Patrick v. Commissioner, 148 T. C. No. 14 (2017)

In Patrick v. Commissioner, the U. S. Tax Court ruled that a qui tam award received under the False Claims Act does not qualify for capital gains tax treatment. The decision, articulated by Judge Kroupa, clarified that such awards are rewards for whistleblowing efforts and must be taxed as ordinary income. This ruling establishes a significant precedent for the taxation of qui tam awards, impacting how whistleblowers and their legal advisors approach the financial implications of such actions.

Parties

Petitioners: Patrick (husband and wife), taxpayers challenging the tax treatment of their qui tam awards. Respondent: Commissioner of Internal Revenue, defending the determination of tax deficiencies and the classification of qui tam awards as ordinary income.

Facts

Petitioner husband was employed as a reimbursement manager at Kyphon, Inc. , a company that marketed medical equipment for spinal treatments. Kyphon instructed its sales representatives to market the procedure as inpatient to increase revenue, despite the equipment being suitable for outpatient use. Petitioner husband, believing this practice violated federal law, along with another employee, Charles Bates, filed a qui tam complaint against Kyphon and later against medical providers for defrauding the government through Medicare billing. The complaints resulted in settlements, and petitioner husband received relator's shares amounting to $5,979,282 in 2008 and $856,123 in 2009. These amounts were reported as capital gains on their tax returns, but the IRS classified them as ordinary income, leading to a dispute over the tax treatment of qui tam awards.

Procedural History

The case was submitted to the U. S. Tax Court fully stipulated under Rule 122. The IRS issued a notice of deficiency for the tax years 2008 and 2009, asserting that the qui tam awards should be taxed as ordinary income. Petitioners timely filed a petition contesting this determination. The Tax Court, after considering the legal arguments and the stipulations, ruled in favor of the Commissioner, affirming the IRS's position on the tax treatment of the qui tam awards.

Issue(s)

Whether a qui tam award received under the False Claims Act qualifies for capital gains treatment under section 1222 of the Internal Revenue Code?

Rule(s) of Law

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Section 1222 of the Internal Revenue Code defines a capital gain as the gain from the sale or exchange of a capital asset. A capital asset is defined under section 1221(a) as property held by the taxpayer, subject to exclusions. The ordinary income doctrine excludes from capital asset classification property that represents income items or accretions to the value of a capital asset attributable to income. The False Claims Act, 31 U. S. C. secs. 3729-3733, allows private individuals (relators) to file a civil action for false claims against the government and receive a portion of the recovery as a relator's share.

Holding

The U. S. Tax Court held that a qui tam award does not qualify for capital gains treatment under section 1222 of the Internal Revenue Code. The court determined that the relator's share is a reward for whistleblowing efforts and should be taxed as ordinary income.

Reasoning

The court's reasoning focused on two key requirements for capital gains treatment: the sale or exchange requirement and the capital asset requirement. For the sale or exchange requirement, the court rejected the petitioners' argument that the qui tam complaint established a contractual right to a share of the recovery. The court clarified that the False Claims Act does not create a contractual obligation for the government to purchase information from the relator but rather allows the relator to pursue a claim on behalf of the government. The court also distinguished the provision of information under the False Claims Act from the sale of a trade secret, noting that the relator did not transfer any rights to the government. Regarding the capital asset requirement, the court applied the ordinary income doctrine, concluding that the right to a share of the recovery is not a capital asset because it represents a reward for the relator's efforts, which is taxable as ordinary income. The court also determined that the information provided to the government did not constitute a capital asset because the relator did not have the legal right to exclude others from its use or enjoyment. The court's analysis included references to precedents such as Tempel v. Commissioner and Freda v. Commissioner, reinforcing its conclusion that qui tam awards are not eligible for capital gains treatment.

Disposition

The Tax Court entered a decision in favor of the Commissioner, affirming the IRS's determination that the qui tam awards should be taxed as ordinary income.

Significance/Impact

Patrick v. Commissioner has significant implications for the taxation of qui tam awards under the False Claims Act. The decision establishes a clear precedent that such awards are to be treated as ordinary income, impacting how whistleblowers

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and their legal advisors approach the financial and tax planning aspects of qui tam actions. This ruling may deter potential whistleblowers from pursuing qui tam claims due to the higher tax burden associated with ordinary income treatment. Additionally, the decision reinforces the application of the ordinary income doctrine in distinguishing between capital assets and income items, providing clarity for future cases involving similar tax issues.

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