ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 28, NUMBER 54 WWW.RBJDAILY.COM MARCH 22, 2013

State law gives whistleblowers a rich incentive in tax cases

TAXING MATTERS
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You may have seen his ads in the New York Times: Mohanbhai Ramchandani, a diminutive celebrity tailor, shown measuring massive sports stars for custom suits.

His business, Mohan's Custom Tailors, which had gotten a jump-start years ago when Patrick Ewing's mother asked the tailor to travel to Georgetown University to measure her son for a suit, suffered a grievous blow earlier this month in the first successful tax whistleblower lawsuit under the New York False Claims Act.

The new law allows members of the public to bring claims against tax cheats on behalf of the government and then keep a portion of the proceeds. It is a potent weapon for the government against people engaged in tax fraud, and it presents new risks and planning considerations for taxpayers.

Congress first enacted the federal False Claims Act during the Civil War in response to military contractor fraud. The act allows private individuals, acting on the government's behalf, to bring claims against people who defraud the government.

The federal False Claims Act provides powerful incentives for whistleblowers: The government is entitled to damages in an amount three times a fraudulent claim, and whistleblowers may receive up to 30 percent of the government's recovery plus attorney fees.

The federal False Claims Act does not apply to taxes. New York, however, amended its False Claims Act in 2011 to include tax claims, making it the first and only state to authorize false claims cases involving tax matters.

Under the amended New York statute, state and local governments, and private citizens on behalf of state or local governments, can bring False Claims Act lawsuits against taxpayers who have engaged in fraud or who knowingly filed false tax returns, and the attorney general may join the suit.

Taxpayers found liable are subject to damages of up to three times the amount deemed owing or not paid, plus a statutory penalty for each false claim. Whistleblowers can receive up to 30 percent of the amount recovered, plus attorneys' fees. The net income or sales of the person against whom a tax False Claims Act action is brought must exceed $1 million for any taxable year, and the damages pleaded must exceed $350,000.

The case against Mohan's Custom Tailors is the first tax settlement under the New York False Claims Act. Over a decade, Ramchandani underreported his income by $20 million and collected more than $1.7 million in sales tax from customers that he did not pay over to the state. Of the $5.5 million he will have to pay to New York, a former employee who brought the case will get $1.1 million. Ramchandani has also agreed to a state prison term and will soon face federal charges.

The tax provisions of New York's False Claims Act can be a weapon against large corporations as well as small businesses.

Last spring, the attorney general's office announced a $300 million lawsuit against Sprint in connection with its alleged failure to charge the appropriate sales tax on cellphone service. Sprint claims the taxes were not owed, but the attorney general's complaint includes apparently incriminating material suggesting that high-level executives were deliberately trying to increase the phone company's competitiveness by turning it into a "low-cost tax leader."

Sprint is currently contesting the case. However, the legal standards may not be in its favor. To win cases against companies like Sprint, the government does not need to show intent to defraud. It merely has to show that the defendant acted in deliberate ignorance or reckless disregard of the truth or falsity of information.

The extension of the state False Claims Act to cover tax matters and the first successful case against Ramchandani change the landscape of New York tax compliance in a number of ways.

Statute of limitations: The typical tax statute of limitations is three years, with a six-year statute applicable in the case of substantial understatement. However, the statute of limitations under the New York False Claims Act is 10 years, beginning, for tax matters, on April 1, 2007. The enactment of the False Claims Act reduces the certainty of the expiration of the statute of limitations in New York because a False Claims Act lawsuit can still be brought.

Adviser liability: The New York act states that any person who "conspires" to present a false claim or use a false record, or anyone who "causes" false claims to be presented, can be held liable. Accordingly, accountants and other advisers could theoretically face exposure based on clients' tax return positions.

From the perspectives of whistleblower and defendant, the potential damages under New York's False Claims Act are incredibly scary and tantalizing large.

For businesses, the act provides a very powerful incentive to ensure the accuracy of New York state reporting. Companies may also wish to review their internal controls systems and consider establishing whistleblower hotlines for employees with knowledge of fraudulent activities to report them directly to senior management or the board before approaching government authorities. If the government does come calling, companies need legal advice to successfully respond to the investigations, to negotiate settlements and to defend themselves in litigation.

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