“Should Tax Informants Be Paid? The Law and Economics of a Government Monopsony”

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by

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Abstract

The Internal Revenue Service promises confidentiality to all who provide it with information about violations of federal tax law and rewards of up to $2,000,000 per tip. Senator Charles Grassley (R-Iowa), Chairman of the Senate Finance Committee, has proposed removing the cap on such rewards, and changing the IRS-administered program in other ways, as a means of combating tax cheating and increasing federal revenues. Illogically, the Wall Street Journal opposed Senator Grassley’s proposals.

This paper analyzes the demand for information about tax cheating microeconomically, legally and mathematically. It concludes that the IRS is essentially a monopsonist in this market, since almost no one else will pay for such information. This leads to a prediction that the number and quality of tax tips, and the resulting federal revenues, will all be maximized if the IRS refines its current policy of rewarding informants on a sliding scale, rather than offer the minimum 15% reward proposed by Senator Grassley. However, this paper agrees with his proposal to uncap the amount of the reward.

Next, this paper analyzes the supply of information about tax cheats. In addition to the overwhelming likelihood that the IRS will not pay an informant for her information, she must consider the potentially huge costs of being exposed as a tax informant. This paper describes those costs of production and proposes that Congress shift some of them to the IRS by: Granting informants, as Senator Grassley proposed, a right of independent, in camera judicial review of IRS reward decisions; and clearly waiving federal immunity to the claims of informants for breach of the IRS’s promises of confidentiality.

This paper details various federal and state laws, some based on professional rules of conduct, that forbid certain potential tax informants from sharing their information with the IRS, on pain of disbarment from their professions and imprisonment. This paper then proposes a universal standard for such laws and professional rules.

The paper also offers suggestions for further research and for legislative and administrative changes that will increase the government’s revenues, net of rewards paid, from the program.

After concluding, the paper provides an Appendix that describes mathematically the supply and demand functions of the market for federal tax informants.
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I. Introduction

For over a half century, federal tax law has authorized the IRS to pay rewards to informants for tips about violations of that law.1 In 1996, Congress amended that reward program as part of the “Taxpayer Bill of Rights 2”2 and declared that “rewards may be paid for information relating to civil violations [of the internal revenue laws] as well as criminal violations. . . [and] that the rewards are to be paid out of the proceeds of amounts (other than interest) collected by reason of the information provided.”3

This paper analyzes the market for information about tax cheats using the tools of law and economics. Section II describes how the law enforces the IRS’s monopsony for such information and how the IRS makes the most of it. Section II also describes what Congress, and the IRS itself, has promised to tax informants and how a recent set of Senate proposals would change those promises.

Section III looks at the supply side of this market and analyzes what encourages and

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1 See Internal Revenue Code of 1986, section 7623 (CCH 2004). Unless otherwise indicated, all of this Article’s references to “sections” are to sections of the Internal Revenue Code of 1986, as subsequently amended, (hereinafter, the “I.R.C.”). The I.R.C. is title 26 of the United States Code.

The current version of section 7623 reads as follows:

The Secretary, under regulations prescribed by the Secretary, is authorized to pay such sums as he [sic] 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 or conniving at the same,
in cases where expenses are not otherwise provided for by law. Any amount payable under the preceding sentence shall be paid from the proceeds of amount (other than interest) collected by reason of the information provided, and any amount so collected shall be available for such payments.


discourages potential informants to share their information and how the government might increase the former and lessen the latter.

Section IV explores the curious role that state laws, and professional codes of conduct, play in restricting the supply of tax tips to the IRS and then argues for a uniform standard among those laws and codes.

Section V offers suggestions for further research and for legislative and administrative changes that would increase the government’s revenues, net of rewards paid, from the IRS’s informant program. Section VI concludes. Finally, a mathematically description of the supply and demand function of this market is appended.

II. The Demand for Information about Tax Law Violators

When trying to determine the demand function of a market, especially when data are few and unreliable, it is best to proceed cautiously. First and foremost, an investigator should distinguish between consumers and middlemen, so that demand is not double counted. An attorney who pays informants for tips on tax cheats, and then files section 7623 claims for those informants, will increase the total supply of such tips, by reducing the transaction costs of direct IRS-informant transactions and by taking advantage of economies of scale. Nonetheless, the demand for tax tips will be unchanged, since virtually the only buyer in this market is the IRS.
A. The IRS as Sole Collector of Taxes

Federal tax collection is the exclusive responsibility of the IRS and, until the October 2004 enactment of the American Jobs Creation Act of 2004, “only government employees were permitted to collect the taxes.” Even though the IRS can now use private collection agencies to locate and contact taxpayers who owe any type of tax imposed by the Internal Revenue Code and to arrange payment of those taxes by the taxpayers, the IRS remains the only entity that may assess taxes imposed by the I.R.C., file federal tax liens and levy upon property in order to collect unpaid taxes.

Compare these powers of the IRS over taxes with the much more limited powers of the Justice Department over false claims: The federal False Claims Act (the “FCA”) allows private “relators” to file “qui tam” actions against “any person who knowingly presents . . . to an officer or employee of the United States Government . . . a false or fraudulent claim for payment.” Under the FCA, a whistleblower, not the government, must initiate legal action by

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4 I know of only one law firm that has hired a tax informant. However, several firms have represented informants on a contingency fee basis. Either way, the supply of tips to the IRS from those informants increased dramatically.
5 I.R.C. § 6301 (CCH 2004).
8 Congress expects the IRS to use those agencies to focus on “(a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.” Id. at 530, n. 825. See Robert Guy Mathews, IRS Names Private Tax Collectors, WALL ST. J., Mar. 10, 2006, at C3.
10 See id. § 6201.
11 See id. § 6321.
12 See id. § 6331.
13 From qui tam pro domino rege, quam pro se ipso in hoc parte sequitur, i.e., “who as well for the king as himself sues in this matter.” BLACK’S LAW DICTIONARY 1251 (5th ed. 1990).
filing a sealed complaint against a false claimer and then serving the complaint upon the Department of Justice.\textsuperscript{15} The government then has 60 days in which to intervene and become the lead plaintiff.\textsuperscript{16} If it does intervene, then the government may, notwithstanding the relator’s objections, dismiss the action;\textsuperscript{17} settle the action, if the trial court determines the settlement is fair;\textsuperscript{18} and limit the relator’s role in the action.\textsuperscript{19} If the government does \textit{not} intervene, the relator may “conduct the action”\textsuperscript{20} but may not dismiss the case without the consents of the trial court and the Department of Justice.\textsuperscript{21}

One obvious difference between the IRS’s informant program and the FCA is that the IRS retains sole discretion to pursue, or not pursue, the leads provided by its informants, while the FCA divides that authority between the informant and the government. That division creates a “competitive allocation of complementary parts . . . . [s]ince both [the] relator and the [government] need to approve a settlement . . . . ”\textsuperscript{22} Thus, the division of authority over FCA settlements will, economic theory predicts, drive up settlement prices.\textsuperscript{23}

Another difference is that the constitution of the IRS’s program allows it to promise

\textsuperscript{13} See id. § 3730(b)(2)(B).
\textsuperscript{14} See id. § 3730(b)(2)(C).
\textsuperscript{16} See id. (footnote omitted).
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confidentiality to its informants,24 while the “cat is out of the bag” if either the government or its relator decides to prosecute a sealed FCA complaint filed in a United States District Court. In light of the many horror stories about relators who have lost their jobs, careers and families once their FCA complaint is unsealed and prosecuted,25 despite the protections written into the FCA,26 it would be more humane for Congress to repeal the FCA, and replace it with an informant program modeled on the IRS’s, than to continue enticing whistle blowers “[o]nce more unto the breach . . .”27 Attorneys representing relators, and certain “public interest” groups, who have invested in specialized skills and systems in order to benefit from the qui tax laws, can be expected to oppose any rollback of the FCA. On the other hand, businesses harmed by FCA claims hired super lobbyist Grover Norquist to cripple the federal FCA by getting Congress “to cap whistle-blower awards at $1 million.”28 Clearly, some very interested, and clever, people believe that one sure way to stifle the supply of informant tips is to cap the amount awarded. The IRS would therefore be well advised to uncap its rewards to tax informants, just as the federal FCA does now.29

B. The Demand for Public Disclosure of Tax Cheats

24 See text accompanying infra notes 46-56.
25 See, e.g., Shawn Taylor, Whistleblowers Say Exposing an Employer Can Deal a Career Crushing Blow, CHICAGO TRIBUNE, Aug. 18, 2002 (“Punishments range from being shunned by colleagues to termination to blacklisting. Whistleblowers have become victims of smear campaigns. Friends and family may distance themselves; some marriages don’t survive the ordeal.”); Cora Daniels, It’s a Living Hell, FORTUNE MAGAZINE, April 2002 (“About half of all whistleblowers get fired, half of those fired will lose their homes, and most of those will then lose their families too”); FRED ALFORD, WHISTLEBLOWERS: BROKEN LIVES AND ORGANIZATIONAL POWER (2001).
26 31 U.S.C. § 3730(h) (1994) (“any employee who is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment by his or her employer . . . is entitled to all relief necessary to make the employee whole.”).
Despite the IRS’s exclusive right to collect taxes, there are others willing to pay for information on tax cheats. One of those is the WALL STREET JOURNAL, which occasionally runs articles on tax cheats. Yet, private parties ordinarily have little incentive to seek, collect or organize information about what taxes others owe the federal government. Thus, in the absence of IRS rewards to informants, the private demand for information about violation of tax law will be limited to those who derive nonpecuniary rewards from such information – and blackmailers.

C. The Market for Blackmail

Richard Posner has modeled the market for blackmail as part of his economic analysis of privacy. Assuming that “the facts about a person (as distinct from his communications) should be in the public domain,” so that others may fully know that person before interacting with him socially or professionally, Posner predicts that laws against blackmail would not be supported by the public, since blackmail serves “as a deterrent to acquiring those characteristics that are undesirable to people with whom one wishes to have social or business dealings.”

See infra notes Part V.A.
See Andy Gardner & Stuart A. West, Spite Among Siblings, 305 SCIENCE 1413 (2004) (explaining how recent research “on sibling conflict among parasitic wasps sheds light on that most puzzling of social behaviors---spite.”)
Defined as “the practice of threatening to disclose discreditable information about a person unless he pays the blackmailer to suppress it.” RICHARD A. POSNER, ECONOMICS OF JUSTICE 283 (1983)
Id. at 283-85.
Id. at 284.
expense on those who act antisocially or unprofessionally.

Yet, blackmail laws are a fact. Posner reconciles this discordance between theory and fact by arguing that the *private* enforcement of the law (or morals), of which blackmail is an example, is inferior to the *public* enforcement of those social codes and that, as the efficiency of public enforcement increases, private enforcement will be suppressed. Put differently, as government expands its control over a society, it will displace private enforcers, be they warlords, relators or blackmailers. Conversely, if a government cannot enforce its laws, then it may offer rewards, or bounties, to private enforcers: Splitting judgments and settlements with relators, and allowing blackmailers to operate unmolested, are two ways of compensating private enforcers for their efforts. A topic for another day is why relators are still “legal” and blackmailers are not.

D. Making the Most of Monopsony

If the market for tax informants were competitive, and if the IRS were a profit-maximizer, then the supply of those informants, and the IRS’s demand for them, would reach equilibrium with a single price, setting aside easily discernable differences in the quality of information offered for sale and the guarantees offered by buyers. The IRS would then maximize its “profits” by “buying” tax tips until the price it paid equaled the marginal revenue generated by a tip, i.e., until the IRS’s marginal profit fell to zero.

In reality, the IRS is virtually the only buyer of tax tips, which makes the market for tax tips a “monopsony”. If a monopsonist is faced with a multitude of competitive suppliers, e.g.,
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potential tax informants, all of whom offer an identical good, then economic theory predicts that a profit maximizing monopsonist with exploit its market power by reducing the amount of the monopsonistic good it buys, thereby reducing its marginal and total cost for that good. The IRS will therefore look, not to its marginal profit, but to its margin cost, of buying tax tips. This monopsony may be illustrated as follows:

**Price of Tax Tips**

![Diagram showing supply and demand curves with price and quantity of tax tips.](http://law.bepress.com/alea/16th/art29)

The line labeled “Demand” is the hypothetical demand curve and shows what the IRS’s demand function would look like if the IRS were a profit-maximizing buyer in a competitive market.

“Supply” shows the number of tips that would be provided to the IRS at various prices. The intersection of those two lines, SC, depicts the hypothetical competitive equilibrium point, with

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35 The following discussion is based on MILTON FRIEDMAN, PRICE THEORY 189-91 (1976) and GEORGE J. STIGLER, THE THEORY OF PRICE 205-07 (3d ed. 1966).

36 See infra Eqn.1 in Appendix and accompanying text.
quantity QC and price PC being the abscissa and ordinate of that point. Economic theory holds that a competitive equilibrium yields the maximum economic benefit for society, as marginal costs of production and supply are each equal to the price set by the market, in this case, PC.

However, if the IRS were a profit-maximizing monopsonist, and could substitute other factors for tips from tax informants, and must pay a uniform price of such tips, then economic theory predicts that the IRS would restrict its demand for tax tips to QM, where the marginal cost of its last tip would equal DM, the marginal revenue it would gain from that purchase. The intersection of the line DM-QM with the Supply line shows us the fixed price that the IRS must pay, PM, to obtain QM of tips. While DM maximizes the IRS’s monopsonistic profits for a fixed price, economic theory holds that there is a deadweight loss to society in that PM < PC and QM < QC, since neither the IRS nor its tip suppliers can obtain the advantages represented by the triangle DM/SC/SM. Graphically, this is the “deadweight loss” of monopsony.

A profit-maximizing monopsonist that can price discriminate among its suppliers can, by paying different prices to different suppliers, capture some of that deadweight loss for itself and even shift some of its suppliers’ profits into its own coffers. That is exactly how the IRS’s four-tier payment plan works: To some of its suppliers, the IRS pays nothing, thereby obtaining some of its tax tips at the rock-bottom marginal cost of its public relations effort and its investigation and administration of those tips. Even to its suppliers who seek a reward, the IRS pays only a percentage of what it collects, excluding interest, and only determines that percentage after it has evaluated the information provided. Thanks to the intelligent design of the IRS’s tax informant program, the federal government has taken immense advantage of the IRS’s
monopsony.

E. What the IRS Offers Informants

In 1996, Congress enacted amended Internal Revenue Code section 7623\(^{38}\) in order to make clear “that rewards may be paid for information relating to civil violations [of the internal revenue laws] as well as criminal violations. . . .[and] that the rewards are to be paid out of the proceeds of amounts (other than interest) collected by reason of the information provided.”\(^{39}\) Some two years later, the IRS amended its Treasury Regulation on the federal tax informant program and, in some ways, drew back from the payment of rewards: For example, “a district or service center director may approve a reward, in a suitable amount,” but only “[i]n cases where rewards are not otherwise provided for by law . . . .”\(^{40}\) In other ways, the Regulation expands the scope of those rewards by stating that rewards are to be based not only on the additional tax, penalties and fines collected as a result of the information provided, but also on any refund of those items that the IRS would have paid “if the information leads to the denial of a claim for refund that otherwise would have been paid.”\(^{41}\) The Regulation also: Bars certain present and

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37 See infra note 52.
38 Prior to that amendment, I.R.C. § 7623 read as follows:

The Secretary, under regulations prescribed by the Secretary, is authorized to pay such sums, not exceeding in the aggregate the sum appropriated therefore, as he may deem necessary for detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws, or conniving at the same, in cases where such expenses are not otherwise provided by law.

I.R.C. § 7623 (1986), amended by Tabor 2, supra note 2, Title XII, § 1209(a).
41 Id.
former federal employees from receiving section 7623 rewards;\(^{42}\) details how an informant is to submit information to the IRS;\(^{43}\) specifies how a claim for reward is to be submitted;\(^{44}\) and states that “[n]o unauthorized person will be advised of the identity of an informant.”\(^{45}\)

More prosaically, the IRS instructs its employees and officers on how to handle an informant, and the information she provides, in Section 1 of Chapter 2 of Part 25 of the Internal Revenue Manual.\(^{46}\) Therein, IRS personnel are told:

> The identity of the informant must not be disclosed to any other Service officials or employees except on a “need to know” basis in the performance of their official duties.

> To maintain maximum security, protect documents and screen displays which [sic] identify informant information or the informant. Keep all documents, screen displays, and forms secured. This information must be kept concealed from all employees in a locked file cabinet until it is forwarded to the responsible function each day.

. . .

> Personnel are required to treat the identity of the informant and the informant’s

\(^{42}\) Id. § 301.7623-1(b)(2), which states:

> No person who was an officer or employee of the Department of the Treasury at the time the individual came into possession of information relating to violations of the internal revenue laws, or at the time the individual divulged such information, is eligible to file a claim for reward if the information provided came to the individual’s knowledge other than in the course of the individual’s official duties.

Patently, those applying to become Treasury employees should file their reward claims before they join the Department.

\(^{43}\) Id. § 301.7623-1(d).

\(^{44}\) Id. § 301.7623-1(f).

\(^{45}\) Id. § 301.7623-1(e).

information as highly confidential and to exercise the security precautions stated above [sic].

Section 1 of Chapter 2 also makes clear that “it is the practice of the Service not to suggest or encourage the informant to submit a claim for reward.” Only when the informant sua sponte asks for a reward are IRS personnel to provide a Form 211, an Application for Reward for Original Information.

Section 2 of Chapter 2 “outlines the procedures for dealing with informant rewards.” Informant rewards are paid out of the taxes, civil penalties and criminal fines, but not the interest, collected by reason of the information provided, in an amount not exceeding $2,000,000, according to one of three formulae. Although an informant may use an assumed name “when it is essential to protect his/her identity, or when the Government’s best interest will be served [, a] claim for reward is not acceptable if signed on behalf of a claimant by his/her agent, regardless of any existing power of attorney.” Instead, the informant must sign a Form 211, “under penalties

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47 Id. ¶ 25.2.1.2.2, 3 and 5.
48 Id. ¶ 25.2.1.4.
49 Id. ¶ 25.2.1.4.1.
50 Id. ¶ 25.2.1.1.
51 Id. ¶ 25.2.2.3.1.
52 Id. ¶ 25.2.2.5.1. Those formulae are stated as follows:

For specific and responsible information that caused the investigation and resulted in the recovery, or was a direct factor in the recovery, the reward shall be 15 percent of the amounts recovered.

For information that caused the investigation and was of value in the determination of tax liabilities although not specific, the reward shall be 10 percent of the amount recovered.

For information that causes the investigation, but had no direct relationship to the determination of tax liabilities, the reward shall be 1 percent of the amount recovered.

Id. at A, B and C. Note that there is an unstated fourth rate in the IRS’s payment structure: Zero, which is what the IRS pays those tax informants who fail to submit a claim form; who work for the Treasury Department, I.R.M. ¶ 25.2.2.1.7.3.E; or whose reward would be less than $100, id. ¶ 25.2.2.1.7.2.
53 Id. ¶ 25.2.2.2.8.
of perjury, in the informant’s true name in order that payment may be made only to the informant in his/her legal name.”"\(^{54}\) Note that all “[r]ewards paid are taxable income to the entity that filed the claim in the tax year the reward is received”\(^ {55}\) and that Form 211 requires the informant to provide the IRS with the informant’s taxpayer identification number. In lieu of Form 211,

Special agreements may be entered into by the IRS and an informant. However, Service employees should never suggest or encourage informants to request special agreements. In cases where an informant has requested a special agreement and the district agrees that such agreement would be beneficial and appropriate:

A. The special agreement must be approved by the Commissioner, or his/her delegate as authorized by Delegation Order 204.

B. The field office must send a request for approval to the Deputy Commissioner in Headquarters.

C. The original agreement and the signed Headquarters’ approval memorandum will be maintained in the Informant’s Claims Examiner’s file in the appropriate service center.

D. A copy of the agreement will be maintained in the office working the case.

E. The reward, if appropriate, should be computed in accordance with the terms of the agreement.\(^ {56}\)

In summary, the IRS offers informants two things: Cash, contingent on the IRS

\(^{54}\) *Id.* ¶ 25.2.2.8.B.

\(^{55}\) *Id.* ¶ 25.2.2.2.

\(^{56}\) *Id.*, at ¶ 25.2.5.3.
collecting something as a result of the informant’s tip; and confidentiality. Cash is authorized by the statute that established the informant reward program; confidentiality is solely a creation of the IRS, via its Internal Revenue Manual. Later in this article, we will explore what happens when the IRS “breaks” one or both of those promises.57

F. Senator Grassley’s Proposal

In 2004, Senator Charles Grassley chaired the Senate Finance Committee and ushered through it, as part the Senate version of what became the American Jobs Creation Act of 2004,58 a proposal to create a “top hat” rewards program. Specifically, the Grassley proposal was to pay at least 15%, and as much as 30%, of the entire amount collected by the IRS, including interest,59 to an informant whose tip resulted in IRS collections more than $20,000.60 Further, any IRS determination about an informant’s reward could be appealed to the United States Tax Court.61 On the other hand, the Grassley proposal followed the current section 7623 in failing to codify a promise of informant confidentiality.

Because the Grassley proposal would have substantially raised the reward an informant might receive, economic theory would predict a resulting increase in the number of informants and their tips. However, economic theory also predicts that the Grassley proposal would not maximize tax revenues resulting from those tips, at least not net of the rewards paid. As

57 See infra Parts III.C. and D.
59 Cf. I.R.C. § 7623, quoted at note 39, supra, which excludes interest collected by the IRS from the amount used to calculate an informant’s reward.
60 J. COMM. ON TAX., JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE ON THE AMERICAN JOBS CREATION BILL OF 2004 (H.R. 4520), at 572 (2004). However, if the payer of those amounts was an individual, the Grassley proposal added the additional requirement that the individual’s gross income must exceed $200,000 in any year.
discussed above, the IRS’s position as monopsonist allows it to appropriate more of the revenues resulting from informants’ tips, by varying the price paid for those tips, than would a single-price paying competitive buyer of such tips. To maximize both the number of tips received, and the net additional revenues kept by the United States Treasury, the IRS should offer a higher maximum reward, e.g., by including interest and increasing the top percentage paid, and no minimum amount or percentage, thereby leaving the amount paid for the IRS, and perhaps the Tax Court, to determine.

III. What Motivates, and Dissuades, Potential Informants

A. Nonpecuniary Rewards and Their Limits

While some individuals are motivated to become tax informants without any hope of obtaining money for their efforts, not everyone will be, particularly in light of the personal and professional risks involved in doing so. Yet the WALL STREET JOURNAL, of all newspapers, was apoplectic that Senator Grassley had proposed to increase the rewards offered to tax informants, and opined that “the job of the federal government is not to collect all the tax it can. It has an equal, if not more compelling, obligation to maintain the confidentiality of the tax records of its citizens. The danger here lies in giving anyone with a grudge – an ex-employee, ex-spouse or unfriendly neighbor – an incentive to use the IRS to settle a personal score and

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61 Id.
62 See supra Part II.D.
63 See supra note 52.
64 See supra note 25 and accompanying text.
65 See text accompanying supra notes 58-61.
make a profit to boot.”66 Although the JOURNAL forecast that Senator Grassley’s proposal would introduce “chaos into the IRS system,” it did concede that the IRS “already makes whistleblower payments.”67

The JOURNAL’s editorial is, frankly, illogical: How would the confidentiality of the IRS’s current records be threatened by an IRS program to pay informants for information that is not in those records? Further, those with nonpecuniary incentives to become tax informants, such as “disgruntled” employees or spouses, are already doing so, without any hope of making “a profit to boot.” Although the IRS will not provide data on this question, it is said that the overwhelming majority of those who provide information to the IRS never file a claim for reward. Eliminating the IRS reward program will not dissuade those informants, since their goal, in ratting out a tax cheat, is not to make (horrors!) “a profit”, but rather “to use the IRS to settle a personal grudge” or to keep the federal tax system honest.

On the other hand, as the JOURNAL’s editorial writers surely know, and clearly fear, the IRS would receive more tax tips, more tax cheats would be “outed” and tax revenues would increase, if only IRS rewards were increased. Which is precisely why the JOURNAL opposed Senator Grassley’s proposal: Like Grover Norquist, the JOURNAL’s true goal is to “starve the beast” by destroying government’s ability to raise revenues.68

B. IRS Refusals to Pay a Reward

1. Merrick and Its Progeny

67 Id.
68 Cf. text accompanying supra note 28 (describing how Grover Norquist tried to cripple a different government
The fate of most Form 211-filing tax informants is to receive a Letter 1010 from the IRS stating “the information you furnished did not meet our criteria for a reward.” The IRS does not provide a rejected reward seeker with any opportunity for administrative review of its decision not to pay her a reward, leaving her free to immediately sue the United States. Unfortunately for such a plaintiff, the United States Court of Federal Claims has almost exclusive original jurisdiction to hear such cases, the sole exception being for reward claims “not exceeding $10,000 in amount, for which claims the United States District Courts have concurrent original jurisdiction.

Thus, virtually all of the case law in this area stems from the Court of Federal Claims, its predecessors, and its overseer, the Federal Circuit Court of Appeals. That case law is not a pretty picture for informants disappointed with the reward, or lack of it, paid by the IRS.

The leading case on an informant’s right to sue the IRS for a section 7623 reward is *Merrick v. United States*, in which federal tax informant Robert Merrick, disappointed with the reward he received from the IRS, sued the government for breach of contract in the United States Claims Court, alleging that:

1. In June 1984, he gave the IRS information, “otherwise unknown to the agency”, that indicated the identities of some 1,600 investors in an illegal tax shelter and allowed

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69 Letter 1010 (SC) (Rev 089-01-2001) in one of the author’s client files.
70 Id.
73 The United States Court of Federal Claims replaced the Claims Court in 1992, which latter court had succeeded to the original jurisdiction of the Court of Claims in 1982. THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION 194 tbl. T.1 (Columbia Law Review Ass’n et al. eds., 18th ed. 2005).
74 846 F.2d 725 (Fed. Cir. 1988).
the IRS to recover over $10 million;\textsuperscript{75}

2. In February 1984, an IRS Acting District Director told him that he would receive a reward calculated under paragraph 1 of the July 1980 version of IRS Publication No. 733, i.e., 10\% of the first $75,000 recovered, 5\% of the next $25,000 recovered and 1\% of any additional amount recovered from each of the snared investors, with a maximum reward of $50,000 for each investor;\textsuperscript{76} and

3. The IRS paid him only $31,000.\textsuperscript{77}

In an unpublished decision,\textsuperscript{78} the Claims Court dismissed his complaint for failure to state a cause of action, which dismissal he timely appealed to the United States Court of Appeals for the Federal Circuit.\textsuperscript{79}

After reviewing the 1982 version of section 7623, and the IRS’s 1987 Regulation interpreting that statute, the Federal Circuit wrote that:

The United States cannot be contractually bound merely by invoking the cited statute and regulation. An enforceable contract will arise under these authorities only after the informant and the government negotiate and fix a specific amount as the reward.

\ldots

\ldots Nonetheless, our precedents establish that the subject statute and regulation amount to an indefinite reward offer that an informant may respond to [sic] by his conduct. Because, however, the obstacle of indefiniteness may be removed by the

\textsuperscript{75} Merrick v. United States, 846 F.2d at 725.
\textsuperscript{76} Id. Note that IRS Publication No. 733, entitled “Rewards for Information Provided by Individuals to the Internal Revenue Service”, was revised in September 1997 after Tabor 2, supra note 1, amended I.R.C. § 7623.
\textsuperscript{77} Merrick at 726.
\textsuperscript{78} No. 654-86 T (Cl.Ct. July 20, 1987).
subsequent conduct of the parties, an enforceable contract arises when the parties fix the reward amount. They have done so here [according to the facts alleged in Merrick’s complaint].

Accordingly, the Federal Circuit held “these facts are sufficient to state a contract claim against the United States.”

In a more recent case, Krug v. United States, an informant argued that the 1980 version of IRS Publication 733 created an implied-in-fact contract, that obligated the United States to pay him for the information he had provided, because it stated that: “Claims for reward will be paid in proportion to the value of information you furnished . . .” In affirming the summary judgment entered by the Court of Federal Claims on this issue in favor of the government, the Federal Circuit held that:

[I]n Publication 733 and pursuant to § 7623 and the regulation, the Government invites offers for a reward; the informant makes as offer by his conduct; and the Government accepts the offer by agreeing to pay a specific sum. So analyzed, it can be readily seen that the change in the formulation of Publication 733 does not carry with it the significance that Mr. Krug would attach to it. . .

. . .

. . . Though Mr. Krug presents an appealing [sic] case, and the IRS’s conduct, as described by the trial court, in dealing with Mr. Krug leaves much to be desired in terms
of how the Government should treat its citizens, perhaps the only conclusion to be drawn from this case is that it may be wiser for an informant to discuss the reward before, rather than after, the information is given. 85

Of course, the typical potential informant will be unable to follow the Federal Circuit’s advice, as her bargaining power with the IRS is quite limited. 86

2. Did Tabor 2 Overturn Merrick?

Merrick set a very high hurdle for informant claims against the government: Unless the informant could prove, by a preponderance of the evidence, that the government had at least told her she would receive a reward, and how that reward would be calculated, the informant claim would be held insufficient, at least under the 1982 statute and the 1987 Regulation. Does Congress’ 1996 amendment of section 7623, 87 the Congressional history of that amendment, 88 or the 1998 version of Treasury Regulation section 301.7623-1, 89 provide sufficient basis for a new look at the Merrick rule?

The recently-decided Beall v. United States 90 may provide an answer: Mr. and Mrs. Beall entered into a settlement agreement with the IRS in 1997 to resolve certain disputes stemming from a 1984 tax shelter investment. 91 Based on that settlement, IRS assessed additional income taxes and interest. After the Bealls paid those amounts, they filed a claim for refund of the tax

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85 Id. at 1310.
86 See infra discussion in Part IV.C.
87 See Tabor 2, supra note 1, and text accompanying supra notes 1-2.
88 See text accompanying supra note 3.
89 See text accompanying supra notes 40-45.
90 336 F.3d 419 (5th Cir. 2003).
91 See id. at 420, n. 1.
they had paid. The IRS denied that claim, and the Bealls’ supplemental claim for the abatement of interest pursuant to Internal Revenue Code section 6404(e)(1), and the Bealls then sued the United States in federal district court. The United States subsequently moved for dismissal, under Federal Rule of Civil Procedure 12(b)(1), on the grounds that courts lack subject matter jurisdiction over section 6404 claims for the abatement of interest charged by the IRS. The district court analyzed the case law and found that, prior to 1996, the Ninth, Tenth and Eleventh Circuit Courts of Appeals had each “clearly stated . . . that the Administrative Procedure Act (“APA”) precluded judicial review of IRS abatement decisions under [Internal Revenue Code section] 6404(e).” In a footnote to that passage, the district court stated that:

In essence, these [appellate] courts found that [Internal Revenue Code section] 6404(e)(1) did not provide a basis for distinguishing between instances in which abatement should and should not be granted. Since there was no meaningful standard against which to judge the IRS’s exercise of discretion in determining whether to abate interest, the courts reasoned that the [APA section] 701(a)(2) exception barring the federal courts from exercising jurisdiction was applicable.

Although the Taxpayer Bill of Rights 2 modified section 6404(e)(1) by including additional grounds on which the IRS could abate interest, and by granting jurisdiction to the United States Tax Court to review IRS decisions not to abate interest, the district court found that neither these

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92 Id. at 421.
94 See infra note 113.
95 Beall, 170 F. Supp. 2d at 710, (citations omitted). The APA is title 5 of the United States Code.
96 Id. at 710, n. 1. Although the APA generally makes final agency decisions judicially review able, review is unavailable in two narrow situations: Where “(1) statutes preclude judicial review; or (2) agency action is committed to agency discretion by law.” 5 U.S.C. § 701(a) (2000).
changes, nor the legislative history, established Congressional intent that federal district courts exercise jurisdiction over section 6404 abatement claims. The court therefore ordered the dismissal of the Bealls’ section 6404 abatement claim for lack of subject matter jurisdiction. The Bealls then appealed to the Fifth Circuit.

Since “[s]overeign immunity is jurisdictional in nature”, the Fifth Circuit first addressed whether that immunity had been waived, and on what terms. The Fifth Circuit found that waiver in section 7422, which “permit’s a claim for refund not only for ‘erroneously or illegally assessed’ taxes, but also for ‘any sum alleged to have been wrongfully collected.’” The court concluded that statutory law waived the United States’ sovereign immunity with respect to the Bealls’ section 6404(e) interest abatement claim. However, the power to hear the Bealls’ claim was not sufficient to establish that a district court may review IRS denials of section 6404(e)(1) interest abatement claims: Judicial review depended on whether Congress meant to overturn the pre-1996 case law when it amended section 6404. Noting the extent of those amendments, Fifth Circuit wrote as follows:

The statutory landscape in which we address the Bealls’ claim for interest abatement is thus substantially different from the one facing the [Ninth, Tenth and Eleventh Courts of Appeal]. And though, were we to address today the same issue that faced those courts, we would most likely, and for the same reasons, conclude that the

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97 Beall, 170 F. Supp. 2d at 711.
98 Id. at 712.
99 See Beall, 336 F.3d 419.
100 Id. at 421 (quoting F.D.I.C. v. Meyer, 510 U.S. 471 (1994)).
101 Beall, 336 F. 3d at 422 (quoting I.R.C. § 7422(a)).
102 Beall, 336 F. 3d at 422-23.
103 Id. at 425. In other words, a Fed. R. Civ. P. 12(b)(1) dismissal was inappropriate, while a Fed. R. Civ. P. 12(b)(6) dismissal for failure to state a claim, or entry of summary judgment, remained possibilities.
judicial review of the [IRS’s] decision to deny an abatement request is barred, our decision now must be guided by the above 1996 amendments. We cannot merely adopt the reason of the [prior] line of case, but must construe, as a matter of first impression, the effect of the 1996 changes to section 6404.

Having reviewed those changes we find that in amending section 6404, Congress clearly expressed its intent that the decision to abate interest no longer rest[s] entirely within the [IRS’s] discretion. . . . We need look no further for support for this conclusion than the simple addition of section 6404(h) granting jurisdiction to the Tax Court to review [such] decision[s]. Indeed, the vesting of jurisdiction in the Tax Court to review interest abatement challenges can be given no meaning other that that the abatement decision is no longer committed solely to agency discretion. Accordingly, we cannot say that either section 701(a)(2) of the APA, or the absence of manageable standards of review generally, any longer precludes judicial review of the denial of a request for the abatement of interest.\textsuperscript{104}

Thus, the amendments of section 6404 by the Taxpayer’s Bill of Rights 2 were read by the Fifth Circuit as tantamount to a Congressional overruling of the case law in three federal circuits.

If nothing else, \textit{Beall} shows how a federal court \textit{should} analyze whether the Taxpayer’s Bill of Rights 2 overruled \textit{Merrick} by amending section 7623. Unfortunately, the post-1996 case law on informant’s claims is bereft of such analysis.\textsuperscript{105}

\textsuperscript{104} \textit{Id.} at 426-27 (citation omitted).

C. IRS Breaches of Confidentiality

There is, as yet, no published court opinion on whether the post-1996 IRS promises of confidentiality waive the federal government’s sovereign immunity and create a right to sue the United States if an informant’s identity is revealed to an unauthorized person. In Jarvis v. United States, a federal tax informant sued for damages for the government’s alleged breach of a written informant reward agreement. One of his causes of action was for the attorney fees he had expended in defending a lawsuit brought against him in state court as a direct result of an IRS special agent’s disclosure of his identity to one of the taxpayers upon whom he had informed. Reviewing its case law, the Court of Federal Claims wrote:

[T]his circuit has been reluctant to treat litigation expenses as an item of contract damage. While it could certainly be the case in some circumstances that parties to an agreement would anticipate suits from third parties for non-performance, here, the nature of the government’s primary obligation was to pay plaintiff for information. The obligation to maintain discretion was secondary, and the concerns implied in this obligation are accordingly less clear. The concerns may equally have been motivated by a concern for personal safety or to prevent embarrassment.

Bottom line: The court granted the government summary judgment on the informant’s cause of

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106 See text accompanying supra notes 45-47.
107 43 Fed. Cl. 529 (1999) [hereinafter, Jarvis I].
108 Id. at 530. See quotation accompanying supra note 56 for current IRS guidelines and procedures for “special agreements” with informants in lieu of Form 211 claims for reward.
109 Id. at 534.
110 Id. at 534 (citations omitted).
action for litigation expenses.\textsuperscript{111}

Having lost on a contract theory in the Court of Federal Claims, informant Jarvis then sued the United States in federal district court for actual and punitive damages on the theory that the IRS had wrongfully disclosed “return information”, in violation of Internal Revenue Code section 6103(a).\textsuperscript{112} The United States then moved to dismiss, under Federal Rule of Civil Procedure 12(b),\textsuperscript{113} on the grounds that the information allegedly disclosed was not the plaintiff’s “tax return information” and that section 7431(a) does not allow an informant to sue for a violation of section 6103.\textsuperscript{114} The district court agreed and dismissed the case because it lacked jurisdiction over the subject matter of the informant’s claim.\textsuperscript{115}

\textit{Jarvis I} makes clear that an informant should exercise great care in negotiating a “special agreement” with the IRS: Among other items, the “concerns” that motivate the informant’s desire for confidentiality, and a right to a jury trial in a district court in case of any breach of that

\begin{itemize}
\item[111] Id.
\item[112] Jarvis v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,805 (E.D. Tex. 2000) [hereinafter, \textit{Jarvis II}]. Section 6103(a) states that:

\begin{quote}
Returns and return information shall be confidential, and except as authorized by this title--

(1) no officer or employee of the United States,\textsuperscript{113}

\begin{quote}
shall disclose any return or return information obtained by him in any manner in connection with his service as such an officer or an employee or otherwise or under the provisions of this section. For purposes of this subsection, the term “officer or employee” includes a former officer or employee.
\end{quote}
\end{quote}

If an officer or employee of the United States knowingly or negligently discloses any return information “with respect to a taxpayer”, in violation of section 6103, “such taxpayer may bring a civil action for damages against the United States in a district court of the United States.” I.R.C. § 7431(a)(1) (2000).

\item[113] "A motion to dismiss pursuant to Rule 12(b)(1) challenges a court’s subject matter jurisdiction and seeks a dismissal of the lawsuit due to a court’s lack of authority to hear the dispute.” \textit{Jarvis II}, supra note112, at p. 85,951.
\item[114] Id. at 85,950.
\item[115] Id. at 85,952.
\end{itemize}
special agreement, should be spelled out in any such agreement.\footnote{See text accompanying supra notes 107-10.} However, few informants will be in a position to negotiate a special agreement with the IRS.\footnote{See quotation accompanying supra note 56 for current IRS guidelines for such “special agreements”.} Further, \textit{Jarvis II} bars an informant from suing the government under section 7431.\footnote{See text accompanying supra note 114.} Instead, informants “betrayed” by the IRS must argue that the post-1996 version of section 7623 created a right to sue the IRS for damages if its officers or employees breach the IRS’s public promises of confidentiality.\footnote{See quotations accompanying supra notes 45-47.} Again, the Fifth Circuit’s decision in \textit{Beall v. United States}\footnote{336 F.3d 419.} is an excellent place for a betrayed informant to begin her research.\footnote{http://law.bepress.com/alea/16th/art29}

\section*{IV. Restrictions Placed on Tax Informants by State Law and Professional Standards}

Much as the IRS would like information of tax law violations to flow freely to it from informants, state law and professional standards impede and sometimes bar disclosure of such information by those who most often see, and understand, such violations. This section of the article surveys those restrictions.

\subsection*{A. Contractual Restraints}

Most commonly, contracts restricting parties from providing information to the IRS take the form of settlement agreements. From “disgruntled” former employees to former spouses, many people know of tax cheaters. However, a careful attorney representing a possible tax violator will insist on a “gag” clause barring disclosure of any information to any entity in return

\footnotesize
\begin{enumerate}
\item \footnote{See text accompanying supra notes 107-10.}
\item \footnote{See quotation accompanying supra note 56 for current IRS guidelines for such “special agreements”.}
\item \footnote{See text accompanying supra note 114.}
\item \footnote{See quotations accompanying supra notes 45-47.}
\item \footnote{336 F.3d 419.}
\end{enumerate}
for certain payments. For example:

Each Party covenants that all terms and conditions of this [Settlement] Agreement shall be maintained in confidence by that Party, and shall not be discussed with nor disclosed to any person or entity by that Party, his or her attorneys, agents or assigns. Each Party further covenants that all factual allegation giving rise to the Action (excepting those matters in writing which are of public record) shall not be discussed with nor disclosed to any person or entity by that Party, his or her attorneys, agents or assigns.

The Parties hereby express that their intent to be collaterally bound by the terms of this Agreement[.]¹²²

A careless attorney will be more specific, barring the payee from, e.g., “disclosing the payer’s fraudulent tax accounting to the IRS”, especially if the settlement agreement is subject to judicial review and approval. Better to make a seemingly overgenerous settlement payment, and obtain agreement to an onerous if vague penalty clause, than to blatantly buy silence for illegal acts.

Employment contracts are another place nondisclosure clauses might be found, especially in the case of accountant retention, or attorney-client, agreements. A careful tax violator might want his professional helpers contractually bound to keep all of his illegalities, which his helpers might see, confidential.¹²³ More likely, a clause barring the disclosure of tax law violations will be inserted by the professional in order to prevent a potential client from appropriating a tax

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¹²¹ See text accompanying supra notes 100-04.
¹²² Settlement agreement in one of the author’s client files.
¹²³ See, e.g., Jonathan Weil and Cassell Bryan-Low, Report Bolsters SEC’s Proposal for Attorneys, WALL ST. J., Sept. 15, 2003, at C1 (quoting an SEC report that law firm Kirkland & Ellis “had plainly advised” a client both that the client was violating securities law, and that “serious consequences, including action by the SEC” that might flow from those violations. Yet, after its client spurned that advice, the law firm then repeatedly prepared and filed false notices with the Securities and Exchange Commission on the client’s behalf because, as spun by a Kirkland partner, “There are no rules that say you must resign if the client doesn’t take your advice.”).
“planning” idea without paying for it. However, a careful drafter will make that clause broad enough to support a state court action for breach if a client “rolls over” and provides information of the tax “plan” to the IRS.

All courts should disfavor gag clauses to the extent that they undermine law enforcement, including tax law enforcement. A court, presented with a complaint for breach of contract against a tax informant, should consider dismissal of the complaint on the grounds of the plaintiff’s unclean hands, especially if the plaintiff currently resides in a penitentiary. Even if a state court were theoretically willing to impose judgment against a tax informant who breached a gag clause, it is doubtful that such clauses are enforceable in practice, especially if the IRS lives up to its public promises of confidentiality about tax informants, since, without IRS cooperation, the plaintiff would be hard put to prove that the defendant was the source of the “leak” that started the IRS audit of the plaintiff’s taxes.

B. Tax Return Preparers

Perversely, some states have made it a crime for anyone to disclose “any information obtained in the business of preparing federal or state income tax returns or assisting taxpayers in preparing those returns” unless such disclosure is: Consented to in writing by the taxpayer in a separate document; expressly authorized by state or federal law; necessary to the preparation of the return; or pursuant to a court order. Whatever good public policies were behind such laws,
as tax policy they are madness: A income tax preparer is the most likely person, outside of her client’s bookkeeper, to discover tax fraud. Yet Illinois law would jail that preparer were she to send evidence of her client’s fraud to the Illinois Department of Revenue, even if that State thereby realized millions of additional dollars of revenue and successfully prosecuted the client for tax fraud. An Illinois income tax preparer, who turns federal tax informant, should seemingly apply for a section 7623 reward, so that she may pay her Illinois criminal attorney’s fees and her court-imposed fine. Unfortunately, the IRS has stated that it will reject claims for informant rewards if “[p]ayment would be contrary to State or local law.”126 Thus, an Illini who learn of tax crimes while preparing a tax return, risks her freedom, and has no prospect of receiving an IRS reward, if she reveals those crimes to a state or federal tax agency.

C. Enrolled Agents

As set forth in its Circular 230,127 the IRS permits “enrolled agents”, as well as state-licensed attorneys and certified public accountants, to represent taxpayers before it, unless such representative is “currently under suspension or disbarment from practice before the Internal Revenue Service . . . .”128 The IRS’s Director of Practice may grant enrollment to “natural persons”129 who either pass an IRS-administered test,130 or have “had a minimum of 5 years continuous employment with the Internal Revenue Service during which he or she must have been regularly engaged in applying and interpreting the provisions of the Internal Revenue Code

127 Circular 230 is comprised of Treas. Reg. §§ 10.0 through 10.93, which sections constitute Part 10 of Title 31 of the Code of Federal Regulations.
128 Treas. Reg. §10.3(c) (2002).
129 Id. § 10.4(c).
and the regulations thereunder relating to income, estate, gift, employment, or excise taxes.”

In order to continue practicing before the IRS, a practitioner must fulfill the duties, and obey the restrictions, imposed by Subpart B of Circular 230. Among those duties is the following:

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper with the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Subpart B also states that:

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

Note that, unlike Illinois law, Circular 230 does not bar an enrolled agent from informing a
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governmental agency about her client’s tax law violations, even if those violations are discovered while the agent is preparing her client’s tax returns.

Clearly, an Illinois enrolled agent must navigate between Scylla and Charybdis if she discovers, while she is preparing her client’s tax returns, that her client has violated a tax law: The IRS requires her to fully inform her client of the consequences of his violation (it would behoove her to put that warning in writing and have her client sign a receipt), and the IRS bars her from signing the return she prepared, while her state’s law threatens to put her in jail if she reveals what she has learned to anyone, even the attorney she hires to advise her on her duties,135 and the IRS will reject her claim for an informant’s reward.136 In fact, an enrolled agent who is convicted of violating Illinois’ Taxpreparer [sic] Disclosure of Information Act137 “may be censured, suspended or disbarred from practice before the Internal Revenue Service . . . .”138 Yet, an Illinois enrolled agent who learns of, and informs the IRS about, her client’s tax violations while representing that client in an audit, or on appeal, or in the course of any business other than preparing income tax returns, is beyond the reach of Illinois prosecutors, or the IRS’s Director of Practice, and may receive a section 7623 reward.

D. Certified Public Accountants

Many states rely heavily upon the Council of the American Institute of Certified Public Accountants for their regulation of CPAs and, in particular, on the AICPA’s Code of

135 Cf. id. §§ 10.21 and 10.34 with 720 ILL. COMP. STAT. 140/1 (1977), which statute is quoted at supra note 125.
136 See I.R.M. ¶ 25.2.2.17.3.G (04-27-99), quoted in relevant portion at supra note 126.
137 720 ILL. COMP. STAT. 140/0.01-140/3 (1977).
138 Treas. Reg. § 10.51(b) (2002).
Professional Conduct. 139 Rule 301 of that Code states the general rule that: “A member in public practice shall not disclose any confidential client information without the specific consent of the client.” 140 Exceptions are provided so that, inter alia, Rule 301 shall not be construed . . . (2) to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy.

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above. 141

Thus, Rule 301 bars a CPA from informing even a law enforcement agency of a client’s crimes, whether murder, child molestation or tax fraud, if that information is “confidential”, unless the client consents or the CPA receives a subpoena.

139 The entire AICPA Code is available at (July 22, 2003).
140 AICPA CODE OF PROF. CONDUCT R. 301.01 (as amended 1992).
141 Id.
In most states, a CPA who reveals confidential information, even of a crime, also risks the loss of her professional license. For example, the Texas State Board of Public Accountancy, pursuant to its statutory duty to “adopt rules of professional conduct to establish and maintain high standards of competence and integrity in the practice of public accountancy”, \textsuperscript{142} prohibits the disclosure of client information “relating to, and in connection with, professional services rendered to the client” unless that disclosure is: Made with the permission of the client or the client’s authorized representative; required by the standards of the public accounting profession; or pursuant to a subpoena or other compulsory process. \textsuperscript{143} A violation of that rule is grounds for the Texas State Board of Public Accountancy to discipline the violator, \textsuperscript{144} which discipline can extend to revocation of a CPA’s Texas license. \textsuperscript{145} Even worse, in some states, a CPA who learns of her client’s tax crimes while preparing his tax return, risks jail time if she reveals that information to the IRS or anyone else. \textsuperscript{146}

To summarize: A CPA who, in the course of her practice, reveals confidential information about a client’s tax crimes to the IRS risks the loss of her AICPA membership, her professional license and, in some states, her freedom. The IRS’s promises of confidentiality, \textsuperscript{147}

\textsuperscript{142} TEX. OCC. CODE ANN. § 901.156 (Vernon ), \textit{accord} VA. CODE ANN. § 54.1-4403.3 (Michie ) \textit{and} CAL. BUS. & PROF. CODE § 5018 (West 2005).


\textsuperscript{144} TEX. OCC. CODE ANN. § 901.502(6) (Vernon ), \textit{accord} VA. CODE ANN. § 54.1-4413.A.7 (Michie ), WASH. REV. CODE § 18.04.295(3) (2003), 225 ILL. COMP. STATE 450/20.01(a)(8) (1992), MASS. GEN. LAWS ch. 112, § 87C(a) ( ) \textit{and} CAL. BUS. & PROF. CODE § 5100(g) (West 2005).


\textsuperscript{146} 720 ILL. COMP. STATE 140/1 (1977) (quoted at \textit{supra} note 125) \textit{accord} CAL. BUS. & PROF. CODE § 17530.5 (West Supp. 2005).

\textsuperscript{147} Int. Rev. Man. ¶¶ 25.2.1.2.2, 3 and 5 (04-27-1999), quoted at \textit{supra} note 47.
and the federal government’s liability for breach of those promises,\textsuperscript{148} should be carefully considered before a CPA decides whether to become a federal tax informant.

E. Attorneys

1. The ABA Model Rule on Disclosure of Confidential Information

Forty-five states have adopted the American Bar Association’s Model Rules of Professional Conduct,\textsuperscript{149} which, in the part relevant to federal tax informants, state:

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

\[ \ldots \]

(3) to prevent, mitigate or rectify substantial injury to the financial interest or property of another that is reasonably certain to result or has resulted from the client’s commission of a crime or fraud in furtherance of which the client has used the lawyer’s services; [and]

(4) to secure legal advise about the lawyer’s compliance with these Rules .

\[ \ldots \]

\footnotesize{\textsuperscript{148} See text accompanying \textit{supra} notes 106-21.}
\footnotesize{\textsuperscript{149} The list of adoptive states is available at http://www.abanet.org/cpr/mrpc/alpha_states.htm (Sept. 16, 2003). The exceptions are: California, Iowa, Maine, Oregon and New York. See id.}
\footnotesize{\textsuperscript{150} \textit{MODEL RULES OF PROF’L CONDUCT} R. 1.6 (2003). Prior to the ABA’s adoption of Model Rule 1.6, “42 states already had similar rules in place” for attorneys. Laurie P. Cohen, \textit{Quattrone Trial: New Template?}, WALL ST. J.,
Comments adopted by the ABA’s House of Delegates explain that:

Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client’s crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be prevented, rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses. Paragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.\textsuperscript{151}

Model Rule 1.6(b)(3) patently permits a lawyer to become a federal tax informant if she discovers that a client has used her services to violate a federal tax law, but only if doing so will “prevent, mitigate or rectify substantial injury to the financial interests” of the federal government. Out of how many dollars may a client cheat the IRS before the ABA would allow his lawyer to inform the IRS? In its Comment [8] to Model Rule 1.6, the ABA seems more generous than in its Rule, stating that the lawyer may reveal confidential information “to the extent necessary to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses”, apparently even if those losses are not “substantial”. Perhaps Comment [8] would permit an ABA-regulated lawyer to inform the IRS about a tax law violation, even if the IRS’s loss from that violation is minimal.

At least the ABA permits a lawyer to consult with another lawyer about these issues, in
order “to secure legal advice about the lawyer’s compliance with these Rules”. Note that neither California’s laws on tax preparer confidentiality, nor the AICPA’s Model Rules of Professional Conduct, permit professionals in those fields to consult with a lawyer regarding a client’s tax crimes.

2. The California Statute

California has staked out an extreme minority position on the issue of attorney-client confidentiality: By statute, California has made it “the duty of an attorney . . . [t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client.” Compare this statutory duty with ABA Model Rule 1.6(b)(3) and two significant differences are seen: First, a California attorney, who discovers that her client has used, or is using, her work to perpetrate a crime or fraud, may not reveal that information to anyone, even if doing so will prevent, mitigate or rectify substantial damage; and second, a California attorney must stay silent about any embarrassing or incriminating fact that she discovers on her own or learns from a third party. This last duty even: 1. extends to those who consult with an

151 Id. cmt. 8.
152 CAL. BUS. & PROF. CODE § 17530.5(a) (West Supp. 2005) and CAL. REV. & TAX. CODE § 7056.6 (West Supp. 2005). The relevant portions of those two statutes are described at supra note 125.
153 AICPA CODE OF PROF. CONDUCT R. 301.01 (as amended 1992), quoted at supra notes 140 and 141.
154 CAL. BUS. & PROF. CODE § 6068(e) (West 2005). However, beginning July 1, 2004, a California attorney may reveal “confidential information relating to the representation of a client to the extent that the lawyer reasonably believes the disclosure is necessary to prevent a criminal act that the attorney reasonably believes is likely to result in death . . . or substantial bodily harm . . . .” Id. § 6068(e)(2) (West Supp. 2005).
155 See generally Mark L. Tuft, For Your Eyes Only, L.A. LAW., Dec. 2002, at 26 (but note that Tuft’s discussion of Model Rule 1.6(b) has been superseded by the ABA’s 2003 amendments).
156 COMM. ON LEG. ETHICS, L.A. COUNTY BAR ASS’N, Op. 436 (1985) (barring a law firm from revealing that its former client had practiced, and might continue to practice, law without a license).
attorney without ever becoming clients;\textsuperscript{157} 2. continues after any attorney-client relationship has ended; and 3. survives the client.\textsuperscript{158} Although the California Evidence Code denies attorney-client privilege in certain circumstances, including when “the lawyer reasonably believes that disclosure of any confidential communication relating to representation of a client is necessary to prevent the client from committing a criminal act that the lawyer believes is likely to result in death or substantial bodily harm”,\textsuperscript{159} the attorney-client privilege remains intact when an attorney “reasonably believes” that her client will commit any other crime. Thus, even though two California appellate courts have asserted that a California attorney’s statutory duty of confidentiality, set forth in the Business & Professions Code, is subject to the exceptions to attorney-client privilege, set forth in the Evidence Code,\textsuperscript{160} a California courts would likely hold that an attorney who informs the IRS of the tax crimes of her client, or former client, violated her client’s confidence and failed to preserve his secrets.\textsuperscript{161}

V. Suggestions for Research and Policy

A. IRS Rewards Should Be Uncapped and Clearly Subject to Judicial Review

In its Internal Revenue Manual, the IRS states that it will not pay an informant more than $2,000,000, regardless of the amount of revenue that IRS collects as a result of the informant’s

\textsuperscript{157} COMM. ON LEG. ETHICS, L.A. COUNTY BAR ASS’N, Op. 366 (1977) (barring a criminal attorney from representing a murder suspect after the attorney had informally consulted with, but not been retained by, another suspect in the same murder); COMM. ON PROF’L RESPONSIBILITY AND CONDUCT, STATE BAR OF CALIFORNIA, Formal Op. 1984-84 (barring an attorney from representing an insurance company against an individual who had consulted with the attorney in another matter years earlier).

\textsuperscript{158} COMM. ON LEG. ETHICS, L.A. COUNTY BAR ASS’N, Op. 414 (1983) (finding that an attorney had breached his statutory duty to preserve client secrets when he publicly revealed his late client’s illegal tax schemes).

\textsuperscript{159} CAL. EVID. CODE § 956.5 (West 1995).

Since this limit does not appear in the statute authorizing the informant reward program, or in the amended Treasury Regulation that IRS issued in 1998, it is clear that the IRS could agree to a reward of more than $2,000,000 in a special agreement with an informant. Obviously, the IRS could also raise, lower or abolish that $2,000,000 cap by simply amending the Internal Revenue Manual: There would be no need for a Congressional amendment of section 7623 or for the proposal/publication/comment process by which Treasury Regulations are amended.

Elimination of the IRS’s cap on rewards is one of the recommendations of Ferziger and Currell, who propose that, in a model government informant reward program “low, fixed-percentage bounties with no nominal cap should be offered with the guarantee that . . . the maximum allowable bounty will always be paid where an agency [collects] on based on an informant’s tip . . . .” They then state that:

In comparison with this proposed model, . . . the IRS program [is] wrongly structured on nearly every count. By offering a relatively high percentage of the penalties, taxes and criminal fines collected as a bounty, the IRS draws in risk-prefering informants who seek to inform on low-probability, high-payout claims. By capping the nominal recovery--formally at one hundred thousand dollars and now at two

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161 See supra notes 156-58 and accompanying text.
162 I.R.M. ¶ 25.2.2.5.1 (04-27-99).
164 Treas. Reg. § 301.7623-1(a) (1998) (which states only that “a district or service center director may approve a reward, in a suitable amount . . . .”).
165 See I.R.M. ¶ 25.2.2.5.3 for the IRS’s procedures for such special agreements, quoted in relevant part at supra note 56.
166 Marsha J. Ferziger and Daniel G. Currell, Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs, 1999 U. OF ILL. L. REV. 1141, 1197 (1999) (original emphasis) (which examined four such programs, including the section 7623 program, and then modeled the incentives and motives of informants and how
million dollars—the IRS discourages risk-averse informants with much to lose and much more to gain by signaling to them that a truly huge payout will not be available, even where the information is worth billions of dollars to the government. By failing to guarantee a recovery to any informant ex ante, the IRS eliminates tips from risk-averse informants concerned about the costs of tipping and thereby undermines its more reliable sources of information. To top it off, the IRS only pays out an average of approximately two percent to claimants anyway, so its policy could simply be to award a low percentage in each case. By publicizing the fact that its bounties are, in fact rather low, the IRS could naturally weed out the gamblers from its pool of informants and focus on the remaining high-value, well-supported claims.\footnote{Id. at 1199-1200.}

While Ferziger and Currell’s analysis differs markedly from this paper’s predictions,\footnote{Cf. id. with supra Part IV.A. (for example, Ferziger and Currell’s recommendation that the IRS offer low reward percentages would, this paper predicts, decrease the supply of tax informants).} both agree that the IRS’s cap on informant rewards is penny-wise and pound-foolish.\footnote{This paper predicts that eliminating the IRS’s cap would, at least for some informants, increase the expected value of their IRS reward and, economic theory predicts, increase the number of tips the IRS receives. See infra Appendix.}

Although an IRS “guarantee” of a reward to an informant\footnote{See Ferziger, supra note 160, at 1200, quoted in full at supra note 167.} would also increase the number of tips received by the IRS, it is highly doubtful that the IRS would, or should, adopt such a policy. Instead, the IRS could waive the case law that seems to protect it,\footnote{See, e.g., Merrick v. United States, 846 F.2d 725 (Fed. Cir. 1988) and the text accompanying supra notes 74-81.} and publicly concede that Congress’ amendment of section 7623,\footnote{Tabor 2, supra note 2 at Title XII, §1209.} and the history of that change,\footnote{Tabor 2, supra note 2 at Title XII, §1209.} “can be given no other meaning that the [reward] decision is no longer committed solely to [IRS] the programs might be evaluated).}
discretion”\textsuperscript{174} and that federal courts may review the IRS’s denial of a reward. In the alternative, those courts should, at the first opportunity, rule that \textit{Merrick} and its progeny have been overturned by Congress’ statement that “rewards \textit{are to be paid} out of the proceeds of amounts (other than interest) collected by reason of the information provided.”\textsuperscript{175} Failing either of those remedies, Congress could further amend section 7623 to provide for a judicial review, possibly restricted to the Court of Federal Claims,\textsuperscript{176} of IRS decisions on informant rewards. Clearly, an informant’s right to an independent judicial review of the IRS’s refusal to pay her a reward would do more to increase her expected value of that reward than would an unreviewable IRS “guarantee”. Again, increasing that expected value will, economic theory predicts, increase the number of tips the IRS receives.\textsuperscript{177}

Of course, \textit{increasing} the IRS’s \textit{expected costs} of defending its refusals to pay informant rewards will \textit{decrease} the IRS’s demand for informant tips.\textsuperscript{178} But let us not lose sleep over IRS pleas for the status quo: The IRS has made excellent use of its monopsonistic power in the market for tax informants,\textsuperscript{179} and would, even with judicial review, very much retain the whip hand on setting the percentages paid to informants.\textsuperscript{180} Further, any informant dissatisfied with the reward she receives from the IRS must surely revalue her expected costs of “Fear”\textsuperscript{181} before filing a lawsuit against the IRS. In sum, the costs to the IRS of independent judicial review of its

\textsuperscript{173} See \textit{supra} text at notes 1-3.
\textsuperscript{174} See Beall v. United States, 336 F.3d 419, at 426-27 (5th Cir. 2003) (quoted at note 104).
\textsuperscript{175} \textit{J. COMM. ON TAX., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS, pt. 3, at 52 (1996) (emphasis added)}.
\textsuperscript{176} See \textit{supra} text accompanying notes 71-72.
\textsuperscript{177} See \textit{infra} Eqns. 1 and 4, in Appendix, and the accompanying text.
\textsuperscript{178} See \textit{infra} Eqns. 6-10, in Appendix, and the accompanying text.
\textsuperscript{179} See \textit{supra} Part V.C.
\textsuperscript{180} See \textit{supra} note 52 for a summary of the four-tier payment structure the IRS has established for informant rewards.
\textsuperscript{181} See \textit{infra} Eqns. 1 and 3, in Appendix, and the accompanying text.
decisions on informants’ rewards may be substantially less than the additional revenue it collects from the tips it receives as a result of the increase in the rewards informants expect as a result of such a public policy.

B. Congress Should Waive Sovereign Immunity from Claims for Breach of Confidentiality

Existing case law also seems to bar tax informants from suing the federal government in another area, i.e., in tort for damages caused by an IRS disclosure of their identities. While Congress’ 1996 amendments to section 7623, and the IRS’s subsequent amendment of Treasury Regulation section 301.7623-1(e) and Internal Revenue Manual paragraph I.R.M 25.2.1.2, might persuade a federal appellate court that the IRS now owes a duty of confidentiality to its informants, the fact remains that a potential informant’s fear of disclosure cannot now be assuaged by the likelihood that the IRS will compensate her for disclosing her identity.

Congress could reduce the consequences of that fear, and increase the likelihood that a potential tax informant will actually inform the IRS of another’s tax law violation, by simply amending sections 6103 and 7430 as follows:

Sec. 6103. CONFIDENTIALITY AND DISCLOSURE OF RETURNS/
RETURN INFORMATION[, AND IDENTITIES OF TAX INFORMANTS]

(a) GENERAL RULE.--Returns[, and return information[, and the identities of tax
informants] shall be confidential, and except as authorized by this title--

(1) no officer or employee of the United States,

(2) no officer or employee of any State, any local law enforcement agency
receiving information under subsection (1)(7(A), any local child support
enforcement agency, or any local agency administering a program listed in
subsection (I)(7)(D) who has or had access to returns[, or return information[, or
the identity of a tax informant] under this section, and

(3) no other person (or officer of employee thereof) who has or had access
to returns[, or return information[, or the identity of a tax informant] under this
subsection (e)(1)(D)(iii), paragraph (6), (12), or (16) of subsection (1), paragraph
(2) or (4)(B) of subsection (m), or subsection (n),

shall disclose any return[, or return information[, or the identity of a tax informant]
obtained by him in any manner in connection with his service as such officer or an
employee or otherwise or under the provisions of this section.188

(b) DEFINITIONS.--For purposes of this section--

\ldots

[(4) IDENTITY OF TAX INFORMANT.--The term “identity of a tax informant”
includes, but is not limited to, the name, address, taxpayer identification number
and other information about any individual who has furnished information about

\footnote{187 See infra Eqns. 1 and 3, in Appendix, and the accompanying text.}
a possible tax law violation to the Secretary.)

and

Sec. 7431. CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION OR DISCLOSURE OF RETURNS[, AND RETURN INFORMATION[, AND IDENTITIES OF TAX INFORMANTS]

(a) IN GENERAL--

(1) INSPECTION OR DISCLOSURE BY EMPLOYEE OF UNITED STATES.-- If any officer or employee of the United States knowingly, or by reason of negligence, inspects or discloses any return or return information with respect to a taxpayer[, or the identity of any tax informant,] in violation of section 6103, such taxpayer [or tax informant] may bring a civil action for damages against the United States in a district court of the United States.

(2) INSPECTION OR DISCLOSURE BY A PERSON WHO IS NOT AN EMPLOYEE OF UNITED STATES.-- If any person who is not an officer or employee of the United States knowingly, or by reason of negligence, inspects or discloses any return or return information with respect to a taxpayer[, or the identity of any tax informant,] in violation of section 6103, such taxpayer [or tax informant] may bring a civil action for damages against such person in a district court of the United States.

(f) DEFINITIONS.--For purposes of this section, the terms “inspect”, “inspection”, “return”, and “return information”[, and “identity of tax informant”] have the respective

meanings given such terms by section 6103(b).\textsuperscript{189}

Once these amendments becomes effective, a “betrayed” tax informant, or her personal representative, would be able to recover actual and punitive damages,\textsuperscript{190} the costs of the action\textsuperscript{191} and, in some cases, reasonable attorney’s fees.\textsuperscript{192} The statute of limitations on such a lawsuit would be “2 years after the date of discovery by the plaintiff of the unauthorized inspection or disclosure.”\textsuperscript{193}

C. ABA Model Rule 1.6 Should Rule All Professions

Of all the professional and statutory restrictions surveyed above,\textsuperscript{194} easily the worst, in terms of tax law enforcement, are Illinois’ Taxpreparer Disclosure of Information Act\textsuperscript{195} and section 17530.5(a) of the California Business and Professions Code, which make it a crime to inform the IRS of a tax law violation, if that violation was discovered while the informant was preparing an income tax return. Those statutes do not even allow a tax preparer to consult with her attorney about her rights and duties after discovering her client’s tax law violations. Nota bene: California has yet to make it a crime to inform the IRS of a tax law violation discovered while preparing an employment, or estate, or excise tax return,\textsuperscript{196} nor is it yet a crime for an

\textsuperscript{189} Cf. I.R.C. § 7431(a) (2000).
\textsuperscript{190} See id. § 7431(c)(1)(B). A tax informant’s recovery of punitive damages would require “clear and convincing” evidence of either a willful inspection or disclosure, or an inspection or disclosure that was the result of gross negligence. Id. § 7431(c)(1)(B)(ii).
\textsuperscript{191} See id. § 7431(c)(2).
\textsuperscript{192} See id. § 7431(c)(3). A tax informant’s recovery of reasonable attorney’s fees would be available only if she were the “prevailing party”, as defined by id. § 7430(c)(4)(A).
\textsuperscript{193} See id. § 7431(d).
\textsuperscript{194} See supra Parts IV.B.-E.
\textsuperscript{195} 720 ILL. COMP. STAT. 140/0.01-3 (1977), described supra accompanying note 125.
\textsuperscript{196} See CAL. BUS. & PROF. CODE § 17530.5(a) (West Supp. 2005) and CAL. REV. & TAX. CODE § 7056 (West Supp. 2005), both described supra in note 125 and accompanying text.
Illinois *bookkeeper* to blow the whistle on the next Enron. Note also that California preparers of employment, estate and excise tax returns, and Illini bookkeepers, may safely consult with their attorneys after discovering their clients are criminals. The public policies of tax collection, and general law enforcement, both favor creation of an exception to criminality for tax preparers who communicate evidence of tax law violations to their attorneys, the IRS and/or state tax agencies. Simply put, it should not *be* a crime to *report* a crime.

The ABA’s Model Rule 1.6,197 the substance of which had previously been adopted by 42 states to regulate their attorneys,198 provides for both of these public policy favored exceptions to client confidentiality. Conforming amendments should be made to the AICPA’s Rule 301.1,199 and to the state statutes and regulations that bar a certified public accountant from consulting with an attorney regarding her client’s tax law violations.200

D. The Need for Longitudinal Data

If the IRS, or Congress, decided to again change the tax informant program, then statistical analysis of the effects of that change could be very useful to future policy makers. Unfortunately, the statistics on tax informants released by the IRS are ill-suited to such analysis, as they consist of nothing more than an annual scorekeeping of number of claims filed; number of claims “allowed”; the total amount paid to informants; and the amounts, *including interest*,201 recovered by the IRS as a result of informant information. A sample of the IRS’s record keeping

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197 See quotation accompanying *supra* note 150.
198 Cohen, *supra* note 150.
199 Quoted in relevant portion at *supra* notes 140-41.
200 See *supra* notes 140-41 and accompanying text.
201 Note that the IRS excludes the interest it recovers from its calculation of rewards paid to an informant. I.R.M.¶
follows:

## Informants’ Claims

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>No. of Claims Filed</th>
<th>No. of Claims Allowed</th>
<th>Rewards Paid</th>
<th>Recovered by IRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>7,096</td>
<td>517</td>
<td>$7,963,594.</td>
<td>$167,529,731.</td>
</tr>
<tr>
<td>2000</td>
<td>4,424</td>
<td>382</td>
<td>$10,835,973.</td>
<td>$266,555,470.</td>
</tr>
<tr>
<td>2001</td>
<td>8,578</td>
<td>379</td>
<td>$3,333,035.</td>
<td>$44,024,333.</td>
</tr>
<tr>
<td>2002</td>
<td>N/A</td>
<td>N/A</td>
<td>$7,700,000.</td>
<td>N/A</td>
</tr>
<tr>
<td>2003</td>
<td>N/A</td>
<td>190</td>
<td>$4,100,000.</td>
<td>$61,600,000.</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>&gt; 20,098</strong></td>
<td><strong>&gt; 1,278</strong></td>
<td><strong>$22,132,602.</strong></td>
<td><strong>&gt; $539,709,534.</strong></td>
</tr>
</tbody>
</table>

Since the IRS has stated that “it can take two or more years before there is a final disposition” of an informant’s tip, it is a very unlikely that a claim will be “allowed”, i.e., a payment will be approved on that claim, in the year of its filing. Also, under the IRS’s post-1997 revisions to

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202 FAX from Anthony Burke, Media Relations Branch, Internal Revenue Service, Washington D.C., to author (Sept. 30, 2003) (on file with author); Tom Herman, How You Can Lose by Winning a Suit, WALL ST. J., Feb. 12, 2004, at D2 (“Since the late 1960s, the IRS has received nearly 250,000 reward claims. It has allowed rewards to only 19,458, less than 8% of the total received.”)

203 IRS Publication No. 733 at 2 (Rev. 09-97).

204 Before any payment is made on an informant’s claim, the IRS requires that:

1. The IRS employee who received the informant’s tip prepare a Confidential Evaluation Report on Claim for Reward, a Form 11369, in accordance with I.R.M. ¶ 25.2.2.4 (04-27-1999);
2. After receiving that evaluation report, a Service Center Informants’ Claims Examiner (an “ICE”) periodically request and review a transcript of the collections from each taxpayer reported by the informant; 3. If a transcript shows collections have been made, then the ICE prepare an allowance memorandum in accordance with I.R.M. ¶¶ 25.2.2.7.1 and 2 (04-27-1999);
4. The Service Center Director, or his designee, approve the allowance memorandum;
5. The ICE prepare both a memorandum to the Chief, Quality Control Assurance and Management Support Division, Attn: Revenue Accounting Control Unit, and a Letter 1136;
6. The Director, Compliance Division, sign both that memorandum and the Letter 1136; and
the tax informant program, “payments are to be made” to informants from the taxes, penalties and fines collected as a result of the information she provided, which makes it possible that payments to an informant may continue for several years as IRS collection efforts continue against the tax law violators exposed by the informant. These facts render the commonly computed ratios of “claims allowed” to “claims filed”, and “amounts paid to informants” to “amounts collected by the IRS”, virtually meaningless.

Instead, the IRS must follow claims longitudinally, i.e., from their filing to their final payment, rather than latitudinally, i.e., taking an annual census of claim stati, if it is to scientifically analyze how the supply of informants in affected by the various elements of the federal tax informant program. Note also that the IRS seems to collect data only on tax informant claims and ignores the revenues collected on tax tips provided to the IRS gratis. This seems short-sighted because it prevents the IRS from gathering data on what are possibly the most profitable tips the IRS receives, i.e., those for which informants ask nothing. Moreover, the IRS, as a monopsonist, could use such data to better price discriminate among tax informants, thereby capturing more tax tips at less cost. For example, if the IRS could distinguish which potential tax informants are more motivated by schadenfreude than by reward, or vice versa, it could adjust the incentives it presents, e.g., by increasing the publicity given to tax cheats, or increasing its reward percentages. The key to such price discrimination is detailed data on all tax
informants, not just the cursory annual survey of tax informant claims that the IRS releases to the public.209

For all that we on the outside know, the IRS already has developed these statistics and is deeply aware of the benefits and costs of changing various elements of its tax informants program.210 As honest taxpayers, we can only hope that the IRS is diligently maximizing its profits from this program.

VI. Conclusion

Federal tax law encourages those with information about violations of federal tax law to share that information with the Internal Revenue Service, which has promised cash rewards of up to $2,000,000 per tip received and confidentiality to all informants. Countervailing that federal tax policy are state and associational policies of confidentiality, some of them codified, which restrict lawyers, accountants and other professionals from disclosing certain information about their clients. Since those professionals are the very persons most likely to have information about federal tax law violations, various conflicts exist between federal and state policies. This paper has explained those conflicts, modeled the market for tax tips mathematically and suggested research and legislation in this area.

209 See table at supra note 202.
210 In the Summer of 2004, I was informed, by two ICEs in the IRS’s Ogden Service Center, that their office had a firm, but unwritten, policy of rejecting any informant’s claim for a reward if the information provided involved an unfiled return. Perhaps the IRS had learned that nothing will be gain by pursuing tax cheats who do not file tax returns.
Appendix: A Mathematical Description of the Market for Tax Informants

A. The Supply Function: What Motivates, and Dissuades, Potential Tax Informers

Congress clearly assumes that the possibility of a reward is one factor that motivates potential tax informers to contact the IRS\(^{211}\): The following model does the same. The model also assumes that ethics and psychology also motivate, and/or dissuade, potential tax informers. Mathematically, we may say:

\[
S = \int (E, \psi, r) \quad \text{(Eqn. 1)}
\]

where \(S\) = the supply of tax informants,

\(E\) = the ethical value of complying with, or breaking, the tax laws,

\(\psi\) = \(\text{sch} - f\) = the net psychological value of harming, and of being harmed by, a tax cheat,

\(r = (\text{Ex}(R))/(1 + i)^n\) = the present discounted value of the expected value of the informant’s reward from the IRS\(^{212}\),

\(\text{sch} = \text{Sch}/(1 + i)^n\) = the present discounted value of the informant’s schadenfreude when the tax cheat is punished,

\(f = F/(1 + i)^n\) = the present discounted value of the informant’s costs of being discovered, or “Fear”;

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\(^{211}\) See Tabor 2, supra note 1, at Title XII, § 1209(a); I.R.C. § 7623 (2000); and text accompanying supra notes 1-4.  
\(^{212}\) For example, if an informant believes that her information will produce $2,000,000 of tax, penalties and fines for the government, and she has a 30% chance at a 10% reward, a 10% chance at a 1% reward and a 60% chance at no reward, then her expected reward will be: \((.3 \times .1 \times 2,000,000) + (.1 \times .01 \times 2,000,000) + (.6 \times 0 \times 2,000,000) = 60,000 + 2,000 + 0 = $62,000.\) Of course, it may be years before the IRS collects that $2,000,000 and distributes the informant’s reward, which is why this expected value must then be discounted to the present before its effect on a potential informant is calculated.
i = interest rate,\textsuperscript{213} and

\[ n = \text{the number of years between the informant’s tip and its consequences to her.} \]

Note that, unlike \( \psi \) or \( r \), a potential tax informer’s ethical rewards or losses, or \( \mathbf{E} \), are immediate and are not discounted from some future date. This formulation predicts that ethics is the most immediate of all the factors that affect whether a potential tax informant will share information with the IRS. For example, if a potential informant places a high ethical value on compliance with the law, then she would realize an immediate, ethical reward when she informs the IRS of a tax law violation. Conversely, a tax protestor or an anarchist would realize an immediate, ethical reward by remaining silent. The IRS could test these predictions by mounting a public relations campaign against tax cheaters, and supporting tax informants, and then surveying tax informants to see if its efforts to change their ethical values had any effect of their decisions to contact the IRS.

Although this model does not predict the net effect of ethics on the supply of tax informants, the model does predict that schadenfreude and fear, the psychological rewards and costs of informing on a tax cheat, will have opposing effects on the supply function of tax informants. Mathematically, this means:

\[ \delta S/\delta \text{sch} > 0 \quad \text{(Eqn. 2)} \]

and

\[ \delta S/\delta f < 0 \quad \text{(Eqn. 3).} \]

In words, increasing a potential tax informant’s expected schadenfreude will increase the

\textsuperscript{213} The short-term federal funds rate is probably a good proxy for this interest rate, since that rate is virtually free of market risk and the risks of receiving a partial, or zero, reward are already accounted for in the formula for \( r \). See
likelihood that she will call the IRS. Conversely, increasing a potential tax informant’s expected costs of disclosure, or fear, will decrease the likelihood that she will call the IRS. However, even the IRS would be hard put to exploit these tendencies since schadenfreude and fear are likely to be highly correlated. That is, the pleasure of seeing another suffer stems from the psychological release of internal pain and persecution by its projection into an external object: However, that pleasure increases the paranoia of the projector, who will expect, and thus suffer from, retaliation from the internalized object. Mathematically, the average value of $\psi$ will be approximately zero, because an increase in a potential tax informant’s schadenfreude will be accompanied by an increase in her fear, and vice versa. The IRS would probably do us all a favor by eschewing any efforts to use psychological factors to increase the supply of tax informants.

Much more straightforward is the model’s prediction that the supply of informants will increase if the expected reward for informing increases, or

$$\frac{\delta S}{\delta r} > 0 \quad \text{(Eqn. 4).}$$

Reward then is, by far, the easiest of the factors influencing supply for the IRS to manipulate.

Finally, the supply of tax informants is predicted to decrease as the time between tipping the IRS, and receiving a reward, increases. Mathematically,

$$\frac{\delta S}{\delta n} < 0 \quad \text{(Eqn. 5).}$$

\textsuperscript{214} See generally IV Sigmund Freud, Instincts and Their Vicissitudes, in Collected Papers 60 (The Hogarth Press 1946).
B. The IRS’s Demand Function

Mathematically,

\[ D = \int (C, r, t) \]  \hspace{1cm} \text{(Eqn. 6)}

where \( D \) = the IRS’s demand for tax informants,

\[ C = PR + Inv, \]

\[ PR = \sum_{j=1}^{k} (\text{Pub}_j (1 + i)^m) \] = the summation of the capitalized IRS’s costs of publicizing the tax informant program,

\[ m = \text{the number of years between an IRS expenditure for publicity and the receipt of an informant’s tip} \]

\[ Inv = \text{IRS’s costs of investigating, and administering, informants’ tips}, \]

\[ r = \frac{\text{Ex}(R)}{(1 + i)^n} \] = the present discounted value of the expected value of the reward the IRS will pay an informant,

\[ i = \text{interest rate}, \]

\[ n = \text{the number of years between the informant’s tip and its consequences to her or the IRS}, \]

\[ t = \sum_{j=1}^{k} \frac{\text{Ex}(T_j)}{(1 + i)^n} \] = the summation of the present discounted values of the tax, penalties, fines and interest the IRS expects to collect as a result of the tax tips it “buys”.

Note that this model takes the receipt of the tip as time zero, with costs incurred prior

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215 The short-term federal funds rate is probably a good proxy for this interest rate, since that rate is virtually free of market risk and the risks of the IRS collecting revenue as a result of a tip, or of an informant receiving a reward are already accounted for in the formulae for \( t \) and \( r \). See supra note 212.

216 For example, if the IRS expects that only five percent of the tips it receives in 2003 will bear fruit, but that those fruit will be $10,000,000 in 2004, $20,000,000 in 2005, and $5,000,000 in 2005, and if \( i = 5\% \), then \( t = \$9,500,000 \).
to that date being treated as accruing interest until time zero, and costs incurred and revenues
received after time zero being discounted in value back to time zero. For convenience, the costs
of investigating and administering informant tips are treated as incurred at time zero.

The partial derivatives of the IRS’s demand function are:

\[
\frac{\delta D}{\delta PR} < 0 \quad (Eqn. 7)
\]

\[
\frac{\delta D}{\delta m} < 0 \quad (Eqn. 8)
\]

\[
\frac{\delta D}{\delta Inv} < 0 \quad (Eqn. 9)
\]

\[
\frac{\delta D}{\delta n} < 0 \quad (Eqn. 10)
\]

\[
\frac{\delta D}{\delta r} < 0 \quad (Eqn. 11)
\]

\[
\frac{\delta D}{\delta t} > 0 \quad (Eqn. 12).
\]

In words, the IRS’s demand for tax informants will decrease:

1. As its costs of publicity, PR, increase;

2. As the time between PR expenditures and its receipt of an informant’s tip, m, increases;

3. As its costs of investigating and administering the tips it receives, Inv, increase;

4. As the informants’ rewards it expects to pay, r, increases; and

5. As the time between tip and collection, n, increases.

Finally, the IRS’s demand for tax informants will increase as the expected revenue, t, generated
by their tips increases.

\[+ $18,140,590 + $4,319,188 = $31,959,778.\]