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New York AG's Tax Probes Energize Whistleblowers, Set
Advisers on Edge

by Amy Hamilton

Summary by taxanalysts®

New York Attorney General Eric Schneiderman (D) spearheaded the state false claims act's expansion to tax matters as a state senator and is now following through as whistleblowers bring qui tam tax cases -- thrusting him on the national stage and putting skeptical corporate tax attorneys on edge.

Full Text Published by taxanalysts®

New York Attorney General Eric Schneiderman (D) is aggressively investigating allegations of large-scale tax fraud under the state's recently expanded false claims act -- the first in the nation to expressly extend to taxes. It's a change that Schneiderman authored two years ago when he was a state senator, and it's one of the driving forces behind his sudden entrance onto the national political stage.

For example, Schneiderman's investigation into the tax implications of the management fee conversion practices of some of the nation's largest private equity firms and hedge funds is proceeding as a possible false claims act case. (For coverage, see *State Tax Notes*, Sept. 10, 2012, p. 698, *Doc 2012-18490* , or *2012 STT 172-16* .)

New York's expanded false claims act allows the attorney general or private whistleblowers to file suit -- *qui tam* actions -- against businesses or individuals alleged to have defrauded the state of more than \$350,000 in revenue through false tax statements and records.

Any party found guilty of tax fraud in a New York false claims act case must pay triple the amount of back taxes owed on top of mandatory penalties and interest. Whistleblowers are eligible to receive up to 25 percent of any revenue collected by New York as a result of the information they provided.

"I think people are maybe worried for the first time that suddenly you've got some state tax authorities that might actually have some teeth," said Dean Zerbe, of Zerbe, Fingeret, Frank & Jadav PC and a senior policy analyst with the National Whistleblowers Center. Zerbe represents Bradley Birkenfeld, the former UBS banker whose information about banks and individuals hiding money in Switzerland helped the IRS collect more than \$5 billion in unpaid taxes. (For coverage, see *Doc 2012-18996* .)

"The exciting thing is the New York AG's office has really embraced the false claims act," said Zerbe, who has taken half a dozen whistleblower tax cases to Schneiderman's office over the past 18 months, though none in the private equity area. "It's really been a tremendous avenue for whistleblowers."

But corporate tax lawyers and executives have expressed concern that Schneiderman might be wading -- into areas where there are ambiguities in the tax law, whereas false claims act cases are intended to address knowing and deliberate fraud.

One such person is Jack Trachtenberg, who served as New York's first Taxpayer Rights Advocate. Now counsel with Sutherland Asbill & Brennan LLP's State and Local Tax Practice, Trachtenberg said it's conceivable that the attorney general could hold New York's enhanced false claims act over a taxpayer "to get a result he would prefer

even if it's not what the law requires."

"I think the question everyone needs to ask is whether the false claims act gives the attorney general, who is an elected official, too much power to label what may be legitimate tax planning as fraud and to leverage a settlement because of threats of treble damages and of being unfairly branded as a fraud in a public proceeding," Trachtenberg said.

"If you're talking about fraud, then we should use the false claims act to go after it and recover damages to the state," Trachtenberg said. "If you're talking about legitimate tax planning and people legitimately trying to comply with ambiguous tax laws, those disputes are better left to the tax authorities in the New York State Department of Taxation and Finance and the New York City Department of Finance."

In interviews with Tax Analysts, attorneys for whistleblowers said Schneiderman has energized their movement, while practitioners with corporate tax clients said the false claims act is an excellent tool for cracking down on deliberate tax fraud but will only work in the long run if applied to appropriate situations.

All of them speculated on Schneiderman's investigation into alleged tax fraud by private equity firms, with the understanding that the opinions expressed are based on incomplete information about the probe as reported in the media.

Controversial Figure

The State Legislature unanimously passed then-Sen. Schneiderman's proposed expansions to the state's false claims act in July 2010. Schneiderman's office immediately issued a press release calling the newly enhanced state law "a false claims act on steroids." Four months later Schneiderman was elected New York's attorney general.

Almost immediately upon taking office Schneiderman established the Taxpayer Protection Bureau within the Office of the Attorney General to enforce the newly expanded act and to work with whistleblowers. Schneiderman then signaled his commitment to pursuing alleged tax fraud under the false claims act by recruiting Daniel Smirlock, a former chief counsel of the State Department of Taxation and Finance, to work as an attorney in the bureau.

Schneiderman filed the first tax enforcement action under the expanded false claims act in April, when he unsealed a \$300 million sales tax case against Sprint Nextel Corp., alleging that the company undercollected \$100 million in sales taxes on flat-rate access charges for wireless calling plans to gain an advantage over competitors.

Schneiderman put out a press release accusing Sprint of deliberately and knowingly evading sales taxes. The company immediately denied the allegations in its own prepared release, saying that it collects taxes in accordance with the law but that Schneiderman's office is focused on a single subsection of New York tax law.

Specifically, Sprint representatives said Schneiderman is ignoring the state's exemption of interstate voice services from sales taxes and federal Mobile Telecommunications Sourcing Act provisions allowing companies to unbundle wireless services to separate taxable and nontaxable charges. Sprint has since filed a motion seeking to dismiss the case. (For coverage, see *State Tax Notes*, June 25, 2012, p. 890, *Doc 2012-12934* , or *2012 STT 117-19* )

In an October 1 viewpoint in *State Tax Notes*, Trachtenberg joined Sutherland attorneys in noting that *qui tam* actions allow the attorney general to take over a case, putting him in complete control of the litigation. Unlike most administrative audits and appeals, *qui tam* proceedings are public, and the attorney general can and will issue press releases accusing the taxpayer of fraud before fraud has been shown, creating significant reputational risks to a company. (For "Between a Rock and a Hard Place: Third-Party Enforcement Actions," see *State Tax Notes*, Oct. 1, 2012, p. 49, *Doc 2012-19510* , or *2012 STT 190-3* )

Adding to this dynamic is the fact that Schneiderman is a Democrat with ties to the Obama administration, serving as cochair of the president's mortgage fraud task force. Many of the legal actions Schneiderman publicizes out of the New York office are criticized nationally as politically motivated.

His investigation into private equity firms made national news in no small part because one of the firms subpoenaed was Bain Capital, founded by Republican presidential nominee Mitt Romney. Meanwhile, U.S. House Ways and Means Committee Chair Dave Camp, R-Mich., and U.S. Senate Finance Committee ranking minority member Orrin G. Hatch, R-Utah, have asked Schneiderman to cease efforts to obtain federal tax return data directly from private equity firms and section 501(c)(4) groups.

"New York's false claims act empowers my office to bring cases against entities or individuals that have committed tax fraud," Schneiderman wrote in response, saying his office follows the federally prescribed process for obtaining tax return information. Schneiderman added that he's responsible for overseeing nonprofits that conduct activities in his state. (For Schneiderman's letter, see *Doc 2012-19970* or *2012 STT 187-23*.)

"He's a lawyer and a politician, and his ambitions are whatever they are," said David Koenigsberg, a partner with Menz Bonner Komar & Koenigsberg LLP who represented the whistleblower in the Sprint case before Schneiderman took it over. "But the people I know that are staffing the cases and running them are career lawyers and civil servants, and they're not politically motivated."

Koenigsberg, a former assistant U.S. attorney for the Southern District of New York, noted that tax enforcement and tax administration at all levels of government ultimately are structured under elected officials. He added that in his former role as an assistant U.S. attorney "we were shielded from any political considerations." Koenigsberg said he believes the AG's staff looks at the cases on their merits.

"It would be very irresponsible to use this as a tool for political gain, other than to do a good job and get headlines for that reason," Koenigsberg said. "You're not going to risk a case and embarrass yourself for personal political purposes."

Turning to Schneiderman's investigation into private equity firms, Koenigsberg said his first thought when reading the original *New York Times* report was it must have been triggered by a whistleblower.

"The speculation that it was politically motivated didn't make any sense to me," Koenigsberg said.

Private Equity Probe

Koenigsberg said the only thing undercutting his first impression of an insider being the whistleblower was the fact that the subpoenas were directed to multiple companies. "I would be surprised if one whistleblower would know intimately that kind of detail at different hedge funds," he said.

Trachtenberg, meanwhile, said he has heard practitioners wonder whether certain auditors -- ones who believe these tax planning techniques regarding carried interest should be pursued -- approached the AG when the tax department decided against it.

Trachtenberg said that if news reports are correct in characterizing Schneiderman's investigation into private equity firms as one looking at the alleged improper conversion of management fees into carried interest to receive capital gains tax treatment, that would suggest the attorney general's office may be auditing above the line.

"In that case, it sounds like he may be looking to determine whether he can recharacterize the income from something that is exempt investment income to something that is essentially taxable compensation for the fund managers' activities," Trachtenberg said. "There's a real question as to whether or not he has the authority to do that."

The Department of Taxation and Finance has long taken the position that it can adjust the federal adjusted gross income. But absent a state-specific adjustment authority in the tax law, it's unclear whether the state can reach to the federal and redetermine the federal adjusted gross income, "especially if the IRS has not made a similar adjustment," Trachtenberg said.

Without a law change, the theories and approaches to get at taxing this income at the New York State and New York City levels have been things such as making discretionary adjustments to expense allocations, attacking the structure as lacking economic substance, or attacking the management fee waiver as lacking a sufficient future risk of loss.

"No one appears to be saying that technically, under the law, what the taxpayer did was wrong," Trachtenberg said. "Instead, the taxing authorities have had to consider relying on discretionary remedial concepts. And that strikes me as not necessarily a knowing violation of the tax law, and maybe not something that's appropriate for a false claims act lawsuit."

"To the extent he thinks there's some sort of abuse going on, it suggests that he may think he can prove a knowing violation of the tax law," Trachtenberg said.

"What would be curious to me is if the attorney general thinks there's something for him to pursue when the two primary enforcement agencies charged with enforcing the tax law [the New York State Department of Taxation and Finance and the New York City Department of Finance] decided they either can't or shouldn't go down this road," Trachtenberg said.

Koenigsberg, however, said one advantage to empowering whistleblowers to bring *qui tam* actions is that individuals can pursue fraud that government agencies might want to address but can't for any number of bureaucratic reasons.

Zerbe, meanwhile, said that one of the key things Schneiderman's office is doing is "harnessing whistleblowers" in tax enforcement actions, and that New York could serve as a model at both the state and federal levels.

"The IRS can almost emulate a lot of that, and my hope is it will," Zerbe said.

'Harnessing Whistleblowers'

The federal False Claims Act bars tax fraud claims, while the separate IRS whistleblower law provides a rewards process for informants but also doesn't allow private *qui tam* actions for tax cases. Zerbe was responsible for writing the IRS whistleblower law -- the Tax Relief and Health Care Act of 2006 -- when he served as the U.S. Senate Finance Committee's tax counsel to U.S. Sen. Chuck Grassley, R-Iowa.

"When you think of the false claims act as the biggest and most successful means by which we've been able to go after fraud at the state and federal levels, it's a no-brainer to expand it to taxes," Zerbe said. When writing the IRS whistleblower law, "the one step we didn't take was the one step New York did take" in allowing private litigation, he said.

But one of the Senate Finance Committee's intentions in writing the IRS whistleblower law had been to give the agency a way to harness how insiders could help the government crack down on tax cheats at the highest levels, Zerbe said. Federal lawmakers were concerned that tax officials are outgunned by the private sector when it comes to sophisticated tax transactions, he said, noting that New York's expanded false claims act targets the highest-end individuals and businesses with the most sophisticated tax planners and advisers.

"Let's face it," Zerbe said. "The field has been tilted in their favor like nobody's business. I don't have lunch-pail Joe doing illegal offshore accounts or 482 transactions or all these other very sophisticated planning techniques. Finally, to me, you've got an effective tool for going after illegal offshore banking."

Zerbe said that with taxes in particular it can be important to have an insider explain the purpose behind certain transactions. If the Senate Finance Committee hadn't had whistleblowers explain the Enron transactions, "it would have taken a thousand years to figure out," Zerbe said.

A whistleblower in Schneiderman's private equity investigation could provide the New York AG's office with difficult legal analysis, assist officials on issues such as valuation and compensation, and point out which documents need to be subpoenaed, Zerbe said.

"Something that earlier looked daunting is now feasible for the state," Zerbe said. "If I were in a state facing a revenue shortfall, I'd be sprinting to get a variation of New York's law on the books."

Schneiderman's end goals are tax fairness and ensuring that everyone is complying with the law, Zerbe said, adding that AG offices tend to already have a great deal of experience in handling false claims act cases outside the tax area. He said the concerns of corporate tax advisers that Schneiderman may be applying the act to inappropriate cases don't jibe with the history of AG enforcement of false claims acts.

"It's odd to make distinctions about the way a person is cheating a government out of revenue," Zerbe said. "In some ways the question is: Why are taxes special? If you're cheating through taxes, you should get different treatment than if you're defrauding the government through billing?"

Finally, Zerbe said, one of the most marked aspects of the federal False Claims Act is its indirect impact on people's behavior. The defense industry cleaned up its act and very few False Claims Act cases are brought on defense contractors anymore, he said.

"If you're playing some 50 shades of gray in terms of your tax planning, it's going to make you wonder how it's going to look showing up on the desk of the attorney general," Zerbe said.

But the Sutherland attorneys said in their October 1 viewpoint that one of the risks in such an environment is that corporate taxpayers may go to the opposite extreme. Particularly in regard to sales and use taxes, the attorneys said, companies might default to collecting and remitting too much sales tax to avoid potential false claims act exposure -- a scenario that would expose them to class action lawsuits by consumers. To help address such scenarios, the American Bar Association last year adopted the Transaction Tax Overpayment Model Act, which provides remedy procedures for overpaid transaction tax.

And in a rare contemporary example of state tax administrators and corporate tax advisers finding themselves on the same side of an issue, the Multistate Tax Commission in July launched a project at the request of the Council On State Taxation to develop model administrative procedures to minimize vendor exposure to class action lawsuits that bypass traditional state tax administration refund claim procedures and allege vendor fraud. (For coverage, see *State Tax Notes*, Aug. 6, 2012, p. 367, *Doc 2012-16157* , or *2012 STT 147-1* )

Conclusion

Maybe there are elements of truth to both sides' assertions.

Timothy P. Noonan, a partner in the Buffalo and New York offices of Hodgson Russ LLP, said that when used in the right way, New York's expanded false claims act has the potential to be a great enforcement tool for weeding out tax fraud.

"Obviously I'm not privy to all the facts and details underlying some of the cases we've seen so far," Noonan said. "But I do question whether the cases being pursued raise the kinds of issues the statute was designed to get at."

Like Trachtenberg, Noonan questioned whether false claims act cases are appropriate in an area that is confusing, ambiguous, and difficult. Noonan also expressed concern that it might be used as a negotiating tool against taxpayers engaged in legitimate tax planning.

"The statute will only work if it's being used in the right way," Noonan said.

However, Noonan also said the AG's office has been professional in its own interactions with staff members.

"I have worked with the AG's office on the other side of a false claims matter, and I found that the attorneys in the Taxpayer Protection Bureau did consider very seriously whether the claim made by the relator was really appropriate for action under the new law," Noonan said. "That experience was encouraging."

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