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April 18, 2011

Via eRulemaking Portal (IRS—REG—131151-10)

Ms. Kirsten N. Witter
Internal Revenue Service
CC:PA:LPD:PR (REG—131151-10)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Treas. Reg. §301.7623-1 and Request for Public Hearing.

Dear Ms. Witter:

The Ferraro Law Firm respectfully submits herein comments on behalf of its clients who have to date made hundreds of tax whistleblower submissions to the Internal Revenue Service ("IRS") representing more than $82 billion in tax underpayments. Specifically, we write to comment on the Proposed Treasury Regulations under section 7623 of the Internal Revenue Code ("IRC") that were published in the Federal Register on January 18, 2011 (the "Proposed Regulations"). These Proposed Regulations at section 301.7623-1(a)(2) address the definition of "proceeds of amounts collected and collected proceeds" for purposes of IRC section 7623. Because we understand that a broader Treasury Regulation project is underway that addresses other issues raised by section 7623, we will confine our comments at this time to only those raised by the definition of "collected proceeds."

First, we would like to applaud the Treasury Department and the IRS for their efforts in writing new regulations for the recently amended IRC section 7623 *Expenses of Detection of Underpayments and Fraud, Etc.* which are consistent with the plain meaning of section 7623. In several ways, we recognize that these Proposed Regulations are contrary to some of the guidance and decisions that have been released by the IRS since the creation of the IRS Whistleblower Office ("WBO"). When Congress passed the Tax Relief and Health Care Act of 2006 (P.L. 109-432) (the "Act"), therein greatly increasing the awards available to tax whistleblowers, their intent was to entice persons with high value and high quality information about tax underpayments to come forward. While the Act did greatly increase the numbers of high quality submissions to the IRS, there remains work to be done to encourage other whistleblowers to come forward.

In summary, our comments can be broken down into four categories:

1) Refunds;
2) Credits, Net Operating Losses, and Other Tax Attributes;
3) Criminal Fines; and
4) Timing of award payments.

We address each of those four categories in turn as follows:

Comment #1) Refunds – We are pleased that the Proposed Regulations provide that a denial of a refund claim should constitute "collected proceeds," but we are concerned that the language used in the Proposed Regulations is too narrowly drafted to cover common scenarios in which refunds are effectively denied in the course of a tax controversy, particularly with respect to complex corporate tax returns.

Section 7623(b)(1) defines collected proceeds from which an award can be paid to a whistleblower under IRC section 7623(b). Specifically, it says that if a whistleblower's information substantially contributed to the IRS's action against a taxpayer, a whistleblower shall receive an award of between 15 to 30 percent of the "collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action."

From an economic perspective, when the IRS either (i) makes an assessment of a tax deficiency, or (ii) denies a claim for refund, the net effect on the public treasury (or "FISC") is the same. Section 7623 was designed to award individuals who bring additional revenue into the FISC, and in the same way, it should award individuals who protect the FISC from paying out erroneous refunds. We are pleased that through the Proposed Regulations, the Treasury Department implicitly acknowledges this fact. However, we are concerned that the language used in section 301.7623-1(a)(2) of the Proposed Regulations to effectuate this simple tenet of economics is too narrowly drafted to achieve the desired result.

We agree with Senator Grassley when he wrote in a June 21, 2010 letter to Treasury Secretary Geithner that denying an award when information leads the IRS to withhold a requested refund - as was contemplated by the IRM provisions released on June 18, 2010 - creates "a perverse incentive for the whistleblower to wait until the IRS has paid an improper refund." We have seen several instances of this exact situation in practice and have advised our clients accordingly. However, there are several scenarios that typically arise in a tax controversy that have the same practical effect as a denial of a claim for refund, but as a technical matter, they would not fit within the language of the Proposed Regulations, which currently state that awards can be paid from:

"amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid." Prop. Treas. Reg. section 301.7623-1(a)(2).

In many tax controversies, in response to deficiencies proposed by the IRS, a taxpayer will file affirmative claims for refund on an amended tax return for the period under examination that can, if allowed, practically act as an "offset" against the proposed deficiencies. The IRS can then examine these claims for refund and either allow them in whole or in part, resulting in a reduction of the deficiency and potentially even a tax refund, or the IRS can deny the claims for refund in whole or in part, resulting in either no change, a reduction of the deficiency, or a denial of a claim for refund. First, the Proposed Regulations should not distinguish between a formal full or partial disallowance of a claim for refund as compared to the full or partial reduction in a deficiency. Second, the Proposed Regulations should not distinguish between cases in which the whistleblower submission contains information that relates to the issues in the affirmative claims for refund, so long as information contained in the whistleblower submission ultimately leads to either a deficiency or denial of refunds.

The following examples illustrate this premise:

Example 1, a tax whistleblower submission contains information only about issue A, and the taxpayer agrees at the conclusion of an examination that issue A led to an underpayment of $10 million. During the examination, the taxpayer affirmatively raised issue B, and the IRS agreed that issue B should reduce the deficiency owed by $3 million. The taxpayer then pays the $7 million deficiency. The section 7623 award should still be based on the $10 million underpayment that the taxpayer agreed was attributable to issue A. But for the information provided by the whistleblower, the taxpayer would have received a $3 million refund, and instead they paid $7 million, for a net "collected proceeds" of $10 million.

Example 2, same facts as *Example 1* but issue B resulted in the IRS agreeing that the deficiency should be eliminated and the taxpayer should get a refund of $2 million. The net "collected proceeds" should still be $10 million, because but for the information provided by the whistleblower, the taxpayer would have received a $12 million refund, and instead they only received a $2 million partial refund.

Example 3, same facts as *Example 1* but the whistleblower supplements his whistleblower submission with information that leads to the IRS denying that issue B should reduce the $10 million deficiency attributable to issue A. The net "collected proceeds" should be $13 million, because but for the information provided by the whistleblower, the taxpayer paid a $10 million deficiency and was denied a $3 million refund.

Suggested Language for the Proposed Regulation to Address Comment #1:

Treas. Reg. section 301.7623-1(a)(2) should read as follows:

> (2) Proceeds of amounts collected and collected proceeds. For purposes of section 7623 and this section, both proceeds of amounts collected and collected proceeds include: tax, penalties, interest, additions to tax, and additional amounts collected by reason of the information provided; *amounts collected if the information provided results in the full or partial denial of a claim for refund that otherwise would have been paid or full or partial denial of reduction in a deficiency owed*; … [emphasis added]

Comment #2) Credits, Net Operating Losses, and Other Tax Attributes – To the extent that the Proposed Regulations only address credit balance carry forwards and ignore all other "credits," Net Operating Losses ("NOLs") under section 172, and tax attributes that directly impact how much tax a taxpayer pays in any particular period, they are too narrowly drafted, and the definition of "collected proceeds" with respect to "credits" needs to be expanded upon.

The Proposed Regulations currently state that awards can be paid from collected proceeds resulting from "a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided." Prop. Treas. Reg. section 301.7623-1(a)(2). Similar to the refund issue, the Proposed Regulations are simply too narrowly drafted with respect to the impact of credits on complex corporate returns. An "overpayment" credit balance is just one of the many types of credit balances that exist under the IRC. Any Fortune 1000 taxpayer has a complicated mixture of credits and tax attributes that greatly affect what they actually pay in tax during any taxable year. To ignore the impact of these credits, NOLs, and tax attributes on "collected proceeds" is to ignore large swaths of the IRC and pretend they simply aren't there, even though they are in many respects analogous to an "overpayment credit balance" situation as described in the Proposed Regulations.

We share Senator Grassley's concern about how the IRS may treat credits for award purposes under section 7623. In his June 21, 2010 letter to Treasury Secretary Geithner, Senator Grassley said, "the IRM says that satisfaction of a taxpayer's liabilities by reducing a credit balance is not within the scope of collected proceeds so the whistleblower would receive no award." Clearly the Proposed Regulations would change that rule with respect to "overpayment credit balances," but we believe that the Proposed Regulations should be more broadly written to cover the "credit balances" that Senator Grassley wrote about. The Proposed Regulations, to the extent they only cover only "overpayment credit balances," fail to address Senator Grassley's concern.

A few admittedly overly simple examples follow to illustrate the effect of tax attributes in a whistleblower case. There are any number of scenarios involving NOLs, credit carrybacks or carryforwards, and other adjustments relating to tax attributes which could be addressed by the Proposed Regulations. The following scenarios would be more relevant than the "overpayment credit balance" scenario that the Proposed Regulations already contemplate, but by no means is this an exhaustive list of examples. Instead, we believe the best approach that can be taken in the final regulations would be to leave the rule broad enough for the WBO to make a determination of how the whistleblower's information effected the taxpayer's tax position including not just deficiencies and refunds, but also the use of tax attributes.

Example 1, just as in the first example under Comment #1 above, a tax whistleblower submission contains information only about issue A, and the taxpayer agrees at the conclusion of an examination that issue A led to an underpayment of $10 million. However, when tax computations are done at the conclusion of the examination, the taxpayer utilizes an excess Alternative Minimum Tax credit under IRC section 53(a) to reduce the deficiency owed by $3 million. The taxpayer then pays the $7 million deficiency. The section 7623 award should still be based on the $10 million underpayment that the taxpayer agreed to that was attributable to issue A. But for the information provided by the whistleblower, the taxpayer would have still had a $3 million tax attribute available to them to use at any time. Instead the taxpayer paid $7 million and used up a $3 million tax attribute, resulting in net "collected proceeds" of $10 million.

Example 2, a taxpayer has a foreign tax credit under IRC section 901 that it is carrying forward from the current taxable period to a future year because it is in an excess credit limitation position under section 904, and a whistleblower submits information that leads to a determination that the taxpayer is not entitled to that credit. While this determination will have no impact on the amount of tax the taxpayer will pay in the current year, it will result in a payment of additional tax in the subsequent year when the taxpayer could have used that credit to reduce their U.S. tax liability. If this information had led to the denial of the credit in the current year, thus increasing the U.S. tax liability in the current year and leading to a deficiency in the current year, we believe that the Proposed Regulations as currently drafted would already pick up that additional payment as "collected proceeds." However, to the extent that it has a future or past year impact the Proposed Regulations are not clear. Even though, in either situation, the net "collected proceeds" are equal to the amount of the denied credit, because due to the information provided by the whistleblower, the taxpayer no longer has the credit available for use.

If the Proposed Regulations do not finally address tax attributes through the use of broader language, then the IRS will be in the position of still having to pay awards to whistleblowers under the plain language of section 7623 in a future year when the current loss of a tax attribute results in an additional tax being paid. This creates what we call a "springing award," such that the whistleblower will be eligible for an award in whatever such future year additional tax is paid, due to the loss of or utilization of the tax attribute (resulting from the whistleblower's information). In practice, this then results in an administrative burden on the WBO and the IRS who would be required to monitor the taxpayer's utilization of tax attributes for many years, perhaps even decades. Such a rule would also unfairly penalize a whistleblower who provided information that resulted in the reduction of a taxpayer's valuable tax attributes, instead of a deficiency or the denial of a refund.

Whether a taxpayer pays cash to settle a deficiency or utilizes a tax attribute is a distinction without an economic difference. The Proposed Regulation should reflect that truth.

Suggested Language for the Proposed Regulation to Address Comment #2:

Treas. Reg. section 301.7623-1(a)(3) should be added to the Proposed Regulations and should read as follows:

> (3) Timing of collected proceeds. Proceeds can be collected within the meaning of (a)(2) of this section due to the utilization of tax attributes or credits in a current taxable year, or by operation of a carryback or carryforward of credits or other tax attributes, including section 172 Net Operating Losses, in a previous or subsequent period of a taxpayer. An award can be paid from such collected proceeds at the time that the carryback or carryforward of credits, other tax attributes, or Net Operating Loss, is utilized.

Comment #3) Criminal Fines – The Proposed Regulations defining collected proceeds should expressly include criminal fines and monies collected under restitution orders for failure to pay tax as part of the definition of collected proceeds.

Monies collected as criminal fines or restitution in tax cases are properly included in the definition of collected proceeds even though IRS's current position, as stated in the Internal Revenue Manual ("IRM"), incorrectly excludes criminal fines from collected proceeds and is silent as to restitution. Criminal fines are properly included in collected proceeds pursuant to the plain language of section 7623 and Treasury Regulation section 301.7623-1(c), and the IRS has traditionally included criminal fines as part of collected proceeds. Restitution payments are properly included in collected proceeds because the amount under a restitution order pursuant to section 3556 of Title 18 for failure to pay any tax imposed under Title 26 is assessed and collected as if such amount were a tax according to section 6201(a)(4).

While criminal fines are properly included in collected proceeds, the IRS has chosen to exclude most criminal fines from collected proceeds. To the extent that IRM 25.2.2 Whistleblower Awards (06-18-2010) says that criminal fines are not part of collected proceeds, it is flatly contrary to the statute. Specifically, IRM 25.2.2.12 Funding Awards (06-18-2010) says:

> 9. Criminal Fines: Criminal fines, which must be deposited into the Victims of Crime Fund, cannot be used for payment of whistleblower awards.

As justification for not paying awards under section 7623 with respect to criminal fines, the IRS says that all criminal fines collected from persons convicted of offenses against the United States, except for those specifically exempted by statute, are required to be deposited in to the Crime Victims Fund. However, Congress included fines when they enacted the enhanced whistleblower provisions found in section 7623(b) for violations of the Internal Revenue Code. Criminal fines are found throughout Title 26 (the Internal Revenue Code) and also in Title 18 (due to a tax imposed by Title 26). We believe that by acting unilaterally, despite statutory language to the contrary, this decision by the IRS to exclude criminal tax fines will lead to unnecessary litigation, fewer informants coming forward when the information relates to the most egregious violations of internal revenue laws, and continued questioning of the integrity of the IRS Whistleblower Program.

The statutory language of section 7623(b)(1) states that collected proceeds include penalties, interest, additions to tax, and additional amounts. Criminal fines are reasonably included in the plain and ordinary meaning of additional amounts. The ordinary meaning of additional amounts is

amounts not otherwise listed, which reasonably includes criminal fines. Additionally, the language of the statute that specifies what is included in collected proceeds should be read as an exemplary, rather than an exclusive list. The statute prefaces the list of monies included in collected proceeds with the term "includes," which "when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined," according to 26 U.S.C. §7701(c). Therefore, the list included in the statutory language should not be treated as an exhaustive list of the types of monies that fall into collected proceeds, but rather as examples of types of monies that that are included in collected proceeds.

The current regulations, specifically Treasury Regulation section 301.7623-1(c), expressly include fines in the types of monies collected that are used to pay an award. That section currently states:

> Payment of a reward will be made as promptly as the circumstances of the case permit, but not until the taxes, penalties, or *fines* involved have been collected. However, if the informant waives any claim for reward with respect to an uncollected portion of the taxes, penalties, or *fines* involved, the claim may be immediately processed. Partial reward payments, without waiver of the uncollected portion of the taxes, penalties, or *fines* involved, may be made when a *criminal fine* has been collected prior to completion of the civil aspects of the case, and also when there are multiple tax years involved and the deficiency for one or more of the years has been paid in full.

Tres. Reg. section 301.7623-1(c) (emphasis added). By expressly including fines in the final version of Treasury Regulation section 301.7623-1(a), the Treasury Regulation would be internally consistent with section 301.7623-1(c).

Prior to the release of IRM 25.2.2.12 Funding Awards (06-18-2010), the IRS had traditionally included criminal fines as part of collected proceeds. The statue was silent on what monies should be included in collected proceeds prior to the 2006 amendments to section 7623, except for an express exclusion of interest from collected proceeds. Nevertheless, the IRS had a long-standing policy of including criminal fines in collected proceeds when it did pay an award under section 7623. IRS policy Statement 4-27 (Aug. 13, 2004) provides:

> 1. Rewards determined by value of information furnished and Computation and payment of rewards
>
> 2. The Internal Revenue Service will pay claims for reward applied for on Form 211 commensurately with the value of the information furnished voluntarily and upon the informant's own initiative with respect to taxes, fines, and penalties (but not interest) the Service collects. ...

IRM 1.2.13.1.12 (Approved 08-13-2004). Additionally, both Publication 733, Rewards for Information Provided by Individuals to the Internal Revenue Service, and the standard contract with whistleblowers[1] included taxes, fines, and penalties (but not interest) in collected proceeds.

[1] See *Confidential Informant 92-95-932X, v United States*, 86 AFTR2d Par. 2000-5392, No. 99-154 T; and *Billy W. Jarvis v. United States*, 84 AFTR2d Par. 99-5199, No. 97-806T for examples of language from whistleblower contracts.

Restitution payments should also expressly be included in the definition of collected proceeds because these payments are assessed and collected as if they were a tax under section 6201(a)(4). If these payments are assessed and collected as though they were a tax, then logically they should be treated as a tax for award purposes under section 7623. Additionally, by excluding restitution payments from collected proceeds the IRS will receive a windfall. Restitution payments are supposed to put the victim of a crime back in the position they would be in but for the crime. In the case of violations of internal revenue laws, the victim is the United States Treasury and restitution orders are entered for the amount of the underpayment of tax arising from the crime. Had the IRS assessed the underpayment through a civil audit the whistleblower would clearly be entitled to an award; therefore, in order to place the IRS in the same position it would have been in had the assessment been made under a civil audit, the restitution payment should be treated as collected proceeds. The windfall the IRS would receive by excluding these payments from collected proceeds would be at the expense of the whistleblower program as a whole.

Suggested Language for the Proposed Regulation to Address Comment #3:

Treas. Reg. section 301.7623-1(a)(2) should read as follows:

> (2) Proceeds of amounts collected and collected proceeds. For purposes of section 7623 and this section, both proceeds of amounts collected and collected proceeds include: tax, penalties, interest, additions to tax, *criminal fines or court ordered restitution under Title 26 or under Title 18 due to a tax imposed by Title 26,* and additional amounts collected by reason of the information provided … [emphasis added]

Comment #4) Timing of Award Payments – The IRS's current rule about when collected proceeds are eligible to be used to pay an award needs to be changed to be consistent with the Proposed Regulations to the extent that they allow for awards to be paid when a claim for refund is denied.

The IRS will need to change its rule about when awards are eligible to be paid from collected proceeds because the current rule can unnecessarily add up to TWO YEARS to the payment process. As discussed above in Comment #1, the IRS's current position, as stated in IRM 25.2.2.12 "Funding Awards," (06-18-2010) paragraph 8, that awards cannot be paid "under 7623 (a) or (b) which are based on information which leads to the denial of a claim for refund which otherwise would have been paid" will need to be revoked to comply with the temporary or final regulations if it therein requires that awards be paid from "amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid…" see Prop. Treas. Reg. section 301.7623-1(a)(2). Our comment relates to the ramifications of this change on when awards become eligible to be paid to whistleblowers under section 7623.

In the "FY 2009 Annual Report to Congress on the Use of Section 7623," (the "Report") the IRS stated that it will not pay any awards on collected proceeds resulting from whistleblower information until after the period of limitations has expired on claims for refund. On page 7 this Report said:

> "After consultation with the Office of Chief Counsel, the Whistleblower Office determined that in cases where the taxpayer has not filed an appeal, the IRS should not pay the claim until the period for filing an appeal has lapsed. The general rule is that a taxpayer may file a claim for refund within two years of the last payment, unless he or she has waived that right. This means that until two years have passed after the last payment, the case is still subject to the possibility of appeal through the process of filing a claim for a refund. Thus, beginning in July 2009, the IRS monitors cases both for collection and then for the expiration of the period for filing a claim for refund. As a result, the IRS will not pay some claims that under prior policy it would have paid in FY 2009 until FY 2010 or FY 2011."

This decision by Chief Counsel was implemented by issuing IRM 25.2.2.12 "Funding Awards," (06-18-2010) paragraph 7, which states that: "The award payment cannot be completed until the statutory period for filing a claim for refund expires or there is an agreement between the taxpayer and the IRS that there has been a final determination of tax for the specific period and the right to file a claim for a refund has been waived."

In the Report the IRS explained that it was the operation of this rule that caused a huge decrease in the number of Section 7623 awards paid by the IRS in Fiscal 2009. Specifically, the Report said: "One factor contributing to the lower award payments in FY 2009 was a change in the IRS definition of the point at which proceeds in a tax case are available to make an award payment." Once this policy was put in place, the number of awards paid fell from 198 to 110 and from $22,370,756 to $5,851,608 (Fiscal 2008 vs. Fiscal 2009, respectively), even though the amounts the IRS collected from taxpayers as a result of the Whistleblower Program increased from $155,985,834 to $206,032,872 during those same years. We know firsthand that the collections amount in Fiscal 2010 has greatly increased, and are expecting an exponential increase in collections in following years.

In many cases a taxpayer resolves their issues in dispute with the IRS on a Form 906, "Closing Agreement on Final Determination Covering Specific Matters" and pays the additional tax deficiency they owe. This agreement is commonly used by the IRS Examination Division to close out cases. The Form 870-AD, "Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment", is commonly used by the IRS Appeals Division to close out cases with a similar effect. Specifically, the effect is that the taxpayer is barred from any further administrative or judicial appeal of the issues that were settled in either of those agreements, even when the period of limitations under section 6511(a) is still open by operation of time for claims for refund on other issues. Because the Proposed Regulations require that awards be paid when the IRS denies a refund based on the whistleblower's information, then an award should be paid irrespective of the status of the period of limitations under section 6511(a). Why? Because it doesn't matter if the taxpayer claims a refund on some other issue, the taxpayer has already irrevocably paid an assessment on the issue raised by the whistleblower and that will ultimately lead to the government either collecting additional tax or denying claims for refund that would have otherwise been paid. If that same taxpayer had not executed the Form 906 or Form 870-AD and paid the assessment on the issues raised by the whistleblower, then the taxpayer could have received in many cases a refund of previously paid taxes. But because of the whistleblower's information, that refund is effectively denied to the extent of the adjustments agreed to on the Form 906 or Form 870-AD and paid by the taxpayer.

Therefore, the IRS will need to change IRM 25.2.2.12 "Funding Awards," (06-18-2010) paragraph 7, to allow for awards to be paid on issues that have been conclusively and finally resolved. We propose the replacement of the last sentence of paragraph seven with the following language: "The award payment cannot be completed until the statutory period for filing a claim for refund expires or there is an agreement between the taxpayer and the IRS that there has been a final determination of tax for the specific period or specific matter relating to the whistleblower's information."

We do not believe that additional language will necessarily need to be added to the Proposed Regulations to give this change effect so long as the language of Treas. Reg. section 301.7623-1(a)(2) ultimately allows for awards to be paid from "collected proceeds" of denied claims for refund. However, Treasury may want to consider adding the following language to the end of Treas. Reg. section 301.7623-1(a)(2) to avoid confusion by the IRS with respect to their ability to pay awards when a section 6511 period of limitations on refunds is still open on issues that do not relate to a whistleblower claim.

Suggested Language for the Proposed Regulation to Address Comment #4:

Treas. Reg. section 301.7623-1(a)(2) could conclude as follows:

> … "Awards are eligible to be paid pursuant to section 7623 on collected proceeds once there is a final determination of tax for a specific period or specific matter relating to a whistleblower's information."

In closing, we again believe that the Proposed Regulations are a step in the right direction in terms of adding clarity to the definition of collected proceeds under section 7623. However, we also believe that both the narrow language of the Proposed Regulations and the current provisions of the IRM cited above with respect to credits, refunds, and criminal fines, are inviting controversy and litigation with the same whistleblowers Congress had hoped to attract. A broader interpretation of and corresponding regulatory language with respect to credits and refunds, and an explicit reference to criminal fines when considering how to interpret "collected proceeds," is needed to avoid those disputes and to be in line with the plain meaning and Congressional intent of section 7623.

Respectfully Submitted,

Scott A. Knott, Esq.

Gregory S. Lynam, Esq.

cc: Richard A. Hurst, Internal Revenue Service.
Senator Charles Grassley, Senate Finance Committee.