Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Stephen A. Whitlock
Director, Whistleblower Office

from: Deborah A. Butler
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subject: Withholding Recommendation

ISSUE

Whether the Service is permitted to withhold income tax on Whistleblower awards under section 7623(b) of the Internal Revenue Code.

CONCLUSION

While challenges to withholding may conceivably be raised, the Service may withhold on Whistleblower awards. Withholding at the highest individual income tax rate provided under section 1 is legally defensible.[1]

DISCUSSION

Section 7623(b), which makes Whistleblower awards mandatory under certain circumstances, is very different than the previous informant award program now found in section 7623(a) (prior reward program). We understand that certain aspects of the prior reward program will be continued, while others will necessarily be different.[2]

[1] The proposed maximum individual withholding rate can be justified by simple mathematics (a minimum payout could be $300,000 - $600,000, computed as 15% - 30% of the $2,000,000 threshold) since withholding is designed to approximate the potential income tax liability. The principal purpose of withholding is to assure current payment of the correct amount of Federal income taxes. See, for example, Notice 92-6, 1992-1 C.B. 495.

[2] Based on conversations with Greg Kane, Deputy CFO, the Service currently retains award payout information and prepares and sends Forms 1099 to award recipients but the Service has not withheld on awards paid under the prior reward program. Under the prior reward program, the awards could be retained in their entirety or decreased to satisfy outstanding liabilities on the part of the informant under common law set off

principles. Because new section 7623(b) includes several requirements that are inconsistent with existing regulations and administrative guidance applicable to award claims under section 7623(a), the regulations that appear at section 301.7623-1, which were promulgated under section 7623(a), are generally not applicable to the new award program authorized by section 7623(b). See Notice 2008-4, 2008-1 C.B. 253, which provides interim guidance applicable to award claims submitted under the authority of section 7623(b). The stakes are extremely high given the sheer size and volume of the expected claims.[3]

Under section 7623(b), awards will be vastly larger; and, therefore, the revenue consequences of nontax compliance will increase exponentially. Moreover, there is a much greater likelihood that awards could be paid to individuals in foreign countries, who may not otherwise have had a federal income tax filing obligation in the United States,[4] and to other individuals who may have been less than totally compliant in their personal filing obligations.

There is no specific statutory authority to withhold on Whistleblower awards.[5] There is also no direct prohibition against doing so. Nor is there currently a single existing withholding regime that will cover all circumstances. As discussed below, the Service has several available options. We consider it legally defensible to implement a systemic, consistent method of withholding at the time of payment of the awards rather than relying on available piecemeal, more burdensome, less efficient means to accomplish the same end result. As also discussed below, any challenge to the Service's ability to withhold will not be immediate. The Service should carefully weigh the risk of losing the tax revenue against the risk of a future challenge that the Service is not authorized to withhold without specific statutory authority.

EXISTING REGIMES

Depending on specific fact patterns, withholding is specifically authorized under sections 3402(t), 1441, 3406, 3402(p)(3)[6], or by contract. It may also possible to make

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[3] Many claims are based upon nontax compliance for multiple millions of dollars of unpaid tax.

[4] We understand that CC:INTL is currently working on a project concerning withholding on awards under section 1441. We note that any withholding under this section may be reduced or eliminated by applicable treaty provisions.

[5] Historically, all identified existing withholding regimes have a statutory basis. See Chapters 3 and 24.

[6] Section 3402(p)(3) is a voluntary withholding regime that appears broad enough to encompass Whistleblower awards. Section 3402(p)(3) requires regulations. We note

jeopardy assessments when warranted to ensure that the tax is paid on the awards. Using these specialized regimes is neither administratively efficient nor reliable.

In analyzing withholding outside the statutory framework, it is not insignificant that the Service has the authority to do whatever is needed to properly enforce the tax laws. Congress has delegated to the Commissioner the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code. National Muffler Dealers Assn., Inc. v. United States, 440 U.S. 472, 477, 99 S. Ct. 1304, 59 L.Ed.2d 519 (1979) (citations omitted). This delegation "helps guarantee that the rules will be written by 'masters of the subject' who will be responsible for putting the rules into effect." 440 U.S., at 477, 99 S. Ct. 1304 (quoting United States v. Moore, 95 U.S. 760, 763, 24 L.Ed. 588 (1877)). See also United States v. Correll, 389 U.S. 299, 307, 19 L. Ed. 2d 537, 88 S. Ct. 445 (1967)(Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U. S. C. § 7805 (a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." Commissioner v. Stidger, 386 U.S. 287, 296. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.) Further, the Secretary's plenary authority over tax matters is acknowledged in the closing agreement provisions. See section 7121.

The federal government has successfully maintained its right under the common law to collect debts by means of offset, and the courts, including the Supreme Court, have recognized and upheld this right. In United States v. Wurts, 303 U.S. 414, 415 (1938), the Court stated, "The Government by appropriate action can recover funds which its agents have wrongfully, erroneously, or illegally paid." See also Woods v. United States, 724 F.2d 1444 (9th Cir. 1984) (food stamp program); Collins v. Donovan, 661 F.2d 705 (8th Cir. 1981) (Labor Department recoupment regulations under Trade Act of 1974); Jacquet v. Westerfield, 569 F.2d 1339 (5th Cir. 1978) (Aid to Families with Dependent Children program); DiSilvestro v. United States, 405 F.2d 150 (2d Cir. 1968) (erroneous payment of disability benefits by Veterans Administration).

It could be argued that some of the Service's options are limited because the proposed liability on an award to the Whistleblower does not technically exist at the time the award is paid, even though it is clear that the informant awards are subject to federal income tax.[7] It is axiomatic that, for every Whistleblower award paid, there will be a resulting income tax liability. Correspondingly, there is great risk concerning the

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that the Service may be limited in its ability to encourage an uncooperative taxpayer to submit to voluntary withholding.

[7] Section 61 provides generally that all accessions to wealth are income unless otherwise provided by law. Treas. Reg. section 1.61-2(a)(1), specifically includes rewards in gross income.

Service's ability to recover known tax on these awards once the payment leaves the control of the government, unless protective actions are taken, particularly if an award is paid to a person with foreign contacts who might easily remove the money from the reach of the government.

It is the Service's long-standing position that a tax liability legally exists independent of any action on the part of the Service, such as the assessment of the liability. See Rev. Rul. 2007-51, 2007-2 C.B. 573; Goldston v. United States, 104 F.3d 1198, 1199-1200 (10th Cir. 1997) (tax liability arises from statutory duty to pay tax, not assessment of liability); and United States v. Latham, 754 F.2d 747, 750 (7th Cir. 1985) (assessment is an administrative determination that is not a prerequisite to tax liability.)

Moreover, the Service has taken steps that support establishing a withholding regime on a clean slate for all awards. Administrative guidance, such as Notice 2008-4 and publically available information such as that found at http://www.irs.gov/compliance/article/0,,id=180171,00.html have consistently provided that Whistleblower awards are taxable, and will be subject to current federal tax reporting and withholding requirements. Information pertinent to the prior reward program has been removed or is being revised in the interim. See Pub. 733, Rewards for Information Provided by Individuals to the Internal Revenue Service (obsoleted 6-19-08), and historical revisions to IRM 25.2.2.

It is important to withhold to ensure that the tax liability on Whistleblower awards is collected prior to any disputes over contingency fee arrangements or constructive receipt issues. The Service should not be in a position from an administrative standpoint of refereeing disputes between Whistleblowers and their counsel or other representatives.

JEOPARDY ASSESSMENTS

The Service may also use jeopardy assessment procedures to immediately assess taxes owed by a taxpayer and to demand payment from the taxpayer when the Service believes that delay would jeopardize future collection of taxes. Section 6861(a). Jeopardy assessments should be used sparingly; withholding is the preferred alternative.

CONTRACTS

An argument can be made that a defensible practice would be to execute contracts, which we understand is not the preferred method of handling these cases. We note that section 7623(c) specifically does not require a contract (but equally important does not prohibit a contract). We note that it is unlikely that Whistleblowers will voluntarily enter into contracts. We also note that when the Service is required to defend against challenges to the denial or amount of an award, the Service must consider restrictions against disclosure. There will necessarily be competing interests.

FUTURE CHALLENGES

The immediate repercussions for withholding without clear statutory authority are remote. For payments made in 2010, the earliest time a Whistleblower could generally challenge the withholding would be April 15, 2011, the required filing date for an individual income tax return for 2010. Before a taxpayer is entitled to a return of the withholding, the taxpayer must demonstrate that there is an overpayment. An overpayment for 2010 cannot be established before the return for the year is a filed.

Moreover, challenges are arguably barred by the Anti-Injunction Act in section 7421(a). The purpose of section 7421(a) is to permit the United States to assess and collect taxes alleged to be due without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund. See Enochs v. Williams Packing & Navigation Co., 370 U.S. 1, 5, 8 L. Ed. 2d 292, 82 S. Ct. 1125 (1962) ([t]he Anti-Injunction Act "withdraw[s] jurisdiction from the state and federal courts to entertain suits seeking injunctions prohibiting the collection of federal taxes," unless a litigant demonstrates one of several statutory exceptions...). The general rule is that, except in very rare and compelling circumstances, federal courts will not entertain actions to enjoin the collection of taxes. See Mathes v. United States, 901 F.2d 1031, 1033 (11th Cir.1990).

The Tax Court has jurisdiction to consider an appeal over an award under section 7623(b), presumably both as to a denial and as to the amount. Section 7623(b)(4). This applies only to awards under subsection (b) and not (a). The Tax Court has exclusive jurisdiction to entertain section 7623(b) award challenges. See DaCosta v. United States, 82 Fed. Cl. 549 (2008).

Weighing the future potential challenge to the Service's authority to withhold against the possible tax losses while factoring in the that taxpayers have been put on notice as to both the taxability of awards and the potential for withholding on the awards, it makes little sense to allow the entire Whistleblower award to leave the control of the government knowing that it is subject to tax and subject to common law setoff principles and various other withholding regimes. On balance, we conclude that it is permissible to withhold potential income tax on Whistleblower awards under section 7623(b).