New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM

An ALM Publication
VOLUME 245—NO. 9
THURSDAY, JANUARY 13, 2011

TAX LITIGATION ISSUES

Expert Analysis

IRS Whistleblower Program: Road Map for Dodd-Frank?

By
Jeremy H. Temkin

Since the Civil War, the federal government has offered financial rewards to encourage private individuals to come forward with evidence of unlawful conduct. The most successful of these programs is set forth in the False Claims Act (FCA), which includes a "mechanism for private whistleblowers to bring legal action on behalf of the government and to earn 'bounties' where such actions lead to the recovery of government funds."[1] The FCA was amended in 1986 to guarantee a minimum reward to individuals whose disclosures lead to recoveries by the federal government. Since that time the government has collected more than $27 billion in settlements and judgments, and has paid out almost $2.9 billion in whistleblower awards.[2]

Historically, the FCA has excluded tax and securities fraud cases.[3] Congress first enacted a provision aimed at encouraging individuals to report suspected tax fraud in 1867. That statute, recodified as §7623 of the Internal Revenue Code in 1954, was viewed as being "particularly ungenerous,"[4] and was amended in December 2006 in hopes of rectifying its perceived shortcomings.[5]

This past July, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included whistleblower provisions[6] aimed at "motivat[ing] those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated securities laws."[7] To a large extent, the whistleblower provisions of the Dodd-Frank Act were modeled on the Internal Revenue Service whistleblower program.[8] As the Securites and Exchange Commission and Commodity Futures Trading Commission contemplate rules for the administration of the new provisions, it is helpful to review the IRS's experience over the past four years.

The IRS Whistleblower Law

The amended IRS statute, set forth in 26 U.S.C. §7623(b), applies to claims filed after Dec. 20, 2006, in which the amount in dispute exceeds $2 million or, if the case deals with an individual, where his or her annual gross income is more than $200,000. Where this threshold is met, the statute mandates a whistleblower award of between 15 and 30 percent of the amount recovered. Claims not meeting the threshold requirements are analyzed under the old law in §7623(a), which permits the IRS to make an award on a discretionary basis.

As part of the 2006 legislation, the IRS created a Whistleblower Office that receives and conducts an initial review of whistleblower claims. In its first year of existence, the Whistleblower Office received 116 submissions that claimed to meet the $2 million threshold of §7623(b). Twenty-four of those claims alleged more than $10 million in tax, penalties, and interest due and owing the IRS.[9] In fiscal year 2008, the IRS received claims relating to 1,246 taxpayers that appeared to meet the statutory threshold. Of the 994 claims that included a specific allegation about the amount of underpayment, 228 alleged an underpayment of at least $10 million and 64 alleged an underpayment of $100 million or more.[10] In fiscal year 2009, the Whistleblower's Office reported receiving submissions relating to 1,941 taxpayers that appeared to meet the criteria set forth in §7623(b), but did not provide information on the amount of underpayment reported in those claims.[11]

> To a large extent, the whistleblower provisions of the Dodd-Frank Act were modeled on the Internal Revenue Service whistleblower program.

According to the IRS, "under the old Informant Award Program only 12 of 227 full paid claims in 2007 involved collections of more than $2 million, and only 3 involved collections of more than $10 million."[12] Thus, at first blush, the claim values set forth in the Whistleblower Office reports suggest that the new law is generating more substantial information. However, those claim values are based on whistleblower submissions, without evaluation of the taxpayers' defenses, and the office's annual reports for both 2008 and 2009 specifically noted that the IRS "cannot yet tell how many of the cases will result in collected proceeds, and whether the whistleblowers' estimates of the amounts in dispute are accurate." It remains to be seen whether the new law has, in fact, generated more substantial tips for the IRS to pursue.

Criticism of the IRS Program

Although the 2006 IRS whistleblower law was intended to incentivize individuals to report tax fraud by signaling the IRS's willingness to compensate informants,[13] critics worry that the IRS's administration of the program over the past four years may undermine that goal. In June 2010, the IRS revised the Internal Revenue Manual (IRM) to set forth the procedures and guidelines for processing and paying whistleblower claims.

These revisions have generated a great deal of criticism. Days after the new IRM provisions were released, Senator Chuck Grassley, the then-ranking minority member of the Senate Finance Committee and the author of the 2006 legislation, asked Treasury Secretary Timothy Geithner to delay implementing the provisions. In his letter to Mr. Geithner, Senator Grassley expressed concern that a "culture of hostility towards and intimidation of whistleblowers at the IRS" that existed prior to 2006 may still be alive and well and working to undermine the potential success of the whistleblower program.[14]

In addition to procedural concerns regarding the IRS's failure to share a draft of the new IRM provisions with Congress or to seek public comment, Senator Grassley took issue with certain substantive provisions. For instance, Senator Grassley noted that the definition of "covered proceeds" limits the payment of awards to cases where the IRS receives a cash payment from a taxpayer, eliminating any recovery where a whistleblower's claim leads to the denial of a taxpayer's refund claim or the reduction of a taxpayer's credit balance. Senator Grassley opined that this result "create[s] a perverse incentive for the whistleblower to wait until the IRS has paid an improper refund" before contacting the IRS with information regarding potential violations of the tax laws.

According to media reports, the IRS has explained this anomaly by noting that the plain

JEREMY H. TEMKIN *is a principal in Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer.* GRETCHAN R. OHLIG, *an associate of the firm, assisted in the preparation of this article.*

language of the statute authorizes payments based on "collected proceeds," and thus if the whistleblower's claim does not generate incremental collections, there are no "proceeds" from which to pay the whistleblower.[15] The IRS otherwise has declined to specifically answer questions about the revised IRM provisions, stating only that its senior leadership "believes that the Whistleblower provisions are an important and valuable tax administration tool that can help improve tax compliance."[16]

Notwithstanding the IRS's purported commitment to using the whistleblower provisions to enhance tax compliance, and despite the significant number of claims filed, no payments have been made under the new statute. The Whistleblower Office explains this phenomenon by noting that "[t]he IRS pays awards from collected proceeds after the completion of an audit or investigation and after the taxpayer has exhausted all appeal rights. Therefore, the IRS may not make payments for several years after the whistleblower has filed the claim."[17]

While the delayed payment of claims is not a new problem,[18] the lack of any pay-outs after the four years under the new statute has led to frustration. Practitioners opine that the IRS "needs to be more responsive" to whistleblower claims or risk a loss of interest from informants.[19] Senator Grassley calls the lack of pay-outs "worrisome," questioning whether the delay may be attributable to the IRS's failure to timely process claims.[20]

In fact, an August 2009 audit of the Whistleblower Program by the Treasury Inspector General for Tax Administration (TIGTA) identified a number of "administrative deficiencies" within the IRS that interfered with its ability to "recover potentially billions of dollars in taxes, penalties, and interest based on information provided by informants."[21] Specifically, the report noted the need for a centralized and accurate inventory system for the input and monitoring of claims. Further, the TIGTA found significant delays in processing claims, noting that 85 percent of the claims reviewed for the report were not evaluated within 60 days of receipt—a period the IRS and the TIGTA agreed would be reasonable—and that 35 percent of the claims processed by the Whistleblower Office were still awaiting action.[22] In its 2009 Annual Report to Congress, the Whistleblower Office indicated that it had responded to the issues identified in the TIGTA report by introducing new case management system technology.

Review of Rejected Claims

The IRS's implementation of the Whistleblower Program is the subject of litigation. In 2008, the IRS rejected two whistleblower applications filed by William Prentice Cooper III, a Nashville lawyer, regarding the avoidance of estate taxes on approximately $300 million. In rejecting the claims, the IRS sent Mr. Cooper a form letter asserting that his information "did not identify a federal tax issue upon which the IRS will take action."[23] In response, Mr. Cooper asked the Tax Court for an order directing the IRS to reevaluate his claims.

Last July, the Tax Court denied the government's motion to dismiss Mr. Cooper's complaint on jurisdictional grounds,[24] and the government has now moved for summary judgment arguing that Mr. Cooper does not meet the threshold requirements for an award under §7623(b) and that the additional relief sought by him is not authorized under the Internal Revenue Code.[25] Observers believe that Mr. Cooper's lawsuit is just a sign of things to come—"the vanguard of what could be a slew of cases interpreting the scope, applicability and generosity of the new whistleblower law."[26]

No Private Qui Tam Provisions

Comparison of the IRS program to the highly successful FCA provisions raises questions regarding whether Congress went far enough in crafting the whistleblower laws governing tax fraud and, potentially, the new laws governing securities and commodities fraud. Unlike the FCA, neither the IRS whistleblower law nor the new provisions set forth in the Dodd-Frank Act provide for qui tam actions in which a private party can bring an action in the government's name if the government declines to proceed based on the information provided by the informant.[27]

Notwithstanding the IRS's purported commitment to using the whistleblower provisions to enhance tax compliance, and despite the significant number of claims filed, no payments have been made under the new statute.

While some believe that "[t]he experience of the FCA suggests that private enforcement of public law can be a particularly powerful monitoring and prosecutorial mechanism in areas of law where government officials…are unable or unwilling to enforce the law or prosecute offenders effectively,"[28] such private enforcement is especially problematic given legitimate concerns for taxpayer privacy and the potential for harassment if individuals are allowed to sue to enforce the federal tax laws.

Conclusion

As evidenced by history under the FCA, the federal government stands to recoup significant revenues from the information generated by whistleblower programs. While the IRS program is proof that the public will respond eagerly to the promise of mandatory rewards, its track record has yielded substantial criticism that the IRS has failed to implement the whistleblower law in a manner likely to generate maximum revenues (and substantial bounties). The SEC and CFTC will be well-served to avoid similar problems in implementing the new Dodd-Frank whistleblower laws.

1. Geoffrey Christopher Rapp, "False Claims, Not Securities Fraud: Towards Corporate Governance by Whistleblowers," 15 Nexus: Chapman's Journal of Law & Policy 55 (2009-2010).
2. See Taxpayers Against Fraud, Fraud Statistics Overview, Civil Division, U.S. Department of Justice, Oct. 1, 1987—Sept. 30, 2010 (available at http://www.taf.org/FCA-stats-2010.pdf); Press Release, Department of Justice, "Department of Justice Recovers $3 Billion in False Claims Cases in Fiscal Year 2010" (Nov. 22, 2010).
3. Rapp, "False Claims, Not Securities Fraud" at p. 63.
4. Dennis J. Ventry, Jr., "Whistleblower and Qui Tam for Tax," 61 Tax Lawyer 357, 364 (Winter 2008).
5. See John J. Tigue, Jr. and Jeremy H. Temkin, "The 'New and Improved' Whistleblower Statute," NYLJ (Sept. 20, 2007).
6. Pub. L. 111-203, Sections 748 and 922 (July 21, 2010).
7. Senate Report No. 111-176, "The Restoring American Financial Stability Act of 2010" at 110 (April 30, 2010).
8. Id. at 111.
9. Internal Revenue Service Whistleblower Office, First Report to Congress on the Whistleblower Program at p. 4 (June 24, 2008).
10. Internal Revenue Service Whistleblower Office, 2008 Annual Report to Congress on the Use of §7623 at p. 2.
11. Internal Revenue Service Whistleblower Office, 2009 Annual Report to Congress on the Use of §7623 at p. 5.
12. First Report to Congress on the Whistleblower Program at pp. 4-5.
13. See Tigue, Jr. and Temkin, "The 'New and Improved' Whistleblower Statute" (detailing criticism of the old law).
14. Letter from Senator Chuck Grassley to Timothy Geithner (June 21, 2010) (available at http://grassley.senate.gov/about/upload/June-21-2010-CEG-to-Geithner-Whistleblower-Provisions-in-IRM.pdf).
15. Dow Jones, "IRS Whistleblower Guidelines Spark Criticism," wallstreetjournal.com (June 18, 2010).
16. David S. Hilzenrath, "Change in IRS Rules Could Block Rewards for Whistleblowers," The Washington Post (July 1, 2010).
17. Internal Revenue Service Whistleblower Office, 2009 Annual Report to Congress on the Use of §7623 at p. 2.
18. A June 2006 report from the TIGTA reveals that, on average, the IRS took 7.5 years between the filing of a claim by an informant and the payment of an award under the old law. Treasury Inspector General for Tax Administration, "The Informants' Reward Program Needs More Centralized Management Oversight," Report No. 2006-30-092 at p. 8 (June 6, 2006).
19. Jean Eaglesham and Ashby Jones, "Whistleblower Bounties Pose Challenges," The Wall Street Journal (Dec. 13, 2010).
20. Letter from Senator Chuck Grassley to Timothy Geithner at p. 4.
21. Treasury Inspector General for Tax Administration, "Deficiencies Exist in the Control and Timely Resolution of Whistleblower Claims," Report No. 2009-30-114 (Aug. 20, 2009).
22. Id. at pp. 3 and 11.
23. William P. Barrett, "Can IRS Be Forced to Check Out Informant's Tip?" Forbes.com (April 30, 2010).
24. *Cooper v. Comm'r of Internal Revenue*, 135 T.C. No. 4, 2010 WL 2697125, at *4 (2010).
25. Order, *Cooper v. Comm'r. Internal Revenue*, 24178-09 W (Tax Court Dec. 20, 2010). Briefing on the IRS's summary judgment motion is scheduled to be complete in February 2011.
26. Barrett, "Can IRS Be Forced to Check Out Informant's Tip?" In one notable matter, Bradley C. Birkenfeld, the former UBS banker who is serving a sentence of 46 months in prison in connection with his conviction for conspiring to evade the taxes due by UBS clients, is involved in litigation with the government regarding his claim for a whistleblower's award for a portion of the $780 million the government received in its settlement with UBS. See Brent Kendall, "UBS Informant Seeks Financial Award," The Wall Street Journal (Oct. 16, 2009).
27. If the government proceeds with the action, the whistleblower shall receive between 15 and 25 percent of the proceeds of the action, depending upon the whistleblower's "substantial contribution" to the prosecution. If the government does not proceed with the action and the whistleblower successfully prosecutes the case, the whistleblower will receive between 25 and 30 percent of the proceeds at the court's discretion. Ventry, Jr., "Whistleblowers and Qui Tam for Tax" 61 Tax Law at p. 369.
28. Id. at p. 359.