The Risks of Over Collecting and Under Collecting Sales Tax

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TEI Columbus, Ohio SALT Day
December 12, 2016
Overview

- What are False Claims Act (FCA) lawsuits?
- How are FCA lawsuits being used to pursue state taxes?
- Interplay with Consumer Class Action Lawsuits
- Tax Policy Initiatives
- How to Protect Your Company
Risks of Under Collection and Over Collection

Under Collection

Qui Tam/
False Claims
Act Risk

Over Collection

Class Action Risk
FALSE CLAIMS ACT
False Claims Act

Under Collection

Qui Tam/False Claims Act Risk

Over Collection

Class Action Risk
False Claims Act

Troubling Trend: False Claims Act Cases

- Some states have expanded False Claims Act “whistleblower” actions to include tax

- Approximately 30 jurisdictions currently have False Claims Acts
  - Most state FCA statutes contain explicit “tax bars” prohibiting *qui tam* actions for allegedly false tax claims (e.g., CA, DC, HI, MA, NM, NYC, NC, TN, VA)
    - Some states impose a tax bar only with respect to income tax matters (e.g., IL, IN, RI)
  - A number of states do not appear to restrict the action to a particular subject matter (e.g., DE, FL, NV, NH, NJ)

- Illinois and New York have seen the most aggressive False Claims Act litigation
False Claims Act

Controversy

- Extremely high stakes:
  - Generally treble damages plus substantial penalties for each return filed
  - Extended Statute of Limitations period
  - Public relations issue: tried in the public domain, often labeled tax fraud
**False Claims Act**

**Qui Tam Actions**

- Brought by a private plaintiff ("relator") for and in the name of the state

- Allows relator with knowledge of "fraud" against state to sue on behalf of the government
  - Intended to encourage true "insiders"

- Action filed under seal

- State investigates and may join action

- Relator may receive percentage of recovery
Example: New York

Damages, Penalties, & Fees

- New York amended its False Claims Act (FCA) to allow whistleblowers to bring *qui tam* actions against taxpayers for false claims under the New York Tax Law

- Taxpayers found liable under the FCA are subject to damages of up to three times the tax deemed owed or not paid, plus a statutory penalty of between $6,000 and $12,000 for each “false” claim

- Taxpayers found liable are also required to pay for the costs and attorneys’ fees of bringing the action
False Claims Act

Elements Needed to Establish Liability

- Must show that the taxpayer “knowingly”:
  - Presented or caused to be presented, a false or fraudulent claim for payment or approval;
  - Made, used, or caused to be made or used, a false record or statement material to a false or fraudulent claim;
  - Made, used, or caused 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
  - Conceals or improperly avoids or decreases an obligation to pay or transmit money or property to the state or a local government
    - This is known as a “reverse false claim”
Example: New York

Scierner

- “Knowingly”
  - Means something more than actual knowledge
  - Also includes acting in *deliberate ignorance or reckless disregard* of the truth or falsity of information

- Not Limited to Fraud
  - FCA specifically provides that there does not have to be any showing of any intent to defraud the government
  - The *qui tam* plaintiff or government must simply prove the taxpayer made a claim that it “knew” was incorrect
Example: New York

Scienter

- Disagreeing with Agency Guidance
  - Liability may attach if a taxpayer takes a reporting position that contravenes published agency guidance, even if the taxpayer has a good faith basis to believe the guidance is incorrect, in excess of the Department’s authority, or unconstitutional
Whistleblower Rewards & Protections

- **Whistleblower Rewards**
  - Up to 30% of the recovered proceeds
  - A whistleblower who planned or initiated the false claim may even recover an award provided that the person is not convicted of a crime for the false act

- **Whistleblower Protections**
  - Employees, contractors, and agents are protected from retaliation for transmitting any information for the purpose of investigating, filing, or potentially filing an action under the FCA, even if the transmission “violate[s] a contract, employment term, or duty owed to the employer or contractor”
  - Encourages current and former employees, contractors, or agents to become whistleblowers
Other Considerations

- 10-year statute of limitations
- Retroactive to April 1, 2007
- Taxpayer secrecy does not apply
- Conspirator liability, including tax professionals
- Voluntary Disclosure may not protect from liability
- Burden of proof not on taxpayer
Defenses to *Qui Tam* Actions

**Procedural Defenses**

- Failure to state claim: no actual knowledge, no false statement, no claim submitted to state

- Relator not an “original source” of the information (e.g., public disclosure)

- Improper parties

- Government (already) had knowledge (e.g., prior sales tax audit)

- Pending civil action
Defenses to *Qui Tam* Actions

Substantive Defenses

- No tax obligation (e.g., no nexus)

- No scienter to make a false claim
  - Negligence
  - Ambiguous law or regulatory guidance
  - Reliance on sound legal theory
FALSE CLAIMS ACT LITIGATION
Illinois

- Illinois courts have seen over 900 qui tam tax suits filed under the state’s FCA by a single law firm
  - Initial wave of suits aimed at out-of-state sellers’ failure to collect and remit sales tax
  - Second round targeted out-of-state sellers’ failure to collect and remit sales tax on shipping and delivery charges

- The last round of FCA suits claim that out-of-state sellers’ collection and remittance of the state’s liquor excise tax on alcohol purchased online and shipped to IL customers
  - Complaints also allege out-of-state wine sellers fail to collect and remit use tax
  - Can registration requirements under a state’s excise tax create nexus for sales tax purposes?

- While the Relator has been generally unsuccessful at trial and in appeals, the Relator has leveraged these lawsuits to collect nearly $30 million in proceeds and attorneys’ fees from settlements
Illinois Cases

- **Ritz Camera** (Ill. App. Ct. 2007) – A reasonable interpretation of the law preempts a finding of a “knowingly” false statement under the FCA. The court also questions whether a False Claims Act suit can be predicated on an unclear area of law.

- **National Business Furniture** (Ill. App. Ct. 2016) – Taxpayer reasonably relied on the results of an audit to determine that it was not required to collect use tax on shipping and handling charges:
  - Even outside of the audit, no knowing violation of reckless disregard where the area of law is unclear, and failure to collect tax was mere negligence.

- **Relax the Back** (Ill. App. Ct. 2016) – No False Claims Act violation based on not collecting use tax on internet or catalog sales because defendant made good faith inquiry into collection obligation:
  - Relied on prior NYS audit result related to its constitutional nexus position
  - Annual financial audits examined position
Illinois Cases

- *Lush* (Ill. Cir. Ct. May 10, 2016; on appeal) – No False Claims Act violation by defendant internet retailer because:
  - No attributional nexus based on in-state affiliate with brick-and-mortar retail stores; and
  - No scienter violation where company relied on expert advice in an area that is “far from clear”

- *My Pillow* (Ill. Cir. Ct. Nov. 19, 2014; on appeal) – Defendant failed to show expert advice defense applied. Expert Advice defense required that the defendant:
  - Sought advice of a trusted advisor;
  - For the purpose of getting advice on operations;
  - Disclosed all the material facts to the advisor; and
  - Acted in accordance with the advice

- *FansEdge* (Ill. Cir. Ct. June 5, 2014)– Taxpayer did not knowingly disregard an obligation to collect tax on shipping and handling charges where the taxpayer relied upon the results of the Department’s audit of the taxpayer’s books and records, which resulted in no assessment of tax on shipping and handling charges
False Claims Act Litigation

New York Cases

  - Alleged $130M in tax underpayment based on taxability of bundled wireless interstate communication charges
  - Sprint filed motion to dismiss
  - New York Court of Appeals held NY AG’s complaint sufficiently pleaded a cause of action under New York’s False Claims Act that Sprint knowingly filed false tax records with the state
  - Court said that an “objectively reasonable” interpretation of tax statute will not preclude action and that reasonableness of position is for trier of fact
  - U.S. Supreme Court denied cert. on question of whether MTSA preempted state law with respect to taxation of bundled services
Sprint Nextel Corp. (continued)

- Sprint later filed a motion to dismiss an amended complaint, which had attached tolling agreements
- On May 4, 2016, the NY Supreme Court denied Sprint’s motion to dismiss, which asserted that the three year tax statute of limitations barred the False Claims Act suit
- NY Supreme Court explained that waivers tolling the limitations period did not apply to assert an assessment amount in a civil complaint
False Claims Act Litigation

New York Cases

  - Plaintiff alleged taxpayer avoided payroll withholding obligations and charged artificially low prices to its related funds for investment management and administrative services
  - Qui tam action dismissed due to violations of attorney ethics rules

  - Plaintiff alleged taxpayer deducted excessive and improper NOLs carried forward from the financial crisis because it had transferred bank equity to the federal government during those years
    - Originally brought case in state court
  - Citigroup removed the case to federal court and moved to dismiss, asserting claims were based on public facts in the media
  - Remanded back to state court
  - Court held it lacked jurisdiction because the complaint does not necessarily raise a federal issue.
False Claims Act Litigation

New York: Notable Settlements

- New York Attorney General investigating art dealings.
  - The Attorney General has taken the position that New York sales tax must be paid by the purchaser, or collected and remitted by a dealer with nexus, if the purchaser or purchaser’s agent takes possession of the item in New York
  - Settled investigation into art gallery, Gagosian, in 2016, resulting in gallery paying over $4 million in tax, penalties, and fees

- *My Pillow* Leveraged into New York Settlement
  - Plaintiff/Relator prevailed in Illinois False Claims Act action by proving that *My Pillow* failed to collect and remit use tax on internet and telephone sales
  - The same plaintiff subsequently filed a New York False Claims Act suit against *My Pillow* on the same issue related to the company’s New York sales
  - Plaintiff leveraged the Illinois win to negotiate a $1.1 million settlement with *My Pillow* in New York
CLASS ACTION LITIGATION
Class Action Litigation

Under Collection

Qui Tam/
False Claims
Act Risk

Over Collection

Class Action
Risk
Class Action Litigation

Basics

- Federal Class Actions
  - Elements to Certify a Class
    - Standing
    - FRCP Rule 23(a) Requirements (must meet all four):
      - Numerosity
      - Commonality
      - Typicality
      - Adequacy of Representation
    - FRCP Rule 23(b) Requirements (must meet one of three):
      - Individual Adjudication would Result in Prejudice
      - Injunctive or Declaratory Relief
      - Common Questions of Law or Fact

- State Class Actions
Class Action Litigation

California

  - California Supreme Court held that the state’s tax code provides the exclusive remedy for a dispute over the applicability of the state sales tax to retail transactions, and thus a class of plaintiffs was precluded from seeking a refund from Target, Inc. for erroneously collected sales taxes on takeout coffee sales.
  - Plaintiffs alleged that by representing to its customers that sales tax was collected on coffee sales, Target violated California’s Unfair Competition Law (UCL) and Consumers Legal Remedies Act (CLRA).
California

- **Loeffler v. Target Corp.,** Docket No. S173972 (Cal. May 1, 2014)
  - CA Supreme Court refused to do so, noting that “the clear basis of plaintiffs’ action—that Target represented that it properly was charging and in fact charged sales tax reimbursement on a sale that plaintiffs believe the tax code exempted from taxation—requires resolution of a sales tax law question”
  - The court held that the issue of taxability is first committed to the State Board of Equalization: the tax code contemplates that challenges be made through an audit or deficiency made by the Board, or through a taxpayer’s refund claim before the Board, followed by judicial review of the Board’s decision
  - Thus, a cause of action under the UCL or CLRA cannot be reconciled with the mechanisms of the state’s tax code
Class Action Litigation

California

  - Customers filed potential class action on May 11, 2015
  - Customers argue:
    - That Costco did not properly collect sales tax on purchases that involved “manufacturer rebates,” even though the customers assert that the manufacturers never reimbursed Costco;
    - That California tax law prohibits sales tax on the pre-discount price unless the retailer received a payment from a third party for the difference between the original and the discounted price for which it actually sold;
    - That Costco collected sales tax on the pre-discount price
California

  - Residents of Los Angeles assert city improperly collected over $1.3 billion from taxpayers
    - Argue that fees tacked onto electric bills constitute an unconstitutional tax on the putative class members
    - Argue that Los Angeles Department of Water and Power overcharged 8% in taxes disguised as fees that are rerouted into the Department’s reserve fund and not used to provide the services’ customers are paying for, as required by the California Constitution
  - Dismissed as untimely in April 2016

  - Consumers filed class action against city of Los Angeles alleging that city unlawfully imposed a 10% tax on telephone services that were not taxable under the Federal Excise Tax
    - Potential liability of up to $300 million
  - Judge granted final approval of settlement, pending execution, on Oct. 26, 2016
Pennsylvania & Ohio

  - Named plaintiff bought two cans of shaving gel with a *buy one get one free* coupon. Total purchase $2.97
  - Alleges Walmart overcharges sales tax in PA stores and Internet sales and has “misappropriated millions of dollars…”
  - Remanded to state court

  - Retailer shortchanged customers who returned items to different stores by applying lower sales tax rates
  - Breach of contract – violates terms of sale by refunding less than the original purchase price
  - Walmart seeks to remove to State Tax Commission from federal court since they are exclusive arbiter of state tax refund claims
  - The parties agreed to a preliminary settlement, which was approved by the court on December 21, 2015
Florida & Illinois

- **Schojan v. Papa John’s Int’l, Inc., No. 8:14-cv-1218-T33MAP (pending, M.D. Fla. 2014)**
  - Three Florida men filed a class action lawsuit against Papa John’s claiming it charges sales tax on delivery fees in violation of Florida law
  - Papa John’s removed the case to the U.S. District Court on May 22, 2014
  - The U.S. District Court denied Papa John’s Motion to Dismiss
  - Plaintiffs’ motion for class certification granted in Dec. 2014
  - Parties agreed to settlement in Feb. 2015
    - Remanded to state court pursuant to Tax Injunction Act

  - Individual filed a class action lawsuit against Papa John’s claiming that it charged unlawful sales taxes on delivery orders
  - Papa John’s removed the case to the U.S. District Court on May 16, 2014
  - Between March and September of 2015, federal judge held that federal court had jurisdiction and refused to remand to state court on several grounds
  - In September 2015, Plaintiff voluntarily dismissed
# Class Action Litigation

## Illinois

- **Wong v. Whole Foods Market Group, Inc., No. 1:15-cv-00848 (N.D. Ill. 2015).**
  - Class action suit alleges overcharging of sales tax on items purchased with coupon (for which Whole Foods is not reimbursed – hence no consideration) but sales tax applied to the pre-coupon sales price
  - Plaintiff paid $7.39; tendered $15 coupon, but paid 9.25% sales tax on $22.39, not $7.39
  - Settled in August 2015.

- **Wong v. Target Corporation, No. 1:15CV01985 (N.D. Ill. 2015)**
  - Largely Identical to the Whole Foods case.
  - Settled in June 2015
Illinois

  - Plaintiffs alleged that Walmart over collected Illinois sales tax on shipping charges in connection with purchases made from its website.
  - From Walmart’s perspective, they merely collected and remitted the tax, which was held by the state.
    - If money is owed to plaintiffs, the state should refund it.
  - Ultimately, the Illinois Supreme Court ruled that Walmart correctly charged and collected sales tax on shipping charges – no refund.
  - Bottom Line:
    - One customer, with no sales tax experience or inside knowledge, dragged Walmart through the courts for years, incurring sizable legal bills and no good way out. Plaintiff deprived taxpayer and the state of the efficient administration of an essential government function.
New York

  - Consumers alleged that Whole Foods engaged in deceptive trade practices and had been unjustly enriched because it overcharged customers by mislabeling the weight of products and that Whole Foods added tax to non-taxable items
  - Court dismissed, finding the consumers lacked standing because they could not demonstrate they purchased any of the mislabeled foods

  - Alleged Dunkin’ Donuts improperly collected sales tax on prepackaged coffee sold in New York
  - Court dismissed for failing to exhaust administrative remedies (i.e., not seeking a refund from the tax department)
TAX POLICY INITIATIVES
Recent Regulations and Legislation

- Illinois Department of Revenue amends its shipping and handling regulations – 86 Ill. Admin. §§ 130.410 and 130.415
  - Safe Harbors for tax periods between November 19, 2009 (Kean decision) and April 1, 2016 – Relied on Kean or Relied on Regulations
  - Effective April 1, 2016

- Illinois has, unsuccessfully, attempted to enact legislation on an annual basis that would amend its False Claims Act procedures
  - Provides: 1) that the Department of Revenue has the sole authority to bring an administrative action resulting from information provided by any person alleging a false claim and; 2) that the Attorney General has the sole authority to bring a judicial action for a false claim pertaining to any tax administered by the Department of Revenue.
  - Includes additional provisions concerning reporting, enforcement, and payment of rewards.
  - An award may be appealed exclusively to the Court of Claim within 30 days of determination.
Multistate Tax Commission

- MTC Sales Tax Uniformity Subcommittee formed a drafting group (public and private sector members) to address class action and false claims issues

- Subcommittee proposed that executive committee recommend states adopt ABA Model Act

- MTC was working toward adopting a model similar to the IRS

- MTC committee, however, has not met since August 2015
American Bar Association Model Act

- Prepared by the Government Submissions and Legislative Whitepapers Subcommittee with the State and Local Tax Committee

- Balances conflicting interests of sellers, purchasers and state and local governments

- Subcommittee drafted a model that would not violate SSUTA but would provide an exclusive remedy for a purchaser to obtain a refund of over-collected tax
American Bar Association Model Act

- The paper outlines **15 governing principles**. Some highlights include:

  - **Principle 6** - Sellers are, in collecting tax from purchasers, and paying it over to the taxing jurisdiction, acting merely as agent for the taxing jurisdiction. Accordingly, sellers should not be subject to claims arising from or in any way related to an overpayment by purchasers or liability to such purchasers or anyone else other than a taxing jurisdiction revenue department, regardless of the nature of the claim or cause of action asserted, unless the party asserting the liability demonstrates that in collecting the tax the seller acted with willful intent to defraud the purchaser.
American Bar Association Model Act

- **Principle 9** – Any purchaser who has overpaid a tax should be entitled to a refund if a timely and adequate claim is filed.

- **Principle 11** – A taxing jurisdiction has a legitimate interest in ensuring that duplicate refunds are not issued. Accordingly, a taxing jurisdiction may establish procedures for that purpose.

- **Principle 14** – A taxing jurisdiction has a compelling interest in the fair and equitable interpretation of its transaction tax laws and should be an indispensable party in any litigation determining the proper application of those laws.
American Bar Association Model Act

- Major provisions:
  - Section 4 sets forth Purchaser Recourse provisions
    - Purchaser’s relief is limited to a refund claim pursuant to §5
    - Seller should not be party to any action
  - Section 5 sets forth Refund Procedures
    - Purchaser may file a claim with the seller with time limits (90 days) for response
    - Purchaser may under certain circumstances file a claim with the taxing jurisdiction
PROTECTING YOUR COMPANY
Protecting Your Company

1. Planning and Foresight
2. Settlement – Eliminate Bad Publicity, Deal with State
3. Legislative Efforts to Reform *Qui Tam* Statutes
4. Efforts to Limit Class Action Lawsuits - ABA Model Transaction Tax Overpayments Act
Questions?

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