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‘Whistle-blower’ lawyer grasps for e-tailer back taxes; Illinois attorney general helps

In an unusual strategy, a Chicago lawyer is using an Illinois whistle-blower statute with a share-the-proceeds provision to force collections on online retailers with bricks-and-mortar presence in the state. Illinois Attorney General Lisa Madigan is going to help. And the tactic could spread to several other states that offer similar contingency payments to whistle-blowers, experts say.

Attorney **Stephen Diamond**, a partner with Beeler, Schad & Diamond, has in his cross-hairs Wal-Mart, Target, Office Depot and its wholly-owned subsidiary Viking Office Products, Toys R Us, Jo-Ann Stores of America and Mothers Work Inc., a maternity clothes merchant. Back taxes may be limited only by a statute of limitations of 10 years provided by the whistle-blower statute, Diamond says. Since the e-tailers had not registered and filed, tax law would offer no statute of limitations, notes **Fred Marcus**, of Horwood, Marcus & Berk in Chicago.

Illinois Director of Revenue **Brian Hamer** says the attorney general’s office had been handling the suits and the Dept. of Revenue was not part of the litigation. So the attorney general will apparently decide any settlement matters such as the lookback period.

“To date, there has been no discussion to my knowledge between this agency and theirs,” Hamer says. “It may be that we will be talking to them.”

As whistle-blower, Diamond could receive a contingency of 15% to 25% of any recovery, Diamond says. The attorney general could receive court costs. Five suits have been made public. Under the whistle-blower statute, suits remain sealed until the attorney general decides whether to litigate for the whistle-blower and become the lead litigant. Diamond won’t say how many other suits remain sealed, but sources suggest that nearly 60 similar suits may be lodged. Many may come to light in coming months, they add.

“I believe that these companies had a duty to collect use tax that they were failing to do,” Diamond insists.

Marcus disagrees. “I think it’s a lousy way to establish tax policy,” he says. “There seems to be a real tension between the Dept. of Revenue, in its responsibility to enforce and interpret tax statutes, and these whistle-blower statutes. I don’t think the Illinois Legislature intended these whistle-blower statutes be used for taxes. Whether use tax collection responsibility on the basis of affiliate nexus is warranted is a question yet to be resolved.”

Diamond insists his strategy is legally sound. “I initiated these whistle-blower cases because I believed they were factually and legally correct,” he says.

Proliferation

Experts fear more whistleblower suits on the horizon.

“It would be my guess that these suits may spread, as the people become aware of them,” says Marcus. “It isn’t just an Illinois problem. Because of the publicity around these suits, we may see these in other states.”

Richard Pomp, a University of Connecticut law professor, agrees. “Quite likely,” he says of the possibility of more similar cases. “There’s money to be made.”

Nevada, Tennessee and Virginia have similar contingency whistle-blower arrangements, Pomp notes.

What to do

The only tax that applies to interstate transactions is the state use tax, Marcus notes. So municipal taxes won't be an issue. Marcus advises mail-order retailers and e-tailers who are concerned about physical presence nexus in Illinois through an agent or representative to consider a statutory voluntary disclosure, which limits the lookback period to four years. Yet a mail-order company or e-tailer that truly believes it lacks physical presence should "sit back and hope they're not attacked, and if they are, then defend it vigorously."

Pomp advises companies buying from sellers with a physical presence in Illinois to make sure they are paying the use tax. Sellers should examine their business organization to see if the state can make an argument for an agency relationship.

"I'd say that if you were a vendor walking a very fine line as to issues of nexus, you're going to be in for a fight—if you're one of the big boys. Obviously, no one is going after the small players."

The current whistle-blower suits only involve large corporations. The outcome of the suits, however, will affect smaller businesses, Pomp notes.

Fate of entity isolation

"Time is running out on entity isolation," says Pomp. "The tide is turning against the viability of that technique."

He points to the recent agreement by Wal-Mart, Target and other large-scale corporations with Internet entities to begin collecting voluntarily nationwide as proof.

"Looking at that agreement it's a pretty good acknowledgment that people are worried about hiding behind the separate incorporation of their brick-and-mortar stores to separate them from their Internet entity," Pomp says. "I think people are tired of taking around their tax lawyer with them every time they want to make a marketing decision and have to clear it through the tax lawyer."

But Marcus notes, "Affiliate nexus is an unanswered question in this state."

Wal-Mart's position

David Smith, assistant general tax counsel for Wal-Mart, says he feels confident the suit against his company will not stand up legally. "We're confident in our position," Smith says.

Similar suits in other states likely will not prevail against the retailer, either, he adds. "I'm not worried," Smith says. "They may cost us attorney fees."

The Illinois statute was modeled after a federal false claims law, which excludes any case under the IRC. The Illinois statute excludes income tax. No mention of sales and use tax in the statute may be an oversight, says Smith.

The whistle-blower statute, essentially a fraud statute, has no application in determining any possible online use tax liability, he added. "We disagreed on an interpretation of *Quill*," Smith says. "That's not fraud."

Diamond's suit alleged that Wal-Mart misled patrons with a statement on the online entity's Web site which said customers in Arkansas, California, Colorado and Georgia—states where the online entity has physical presence—owed tax on purchases.

Smith noted that the Wal-Mart online company began selling in 2000. A previous, smaller Internet company did little in sales, but collected taxes.

Attorney general silent

Meanwhile, the attorney general has decided to keep quiet about what she intends to do, and apparently recently stifled her staff. Madigan would not take calls from *SUTA*. Her spokeswoman, Melissa Merz, said only, "We'd like them to pay what they owe. The Dept. of Revenue will provide estimates." Merz demanded questions by email, then later refused to answer them. Earlier, one of Madigan's subordinates who handles policy, Stephen Mange, had promised to talk at a more convenient time, then would not return calls for days afterward. Charles Godby checked to see if he could speak on the matter, then said he must refer all matters to Merz. ®

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