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New York's Tax Cheat Haul Has States Eyeing Whistleblower Laws

By Michael J. Bologna 2021-03-04T15:30:53000-05:00

- Tax whistleblower laws getting new attention after record-setting case
- New York has collected \$577.8 million in tax settlements

New York's record \$105 million fraud settlement against a hedge fund billionaire is sparking renewed interest in aggressive state whistleblower laws to bust tax cheats and replenish coffers emptied by the pandemic.

New York Attorney General Letitia James (D) March 2 [announced](#) a settlement with Thomas Sandell and his Sandell Asset Corp. after alleging he employed an aggressive scheme to avoid recognizing \$450 million in offshore income for state and city tax purposes. The settlement not only puts more New York financial titans under scrutiny for their tax treatment of offshore management fees, but it makes the use of such whistleblower-prompted suits more enticing for other states.

The huge penalty against a single taxpayer is certain to catch the attention of lawmakers in the District of Columbia, which adopted New York's model in January, and California and Maryland, which have both considered changes to their false claims laws to address tax frauds, said Dennis Ventry, a professor at the University of California Davis School of Law and a supporter of FCA reforms.

"This recovery demonstrates yet again the wisdom and power of New York's one-of-a-kind FCA and the law's ability to encourage courageous whistleblowers to report tax frauds perpetrated against the state," Ventry said. "Tax cheats are slippery and tax administrators need traditional as well as non-traditional enforcement mechanisms to hold them accountable."

New York's settlement is "impressive," said Maryland Sen. Cory McCray (D), sponsor of [S.B. 916](#), which would create the Whistleblower Reward Program. The proposed law differs from the New York model because it encourages whistleblowers to bring evidence of tax frauds to the state comptroller in return for a portion of any tax settlements won by the state.

"We want to make sure we are incentivizing folks to provide information on tax cheats so we can bring that revenue back to the State of Maryland," McCray told Bloomberg Tax.

The Sandell settlement is the largest state income tax recovery under New York's first-in-the-nation false claims law, which explicitly authorizes whistleblowers to file civil actions on behalf of the state alleging tax fraud. With the \$105 million collected from Sandell, New York has reached settlements totaling \$577.8 million with 21 defendants since amending its False Claims Act in 2010, according to an [analysis](#) by the law firm Kirby McInerney LLP.

Tax Terrorists?

State false claims laws generally permit whistleblowers to step into the shoes of the attorney general and file suits, known as qui tam actions, against parties that knowingly perpetrate fraud against the state. Whistleblowers are motivated by rules permitting judges to award a bounty of between 15% and 30% of any proceeds won, plus attorneys' fees.

Most state False Claim Acts are modeled after the federal law and exclude tax qui tams. New York and the District of Columbia are the only jurisdictions that explicitly permit them for tax code violations, according to Taxpayers Against Fraud. Illinois, Indiana, and Rhode Island allow actions on some types of tax violations. Delaware, Florida, Hawaii, Nevada, and New Hampshire don't explicitly deny tax qui tams, creating limited opportunities for tax whistleblowers.

Stephen Kranz, a tax partner in the Washington office of McDermott, Will & Emery and a prominent opponent of state FCAs, said the Sandell case alone is a weak rationale for states to launch tax whistleblower programs. He described false claims plaintiffs and their attorneys as "tax terrorists."

"They strap the nuclear bomb of the FCA to ordinary tax problems, demand treble damages, and threaten to pull the pin," Kranz said. "While it is always possible a one-off abuse justifies that type of explosive device, the FCA applies to even run of the mill ambiguous tax questions. That's just wrong."

The largest single state tax whistleblower settlement came in 2018 in a case brought in New York against telecommunications giant Sprint Corp., capturing \$330 million in penalties and previously unpaid sales taxes. But the Sandell case is distinct in the history of false claim filings, ranking as the second largest overall and the largest involving an individual income taxpayer, said Randall Fox, a partner with Kirby McInerney and lead counsel for the unnamed whistleblower in the matter.

Sandell's Scheme

Sandell earned management and performance fees from overseeing offshore hedge funds between 1998 and 2008, according to settlement [documents](#). Federal rules at that time permitted Sandell to defer such income on his federal return, which flowed through at the state and local level. Those rules changed in 2008 when Congress ended indefinite deferral under Section 457A and required taxpayers to recognize these taxes by Dec. 31, 2017.

Rather than recognize this liability on his New York state and city tax returns, Sandell engineered a tax avoidance scheme together with a “Big 4” accounting firm described as “Accounting Firm A,” according to James, the state attorney general. As part of the scheme, Sandell opened a shell office in Florida and portrayed it as his sole base of operations, even though he continued to operate in New York City.

Sandell was informed, James said, that this structure was problematic by his long-time tax preparer, described as “Accounting Firm B.” Sandell responded by replacing Accounting Firm B with Accounting Firm A and “wrongfully” claiming no New York state and city taxes were due on returns filed in 2017, avoiding a \$50 million tax bill. As part of the settlement, Sandell neither admitted nor denied the allegations. Through his attorney, Sandell and his company declined to discuss the settlement.

Fabien Levy, press secretary for James, declined comment on the possibility of additional litigation targeting hedge fund managers, but Fox, a former chief of the New York attorney general's Taxpayer Protection Bureau, said schemes similar to the one Sandell is accused of were common in 2017.

“This framework could certainly give rise to other investigations,” Fox said in an interview. “This whole notion of rich hedge managers having offshore funds and lots of deferred income all coming due at the end of 2017 sparked sort of a cottage industry among tax advisers to figure out ways for these hedge fund managers to avoid this taxation coming due for 2017. For Sandell, it was \$450 million; for others you could imagine it was in the billions.”

Following New York?

Maryland could be the next state to use a whistleblower process to address tax fraud. McCray's

proposal, modeled after a similar federal program administered by the IRS, is scheduled for a hearing in the Senate Budget and Tax Committee March 9.

For two years California Assemblyman Mark Stone (D) and former Attorney General Xavier Becerra (D) unsuccessfully sought passage of [A.B. 2570](#), which would have expanded the state FCA to include claims of tax fraud. Stone said he wouldn't push the issue this year, but the Sandell case signals the New York strategy is working.

"I hope other states see the success of this and adopt similar measures to stop large tax evaders," Stone told Bloomberg Tax in a statement.

New York Sen. Brad Hoylman (D) is pushing for an expansion of the state FCA under [S.B. 8872](#). The proposed law would remove the requirement that a defendant "knowingly" violated the state tax code, bringing a wider group of simple tax failures into the FCA net. Potential recoveries by the state would be reduced from triple damages, common in cases of fraud, to single damages.

— With assistance from Laura Mahoney in Sacramento

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