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IRS 'Rewards-for-Snitches' Program Comes Under Fire

Taxes: Informants paid up to 15% of recovered funds. Questions arise over ethics, greed and revenge.

April 15, 1998 | RALPH VARTABEDIAN | TIMES STAFF WRITER

Americans voluntarily hand over most of the $1.3 trillion owed to the Internal Revenue Service each year, but a tiny fraction of tax collections depends on an obscure and increasingly controversial IRS program of using paid informants.

Motivated by a combination of greed and revenge, informants are typically business associates, employees, acquaintances, neighbors or ex-spouses of tax cheats. Many experts say the program is one of the most unseemly parts of the U.S. tax system.

However, IRS officials say they exercise great care in handling the informants, weeding spurious allegations, and that the rewards play an important role in the nation's tax enforcement system.

The IRS pays the informants up to 15% of the taxes it recovers from their tips--up to a maximum of $2 million--though the vast majority of informants end up empty-handed.

After a series of recent congressional disclosures about widespread taxpayer abuses, watchdog groups are growing concerned about the ethics of the agency's informant reward program.

"We should refocus our efforts on good citizenry, not bribing people to answer questions," said John Berthoud, president of the nonpartisan National Taxpayers Union, who called on the IRS to end the program in an interview with The Times.

The program has been sharply criticized by individuals who say they were victimized by bogus allegations, and even by informants, such as Mary Case of Sherman Oaks, who say the IRS has stiffed them on their rewards.

The Senate Finance Committee, which has been broadly investigating IRS abuses over the last year, is expected to unveil new evidence later this month that taxpayers have been devastated by aggressive IRS investigations based on phony information from snitches.

One Tax Accountant Snitched on His Client

Tax attorneys and accountants generally decry the informant reward system, asserting that the government is on thin ice in offering money to taxpayers to turn each other in. They argue that a cornerstone of the U.S. tax system is the protection of taxpayer privacy and that the IRS is wrong to encourage people to breach confidential business or family relationships. In one case, a St. Louis tax accountant informed on his own client.

"It smacks of communism, turn in your parents if you catch them cheating," said San Francisco tax attorney Frederick Daily, author of the book "Stand up to the IRS."

Bruce Hockman, a top Los Angeles tax attorney whose clientele includes the rich and famous, refuses to help clients snitch to the IRS. "I have had people come in and ask me to take them downtown to IRS district headquarters," Hockman said. "I say no way. The Nazis did it, turn people in. It is unseemly."

Of course, Congress authorized the IRS to create the informant reward program in the first place. Former IRS historian Shelley Davis says her research indicates that informant rewards date back to the Civil War era.

Tipsters are one of the important parts of the IRS toolbox for enforcing tax compliance, says Thomas J. Smith, assistant IRS commissioner for examination and chief of the agency's informant reward program.

93% of Snitches' Tips End Up in Trash Can

IRS figures for 1996, the last year for which data are available, show that 9,430 Americans sought rewards. Of those, the IRS acted on just 650--meaning that 93% of the tips ended up in the IRS garbage can. The IRS paid out about $3.5 million in rewards and recovered $103 million in taxes.

"If you look at the last three years, we have had 2,000 cases closed, resulting in taxes of $797 million," Smith said. "So, in terms of dollars, most people would judge that as reasonably significant. It does supply a very useful source of information for us."

The IRS has a national informant hotline (1-800-829-0433), though many informants walk in or call in to the IRS' 33 district offices or 10 regional service centers, Smith said.

With little fanfare and with no explanation, the IRS last year decided to substantially boost the maximum allowable award to $2 million from $100,000. It also set a minimum reward of $100, eliminating a lot of penny ante payments.

In 1996, the agency's largest award was a jackpot-size $1.06 million. (The agency does not disclose who gets the awards or what cases they involve.) The agency's smallest was just $18--less than the typical reward advertised in newspapers for lost dogs.

Under the new guidelines, rewards range from 1% to 15% of the tax recovered, depending on the assistance provided by the informer. But all awards are at the "discretion" of IRS officials, who make their decisions behind closed doors. Of course, the rewards are taxable income.

The IRS takes a low-key approach, not seeking to send the message that the federal government is actively recruiting paid stool pigeons. The agency does not make Form 211, which informants must fill out to claim a reward, widely available. It isn't even kept in the IRS national headquarters lobby, where the agency has almost every form on display.

Asked if the IRS encourages Americans to inform on others, Smith said he could offer no advice and suggested that individuals do what they feel is right. But former IRS officials are more blunt.

Garbage Information Comes Streaming In

"Informants rewards are pretty distasteful to everybody except the person who gets one," said Phillip Brand, a tax expert at KPMG Peat Marwick LLP and former IRS chief of compliance. "People have a different feeling about informing when they do it as good citizens."

Another problem with paying for information is that the IRS gets a lot of garbage information. Brand recalled a tipster once sought a reward for the disclosure that the secretary of State was dealing drugs to Queen Elizabeth II and not reporting the sales on his taxes.

But weak allegations are less humorous when the IRS pursues them against innocent taxpayers. That apparently happened to John Colaprette of Virginia Beach, Va., whose home and two restaurants were raided in 1994 by armed IRS agents after his bookkeeper, Deborah A. Shofner, made phony allegations.

The bookkeeper was later arrested and charged with stealing from a Colaprette restaurant, the Jewish Mother. She was sentenced to 6 years and 11 months in Virginia.

"This case was investigated for just one and a half days before they obtained a search warrant, which was then executed 12 hours later," said Colaprette, who is expected to testify this month before the Senate Finance Committee's hearings on IRS abuses.

Although the committee is saying little about its planned hearings, it is expected to focus on the IRS' criminal investigation division, which handles most of the paid informants and conducts a wide range of undercover operations.

Since the raid on the Jewish Mother, the IRS has never assessed any back taxes or made any changes to his tax returns, Colaprette said. He has a $20-million suit against the IRS.

"Why do we have an agency that nobody controls?" Colaprette asked.

It isn't unusual for the IRS to deal with informants who violate confidential relationships. Like Colaprette's bookkeeper, when St. Louis tax accountant James Checksfield informed on his own client in 1989, he was discredited. The government dropped its tax evasion case against the client and the accountant lost his license.

Smith, the IRS chief of exams, said he could not discuss any specific cases because of privacy laws. But he said the IRS carefully screens allegations and is mindful of the potential for bogus information.

"It is a concern that we take very seriously," Smith said. "We absolutely try to be very careful about looking at returns with the greatest probability of error." Smith added that 89% of the returns examined as a result of a tip end up with changes.

While it isn't surprising that the targets of allegations feel abused, informants also are often frustrated over how the agency treats their claims.

If Case Isn't Closed, No Reward Is Paid

Case, the Sherman Oaks woman, tipped the IRS in 1985 to Stanley D. Hexom, a San Jose real estate broker later accused of swindling millions of dollars from elderly California investors in fraudulent real estate deals. She has never received a reward from the IRS, but neither has the agency closed her case.

As Hexom's bookkeeper, Case provided IRS agents boxes of evidence, including copies of doctored tax returns and locations of bank accounts, as well as testifying to a federal grand jury.

Under IRS guidelines, an informant who provides such specific information is supposed to get 15% of the back taxes. But a big caveat is that the IRS has to actually collect the back taxes. So, if the agency comes up empty-handed, so does the informant.

There is no doubt that the IRS went after Hexom, who was convicted on two counts of bank fraud and one count of preparing a false tax return. IRS agents tried to collect from Hexom's wife, though she may have escaped assessment by claiming she was an innocent spouse, said Richard Blos, Hexom's attorney in San Jose.

Hexom was released from prison in 1993 and is currently living in the Phoenix area. He could not be reached for comment.

Smith acknowledged that the agency is often criticized for taking too long time to pay rewards, but he added that 13 years is an abnormally long time for an informant to be kept waiting.

Other informants say the agency's criminal investigation division takes all the credit for big money cases and undermines the role played by informants.

Joseph Pinnavaia, an Oceanside gemstone expert, helped the IRS crack a tax fraud ring in the early 1980s, in which worthless stones were being donated to museums for big tax write-offs.

Pinnavaia died last November, but not before completing a manuscript, entitled, "The Most Corrupt Agency in the Federal Government: The Internal Revenue Service," which detailed how the agency mishandled his case.

With Pinnavaia's help, the IRS went after a doctor in Florida who had donated an allegedly worthless blue topaz gem to the Smithsonian Institution. By 1979, the IRS was receiving 10,000 tax returns a year with deductions for gemstones, it was later discovered.

Though Pinnavaia was awarded $11,000 for his help in the case, he asserted that the IRS cheated him by claiming it already knew about the larger nationwide fraud ring. The manuscript, a copy of which was provided to The Times, includes a variety of internal IRS documents, in which criminal division agents downplayed his role in the case.

"He felt the $11,000 didn't even cover his expenses," said Mathew D. Pinnavaia, his son. "They tried to deny he played any role."

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Tax Cheat Rewards

The increasing money paid out in an IRS program that rewards informants for turning in those who cheat on their taxes:

In millions

'96: $3,530,245

Source: Internal Revenue Service