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In Support of Bill 22-0166, the False Claims Amendment Act of 2017

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Thank you for the opportunity to submit this testimony on behalf of myself, as a District resident and taxpayer, and Constantine Cannon LLP, a law firm with a specialty in representing whistleblowers under state and federal False Claims Acts, including the whistleblower reward program of the Internal Revenue Service. Based on our collective decades of experience with *qui tam* actions such as those permitted by the District's False Claims Act, we urge the Committee and the Council to eliminate the tax-fraud loophole.

The tax gap – the difference between the taxes owed and those actually paid – is a difficult problem for every jurisdiction. Eliminating the tax-fraud loophole in the District's successful False Claims Act would help reduce it, by enabling the District to crack down on tax fraudsters, generate revenue, and increase enforcement resources in a revenue-neutral manner. Below, we explain why. We also suggest some minor modifications to the Bill to help maximize its effectiveness.

I. Challenges of Tax Enforcement

While the District's Office of Tax and Revenue can and does investigate and prosecute tax cheats, it faces the same problems as every other taxing authority. Two particularly difficult problems are squarely addressed by the Bill.

First, budgetary realities mean that the District has finite enforcement resources. As a result, OTR cannot pursue every audit that it might like. Moreover, those same budgetary constraints may limit OTR's ability to identify potential non-compliance with the tax laws in the first place, further reducing the likelihood that it will successfully find and audit all non-compliant taxpayers. Compounding the problem, would-be tax cheats are aware of these limitations, and they will often choose to play the "audit lottery" rather than comply with the law.

Second, like all enforcement agencies, OTR is at an informational disadvantage compared to taxpayers. In my near-decade of experience representing the Internal Revenue Service at the U.S. Department of Justice, I learned first-hand how little information even federal tax authorities have compared to the taxpayers. Because federal and District tax law are based on self-reporting, tax authorities are frequently simply unaware of non-compliance prior to an audit. Some frauds are completely invisible to the outside, particularly those that are highly complex or perpetrated by non-filers or entities outside the jurisdiction who nonetheless have a legal duty to pay District taxes.

II. Eliminating the Tax-Fraud Loophole in the False Claims Act Would Address These Difficulties

Adopting the Bill would permit the District to address these two key problems in tax enforcement, in a revenue-neutral manner and with limited downside. *Qui tam* suits are among the most successful of government enforcement mechanisms, and the District should join the growing number of states employing them to combat tax fraud.

A. The Benefits of Enforcement Through False Claims Acts

As the Council is well aware, the District False Claims Act (D.C. Code § 2-381.01 – .10) already imposes strict civil penalties and liability for damages on those who defraud the District government of public funds, and it permits whistleblowers to bring civil actions on behalf of the government to stop fraud. Most of the funds are restored to the public treasury, but the Act encourages whistleblowers by awarding them a certain portion of damages collected from the defendant. The District has recovered millions of dollars in wrongfully obtained public funds in cases brought under the Act. Similarly, the federal False Claims Act has netted the U.S. Treasury over $40 billion in whistleblower-originated fraud recoveries since its enactment in 1986.

As a result, false claims acts are considered the most effective tool to combat fraud against the government. But in the District, as in many states, the tax-fraud exemption bars the Attorney General and whistleblowers from bringing cases against entities that defraud the government by failing to pay taxes.

By lifting that restriction, the Bill would bring the many benefits of *qui tam* provisions to tax enforcement. *Qui tam* provisions extend the government's reach by using whistleblowers to level a playing field characterized by asymmetric information and tax cheats' active concealment. Whistleblower "insiders" can point regulators to tax avoidance that would otherwise fly under the radar, and they can provide critical information that permits regulators to see behind the façade to the fraud that would otherwise escape view. This makes whistleblowers a vital resource to expose tax frauds that would otherwise go undetected.

Encouraging whistleblowers to report tax fraud will also multiply the limited resources available for enforcing tax laws. *Qui tam* suits, particularly with the proposed statutory minimum amount at issue, would also increase the efficiency of enforcement by focusing on large-scale frauds. If the District closes the tax-fraud loophole, whistleblowers would build a case for the government, provide a submission that explains the tax fraud in detail, and allow the District tax authorities to efficiently determine whether to join the suit and reap the rewards of the whistleblower's work.

As a side benefit, closing the tax-fraud loophole in the District also would strengthen federal-tax enforcement efforts, with resulting benefits for District enforcement. Since District

tax law often mirrors federal law, it is common for the IRS and OTR to take action against the same violations. Because insufficient resources and endless delays so hamper IRS enforcement, whistleblowers would embrace the option to file parallel cases with District authorities.

B. New York's Successful Tax *Qui Tam* Experience

Numerous states have already realized that tax *qui tams* can help them address some of their issues with tax enforcement. False-claims statutes in Delaware, Florida, Illinois, Indiana, Nevada, New Hampshire, New York, Rhode Island, and Washington allow actions targeting some or all types of tax fraud.

New York's statute, which follows similar lines to what the Bill proposes for the District, has been extremely successful, demonstrating the enormous positive impact reliance on whistleblowers can have on enforcement. New York amended its false-claims statute in August 2010 to expressly allow *qui tam* suits for tax fraud. Like the District's proposal, New York's law sensibly requires whistleblowers to bring only actions that allege large-scale tax fraud; it does so by limiting the law's application to situations in which a defendant's net income or sales exceed $1,000,000 for the tax year, and the alleged underreporting deprives the government of $350,000 or more.

Complex tax fraud cases take many years to resolve. Yet the tax-fraud provisions of the New York False Claims Act, in effect for only eight years, have already shown considerable success. For example:

- In related settlements, in October 2018, an investment manager agreed to pay $30 million, and in April 2017, a hedge fund sponsor and its top executives agreed to pay $40 million, all to resolve allegations that originated with a whistleblower that they had failed to pay millions in New York State income tax on performance-fee income.
- In October 2017, Yankee Clipper Food Services I Corporation was convicted of a multi-year scheme to avoid paying New York taxes, after an investigation that was kicked off by a whistleblower. Together with other entities involved in the scheme, it paid $13 million to the state.
- In August 2016, a Minnesota pillow company paid $1.1 million to resolve a whistleblower suit alleging it knowingly failed to collect state and local sales taxes on website and telephone sales to New York residents.
- In August 2014, Topline Appliance Center agreed to pay $1.56 million to settle a false-claims lawsuit that accused the company and its owner of failing to collect and pay New York sales taxes and corporate franchise taxes for nearly 10 years.
- In March 2013, Mohanbhai Ramchandani, owner of a celebrity custom clothing business, paid $5.5 million to settle a whistleblower's claims that he failed to pay state and local sales taxes that his business charged to customers.

- In April 2012, the New York Attorney General intervened in a whistleblower action alleging Sprint fraudulently failed to collect and pay more than $100 million in New York sales taxes for wireless services since July 2005.

Because complex tax cases require such lengthy investigations, it is certain that, in addition to the few that have been publicly reported, dozens or even hundreds of other cases in New York remain under investigation.

C. The IRS's Whistleblower Program

The IRS's Whistleblower Program also provides an instructive lesson. Like the District's current act, the federal False Claims Act excludes tax claims. In 2006, however, Congress created the Whistleblower Program—a standalone whistleblower law that mandates rewards for whistleblowers who provide information to the IRS that results in the collection of unpaid federal taxes—to close that loophole. *See* 26 U.S.C. § 7623(b).

The IRS whistleblower program has been a huge boon for the federal treasury, leading to the recovery of $3.6 billion in unpaid taxes and penalties since 2010. In one notable case, a whistleblower revealed that UBS helped American clients hide income from the IRS in offshore accounts. As the *New York Times* reported, not only did UBS pay the IRS $780 million to settle its case, but the whistleblower's information "led to an investigation that … allowed the Treasury to recover billions in unpaid taxes." *See* David Kocieniewski, *Whistle-Blower Awarded $104 Million by I.R.S.*, N.Y. TIMES, Sept. 11, 2012, at A1. This case is but one of many examples.

While the IRS Whistleblower Program enables whistleblowers to provide the IRS with information about tax fraud, it could be even more effective. Critically, the IRS whistleblower program has no *qui tam* provision, which allows a whistleblower to file suit on the government's behalf to recover public funds, further leveraging private resources to the government's benefit. Several other problems—including delays in processing whistleblower claims, a lack of communication, a practice of rejecting claims without explanation, and a subjective process for determining whether to grant whistleblower awards—further hamper the program's effectiveness.

Apart from the IRS Whistleblower Program's own shortcomings, federal resources to police tax cheats have been—and will continue to be—greatly cut back. The IRS has long been the target of lawmakers in Washington, who since 2010 have slashed the IRS's enforcement budget by 20 percent, leading the agency to lose nearly a quarter of its workforce. *See* Brandon Debot, Emily Horton & Chuck Marr, *Trump Budget Continues Multi-Year Assault on IRS Funding Despite Mnuchin's Call for More Resources*, Center on Budget and Policy Priorities, March 16, 2017. The current administration has proposed even deeper cuts to the IRS that would further hobble its ability to pursue tax cheats. The IRS's resulting ineffectiveness will embolden tax cheats to violate the law at all levels of taxation, including the District.

By closing the tax-fraud loophole, the District can fight this tide. *Qui tam* plaintiffs leverage private resources, avoiding the budgetary constraints facing the tax authorities and boosting their ability to target frauds. Moreover, strong enforcement at the District level will help combat slackening enforcement elsewhere and ensure that the District receives the taxes it is owed.

III. Suggested Changes to the Proposed Statutory Language

We would also urge the Committee to make a minor change to the Bill's language. As written, the Bill would add the following language to the District False Claims Act:

> "…taxation, unless the person making any such claim, record, or statement reported net income, sales, or revenue totaling $1 million or more in a tax filing to which that claim, record, or statement pertained, and the damages pleaded in the action total $350,000 or more."

Unfortunately, the wording as proposed would leave two unintended loopholes. Ironically, the first would benefit those most successful at defrauding the District of its rightful tax revenue. Specifically, if the individual or entity dodging taxes did not "report[] net income, sales, or revenue totaling $1 million or more in a tax filing," no False Claims Act liability would attach, *even if* the alleged tax fraudster *actually had* net income, sales, or revenue totaling $1 million that it should have reported. A simple change to the wording would resolve the problem, putting the emphasis back on the reality of the taxpayer's situation, as opposed to what it reported.

Second, the language as proposed in the Bill is ambiguous in a way that runs the risk of being underinclusive for taxpayers committing fraud over multiple years. Imagine a taxpayer with net revenues of $1.8 million in 2017, but only $900,000 in 2016 and 2018. As writing, the Bill might permit an action against that tax cheat only for 2017, but not 2016 or 2018, even if the fraud covered all of those years. Again, a simple wording change would make clear that this unintended narrowing is not the case, without undercutting the goal of preventing minor claims.

As a result, we propose the following change to the statutory amendment, which would fix both unintended problems:

> "…taxation, unless the person making any such claim, record, or statement ~~reported~~ **had** net income, sales, or revenue totaling $1 million or more in ~~a tax filing to which that claim, record, or statement pertained~~ **any tax year subject to such an action**, and the damages pleaded in the action total $350,000 or more."

IV. Conclusion

We urge the Committee to support the Bill, with the modifications proposed above, to help the District take enormous steps forward for tax enforcement. Doing so would crack down on tax fraudsters, raise revenues, and increase the government's tax-enforcement resources, all without costing taxpayers additional money.