

## Sprint lawsuit is the first ruling on amended False Claims Act

**N**ew York's highest court has allowed a tax whistleblower to proceed with a \$390 million lawsuit alleging that Sprint shortchanged New York on sales taxes for cell phone service.

The decision is the first ruling by the New York Court of Appeals on the tax provisions of the New York State False Claims Act—a law that allows members of the public to bring claims against tax cheats on behalf of the government and keep a portion of the proceeds. The ruling provides important guidance for future tax whistleblower suits.

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 persons that defraud the government.

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

The federal False Claims Act does not apply to taxes. However, in 2010, New York State amended its False Claims Act to include tax claims, making it the first state to specifically authorize False Claims Act cases in 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 engaged in fraud or who knowingly filed false tax returns, and the attorney general can choose to 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 tantalizing rewards: 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 \$1M for any taxable year, and the damages



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pleaded must exceed \$350,000.

The case against Sprint was the first public case in which the attorney general “intervened” or took over the case from the whistleblower on behalf of the public. It alleges that unlike any other carrier, Sprint did not charge sales tax on the full cost for its monthly flat rate calling plan, instead claiming that a portion of the charges were for interstate calls and therefore not taxable. Sprint claims that the taxes were not owed, but the attorney general's complaint included 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 moved to dismiss the case, arguing that its actions were lawful, the statute was ambiguous, and it didn't “knowingly” violate the law as required by the False Claims Act. It also asserted that the amendment to New York law applying the False Claims Act to taxes retroactively violated the federal constitution.

The Court of Appeals rejected all of these claims.

First, it analyzed the text of the relevant law and regulations, as well as other authority, and held that the rules applicable to Sprint were unambiguous. While the decision implies that in the correct case, ambiguity in the law could be a defense, the court held that this could not serve as a defense for Sprint.

Next, the court addressed the issue of whether Sprint knowingly defrauded the government.

The False Claims Act states that the government does not need to show intent to defraud. It merely has to show that the defendant acted knowingly, which in-

cludes actions in deliberate ignorance or reckless disregard of the truth or falsity of information.

Sprint argued that because there was a reasonable interpretation of the law under which it did not have to pay the tax, there could be no valid claim. But the court found that for this to serve as a defense, Sprint would have to substantiate that it actually held such a reasonable belief and acted upon it; coming up with a reasonable interpretation of the law after the fact is not sufficient. In reaching this conclusion, the court relied on the general rules applicable to False Claims Act cases, declining the suggestion in a friend of the court brief that it create a new set of rules for tax cases.

Based on this finding, the court held that the case could proceed. The court stressed that the False Claims Act “is certainly not to be applied in every case where taxes were not paid” and that “notice of a contrary administrative position alone” is insufficient to prove False Claims Act liability. Yet the attorney general had alleged “agency guidance,” “industry compliance,” “Sprint's payment of the proper amount of sales tax” in earlier periods, “Sprint's undisclosed reversal of its practices in 2005,” and “explicit warnings that Sprint received from the Tax Department.” Those allegations were sufficient to state a False Claims Act case.

Finally, the court held that the ex post facto clause of the U.S. Constitution does not bar the retroactive application of the False Claims Act to taxes. New York adopted the amendments applying the act to taxes in 2010, but made them retroactive to 2007. The court held that because the act was not penal in character within the meaning of the case law, the constitutional limitation did not apply.

The ruling removes much of the lingering uncertainty surrounding the application of the False Claims Act to New York taxes, explaining the legal standard applicable in determining whether a defendant knowingly violated the law and clearing up the constitutional issues.

In addition to the case against Sprint, there are significant False Claims Act cases

pending against Vanguard and Citigroup. As these cases move forward, they will further establish the contours of this significant new tool of tax enforcement.

In the context of the evolving landscape,

businesses should review their internal controls systems to ensure compliance with New York law and consider enacting internal whistleblower policies to enable them to identify any issues as quickly as pos-

sible. The best defense to a False Claims Act case is ensuring that no fraud occurs in the first place.

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