Whistleblower Tax Issues: A Checklist

by Robert W. Wood

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In this article, Wood examines whistleblower concerns, including reporting awards, the treatment of attorney fees, foreign taxpayer status, and estate and gift planning.

This discussion is not intended as legal advice.

Every plaintiff thinks about taxes, and whistleblowers are no exception. They have some of the same issues as every plaintiff, although some are distinct. Whistleblower claims come in numerous varieties. The federal False Claims Act has been around since the Civil War and is still going strong. There are state false claims acts, too, and even some city ones.

Some programs allow claims involving taxes, and there is also a dedicated IRS program for people to blow the whistle on federal tax evasion. Under the IRS program, UBS banker Bradley Birkenfeld famously collected more than $100 million for blowing the whistle on Swiss banking. That and related actions led the IRS to collect more than $50 billion in taxes and fines in a wave of offshore account disclosures and bank agreements that changed banking worldwide.

Some states have their own tax whistleblower programs or permit tax claims under their false claims act programs. Then there are the SEC and Commodity Futures Trading Commission programs. I am probably leaving some programs out. But whatever the program or vehicle for making a claim, whistleblowers may have a mix of goals.

A goal for most whistleblowers is to correct a wrong and make sure that the authorities know about what is going on. Sometimes whistleblowers may be motivated in part by animus, wanting to make sure that someone gets what is coming to them. Of course, most whistleblowers hope to get something out of their claim if the government ends up collecting money from the putative wrongdoer.

But patience is usually needed. In any setting, most claims are unlikely to produce quick cash. Some cases resolve more quickly than others, while others are notoriously slow.

Even under the best of circumstances, the odds of a successful recovery can be slim. For some, when success comes, it can be bewildering.

If you are one of them, for a very long time, you may have felt as if you were living a secret life or that you had become a pariah. With success, well-meaning family, friends, and advisers may rush in to help or to benefit financially. In some cases, remaining anonymous is possible, and when it is, keeping a low profile can save some headaches.

Taxes and Forms 1099

State and federal income taxes are due on whistleblower awards, and obtaining tax advice is wise. You are usually better off doing this before you sign a settlement agreement. In many legal settlements, wording can improve your tax posture. It never hurts to see if language can be tweaked to improve your outcome. Tax language and reporting can affect how your recovery is taxed, how you can deduct your attorney fees, or both.

Apart from wording, how the checks are prepared or how wires are sent can also affect your taxes. Even when nothing can be changed, it is good to know what to expect. You don't want to be surprised the year after your payment when you receive IRS Forms 1099 or sit down to do your taxes. In some cases, the whistleblower will receive some funds as an employee or former employee for retaliation.

Such amounts are generally separate from the government whistleblower claim and are often covered in a separate settlement agreement. A retaliation settlement, like many other employment settlements, will likely be split between wage and nonwage income. Those tax and tax reporting issues are similar to many employment settlements.[1]

But the actual whistleblower award itself is generally paid by the government for the whistleblower's assistance in helping the government collect money. In most cases, the money is paid, and an IRS Form 1099 arrives the following January. Most whistleblower programs report on Form 1099-MISC, but the SEC reports on Form 1099-NEC. Both Forms 1099 report income to the payee that must be reported on the whistleblower's tax return.

However, the SEC's form generally suggests that self-employment taxes are also payable, although the form itself isn't conclusive on this issue. The amount on the Form 1099 the client receives can be upsetting to an unprepared whistleblower. The whistleblower will be treated as receiving 100 percent of the proceeds, even if the funds are sent to their lawyer. The lawyer customarily receives the proceeds, deducts the fees and costs, and remits the balance to the client.

But for tax purposes, the client is deemed to receive 100 percent of the proceeds, even if their lawyer disburses the net amount to them. That makes legal fee deductions critical.

Legal Fees

Most whistleblowers, like most plaintiffs, assume that only their net recoveries will be taxed, not the gross amount. In most cases, a contingent fee lawyer files and progresses the case in exchange for a contingent fee. Understandably, when projecting the amount of their recovery, the whistleblower won't expect to pay tax on the fees that will essentially be taken off the top.

Yet under *Banks*,[2] the whistleblower is treated as receiving 100 percent of an award, even if the lawyer collects a large percentage and only remits the net proceeds to the client. Fortunately, since 2004, there has been an above-the-line deduction for legal fees. It has steadily been expanded over the years. One especially significant amendment was introduced in 2018 when SEC claims were finally added.

It is no overstatement to say that it should now apply to almost all whistleblower claims. There may be small points of debate, such as whether the District of Columbia's program is counted as a state false claims act for this purpose. I would argue that it should be. Some glitches remain.

For example, New Jersey state tax law doesn't provide an above-the-line deduction for whistleblowers or even for plaintiffs in employment cases. And returning to federal tax law, what about legal fees a whistleblower pays hourly? If the award and the legal fees are not paid in the same tax year, the above-the-line deduction isn't much help. The tax deduction is limited to the amount of income included from the claim in the same year.

In short, if a whistleblower pays fees hourly, or pays costs, in other tax years, is there a deduction? Until 2018, a miscellaneous itemized deduction might have been OK, albeit subject to the 2 percent adjusted gross income threshold and potential alternative minimum tax issues. But miscellaneous itemized deductions were suspended until 2026. However, what about a trade or business deduction for a whistleblower who is making claims as a business? It may be more common than you might think. Of course, a vast majority of claims are financed on a contingent fee basis.

[1] *See* Robert W. Wood, "Beware 12 Tax Myths in Employment Suit Settlements," *Tax Notes Federal*, July 11, 2022, p. 223.

[2] *Commissioner v. Banks*, 543 U.S. 426 (2005).

Co-Relator and Finder's Fees

Before leaving the topic of deductions for fees, it is worth addressing what is not expressly covered. What if, apart from legal fees and costs, a whistleblower has to pay (out of the whistleblower's share) a percentage to a finder or co-relator? Is there a tax deduction for that? The answer on the surface appears to be no, though there is likely a better answer.

First, in some cases (using the nomenclature of the False Claims Act), co-relators can all be treated as relators by the government, with their amounts and related legal fees divided. If half the award goes to one relator and his counsel while the other half goes to the co-relator and her counsel, the Forms 1099 can track that clean result.

It is less clear if the other payee is in the background. How can the named relator deduct the amount? If the relator can make a case that this is a business, Schedule C should help. Of course, Schedule C carries the added cost of self-employment tax. Is there another route to deduct the finder or co-relator fee? One possibility may lie with the lawyer.

Suppose there is an agreement with the finder, whistleblower, and lawyer to treat the finder's fee as a cost of the case to be paid out of the proceeds. That way, the finder's fee ends up on the lawyer's statement of costs, along with travel, court costs, court reporters, etc. In effect, the fee is grouped with the fees and costs and claimed as part of the above-the-line deduction. That may not be perfect, but it doesn't seem unreasonable.

Limited Liability Companies as Whistleblowers

This is a big topic and can affect many of the points discussed in this article. It is becoming increasingly popular in some types of whistleblower cases. There may be anonymity advantages, but the potential tax advantages seem obvious. An LLC with one member can be taxed as a disregarded entity, but most LLCs in this context seem to have multiple members and taxed as partnerships.

That decision may affect and might ameliorate some of the topics discussed here. One key issue, for example, would be co-relator fees. A single whistleblower may feel confident about deducting contingent legal fees. If a whistleblower feels he may receive a gross Form 1099 and have to somehow try to deduct a payment to another person that is not for legal fees, an LLC may look especially attractive.

IRS Tax Withholding

Some whistleblowers are getting paid in two capacities, one as a whistleblower and another as an employee or former employee. The employment part of the case may be about retaliation. As noted, the employment part of the case can involve some of the same tax issues as most other employment cases.

For example, most defendants will insist on treating portions of the payments as wages, subject to withholding. Those numbers are often negotiated, but there will likely be some wages and a Form W-2. Apart from that issue, though, nearly all whistleblowers are supposed to pay their own taxes, not have taxes taken by withholding. That is, most whistleblowers are receiving funds, not in the capacity of an employee or former employee.

There is, however, one program that withholds taxes. In general, under the IRS program, whistleblower awards paid to U.S. citizens or resident aliens exceeding $10,000 are usually subject to 24 percent withholding. Curiously, that 24 percent rate is the same withholding rate the IRS requires for payments to winners of Powerball and other lottery programs.

It can seem particularly grating to a whistleblower who has reported an underpayment of tax that the IRS takes out taxes while the SEC and Justice Department do not. Of course, with a top federal tax rate of 37 percent, whistleblowers are still likely to owe more taxes in April — up to 13 percent more. But there is a critical legal fee deduction issue too. Remember, under *Banks*, the whistleblower is treated as receiving 100 percent of an award, even if the lawyer collects a large percentage.[3]

The 24 percent IRS withholding is applied to the gross award, not the net. Depending on the fee agreement, that may mean the whistleblower has too much in taxes withheld. To account for this, an IRS whistleblower can file an IRS Form 14693,

[3] *Banks*, 543 U.S. 426 (2005).

"Application for Reduced Rate of Withholding on Whistleblower Award Payment." If accepted, that will change the tax withholding from 24 percent to 37 percent.

More withholding probably doesn't sound like a good deal. But notably, awards paid under the Whistleblower Office's Reduced Withholding Program will be withheld at 37 percent *after* factoring in the whistleblower's legal fee deductions. If you are an IRS whistleblower facing withholding, it is worth doing the math, planning ahead, and trying to get what you want. The higher 37 percent rate may result in lower tax withholding because the IRS will subtract the attorney fees. Even so, some practitioners say that filing a Form 14593 is rare and question if the IRS is still allowing it.

Finally, there is still an apparent deduction glitch for IRS whistleblowers in some cases. Sens. Chuck Grassley, R-Iowa, and Ron Wyden, D-Ore., introduced the IRS Whistleblower Improvement Act of 2021, S. 2055, which would create tax parity for IRS awards under section 7623(a) and (b). Today, attorney fees can be deducted only under section 7623(b) (the IRS mandatory award program), and not under section 7623(a) (which covers the discretionary IRS award program).

Foreign Whistleblowers

Our next withholding topic applies not only to IRS programs but to most any program. Some whistleblowers are foreign and aren't U.S. taxpayers. That can occur with the IRS or other programs, such as the SEC, the False Claims Act, and others. Special tax withholding concerns can arise in those cases. It is difficult to make comments on these situations because of the variations.

However, a typical goal of a foreign whistleblower is to avoid U.S. tax withholding and U.S. taxes altogether. Depending on the whistleblower's home country, they may have higher taxes to pay somewhere else. Or, in rare cases, they may be able to sidestep taxes altogether, paying no tax anywhere.

The foreign and U.S. tax issues can be interrelated, but can non-U.S. whistleblowers avoid U.S. taxes? It depends. In my experience, it is frequently possible for them to avoid U.S. taxes with SEC awards and other programs. Some issues can depend on how much time the foreign person spent in the United States, working on the case or otherwise. And since some foreign people have some U.S.-source income and file Form 1040NR, that can be relevant too.

It may start when the government requests an IRS Form W-9, which the foreign person cannot sign. One response is for the whistleblower to provide a Form W-8BEN. In some cases, that can involve claiming tax treaty benefits. But often, if the whistleblower manages to avoid U.S. tax withholding, they won't view the award as U.S.-source income and won't file a U.S. tax return.

The withholding issue may be more delicate in the case of the IRS, which is geared to withhold taxes even on awards paid to U.S. whistleblowers. It is not clear that it occurs in 100 percent of the cases, but the IRS is likely to treat payments to foreign persons as fixed or determinable annual or periodical income and withheld at 30 percent, subject to any reduction under an applicable exception or tax treaty.

Structured Settlements?

Are structured settlements available for whistleblowers? It depends. Structured settlements are common in many types of settlements but seem rare with whistleblowers. One exception would be for the employer-paid settlements for retaliation. Wages cannot be structured, but other money often can.

The goal of any structured settlement is to have payments made over time — but not by trusting the defendant. Rather, the lump sum is paid to a third party, like an annuity company, which then makes periodic payments over many years. An annuity is a contractual arrangement in which a third party pays a sum of money over a set period, with taxes due only as those payments are made.

Such arrangements are common in various types of lawsuit settlements. They must be agreed to in advance as part of the settlement agreement, so they are locked in before all the documents are signed. Annuities can help reduce taxes, ensure long-term economic security, and protect a settlement from being dissipated. Another goal of structured settlements is investment return and tax efficiency.

Because the plaintiff or whistleblower is not treated as receiving the lump sum, the money is effectively growing on a tax-deferred basis while the third party has the money. With traditional physical injury case structured settlements, 100 percent of each payment is tax free, including the investment return element. With taxable structures like those used in employment cases, each payment in the series is taxable.

However, each payment is taxable only when and as received. Structured settlements of the retaliation component of whistleblower cases can sometimes be negotiated. Rather than a government, it is generally the employer paying the money. In that sense, it can be much like a regular employment settlement. For the nonwage portion of the settlement, that may make a structured settlement available.

State Income Taxes

Whistleblowers about to collect big may react like other plaintiffs about to collect big. For that matter, similar tax incentives can exist for investors or company owners about to make a sale. Expecting a large recovery of any sort can make moving to another state attractive for some people. If you are about to recover a very large and long-awaited sum, considering the tax consequences of where you reside can make sense.

If you live in California, you can pay up to 13.3 percent in state income tax on your recovery. New York and many other states also have high state taxes, though many state taxes hover around 5 percent. Of course, paying no tax is even better. Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming don't have general individual income taxes, making them popular states for taxpayers expecting a recovery.

The laws governing residence and domicile vary, but most steps that are appropriate to establish or move one's residence are common sense, including physical presence, intent, voting, driver's license, and vehicle registration. There are about 25 things you should do to move, connecting yourself to your new domicile and disconnecting yourself from the old.

As you would expect, timing matters a lot too. The success of any move from a tax viewpoint is eased by how far ahead of your award you move. Moving right before an award is never as persuasive, in part because a move date isn't usually a single date. If you have 25 things to do, you can't do them all in a single day.

Depending on your timing and thoroughness, be aware that your old state may claim you are still a resident after you receive your recovery. It's always possible for a state to claim taxes post-move. The tax claim may be that you didn't really move or that you didn't move soon enough to protect your recovery from your old state's taxes.

Many tax residency disputes aren't about whether you really moved. It often takes a few years for a tax audit and dispute to occur. By then, your old state may agree that you moved and are no longer a resident. But if you claim to have moved in April, your old state may say they think you moved in July.

If you haven't built in an adequate buffer between your move date and your big recovery, a dispute about exactly when you moved can be enough for your old state to collect. Sometimes, state tax disputes are more sophisticated than only focusing on the residence and move dates.

In some cases, your old state's claim may be that even assuming that you moved before your recovery, because of your work on the case while you were a resident of the high-tax state, some or all of your recovery is still sourced to the high-tax state. There is a lot of variation in these cases, and the facts, dates, and support matter. So if you are considering a move related to a significant recovery, getting professional advice is a good idea.

Family Gifts

Family gifts are an estate planning topic, but they are also worth noting separately. You can generally give up to $16,000 per year to any number of people without filing a gift tax return. This allowance is personal, so you and your spouse combined can give as much as $32,000 to each person every year. Getting some advice about how to formalize and document gifts can be wise.

Of course, these gifts are post-recovery, and an estate planner is worth consulting. Even big gifts — millions — may not trigger gift or estate tax. Now (for 2023), every person can give up to $12.92

million during their life, tallied at death. That means a married couple can give up to $25.84 million without paying gift or estate tax. However, you must file a gift tax return recording how much you gave, so you can't use that portion of your unified credit again.

In fact, gift tax returns can be a good idea, even when they aren't required. A gift tax return ensures that the IRS statute of limitations (usually three years from filing) will run with the IRS. Gift tax returns are also required for noncash property, such as interests in LLCs. Some people consider forming a family LLC or partnership before a recovery.

The idea is generally to try to divide up a later award in advance. This kind of planning is best done long before a recovery, when the value of the claim is small or highly uncertain. That way, shares in the entity can be gifted with little or no gift tax consequences. And if the recovery comes in, the award may belong and be taxed to several people. Gifts of family partnerships, real estate, and interests in businesses require gift tax returns, even if they are less than $16,000 in value.

Charitable Donations

If you are facing a big tax bill and are charitably minded, one way to reduce that bill is to consider gifts to charity that can help offset income with charitable contributions. Some people form their own private foundation or donor-advised fund, especially if they aren't sure where they want their money to go before the end of the year.

Estate Planning

Whether a recovery is big or small, you should think about estate planning. Even if you aren't wealthy, you'll save yourself and your family money, time, expense, and privacy by having a plan in place. A living trust and a pour-over will (that upon your death pours all your assets into your trust) will keep your estate out of probate. Probate is public, time-consuming, expensive, and unnecessary. You want to avoid it. Of course, you should also consider taxes.

The good news is that under today's tax law, for deaths in 2023, there is no federal estate tax for any sum that has a value of less than $12.92 million. For a married couple, you get double that amount. That means a married couple can transfer $25.84 million before paying estate tax. Of course, gifts made during your life are added to those made at death, and you must file gift tax returns every year in which you give more than $16,000 per person.

Conclusion

Whistleblowers understandably worry about taxes, perhaps even more than most plaintiffs. With issues such as anonymity, the use of an LLC, and dealing with co-relators and finders, it is good to plan ahead whenever possible. ■