Tax Whistleblowers: Prevention and Mitigation of Costs Associated With Meritless Claims

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A New Challenge

In December 2006, Congress amended section 7623 of the Internal Revenue Code to establish the IRS Whistleblower Office and set forth new procedures for the granting of rewards to individuals whose whistleblowing activities lead to the collection of additional tax. Based on current press reports, since the legislation was enacted, the IRS Whistleblower Office has received claims seeking rewards based on more than $10 billion in taxes, with many of the claims reportedly involving Fortune 500 companies.

Plaintiff firms, and now even traditional tax firms, are representing whistleblowers who want to bring such claims. The lawyers bringing the claims are motivated and serious in pushing the IRS to promptly and thoroughly investigate the claims. The reasons for this explosion in claims are apparent from the face of new section 7623: The statute establishes awards for whistleblowers of between 15 and 30 percent of the tax interest and penalties recovered based on their tips. There is no requirement that the whistleblower's tip uncover fraud or other mal-intent; any underpayment will suffice. Thus, the new statute offers huge financial incentives for employees and others to allege that corporations misreported their tax. For example, if a company had a "should" level opinion on the tax issues related to a large transaction, a whistleblower could still profit under the statute if, upon audit, the company decided to settle by giving up the 20 or even 10 percent of the issue that it considered to be its litigation hazard.

When section 7623 was enacted, it provided financial incentives to individuals bringing forward claims of taxes due to the United States, and called these individuals "whistleblowers." The textbook definition of "whistleblower" is one who reveals corporate illegality or wrongdoing, rather than merely alleging it. The False Claims Act uses the term "relator," which is more neutral and accurately reflects the status of individual plaintiffs who bring cases that may or may not have merit. The language of section 7623, unrestrained by any requirement to demonstrate fraud or other mal-intent, allows rewards to individuals for innocent, non-malicious, corporate mistakes. Indeed, some lawyers are now actively marketing their services to potential plaintiffs based on tax discrepancies arising from items as innocent as return errors. Furthermore, the potential monetary windfalls from becoming a whistleblower are so great that they likely induce people to bring meritless claims. Thus, the term "whistleblower," in the tax context, must now be understood to include a wide range of individuals, from those who bravely report and bring forward fraudulent corporate conduct to those who attempt to line their own pockets based on innocent errors, to those who attempt to capitalize on false claims of wrongdoing in the hopes that they will receive a personal windfall if the company settles a meritless action.

Any responsible company wants individuals who have evidence of corporate fraud to bring it forward so the problems can be corrected — and companies should make sure their policies and procedures provide incentives and encouragement for individuals to do so. Any responsible company also wants to make sure that it minimizes the expense and issues attendant with having to respond to and address unfounded allegations. Against this backdrop, the time has come for companies to move beyond questioning the policy basis for allowing an employee to receive a reward equal to 15 to 30 percent of the tax caused by a math error and move toward responsibly implementing safeguards to prevent and mitigate unwarranted "whistleblower" activities.

The stakes for corporate taxpayers can be high. Whistleblower claims may cause the IRS to institute an audit or expand the scope of an existing audit, placing a greater burden on the corporate tax department. In addition, basing payments to the whistleblower and his or her lawyer, on the IRS's collections on the claim can result in submission of a highly biased whistleblower package to the IRS. This package may make a strong return position look like a slam-dunk for the IRS, and it can take substantial time, effort, and resources for a corporate tax department to convince the IRS audit team that the whistleblower was off-base. Finally, there may be an increased tendency for the IRS to assert penalties when the whistleblower strongly argues that penalties are justified to make the conduct appear as egregious and willful as possible — which will result in higher payments to the whistleblower.

Background

Whistleblowers are not new. The False Claims Act relies in significant part for its enforcement on qui tam claimants — essentially whistleblowers — to come forward with evidence of fraudulent behavior. The Sarbanes-Oxley Act also envisioned a significant role for whistleblowers, and that role has been borne out in practice. Enforcement actions under many other federal statutes are routinely brought, at least in part, on the basis of conduct discovered and disclosed by whistleblowers; a good example of which is the Foreign Corrupt Practices Act. These statutes all aim to enhance the reach of related substantive law by effectively "outsourcing" enforcement to "private attorneys general." Although the concepts are similar, the issues implicated in tax whistleblower conduct are different. First, there is no requirement that the conduct involve fraud or other abusive conduct. Moreover, unlike other whistleblower situations, the underlying conduct in the tax whistleblower context likely is well-known to the core management and tax teams. Indeed, in many instances the underlying conduct may be a structured transaction or an event, well known to the company, that the plaintiff alleges is improper.

Thus, in response to concerns about the heightened potential for tax whistleblower activity, corporate taxpayers should formulate responses that reflect the learning in non-tax whistleblower suits generally, such as identifying problematic corporate conduct. Just as important, the corporate response must focus on preventing or mitigating whistleblower activity by, among other things, changing the perception among potential whistleblowers that potential disagreements with the IRS are an indication of problematic conduct.

Prevention

The first step in preventing individuals from reporting any conduct — problematic or not — outside the company is to understand that there are protections given to whistleblowers in certain circumstances (though typically only when the underlying conduct is a crime or fraud) under federal and state law. It is critical to understand those protections, because a whistleblower compliance program should always meet, and ideally exceed, those minimum standards where they are applicable. One action that companies must take to avoid making matters worse is to understand and train its personnel on the difference between (a) proper and legitimate actions designed to promote internal corporate policies on disclosure and resolution of issues, and (b) improper retaliation against those who bring these issues forward. The goal of whistleblower prevention cannot be to prevent an employee or other individual from contacting governmental authorities with a valid claim. Rather, the goal ultimately is to get that employee to understand whether they have a good faith claim or not and —at least initially — to route the claim through an internal process in order to evaluate its merit and take corrective action, which may include a prophylactic disclosure to the IRS.

In the context of tax whistleblowers, one of the most basic steps is to establish a means for employees and others to report internally any concerns regarding tax positions. Many companies already have an ombudsman program or similar structure in place for the reporting of Sarbanes-Oxley related items so the cost and effort to expand this to cover tax issues likely is minimal. Valid claims can then be fed to an independent group within the company that will investigate and recommend a course of action. The company may pay a reward to employees for raising meritorious issues.

Employees — or at least those employees with access to sensitive tax information — can also be trained on what is involved in taking a tax position that saves the company taxes but is less than 100-percent clear-cut and why taking such a tax position is acceptable and not fraudulent or abusive. A key element of this training should focus on a company's responsibility to comply with the law, but also its obligations to shareholders and others not irresponsibly to pay any more tax than the law requires. For those in the accounting and finance groups, this can be useful in minimizing meritless claims based on a misunderstanding of the way the tax law is applied.

In this same vein, confidentiality rules should be established, reviewed with employees and consultants, and strictly enforced. Access to key information should be restricted to individuals, such as attorneys and some accountants, who have professional responsibilities to make sure these issues are disclosed and addressed internally, but who also have limitations on their ability to make external disclosure. These individuals should be reminded, in writing, of their obligations on a regular basis. The company should also be particularly open to concerns voiced from such personnel — individuals who are well positioned to spot conduct that is truly problematic — and encourage them to work within, rather than without, the company reporting structure. The company also should maintain core groups of employees who are subject to and can protect the attorney-client privilege and attorney work product, and personnel outside of those core groups should not be able to access sensitive documents. Where possible, employee involvement in sensitive planning matters should be restricted to these core groups. Proper application of attorney-client privilege and attorney work product can be used to protect key analyses so that others to whom any documents are disclosed by a whistleblower may not be able to use them. In addition to these basic measures, monitoring of email and web-browsing and a host of other similar measures also can be implemented within both the letter and spirit of the law, with the goal of addressing legitimate issues internally first and preventing unfounded whistleblower allegations.

Mitigation

Whistleblower activity — both legitimate and illegitimate — will occur despite preventative measures. It is therefore necessary for a well-informed company to take an active role to mitigate the potential harm caused by that activity in the company's dealings with the IRS. The company should be aware of signs indicating potential whistleblower activity. These may include (i) opening of an audit (particularly one that appears focused on specific issues) after long periods of inactivity; (ii) odd questions by new members of audit team focused on specific issues; (iii) unusually focused or detailed questions; and (iv) repeated requests for the same or substantially similar documents and information. Any of the foregoing could indicate that whistleblower activity may be afoot.

When a company detects potential whistleblower activity, it must move into a protective role. Having an adversary like the IRS well-armed with information from a potentially biased insider is dangerous. Audit best practices must be implemented to prevent serious consequences. Among other things, this means that responses to IDRs and summonses should be very carefully considered. Reasoned file documentation should be maintained to support decisions not to provide documents as irrelevant, immaterial, or privileged. All submissions to the IRS should be considered for potential exposure under 18 U.S.C. § 1001 (false statements) and other similar provisions.

In certain circumstances, direct questions to the IRS regarding whistleblower involvement may be appropriate and can be illuminating regardless of whether they draw an affirmative response. This may be particularly important in situations in which the allegations presented in the audit appear to raise claims that may be drawn from a whistleblower (such as allegations of fraudulent conduct). In such circumstances, a very direct approach to the IRS examination team, to confront the apparent allegations, may be useful in establishing credibility, proper "tone at the top" and demonstrating seriousness in investigating what the IRS may consider to be very important claims.

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Time and experience will establish the ultimate importance of legitimate tax whistleblowers in our system of tax administration. For now, the advent of the tax whistleblower (legitimate or illegitimate) affects all companies who may have a potential tax adjustment — even if caused by a mere error. The time for ignoring the problem has passed; companies should implement a measured response to prevent meritless or bad faith whistleblower activities and to mitigate the consequences of those activities when they do arise. Although retaliation against good faith claims must be avoided, there are legitimate steps companies can and should take to successfully manage the effect of the tax whistleblowing provisions.

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