

## IRS Withholding on Whistleblower Awards Ignites Controversy

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News that the IRS intends to withhold on tax whistleblower award payments has raised cries of protest from practitioners representing claimants, who view the new policy as unjustified. “This is an unprecedented concept,” said Bryan C. Skarlatos of Kostelanetz & Fink LLP.

While the IRS did not withhold on award payments made under section 7623, enactment of enhanced mandatory reward guidelines in subsection (b) has introduced new considerations that make it permissible for the agency to hold a portion of any reward disbursement, the IRS wrote in an Office of Chief Counsel legal memorandum to its Whistleblower Office. (For PMTA 2010-063, see *Doc 2011-8491* or *2011 TNT 77-12*.)

In reconsidering its position on withholding for section 7623 awards, the IRS said the potentially unprecedented size of whistleblower award claims justifies efforts to ensure that the federal government is protected against the whistleblower’s resulting tax liability once a payment is issued. “The stakes are extremely high given the sheer size and volume of expected claims,” chief counsel wrote. Because section 7623(b) awards are “vastly larger” than those available under the old statutory framework, “the revenue consequences of nontax compliance will increase exponentially,” and the likelihood of payments going to foreign individuals requires extra vigilance on the part of the government, the IRS said.

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Consequently, the IRS considers it “legally defensible to implement a systemic, consistent method of withholding at the time of payment of the award.” As noted in the memo, existing withholding practices are based on specific statutory authority. For whistleblower awards, however, “there is no specific statutory authority to withhold,” but neither is there a “direct prohibition against doing so,” the IRS wrote.

Instead, the agency argues, Congress has given it broad authority “to do whatever is needed to properly enforce the tax laws.” That authority extends to whistleblower payment withholding, and therefore the agency’s decision to withhold is permissible as a protective action against the risk of award recipients’ failing to pay income tax, according to the IRS.

Withholding also lets the Service avoid getting dragged into potential fights between whistleblowers and their legal representatives, because it ensures that the whistleblower's tax liability is "collected prior to any disputes over contingency fee arrangements or constructive receipt issues," the IRS wrote.

In a follow-up memo, chief counsel advised the Whistleblower Office that payments under section 7623(a) also could be subject to withholding, because "there is no legal or factual basis" for taxing the two types of payments differently and that the "same hazards and risks apply equally." (For PMTA 2011-01, see *Doc 2011-8497* or *2011 TNT 78-16*.)

Skarlatos told Tax Analysts that the IRS's withholding decision will prove controversial because its legal reasoning is inconsistent with its approach in other tax areas. "The reasoning in the memo seems to come down to the idea that the government should not allow large amounts that clearly are subject to tax to leave the government's hands without withholding the necessary tax," he said. "If that were a valid premise, there are many other types of government payments that should be subject to withholding." He said all payments to government contractors might be subject to some withholding if the memo's logic were applied universally.

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In the absence of specific authority to either withhold or not on whistleblower payments, "there does not seem to be a rational basis to target this class of taxpayers for special treatment," Skarlatos said, especially since no tax debt will have yet accrued because the tax return reporting the award payment will not have been filed at the time of the award. It is unlikely that the IRS could justify a jeopardy assessment or jeopardy levy in most of those situations, he said. "If there is no basis for a jeopardy determination, why is there a basis for an administrative determination to withhold absent express authorization from Congress?" he asked.

The government's two stated rationales hinge on the difficulty of collecting from a foreign individual and the possibility of giving monies to noncompliant taxpayers, but both are inadequate for the IRS's withholding framework, Skarlatos said. "Giving deference to the Service's need to collect the proper amount of tax, the Service's decision to withhold would be more rational if it were tailored to the

enunciated concerns and applied only to nonresidents or whistleblowers with a demonstrable history of noncompliance," he said.

Scott A. Knott, a tax partner at the Ferraro Law Firm, said the government in its own advice admits that its legal position on withholding is shaky and subject to future challenge. Knott cited a footnote in the 2010 memo: "Historically, all identified existing withholding regimes have a statutory basis." That footnote "tips the IRS's hand" about the real reason for withholding, "which is because they can and they believe it will be at least a year before anyone can challenge them on it," he said, adding, "That's like saying, 'Why try to efficiently solve a legal issue now with rational guidance and a cooperative process when you can resolve it next year in protracted litigation?'"

The memo's conclusion relies solely on a line from a 1992 notice, which Knott said appears to have been written by the IRS Public Affairs division and to have been taken completely out of context. "The only conceivable legal authority for withholding on an award to a whistleblower under section 7623 is the backup withholding provisions of section 3406," which would permit withholding only if the informant did not provide the IRS with a Social Security number, he said. "A tax whistleblower not having or disclosing a Social Security number is the exception rather than the rule," he added. (For Notice 92-6, 1992-1 C.B. 495, see *Doc 92-907* or *92 TNT 21-28*.)

Knott said that the IRS's position will likely lead to overwithholding, because the withholding structure imposed by the memo ignores any deductions a whistleblower might claim for contingent fees paid to his attorneys. Whistleblowers commonly use legal counsel and often don't have upfront resources when making a claim, so many enter into contingent fee contracts with their counsel, a likelihood Congress anticipated by allowing an above-the-line deduction for legal fees in section 7623 cases. Knott estimated that claimants will now get only about half as much of the award as expected because of overwithholding that does not take that deduction into account.

Rather than imposing a blanket rule based on compliance concerns about foreign informants, the IRS should try "to work through this problem rather than unilaterally causing whistleblowers economic damage from both the 'time value of money' perspective and perhaps additional legal fees," Knott said. By letting whistleblowers enter into withholding agreements that take into account deductions available to offset tax liability, "the IRS would achieve its stated goal of assuring current payment of the correct amount of tax," he said.

Gregory S. Lynam, also a tax partner at the Ferraro Law Firm, said that if the government's "authority for withholding is 'We're the IRS, duh,' then at least make up a rule that doesn't result in massive overwithholding." Given the size and scrutiny of whistleblower award payments, "the chances of a U.S. whistleblower not paying their taxes is so remote as to be laughable," he said.

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### Foreign Whistleblowers

According to advice provided by the IRS Office of Associate Chief Counsel (International), if a whistleblower award is made to a nonresident alien, withholding under section 1441 is appropriate unless the whistleblower is "exempted by a U.S. income tax treaty." Section 7623 payments will be "characterized as compensation for services" in determining the source of the award, according to the memo. (For PMTA 2011-02, see *Doc 2011-8498* or *2011 TNT 78-17*.)

The memo concludes that an informant's passing information to the IRS is the performance of an affirmative act akin to services, although no employer/employee relationship is created between the whistleblower and the government. The sourcing rules of sections 861-863 require the IRS Whistleblower Office to consider all the facts and circumstances involved in determining what amount of an award paid to an NRA should be U.S. sourced, chief counsel wrote. Section 1441 withholding on U.S.-source gross income applies unless there is a non-employment personal services provision in an applicable treaty, according to the IRS.

### Definition of Proceeds

Concerns over withholding aren't all that's troubling tax professionals representing claimants. Questions have arisen about the IRS's definition of collected proceeds that serve as a base on which to calculate a whistleblower's award payment. In response to congressional inquiry and practitioner input, the IRS in January released proposed regulations expanding the scope of proceeds to include refund denials and credit balance overpayment reductions. (For REG-131151-10, see *Doc 2011-880* or *2011 TNT 11-11*. For prior coverage, see *Tax Notes*, Jan. 24, 2011, p. 376, *Doc 2011-883*, or *2011 TNT 11-3*.)

That guidance seems to stem in part from a chief counsel memo that reconsidered the issue of collected proceeds. Although partially redacted, the

memo concluded that information leading to prevented refunds reaches "the same result that would occur if the IRS issued the refund to the taxpayer, initiated an action to recover the refund, and then used the money collected from the taxpayer to pay the whistleblower an award." The expanded definition is consistent with congressional intent behind section 7623(b) to "provide an incentive to whistleblowers to come forward with information about tax noncompliance," chief counsel wrote. (For PMTA 2010-062, see *Doc 2011-8490* or *2011 TNT 77-10*.)

In a separate legal memo, the Office of Chief Counsel (General Legal Services) informed the IRS Whistleblower Office that collected proceeds do not encompass criminal fines that the federal government receives as a result of tax crimes. The IRS does not collect those criminal fines, which are instead placed into a separate financial account when collected under a district court's order, according to the memo. (For PMTA 2010-060, see *Doc 2011-8488* or *2011 TNT 77-11*.)

The IRS noted that under section 7623, collected proceeds are the exclusive funding source for tax whistleblower award payments. Consequently, "there is no legal basis or mechanism by which the IRS can retrieve [the fines] to pay awards to whistleblowers under Title 26." Further, chief counsel wrote that the IRS is prohibited, in a contract with a whistleblower, from agreeing to pay awards resulting from criminal fines.

The government's position on criminal fines is contrary to the one many commentators have expressed regarding the proposed regulations, Knott said. He pointed out that criminal fines were noticeably absent from the draft regulations' definition of collected proceeds under section 7623 awards, probably because "chief counsel appears to have drawn a proverbial line in the sand on this issue." The issue "will have to be litigated, and now that whistleblower award determinations issued on the basis of this guidance should be forthcoming, these cases will soon be ripe to be heard before the U.S. Tax Court," he said.

### Tax Court Review

While section 7623(b) invests the Tax Court with exclusive jurisdiction to review appeals of enhanced whistleblower award determinations by the Whistleblower Office, the court hasn't recently proposed any changes to its rules of practice and procedure covering those cases. But several IRS divisions have suggested that the court consider rule amendments to reduce the incidence of disclosure of nonparty taxpayer identifying information in court filings.

The IRS Office of Associate Chief Counsel (Procedure and Administration) asked the Tax Court to

develop rules that would require whistleblowers who file award appeals to redact taxpayer identifying information in the petition and subsequent filings. National Taxpayer Advocate Nina Olson wrote the court to urge rule changes, arguing that “the taxpayer who is the subject of the claim is not a party and has no control over what information is presented.” Mandatory redaction in whistleblower proceedings of specific information — such as names, trade secrets, and commercial and financial information — would help protect against disclosure that “would constitute a clearly unwarranted invasion of personal privacy” of a third-party taxpayer, Olson said. (For comments received by the court, see *Doc 2011-5903* or *2011 TNT 55-29*.)

But Lynam said the Tax Court already has the means to protect the target taxpayer’s return information under Rule 103. “We envision that many cases will be filed with a request to file anonymously and under seal, and in most instances it will be appropriate for the Tax Court to grant it,” he said. While the targets of tax whistleblower submissions may not want their dirty laundry aired in court, many whistleblowers, if not all, still fear their targets and don’t want to be identified as informants or to have the facts of the case go public either, he said.

“Nothing prevents a tax whistleblower from legally, publicly revealing a target’s information other than the tax whistleblower,” Lynam said. “Other than not wanting to be the forum for initial disclosure, it is unclear how the Tax Court could shield targets from public scrutiny if the tax whistleblower so wishes.”

***Lynam said the suggestion that target taxpayers be allowed to intervene to ensure that adequate redaction has occurred ‘is absurd.’***

Using the anonymity procedures “prevents the target taxpayer’s information and the tax whistleblower’s information from being disclosed,” Lynam said, but “it is unlikely that the Tax Court would approve a blanket rule of keeping all cases under seal,” he added. If a target taxpayer’s information is revealed, “there is nothing unfair to the target taxpayer,” he said, because either the target taxpayer committed the acts described by the tax whistleblower, or the IRS determined that it did not (or at least likely did not).

Lynam said the suggestion that target taxpayers be allowed to intervene to ensure that adequate redaction has occurred “is absurd.” The target taxpayers “have absolutely no interests in a case between a tax whistleblower and the commis-

sioner,” he said. “There is no law that would provide them standing, and to interject target taxpayers into the case would be counterproductive.” Where there is particular sensitivity, “the IRS can champion the target taxpayer’s interests and seek to seal the case,” he said.

### **Corporate Concerns**

George M. Clarke III of Miller & Chevalier said the numerous internal agency discussions on tax whistleblower payments show that the IRS is taking steps to use the program as “an enforcement tool.” He suggested that the IRS may have decided to announce the first enhanced whistleblower award right before the filing deadline to send a message about the seriousness of the whistleblower program, making it incumbent on companies to “look hard at their practices and procedures in the tax area.”

According to Clarke, whistleblower activity — both legitimate and illegitimate — will occur despite preventive measures. To best protect themselves, well-informed companies should “take an active role to mitigate the potential harm caused by that activity in the company’s dealings with the IRS,” he said.

One perceived deficiency in the current statute is the lack of a requirement that the inaccuracies that whistleblowers find in unpaid taxes be purposeful, corrupt, or fraudulent, Clarke said. Given the large potential awards, that should be changed so as not to encourage individuals to capitalize on companies’ mistakes or oversights before the firms have a chance to correct them, he said. ■