



TAX LITIGATION ISSUES

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The 'New and Improved' Whistleblower Statute

For over 50 years, the Internal Revenue Service (IRS) has been authorized to pay money that it deems necessary for detecting the underpayment of taxes or bringing tax cheats to justice.

This authority includes the payment of financial rewards to informants or whistleblowers who report tax fraud by others.

Although the Informants' Claim for Reward Program, as it was initially known, contributed to the IRS's efforts to enforce the tax laws, over the years it became apparent that the program lacked efficient management and standardized procedures to review claims.¹

Last December, as part of its efforts to confront the "tax gap" resulting from the underpayment of taxes, Congress amended the whistleblower statute to increase the financial incentive for those willing to report tax fraud and to ensure that informants are treated fairly and consistently. The new law has not been fully implemented and it remains to be seen whether Congress' goal of assisting the IRS's compliance efforts by deputizing private citizens will succeed.

The Old Whistleblower Statute

Before its amendment, the whistleblower statute authorized the secretary of the Treasury under "regulations proscribed the Secretary...to pay such sums, as he deems



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necessary for (1) detecting underpayments of tax...."² The regulations made it clear that the payment of such rewards was discretionary, providing that the IRS "may approve a reward, in a suitable amount, for information that leads to the detection of underpayment of taxes."³

With the exception of certain current or former government employees, any person who provided the IRS with information relating to tax violations was eligible for a reward. The informant could request a reward by filing a formal claim on IRS Form 211, the Application for Reward for Original Information.⁴ Individuals making claims under the old whistleblower statute generally consisted of ex-spouses, business rivals, and disgruntled current or former employees. While these informants may have been successful in obtaining a measure of revenge, their efforts to bring tax cheats to justice were not necessarily lucrative.⁵ The regulations specifically provided that any reward paid generally could not exceed 15 percent of the amounts collected by reason of the information, excluding interest.⁶ The IRS, however, had broad discretion in determining the amount of the reward, and informants generally received far less than the 15 percent maximum allowed.

For fiscal years 2001 through 2005, the IRS collected more than \$340 million in

taxes, fines, penalties, and interest based on information from informants. During that same period, the IRS paid informants approximately \$27 million, thereby netting more than \$313 million over the five-year period. For the same years, there were 28,445 claims filed by informants, and only about 4 percent of those claims were allowed.

Moreover, informants were without recourse to complain that they had been wrongly denied a reward or that their reward was too small. Courts recognized an enforceable contractual obligation only where there had been some "special negotiations between the IRS and the persons seeking an award."⁷ Absent such an express agreement, the IRS's decision regarding whether to grant a reward and in what amount was essentially nonreviewable, and would be upheld by the courts so long as there was a rational basis.⁸

Criticisms of the Old Law

During hearings on the IRS Restructuring Reform Act of 1998, some members of Congress had expressed concern that the Informants' Reward Program was subject to abuse and "resulted in unwarranted examinations of honest taxpayers."⁹ While consideration was given to eliminating the program, it remained on the books, albeit not actively promoted by the IRS.¹⁰ By 2004, the tide had turned. During hearings on "Bridging the Tax Gap," the Senate Finance Committee heard testimony from an anonymous witness who had served as a confidential informant for the IRS for a number of years. The witness, referred to as Mr. ABC, estimated that he had provided original information to the IRS regarding abusive tax shelters used to avoid taxes on over \$10 billion. He noted, however, that "[i]n providing all this information, my

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experience with the IRS has been extremely frustrating and discouraging. What I have encountered is an agency that is resistant to and suspicious of confidential informants, that is, private citizens who are trying to do the right thing by coming forward and blowing the whistle on significant tax fraud. I have also encountered an agency that is disorganized, and that is generally not equipped to deal with complex and sophisticated tax shelters in an effective fashion."¹¹

Mr. ABC noted that the service lacked staff and resources to deal with significant cases of tax fraud and individuals who were prepared to provide information about tax shelters. For instance, he testified that his Form 211 claims initially were rejected without consideration, despite the fact that he was actively supplying information to the IRS. Furthermore, Mr. ABC noted a number of instances in which the IRS failed to follow up on information that he had provided. He argued that "if the IRS ever wants to put an end to Wall Street tax shelter schemes, they are going to need the help of Wall Street insiders to get the information and the expertise that it will take. Right now the IRS does not have such resources or expertise—and they should welcome the assistance from knowledgeable insiders."¹²

Subsequently, in June 2006, the Treasury Inspector General for Tax Administration issued a report which noted that while IRS audits and exams based on whistleblower information were "nearly twice as productive as normal IRS examinations," the IRS had failed to effectively benefit from whistleblowers.¹³ The report concluded that the whistleblower program was limited by a lack of detailed policies and procedures and centralized management oversight. Indeed, it noted that in 76 percent of the rejected whistleblower claims reviewed, the IRS's files did not describe the rationale for denying the claim.

Based on the information gleaned from the hearings and the Inspector General's report, Congress was moved to act. As stated by Senator Chuck Grassley, R-Iowa, then chairman of the Senate Finance Committee, "[i]t's important for people with concrete information about tax fraud to be heard and not treated like skunks at the picnic."¹⁴

The New Law

The Tax Relief and Health Care Act of 2006 was signed into law in December 2006. The new law provides for larger rewards for whistleblowers and reduces the IRS's discretion in cases involving significant amounts of unpaid taxes. In addition, a claimant who feels he has not been properly rewarded is entitled to appeal the government's reward decision.

The amended whistleblower statute applies to rewards sought in connection with any action where the additional tax, penalties, and interest in dispute exceeds \$2 million. In addition, where the taxpayer at issue is an individual, her gross income must exceed \$200,000 for a taxable year.¹⁵ Informants providing information in these

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cases are eligible for rewards ranging from a minimum of 15 percent to a maximum of 30 percent of the amount collected (including additional taxes, interest, and penalties).¹⁶

Moreover, the fact that an individual may have been involved in the activities that served as the basis of the tax fraud does not make her ineligible for a reward under the amended whistleblower statute. However, the IRS has the discretion to reduce an award on this ground, and a criminal conviction for such conduct will result in the denial of any reward.¹⁷

The amended whistleblower statute removes some of the uncertainty associated with filing a claim for a reward under the old statute. Where an informant is the primary source of information resulting in the government's decision to proceed with an

administrative or judicial action, the statute provides that the individual shall receive an award ranging between 15 percent and 30 percent. Moreover, the statute makes clear that the claimant does not need to have a contract with the IRS in order to be compensated.¹⁸ Nonetheless, individuals with information regarding substantial cases would be wise to enter into a formal agreement with the IRS.

The new statute does not, however, completely eliminate the IRS's discretion, and therefore its ability to severely reduce the amount of any reward paid. It provides that the amount of a reward will be capped at 10 percent if the IRS determines that the action was based on disclosures resulting from certain public sources, unless the claimant was the original source of the information. In such cases, the IRS can take into account "the significance of the individual's information and the role of such individual and any legal representative of such individual in contributing to such action."¹⁹

Similarly, the 15-30 percent range is inapplicable to cases falling below the thresholds set forth in the new statute (i.e., more than \$2 million in dispute and, in cases involving individual taxpayers, gross income greater than \$200,000). In these cases, the government retains its full discretion in determining how much, if anything, to award. Thus, informants filing claims in smaller cases cannot reap the benefits of the new law.²⁰ Rather, the law strikes a balance between encouraging insiders to bring information regarding substantial cases to the IRS's attention, while limiting the potential for abuse by people seeking to misuse the IRS to serve an ulterior agenda in connection with a personal dispute.

The other significant change in the amended whistleblower statute is the provision allowing informants to appeal the IRS's reward determinations.²¹ The statute confers jurisdiction over such matters on the Tax Court. Appeals are to be filed within 30 days of the reward determination.

Despite the fact that the amended law provides claimants with more security in recovering a reward, these provisions will not necessarily reduce the length of time an informant will have to wait to get his money. Under the current regulations, payment is

to be made as promptly as circumstances permit. However, unless an individual seeking a reward waives a claim for the portion of the reward relating to uncollected taxes, penalties, or fines, he will not get anything "until the taxes, penalties, or fines involved have been collected."²² The report issued by the Treasury Inspector General noted that claimants typically waited an average of 7 ½ years between the filing of their claim and receiving any reward.²³ The IRS has attributed the long wait to the fact that the subject taxpayers typically exercised control over the length of the litigation and any appeals and often delayed in paying the taxes due.²⁴ While the new statute seeks to make the program more user-friendly, it does not address the pace of the investigation, which is commonly the cause of the greatest delay in granting rewards.²⁵

The Expected Impact

The IRS is expecting an influx of informant claims as a result of the statute's new rewards program.²⁶ In response to criticisms regarding the lack of centralized management of the Informants' Reward Program, the statute established a new IRS Whistleblower Office to deal with the administration of all claims and to facilitate the expedient and uniform processing of informants' information and claims.²⁷ Thus, the Whistleblower Office is responsible for assessing and analyzing incoming tips, assigning credible tips to the appropriate IRS office for further investigation, coordinating with Criminal Investigation and the IRS's operating divisions to ensure that the program is operating properly, and processing reward claims.²⁸

The office was opened in February 2007, under the direction of Stephen A. Whitlock. Initially, Mr. Whitlock's key responsibilities include "establishing the strategic direction of the program; defining specific goals and operating guidelines; [and] communicating and implementing guidance to ensure the office's success."²⁹ As an initial step, the Whistleblower Office is drafting regulations and other guidance, which are required to be issued on or before Dec. 20, 2007.

Congress has made clear its hope that the new law will help the IRS collect significantly larger amounts of back taxes, estimating that the new statute will raise

\$32 million over five years and \$182 million over ten years.³⁰ Mr. Whitlock anticipates that, with greater financial incentives, whistleblowers will provide detailed information regarding complex tax schemes, thereby assisting the IRS's enforcement efforts.³¹ In the first five months, the IRS reported receiving approximately 20 claims, some of which, according to the head of the IRS, "involv[e] hundreds of millions of dollars."³²

Commentators note that the IRS whistleblower statute serves to fill a gap left in the False Claims Act (FCA),³³ a federal whistleblower statute which specifically exempted tax fraud. The FCA, referred to as "the federal government's single most important tool for fighting [fraud] perpetrated against the federal government," has helped the government recoup more than \$18 billion since 1986. Given that whistleblower claims under the FCA were responsible for the government recovering approximately \$1.3 billion in 2006 alone, many believe that amended §7623 will have a similar effect.³⁴

Incentive to Come Forward

Under the new whistleblower statute, individuals with information on potential tax fraud have a tremendous incentive to come forward. Law firms specializing in the filing of whistleblower claims note that the profile of a tipster has changed since the amendments have been enacted. "Unlike the old days where the typical tipster was the ex-boyfriend, girlfriend or spouse, the new whistleblower informant is typically a businessman or woman with significant and verifiable insider information concerning the underreporting of significant amounts of income. This is exactly what Congress intended."³⁵



1. The Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," (June 2006) at pp. 1-2 (available at <http://www.ustreas.gov/tigta/auditreports/2006reports/200630092fr.pdf>) (hereinafter, the "TIGTA Report").

2. 26 U.S.C. §7623.

3. 26 C.F.R. §301.7623-1(a) (emphasis added).

4. Id. at §301.7623-1(f).

5. See John J. Tiguel, "The IRS Informant Reward Program—A Caveat," *New York Law Journal* (Jan. 20, 2000); "The Profile of the New Tax Whistleblower," *Whistleblower Lawyer Blog* (July 25, 2007) (available at http://www.whistleblowerlawyerblog.com/2007/07/the_profile_of_the_new_tax_whi.html).

6. Id. at §301.7623-1(c).

7. *Lagermeier v. United States*, 1977 WL 25858, *2 (Ct. Cl. May 13, 1977).

8. *Conway v. United States*, 56 Fed.Cl. 572, 575-76 (June 2003).

9. TIGTA Report, supra Note 1, at 2.

10. Id.

11. Testimony of "Mr. ABC," A Confidential Witness, Before the Senate Finance Committee (July 21, 2004) (available at: <http://finance.senate.gov/hearings/testimony/2004test/072104abctest.pdf>).

12. Id.

13. TIGTA Report, supra Note 1, at pp. 10-11.

14. Press Release from Senator Chuck Grassley, Chairman of the Senate Finance Committee (June 9, 2006).

15. §2673(b)(5).

16. §2673(b)(1).

17. §2673(b)(3).

18. §2673(b)(5).

19. §2673(b)(2)(A).

20. Tom Herman, "Whistleblower Law Scores Early Success," *The Wall Street Journal* (May 16, 2007).

21. §2673(b)(4).

22. 26 C.F.R. §301.7623-1(c).

23. TIGTA Report, supra Note 1, at p. 8.

24. Mark E. Matthews, Deputy Commissioner for Services and Enforcement, "Draft Audit Report Memorandum" (May 23, 2006) (attached as Appendix VII to Treasury Inspector General Report).

25. "Conversations: Stephen Whitlock," *Tax Notes* (July 9, 2007) at 99.

26. Robert E. McKenzie, "New Law Raises the Financial Incentive for Turning in Tax Cheats," *Practical Tax Strategies* (July 2007).

27. 26 U.S.C. §2673.

28. Internal Revenue Service, Press Report, "IRS Begins Work on Whistleblower Office; Whitlock Named First Director" (Feb. 2, 2007); "Conversations: Stephen Whitlock," *Tax Notes* (July 9, 2007) at 98.

29. Internal Revenue Service, Press Report, "IRS Begins Work on Whistleblower Office; Whitlock Named First Director" (Feb. 2, 2007).

30. Nancy O. Kuhn and Ralph J. Caccia, "Congress Strengthens IRS Whistleblower Statute," *Practical US/Domestic Tax Strategies* (February 2007).

31. "Conversations: Stephen Whitlock," *Tax Notes* (July 9, 2007) at 100.

32. Tom Herman, "Whistleblower Law Scores Early Success," *The Wall Street Journal* (May 16, 2007).

33. 31 U.S.C. §3729 et seq.

34. Adam S. Laurie, "Turning on the Lights for Whistleblowers in the Dark: New Legislation Increases Rewards for Tax Fraud Whistleblowers," *White-Collar Crime Committee Newsletter* (May 2007).

35. "The Profile of the New Tax Whistleblower," *Whistleblower Lawyer Blog* (July 25, 2007).