JAMES L. FERRARO*
DAVID A. JAGOLINZER**

SCOTT A. KNOTT***
GREGORY S. LYNAM+
DINO G. GALARDI
CASE A. DAM****
JUAN P. BAUTA, II
ERICA L. BRADY+++
ILONA M. DEMENINA
JEFFREY H. SLOMAN
ALLAN B. KAISER*****
MELISSA DAMIAN VISCONTI
MARC P. KUNEN
JAMIE N. ISICOFF

HONORABLE JOHN GALE ++

THE FERRARO LAW FIRM

MIAMI • WASHINGTON, D.C. • NEW YORK

4000 PONCE DE LEON BOULEVARD
SUITE 700
MIAMI, FLORIDA 33146
TELEPHONE (305) 375-0111
TELEFAX (305) 379-6222
TOLL FREE (800) 275-3332
www.ferrarolaw.com

*ALSO LICENSED IN MA, NY, OH
**ALSO LICENSED IN MA, DC, NY
*** ALSO LICENSED IN DC
****ALSO LICENSED IN IL
***** ALSO LICENSED IN MO
+ONLY LICENSED IN CA, IL
+++ ONLY LICENSED IN CA, NY

++ OF COUNSEL

January 11, 2012

Via email

Stephen Whitlock
Director, Whistleblower Office
Internal Revenue Service
SE: WO
1111 Constitution Ave., N.W.
Washington, D.C. 20224

RE: IRS Policy of Withholding on Tax Whistleblower Award Payments.

Dear Mr. Whitlock:

It goes without saying that we and the tax whistleblowers we represent were disappointed when PTMA 2010-63, *Withholding Recommendation* (Sept. 30, 2010) was published last year announcing the IRS's intent to withhold on whistleblower award payments made pursuant to section 7623(b). I think you may have seen our public comments about this policy in terms of how it economically damages whistleblowers, but in a nutshell, the problem is that it leads to gross overwithholding on whistleblowers who are represented by counsel on a contingent fee basis.

At our meeting with you on October 13, 2011, we promised to share with you in writing our detailed concerns about this policy along with proposed solutions that may alleviate the damage it is doing to the IRS Whistleblower Program and to whistleblowers themselves. The following document sets forth those issues and alternative solutions. We hope that this discussion is helpful in considering how the IRS could ensure that tax is properly paid by whistleblowers on award payments going forward without causing undue harm to everyone involved.

Issue Summary

Despite what PTMA 2010-63 says, there is actually no legal authority for withholding on section 7623(b) award payments to tax whistleblowers. The IRS policy of withholding at 28% causes economic harm to whistleblowers due to the time value of money on overwithheld amounts, because in a section 7623(b) case the actual taxable income of the whistleblower would reflect their section 62(a)(21) deduction for contingent attorney's fees. The current IRS policy of withholding on award payments could also subject whistleblowers to additional accounting and legal fees if they need to pursue claims for refund of such overwithheld amounts.

Proposed Solution

To avoid the economic harm to the whistleblower and a future refund dispute about the amounts withheld, the IRS can abandon its position and not withhold on award payments made to U.S. citizens or residents. Alternatively, a whistleblower could enter into a withholding agreement with the IRS or obtain a withholding certificate from the IRS, wherein they could consent to a sufficient amount of withholding to cover their actual tax liability. Both of these withholding alternatives already exist as procedural mechanisms the IRS uses to avoid overwithholding in other areas, and can be employed in tax whistleblower cases to achieve the same result.

Discussion

It is the current "policy" of the IRS is to withhold on section 7623(b) whistleblower awards to U.S. citizens or residents at 28% of the gross award. We say policy in quotes because there is no legal authority to withhold on these payments. Nowhere in the Internal Revenue Code or in the Treasury Regulations will you find a legal justification for such withholding, nor will you find a source for the rate at which the IRS is currently withholding on whistleblower awards to U.S. citizens or residents. In PTMA 2010-63, *Withholding Recommendation*, Chief Counsel established the rationale for withholding in such cases by basically saying: nothing in the law says we can't, so that means we can. Associate Chief Counsel Procedure & Administration Deborah Butler stated in this document "There is no specific statutory authority to withhold on Whistleblower awards" and as a footnote to that statement, despite her conclusion in this instance to the contrary, that "Historically, all identified existing withholding regimes have a statutory basis." We completely and fully agree with both of those premises.

What we do not agree with in PTMA 2010-63 is that it still reached the conclusion that the IRS should withhold on whistleblower awards to U.S. citizens or residents despite the lack of statutory authority to do so. On page one of this document, the conclusion that this policy of withholding is "legally defensible" relies solely, as stated in footnote 1, on a misquoted line[1] from a Notice 92-6 - which appears to have been written by the IRS Public Affairs Division. We were not aware that the IRS's press releases were precedential authority which the IRS could use to defend its legal position.

[1] Notice 92-6 actually said on page 1 under the heading REASON FOR THE NEW TABLES: "The principal purpose of **wage** withholding is to assure current payment of the correct amount of Federal income taxes." (Emphasis added to the missing word.) The sentence directly preceding this quote was "Section 3402 of the Code requires every employer to withhold Federal income taxes on wages in accordance with tables and computational procedures established by the Service." Thus, even Notice 92-6 illustrates that there must be a statutory basis for each withholding regime, in that instance section 3402 of the code.

It is sadly ironic that in contrast with PTMA 2010-63, the subsequently released PTMA 2011-02, *Determination of Character, Source, and Withholding Requirements with respect to Whistleblower Awards paid to Nonresident Alien Individuals*, (Mar. 22, 2011) concluded that non-U.S. citizen or resident (Non Resident Alien, or "NRA") whistleblowers may not be subject to withholding if they live in a jurisdiction covered by a treaty that contains the relevant protections. In other words, NRA whistleblowers get more favorable withholding treatment from the IRS than U.S. whistleblowers. PTMA 2011-02 rightfully addresses the instance where we agree with the IRS that there should be withholding – when the whistleblower does not provide a social security number or a Form W-8 to the IRS.

The only conceivable legal authority for withholding on an award to a U.S. whistleblower under section 7623 is the backup withholding provisions of section 3406. However, section 3406 would only permit the IRS to backup withhold if the whistleblower did not provide the IRS with a social security number. That is obviously not the scenario that PTMA 2010-63 is framed to cover with its new withholding policy. What we are dealing with here isn't backup withholding, it's bogus withholding. Therefore, the IRS should not be withholding at all on award payments to U.S. citizen or resident whistleblowers under section 7623.

In light of the lack of statutory or regulatory authority for withholding on award payments to U.S. whistleblowers, it is clear that the IRS decision to withhold on whistleblower award payments without such authority is merely a policy decision, thus making the act of withholding discretionary. In other words, the Commissioner is free not to withhold on award payments to whistleblowers despite the current policy contained in PTMA 2010-63. In fact, PTMA 2010-63 concedes that the IRS is not even required to withhold on such payments.

Because the act of withholding on award payments to whistleblowers is discretionary and not statutory or regulatory in nature, the rate at which the IRS withholds on such payments is also discretionary. There doesn't appear to be any statutory or regulatory foundation for the 28% figure that is currently being used as the withholding rate. Being that the rate of withholding is discretionary, the Commissioner can choose to lower the rate from the current policy of 28%. While we would prefer that withholding on award payments to whistleblowers be eliminated entirely because of the damage it causes to both the IRS Whistleblower Program and to tax whistleblowers, the IRS could also exercise its discretion by withholding at a lesser rate than the current policy, thus minimizing the damage caused.

Unfortunately, whistleblowers are stuck between a rock and a hard place when it comes to their ability to challenge this policy of overwithholding. PTMA 2010-63 is correct that whistleblowers can't immediately challenge the overwithholding imposed upon them, no matter how much immediate economic harm it causes. The aggrieved whistleblower must wait to file a claim for refund when her next tax return is due and then wait some more to receive her refund, all the while receiving no interest from the government for the use of her money. Waiting for the next year's return to be due and then waiting for the refund to be paid can easily add an additional year delay to the whistleblower's receipt of the total award they are entitled to under section 7623(b). This delay is often on top of an additional two years that the IRS has improperly delayed the award payment after collecting the tax underpayment from the target taxpayer, an issue that was the subject of our August 18, 2011 letter to Commissioner Shulman. In total, the policies that the Office of Chief Counsel imposed on the IRS Whistleblower Program after Congress amended section 7623 have added up to three years to the full payment of an award to a whistleblower after the IRS has collected the tax underpayment they discovered. Potential additional delays in the payment of the

claim for refund would be on top of that three year delay. However, we would expect that any whistleblower who wasn't immediately issued a refund of this overwithheld amount will be suing the IRS in a Federal District Court or the Court of Federal Claims, where the jurisdiction for denied claims for refunds properly lies. It would clearly be in the best interest of everyone involved to avoid refund disputes by not overwithholding.

Why this overwithholding is a problem: As you are surely aware, it is common for tax whistleblowers to be represented by counsel, and those individuals typically do not have the resources to pay legal fees on a time and materials basis during the several years that a case may take before an award is paid, if any. Therefore, many whistleblowers utilize contingent fee contracts with their counsel. Congress anticipated this structure and allowed for an above the line deduction for legal fees in section 7623 whistleblower cases by amending section 62(a)(21) at the same time they added section 7623(b). The withholding that the IRS has begun imposing on whistleblower awards ignores any deductions a whistleblower has for those contingent fees, leading to significant overwithholding. The whistleblower, who in most if not all cases has waited several years for the IRS to utilize her information and collect the tax underpayment from the taxpayer, who then waited as much as an additional two years after the payment is made by the taxpayer for the IRS to decide if the award is eligible to be paid, finally now gets about half of the award she is expecting because of overwithholding. For example:

> Assume a client of ours gets a $10 million award determination. The IRS withholds 28%, or $2.8 million, for a net payment to the whistleblower of $7.2 million. Our 40% contingent attorney's fees are deducted from the gross amount of the award, leaving the whistleblower with a net payment of $3.2 million ($7.2 million after withholding - $4 million in attorney fees = $3.2 million). Overwithholding has occurred because contingent attorney's fees are an above the line deduction for the whistleblower, such that her actual taxable income was $6 million instead of $10 million. The $2.8 million of withholding represents an equivalent tax rate of 46.67% on her $6 million of actual income, which is significantly higher than the top current marginal tax rate of 35%. In dollar terms, this whistleblower would have overpaid tax on this award income by ~$700,000. That equates to 7% of the award amount of overwithholding in percentage terms. In other words, because the actual effective rate of tax on the gross award to this whistleblower was 21%, the IRS policy of withholding at a 28% rate resulted in gross overwithholding

This overwithholding isn't just a problem for whistleblowers, it is a problem for the IRS. As stated above, the overwithholding invites refund disputes with whistleblowers that may result in litigation in Federal District Courts or the Court of Federal Claims. The administrative dispute before the complaint is filed will require IRS staff resources as well as those IRS resources required to support the litigation once the case is docketed, so it is not just the Department of Justice's problem. The overwithholding itself could also arguably be a violation of a whistleblower's Constitutional rights, akin to a "taking" of the property of the whistleblower without just compensation or due process. Last, but not least, this policy of overwithholding makes the IRS look bad and alienates future potential whistleblowers who perceive that they will be treated unfairly by the IRS. Any of these factors alone do not contribute to the success of the IRS Whistleblower Program, nor do they achieve the IRS's goal of detecting underpayments of tax with minimal enforcement resources.

Proposed Solutions

Alternative 1: Withholding Agreements. We can't speak for all whistleblowers, but we believe that all of our clients would be willing to enter into a withholding agreement with the IRS in which they would consent to the IRS withholding at the current top marginal rate but only on the amount of their actual taxable income. Their actual taxable income would of course reflect their deduction for contingent attorney's fees and other deductions, credits, or exclusions from income, which they would document accordingly. The withholding agreement itself could be modeled after the Central Withholding Agreement, (*See* Publication 515) which is what the IRS uses for NRA entertainers and athletes to avoid overwithholding on their U.S. source income, which the 30% withholding of Section 1441(a) would otherwise often cause.

It is theoretically possible that an NRA whistleblower could obtain a Central Withholding Agreement. In PTMA 2011-02, Associate Chief Counsel International Steven Musher said that pursuant to section 1441(a) the IRS can withhold on award payments to NRA whistleblowers at 30% "to the extent of the portion attributable to the activities of the NRA whistleblower undertaken in the United States, if any, in order to provide information in accordance with the statute." Central Withholding Agreements, as discussed above, are meant to relieve the burden of overwithholding not only due to the effect of marginal income tax rates, but also to address the question of what portion of the NRA's income was U.S. source. Therefore, because this program is already positioned to use a withholding agreement to ameliorate overwithholding for NRA whistleblowers, a similar withholding agreement should be used to eliminate burdensome overwithholding on U.S. whistleblowers.

The IRS can utilize the existing model withholding agreement language from the Central Withholding Agreement program to create a model withholding agreement for U.S. whistleblowers. The NRA's Central Withholding Agreements are coordinated out of the Austin Service Center. We leave it to the IRS to determine who within the IRS would process a withholding agreement with a whistleblower, but in light of the fact that the withholding is being done without authority in the first place, we hope a reasonable accommodation could be made.

The IRS could establish to its satisfaction as a predicate to the entering into a withholding agreement the existence of a contingent fee arrangement or other fact that would lower the whistleblower's effective rate of taxation on their gross award under section 7623(b). Specifically, the whistleblower can attach to the application for the withholding agreement a copy of their executed and legally binding contingent fee contract with their attorney. Furthermore, the client can represent and warranty that they will deposit their gross award in their counsel's respective Attorney Trust Account, out of which the attorney's contingent fees will be deducted and the balance of the net award will be disbursed to the whistleblower. PTMA 2010-63 stated on page 4 as additional support for its (legally indefensible) conclusion favoring withholding that "The Service should not be in a position from an administrative standpoint of refereeing disputes between Whistleblowers and their counsel or other representatives." This proof of the legally binding obligation to pay attorney's fees for which there is a section 62(a)(21) above the line deduction, along with the representation and warranty that the fees will be paid and the manner by which they will be disbursed to the whistleblower, should alleviate any concerns that the IRS will be "refereeing" any disputes between whistleblowers and their representatives. If the whistleblower doesn't present this evidence or even ask for the reduced withholding as part of a withholding agreement, the IRS can apparently withhold at whatever rate it wants to anyway. Note that if the whistleblower is not paying any contingent attorneys fees on their section 7623(b) award, it is likely

that their effective rate of taxation on the award is closer to 35%, resulting in "underwithholding." What we are left with is that the IRS will not be withholding at the actual effective rate of tax of any whistleblower EXCEPT those who have entered into a withholding agreement. Everyone else's withholding will be either too high or too low, and by a large margin.

Alternative 2: Withholding Certificates. This proposed solution is a little unconventional, but we believe the whistleblower could utilize a withholding certificate to effectuate reduced withholding when warranted. This document would be relied upon by the IRS in setting the withholding rate for that whistleblower/taxpayer based on their effective rate of taxation. Like the Central Withholding Agreement, withholding certificates are existing procedural devices that taxpayers and the IRS currently use to modify withholding rates to avoid overwithholding. This approach is a little unconventional because typically the withholding certificate is provided by the taxpayer to a withholding agent that is making payments to the taxpayer that would otherwise be subject to withholding at a fixed statutory rate. In this instance, however, the whistleblower/taxpayer would be providing the certificate to the IRS to be relied upon by the IRS when making an award payment.

There are currently several forms of Withholding Certificates available from the IRS to eliminate withholding or reduce the rate of withholding in certain circumstances where withholding would otherwise occur by law. As we all know, Forms W-4 and W-8[BEN, ECI, etc.] are commonly used withholding certificates. However, one specific type of withholding certificate appears to address the concerns of the IRS in a whistleblower situation because it would involve applying to the IRS for the certificate in advance based on the facts and circumstances of the taxpayer/whistleblower. With respect to the tax due under section 897, (commonly referred to as the Foreign Investment in Real Property Tax Act, or "FIRPTA"), an amount that must be withheld from the disposition of a U.S. real property interest can be adjusted pursuant to a withholding certificate issued by the IRS. The request for this kind of withholding certificate is made on a Form 8288-B *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests* (Rev. November 2006). In these situations, the transferee, the transferee's agent, or the transferor may request the withholding certificate from the IRS. The withholding certificates issued by the IRS with respect to FIRPTA are coordinated out of the Philadelphia Service Center.

This kind of withholding certificate can be issued by the IRS due to:

1) A determination by the IRS that reduced withholding is appropriate because either:
   a) The amount that must be withheld would be more than the transferor's maximum tax liability, or
   b) Withholding of the reduced amount would not jeopardize collection of the tax,
2) The exemption from U.S. tax of all gain realized by the transferor, or
3) An agreement for the payment of tax providing security for the tax liability, entered into by the transferee or transferor.

In a case where a whistleblower was represented by counsel on a contingent fee contract and had a valid above the line deduction for attorneys fees under section 62(a)(21), then reason 1)(a) above would apply: "*The amount that must be withheld would be more than the transferor's maximum tax liability*" to justify the IRS issuing a withholding certificate in such instance. *See* Publication 515.

Just like the proof of the reduced rate of taxation that could be provided to the IRS with respect to the withholding agreement discussed above, the whistleblower could provide proof to the IRS of their actual tax liability on their award. Normally, to obtain a withholding certificate under

FIRPTA, an applicant would have to provide to the IRS all information required to verify that representations relied upon in accepting the agreement are accurate, and that the obligations assumed by the applicant will be performed pursuant to the agreement. For the other commonly used withholding certificates referenced above, no application or proof is provided to the IRS to obtain the reduced withholding rate. The withholding agent relies merely on the representations made by the taxpayer on the withholding certificate they provide. By requiring an application for a withholding certificate with proof attached to it, rather than merely relying on the representations of the taxpayer/whistleblower on a form, the IRS could have comfort in advance that it is withholding on award payments under section 7623(b) at a rate which will result in the collection of the correct amount of tax.

Alternative 3: Eliminate Withholding. To avoid causing further harm to whistleblowers and to increase the chances of success in attracting more whistleblowers, the IRS could simply eliminate withholding on award payments to U.S. whistleblowers all together. Awards paid to NRA whistleblowers can be addressed on a facts and circumstances basis in accordance with PTMA 2011-02. As PTMA 2010-63 correctly states, the IRS is not required to withhold on these payments. Obviously the decision was made to do so anyway, claiming concern over the ability to later collect tax from whistleblowers on award income. However, the IRS is imposing this withholding policy on persons who in almost all cases would not be subject to Jeopardy Assessments under section 6861. The government doesn't even withhold on payments to its own contractors or grant recipients who are behind in their tax payments,[2] yet the IRS has singled out whistleblowers as a class of persons who are for some reason unlikely to pay their taxes. Again, it is another instance of sad irony that the IRS is hurting the very people who are trying to help them bring in more revenue to the government.

[2] *See* GAO-11-686T, May 24, 2011, *Thousands of Recovery Act Contract and Grant Recipients Owe Hundreds of Millions in Federal Taxes.*

Conclusion

The IRS policy of withholding on whistleblower award payments under section 7623(b) is legally indefensible and it adds insult to injury. Specifically, the current policy leads to gross overwithholding on most whistleblowers. The IRS has the authority and the capacity to alleviate the economic harm to the whistleblower caused by overwithholding by either entering into a withholding agreement with the whistleblower, by issuing the equivalent of a withholding certificate to the whistleblower, or by eliminating their withholding policy entirely. Either of the first two strategies would allow for the IRS to have an actual legal basis for withholding – the agreement or certificate itself – and would provide a means to establish with the whistleblower what the correct amount of taxation would be to avoid overwithholding.

We would be happy to assist the IRS in any way possible, and will make ourselves available for any further assistance deemed necessary so that a policy that is mutually beneficial to whistleblowers and the IRS can be established. Please do not hesitate to contact us at (202) 775-1630.

Sincerely,

Scott A. Knott

Gregory S. Lynam

cc: Robert Gardner
Neil Getnick
Erika Kelton
Brian Kenney
Steve Kohn
Paul Scott
Bryan Skarlatos
Jeb White
Dean Zerbe