New York's False Claims Act — Good or Bad Tax Administration?

BY JAMES W. WETZLER, TAX DIRECTOR, DELOITTE TAX LLP

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James W. Wetzler is a tax director in Deloitte Tax LLP's Multistate Tax Practice in the firm's New York office. He served as New York state commissioner of taxation and finance from 1988 to 1994. He can be reached at jwetzler@deloitte.com. *The author gives special thanks to William Comiskey, a partner at Hodgson Russ LLP, for helpful comments.*

Last August, flying below the tax community's radar screen, the New York State Legislature effectively repealed the exemption for tax claims in the State's False Claims Act (FCA),[1] making New York what would appear to be the only state whose false claims act affirmatively applies to tax claims. This article explores the implications of the new law for tax administration in New York and potentially in other jurisdictions that are considering New York's approach.

I. Summary of New York's False Claims Act

Modeled on the federal False Claims Act[2] and those of other states, New York's FCA sets forth procedures under which whistleblowers can provide information about false claims against New York state or its local governments and recover rewards based on recoveries from the false claimants. In addition to actions commenced by whistleblowers, the FCA authorizes the attorney general and local governments to initiate their own false claims actions (in which case rewards are not paid to whistleblowers).

The FCA imposes a civil penalty of 300 percent of the amount of damages sustained by the state or local government.[3] False claimants are also liable for attorney fees.[4] Awards to whistleblowers under the FCA can be correspondingly large, ranging as high as 30 percent of the amount recovered.[5]

Liability under the FCA may be imposed on any person who:

- knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval;
- has possession of money used, or to be used, by the state or a local government and knowingly delivers, or causes to be delivered, less than all of that money;
- 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 a local government; or
- conspires to do any of the above.[6]

Thus, the FCA now appears to cover false tax returns that understate tax liability or seek a tax refund.[7] Because penalties are extended to persons conspiring to commit those acts, they potentially apply to tax preparers and tax advisers as well as taxpayers themselves.[8] These FCA penalties apply in addition to the civil and criminal penalties on taxpayers and preparers under the Tax Law.

A. The Knowledge Requirement

Timothy P. Noonan and William Comiskey have described the FCA's definition of knowingly as follows:

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[1]The FCA is found under N.Y. State Fin. Law sections 187-194. The law amending the exemption for tax claims (and making various other modifications to the FCA) is 2010 N.Y. LAWS 379.

[2]31 U.S.C. sections 3729-3733.

[3]N.Y. State Fin. Law section 189.1(g). There is also a penalty of between $6,000 and $12,000. *Id.* The maximum penalty is reduced to 200 percent of the damages if the false claimant cooperates with the investigation in certain ways. *Id.* at section 189.2.

[4]*Id.* at section 189.3.

[5]*Id.* at section 190.6(b).

[6]*Id.* at sections 189.1(a), (c), (d), (g).

[7]Timothy P. Noonan and William Comiskey, "Calling All Tax Whistleblowers — New York Wants You!" *State Tax Notes,* Jan. 31, 2011, p. 349, *Doc 2011-1080*, or *2011 STT 20-4*.

[8]*Id.*

> The law does not require the plaintiff to prove that the defendant intended to defraud the government. Instead, the plaintiff has only to prove that the person knowingly, as that term is broadly defined in the act, submitted a false claim. Section 188(3)(a) provides that a person acts knowingly regarding information if that person (1) has actual knowledge of the falsity, (2) acts in deliberate ignorance of the truth or falsity of the information, or (3) acts in reckless disregard of the truth or falsity of the information.
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> Under that definition, a person can be held responsible for a false claim and required to pay treble damages even if he did not actually know that the claim was false and even if he were not deliberately trying to defraud the government. To the contrary, liability can be imposed if he should have known that the claim was false but did not because he deliberately ignored or recklessly disregarded the truth of the matter asserted. Although intentional deception is not required, the act also makes clear that false claims that are the result of mistake or mere negligence are excluded from its reach. [footnote omitted] Something more is required than merely making a mistake, but that something is less than deliberate deception.[9]

B. Restricting Tax Claims

The FCA places some restrictions on tax claims that do not apply to false claims generally. Tax claims may be brought only against persons whose net income or sales in at least one contested year is $1 million or more and only when the damages equal or exceed $350,000.[10] Also, the attorney general is instructed to consult with the commissioner of taxation and finance before intervening in state tax-related false claims actions.[11]

C. Commencement of Actions and Effective Date

Civil actions under the FCA can be commenced within 10 years of the false claim.[12] The effective repeal of the tax claims exception from the FCA is applicable for "claims, records or statements made or used prior to, on, or after April 1, 2007."[13] Accordingly, the new law contains a substantial measure of retroactivity.

[9]*Id*.
[10]N.Y. State Fin. Law section 189.4(a).
[11]*Id.* at section 189.4(b).
[12]*Id.* at section 192.1.
[13]2010 N.Y. LAWS 379

II. Issues Posed for Tax Administration

To analyze the effect of the FCA on tax administration, it is helpful to break down the FCA into its component parts. First, the FCA sets up a structure under which the government can, in effect, buy information from whistleblowers and provides a dedicated funding source (the recoveries) to pay for that information. Second, the FCA applies additional civil penalties to taxpayers and tax preparers whose tax evasion is uncovered as a result of false claims actions. Third, the FCA establishes a procedure to resolve the tax controversies that fall within its purview that differs from the ordinary tax administration process. Fourth, the FCA gives the attorney general a larger role in tax administration. Each of these component parts raises issues for tax administration.

A. Cost-benefit Analysis and Use of Resources

Much of the work of a tax administration agency consists of obtaining information germane to determining taxpayers' tax liabilities, and tax administrators routinely acquire information from third parties by, for example, purchasing databases. Like all expenditures made in a tax enforcement program, purchases of information should satisfy a cost-benefit test. Typically, the marginal dollar spent on enforcement can and should produce substantially more than a dollar of additional tax revenue.[14] The question arises regarding whether purchases of information from whistleblowers under the FCA are likely to satisfy a properly specified cost-benefit test.

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Measuring the costs and benefits of a whistleblower program is a tricky exercise. First, consider costs. The government's out-of-pocket cost of the FCA includes not only the rewards to whistleblowers but also the expenses associated with the investigations and the enforcement proceedings arising from

[14]It is a common misconception that the tax enforcement effort should be expanded to the point at which the marginal dollar of expenditure leads to just more than $1 of additional revenue. Taxes are a transfer from the taxpayer to the government, while the resources used to administer and comply with the tax law could have been used to produce other useful goods and services. Therefore, as a rule of thumb, one would want the marginal dollar spent on tax enforcement to produce significantly more than $1 of additional revenue. *See* Joel Slemrod and Shlomo Yitzhaki, "The Costs of Taxation and the Marginal Efficiency Cost of Funds," 43 *International Monetary Fund Staff Papers* (March 1996).

the whistleblowers' information. However, the costs of a tax enforcement effort are not limited to the government's out-of-pocket expenditures; they include private costs incurred by taxpayers as well. Just as resources used by the government to enforce the tax laws could have been used to produce useful goods and services, so could resources used by taxpayers to respond to the enforcement effort. One might argue that private costs incurred by noncompliant taxpayers should not be heavily weighted in an accounting of costs, but even noncompliant taxpayers are citizens whose well-being counts for something and whose costs deserve some weight. Furthermore, not all the private costs of responding to tax enforcement efforts are borne by persons who are at fault. Some targets of FCA actions will prove to have been compliant. Some of the costs incurred by taxpayers will be borne by arguably innocent parties, such as shareholders of noncompliant taxpayers that are public corporations. Possibly, some false claimants will shift their higher costs to consumers as higher prices for the goods and services they sell.

The benefits from the program are related to the amount of tax and interest recovered from the false claimants and whatever improvement in voluntary compliance results from the program. Note in this regard that the measured benefit should not necessarily include the civil penalties collected from the false claimants. The goal of the tax administrator is to collect the proper amount of tax from each taxpayer, not to maximize revenue, so penalty collections (which by definition exceed the proper amount of tax) are not necessarily a benefit from a whistleblower or other tax administration program.[15] Rather, the penalties are transfers from the noncompliant taxpayers to the public at large, which may or may not be socially desirable. Even if one believes that the interests of noncompliant taxpayers deserve little weight, some of the economic burden of FCA penalties will be borne by innocent parties, such as shareholders of public corporations. A complete analysis of the economic impact of transferring resources from noncompliant taxpayers to the public at large through imposition of FCA penalties would have to include an assessment of the effect on the state's business climate.

Even the direct effect of the program on revenue may be hard to measure. The information provided by the whistleblower may be information that the Department of Taxation and Finance would have uncovered in the ordinary tax administration process. For example, if a whistleblower simultaneously files claims under the IRS whistleblower program and the FCA, the information provided under the FCA would have eventually been received by the department when the IRS reports federal audit changes to the department through the fed-state information exchange program. If the information relates to a taxpayer that is routinely subject to audit, the noncompliance may be expected to be identified by the auditor.

Those considerations suggest that it is likely that if the benefit from the whistleblower program is limited to tax and interest collected directly from the noncompliant taxpayers, the program will fall well short of satisfying a cost-benefit test. In the extreme case, when a whistleblower receives a reward equal to 30 percent of a civil penalty equal to 300 percent of the unpaid tax liability, the reward will be 90 percent of the tax collected. The cost effectiveness of the program will depend on its having a positive effect on voluntary compliance.[16]

The fact that the payments to whistleblowers bypass the budget process and are funded directly from the recoveries from false claimants should not change the cost-benefit calculation. The recoveries could have been used as general revenue with payments to whistleblowers funded through the ordinary budget process, so that the payments to whistleblowers still represent a true cost.

Tax administrators routinely manage their enforcement programs with an eye toward getting the most bang for the buck. The attorney general should attempt to manage the information flow from FCA whistleblowers the same way — with an eye toward whether the department is likely to discover the whistleblower's information through its ordinary-course tax enforcement program; whether the costs of investigating the noncompliance, including private costs, are expected to be large in relation to the amount of tax involved; and the likely effect on voluntary compliance. Cases in which the ordinary tax administration process would have a high probability of uncovering tax underpayments would include, for example, allegations based on tax return positions disclosed on the tax return.

B. Penalties

Taxpayers and their advisers who are targets of successful FCA lawsuits are subject to large penalties. As noted previously, the FCA penalty is generally 300 percent of all damages sustained by the state government. In contrast, the civil fraud penalty in the Tax Law for the personal and corporate

[15]On the proper objective of the tax administration program, see Alan H. Plumley and C. Eugene Steuerle, "Ultimate Objectives for the IRS: Balancing Revenue and Service," in Henry J. Aaron and Joel Slemrod, eds., *The Crisis in Tax Administration,* Brookings Institution Press, 2004.

[16]In this respect, the program is similar to criminal tax enforcement, in which costs are high in relation to the tax recovered from the taxpayers, but the program is justified on the basis of its effect on voluntary compliance.

income taxes and the sales and use tax is 200 percent of tax liability.[17] These large penalties are essential to the program as currently structured because they provide the source of funds with which to pay the whistleblowers.[18]

As a result, otherwise identical noncompliant taxpayers are potentially subject to different penalties depending on whether their tax evasion is addressed under the FCA, such as false claims actions initiated by whistleblowers, or under the ordinary tax administration process. That raises the issue of whether and how to coordinate the FCA penalty structure, which was not designed to address tax violations, with that under the Tax Law.

> ***The FCA penalty is essentially a significant increase in the maximum Tax Law civil fraud penalty — from 200 percent to 500 percent of unpaid tax liability.***

For taxpayers who have willfully filed false returns, the FCA penalty is essentially a significant increase in the maximum Tax Law civil fraud penalty — from 200 percent to 500 percent of unpaid tax liability. Would that increase be justified as a standalone proposal? To analyze that, one would weigh the additional voluntary compliance expected to result from the harsher sanction against the various problems posed by a high penalty, including concerns that a draconian penalty is unfair to the noncompliant taxpayer, that tax administrators will be reluctant to impose a penalty perceived as unfair, and possibly that a large penalty will adversely affect the state's economic climate. Presumably, to support a significant increase in what is already a high civil fraud penalty, one would have to believe that the increase would lead to a significant improvement in voluntary compliance. As indicated above, the fact that the penalty collections themselves produce revenue for the government (net of what is paid to whistleblowers and other costs of administering the program) is not by itself a valid reason to favor a higher penalty.

Taxpayers subject to the FCA penalty whose noncompliance is not willful may also be subject to various penalties under the Tax Law other than the fraud penalty — substantial understatement, negligence, and so forth. For these cases of non-willful noncompliance, the FCA penalty raises the question whether New York's tax system needs a new penalty based on taxpayer behavior whose egregiousness lies somewhere between negligence and fraud.

It is worth noting that before enactment of the FCA, there does not appear to have been any public discussion in New York of enacting either a significant increase in the Tax Law civil fraud penalty or a new penalty for non-willful taxpayer behavior. There is no particular reason to believe these ideas would have been taken seriously as stand-alone proposals.

Indeed, the recent trend in civil tax penalties for both the federal and New York state tax laws is to base the penalties not on the taxpayer's behavior but rather on the results of that behavior. For example, the penalty for substantial understatement of tax liability applies when a taxpayer lacks substantial authority for an undisclosed position on the tax return or when a disclosed position lacks a reasonable basis.[19] Why the taxpayer took the incorrect tax return position becomes relevant only when penalty abatement is considered on the grounds that the taxpayer had reasonable cause for the understatement.

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As applied to preparers, the FCA represents a dramatic change in the penalty structure. No civil preparer penalty in the Tax Law is anywhere near as harsh as the 300 percent FCA penalty. Again, there is no reason to believe that such an increase in Tax Law preparer penalties would have been seriously considered as a stand-alone proposal.

Indeed, the harshness of the FCA penalty leads one to suspect that many FCA lawsuits will be settled (in other words, the full penalty will not be imposed) because taxpayers and preparers will be reluctant to engage in high-stakes litigation and possibly also because, in cases in which the taxpayer has taken an uncertain tax position, the attorney general and the commissioner will be reluctant to have courts without tax expertise make decisions about substantive tax law in situations in which the

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[17]N.Y. Tax Law sections 685(e), 1085(f), and 1145(a).

[18]In contrast, in the whistleblower program run by the IRS, no special penalties apply. See IRC section 7623(b). As is the case with the FCA, the IRS whistleblower program funds rewards to the whistleblowers from the recoveries from taxpayers outside the normal appropriations process. IRC section 7623(a).

[19]*See, e.g.,* N.Y. Tax Law section 1085(k) for the substantial understatement penalty under the corporate franchise tax.

penalty structure might cause the judge to be sympathetic to the taxpayer's plight.

As noted above, the cost effectiveness of the FCA program depends on its improving voluntary compliance. It is not unreasonable to expect that this will be the case: Both harsher sanctions for noncompliance and greater perceived probability of detection owing to the incentives being provided to whistleblowers can be expected to lead to more voluntary compliance under standard theories of tax compliance behavior. Possibly, the greater publicity given to tax enforcement activity owing to the public nature of FCA proceedings will also increase perceived probability of detection. Unfortunately, these will be difficult things to measure.

One might argue that the existing Tax Law penalty structure has been ineffective in producing an appropriate level of voluntary compliance because, for example, the penalties are too low or are too routinely abated. Reform of the Tax Law penalty structure is an alternative to creation of a new penalty structure outside the ordinary tax administration process. At a minimum, some effort should be made to coordinate the FCA penalties and the Tax Law penalties.

C. Taxpayer Rights

There is a broad consensus that tax administration should be a process in which taxpayers have certain rights and that tax administrators should take into account the burdens their activities impose on taxpayers. The FCA changes the process for resolution of the tax controversies that fall within its purview in a way that erodes some of the rights to which taxpayers are entitled in the ordinary course of the tax administration process. Taxpayer rights affected by the FCA include the statute of limitations, the economic burdens of the tax administration process, and tax privacy.

In some cases, the 10-year statute of limitations under the FCA is significantly longer than the statutes of limitations under the Tax Law. Under the personal income tax, underreported tax liability on non-fraudulent returns is subject to a three-year statute of limitations generally, with a six-year statute for large understatements of gross income or tax avoidance transactions.[20] The statute of limitations on nonfraudulent erroneous refunds is only two years.[21] Thus, it appears that there can be false claims actions alleging damages for years in which the department can no longer collect the tax at issue because the Tax Law statute of limitations is closed. In those instances, the Tax Law imposes no obligation on the taxpayer to retain records, and the lack of records may make it difficult to establish the validity of the whistleblower's information or the amount of damages.[22]

Under the Tax Law, taxpayers have access to an appeals process designed to limit the economic burdens imposed. First, they can try to resolve their cases with the department's auditors. If that fails, they can protest to, and receive an informal hearing from, the Bureau of Conciliation and Mediation Services. If questions of law arise during the process, they can ask for an advisory opinion from the department to clarify the department's interpretation of the law. If no resolution is reached, taxpayers can protest further to the Division of Tax Appeals. If that fails, they can appeal in the court system. Only the last of those stages is a formal court proceeding in which the taxpayer must be represented by an attorney and must incur the expenses associated with litigation. In the earlier stages, the taxpayer can proceed with no representation or can choose to be represented by a non-attorney practitioner. The entire process is a bilateral relationship between the taxpayer and the tax administrator.

In contrast, under the FCA, the entire process is a legal process requiring representation by an attorney from the start. That process is likely to involve much more expense for the affected taxpayers than the ordinary tax administration process. When whistleblowers are involved, the process is trilateral, and the whistleblower has certain rights, including the ability to pursue his or her claim in the courts. Unlike the tax administrator, the whistleblower is not expected to consider the burdens his or her actions place on the taxpayer or, for that matter, whether those actions represent good tax policy or administration.

As a general rule, tax return information is not subject to public disclosure in the ordinary tax administration process. However, like criminal tax enforcement proceedings, most FCA legal proceedings will be publicly disclosed.

Thus, the FCA potentially represents an erosion of taxpayer rights, especially if not managed by the attorney general with taxpayer rights and burdens in mind.

D. Role of the Attorney General

In New York, responsibility for administering the Tax Law has been delegated to the commissioner. The department issues advisory opinions and promulgates regulations to set forth its interpretation of the Tax Law, and this guidance is binding. The department enters into closing agreements with taxpayers that also bind the government. The department also undertakes tax audits and collection

[20]N.Y. Tax Law section 683.
[21]*Id.* at section 683(c)(5).

[22]For record retention requirements under the personal income tax, see N.Y. Tax Reg. section 158.8(a).

activities. The attorney general represents the state in court proceedings involving appeals of tax matters and bankruptcy proceedings. The attorney general also prosecutes criminal tax cases based on referrals from the department.

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The FCA significantly expands the attorney general's role in tax administration. That raises several issues.

First, the attorney general is an elected official. Although the commissioner is appointed by the governor, he or she is generally barred from disclosing any tax return information to the governor or other executive branch officials, which provides insulation against politicization of the tax administration process. Although the attorney general has had authority to gain access to tax return information,[23] he has typically not used that authority. That may change under the FCA.

Second, when false claims actions involve uncertain tax positions, the possibility exists that the attorney general and the commissioner will disagree over how to interpret the law. The commissioner may believe that a taxpayer has paid the proper amount of tax; the attorney general may disagree and believe that damages exist and justify a false claims action. The commissioner may think it appropriate to apply an interpretation of the law on a prospective basis; the attorney general may disagree and want to pursue false claims actions against the affected taxpayers. One can envision a potentially embarrassing fact pattern in which the attorney general takes a position in a false claims action and the taxpayer responds by asking for and receiving an advisory opinion from the department that contradicts the attorney general's interpretation of the law.

An alternative to a whistleblower program operated by the attorney general would be a program within the department. The federal tax whistleblower program, for example, is operated by the IRS outside the purview of the federal False Claims Act.

III. What Is to Be Done?

Many of the issues with the extension of the FCA to tax claims can be addressed by the way the attorney general discharges his or her responsibilities under the FCA and interacts with the commissioner.

Most important, the attorney general should recognize that the tax portion of the FCA is now part of a tax administration program. In discharging his or her responsibilities under the program, the AG should consider whether pursuit of a particular false claims action satisfies a properly specified cost benefit test. Is it likely to lead to increased voluntary compliance? Is the information being "purchased" from the whistleblower too expensive? Are excessive burdens being imposed on taxpayers? Those considerations are routinely factored into a well-run tax administration agency's decision-making about resource allocation but may involve some culture change for the attorney general.

The attorney general should take seriously the FCA's mandate to consult with the commissioner. The attorney general should refrain from pursuing claims when the commissioner contends that pursuit of the claim would be inconsistent with good tax administration. In some situations, for example, the department might decide to apply an interpretation of the law on a prospective basis or to forgive past liabilities if taxpayers agree to comply on a prospective basis. Those judgments should be respected.

The attorney general should refrain from pursuing claims when the commissioner takes the position that pursuit of the claim would be inconsistent with good tax administration.

The attorney general should consider creating some safe harbors, perhaps through regulation. For example, the attorney general could adopt a policy of not pursuing false claims when taxpayers have disclosed uncertain tax positions on tax returns or when the Tax Law statute of limitations on the underlying tax liability has expired.

Finally, in settlement discussions with taxpayers, the attorney general should take account of the draconian nature of the FCA's penalties in relation to the Tax Law's civil penalties and the desirability of coordinating the two overlapping penalty structures.

IV. Conclusion

New York's extension of the FCA to tax matters was done without the participation of the tax community and raises some serious issues of tax administration. Some of those can be alleviated if the attorney general takes seriously the mandate to consult with the commissioner and pays attention to how the new program fits in with the state's ordinary-course tax administration program. The operation of the program should be monitored with these concerns in mind, perhaps through periodic audits by the state comptroller. ✰

[23]N.Y. Tax Law section 697(e).