

IRS Proposes Expanded Definition of Proceeds for Whistleblower Awards

by Jeremiah Coder

Full Text Published by **taxanalysts**[®]

Whistleblowers who alert the IRS to violations of tax law could qualify for rewards based on refunds withheld from the reported violator under proposed regulations (REG-131151-10) the IRS issued on January 14.

The regs would clarify that the definition of collected proceeds in whistleblower cases would include prevented refund payments in the potential base amount for calculating an award.

In a release, Senate Finance Committee member Chuck Grassley, R-Iowa, called the regulation a "common-sense decision" that will help reward individuals who point out improper refund claims to the IRS, as he said was intended when he wrote the law. (For the release, see *Doc 2011-1020*.)

"The IRS needs to finalize these regulations quickly so they will apply to all whistleblowers who filed claims after the 2006 law and have been waiting for their awards," Grassley said.

As part of the Tax Relief and Health Care Act of 2006, section 7623(b) was enacted to permit larger payouts to whistleblowers if, in the case of a reported individual, that individual's gross income for the year exceeds \$200,000 and the amount of tax (plus penalties, interest, and additions to tax) in dispute exceeds \$2 million. Under section 7623(b), the IRS must issue an award amount of between 15 and 30 percent of the collected proceeds from a successful administrative or judicial action based on information submitted by a whistleblower.

The IRS Whistleblower Office is still working on internal and external guidance as it adapts to a two-tier system of award payments. However, the IRS has disagreed with practitioners and lawmakers in defining what constitutes collected proceeds. (For prior coverage, see *Doc 2010-26590* or *2010 TNT 240-4*.) In its revised Internal Revenue Manual provisions covering section 7623, the IRS said last June that collected proceeds do not include offsets, application of net operating losses, refunds, or other amounts that might reduce a tax liability. (For the relevant IRM sections, see *Doc 2010-13536* or *2010 TNT 117-20*. For prior coverage, see *Doc 2010-13529* or *2010 TNT 117-2*.)

That determination provoked Grassley, the Finance Committee's ranking minority member at the time, to send a letter to Treasury in which he questioned the IRS's interpretation of the statute. Denying an award when information leads the agency to withhold a requested refund creates "a perverse incentive for the whistleblower to wait until the IRS has paid an improper refund," Grassley wrote. (For the letter, see *Doc 2010-14794* or *2010 TNT 128-70*.)

In the proposed regulation, the IRS said that the "reduction of an overpayment credit balance is also considered proceeds" available for a section 7623 award. However, the reg said that the changes to determining proceeds would not apply to paid awards until after the reg is finalized. (For REG-131151-10, see *Doc 2011-880*.)

Dean Zerbe, national managing director at Alliantgroup and the former tax counsel to Senate Finance Committee Republicans who was responsible for drafting section 7623(b), praised the proposed reg as the "exactly right decision." The guidance indicates "a great success by Senator Grassley to make the whistleblower program attractive, and just as important, is a tangible sign that the IRS senior leadership, led by Commissioner [Douglas] Shulman, are paying attention to the whistleblower program and want it to succeed," he said.

Since the IRS has not yet paid out an award under the new framework, "this is a positive signal that is going to make a real difference for many whistleblowers in deciding whether to come forward," Zerbe said.

Gregory S. Lynam, a tax partner at the Ferraro Law Firm, said that while the proposed reg is favorable to tax whistleblowers, its content is lacking. "The reg sets out a broader definition for proceeds than what has administratively been used in the past, but it remains fairly vague," he said. In particular, the IRS didn't provide any guidance on how its definitions will affect whistleblower claims dealing with complex corporate returns, he said. "Any Fortune 1000 taxpayer has a complicated mixture of credits and offsets and various issues on the table that give rise to areas that could use further clarification."

As a result, the Ferraro firm intends to submit comments requesting greater specificity, Lynam told Tax Analysts. "Even just a few examples would be immensely helpful, as there are any number of scenarios involving credit carrybacks or carryforwards, and other taxpayer-favorable adjustments," he said. One large omission from the proposed regulations was criminal penalties, he said. "The IRM still says that criminal penalties are not part of collected proceeds and this is flatly contrary to the statute."

The IRS's about-face on what constitutes proceeds for an award determination will require the agency to update Internal Revenue Manual provisions it just released last summer, said Scott A. Knott, also a tax partner at the Ferraro firm. Asked about the possible prospective application of the reg's rule change, he said that the Service "can and should pay awards under the statutory authority of section 7623 without waiting for these regs to come out in either temporary or final form." Overall, the IRS's policy change hews closer to Congress's intent and "opens the door to awards in areas the agency previously said were closed," he said.

David B. Blair of Miller & Chevalier said that "although the proposed changes are technical in nature, they do tend to reassure whistleblowers and their counsel that they can receive an award regardless of the status of the taxpayer's account -- for example, deficiency or refund status -- at the time that the whistleblower files his or her claim." The proposals are "consistent with an IRS policy of removing disincentives to filing these types of claims," he added.

Blair also said the proposal serves as a reminder that whistleblowers have the right under section 7623(b)(4) to challenge award amounts in the Tax Court, which may focus on details of the reported taxpayer's case. "Although this is a developing area, it holds the potential to subject the taxpayer to public scrutiny and cause further embarrassment and expense," he said.

Bryan C. Skarlatos of Kostelanetz & Fink LLP called the new regulations a welcome development. "These new regs adopt the adage of Benjamin Franklin that 'a penny saved is a penny earned' by providing that a denial of a refund claim or reduction of a credit will constitute 'collected proceeds,'" he said.

Skarlatos said that one remaining technical issue is whether a reduction of a refund claim, as opposed to a complete denial of a refund claim, will constitute collected proceeds to the extent of any such reduction. He said that it should, "as this would be consistent with the issues expressed in Senator Grassley's letter and there is no good reason to distinguish between a reduction in a refund claim and a complete denial of a claim."

The language of the regulation dealing with reductions in refunds is ambiguous and needs clarification, Skarlatos said. "This issue is certain to come up as the financial difficulties of recent years will generate refund claims or credits for many large companies against whom whistleblower claims have been filed."

George M. Clarke III of Miller & Chevalier said the target of the reg "is probably bigger ticket refund claims" such as redeterminations based on the research credit and foreign sales corporation regime. He said that inclusion of the credit offset was merely a clarification, but that the "refund claim provision is a bigger deal, although, even there, you could make a good argument that the statute already covered" such elements in an award.