Craig Patrick and Michele Patrick v. Commissioner of Internal Revenue, 142 T. C. No. 5 (2014)

In a significant tax ruling, the U. S. Tax Court determined that monetary awards received from qui tam actions under the False Claims Act are to be treated as ordinary income, not as capital gains. The court rejected the argument that such awards were akin to selling information to the government, ruling that no sale or exchange of a capital asset occurred. This decision impacts how whistleblowers report income from such actions, affirming that these awards are rewards and not proceeds from the sale of a capital asset.

Parties

Craig Patrick and Michele Patrick, Petitioners, challenged the Commissioner of Internal Revenue, Respondent, in the United States Tax Court regarding the tax treatment of qui tam awards they received.

Facts

Craig Patrick, a former reimbursement manager at Kyphon, Inc. , and Charles Bates, another employee, suspected Kyphon of fraudulent practices in marketing spinal treatment equipment. They filed qui tam complaints under the False Claims Act against Kyphon and various medical providers, alleging fraudulent billing to Medicare. Kyphon settled for $75 million, and subsequent settlements were reached with other providers. Patrick received a relator’s share of $5,979,282 in 2008 and $856,123 in 2009, which he reported as capital gains on his tax returns. The IRS issued a deficiency notice disallowing capital gains treatment and characterizing the income as ordinary.

Procedural History

The Patricks petitioned the U. S. Tax Court after receiving a notice of deficiency from the IRS, challenging the characterization of their qui tam awards as ordinary income. The case was fully stipulated and proceeded without trial. The Tax Court reviewed the case de novo, applying the preponderance of the evidence standard.

Issue(s)

Whether the qui tam awards received by Craig Patrick qualify for capital gains treatment under I. R. C. § 1222?

Rule(s) of Law

Under I. R. C. § 1222(1), (3), capital gain is defined as gain from the sale or exchange of a capital asset. I. R. C. § 1221(a) defines a capital asset as property held by the taxpayer, excluding certain categories. The ordinary income doctrine excludes from capital asset status any property representing income items or

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accretions to the value of a capital asset attributable to income.

Holding

The Tax Court held that the qui tam awards received by Craig Patrick do not qualify for capital gains treatment because they did not result from the sale or exchange of a capital asset. The awards were characterized as ordinary income.

Reasoning

The court's reasoning focused on two primary requirements for capital gains treatment: the sale or exchange of a capital asset. Firstly, the court determined that the qui tam awards did not arise from a sale or exchange. The False Claims Act does not establish a contractual right to sell information but rather permits individuals to advance claims on behalf of the government. The court rejected the analogy of the relator's provision of information to the sale of a trade secret, as no rights were transferred to the government. Secondly, the court examined whether the right to future income or the information provided constituted a capital asset. The court applied the ordinary income doctrine, concluding that the right to a qui tam award, being a reward, is not a capital asset. Additionally, the information provided to the government was not considered a capital asset, as Patrick lacked the legal right to exclude others from its use. The court also considered and dismissed the applicability of I. R. C. § 1234A, which treats gains from certain terminations as capital gains, due to the absence of a capital asset.

Disposition

The Tax Court entered a decision for the respondent, affirming the IRS's characterization of the qui tam awards as ordinary income.

Significance/Impact

This decision clarifies the tax treatment of qui tam awards, establishing that they are to be reported as ordinary income rather than capital gains. It impacts the financial considerations of potential whistleblowers under the False Claims Act, potentially affecting the incentives for such actions. The ruling reinforces the application of the ordinary income doctrine to rewards and underscores the narrow interpretation of what constitutes a sale or exchange of a capital asset. Subsequent cases and tax guidance have followed this precedent, impacting the taxation of similar awards and influencing the strategic considerations of relators in qui tam litigation.

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