Blowing the Whistle on Taxing Whistleblower Recoveries

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In this article, Wood and Shapiro consider the taxation of whistleblower recoveries under the False Claims Act.

Distinguishing capital gain from ordinary income can be tricky, but it makes a big difference in effective tax rates. As with much of tax law, common sense and fairness are rarely enough to determine how something is taxed. The basic principle underlying preferential treatment for capital gain is that risk taking should be rewarded. Congress "believed it is important to encourage risk-taking and believed that a reduction in the taxation of capital gains will have that effect."[1]

A whistleblower is the quintessential risk taker. He can end up unemployed, shunned by peers and colleagues, penniless, or worse. In short, the whistleblower's position can be terrifying. One might expect the government to welcome whistleblowers who run this gauntlet and are willing to come forward.

Nevertheless, the Service's own whistleblower program is regarded with almost universal skepticism. Although the notorious UBS whistleblower Bradley Birkenfeld collected more than $100 million of the government's reported collection of $5 billion in unpaid taxes, many believe whistleblower awards are usually nil or unfairly reduced.[2] Some observers believe that Birkenfeld's award was mostly for show and hardly makes up for thousands of legitimate claims that languish or are simply denied. The program has largely been a disappointment.[3]

In fact, beyond tax whistleblowers, the Service's treatment of whistleblowers in general has been disappointing. For example, in the view of the IRS and one circuit court, recoveries under the False Claims Act (FCA) are ordinary income. However, a strong case can be made to support capital gain treatment.[4]

The FCA is designed to let the government "purchase information it might not otherwise acquire,"[5] and since 1986, the government has collected more than $24 billion under the law.[6] Those who come forward with information about fraud

[1]Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 108th Congress," JCS-5-05 (May 31, 2005).

[2]Jeremiah Coder, "Group Questions Reduced Awards Under Whistleblower Guidelines," *Tax Notes*, Aug. 15, 2011, p. 668.

[3]Senate Finance Committee member Chuck Grassley, R-Iowa, has expressed extreme disappointment in the management of the program. Letter from Grassley to former Treasury Secretary Timothy F. Geithner and former IRS Commissioner Douglas Shulman (May 3, 2012). The Government Accountability Office also rebuked the program for being slow in granting awards and lacking proper systems. GAO, "Tax Whistleblowers: Incomplete Data Hinders IRS's Ability to Manage Claim Processing Time and Enhance External Communication," GAO-11-683 (Aug. 2011).

[4]*See, e.g.*, Robert W. Wood, "Capital Gain for Relators Under the False Claims Act," *Tax Notes*, Mar. 22, 2010, p. 1537.

[5]*United States ex rel. Russell v. Epic Healthcare Management Group*, 193 F.3d 304, 309 (5th Cir. 1999).

[6]*See* Fraud Statistics — Overview, Oct. 1, 1987-Sept. 30, 2009, Civil Division, Department of Justice, *available at* http://www.taf.org/FCAstats-2009.pdf (identifying $24,056,382,238 in *qui tam* and non-*qui tam* recoveries through Sept. 30, 2009).

perpetrated against the government — and therefore against taxpayers — deserve incentives, tax and otherwise. Even if FCA recoveries are not treated as tax exempt (something that has been proposed), the public policy of rewarding risk taking favors capital gain treatment.

This article considers the taxation of whistleblower recoveries under the FCA. It examines a Ninth Circuit decision in which the court held that a relator's recovery was not entitled to capital gain treatment. It discusses key points the court overlooked and predicts what whistleblowers can expect in light of the IRS position.

False Claims Act

The FCA imposes a civil liability on any person who defrauds the federal government.[7] The United States can bring an action under the FCA, but most cases are actually brought by relators — private whistleblowers who have information regarding fraud. The relator's case is called a *qui tam*[8] action, and the relator must serve a copy of the complaint and all related information on the federal government. The government then has a right to intervene in the case.

To reward relators for the extraordinary risks they take in coming forward and the inside information they provide, the government pays them a share of the recovery. If the government intervenes, that share ranges from 15 to 25 percent. If the government does not intervene, the share ranges from 25 to 30 percent. Within these ranges, the percentage awarded depends on the extent to which the relator substantially contributed to the case.[9]

For years, the IRS taxed relators on their gross recoveries, even on the share (often exceeding 50 percent) their lawyers received.[10] In 2004, Congress provided an above-the-line deduction for the attorney fees.[11] However, even after that change in the law, the IRS pursued taxpayers who received their relator shares before the effective date of the deduction.[12]

Some relators have argued that their recoveries were not income.[13] Although the courts have not been receptive to that argument, Congress is considering legislation that would allow illegally fired whistleblowers and civil rights plaintiffs to pay taxes on back pay at favorable rates and to be awarded tax-exempt compensatory damages.[14] Bills specifically exempting *qui tam* recoveries from gross income have been introduced as well.[15] Legislative relief for *qui tam* relators is therefore conceivable.

Still, a relator taxed on his net income might reasonably think it should be taxed not as ordinary income, but as capital gain. An apt analogy would be intellectual property recoveries, which are often entitled to the more favorable rates.[16] Before obtaining an FCA award, whistleblowers generally must wait many years after furnishing the intelligence that leads to a government recovery.

***Alderson* Case**

The Ninth Circuit is the first and only circuit court to consider whether a relator's share of a recovery should be taxed as ordinary income or capital gain. The court in *Alderson v. United States*[17] held for the IRS, finding that the relator's share was not entitled to capital gain treatment. Other taxpayers in the Ninth Circuit may find their facts distinguishable from *Alderson*. Even more obviously, the decision should not bind taxpayers in other circuits, but the IRS clearly likes the result.

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[7]31 U.S.C. section 3729(a).

[8]31 U.S.C. section 3730(d). *Qui tam* is short for "qui tam pro domino rege quam pro se ipso in hac parte sequitur," meaning "who pursues this action on our Lord the King's behalf as well as his own." *See Woods v. Empire Health Choice Inc.*, 574 F.3d 92, 98, n.1 (2d Cir. 2009).

[9]31 U.S.C. section 3730(d)(1).

[10]*See Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Benci-Woodward v. Commissioner*, 219 F.3d 94 (9th Cir. 2000); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995). A minority of circuits allowed plaintiffs to report gross income measured only by their net recovery. *See Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000).

[11]*See* section 62(a)(19); P.L. 108-357, section 703; and 118 Stat. 1418, 1548.

[12]*Sims v. Johnson*, 2006 U.S. Dist. LEXIS 18399 (D.D.C. 2006) ("the Act only applies to fees paid after the passage of the Act on October 22, 2004 by its plain language"). *Bagley v. United States*, 112 A.F.T.R.2d (RIA) 5602, 2013 U.S. Dist. LEXIS 109801 (C.D. Calif. 2013) (relator originally deducted attorney fees paid before 2004 on Schedule A but, on amended return, reported *qui tam* award on Schedule C and was allowed to deduct fees as ordinary and necessary business expenses).

[13]*Brooks v. United States*, 383 F.3d 521 (6th Cir. 2004). *See also Campbell v. Commissioner*, 658 F.3d 1255 (11th Cir. 2011); *Roco v. Commissioner*, 121 T.C. 160, 164-165, n.2 (2003); and *Trantina v. United States*, 512 F.3d 567, 570, n.2 (9th Cir. 2008).

[14]H.R. 3195 (introduced Oct. 13, 2011, by Reps. John Lewis, D-Ga., and Jim Sensenbrenner Jr., R-Wis.); and S. 1781 (introduced the same day by then-Sen. Jeff Bingaman and Sen. Susan Collins, R-Maine), together known as the Civil Rights Tax Relief Act of 2011.

[15]H.R. 1274, 110th Cong., 1st Sess. (2007); H.R. 4887 109th Cong., 2d Sess. (2006).

[16]Wood, "Patent Suit Recovery: Ordinary or Capital?" *Los Angeles Daily Journal* (Sept. 7, 2012).

[17]686 F.3d 791 (9th Cir. 2012).

James Alderson had been the CFO of a hospital that kept two sets of books: one for the auditors and one for Medicare. Alderson refused to prepare separate books and was fired. During his wrongful termination suit, he obtained documents in discovery suggesting widespread accounting fraud and used them to file a *qui tam* suit against his former employer in 1993.[18]

Alderson tried for five years to convince the government to intervene. In the meantime, he assisted the government with its own investigation into the fraud and prepared analyses of documents it had obtained. The government finally intervened in 1998 and in 2003 settled for $631 million.[19]

Alderson received a 16 percent relator's share, 1 percent above the minimum percentage allowed by the FCA. Alderson had formed a partnership, the Alderson Family Limited Partnership (AFLP), to which he assigned the relator's share. Alderson and his wife timely filed gift tax returns reporting taxable gifts of AFLP interests to their children, and they also had the shares valued.[20]

Alderson claimed that his share should be taxed as capital gain. After all, he had a property right in the information he provided to the government, and he exchanged that property right for his relator's share. The IRS argued that it was ordinary income, claiming that Alderson did not have (and could not have) a property right in the information. The IRS claimed that his relator's share was simply pay for his services to help the government prove its case.

No Sale or Exchange?

Agreeing with the IRS, the Ninth Circuit found that Alderson did not sell or exchange his information. The court said his right to a relator's share was simply conferred by the FCA. The court said that if Alderson had offered to sell the information to the government in return for a sum of money, ''the government would almost certainly have refused the offer.''[21]

The court found that the relator's share compensated Alderson for his *efforts*, not for the *information* he provided. As support for this conclusion, the court noted that Alderson spent five years persuading the government to intervene, performed an extensive analysis of 2,500 documents the government had obtained through subpoenas, and prepared his own spreadsheet based on the analysis. The court theorized that Alderson was paid for all of that legwork, rather than for transferring the information.

Relator's Information Not a Capital Asset?

The court determined that neither the information Alderson provided nor the relator's share was a capital asset. The court conceded that information and papers are often protected by property rights. However, it also held that the information and papers Alderson provided were not *his* property. Rather, the court emphasized, he had no legal right to exclude others from using the information, and it was known by others.[22]

The court acknowledged that Alderson was required by the FCA to file the information under seal, so there was admittedly some element of secrecy. Nevertheless, the court stressed that Alderson had no power to prevent others from disseminating or using that information. Therefore, the court held, he had no property right in the information.

Relator's Share Not a Capital Asset?

The court also dismissed Alderson's theory that the relator's share *itself* was a capital asset. The court grudgingly conceded that the relator's share can be property for some purposes. For example, it could be assigned to others — Alderson had assigned part of his share to his wife and children, following a formal appraisal and gift tax return filings.

The court relied on a capital gain test from *United States v. Maginnis*: (1) whether the taxpayer made an ''underlying investment of capital in return for the receipt of his'' right, and (2) whether the sale of his right reflected ''an accretion in value over cost to any underlying asset.''[23] Surprisingly, the court found that Alderson did not meet either *Maginnis* criterion. The court held that uncovering accounting fraud is not an investment of capital, even if Alderson had to incur expenses to acquire the information. It noted that expenses can be incurred in the production of ordinary income.

Even more surprisingly, the court found that the increase in value between 1993 and 2003 did not reflect an increase in value over the cost of the underlying asset. Rather, the court stated, the increase in value was a result of Alderson's work.[24] This conclusion might seem reasonable if one ignores the relator's share provisions of the FCA.

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[18]*United States ex rel. Alderson v. Quorum Health Group Inc.*, 171 F. Supp.2d 1323, 1325 (M.D. Fla. 2001).

[19]*Alderson*, 686 F.3d 793. There was an earlier settlement in 2001, but the matter of the tax treatment of Alderson's share of that recovery was not before the Ninth Circuit.

[20]*Id.*

[21]*Id.* at 795.

[22]*Id.* at 795.

[23]*Id.*

[24]*Id.*

Nonsecret Information Can Be Property

The Ninth Circuit's decision was a defeat for the taxpayer and whistleblowers in general. Moreover, it seems downright wrongheaded in theory and ignores persuasive and pertinent authorities.

The court emphasized that a property right exists only in information that cannot be accessed by others. However, this statement contradicts established precedent. For example, in *United States Mineral Products Co. v. Commissioner*,[25] the Tax Court found that a sale of manuals, reports, and other documents containing manufacturing methods, raw material specifications, and sales material resulted in a capital gain. Each was held to be property for tax purposes, even though "some portion of this material was accessible to petitioner's competitors."[26]

The court also ignored *Ofria v. Commissioner*,[27] although it was cited in the briefs. In *Ofria*, the taxpayer submitted an engineering proposal to the U.S. Air Force. The contract allowed those submissions to remain confidential if the taxpayer included a special legend. Ofria failed to include the required legend, and the IRS argued that capital gain treatment was unavailable.

The court sensibly rejected the Service's extreme interpretation by relying on common sense. Because the Air Force had paid more than $1.5 million for the proposal, confidentiality was obviously intended.[28] *Ofria* shows plainly that absolute secrecy is not required for capital gain treatment. Even though the *qui tam* relator's information is known by others and is only valuable to the government, it is nevertheless entitled to capital gain treatment.

The taxpayer-favorable case law goes far beyond *Ofria*. There is a long line of cases holding that a common law property right exists even in journalism. News, it goes without saying, is definitely not secret.[29] One state court explained that such a property right exists in "facts and information collected and utilized by skill, labor, and expense, *although the same information is available to anyone who chooses to collect it*."[30]

Even the U.S. Supreme Court has recognized these property rights. In *International News Service v. AP*, the Supreme Court held that news is quasi-property and can be given protection against unfair competition.[31] The Court upheld an injunction prohibiting a newspaper from routinely copying another newspaper's stories and selling them as its own. Even more importantly, the Court recognized the "right in news as a property right upon its value as a commercial product, resulting from the use of *capital and labor*, and possessing value capable of being realized only by sale and purchase."[32]

The Court noted that regarding "capital and expenditures involved, *the gatherer is in no different position than is the author or inventor*."[33] The same can be said of a relator under the FCA. The Supreme Court's decision recognized both the property right that exists in gathered news and the capital nature of that asset. These recognized rights and their character are significant under the income tax law.

Of course, the Court in *International News Service* held that news was quasi-property, and not full property. It is worth noting that the Court's hedging may have been because of concern that granting full property recognition to news would chill free speech.[34] Alderson simply sought recognition that he turned over valuable capital assets to the government. That would not jeopardize free speech or violate public policy.

On the contrary, it would further encourage whistleblowers to come forward with information that is valuable to society and the fisc. Moreover, unlike newspaper companies, which are in the business of news, most *qui tam* relators are not in the business of selling *information property* regarding fraud to the government. Alderson clearly was not. Most *qui tam* relators are transferring unique information property that the government needs and values.

Further, although Alderson may not have been able to prevent access to some of the facts on which the government relied, he had *sole* access to his own information and documents regarding those facts. His personal collection of information property, which consisted of his own experience, knowledge, and understanding of facts regarding Medicare fraud, as well as his collection of documents, was solely his own.

When it comes to information property, a myopic focus on exclusive possession is ill-advised. The opinions in *United States Mineral Products Co.*, *Ofria*, and *International News Service* show that property

[25]52 T.C. 177 (1969).
[26]*Id.* at 189, 199.
[27]77 T.C. 524 (1981).
[28]*Id.* at 543-544.
[29]*Sioux Biochemical Inc. v. Cargill Inc.*, 410 F. Supp.2d 785, 805 (N.D. Iowa 2005); *U.S. Sporting Products Inc. v. Johnny Stewart Game Calls Inc.*, 865 S.W.2d 214, 217-218 (Tex. App. 1993); *McCord Co. v. Plotnick*, 108 Cal. App. 2d 392, 239 P.2d 32 (1951); *Bond Buyer v. Dealers Digest Publishing Co.*, 25 A.D.2d 158, 267 N.Y.S.2d 944 (1966).
[30]*Gilmore v. Sammons*, 269 S.W. 861, 863 (Tex. Civ. App. 1925) (emphasis added).
[31]*International News Service v. AP*, 248 U.S. 215 (1918).
[32]*Id.* (emphasis added).
[33]*Id.* (emphasis added).
[34]*Id.* at 241 ("The view we adopt does not result in giving to complainant the right to monopolize either the gathering or the distribution of the news").

rights can exist in information, regardless of whether others can be completely excluded. These conclusions strongly suggest that a relator's recovery should be entitled to capital treatment.

Guaranteed Share Cannot Be for Services

The Ninth Circuit also erred in giving short shrift to the FCA's guarantee of a fixed recovery in exchange for the information provided. It is difficult to explain that failing because the FCA is so clear. The statutory guarantee indicates that the relator has a property right to the information and documents that form the basis of the *qui tam* action. The relator's share represents a payment for the exchange of the information and documents.

The FCA only guarantees a fixed right to a recovery for nonpublic information. The FCA provides no guaranteed recovery for relators who rely on publicly disclosed information.[35] A relator who relies on publicly disclosed information may receive 0 to 10 percent of the proceeds, depending on the significance of the information and the relator's role in advancing it.

The right to a *minimum* recovery is only guaranteed for relators who provide inside information that the government does not already have and that it cannot access through public channels. The FCA clearly values the information and documents more than any services rendered by the relator. When the government does not intervene, the relator is guaranteed at least 25 percent of the proceeds. The relator may receive up to 30 percent on a discretionary basis, depending on the significance of the information provided and the contributions the relator made.

That is no mere theoretical distinction. In fact, it is difficult to understand how the guaranteed share can somehow be equated with the performance of services. Even the relative value of the guaranteed versus discretionary shares carries a message. The discretionary portion of any FCA recovery is always going to be minimal in comparison with the guaranteed portion. Even if the relator receives the maximum recovery of 30 percent, the 5 percent discretionary share is still less than 17 percent of the total recovery.

Even if the government intervenes, the relator's discretionary share above the minimum 15 percent will never constitute the bulk of a relator's total recovery. For example, if the relator receives the maximum discretionary share and recovers 25 percent, his 10 percent discretionary share is still only 40 percent of his total recovery. The guaranteed 15 percent portion is always going to be the largest component of the award.

Even if the discretionary share wholly represented payment for services (it often represents an extra bonus for the significance of the relator's information and documents), it will always be less than half of the total recovery. The bulk of the recovery will always be the guaranteed portion to which the relator is entitled by virtue of the information provided.

That is a compelling structural and statutory reason for capital gain treatment. Yet it is one the Ninth Circuit appears to have ignored. The FCA's statutory scheme strongly suggests that the relator's recovery is capital. The bulk of the award is for the information property transferred, not for services rendered.

The case law on intellectual property recoveries is particularly helpful. In *Kucera v. Commissioner*, the Tax Court held in a memorandum opinion that an inventor — an inveterate tinkerer with 21 inventions and several patents — was still not a professional and therefore was entitled to capital gain treatment.[36] Most *qui tam* relators are even less likely to be engaged in a trade or business.[37] They are taking a significant risk — one they will probably never be in a position to take again.

As the Tax Court has noted, "Courts and the Commissioner's rulings frequently treat government-granted rights as capital assets."[38] Relator rights under the FCA certainly qualify. The statute provides a government-granted right to a percentage recovery in exchange for valuable nonpublic information. This guaranteed recovery is not dependent on any services performed by the relator.

Finally, there has been no suggestion that the IRS could view *qui tam* recoveries as self-employment income subject to payroll taxes. If the payment to a relator is — despite the FCA's clear language — truly payment for services, wouldn't consistency require the Service to collect self-employment tax, too?

It would seem so, but the Justice Department must not think the relator is being paid for services. After all, the department's policy when issuing

[35]31 U.S.C. section 3730(d)(1) (if the action is primarily based on specific information ("other than information provided by the person bringing the action"), the court may award from 0 to 10 percent of the proceeds); *Cook County v. United States ex rel. Chandler*, 123 S. Ct. 1239, 1243, n.2 (2003); *United States ex rel. Merena v. SmithKline Beecham Corp.*, 205 F.3d 97, 106 (3d Cir. 2000) (the 0 to 10 percent range applies when an original source brings a claim primarily based on publicly disclosed information).

[36]10 T.C.M. 303 (1951).

[37]*But see Bagley v. United States*, 112 A.F.T.R.2d 2013-5166 (C.D. Calif. 2013) (taxpayer with trade or business of bringing *qui tam* cases receives ordinary income).

[38]*Tempel v. Commissioner*, 136 T.C. 341 (2011).

Forms 1099 on FCA recoveries is to report them as other income (on Form 1099-MISC, box 3), not as non-employee compensation (box 7).

Looking Forward

Nearly a century and a half after its enactment, the FCA continues to be important for policing government contractors and protecting the fisc. Given the Ninth Circuit's donning of blinders in denying capital treatment to Alderson, its decision is unlikely to be the final word. In holding that the income was ordinary rather than capital, the court focused on Alderson's lack of control over the information he provided, as well as the services he rendered to the government.

In the Ninth Circuit's defense, subsequent cases may be less confusing to courts. Other *qui tam* relators may not engage in the same degree of extraordinary personal effort as Alderson. The *Alderson* decision may also have been influenced by a perception that the relator was attempting to split income between himself and his family limited partnership.

It is even possible that the Ninth Circuit believed the government's argument that Alderson had made his own bed. Alderson had originally filed returns reporting the relator's share as ordinary income, only later amending them to report the share as capital gain. Whatever the reasons for the court's holding, it is worth questioning.

Tax law, intellectual property law, and property law all point to the opposite conclusion. If a newspaper reporter has a property (or even quasi-property) right in publicly available information, the *qui tam* relator must also have such a right. In fact, the relator's case is far stronger.

After all, the information the relator exchanges for a right to a guaranteed payment is confidential and, by definition, unavailable to the government. The *qui tam* complaint is filed under seal and the court can enforce this secrecy through its contempt authority.[39] With a misguided analysis of control and secrecy, the Ninth Circuit failed to recognize that the FCA's formula itself rewards risk-taking relators for providing inside information. The bulk of the relator's recovery is for the information provided.

Alderson, who worked for five years on his own to assist the government and analyzed 2,500 documents without pay, still received only a 1 percent discretionary share in addition to the guaranteed 15 percent share he received in 2003.[40] His 1 percent discretionary share did not even relate entirely to the services he rendered. The court presiding over his underlying *qui tam* case noted that Alderson's initial disclosures were also significant.[41]

Courts addressing this important issue should consider whether the Ninth Circuit missed both the forest and the trees. The *qui tam* relator transfers rights to valuable property in exchange for a guaranteed right to a share of the recovery. Any recovery attributable to services rendered is discretionary and is a minor portion of the overall relator's reward.

There is perhaps no more deserving a recipient of preferential treatment than the *qui tam* relator. Nevertheless, according capital gain treatment to the relator requires no policy argument or bending of the tax law. Treating the relator's income as capital gain is consistent with legal authorities and with the treatment of many payments for intellectual property. It is also consistent with the congressional intent to reward risk taking through preferential treatment for capital gain.

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[39]18 U.S.C. section 401.

[40]*Alderson*, 686 F.3d at 793.

[41]*Quorum Health Group*, 171 F. Supp.2d 1332 ("Although the government questions the quality of Alderson's initial disclosures, the significance of the disclosures is indisputable. Admittedly, years passed and an heroic effort by many, including prominently Alderson and the team he assembled, contributed to the development of the factual information, documentary evidence, and legal arguments necessary to prevail. Nonetheless, the weight and importance of Alderson's initial allegations and his knowledge of hospital cost accounting formed the enduring foundation upon which the multi-million dollar recovery stands").