

Tax Practice Corner

Whistleblowers Wanted

The government has decided that whistleblowers are its friends, and it is increasingly making efforts to nourish and protect them. This is evidenced by a provision of the Tax Relief and Health Care Act of 2006 that increased potential rewards to people who provide information on individuals and businesses that underpay income taxes.

The law, signed on Dec. 20, 2006, doubled the percentage of a settlement that can be paid as a reward to whistleblowers and reduced the government's discretion in whether to pay one. The result could be a much greater incentive for people to alert the IRS to tax underpayments.

PAYMENTS MANDATORY

Section 406 of the act amended IRC section 7623 to increase rewards to between 15% and 30% of the collected proceeds (including penalties, interest, additions to tax and other amounts) where the IRS pursues an administrative or judicial action against a taxpayer based on information brought to its attention by a whistleblower. The percentage paid is determined by the new Whistleblower Office of the IRS and depends on the extent to which the whistleblower's information substantially contributed to a collection action. Payments to whistleblowers in most cases are mandatory, and whistleblowers have the right to appeal unsatisfactory IRS award determinations to the Tax Court. The statute places a 10% cap on awards to whistleblowers in certain cases where there have been prior public disclosures of the allegations, and rewards can be reduced or barred if whistleblowers planned and initiated the actions that led to the underpayment.

The new program is limited to claims against taxpayers whose gross annual income exceeds \$200,000 for an individual—there is no income floor for businesses—and whose potential indebtedness for taxes, penalties and interest is greater than \$2 million. Companies and individuals that underpay taxes and have the whistle blown on them do not have to be guilty of a criminal violation.

Whistleblowers must report a reward as income but can take an above-the-line

deduction for attorney's fees and costs to recover the reward.

PREVIOUS REWARDS LIMITED

Since 1954, the IRS has had statutory authority to pay rewards, most notably as outlined in revenue publication 733. Under it, whistleblowers could seek a reward of up to 15% by submitting form 211, *Application for Reward for Original Information*. The procedure had limited impact, however, mostly due to its \$2 million cap on rewards, the absence of any provisions allowing whistleblowers to enforce their claims to rewards and limited promotion of the program. In the latter half of 2004, the IRS implemented policy statement 4-27, which increased the maximum reward to \$10 million but did not resolve the other fundamental limitations. In another, lesser-known option, select whistleblowers have contracted with the IRS for a percentage of recoveries.

EXPONENTIAL INCREASE

The striking feature about most of the new reforms is that they directly parallel the False Claims Act (FCA), enforced by the Department of Justice, which has had tremendous success in attracting tips regarding fraud in federal government programs. The FCA permits whistleblowers to file suits (called *qui tams*) on behalf of the United States against those who defraud the government and allows whistleblowers to share in the recoveries. In 1986, Congress amended the False Claims Act to enhance the incentives for whistleblowers to file *qui tams*. Under the amended FCA, whistleblowers can receive up to 25% to 30% of recoveries (previously 10% to 25%), depending on whether the United States takes over prosecution of a case. There is no cap on the amount that can be recovered, and whistleblowers have the right to enforce their claims to rewards in federal district court. The amendments removed earlier provisions that had weakened the ability of individuals to collect rewards for information of which the government had prior knowledge.

Since the FCA was amended in 1986, recoveries under it from whistleblower cases have been increasing exponentially (from zero in 1987 to more than \$1.4 billion in 2006). By comparison, recoveries by the IRS under its whistleblower program in recent years have not exceeded \$100 million annually (including taxes, penalties and interest).

IMPACT ON TAXPAYERS

It is anticipated that certain practices will likely receive immediate scrutiny under the program. Tax shelters that might previously have gone unnoticed are far more likely to be discovered, as insiders begin to see the benefits of blowing the whistle. Less obviously, publicly traded companies with internal reserve schedules that outline borderline tax positions for financial accounting purposes are likely to see a rash of such schedules used as road maps for whistleblower claims. The \$2 million threshold of unpaid taxes required for claims will necessarily focus whistleblower efforts on large and medium-size businesses and high-net-worth individuals.

By **Paul D. Scott, Esq.** He can be contacted at counsel@lopds.com or via www.taxwhistleblowers.org.

[©2008 AICPA](#)