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**Memorandum**

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subject: Section 162(f) and the Character of Relator Fees under the False Claims Act

This memo is in response to your request for advice dated January 4, 2007. This document should not be used or cited as precedent.

ISSUE:

Whether an amount paid to a relator from the proceeds of a lump-sum settlement of a lawsuit brought against the taxpayer under the False Claims Act (31 U.S.C. § 3729-33 (2000)) is a nondeductible fine or other similar penalty pursuant to § 162(f) of the Internal Revenue Code.

CONCLUSION:

An amount paid by the taxpayer to compensate the government for its obligation to pay a relator from the proceeds of a lump-sum settlement of a lawsuit brought against the taxpayer under the False Claims Act is not a nondeductible fine or other similar penalty pursuant to § 162(f) when the amount of the relator fee is specifically outlined in the settlement agreement.<sup>1</sup>

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<sup>1</sup> Relator fees are paid by the government to the relator from the proceeds of settlement. Part of the multiplier has the effect of making the government whole for the expenses of investigation, including paying the relator. Hence, when the relator fee is expressly provided for in the agreement so that both parties are aware of the amount necessary to make the government whole for payment of such expense, an amount of the settlement paid to the relator must always be compensatory.

This conclusion is based upon the facts provided, one of which is that the settlement agreement clearly states that the relator would receive its fee and the agreed amount of that fee is specifically outlined in the settlement agreement. Therefore, we need not engage in an analysis of whether the parties intended for this portion of the lump-sum payment to be compensation or a penalty, since they clearly intended it to be paid to the relator.

### FACTS:

The federal government becomes aware of the alleged fraudulent conduct of a healthcare provider (filing false reimbursement claims through Medicare) when a *qui tam* plaintiff (relator) files suit under the False Claims Act (FCA). The government intervenes, takes over the task of investigating the fraud claims, and eventually settles with the healthcare provider. The settlement agreement provides that the healthcare provider will pay a lump-sum payment to the government in settlement of all potential claims under the FCA. The agreement is silent as to what portion of the payment constitutes compensation to the government for its singles (actual) damages. The agreement provides that a portion of the settlement payment (\$20 million of the \$200 million payment) will be paid to the relator by the government in satisfaction of the statutory relator fees. After court approval of the settlement agreement (as is required in FCA cases), the federal government disburses the settlement proceeds as follows: \$100 million to HHS (the agency that suffered harm as a result of the fraudulent medicare claims), \$20 million to the relator, and the remaining \$80 million to the fraud and abuse control account of the general treasury.

LMSB's suggested treatment of this settlement payment is to allow a § 162(a) deduction for the \$100 million disbursed to HHS (representing the government's singles damages) and to treat the remaining \$100 million as a nondeductible fine or other similar penalty pursuant to § 162(f). The request for advice concerns only the relator fees portion of the settlement. LMSB takes the position that amounts paid to relators are always nondeductible fines or other similar penalties pursuant to § 162(f), even when the relator's fee is mentioned as a specific amount in the settlement agreement itself. In support of its position, LMSB states that the purpose of the relator fee provision is clearly law enforcement because it exists to encourage private citizens to assist in the detection of fraud against the government. LMSB further states that the amount of the relator's fee bears no relationship to the relator's damages, if any, and that the fact of a relator's involvement is not relevant to the calculation of the amount of the government's damages. Thus, punishment and deterrence are goals of the relator fee provision, and all payments to relators should be treated as nondeductible fines or penalties.

### LAW AND ANALYSIS:

#### Statutory Background

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business. An amount expended by a taxpayer engaged in a trade or business to settle litigation may be deductible as an ordinary and necessary business expense. See, e.g., *Ditmars v. Commissioner*, 302 F.2d 481, 485 (2d Cir. 1962); *Old Town Corp. v. Commissioner*, 37 T.C. 845 (1962), acq. 1962-2 C.B. 5. Because deductions are a matter of legislative grace, a taxpayer must show that it comes squarely within the terms of the law conferring the benefit sought. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

Section 162(a) must be read in conjunction with § 162(f), however, which prohibits the deduction of any “fine or other similar penalty paid to the government for the violation of any law.” Section 1.162-21(b)(1) of the Income Tax Regulations defines a fine or other similar penalty to include any amount (i) paid pursuant to a conviction or a plea of *nolo contendere* for a crime in a criminal proceeding; (ii) paid as a civil penalty imposed by federal, state, or local law; (iii) paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal); or (iv) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. The regulations further provide that compensatory damages paid to a government do not constitute a fine or penalty. § 1.162-21(b)(2).

As the regulation indicates, not all penalties imposed by law are within the scope of § 162(f) because Congress had a purpose in using the word “similar.” The legislative history to § 162(f), as discussed in case law, indicates: (1) if a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is “similar” to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not “similar” to a fine within the meaning of § 162(f). *S. Pac. Trans. Co. v. Commissioner*, 75 T.C. 497, 652 (1980), *supp. by*, 82 T.C. 122 (1984); *Talley Indus., Inc. v. Commissioner*, 116 F.3d 382, 385-86 (9<sup>th</sup> Cir. 1997).

With respect to settlement payments made to compromise civil actions brought by, or on behalf of, the government, courts first look to the statute pursuant to which the action is brought. If the statute provides only compensatory remedies, then, pursuant to the rules discussed above, the inquiry ends and the payment is wholly deductible. In accordance with these same rules, no part of a settlement payment is deductible if the compromised action was brought pursuant to a civil statute that is wholly punitive. However, discerning the purposes of payments made in the compromise of an action brought pursuant to a statute that serves both a compensatory and punitive purpose is a much more difficult task. Courts first look to the settlement agreement to determine the characterization or purpose of the payment. If the agreement is silent or ambiguous, the characterization or purpose may be determined by examining the intent of the parties. Discerning such intent is an intensely factual inquiry requiring examination of the relevant facts and circumstances of the specific payment at issue and the manner in which it was

calculated. *Talley Indus.*, 116 F.3d at 387-88; *Middle Atlantic Distributors*, 72 T.C. 1136, 1145-46 (1979), *acq.* 1980-2 C.B. 1.

### The Civil False Claims Act

The Civil False Claims Act, 31 U.S.C. §§ 3729–33 (2000) (FCA), creates civil liability for any person who knowingly submits a false claim for payment to the U.S. government, knowingly uses a false statement to induce the government to pay a false claim, conspires to defraud the government to pay a false claim, or knowingly uses a false statement to decrease an obligation to pay money to the government. 31 U.S.C. § 3729(a). “Claims” include any request for payment of money or property where the government pays for any of the money or property in question. 31 U.S.C. § 3729(c). “Knowing” conduct includes actual knowledge as well as “deliberate ignorance” or “reckless disregard” of the truth. 31 U.S.C. § 3729(c).

The government may recover three types of damages under the FCA: (1) a civil penalty of at least \$5,000 and not more than \$10,000 for each false claim<sup>2</sup>; (2) three times the amount of actual damages sustained (reducible to double damages for cooperative defendants); and (3) costs of investigating and prosecuting any alleged violation of the Act. 31 U.S.C. § 3729(a).

The FCA was originally enacted in 1863 to combat rampant fraud in Civil War defense contracts. Senate Rep. No. 99-345, 99<sup>th</sup> Cong., 2d Sess. at 8. The first major amendments to the Act in general occurred in 1986, when the Congress revised the liability standard, burden of proof, and *qui tam* provisions; and expanded the damages available to the government in response to concerns that fraud in government procurement was severe and on the rise. *Id.* at 2. Prior to 1986, the amount of the per-claim fixed penalty was \$2,000, and the government was entitled to recover only double damages. The legislative history of the 1986 amendments contains several references to the damages provision, stating that increasing the damages available is necessary both to make the government “completely whole” for all of its losses and to deter and punish fraudulent conduct. Senate Rep. No. 99-345, 99<sup>th</sup> Cong., 2d Sess. at 2, 17 (July 28, 1986); H.R. Rep. No. 99-660, 99<sup>th</sup> Cong., 2d Sess., at 16, 20 (June 26, 1986). Thus, according to the legislative history, the multiple damages provision serves both punitive and compensatory purposes.

The Supreme Court has long held that the multiple damages provisions of the FCA (i.e., any damages in excess of the “singles” damages which relate directly to the amount of actual harm sustained) serve dual purposes of compensation and punishment. *United States v. Bornstein*, 423 U.S. 303, 314-15 (1976). In *Bornstein*, the Court noted that the then double damages provision was intended to make sure that “government would be

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<sup>2</sup> The statutory penalty is adjusted upward for inflation and is currently \$5,500 to \$11,000. 28 U.S.C. § 2461 (2000); 28 C.F.R. § 85.3(a)(9) (2004).

made completely whole” for all of its losses and was also intended to deter fraudulent conduct. *Id.* at 317 (quoting *United States v. Hess*, 317 U.S. 537, 551-52 (1943)).

The Court recently examined the multiple damages provisions in more detail, and has stated that the current version of the FCA (authorizing treble damages) “imposes damages that are essentially punitive in nature.” *Vermont Agency of Natural Resources v. United States ex rel. Stevens*, 529 U.S. 765, 784 (2000) (*Stevens*). The Court stated, “[t]he very idea of treble damages reveals an intent to punish past, and to deter future, unlawful conduct, not to ameliorate the liability of wrongdoers.” *Id.* at 786. However, several years later, the Court refined its “essentially punitive” observation in *Cook County, Illinois v. United States ex rel. Chandler*, 538 U.S. 119, 130-32 (2003) (*Chandler*). In *Chandler*, the Court considered whether the multiple damages provision is compensatory or punitive in order to determine whether a local government may be a “person” subject to a *qui tam* action under the FCA. Cook County argued that it could not be such a “person” in light of the fact that the multiple damages provision is punitive in nature, and municipalities may not be subjected to punitive damages (treble damages are mandatory under the FCA if the government sustains any actual damages). *Id.* The Court rejected Cook County’s argument, admonishing “it is important to realize that treble damages have a compensatory side, serving remedial purposes in addition to punitive objectives.” *Id.* at 130. The Court held that a local government may, indeed, be a “person” capable of making a false claim to the federal government within the meaning of the FCA, in part because the multiple damages provision of the FCA serves both compensatory and punitive purposes. *Id.* at 132.

### Relator Fees

The FCA provides that either the Attorney General or a private citizen may bring an action in the name of the government for a violation of the FCA. 31 U.S.C. § 3730. Such a private citizen, called a “relator” in the FCA, is commonly referred to as a “*qui tam*” plaintiff. “*Qui tam*” is a shorthand expression for the phrase “*Qui tam pro domino rege quam pro si ipso in hac parte sequitur*,” which means, “[w]ho sues on behalf of the King as well as for himself.” Black’s Law Dictionary 1251 (6<sup>th</sup> ed. 1990).<sup>3</sup>

The FCA entitles a *qui tam* plaintiff (relator) to a share of any amounts recovered. The amount of this share depends mainly on whether the Department of Justice (DOJ) intervenes to prosecute the case and whether the relator participated in the conduct that forms the basis of the suit. If DOJ prosecutes the suit, the relator is entitled to receive

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<sup>3</sup> Although the earliest *qui tam* suits were brought in the 13<sup>th</sup> century by individuals who had suffered injury on both their own and the Crown’s behalf as a mechanism to get into the royal courts, later Parliament began enacting statutes allowing informers to obtain a portion of the penalty as a bounty for their information, even if they had not suffered an injury themselves. *Vermont Agency of Natural Resources v. United States ex rel. Stevens*, 529 U.S. 765, 774-75 (2000). Relators under the FCA are descendants of these later statutes and need not have suffered a personal injury in order to file a *qui tam* suit. *Id.* In fact, relators asserting FCA claims are commonly employees, or former employees, of the party perpetrating the fraud and might have participated in the fraud during his or her employment.

15% to 25% of the recovery, plus reasonable attorneys' fees, costs, and expenses. 31 U.S.C. § 3730(d)(1).<sup>4</sup> The court may limit the relator's bounty to 10% or less if the action was based mainly on public disclosures of information other than that provided by the relator.<sup>5</sup> *Id.* If DOJ does not intervene to prosecute the action, the relator's bounty increases to 25% to 30% of the recovery. 31 U.S.C. § 3730(d)(2). In addition to the relator's share of the proceeds, the relator is also entitled to recover attorneys' fees, costs, and expenses. 31 U.S.C. § 3730(f). These amounts are calculated and paid separately, directly by the defendant to the relator, because the FCA provides that the government is not liable for these costs. *Id.*

### Analysis

As set forth above, it is well-settled law that the multiple damages provision of the FCA serves dual purposes of compensation and punishment. Therefore, in the factual scenario set forth above, we must determine whether amounts paid by the taxpayer to make whole the government obligation to pay the relator fees from the proceeds of a lump-sum settlement payment fall into either one of these classifications.

*United States ex rel. Chandler*, 538 U.S. 119 (2003) (*Chandler*) discussed the issue of the character of relator fees under the FCA. The issue in *Chandler* (a case not involving the Internal Revenue Code) was whether local governments are "persons" within the meaning of the FCA, such that they may be liable for making false claims to the federal government.<sup>6</sup> The Court concluded that local governments are "persons" within the meaning of the FCA. In reaching this conclusion, the Court examined two arguments advanced by the local government: (1) that the drafters of the FCA did not intend to include local governments within the definition of a "person," and (2) the *Stevens* Court's reference to the multiple damages as "essentially punitive" meant that even if the original FCA applied to local governments, the amended act, with treble damages, did not. With regard to the first argument, the Court held that municipalities were presumptively considered "persons" and nothing in the statute or its legislative history suggests that

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<sup>4</sup> The specific amount of the relator's share between 15% and 25% depends upon "the extent to which the [relator] substantially contributed to the prosecution of the action." 31 U.S.C. § 3730(d)(1).

<sup>5</sup> Moreover, the relator is not entitled to a fee at all unless he or she is the "original source" of information. 31 U.S.C. § 3730(e)(4). The "original source" limitation is frequently litigated between the federal government and relators. See, e.g., *United States ex rel. Merena v. SmithKline Beecham Corp.*, 205 F.3d 97, 106 (3d Cir. 2000) (where an FCA case is primarily based on publicly disclosed information, a relator must still be an "original source" to be eligible for the 10% statutory fee available under § 3730(d)(1)).

<sup>6</sup> As discussed above, previous to the *Chandler* decision, the Supreme Court had held that States are not "persons" subject to *qui tam* actions under the FCA. *Stevens*, 529 U.S. at 784-85. The *Stevens* holding was based, in part, on a finding that the FCA treble damages provision is "essentially punitive in nature" and States, as governmental entities, cannot be subject to punitive damages absent express statutory authority to the contrary. *Id.* at 784-85. As discussed below in note 6, the *Stevens* holding is more correctly characterized as a finding that the jump from double to treble damages was "essentially punitive," not that all damages in excess of singles damages are punitive.

they should be excluded. *Id.* at 129. With regard to the second argument, the Court clarified its earlier statement in *Stevens*:

[t]o begin with it is important to realize that treble damages have a compensatory side, serving remedial purposes in addition to punitive objectives. . . . While the tipping point between payback and punishment defies general formulation, being dependent on the workings of a particular statute and the course of particular litigation, the facts about the FCA show that the damages multiplier has compensatory traits along with the punitive.

*Id.* at 130.

Concerning relator fees in particular, the Court continued:

[t]he most obvious indication that the treble damages ceiling has a remedial place under this statute is its *qui tam* feature with its possibility of diverting as much as 30 percent of the Government's recovery to a private relator who began the action. In *qui tam* cases the rough difference between double and triple damages may well serve not to punish, but to quicken the self-interest of some private plaintiff who can spot violations and start litigating to compensate the Government, while benefiting himself as well.

*Id.* 131.<sup>7</sup> The Court observed that once the relator's share is subtracted, the Government's damages are closer to double damages, which had been previously held to be remedial, at least in part. The Court also noted that the FCA does not provide for prejudgment interest or consequential damages, two items thought to be essential to full compensation.<sup>8</sup> Thus, the Court concluded that the multiple damages provision was intended to be "punitive" in that the government's recovery will exceed full compensation in some cases, but, because the multiple damages serve to compensate the government for costs incurred beyond any actual losses sustained as a result of the fraud, the treble damage remedy is not as "robust" as if it were a pure penalty in all cases. *Id.*

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<sup>7</sup> The *Stevens* decision was the first to consider the nature of the FCA multiple damages subsequent to the 1986 amendments which raised the damages from double to treble. Before the 1986 amendments, the Court had held that the double damages provision served dual purposes of compensation and punishment, because some amount of the double damages is "necessary to compensate the Government completely for the costs, delays, and inconveniences occasioned by fraudulent claims." *United States v. Bornstein*, 423 U.S. 303 (1976).

<sup>8</sup> The Court also noted that, in a way, the treble damages provision was adopted in substitute for consequential damages. *Chandler*, 538 U.S. at 131 n.9. The Senate version of the bill proposed consequential damages on top of treble damages, while the House version proposed consequential damages plus double damages. See S. Rep. No. 99-345, p. 39 (1986); H.R. Rep. No. 99-660, p. 20 (1986). The final amendments utilized the Senate's treble figure and the consequential damages provision was dropped.

Although it has been suggested that the above language from *Chandler* is *obiter dictum*, we disagree. It is a factual observation underlying the Court's rejection of the petitioner's alternative argument that it is not a "person" subject to a *qui tam* suit. The petitioner's argument is that it is not a "person" within the meaning of the FCA because of the *Stevens* Court's characterization of the treble damages provision as "essentially punitive," and a local municipality cannot be subject to punitive damages. The *Chandler* Court clarifies its earlier statement in *Stevens* and holds that treble damages serve remedial and punitive objectives. In support of this clarification, the Court states that "the most obvious indication" that treble damages can serve a remedial [not punitive] purpose is the possibility of diverting as much as 30% of the government's recovery to the relator. Thus, the treble damages provision may "serve not to punish," but to reward a private citizen for spotting the fraud and starting the litigation. *Chandler*, 538 U.S. at 131.

Thus, we read *Chandler* to stand for the proposition that the statutory provision for relator fees indicates that the multiple damages may serve a remedial rather than a strictly punitive purpose, which supports the conclusion that the FCA multiple damages provision was designed to serve both punitive and compensatory purposes.

Other courts, including the Tax Court, have concluded that relator fees are not penalties. See, e.g., *Rocco v. Commissioner*, 121 T.C. 160, 165 (2003) ("The payment to a relator in a *qui tam* action is not a penalty imposed on the wrongdoer; instead, it is a financial incentive for a private person to provide information and prosecute claims relating to fraudulent activity.") The *Rocco* case involved the issue of whether the relator's fee is includable in a relator's gross income pursuant to § 61(a). The Tax Court held that it is so includable. See also *United States ex rel. Semtner v. Medical Consultants, Inc.*, 170 F.R.D. 490 (W.D. Okla. 1997) (relator's claim for statutory fee survives the death of the relator, in part, because relator fees are not punitive in nature); cf. *United States v. NEC Corp.*, 11 F.3d 136 (11<sup>th</sup> Cir. 1994) (relator's claim for statutory fee survives the death of the relator because relator fees are compensatory in nature).

LMSB argues that the purpose of relator fees cannot be remedial or compensatory because 31 U.S.C. § 3730(d) provides that the amount of relator fees is defined solely as a percentage of the government's recovery and bears no relationship to any damages suffered by the relator. We agree that there is no relationship between the amount of a relator's fee and any damages suffered by the relator. This is true because relators do not file a *qui tam* suit because of personal harm. The standing requirement for a *qui tam* plaintiff under the FCA is that the government, not the *qui tam* plaintiff, has suffered harm. 31 U.S.C. § 3730(b). The only measures in the FCA arguably aimed at compensating relators for any personal losses are 31 U.S.C. § 3730(h,) which allows relators some protections from retribution from a current employer who is accused of the fraudulent conduct, and § 3739(f), which allows relators to collect their attorneys' fees and costs directly from the defendant. Otherwise, the relator is entitled to a statutory fee, which is a share of the government's recovery, as a reward for exposing the fraud.



We read the *Chandler* decision to stand for the proposition that the amount of the government's recovery paid out as relator fees is remedial or compensatory from the government's perspective; relator fees do not constitute compensatory damages to the relator. From the government's viewpoint, the statutory obligation to pay a portion of the recovery to a relator is simply an expense of intervening in an FCA suit originally filed by a relator. In this regard it is similar to the government's own attorneys' fees and costs, investigatory costs, expert witness fees, or a claim for pre-judgment interest. The relator fee is simply another cost to the government of pursuing the action. Although relator fees are not a component of the government's singles damages (i.e., a quantification of the actual losses sustained by a particular federal agency as a result of the fraudulent conduct), they are an expense that is statutorily mandated in an FCA case where a relator is the first one to expose the fraud.<sup>9</sup>

Accordingly, the statutory provision for relator fees indicates that the damages paid in the context of an FCA settlement serve a remedial purpose as well as a punitive purpose. In applying this proposition to the Internal Revenue Code, we interpret *Chandler* to prohibit the adoption of a position that amounts paid to taxpayers to make the government whole for amounts ultimately paid to relators are presumptively punitive within the meaning of § 162(f).

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<sup>9</sup> Viewed in this light, relator fees are similar to a contingency fee arrangement between a private plaintiff and his or her attorney. Like a relator in a FCA case, the attorney does not have a claim against the defendant directly for his or her fee. The attorney's claim is against the plaintiff for a share of the plaintiff's recovery. Likewise, a relator's claim for its statutory fee is not against the defendant, but is against the government for a share of the government's recovery.