SEC, CFTC Whistleblowers Dodge A Devastating Tax Bullet

By **Gary Aguirre** (February 12, 2018, 12:03 PM EST)

Gary Aguirre

Whistleblowers destined to receive bounties from the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission under the Dodd-Frank Act just dodged a deadly tax bullet. This drama within a drama played out last week when the U.S. government shut down for a few hours on Friday morning.

Before the government shutdown at midnight on Thursday, whistleblowers who received a bounty from the SEC and the CFTC faced devastating tax liability on any future award. The increased tax liability would have diluted the monetary incentives for Wall Street insiders to risk their careers by becoming whistleblowers. That, in turn, could cripple the SEC's whistleblower program, which Congress embedded in the Dodd-Frank Act to deter Wall Street banks from getting too creative with risky financial products, as they did with the toxic debt and credit default swaps in the run-up to the 2008 financial crisis.

But this all changed during the early hours of Friday, Jan. 9. The bill that reopened the government on Friday morning also granted SEC, CFTC, and state qui tam whistleblowers the same tax treatment as 22 other classes of whistleblowers, discrimination victims and civil rights claimants. Tucked away in Section 41107 of the 600-page bill were 23 words[1] that may have kept the SEC and CFTC whistleblower programs from becoming paper tigers. It short, this text vaporized the tax bullet about to strike this narrow class of whistleblowers. In the analysis below, I examine the potential impact of the bullet, who fired it, and who deflected it.

The Bullet's Impact

A simple hypothetical illustrates the harsh tax treatment SEC and CFTC whistleblowers were on track to receive when 2018 began. Assume two California residents (Jack and Jill) have evidence their employers are violating federal law. Jack's evidence proves a hedge fund made a $50 million profit by insider trading. Jill's evidence proves the same hedge fund falsely claimed losses on its tax return that reduced its tax liability by $50 million. Using Jack's proof, the SEC recovers $50 million from the hedge fund. Using Jill's evidence, the IRS also recovers $50 million. All funds go to the U.S. Treasury. The SEC awards Jack $5 million and the IRS does the same for Jill.

At this point, Jack's and Jill's fortunes differ. Under the tax law in effect on Jan. 1, 2018, Jack's taxable income would have included the entire $5 million award. Jack would net approximately $2.5 million after the payment of all state and federal taxes.[2] Jack must also pay his attorney 40 percent of the total $5 million award, the sum of $2 million. This leaves Jack with a net recovery of approximately $500,000: 1 percent of the SEC's $50 million recovery. From Jill's $5 million award, she takes an above-the-line deduction — an exclusion from gross income — for the $2 million she paid her attorney, leaving her with taxable income of $3 million. After state and federal taxes, Jill takes home approximately $1.5 million, three times Jack's award.

Had Jack received his award in 2017, the tax bite would not have been so severe. He could

have taken an itemized miscellaneous deduction on his federal return for his legal expenses and another deduction for any state taxes paid on his award,[3] subject to alternative minimum tax at 28 percent and 2 percent floor. He would have taken home $1.35 million.[4] But these deductions all but vanished in 2018 when the Tax Cuts and Jobs Act became operative.[5] Consequently, Jack's net take-home would be $500,000, one-third of Jill's award, despite the fact both won awards of $5 million.

Who Fired the Bullet?

The evolution of this tax anomaly began with Commissioner v. Banks.[6] It broadly held that discharged employees who obtain recoveries relating to their job loss could not take an above-the-line deduction for their attorneys' fees. After Banks, the case law got worse. In Campbell v. Commissioner,[7] the tax court applied Banks in holding a qui tam whistleblower could not take an above-the-line deduction for his attorney's fees. Campbell put an exclamation mark on Banks; it tacked on a 20 percent penalty against Campbell.

Meanwhile, Congress amended Internal Revenue Code § 62 in 2004 to give above-the-line deductions for attorneys' fees to a sweeping class of whistleblowers, discrimination victims and civil rights claimants under federal statutes, common law and state law.[8] However, the IRS, SEC and CFTC whistleblower statutes did not exist in 2004 and thus were not included in the amendment's broad language.

In 2006, when Congress created the IRS whistleblower statute, it also amended IRC § 62 to give IRS whistleblowers an above-the-line deduction for attorneys' fees.[9] In enacting the SEC-CFTC whistleblower incentive legislation, Congress used the IRS program as the model, but it failed to amend Section 62 to give this new class of whistleblowers an above-the-line deduction for their attorneys' fees.

Consequently, SEC-CFTC whistleblowers who receive an award in 2018 would be sailing into a perfect storm: Banks means they may not exclude their attorneys' fees from gross income. The TCJA all but eliminates the option of taking itemized miscellaneous deductions. Finally, Campbell serves notice the IRS will seek a 20 percent penalty if they get too creative.

The Bullet's Collateral Damage: The SEC's Whistleblower Program

The TCJA would have stripped the SEC's whistleblower program of its key deterrent for keeping Wall Street banks from a repeat performance of the 2008 financial crisis: awards large enough to incentivize Wall Street insiders to become whistleblowers before their banks become "too big to fail." According to the U.S. Government Accountability Office, the 2008 financial crisis inflicted a $22 trillion loss on the U.S. economy.[10] A report by the Senate Subcommittee on Investigations blamed Wall Street fraud for that hit,[11] just as the Pecora investigation blamed Wall Street fraud for the 1929 crash and the Great Depression.[12]

Congress intended for large awards under the SEC and CFTC whistleblower programs to motivate insiders to blow the whistle on their errant institutions, even though those insiders could commit "career suicide" in doing so. To overcome the "career suicide" risk, according to a report by the Senate Banking Committee, the SEC and CFTC whistleblower programs provide "for amply rewarding whistleblower(s), with between 10% and 30% of any monetary sanctions that are collected."[13]

Due to the double taxation created by the TCJA, Banks and Campbell on SEC and CFTC

whistleblowers, the incentive for Wall Street insiders to risk “career suicide” had vanished. Insiders like Jack in the hypothetical would recalibrate the risk of being blackballed from the financial industry for 1 percent of an SEC award. Hence, coming into 2018, the SEC whistleblower program had become Wall Street’s paper tiger.

Who Deflected the Bullet

As unlikely as it might seem, SEC and CFTC whistleblowers were beneficiaries of the U.S. government shutdown on Feb. 8, 2018. The act that reopened the government had a unique feature when it reached the floor of the House and the Senate as a bill — it could not be amended.[14] In this sense, when the bill came to the floor of the Senate and the House, it was "take it or leave it."

For SEC and CFTC whistleblowers, the take-it-or-leave-it feature may have been a godsend. Tucked away in Section 41107 of the 600-page bill[15] were 23 innocuous words amending Section 62 to give the SEC and CFTC whistleblowers an exclusion from gross income, retroactive to Jan. 1, 2018. Sen. Chuck Grassley, R-Iowa, had included the same amendment in the the bill that became the TCJA, but his fellow Republicans cut it from the bill during the reconciliation process. By adding the same text to the bill to reopen the government, Grassley assured its passage.

Gary J. Aguirre is a former SEC staff attorney who now focuses his practice on investor and whistleblower claims involving banks, hedge funds, mutual funds, private equity funds, brokers and other financial institutions. His firm, Aguirre Law APC, is based in San Diego.

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[1]164 Cong Rec S 709, 749.

[2] I used Tax Form Calculator (available at https://www.taxformcalculator.com/) to compute Jack’s and Jill’s taxes.

[3] Id. Jack took itemized deductions for $2 million in litigation expenses and $600,000 in California state taxes.

[4] IRS Publication 529 (2017), Miscellaneous Deductions, at 8; available at https://www.irs.gov/pub/irs-pdf/p529.pdf.

[5] See 26 USCS § 67.2(g).

[6] Commissioner v. Banks, 543 U.S. 426 (2005).

[7] Campbell v. Commissioner, 134 T.C. 20 (2010).

[8] 26 U.S.C. § 62(a)(20).

[9] 26 U.S.C. § 62(a)(21).

[10] U.S. General Accounting Office (GAO) Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act, GAO-13-180 (Washington, D.C.: Jan. 2013); available at http://www.gao.gov/assets/660/651322.pdf.

[11] U.S. Senate, Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report 7-11, 318-625 (April 13, 2011), available at http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[12] Ferdinand Pecora, Wall Street under Oath: The Story of Our Modern Money Changers.

[13] S. Rep. No. 111-176, at 38, 110-12, 217-18 (2010).

[14] Associated Press, Used to Scuffles, Rand Paul Takes on Senate, Forces Shutdown, NYTimes.com, Feb. 9, 2018.

[15] Supra, n. 1.

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