Negligence Is Not Enough for Illinois False Claims Act Violation

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In this viewpoint, the authors describe a recent case addressing the Illinois False Claims Act (FCA) as applied to sales and use taxes. They write that although businesses cannot simply ignore the sales and use tax rules and regulations, the case is a good example of when mere negligence is insufficient to create an FCA violation.

For more than a decade, *qui tam* actions for alleged underpaid sales taxes have been a scourge in Illinois.[1] Numerous cases under the Illinois False Claims Act (FCA)[2] have been brought challenging businesses — usually non-Illinois-domiciled businesses — for failing to pay the proper amount of tax the plaintiffs alleged was due on the businesses' Illinois sales.[3] Those cases seek treble damages of the amount of tax claimed unpaid, as well as attorney fees. Because of the cost of ligation, most cases are settled with the businesses shelling out thousands of dollars to the law firms bringing the case.

A *qui tam* (sales tax) action is usually brought by a private law firm that alleges it is bringing the action for the state. It claims that an underpayment of sales tax has occurred. The private attorney steps into the shoes of the state to prosecute the case. The Illinois attorney general could take over the case but usually does not, leaving the private law firm to handle the entire case. Those cases generally hinge on two important issues: (1) whether there was an actual underpayment of tax and (2) whether the business knowingly underpaid the tax or knowingly concealed or improperly avoided its obligation to pay the proper tax due.[4]

A business is considered to be knowingly concealing or avoiding an obligation to pay a tax when the business has "actual knowledge" of the tax obligation or "acts in deliberate ignorance" or "reckless disregard" of its tax obligation.[5] As a result, for years, businesses were concerned with what actions or inactions create FCA violations, thereby possibly subjecting them to damages under those *qui tam* actions. While the facts in each case will differ, the appellate court in *National Business Furniture* has now alleviated some of those concerns by making it clear that mere negligence will not give rise to a FCA violation.

The Illinois False Claims Act

The FCA is an anti-fraud statute derived from the federal False Claims Act.[6] Under the FCA, a party that is found liable of fraud is liable for civil penalties and treble damages. As noted in the introduction, in a *qui tam* action, claims may be brought for the state by the attorney general or by a private party. That private party is referred to as a relator. Under a *qui tam* action, the state has the option to intervene or allow the relator to proceed with the action. The relator is then entitled to a percentage of the proceeds or settlement amount in the event it is successful in the action.

The Background of *National Business Furniture*

In *National Business Furniture*, a complaint was filed against National Business Furniture (NBF), alleging that it violated the FCA because it knowingly failed to collect and remit use taxes to the state of Illinois on shipping charges for its sales made to Illinois residents through NBF's internet and catalog sales. There was no dispute that NBF had not

[1] *See, e.g., State ex rel. Beeler, Schad and Diamond PC v. Burlington Coat Factory Warehouse Corp.*, 369 Ill. App. 3d 507 (1st Dist. 2006).

[2] 740 ILCS 175/1 (West 2020).

[3] Notably, a business can also be challenged by a private law firm for possibly over-collecting a tax in Illinois under the Consumer Fraud and Deceptive Business Practices Act. *See Kean v. Wal-Mart Stores Inc.*, 235 Ill. 2d 351 (2009).

[4] *The State of Illinois ex rel. Schad, Diamond and Shedden PC v. National Business Furniture LLC*, 2016 Ill. App. (1st) 150526, para. 29.

[5] *Id.* at para. 29.

[6] 31 U.S.C. sections 3729-3722 (2006).

been charging use taxes on its shipping charges and that former and current CFOs had made little to no inquiry whether that was proper under Illinois law, let alone actively investigated Illinois's tax laws. Thus, the issue before the court centered on whether NBF's actions or inactions regarding the taxation of those shipping charges violated the FCA.

National Business Furniture involves whether NBF was required to collect Illinois use tax on its shipping charges. The Illinois Use Tax Act, 35 ILCS 105/3, imposes a tax on the privilege of using tangible personal property in Illinois when purchased from a retailer at retail. Retailers are to collect and remit use tax to Illinois. Section 130.415 of the Illinois Department of Revenue regulations states that the collection of use tax depends not on the separate billing of the shipping charges but rather on whether the shipping charges are part of the sale price. As a result, section 130.415 instructs a retailer that no use tax on shipping fees is due when a separate and distinct contract for transportation exists. That can usually be shown if shipping is not only separately stated but also optional to the buyer.[7]

The Illinois DOR has also issued numerous information letters on the taxation of shipping charges. While the DOR information letters are not binding statements of policy, they do provide guidance to retailers on when use taxes must be collected on shipping charges.[8] The letters state that merely listing the shipping charges on a contract without further evidence is not enough to constitute a separate shipping contract apart from the sale price. However, because those issues are fact specific, most of the DOR letters conclude that the tax liability generally cannot be determined without additional information on the transactions and delivery options available.

In addition to the DOR's regulations and letter rulings, the Illinois Supreme Court in *Kean v. Wal-Mart Stores Inc.*[9] had recently issued guidance on the taxability of shipping charges.[10] In *Kean*, Wal-Mart collected and remitted use tax on shipping charges by treating them as part of the sales contract. The plaintiffs in that case alleged that this collection was improper in connection with purchases made from the website. The trial and appellate courts agreed that the shipping charge was taxable. On appeal, the supreme court agreed and concluded that there was no separate agreement for delivery in the sale. In *Kean*, while there were several options for shipping, there was no option to pick up at the store or to avoid the shipping requirement. Consequently, an online shopper was unable to check out without paying for the shipping. Thus, the supreme court agreed that Wal-Mart correctly collected and remitted use tax on the shipping charges associated with the online purchases.

[7]86 Ill. Admin. Code 130.415(d).
[8]*National Business Furniture*, at para. 5
[9]235 Ill. 2d 351 (2009).
[10]*National Business Furniture*, at para. 6

The Circuit Court Trial in *National Business Furniture*

NBF is a Wisconsin-based office furniture and supplies company that sells to customers across the country. NBF allows a customer to purchase retail merchandise in-store, online, over the phone, and through the mail-order catalog. While NBF has no physical presence in Illinois, NBF contracts with a third party to ship merchandise directly to the customer. Sometimes the customer can pick up the merchandise at such third party's warehouse.

NBF does not have a separately written contract regarding delivery. Generally, customers will select their shipping options at checkout. NBF uses UPS or FedEx to ship the merchandise. On the invoice, there is a note to call NBF's toll-free phone line if the customer needs "additional services." On the website, the shipping charges are not added on until checkout, and the catalog states that delivery charges are not in the advertised price and further instructs customers to call NBF regarding shipping.

Also, in the FAQ section of NBF's website, there are several delivery options. Again, customers are encouraged to call NBF for more information regarding shipping options. NBF offers an alternative to its contracted shipping and allows the customer to arrange delivery using its own delivery company. This is called the freight collect option. It was noted in the case that out of thousands of purchases made in Illinois, only 20 to 25 orders were made using that freight collect option. NBF further has had a practice at all times not to collect and remit taxes on shipping charges unless there was a governmental agency exception or the pricing was bundled with shipping.

The relator filed a complaint in 2012, alleging that NBF had a clear duty to collect and remit taxes on the shipping charges regardless of the company policy. The relator further alleged that before July 27, 2010, NBF "knowingly made or caused to be made" false records or statements to "conceal, avoid or decrease [this] obligation to pay or transmit money or property to the State." The relator referred to the monthly ST-1 tax returns, claiming that NBF "falsely omitted" tax on the shipping and handling charges from NBF's internet and catalog sales. The relator amended its complaint in 2014, adding NBF's continued failure to pay during that two-year lawsuit. In the circuit court, a two-day bench trial was held in which testimony from two of NBF's past CFOs and the current CFO was presented.

The first CFO, Daniel Paruzynski, testified that NBF collected use tax on merchandise in 20 states and use taxes on shipping in only 15 of those states. Paruzynski further testified that the company took that position based on its interpretation of the rules. However, Paruzynski testified that he did not remember reviewing any case law or general information letters from the DOR. But he said that when he read section 130.415 of the regulations, he concluded that

no tax was due on the company's shipping charges.[11] He also said that he never received any indication that the law changed and, if he had, the company would have revised its policy in Illinois.

The second CFO, Eileen Bause, became CFO immediately after Paruzynski. Bause had worked for NBF since 1996 in two other accounting roles. She testified that Illinois is one of the 20 states where NBF sells merchandise and that NBF subscribes to publications announcing the changes in state laws regarding sales and use taxes. Bause testified that she never reviewed any statutes or regulations or discussed Illinois use tax with any accountants or lawyers. She was also not aware of the *Kean* decision until the case at hand was filed. Bause testified that in 2010, new tax software was purchased but that no new review of the tax laws was analyzed; only the past policies were programmed into the software. She testified that no changes to NBF's policy were made since the lawsuit was filed.[12]

The third and current CFO, Perry Amadon, took over in 2012. Amadon testified that he skimmed through *Kean* but did not read any other case law. Amadon further testified that it was his decision to keep the current policy in place and never saw anything that clearly required NBF to collect and remit use taxes on shipping charges. Amadon was specifically questioned by the court, which asked: If he's such a careful person, why didn't he reach out to experts on the matter? Amadon could only respond, "I can't tell you why I didn't do that."[13]

In addition to testimony from Amadon, a letter from the DOR was presented as to the audit it planned to conduct in late 2007 to early 2008. That letter informed NBF of the DOR's intent to audit the company on its sales and use tax. Paruzynski stated that he and his staff worked with the DOR's auditors on a day-to-day basis and that NBF "made every attempt" to comply with the auditor's requests. Paruzynski did note that he could not recall if the auditor specifically asked about the issue at hand. However, the audit file contained several transactions that the auditor had asked about. Those documents indicated that NBF was not collecting use tax on shipping charges. Paruzynski stated that at no time did he doubt the company was paying the proper Illinois use tax. He also pointed to the final audit report that did not assess use tax on NBF's shipping charges.[14]

The relator's fundamental argument against NBF was that NBF violated the Illinois Use Tax Act by not collecting use tax on its shipping charges and acted recklessly when it did not conduct an inquiry into the taxation of its shipping charges and did not seek out professional tax help to determine if its shipping charges were taxable. Moreover, the relator noted that there was no certainty that the DOR in the audit was shown the documents that revealed NBF's policy to not collect use tax on its shipping charges. As a result, the relator asserted that the tax returns were false records in violation of the FCA.[15]

The circuit court opinion concluded that NBF did not act with reckless disregard. The court found that the CFOs were credible witnesses and also found that NBF acted reasonably in relying on the results of the DOR audit, as well as its own interpretation of section 130.415, to not collect and remit use taxes on its shipping charges. Thus, no violation of the FCA occurred.

Appellate Court Decision in *NBF*

In the appellate court, the relator argued that the circuit court erroneously concluded that NBF did not act with reckless disregard in violation of the FCA. In stating the standard of review, the appellate court held that it would defer to the findings of fact by the circuit court, unless contrary to the manifest weight of the evidence.[16] As to the law, the appellate court stated that for the purposes of determining a violation of the FCA, a party knowingly conceals or avoids an obligation to pay when it has "actual knowledge" of the obligation or acts in "deliberate ignorance" or "reckless disregard" of the obligation."[17]

In its analysis, the appellate court first evaluated the meaning of reckless. The court noted that reckless disregard does not encompass mere innocent mistakes or negligence. The court cited federal case law for the proposition that to commit reckless disregard, an individual would have had to have "buried [his] head in the sand and failed to make inquiries which would have [alerted him] that false claims are being submitted."[18] That reckless disregard is demonstrated when a party ignores "obvious warning signs."[19]

The appellate court reiterated that the circuit court found all three CFOs to be credible witnesses in that they honestly believed the shipping and handling costs were not part of the selling price that could be taxed under the use tax act. The appellate court also reiterated the circuit court's holding that because of the proliferation of statutes and regulations, it has become increasingly difficult for the average citizen to "know and comprehend" the duties of the law. The appellate court likewise agreed that it is not the FCA's intention to penalize the difference of opinions or innocent errors despite the use of reasonable care.[20]

Also, the appellate court noted that the DOR's audit would have revealed NBF's policies on use tax collection for shipping costs and further that the audit in no way showed

[11] *Id.* at para. 14.
[12] *Id.* at para. 15.
[13] *Id.* at para. 16.
[14] *Id.* at para. 20.
[15] *Id.* at para. 21.
[16] *Id.* at para. 32.
[17] *Id.* at para. 29.
[18] *Id.* at para. 33.
[19] *Id.* at para. 33.
[20] *Id.* at para. 34.

that NBF was improperly not collecting use taxes on shipping costs. The appellate court agreed that NBF could have reasonably relied on the results of the audit to ensure that it was complying with Illinois law.[21] And the court stated that the relator did not proffer any evidence that NBF was anything but upfront with the auditor.[22]

Because the circuit court was in the best position to give weight to the witness testimony and conclude whether the CFOs were truthful, the appellate court concluded that the circuit court was not unreasonable to find that NBF did not act with "reckless disregard." Moreover, the appellate court found that even without the DOR audit, neither the supreme court in *Kean*, regulation section 130.415, the DOR's general information letters, nor any other case law provided information or guidance on the freight collect option offered by NBF that could have been used by a customer to avoid a shipping charge. Thus, the court held that reasonable minds could differ on whether a sales tax was due on NBF's shipping charges.[23]

The appellate court summed the case up as follows:

> Relator instead needed to prove that defendant ignored obvious warning signs, buried its head in the sand, and refused to learn information from which its duty to pay money to the State would have been obvious. The evidence presented in that case, taken as a whole together with all reasonable inferences in defendant's favor, was not manifestly inadequate to support the circuit court's conclusion that relator failed to meet that burden.[24]

In short, the appellate court held that while the company's failure to periodically review its policies may or may not have been negligence, the company did not act with reckless disregard.[25] As a result, no violation of the FCA occurred, and the appellate court affirmed the decision of the circuit court.

Conclusion

The NBF case is a good example of when mere negligence for failing to actively keep abreast of the tax law will not rise to the level of reckless disregard that violates the FCA. While no two cases are exactly alike, businesses should view the NBF case as a signal that courts will be looking to some active indifference to Illinois tax law before finding an FCA violation. But while mere negligence is not enough to violate the FCA, that does not mean that a business can simply ignore rules, regulations, or case law that clearly provide how the tax is to be applied. If a company ignores clear warning signs that the tax is due, an action against it for a violation of the FCA may still be in its future. ■

[21] *Id.* at para. 35.
[22] *Id.*
[23] *Id.* at para. 38.
[24] *Id.* at para. 39 (citation omitted).
[25] *Id.* at para. 39.