THE WALL STREET JOURNAL.
WSJ.com

WEEKEND INVESTOR

SEPTEMBER 3, 2011

Taxes: How To Turn In Your Neighbor to the IRS

BY LAURA SAUNDERS

Maybe it's your brother-in-law, who has a new Mercedes and likes to quip that only fools pay all their taxes. Or else a contractor who overcharged for a home renovation and then demanded you make the check payable to "cash." Or perhaps your company's chief tax accountant, who is cutting corners to boost his bonus.

If tax cheating sticks in your craw, the Internal Revenue Service has a deal for you: Turn in a lawbreaker and collect some of the proceeds.

The bigger the amount recouped, the bigger your take. The agency has two whistleblower programs: The small-awards program is for cases involving less than $2 million of tax, and the award can be as high as 15%, though it often is less. The large-awards program is more generous: For cases involving $2 million or more of tax, the reward can go as high as 30%.

So what's the catch? Among others: The IRS takes relatively few cases, and those it does pick up often take five or more years to resolve. It often takes copious leg work on your part to pique Uncle Sam's interest. And while the IRS tries to protect whistleblowers' privacy, there isn't any legal protection from retaliation by an employer.

Still, it can be worth the effort. This spring the IRS made its first award in the large-case program: $4.5 million, to an unnamed retired accountant.

The U.S. has been rewarding people who turn in fellow citizens or companies defrauding government programs since Congress's passage of the False Claims Act in 1863. Whenever there has been an income tax—briefly during the Civil War, and permanently since 1913—the IRS (or its predecessor) has had its own whistleblower program, says tax historian Joseph Thorndike of Tax Analysts, a nonprofit publisher. But payments tended to be small and rare because IRS officials were uncomfortable with "bounty hunting."

The landscape changed in 2006. Heartened by the success of a whistleblower program for nontax issues such as government contracts, Congress overhauled the special tax provisions on whistleblowers and set up the IRS's large-award program.

Since then, according to just-released data, the agency has had 1,328 qualified submissions involving nearly 10,000 alleged tax cheats under the large-awards program. (Some cases, such as tax shelters, involve multiple taxpayers.)

Scott Knott of the Ferraro Law Firm in Washington says the IRS has accepted from his firm alone cases involving claims of $98.6 billion of unpaid tax, with one case involving unpaid corporate tax of more than $10 billion. The IRS doesn't break out data on pending cases.

In April, tax experts say, the agency paid the first-ever award under this new program: the $4.5 million to a former in-house accountant for a large financial-services firm. The taxpayer's lawyer, Eric Young of Egan Young in Blue Bell, Pa., announced the payment and said it was 22% of the tax collected. Mr. Young, who has won three big nontax whistleblower cases, wouldn't disclose his client's name or firm, but did say the person is retired.

The IRS doesn't confirm individual awards out of concern for taxpayer privacy, and won't release data on large awards such as this one until next summer.

Experts say other whistleblowers are waiting for what they hope are imminent payments on large issues as varied as payroll tax withholding, tax shelters, illicit foreign accounts or arcane corporate accounting matters like transfer pricing.

One is Bradley Birkenfeld, who has a pending claim involving $580 million in fines paid by Swiss banking giant UBS as part of a deferred prosecution agreement involving charges of conspiring to defraud the U.S by providing undeclared offshore accounts to U.S. taxpayers. He also has submitted other whistleblower claims as well, according to his lawyer, Dean Zerbe of the law firm Zerbe, Fingeret, Frank & Jadav in Washington.

Notably, the law doesn't prohibit convicted felons from receiving whistleblower awards unless they were architects of the cheating. Mr. Birkenfeld, who was a private banker at UBS, was convicted of conspiring to help a billionaire hide money in UBS accounts. He is serving a 40-month prison sentence.

Experts say Mr. Birkenfeld's involvement in UBS's activities will likely lower his award for turning in the big bank, but Mr. Zerbe says he believes he will receive one.

"The government made clear that thanks to Brad's coming forward to blow the whistle on UBS and illegal offshore accounts, the Treasury has recovered billions of dollars."

A spokesman for UBS said the terms of the deferred prosecution agreement were fulfilled and the U.S. government ended the case against UBS in the last quarter of 2010, resolving the cross-border matter.

Smaller whistleblower cases such as those involving unreported income or payroll taxes at a small business—are on the upswing as well. In fiscal 2010 the IRS accepted nearly 7,600 new claims, the highest total since 2006.

Last year the agency collected $464.7 million in extra tax but paid out a lower percentage than in most years—just 4%, or $18.7 million. An IRS spokesman said the agency had no comment on how it decided what awards to make.

Sometimes bountiful dreams don't pan out, however. Attorney Gregory Lynam of the Ferraro firm says he recently declined to represent a 16-year-old boy who was furious that his father claimed him as a dependent on his tax return. The youth said he was supporting himself with a job at Arby's, says Mr. Lynam.

Mr. Lynam says he dissuaded the youth by pointing out that any cheating would cost Uncle Sam a few hundred dollars at most.

If you are thinking of turning in a tax cheat, here is what you need to know before you go for the dough:

Scale matters. The IRS has two separate whistleblower programs. The more generous one applies to cases where unpaid taxes are more than $2 million and, if the taxpayer is an individual, the taxpayer had gross income of more than $200,000 for at least one of the years in question. Awards are generally between 15% and 30%, with no limit on the dollar amount.

The award is based on taxes, penalties and interest—which can add up. Whistleblowers who are unhappy with the result may appeal cases to U.S. Tax Court, which has the ability to keep taxpayer identities secret.

The small-awards program applies to tax underpayments less than $2 million. The reward is at the discretion of the IRS, with a maximum of 15%, and the agency doesn't have to pay at all. The award is based on taxes and penalties but not interest, and the whistleblower can't appeal the size of the award to Tax Court.

According to an IRS spokesman, cases can migrate between the two categories if facts change. IRS Form 211 applies to both programs. (For more, see www.irs.gov.)

The IRS wants a timely, well-developed claim. The agency seeks "specific and credible" information. That means a road map, not just that your neighbor is driving a new car and runs a cash business.

The information should be fresh, too. The statute of limitations on both corporate and individual issues can be as short as three years, and agents don't want to be hobbled by expiring statutes. While it is true that there is no statute of limitations for fraud, such cases are difficult and the IRS may avoid them, experts say.

"Good cases often come from employees with tax expertise who are unhappy with corporate cheating," says Paul D. Scott, a whistleblower attorney in San Francisco. But information needs to be legally obtained in the normal course of business.

It is best if whistleblowers haven't orchestrated or profited from the cheating, either. The IRS has the right to reduce awards in the large-case program to less than 15% if the whistleblower was involved in the tax fraud.

A whistleblower who was involved in the cheating might even wind up being prosecuted. Attorney Bryan Skarlatos with Kostelanetz & Fink in New York, who has filed whistleblower claims on more than $1 billion of unpaid tax, says he has rejected cases for this reason.

The IRS has enormous discretion over which cases to accept and how to handle them. Whistleblower attorneys agree that there is no such thing as a "slam-dunk" case.

"Once I thought I knew, but now I don't," says Mr. Knott of the Ferraro firm.

A current Tax Court wrangle involves the IRS's decision not to pursue a whistleblower case involving the estate of Dorothy Dillon Eweson, who died in 2005. Ms. Eweson, who lived in Far Hills, N.J., was the daughter of financier Clarence Dillon and sister of former U.S. Treasury Secretary C. Douglas Dillon.

The whistleblower, Tennessee attorney William Prentice Cooper III, filed the case out of concern that other heirs of Ms. Eweson maneuvered to short-change Ms. Eweson's great-grandson, who is his girlfriend's son.

Mr. Cooper's claim alleged the estate failed to pay more than $75 million of estate and generation-skipping taxes due on trusts holding more than $200 million in assets.

Last year, the court ruled that while it had the power to review the IRS's awards. This year, the court agreed with the IRS that it couldn't tell the agency which whistleblower cases to accept, and this week it denied Mr. Cooper's motion for reconsideration of this decision. Both the IRS and Mr. Cooper, through his lawyer, declined to comment on the case.

Even if the IRS takes a case, it is difficult to predict the outcome or the size of an award. It is even possible that agents might drop a whistleblower's issue as part of a larger tax settlement with a corporation, Mr. Skarlatos says.

Whistleblower attorneys say they usually avoid two types of cases: those involving churches or nonprofits, because of what they see as the IRS's reluctance to pursue them; and those involving money laundering or organized crime, for fear of physical harm.

There is no legal protection from retaliation. There is a law shielding other types of whistleblowers from retaliation by an employer, but no similar provision in the tax whistleblower statute, although the tax code makes it a felony for IRS agents to disclose taxpayer information.

Mr. Skarlatos says he has a client who was so worried about retaliation that he refused to give his name and demanded a meeting in a bar, to which he showed up wearing dark glasses. Mr. Skarlatos took the case, but says the company later fired the man for what it claimed were business reasons.

The case was accepted by the IRS and is pending.

As for cases involving individual taxpayers, Mr. Skarlatos and others say the IRS safeguards information, even in-house, and works hard to protect taxpayer identities. For example, "they'll frame document requests to avoid raising a single sensitive issue that can be traced back to the whistleblower," he says.

All agree that usually the biggest danger to a whistleblower's privacy is himself or a disgruntled spouse.

The upshot: You probably are safe from being exposed, but watch what you say around town—and even at home.

Tax whistleblower cases can take a long, long time. The average appears to be six to seven years, says Erika Kelton of Phillips & Cohen in Washington.

The wheels of justice turn slowly for many reasons. The work is painstaking and the IRS is understaffed, plus it has a policy of not paying awards until the taxpayer's rights to appeals and refunds from other issues have ended. If a whistleblower's submission becomes a criminal case, that can lengthen the wait as well.

Agency policy isn't to talk to whistleblowers except at the beginning of an accepted case, so it is possible to go years without hearing a word on its progress.

If you use a lawyer, expect to pay a large fee. It is possible to file your own whistleblower claim, but an expert can probably make a better one. The initial conversation is often free; contingency fees range from 20% to 40% of the gross.

The good news: Taxpayers get a full deduction for attorney's fees, meaning that Uncle Sam absorbs up to about one-third of the fees.

Taxpayers Against Fraud, a nonprofit group, offers free referrals to attorneys.

Whistleblower awards are taxable. Yes, it is true. The executive who won the $4.5 million award received a check from Uncle Sam for $3.2 million, says his lawyer Eric Young, because the IRS withheld taxes at a 28% rate. The IRS chief counsel's office says "withholding at the highest individual income tax rate is legally defensible."