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Capital Gain for Relators Under the False Claims Act

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Federal False Claims Act cases involve relators who come forward with evidence of fraud and enter into what is usually a long-term contractual relationship with the federal government leading to a relator share. In this article, Wood asserts that the resulting relator share in those cases should be taxed as capital gain, not as ordinary income.

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The federal False Claims Act (FCA)[1] was enacted in 1863 to ferret out fraud in the federal government. There were major amendments to the law in 1943, 1986, and 2009.[2] The financial impact of the legislation is significant, with the government collecting more than $24 billion between 1987 and 2009.[3]

A relator files suit under seal on behalf of the United States under the FCA's *qui tam* provision.[4] Within 60 days, he must turn over all related information to the federal government. In return,[5] the government pays a relator share of 15 to 25 percent if the government intervenes, or 25 to 30 percent if it does not.

Should the relator share be taxed as ordinary income or as capital gain, as would a sale of intellectual property? Should the answer depend on exactly what the relator provided to the government and how it stands up to the know-how and trade secrets tax authorities? Although no court has yet addressed this issue, I'll attempt to show that the case for capital gain treatment is strong.

A relator share ranges from 15 to 30 percent,[6] dipping below 15 percent *only* if the relator's action is based primarily on publicly disclosed information. In that event, the relator receives 0 to 10 percent, depending on the significance of the information and the relator's role in advancing it.[7] The relator must turn over all documents and testimony to the government, but there is no guarantee the government will intervene to take over the case.

Within 60 days after the relator files suit and hands over the evidence,[8] the Department of Justice must decide whether to intervene.[9] However, this deadline is often extended, sometimes for years.[10] The government intervenes in roughly one case out of five.[11] When it does, statistics show a dramatically higher rate of return for the relators, despite the lower percentage of their relator shares.[12]

Relator Share as Property

When the government receives damages, it determines the relator share.[13] What the relator will receive depends on:

- the significance of the information he provided to the government;
- the contribution he made to the result; and

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[1]31 U.S.C. sections 3729-3733.

[2]Significant amendments to the FCA were enacted in 1986. *See* 99 P.L. 562, 100 Stat. 3153.

[3]*See* Fraud Statistics — Overview, Oct. 1, 1987-Sept. 30, 2009, Civil Division, U.S. Depart. 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).

[4]31 U.S.C. section 3730(d). That 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).

[5]*See U.S. ex rel. Hebert v. Dizney*, 295 Fed. Appx. 717, 723 (5th Cir. 2008).

[6]*See* 31 U.S.C. section 3730(d)(1) and (2).

[7]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. Pa. 2000) (the 0 to 10 percent range applies when an original source brings a claim primarily based on publicly disclosed information).

[8]*See* 31 U.S.C. section 3730(b)(2).

[9]*Id.*

[10]In one case, six years passed before the government finally intervened and the complaint was unsealed. *United States ex rel. Ramadoss v. Caremark Inc.*, 586 F. Supp.2d 668, 672 (W.D. Tex. 2008), *vacated and remanded on other grounds*, 584 F.3d 655 (5th Cir. 2009).

[11]*See supra* note 3.

[12]*Id.*

[13]31 U.S.C. section 3730(d)(2).

- whether the information the relator provided was previously known to the government.[14]

Every *qui tam* claim emanates from the government's claim for fraud,[15] a property right of the government that is also part-owned by the relator. Neither the code nor the Treasury regulations define what constitutes property.[16] However, "property" generally includes the aggregate of rights protected by the government, including the right to dispose of something, to possess and use it, and to exclude everyone else from interfering.[17]

Significantly, the relator's filing triggers an enforceable assignment to the relator of part of the government's claim.[18] The relator exchanges his intellectual property for a portion of the government's property right. Under traditional authorities, what the relator remits qualifies as property, but is it a capital asset?

Although it is easier to say what a capital asset is *not* than to say what it is, a relator's property interest is clearly capital. Section 1221 defines a capital asset by reference to the follwing excluded categories of property:

1. stock in trade (inventory);

2. depreciable or real property used in a trade or business;

3. a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property;

4. accounts or notes receivable acquired in a trade or business;

5. certain federal publications received without consideration or a discount;

6. certain commodities derivative financial instruments held by commodities dealers;

7. certain hedging transactions that are clearly defined as such before the close of the day on which the transaction was acquired, originated, or entered into; and

8. supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business.[19]

The relator's claims do not run afoul of any of these exclusions: Of course, it should be no surprise that much of the focus in the case law is on whether the underlying claims relate to "property." Many legal rights constitute property, including life estates,[20] foreign currency, and currency contracts.[21] Oil, gas, and mineral rights are also property[22] yielding capital gain or loss, whether via a direct transfer of mineral interests, futures contracts, or the proceeds of condemnation sales.[23]

In all, the property and capital asset hurdles do not seem high. Even sales of body parts and plasma can qualify for capital gain or loss treatment, because none of the statutory exclusions apply.[24] Clearly, what is entitled to capital gain treatment continues to evolve.

Contract Rights, Name Rights, and Trade Secrets

Many contract recoveries are considered capital by the courts. For example, commodity contracts are treated as property rights, their disposition being capital.[25] The right to develop agricultural land has been analogized to condemnation rights[26] and thus also treated as property.[27] As a whole, the authorities on the capital versus ordinary character of contract rights have favored taxpayers.[28]

A relator has a *qui tam* claim only when he has independent knowledge and acts as a supplier of know-how or secret information.[29] It is notable that secret information has fared well in tax law. The right to a

[14]31 U.S.C. section 3730(d)(1); *see also United States ex rel. Alderson v. Quorum Health Group*, 171 F. Supp.2d 1323, 1332 (M.D. Fla. 2001) (citing S. Rep. No. 99-345, at 28 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5293 (the "Senate factors") regarding 1986 amendments to the FCA).

[15]*See* 31 U.S.C. section 3729(a).

[16]*See, e.g., Crane v. Commissioner*, 331 U.S. 1 (1947).

[17]*See Black's Law Dictionary*, 845-846 (6th ed. 1991).

[18]*Vt. Agency of Natural Res. v. United States ex rel. Stevens,* 529 U.S. 765, 773 (2000). ("The FCA can reasonably be regarded as effecting a partial assignment of the Government's damages claim.")

[19]Section 1221(a).

[20]*See Bell Estate v. Commissioner*, 137 F.2d 454 (8th Cir. 1943); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); *Allen v. First National Bank and Trust Co.*, 157 F.2d 592 (5th Cir. 1946), *cert. denied*, 330 U.S. 828 (1947).

[21]*See* Rev. Rul. 74-7, 1974-1 C.B. 198; *Carborundum Co. v. Commissioner*, 74 T.C. 730 (1980), *acq.*, 1984-2 C.B. 1; *see also Hoover v. Commissioner*, 72 T.C. 206 (1979), *nonacq.*, 1980-2 C.B. 2, *acq. in part*, 1984-2 C.B. 1. *See* cases collected in Rothman, Brady, Capps, and Herzog, *Capital Assets*, 561-2nd T.M. A-32(1) (Tax Management Inc. 2008).

[22]*See, e.g.,* section 614 (definition of property); section 1254 (gain from disposition of interest in oil, gas, geothermal, or other mineral properties); *Commissioner v. Farmers and Ginners Cotton Oil Co.*, 120 F.2d 772 (5th Cir. Ala. 1941), *cert. denied*, 314 U.S. 683 (1941).

[23]*See Jahn v. Commissioner*, 58 T.C. 452 (1972), *aff'd per curiam*, 475 F.2d 1140 (6th Cir. 1973).

[24]*See* discussion in Rothman, et al., *supra* note 21; Note, "Tax Consequences of Transfers of Bodily Parts," 73 *Columbia Law Review* 842 (1973); *see also* Note, "The Sale of Human Body Parts," 72 *Michigan Law Review* 1183 (1974).

[25]*See Renzeihausen v. Lucas*, 280 U.S. 387 (1930); *Greenbros. Inc. v. Commissioner*, 23 T.C. 226 (1954), *acq.*, 1955-1 C.B. 3; *S.S. Pierce Co. v. United States*, 57-2 U.S. T.C. para. 9886 (D. Mass. 1957); *Cont'l Distrib. Co. v. United States*, 143 F. Supp. 652 (E.D. Ill. 1956).

[26]*See* Rev. Rul. 77-414, 1977-2 C.B. 299.

[27]*See Trunk v. Commissioner*, 32 T.C. 1127 (1957), *acq.*, 1960-2 C.B. 7.

[28]*See, e.g.,* TAM 200049009 (Aug. 9, 2000), *Doc 2000-31669*, *2000 TNT 238-17* (power supply contracts were property for purposes of capital gain treatment); LTR 200215037 (Jan. 14, 2002), *Doc 2002-8807*, *2002 TNT 72-44* (termination of an existing power agreement qualified as the sale of the contract producing capital gain or loss); *Lehman v. Commissioner*, 25 T.C. 629, 635 (T.C. 1955) (contract rights from whiskey purchase agreements were incident to taxpayers' investment allowing profits realized on their sale to be long-term capital gains); *Estate of Shea v. Commissioner*, 57 T.C. 15 (T.C. 1971), *acq.*, 1973-2 C.B. 1.

[29]"With this requirement the government seeks to purchase information it might not otherwise acquire." *U.S. ex rel. Hebert*,

(Footnote continued on next page.)

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corporate name, trade name, or business name is clearly property, its disposition capital.[30] The same is true of trade secrets,[31] often defined as any information not generally known in a trade.[32] Payment for inventions, formulas, patterns, processes, customer lists, and even news[33] generates capital gain or loss,[34] often without defining "trade secrets" or "know-how."[35] In fact, the IRS sees little difference between know-how and trade secrets.[36]

Patents and Know-How

Section 1235 gives broad capital gain treatment to patent holders regardless of holding period, method of payment, or even the inventor's status.[37] All other forms of intellectual property qualify for capital gain treatment, but not as automatically as with patents. Still, if a technique, formula, or other asset qualifies as know-how, it will be eligible for capital gain treatment.[38]

Although know-how is not defined in the code or regulations, the IRS and the courts have been flexible. As early as 1955,[39] the IRS acknowledged that know-how (although nonpatentable) is simply "something that its possessor can grant to another for a consideration."[40] By 1969, the IRS identified criteria for evaluating whether information is know-how for tax purposes[41]:

- It is secret, safeguarded, and known only by the owner and certain employees.
- It represents a discovery, which, although not patentable, is original, unique, and novel.
- It is not revealed by a patent, subject to a patent application, or disclosed by the product to which it relates.
- It does not represent mere knowledge or efficiency resulting from experience, or mere skill and manipulation.
- It is not merely the rights to tangible evidence of information.
- It is not developed especially for the transferee.
- It is not assistance in the construction of a plant building, or advice as to the layout of machinery and equipment.
- It is not educational training for the transferee's employees.
- Technical information of a related or similar nature will not be furnished on a continuing basis without adequate compensation.

Since trade secrets and know-how appear to be indistinguishable for purposes of receiving capital gain treatment,[42] it is not necessary to determine which the relator transfers. In any event, a relator's *qui tam* claim satisfies each of those criteria. Secrecy is also present, for the relator must file suit under seal.[43] However, absolute secrecy is not required. Many cases recognize the capital status of know-how or trade secrets even though the information is known to people other than the transferor.[44]

The size of the relator share depends on the significance of the information the relator provided, the contribution he made to the end result, and whether the information was new to the government or previously known.[45] The focus is unequivocally on the knowledge or know-how the government acquires.

Court Cases on Know-How

Although court decisions generally agree that some level of secrecy is an element of know-how, they extend capital gain treatment to nonsecret materials ancillary to a transfer of know-how and patents. Furthermore, a nominally secret formula or process can qualify for capital gain treatment even if it can be easily discovered.[46] In the seminal case of *E.I. du Pont de Nemours & Co. v. United States*,[47] the Court of Claims defined trade secrets broadly, noting that the information is frequently in the public domain.[48] Hence, sometimes it is not that the *information* itself must be secret, but how it is *used*.[49]

Another granddaddy case is *Ofria v. Commissioner*,[50] involving a taxpayer (CMC) producing bomb couplers for the Air Force. The contract granted the Air Force all rights to use any data in exchange for incentive payments that CMC and its shareholders reported as capital gain. The IRS argued that the incentive payments were for services, claiming the information was not property, or that even if it was, it was not a trade secret.

Nevertheless, the Tax Court held the transferred data was property and a capital asset. Any link to services was unimportant, because when one pays for an invention it necessarily compensates the inventor for services. Without deciding which one, the Tax Court ruled the incentive

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295 Fed. Appx. at 723 (citing 31 U.S.C. section 3730(e)(4) and *U.S. ex rel. Russell v. Epic Healthcare Mgmt. Group*, 193 F.3d 304, 308-309 (5th Cir. Tex. 1999)).

[30]*See United States v. Gen. Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968); Rev. Rul. 55-694, 1955-2 C.B. 299.

[31]*See E.I. DuPont de Nemours & Co. v. United States*, 288 F.2d 904 (Ct. Cl. 1961).

[32]*Id.* at 911.

[33]*Id.*

[34]*See* Rothman et al., *supra* note 21, at A-33.

[35]*See, e.g., U.S. Mineral Products Co. v. Commissioner*, 52 T.C. 177, 196 (T.C. 1969); *Taylor-Winfield Corp. v. Commissioner*, 57 T.C. 205, 213 (T.C. 1971), *aff'd*, 467 F.2d 483 (6th Cir. 1972); Rev. Rul. 64-56, 1964-1 C.B. 133.

[36]*See* Rev. Rul. 55-17, 1955-1 C.B. 388, modified, Rev. Rul. 64-56; 1964-1 C.B. 133; Rev. Rul. 71-564, 1971-2 C.B. 179.

[37]*See* section 1235; Charles Edward Falk, *Tax Planning for the Development and Licensing of Patents and Know-How*, 557 T.M. A-10(1) (Tax Management Inc. 2008), Rev. Rul. 69-482, 1969-2 C.B. 164.

[38]*Id.*; *see also Ofria*, 77 T.C. at 535.

[39]Rev. Rul. 55-17, 1955-1 C.B. 388, modified, Rev. Rul. 64-56, 1964-1 C.B. 133, amplified, Rev. Rul. 71-564, 1971-2 C.B. 179.

[40]*Id.*

[41]Rev. Proc. 69-19, 1969-2 C.B. 301, amplified, Rev. Proc. 74-36, 1974-2 C.B. 491.

[42]*See, e.g.,* Rev. Rul. 71-564, 1971-2 C.B. 179.

[43]31 U.S.C. section 3730(b)(2).

[44]*See* Falk, *supra* note 37, at A-29.

[45]*See United States ex. rel. Alderson v. Quorum Health Group, Inc.*, 171 F. Supp.2d 1323, at 1332; 31 U.S.C. section 3730(d)(1).

[46]*See* Falk, *supra* note 37, at A-29.

[47]288 F.2d 904 (Ct. Cl. 1961).

[48]*Id.* at 911.

[49]*See supra* note 46.

[50]77 T.C. 524 (1981), *nonacq.*, 1983-1 C.B. 1.

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payments were for trade secrets, know-how, or unpatented technology protectable as a form of property.[51] Even without secrecy, that was enough for capital gain treatment.

The body of trade secret and know-how tax authorities suggest that secret information clearly qualifies for capital gain treatment,[52] and that even something *less* than secret may still qualify.[53] A relator's transfer of information stands up well to those authorities. The relator transfers know-how, providing the government with written disclosure of substantially all material evidence and information he possesses.[54] The relator must file his complaint under seal, and it must remain so for at least 60 days after the government receives his evidence. Frequently, it remains under seal much longer.[55]

The *sine qua non* of the *qui tam* claim is the information itself, and any link to services is tenuous. As one court noted, in an FCA case, ''the government seeks to purchase information it might not otherwise acquire.''[56] The 15 percent minimum payment is in exchange for the relator's independent knowledge of fraud.[57] A higher percentage beyond 15 percent may depend *in part* on the relator's ''contribution'' to the action, but that contribution can involve both data and services.[58]

The import of the relator's secret knowledge runs throughout the FCA, allowing for a reduced relator share only if the relator brings an action based primarily on *already publicly disclosed information*.[59] To be sure, the authorities addressing the tax treatment of know-how transfers are not uniform in their handling of secrecy. However, even if secrecy is viewed as essential, a relator clearly satisfies it. A relator's *qui tam* claim also falls within traditional notions of a chose in action — intangible personal property constituting a capital asset.[60]

[51]*Ofria*, 77 T.C. at 540.

[52]Bertrand M. Harding, ''Obtaining Capital Gains Treatment on Transfers of Know-How,'' 37 *Tax Lawyer* 307, 309 (Winter 1984).

[53]*Id.*; *see also* Falk, *supra* note 37, at A-30.

[54]*United States ex rel. Kelly v. Boeing Co.,* 9 F.3d 743, 746 (9th Cir. Wash. 1993); 31 U.S.C. section 3730(b)(2).

[55]31 U.S.C. section 3730(b)(2).

[56]*United States ex rel. Hebert*, 295 Fed. Appx. at 723; *United States ex rel. Russell*, 193 F.3d at 308-309.

[57]*United States ex rel. Hebert*, 295 Fed. Appx. at 723 (citing 31 U.S.C. section 3730(e)(4) and *United States ex rel. Russell*, 193 F.3d at 308-309).

[58]31 U.S.C. section 3730(d)(1).

[59]*Id.*; *Cook County*, 123 S. Ct. at 1243 n.2; *United States ex rel. Merena*, 205 F.3d at 106 (legislative history suggests the 0 to 10 percent range applies only when an original source brings a claim primarily based on publicly disclosed information).

[60]*See, e.g., Commissioner v. Golonsky*, 200 F.2d 72, 74 (3d Cir. 1952), *acq.*, 1956-2 C.B. 6 (1956) (a chose in action as intangible property); *Osenbach v. Commissioner,* 198 F.2d 235, 236-237 (4th Cir. 1952) (sale or exchange of a chose in action produces capital gain); *Benedum v. Granger*, 180 F.2d 564, 566 (3d Cir. 1950) (disposition of a chose in action ''clearly constitutes an exchange of capital assets''); *Jeffrey v. United States, IRS (In re Jeffrey)*, 261 B.R. 396, 401 (Bankr. W.D. Pa. 2001) (right to assert tort claim is a chose in action constituting intangible personal property).

Substitutes for Ordinary Income

One might expect the IRS to argue that a relator's share represents a right to future ordinary income, invoking the substitute for ordinary income authorities. The substitute for ordinary income doctrine views a payment as ordinary if it substitutes for what would have been ordinary income in the future. The major cases involve sales of lottery payment streams.

Thus, in the context of a sale of a stream of lottery payments, the Ninth Circuit has ruled that a capital gain requires: (1) the taxpayer to make an underlying investment of capital in exchange for the asset; and (2) the sale to reflect an accretion in value over cost to any underlying asset.[61] Against this test, the mere purchase of a lottery ticket is obviously not an investment.[62] In contrast, relators make substantial investments of time and money.

Even if a contingent fee attorney bears most costs, relators have ongoing out-of-pocket costs for travel and other expenses, usually for many years. It is hard to see how those costs would not be the requisite ''investment.'' The Ninth Circuit's second capital gain prerequisite requires an accretion in value.[63] Although a lottery ticket spiked from its $1 cost to an overnight bonanza on random selection, a relator's *qui tam* claim appreciates more gradually.

Indeed, when the relator receives a contract right in exchange for his secret information and know-how, it may have a zero or unascertainable value. Thereafter, the value of his *qui tam* claim increases. The government intervening can be one signpost of appreciation, since the value of a claim increases significantly when the government intervenes.[64]

In another substitute for ordinary income case, *Lattera v. Commissioner*,[65] the Third Circuit noted that not all assets increase in value (for example, cars often depreciate).[66] The Third Circuit looked for a ''family resemblance'' to capital assets. The court put stocks, bonds, options, currency contracts, automobiles, and land into the capital asset family. Rental and interest income, the court said, spring from an ordinary income family. In-between are contracts and payment rights requiring one to assess the type of carveout (that is, whether horizontal or vertical) and the asset's character.[67]

As enunciated by the Third Circuit, when a taxpayer makes a horizontal carveout (disposing of only a portion of a property interest), the disposition produces ordinary income. A vertical carveout (completely disposing of a property interest) yields ordinary or capital treatment

[61]*United States v. Maginnis,* 356 F.3d 1179, 1183 (9th Cir. 2004), *Doc 2004-1978*, *2004 TNT 21-27.*

[62]*Id.* at 1184.

[63]*Id*. at 1183.

[64]*See supra* note 3.

[65]437 F.3d 399 (3d Cir. 2006), *Doc 2006-2962, 2006 TNT 31-8*, *cert. denied*, 127 U.S. 1328 (2007).

[66]*Id*.

[67]*Id*. at 406.

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depending on the asset's character.[68] Using this nomenclature, a relator's share is clearly vertical, for it completely disposes of the relator's claim interest. In the parlance of substitute for ordinary income cases, the relator receives payment for a right to *earn* income (not a right to *already earned* income).[69] That makes it capital.

Sale or Exchange

In general, for an asset to receive capital gain treatment, it must be disposed of in a sale or exchange. Although neither term is defined in the code or regulations, the courts have applied ordinary meanings[70]: A ''sale'' is a transfer of property for cash or a cash equivalent[71]; and an ''exchange'' is a transfer of property for other property.[72]

In assessing the presence of a sale or exchange, courts have considered whether: (1) legal title has passed; (2) the purchaser has acquired an equity interest in the property; (3) the acquisition creates a present obligation to transfer legal title for an agreed-on consideration; (4) legal title is vested in the purchaser; and (5) the purchaser bears the risk of loss and has the benefits of ownership.[73]

Relator shares overwhelmingly meet those criteria. Under an enforceable contract between relator and government,[74] legal title to a portion of the government's claim vests in the relator when he files suit.[75] It is not clear that a relator needs to prove the occurrence of a sale or exchange to receive capital treatment.

Indeed, other authorities have simply considered the sale or exchange requirement inapplicable to litigation settlements.[76] Legal rights are released when a settlement agreement is signed, so many authorities have considered a settlement *itself* as effecting a sale or exchange.[77] Some authorities uphold capital treatment without mentioning a sale or exchange.[78]

In any event, to receive his relator share, the relator will sometimes sign a relator share agreement or the government's settlement agreement with the defendant, either way relinquishing all his remaining rights. That means there is no impediment to capital treatment based on the lack of sale or exchange.

Contract Termination

Although the argument for capital gain treatment under traditional tax authorities is strong, there is independent support. Section 1234A imports capital gain treatment to the cancellation, lapse, expiration, or other termination of a right or obligation related to property that is a capital asset in the hands of the taxpayer.[79] Interestingly, section 1234A was originally designed to prevent taxpayers from claiming ordinary losses on dispositions of capital assets.[80] Yet it also applies to gains.[81]

A relator's *qui tam* claim is a *contract* with the government,[82] empowering the relator to proceed on its behalf. For consideration, it promises a minimum of 15 percent of the restitution the government collects. Payment for the relator's contract rights to share in the government's recovery is thus squarely within section 1234A.

Determining Gain

Although I believe the entire relator share should be capital gain, the IRS might argue that capital treatment should be limited to the statutory 15 percent minimum. The FCA suggests many factors for determining the extent of a relator share, some involving services by the relator.[83] Yet referring to services enhancing a capital asset as triggering ordinary income is a red herring. The owner of a business, real estate, or intellectual property

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[68] *Id.* at 407 (citing *Maginnis,* 356 F.3d at 1185-1186).

[69] *See Lattera*, 437 F.3d at 408 (citing Thomas G. Sinclair, ''Limiting the Substitute-for-Ordinary Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights,'' 56 *S.C. L. Rev.* 387, 406 (2004)).

[70] *Nahey*, 111 T.C. at 262 (citing *Helvering v. William Flaccus Oak Leather Co.,* 313 U.S. 247, 249 (1941)).

[71] *Rogers v. Commissioner,* 103 F.2d 790, 792 (9th Cir. 1939), *cert. denied*, 308 U.S. 580 (1939); *Guardian Indus. Corp. v. Commissioner*, 97 T.C. 308, 318 (1991), *aff'd,* 1994 U.S. App. LEXIS 7242, 73 A.F.T.R.2d (RIA) 1903 (6th Cir. 1994), *Doc 94-4567*, *94 TNT 88-15*.

[72] *Helvering v. William Flaccus Oak Leather Co.,* 313 U.S. 247, 249 (1941) (an exchange ''implies reciprocal transfers of capital assets'').

[73] *See Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (T.C. 1981); *see also United States v. Ivey*, 414 F.2d 199 (5th Cir. 1969).

[74] *See United States ex rel. Kelly*, 9 F.3d at 748; *Biddle v. Biddle (in Re Biddle)*, 52 Cal. App. 4th 396, 399 (Cal. App. 1st Dist. 1997) (citing *U.S. ex rel. Kelly*, 9 F.3d at 748).

[75] *See, e.g., United States ex rel. Kelly,* 9 F.3d at 748 (''the FCA's qui tam provisions operate as an enforceable unilateral contract''); *see also Alpine Buffalo, Elk & Llama Ranch, Inc. v. Andersen,* 2001 MT 307, P19 (Mont. 2001) (''an assignment of a claim transfers all legal rights and title to the claim to the assignee'').

[76] FSA 200228005 (Mar. 29, 2002), *Doc 2002-16265*, *2002 TNT 135-16*; Rev. Rul. 81-152, 1981-1 C.B. 433; LTR 9335019 (June 2, 1993), *93 TNT 185-25*; LTR 9343025 (Jul. 13, 1993), *93 TNT 224-50*; Rev. Rul. 81-277, 1981-2 C.B. 14.

[77] *See, e.g., Inco Electroenergy Corp. v. Commissioner*, T.C. Memo. 1987-437 (1987); *State Fish Corp.* 48 T.C. at 474; FSA 200228005; Rev. Rul. 81-152, 1981-1 C.B. 433; LTR 9335019 (June 2, 1993); LTR 9343025 (Jul. 13, 1993); Rev. Rul. 81-277, 1981-2 C.B. 14.

[78] *See, e.g.,* the following authorities wherein the IRS applied capital treatment without even mentioning a sale or exchange requirement: Rev. Rul. 81-277, 1981-2 C.B. 14; Rev. Rul. 81-152, 1981-1 C.B. 433; LTR 9335019 (June 2, 1993).

[79] Section 1234A; *see also* LTR 200823012 (Mar. 10, 2008).

[80] 1981-2 C.B. 412 (IRB 1981), S. Rep. 97-144; *see also Wolff v. Commissioner*, 148 F.3d 186 (2d Cir. 1998) (citing S. Rep. 97-144) (for an example of the problem that section 1234A seeks to remedy).

[81] *See* LTR 200826026 (Mar. 26, 2008), *Doc 2008-14323*, *2008 TNT 126-32*; *see also* LTR 200919055 (Feb. 13, 2009), *Doc 2009-10454*, *2009 TNT 88-63*; LTR 200735019 (June 1, 2007), *Doc 2007-20148*, *2007 TNT 171-35*.

[82] *United States ex rel. Kelly*, 9 F.3d at 748.

[83] *See* 31 U.S.C. section 3730(d)(1) (relator's share depends on the extent he substantially contributed to the prosecution of the action); *Quorum Health Group*, 171 F. Supp.2d at 1332 (citing S. Rep. No. 99-345, at 28 (1986) (the Senate suggested factors determinative of a relator share as including: (1) the significance of the information he provided; (2) the contribution he made the result; and (3) whether the information the relator provided was previously known to the government)).

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may devote endless hours to improving and enhancing it to realize a higher sales price. Plainly, that activity does not import ordinary income treatment to any portion of the gain.[84]

Perhaps bifurcating a relator share between its 15 percent minimum (capital gain) and the overage (ordinary income) might avoid awkward line drawing, but it would be arbitrary. Furthermore, any intimation that services are material is belied by the statute itself. The baseline 15 percent relator share is plainly payment for the *information*.[85] Even the range between 15 and 25 percent takes into account three factors, two based entirely on the relator's intellectual property, with the third being mostly based thereon.[86]

Finally, a word about basis. The gain or loss realized when a capital asset is sold is the difference between the amount realized and the taxpayer's adjusted basis in the property, including capitalized expenses.[87] An FCA relator will usually incur out-of-pocket costs unreimbursed by a contingent fee law firm. They should be added to the relator's basis.

Just the Facts

I have avoided particularizing my discussion to a specific set of facts, and have instead considered the issue in general. The nature of the provisions in the FCA are salient whatever the facts of a particular case. Yet I acknowledge that it may be possible to posit FCA cases where the information the relator provides to the government in filing suit and providing written disclosure of all requisite evidence may fall short of the trade secret and know-how authorities.

The trade secret and know-how authorities are at least somewhat fact specific, and not terribly precise in defining exactly what does and does not qualify. Thus, if there is an FCA case in which the relator provides no smoking gun of any sort, but nevertheless somehow ends up with at least a 15 percent minimum relator share, I acknowledge that the argument for capital gain treatment could suffer. Yet the FCA framework itself supports capital gain treatment because with the required disclosure, even information that is not itself a smoking gun could lead to the discovery of a smoking gun. The FCA implicitly and explicitly recognizes the value of the relator's information when that information is not already publicly disclosed and the relator is the original source of such information.

Of course, there is also the section 1234A statutory argument. In any event, what the relator provides is likely (easily I might add) to qualify as trade secrets or know-how (or both). That should make it capital.

Conclusion

The process an FCA relator pursues in filing a complaint under seal, transferring his intellectual property to the government, and ultimately receiving a relator share is unique. The relator's *qui tam* claim is demonstrably capital under several traditional theories, its value inextricably tied to the relator's provision of key information and know-how to the government. That makes it capital, and well within the authorities according capital gain treatment for know-how, trade secrets, etc.

Independently, the relator's *qui tam* claim encompasses a contract right terminated on payment of the relator share, and thus also qualifies for capital gain treatment under section 1234A.

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[84]*See* Thomas J. Brennan and Karl S. Okamoto, ''Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation,'' 60 *Hastings L.J.* 27, 37 (2008) (regarding entrepreneur's conversion of sweat into equity producing capital gain rather than ordinary income).

[85]*See* 31 U.S.C. section 3730(d)(1); *Cook County v. United States ex. rel. Chandler*, 123 S. Ct. 1239, 1242-1243 (2003).

[86]*Supra* note 82.

[87]*See* sections 1001, 1012, and 263.

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