Whistleblowers and Tax Enforcement: Using Inside Information to Close the "Tax Gap"

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WHISTLEBLOWERS AND TAX ENFORCEMENT:
USING INSIDE INFORMATION TO CLOSE THE “TAX GAP”

Edward A. Morse*

This article examines the current legal structure allowing rewards for informants who provide information to assist the IRS in the enforcement of the tax laws. IRS data suggest that informants are a cost-effective means of enhancing tax enforcement. The Tax Relief and Health Care Act of 2006 introduced a separate whistleblower award program that provides significant monetary rewards (up to 30 percent of the amount collected) and attempts to provide greater certainty in the payment of such rewards, including a process for enforcing reward claims through litigation in the Tax Court. Although informant rewards enhance tax enforcement, they also raise significant issues concerning taxpayer privacy and IRS secrecy, particularly in the context of lawsuits to enforce reward claims. Moreover, prospects for large financial rewards without comprehensive attention to eligibility constraints may effectively induce prospective whistleblowers to breach other legal or ethical responsibilities. The article discusses ethical and privacy issues lurking in the whistleblower program, arguing that these issues deserve more careful attention from Congress and should not be relegated to administrative or judicial development.

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I. Introduction.

Voluntary self-assessment is a longstanding and indispensable aspect of our federal income tax system. The Internal Revenue Code requires taxpayers to file timely

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1 See Millsap v. Commissioner, 91 T.C. 926, 931 (1988) (“This concept [that a return is required for an assessment of federal income tax] is deeply rooted in our history. In part, our country was founded as the result of tax revolt wherein citizens protested being taxed without their consent. Our tax system is rooted in the concept of voluntary compliance which does not permit the government to arbitrarily assess tax without a proper list or report.”)
and accurate returns of their taxable income and to pay the taxes due.\textsuperscript{2} Taxpayers generally comply with these obligations without direct intervention by the government.\textsuperscript{3} The “tax gap” is born in this private zone of voluntary compliance whenever a taxpayer, whether intentionally or unintentionally, reports and pays less tax than if the law were correctly applied.\textsuperscript{4}

Taxpayers have sometimes misunderstood what voluntary compliance means.\textsuperscript{5} Unfortunately that misunderstanding works to their detriment. Legal penalties, including civil and criminal sanctions for taxpayers\textsuperscript{6} and their professional advisors\textsuperscript{7} are designed to reinforce the Code’s requirements to file and pay one’s taxes.\textsuperscript{8} However, the efficacy of penalties to deter noncompliance is ultimately linked to prospects for enforcement, which in turn requires discovery of noncompliance.

The Federal government has various means at its disposal to discover noncompliance by taxpayers and to enforce the tax laws. Examination powers are at the core of these efforts, as they allow the government to penetrate a taxpayer’s otherwise

\textsuperscript{2} See, e.g., I.R.C. §§ 6001 (imposing general obligation to keep records and make returns); 6012 (requiring income tax returns); 6072 (time for filing income tax returns); 6151 (time and place for paying tax).


\textsuperscript{4} See id.

\textsuperscript{5} For example, in 1999, the Commissioner included this statement in the instructions for Form 1040: “Thank you for making this nation’s tax system the most effective system of voluntary compliance in the world.” In response, a taxpayer (or non-taxpayer, to be more accurate) asked: “(1) Why does the Commissioner say that? (2) What does that mean? (3) How does it affect the [Petitioner]?” Takaba v. Commissioner, 119 T.C. 285, 288 (2002).

\textsuperscript{6} See, e.g., I.R.C. §§ 6651 (failure to file penalty); 6662 (accuracy-related penalties); 6662A (special accuracy-related penalties regarding reportable transactions); 6663 (fraud penalty). For criminal provisions applicable to taxpayers, see, e.g., IRC §§ 7201-07 (identifying various tax crimes).

\textsuperscript{7} See, e.g., I.R.C. §§ 6694 (understatement of taxpayer’s liability by tax return preparer); 6695 (other assessable penalties regarding preparation of tax returns for others); 6700 (promoting abusive tax shelters); 6701 (aiding and abetting understatement of tax liability). For an overview and critique of rules and penalties imposed on preparers, see generally Richard M. Lipton, What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone, 107 J. OF TAX’N 68 (2007).

\textsuperscript{8} See, e.g., Richard J. Wood, Accuracy-Related Penalties: A Question of Values, 76 IOWA L. REV. 309 (1991). They may also help to offset some of the government’s compliance costs, although Professor Wood contests the validity of this purpose from a policy perspective. See id.
private realm to evaluate whether reporting positions comply with the law and the facts.\textsuperscript{9} Laws requiring disclosure of tax information by third parties also facilitate government scrutiny of taxpayer reporting and enhance compliance.\textsuperscript{10}

Enforcement efforts have a direct and measurable impact on closing the tax gap among noncompliant taxpayers.\textsuperscript{11} Other benefits may also resonate throughout the tax system, which are more difficult to quantify.\textsuperscript{12} For example, the threat of enforcement presumably reinforces voluntary compliance; information developed from examination of taxpayer returns may enhance prospects for accurately targeting likely noncompliant practices.\textsuperscript{13}

Enforcement efforts involve significant costs for the government and for affected taxpayers.\textsuperscript{14} Some taxpayers selected for examination have no changes to their returns, resulting in costs incurred by both parties without any recovery of additional tax collections.\textsuperscript{15} Although information technology may increase the accuracy of targeting enforcement efforts toward those likely to be noncompliant,\textsuperscript{16} a low-tech solution is also available. Informants or “whistleblowers”\textsuperscript{17} may potentially enhance effectiveness of

\textsuperscript{9}See I.R.C. § 7602.
\textsuperscript{11}See section II, infra.
\textsuperscript{12}See id.
\textsuperscript{13}See Department of the Treasury, Budget in Brief FY 2008 at 6, available at http://www.irs.gov/pub/newsroom/budget-in-brief-2008.pdf (visited May 21, 2008). The budget includes funding for studies to capture data needed to “keep the IRS’s targeting systems and compliance estimates up to date” and to “develop strategies to combat specific areas of non-compliance, improve voluntary compliance, and allocate resources more effectively.” Id. One significant taxpayer benefit was the potential to “reduce the burden of unnecessary taxpayer contacts.” Id.
\textsuperscript{14}See id.
\textsuperscript{15}See section II, infra.
\textsuperscript{17}These terms will be used interchangeably throughout the article, although the term “informant” is arguably broader than the term “whistleblower,” which might be interpreted as an employee who informs
examinations by identifying noncompliant taxpayers based on access to inside information that may not be generally available. In effect, the informant becomes a tool for peeking inside the otherwise private zone of voluntary compliance.

Whistleblower laws have been widely used by state and federal government to enhance enforcement and to prevent future harms from violators. \(^1^8\) Although some statutes only protect the whistleblower against retaliation, others also incentivize disclosure through providing monetary rewards. \(^1^9\) Such incentives may indeed enhance enforcement effectiveness, but collateral impacts on other social values, including privacy and fidelity in professional relationships, also deserve consideration.

This article provides a critical look at the current scheme for rewarding tax informants in relation to the “tax gap.” Despite efforts to enhance incentives for informants to come forward, current award programs continue to operate in an environment based on discretion and uncertainty. Additional reforms are needed to clarify uncertainties and to consider limitations that will take into account other competing values, including the protection of tax return information and the propriety of incentivizing the breach of professional, legal, or ethical obligations through rewards.

Part II provides an overview of the IRS examination function and examines data involving the utility of informants in selecting returns for examination. Part III explores

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\(^1^8\) See generally Terry Morehead Dworkin, Sox and Whistleblowing, 105 Mich. L. Rev. 1757, 1768-72 (2007) (discussing various models for whistleblowing legislation); Mary Kreiner Ramirez, Blowing the Whistle on Whistleblower Protection: A Tale of Reform, 76 U. Cin. L. Rev. 183, 191 (2007) (“The sheer number of anti-retaliation laws illustrate that whistleblowers are a critical component to effective law enforcement in a complex society as insiders often furnish invaluable assistance in the investigation and prosecution of public corruption and corporate frauds.”)

\(^1^9\) See id. Professor Dworkin strongly favors legislation that provides incentives in addition to mere protections against retaliation, criticizing the protective model as based on the “faulty premise” that “most observers of wrongdoing are people of conscience who would report the wrongdoing absent the fear of retaliation.” Id. at 1768.
the statutory scheme for rewarding informants under I.R.C. § 7623, which was recently amended to include a separate whistleblower awards program affecting relatively large tax deficiencies. Part IV discusses some ethical and legal issues presented by the current whistleblower scheme. In particular, it identifies the need to balance respect for professional and legal obligations concerning confidentiality with broader compliance goals. It argues for further clarification of reward parameters in order to provide appropriate incentives to help reduce the tax gap, while deterring participation by those who would violate professional or legal standards in making disclosures.

II. Overview of the IRS Examination Function.

Section 7602 of the Code provides broad authority for the Treasury Department to “examine any books, papers, records, or other data which may be relevant or material” for the purpose of “ascertaining the correctness of any return, making a return where none has been made, determining the liability for any internal revenue tax … or collecting any such liability.” The examination function entails significant coercive powers, including summons authority, which operate primarily against the taxpayer whose return is under examination. As discussed below, examinations raise revenues from taxpayers under examination, but they are also likely to enhance tax administration in other important ways that are more difficult to quantify.

A. Prophylactic benefits.

Approximately 179 million tax returns were filed in 2007. The sheer volume of returns suggests certain practical limits upon the government’s ability to examine all

20 See IRC § 7602(a)(1).
21 See IRC § 7602(a)(2).
22 See Electronic Tax Administration Advisory Committee, Annual Report to Congress, Appendix 1, Table 1 (June 20, 2007), available at http://www.irs.gov/pub/irs-pdf/p3415.pdf (accessed May 20, 2008). Of these, approximately 136.3 million are individual returns, 6.51 million are corporate returns, 3.05 million
returns that may contain tax underpayments. Based on current audit practices, only about one percent of these returns are likely to be examined. Moreover, a majority of these examinations will involve a “correspondence” examination focusing on select narrow issues rather than a comparatively more comprehensive “field” examination.

Examinations contribute important intangible benefits that enable the tax system to continue depending on voluntary compliance. The Internal Revenue Manual states: “The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers.” Despite limited examination coverage, the knowledge that one could be selected for an examination potentially reinforces the obligation to report fairly and honestly. Taxpayers who are tempted to cheat may be deterred from deliberately violating the law and honest taxpayers may be

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23 Computer technology may provide a partial solution to the volume of information that must be processed. The Electronic Tax Administration Advisory Committee estimates that approximately 59 percent of all individual tax returns are expected to be filed electronically for the 2007 tax year. See Electronic Tax Administration Advisory Committee, Annual Report to Congress 1 (June 20, 2007), available at http://www.irs.gov/pub/irs-pdf/p3415.pdf (accessed May 20, 2008). Benefits from electronic filing include avoiding transcription of paper returns and validation of mathematical functions and certain input data, which ultimately may benefit both taxpayers and the government. See id. at 9. However, taxpayer concerns about enhanced audit rates (which may or may not be true) may be limiting participation. See id. at 16 (“There is a strong perception among many paper filers that e-filing increases the chances of an audit. While we know that e-filed returns are twenty times more accurate than paper ones, the IRS needs to address the audit concerns for this taxpayer segment.”)


25 There were 311,339 “field” audits and 1,073,224 “correspondence” audits reported for individuals in fiscal 2007. See id.

26 See I.R.M. 4.1.1.1. (quoting Policy Statement P-4-21) (10/24/06).

27 See Florsheim Bros. Drygoods Co. v. United States, 280 U.S. 453, 461 (1930) (“T]he purpose of these [IRS] audits is not to eliminate the necessity of filing the return, but to safeguard against error or dishonesty.”)

28 See Department of the Treasury – Budget in Brief FY2008 2 (February 5, 2007) available at http://www.irs.gov/pub/newsroom/budget-in-brief-2008.pdf (accessed 5/21/08) (noting that estimates of enforcement revenues “exclude[ ] the likely larger revenue impact from the deterrence value of these and other IRS enforcement programs (e.g., criminal investigations)”).
assured that they are not alone in following the law.29 These are important values that are likely to enhance taxpayer commitment to compliance throughout the system.

In addition to promoting voluntary compliance, other benefits may accrue within the tax system itself. Examinations may uncover facts about taxpayer behavior that prove useful in designing better rules or in designing better audit techniques. For example, they may identify areas where complex rules are commonly misunderstood and misapplied, indicating a need for simplification or additional clarification. As the IRS has recognized, “The complexity of the nation’s current tax system is a significant reason for the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their tax obligations is a critical part of improving voluntary compliance.”30

Examinations may also expose common means that taxpayers use to cheat, and these experiences may be transmitted to revenue agents. For example, industry specialization programs provide guidance and training concerning specialized issues that may deserve audit attention.31 Such information can assist in improving the efficiency and effectiveness of examination efforts by providing training and guidance for examiners. To the extent that this information is also communicated to taxpayers, additional voluntary compliance may also be achieved.32

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29 See id. at 1 (“[Enhanced enforcement] ensure[s] taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same …”).


32 Cf. Rev. Proc. 89-14, 1989-1 C.B. 814 (“The purpose of publication of revenue rulings and revenue procedures in the Bulletin is to promote uniform application of the tax laws by Service employees and to assist taxpayers in attaining maximum voluntary compliance by informing Service personnel and the public...”)
B. Direct benefits.

Examinations also help to close the tax gap in more quantifiable ways. The IRS enforcement budget for fiscal 2007 is less than $7 billion.\textsuperscript{33} It leveraged these resources to collect $59.2 billion in unpaid taxes through its enforcement efforts in fiscal 2007, up more than twenty-one percent from the $48.7 billion in fiscal 2006.\textsuperscript{34} Of this $59.2 billion, about $23.5 billion was attributable to examinations and $3.9 billion came from document matching programs, which correlate information reporting to amounts reported on taxpayer returns; the balance of $31.8 billion is attributable to collection efforts for previously determined tax liabilities.\textsuperscript{35}

As noted above, only about one percent of all returns are audited. The IRS uses mathematical and statistical techniques, including a so-called “discriminate index function” (DIF) to weight various return characteristics for purposes of selecting some for examination.\textsuperscript{36} Particular algorithms or details regarding this function or methods for return selection are closely guarded secrets, but considerable information is provided concerning the examination rates for particular segments of the population. Selected audit rates and information are displayed in table 1, below.

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\textsuperscript{35} See id.

Table 1: Selected Examination Rates by Segment, FY 2007

<table>
<thead>
<tr>
<th>Individuals</th>
<th>Total Examinations</th>
<th>Returns filed in prior calendar year</th>
<th>Examination Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Individuals</td>
<td>1,384,563</td>
<td>134,421,400</td>
<td>1.03%</td>
</tr>
<tr>
<td>Income &gt;= $1 million</td>
<td>31,382</td>
<td>339,138</td>
<td>9.25%</td>
</tr>
<tr>
<td>Income &gt;= $200,000</td>
<td>113,105</td>
<td>3,942,702</td>
<td>2.87%</td>
</tr>
<tr>
<td>Income &gt;= $100,000</td>
<td>293,188</td>
<td>16,599,800</td>
<td>1.77%</td>
</tr>
<tr>
<td>Income &lt; $200,000</td>
<td>1,277,065</td>
<td>130,478,698</td>
<td>0.98%</td>
</tr>
<tr>
<td>Income &lt; $100,000</td>
<td>1,091,375</td>
<td>117,821,600</td>
<td>0.93%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Businesses</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Businesses</td>
<td>59,516</td>
<td>9,072,828</td>
<td>0.66%</td>
</tr>
<tr>
<td>Small Corp. (Assets &lt; $10 million)</td>
<td>20,020</td>
<td>2,171,144</td>
<td>0.92%</td>
</tr>
<tr>
<td>Large Corp. (Assets &gt;=$10 million)</td>
<td>9,644</td>
<td>57,357</td>
<td>16.81%</td>
</tr>
<tr>
<td>Large Corp. (Assets&gt;=$250 million)</td>
<td>3,427</td>
<td>12,599</td>
<td>27.20%</td>
</tr>
<tr>
<td>S Corporation</td>
<td>17,657</td>
<td>3,909,730</td>
<td>0.45%</td>
</tr>
<tr>
<td>Partnership</td>
<td>12,195</td>
<td>2,934,597</td>
<td>0.42%</td>
</tr>
</tbody>
</table>

This data shows that examination rates vary depending on income demographics. Individuals earning under $100,000 are audited at only about one ninth the rate for those earning $1 million or more, and only about one third of the rate for those with incomes of $200,000 or more. Business categories reflect a similar bias favoring large corporations over their smaller counterparts.

The total for examinations shown in Table 1 does not reflect differences in the extent of the examination. Correspondence examinations, which are more limited in scope than a field examination, make up a significant portion of examination coverage for individuals. Table 2 breaks down correspondence and field examinations by income strata:

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Table 2: Examination Types for Individuals, FY 2007

<table>
<thead>
<tr>
<th></th>
<th>Total Examinations</th>
<th>Field Examinations</th>
<th>% of Total</th>
<th>Correspondence Examinations</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Individuals</td>
<td>1,384,563</td>
<td>311,339</td>
<td>22.49%</td>
<td>1,073,224</td>
<td>77.51%</td>
</tr>
<tr>
<td>Income &gt;= $1 million</td>
<td>31,382</td>
<td>12,259</td>
<td>39.06%</td>
<td>19,123</td>
<td>60.94%</td>
</tr>
<tr>
<td>Income &gt;= $200,000</td>
<td>113,285</td>
<td>43,640</td>
<td>38.52%</td>
<td>69,645</td>
<td>61.48%</td>
</tr>
<tr>
<td>Income &gt;= $100,000</td>
<td>293,188</td>
<td>127,544</td>
<td>43.50%</td>
<td>165,644</td>
<td>56.50%</td>
</tr>
<tr>
<td>Income &lt; $200,000</td>
<td>1,276,965</td>
<td>267,699</td>
<td>20.96%</td>
<td>1,009,266</td>
<td>79.04%</td>
</tr>
<tr>
<td>Income &lt; $100,000</td>
<td>1,091,375</td>
<td>183,795</td>
<td>16.84%</td>
<td>907,580</td>
<td>83.16%</td>
</tr>
<tr>
<td>Income &gt;= $100K,&lt;200K</td>
<td>179,903</td>
<td>83,904</td>
<td>46.64%</td>
<td>95,999</td>
<td>53.36%</td>
</tr>
</tbody>
</table>

Taxpayers with higher income levels are generally receiving a greater percentage of field examinations (and a likely greater share of examination resources) than lower income taxpayers. However, somewhat surprisingly, those with incomes in the $100,000 to $200,000 range experience more field examinations (46.64%) than the millionaire group (39.06%).

Although higher income strata generally have higher examination rates, it should be noted that relatively few individual taxpayers will face field examinations. As shown in table 3, below, the risk of a field examination remains low for every category, suggesting that the so-called audit lottery is still open for those who wish to play.

Table 3: Field Examinations as Percentage of Prior Year Returns Filed, FY 2007

<table>
<thead>
<tr>
<th></th>
<th>Field Examinations</th>
<th>Total Returns from prior year</th>
<th>Field Exam Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Individuals</td>
<td>311,339</td>
<td>134,421,400</td>
<td>0.23%</td>
</tr>
<tr>
<td>Income &gt;= $1 million</td>
<td>12,259</td>
<td>339,138</td>
<td>3.61%</td>
</tr>
<tr>
<td>Income &gt;= $200,000</td>
<td>43,640</td>
<td>3,942,702</td>
<td>1.11%</td>
</tr>
<tr>
<td>Income &gt;= $100,000</td>
<td>127,544</td>
<td>16,599,800</td>
<td>0.77%</td>
</tr>
<tr>
<td>Income &lt; $200,000</td>
<td>267,699</td>
<td>130,478,698</td>
<td>0.21%</td>
</tr>
<tr>
<td>Income &lt; $100,000</td>
<td>183,795</td>
<td>117,821,600</td>
<td>0.16%</td>
</tr>
</tbody>
</table>

38 See id. The final category in this table is derived by subtraction of the figures from the income >=$100,000 category from the income >=$200,000 category. The results from subtracting the income <$100,000 category from the income <$200,000 category are comparable in magnitude, although not identical.
39 See id.
C. Costs to Government and Affected Taxpayers.

Examinations are potentially costly for taxpayers and the government. Generalizations about cost are fraught with difficulty, due in part to variations in the nature and extent of the examination. However, a general measure may be derived from budget figures for enforcement activities. Assuming an annual budget of $7.2 billion for enforcement, and assuming further that about 40 percent of this budget is spent on examination activities and that about 1.5 million returns are examined, this translates into an average government cost of $1,920 for each examined return.

Data disclosed by the Treasury Inspector General for Tax Administration (TIGTA) provide another basis for an estimate based on hours spent per return, which would seem to confirm that this $1,920 figure is a plausible estimate. A government study involving 997,555 returns from 1996-98 that were selected for examination required 13,418,772 hours, or about 13.45 hours per return. This measure of labor would translate to an adjusted hourly rate of approximately $143/hour (including direct employee costs and associated overhead costs), which does not seem unreasonable.

Of course, examinations also impose costs on taxpayers. Examinations can be intrusive and disruptive, imposing intangible costs that are difficult to quantify. IRS training materials caution that “In-depth examinations of income may involve a thorough

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41 This is based on FY 2007 total of $59.2 billion, of which $23.5 billion (about 40%) was attributable to collection. See text at footnote 35, supra. This metric assumes a pro rata relationship between revenues and costs.
42 See data in Table 1, supra.
43 See TIGTA 2006 Report, supra note 36.
44 $1,920/13.45 hours = $142.75. It should be noted that the TIGTA report also includes data from smaller return samples, which generate a higher figure for hours per return. Without more data as to the method for selection, the larger sample would seem to provide a more reliable estimate.
examination of the taxpayer's books and records or contacting third parties. Examiners should be sensitive to the burden this places on the taxpayer and the impact an in-depth examination may have upon the taxpayer's personal and professional life.” Moreover, if professional advice is required, significant additional direct costs may also be incurred. Only in rare cases will taxpayer costs be reimbursed, as in matters where the IRS proceeded to litigation without substantial justification for its position.

The primary method used by the IRS selecting returns is known as the “Discriminate Index Function” or “DIF” – which is a mathematical weighting approach that assigns weights to different return characteristics. The DIF approach is reasonably effective in selecting returns that produce positive audit adjustments, but a significant number of examined returns nevertheless result in no changes. A sample of examined returns for the years 2003-2005 showed that out of 15,832 returns selected pursuant to the DIF approach, 4,435 (28 percent) resulted in no change. A larger sample of 997,550 returns for fiscal 1996-98 showed 169,148 (17 percent) with no changes.

Examinations that produce no changes are not necessarily valueless, as they may provide useful information to the government concerning the particulars of taxpayer compliance. However, significant costs are nevertheless involved, and as noted above, compliant taxpayers are unlikely to be reimbursed for incurring them.

46 See, e.g., I.R.C. § 7430 (permitting recovery of fees and administrative costs by prevailing party in litigation unless position of the United States was “substantially justified”). For critical discussion of prevailing party awards, see generally Wm. Brian Henning, Comment, Reforming the IRS: The Effectiveness of the Internal Revenue Service Restructuring and Reform Act of 1998, 82 MARQ. L. REV. 405, 419-25 (1999). It should be noted that costs incurred in connection with an audit would not be within the scope of an award under section 7430. See Columbus Fruit and Vegetable Co-op Ass’n v. United States, 8 Cl. Ct. 525, 530-31 (1985) (quoting legislative history indicating that preparing the petition or complaint that commences a tax case is the first of recoverable attorney’s fees).
47 See TIGTA 2006 Report, supra note 36, at n.18.
48 See id. Figure 2.
49 See id. Figure 3.
Comparative information concerning examinations conducted pursuant to the informants’ program and the DIF method confirm that the informants’ program not only produced fewer no change returns, thereby minimizing costs imposed on compliant taxpayers, but they also returned a higher amount of adjustment dollars per hour. Salient results are summarized in table 4, below.

Table 4: TIGTA Study Results for DIF and Informant Examinations

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Total Adjustments</th>
<th>Total Hours</th>
<th>Adjustment $/hour</th>
<th>No Change Return %</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2003-2005</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Informants</td>
<td>$26,233,554</td>
<td>38,139</td>
<td>$688</td>
<td>21%</td>
</tr>
<tr>
<td>DIF</td>
<td>$422,356,790</td>
<td>1,105,890</td>
<td>$382</td>
<td>28%</td>
</tr>
<tr>
<td>FY 1996-1998</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Informants</td>
<td>$160,091,580</td>
<td>169,259</td>
<td>$946</td>
<td>12%</td>
</tr>
<tr>
<td>DIF</td>
<td>$7,358,908,430</td>
<td>13,418,772</td>
<td>$548</td>
<td>17%</td>
</tr>
</tbody>
</table>

This data indicates that using informants to gather information about noncompliant taxpayers increases the likelihood of additional tax collections from examinations. Informants have increased the dollars returned per hour invested by the IRS, nearly doubling the proposed adjustment per hour over the DIF sample. Moreover, informants have apparently reduced the number of no-change audits, thereby saving scarce government resources and benefiting compliant taxpayers.

The above figures do not show the effects of additional costs incurred due to awards on the net recovery obtained. However, the TIGTA report indicates that expenditures for rewards through fiscal 2005 have been highly productive. As shown in table 5, below, rewards for Fiscal 2001-2005 have generated significant benefits over and above the taxes, fines, penalties, and interest recovered in those cases.

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50 See TIGTA 2006 Report, supra note 36.
Table 5: Excess of Recoveries over Rewards to Informants FY 2001-2005

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recoveries</td>
<td>$44,024,333</td>
<td>$66,940,519</td>
<td>$61,556,175</td>
<td>$74,130,794</td>
<td>$93,677,606</td>
</tr>
<tr>
<td>Rewards</td>
<td>$3,337,035</td>
<td>$7,707,402</td>
<td>$4,057,476</td>
<td>$4,585,143</td>
<td>$7,602,685</td>
</tr>
<tr>
<td>Benefit</td>
<td>$40,687,298</td>
<td>$59,233,117</td>
<td>$57,498,699</td>
<td>$69,545,651</td>
<td>$86,074,921</td>
</tr>
</tbody>
</table>

The figures in Table 5 show positive contributions from rewards to informants. However, the direct impact on the tax gap during these years seems modest – less than $100 million annually. It is important to note that these recovery figures only report direct effects, and they do not reflect any indirect effects on compliance that may come from effective enforcement. Moreover, it appears that informants are getting a small part of the total recovery – rewards are averaging about 8 percent of the total recovered amount (including interest).

As discussed below, structural amendments to the whistleblower/informant reward programs in 2006 are likely to increase the total award payout. However, even if award percentages increase substantially, the extra payout is unlikely to offset the gains that have historically been shown from using informants. For example, even if the adjustment per hour is reduced by a full 30 percent (i.e., the top rate for prospective awards under section 7623(b)), the adjustment rate per hour for informants would continue to be higher than that obtained through the DIF approach. However, the extent to which the additional awards will be effective in closing the tax gap remains untested. In part, this will depend on how award programs will be administered, which is covered in the next section.

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51 See id. (totals adapted from Figure 1).
52 To illustrate, using the FY2003-2005 adjustment for examinations initiated by informants of $26.2 million (see Table 4, above), and assuming a full 30 percent of the adjustment is diverted to a whistleblower under I.R.C. § 7623(b), that would still leave $18.3 million for the government and a net adjustment per hour of $481, which would continue to exceed adjustment rates from the DIF approach.
III. Rewards for Informants.

The Federal government has a long history of providing rewards or incentives for information that assists in the enforcement of tax laws. According to the IRS, federal legislation has provided for rewards for information since 1867.\(^{53}\) Two separate programs currently provide a basis for seeking rewards for tax-related information, and each program is explored separately below.


Section 7623(a) of the Code continues a longstanding discretionary system for authorizing the payment of rewards to informants. This provision generally authorizes the Secretary of the Treasury to “pay such sums as he[or she] 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, in cases where such expenses are not otherwise provided for by law.”\(^{54}\) Legislation in 2006 substituted “or” for “and” between clauses (1) and (2).\(^{55}\) This amendment presumably clarifies and confirms that rewards may be given for detecting both civil and criminal violations of tax laws, although this has long been the law in this area. Regulations first promulgated in 1997 also state these two criteria in the disjunctive.\(^{56}\)

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\(^{54}\) IRC § 7623(a).


\(^{56}\) See Treas. Reg. § 301.7623-1(a) (“In cases where rewards are not otherwise provided for by law, a district or service center director may approve a reward, in a suitable amount, for information that leads to the detection of underpayments of tax, or the detection and bringing to trial and punishments of persons guilty of violating the internal revenue laws or conniving at the same.” (Emphasis added)). This regulatory change was promulgated in T.D. 8737, 1997-2 C.B. 273, which included temporary regulations issued in response to section 1209 of the Taxpayer Bill of Rights 2, Pub. L. 104-168, 110 Stat. 1452 (1996).
Rewards are generally sourced from the “proceeds of amounts collected by reason of the information provided.”\textsuperscript{57} Prior to amendment in 2006, rewards could not be based on interest, but instead were restricted to the recovery of taxes and penalties.\textsuperscript{58} Thus, the 2006 amendment potentially expands the base from which these discretionary rewards may be paid. This has the indirect effect of also compensating the informant for waiting until the IRS collects these amounts from the taxpayer before obtaining payment of an award.\textsuperscript{59}

Treasury regulations\textsuperscript{60} and other administrative pronouncements\textsuperscript{61} provide additional guidance to prospective informants, but they provide no basis to determine with certainty either eligibility or the amount of the payment.\textsuperscript{62} The discretionary nature of rewards in this context has been confirmed in case law involving the adjudication of claims by informants seeking to recover their rewards.

For example, in \textit{Confidential Informant v. United States},\textsuperscript{63} an informant brought a claim against the government in the United States Court of Federal Claims based on what he had characterized as a “substantive right pursuant to I.R.C. § 7623.”\textsuperscript{64} At the core of this claim was the issue of whether section 7623 was “money-mandating,” which was necessary to invoke jurisdiction of the claims court.\textsuperscript{65} However, the court rejected the informant’s claim of a putative right to an award on the grounds that “neither the statute

\begin{itemize}
\item \textsuperscript{57} \textit{Id.}
\item \textsuperscript{58} See Pub. L. No. 109-432, Title IV § 406(a)(1)(C), 120 Stat. 2922, 2958 (2006) (striking the parenthetical restriction “other than interest” from current section 7623(a)).
\item \textsuperscript{59} However, to the extent that interest assessed precedes the date the informant provides information, the informant receives a direct benefit that does not correlate to the time value of his award.
\item \textsuperscript{60} See Treas. Reg. § 301.7623-1.
\item \textsuperscript{62} See, e.g., Treas. Reg. § 301.7623-1; IRM Part 25, Chapter 2, Section 2, Informant Rewards (4/27/1999).
\item \textsuperscript{63} 46 Fed. Cl. 1 (2000).
\item \textsuperscript{64} \textit{Id.} at 4.
\item \textsuperscript{65} See \textit{id.} at 5-6.
\end{itemize}
nor the regulation contains specific requirements that an informant must meet in order to
be eligible for compensation. Furthermore, neither the statute nor the regulation states a
sum certain.”

Regulations state that a “district or service center director” determines whether a
reward will be paid and the amount of the reward based on “all relevant factors, including
the value of the information furnished in relation to the facts developed by the
investigation of the violation.” Regulations also provide that “[t]he amount of a reward
will represent what the district or service center director deems to be adequate
compensation in the particular case, generally not to exceed fifteen percent of the
amounts (other than interest) collected by reason of the information.” Thus, the
regulations only provide an outer percentage limit for an award, but they do not entitle a
claimant to a particular amount.

Claims based on a putative contract with the IRS to pay a reward for information,
which would be money-mandating, are difficult to prove. One significant barrier is found
in the regulations, which state in part: “No person is authorized under this section to
make any offer, or promise, or otherwise to bind a district or service center director with
respect to the payment of any reward or the amount of the reward.” Persons other than
the district or service center director are not expressly authorized to contract on the
government’s behalf.

66 Id. at 6.
67 Treas. Reg. § 301.7623-1(c).
68 See id. The restriction “other than interest” in the current regulations do not yet reflect changes from the
Tax Relief and Health Care Act of 2006. See notes 56-58, supra.
69 See id.
70 See, e.g., Confidential Informant, supra, 46 Fed. Cl. at 7 (“Because neither the statute nor the
implementing regulation granted the government officials in this case the authority to bind the government
in contract, plaintiff’s contractual theory of relief cannot rely on the express authority of the government
agents.”)
A recent case illustrates the difficulties encountered in seeking a discretionary reward. In *Abraham v. United States*,\(^{71}\) the claimant became suspicious about the estate tax return that was being prepared for his mother’s estate. He contacted the IRS with these concerns and was allegedly advised by the agent on duty that he would receive a reward of from 15-25 percent of the taxes collected if he would submit a letter documenting his concerns along with a check for his share of estate taxes due.\(^{72}\) Abraham duly complied by sending such a letter along with a check for $109,292.\(^{73}\)

The Service audited the returns and after years of litigation it collected a deficiency of some $1.125 million from the estate.\(^{74}\) Abraham thereafter filed an “Application for Reward for Original Information,” and his claim was rebuffed by the IRS. He filed suit in the Court of Federal Claims alleging breach of contract and demanding 10-15% of the deficiency under I.R.C. § 7623(a).\(^{75}\)

Despite precedents that are adverse to creation of a contract claim until the amount of the award is fixed and promised by the IRS,\(^{76}\) the court permitted this taxpayer to go forward with proof that an “implied in fact” contract may exist between the taxpayer and the government.\(^{77}\) Here, instead of an indefinite offer that would otherwise preclude the formation of a contract because there was no acceptance by the government, the claimant had asserted a specific offer, to which he responded with a letter and a

\(^{71}\) 81 Fed. Cl. 178 (2008).
\(^{72}\) Id. at 179.
\(^{73}\) Id.
\(^{74}\) Id. at 180.
\(^{75}\) It should be noted that an earlier claim had been filed in the Tax Court under the whistleblower provisions, but it was dismissed for lack of jurisdiction. See id. (citing Docket No. 8308-07W). Presumably, the lower percentage that Abraham requested reflects the general limitation found in the regulations applicable to informant rewards, rather than the higher amount allegedly promised by the agent that may have contemplated an award under the whistleblower program of I.R.C. § 7623(b).
\(^{76}\) See, e.g., United States v. Krug, 168 F.3d 1307 (Fed. Cir. 1999); United States v. Merrick, 846 F.2d 725 (Fed. Cir. 1988).
\(^{77}\) See Abraham, supra, 81 Fed. Cl. at 183-87.
check.\textsuperscript{78} As for the authority of an agent to bind the government, the court would allow proof on the issue of whether implied actual authority existed in this case – despite the fact that the regulations limit express authority. \textsuperscript{79}

Cases like \textit{Abraham} show the perils faced by potential claimants in collecting their rewards. If Abraham is successful in his claim, he will potentially offset his share of estate taxes by “ratting out” his fellow beneficiaries. However, it is highly uncertain whether he will be paid at all. The message to the informant community does not appear encouraging. Short of contracting in advance with the district or service center director (or someone with express authority to negotiate on his or her behalf) for a specific award, contract theory provides a doubtful remedy for this uncertainty. Sound policy reasons may exist for limiting those who can contract on behalf of the government, but raising this defense also raises doubts concerning the reliability of IRS personnel. As the Federal Circuit has commented in a case involving another disaffected claimant for an award, IRS conduct in these matters may sometimes “leave[ ] much to be desired in terms of how the Government should treat its citizens.”\textsuperscript{80}

Even if the government follows through and pays a reward, collection may take many years until litigation has run its course and the amounts at stake are collected. Regulations permit an informant to waive a claim to a future reward in exchange for a current payment.\textsuperscript{81} However, the Internal Revenue Manual requires that all rewards are subject to repayment if the collections on which it is based are subsequently reduced.

\textsuperscript{78} See id. at 186.
\textsuperscript{79} See id. at 186-87.
\textsuperscript{80} See Krug v. United States, 168 F.3d. at 1310.
\textsuperscript{81} See Treas. Reg. § 301.7623-1(c).
which presents some additional risk to the claimant in this context.\textsuperscript{82} Moreover, one would suspect that an early payment is significantly discounted, reflecting a conservative measure of the litigation or collection hazards in the particular case.\textsuperscript{83}

**B. Whistleblower Awards Under I.R.C. § 7623(b).**

The Tax Relief and Health Care Act of 2006 also added section 7623(b) to the Code.\textsuperscript{84} This provision creates an alternative reward system for high-value cases, which is intended to provide greater certainty and predictability for potential claimants. However, as discussed below, considerable discretion remains, and the scheme adopted may raise other significant and unanticipated problems for tax administration.

1. Threshold amounts.

The award program under section 7623(b), entitled “awards to whistleblowers,” applies with regard to enforcement actions where the “tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2,000,000.”\textsuperscript{85} Additionally, if an individual taxpayer is involved, that individual must have gross income in excess of “$200,000 for any taxable year subject to such action.”\textsuperscript{86}

The rationale for imposing a relatively high threshold – $2 million – for the disputed amount is not clearly stated. Legislation has been introduced to amend this

\textsuperscript{82} See IRM § 25.2.2.9 (4-27-1999). A special agreement might alter this requirement, though such agreements are discouraged. See IRM 25.2.2.5 ¶ 2 (4/27/1999). The Internal Revenue Manual also cautions: “[I]n the interest of maintaining a viable informants’ reward program, the merit of requiring repayment should always be weighted against the veracity of the informant and the information provided.” IRM § 25.2.2.9 (4/27/1999).

\textsuperscript{83} See I.R.M. Exhibit 25.2.2-6 (04/27/1999), containing a “sample letter which may be used to offer the Informant an early reward” which states “by signing the Request for Early Award, you will be waiving any possibility of a larger reward.”


\textsuperscript{85} I.R.C. § 7623(b)(5)(B).

\textsuperscript{86} Id. § 7623(b)(5)(A).
provision by reducing this amount to $20,000, but this change was not enacted. The high threshold will likely relegate most potential claims from informants to the discretionary informant program in section 7623(a), rather than to the whistleblower award program. There are plausible policy reasons for such an approach. For example, the Whistleblower Office is a new division within the IRS that is charged with administering the whistleblower award program. It may be prudent to limit the extent of its obligations during the early periods for this program in order to ensure that it is able to handle the workload. This will also allow the Whistleblower Office to focus on relatively high value targets that are most likely to generate favorable adjustments in relation to the costs incurred. If whistleblowers can significantly reduce the tax gap, tangible results may be more easily achieved by focusing on the largest, most promising cases.

The rationale for imposing an additional income limit for individual taxpayers is also unclear, particularly when that limit applies in addition to the $2 million threshold. If the $2 million threshold is otherwise satisfied, the amount at stake would seem to provide a sufficient basis for IRS attention despite the fact that the individual has a modest annual gross income. Nevertheless, this restriction is unlikely to impose a significant practical constraint on whistleblower awards. Few taxpayers with income tax

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87 See H.R. 1591, 110th Cong., 1st Session, § 543(a).
89 Corporate tax abuses in prominent public cases may have also influenced Congress' interest in focusing whistleblower incentives on large corporate targets. For example, Enron Corporation reported positive income for financial reporting purposes, but paid taxes in only one year during the period 1996-2001. See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS-3-03), February 2003. Even though Enron was under audit, the full scope of tax misconduct was not known until after its collapse. See id.
related liabilities exceeding the $2 million threshold under the statute would not also satisfy the $200,000 income threshold. However, claims involving taxes that are not based on income, such as those involving federal wealth transfer taxes, could conceivably be affected by this income limit.

2. Award Parameters.

If the above thresholds are met, the whistleblower award program generally provides that the claimant “shall … receive an award of at least 15 percent but not more than 30 percent of the collected proceeds … resulting from the action or from any settlement in response to such action.” On its face, the statute defines this program in a manner that is quite different from the discretionary informant program under section 7623(a). First, it generally entitles the whistleblower to an award, rather than leaving the award entirely to the discretion of the district or service center director. Second, it potentially increases the amount by defining the minimum award at fifteen percent, which was essentially the maximum generally allowed under the discretionary informant award program.

The whistleblower award program may circumscribe the role of IRS discretion, but it does not eliminate discretion entirely. The Whistleblower Office of the IRS, which is authorized to process tips received by taxpayers and to determine eligibility for whistleblower awards, must still determine whether to proceed with an enforcement action. In particular, the statute requires that the IRS must proceed with an enforcement

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90 Id. § 7623(b)(1).
91 See Treas. Reg. § 301.7623-1(c) (“The amount of a reward will represent what the district or service center director deems to be adequate compensation in the particular case, generally not to exceed fifteen percent of the amounts (other than interest) collected by reason of the information.”)
92 See id.
action “based on information brought to the Secretary’s attention” in order to secure an award.\textsuperscript{94} Further, determining the amount of the award within the range of 15 to 30 percent of the recovery depends primarily on “the extent to which the individual substantially contributed to such action.”\textsuperscript{95}

Whether the IRS proceeds “based on” information provided by the whistleblower is potentially complex, leaving room for uncertainty. For example, if multiple sources provide the same information, which of them has brought the matter to the IRS’s attention for purposes of being entitled to the award? If the IRS had previously been building a case, must additional whistleblower information be outcome-determinative in the decision to proceed? Stated differently, is one entitled to an award when the IRS proceeds based “in part” on that information? Or is it “primarily” on that information? Or is the standard somewhere in between?

The parameters for determining whether an individual “substantially contributed” also present uncertainty. The determination appears to involve an inquiry into the connection between information the whistleblower provides and the ultimate success of the IRS claim asserted against the taxpayer.\textsuperscript{96} Moreover, whether the individual “substantially contributed” is arguably limited to the determination of where, within the 15 to 30 percent range, a payment should be made.

Although some discretion may be unavoidable, additional guidance as to the meaning of a substantial contribution and its relationship to the “based on” determination

\textsuperscript{94}I.R.C. § 7623(b)(1).
\textsuperscript{95}\textit{Id.}
\textsuperscript{96}Compare I.R.M. § 25.2.2.17 (4/27/1999), which provides with regard to informant cases that “No reward is allowable if the information originally furnished was unworthy of investigation even if the return is examined at some later date (but without reference to the information furnished) and a deficiency is assessed. Such claims should be rejected on the basis that the information did not cause the investigation nor did it, in itself, result in the recovery of taxes, fines, and penalties.”
would be helpful to enhance certainty and predictability of this process. For example, suppose the IRS already has information in its possession showing a likely deficiency, but it needs further proof to establish penalties for fraud. If a whistleblower provides this information and further actions are taken to assert fraud penalties, has the “based on” test been met? If so, has the individual substantially contributed assuming that this is only one issue? Is the award to be constrained to the amount collected from that issue, if the examination was already underway? Additional administrative guidance here would be appropriate to limit potential litigation on these kinds of questions.

The statute indicates that the source of the information provided by the whistleblower may also be important in determining eligibility for an award. If the Whistleblower Office determines an action is based principally on disclosures of specific allegations (other than information provided by the individual described in paragraph (1)) resulting from a judicial or administrative hearing, from a governmental report, hearing, audit, or investigation, or from the news media, the Whistleblower Office may award such sums as it considers appropriate, but in no case more than 10 percent of the collected proceeds … resulting from the action … taking into account the significance of the individual's information and the role of such individual and any legal representative of such individual in contributing to such action.

Thus, the whistleblower award program arguably permits, but does not require, an award of no more than ten percent if the whistleblower merely transmits information that comes from a public source, such as a judicial hearing, government report, or news story. Presumably, such information would have doubtful utility to the IRS, as it would already have access to the information and it could act independently to initiate an examination.

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97 It should be noted that the statute provides that the award is a percentage of “collected proceeds … resulting from the action (including any related actions)…” I.R.C. § 7623(b)(1). This indicates that information leading to an audit for one issue, but which expands to address other issues, may generate a whistleblower award that is a percentage of the entire recovery and is not limited to the particular scope of relevant whistleblower information.

Discretionary powers to provide a lesser award, or none at all, in this context resemble those in section 7623(a).

However, the statute also states that this discretionary approach “shall not apply if the information resulting in the initiation of the action described in paragraph (1) was originally provided by the individual provided in paragraph (1).” 99 For example, assume the whistleblower provides information before it becomes available from a public source, such as the news media or a judicial hearing. The subsequent availability of that information would not necessarily deprive the whistleblower of an award at the minimum fifteen percent level under section 7623(b)(1), assuming the IRS acted based on that information brought to its attention and the information otherwise substantially contributed to the success of the action. 100

In addition to evaluating the source of the information and its contribution to the success of the IRS claim, the statute also requires the Whistleblower Office to evaluate whether the claim for an award “is brought by an individual who planned and initiated the actions that lead to the underpayment of tax [or other violation of internal revenue laws].” 101 If so, the Whistleblower Office “may appropriately reduce [the] award.” 102 If that individual is convicted of criminal conduct arising from his or her role in planning and initiating these actions, the award must be denied. 103

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100 See I.R.C. § 7623(b)(1). As discussed below, the IRS may also seek additional cooperation or assistance from an informant. In this context, the substantial contribution analysis might also include effort, as well as information.
101 See I.R.C. § 7623(b)(3).
102 See id.
103 See id.

The scope of discretion permitted is significant because the Code provides that whistleblower award determinations are eligible for judicial review by the Tax Court.\(^\text{104}\) As discussed above, decisions involving discretionary awards under section 7623(a) do not provide a basis for judicial review unless the claimant can establish a contract for payment.\(^\text{105}\) In contrast, a whistleblower seeking an award under section 7623(b) has standing to enforce his or her claim to an award regardless of whether a contract exists. The statute expressly provides that “[n]o contract with the Internal Revenue Service is necessary for any individual to receive [a whistleblower award].”\(^\text{106}\) In addition, a whistleblower under section 7623(b) receives one other benefit that informants under section 7623(a) generally do not receive: the ability to deduct attorney fees and court costs in enforcing that claim as an above-the-line deduction.\(^\text{107}\)

The statutory scheme outlined above is likely to present challenges for judicial resolution, which deserve additional legislative or administrative guidance. In particular, permitting judicial review in this context presents the distinct possibility of disclosure of otherwise secret policies and practices within the IRS. It may also jeopardize the secrecy of taxpayer information.

Treasury regulations restrict testimony and/or disclosure of IRS records or information in various circumstances, such as where that information might “disclose investigative techniques and procedures, the effectiveness of which could thereby be

\(^{104}\) See I.R.C. § 7623(b)(4).

\(^{105}\) See notes 69-79, supra. See also Destefano v. United States, 52 Fed. Cl. 291, 293 (2002) (“The applicable statute and regulations [i.e., I.R.C. § 7623(a) and Treas. Reg. § 301.7623-1] neither create contractual obligations nor do they empower judicial review.”)

\(^{106}\) I.R.C. § 7623(b)(6)(A).

\(^{107}\) See I.R.C. § 62(a) (21). It should be noted, however, that this benefit may prove illusory if the whistleblower is required to pay costs or fees in a taxable year that differs from the year the award is paid. This deduction is not available for “any deduction in excess of the amount includible in the taxpayer’s gross income for the taxable year on account of such award.” Id.
impaired.” The discretionary informant award scheme did not require the IRS to disclose the basis for rejecting an award. For example, in Conner v. United States, the Court of Federal Claims dismissed a pro se case brought by an informant who claimed a monetary reward for reporting several individuals who allegedly underpaid their taxes. The claimant had received a rejection letter from the IRS which effectively stated that “Federal disclosure and privacy laws” prohibited disclosure of the specific reason for rejecting a claim for an award. In contrast, a whistleblower award claim involving the matter of whether the IRS acted “based on” the taxpayer’s information and whether that information “significantly contributed” to the result may require evaluation of the scope and effect of various investigative techniques, which have thus far been left in the realm of secrecy.

The privacy rights of taxpayers under investigation also present potential concerns in whistleblower award litigation. Regulations provide that neither testimony nor information may be disclosed if doing so would violate the confidentiality of taxpayer information provided by section 6103 of the Code, or would violate regulations governing information obtained under Bank Secrecy Act investigations. In a whistleblower award case, the amount of the award may depend on whether the IRS collected a particular amount in a settlement (as opposed to litigation where the results can be known to the public). Thus, resolution of such a claim might require the disclosure of particular information from the taxpayer under examination for the purpose

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109 Id. at 87.
110 Id. A similar form letter is also found in the Internal Revenue Manual. See IRM Exhibit 25.2.2-7 (04/27/1999) (“Letter 1010(SC), which can be used to reject a claim for reward”).
111 I.R.C. § 7623(b)(1).
of satisfying the informant. Such disclosure would not be necessary where the amount of the award was entirely discretionary.

Proposed legislation in 2007 sought to address general privacy issues through an amendment of section 7623(b)(4), which would state in part:

Notwithstanding sections 7458 and 7461, the Tax Court may, in order to preserve the anonymity, privacy, or confidentiality of any person under this subsection, provide by rules adopted under section 7453 that portions of filings, hearings, testimony, evidence, and reports in connection with proceedings under this subsection may be closed to the public or to inspection by the public.\(^{114}\)

This amendment was not enacted, but ample administrative authority nevertheless exists for the Tax Court to provide for confidentiality and anonymity when necessary.\(^{115}\)

However, such authority does not necessarily resolve the problem concerning the preservation of the privacy of the taxpayer under investigation, where disclosure to the informant and his/her counsel is necessary to enforce an award claim.

Temporary regulations have been promulgated to address this disclosure issue if the IRS contracts with the whistleblower or his legal representative for additional services – a so-called “tax administration contract”.\(^{116}\) The preamble to these regulations explains that section 6103(n) of the Code permits disclosure of return information pursuant to a

\(^{114}\) See H.R. 1591, 110th Cong. 1st Sess., § 543(c).

\(^{115}\) Despite a general practice favoring disclosure in judicial proceedings, I.R.C. § 7461(b)(1) provides in part that “[t]he Tax Court may make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information, including a provision that any document or information be placed under seal to be opened only as directed by the court.” See also Anonymous v. Commissioner, 127 T.C. 89 (2006) (discussing considerations for sealing records and proceeding anonymously in the Tax Court.)

\(^{116}\) See T.D. 9389, 2008-18 I.R.B. 863. The preamble states in part:

In analyzing information provided by a whistleblower, or investigating a matter, the Whistleblower Office may determine that it requires the assistance of the whistleblower, or the legal representative of the whistleblower. The legislative history of section 406 of the Act states that “[t]o the extent the disclosure of returns or return information is required [for the whistleblower or his or her legal representative] to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.” Joint Committee on Taxation, Technical Explanation of H.R. 6408, The “Tax Relief and Health Care Act of 2006,” as Introduced in the House on December 7, 2006, at 89 (JCX-50-06), December 7, 2006.
tax administration contract.\textsuperscript{117} However, the preamble also notes that “[I]t is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed.”\textsuperscript{118} Conditions for disclosure include restrictions that limit the content to that which is relevant to the services being procured, and appropriate safeguards must also be in place to ensure the continued confidentiality of this information.\textsuperscript{119}

These regulations may assist whistleblowers with a tax administration contract in obtaining information on which to evaluate an award claim. However, other whistleblowers without such contracts may still face problems in enforcing their claims, assuming that taxpayer protections are otherwise taken seriously in this area. Further attention to these issues may be needed if Tax Court review is to fulfill its purpose of assuring a whistleblower that an award will not be denied arbitrarily and without prospects for meaningful review. On the other hand, taxpayers subject to whistleblower tips also deserve assurances that their return information is not disclosed inappropriately to whistleblowers seeking to enforce putative reward rights. Important policy choices thus remain unresolved here. Reducing discretion may have a salutary effect on the incentive to come forward with information, but careful attention is required to provide the rules that will fill the discretionary void.

\textbf{IV. Ethical Considerations: Other Limits for Whistleblower Awards?}

Informant programs depend on the willingness to share information for the purpose of assisting law enforcement efforts. Persons with information may be motivated to come forward in part by civic duty, but financial rewards here also inject

\footnotesize{\textsuperscript{117} See id.}  
\footnotesize{\textsuperscript{118} See id. (internal quotation omitted).}  
\footnotesize{\textsuperscript{119} See id.}
intense personal financial interests into this decision. The amount of the reward could be substantial – perhaps even life-changing – especially under the whistleblower award provisions, which are not subject to the cap of $10 million imposed on other discretionary informants.\textsuperscript{120}

Informants seeking whistleblower awards under section 7623(b) must submit information under penalty of perjury.\textsuperscript{121} The criminal penalty for perjury – which may include fines and/or imprisonment for up to five years – presumably deters intentionally false statements designed to harass or harm prospective taxpayer investigation targets.\textsuperscript{122} However, there is no assurance that information from a whistleblower will not be incorrect, unreliable, or insufficient as a basis for finding an underpayment of tax. As discussed above, informant-based examinations can still result in no changes on audit, even though that result appears less likely than under other examination selection techniques.\textsuperscript{123} Thus, the discretion and judgment of the IRS continues to be important in determining whether to proceed on an informant’s tip.

The source of an informant’s information is one aspect of that discretion. Informants under section 7623(a) submit Form 211, Application for Award for Original Information, which asks the informant, among other things, to “[d]escribe how you learned about and/or obtained the information that supports this claim and describe your present or former relationship to the alleged noncompliant taxpayers.”\textsuperscript{124} This inquiry is arguably relevant for the purpose of determining whether there is any reason to doubt the

\textsuperscript{121} See I.R.C. § 7623(b)(6)(C).
\textsuperscript{122} See 18 U.S.C.A. § 1621 (defining perjury and its penalties).
\textsuperscript{123} See notes 47-50, supra.
veracity of the information provided. However, it is also relevant for the purposes of evaluating whether there may be other reasons to avoid dealing with this person as a source of information, or not to give the person a reward for his participation even if the information is reliable.

The whistleblower award provisions contain only limited restrictions on the identity of informants eligible for awards. As previously noted, prospective award-seekers are on notice that their award may be reduced or denied if they “planned and initiated the actions that lead to the underpayment …” Nevertheless, discretion to grant an award exists unless the planner/initiator is also “convicted of criminal conduct arising from the [planning/initiation] role,” in which case an award may not be given.

Informants who helped to plan or initiate an unlawful tax-avoidance scheme are well-qualified to provide reliable information for the purpose of identifying returns likely to generate positive tax adjustments. Significantly, the statute does not prevent the IRS from using the information gained in this manner. It only prevents the IRS from giving an award if the informant’s conduct in planning/initiating on behalf of another results in a criminal conviction. Without a criminal conviction, planner/initiators are only subjected to the uncertainty of a discretionary award, which would presumably reduce any financial incentive to disclose. Thus, in this case, discretion is added to deter disclosure.

Enhanced tax compliance is a worthy goal, but other values are also at stake in defining the scope of appropriate enforcement measures. The constraint on awards to planner/initiators may arguably reflect some value judgments about granting awards to persons who have assisted the taxpayer in violating the law, and who may be subject to

125 See notes 101-103, supra.
126 I.R.C. § 7623(b)(3).
127 See id.
other penalties short of criminal sanctions.\textsuperscript{128} In this sense, the Code may not go far enough in restricting the scope of award-eligible behavior.

Incentivizing disclosure may, in some cases, induce other harms or wrongs. Unfaithfulness involving one’s tax obligations may be undesirable, but what about inducing an informant to violate a longstanding professional obligation for trust and confidentiality? Consider a prospective informant who is a member of the bar with a professional obligation to maintain confidentiality of client information.\textsuperscript{129} Breaching client confidentiality may result in civil sanctions or disbarment, but these consequences are not criminal sanctions necessary to prevent an award under the statute.

The value of confidentiality in the lawyer-client relationship has persisted despite longstanding recognition that it may prevent us from knowing the truth.\textsuperscript{130} As Professors Hazard and Hodes have observed in their seminal work, THE LAW OF LAWYERING, “the confidentiality principle can stand on a moral base of its own. It creates a zone of privacy that cannot be breached by a too-inquisitive government, and thus enhances the autonomy and individual liberty of citizens.”\textsuperscript{131} Admittedly, the primary mechanisms for deterring disclosure of confidential information are found in social and professional

\begin{itemize}
\item \textsuperscript{128} See authorities in note 7, supra.
\item \textsuperscript{129} See, e.g., MRPC Rule 1.6(a), which provides in part: “A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).” Paragraph (b) allows disclosure, among other things, “to prevent the client from committing a crime or fraud” or to “prevent, mitigate, or rectify substantial injury to the financial interests or property of another [due to crime or fraud],” which involves the use of the lawyer’s services. See MRPC Rule 1.6(b)(2), (3). Attorneys who are not giving advice that is used in planning or initiating transactions involving crimes, but who merely become aware of information would not be within the scope of these permitted exceptions. Comments clarify that that paragraph (b)(3), affecting disclosures for a crime or fraud that has already occurred, does not apply “when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offence.” Id. Comment [8].
\item \textsuperscript{130} See Geoffrey C. Hazard, Jr. & W. William Hodes, I THE LAW OF LAWYERING 132 (1993 & 1998 Supp.) (“It is the confidentiality principle that most often creates tension between the law of lawyering and ‘other’ law, for it exacts significant sacrifice of the truth-finding and justice-seeking aims of the law generally, and often requires that the victims of a client’s misdeeds be forsaken.”)
\item \textsuperscript{131} Id. at 131.
\end{itemize}
sanctions, rather than in criminal penalties. However, the deterrent effect of the sanction of disbarment depends in significant part on the economic penalty of being deprived of future earnings from practicing a profession. Reputational sanctions may also occur, which alter the purely economic calculus. Nevertheless, the efficacy of that economic calculus is a matter of concern when government alters it through rewards, and particularly when those rewards may be large.

An award program that offers discretionary payments that are highly uncertain and usually small would be unlikely to tip the scales in favor of disclosure. However, a whistleblower award that is financially significant and provides relatively greater certainty for payment presents heightened risks. If the expected value of the award would exceed the expected value of future earnings lost through disbarment by an amount sufficient to also offset any reputational harms to the informant, this could tip the scales in favor of disclosure. Such an award program may prove highly tempting to the professional whose personal values of trust and loyalty to the client are outweighed by his or her own personal financial self-interest.

Government should be cautious in creating incentives for citizens to violate important ethical norms. The IRS has apparently recognized this value in other limited contexts involving taxpayer representatives. As a general matter, the Chief Counsel has advised IRS employees working with informants that “under no circumstances is it appropriate to accept any information from an informant … when the informant is also the taxpayer’s representative in any administrative matter pending before the Service.”

132 See id. at 132 (noting that “lawyers demonstrate the moral values of trust and loyalty when they say they will keep quiet and then do so, even when there are compelling reasons to speak out.”)
133 See CC-2008-011 (February 27, 2008). This Notice also cautions IRS employees to seek approval before engaging in additional contacts with an informant that might violate the so-called “one bite” rule,
Although this language does not extend to all lawyer-client relationships, it nevertheless reflects a propensity for restraint and respect in this area. However, the matter of government restraint in this area is far from settled, as other commentators have raised concerns about the sanctity of the attorney-client relationship in other legal matters where attorneys may be required to disclose information to the government.\textsuperscript{134}

Discretion to deny an award to a planner/initiator under the whistleblower program is useful in diminishing the possibility that a professional in this category will be induced to betray a client.\textsuperscript{135} An absolute bar would arguably provide greater protection for the lawyer-client relationship and possibly for other professional relationships involving trust or confidence.\textsuperscript{136} However, the planner/initiator constraint is not sufficient for the purpose of ensuring protection of lawyer-client relationships.

Not all lawyers who have information about client noncompliance with tax laws are considered planner/initiators. For example, a lawyer providing advice to a taxpayer in an unrelated matter (such as criminal law) may have access to information showing which allows the government to use information, even though it may have been obtained in an illicit or illegal manner, as long as the government did not encourage or acquiesce in the informant’s conduct.\textsuperscript{134} See, e.g., Elizabeth A. Cheney, Note, Leaving No Loopholes for Terrorist Financing: The Implementation of 58 VAND. L. REV. 1705, 1729-35 (2005) (discussing exemptions for attorneys to disclosure requirements under anti-money-laundering rules, as well as under section 307 of Sarbanes Oxley); Robert J. Jossen, Dealing with the Lawyer’s Responsibilities under the Sarbanes-Oxley Act of 2002: Ethical Dilemmas and Practical Considerations, SL 027 ALI-ABA 417 (October 6-7, 2005) (discussing disclosure and “noisy withdrawal” effects on confidentiality obligations). Tax shelter transactions have sometimes generated advocacy for relaxed protections of confidentiality and privilege for those involved in planning and facilitating them. See, e.g., Richard Lavoie, Making a List and Checking It Twice: Must Tax Attorneys Divulge Who’s Naughty and Nice?, 38 U.C. DAVIS L. REV. 141 (2004) (arguing that limited privilege protection is appropriate in tax shelter matters); Brian R. Ford, Current Development, Helter Shelter: Protecting Taxpayers’ Identities in Tax-Shelter Cases, 18 GEO. J. LEGAL ETHICS 723 (2005).

\textsuperscript{135} However, penalty provisions affecting return preparers also provide some deterrent effects here, which would presumably impact a decision to disclose. See note 7, supra.

\textsuperscript{136} See, e.g., AICPA Model Code of Professional Conduct Rule 301 (requiring accountants to not disclose confidential client information without specific consent from the client); AMA Principles of Medical Ethics, Principle IV (“A physician shall respect the rights of patients, colleagues, and other health professionals, and shall safeguard patient confidences and privacy within the constraints of the law.”), available at http://www.ama-assn.org/ama/pub/category/2512.html (accessed 6/4/2008).
noncompliance with tax laws. Should a whistleblower award be granted to for this kind of disclosure? A blanket rule prohibiting awards if the disclosure breaches an obligation of professional ethics should be considered here in lieu of the more limited planner/initiated restriction.

Other legal or ethical conundrums are also presented in matters of awards. Whistleblowers receiving attention from the news media have included a foreign bank employee who disclosed depositor account information in violation of foreign bank secrecy laws, which has generated international attention in the area of tax enforcement. Another bank employee disclosed transactional details concerning the bank’s involvement in facilitating tax shelter transactions for others, which potentially involves more than $1.5 billion in tax liability.

Further discussion and exploration of the ethical concerns presented in this context is beyond the limited scope of this article. However, it is quite clear that important issues remain essentially unresolved in Congress’ attempt to design the whistleblower award scheme. IRS administrative rules impose a number of other limitations on eligibility for the informant discretionary award program, which are rooted in prudential and ethical concerns. For example, employees of the Treasury Department, whether or not they are also employees of the IRS, are ineligible for informants’


138 See David Armstrong and Jesse Drucker, Netherlands bank funded tax shelters for U.S. firms, Wall Street Journal Online, May 5, 2008, available at http://online.wsj.com/article_print/SB120994505887466249.html (accessed 5/7/2008) (discussing whistleblower claim for federal recoveries of taxes involving more than 100 tax shelters involving U.S. companies, which may have saved these companies at least $1.46 billion in taxes). At an award level of 15%, this translates to more than $200 million, excluding penalties and interest which may also form the basis for an award.
Other Federal employees are also ineligible if they obtained the information as part of their official duties. However, a Federal employee who obtained information apart from his/her official duties is deemed eligible to the same extent as other informants. Police officers are also eligible for rewards, unless a statute or ordinance specifically excludes them from accepting a reward. Moreover, an award payment that would be “contrary to State or local law,” may be denied.

In Notice 2008-4, the IRS issued interim guidance indicating that it will follow some of these restrictions from the discretionary informant award program in the whistleblower award program. The notice lists several examples of claims that would not be processed, including those submitted by Treasury Department employees or other government employees acting within the scope of his or her duties. Significantly, the Notice also includes “claims submitted … by an individual who is precluded by Federal law or regulation from making the disclosure.” Although this example indicates that IRS administrative practices may respect U.S. legal obligations to maintain privacy, the statutory basis for such a restriction is unclear, and this may be tested in litigation.

139 See IRM § 25.2.2.16 (4/27/1999).
140 See id. § 25.2.2.17.
141 I.R.M. § 25.2.2.16. To illustrate, the Internal Revenue Manual states that a postal worker who overheard a taxpayer boasting about his nonpayment of taxes to customers in his store was allowed a reward. Here, the IRM does not state whether the postal worker was on his rounds delivering mail, and if so whether that would affect eligibility based on performance of official duties.
142 See id.
143 See id. § 25.2.2.17.
145 Id. § 3.04 (Example 1).
146 Id. § 3.04 (Example 2). It should be noted that state laws are not taken into account in this example, although the Internal Revenue Manual would consider a violation of state laws as a basis for denial.
147 Moreover, not all legal obligations to maintain privacy may bear the same weight in relation to competing values of improving tax compliance. For example, legislative protections aimed at protecting an individual’s personal information from disclosure to other firms or to the public (including those who might steal his/her identity) may not provide a sufficient basis to prevent disclosure to the IRS for the limited purpose of enhancing tax compliance, particularly when sufficient safeguards exist to protect that information from further public disclosure.
When the parameters for obtaining an award are set forth in the whistleblower award statute, introducing additional restrictions or constraints by administrative pronouncement or regulation is problematic. As the politically accountable branch, Congress should direct attention to the important value questions lurking here and provide legislation to address additional categories for restricting whistleblower awards. These issues are too significant and value-laded to be left to the discretion of the IRS, or to ad hoc development through the courts.

V. Conclusions.

The available data suggest that using informants can improve the effectiveness of the examination function. Informants have the potential to reduce the tax gap directly by enhancing collections from noncompliant taxpayers. They may also reduce the costs imposed on compliant taxpayers for unproductive audits.

Awards provide an incentive for informants to come forward with useful information. However, prospective informants face considerable uncertainty under the discretionary informant program in section 7623(a) of the Code. Cases such as Abraham, discussed above, illustrate the perils of relying upon representations by revenue agents. The resulting uncertainty, coupled with public relations problem of allowing the government to engage in behavior that, at a minimum, may appear untrustworthy, potentially deters informant participation.

Statutory changes to the award program from the Tax Relief and Health Care Act of 2006 may indeed increase the incentives for informant participation. Claimants under the discretionary informant program may now obtain larger rewards based on collections that include interest, as well as taxes and penalty collections. More significantly, the

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148 See discussion at notes 68-72, supra.
whistleblower award program under section 7623(b) of the Code enhances not only the percentage amounts for available awards, but also attempts to enhance the certainty and predictability of obtaining them without an advance contract.

Despite a worthy effort, significant shortcomings persist in the whistleblower award program. By empowering claimants to seek judicial review of award determinations and removing the requirement for an advance contract, the whistleblower award program bolsters incentives for coming forward. However, judicial review presents additional practical and legal questions that deserve further attention. These include the protection of taxpayer privacy and security, as well as protection for the internal investigative processes of the IRS, which have thus far been kept confidential.

Granting awards for information also raises important ethical questions, particularly when the information is derived from a relationship of trust or confidence. The current whistleblower award program contains only limited categorical constraints applicable to prospective claimants, affecting those who planned or initiated transactions on behalf of others. However, other categorical restrictions may be important to preserve other social values, including the sanctity of the attorney-client relationship or other trusted professional relationships. Tax administration is important, but other important values also deserve consideration in framing an effective award system. These values deserve attention from Congress, and should not be left to bureaucratic development or judicial speculation.

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