MCLE ARTICLE AND SELF-ASSESSMENT TEST

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by STEVEN TOSCHER and HEATHER KIM LEE

Cheaters BEWARE

The IRS's revamped whistleblower program offers new incentives to inform on corporate and individual tax cheats

"Don't be a tattletale" is advice given to all youngsters. This cautionary note is especially pertinent when the infraction by the errant child is minor and the tattletale is seeking an advantage. On the other hand, children are also taught to call the police when they observe a crime. So what should adults do when they learn that their employer, neighbor, former business associate, business competitor, soon to be ex-spouse—or anybody else for that matter—is a tax cheat? The possible responses on the moral spectrum range from ignoring the wrong to reporting it to the Internal Revenue Service.

Congress has provided its response: "Do be a tattletale," particularly when sufficiently large tax amounts are at issue. In the Tax Relief and Health Care Act of 2006,[1] Congress amended Internal Revenue Code Section 7623 to substantially enhance the IRS informant or whistleblower program. This new statute follows a series of changes made over the last 10 years to expand the IRS program.

Rewarding persons who inform on errant taxpayers is not a new aspect of U.S. tax enforcement policy. The practice has occurred since the earliest U.S. tax laws and predates the income tax.[2] A form of the current statutory provision has been in existence since at least the 1939 version of the Internal Revenue Code, authorizing the IRS to pay rewards to informants largely for information leading to criminal tax violations.[3] The statute was substantially amended in 1996 to clearly authorize payment of rewards for information regarding civil violations and to pay rewards

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out of proceeds collected as a result of the information provided by the informant.[4] In 1997, the IRS raised the reward ceiling from $100,000 to $2 million, although amounts can exceed the ceiling under an express contract with the IRS.[5] In 2004, the IRS raised the reward ceiling to $10 million.[6]

The 2006 act substantially amended Section 7623 to create a statutory right for informants to receive monetary rewards for information directly leading to an administrative or judicial action by the secretary of the treasury that results in a recovery. Section 7623(a) authorizes the secretary of the treasury to pay a reward in "such sum as he deems necessary for (1) detecting underpayments of tax, or (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same...." Section 7623(b) allows an informant to receive a reward of at least 15 percent, but no more than 30 percent, of the collected proceeds—including penalties, interest, additions to tax, and additional amounts—resulting from the adjudication or settlement of the action.[7] The computation of the amount of the reward would include not only the tax and penalties but also the statutory interest collected. The legislation also provides for an award of up to 10 percent of the collected proceeds for "less substantial" information. It also eliminates any cap on the amount of potential recoveries, which previously was $10 million.[8] The 2006 act reflects the effort of Congress to make the IRS program more analogous to the program created by the False Claims Act, which permits remedial actions by private whistleblowers.[9]

No contract with the IRS is necessary for an individual to have a legal right to an award under Section 7623.[10] The 2006 act allows informants to appeal award determinations by granting U.S. Tax Court jurisdiction to review these cases. Under the prior law, judicial review of an IRS award determination was limited to cases in which the informant had an express contract with the IRS.[11]

The 2006 act also establishes the IRS Whistleblower Office (WBO) to centrally process and manage the tax informant reward program. The WBO will set the strategic direction of the program, define specific goals and operating guidelines, and communicate and implement guidelines to ensure success of the program.[12]

Improving the Reward Program

The deficiencies enumerated in a report by the Treasury Inspector General for Tax Administration (TIGTA) were the impetus for the 2006 act.[13] The TIGTA report—titled "The Informant's Reward Program Needs More Centralized Management Oversight"—had two important conclusions. First, the report declared that the IRS informant program has been an effective method of identifying and collecting unpaid taxes and detecting and collecting underpaid taxes. According to information reported by the IRS to Congress from 2001 through 2005, $340,329,427 was recovered as a result of informant information provided during this period, and an average reward of 10.9 percent of the collected proceeds, excluding interest, was paid to the informants. TIGTA reported that examinations based on informant information involved taxpayers or issues that would not have been selected by the IRS without the informant information and were more productive than examinations initiated using the usual methods of the IRS.[14]

Second, the TIGTA report concluded that the effectiveness of the informant program was compromised by a lack of standardized procedures and limited managerial oversight. No database existed to allow management to track and monitor claims on a nationwide basis. For informant claims paid in 2005, 45 percent of the case files reviewed had a problem with basic controls—for example, copies of key forms or letters to informants were missing. In most cases, reviewers noted their decisions and reward percentages in approved cases but provided little or no description of the basis for their decisions. In 32 percent of the paid claims reviewed, TIGTA was unable to determine the justification for the percentage granted. In 76 percent of the rejected claims reviewed, TIGTA was unable to determine the rationale for the reviewer's decision to reject the claim.[15]

While the new statute mandates the WBO to consider the extent to which the informant substantially contributed to an action in determining the reward, it is silent on the issue of how the WBO is to determine whether the information actually caused the IRS action. The Joint Committee on Taxation has suggested that the standard should be whether or not the information "substantially or directly" caused the action. However, this provides little guidance.[16] If the treasury secretary proceeds with any administrative or judicial action based principally on "disclosures of specific allegations resulting from a judicial or administrative hearing, from a governmental report, hearing, audit, or investigation, or from the news media," the amount of the award is not to exceed 10 percent of the collected proceeds.[17] If the informant is the original source of the information that leads the treasury secretary to proceed with an action, the 10 percent cap does not apply.[18]

The new legislation's statutory entitlement of prescribed percentages only applies to information relating to an individual (nonentity) taxpayer if the individual's gross annual income exceeds $200,000 for the applicable tax year and the potential indebtedness for taxes, penalties, and interest exceeds $2 million.[19] If the taxpayer is a corporation or other taxpaying entity, there is no threshold requirement. The statutory threshold for individual taxpayers reflects a balance reached by Congress that will help the IRS avoid spending limited resources on an avalanche of informant claims that have little revenue potential.[20]

If the individual taxpayer does not meet the statutory threshold, the informant still may be able to claim a reward under the law and administrative practice as it existed prior to the 2006 act. This means that rewards under these circumstances generally will be subject to the discretion of the IRS. Most likely the WBO will follow the guidelines it

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1. The Tax Relief and Health Care Act of 2006 was the first enactment of an IRS tax reward program.
True.
False.

2. The current program rewards informants for information leading solely to criminal tax violations.
True.
False.

3. The rewards are derived from the proceeds—including taxes and penalties, but not interest—that are collected as a result of the information provided by informants.
True.
False.

4. Informants are entitled to a reward of at least 15 percent of the collected proceeds for information that directly leads to an administrative or judicial action by the secretary of the treasury.
True.
False.

5. The IRS tax reward program has a ceiling of $2 million for information regarding individual taxpayers.
True.
False.

6. Under current law, the U.S. Tax Court has jurisdiction to review an award determination by the IRS only in cases involving an express contract with the IRS.
True.
False.

7. The IRS Whistleblower Office (WBO) was established in 1996 to process and manage the tax reward program.
True.
False.

8. Examinations of tax returns based on an informant's information are more productive than the examinations initiated by using the usual methods of the IRS.
True.
False.

9. Informants must file Form 211 to make claims for their rewards.
True.
False.

10. Informants are entitled to an award of at least 10 percent of the collected proceeds if their information includes the disclosure of specific allegations resulting from a judicial or administrative hearing, a governmental report, an audit or investigation, or a report by the news media.
True.
False.

11. The reward program applies to information about an individual taxpayer—but only when the taxpayer's gross annual income exceeds $200,000 for the applicable tax year, and the potential indebtedness for taxes, penalties, and interest exceeds $500,000.
True.
False.

12. An informant who planned and initiated the actions that led to an underpayment of tax may be eligible for a reward, unless the informant is convicted of a crime for his or her role in the underpayment scheme.
True.
False.

13. Information about potential tax violations can be reported to the IRS by mailing Form 3949-A to the address indicated on the form, by letter or telephone, or in person at an IRS walk-in office.
True.
False.

14. An informant may submit information about a potential tax violation anonymously, but the informant must disclose his or her identity when making a claim for a reward.
True.
False.

15. Historically, informants have received their awards about seven and one-half years after they have filed their claims.
True.
False.

16. A tax informant reward is not taxable.
True.
False.

17. In determining the informant's adjusted gross income, the attorney's fees and court costs that the informant incurs in seeking a reward are only deductible if a reward is granted.
True.
False.

18. From 2001 through 2005, the IRS paid informants an average reward of 30 percent of the collected proceeds.
True.
False.

19. Under prior law, if the IRS denied a claim for reward without stating the basis for denial, the tax court had jurisdiction to review the decision.
True.
False.

20. The amount of a reward is subject to the discretion of the IRS in all tax informant reward cases.
True.
False.

MCLE Answer Sheet #162

CHEATERS BEWARE

Name

Law Firm/Organization

Address

City

State/Zip

E-mail

Phone

State Bar #

INSTRUCTIONS FOR OBTAINING MCLE CREDITS

1. Study the MCLE article in this issue.

2. Answer the test questions opposite by marking the appropriate boxes below. Each question has only one answer. Photocopies of this answer sheet may be submitted; however, this form should not be enlarged or reduced.

3. Mail the answer sheet and the $15 testing fee ($20 for non-LACBA members) to:

Los Angeles Lawyer
MCLE Test
P.O. Box 55020
Los Angeles, CA 90055

Make checks payable to Los Angeles Lawyer.

4. Within six weeks, Los Angeles Lawyer will return your test with the correct answers, a rationale for the correct answers, and a certificate verifying the MCLE credit you earned through this self-assessment activity.

5. For future reference, please retain the MCLE test materials returned to you.

ANSWERS

Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1.	☐ True	☐ False
2.	☐ True	☐ False
3.	☐ True	☐ False
4.	☐ True	☐ False
5.	☐ True	☐ False
6.	☐ True	☐ False
7.	☐ True	☐ False
8.	☐ True	☐ False
9.	☐ True	☐ False
10.	☐ True	☐ False
11.	☐ True	☐ False
12.	☐ True	☐ False
13.	☐ True	☐ False
14.	☐ True	☐ False
15.	☐ True	☐ False
16.	☐ True	☐ False
17.	☐ True	☐ False
18.	☐ True	☐ False
19.	☐ True	☐ False
20.	☐ True	☐ False

develops under the new statutory scheme.

Anyone except certain present and former employees of the Treasury Department may submit information regarding a violation of the internal revenue laws and be eligible to file a claim for reward under Section 7623.[21] The statute expressly provides that if the claim for an award is brought by an individual who "planned and initiated" the actions that led to the underpayment of tax or the violation of internal revenue laws, the WBO may appropriately reduce the award. The WBO must completely deny the award if the individual is convicted of criminal conduct arising from his or her role in planning and initiating the actions that led to the underpayment of tax.[22]

This language can lead to potentially odd results. Planners and initiators of a tax plan or scheme–whether criminal or not–can benefit from their own wrongdoing. It appears the WBO is directed to deny the reward totally if there is a criminal conviction of the informant. If a planner or initiator is the first informant to notify the IRS or Justice Department of the wrongdoing and negotiates a deal involving immunity from criminal liability, the planner or initiator could not only escape criminal punishment but also receive up to 30 percent of the tax, penalties, and interest collected from the taxpayers who entered into the plan or scheme. The WBO is empowered to reduce the reward in this circumstance—perhaps to a de minimis amount if the culpability of the informant is substantial—but is apparently not empowered to eliminate the award completely if the informant substantially contributed to an action taken by the secretary of the treasury.

Information about potential tax violations can be reported to the IRS by completing and mailing Form 3949-A to the address indicated in the form's instructions, by letter or telephone,[23] or in person at an IRS walk-in office.[24] An informant may be represented by counsel.[25] To receive an award, information must be submitted under penalty of perjury.[26]

Information reported via letter should include the name and address of the person about whom the informant is reporting; the taxpayer identification number of the alleged violator; a brief description of the alleged violation, including how the informant became aware of or obtained the information; the years in which the violations occurred; an estimated dollar amount of any unreported income; and the name, address, and daytime telephone number of the informant or the informant's representative.

Instructions to Form 3949-A state that informants are not required to identify themselves, although it is helpful to do so, and the IRS keeps the identities confidential. However, the identity of an informant will have to be disclosed when a claim for a reward is made.[27] Informants must file Form 211 to make claims for their rewards.[28]

Historically, informants have received their awards about seven and one-half years after they have filed their claims. This is because payment cannot be made until the IRS completes its administrative or judicial action and collects the tax.[29] In the past, if the claim was rejected, an informant usually received a letter with this information six months after filing the claim.[30] The administrative process for informant claims is expected to be accelerated under the new WBO.

Informants seeking to get the attention of the IRS for their claims should present their cases with strong supporting facts and documents and develop the case as much as possible for the IRS. In determining the amount of reward, the WBO is required to consider the extent the informant "substantially contributed" to the IRS action on the matter. Theories and speculation unsupported by facts and documents will not attract the resources of the IRS.

Judicial Review

The 2006 act's most significant change may be that, for the first time, the IRS informant program will be subject to judicial review by the U.S. Tax Court. Under the new law, any determination regarding an award may be appealed to the tax court within 30 days.[31] This change raises many questions concerning the standard of review of the WBO's determinations and the review procedures that will be adopted by the tax court. Given the express statutory authorization granting the tax court jurisdiction to review the award determinations, any limited jurisdiction that the federal district courts or the U.S. Court of Federal Claims once had may no longer be available.[32]

IRC Section 6103 may, however, limit the scope of the new statute's judicial review. The section permits disclosure of taxpayer and tax return information only in limited and statutorily prescribed circumstances. The new legislation does not address this issue, and the disclosure limitations historically asserted by the IRS regarding taxpayer information will likely continue.

Under prior law, in the absence of an express contract with the IRS, informants could not seek judicial review of the denial by the IRS of the reward claim or dispute the amount of the award.[33] Courts consistently held that the United States was not contractually bound merely by a claimant invoking Section 7623. Moreover, courts have regularly ruled that they were without jurisdiction to hear claims disputing reward determinations.[34] For example, in *Carelli* v. *I.R.S.*,[35] the plaintiff brought suit to recover amounts allegedly due to him for furnishing information to the IRS under Section 7623. The plaintiff filed a claim for a reward, which was denied without explanation and without accounting for any monies collected as a result of his information. The court dismissed the case for lack of jurisdiction.

The new statute does not specify the tax court's standard of review of a determination of an award by the IRS. The determination could be reviewed de novo, like most tax deficiency determinations by the tax court, or for an abuse of discretion, or some combination of the two. Since the new statute is silent and does not expressly limit review for an abuse of discretion like some statutes granting tax court review,[36] general principles of administrative law should apply. These principles allow for plenary review unless the determination has been "committed" to agency discretion.[37]

Prior law suggests the WBO will be given wide latitude, at least within the statutory ranges prescribed by Congress. In one case in which the court was able to find jurisdiction to review a reward determination under prior law, the court stated that "where Congress has committed to the head of a department certain duties requiring the exercise of judgment and discretion, his action thereon, whether it involves question of law or fact, will not be reviewed by the courts, unless he has exceeded his authority or this court should be of opinion that his action was clearly wrong." The court further noted that the "judicial function is exhausted when it is found that there is a rational basis for the conclusions of the administrative agency."[38] The fact that the reward was less than the 10 percent mentioned in the regulation as a possible upper limit did not authorize the court to set aside the award and order a trial to determine adequate or reasonable compensation. The court found that the plaintiff failed to establish that there was no rational basis for the district director's decision, and the reward was within the range contemplated by the statute and the regulation.[39]

A reward received under Section 7623 is taxable as ordinary income. The IRS has characterized a reward under the section as service income, presumably for the act of furnishing information to the IRS as well as the act of uncovering the information.[40] The reward is taxed in the year of receipt for individual taxpayers, since individual taxpayers report income on a cash basis, despite the fact that the "service" could be performed over several years in some cases.

The 2006 act also added Section 62(a)(21) to the Internal Revenue Code to allow an above-the-line deduction for attorney's fees

and court costs incurred by the taxpayer in connection with an award under Section 7623(b)—but not in excess of the amount of the award that is includible in gross income.[41] Section 62(a)(21) is broadly drafted to include attorney's fees incurred to present the information to the IRS and to file and negotiate the reward with the IRS, not just the costs of litigating the determination of the reward.

While the 2006 act is still new, it appears to be having its intended effect. The director of the WBO recently indicated that since its enactment, the IRS has received about 20 reward claims, some involving hundreds of millions of dollars: "They're coming in with big, fat piles of paper, and they have, at least on the surface…some credibility about the information they're bringing to us."[42] Taxpayers, informants, and the IRS all need to proceed cautiously in this new bounty hunting environment. While no one should condone tax cheats, the economic incentive to become a deputized tax collector is substantial—and may create more mischief than it was designed to uncover. ■

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[1] The Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, §406(a) (effective Oct. 20, 2006).

[2] *See* An Act to Amend Existing Laws Relating to Internal Revenue and for Other Purposes, ch. 169 at 7, 14 Stat. 471, 473 (1867) (authorizing the commissioner of internal revenue to pay amounts "deemed necessary for detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws").

[3] *See* 1939 I.R.C. *and* 1954 I.R.C., which contained language now included in I.R.C. §7623(a)(2). *See* text, *infra*.

[4] *See* COMMITTEE REPORT ON P.L. 104-168, THE TAXPAYER BILL OF RIGHTS 2 (1996).

[5] I.R.S. Pub. No. 733 (1997), Rewards for Information Provided by Individuals to the Internal Revenue Service. The 2004 version is currently available on the IRS Web site *at* http://www.irs.gov/pub/irs-pdf/p733.pdf.

[6] *Id*.

[7] *See* J.C.T. REP. NO. JXC-50-06. The term "collected proceeds" also includes amounts collected prior to receipt of the information if the information leads to the denial of a claim for a refund that otherwise would have been paid. Treas. Reg. §301.7623-1(a).

[8] *Id*.

[9] The False Claims Act, 31 U.S.C. §§3729 *et seq*.

[10] I.R.C. §7623(b)(6)(A). Under prior law, a contract with the IRS was necessary to enforce an award. *See* Krug v. United States, 41 Fed. Cl. 96 (1998).

[11] Krug, 41 Fed. Cl. 96.

[12] I.R.S. IR-2007-25 (Feb. 2, 2007).

[13] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE INFORMANT'S REWARD PROGRAM NEEDS MORE CENTRALIZED MANAGEMENT OVERSIGHT (June 6, 2006), Reference Number: 2006-30-092, *available at* http://www.treas.gov/tigta/auditreports/2006reports/200630092fr.html [hereinafter TIGTA REPORT].

[14] *Id*.

[15] *Id*.

[16] J.C.T. REP. NO. JXC-50-06.

[17] I.R.C. §7623(b)(2)(A).

[18] I.R.C. §7623(b)(2)(B).

[19] I.R.C. §7623(b)(5).

[20] Congress has considered lowering the threshold for

individuals. Participants in a Senate Finance Committee roundtable on the new IRS whistleblower program on February 2, 2007, largely agreed, however, that lowering the threshold could be detrimental to the program and could invite a flood of frivolous claims. *See* 2007 TNT 25-5.

[21] Treas. Reg. §301.7623-1(b). If an individual was an officer or employee of the Treasury Department at the time the individual came into possession of information relating to the violation, or at the time the individual divulged the information, the individual is not eligible for reward under I.R.C. §7623.

[22] I.R.C. §7623(b)(3).

[23] The toll-free telephone number is 1-800-829-0433. *See* I.R.S. Pub. No. 733, *supra* note 5. I.R.S. Form 3949-A is available at http://www.irs.gov/pub/irs-pdf/f3949a.pdf.

[24] Generally, an IRS employee receiving an allegation of a potential tax violation will record the information on an Information Report Referral (I.R.S. Form 3949).

[25] I.R.C. §7623(b)(6)(B).

[26] I.R.C. §7623(b)(6)(C).

[27] *See* I.R.S. Form 211. *See also* http://www.irs.gov/compliance/enforcement/article/0,,id=106778,00.html.

[28] I.R.S. Form 211 is available at http://www.irs.gov/pub/irs-pdf/f211.pdf. The completed form must be mailed to Ogden Campus Center, Internal Revenue Service, 1973 North Rulon White Boulevard, MS/4110-ICE, Ogden, UT 84404.

[29] *See* TIGTA Report, *supra* note 13.

[30] *Id.*

[31] I.R.C. §7623(b)(4). The appeal may be assigned to a special trial judge. I.R.C. §7443A(b)(6).

[32] *See* Hinck v. United States, 127 S. Ct. 2011 (2007), (holding that statutory change in I.R.C. §6404(h) vested exclusive jurisdiction in the tax court).

[33] *See* the Tucker Act, 28 U.S.C. §1491. This act grants jurisdiction to federal district courts and the U.S. Court of Federal Claims to render judgement on any claim against the United States under an express or implied contract with the United States.

[34] These suits have been denied whether brought under the Tucker Act, 28 U.S.C. §§1346(a)(2), 1491; the Administrative Procedure Act, 5 U.S.C. §§701 *et seq.*; the Federal Tort Claims Act, 28 U.S.C. §§1346(b), 2671 *et seq.*; I.R.C. §7623; and 28 U.S.C. §§1340, 1346(a)(2), or 1361 as an action in mandamus. *See* Diamond v. United States, 213 Ct. Cl. 766 (1977); Silverstein v. United States, 7601 U.S. Tax Cas. (CCH) 9434, 38 A.F.T.R. 2d 5130 (S.D. N.Y. 1976); De La Forest Divonne v. I.R.S., 36 A.F.T.R. 2d 5560 (S.D. N.Y. 1975); Saracena v. United States, 206 Ct. Cl. 90, 508 F. 2d 1333 (1975); *and* Schein v. United States, 352 F. Supp. 182 (E.D. N.Y. 1972).

[35] Carelli v. IRS, 668 F. 2d 902 (6th Cir. 1982).

[36] *See*, *e.g.*, I.R.C. §6404(h) concerning review of IRS determinations of requests for the abatement of interest. Section 6404(h) expressly provides for review under an abuse of discretion standard.

[37] *See* Fisher v. Comm'r, 45 F. 3d 396 (10th Cir. 1995).

[38] Saracena, 206 Ct. Cl. 90, 508 F. 2d 1333 (quoting from United States v. Shimer, 367 U.S. 374 (1961)).

[39] *Id.*

[40] Rev. Rul. 70-576, 1970-2 C.B. 331, held that a reward under §7623 is compensation for services rendered to the U.S. government by supplying information. The reward was exempt from U.S. tax under the U.S.-Canada income tax treaty as compensation for personal services performed during the taxable year within the United States.

[41] I.R.C. §62(a)(21), *enacted by* Pub. L. No. 109-432, 109th Cong., 2d Sess., §406(a)(3). *See also* J.C.T. Rep. No. JCX-50-06 on whistleblower reforms.

[42] T. Herman, *Whistleblower Law Scores Early Success*, Wall Street J., May 15, 2007, at D3.