such purchaser did not previously file a refund claim with the seller pursuant to this subsection, or

(B) Such purchaser previously filed a refund claim with the seller under this subsection and all or part of such claim was denied or deemed denied; provided, however, that the filing by a purchaser of a refund claim with the seller under this subsection shall extend for one hundred twenty (120) days the limitations period for such purchaser to file a refund claim with the taxing jurisdiction.

(b) A refund claim filed by a purchaser with the taxing jurisdiction shall be in writing and shall include the information reasonably required by the taxing jurisdiction, which may include, but is not limited to, the purchaser's name and address, the name and address of the seller, the amount of the claimed overpayment that has not previously been refunded by the seller (or a reasonable estimate thereof), the approximate date or dates of the claimed overpayment, evidence that the amount claimed was paid to the seller, and a brief explanation of why the purchaser believes that the amount claimed constitutes an overpayment.

(c) (1) The taxing jurisdiction shall, within ninety days following receipt of a refund claim from a purchaser, notify the purchaser in writing of any specific information or records needed for purposes of determining whether and in what amount an overpayment was made.

(2) The taxing jurisdiction may seek information, documents or records in the seller's possession that are needed in processing the purchaser's refund claim; provided,

however, that any such requests must be consistent with the taxing jurisdiction's authority to examine the seller's books and records to determine whether the correct amount of tax has been remitted.

(3) (A) The taxing jurisdiction shall notify the purchaser in writing of its determination with respect to the purchaser's refund claim.

(B) If the purchaser's refund claim is approved in whole or in part, and such approval is based on a new policy or interpretation that would apply to the tax treatment of other transactions, the taxing jurisdiction shall provide guidance concerning such policy or interpretation in the manner generally used for providing informal guidance to taxpayers with respect to the subject tax.

(C) If the purchaser's refund claim is denied in whole or in part, the notification shall include the specific legal and factual reasons for denial. A purchaser's refund claim shall be deemed to have been denied if the taxing jurisdiction does not approve or deny such refund claim within six (6) months of the later of (i) the taxing jurisdiction's receipt of the purchaser's refund claim, or (ii) the taxing jurisdiction's receipt of the purchaser's response to a request for information or records made by the taxing jurisdiction pursuant to this subsection.

(4) If the taxing jurisdiction determines that an overpayment was made, the taxing jurisdiction shall refund such amount to the purchaser and shall allow and pay interest on such amount for the time period and at the rate prescribed by law for overpayments of the subject tax.

(d) Nothing in this Act shall be construed to preclude a seller from acting on its own initiative to refund to a purchaser an overpayment that the seller has determined to have been made or to file a refund claim with the taxing jurisdiction in its own name and have the taxing jurisdiction determine whether an overpayment was made by ruling on such refund claim. Notwithstanding the foregoing, a seller that has received a ruling on a refund claim that an overpayment was made shall only be entitled to receive a refund of such overpayment from the taxing jurisdiction if such seller either—

(1) establishes that the seller has refunded the overpayment to the purchaser or purchasers from whom the amount was collected; or

(2) agrees that, within 30 days or such longer period agreed to by the taxing jurisdiction, the seller will refund the overpayment to the purchaser or purchasers from whom the amount was collected, together with any interest paid by the taxing jurisdiction.

(e) A seller that has previously refunded an overpayment to a purchaser may, within *[the applicable limitations period]*, file a refund claim or take credit for the amount of such overpayment against remittances of the tax; provided, however, that any such credit shall be subject to examination by the taxing jurisdiction, and provided further that the seller shall not be allowed or paid any interest on such amount for the period of time prior to the date the seller refunded the overpayment to the purchaser, and on or after that date interest shall be paid only in accordance with applicable law.

(f) Nothing in this Act shall be construed to preclude a seller from obtaining a refund of an overpayment from a taxing jurisdiction if such seller establishes that it is obligated to pay or has paid tax in the amount of such overpayment on the same transaction(s) to another taxing jurisdiction pursuant to a valid assessment or claim by such other taxing jurisdiction.

(g) The taxing jurisdiction may establish procedures for assuring that the amount of any overpayment is not refunded by the taxing jurisdiction to both the seller and the purchaser, as well as other procedures necessary to administer this Act.

(h) In the event that a taxing jurisdiction determines, in connection with three or more refund claims from purchasers that it has approved, that there are numerous similar transactions with respect to which tax should not have been collected, the taxing jurisdiction shall send written or electronic notice to all affected registered sellers advising them not to collect tax on such transactions. The taxing jurisdiction shall also post an announcement prominently on its official website notifying affected purchasers of the procedures they must follow in order to request a refund of tax on any such purchase transactions.

REPORT

I. Introduction

A topic of concern to sellers, purchasers and state and local governments alike is seller liability and purchaser remedy procedures for overpaid transaction tax. The conflicting interests of sellers, purchasers and state and local government call for legislation that balances such interests. The attached model, the "Transaction Tax Overpayment Model Act," attempts to resolve these issues in the manner best-suited to addressing the needs of all interested parties. By using the term "transaction tax," we are referring to state and local taxes that a seller is required to collect from a purchaser on taxable sales.

Sellers collecting state and local transaction taxes face two main liability risks: First, if sellers fail to collect sufficient tax, they face liability risks attributable to audit assessments. Second, if sellers over-collect or collect for the wrong jurisdiction, they face potential actions and lawsuits filed on behalf of purchasers or pursuant to consumer protection statutes. These lawsuits can also name state and local governments as codefendants.

Purchaser liability actions relating to collection and administration of state and local transaction taxes generally fall under three main categories: jurisdictional rate assignments, sourcing conventions and product/service taxability.

Sellers often successfully defend against these actions because they used due diligence and remitted the funds to the taxing jurisdictions. Sellers do not benefit from any over-collection because they remitted in full the taxes collected to the taxing jurisdictions. However, even a successful defense is not without costs to the seller. These costs can add up to significant amounts for large sellers. Exposure to lawsuits will increase the cost of collection and will discourage some retailers from voluntarily collecting state and local transaction taxes. It is in the interest of both state and local governments and sellers and purchasers to address liability risks resulting from complying with state and local transaction tax provisions.

Common themes in recent cases and emerging issues in the area of seller liability for transaction tax collection duties include:

1. Most of the recent cases are class actions, with the plaintiffs/purchasers suing the defendant/seller for improperly collecting a state or local transaction tax from the plaintiffs/purchasers.

2. The typical forum is not a tax tribunal, but rather a state trial court of general jurisdiction.

3. Typically, the taxing authority is not a party to the case.

4. In many cases, the court must first decide whether the relevant tax applies to the transaction at hand. In these cases, a non-tax tribunal is deciding the threshold tax issue without the input of the taxing authority.

Even though consideration was given to whether the Streamlined Sales and Use Tax Agreement ("SSUTA") had made seller liability issues moot in the area of sales and use tax collection, SSUTA clearly contemplated a consumer action as a second level/stage remedy, Ultimately, it was concluded that, although SSUTA attempted to balance the rights of purchasers, sellers and state and local governments, it does not resolve all of the problems in this area. The SSUTA is generally silent on refund procedures, but it does require member states whose laws allow consumers to seek refunds from sellers to adopt two seller-protection provisions. That is, SSUTA contemplates that some states will have pre-existing mechanisms for allowing some type of purchaser claims against the seller and does not deprive the purchaser of recourse against an adverse determination of the seller. The 60-day notice language of SSUTA provides additional protection to sellers in those states where it is already clear that state customers have a valid cause of action against the sellers. Unfortunately, in other states where this is not clear, the SSUTA provision appears to enhance the risk of consumer suits. Accordingly, the draft model legislation is consistent with SSUTA while, at the same time, providing an exclusive remedy for a purchaser to obtain a refund of over-collected tax.

Competing public policy concerns regarding the topic of seller exposure to class actions, consumer protection claims, claims for unfair trade practices, etc. have to be taken into account in any model legislation. These concerns include:

1. Difficulties presented when highly technical tax issues are adjudicated in non-tax forums by non-tax lawyers and, perhaps, without involvement of the state revenue departments who are the real parties in interest.

2. Potential chilling effect of the threat of litigation on seller decisions whether to tax a transaction, i.e., incentive to avoid taxing in close cases.

3. Subjecting a seller to material defense costs when it is not the real party in interest with respect to collected taxes may seem unfair and, again, a deterrent to diligent tax collection efforts.

4. The likelihood that consumers who are overcharged taxes in relatively small amounts will not have any effective recourse if they cannot be represented in class actions brought either against retailers or revenue authorities.

5. The impracticality of maintaining refund claims against revenue authorities by groups of small taxpayers other than through the class action approach, i.e., practical problems with lawyers representing large groups of small taxpayers before the revenue departments, difficulty of mobilizing such groups, privacy concerns, decision-making, etc.

"Governing Principles on Transaction Tax Overpayments" which are addressed in the model legislation are set forth below:

Principle 1: The use of licensed sellers to collect transaction taxes on behalf of a taxing jurisdiction is an effective and efficient way to collect transaction taxes.

Principle 2: State legislatures have determined that the collection burden imposed on sellers is justified generally because --

a. the taxing jurisdictions are granting sellers the privilege of doing business in the taxing jurisdiction, and

b. the compliance burden on the purchaser and the administrative burden on the taxing jurisdiction are greatly reduced.

Principle 3: Because sellers are fulfilling a statutory mandate in collecting the tax on behalf of the taxing jurisdiction, the burdens on sellers should be kept as low as possible[3].

Principle 4: In most taxing jurisdictions, the economic burden of the tax is intended to fall on the purchaser – not on the seller. The taxing jurisdiction and the purchaser are the "real" parties in interest in a transaction tax dispute.

Principle 5: Transaction tax laws are complex and their application to various fact situations may be unclear.

Principle 6: Sellers are, in collecting tax from purchasers and paying it over to the taxing jurisdiction, acting merely as agents for the taxing jurisdiction. Accordingly, sellers should not be subject to claims arising from or in any way related to an overpayment by purchasers or liability to such purchasers or anyone else other than a taxing jurisdiction revenue department or other government official, regardless of the nature of the claim or cause of action asserted.

Principle 7: Because sellers may be subject to pay the tax if they fail to collect it from their purchasers, sellers should not have any obligation to construe doubts in favor of the purchaser.

Principle 8: Similarly, sellers should not have any obligation to contest written guidance provided by a revenue department or an audit determination of the revenue department, even if reasonable grounds exist to do so.

Principle 9: Any purchaser who has overpaid a tax should be entitled to a refund if a timely and adequate claim is filed.

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[3] For example, some state legislatures have determined that it is appropriate to allow a vendor discount or allowance to compensate the seller, to some degree, for the costs incurred in complying with their collection obligations.

Principle 10: A seller has no right to a refund of any transaction tax that is collected by the seller unless it can demonstrate that the tax has been or will be refunded or credited to the purchaser.

Principle 11: A taxing jurisdiction has a legitimate interest in ensuring that duplicate refunds are not issued. Accordingly, a taxing jurisdiction may establish procedures for that purpose.

Principle 12: Taxing jurisdictions should attempt to minimize costs to the seller of administering any refunds.

Principle 13: A clear and practicable method should be available for a purchaser to obtain a refund of any overpaid tax, which may include expedited procedures or consolidation of claims.

Principle 14: A taxing jurisdiction has a compelling interest in the fair and equitable interpretation of its transaction tax laws and should be an indispensable party in any litigation determining the proper application of those laws.

Principle 15: The taxing jurisdiction has no legitimate interest in administering a lawful tax in an unlawful manner.

Model Transaction Tax Overpayment Act

Findings:

Requiring licensed or registered sellers to collect state and local transaction taxes from purchasers on taxable sales and to remit those taxes to the taxing jurisdiction is an effective and efficient way for the taxing jurisdiction to collect those taxes.

The collection and remittance burdens imposed on sellers are justified because the taxing jurisdiction grants such sellers the privilege of doing business in the taxing jurisdiction and because the compliance burden on the purchaser and the administrative burden on the taxing jurisdiction are greatly reduced.

Because a seller is fulfilling a statutory duty in collecting state and local transaction taxes from a purchaser at the time of sale and remitting those taxes to the taxing jurisdiction, the seller is acting merely as an agent of the taxing jurisdiction; and therefore the burdens on the seller should be kept as low as possible.

Transaction tax laws are complex and their application to various fact situations may be unclear.

Because a seller is fulfilling a statutory duty in collecting taxes from the purchaser at the time of sale, and because the seller can be held liable to the taxing jurisdiction for under remitting tax, the seller has no obligation to resolve doubts as to taxability in favor of purchasers.

The taxing jurisdiction and the purchaser are the real parties in interest in a dispute regarding the application of state and local transaction taxes that a seller is required to collect from the purchaser and remit to the taxing jurisdiction.

A seller should not be subject to claims or liability with respect to an overpayment of state and local transaction taxes that the seller collects from the purchaser and remits to the taxing jurisdiction, regardless of the nature of the claim, provided that tax and other governmental entities should retain any powers they may have to take action to prevent continuing over-collection of tax.

The taxing jurisdiction has a compelling interest in the correct, fair and equitable interpretation of its tax laws and should be an indispensable party in any litigation determining the proper application of those laws.

A clear and practicable method should be available for a purchaser to seek a refund of state and local taxes that a seller has collected from the purchaser if the purchaser believes the taxes were overpaid.

Respectfully submitted,

Charles H. Egerton
Chair, Section of Taxation
February, 2011

GENERAL INFORMATION FORM

Submitting Entity: Section of Taxation

Submitted By: State and Local Tax Committee

1. Summary of Recommendation(s).

   That the Association urge all state, territorial and local legislative bodies to adopt the Model Transactional Tax Overpayment Act or an adaptation thereof appropriate to conform with existing state, territorial or local tax procedural requirements. The Act applies to state and local taxes that a seller is required to collect from a purchaser on taxable sales and obligated to remit to state and local tax collectors. The Act provides protections for sellers who merely act as a conduit for such taxes, as required by state and local law, and who have no interest in the amounts collected. The typical state refund procedure requires a purchaser to file any claim for refund after the collected tax is paid over to the taxing authority and, in fairness, the seller should be immune from any liability to the purchaser once the tax is paid over. The Act outlines procedures a purchaser may use to seek a refund of an overpayment of those state and local taxes; limits the ability of a purchaser to assert claims against a seller arising from or in any way related to an overpayment because sellers typically are required by state law to participate in the tax collection system and have no material interest in amounts collected as tax; and establishes rights and obligations of purchasers, sellers, and the taxing jurisdiction with respect to such overpayments. The Act balances the competing interests of tax collectors, purchasers and sellers and promotes compliance with and administration of sound tax policy.

2. Approval by Submitting Entity.

   Submitted to House of Delegates contingent on Section Membership approval at the Midyear Meeting Plenary Session on January 22, 2011.

3. Has this or similar recommendation been submitted to the House or Board Previously?

   None.

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

   None.

5. What urgency exists which requires action at this meeting of the House?

   None.

6. Status of Legislation. (If applicable.)

Not Applicable.

7. Cost to the Association. (Both direct and indirect costs.)

None.

8. Disclosure of Interest. (If applicable.)

None.

9. Referrals.

To all Sections and Divisions. NCCUSL has been given an opportunity to review this recommendation and did not have any substantive issues with the Act and, as they have previously looked at, and decided against, working in the area of state sales tax, they anticipate that there would not be any conflict with their ongoing work. They did ask, however, that the report to the House of Delegates reflect the fact that that the Section consulted with NCCUSL in accordance with Bylaw 24.6 of the American Bar Association. The Section of Litigation has also been given the opportunity to review this recommendation.

10. Contact Person. (Prior to the meeting.)

Charles H. Egerton, Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A., 800 North Magnolia Avenue, Ste. 1500, Orlando, FL 32803, (407) 428-5112, cegerton@deanmead.com
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Christine A. Brunswick, American Bar Association, Section of Taxation, 740 15th St., NW, 10th Fl., Washington, DC 20005, (202) 662-8675, brunswickc@staff.abanet.org

11. Contact Person. (Who will present the report to the House.)

Richard M. Lipton, Baker & McKenzie LLP, 130 East Randolph St., Chicago, IL 60601, (312) 861-7590, richard.m.lipton@bakernet.com
Susan P. Serota, Pillsbury Winthrop Shaw Pittman LLP, 1540 Broadway, New York, NY 10036, (212) 858-1125, susan.serota@pillsburylaw.com

EXECUTIVE SUMMARY

1. Summary of the Resolution

   That the Association urge all state, territorial and local legislative bodies to adopt the Model Transactional Tax Overpayment Act or an adaptation thereof appropriate to conform with existing state, territorial or local tax procedural requirements. The Act applies to state and local taxes that a seller is required to collect from a purchaser on taxable sales and obligated to remit to state and local tax collectors. The Act provides protections for sellers who merely act as a conduit for such taxes, as required by state and local law, and who have no interest in the amounts collected.

2. Summary of the Issue that the Resolution Addresses

   The typical state refund procedure requires a purchaser to file any claim for refund after the collected tax is paid over to the taxing authority and, in fairness, the seller should be immune from any liability to the purchaser once the tax is paid over.

3. Please Explain How the Proposed Policy Position will address the Issue

   The Act outlines procedures a purchaser may use to seek a refund of an overpayment of those state and local taxes; limits the ability of a purchaser to assert claims against a seller arising from or in any way related to an overpayment because sellers typically are required by state law to participate in the tax collection system and have no material interest in amounts collected as tax; and establishes rights and obligations of purchasers, sellers, and the taxing jurisdiction with respect to such overpayments. The Act balances the competing interests of tax collectors, purchasers and sellers and promotes compliance with and administration of sound tax policy.

4. Summary of Minority Views

   No minority views have been identified at this time.

22-JAN J. Multistate Tax'n 14

Journal of Multistate Taxation and Incentives
****1**
January, 2013

Procedure

Christopher T. Lutz, Fred O. Marcus, and Jordan M. Goodman [a1]

A RECIPE FOR BAD TAX POLICY: FALSE CLAIMS ACTS AND STATE TAXATION

Given the complexity of state tax issues and the need for such issues to be uniformly applied by state departments of revenue, states should unequivocally reject the application of FCAs to state and local taxes.

***16** The Civil War brought about an explosion in government spending that lined the pockets of many unscrupulous contractors. Fraud was pervasive. '[H]aste, negligence, collusion, or favoritism' tended to prevent the government from ever detecting shoddy quality in products until it was too late. [1] Union soldiers, 'on the first day's march, or in the earliest storm, found their clothes, over-coats and blankets, scattering to the winds in rags, or dissolving into their primitive elements of dust under the pelting rain.' [2] Congress, recognizing that people with unique knowledge of corruption could provide a helpful hand detecting fraud, consequently enacted, in 1863, the Informer's Act, now known as the False Claims Act, to root out fraud in government contracting. [3] The most important component of the Act was a *qui tam* provision that allowed a private individual (a 'relator') to bring an action on behalf of the government in exchange for a substantial percentage of any awards or settlements. [4] After the Civil War, however, the Act lay relatively dormant for many years.

As the federal government's presence in economic life began to increase in the 1930s and 1940s, fraud and corruption again became more ubiquitous. By that time, however, savvy relators began to abuse *qui tam* actions. In 1943, in *U.S. ex rel. Marcus v. Hess,* [5] the U.S. Supreme Court even upheld the ability of any person to bring suit on behalf of the federal government with no exception or qualification. In that 1943 case, the relator obtained all information necessary for his *qui tam* action through the public record, principally from an indictment against the defendant. Quickly responding to the Court's broad reading of who could bring a *qui tam* action, Congress amended the act to bar suits brought if 'the same allegations or transactions as alleged in the action or claim were publicly disclosed' from any number of sources, including criminal, civil, or administrative hearings, as well as from the GAO (the General Accounting Office, now the Government Accountability Office), any other federal report, hearing, or investigation, and from the news media. [6]

States adopt FCAs.

****2** Over time, states began to see the revenue that a False Claims Act (FCA)-type statute could generate. In 1987, California became the first state to pass its own False Claims Act. [7] Today, approximately 30 states and the District of Columbia all have FCAs. [8] Almost all of these FCAs mimic the federal FCA, and all have *qui tam* provisions. Moreover, every state statute bars *qui tam* actions where the source information has been publicly disclosed.

The obvious justification for barring *qui tam* actions where the information has been publicly disclosed is that the government has knowledge similar to (and typically more than) that possessed by any potential relator, and, for whatever reason, has not chosen to pursue the case. This also may be the justification for why the federal FCA excludes from *qui tam* actions all allegedly fraudulent conduct under the Internal Revenue Code. Unfortunately, perhaps for want of resources or political ambition, many state attorneys general have allowed, and sometimes encouraged, relators to move forward with *qui tam* actions against taxpayers that the relators contend have violated the states' FCAs by failing to collect a variety of taxes, despite the fact that state revenue agencies exist for the sole purpose of monitoring taxpayer enterprises. Such claims have been filed in Illinois, Nevada, New York, and Tennessee. These relators, however,are hardly the original sources of information that the states' FCAs envisioned, nor are they, as explained below, the best vehicles for resolving state tax issues.

Qui tam and sales and use tax collection.

Today, a number of complicated tax issues exist that have not yet been resolved by state departments of revenue or legislatures. One notable area has been that of online or ‘remote‘ sellers and the extent to which they are responsible for collecting and remitting sales and use taxes from online purchasers. Another difficult area involves the extent to which businesses must collect and remit sales taxes on shipping and handling charges. Unfortunately, a handful of relators have mischaracterized complicated and controversial areas of state tax law as having been settled and are instituting actions against taxpayers that have made justifiable decisions regarding their responsibilities.

What is most perplexing about this relatively recent development is not only that such remote sellers are by no means acting fraudulently, but that the relators are mere opportunistic members of the public with significantly less knowledge than the departments of revenue that have chosen not to pursue the taxpayers being sued. This article describes some of these *qui tam* actions and highlights the problems associated with applying these state FCAs to reasonable decisions made by taxpayers. At best, applying FCAs to state and local tax will embroil taxpayers in litigation despite decisions by departments of revenue to not impose a tax or tax collection responsibilities; at worst, such application allows private opportunistic individuals to effectively set and enforce bad state tax policy.

***17 The First ‘Qui Tax‘ Wave**

****3** Almost ten years ago, a small number of lawyers filed suits in Illinois, Nevada, and Tennessee under each state's respective FCA. Far from uncovering corruption or fraud, these actions jumped on an issue that for decades has been perhaps the most hotly debated in the area of state taxation. These relators' basic arguments were that remote sellers had defrauded the states when they did not collect taxes on sales to customers in those states made via the Internet or mail-order. Among the most egregious of these ‘*qui tax*‘ actions were the more than 60 suits filed in Illinois.

The Illinois False Claims Act (also known as the Whistleblower Act) [9] is substantially modeled after the federal FCA. It applies to any person who, among other things, ‘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 knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the State. ‘ [10] Anyone liable under the statute can be subject to a civil penalty of between $5,500 and $11,000, plus three times the amount of damages that the state sustains because of the act of that person. [11] The liable party also will be required to pay costs and attorney's fees if an action against the party succeeds. Notably, the Illinois Act explicitly excludes ‘claims, records, or statements made under the Illinois Income Tax Act.‘ [12] That exclusion, however, does not apply to the Illinois Retailers' Occupation Tax or Use Tax.

The Illinois suits.

A single Chicago-based law firm brought approximately 62 actions, claiming that each defendant taxpayer violated the Illinois Whistleblower Act. The defendants were generally remote sellers that were affiliated with some in-state presence. In each action, members of the relator's law firm purchased products from the remote sellers' online stores. Because the sellers were not located in Illinois, they did not collect sales or use taxes on any of the sales. [13] Next, either because the law firm's members did not like all the products they purchased or because this was part of a scheme to induce a supposed violation of the Illinois Act, the relator returned most of the products to the Illinois 'brick and mortar' stores operated by the remote sellers' affiliates.

After inducing these supposed violations of the Illinois Whistleblower Act, the relator promptly copy-and-pasted dozens of company names onto complaints alleging that the remote sellers' affiliations with the brick-and-mortar stores constituted a sufficient nexus between the remote sellers and Illinois so as to require collection of the state's sales or use taxes on online purchases. Additionally, the relator argued that the remote sellers' mail solicitations and marketing also created nexus with the state that was sufficient to require collection of use taxes. The sellers' failure to collect use taxes on such sales, according ***18** to the relator, violated the state's Whistleblower Act. In return for rooting out the remote sellers' violations, the relator claimed that relief should constitute three times the tax and interest owed, plus penalties of between $5,000 and $10,000 for each 'violation.' The relator also claimed that it deserved 25% of the recovery obtained, along with expenses, costs, and attorney's fees. In response to these suits, the Council On State Taxation (COST) concluded that the 'litigation is so absurd that it shocks the conscience of tax professionals throughout the country, shaking decades worth of established practice and procedure to its core.' [14]

****4** Two glaring problems with these actions were readily apparent to tax professionals. First, in most cases, there simply were no violations of the Whistleblower Act. Whether these remote sellers could be required to collect use taxes on online sales was both a difficult legal question as well as one of first impression before the courts. The decision to not collect such use taxes could not have constituted 'knowingly' avoiding an obligation to pay the state. Second, to the extent any taxpayer should have known it was required to collect use taxes (an issue still unsettled today), many of the relator's complaints were based upon public disclosures, so the relator was not the original source of the information regarding the 'violations' in a number of the cases. Indeed, in some cases, the companies or their in-state affiliates had already been audited by the Illinois Department of Revenue.

The majority of these cases settled out of court and the relator obtained a windfall. Despite the relator's hard work copying five dozen complaints, one can only imagine that this money would have been put to better use in the hands of the businesses that made justifiable decisions regarding their tax liabilities. Unfortunately, because many of these taxpayers were small businesses, the costs of litigating these cases far exceeded the costs of settling. The relator undoubtedly knew these businesses were likely to settle when the relator filed suit.

Some taxpayers did litigate these cases, however. One notable case in that regard was *State ex rel. Beeler, Schad and Diamond, P.C. v. Target Corporation.* [15] At issue in that case was whether the trial court erred in finding that the relator based its complaints upon public disclosures and that the relator was therefore not an original source within the purview of the Act. The state, which had joined the case and filed to dismiss the relator, presented a number of news articles that described in detail the activity the relator claimed to have uncovered. Despite the affidavit from one of the relator's shareholders that he "neither read nor saw any of the three articles, " prior to initiating the suit, the Illinois Appellate Court found that the complaint was nonetheless 'based upon' at least six different publications' descriptions of the remote sellers' activities. [16] The court accordingly affirmed dismissal of the relator as a party in the lawsuit. The substantive questions before the court regarding nexus were never resolved.

While the appellate court in *Target* focused on ‘striking a balance between the competing interests of encouraging whistleblowers and preventing parasitic lawsuits,‘ the court did not focus on what is perhaps a more important component to these *qui tax* actions. Whereas other whistleblower cases, such as those in health care fraud, involve discrete, obviously falsified documents, these *qui tax* actions require courts to take a considerably prominent role in state tax policy. Indeed, whether remote sellers have sufficient nexus with a given state to justify collection of use taxes is a policy question best answered by a state's legislature or department of revenue, subject to constitutional restraints. In the Illinois cases, however, the relator's sophomoric grasp on state taxation resulted in an inaccurate characterization of the remote sellers' tax liability. Unfortunately, Illinois, along with many other states, has not yet recognized the self-interested policies that relators are inclined to pursue in the area of state tax.

State Legislation

****5** States are all over the board regarding whether their FCAs apply to state taxation. Some states, such as Illinois, exclude their income taxes but fail to address sales tax merely because the state FCA mimics federal legislation that, for obvious reasons, does not discuss sales tax. At least one state, New York, recently amended its FCA to explicitly *include all taxes.* [17] A significant number of states, on the other hand, have ***19** explicitly excluded taxation from their FCAs. As states consider whether to follow New York in applying their FCAs to tax actions, they should remain cautious of the perverse incentives that will lead relators to craft poor tax policy in their states.

Although New York adopted its FCA only recently, in 2007, the state, even more recently, has amended the statute to, as noted above, explicitly include tax actions. In order for a ‘false‘ tax payment to be reported, the taxpayer must act either ‘in deliberate ignorance of the truth or falsity of the information, ‘ or ‘in reckless disregard of the truth or falsity of the information.... ‘ [18] Moreover, taxpayers with net income or sales of less than $1 million for the tax year for which the action may be brought, or taxpayers whose under-reporting deprives the state of no more than $350,000, are not subject to the statute. [19]

Most notably, this new amendment extending the New York FCA to taxes has led the New York Attorney General to file a law suit for over $300 million against Sprint-Nextel for the company's failure to collect sales taxes on calling plans. [20] Similar to the problem with the Illinois tax nexus cases, sales and use taxes on telecommunications are a highly contentious and unsettled area of the law. Most observers predicted, however, that the New York Attorney General, Eric Schneiderman, who also happened to write the state's FCA law, would aggressively enforce the new provision. [21] It remains questionable, however, whether a politically motivated attorney general and any number of self-interested relators can be effective arbiters of tax policy. The federal FCA left the issue in the hands of the IRS for that exact reason.

Fortunately, few states have sided with New York regarding whether to allow relators to pursue actions against taxpayers. Several jurisdictions exclude taxes from their FCAs. For example, California, Massachusetts, Minnesota, Montana, New Jersey, New Mexico, North Carolina, Rhode Island, Tennessee, Virginia, and the District of Columbia, all explicitly exclude all taxes from *qui tam* actions. [22] Many other states are simply silent on the issue. Delaware, Florida, Nevada, and New Hampshire, for example, do not address whether their FCAs apply to taxes at all. [23] A third group of states excludes certain taxes but ostensibly allows for suits regarding others; these are Illinois, Indiana, and Rhode Island. [24] Whether these latter two groups of states ever envisioned their FCAs being applied in tax cases is unclear and unlikely. What is clear, however, is that the absence of explicit language leaves taxpayers vulnerable to suits brought by opportunistic relators.

****6** Consequently, states are currently debating what to do about the ‘*qui tax*‘ issue. In Illinois, H.B. 6202 was introduced by Rep. Michael Zalewski on 7/17/12 and sent to the House Committee on Rules on 8/16/12. That bill would amend the Illinois FCA to exclude all taxes, unless the action were brought by the Illinois Attorney General at the request of the Department of Revenue. Thus, the authority to pursue violations of tax matters would remain exclusively with the Department and the Attorney General. The House Revenue and Finance Committee recently met to consider these reforms. At that hearing, Brian Hamer, the Illinois Director of Revenue, testified that 99% of these *qui tam* actions interfere with the Department's ability to administer taxes. Illinois, along with all other states that lack explicit language preventing these *qui tax* suits, would do well to follow the lead of Tennessee and those other states that have unequivocally disallowed relators from pursuing taxpayers. Otherwise, opportunistic relators will continue to take advantage of the existing laws.

The Ramifications of States' Failing to Enact 'Qui Tax' Reform

As another example of what can happen when states apply FCAs to state and local tax, more than 200 *qui tam* actions have recently been filed in Illinois. In these actions, the same relator from a decade earlier is now claiming that ***48** a number of remote sellers' failures to collect sales tax on shipping charges constitutes a violation of the state's FCA. The relator's approach in these actions is almost identical to those of a decade ago: he makes online purchases, prints out the receipt, and then files a complaint alleging violation of the Whistleblower Act where the sellers do not collect sales tax on shipping and/or handling charges.

The problem with this second *qui tax* wave is that the question of whether shipping or delivery charges are subject to sales tax is highly contentious. In 2009, in *Kean v. Wal-Mart Stores, Inc.,* [25] the Illinois Supreme Court nuanced what many retailers believed to be the general rule that shipping services are not taxable in Illinois. There, the court stated that for shipping services to be nontaxable, they must be separately contracted for. In that case, a class action was brought against Wal-Mart for having collected taxes on shipping and handling charges for online sales. Because the shipping was not separately contracted for, despite having been separately itemized on receipts, the court held that Wal-Mart appropriately collected sales tax on its shipping charges. Whether shipping charges are separately contracted for, however, is not easily discerned. Retailers must now walk a fine line between ensuring that they collect tax where necessary, while avoiding collecting tax where they should not. Regarding the nature of its shipping services, a retailer can easily make a justifiable position with which the Department or a court might disagree. Hence,regardless of whether they collect taxes on shipping and handling charges, retailers may be subject to class action suits on the one hand and *qui tam* suits on the other.

****7** These actions also demonstrate the exact problems with allowing private relators to pursue state tax actions. The relator refuses to acknowledge the complexity of the law and the fact that the taxpayers have taken justifiable positions regarding how they collect sales tax. Even assuming arguendo the validity of the relator's position that the state of the law is clear and that the retailers have failed to collect required taxes, these cases further demonstrate the problems associated with allowing private relators to enforce the collection of taxes via *qui tam* actions because the relator does not even apply the correct tax rates in his complaints. Rather than apply Illinois' place-of-origin test in determining which local sales tax rate to apply, [26] the relator chose Chicago's rate, the highest in the state, regardless of whether products were shipped to or from Chicago. By applying Chicago's rate rather than the correct rate, the relator again reveals the true purpose of these actions. Moreover, while all 200-plus complaints filed by the same relator are almost entirely identical, the relator has demanded attorney's fees and expenses as high as $100,000 in some individual cases.

Despite having gone through all these issues a decade ago, the relator has, once again, managed to utilize the Whistleblower Act to give himself a windfall. Few, if any, of these cases will go to litigation because the cost of litigation will likely exceed the taxes owed. Thus, the relator, a self-interested attorney with virtually no sophistication in state and local tax, continues to influence Illinois tax policy. Even worse, a significant number of businesses, both large and small, that have made reasonable tax decisions will be effectively blackmailed into paying the relator in order to avoid litigation.

Future Developments

Looking into the future, it is apparent that other complicated legal areas will be ripe targets for opportunistic *qui tam* relators. In the past year, *qui tam* suits were filed in Illinois, Ohio, New York, and Minnesota against insurance companies on a theory that the companies were not aggressive enough either in finding the beneficiaries of policies or in escheating the property to the state. [27] Although not technically a tax, unclaimed property has recently become a tempting target for cash-strapped states to raise revenues without raising taxes. [28] In these cases, as in the *qui tax* cases, the relators are not true whistleblowers but, rather, are opportunistic third parties with no real knowledge of any alleged violations. By all indications, the relators in these cases have again dramatically over-calculated whatever the companies might owe and have supplanted the traditional authorities that are tasked with ensuring compliance with each state's laws.

Qui tax relators and their unclaimed property counterparts tend to focus almost always on areas where compliance with the law is a sophisticated and imprecise art. These are areas for which there have typically been undeniable public disclosures, most often in the form of audits and in the media, and state agencies continue to debate the best solutions in addressing them. Allowing these relators to move forward with such actions not only will further the injustice of allowing private individuals to reap the benefits of statutes that were not intended to apply to them, but also will allow these unsophisticated and opportunistic individuals to set policy in very difficult and sensitive areas of the law. Hence, states should begin to rethink their characterization of proper relators. A proper relator should be a true whistleblower with actual insider knowledge of violations of the Act. More important, given the complexity of state tax issues and the needfor such issues to be uniformly applied by state departments of revenue, states should unequivocally reject the application of FCAs to state and local taxes. [29]

****8** Congress, recognizing that people with unique knowledge of corruption could provide a helpful hand detecting fraud, enacted the Informer's Act in 1863.

A *qui tam* provision allowed a private individual to bring an action on behalf of the government in exchange for a percentage of any awards or settlements.

Approximately 30 states and the District of Columbia have FCAs, almost all of which mimic the federal FCA, and all have *qui tam* provisions.

Many state attorneys general have allowed, and sometimes encouraged, relators to move forward with *qui tam* actions against taxpayers.

Far from uncovering fraud, these actions jumped on an issue that for decades has been perhaps the most hotly debated in the area of state taxation.

'*Qui tax*' relators and their unclaimed property counterparts tend to focus on areas where compliance with the law is a sophisticated and imprecise art.

Footnotes

a1 CHRISTOPHER T. LUTZ is an associate with the law firm of Horwood Marcus & Berk Chartered, in Chicago, Illinois. He concentrates his practice on multistate tax issues, advising clients on a range of issues including sales and use tax, corporate income tax, franchise tax, personal income tax, and unclaimed property. FRED O. MARCUS is a principal of the firm and co-chairs the state and local tax practice group. He concentrates his practice in state and local tax planning and the resolution of state and local tax disputes on a nationwide basis for multistate and multinational corporations. A frequent lecturer and writer on a variety of tax topics, he is also an adjunct professor of law at Northwestern University's School of Law's Graduate

Tax Program where he teaches state and local taxation. JORDAN M. GOODMAN is a partner with the firm, where he co-chairs the firm's state and local tax practice. He plans for and resolves state and local tax controversies for multistateand multinational corporations, and has successfully resolved state tax controversies in virtually every state. He lectures and writes frequently on numerous state and local tax topics, is a member of THE JOURNAL's editorial advisory board, and also is a Certified Public Accountant. Messrs. Marcus and Goodman have previously written for THE JOURNAL.

1 Tomes, 'Fortunes of War,' 29 Harper's New Monthly Magazine 227, 228 (July 1864).

2 *Id.*

3 See False Claims Act, ch. 67, 12 Stat. 696 (1863) (current version codified at 31 USC §§3729 and 3730).

4 The shorthand term *qui tam* derives from 'the Latin phrase qui tam pro domino rege quam pro se ipso in hac parte sequitur, which means 'who pursues this action on our Lord the King's behalf as well as his own.'' See State ex rel. McCann v. Bank of America, N.A., 191 Cal. App. 4th 897, 120 Cal. Rptr. 3d 204 (1st Dist., 2011), fn. 4 (internal citation and quotation marks omitted). That private individual, or 'relator,' who pursues the action has become known also as a 'whistleblower.'

5 317 U.S. 537 (1943).

6 31 USC §3730(e)(4)(A) .

7 Cal. Gov't Code §§12650 to 12656.

8 See the website of the Taxpayers Against Fraud Educational Fund (TAFEF), at www.taf.org (select 'Resources by Topic' and, under 'FCA,' click on 'State FCAs'). Most states have adopted their FCAs since 2000. As described on the website, TAFEF is 'a nonprofit, public interest organization dedicated to combating fraud against the government and protecting public resources through public-private partnerships.' Taxpayers Against Fraud (TAF, the IRC §501(c)(4) arm of the TAFEF) advocates for 'legislation, rules and regulations creating and enhancing whistleblower reward and private enforcement provisions in federal and state laws.'

9 740 ILCS §§175/1 to 175/8. Section 175/4(b) provides that a private person 'may bring a civil action for a violation ... for the person and for the State.' Section 175/8 created 'the Whistleblower Reward and Protection Fund.'

10 740 ILCS §175/3(a)(1)(G).

11 *Id.*

12 740 ILCS §175/3(c).

13 Interestingly, although required, the relator never alleged that the purchasers paid use taxes on the purchase. Despite the out-of-state sellers' apparent decision not to collect use taxes, there is no question that the purchasers themselves were required to pay such taxes to the state. Whether such failure suggests that the relators had unclean hands and were thus unfit to act as whistleblowers has never been addressed by the courts.

14 Brief of amicus curiae Council On State Taxation (2005 WL 6137820) in State ex rel. Beeler Schad and Diamond, P.C. v. Ritz Camera Centers, Inc., 878 N.E.2d 1152 (Ill. App. Ct. 1st Dist., 2007).

15 856 N.E.2d 1096 (Ill. App. Ct. 1st Dist., 2006).

16 *Id.*

17 N.Y. State Fin. Law §189.4(a), which states: 'This section shall apply to claims, records, or statements made under the tax law only if (i) the net income or sales of the person against whom the action is brought equals or exceeds one million dollars for any taxable year subject to any action brought pursuant to this article; and (ii) the damages pleaded in such action exceed three hundred and fifty thousand dollars.' New York's False Claims Act is codified at N.Y. State Fin. Law §§187 to 194.

18 N.Y. State Fin. Law §§188.3(a)(ii) and (iii).

19 N.Y. State Fin. Law §189.4(a).

20 See 'A.G. Schneiderman Files Groundbreaking Tax Fraud Lawsuit Against Sprint for Over $300 Million' (4/19/12), available online via the attorney general's website at www.ag.ny.gov/ (select 'Media Center' and 'Press Releases').

21 Hamilton, 'New York's Qui Tam Law: Jackpot Justice or Creative Tax Tool—or Both?,' 59 State Tax Notes 109 (1/10/11) (electronic cite: 2011 STT 6-4).

22 Cal. Gov't Code §12651(f); Mass. Gen. Laws, ch. 12, §5B(12); Minn. Stat. §15C.03; Mont. Code Ann. §17-8-403(4); N.J. Rev. Stat. §2A:32C-2; N.M. Stat. Ann. §44-9-3.E; N.C. Gen. Stat. §1-607(c); Tenn. Code Ann. §4-18-103(f); Va. Code Ann. §8.01-216.3.D; D.C. Code Ann. §2-381.02(d)(3).

23 6 Del. Code §1201 *et seq.*; Fla. Stat. §68.081 *et seq.*; Nev. Rev. Stat. §357.01 *et seq.*; N.H. Rev. Stat. §167:61-a *et seq.*

24 740 ILCS §175/3(c); Ind. Code §5-11-5.5-2(a); R.I. Gen. Laws §9-1.1-3(d).

25 919 N.E.2d 926 (Ill., 2009).

26 See 86 Ill. Admin. Code §270.115; Gen'l Information Ltr. No. ST 08-0044-GIL (Ill. Dept. of Revenue, 4/10/08).

27 See, e.g., Total Asset Recovery Services, LLC v. MetLife, Inc., Ill. Cir. Ct. Cook County, Case No. 2011-L-001225; Total Asset Recovery Services, LLC v. MetLife, Inc., Minn. Dist. Ct. Hennepin County, Case No. 27-CV-11-2113.

28 For more on escheat generally, see THE JOURNAL's most recent article on the subject, Hopkins and Hedstrom, ‘Unclaimed Property Laws: Custodial Safekeeping or Disguised Tax?,‘ 21 JMT 22 (January 2012).

29 For a contrary view, see, e.g., Bruegger, ‘Tax Whistleblower Proceedings at the State Level: Common Themes and a Call to Action,‘ 19 JMT 12 (May 2009).

News

June 16, 2017

Court Tosses Fees for 'King of Qui Tam,' Business Model Done?

By Michael J. Bologna

The profit motive driving hundreds of false claims lawsuits by a Chicago lawyer known as the "king of qui tam" may be drying up after an appeals court rejected the prolific whistle-blower's demand for fees in a case involving unpaid sales and use taxes (*Illinois ex rel. Schad, Diamond & Shedden PC v. My Pillow, Inc.* , Ill. App. Ct., No. 152668, 6/15/17).

In a case of first impression, a three-judge panel of the Illinois Appellate Court reversed a portion of a circuit court ruling that granted Stephen B. Diamond attorney fees in an action under the Illinois False Claims Act (FCA) against the retailer My Pillow Inc.

Diamond had successfully demonstrated that My Pillow had failed to collect and remit tax on merchandise sold to Illinois customers from internet and telephone sales platforms. After a bench trial in September 2014, a Cook County Circuit Court judge awarded a judgment of $1,383,627, with $782,667 in the form of damages and penalties, and $600,960 in the form of attorney fees.

The appeals panel upheld the circuit court's judgment with regard to My Pillow's failure to collect and remit taxes to Illinois, but it reversed on Diamond's eligibility for attorney fees. The court found Diamond, serving as relator on behalf of the State of Illinois, couldn't achieve benefits in the litigation as both the whistle-blower and the attorney for the whistle-blower.

"We hold that the fee-shifting provision in the Act does not permit the award of attorney fees to relator, who served as its own attorney for much of this case," Judge David Ellis wrote on behalf of the panel. "To the extent that the trial court awarded relator fees for work performed by relator's own attorneys, that fee award is reversed."

Notorious Whistle–Blower

The ruling—the first of its kind dealing with a whistle-blower also serving as his own counsel—could derail the false claims freight train that Diamond, and his law firm Stephen B. Diamond P.C., has steered through Cook County Circuit Court for more than a decade. Diamond is regarded as the most prolific tax whistle-blower in the country, and his "cottage industry" of FCA actions has perplexed and annoyed retailers, policymakers, and legal scholars across the country. All of the cases involve purported violations of the Illinois sales and use tax code.

“We think this could really solve the problem here in Illinois,” said Catherine A. Battin, a partner with McDermott Will & Emery in Chicago and counsel to My Pillow. “There have been discussions about solving it legislatively. This decision leaves the door open for legitimate insiders and relators, but not this kind of cottage industry where you have one lawyer filing a 1000 lawsuits.”

Diamond has served as relator in about 1,000 qui tam actions over the last 15 years. A recent investigation by Bloomberg BNA revealed Diamond has collected almost $12 million through this pattern of litigation. The Illinois General Assembly is considering various legislative fixes to address Diamond’ strategies.

Officials with Diamond’s law firm didn’t immediately respond to a request for comment. Battin speculated that Diamond would likely appeal the ruling to the Illinois Supreme Court because it undermines the “abusive fee generation” component of his business model.

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For More Information

Text of the decision is at http://src.bna.com/pUN.