



2010 Investment Guide

Tax Informants Are On The Loose

Janet Novack and William P. Barrett 12.14.09, 12:00 AM ET

For 24 years Vincent A. Spondello toiled away as an accountant for a group of related companies known as Monex, a large Newport Beach, Calif. precious metals dealer. A trusted employee, he prepared tax returns and was given such tasks as overseeing the destruction of old corporate documents. It turns out that some records that were supposedly destroyed he took home instead.

In May Spondello sent 25 boxes of original Monex papers to the Internal Revenue Service--documents that could buttress the IRS' claim that Monex's owners fraudulently moved around assets to avoid a \$378 million tax bill. He made his document drop after hiring lawyers and filing a claim for a whistleblower reward that could total \$57 million or more. Monex denies it owes anything, has fired Spondello and is demanding back its documents.

"He's a good guy," says Spondello lawyer Robert D. Coviello. "But he is a rat."

Pay attention. There are Vincent Spondellos taking notes, taking names and taking documents across America, and beyond.

For years the IRS grudgingly paid stingy rewards to squealers who brought it mostly small cases; during 2004 and 2005, 428 informants received a total of \$12 million--only 7% of the paltry \$168 million all their leads brought in. But in 2006, hoping to entice insiders to rat out big-dollar cheats and corporate tax shelters and games, Congress directed the IRS to pay tipsters at least 15% and as much as 30% of taxes, penalties and interest collected in cases where \$2 million or more is at stake.

The gambit seems to be working very well. The IRS continues to get thousands of small case tips a year. But in fiscal 2009, ended Oct. 30, the IRS Whistleblower Office also logged big case leads on 1,900 taxpayers, up from 1,246 in fiscal 2008, the first full year the new law was in effect. Dozens of these tips involve purported tax losses of \$100 million or more. Sure, those are just allegations. But informants "often provide extensive documentation to support their claims," the Whistleblower Office noted in a report. The Treasury Inspector General for Tax Administration, in a separate report, added up all the 2008 tips and found that \$65 billion in unreported income was alleged.

The slow-moving IRS has yet to pay any bounties under the new scheme, which the Inspector General report said still had "deficiencies" in its execution. But the government itself is already reaping big rewards.

In June 2007 Bradley C. Birkenfeld--motivated in large part, he now acknowledges, by the new reward law--came to U.S. officials with documents in hand and laid out how his former employer, UBS AG, helped wealthy Americans hide money offshore. So far the investigation he triggered has produced a \$780 million payment to the U.S. government from UBS, Switzerland's largest bank; an unprecedented agreement by the Swiss to finger 4,450 U.S. taxpayers with secret UBS accounts; and criminal investigations of more than 150 American UBS clients. That, in turn, helped pressure 14,700 taxpayers to make "voluntary" disclosures of previously undisclosed offshore kitties during a special program earlier this year, yielding extra billions in tax for the Treasury. "The entire game has changed on international tax evasion," crows IRS Commissioner Douglas Shulman.

The Boston-born Birkenfeld is facing 40 months in the federal pen but could leave prison with millions in reward money. Stephen Whitlock, director of the IRS Whistleblower Office, won't comment on any specific cases. Yet asked if the IRS might end up sending reward checks to the government's own inmates, he responds: "It could happen."

That represents another big change. Before the new law, Whitlock notes, "if you participated in the tax noncompliance--you could have been the accountant doing the ministerial activity--you could be flat-out barred" from a reward. Now such a functionary is eligible for a full reward, even if he is convicted of, say, stealing from the company he squeals on. An informant who "planned and initiated" a tax scheme is still eligible for a reduced award--unless he's convicted for that planning role.

Birkenfeld pleaded guilty to helping billionaire California real estate developer Igor M. Olenicoff hide \$200 million offshore and evade \$7.2 million in tax--not to orchestrating the broader UBS scheme that began before he was hired as a UBS private banker and continued after he complained about it internally and then left.

Birkenfeld was indicted, prosecutor Kevin Downing said during his August sentencing, because while fingering UBS brass, he didn't come clean about his own role helping Olenicoff. As described in a 2006 FORBES story, the billionaire's offshore dealings had been investigated by the IRS for years. In December 2007 he pleaded guilty to filing a false tax return. The Forbes 400 member got a sweet deal, paying \$52 million in back taxes, interest and civil fraud penalties but drawing no jail time. Had Birkenfeld revealed what he knew about Olenicoff in June 2007, "Mr. Olenicoff would be in jail," Downing told the court.

As a former tax counsel to Senator Charles Grassley (R--Iowa), Dean Zerbe helped draft the new whistleblower law. Now he represents Birkenfeld and other reward-seekers before the IRS. "It takes a rogue to catch a rogue" is how Zerbe explains the law's philosophy. He argues that jailing Birkenfeld could deter informants. "We have people in Switzerland who want to blow the whistle on other banks but are scared to because of what they saw with Birkenfeld," he says.

"I don't think what happened to him will deter anybody else," retorts Jack A. Blum, who represents another offshore informant in his claim before the IRS. Blum's client was a backroom functionary. After being hired by Liechtenstein's Igt Group, a bank owned by the tiny European tax haven's royal family, to help digitize client trust files, Blum's client walked off with a disc full of names. He sold a copy to the German government for \$6 million and then filed an informant's claim with the IRS for a cut of the taxes owed by the 100-plus Americans whose financial secrets were on that disc.

The new willingness of governments to pay big rewards "has changed the game," says Blum, a longtime advisor to Congress and the IRS on the offshore world. "In the Caribbean there are people working in these offshore banks for next to nothing." Now they have a way to get rich.

Despite IRS processing that Blum describes as "slow as molasses," he expects the Liechtenstein whistleblower to start getting reward money next year. Long term, he says, the informant law's "potential, particularly internationally, is huge."

The Caribbean looks like a fertile source for tips. In August business partners John DaCosta and N.B. Salty Miller sued the IRS in the U.S. Court of Federal Claims to collect a reward on what they said were tips that led the IRS to collect \$30 million from the American-born widow of a Jamaican businessman. DaCosta worked for him, perhaps one reason many internal financial documents found their way to the agency. The IRS has asked the court to dismiss the men's complaint on jurisdictional grounds.

So squealing has already set the offshore world on its head. Less clear is what effect it will have on domestic tax avoidance. Whistleblowers' lawyers say that the presence of informants could eventually

curb aggressive corporate tax practices and that the law's impact will grow over time--if experience with the False Claims Act, on which the tax law is modeled, is an indication.

Since Congress rewrote the Civil War-era False Claims Act at Grassley's urging in 1986, the government has collected \$14.5 billion from whistleblower cases--known as *qui tam* suits, from a Latin phrase declaring that a suitor is acting on behalf of the king as well as himself--and paid out \$2.7 billion of that to informers and their lawyers, calculates Joel D. Hesch, a former Department of Justice false-claims litigator. The biggest awards have come in recent years. In September, for example, a whistleblower was awarded \$51.5 million for fingering Pfizer's illicit marketing of the painkiller Bextra.

Hesch, author of the 200-page how-to manual *Reward: Collect Millions for Reporting Tax Evasion*, predicts the tax program will eventually pay even bigger rewards. Why? Under false claims a whistleblower must have evidence a contractor intentionally ripped off the government. Under the tax informant program, however, the tax underpayer doesn't have to have fraudulent intent. Every company and every upper-income citizen is a potential target. (Tips about individuals whose adjusted gross hasn't hit \$200,000 for at least one year covered by the tip are handled under the IRS' old, less generous reward system.) If a company pays more tax because the IRS disallows some strategy or deduction the company believed was okay, the informant can collect. Hesch cites some fairly mundane matters--say, misclassification of workers as independent contractors to avoid payroll tax--as potential targets for tipsters. He also points to the \$3.4 billion GlaxoSmithKline paid to settle IRS claims it had improperly shifted income to foreign affiliates as evidence that a squealer might some day reap a reward worth hundreds of millions of dollars.

Birkenfeld told a colorful tale of encrypted laptops and smuggling diamonds into the U.S. in a toothpaste tube. Some of the biggest cases being flagged by whistleblowers are made of duller material: They involve complex corporate transactions designed to cloak a company's tax-avoidance purpose. Gregory S. Lynam, who left a corporate tax law practice to represent whistleblowers, says one case he brought to the IRS involved a 120-step transaction used by a multi-national to repatriate foreign earnings without paying U.S. taxes on them. Only with help from an insider could the IRS find the weak links in this structure, Lynam argues.

So far, Lynam says, he and three tax lawyers he works with have filed claims asserting, in total, \$40 billion in additional taxes and penalties due. Even if a company is already under audit, he notes, if a whistleblower provides crucial information the auditor hasn't yet found, he is eligible for a reward.

There's yet another noteworthy difference between a tax and a false claims informant. The latter files a secret *qui tam* lawsuit, the government investigates and, if it finds the case has merit, takes it over, with the tipster picking up 15% to 25% of the eventual recovery. But whether the government intervenes or not, the false claims suit eventually becomes public and the identity of the informant is revealed.

By contrast, the IRS aims to keep secret a tax informant's identity and even, if possible, his very existence. "If everybody does what they're supposed to do and is careful, taxpayers really shouldn't find out how it happened they were selected for an audit," says the IRS' Whitlock. That means a snitch could file his claim about a corporate tax ploy and quietly move on to work at another company or even stay at the target company.

The IRS process works like this: The informant (usually with the help of a lawyer) files a Form 211, "Application for Award for Original Information," describing what he knows and attaching documents. The Whistleblower Office screens the material to see if there's a plausible and big enough tax issue and to make sure papers that might "taint" the investigation--because, for example, they are protected from IRS discovery by the attorney-client privilege--aren't given to auditors.

According to the Inspector General's report, as of March, the Whistleblower Office had processed Form 211s alleging more than \$2 million in taxes due from each of 1,800 taxpayers. Only 300 cases had been rejected, while 700 were pending in the IRS' Criminal Investigation unit and 800 in its civil divisions.

Zerbe and other private whistleblower lawyers argue the law permits continuing involvement by informants and their lawyers where their knowledge might help build a case. But ever protective of both taxpayer privacy and its own powers, the IRS plays its cards close to the vest. A whistleblower is told nothing about the progress of a civil case until it is closed or he's paid a reward. That can take years, since the IRS doesn't pay until the target has exhausted his appeals and anted up the cash. "I tell my clients, 'The IRS is like a glacier. It moves very slowly but with certainty destroys everything in its path,'" Lynam says. (His group of tax lawyers can afford to wait because they have joined a plaintiff firm that has fees rolling in from asbestos and other claims.)

Informants so far run the gamut. "We have people who are an ex-something--an ex-partner, an ex-spouse or significant other, an ex-employee," says Whitlock. "We have people who are current employees who are bothered by what is going on, people who had a potential business relationship [with the target] and decided not to pursue it."

Another source of informants: lawsuits and arbitration battles. "Anybody who is sophisticated could see this as an opportunity to fight back in litigation," says Chicago tax lawyer Robert E. McKenzie. He knows whereof he speaks. A disgruntled client of a national brokerage firm filed an arbitration claim over the handling of her account. During discovery the firm learned that the woman, a foreign national, had lived in a California mansion for years but had never filed U.S. tax returns. So the firm hired McKenzie to file a Form 211 (with its general counsel listed as the informant) reporting the client to the IRS.

Still, McKenzie, who mostly defends taxpayers, has some qualms about this new age of informants. "I think we should enforce the law. But do we want a Soviet-style society where neighbors turn in neighbors, friends turn in friends and employees turn in bosses?"

Or where, as a litigation tactic, heirs turn in heirs? Nashville lawyer William Prentice Cooper III, a son of a Tennessee governor and brother of Democratic Congressman James Cooper, filed Form 211 informant claims stemming from his efforts on behalf of an 11-year-old great-grandson of Dorothy Dillon Eweson and the youth's married-into-the-family mother in a raging probate fight. Eweson, daughter of famed financier Clarence Dillon, died in 2005 at age 92, leaving an estimated \$300 million held personally and in trusts.

With himself as the plaintiff, Cooper has just started two lawsuits in U.S. Tax Court, primarily seeking a review of the IRS' decision not to pursue his Form 211 claims. His lawsuits suggest that one trust set up by Clarence 91 years ago and valued at \$103 million was improperly left out of Eweson's probate and also that a hefty generation-skipping tax wasn't paid.

Cooper tells forbes he hopes his Tax Court actions will prompt the IRS to take a new look at the situation and generate some money for the heirs he's helping. "This was taken as a step of last resort," he says. However, experts doubt the 2006 whistleblower law created a legal right for someone to challenge an IRS decision not to pursue a Form 211 tip.

The Eweson estate and other members of the Dillon family are not named defendants in Cooper's Tax Court lawsuits. In a statement, a Dillon family spokesman says an IRS audit was already under way when Cooper filed his informant claims and that the estate tax return was later "accepted by the IRS and a closing letter was issued."

Still another family informant drama is playing out in the case of John M. Potter, owner of a Jackson, Mich. topless bar who was indicted in January on charges he underreported his taxable income by \$2 million from 2002 to 2005. He was turned in to federal authorities by an estranged daughter

contemplating a reward. She sent in an 11-page single-spaced statement that reads like a *Sopranos* script.

"Money is all important to him! If he found out that I turned him in I have no idea what he would do. He has a very short temper and can be violent," the daughter wrote. She then detailed how Potter, now 74, siphoned cash from his business; paid employees off the books; kept ledgers hidden under a seat cushion; and was assisted by her older sister who "wants to inherit everything" and his 23-years-younger girlfriend who "is no prize." (Neither was charged in the case.) In November Potter pleaded guilty to filing a false tax return. Stephen J. Dunn, his attorney, says he'll argue Potter should get probation based on his age, military service, lack of prior convictions and cooperation with the IRS after his daughter squealed on him. "She was motivated by the reward, a few pieces of silver," Dunn complains.

Joseph R. (Joe) Francis, the *Girls Gone Wild* video impresario, last year was convicted of child abuse and prostitution charges in Florida. He just pleaded guilty in Los Angeles to nonfelony charges of filing false tax returns, was fined \$10,000 and paid \$250,000 in back taxes but got no new jail time. Light punishment? In a pending civil lawsuit filed in the name of his company, Francis claims three now-ex-executives plotted to embezzle money from his company and "began contacting" the IRS on an informant basis hoping Francis would be convicted and jailed and their own frauds would go undiscovered. Francis' pleading says one defendant e-mailed another a copy of a news story headlined, "IRS Pays Informants to Squeal on Tax Cheats." With that civil case still in its early stages, defendants have not answered in court and couldn't be contacted.

For sheer fascination it's hard to beat the growing California litigation surrounding accountant Vincent Spondello and Monex, the company that employed him for nearly a quarter-century. Founded by Louis Carabini in 1967 and still run by his family, Monex has a long history of regulatory run-ins, consumer complaints and lawsuits against it by its own (often former) employees. In the mid-1990s the IRS disallowed Monex's use of a 1980s tax shelter involving London Metal Exchange straddle transactions. Monex agreed in 1998 that it owed the IRS \$134 million, a sum that with interest and penalties is now nearly \$400 million.

In June 2008, just before expiration of the ten-year statute of limitations for acting on that debt, the IRS filed a lawsuit in federal court in Santa Ana, Calif. essentially alleging that the Carabini family had moved all its business assets, including its 800 number, into other legal entities, leaving the feds with a claim against worthless shells. The IRS asked the court to enforce the assessment against the new entities. Denying wrongdoing and liability, Monex argued, among other points, that its ability to defend itself was hampered by the fact that the IRS had waited so long.

As Monex lawyers began preparing their defense, an astonishing informant tale emerged. Here's what court records show: Instead of carrying out orders to dispose of old records in 1996 and 1997, Spondello, a Monex accounting supervisor, had taken boxes of them home. In the same time frame--before Monex agreed to that \$134 million bill--he anonymously fed information to the IRS about Monex asset transfers.

In May 2009 Spondello, who was still working at Monex, secretly requested a reward from the IRS by filing a Form 211, with an attached 33-page memo prepared by one of his lawyers describing the documents. Ten days later the boxes and their contents were turned over to the IRS. Monex officials, who by then had learned Spondello had squirreled away an unspecified number of old records, soon fired him. Eventually, Spondello's lawyers informed Monex that he was an IRS informant who had handed over 25 boxes--possibly upwards of 50,000 pages.

During a deposition for a lawsuit that Monex has filed against him, Spondello testified he kept the documents because he worried that Monex was engaging in tax offenses and he might be held personally liable. Spondello has filed a counterclaim against Monex alleging wrongful termination.

As you might imagine, Monex is crying foul, claiming the IRS and its lawyers from the U.S. Department of Justice violated attorney-client and other legal privileges and the government's own rules in their dealings with Spondello while he was still a Monex employee. Monex is desperately trying to get back and prohibit use in court of the documents, or at least get copies.

Last month a federal judge rejected Monex's efforts to dismiss the lawsuit as insufficiently precise in its allegations. The ruling would appear to increase greatly the evidentiary value of Spondello's many boxes.

One big issue in this case is the so-called one-bite rule, an IRS directive that says the agency can be a one-time passive recipient of documents an informant brings from a target but can't have him go back and take more documents. Monex claims federal agents knew the 25-box document drop was simply the latest bite in a long series of disclosures from Spondello. The feds say they followed the rules.

Are you ready for the new world of tax snitching? If you are chiseling, you can't trust anybody.