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Expanded Whistleblower Regulations, Schedule UTP and Corporate Governance: A Potent Combination of IRS Strategies

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The Internal Revenue Service's interest in encouraging and incentivizing whistleblowers appears unlikely to subside. Indeed, on January 18, 2011, the IRS published proposed regulations under section 7623 of the Internal Revenue Code, which authorizes the IRS to reward whistleblowers. The IRS is accepting comments on the proposed regulations until April 18, 2011. The proposed regulations, if made final, will expand informants' opportunities to get paid for assisting the IRS. Along with other recent developments, the whistleblower regulations will continue to complicate life for small businesses, as well as for the most sophisticated of corporate tax departments.

This alert discusses the proposed regulations, their importance to corporate management and tax departments and interaction with the new requirement to disclose uncertain tax positions, and the IRS Corporate Governance Initiative. These new initiatives and disclosure requirements may provide new avenues for whistleblowers. Corporate taxpayers should, therefore, consider changes necessary to ensure proper oversight, reporting and compliance — the best ways to manage and mitigate whistleblower risk.

CODE SECTION 7623

Section 7623(a) generally authorizes the IRS to pay sums necessary to detect underpayments of tax, or to detect and bring to trial and punishment persons who violated the tax laws. These sums come from proceeds the IRS collects on the basis of whistleblowers' information. Section 7623(b)(1) requires the IRS to award an informant 15 to 30 percent of the collected proceeds where his or her assistance substantially contributed to (i) the detection of underpayments in an administrative proceeding, or (ii) the successful trial and punishment of tax law miscreants.¹ If the IRS determines that the violation was detected primarily because of sources other than the whistleblower — for example, the media or judicial proceedings — then section 7623(b)(2) limits the reward to an amount (in the IRS's discretion) no greater than 10 percent of the collected proceeds. And section 7623(a) gives the IRS further discretion to make an award pursuant to its general authority where the informant's claim doesn't even meet the requirements of section 7632(b). See <http://www.irs.gov/compliance/article/0,,id=180174,00.html>. Section 7632 was amended in 2006 to increase awards and provide other incentives to whistleblowers. See 2006 Tax Relief and Health Care Act, Pub. L. No. 109-432.

IRS WHISTLEBLOWER OFFICE

The IRS has established a dedicated office to make determinations regarding awards to informants:

¹ To enhance communication between whistleblowers and their lawyers, the IRS can ignore the normal restrictions on its ability to share taxpayer information with persons other than the taxpayer. Treas. Reg. § 301.6103(n)-2T.

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The IRS Whistleblower Office, which was established by the Tax Relief and Health Care Act of 2006, 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.

See <http://www.irs.gov/irs/article/0,,id=179207,00.html>. Apparently the Office has yet to make an award under the amended statute, though it has received plenty of tips. See <http://www.businessweek.com/news/2011-01-14/irs-alters-rules-to-pay-informants-in-more-cases.html> (noting Sen. Grassley's comment that the Office has been "underused").² The IRS's relative inaction has prompted several lawsuits in the United States Court of Federal Claims and the United States Tax Court in largely unsuccessful attempts to force the IRS to follow up on tips or provide award money. The Tax Court gained exclusive jurisdiction over denials of section 7623(b)(1) awards effective December 20, 2006, by the 2006 Tax Relief and Health Care Act, Pub. L. No. 109-432.

PROPOSED REGULATIONS

Treasury Regulation § 301.7623-1(a) is the only regulation promulgated under the specific grant of authority to the Treasury under section 7623(a). It was last amended in August 1998 to provide for awards leading to the denial of refund claims. See Treasury Decision 8780 (August 20, 1998). Thus, currently, awards can be made from proceeds of amounts (other than interest) collected by reason of the information provided. "Amounts collected" includes amounts collected because of the information provided and amounts collected prior to receipt of the information if the information leads to the denial of a claim for refund of such amounts that otherwise would have been paid.

The proposed regulation removes the exception of "interest" from the definition of amounts collected (consistent with the 2006 amendment) and broadens yet again the definition of collected proceeds. It provides that the refund claim denial provisions in the regulation apply to claims under section 7623(a) and (b). In clarifying the definitions of proceeds of amounts collected and collected proceeds, the proposed regulation further provides that the reduction of an overpayment credit balance is also considered proceeds of amounts collected and collected proceeds under section 7623.

The overall effect of these changes is to expand the opportunities for informants to receive an award under section 7623(b) by relaxing the criteria for informants who assist in the prevention of erroneous refund claims. Thus, beyond the basic scenario in which a whistleblower can receive an award for leading the IRS to conduct an audit that results in collection of additional tax, a whistleblower can now also receive an award where no additional tax is collected because of the information provided but where the taxpayer's overpayment balance is reduced. Senator Grassley, the author of the 2006 amendments to section 7623, expressed his agreement with the proposed regulations:

These regulations are good news for whistleblowers. The Commissioner made the common-sense decision of ensuring that individuals who blow the whistle on improper refund claims will be rewarded, as I intended when I wrote the law. These new regulations will help the IRS target tax fraud.

See January 14, 2011 press release from the office of Sen. Grassley. While it can be argued whether the emphasis on tips from whistleblowers generates high-quality, useful information, it is apparent that at least some elected officials

² In Fiscal Year 2009, the IRS received 460 whistleblower submissions relating to 1,941 taxpayers. The Whistleblower Office routinely gets submissions from one informant regarding multiple taxpayers. See <http://www.irs.gov/pub/irs-utl/whistleblowerfy09rtc.pdf> at 6. Some awards have been paid out under the prior statute.

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believe that it does.

INCREASED INCENTIVES BREEDS MORE INFORMANTS

The government's broadening of the availability of informant awards under section 7623 assumes — sensibly, given human nature — that higher potential rewards will lead to more whistleblower tips. And because eligible whistleblower information is not restricted to information that leads to criminal tax violations, but includes information that leads to civil violations, the door is open for employees to inform the IRS about aggressive tax strategies even where those strategies do not result in an immediate tax savings or serve only to prevent or reduce a refund. With awards of up to 30 percent of the tax, penalty and interest collected, even where a claim just meets the minimum \$2 million required to become eligible, the potential payoff for informants is sizeable. The obvious danger of these rules is that they can incentivize employees to act in their own, rather than their employers', interests.

ENHANCED CORPORATE DISCLOSURE: SCHEDULE UTP

As we have previously reported, the IRS has finalized requirements for disclosure of uncertain tax positions of corporate filers that issue audited financial statements. See <http://www.mofo.com/files/Uploads/Images/101006-Schedule-UTP.pdf>. Uncertain tax positions generally are those for which the corporate taxpayer has recorded tax reserves. The IRS requires these taxpayers to attach Schedule UTP to their annual income tax return, with the first such disclosures being filed March 15, 2011. The Schedule must provide certain basic information about the uncertain position, including the ranking of the position relative to other positions, whether the position is a "Major Tax Position," and a concise description of each disclosed position. A common criticism of this new disclosure requirement is that the IRS auditors will use the Schedule as a roadmap to a taxpayer's issues and will set up audit adjustments based on the major uncertain positions. As a result, corporate tax departments will scrutinize their disclosures carefully, and, where they are able, remove positions from the Schedule or otherwise minimize the likelihood the IRS will investigate sensitive disclosed positions.

Because Schedule UTP asks taxpayers to divulge various positions that are not certain, and given the incentive for corporate taxpayers to minimize disclosures, the Schedule may become a fertile field for whistleblowers. Clearly positions that are appropriately disclosed on the Schedule UTP could not become the source of a whistleblower submission to the IRS. Things get complicated if a corporate tax department concludes that a previously reserved position should not be reserved and removes it from the Schedule. Or, what if a disclosed position is not properly disclosed on the Schedule UTP? With the liberalization of section 7623 award criteria, whistleblowers may be especially interested in just how the Schedule UTP is finally prepared and submitted to the IRS.

IRS'S CORPORATE GOVERNANCE INITIATIVE

Over the past year, high level officials, including the Commissioner and Deputy Commissioner for Enforcement, have described a new initiative to identify what the IRS sees as responsible corporate board conduct with respect to tax risk. This has become known as the Corporate Governance Initiative, and though it is still in the beginning stages, the IRS is clearly putting pressure on corporate boards to take tax risk more seriously. In January 2010, the Commissioner explained:

My proposition is simple: Tax expenses are like other major expenses. Manage them too loosely and you give up profit. Manage them too aggressively and there are bad consequences.

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Commissioner Shulman went on to warn companies that:

The board must oversee how management manages them. And that means some level of understanding, a set of policy principles and then a control system of review and reporting that assures the board that their policy is being carried out.

And he called on “corporate boards [to] have a regular dialogue regarding tax risk with their CFOs, tax directors and external tax advisors.” See Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City, Jan. 26, 2010.

The IRS’s goal in this initiative is to dissuade corporate tax managers from taking overly aggressive positions. The prospect that a vice president of tax or director of tax would have to justify certain proposed tax positions to the corporate board or a special committee on tax risk would seem bring to a certain conservatism into decision making because the board itself would not want to be viewed as derelict for not having adequately considered tax risk. Moreover, the threat of whistleblowers and the increased opportunities for them under the new proposed regulations is an added incentive for corporate boards to institute certain control procedures and protocols regarding tax risk.

SOME CONSIDERATIONS

Most corporations already understand the potential for whistleblowers in other regulatory areas and have implemented various policies with respect to nonretaliation provisions, confidentiality, and related processes to comply with Sarbanes-Oxley and other laws. Companies should continue to encourage employees to first report perceived instances of noncompliance internally. In that regard, they can consider establishing a protocol whereby the audit committee, or a specially constituted subcommittee, can receive information directly from an employee, for example a member of the company’s tax department. This can help manage whistleblower risk, as well as tax risk more generally. If real protections are in place for reporting employees, this should encourage internal reporting and presumably also better overall tax compliance. Also, corporate taxpayers should make sure that the implications of major proposed transactions or proposed tax return positions are thoroughly vetted within the tax department. These steps comport nicely with the IRS’s current focus on corporate governance. Finally, as to the Schedule UTP, companies may adopt additional steps, including solicitation of outside counsel’s views, before deciding not to include any major tax position on the Schedule where the position’s certainty has been debated internally.

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