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WHISTLEBLOWERS AND TAX ENFORCEMENT

Executive Summary

Throughout history, governments have relied on informants to help identify those who break the law. The U.S. government has sought to encourage tips through various techniques, such as by establishing hot lines and by trying to protect whistleblowers from retaliation. In some instances the government also offers rewards for tips that prove valuable.

In 1867, Congress passed legislation allowing the U.S. Treasury to pay informants for tips that lead to the recovery of unpaid taxes. Rewards are a percentage of what the government collects, with the percentage depending, within limits, on the usefulness of the information. In 2006, Congress established a special Whistleblower Office at the Internal Revenue Service (IRS) and set higher percentage rewards for tips that lead to very large recoveries (over \$2 million).

On net, evidence and economic analysis indicate that the tax whistleblower program is effective and better than many other current or proposed tax enforcement tools.

A 2006 study by the Treasury Inspector General for Tax Administration found that the informants' program was highly cost effective for the government. Formal investigations based on tips were more likely to result in recoveries and they cost the IRS less per dollar recovered than investigations based on the IRS's own statistical formulas for spotting tax underpayments. Moreover, by providing the government with an additional enforcement tool, a whistleblower program reduces tax evasion by making it riskier.

Although not mentioned in the 2006 study, a welcome hidden value of the whistleblower program is that it places fewer paperwork demands on taxpayers and third parties than many other enforcement programs. It is also less likely to entangle innocent taxpayers in IRS investigations.

A key reason why the whistleblower program works relatively well is that the IRS carefully and independently screens the tips it receives and only proceeds if the charges appear to have substance.

A word of caution: tax-enforcement efforts, of which the whistleblower program is only one, are more acceptable if a nation is a democracy, follows the rule of law, respects taxpayers' rights, keeps tax burdens low, and enacts tax rules that are clear and understandable. The current U.S. tax system is too complicated. It should be simplified for fairer and more efficient tax enforcement. Calls to increase taxes sharply on the taxpayers who are already bearing the heaviest burdens should be resisted.

WHISTLEBLOWERS AND TAX ENFORCEMENT

The federal government uses many tools in its efforts to enforce tax laws. One of its tools is to collect and evaluate tips supplied by informants. The government has long seen value in informants, and, in 2006, Congress enacted legislation that modifies and significantly expands what it now calls the whistleblower program. Given the recent changes, as well as Congress's continuing interest in adding new enforcement devices and expanding old ones, it is worth examining whether the whistleblower program is an appropriate part of the tax system. A backdrop to the study is the tension that exists between, on the one hand, collecting tax dollars, and, on the other hand, guarding against government enforcement efforts that are unreasonably costly to taxpayers or deprive them of their rights.

Since 1867, the federal government has used monetary incentives to encourage tax whistleblowing.¹ Under section 7623 of the Internal Revenue Code, the U.S. Treasury Secretary "is authorized to pay such sums as he deems necessary for – (1) detecting underpayments of tax, and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws..." Congress has tweaked the tax statute for whistleblowers several times over the years. Probably the biggest change occurred in 2006 when, as part of the Tax Relief and Health Care Act of 2006 (P.L. 109-432), Congress significantly increased the rewards for whistleblowers who provide information resulting in multi-million-dollar tax collections.

Americans have long been of two minds about whistleblowers. One view is that whistleblowers are snitches, betray confidences, are self-serving, and sometimes provide false information.

The other view is that regardless of informants motivations (civic responsibility, a grudge, or some other impulse), they help uncover violations of the law. In his classic "Democracy in America" (1835),

Alexis de Tocqueville described what is essentially whistleblowing as an aspect of American exceptionalism and one that promotes the rule of law while allowing the government to be smaller and less intrusive than otherwise.

"In America, the means available to the authorities to uncover crime and to arrest criminals are small in number. . . . However, I doubt whether crime evades punishment less often in any other country. The reason for that is that everyone feels involved in *providing evidence* of the offense and in apprehending the offender."² [Emphasis added.]

Supporters of government whistleblower programs argue that the initiatives are cost effective and improve general legal compliance.

Types of whistleblowing programs and laws

Most whistleblowing activities have nothing to do with federal taxes or the Internal Revenue Service (IRS). For example, whenever a company or a government agency provides a suggestion box or 800 number for anonymous suggestions and tips by employees, suppliers, or other parties, the organization can be thought of as operating a whistleblower program. Similarly, people who pass tips to the police about crimes and criminals are often behaving as whistleblowers. Of course, an informants' program cannot be effective unless the complaints are carefully reviewed. Further, because many complaints are baseless or exaggerated, it is vital that each accusation be treated skeptically unless investigation bears it out.

At a more formal level, numerous government agencies maintain an office of the inspector general or equivalent position. While these offices launch many investigations on their own initiative, informants are a valuable resource and often provide

leads and evidence that help uncover cases of waste, fraud, abuse, or negligence that would otherwise escape detection.

In terms of federal statutes, the government's most powerful whistleblower tool is the False Claims Act (now 31 U.S. Code, sec. 3729-33). Passed during the Civil War at President Lincoln's behest, this law responded to fraud accusations against some military suppliers. The False Claims Act allows citizens to act as agents of the government and sue those they accuse of defrauding the government. (These suits, in which private citizens sue as self-appointed agents of the government, are known as "qui tam" suits.) In the act's original form, for each false claim on which the accused was convicted in court, the government could collect double damages and a \$2,000 fine, and half of that went to the party filing the suit (known as the "relator"). During World War II, in response to the perception that some accusers were abusing the act, Congress scaled back the rewards. In 1986, Congress moved in the other direction. The 1986 amendments increased monetary penalties for those convicted of defrauding the government and generally set the relator's share of the recovery at between 15% and 30%, with a reduced share if the relator participated in the false claim or if the conviction was mainly based on information not provided by the relator.³ The government has the option of intervening in the cases, if it wishes.

Because government and private-sector employees who suspect their employers are not behaving properly might hesitate to come forward if they fear on-the-job reprisals, Congress has also enacted a number of laws that attempt to protect whistleblowers from job-related retaliation.⁴ Many states likewise try to protect whistleblowers.

The False Claims Act is widely regarded as sound in general concept, and so is the idea of protecting informants from retaliation. There are heated disputes, though, about whether the specific legislative details strike the right balance. As just two examples, many whistleblowers within the government believe that coming forward has derailed their careers,⁵ while many private companies can

point to cases in which they believe *they* were the victims, harassed by employees who filed baseless charges of retaliation after claiming to be whistleblowers.

The False Claims Act explicitly does not apply in the tax area,⁶ but the Treasury has historically accepted tips, anonymous or otherwise, about unpaid taxes. The Treasury, though, has generally avoided actively soliciting tips. Restraint in this area is desirable because it reduces the odds that the government will pressure informants into providing false information or betraying confidences. As noted earlier, the Treasury has long offered rewards for tips that result in added tax collections, but it usually does not mention the availability of rewards unless asked. Congress does not allow "qui tam" suits in tax cases, perhaps in recognition of the potential for harassment and reduced financial privacy if people could sue each other for allegedly not paying enough tax.

The IRS's Whistleblower Program

A person with a tip can call, write, or visit the IRS. However, those seeking an informant's reward must also file IRS Form 211, "Application for Award for Original Information." The IRS's Whistleblower Office then evaluates the information to determine if it is worth pursuing.

The existence of a separate Whistleblower Office at the IRS is fairly recent. In writing the Tax Relief and Health Care Act of 2006, Congress created the office to give tips from informants a higher profile within the IRS and to provide for more uniform treatment of informants.

Weeding out questionable tips at an early stage is extremely important to minimize the burden on innocent taxpayers and economize on the IRS's time. Most tips do not contain actionable information. Mark Matthews, IRS Deputy Commissioner for Services and Enforcement at the time, commented, "Over 90% of informant reports we receive yield little or no usable information."⁷ Moreover, the word of a tipster cannot safely be accepted without a critical, independent review because, as one news

story put it, "Typical informants include what one government official calls 'the exes' – ex-boyfriends and girlfriends, ex-spouses and ex-business associates."⁸ Some "exes" manufacture allegations simply to hurt the taxpayer. On the other hand, although informants often have what Mr. Matthews described as "motives that are less than pure," their tips sometimes furnish powerful evidence that could not be obtained elsewhere.⁹ That is to say, even when informants act for self-interested reasons, they may sometimes be serving the broader interests of society.

If the IRS proceeds with a case and eventually collects, the reward, except in certain large cases, is up to 15% of the taxes, fines, and penalties (but not interest) that the Treasury recovers.¹⁰ The IRS emphasizes that the percentage will depend on how helpful the informant's information is in building the case. The reward is not to exceed 10% if the information was valuable but not specific, and it is not to exceed 1% if the tip sparked the inquiry but was not of further use. Subject to these ceilings, the IRS has sole discretion to decide whether a reward is merited and at what percentage, and the IRS's decision cannot be appealed. The whistleblower normally receives payment only after the tax case has been settled, which takes an average of about 7½ years.¹¹

The Tax Relief and Health Care Act of 2006 added a second, more generous reward structure for large cases.¹² Large cases are defined as those involving additional taxes, fines, penalties, and interest of over \$2 million. Further, if the alleged tax underpayer is an individual, the taxpayer's gross income must exceed \$200,000 in at least one of the tax years in dispute. In these large cases, the reward is between 15% and 30% of additional tax, fines, penalties, and interest. However, the reward is not to exceed 10% if the determination is primarily based on allegations from other sources, such as hearings, audits, or news accounts. Also, the reward is to be reduced if the informant planned or initiated the underpayment. Within these bounds, the IRS's Whistleblower Office decides the percentage based on the value of the information. However, the

Whistleblower Office's does not have the final say in determining rewards in these large cases: informants who are dissatisfied may appeal the amount or the denial to the U.S. Tax Court. In large cases, the legislation also removes a dollar cap that had previously limited the maximum amount of any reward.

When the government pays rewards, the payments are treated as additions to informants' taxable incomes. That reduces the government's net cost in making awards because informants have to hand back a portion when they submit their own taxes. In large tax-whistleblower cases, the Tax Relief and Health Care Act of 2006 contains a provision to make sure that informants can deduct attorney fees related to the awards. (Informants often use lawyers as intermediaries in their dealings with government enforcement agencies.)

To respect the privacy of all parties, the IRS's general policy in whistleblower cases is not to publicly identify the informant (although taxpayers can sometimes guess from the nature of the allegations) and to avoid telling the informant anything about the taxpayer (although a limited exception may be made when the informant is needed to review certain tax information).

The pre-2006 law was cost effective for the government

In a study requested by the Senate Finance Committee and issued in 2006, the Treasury Inspector General for Tax Administration concluded that the IRS's Informants' Rewards Program (the pre-2006 name for the program) enabled the government to collect additional money and did so in a cost-effective manner.¹³ As a result, the program "significantly contributed to the IRS' efforts to enforce tax laws."¹⁴ The Inspector General's Office found that during fiscal years 2001-2005, the program generated "over \$340 million in taxes, fines, penalties, and interest ... with rewards of over \$27 million paid to informants."¹⁵ Between the late 1960s and 2005, recoveries totaled almost \$3 billion.¹⁶

The Inspector General's report referred to an earlier study which found that the program was superior in key respects to the IRS's own statistical formulas¹⁷ for spotting suspicious tax returns. In fiscal years 1996-1998, the IRS's costs were "slightly over 4 cents ... for each dollar collected from the Informants' Rewards Program (including interest), compared to a cost of over 10 cents per dollar collected for all enforcement programs."¹⁸ Moreover, when the IRS pursued cases, tips were more likely than the IRS's own statistical formulas to result in recommended tax changes: 88% versus 83% during fiscal years 1996-1998. Similarly, in fiscal years 2003-2005, at the IRS's Small Business/Self-Employed (SB/SE) Division, examinations stemming from informants' information led to recommended tax changes 79% of the time while examinations based on the IRS's own statistical tools led to recommended tax changes only 72% of the time.

Although not mentioned in the Inspector General's study, an important corollary is that the whistleblower program was less likely to inconvenience innocent taxpayers than many other IRS programs.

The Inspector General's Office expressed several concerns, though: different IRS units often followed different procedures in handling cases; centralized management oversight was lacking; there was no national database regarding informants' claims; decisions to reject claims were poorly documented; and when rewards were made, case files frequently did not explain how the IRS chose what percentage to award the tipster. The IRS responded that it agreed with the recommendations and was already consolidating the program in a single office and establishing a national database.

The generally positive report, along with the criticisms, were factors when Congress voted later in 2006 to expand the whistleblower program. Senator Charles Grassley (R-IA), who has been the leading proponent of federal whistleblowing initiatives for the last 20 years, articulated the opinion of many

members of Congress when he said the Treasury and IRS "are in a tough fight against tax cheats, and they need to put out the welcome mat for whistleblowers."¹⁹

Do rewards encourage whistleblowing and are the 2006 changes working well?

The long-standing desire of enforcement agencies throughout government to receive tips suggests that informants provide value. The Inspector General's report confirmed this value at the IRS, where leads supplied by informants cost less to investigate and had better odds of producing recoveries than the IRS's own statistical methods for identifying suspicious returns.

Moreover, when it comes to paying informants, Congress is correct that people respond to incentives. By offering rewards for information that leads to recoveries, the IRS receives more tips and recovers more money than if it did not pay rewards. Another benefit of rewards in terms of tax enforcement is that it gives taxpayers more incentive to comply with the law if they know that the government is paying whistleblowers.

This does not tell us, of course, what reward structure is best in terms of enforcement. Once the new, more generous reward system for large cases has been in operation long enough to see results, it would be very useful if the Inspector General for Tax Administration or the Government Accountability Office were to perform a study to compare experience under the new system with performance under the system that still applies in most whistleblower cases. In particular, will the new reward structure produce an upsurge in tips compared to the regular system? Will the additional information be of higher or lower quality than the IRS normally receives in whistleblower cases? When informants in large cases claim they should be paid more, will the option of appealing to the Tax Court work smoothly or lead to extended litigation and huge bounties for tips the IRS thinks are of little value? The answers to these and similar questions

will clarify whether further adjustments in the reward structure would be helpful from an enforcement perspective.

Gauging compliance costs for honest taxpayers

Many conceivable government enforcement practices would improve tax compliance – but at an excessive cost to taxpayers who are playing by the rules.

For instance, from the 1960s to the late 1980s, the IRS regularly conducted exhaustively detailed tax audits of a randomly chosen sample of taxpayers under its Taxpayer Compliance Measurement Program (TCMP). Although the audited taxpayers were not accused of doing anything wrong, they were nevertheless forced to defend every line on their tax return, such as providing a marriage license if they claimed to be married or furnishing a dependent child's birth certificate and report card if they claimed the child was of school age and living with them. These random audits, which were dubbed "tax audits from hell", aided tax enforcement by allowing the IRS to better understand where noncompliance was most likely, but they were eventually discontinued because of public outrage at their intrusiveness, and the time and money they cost innocent taxpayers.²⁰ (The IRS has more recently conducted random audits to measure tax compliance under its National Research Program, but these audits are fewer and not as onerous as the old ones.²¹)

Another way to improve enforcement would be by requiring employers, banks, and other third parties to report additional information about taxpayers' incomes and expenses. However, Congress already requires so much third-party reporting that most of the low-hanging fruit has been picked. Many proposals for yet greater third-party reporting are troubling because they involve data that are inaccurate, confusing, difficult to gather without inconveniencing taxpayers, or expensive for third parties to assemble. For example, Congress tucked into the recently enacted housing legislation (H.R. 3221, which became P.L. 110-289, the "Housing and Economic Recovery Act of 2008") a provision that requires credit card companies and

other third-party payment processors to tell the IRS how much they pay each merchant, except for very small merchants. Congress is correct that telling the IRS more about merchants' gross receipts will aid tax enforcement (Congress's Joint Committee on Taxation estimates it will pull in \$10 billion over 10 years²²), but the business community is concerned because it will be expensive to prepare and distribute the information returns and review them for accuracy, while privacy advocates worry about security and privacy risks.

Similarly, Congress could improve tax compliance by enacting stiffer, more easily triggered penalties. However, many penalties are already so high that they raise questions about whether the punishment fits the infraction, and penalties with hair triggers have the drawback that they penalize many basically innocent taxpayers for inadvertent, debatable, or hyper-technical violations.

In contrast, the whistleblower program leaves most taxpayers and third parties alone, and saddles them with no extra compliance costs. That is a significant point in its favor. Of course, taxpayers who are investigated as the result of informants' tips do incur the costs and aggravation of collecting and producing records and paying accountants and lawyers. However, the Inspector General's report indicates that after the IRS finishes reviewing and filtering the tips it receives, the investigations it launches are better targeted than most IRS investigations. In terms of taxpayers' compliance costs, that is another point in favor of the whistleblower program.

The whistleblower program and the tax gap

Although tax compliance is relatively high in the United States compared to many other countries, not all taxpayers pay as much as they owe. Most tax evasion is accomplished by underreporting income (omitting income items or overstating credits and deductions). In addition, some taxpayers do not file required returns, and some do not pay the Treasury what they have calculated they owe. The underpayments are called the tax gap. The size of the gap is not precisely known. An often-cited IRS

guess is that it was \$345 billion in 2001, with \$55 billion of that subsequently recovered by the IRS or paid late, leaving a net tax gap of \$290 billion.²³

The tax gap is often viewed in Washington as a challenge to government power and an attractive revenue source. The problem is how to reduce the tax gap without imposing huge costs on a broad swath of the population or thoroughly trampling upon taxpayers' civil liberties. As mentioned above, the whistleblower program is much less burdensome with regard to these concerns than many other enforcement options.

The amount recovered through informants' tips is small compared to the tax gap, but for those who want to narrow the gap, every dollar helps. Moreover, beyond the dollars it explicitly recovers, the whistleblower program reduces the tax gap by deterring some cases of tax evasion.

Fairness

Fairness is prominently mentioned in discussions of whistleblowing laws. Unfortunately, fairness is a highly subjective concept, with a person's perception of fairness often depending on his or her own circumstances. Whether or not people regard whistleblowing as fair depends critically on their attitude toward the tax system and the perceived behavior of tax cheats and the IRS.

The general public. People tend to become upset when they hear of someone who thumbs his or her nose at tax laws, be the transgressor a neighbor, acquaintance, business partner, business rival, or someone in the news. Because most people believe they are paying more than enough tax dollars to the government, the reaction is partially based on the feeling that those who do not pay what they owe are gaining an unfair advantage. Some people may also be bothered because tax evasion reduces government revenues, which means less money is available for government spending programs. Accordingly, many people may feel that encouraging whistleblowing serves justice and makes the tax system fairer.

A major caveat is that if people regard tax levels or rules as oppressive or discriminatory, they may be sympathetic to tax evasion and critical of whistleblowing. People may also believe that enforcement efforts, including whistleblowing, have gone too far if tax enforcers appear to be out of control. In the 1980s and 1990s, stories emerged about the IRS treating some taxpayers in an overly aggressive and confrontational manner, sometimes in violation of the law. The General Accounting Office (GAO) reported, "Despite IRS' efforts to prevent violations of taxpayers' rights, we found various instances of what we consider to be taxpayer abuse by IRS."²⁴ The GAO noted violations of the law, violations of the IRS' rules of conduct, application of "discretionary enforcement power in a way that appeared to unnecessarily create a financial or other hardship for the taxpayers", and problems due to the IRS's flawed computer system.²⁵ The GAO also criticized the IRS for lacking a management information system to track and quantify the extent of taxpayer abuse.²⁶ A series of congressional hearings showcased the problems.²⁷ Congress and the President responded by enacting a Taxpayer Bill of Rights in 1988, another in 1996, and a third in 1998. Since then, the IRS has taken steps to redress the problems and seems to have made progress in that there have been fewer reports of overzealous IRS enforcement efforts. Partially as a result, there has been less criticism of the whistleblower program in recent years.

Taxpayers pointed to by informants. Taxpayers accused of underpaying their taxes or concerned they might be accused in the future have more direct concerns about the underlying fairness of the tax system. If the government has a reputation for doggedly pursuing the accused regardless of guilt or innocence, the tax system will seem unjust to them and so, by extension, will an informants' program. The tax system will likewise appear unfair and taxpayers will have good reason to condemn whistleblowing if the government uses alleged tax violations to punish those it does not like or if the government in general oppresses the citizenry. Regrettably, such abuses occur in many countries.

From the perspective of those who pay taxes, extremely heavy taxes also undermine fairness. For example, although some people insist that highly redistributive taxes are fair, the people from whom the money is taken often regard the coercive redistributions as akin to theft. Similarly, when governments impose exorbitant taxes on particular commodities, such as alcohol or cigarettes, consumers of the taxed products often feel victimized and regard the exactions as unjust.²⁸

Another problem arises if tax statutes are so complex and murky that taxpayers who want to play by the rules, but not overpay their taxes, cannot be sure what the rules are. This is an area where the United States, with its mind-numbingly complicated individual and corporate income taxes, is open to criticism. It is unfair when the tax system is so hard to understand that many taxpayers, especially those with business income, investment income, and foreign-source income, who try to be honest are at risk of being accused of dishonesty.

The 2006 whistleblower legislation may have made concerns about the tax code's lack of clarity more acute. Some law firms have responded to the fattened rewards in large whistleblower cases by suggesting that people become informants (and hire the law firms for assistance, in return for a share of any eventual rewards) if the potential tipsters have information on companies that have taken aggressive tax positions in areas where the tax code is murky, even if there is no indication that the companies engaged in fraud or otherwise intended to break the law.²⁹ The whistleblower program's perceived fairness and its appeal as a means of bringing the guilty to justice will suffer if it becomes primarily a device for extracting more money from taxpayers in cases where the real culprit is the tax code's complexity and ambiguity.

Enhancing fairness. In some countries, government limitations on personal freedom and disregard for the rule of law are so great or taxes are so crushing that reasonable people in those places might wonder whether informants are instruments of justice or oppression. In the United States, taxpayers are most likely to perceive the IRS's whistleblower

program as fair if the tax system possesses various characteristics that can be summed up in the word "moderation". IRS agents should behave courteously and professionally (and the vast majority do). Tax levels should be low. Tax rules should be simple and clear. Consider a few examples of helpful and hurtful tax changes.

- The safeguards provided by the three taxpayer rights bills of the 1980s and 1990s have dramatically lessened criticism of IRS enforcement efforts. Conversely, if a future Congress were to order the IRS to return to its previous, highly aggressive tactics, the IRS and its enforcement programs would quickly earn a black eye. Senator Grassley, who has consistently supported the whistleblower program in combination with taxpayer rights legislation and relief for those paying the heaviest taxes, ably expressed the desirability of moderation when he said, "The Federal Government needs to collect its revenue, which taxpayers are obliged to pay. But taxpayers have certain rights that should not be abused. All of us should support a proper balance between these two needs."³⁰

- The Bush tax cuts eased the tax load for people at all income levels, including upper-income individuals who tend to pay the heaviest taxes. Two of the provisions that have reduced the tax load where it is heaviest are the marginal tax rate cuts in the top brackets, such as lowering the top statutory rate from 39.6% to 35%, and the scaling back of the estate and gift tax, which is better known as the "death tax". If redistributionists have their way, however, the top income tax rates will jump back to their pre-2001 values or climb even higher, and the draconian and complicated pre-2001 "death tax" will come roaring back. Although redistributionists would laud that as fair, many heavily taxed people would denounce the undoing of the earlier reforms as grossly unfair. Higher taxes would make it harder to enforce tax laws because of greater complexity, because people with disproportionately heavy burdens would regard the system as less fair, and because they would have a stronger financial incentive to avoid taxes (legal changes in behavior to reduce taxes) or evade taxes (illegal techniques).

- Tax simplification would bolster fairness and improve tax compliance by letting taxpayers better understand the rules. The Treasury Inspector General for Tax Administration explained, "Tax complexity and frequent revisions to the Internal Revenue Code make it more difficult and costly for taxpayers who want to comply with the system's requirements, and for the IRS to explain and enforce the tax laws....Simplification and reform have the potential for reducing the tax gap by billions of dollars."³¹ Sadly, legislators have pushed the tax system in the opposite direction. A proliferation of tax credits (which are often disguised spending programs), Congress's growing inclination to phase out various credits and deductions with rising income, increasingly complicated tests for determining eligibility for various credits and deductions (with many of the tests serving as hidden revenue raisers), and the rapidly expanding reach of the alternative minimum tax (a parallel income tax with arbitrary, unfamiliar rules) are among the factors leading to constantly worsening tax complexity.

Conclusion

Many people are ambivalent about a tax-enforcement program that uses informants, especially when the government pays rewards for tips that prove valuable. Probably the main reason for the ambivalence is that some informants have selfish motives, not the mixture of altruism and moral responsibility suggested by the term whistleblower. However, regardless of informants' motives, the IRS whistleblower program is, on net, a reasonable means for improving the enforcement of the tax laws.

The whistleblower program bolsters tax compliance by helping the IRS identify individual

and business taxpayers who are underpaying their taxes, and it does so in a cost-effective manner. The program has the virtue that, except in rare cases, it does not impose extra paperwork costs on innocent taxpayers and third parties, which is a welcome contrast to many tax-enforcement requirements and programs.

Another plus is that the IRS independently reviews the accusations and only proceeds with a formal investigation if the evidence looks strong. To be sure, tips sometimes lead the IRS to examine taxpayers who are ultimately found to owe nothing extra, which inconveniences and distresses the innocent taxpayers. However, because the IRS screens its tips carefully, investigations based on informants tips are actually less likely to ensnare innocent taxpayers than investigations triggered by the IRS's own statistical tools.

A valid criticism, but one that applies to enforcement in general, is that the tax code is too complex and unclear for many taxpayers with complicated returns to be sure they have computed their taxes correctly. That makes them vulnerable to IRS enforcement actions. Tax enforcement would be fairer if Congress simplified the tax system. Regrettably, most tax bills that emerge from Congress make the system more complex. Also troubling is the possibility that a future Congress will sharply raise taxes for those who already shoulder the heaviest tax burdens. Very high taxes simultaneously create stronger incentives to evade taxes and erode the moral authority of those who try to enforce tax laws.

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Endnotes

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8. *Ibid.*
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12. See 109th Congress, Second Session, Tax Relief and Health Care Act of 2006 (H. R. 6111, which became P.L. 109-432), sec. 406.
13. Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," *op. cit.*
14. Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," *op. cit.*, p. 1 of cover note.
15. Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," *op. cit.*, p. 1 of cover note.
16. Herman, "IRS Reworks Its Whistle-Blower Program," *op. cit.*
17. The Inspector General's Office explains, "IRS' primary method of selecting returns, the Discriminant Index Function (DIF) ... is a mathematical technique used to classify income tax returns for examination potential by assigning weights to certain basic return characteristics." (Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," *op. cit.*, p. 4.)
18. Treasury Inspector General for Tax Administration, "The Informants' Rewards Program Needs More Centralized Management Oversight," *op. cit.*, p. 4. The numbers cited in the remainder of the paragraph in the text are also from this study.
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20. For example, see Kay Bell, " IRS Reinstates Random, Detailed Audits," Bankrate.com, February 19, 2003, accessed at <http://www.bankrate.com/brm/itax/news/20020325a.asp>.

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22. U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Tax Provisions Contained in H. R. 3221, The 'Housing and Economic Recovery Act of 2008,'" JCX- 64- 08, July 23, 2008, accessed at <http://www.jct.gov/x-64-08.pdf>.
23. See Internal Revenue Service, "IRS Updates Tax Gap Estimates," IR-2006-28, February 14, 2006, accessed at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>. For a more detailed discussion of the tax gap, see Mark J. Mazur and Alan H. Plumley, "Understanding The Tax Gap," *National Tax Journal*, September 2007.
24. U.S. General Accounting Office, "IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly," GAO/GGD-95-14, October 1994, p. 5, accessed at <http://www.gao.gov/archive/1995/gg95014.pdf>.
25. GAO, "IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly," *op. cit.*, p. 6.
26. In addition, the GAO was aware of allegations that whistleblowers within the IRS sometimes faced retaliation for reporting shortcomings at the agency. The GAO could not estimate the severity of this problem, however, because the IRS neglected to track these cases. (See U.S. General Accounting Office, "Allegations of IRS Employee Misconduct," GAO/GGD-99-82, May 1999, pp. 2-4 and 19-22, accessed at <http://www.gao.gov/archive/1999/gg99082.pdf>.) It is ironic that an agency with an informants program failed to recognize the value of internal whistleblowers and the importance of protecting them from retaliation.
27. For on-line links to Taxpayer-Bill-of-Rights hearings and legislation, see "The Taxpayer Bill of Rights," UncleFed's Tax*Board, National Tax Services, Inc., accessed at <http://www.unclefed.com/TxprBoR/index.html>.
28. The sense of injustice, together with the financial gains from evasion, largely explain why cigarette smuggling is flourishing in this country, as state government raise tobacco taxes to extraordinary levels. For a recent news report on inter-state tobacco-tax evasion, see "Cigarette Tax Burnout," *The Wall Street Journal*, August 11, 2008, accessed at http://online.wsj.com/public/article_print/SB121841215866128319.html.
29. Specific law firms will not be cited here, but several can easily be found through a quick search on the Internet. The law firms are not acting improperly, given the law, but, as suggested in the text, the law itself may need improvement.
30. Senator Charles E. Grassley, "Testimony of Senator Charles E. Grassley," Senate Finance Committee, IRS Investigative Hearings, September 23, 1997, accessed at <http://www.unclefed.com/TxprBoR/1997/Grassley.html>.
31. The Treasury Inspector General for Tax Administration, *Semiannual Report To Congress, October 1, 2007 through March 31, 2008*, p. 16, accessed at http://www.treas.gov/tigta/semiannual/semiannual_mar2008.pdf.