142 T.C. 124 (2014)

A monetary award received for bringing a qui tam complaint under the False Claims Act is considered ordinary income, not a capital gain, for federal income tax purposes.

Summary

Craig and Michele Patrick received monetary awards for filing qui tam complaints under the False Claims Act (FCA). They reported these awards as capital gains on their tax returns. The Commissioner of Internal Revenue issued a deficiency notice, disallowing capital gains treatment and characterizing the awards as ordinary income. The Tax Court upheld the Commissioner's determination, finding that a qui tam award does not result from the sale or exchange of a capital asset and is therefore taxed as ordinary income. This decision clarifies the tax treatment of qui tam awards, impacting relators who receive such payments.

Facts

Craig Patrick, while working as a reimbursement manager for Kyphon, Inc., discovered that Kyphon was marketing a spinal procedure as inpatient to increase revenue, leading to potentially fraudulent Medicare billings. Patrick, along with another employee, Charles Bates, filed qui tam complaints against Kyphon and later against medical providers involved in the fraudulent billing. Kyphon settled for $75 million after the government intervened. Patrick received a relator's share of $5,979,282 in 2008 and $856,123 in 2009.

Procedural History

The Patricks reported the qui tam awards as capital gains on their 2008 and 2009 tax returns. The IRS issued a deficiency notice, reclassifying the awards as ordinary income. The Patricks petitioned the Tax Court, challenging the IRS's determination. The case was submitted fully stipulated to the Tax Court.

Issue(s)

Whether a qui tam relator's share award qualifies for capital gains treatment under Section 1222 of the Internal Revenue Code.

Holding

No, because a qui tam award is not the result of a sale or exchange of a capital asset as required for capital gains treatment under Section 1222 of the Internal Revenue Code; it is considered ordinary income.

Court's Reasoning

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The court reasoned that to qualify for capital gains treatment, the income must result from the "sale or exchange" of a "capital asset." The court rejected the Patricks' argument that filing a qui tam complaint constitutes a contract where the relator sells information to the government. The court stated, "The Government does not purchase information from a relator under the FCA. Rather, it permits the person to advance a claim on behalf of the Government. The award is a reward for doing so. No contractual right exists." The court also found that the information provided by Patrick was not a capital asset because he did not have the right to exclude others from using or disclosing it. Quoting *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965), the court noted that the ordinary income doctrine excludes from the definition of a capital asset "property representing income items or accretions to the value of a capital asset themselves properly attributable to income." Since a qui tam award is a reward, it is treated as ordinary income, not a capital asset.

Practical Implications

This case clarifies that qui tam awards are generally taxed as ordinary income, not capital gains. This means relators receiving such awards will face higher tax rates than if the awards were treated as capital gains. Attorneys advising clients on qui tam actions must inform them of this tax implication. This ruling reinforces the principle that rewards for providing information leading to government recoveries are considered ordinary income, impacting tax planning for whistleblowers. This case has been followed in subsequent tax court cases involving similar whistleblower awards.

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