

## Bankruptcy Taxation Committee

To monitor the activities of the Congressional committees and IRS on matters concerning bankruptcy tax legislation and regulations.



### New IRS Whistleblower Law Creates Potential Asset Bankruptcy

**Written by: Robert E. McKenzie**

Arnstein & Lehr LLP; Chicago  
remckenzie@arnstein.com

**Barry A. Chatz**

Arnstein & Lehr LLP; Chicago  
bachatz@arnstein.com

A little-noticed provision of the Tax Relief and Health Care Act of 2006<sup>1</sup> (effective Dec. 20, 2006) has created a rewards program for individuals informing the IRS of large tax omissions. The IRS is gearing up for an influx of informant claims: IRS managers report that whistleblowers have already provided tips involving hundreds of millions of dollars in tax underpayments.

Thus, debtors-in-possession (DIPs)/bankruptcy trustees, or other parties in interest, including creditors or equityholders who are aware of tax-games fraud committed by former management, existing employees or otherwise, potentially have a new asset from which recourses may flow. The rights created as described below do not appear to require action be taken derivatively.

#### Generous Awards

The new whistleblower law applies to claims for reward in cases in which the potential amount owed to the IRS for taxes, penalties, and interests exceeds \$2 million and, in cases of individuals, the taxpayer's gross annual income must exceed \$200,000. The new law provides a minimum reward of 15 percent and a maximum reward of 30 percent. This is a substantial increase over the previous regulations that provided a minimum recovery of 1 percent and a maximum recovery of 15 percent for whistleblowers. The law does place a cap of 10 percent on rewards if the IRS determines that the whistleblower's information was not the original source of information but still contributes to the additional collection. The fact that an individual participated in the activities that created a tax omission does not preclude a reward but the IRS uses involvement in the tax underpayment as a basis to reduce the reward.

The law also provides that IRS must make a reward payment in all cases that pursues a remedy against a taxpayer based upon information provided by the whistleblower. The previous awards were discretionary and in many cases the IRS refused to pay any award to the informant even when the information resulted in a substantial recovery of taxes. Smaller informant items that do not meet the statutory minimums of the

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<sup>1</sup> 26 U.S.C. §7623

whistleblower law will still be entitled to awards under the IRS discretionary award program. Under the traditional program, the IRS limited awards to 15 percent and most were for significantly less.

## **Public Information**

Whistleblowers may also seek a reward for bringing publicly-available information to the attention of the IRS if it results in the recovery of additional taxes. This type of award is limited to 10 percent of the IRS recovery. For example, aspiring informants might review a company's SEC filings to find apparent tax omissions and then file for a reward. Others might spot apparent tax violations in the public media and seek an award. One could contemplate a little-noticed story in a newspaper that could provide a tax lead. For example, if a company was accused of bid rigging or other financial crimes where the company's net income was not likely to have been properly reported, a whistleblower could inform the IRS and seek a reward.

## **Litigation Disclosures**

Another source of potential whistleblower material is company litigation. During the course of most commercial litigation, substantial economic information becomes part of the record. Since the court system is open, nothing prevents someone who witnesses testimony from reporting information to the IRS. This includes a judge, juror, court reporter, other court employee and your opponent. Sworn testimony and related evidence in a proceeding can be freely given to the IRS under this whistleblower program. Matters that might disclose tax underpayment should be settled before additional information regarding the conduct becomes made public.

## **Regulatory Investigations**

Investigations by state and local regulatory agencies might also generate informant items to the IRS. A state environmental investigator might note improper expensing of pollution equipment during the course of verifying environmental compliance and decide to try for an award. Likewise, a liquor inspector might note inventory issues while performing her duties. With so many state and local regulators from building inspectors to safety inspectors checking businesses each year one can contemplate that some may come to view the whistleblower program as a way to secure an economic windfall.

## **IRS Whistleblower Office**

On Feb. 2, 2007 the IRS named Stephen A. Whitlock as director of its new Whistleblower Office, where he is responsible for administering the program designed to receive information that helps uncover tax cheating and to provide appropriate rewards to whistleblowers. The IRS Whistleblower Office will process tips received from individuals who spot tax problems in their workplace while conducting day-to-day personal business or anywhere else they may be encountered. Whitlock's office will be responsible for assessing and analyzing incoming tips. After determining their degree of credibility, his office will assign the information to the appropriate IRS office for further investigation.

## **Form 211**

A whistleblower should submit her information to the IRS with Form 211, Application for Award for Original Information. If the tax omission is substantial it would be wise to contact the IRS Whistleblower office in

advance and negotiate the terms of award. If the whistleblower was in any way involved in the tax omission it would wise to consult an experienced tax attorney prior to any IRS contact. For example, an ex-spouse who plans to inform on an ex after filing joint returns. The informant might end up with significant personal tax problems based on her own tax history.

### **Right to Sue for an Award**

The whistleblower law allows a claimant to sue the IRS in U. S. Tax Court if it denies a reward. In the past a whistleblower had no right to sue the IRS because rewards were discretionary.

### **Value of Informant Information for Tax Enforcement**

In June 2006, the U.S. Treasury issued a report that found that examinations initiated based on informants' data is more effective and efficient in identifying taxes than returns selected using the IRS' primary method for selecting returns for examination. Normally the IRS uses mathematical screening programs to select many returns for audits.

### **Tax Gap**

There are billions of dollars in unreported taxes in the United States. Last year the IRS issued a revised report on the Tax Gap estimating that there was about \$345 billion in unreported and underpaid taxes. Though the net misreporting percentage varies by category of income, the rates reflect that compliance is highest where there is third-party reporting or withholding. Simply stated, compliance is highest where there is third-party reporting.

**For example**, one percent of all wage, salary and tip income is misreported, contributing an estimated \$10 billion to the tax gap. In contrast, nonfarm sole proprietor income, which is reported on a Schedule C and is subject to little third-party reporting or withholding, has a net misreporting percentage of 57 percent, contributing about \$68 billion to the tax gap.

The tax gap can be divided into three components:

- nonfiling,
- underreporting and
- underpayment.

### **Nonfiling**

Nonfiling occurs when taxpayers who are required to file a return do not do so on time. Underreporting of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. Underpayment occurs when taxpayers file their return but fail to remit the amount due by the payment due date.

### **Underreporting**

Of these three components, underreporting of income tax, employment taxes and other taxes represents about *80 percent* of the tax gap. The single largest sub-component of underreporting involves individuals understating their incomes, taking improper deductions, overstating business expenses and erroneously claiming credits. Individual underreporting represents about half of the total tax gap. Individual income tax also accounts for about half of all tax liabilities.

### **Underpayment**

Underpayment occurs when a taxpayer files a return without paying the balance of tax due. It also can occur when the taxpayer fails to pay taxes assessed as a result of an IRS audit. More than \$30 billion in assessed taxes go uncollected as a result of taxpayer under payments each year.

### **The Coming Wave of Informants**

Given the immensity of the Tax Gap one must anticipate that the IRS will come to increasingly rely on the new Whistleblower Office to find tax underreporting. There are already websites established by law firms seeking to profit from the coming wave of whistleblowers. Many advertise their services on a contingent fee basis. Given the huge the high level of tax cheating in this country there are opportunities for rewards.

Audits of businesses are long complex processes and will prove to be a drain on company resources. Even an inaccurate informant item might cause the IRS to open an audit which ultimately discovers another mistake on company tax returns. The company may never discover the source of the original whistleblower information because the IRS must keep whistleblowers' identities secret.